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Using Nonprofits to Serve Charitable Goals of Social Businesses in the United States: Circumventing the Lack of Recognition of the Social Business Model in the Federal Tax Code

Gautam Jagannath*

I. Introduction

Is the pursuit of profit always contrary to the public good?¹ Social businesses are for-profit businesses focused on pursuing their charitable goal rather than maximizing profits.² Often, they cater solely to their social mission. These social enterprises opt to maximize their social benefit while nevertheless producing a profit.³ One area in which social businesses have garnered attention is microfinance. In 2005, the *New York Times* reported that there were less than three hundred American-based microfinance companies offering microloans.⁴ Today, the ubiquity of microfinance is evidenced by the measure of social concern for the so-called “indigent third-world.”⁵ However, the burgeoning excitement

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1. Darryll K. Jones, *Restating the Private Benefit Doctrine for A Brave New World*, 1 NW. J. TECH. & INTELL. PROP. 1, 4 (2003).

2. See Muhammad Yunus, Founder, Grameen Bank, 2006 Nobel Peace Prize Lecture (Dec. 10, 2006), available at http://www.nobelprize.org/nobel_prizes/peace/laureates/2006/yunus-lecture-en.html#.

3. *What Is Social Enterprise?*, SOC. ENTERPRISE ALLIANCE, <https://se-alliance.org/what-is-social-enterprise> (last visited Nov. 23, 2011). This form of business is quite old—predating capitalism—and has origins in the natural economy vis-à-vis bartering.

4. Amy Zipkin, *For Some, a Little Loan Goes a Long Way*, N.Y. TIMES, Dec. 22, 2005, at C5.

5. See Kentaro Toyama, *Lies, Hype and Profit: The Truth About Microfinance*, ATLANTIC (Jan. 28, 2011, 11:07 AM), <http://www.theatlantic.com/business/archive/2011/01/lies-hype-and-profit-the-truth-about-microfinance/70405/>.

about microfinance raised an issue in American law: is the industry charitable and should it be considered tax-exempt?⁶ In considering the value of these organizations, it should be noted that, while microlending organizations represent a form of social business, they are certainly not the final solution to poverty.⁷ As states only recently begin to recognize social enterprise, the United States federal government is still stuck with traditional notions of charitable entities.⁸

Social enterprise is older than microfinance and is ubiquitous albeit unrecognized.⁹ Literally hundreds of companies are operated as social businesses in America.¹⁰ Nobel Laureate Muhammad Yunus of the Grameen Bank contributed to, but did not “create,” the social enterprise business model.¹¹ Examples from recent times are varied and diverse, including diners, rural clinics, start-ups, and public corporations.¹² There is a strong potential for these companies to do good, and even perhaps change the face of capitalism.¹³ While this may be the case, the legal separation between nonprofits and for-profits continues to enforce the stale notion that they cannot be interrelated.¹⁴ Legislators have fixed notions about what a nonprofit should do, and do not see for-profit values as being an essential part of a nonprofit business model. As a

6. Kiva, for example, is an American based microfinance corporation that is wholly based upon individual contributions and does not itself earn any interest. *See About Us*, KIVA, <http://www.kiva.org/about> (last visited Nov. 23, 2011).

7. *See* Rashmi Dyal-Chand, *Reflection in a Distant Mirror: Why the West Has Misperceived the Grameen Bank's Vision of Microcredit*, 41 STAN. J. INT'L L. 217 (2005).

8. Stephanie Strom, *A Quest for Hybrid Companies that Profit, but Can Tap Charity*, N.Y. TIMES, Oct. 12, 2011, at B1.

9. Julia Taylor Kennedy, *A Conversation with Microfinance Pioneer Susan Davis*, POL'Y INNOVATIONS (Jul. 5, 2011), <http://www.policyinnovations.org/ideas/audio/data/000615>.

10. John Tozzi, *America's Most Promising Social Entrepreneurs 2011*, BUS. WK. (Jun. 22, 2011, 2:24 PM), http://www.businessweek.com/smallbiz/content/jun2011/sb20110621_158462.htm.

11. This is not to diminish the fact that Yunus is a key actor in modern microfinance. *See* Yunus, *supra* note 2.

12. *See* DENNIS R. YOUNG, SOCIAL ENTERPRISE IN THE UNITED STATES: ALTERNATE IDENTITIES AND FORMS (2001), *available at* http://www.community-wealth.org/_pdfs/articles-publications/social/paper-young.pdf. Apparently, even Ben & Jerry's Homemade, Inc. was at one time a social business. *Id.* at 5.

13. Muhammad Yunus et al., *Building Social Business Models: Lessons from the Grameen Experience* 22 (HEC Paris, Working Paper No. 913, 2009).

14. *See e.g.*, P.L.L. Scholarship Fund v. Comm'r, 82 T.C. 196, 200 (1984); I.R.S. Priv. Ltr. Rul. 201115026 (Jan. 19, 2011).

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result, social businesses live on the fringe of American corporate law.¹⁵

Social businesses are organized as traditional for-profit organizations, such as corporations. This is the reality because limitations would befall them if they were organized as tax-exempt organizations.¹⁶ One such problem recognized by social business owners is that exempt organizations are limited by their operating budgets.¹⁷ Unlike social businesses, nonprofits tend to be dependent on charitable donations for a large percentage of their work.¹⁸ The social business is not constrained in this manner through the Internal Revenue Code (IRC) because it is legally indistinguishable from any other for-profit.¹⁹ While this provides great freedom for the social business, it is also unfortunate because social businesses are not conferred any tax benefits or incentives for the public service they perform.²⁰ While the concept of the social business is quite novel in American law, its potential is so high that it should be rapidly embraced by the business sector. The problem lies only in the implementation.

If social businesses were tax exempt, they would nevertheless be taxed under federal tax law. This is because of the Unrelated Business Income Tax (UBIT) rules, as well as the Excess Benefit Tax (EBT), which seek to keep enterprises in line with their charitable goals.²¹ Social businesses are not bound by the non-distribution rule, can expand operations, and their executives are able to reap the financial rewards of productivity.²² This level of discretion would be unacceptable for federal tax-exempts. Accordingly, social businesses are wary about taking on the risk of becoming an exempt, which includes liability. Such businesses do not desire heightened governmental scrutiny arising from seeking exempt

15. MUHAMMAD YUNUS, BUILDING SOCIAL BUSINESS: THE NEW KIND OF CAPITALISM THAT SERVES HUMANITY'S MOST PRESSING NEEDS 117 (2010).

16. See Marci Alboher, *A Social Solution, Without Going the Nonprofit Route*, N.Y. TIMES, Mar. 4, 2009, at B5. See also James R. Hines, Jr. et al., *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179 (2010) (discussing the implications of offering nonprofit benefits to socially active for-profit organizations).

17. Shelly Banjo, *Report Faults Nonprofits on Service*, WALL ST. J., Nov. 4, 2010, at A28.

18. Yunus, *supra* note 2.

19. Social businesses are organized just like any other for-profit, generally in a corporate form.

20. See generally FAQs, YUNUS & YOUTH TUBE, http://yytube.net/index.php?option=com_jefaq&view=faq&Itemid=57 (last visited Nov. 23, 2011).

21. Hines et al., *supra* note 16, at 1190.

22. YUNUS & YOUTH TUBE, *supra* note 20.

status.

As a result, nonprofit exempt organizations are not a suitable business vehicle to pursue the desires of social enterprise.²³ Social businesses generally require tremendous capital, have large cash flows, and perform a wide variety of services, including the sale of goods and offering of services unrelated to their charitable goals.²⁴ Naturally, these activities fall squarely within the goals of traditional corporations.²⁵ These activities, while ultimately leading to charitable purposes, do not necessarily do so within the meaning of the IRC's exclusive charitable activity requirement.²⁶ One way to characterize many social businesses is that they are companies that would have qualified as tax-exempt organizations under the old income destination test that was eliminated over a half century ago.²⁷ Since that time, although social businesses persist, Congress has not developed a way to recognize and reward for-profit social enterprise in the tax code. Entrepreneurs have devised alternative, self-regulating business models to accomplish the beneficial aspects of obtaining tax-exempt status.²⁸ They have also sought non-tax benefits of social entrepreneurship, which include a competitive advantage.²⁹ However, if social business truly act charitably then they should be conferred some tax advantages as well.

This Article considers the possibility of reincorporating a social

23. YUNUS, *supra* note 15, at 120.

24. Yunus' Grameen Bank is an example, having approximately 1.7 billion dollars in revenue in 2010 (stemming largely from private sources, especially in its early days). See *Balance Sheet of Grameen Bank (1983-2010) in USD*, GRAMEEN BANK, http://www.grameen-info.org/index.php?option=com_content&task=view&id=179&Itemid=424 (last visited Nov. 23, 2011).

25. As one social business manager has noted, the social business can sometimes perform profit-maximizing activities easier because actors are invested in the social cause. See Rodney Schwartz, *Is There an Alternative to the Big Society?*, TELEGRAPH (Feb. 17, 2011, 6:29 PM), <http://www.telegraph.co.uk/news/politics/8331664/Is-there-an-alternative-to-the-Big-Society.html>.

26. I.R.C. § 501(c)(3) (West 2011).

27. See Revenue Act of 1950, Pub. L. No. 81-814, § 301, 331, 64 Stat. 906, 947, 957 (1950) (codified as amended in scattered sections of 26 U.S.C.).

28. B-corporations are examples of such businesses. See CERTIFIED B CORP., <http://www.bcorporation.net/> (last visited Nov. 23, 2011). Also notable are L³Cs (low-profit limited liability companies), which are rapidly increasing in popularity. See AMS. FOR COMMUNITY DEV., <http://www.americansforcommunitydevelopment.org/> (last visited Nov. 23, 2011).

29. *Enterprises See a Competitive Advantage in Social Responsibility*, INTER-AMERICAN DEV. BANK (Dec. 2, 2009), <http://www.iadb.org/en/news/news-releases/2009-12-02/enterprises-see-a-competitive-advantage-in-social-responsibility,6023.html>.

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business as a tax-exempt nonprofit. An analysis of the costs and benefits is performed with an eye toward federal tax law. First, I discuss the potential problems with running a social business as an exempt nonprofit. There are federal regulations that get in the way of making this a savvy decision. Second, I posit that a social business can benefit from devising a parallel exempt organization with similar or identical charitable goals. There are a few ways to do this and I consider the pros and cons. Finally, I consider the practical hurdles that social businesses face by maintaining and operating tax-exempt organizations within the context of how social businesses have positive consequences for global development.

II. The Framework

In order to follow through with the analysis, this Article envisions a hypothetical social business that (1) purchases relatively low-cost goods (“goods”) produced by low-income producers (“producers”) substantially above the prevailing market rate; (2) sells these goods in a new, comparatively affluent market for a substantial profit; and (3) returns a vast majority of these profits back to indigent suppliers by providing a growing, consistent revenue stream of purchases (“reinvestment”). In other words, the charitable purpose of the social business is to loyally provide a monopsony for goods at a higher return for the producers. Essentially, this reinvestment spurs development and leads to economic growth for the producers.

Depending on how such a framework is implemented, the sale of goods might not necessarily deviate substantially from the charitable purpose of the organization.³⁰ This means that some social businesses could qualify for a tax exemption without incurring UBIT. However, this would be unlikely and the problem looms for many social businesses that engage in unrelated trade or business or simply raise capital.³¹ Substantial deviations from the exempt purpose would create a major problem if the social business was an exempt.³²

30. See § 513. See also Treas. Reg. § 1.513-1(d) (1983).

31. See Hadley Rose, Comment, *The Social Business: The Viability of a New Business Entity Type*, 44 WILLAMETTE L. REV. 131, 142 n.74 (2007).

32. Indeed, it would threaten the exempt status of the organization. See discussion *supra* Part I.

III. Can a Social Business Be a Federal Tax-Exempt Nonprofit?

I only consider nonprofits to be those that have qualified, sought, and obtained exempt status under IRC 501(c)(3) as public charities. Although exemption from taxes is a major, if not sole, factor in seeking exempt status, not all nonprofits qualify for or obtain the special tax exemption.³³ Those that do not obtain exemption unfortunately cannot benefit from the crux of this Article.

In order to become tax-exempt IRC 501(c)(3) public charities, there are several requirements social businesses must meet.³⁴ Paperwork and patience form the bulk of it. While state law is what governs nonprofit status, a separate application governs the exemption conferred by the federal government. An exempt can pool and spend money more efficiently toward its charitable goal.³⁵ Controversially, the exemption has been thought of as a subsidy to companies that are doing “good” for American society.³⁶ While a wonderful concept, little legislative history exists to back this claim.³⁷ Tax exemptions have also consistently been thought of as a privilege or boon given by the federal government.³⁸ There are also state tax benefits that arise from being organized as a nonprofit under state law.³⁹ This often includes exemption from sales tax, which can boost revenue.⁴⁰

This Article will compare social businesses with what they could become—501(c)(3) public charities. If this were possible or beneficial

33. There is no special requirement that compels a nonprofit to obtain federal tax-exempt status. Presumably many nonprofits, which are stripped of (or never qualified for) exempt status, continue to operate under state nonprofit law. See *A Short Guide to Vermont's Nonprofit Corporations Law*, VT. SECRETARY OF ST., <http://www.sec.state.vt.us/tutor/dobiz/noprof/noprofex.htm> (last visited Nov. 23, 2011).

34. § 501(c)(3).

35. ANTHONY MANCUSO, *HOW TO FORM A NONPROFIT CORPORATION IN CALIFORNIA* 6 (Diana Fitzpatrick ed., 13th ed. 2009).

36. Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 301 (1976).

37. *Id.* at 303.

38. *Id.* at 342.

39. See, e.g., *Non-Profit/Exempt Organization*, CAL. TAX SERVICE CENT., <http://www.taxes.ca.gov/exemptbus.shtml/> (last visited Nov. 23, 2011). See also *Corporate Income Tax: Exemptions*, 50 STATE STATUTORY SURVEYS (Thomson Reuters/West 2011), 0140 SURVEYS 5 (West) (listing the applicable law in each state).

40. See generally Dale Joseph Gilsinger, Annotation, *Exemption of Charitable or Educational Organization from Sales or Use Tax*, 69 A.L.R.5th 477 (1999).

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under the restrictions imposed largely by United States tax law, then an entire fleet of benefits, not merely financial in scope, would likely follow.⁴¹ However, the ultimate question is whether it is economically rational to convert a for-profit into a nonprofit for social businesses similar to the hypothetical discussed above. If not, then the alternatives should be seriously considered.

1. Reorganization

A social business must first convert itself legally into a tax-exempt organization. Curiously, little has been written about converting a for-profit business into a tax-exempt organization. The Model Nonprofit Corporations Act discusses how a nonprofit may convert into a for-profit under state law, but does not provide information regarding the converse.⁴² The Model Business Corporation Act is also silent on this matter.⁴³ This may be because this conversion process rarely occurs or perhaps because the process may seem straightforward.

The rarity of this conversion process may be because for-profits would rather donate a percentage of their profits to charities than deal with the paperwork of becoming tax-exempt. Assuming a for-profit is willing to become tax-exempt, donations possess the tax benefit of amounting to corporate tax deductions, over and above ordinary operating expenses.⁴⁴ These charitable donations can be written off during the tax year in which the donations occurred.⁴⁵ It is simply not important for companies whose primary output is human capital to seek exemption. Furthermore, exempt status cannot circumvent federal income tax for employees.

In order for a for-profit to convert itself to an exempt, it would need board approval to incorporate as a separate nonprofit under state law.⁴⁶ This traditionally involves filings with the state's secretary of state, to

41. The benefits of becoming a nonprofit begin with income tax exemptions; however, there are several other ancillary benefits, including, for example, improved public image from simply declaring 501(c)(3) status. *See* I.R.C. § 501(a) (West 2011).

42. *See* MODEL NONPROFIT CORP. ACT §§ 9.30-9.34 (2008).

43. MODEL BUS. CORP. ACT § 12 (2007) (governing the disposition of assets) (amended 2008).

44. I.R.C. § 170 (West 2011).

45. *Id.*

46. 8 FLETCHER CYC. CORP. § 3993.50 (West 2012).

form and legitimize the corporation.⁴⁷ Essentially two companies would exist on the books at the same time for a short duration before the for-profit is dissolved pursuant to its articles of incorporation.⁴⁸ Both shareholders and the board of directors must agree that conversion is in the best interest of the corporation.⁴⁹ Once the newly formed nonprofit is given approval by the IRS for exempt status (in this case as a public charity), it then becomes a requirement for the for-profit to donate (or sell) the assets in its entirety to the newly formed exempt organization.

While the process might sound deceptively simple, it would require more than merely the will of the for-profits' owners. The entire process may be everything but hassle free if the social business has significant assets, debts, and liabilities. The self-interest of directors and shareholders can effectively prevent the conversion of a corporation, and, at the very least, it seems that interested shareholders may be able to prevent the conversion.⁵⁰ If shareholders assert rights to the fair market value of their shares, then the corporation may effectively become bankrupt, leaving nothing to capitalize the new exempt.⁵¹ This extreme circumstance is indicative of how difficult it is to alter corporate status quo.

2. Fulfilling the Organizational but Failing the Operational Test

In order to form and survive, exempts must satisfy both an organizational as well as an operational test.⁵² The organizational test is generally a nonissue and determined by the paperwork filed, as well as

47. BRUCE R. HOPKINS, *STARTING AND MANAGING A NONPROFIT ORGANIZATION: A LEGAL GUIDE* 133 (5th ed. 2009).

48. 19 C.J.S. *Corporations* § 916 (2011).

49. One can imagine how difficult it might be if the corporation is even modestly lucrative. See MODEL BUS. CORP. ACT § 12.01 (2008). Presumably, shareholders would put up a fight to dissolve the corporation because conversion would not be in line with the desire to maximize profit.

50. DEL. CODE. ANN. tit. 8, § 275(b) (2011) (indicating that shareholders have a say in corporate dissolution).

51. Colin T. Moran, *Why Revlon Applies to Nonprofit Corporations*, 53 BUS. LAW. 373, 382 (1998).

52. See Treas. Reg. § 1-501(c)(3)-1 (as amended in 2008). Further, as an example of how these tests have traditionally been employed, see *Columbia Park & Recreation Ass'n v. Comm'r*, 88 T.C. 1, 13 (1987).

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the articles of incorporation.⁵³ The operational test is fact-intensive and poses a larger problem. The fact-intensive inquiry is based upon the actual business dealings of an exempt, as opposed to merely looking at the intent of the creators in the filing documents.⁵⁴ Satisfying the operational test for the IRS is crucial to maintaining exempt status, but also is a substantial loophole for social businesses. Case law has made it extremely difficult to understand what factors go into the test, however it is clear that no factor is dispositive and new factors can be considered as needed.⁵⁵

A for-profit social business will not satisfy the operational test because its goals are inherently not exclusively charitable. Social businesses serve profit motives in addition to charitable outcomes. Any single non-exempt purpose will eliminate the possibility that a social business can be a tax-exempt.⁵⁶ It is easy to see that a social business will fail the operational test due to the facts and circumstances that make it profitable for owners while simultaneously contributing to a charitable cause.⁵⁷

If we assume that the social business is purchasing goods at above-market rate, this additional revenue to the producer should ideally be considered a donation. The current tax law does not permit such a transaction to be considered a charitable donation, but rather deems it a purchase and sale.⁵⁸ Under tax regulations, the only deductible portion of charitable contributions is that which is above and beyond the prevailing market rate of the good or service purchased.⁵⁹ Therefore, a social business is unable to deduct the full value of its inventory cost because it likely spent fair market value on the goods as a market buyer.

In the hypothetical presented above, the social business' purchase of goods at above-market rate is considered to be merely an expense to the

53. See *Nat'l Found., Inc. v. United States*, 13 Cl. Ct. 486, 491 (1987); Treas. Reg. § 1.501(c)(3)-1 (as amended in 2008).

54. See *B.S.W. Group, Inc. v. Comm'r*, 70 T.C. 352 (1978); Jessica Peña & Alexander L.T. Reid, Note, *A Call for Reform of the Operational Test for Unrelated Commercial Activities in Charities*, 76 N.Y.U.L. REV. 1855, 1868 (2001).

55. See, e.g., *Nonprofits' Ins. Alliance of California v. United States*, 32 Fed. Cl. 277, 284 (1994).

56. Treas. Reg. § 1.501(c)(3)-1(b)(4) (as amended in 2008) (indicating that one nonexempt purpose—even when mingled with exempt purposes—voids exempt status).

57. See Peña & Reid, *supra* note 54, at 1872-74.

58. See I.R.C. § 170(c) (West 2011).

59. INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, PUB. NO. 526, CHARITABLE CONTRIBUTIONS 3 (2010).

business. Any proceeds from the sale of those goods simply offset the additional cost to the business. Ultimately, the charitable goal is unrecognized, and therefore the social business fails to engage in a charitable activity in its operation with respect to that transaction.⁶⁰ Conversely, the nonprofit would be able to benefit financially from the entire transaction being tax-free and completely related to its charitable purpose. This is an odd result, because in both corporate situations the results are charitable and only the effect upon the tax situation of the companies is altered.

The irony in this is that in this hypothetical a social business, as compared to a nonprofit, has the potential to do far greater “good” in total pecuniary benefit to the producer.⁶¹ This is because, while a nonprofit has to depend on donors, members, grants, and other forms of support, the social business is purely market-based. If the social business thrives, then the producers gain tremendously through direct revenue. An effective social business can create social benefits that rival the salaries (and bonuses) of top executives on an annual basis. The fact that the operational test would fail means that the social business would struggle to convert into an exempt.

3. Lack of True Ownership and Control

Another problem with converting a social business into a tax-exempt organization is that an exempt is not “owned” by anyone.⁶² Board members may feel like they own the exempt organization, but as a matter of law they do not. There are generally no shares of stock in a nonprofit.⁶³ Also, there is a requirement that no individual benefits from

60. See *Living Faith, Inc. v. Comm’r*, 950 F.2d 365 (7th Cir. 1991). In that case, an exempt sold groceries which were essential to their religious practice. The sale of groceries was substantially related to the religious purpose, but the business also had a profit motive. However, the appellate court was unable to grapple with the ostensibly commercial nature of the business. I would argue that the *Living Faith* grocery store is an example of a social business that was unrecognized in the revenue code.

61. *The Concept of L³C*, AMS. FOR COMMUNITY DEV., <http://www.americansforcommunitydevelopment.org/concept.php> (last visited Feb. 24, 2012).

62. See 1 NONPROFIT ORGANIZATIONS: LAW & TAXATION § 1:1 (West 2011); *Nonprofit Organization*, CITIZEN MEDIA L. PROJECT, <http://www.citmedialaw.org/legal-guide/nonprofit-organization> (last updated Feb. 3, 2009).

63. *Nonprofit Organization*, *supra* note 62. Some states do allow shares of stock in nonprofits. See, e.g., KAN. STAT. ANN. § 17-1602 (West 2012).

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any transaction.⁶⁴ The lack of an equity-based return is a serious detriment to the nonprofit business model. Some nonprofit directors choose not to receive compensation.⁶⁵ As a result, key corporate actors are generally not provided with any reward.⁶⁶ This provides a strong disincentive to innovate beyond the reasonable compensation that is allowed.⁶⁷ This can dissuade many social business entrepreneurs who are interested in being well compensated for their charitable efforts or who compete with businesses in which their own financial status can determine the relative likelihood of their success.

An exempt organization cannot exist beyond the scope of its mandate.⁶⁸ Specifically, once the money supply is gone the nonprofit ceases to exist. Once the individuals who maintained the exempt are deceased, there is nothing tangible to exist into perpetuity.⁶⁹ While board members may have agreed upon rights to succession, and perhaps even wrote a procedure for dissolving the exempt, the fact that there is no personal ownership is profound. The federal tax regulations mandate that assets cannot be transferred among the board or members, which speaks to the fact that the directors of a nonprofit do not generally exert “personal control” over matters.⁷⁰ The lack of a personal stake in the outcomes of the organization ideally means that individual interests are truly altruistic, regardless of the reality of this ideal. Such severe restrictions upon exempt organizations make it an unsuitable model for social businesses, which are ostensibly retail in character.

64. See *Nonprofit Organizations*, *supra* note 62. Again, while some states may permit stock ownership; most nonprofits are deemed non-stock corporations. 1 FLETCHER CYC. CORP. § 68.05 (West 2012).

65. See BROADSOURCE & INDEP. SECTOR, *The Sarbanes-Oxley Act and Implications for Nonprofit Organizations*, BOARDSOURCE (2003) http://www.boardsource.org/dl.asp?document_id=558.

66. I.R.C. § 4958(c)(1)(A) (West 2011); Treas. Reg. § 53.4958-4(a)(1) (2002). Intangible rewards are hard to quantify. If the principal director of a nonprofit gets public accolades for her work, is she in violation of the private inurement doctrine?

67. See *Riley v. Nat'l Fed'n of the Blind of N.C., Inc.*, 487 U.S. 781 (1988).

68. See *Internal Revenue Manual—7.25.2 Single Parent Title Holding Corporations*, INTERNAL REVENUE SERVICE, http://www.irs.gov/irm/part7/irm_07-025-002.html (last visited Nov. 25, 2011).

69. MODEL NONPROFIT CORP. ACT § 12.03 (2008) (indicating that assets dedicated to a charitable purpose cannot be diverted to serve another purpose).

70. See Martin J. Trupiano, *Nonprofit Directors: IRS Raises the Governance Bar*, LAW OFFICES MARTIN J. TRUPIANO, (2008), http://www.mtrupianolaw.com/uploads/IRS_Raises_the_Governance_Bar.pdf. IRS Form 990 is an example of how the IRS has sought to make the role of directors more transparent.

The lack of an ownership stake in an exempt demands that the exempt have an inflexible business model. Ownership provides personal financial involvement and interest in obtaining a return on investment. This is especially true because if the goals of the social business change, it becomes difficult to alter the nature of the corporation to pursue new activities. This is perhaps why some social businesses have decided to not risk pursuing legitimacy as an exempt from the federal government.⁷¹ The possibility of losing the flexibility that is inherent to business organizations in the United States is scary and sufficient to ward off potential do-gooders.

The traditional exempt organization, devoid of any for-profit entanglements, would not struggle with many of these issues because its origin developed organically and not through the product of contrivance for exempt status. However, the converted social business may run into trouble if it is closely held and has an expectation to produce a certain amount of stable income for a small group of investors over the long term. These investors may have their whole lives staked in the business. If the exempt organization no longer has committed members, then day-to-day operations of the social business could suffer. If corporate activities proceed downhill, dissolution or bankruptcy can become a reality. In fact, some state statutes prevent certain relationships among directors of a nonprofit.⁷²

An exempt organization's assets cannot be sold and used for a non-exempt purpose without incurring major tax liability as an excess benefit transaction.⁷³ Because of this prohibitive rule, the social business nonprofit is compelled to use proceeds for charitable purposes.⁷⁴ This is extremely difficult because the law is unsettled in how this might occur. Valuing a social business can end up posing a multi-million dollar loss for the initial group of investors who may have risked a substantial portion of their own money during the social business' inception and would like to see some financial reward for their initial outlay.⁷⁵

71. See, e.g., Dana Brakman Resier, *For-Profit Philanthropy*, 77 *FORDHAM L. REV.* 2437 (2009) (recounting Google's pursuit of for-profit philanthropy).

72. *CAL. CORP. CODE* § 5227 (West 2011).

73. *I.R.C.* § 4958(b) (West 2011) (referring to a 200 percent tax on excess benefit transactions that are uncorrected).

74. See *id.*

75. Because of the excess benefit tax, families cannot reasonably pass on a nonprofit. See *id.*

4. Restrictions on Corporate Activity

One major problem with converting a for-profit business into a nonprofit is the limitations on the types of activities an exempt business may perform. Charitable organizations must stick closely to the work defined in their charitable purpose stated in their articles of incorporation. Nonprofits that engage in activities that do not seem to relate to their charitable purpose are taxed on these so-called unrelated business transactions.⁷⁶ If they become excessive, the nonprofit exempt status can be jeopardized.⁷⁷

This limitation is different from the standard applied in corporate law under traditional ultra vires activities because nonprofit exemptions are subject to restrictive tax rules, which compel the organization to act only with respect to furthering the activities which benefit the charitable cause. Otherwise, they risk loss of its nonprofit status.⁷⁸ The rationale behind the tax-based restriction on nonprofit activity is to ultimately ensure that the taxpayers as a whole are subsidizing only charitable work and not largely unrelated business. While all corporations must follow their articles of incorporation, exemptions have more duties and restrictions imposed by the federal tax laws.⁷⁹ The restriction on corporate activity makes the exempt more susceptible to dramatic loss of revenue for their operations because they are limited in how they can innovate.

Exempt corporate activity is largely governed by the prohibition against self-dealing.⁸⁰ To some extent, self-dealing has benefitted the for-profit market, and perhaps shareholders tangentially.⁸¹ As for-profits, social businesses could also benefit from limited self-dealing.⁸² This is

76. § 513.

77. See Treas. Reg. § 1.501(c)(3)-1 (as amended in 2008); CELIA ROADY, UBIT PROBLEMS FOR TAX EXEMPT CHARITABLE TRUSTS 2 (2000), available at http://www.morganlewis.com/pubs/A353BFFF-AA44-4FF3-AAE3C25E55A48AC3_Publication.pdf.

78. James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 237 (2003). The duty of obedience probably has a stronger tie to the ultra vires doctrine of corporate law.

79. Hines et al., *supra* note 16, at 1191.

80. See, e.g., *Estate of Reis v. Comm'r*, 87 T.C. 1016 (1986).

81. The fact that jurisdictions often do not ban self-dealing is indicative of potential efficiencies contained within such transactions. See Zohar Goshen, *The Efficiency of Controlling Corporate Self-Dealing: Theory Meets Reality*, 91 CAL. L. REV. 393, 401-5 (2003).

82. See generally Treas. Reg. § 53.4941(a)-1 (1973); Treas. Reg. § 53.4941(b)-1 (as

because self-dealing involves benefit to the individuals of the company—otherwise known as “disqualified persons.”⁸³

These people are also key stakeholders in the future and growth of the company and are oftentimes visionaries. In a stock-ownership context, if transparency exists, investors are likely to obtain a portion of the benefit from their investment relationship to a successful firm. This is not the case for exempts because of the lack of shareholders to “benefit” financially and the per se assumption that self-dealing violates the non-distribution rule as well as the exclusive charitable purpose requirement.⁸⁴ The lack of ownership and transparency of a nonprofit makes the exempt model more susceptible to malicious self-dealing.

Self-dealing is generally considered a problem in business law, but the reality is that a board of directors of an exempt caught self-dealing will be financially injured in the long term. A social business may simply be able to walk away from the problem by removing the director and undoing the unfair transaction. Perhaps they would have to pay shareholders directly or through court order. However, an exempt would be attacked by the state as well as the federal government. This is because state attorney generals’ have the power to regulate exempts.⁸⁵ If the exempt fails, then the goodwill of the company ceases to exist and is erased in an onslaught of negative media attention.

5. Inability to Deduct Monetized Social Benefits

With no exempt status, our hypothetical social business is in a quagmire—potentially losing tax-deductible expenditures because it has no possibility of a tax deduction at all. It can donate a substantial sum of money to some other exempt “qualified organization” but it cannot do so within the exact meaning of its own goals as a social business. If the goal of the social business is to sell products at a substantial profit and then to return a vast percentage of those profits to the producers, it would fall afoul of the nonprofit rules.

amended in 1986); Treas. Reg. § 53.4941(c)-1 (as amended in 2009); Treas. Reg. § 53.4941(d)-1 (1973); Treas. Reg. § 53.4941(e)-1 (amended in 1986); Treas. Reg. § 53.4941(f)-1 (amended in 2009).

83. Treas. Reg. § 53.4958-3 (2002).

84. The nature of self-dealing is conferring a private benefit and this violates the principle that any profit in an exempt be directed to an exempt purpose.

85. See PRINCIPLES OF THE LAW OF NONPROFIT ORGS. § 610 (Tentative Draft No. 3, 2011).

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In other words, a social business is punished for its explicit profit motive which underlies the overarching goal of maximizing social welfare. One goal of working with an exempt is that a social business would be able to deduct the charitable portion of its work.⁸⁶ While the IRC specifies a charitable deduction limit for corporations, at least some percentage of a social business' charitable work would be recognized in the form of a tax break. It is from this core benefit that the notion of managing an exempt in conjunction is born and discussed herein.

6. Tax Liabilities Increase

What remains, however, are the tax implications of running a social business as an exempt. On paper, reorganization is possible and, while difficult, may be worthwhile for some social businesses. Perhaps the initial group of investors could eschew any personal and financial reward they may obtain from the sale of the business after they are gone, but there are issues with increased tax liability. The increase in liability is comparable to a social business merely donating a percentage of its profits to a nonprofit.

One major point of concern for social businesses is the prohibition on conducting activities that would produce ongoing income obtained from trade or business activities that are not substantially related to the charitable goal.⁸⁷ For example, if corporations raise money through regularly performed fundraising events that involve the sale of goods not related to benefitting the stated class of individuals, then income from that activity is ultimately reduced by the UBIT liability.⁸⁸ Federal tax law conceptualizes these activities as, among other things, not being motivated for charity because they compete with for-profits engaging in the same business.⁸⁹ This problem should be analyzed in depth whenever conceptualizing the work of an exempt organization.

Significant UBIT (also known as Unrelated Business Taxable Income, or UBTI) may even pose a threat to the exempt status of a nonprofit social business.⁹⁰ This would occur when the UBTI begins to

86. I.R.C. § 183 (West 2011).

87. §§ 511-512.

88. INTERNAL REVENUE SERV., U.S. DEP'T OF THE TREASURY, PUB. NO. 598, TAX ON UNRELATED BUSINESS OR INCOME OF EXEMPT ORGANIZATIONS 3, 8 (2010).

89. See H.R. REP. NO. 81-2319 (1950) (indicating that unfair competition was key in passing the unrelated business taxable income rules).

90. § 501(c)(3) (indicating that a nonprofit charitable organization must be

become a “substantial” portion of the total income.⁹¹ Merely producing income from the sale of goods would not jeopardize tax-exempt status, so long as the activities do not become “substantial.”⁹² What “substantial” means in monetary terms is still a mystery; however the IRS has determined that “substantial lobbying” probably means more than 20 percent of the exempt purpose expenditures.⁹³ While this value is *not* on-point for the analysis of what constitutes “substantial” for the hypothetical exempt organization, it provides a yardstick of what the IRS perhaps believes to be significant. In other words, it is prudent for an exempt to not permit UBTI to exceed a quarter of annual revenue generated.

IV. Operating a Nonprofit in Parallel with a Social Business

Why would social businesses want to simultaneously run an exempt charity? First, the tax rules for social businesses are the same as for any other for-profit corporation and therefore there are no special tax benefits for maximizing social benefit as opposed to profit. This has already created a disincentive to “do good.” It poses a problem for competition because businesses are often engaged in the same activities in which exempt charities are engaged.⁹⁴ The disparity may create a financial incentive to subject a corporation to additional regulations as an exempt, absent the retail work of the business.

Scholars argue that the exempt entity is not as efficient as a for-profit simply for the reason that the profit motive does not have a well-defined incarnation in a nonprofit.⁹⁵ At least one problem with nonprofits is that they are expected to profit for their cause but cannot engage in profit motives. That makes the nonprofit exempt inherently uncompetitive in a market filled with for-profits. The inefficiency of lacking a profit motive means that it would not be wise to eliminate the for-profit, but at the same time managers want public support and positive media attention that exempt organizations often receive.

“exclusively” operated for its charitable purpose).

91. *Id.* See also *Living Faith Inc. v. Comm’r*, 950 F.2d 365, 370 (7th Cir. 1991).

92. Treas. Reg. § 1-501(c)(3)-1 (as amended in 2008).

93. § 4911(c)(2) (specifically for organizations operating with a revenue of less than five million dollars).

94. See Michael S. Knoll, *The UBIT: Leveling an Uneven Playing Field of Tilting a Level One?*, 76 FORDHAM L. REV. 857 (2007).

95. Hines et al., *supra* note 16, at 1192.

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More to the point, many social businesses could not run themselves as exempts because of their low profit margins.⁹⁶ While profit is theoretically on the agenda, social business profit tends to be essentially ancillary to the social goal and therefore social businesses are profiting by a shoestring.⁹⁷ By running a parallel exempt corporation, a social business can begin to take advantage of its role by utilizing tax benefits the law recognizes. It will alleviate some accounting issues as well. It is not uncommon for for-profit business leaders to sit on multiple boards, including those of nonprofits.⁹⁸ Having multiple opportunities to connect with wealthy donors and other like-minded corporations can be beneficial.

Managing an exempt, if done effectively, should allow a social for-profit business to take tax deductions for the monetary portion of its giving per year, if the giving can be monetized.⁹⁹ This would allow for both a tax deduction as well as a lowering of its tax base, the limit being 10 percent of the annual taxable income.¹⁰⁰ Contributions for corporations can carry over for five consecutive tax years.¹⁰¹ This is wonderful for a social business, because while it will be unable to deduct the total contributions per year, it can develop a carryover balance, which will persist for a statutory period of fifteen years.¹⁰² The deduction reserve balance will presumably be helpful for the business during less profitable years.

1. Benefits of a Nonprofit at a Glance

Exempt organizations can be a lot of work to incorporate and operate. However, an exempt organization should do more for the social business than simply accepting profits. The exempt's goals should work

96. Exempts are often funded heavily on contributions such as grants which social businesses cannot woo. See § 170(c)(2).

97. YUNUS, *supra* note 15, at 114.

98. See *Making Nonprofit Partnerships Effective*, BOARDSOURCE, <http://www.boardsource.org/Spotlight.asp?ID=116.375> (last visited Nov. 23, 2011); see also GRANT THORNTON, NOT-FOR-PROFIT BOARDMEMBER HANDBOOK 31 (2011), available at <http://www.granthorton.com/staticfiles/GTCom/Not-for-profit%20organizations/Board%20member%20handbooks/NFP%20booklet%20-%20FINAL.pdf>.

99. See generally § 162.

100. § 170(b)(2)(A).

101. § 170(d)(2)(A).

102. *Id.*

in tandem with the social business. It would provide a positive public relations outlet for the for-profit and could be able to solicit donations and contributions stemming from its 501(c)(3) status.¹⁰³ It would be able to raise capital for charitable purposes through funding from private grants and provide an outlet for interested parties and investors to serve as leaders of the nonprofit board.¹⁰⁴ Many public charities seek out powerful socialites or recognized figures to serve on the board of directors in order to make connections and obtain charitable gifts. Charities often make inroads with politicians and lobbyists, seeking to alter the law within the constraints of 501(c)(3).

The exempt would also be able to benefit from passive investments without incurring UBIT, which can in turn be used to further the goals of the exempt and the for-profit.¹⁰⁵ The exempt organization can seek out volunteers to assist in the activities in which the social business would have engaged.¹⁰⁶ This leads to the final controversial point: the exempt organization may be able to increase the profitability of the social business by supplanting some of the “social” roles that it otherwise engages in.

2. Methods of Utilizing or Implementing a Nonprofit

There are at least two principal ways of pairing a nonprofit with a social business. One model would be to have an exempt nonprofit own and operate the social business entity. I call this the “nonprofit parent model.” Another method would be to have the for-profit manage an exempt organization. This I note as the “social business mutual benefit model.” Both methods accomplish many of the same financial desires, but they have different corporate and tax ramifications. Each method is better suited to the unique needs of a social business. Because a non-stock nonprofit corporation has no true owners, the social business

103. For-profits are also free to solicit donations, but the likelihood of individuals making such a donation is minimal.

104. Many grants are solely awarded to 501(c)(3) public charities. *See generally Advanced Search*, GRANTS.GOV, <http://www.grants.gov/search/advanced.do?jsessionid=bWGLTmpSjQtpN2TDJ2bW4cHsscQz3GLxNVBMt2nJQJnmsvHJLpS!-1373114776> (last visited Nov. 25, 2011) (allowing searches for current and archived federal grants that are available to 501(c)(3) charities (some of which are restricted *solely* to 501(c)(3) charities)).

105. Treas. Reg. § 1.512(b)-1 (1992).

106. § 513(a)(1).

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directors instead would carefully select individuals who would be loyal to both the social business and the nonprofit goals, to ensure that the organizational charitable purpose of the exempt is essentially identical to that of the social business. Although exempt organizations tend to have distinct names, the corporate name of the social business could even be shared pursuant to fictitious name rules.¹⁰⁷

3. Nonprofit Parent Model

The nonprofit parent model would have been an ideal model before the 1950s. This is because Congress passed the UBIT tax rules for exempt organizations only after that time. This scenario would have the social business sending all the profits over to the exempt organization and thereby totally avoiding tax liability on the charitable contributions under the destination of income test.¹⁰⁸ The social business would therefore be a “feeder” corporation for the nonprofit exempt. This model was perfect and social enterprises in foreign jurisdictions that permit such a corporate relationship should utilize this method.

Today, this set-up is highly restrictive for the social business because UBIT would be assessed against the nonprofit for its ownership stake in the for-profit business.¹⁰⁹ For example, if the social business ran a macaroni factory, the sale of that good probably does not advance the charitable purpose of the exempt parent.¹¹⁰ Indeed, if all the nonprofit did was simply accept money from the feeder and pour it into a charitable cause, its nonprofit status could be in jeopardy.¹¹¹ This is unfortunate because the social business should be free to do what it pleases, within the confines of legal corporate action, to product profits for the nonprofit parent.

There is a not-so clever way to circumvent this problem, but it could require significant administrative burden. This would require that the social business sell goods and services which advance the charitable

107. 6 FLETCHER CYC. CORP. § 2442 (West 2011).

108. §§ 512-514. *See also* United States v. Am. Bar Endowment, 477 U.S. 105 (1986).

109. UBIT would be assessed assuming that some unrelated business is conducted.

110. This is a famous reference in nonprofit law. *See* C.F. Mueller Co. v. Comm’r, 190 F.2d 120, 121 (3d Cir. 1951).

111. § 501 (permitting such conduct would violate the “exclusive” purpose clause of the statute which bore the “operational test”). *See also* Treas. Reg. § 1-501(c)(3)-1 (as amended in 2008).

purpose of the nonprofit parent—that is, it substantially advances the goals directly as opposed to simply via financial backing. For example, a nonprofit dedicated to elevating the economic status of certain craftspeople could legitimately own a social business whose sole purpose is to sell the products produced by the very same artisans.¹¹²

Then there is the clever method to circumvent the problem. The following suggestion is viable only for larger social businesses with the wherewithal to manage a complex business. The nonprofit would have to set up some sort of intermediate corporation in order to avoid triggering excessive UBIT liability or revocation of exempt status. This “blocker” corporation would perhaps be a limited liability company (LLC) whose sole purpose is to “shield” the nonprofit from UBIT. It is imaginable that many nonprofits are not going to appreciate having to set up something like this. The LLC would also have to be set up as a corporation rather than a partnership to avoid pass-through taxation.¹¹³ This is possible under state law where the incorporator can elect a taxation preference.¹¹⁴ This intermediary corporation would be able to solve some other problems as well, and should carry on some other legitimate business purpose. This business purpose would be hard to define in the abstract, but at least its presence would not require a new payroll.

4. Maximizing the Blocker LLC

The blocker LLC’s ability to benefit the organization depends on the size of the social business. The exempt organization should utilize the LLC to engage in substantial investments. The LLC intermediary would not escape standard corporate tax rates on whatever activities it engages in.¹¹⁵ The rule on passive income is that it will not trigger UBIT for the nonprofit exempt if it is not commercial in nature.¹¹⁶ While active

112. See *Aid to Artisans, Inc. v. Comm’r*, 71 T.C. 202 (1978).

113. There is a presumption that state LLC statutes organize members as a partnership for tax purposes. See Ann K. Wooster, Annotation, *Construction and Application of Limited Liability Company Acts—Issues Relating to Formation of Limited Liability Company and Addition or Disassociation of Members Thereto*, 43 A.L.R.6th 611 (2008).

114. See *Limited Liability Company*, CAL. FRANCHISE TAX BOARD, http://www.ftb.ca.gov/businesses/bus_structures/LLcompany.shtml (last visited Nov. 25, 2011).

115. Limited Liability Companies are treated as corporations when they elect to be taxed independently. See 51 AM. JUR. 2d *Limited Liability Companies* § 1 (2011).

116. Treas. Reg. § 1.512(b)-1(a)(1) (1992).

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management of investments may constitute UBIT, shifting the investment task to another company would be permissible without jeopardizing exempt status.¹¹⁷

Nonprofits cannot themselves engage in so-called “debt-financed” or leveraged investments.¹¹⁸ However, the nonprofit can circumvent the prohibition against margin trading by using the LLC to engage in derivatives or securities investment.¹¹⁹ This would leverage cash coming in from the for-profit and presumably significantly increase it.¹²⁰ The goal of debt-financed investments has been deemed by courts to be a profit motive.¹²¹ Therefore, this intermediary accomplishes debt-financed investing without having to subject the exempt parent to UBTI liability.¹²² Because the LLC is a separate legal entity, it does not affect the exempt status of the parent.

Depending on the financial circumstances, the exempt organization may prefer to simply partake in passive investments on its own without bothering with the intermediary. A nonprofit exempt is permitted to invest its capital in securities which would be otherwise taxed for a social business.¹²³ This theoretically results in a net gain for social businesses, which allows them to contribute more money to charities.

5. The Problems with the Nonprofit Parent Model

Ultimately, the nonprofit parent model is a bit too unwieldy to be applied to small and medium-sized social businesses. This rests largely on the fact that a nonprofit which owns a social business cannot gain

117. MORGAN LEWIS, ACCOMMODATING TAX-EXEMPT INVESTORS: UNDERSTANDING UBTI 3 (2012), available at http://www.morganlewis.com/documents/VCPEFdeskbook/VCPEFdeskbook_AccommodatingTaxExemptInvestors.pdf.

118. See *Bartels Trust ex rel. Univ. of New Haven v. United States*, 209 F.3d 147 (2d Cir. 2000).

119. See *id.*

120. While the S&P 500 index has performed poorly in the past decade, during positive times gains are significant. See Floyd Norris, *A Historical Cycle Bodes Ill for the Markets*, N.Y. TIMES, Jan 6, 2012, at B3.

121. See *Bartels Trust*, 209 F.3d at 155.

122. I.R.C. § 514 (West 2011). See also *Bartels Trust*, 209 F.3d at 155 (explaining that debt-financed investments trigger UBTI).

123. Treas. Reg. § 1.170A-9(f) (as amended in 2011). In many instances, at least 33.33 percent of an exempt’s revenue must arise from public support, through direct or indirect contributions from the general public, known as the “public support test.” See § 1.170A-9(f)(1)(ii).

anything through tax planning if its desires are to utilize the social business for unrelated business activity. It would take a lot of careful planning and management of the social business to ensure its activities serve the social outcomes of the exempt.

The nonprofit parent does not solve the problem of principal investors not being able to own the social business. This is because the social business must continue to be operated by the exempt.¹²⁴ As a result, the nonprofit parent model is still plagued with problems that affect any transition from social business to a nonprofit exempt. For each corporate intermediary that gets added on, taxes are due, and UBIT issues could persist without respite.

A minor problem exists regarding who controls the for-profit and the propriety of this control. It will not seem prudent if the directors of the nonprofit spend a considerable amount of time managing the for-profit as opposed to managing the affairs of the nonprofit. While there is nothing to necessarily prevent a nonprofit from possessing a social business, many questions would be raised if the principal human actors in each organization were the same. In the extreme case, the social business could be thought of as a mere instrumentality of the nonprofit.¹²⁵ A nonprofit that possesses a social business and is financially successful is not necessarily committing fraud.¹²⁶ Although six-figure salaries are common for nonprofit directors, a court will not be reluctant to find foul play if salary increases as a result social business presence can be found.¹²⁷

Finally, in some states there is a minimum franchise tax which is a practical disincentive to create corporate intermediaries.¹²⁸ Consider that nonprofits are often poorly funded, survive on thin budgets, and do not have the extra personnel to allocate to red tape. If the social business is not producing enough revenue to warrant substantial investments for

124. If the social business is wholly owned and operated by the exempt, the exempt cannot simply sell its equity stake in the company without incurring taxes. It is treated as non-divertible property.

125. *Mobil Oil Corp. v. Linear Films, Inc.*, 718 F. Supp. 260, 266 (D. Del. 1989).

126. It is worth noting that a nonprofit is not barred from making a profit at all. *See* MODEL NONPROFIT CORP. ACT §§ 3.01-3.02 (2008); 1 NONPROFIT ORGANIZATIONS, *supra* note 64, at § 1:1.

127. *See* CHARITY NAVIGATOR, 2010 CEO COMPENSATION STUDY 1 (2010), available at http://www.charitynavigator.org/__asset__/studies/2010_CEO_Compensation_Study_Revised_Final.pdf

128. *See, e.g., What Is the Minimum Franchise Tax?*, CAL. FRANCHISE TAX BOARD, <http://www.ftb.ca.gov/businesses/faq/712.shtml> (last visited Nov. 25, 2011).

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these intermediary corporate entities, then the nonprofit parent model is simply a bureaucratic nightmare which is not outweighed by its benefits. Many nonprofit exempts can avoid paying franchise tax.¹²⁹

6. Social Business Mutual Benefit Model

The premise of the social business mutual benefit model is to convert social business made profits into federally recognized tax deductions by sending them over to a related exempt organization whose charitable goal is substantially the same as the social business. This model benefits the for-profit social business by utilizing the corporate charitable contribution tax deduction and the social business could deduct business expenses incurred by the nonprofit. It is also a more flexible model because it permits the social business to conduct a wide range of business activities which would have otherwise been considered unrelated in the nonprofit parent model.

In the social business mutual benefit model, the social business has control over the exempt.¹³⁰ This requires that members of the exempt organization's board be carefully selected and vetted by the shareholders of the social business. Rather than the social business "giving away" the money to the supplier, either directly (as could happen for profit and loss rationales) or via increased purchase prices, a legally recognized nonprofit entity accepts the contribution.¹³¹ Here, taxpayers actually see a net benefit to governmental coffers to boot because, although the money is not taxed at the exempt end, the social business continues to pay taxes at the corporate taxation rate, less any deductions it is able to write-off. There is no UBTI complication.

One advantage of this model is that it does not require the use of intermediary corporations. While extensive use of intermediary corporations can help solve business (usually tax) problems, they are not considered "ethical" in the eyes of some nonprofit directors and donors.¹³² These organizations may conflate what are commonplace in

129. 1 NONPROFIT ORGANIZATIONS, *supra* note 64, at § 2:27.

130. HOPKINS, *supra* note 47, at 59.

131. I.R.C. § 170(h) (West 2011). It is important to note that one cannot deduct money given away to an individual. *See* § 170(c). For example, a donation to a homeless beggar, regardless of how destitute, is not contemplated as a charitable deduction under the plain language of the prevailing deductions provision. *Id.*

132. *See, e.g.,* Lynnley Browning, *I.R.S. Offers a Tougher Amnesty Deal for Offshore Accounts*, N.Y. TIMES, Feb. 9, 2011, at B3; Stephanie Strom, *I.R.S. Takes on*

the for-profit arena with greedy practices that they may associate only with business executives, regardless of legality of the practice.

7. Benefits for the Social Business from the Presence of a Nonprofit

Overall, the presence of an exempt nonprofit can tremendously benefit a social business' charitable goal. However, other benefits are not immediately conspicuous. These include the ability to obtain grant funding for the charitable cause, name recognition, public support and recognition, and, controversially, enhanced profits for the social business itself. Public recognition is not something that would be possible simply among the for-profit sector for most social businesses.

When a new exempt becomes successful, philanthropic circles focus their attention. After all, philanthropy is not totally altruistic—donors want to know their money is being used to a positive end. This leads to public media attention and increased competitiveness of the charitable goal. The intangible benefit of recognition is something that cannot be replicated with tax incentives. This is largely because the relationships that are formed by the presence of an exempt can provide a self-sufficient monetary backbone for an exempt and may prop up the social business as well.

The presence of an exempt can also ensure that operations that are exempt and non-exempt are kept separate. It cannot be undervalued that the social business mutual benefit model is an excellent choice for smaller operations because separate entities would force managers to keep separate books. The separation makes tracking and earmarking funds a simpler task for the organizations. Having separation also means dividing projects based on what organization would be better suited. Social businesses are better suited for retail than exempts, and therefore the clear separation of entities would further this end.

8. Inurement or Private Benefit?

Private benefit and inurement pose interesting problems for the social business parent model. Exempts cannot confer a private benefit

Tax Abuse by Charity Support Groups, N.Y. TIMES, Feb. 15, 2011, at B1. Usually what makes this worse is incorporating intermediaries in other countries.

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upon any single person or organization.¹³³ This rule is quite old and relates back to the exclusive charitable purpose of an exempt and the rationales for providing tax exemption as a special benefit to the organization.¹³⁴ Thus, if the nonprofit exempt is acting in a way that makes the social business more profitable, it is arguably conferring an impermissible private benefit upon the owners of the social business. While that does create a certain level of liability if the organization gets attention, the positive end is that it increases productivity of the for-profit without the need of any additional capital—human or financial. It can be said to relieve the burden incumbent upon the social business to carry out the benefits it seeks as well. The exempt would be managing the “social” end of the social business.

There are two arguments that directors could use to avoid this problem. First, a substantial amount of directors should not sit on the boards of both the nonprofit exempt and the social business.¹³⁵ It may be permissible for one or more individuals to be shared, depending on the size of the board. Having a board with more shared directors than the minimum number required would be preferable.¹³⁶ This action would mitigate any private inurement issues. Second, it is important to show that any excess benefit is not accruing to the individual owners of the social business but to the hypothetical producers.¹³⁷ Having a good portion of the board be unrelated by blood or marriage would also mitigate the notion that a benefit was being conferred upon individuals.¹³⁸

Finally, the mere presence of another company cannot reasonably be said to automatically create a private benefit because it may be argued that any nonprofit exempt may confer a private benefit on some for-profit company or individual unrelated to that company. For example, if certain lending companies benefitted from the transactions of a nonprofit, would this be a private benefit? It seems that private benefit is quite an

133. See *Church of Scientology of Cal. v. Comm’r*, 823 F.2d 1310 (9th Cir. 1987); *Am. Campaign Acad. v. Comm’r*, 92 T.C. 1053 (1989).

134. See *Universal Oil Prods. Co. v. Campbell*, 181 F.2d 451, 458 (7th Cir. 1950) (indicating existence before 1950); Act of Aug. 27, 1894, ch. 349, sec. 32, 28 Stat. 509, 556-57 (1894); Treas. Reg. § 1.503(b)-1 (1976).

135. See *P.L.L. Scholarship Fund v. Comm’r*, 82 T.C. 196, 200 (1984).

136. Compare MODEL NONPROFIT CORP. ACT § 8.03(a) (2008) (requiring at least three directors), with DEL. CODE ANN., tit. 8, § 141(b) (West 2011) (mandating a minimum of one director).

137. See *KJ’S Fund Raisers, Inc. v. Comm’r*, 74 T.C.M. (CCH) 669 (T.C. 1997)

138. *Id.*

extensive doctrine and hard to predict.¹³⁹ Although the benefit doctrine is very much alive and well, it has yet to be applied in the novel context described above.¹⁴⁰

The IRS has been very active in stripping exempt status from organizations that violate the private benefit rule, and can do so because of the strict rule that a single non-exempt purpose, even insubstantial, can defeat exempt status for an organization.¹⁴¹ This rule originates from the notion that Congress confers a tax exemption to an organization as a privilege, not a right, and that any interpretation of applicable law will most likely be strictly construed, or at least given plain meaning.¹⁴² This is not to say that pursuing a federal tax exemption in the United States is impossible for a social business, but, depending on how large the social business ends up, the tax commissioner may begin to investigate the nature of the exempt and its business conduct.

V. Ramifications for Development

The foregoing discussion has been practical in nature. I hope it is beneficial to those considering the social business model for their own entrepreneurial endeavors. However, the implications of the social business model should enhance both an exempt's charitable output as well as a social business' profit *and consequent* charitable output. This combination theoretically presents a phenomenal outcome for self-interested actors who still want to "do good," but not at the expense of their quality of life.

If anyone can claim to have implemented social development on a large scale, it is ironically the private sector. There has been discourse about such development in legal academia for decades.¹⁴³ The United States has not only been reluctant to adopt the right to development recognized by the United Nations—it has not allocated resources to the

139. See, e.g., *Am. Campaign Acad. v. Comm'r*, 92 T.C. 1053, 1072-73 (1989) (indicating that the disproportional training of Republican candidates would confer a private benefit).

140. HOPKINS, *supra* note 47, at 59.

141. See I.R.S. Priv. Ltr. Rul. 201008050 (Feb. 26, 2010); HOPKINS, *supra* note 47, at 52.

142. See *Better Bus. Bureau of D.C. v. United States*, 326 U.S. 279, 284-85 (1945).

143. See, e.g., Philip Alston, *Making Space for New Human Rights: The Case of the Right to Development*, 1 HARV. HUM. RTS. Y.B. 3 (1988); Stephen Marks, *The Human Right to Development: Between Rhetoric and Reality*, 17 HARV. HUM. RTS. J. 137 (2004).

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effort.¹⁴⁴ Government apathy has not stymied the private sector's drive for innovation. The social business model is apt for the private sector because it allocates rewards for efficient and superior management, while simultaneously recognizing the virtues of charitable giving on a much larger scale. The motto of social business gels well with the modern consumer conscience.

An example of increased charitable output arises from the hypothetical symbiosis of the social business and the nonprofit exempt. The practical relationship between these two entities is governed by the transfer of cash between the social business and the exempt. From this transfer the profitability increases for the social business because the exempt benefits from an increase in capital for its charitable cause. The producers who are benefitting from the presence of the exempt improve their lives and, presumably, the output is used by the social business to turn a profit. Thus, the cycle can repeat itself, and an extremely sustainable model for development flourishes.

VI. Conclusion

While the tax code does not yet embrace social businesses as a charitable business model, it does not prevent creative implementation of a nonprofit exempt. While social businesses could theoretically convert themselves into nonprofits under state law, most will not generally qualify as federal tax exempts due to the harsh requirements. The current tax code does not make conversion a viable option for social businesses. Not only is it not lucrative to convert into a nonprofit exempt, it is also harmful for the social cause because exempt status brings with it severe restrictions that do not comport with retail commercial models.

The solution is a two-part, symbiotic organization. It seems logical for small social businesses to manage an exempt company. This exempt company, owned by no one, would be dedicated to carrying out the goals of the social business. This exempt organization would act in ways that further the goals of the social business through contributions from the social business and other sources. The reverse is also a viable option for larger nonprofits that can afford to manage a wholly owned and operated social business. This structure may raise suspicion from regulators, but, if carefully operated, the business purpose of the social business could be tailored to avoid any excessive tax liability for the nonprofit.

144. See Marks, *supra* note 143, at 152-53.

Finally, the social business model could accelerate the rate of global economic development while also aligning the financial incentives for developers. In a future with significant investment in social business, the shift can move away from microfinance and lending to larger-scale social enterprise. While there is a bright future for the social business model, there is no need to wait for the current legal regime to provide the correct incentives.