

BENEFIT CORPORATIONS: WORTHY OF TAX BENEFITS?[□]

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INTRODUCTION

In 1978, when Bennett Cohen and Jerry Greenfield invested \$12,000 in an ice cream venture and began selling ice cream from a renovated gas station in Burlington, Vermont, they did not envision that only six years later they would be generating \$4 million in annual sales.¹ Ben & Jerry's reputation as a company with a quality product and a dual mission of social conscience and profit kept them both profitable and in the headlines. In 1984 and 1985 they sold shares to the public to expand their operations. In 2000, Unilever offered to buy the company at \$43.60 per share (for a total sale price of \$326 million), a bid well above the competing take-over bids for the company. While Ben and Jerry had reservations about whether a parent company such as Unilever would stay true to the social-minded ideals the pair had worked hard to maintain, they also believed that they had a duty to maximize shareholder value by accepting the take-over bid. According to Greenfield, "[i]t was a very difficult time. But we were a public company, and the Board of Directors' primary responsibility is the interest of the shareholder. So that is what the decision came down to. It was extremely difficult, heart-wrenching."² In the year 2000, there was no for-profit business form available to social-minded business owners — no business form that would allow them to consider the interests of stakeholders rather than just shareholders in their corporate decision-making. But today, in a growing number of states, that has changed. A new

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¹ Lauren Falino, *The Great Leaders Series: Ben Cohen and Jerry Greenfield, Co-founders of Ben & Jerry's Homemade, INC.*, Feb. 18, 2010, available at <http://www.inc.com/30years/articles/ben-and-jerry.html>.

² Hannah Pool, *Question Time with Hannah Pool*, GUARDIAN, July 31, 2008, <http://www.guardian.co.uk/business/2008/jul/31/5>.

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form of hybrid business, the Benefit Corporation, would have given Ben & Jerry's the focus its founders sought.

The Benefit Corporation allows corporate directors to consider social mission and objectives in addition to profits in carrying out their fiduciary duties. Benefit Corporations provide shareholders with "additional rights to hold directors accountable for failure to create material positive impact on society or to consider the impact of decisions on employees, community, and the [local and global] environment."³ While Benefit Corporations are relatively new and untested entities, they hold great promise for encouraging and allowing an increasing number of companies to operate with a view toward people, planet, and profit. Because of this, there have already been calls for tax-preferred status for these hybrid entities. The purpose of this article is to consider whether Benefit Corporations warrant special tax treatment.

Maryland was the first state to pass Benefit Corporation legislation in April, 2010. Since that time Vermont, New York, Hawaii, California, Virginia, and New Jersey have followed suit. Several prominent social-minded businesses have welcomed the new form of business and modified their corporate charters to adopt this form. For example, shortly after Vermont enacted Benefit Corporation legislation in July, 2011, King Arthur Flour Corporation became one of the first businesses in the state to become a Benefit Corporation. Becoming a Benefit Corporation was a logical step for this 200+ year old employee-owned corporation that prides itself on its commitment to the community, to its employees, and to the environment. In recognition of these efforts, it has received accolades such as a Social Legacy Award "for handing down to employee owners a centuries-old tradition of purity, for both the consumer and the environment."⁴ According to a King Arthur Flour spokesperson, "even in becoming . . . a Vermont Benefit Corporation, it wasn't a significant change for employees, because we were already operating in this socially responsible way. It just codified that commitment."⁵

³ Press Release, The Corporate Social Responsibility Newswire: Maryland First State in Union to Pass Benefit Corporation Legislation (April 14, 2010), http://www.csrwire.com/press_releases/29332-Maryland-First-State-in-Union-to-Pass-Benefit-Corporation-Legislation.

⁴ Peter Asmus, *16th Annual Business Ethics Awards*, BUSINESS ETHICS, Fall 2004, at 8, 15, *available at* [http://secure.pdcnet.org/852575A9004F1216/file/B95146B60F5C3DBC852576850063DFD5/\\$FILE/bemag_2004_0018_0003_0006_0015.pdf](http://secure.pdcnet.org/852575A9004F1216/file/B95146B60F5C3DBC852576850063DFD5/$FILE/bemag_2004_0018_0003_0006_0015.pdf).

⁵ Jeff Gangemi, *King Arthur Flour: A Sustainability-Minded Corporation Expands Its Footprint*, May 2, 2012, <http://www.farmplate.com/category/blog-tags/local-food>.

Does the social good promoted by Benefit Corporations qualify them for preferred tax treatment? To answer this question, it is important to understand not only the nature of Benefit Corporations, but also the rationale behind offering tax benefits to organizations that serve an exempt purpose. Part I of this article explores the evolution of the social enterprise movement and the rise of the hybrid entity in the United States. Part II provides a closer look at the legal requirements of Benefit Corporations. Part III considers the role of tax policy generally, and more specifically, the role that tax policy can and should play with regard to encouraging social mission by for-profit entities. The paper concludes with a recommendation that Congress not be too quick to carve out special tax privileges for these entities, but rather that such entities should only be entitled to those tax incentives that are otherwise available to the similar social-minded efforts of other corporations.

I. THE EVOLUTION OF THE HYBRID ENTITY

In 1970 Milton Friedman assured us, “There is one and only one social responsibility of business — to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.”⁶ In 2005 John Mackey offered a different perspective, “Someday businesses like Whole Foods which adhere to a stakeholder model of a deeper business purpose will dominate the economic landscape. Wait and see.”⁷ In his 2009 Encyclical Letter, *Caritas in Veritate* Pope Benedict XVI, considering the relationship between business and ethics, concluded that “the traditionally valid distinction between profit-based companies and nonprofit organizations can no longer do full justice to reality or offer practical direction for the future,” and called for the recognition of “a broad new composite reality embracing the public and private spheres, one which does not exclude profit, but instead considers it a means for achieving human and social ends.”⁸

⁶ Milton Friedman, *The Social Responsibility of Business Is to Increase Profits*, N.Y. TIMES MAG., Sept. 13, 1970.

⁷ *Rethinking the Social Responsibility of Business*, REASON MAG., Oct. 2005, available at <http://reason.com/archives/2005/10/01/rethinking-the-social-responsibility/singlepage>.

⁸ Pope Benedict XVI, Encyclical Letter, *Caritas in Veritate* ¶ 46 (June 29, 2009), http://www.vatican.va/holy_father/benedict_xvi/encyclicals/documents/hf_ben-xvi_enc_20090629_caritas-in-veritate_en.html. This Encyclical attracted the attention of the international media according to Bill Moyers Journal. See *The Pope's Encyclical: Charity in Truth*, July 7, 2009, <http://www.pbs.org/moyers/journal/07032009/profile4.html> (citing the following examples of international media attention: *Pope Calls for God-*

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In 2012 we find ourselves moving ever increasingly away from the Friedman approach and toward the John Mackey view of the role of the corporation. The financial crisis of 2010 that has had global repercussions, the distrust of Wall Street resulting from the crisis, and the seemingly never ending headlines of a new corporate scandal have caused many to question and rethink the proper role of the corporation. Should corporations be purely profit driven entities, first and foremost serving the financial interest of shareholders? Not surprisingly, in the United States this very question has been brought into the forefront. “With public trust in business at an all time low, [benefit corporations] represent[] the first systemic response to the underlying problems that created the financial crisis.”⁹ There is an increasing acceptance of the Benefit Corporation by state legislatures and their constituents who recognize the value of the expansion of the corporate social conscience. Although recent events have certainly helped accelerate the acceptance of these hybrid entities, the concept of this form of business has been many years in the making.

A. *Remedying Social Ills*

The notion of joining nonprofit and for-profit objectives is not a new one. Over a century ago, “beginning with the creation of The Carnegie Corporation in 1911 and the Rockefeller Foundation in 1913, the modern philanthropic foundation came into existence.”¹⁰ There was a recognition that those generating wealth had a responsibility to use that wealth to benefit society. “The private foundation . . . arose as an institutional response to the rapid social, economic, and cultural changes of the late nineteenth and early twentieth century.”¹¹ Prior to this time, charitable efforts were generally focused on discrete local issues, but the new foundations represented a more managerial and bureaucratic approach to

Centered Global Economy, USA TODAY, July 7, 2009; *Post Litteram*, RELIGION NEWS SERVICE, July 7, 2009; *Pope Benedict on Economic Justice: The Catholic’s View*, WASH. POST, July 7, 2009; *Pope Benedict Appeals for Less Greed and More Soul*, DEUTSCHE WELLE, July 7, 2009; *Encyclical Covers Issues from Sex to World Economy*, GUARDIAN [UK], July 7, 2009).

⁹ B CORPORATION, 2011 ANNUAL REPORT 17 (2011), http://www.bcorporation.net/resources/bcorp/documents/B%20Corp_2011-Annual-Report.pdf (quoting Jay Coen Gilbert, co-founder of B Lab).

¹⁰ Barry D. Karl & Stanley N. Katz, *The American Private Philanthropic Foundation and the Public Sphere 1890-1930*, 19 MINERVA 236, 246 (1981).

¹¹ Carl J. Schramm, *Law Outside the Market: The Social Utility of Private Foundations*, HARV. J.L. & PUB. POL’Y 356, 368 (2006).

broad social concerns.¹² According to the most recent data available from the National Center for Charitable Statistics,¹³ in 1999 there were approximately 77,978 private foundations. By 2010 there were approximately 120,810 foundations with revenue of approximately \$43 billion and approximately \$582 billion in assets. This represented an approximately 55% increase. Today's high profile foundations, such as the Bank of America Charitable Foundation and the GE Foundation, highlight the close relationship that can sometimes exist between the for-profit entity and the non-profit organization. Moreover, nonprofit organizations themselves might sometimes create a for-profit enterprise to serve their purposes. For example, in 2004 the IRS ruled that the joint venture of an exempt university teaching program and a for-profit corporation to conduct video training did not jeopardize the university's exempt status.¹⁴ A non-profit can set up a for-profit retailer to sell its merchandise.¹⁵ Such efforts increasingly blur the for-profit/nonprofit distinction.

The inherent risk in blurring this distinction was made clear to Henry Ford when he announced that he intended to use the benefits derived from his successful business venture to help ensure the betterment of a broad spectrum of individuals rather than just his shareholders.¹⁶ In response to a legal challenge filed by shareholders of the Ford Corporation, the court ultimately ordered the Ford Corporation to declare a special dividend to the shareholders.¹⁷ The stage was not quite set for the stakeholder approach during Henry Ford's time, but that all changed with the birth of the social enterprise movement.

B. Understanding Social Enterprise

Social enterprise is the application of private enterprise to the remedy of social needs or ills. There was increased recognition that the government alone could not solve social problems. Unconstrained by bureaucracy, politics, and set budgets, and having access to private resources, social entrepreneurs possess distinct advantages over government agencies when it

¹² *Id.*

¹³ *Number of Nonprofit Organizations in the United States, 1999-2009*, NATIONAL CENTER FOR CHARITABLE STATISTICS, <http://nccsdataweb.urban.org/PubApps/profile1.php?state=US> (last visited June 1, 2012).

¹⁴ See Rev. Rul. 2004-51, 2004-1 C.B. 974.

¹⁵ Allen Bromberger, *A New Type of Hybrid*, STAN. SOC. INNOVATION REV., Spring 2011, at 49-53.

¹⁶ Mathew Doerlinger, *Fostering Social Enterprise: A Historical and International Analysis*, 20 DUKE J. COMP. & INT'L L. 291 (2010).

¹⁷ *Dodge v. Ford Motor Co.*, 170 N.W. 668, 671 (Mich. 1919).

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comes to exploring and solving social ills.¹⁸ “Social entrepreneurs have an important role to play, whether it is to complement or supplant government efforts.”¹⁹ The development of social entrepreneurs can be traced to the work of three innovative entities in the 1980’s: Ashoka, New Ventures, and the Alpha Center for Public and Private Initiatives.²⁰ Ashoka, a global organization founded by Bill Drayton in 1980, was created to promote social change by investing in social entrepreneurs and pioneering the “global field of social entrepreneurship.”²¹ In that same year, New Ventures was founded by Ed Skloot as a consulting firm with the goal of helping nonprofit organizations to discover new sources of funding. This mission soon advanced to also helping the nonprofits develop business skills that could enhance their financial viability. A few years later, in 1985, the Alpha Center for Public and Private Initiatives was founded to encourage entrepreneurs to address social problems. Most significantly, the Alpha Center “brought into the conversation this idea of blurring the sector boundaries. And it raised the question of what can and should be done by nonprofits and what role for-profit or hybrid structures might play in achieving sustainable social impact.”²²

“Social and business entrepreneurs uncover or create new opportunities through a process of exploration, innovation, experimentation, and resource mobilization.”²³ While the formation of Asoka, New Ventures, and the Alpha Center were not likely on the radar screen of the average consumer, soon recognizable brands such as Ben & Jerry’s, Seventh Generation, and Newman’s Own, introduced the notion of the social responsibility of business to consumers.²⁴ Ben & Jerry’s introduced the improvement of the environment as a “second bottom line” for business. For this reason it is sometimes considered to be the first socially responsible business.²⁵ Soon a third “bottom line” was added to the socially responsible business agenda with a focus on people – not just employees and consumers, but the

¹⁸ *Id.*

¹⁹ *Id.* at 27.

²⁰ *The Past, Present, and Future of Social Entrepreneurship, a Conversation with Greg Dees*, DUKE UNIV. CENTER FOR ADVANCEMENT OF SOCIAL ENTREPRENEURSHIP (2006), <http://www.caseatduke.org/documents/deesinterview.pdf> [hereinafter *Past, Present and Future*].

²¹ *Ashoka Facts*, ASHOKA, <http://www.ashoka.org/facts> (last visited July 11, 2012).

²² *Past, Present and Future*, *supra* note 20.

²³ J. Gregory Dees, *Taking Social Entrepreneurship Seriously*, 40 SOCIETY 24 (Mar./Apr. 2007).

²⁴ Alissa Mickels, 32 HASTINGS INT’L & COMP. L. REV. 271, 274 (2009).

²⁵ JEFFREY HOLLENDER & STEPHEN FENICHELL, WHAT MATTERS MOST: HOW A SMALL GROUP OF PIONEERS IS TEACHING SOCIAL RESPONSIBILITY TO BIG BUSINESS AND WHY BIG BUSINESS IS LISTENING (2004).

environment as well.²⁶ This “triple bottom line” began to be referred to as “Corporate Social Responsibility” and was soon gaining traction.

The start of the twenty-first century has brought with it a marked increase in interest in and development of social entrepreneurship. The terms “Corporate Social Responsibility” and “Triple Bottom Line” are now common terms in the marketplace. The latest data available from Bloomberg shows that “by 2007 about 11% of all assets under professional management (more than 2.7 trillion) were invested in a socially responsible investment and more than 30,000 U.S. companies were members of socially responsible business organizations”²⁷ In 2009, the White House Office of Social Innovation was created to increase investment in social enterprises.²⁸ In fact, the notion of corporate social responsibility had become so accepted, that, in 2011, for the first time in its 94 year history, Forbes magazine released a ranking list based on social innovation. The Forbes Impact 30 ranking recognizes the top 30 social innovators judged on impact, social accountability, and social entrepreneurship.²⁹ With growing widespread recognition of social entrepreneurship, it is not surprising that the next step along the journey was the creation of a hybrid entity — a for-profit entity with a nonprofit purpose. In this case, the L3C, the low profit, limited liability company.

1. The L3C: The First United States Hybrid Entity

How then, did the first truly hybrid entity come about in the United States? To answer this question, we first look to the Aspen Institute. The Aspen Institute is a widely recognized, international nonprofit organization working “to foster values-based leadership, encouraging individuals to reflect on the ideals and ideas that define a good society, and to provide a neutral and balanced venue for discussing and acting on critical issues.”³⁰ Established in 1950, as part of its mission the Institute hosts regular seminars and policy programs that bring together for discussion and

²⁶ Mickels, *supra* note 24.

²⁷ John Tozzi, *New Legal Protections for Social Entrepreneurs*, BLOOMBERG BUSINESS WEEK, Apr. 22, 2010, http://www.businessweek.com/smallbiz/content/apr2010/sb20100421_414362.htm.

²⁸ Steven Haymore, *Public(ly Oriented) Companies: B Corporations and the Delaware Stockholder Provision Dilemma*, 64 VAND. L. REV. 1311 (2011).

²⁹ Helen Coster, *Forbes List of the Top Thirty Social Entrepreneurs*, FORBES, Nov. 30, 2011, <http://www.forbes.com/sites/helencoster/2011/11/30/forbes-list-of-the-top-30-social-entrepreneurs/>.

³⁰ *The Aspen Institute Mission Statement*, ASPEN INSTITUTE, <http://www.aspeninstitute.org/about> (last visited July 11, 2012).

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problem-solving some of the leading figures in the social enterprise movement. At one such meeting in September of 2006 entitled, “Exploring New Legal Forms and Tax Structures for Social Enterprise Organizations” one of the participants, Robert Lang, proposed a plan for a low-profit, limited liability company (“L3C”) that would advance a social mission and at the same time provide a vehicle to receive investment from private investors, the government, and nonprofit foundations.³¹ This last item, securing funding from private foundations, referred to as Program Related Investments or PRIs, was one of Lang’s primary motivators in creating the L3C.

a. Understanding the Role of the L3C

The law governing private foundations requires foundations to spend a certain percentage of their funds each year on charitable purposes.³² Failure to distribute 5% of income (whether through grants, donations, or PRIs)³³ results in the imposition of an excise tax.³⁴ Excise taxes are also imposed when a private foundation makes investments that may jeopardize the carrying out of their exempt purpose.³⁵ According to Treasury Regulations,

an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. In the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return

³¹ Thomas J. Billitteri, *Mixing Mission and Business: Does Social Enterprise Need a New Legal Approach, Highlights from an Aspen Institute Roundtable*, ASPEN INSTITUTE, Jan. 2007, http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/New_Legal_Forms_Report_FINAL.pdf.

³² I.R.C. § 4942 (2012).

³³ Matthew Doeringer, *Fostering Social Enterprise: A Historical and International Analysis*, 20 DUKE J. COMP. & INT’L L. 291 (2010).

³⁴ Section 4942 of the Internal Revenue Code imposes an excise tax of 30% of the amount of income that is undistributed at the beginning of the subsequent tax year. This amount will increase to 100% if distribution requirements are not met in a specified period.

³⁵ I.R.C. § 4944 (2012).

(including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return).”³⁶

There is an exception to the imposition of excise taxes on jeopardizing investments if the investment is a PRI. To be considered a PRI: (1) the primary purpose of the investment must be to accomplish a charitable or educational purpose as described in Internal Revenue Code section 170(c)(2)(B); (2) the production of income or capital appreciation of property cannot be a significant portion of the investment; and (3) the investment cannot be used for political or legislative purposes described in Internal Revenue Code section 170(c)(2)(D). Under these rules, a private foundation’s investments in the form of loans, grants, and equity purchases in socially-motivated for-profit entities could qualify as a PRI.³⁷ Richard Lang structured the L3C so that it would be able to meet the PRI requirements, thereby encouraging investment by the nonprofit sector in the for-profit LLC.

b. The Growth of the L3C

Working with Richard Lang, Americans for Community Development (ACD) has been responsible for promoting the state adoption of the L3C form of business. Lang and the ACD achieved a measure of success when Vermont became the first state to recognize the L3C as a legal entity in April, 2008.³⁸ Since that time, 149 L3Cs have organized in Vermont.³⁹ In addition to Vermont, eight other states have adopted the L3C: Illinois,⁴⁰ Louisiana,⁴¹ Maine,⁴² Michigan,⁴³ North Carolina,⁴⁴ Rhode Island,⁴⁵ Utah,⁴⁶

³⁶ Treas. Reg. § 53.4944-1(a)(2)(i) (2012).

³⁷ Deborah Andrews, *The “L3C”: The New Double-Hybrid Entity*, PHILANTHROPY J., Dec. 10, 2010, <http://www.philanthropyjournal.org/resources/managementleadership/%E2%80%9813c%E2%80%99-new-double-hybrid-entity>.

³⁸ VT. STAT. ANN. tit. 21, § 3001(27) (2012).

³⁹ *Here’s the Latest L3C Tally*, INTERSECTOR PARTNERS L3C, July 5, 2012, http://www.intersectorl3c.com/l3c_tally.html.

⁴⁰ 805 ILL. COMP. STAT. 180/1-26 (2012).

⁴¹ L.A. REV. STAT. ANN. § 12:1305 (2012).

⁴² ME. REV. STAT. tit. 31, § 1611 (2012).

⁴³ MICH. COMP. LAWS § 450.4102 (2012).

⁴⁴ N.C. GEN. STAT. § 57C-2-01(d) (2012).

⁴⁵ R.I. GEN. LAWS § 7-16-2 (2012).

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and Wyoming.⁴⁷ L3C legislation is currently pending in several other states.⁴⁸ Two federal jurisdictions — the Oglala Sioux Tribe and the Crow Indian Nation of Montana — have also adopted L3C legislation.⁴⁹ This legislation allows “a limited liability company (LLC) to become a low-profit limited liability company (L3C) when organized for a business purpose and operated to significantly further charitable purposes but without a significant purpose to produce income or asset appreciation.”⁵⁰

c. Understanding the Nature of the L3C

The following statutory requirements of the Vermont L3C are substantially the same as those adopted in the other states. The L3C may be organized for any purpose, but must be operated to satisfy the following requirements:

(A) The Company significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the IRS Code of 1986 . . . and (ii) would not have been formed but for the company's relationship to the accomplishment of charitable⁵¹ or educational purposes.

⁴⁶ UTAH CODE ANN. § 48-2c-102(4)(b) (2012).

⁴⁷ WYO. STAT. ANN. § 17-29-102(ix) (2012).

⁴⁸ See S.B. 517, 2011 Reg. Sess. (Ala. 2011); S.B. 1503, 50th Leg., 1st Reg. Sess. (Ariz. 2011); S.B. 323, 2011-2012 Reg. Sess. (Cal. 2011); H.B. 594, 151st Gen. Assemb. (Ga. 2011); H.B. 2082, 26th Leg., Reg. Sess. (Haw. 2011); S.F. 158, 85th Gen. Assemb. (Iowa 2011); S.B. 501, 117th Gen. Assemb., 1st Reg. Sess. (Ind. 2011); H.B. 110, 2011 Leg., Reg. Sess. (Ky. 2011); S.B. 209, 428th Gen. Assemb., Reg. Sess. (Md. 2011); H.B. 1868, 187th Gen. Ct. (Mass. 2011); S.B. 2063, 87th Legis. Sess., 2nd Reg. Sess. (Minn. 2012); H.B. 1561, 96th Gen. Assemb., 2nd Reg. Sess. (Mo. 2012); S.B. 352, 162nd Legis. Sess. (N.H. 2011); S.B. 3011, 234th Legis. Sess. (N.Y. 2011); H.B. 1088, 53d Leg., Reg. Sess. (Okla. 2011); S.B. 351, 2012 Sess. (Va. 2012). See Carter G. Bishop, *Fifty State Series: L3C and B Corporation Legislation Table* (SUFFOLK UNIV. LAW SCH., LEGAL STUDIES RESEARCH PAPER SERIES, RESEARCH PAPER 10-11, Mar. 5, 2012), papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID2018900_code737120.pdf?abstractid=1561783&mirid=1. Professor Bishop updates this list regularly.

⁴⁹ See *Laws, AMERICANS FOR COMMUNITY DEVELOPMENT: THE ORGANIZATION FOR THE L3C*, <http://www.americansforcommunitydevelopment.org/laws.php> (last visited July 12, 2012).

⁵⁰ Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion?*, 63 ARK. L. REV. 243, 243 (2010).

⁵¹ Charitable and education purposes include “religious, charitable, scientific, literary, or educational purposes . . . foster[ing] national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), . . . [and] prevent[ing] cruelty to children or animals.” I.R.C. § 170(c)(2)(B) (2012).

(B) No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.

(C) No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the IRS code of 1986 . . . [and]

(D) If a company that met the definition of this subdivision . . . at its formation at any time ceases to satisfy any one of the requirements, it shall immediately cease to be a low-profit LLC, but by continuing to meet all the other requirements of this chapter, will continue to exist as a limited liability company.⁵²

Notice how this language mirrors that of the PRI requirements. This statutory language was drafted with the intention of having the L3C qualify as a PRI for private foundations to help facilitate this funding.⁵³ All states require that some variation of L3C or low-profit LLC be included in the entity name. As a general rule, state laws also include ramifications in the event the entity no longer qualifies as an L3C.

The L3C provides all the benefits of an LLC, such as a flexible ownership structure, profit distributions, and flow-through taxation. The L3C provides “both that credibility and liability protection for the owners and management, while leaving enforcement to the state and not subjecting the business to periodic audits by a third party. Plus, great branding and marketing opportunities.”⁵⁴ Some areas where L3Cs have been utilized include: carbon trading, alternative energy, food bank processing, social services, arts funding, job creation programs, and housing for low income and aging populations.⁵⁵ In Maine, this hybrid form of business seemingly saved a group of Maine dairy farmers. When Maine dairy farmer David

⁵² VT. STAT. ANN. tit. 11, § 3001(27) (2012).

⁵³ For an excellent discussion of the L3C as a qualified Program Related Investment, see generally Bishop, *supra* note 50.

⁵⁴ Jessica Manganello, *The Low Profit Limited Liability Company (L3C): A New Model for Cleantech?*, GREENLIGHTDISTRIKT, Sept. 13, 2010, <http://thegreenlightdistrikt.com/2010/09/13/the-low-profit-limited-liability-company-l3c-a-new-model-for-cleantech>.

⁵⁵ Jim Witkin, *The L3C: A More Creative Capitalism*, TRIPLEPUNDIT, Jan. 15, 2009, www.triplepundit.com/2009/01/the-l3c-a-more-creative-capitalism.

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Vaughn lost his contract with his organic milk processor H.P. Hood, he, along with nine other small farmers also let go by Hood, joined together to create an L3C, MOOMilk, to process and sell their milk on their own. By doing business in this form, they hope to gain funding from both social funds and foundations. According to attorney Paul Dillon, who structured the business, the L3C made sense for the farmers. “Instead of building equity for the middle guy, we’re using the low-profit model to keep profits going to the farmers . . . Nobody’s going to get rich investing in this L3C. But, if the goal is to save family farms, that is going to happen.”⁵⁶

Given the short life of this entity, the legal and tax consequences of this form of doing business remain to be seen. At present no special tax incentives exist for this form of business. To date, the level of PRI funding anticipated by the founders of the L3C movement has not been realized. The most significant reasons for this are likely that (1) foundations tend to refrain from making PRIs due to the costs of ensuring compliance with the private foundation rules governing PRIs and (2) the L3C is a new form of business with an unproven track record.⁵⁷ Foundations would want certainty that the L3C qualifies as a PRI in order to avoid making a “jeopardizing investment.” Usually, this certainty takes the form of a private ruling, but “this is an expensive and time consuming process so a private foundation is more likely to shy away from investing in for-profit entities. If the investment does not qualify, the foundation and its directors may face penalties and the foundation may lose its tax exempt status.”⁵⁸ Although the IRS has issued favorable rulings on the ability of private foundations to invest in for-profit LLCs with a charitable purpose, the IRS has not ruled that a private foundation’s investment in an L3C automatically qualifies as a PRI.⁵⁹ In November of 2011, H.R. 3420, the Philanthropic Facilitation Act of 2011, was introduced in Congress by Congressmen Jared Polis (D-Colorado) and Aaron Schock (R-Illinois) to “simplify the ability of foundations to invest in businesses with common missions.”⁶⁰ This bill is not designed to change the criteria as to what qualifies as a PRI but rather to

⁵⁶ Malika Zouhali-Worrall, *For L3C Companies, Profit Isn’t the Point*, CNNMONEY, Feb. 9, 2010, http://money.cnn.com/2010/02/08/smallbusiness/l3c_low_profit_companies/# (last visited May 26, 2012).

⁵⁷ Elizabeth Schmidt, *Vermont’s Social Hybrid Pioneers: Early Observations and Questions to Ponder*, 35 VT. L. REV. 163 (2010).

⁵⁸ William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972).

⁵⁹ *Id.*

⁶⁰ Karl Dakin, *Congressman Polis Introduces Philanthropic Facilitation Act of 2011*, SULLIVAN CHAIR (REGIS UNIV.), Nov. 22, 2011, <http://sullivanchair.com/congressman-polis-introduces-philanthropic-facilitation-act-of-2011/>.

simplify the process by which a business can receive approval from the IRS that it qualifies as a PRI, a factor that might make the L3C investments more attractive to private foundations. This legislation is still pending. Similar legislation was proposed but not passed in 2010.

More recently, in April 2012, proposed Treasury Regulations were released to supplement the existing forty-year-old regulations defining PRIs. These regulations have been proposed because “[t]he Treasury Department and the IRS are aware that the private foundation community would find it helpful if the regulations could include additional PRI examples that reflect current investment practices.”⁶¹ The new examples make it clear that PRIs can include equity investments in and loans to for-profit organizations that serve as a vehicle for accomplishing an exempt purpose. For example, proposed example 11 describes a private foundation’s purchase of stock of a for-profit subsidiary of a for-profit drug company. The subsidiary was formed to research and develop a vaccine to prevent a disease that predominantly affects poor people living in developing countries. The subsidiary will also distribute the vaccine at an affordable price. According to the proposed regulations, this investment qualifies as an investment in a PRI since the purpose of advancement of science furthers the foundation’s exempt activities. This example is similar to the \$10 million investment of the Bill & Melinda Gates Foundation in Liquidia, a biotechnology company involved with vaccine development.⁶² “[I]nterest is growing rapidly in using PRIs to buy stakes in businesses that can help foundations achieve their missions...and the Gates Foundation alone will change the dynamics.”⁶³ While the proposed regulations do not provide any specific guidance on the investment in an L3C, the fact that they clarify that investment in a for-profit entity is permissible, and that a broad array of activities can be supported (such as advancing science, promoting the arts, and addressing environmental concerns⁶⁴) may make private foundations more willing to invest in this relatively new form of business. Further guidance may be forthcoming as the government is encouraging that the public comments on the proposed rules by July 18, 2012. “We hope that the proposed rule will spark a dialogue over the next

⁶¹ Examples of Program-Related Investments, 77 Fed. Reg. 23,429, 23,429 (Apr. 19, 2012).

⁶² Stephanie Strom, *To Advance Their Cause, Foundations Buy Stocks*, N.Y. TIMES, Nov. 25, 2011, at B1, available at <http://www.nytimes.com/2011/11/25/business/foundations-come-to-the-aid-of-companies.html?pagewanted=all>.

⁶³ *Id.*

⁶⁴ Examples of Program-Related Investments, 77 Fed. Reg. 23,429, 23,430 (Apr. 19, 2012).

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few months with the philanthropic community. Through feedback on the guidelines and an exchange of ideas, we hope to update the regulations in a manner that serves the public interest.”⁶⁵

While the L3C is admittedly a flexible hybrid form that may expand the funding of for-profit social enterprise, some argue that the L3C is an unnecessary form of business in that it adds nothing new to existing law.⁶⁶ For example, in Delaware, as in many other states, an LLC can be organized for any purpose and can choose to both provide societal benefits and produce profits; no special designation is required since the “freedom to contract” permits operating agreements to be drafted as the parties see fit.⁶⁷ Further supporting this view is a private letter ruling in which the Internal Revenue Service approved a foundation’s investment in a for-profit LLC as a PRI because the operating agreement of the entity matched the foundation’s mission objectives.⁶⁸

The next logical step for the social enterprise movement was the creation of a hybrid corporate form of doing business. Enter the Benefit Corporation.

II. The Benefit Corporation Arrives on the Scene

According to a recent White Paper on the need and rationale for the Benefit Corporation, “[f]or-profit entrepreneurship, social investing, and the sustainable business movement have reached critical mass . . . accelerating consumer and investor demand has resulted in the formation of a substantial marketplace for companies that put purpose, not profit, at the center of the business.”⁶⁹ Responding to the call for an increased emphasis on stakeholders in corporate decision making,⁷⁰ in April, 2010, Maryland

⁶⁵ Jonathan Greenblatt, *Opening the Door for Program Related Investments*, WHITE HOUSE OFFICE OF SOCIAL INNOVATION & CIVIC PARTICIPATION, May 4, 2012, <http://www.whitehouse.gov/blog/2012/05/04/opening-door-program-related-investments>.

⁶⁶ For an in-depth critique of the L3C, see Ann E. Conaway, *The Global Use of the Delaware Limited Liability Company for Socially-Driven Purposes*, 38 WM. MITCHELL L. REV. 772 (2012).

⁶⁷ *Id.* at 784.

⁶⁸ I.R.S. Priv. Ltr. Rul. 2006-10-020, at 1-3, 18 (Mar. 10, 2006).

⁶⁹ William H. Clark & Larry Vranka, *The Need and Rationale for the Benefit Corporation: Why It Is the Legal Form that Best Addresses the Needs of Social Entrepreneurs, Investors, and, Ultimately, the Public*, BENEFIT CORP INFORMATION CENTER, Jan. 26, 2012, http://benefitcorp.net/storage/The_Need_and_Rationale_for_Benefit_Corporations_-_April_2012.pdf.

⁷⁰ Michael Deskins, *Benefit Corporation Legislation: Version 1.0 — A Breakthrough*

became the first state to enact Benefit Corporation legislation. Since then, several other states have followed suit. Benefit Corporations are formed to have a “material, positive impact on society and the environment.”⁷¹ Language in the corporate charter⁷² requires directors to consider the interests of a broad variety of stakeholders, including, but not limited to, the community, employees, and consumers. “[S]hareholders of Benefit Corporations now have additional rights to hold directors accountable for failure to create a material positive impact on society or to consider the impact of decisions on employees, community, and the [local and global] environment.”⁷³ In addition to having a general positive impact on society, the Benefit Corporation may also choose to provide specific public benefits such as preserving the environment, improving human health, promoting the arts, sciences, and advancement of knowledge.⁷⁴ Whether or not the Corporation meets its obligations and has a positive impact on society is determined with reference to an independent, third party standard. The Corporation is required to report annually on its social and environmental performance using this standard.

Having a third party conduct an annual evaluation is an important component of Benefit Corporation status. Responding to increased consumer demand for socially responsible products, product marketing terms such as “green” and “sustainable” are now so widely used that they begin to lose their meaning.⁷⁵ To combat this problem, known as “greenwashing,” a variety of organizations, among them: Greenseal, Underwriters Laboratories, Global Reporting Initiative, Green American, and B-Lab,⁷⁶ provide performance evaluations and certifications such as “Organic,” “Free Trade,” “Energy Star,” and “Greenseal.”⁷⁷ One the challenges this presents is how this standard will be set and applied. The model legislation does not specify what form the standards will take, nor

in Stakeholder Rights?, 15 LEWIS & CLARK L. REV 1047 (2011).

⁷¹ Dana Brakman Reiser, *Benefit Corporations: A Sustainable Form of Organization?*, 46 WAKE FOREST L. REV. 591, 597 (2011) (quoting S.B. 298, 2011 Leg., 26th Sess. §§ 2, 5 (Haw. 2011)).

⁷² Existing corporations can convert to Benefit Corporation status as long as two-thirds of the shareholders approve the necessary amendments to the corporate charter.

⁷³ Press Release, *supra* note 3.

⁷⁴ Reiser, *supra* note 71.

⁷⁵ William H. Clark & Elizabeth Babson, *How Benefit Corporations Are Redefining the Purpose of Business Corporations*, 38 WM. MITCHELL L. REV. 817, 820–21 (2012).

⁷⁶ Briana Cummings, Note, *Benefit Corporations: How to Enforce a Mandate to Promote the Public Interest*, 112 COLUM. L. REV. 578, 594 (2012).

⁷⁷ Clark & Babson, *supra* note 75, at 821.

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does it dictate how compliance will be monitored; all that is required is independence and transparency in the process.⁷⁸

A. Origins of the Benefit Corporation & The Model Charter

One such entity available to provide an independent, third party review of Benefit Corporations is B-Lab a Pennsylvania non-profit with a direct connection to the Benefit Corporation movement. B-Lab was formed in 2006 by three friends, Andrew Kassoy, Jay Coen Gilbert, and Bart Houlahan, who recognized at that time that, “there is a huge marketplace of companies and their consumers and investors who are interested in creating value for all stakeholders, not just shareholders,”⁷⁹ B-Lab proposed the idea of a Certified B Corporation that would be certified by B-Lab. A B Corporation is a corporation that creates a general public benefit as measured by an independent third-party standard. Unlike the Benefit Corporation, the Certified B Corporation does not represent a new corporate structure; rather, it is a for-profit entity given a social enterprise seal of approval by the B-Lab. A Certified B Corporation must meet a minimum set of social and environmental performance standards and also submit to periodic audits.⁸⁰ To become certified as B Corporation an entity must (1) earn a minimum score of 80 on the B Impact Assessment,⁸¹ (2) adopt the B Corporation Legal Framework,⁸² and (3) sign a Term Sheet⁸³ and Declaration of Interdependence⁸⁴ to make the certification official. Once certified, 20% of B Corporations are randomly selected for an on-site review during every two-year term.

⁷⁸ Reiser, *supra* note 71.

⁷⁹ *The B Corporation: A Business Model for the New Economy*, CAPITAL INSTITUTE, <http://www.theimpactinvestor.com/b-corp-model-rewrites-the-c.html> (last visited July 12, 2012).

⁸⁰ *Id.*

⁸¹ This is a benchmark tool for social and environmental impact. According to the company’s website, this assessment “has been reviewed by 600+ entrepreneurs, investors, thought leaders and academics, all of whom have had the opportunity to offer line-item critical feedback. . . . The B Impact Ratings System is governed by an independent, nine person Standards Advisory Council (SAC). The SAC evaluated the collective feedback from the beta test, and incorporated the community’s input to ensure the application of best thinking and practices.” *See How Was the B Impact Rating System Developed?*, B LAB, <http://www.bcorporation.net/become/BRS> (last visited July 12, 2012).

⁸² This legal framework clarifies the pursuit of the dual mission of social benefit for stakeholder and profit.

⁸³ Key provisions of the Term Sheet are: certification is for a two year period, B Corporations must submit an Impact Assessment; corporations must agree to an on site review, and corporations must comply with use of B Lab intellectual property.

⁸⁴ The Declaration of Interdependence recognizes the ability of private enterprise to produce a public benefit.

To date, there are over 533 Certified B Corporations generating revenue of \$3.11 billion annually, and doing business in over 60 industries.⁸⁵ One of the stated goals of B-Lab has been to effect a broader change in the marketplace and move toward a system in which entities like the Certified B Corporation would be accorded a legal form of their own. To that end, B Lab has been actively engaged in encouraging the adoption of Benefit Corporation legislation in the states. The following summary of the Model Benefit Corporation Legislation proposed by B Lab is instructive in that it contains many of the provisions adopted in each of the states that have enacted Benefit Corporation legislation.

Table 1 – Highlights of Model Legislation⁸⁶

Corporate Purposes
Create a general public benefit as measured by a third party standard
Right to name a specific benefit
Creation of public benefit in best interest of the corporation
Accountability
Director's duty – make decisions in best interest of the corporation
Director's duty – consider effects on stakeholders
Independent Benefit Director to attest board acted in accordance with duties
Transparency
Annual benefit report published in accordance with third party standards
Annual Report delivered to shareholders, website, Secretary of State
Right of Action
Only shareholders and directors have a right of action
Right of action for violation of duty (purpose or standard of conduct)

B. State Adoption of the Benefit Corporation

Eight states have already enacted Benefit Corporation legislation and legislation is pending in several others. This section reviews the Benefit Corporation for three states: Maryland, Vermont, and California.

1. Maryland Becomes the First State to Adopt the Benefit Corporation

Speaking on the day that the Benefit Corporation was signed into law by Maryland Governor Martin O'Malley, the bill's co-sponsor, State

⁸⁵ B CORPORATION, 2012 ANNUAL REPORT (2012).

⁸⁶ *Benefit Corporation: Legal Provisions and FAQs*, B LAB, <http://www.bcorporation.net/resources/bcorp/documents/Benefit%20Corporation%20-%20Legal%20Provisions%20and%20FAQ.pdf> (last visited July 12, 2012).

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Senator Jamie Raskin said, “This is a great moment in the evolution of commercial life in Maryland and America.”⁸⁷ Speaking on the same day, B-Lab co-founder, Jay Coen Gilbert said, “Today marks an inflection point in the evolution of capitalism. With public trust in business at an all-time low, this represents the first systemic response to the underlying problems that created the financial crisis — protecting companies from the pressures of short-termism while creating benefit for shareholders and society over the long-haul.”⁸⁸ As initially drafted, the Benefit Corporation legislation did not encompass Limited Liability Companies. However, this was soon rectified when Maryland modified its statute and became the first state to enact the Benefit LLC.⁸⁹ In a more recent update to Benefit Corporation rules, in May, 2011, Maryland became the first state to add the requirement that the term “Benefit” be included in the corporate name.⁹⁰

When making business decisions, directors of a Maryland Benefit Corporation must consider: (1) the stockholders, (2) employees of the Benefit Corporation as well as subsidiaries and suppliers of the benefit Corporation; (3) customers, (4) community and societal concerns, and (5) the local and global environment.⁹¹ The directors do not owe a duty to the beneficiaries of the corporation’s purposes and, therefore, these beneficiaries lack standing to bring a claim against the directors.⁹² While Maryland Benefit Corporations are required to disclose their stakeholder impact as per a third party standard, Maryland does not require a minimum level of impact nor does the state require that all of the performance requirements that apply to B Corporations be met.⁹³ While the legislation does not provide details on what an acceptable third party standard is, it does require that the standard be transparent.⁹⁴

⁸⁷ B Lab, *Maryland First State in the Union to Pass Benefit Corporation Legislation*, CSRWIRE, Apr. 14, 2010, www.csrwire.com/press_release/29322-Maryland-First-State-in-Union-to-Pass-Benefit-Corporation-Legislation.

⁸⁸ Press Release, *supra* note 3.

⁸⁹ *Clean Currents First Benefit LLC in State of Maryland and Country*, CLEAN CURRENTS, June 1, 2011, <http://www.cleancurrents.com/index.php/newsroom/86-clean-currents-first-benefit-llc-in-state-of-maryland>.

⁹⁰ Reiser, *supra* note 71.

⁹¹ MD. CODE ANN. CORPS & ASS’NS, § 5-6C-07 (West 2012).

⁹² Penny J. Minna & Namha B. Corbin, *Benefit Corporation Law Could Spur Socially Responsible Business Boom*, DAILY RECORD [MARYLAND], July 29, 2010, <http://thedailyrecord.com/2010/07/29/benefit-corporation-law-could-spur-socially-responsible-business-boom/>.

⁹³ *Maryland Creates New Category of Organizations: Mission-Based, For-Profit Benefit Corporations*, Apr. 26, 2010, <http://www.bcorporation.net/resources/bcorp/documents/openminds042610maryland.pdf>.

⁹⁴ MD. CODE ANN. CORPS & ASS’NS, § 5-6C-01(E) (West 2012).

In the first three months after the new legislation was passed, fifteen benefit corporations were formed in Maryland. The Maryland State Department of Assessments and Taxation does not keep a record of the number of Benefit Corporations in the state, but a recent estimate by the state and lawyers working with Benefit Corporations estimate that there are approximately 20 to 25 Maryland Benefit Corporations.⁹⁵

“There are no tax breaks or procurement incentives for benefit corporations in Maryland, but the classification offers a competitive advantage. ‘If you are feeding back into your customers goodwill, social justice, making sure your employees have sustainable wages, people understand that and in turn will support you for it,’ said Penny Jones-Napier, a Maryland Benefit Corporation business owner.”⁹⁶

2. Vermont Follows Suit

Soon Vermont followed Maryland’s lead and adopted Benefit Corporation legislation that became effective on July 1, 2011. As in Maryland, new corporations can be formed as Benefit Corporations or existing corporations can convert to Benefit Corporation status as long as two-thirds of the shareholders approve. At least one board member of the Vermont Benefit Corporation must be designated as a benefit director with the responsibility for the company’s annual report of its social and environmental performance. Compared to Maryland, Vermont provides more specific guidance regarding the rights of shareholders and how the actions of the directors can be challenged.⁹⁷

Vermont Benefit Corporations shareholders have legal standing to bring a “benefit enforcement proceeding” against the directors for a failure to meet the general public benefit purpose or a specific purpose adopted in the corporate charter.⁹⁸ Discussing the new law, Jeffrey Hollander, co-founder of Seventh Generation remarked, “There’s little doubt that there is a financial advantage for companies that commit to a corporate philosophy that goes beyond profits. I believe that over time there will be increasing

⁹⁵ Ben Mook, *Benefit Corporations Spark Interest and Questions*, DAILY RECORD [Maryland], Feb. 20, 2012, www.thedailyrecord.com/2012/02/20/benefit-corps-spark-interest-and-questions/.

⁹⁶ Danielle Douglas, *Benefit Corporations Sign Up*, WASH. POST, Jan. 24, 2011, at A11.

⁹⁷ Deskins, *supra* note 70, at 1072.

⁹⁸ VT. STAT. ANN. tit. 11A, §§ 21.09(e), 21.13 (2012).

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financial benefits because it will become easier for investors, who want to support responsible businesses, to identify businesses that are organized primarily around that purpose.”⁹⁹

3. The California Variation

Effective January, 2012 California introduced two new entities — the benefit corporation and the flexible purpose corporation.¹⁰⁰ The Benefit Corporation, much like that adopted in Maryland and Vermont is formed for a public purpose and directors will take into account the interest of stakeholders, such as shareholders, employees, customers, suppliers, the environment, and the community in decision-making. The flexible purpose corporation, or “FlexC,” is similar to a benefit corporation and in addition provides the entity the opportunity to designate an additional purpose for which it is formed — its own special purpose in its organizing document.¹⁰¹

In California, retailer Patagonia became the first corporation to register as a Benefit Corporation. For Patagonia’s CEO, Yvon Chouinard, one of the primary reasons his company adopted Benefit Corporation status was the legal recognition of the company’s moral mission.¹⁰² “He was glad to know that his company, which had become his life’s work, would carry on long after him and would be able to stay true to the principles he instilled in it.”¹⁰³

While the legislative requirements governing Benefit Corporations may vary slightly between the states, the need to provide a general public benefit represents a common ground between them. It is this provision of a public benefit that has resulted in a call for tax benefits for Benefit Corporations. Parts III discusses the role of tax policy with regard to subsidizing charitable behavior and whether any such tax preferences or variations

⁹⁹ Bruce Edwards, *New Law Keeps with Vt’s Social Conscience*, RUTLAND HERALD, June 13, 2010, available at <http://www.vermonttoday.com/apps/pbcs.dll/article?AID=/RH/20100613/BUSINESS/100619977/-1/VBJ>.

¹⁰⁰ *Two New Types of Corporations Effective January 1, 2012*, CALIFORNIA SECRETARY OF STATE, <http://www.sos.ca.gov/business/be/forms/flexible-purpose-corp-and-benefit-corp.pdf> (last visited July 12, 2012).

¹⁰¹ *The New ABC’s of California Corporations*, KAYE & MILLS, <http://www.kayemills.com/articles/new-abcs-of-california-corporations.html> (last visited July 12, 2012).

¹⁰² Aiden Livingston, *To B or Not to B? Weighing the Benefits of Benefit Corporations*, MASHABLE, Mar. 2, 2012, <http://mashable.com/2012/03/02/benefit-corporations/>.

¹⁰³ *Id.*

thereof should be extended to Benefit Corporations.

III. THE ROLE OF TAX POLICY

“Taxes are the price we pay for a civilized society,”¹⁰⁴ is an oft quoted rationalization for the necessity of a broad based system of taxation. The tax structure plays a major role in shaping social issues. Tax structures in competitive political systems, such as that we have in the United States, are part of a political equilibrium.¹⁰⁵ Whether it is the tax incentives provided for homeowners that encourage home ownership, the accelerated depreciation deductions that encourage business investment, the deductions for charitable contributions that encourage charitable giving, the social security payments to ensure assistance in retirement, the progressive tax rates, or the excise taxes imposed on tobacco products that discourage such purchases, there is no doubt that tax policies shape society. “[C]ompetition between political parties for support from utility maximizing voters of differing political influence forces the government to choose a tax structure based on the loss in support — or, political costs — associated with different tax sources.”¹⁰⁶ For example, the federal budget debate over the most effective use of government resources has no doubt been shaped not only by the current economic downturn, but also by differences between the political parties.¹⁰⁷

A. Direct Spending vs. Tax Expenditures

Before looking specifically at the preferred tax status of nonprofit organizations, it is important to understand the broader tax structure within which that preference is expressed. The tax system is at the heart of the debate over the federal budget and the question of how to lead American out of its economic downturn. Faced with a deficit of \$15 trillion, lawmakers on both sides of the political aisle recognize that a valid budget initiative must include government spending cuts, although a consensus cannot seem to be reached on the where those cuts should be. And while the concept of direct spending is readily understood (e.g., government support

¹⁰⁴ The statement is attributed to Oliver Wendell Holmes from a speech given in 1904, and is engraved above the entrance to the IRS Headquarters in Washington D.C.

¹⁰⁵ Lawrence W. Kenny & Stanley L. Winer, *Tax Systems in the World: An Empirical Investigation into the Importance of Tax Bases, Administration Costs, Scale and Political Regime*, 13 INT’L TAX & PUB. FIN. 181 (2006).

¹⁰⁶ *Id.* at 4.

¹⁰⁷ *Federal Budget*, N.Y. TIMES, May 23, 2012, available at http://topics.nytimes.com/top/reference/timestopics/subjects/f/federal_budget_us/index.html?8qa.

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of Social Security and Medicaid), the term “tax expenditure,” which represents indirect government spending, is less well known. More commonly known as tax breaks or loopholes, tax expenditures are “departures from the normal tax structure . . . designed to favor a particular industry, activity, or class of persons.”¹⁰⁸

1. Understanding Tax Expenditures

The term “tax expenditure” is attributed to Stanley Surrey, former Assistant Secretary of the US Treasury for Tax Policy during the Kennedy Administration, who was convinced that some tax preference provisions in the Internal Revenue Code were essentially forms of government spending, although not treated as such for budget purposes.¹⁰⁹ He believed these provisions were favored by politicians to provide subsidies that might not otherwise be feasible if subject to the same scrutiny received by direct government spending programs.¹¹⁰ In 1967, Secretary Surry directed his staff to compile a list of the tax provisions that were in the nature of expenditures, and he advocated that production of such a list be incorporated as a mandatory annual requirement. In response to this, the Congressional Budget Act of 1974¹¹¹ requires the Administration to annually report tax expenditures as part of the annual budget submission. While these are included in the budget submission, interestingly, these expenditures do not impact budget/spending and the information on tax expenditures can only be found in the appendix to the submission. “In Washington, however, tax expenditures aren’t considered spending programs. They’re considered tax breaks.”¹¹²

Picking up on Surrey’s theme of the problem with tax expenditures, political scientist Chris Howard has dubbed these expenditures the “hidden welfare state.”¹¹³ To Howard, “the hidden welfare state illustrates a greater range of political possibilities for social programs in the United States than we are accustomed to seeing.”¹¹⁴ Since tax expenditures generally do not

¹⁰⁸ STANLEY S. SURRY & PAUL MCDANIEL, *TAX EXPENDITURES* 3 (1985).

¹⁰⁹ Jeffrey H. Kahn, *Personal Deductions: A Tax Ideal or Just Another Deal*, 2002 L. REV. MICH. ST. U. DETROIT C. L. 1 (2002).

¹¹⁰ *Id.*

¹¹¹ Congressional Budget Impound Control Act of 1974, Pub. L. No. 93-344, 88 Stat. 297 (1976).

¹¹² Brad Plumer, *Why You Should Care About Tax Expenditures*, WASH. POST, Sept. 1, 2011.

¹¹³ CHRISTOPHER HOWARD, *THE HIDDEN WELFARE STATE: TAX EXPENDITURES AND SOCIAL POLICY IN THE UNITED STATES* (1999).

¹¹⁴ *Id.* at 10.

undergo the same degree of analysis as direct spending, the criteria by which they are to be evaluated are often not clearly articulated resulting a certain level of ambiguity that shifts the costs of administration away from the government and on to individuals, corporations, and other parties.¹¹⁵ Suzanne Mettler, refers to tax expenditures as “the submerged state.”¹¹⁶ “Mettler contends that ‘the relative invisibility of tax expenditures undermines democracy because their relative obscurity makes it more difficult for citizens to understand how government programmes affect them. Lobbyists can sneak expensive ineffective subsidies into the tax code that would never pass muster as direct spending programmes — think ethanol tax credits.’”¹¹⁷ As a result of this, voters may not fully understand the cost of expenditures, allowing the government to be larger and more inefficient than might be permitted if citizens had full information.¹¹⁸

2. The Economic Effect of Tax Expenditures

The economic effect of tax expenditures is substantial. A recent National Bureau of Economic Research Working Paper states that based on Treasury estimates 2011 income tax expenditures by the federal government will amount to \$1.2 trillion.¹¹⁹ Overall, income tax expenditures amount to one-quarter of total spending.¹²⁰ Ranking number seven on a list of the ten largest tax expenditures in 2011 is the Charitable Deduction totaling \$43.9 billion.¹²¹

B. The Tax Preferred Status of Charitable Organizations

Tax-exempt organizations represent a significant segment of the national economy. In 2009, public charities reported \$1.4 trillion in revenue, \$1.4 trillion in expenses and \$2.53 trillion in assets, with the revenue of reporting public charities growing 36 percent over the decade,

¹¹⁵ *Id.* This shift in costs results from the ever-increasing time and cost associated with the complexity of the Tax Code.

¹¹⁶ Suzanne Mettler, *Reconstituting the Submerged State: The Challenges of Social Policy Reform in the Obama Era*, 8 PERSPECTIVES ON POLITICS 803 (2010).

¹¹⁷ Leonard Burman & Marvin Phaup, *Tax Expenditures: The Big Government Behind the Curtain*, VOX, Nov. 17, 2011, <http://voxeu.org/index.php?q=node/7287>.

¹¹⁸ *Id.*

¹¹⁹ Leonard E. Burman & Marvin Phaup, *Tax Expenditures, The Size and Efficiency of Government, and Implications for Budget Reform* (NBER Working Paper No. 17268, Aug. 2011).

¹²⁰ *Id.*

¹²¹ *Id.*

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their expenses growing 49 percent, and their assets growing 33 percent.¹²² Those exempt organizations that meet the statutory requirements of Internal Revenue Code § 501(c)(3)¹²³ receive two primary tax benefits: (1) exemption from taxation on their income associated with their exempt activities and (2) the ability to receive tax deductible contributions. “Most scholars agree that these tax benefits have contributed to the size and success of the charitable sector.”¹²⁴

An exempt organization includes:

Corporations, and any community chest, fund, or foundation, *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 (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, *no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided . . .), and which does not participate in, or intervene in* (including the publishing or distributing of statements), *any political campaign* on behalf of (or in opposition to) any candidate for public office.¹²⁵

Nonprofit organizations are either public charities or private

¹²² Katie L. Roeger, Amy Blackwood & Sarah L. Pettijohn, *The Nonprofit Sector in Brief: Public Charities, Giving and Volunteering, 2011*, URBAN INSTITUTE, <http://www.urban.org/UploadedPDF/412434-NonprofitAlmanacBrief2011.pdf>.

¹²³ Section 501(c)(3) represents the most widely known class of exempt organizations and will be the focus of this discussion. The Code also recognizes about thirty other categories of tax exempt entities. These other entities (with a few exceptions) are not eligible to receive tax deductible contributions.

¹²⁴ According to the most recent Statistics of Income released by the IRS in December, 2011, nonprofit charities exempt under 501(c)(3) reported nearly \$2.5 trillion in assets and over 1.4 billion in revenue for 2008. This report also shows steady and significant growth in this sector: cumulative growth of 118 percent between the tax years 1985 and 2007, compared to cumulative growth in the GDP of 67 percent. *Charities and Other Tax-Exempt Organizations*, IRS STATISTICS OF INCOME, <http://www.irs.gov/pub/irs-soi/11esgiftsnap.pdf> (last visited July 13, 2012).

¹²⁵ I.R.C. § 501(c)(3) (2012) (emphasis added).

foundations. Those that are public charities have more broad based public support than private foundations.

1. Organized for an Exempt Purpose

To qualify for tax exempt status under 501(c)(3) an organization must be organized for an charitable exempt purposes. Defining “charitable” for purposes of tax exemption has been the subject of much discussion. Commentators agree that Congress has not given any clear indication of the meaning of “charitable,”¹²⁶ although there is some support for the notion that the exemption broadly provides “benefits resulting from the promotion of the general welfare.”¹²⁷ While charitable goals have been broadly interpreted, “as a general rule such organizations must provide some type of “community benefit” in the form of fulfilling needs not being met by the private market.”¹²⁸ In the popular sense charitable has often been associated with relief for the poor and distressed.¹²⁹ However, the legal sense of the term, which is currently found in the Treasury Regulations and used for purposes of tax exemption, is much broader:

The term “charitable” is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of “charity” as developed by judicial decisions. Such term includes: Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile

¹²⁶ BRUCE R. HOPKINS, *THE LAW OF TAX EXEMPT ORGANIZATIONS* § 5.2 (8th ed. 2003); Lars F. Gustafsson, *The Definition of “Charitable” for Federal Income Tax Purposes: Defrocking the Old and Suggesting Some New Fundamental Assumptions*, 33 HOUS. L. REV. 587, 590 (1996).

¹²⁷ H.R. Rep. No. 1860, 75th Cong., 3d Sess. 19 (1938).

¹²⁸ Miranda Perry Fleischer, *Equality of Opportunity and the Charitable Tax Subsidies*, 91 B.U. L. REV. 601, 607 (2011).

¹²⁹ Hopkins, *supra* note 126, § 5.1.

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delinquency.¹³⁰

In addition to serving an exempt purpose the organization cannot act contrary to public policy. So, for example, private school, while serving an education purpose, will not qualify as charitable organization unless they adopt a racially nondiscriminatory admissions policy.¹³¹ “To meet the organizational requirement that entity’s article of incorporation must limit the purposes to one or more purposes within 501(c)(3); limit the organization’s powers to those that further its purpose(s); and contain a dissolution clause that distributes all assets upon dissolution to exempt purposes, to another 501(c)(3) organization, or to the federal or state government.”¹³²

2. Operated for an Exempt Purpose

The operational test requires that the organization be operated exclusively¹³³ for one or more exempt purposes. This standard is not met if more than an insubstantial part of its activities are not in furtherance of an exempt purpose. Even if the organization carries on a trade or business, this will be permissible if it furthers an exempt purpose. If the organization’s primary purpose becomes the furtherance of an unrelated trade or business, the organization risks loss of its exempt status.

3. Private Inurement and Private Benefit Prohibition

Private inurement is receipt by an organization insider of benefits not commensurate with that individual’s contribution to the entity (*e.g.*, unreasonable compensation). Receipt of more than an incidental private benefit by those who are not insiders is also prohibited, unless the benefit is received as part of the organization’s exempt activities. If an organization operates for the benefit of the creator of the organization, her family, or others associated with the organization the organization does not operate for an exempt purpose.¹³⁴ According to the legislative history, the language against private inurement was added to “provide assurance that the exemption for charities was limited only to those institutions that have no element of personal gain and that are exclusively devoted to exempt

¹³⁰ Treas. Reg. § 1.501(c)(3)-1(d)(2) (2012).

¹³¹ Rev. Proc. 75-50, 1975-2 C.B. 587.

¹³² FRANCES HILL & BARBARA KIRSCHEN, *FEDERAL AND STATE TAXATION OF EXEMPT ORGANIZATIONS* (1994).

¹³³ The word “exclusively” has been interpreted to mean “primarily.”

¹³⁴ *Am. Campaign Acad. v. Comm’r*, 92 T.C. 1053, 1065–66 (1989).

purposes.”¹³⁵

4. Political Activities

Charitable organizations may not engage in political activity such as participation in a political campaign. While the statutory law does not provide a specific amount of lobbying activities that may be conducted, charitable organizations may engage in such activities as long as they are not substantial.

C. Why Offer Tax Benefits To Charity?

“Despite the large role that charities play in our society and the long history of these provisions, no consensus exists as to the purpose of either tax exemption or the charitable deduction.”¹³⁶ The notion of preferred tax status for organizations with a social purpose or public mission is not unique to our modern tax system. As illustrated in Table 2, preferential tax treatment predates the passage of the 16th Amendment¹³⁷ in 1913.

Table 2—The Development of the Rules for Tax Exempt Organizations¹³⁸

ACT	TAX TREATMENT
Tariff Act of 1894	First statutory Federal income tax exemption for charitable organizations: “nothing herein contained shall apply to ...corporations...or associations organized and conducted solely for charitable, religious, or educational purposes.”
The Payne Aldrich Tariff Act of 1909	Exempted from corporate excise tax “any corporation or association organized and operated exclusively for religious, charitable, or educational purposes, no part of the income of which inures to the benefit of any private stockholder or individual.”

¹³⁵ 44 Cong. Rec. 4150 (1909) (remarks of Sen. Bacon).

¹³⁶ Miranda Perry Fleischer, *Theorizing Charitable Tax Subsidies: The Role of Distributive Justice*, 87 WASH. U. L. REV. 505, 514 (2010).

¹³⁷ U.S. CONST. amend. XVI.

¹³⁸ Joint Committee on Taxation, *Historical Development and Present Law of the Federal Tax Exemption for Charities and Other Tax-Exempt Organizations*, Apr. 19, 2005, https://www.jct.gov/publications.html?func=download&id=1586&chk=1586&no_html=1.

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Tariff Act of 1913	Exempts from Federal income tax “any corporation or association organized and operated exclusively for religious, charitable, scientific, or educational, no part of the net income of which inures to the benefit of any private shareholder or individual.”
1917 Income Tax Act	Charitable contribution deduction added for contributions to organizations and associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children and animals.

1. The Case for Tax Benefits

There are a variety of rationales offered for the tax benefits received by nonprofit organizations. Those most commonly cited are (1) administrative difficulties of imposing a tax (2) nonprofits provide public goods and services that would otherwise have to be provided by the government; (3) nonprofits promote pluralism; and (4) nonprofits are efficient providers but have limited access to capital.

a. Administrative Concerns

Boris Bittker and George Rahdert support the tax exemption for nonprofits, in part, based on the administrative infeasibility of calculating adjusted gross income for these organizations. “Though differing in form and in the boundaries of their permissible activity, all exempt organizations engaged in public service activities share one common feature: if they were deprived of their exempt status and treated as taxable entities, computing their ‘net income’ would be a conceptually difficult, if not self-contradictory task.”¹³⁹ According to Bittker and Rahdert, this difficulty results from the legal and accounting principles by which adjusted gross income is calculated because those principles are based on the fact that the organization operates under a profit motive. For example, there is an issue of whether dues and contributions would be the considered gifts or business income and on the expenditure side there is an issue whether the expenses for the conduct of the organization’s activities, would be deductible as ordinary and necessary expenses or nondeductible since they were not spent

¹³⁹ Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 307 (1976).

in furtherance of a profit motivated activity.¹⁴⁰ Even if this income could be measured, Bittker and Rahdert assert it would be difficult to set tax rates on this income since this tax would ultimately be paid by the nonprofit's beneficiaries.¹⁴¹ "If the game of taxing charities were to be played, the predictable losers would be the beneficiaries."¹⁴² Henry Hansmann is one scholar who has taken issues with these conclusions on the grounds that most income of nonprofits comes, not from contributions, but from the sale of goods or services and even if such income came from contributions, making a matching of expenses and income less complex than perhaps Bittker and Rahdert suggest.¹⁴³

b. The Public Benefit and Relief of a Government Burden

One of the most compelling reasons supporting the federal tax benefits for nonprofit organizations is that these organizations produce public goods, goods that provide a public benefit.¹⁴⁴ These goods or services can either be considered inherently good or can be provided to those who are in need.¹⁴⁵ "Charities provide primary public benefits in two ways; especially good goods to ordinary people, and ordinary goods to the especially deserving."¹⁴⁶ In a thin market, "demand for a product is so small that no commercial firm could make a profit selling it. Because of their subsidies which artificially lower costs, nonprofits can serve such a market."¹⁴⁷ Jurists have recognized the value of this function as well. In a concurring opinion in a case involving a New York tax exemption, Supreme Court Justice Brennan stated that, "private, nonprofit organizations contribute to the well-being of the community . . . and thereby bear the burdens that would otherwise have to be met by general taxation, or be left undone, to the detriment of the community."¹⁴⁸ "[T]he government is compensated for the loss of revenue by its relief from financial burdens which would otherwise have to be met by appropriations from other public funds."¹⁴⁹

¹⁴⁰ Rob Atkinson, *Theories of the Federal Income Tax Exemption for Charities: Thesis, Antithesis, and Syntheses*, 27 STETSON L. REV. 395, 409 (1997).

¹⁴¹ Bittker & Rahdert, *supra* note 139.

¹⁴² Atkinson, *supra* note 140.

¹⁴³ Henry B. Hansmann, *The Rationale for Exempting Nonprofits from Federal Income Taxation*, 91 YALE L.J. 54 (1981).

¹⁴⁴ *See id.*

¹⁴⁵ Atkinson, *supra* note 140, at 402.

¹⁴⁶ *Id.*

¹⁴⁷ JAMES T. BENETT & THOMAS J. DiLORENZO, UNFAIR COMPETITION: THE PROFITS OF NONPROFITS 26 (1989).

¹⁴⁸ *Walz v. Tax Comm'n of the City of N.Y.*, 377 U.S. 664 (1970).

¹⁴⁹ H.R. Rep. No. 75-1860, 75th Cong., 3d Sess., at 19 (1938). *See also* Fleischer,

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Scholars also acknowledge the possibility of market failure. In order for a market to operate efficiently, ideally consumers would be able to assess the quality of goods or services prior to purchase. In instances where this is not possible, a for-profit entity may have incentive to curtail quality to enhance profits whereas a nonprofit that is unable to distribute net earnings does not have the same incentive to lower quality. This results in a public perception that goods provided by a nonprofit are of higher quality.¹⁵⁰

c. Promoting Pluralism

Pluralism is another often cited rationale for the tax exemption of nonprofits. “[T]he promotion of a healthy pluralism is often viewed as a prime social benefit of general significance.”¹⁵¹ Advocates of this theory “emphasize the role that charities play in providing creative and diverse solutions to society’s problems in offering alternative viewpoints in the arts and culture, in countering government power, and . . . enhancing experimentation.”¹⁵² Having a charitable deduction in place allows the individual taxpayer to be more engaged in deciding which projects should receive support thereby likely increasing the individual’s commitment to that particular project.¹⁵³

d. Limited Ability to Raise Capital

Hansmann was one of the first to apply an economic subsidy based argument for tax exemption.¹⁵⁴ Relying on economic theory, Henry Hansmann concluded that the prohibitions against private inurement and distributions of net earnings make it difficult for nonprofit organizations to attract capital.¹⁵⁵ Their inability to raise adequate capital, maintains Hansmann, prevents them from operating as efficiently as possible. In addition, Hansmann asserts that nonprofits are also susceptible to contract

supra note 136; JOHN D. COLUMBO & MARK A. HALL, THE CHARITABLE TAX EXEMPTION (1995); Hansmann, *supra* note 143.

¹⁵⁰ While this issue is beyond the scope of this article, interested readers may wish to consult BENNET & DiLORENZO, *supra* note 147 and Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980), for consideration of whether the higher quality perception represents reality.

¹⁵¹ *Green v. Connally*, 330 F. Supp. 1150, 1162 (D.D.C.), *aff’d sub nom. Colt v. Green*, 404 U.S. 997 (1971).

¹⁵² Fleischer, *supra* note 128, at 610.

¹⁵³ *Id.* at 613 (citing Saul Levmore, *Taxes as Ballots*, 65 U. CHI. L. R. 387 (1998)).

¹⁵⁴ Fleischer, *supra* note 128.

¹⁵⁵ Hansmann, *supra* note 143.

failure, meaning for example, that donors pledging an amount to an organization for a specific purpose could not verify whether, in fact, the funds were put toward that purpose. In Hansmann's view the tax exemption afforded to nonprofit organizations served as a necessary subsidy to help negate these detriments. Taking the view that the contract failure was the key for obtaining the subsidy allowed Hansmann to support the subsidy without reference to the merits of the goods or services provided.¹⁵⁶

D. Why Subsidize Charity Through the Tax System?

Even if one agrees with the notion that charities play a vital role in our society and are, therefore, entitled to tax benefits, a more interesting question remains: should this government support be channeled through the tax system? As explained at the start of this Part, government support generally takes the form of direct spending or tax expenditures. Which method is more effective is open for debate.

It should be noted that not all scholars agree with the underlying assumption made here that charitable contributions are tax expenditures. One such scholar is Professor Kahn. Professor Kahn views charitable contributions, not as tax expenditures, but as tax neutral.¹⁵⁷ For Kahn, this conclusion stems from the most commonly used definition of income, the Haig-Simmons definition: "a person's income equals the amount of increase in wealth accumulated by that person during a specified period (usually one year) plus the market value of the person's consumption during the year."¹⁵⁸ In reaching his conclusion, Professor Kahn first details the two principle opposing viewpoints on this issue expressed by Professors Andrew and Kelman. Professor Andrews argues that charitable contributions should not be treated as personal consumption because they benefit a larger group than the person making the contribution.¹⁵⁹ Since the taxpayer is not consuming or accumulating the donated money, the taxpayer should not be subject to taxation on it.¹⁶⁰ Professor Kelman maintains that contributors obtain extensive private benefits from a charitable contribution and this should not escape taxation just because there is a public benefit as well.¹⁶¹ Unless the

¹⁵⁶ Fleischer, *supra* note 128.

¹⁵⁷ Kahn, *supra* note 109.

¹⁵⁸ HENRY C. SIMONS, *PERSONAL INCOME TAXATION* 50 (1980).

¹⁵⁹ William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972).

¹⁶⁰ *Id.*

¹⁶¹ Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an Ideal Income Tax and Why They Fit Worse in a Far From Ideal World*, 31 STAN. L. REV. 831

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gift was anonymous, a charitable gift can enhance the donor's standing in the community.¹⁶² Reconciling the two viewpoints, Professor Kahn maintains that if the public benefit of a gift is substantial, this should be a tax neutral event; to the extent the donation provides a private benefit to the donor opens up a question of whether the contribution deduction should be permitted.

Despite some concerns with the implications of tax expenditures, several arguments have been advanced in favor of maintaining the current system of charitable deductions as opposed to relying on direct government grants. Proponents of this view primarily rely on efficiency, pluralism, and donative theory to support their position.¹⁶³ Allowing a deduction for charitable contributions is more efficient than direct grants because direct grants would likely require a broad based income tax increase which might not be in proportion to how much a taxpayer values the good or service being subsidized.¹⁶⁴ This method does not require value-based judgments, with the only inquiry being whether the entity provides public goods or service.¹⁶⁵ Allowing taxpayers to have a say in which projects to fund, as opposed to having the government direct such efforts, enhances pluralism and often results in a greater commitment by the individual to the project.¹⁶⁶ The donative intent behind voluntary contributions to charitable organizations is also considered an indication of a good or service being undersupplied either in the market or by the government, and thus in need of a subsidy.¹⁶⁷

E. Tax Benefits and the Benefit Corporation

Given the Benefit Corporation's mission of people, planet, and profit, it is not surprising that there have already been calls for special tax treatments for these corporations.¹⁶⁸ At present, these organizations receive no federal

(1979).

¹⁶² *Id.*

¹⁶³ Fleischer, *supra* note 136.

¹⁶⁴ Mark Gergen, *The Case for a Charitable Contribution Deduction*, 74 VA. L. REV. 1393 (1988).

¹⁶⁵ Fleischer, *supra* note 136.

¹⁶⁶ Levmore, *supra* note 153.

¹⁶⁷ Columbo & Hall, *supra* note 149.

¹⁶⁸ Andrew Kassoy, co-founder of B-Lab has stated that the goal "will be to use this new corporate platform for states or municipalities or federal governments to offer procurement, investment, or tax incentives for benefit companies. So in the dream scenario when you have companies obligated to create public benefits you can measure the externalities those companies are internalizing and say they should be taxed at a lower rate

or state tax benefits similar to those available to charitable organizations, although there are signs that these may be on the road ahead. For example, the first sign is a tax concession for a for-profit B Corporation branded entity (a B Corp.) at the local level was adopted in 2009, when Philadelphia became the first city in the nation to provide a financial incentive for sustainable businesses. For 2012 through 2017, twenty-five eligible B-Lab corporations meeting sustainability standards will receive a \$4,000 tax credit against the Business Privilege Tax.¹⁶⁹

1. The blurring lines between nonprofit and for-profit entities

For-profit, social enterprises are increasingly stepping into roles traditionally held by the government or nonprofit sector, fully willing to put public mission above profitability. Take, for example, Google.org, the philanthropic arm of Google created as a for-profit entity. It is considered for-profit because Google.org is free to distribute its profits, but it is nonprofit in its mission because its central mission is meeting societal needs rather than profit maximization. Google's announcement of its creation of a for-profit charity caused mixed reactions both within and outside of the nonprofit sector.¹⁷⁰ As observed by Malani and Posner, "The problem with for-profit charities is that they forfeit all the state and federal tax benefits available to nonprofit charities. So, even if Google is successful, Google may be reluctant to increase funding of the entity and they may have difficulty raising funds from donors because a tax deduction is not available. . . . If it turns out that Google's charitable efforts benefit poor

than a C corporation." *The B Corporation: A Business Model for the New Economy*, CAPITAL INSTITUTE, <http://www.theimpactinvestor.com/b-corp-model-rewrites-the-c.html> (last visited July 12, 2012).

¹⁶⁹ PHILADELPHIA, PA., CODE § 19-2600 (2009).

¹⁷⁰ Some are skeptical of the long-term ability to maintain its dedicated funding. *See, e.g.,* Katie Hafner, *Philanthropy Google's Way: Not the Usual*, N.Y. TIMES, Sept. 14, 2006 ("The money is at the beck and call of the board of directors and shareholders," said Marcus S. Owens, a tax lawyer in Washington who spent a decade as director of the exempt organizations division of the Internal Revenue Service. "It's possible the shareholders of Google might someday object, especially if we go into an economic depression and that money is needed to shore up the company."); Christopher Quay, *Non-Profit Sector Has Mixed Reactions to Google's For-Profit Charity*, TAX NOTES TODAY, Sept. 15, 2006 (Richard Cohen, executive director of the National Committee for Responsive Philanthropy, said, "While Google may have only the best of intentions and the highest ethical standards, the notion that philanthropy can be run, not like a business, but as a business, leads to questions of reporting, accountability, and oversight that are pretty daunting for the philanthropic sector." Diana Aviv, president and CEO of Independent Sector, was more optimistic, "There is a big difference between for-profit companies and nonprofit organizations. . . . I think it's great that Google is going to work in both spheres and harness the good in both.").

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countries more effectively than those of nonprofits with similar missions, why should the tax code steer donors to the nonprofits rather than to Google?”¹⁷¹

2. Concerns of Unfair Competition

Questions about the validity of the extent of nonprofit tax benefits are not new. “In response to growing complaints about unfair competition arising from special privileges accorded nonprofit organizations, the U.S. Small Business Administration has identified unfair competition as “an issue for the 1980s.”¹⁷² Instances of unfair competition date back as far as 1874 when the Metropolitan Museum of Art in New York City began to sell photos of museum paintings to the public.¹⁷³ New York University’s receipts of ownership of the Mueller Macaroni Company in the 1940s’, resulting in Mueller’s nonprofit status sparked concerns of unfair competition that led to the adoption of the unrelated business income tax in 1950.¹⁷⁴

3. A Level Playing Field

a. Nonprofits are Unfairly Limited

While those concerned with unfair competition generally focus on the potential subsidies provided to commercial nonprofits, self-described activist and entrepreneur, Dan Pallotta, approaches the inequity on the playing field from a difference perspective. Mr. Pallotta questions the need for a nonprofit ideology and believes that the economic constraints on nonprofits undermine their effectiveness and potential. He therefore advocates allowing nonprofits the ability to raise capital from investors. In his view, “[n]onprofit ideology disrupts the natural tendency of people to solve problems. People see the urgent need of the needs of the world’s most helpless citizens but they are denied the proper economic incentives . . . to make them willing to devote their lives to meeting them.”¹⁷⁵

¹⁷¹ Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2020 (2007).

¹⁷² BENNETT & DILORENZO *supra* note 147, at 9 (citing Small Business Administration, *Unfair Competition by Nonprofit Organizations with Small Business an Issue for the 1980s* (3d ed. 1984)).

¹⁷³ *Id.* at 1–2 (citing Edward Skloot, *Should Not-For-Profits Go Into Business?*, HARV. BUS. REV. 20 (1983)).

¹⁷⁴ *Id.* at 2.

¹⁷⁵ DAN PALLOTTA, UNCHARITABLE (2008).

b. For-Profit Charities Unfairly Denied Tax Benefits

More recently scholars have begun to call for a reassessment and expansion of the tax benefits provided to nonprofits into the for-profit social enterprise sector. Relying on the example of Grameen Bank,¹⁷⁶ Hadley Rose has called for an expansion of Code § 501(c)(3) to include social enterprises formed to meet both social and economic goals.¹⁷⁷ Malani and Posner argue that nonprofit form should not be a prerequisite to tax subsidies. With a focus on the social benefits that for-profit social enterprises achieve, they conclude that any tax subsidies made available to nonprofit organizations should be available to social enterprise. In discussing this “Public Goods Theory,” Professors Malani and Posner note that, “The theory does not justify giving such tax breaks exclusively to nonprofit firms that produce public goods. If the theory is correct, the tax deduction for charitable contribution should be made available to any firm — for profit or nonprofit — that engages in appropriate activities that benefit third parties.”¹⁷⁸ From the perspective of a “public goods theory” there may be some validity to their conclusions, but their error becomes clear when the focus shifts to the nature of the nonprofit entity exemption.

4. In Defense of the Nonprofit Distinction

While double bottom line and triple bottom line for-profit enterprises undeniably have a focus on providing a benefit to society, focusing too much on the social mission of these businesses without further assessing the lack of restrictions on their activities can cause one to incorrectly conclude that Benefit Corporations should receive tax benefits.

Tax benefits for Benefit Corporations are inadvisable for three reasons: (1) It is by no means certain that the purposes of the Benefit Corporation will dovetail with those in Code section 501(c)(3) and accompanying regulations; (2) Benefit Corporations do not operate under the same distribution and private inurement restrictions as nonprofit organizations; and (3) Extending nonprofit tax benefits to for-profit Benefit Corporations will undermine the efforts of the charitable sector.

¹⁷⁶ Grameen Bank is an independent bank that has achieved remarkable results in Bangladesh as a result of its microlending activities. Hadley Rose points out that if the bank were operated under United States charity law, its nonprofit status would be in jeopardy.

¹⁷⁷ Hadley Rose, Comment, *The Social Business: The Viability of a New Business Entity Type*, 44 WILLAMETTE L. REV. 131 (2007).

¹⁷⁸ Malani & Posner, *supra* note 172.

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a. The Exempt Purpose

As explained more fully in Part III B, the operational tests require that the nonprofit be operated exclusively for one or more exempt purposes. “Exclusively” has been interpreted to mean “primarily” and a nonprofit organization can carry on a substantial amount of commercial activity as long as the organization’s primary purpose is not to carry on an unrelated trade or business. A look at the Maryland Benefit Corporation statute is instructive on this point. The statute includes a requirement that the charter “identify as *one* of the purposes of the benefit corporation the creation of certain specific public benefits”¹⁷⁹ Glaringly absent is any hint at a limitation on those activities which will not further a general or specific public benefit. Such a limitation is a hallmark of a nonprofit enterprise. Without some limitation, taxpayers would subsidize not only the public benefits created by the Benefit Corporation, but also those activities not producing a public benefit and instead engaged in purely for-profit driven reasons.

b. Distribution Restrictions

The net earnings of a nonprofit organization cannot inure to the benefit of any organizational insider. Even those who are not insiders cannot receive any substantial benefit from the nonprofit unless those benefits are received in furtherance of the organization’s exempt activities. Also, as explained in Part III B, upon dissolution of a nonprofit organization the assets must be distributed in furtherance of an exempt purpose or to a federal or state government. What distribution requirements are imposed on the Benefit Corporation? A look at the Vermont Benefit Corporation statute is instructive. A review of the statute uncovered no limitations on the discretion of the directors in paying out the net profits of the corporation. Apart from the general fiduciary duties of corporate law on the action of directors, directors can allocate net profits as they think best. Also instructive is the way in which Benefit Corporation status can be terminated. “A corporation whose status as a Benefit Corporation terminates shall immediately become subject to the obligations and rights of a general corporation.”¹⁸⁰ As explained in Part II, this simply requires a two-thirds vote of shareholders. Upon termination or conversion back to a C Corporation there is no requirement that proceeds be distributed in furtherance of an exempt purpose. On termination such proceeds will revert

¹⁷⁹ VT. STAT. ANN. tit. 11A, § 21 (2012).

¹⁸⁰ *Id.*

to the shareholders, and upon conversion to a C Corporation these assets will presumably be rolled over into the C Corporation.

Without distribution restrictions, the tax preference rationale based on the nonprofits limited ability to raise capital would cease to apply. Dana Brakman Reiser has aptly termed the need of a charity to focus on benefits provided to others and the restrictions on distributions as “other-regarding orientation.” She views this as an essential element of charity law.¹⁸¹ As currently drafted, the Benefit Corporation legislation fails this standard.

c. Undermining the Charitable Sector

With the continued growth of the charitable sector, the nonprofit arena remains a competitive environment. Economic recession resulting in rising unemployment and less discretionary income has had negative implications for the charitable sector. Financial pressures on state and local governments have caused some taxing authorities to reconsider the tax preferences offered to nonprofit organizations. “Given the degree of competition in the nonprofit sector, greater entry by for-profits cannot be expected to enhance the degree of competition meaningfully, instead changing its nature to something less consistent with what is envisioned by granting public support to charity and its providers.”¹⁸²

CONCLUSION

In a time of increasing calls for corporate social responsibility, the hybrid corporate entity seems to provide the ideal vehicle for allowing a socially-minded entrepreneur the latitude to put social mission and stakeholders ahead of the financial bottom line for shareholders. The notion of joining for-profit and nonprofit motivation is not a new one. The evolution of the Benefit Corporation has been a gradual process. Even among those who agree on the positive social value of Benefit Corporations, a question remains as to whether these entities should also be extended the tax benefits enjoyed by nonprofit organizations. The failure of Benefit Corporations to meet the long-standing requirements imposed on nonprofit organizations leads to the conclusion that Benefit Corporations, as currently designed, do not warrant special tax treatment.

¹⁸¹ Dana Brakman Reiser, *Charity Law's Essentials*, 86 NOTRE DAME L. REV. 1 (2011).

¹⁸² James R. Hines, Jill R. Horwitz & Austin Nichols, *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179, 1219 (2010).