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BALANCING THE EQUITIES: CONSIDERING THE “FLIP-SIDE” OF THE UBIT AND FORMING A WORKABLE SOLUTION

INTRODUCTION

In 2007, Professors Anup Malani and Eric Posner published a controversial article, which argued that tax benefits currently available to nonprofit organizations should be extended to for-profit companies doing charitable work.¹ They based their argument on the assumption that nonprofit tax benefits were created to encourage and reward “community-benefit” work, and not the choice to refrain from distributing profits.² They argued that conditioning tax benefits on the work of the organization, irrespective of its chosen corporate form, would incentivize for-profit firms to produce public goods.³ According to Malani and Posner, this approach is important because for-profit firms will produce these goods more efficiently than their nonprofit counterparts.⁴

Although the extension of tax benefits would likely increase the overall production of public goods,⁵ there are a number of ways in which the implementation of Malani and Posner’s proposal would degrade the charitable sector. Consequently, this proposal has received a great deal of criticism.⁶ Most critiques reflect the concern that an extension of 501(c)(3)⁷ tax benefits to for-profit organizations would severely diminish the utility of the “nondistribution constraint,”⁸ which arguably does most of the work in distinguishing charitable organizations.⁹

The most common attacks on this proposal include (1) without the “nondistribution constraint,” determining which organizations should be eligible for tax benefits would be administratively untenable;¹⁰ (2) without the “nondistribution constraint,” the government would be forced to define

1. Anup Malani & Eric Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2023 (2007). “The issue we raise is the flip side of the UBIT debate: should for-profit firms be taxed like nonprofit firms (or more precisely, be exempt from taxes like nonprofit firms) when they engage in charitable activities? Our answer is yes, because there is no reason to condition the tax subsidy for charitable activities on organizational form.” *Id.*

2. *Id.* at 2029.

3. *Id.* at 2022.

4. *Id.* at 2022, 2055.

5. See Dana Brakman Reiser, Essay, *For-Profit Philanthropy*, 77 FORDHAM L. REV. 2437, 2464 (2009).

6. See *infra* text accompanying notes 12–16.

7. I.R.C. § 501(c)(3) (2010).

8. The “nondistribution constraint” is a term coined by Henry Hansmann to describe the prohibition on the distribution of profits generated by nonprofit organizations. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980) [hereinafter *The Role of Nonprofit Enterprise*].

9. See Victor Fleisher, Response, “*For Profit Charity*”: *Not Quite Ready for Prime Time*, 93 VA. L. REV. IN BRIEF 231, 231–32 (2008) [hereinafter *For Profit Charity*].

10. See, e.g., *id.*

charity more precisely, which would stifle experimentation by nonprofits;¹¹ (3) profit-making motives would prompt managers and entrepreneurs to sacrifice quality in order to retain a profit, which could go largely unnoticed because of “contract failure”;¹² (4) people would engage in tax avoidance and arbitrage, and as a result, the tax base would be eroded;¹³ and (5) an increase in for-profit philanthropy would weaken the public perception that charities are altruistic, which would inhibit the growth and success of the charitable sector.¹⁴

These critiques are primarily focused on the issue of charitable deduction.¹⁵ They consider how the ability of an individual to deduct a donation to a for-profit entity from their taxable income would affect the nonprofit sector and the tax base. Conversely, this note will focus on the extension of income tax exemption to for-profit organizations engaged in charitable work. It will analyze and critique the extension of tax exemption to three categories of charitable work done by for-profit organizations.

These three categories of for-profit charitable endeavors include: (1) the hybrid organization that is vested with a social mission and a market philosophy;¹⁶ (2) the commercial service provider of public goods;¹⁷ and (3) the corporation that practices corporate social responsibility.¹⁸ Malani and Posner’s proposal would extend tax benefits to each type of for-profit

11. See, e.g., David M. Schizer, *Subsidizing Charitable Contributions: Incentives, Information, and the Private Pursuit of Public Goals*, 62 TAX. L. REV. 221, 254–55 (2009).

12. See, e.g., Mitchell A. Kane, Response, *Decoupling?*, 93 VA. L. REV. IN BRIEF 235, 240–41 (2008). “Contract failure” is a term coined by Henry Hansmann. Hansmann theorized that one problem faced by donors and consumers of charitable organizations is consumers’ inability to measure the quality of the goods or services purchased. This problem is generally created by the nature of the service, or the disconnection between the purchaser and the beneficiary. Hansmann believes that by ensuring that organizations do not distribute profits, consumers and donors will more readily invest in these goods and services. See *The Role of Nonprofit Enterprise*, supra note 8, at 844–47; see also Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice*, 87 WASH. U. L. REV. 505, 519–21 (2010) [hereinafter *Theorizing the Charitable Tax Subsidies*].

13. See, e.g., James R. Hines Jr., Jill R. Horowitz & Austin Nichols, *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179, 1183 (2010) [hereinafter *The Attack on Nonprofit Status*].

14. See, e.g., Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1213, 1213–14 (2010).

15. See supra notes 11–15.

16. See Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 339 (2009) [hereinafter *Law and Choice of Entity*].

17. Celia R. Taylor, *Carpe Crisis: Capitalizing on the Breakdown of Capitalism to Consider the Creation of Social Businesses*, 54 N.Y.L. SCH. L. REV. 743, 759 (2009/2010).

18. See Janet E. Kerr, *The Creative Capitalism Spectrum: Evaluating Corporate Social Responsibility Through a Legal Lens*, 81 TEMP. L. REV. 831, 856–57 (2008). Kerr formulates a spectrum of corporate social responsibility. One of the categories on this spectrum, “Compliance-Plus,” encapsulates the sort of activity that this note ascribes to the term “corporate social responsibility.” *Id.* Kerr describes these businesses as those that “abide by current laws relating to social welfare—labor practices, environmental policies, anticorruption measures, and the like—but go beyond mere compliance to integrate socially responsible practices into the model.” *Id.* at 857 (footnote omitted).

organization. Their reasoning, however, does not account for the disparate effects that would result from extending the same tax benefits to these organizations.¹⁹ They take a utilitarian approach; they believe that by rewarding the desired work—as opposed to the organization’s mission—the organization’s output of public goods and efficiency will increase.²⁰

Malani and Posner argue that just as nonprofit firms are taxed for business activities that are not “substantially related” to an organization’s charitable purpose, under the unrelated business income tax (UBIT), for-profit firms should *not* be taxed for the charitable work that they do.²¹ Malani and Posner then claim that just as the UBIT was enacted to prevent tax discrimination against for-profit organizations competing with nonprofit organizations, a policy should be crafted to prevent discrimination against for-profits engaging in charitable work.²² Although Malani and Posner do not expand on this analogy,²³ one can envision a tax policy that would operate similarly to the UBIT in order to exempt the charitable work of for-profit organizations.

This policy would allow organizations to retain their nonprofit or for-profit status, while simultaneously rewarding organizations for their production of public goods. Just as the UBIT aims to prevent unfair competition between for-profit and nonprofit organizations that are engaging in the same trade or business,²⁴ this sort of mechanism would theoretically increase fairness. On the other hand, this policy has the potential to create the types of unfairness against which the UBIT was created to protect.²⁵

Despite the difficulty presented by this potential unfairness, the UBIT provides a useful model for a tax policy that would exempt the charitable activities of for-profit organizations. The creation of this model will help distinguish those types of activities that are worthy of exemption. In addition, this model will clarify the extent to which charity law must protect against the collapse of the distinction between nonprofit and for-profit organizations. The application of this model to the three types of for-profit charities discussed above will illustrate the impracticability of this generalized utilitarian approach. Finally, it will provide a basis from which to discuss alternative reforms.

This note will argue that the line drawing required to create a tax policy that exempts community-benefit activities would undermine Malani and

19. See generally Malani & Posner, *supra* note 1.

20. *Id.* at 2022–23.

21. *Id.* at 2061.

22. *Id.* at 2023.

23. *Id.*

24. STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., HISTORICAL DEVELOPMENT AND PRESENT LAW OF THE FEDERAL TAX EXEMPTION FOR CHARITIES AND OTHER TAX-EXEMPT ORGANIZATIONS 38–39 (Comm. Print. 2005) [hereinafter JOINT COMM. REPORT].

25. *Id.* at 5.

Posner's goals of increased production of public goods and efficiency.²⁶ The externalities created by the application of this type of policy would outweigh the logical benefits. In addition to the adverse effect of this policy on the nonprofit sector,²⁷ the overall production of public goods would be diminished by the increase in the administrative costs to the government²⁸ and the potential loss of tax revenue.

Part I will discuss the three categories of for-profit organizations doing charitable work. Part II will provide background information on the UBIT, including a brief synopsis of its history and the rationale behind its creation. Part III will use the UBIT as a model for a tax policy aimed at exempting community-benefit activities carried out by for-profit organizations. Part IV will apply this policy to the various types of for-profit charities, and reveal the disutility of the policy. Part V will analyze the costs and the benefits of the application of this model. This analysis will argue that the wholesale extension of tax exemption to for-profit charities would undermine Malani and Posner's goal of increasing public goods. It reasons that (1) this broad sweeping policy would erode the tax base and thus limit the ability of the government to provide social services; and (2) the policy is inefficient because large corporations are not likely to change their behavior based on the money saved through tax relief, whereas, small socially driven for-profits and nonprofits would be able to reinvest and expand their charitable pursuits with the money saved.²⁹ Part VI will discuss an alternative to the wholesale extension of tax exemption.

I. CURRENT DEVELOPMENTS IN FOR-PROFIT PHILANTHROPY

For-profit charities can be understood as falling into one of three categories³⁰: (1) hybrid organizations,³¹ which are for-profit entrepreneurial organizations created for a socially beneficial purpose;³² (2) for-profit service providers with nonprofit counterparts,³³ such as hospitals, day-care centers, and after-school programs;³⁴ and (3) for-profit companies that practice corporate social responsibility (CSR).³⁵

26. See Malani & Posner, *supra* note 1, at 2022.

27. See *supra* text accompanying notes 11,14.

28. See *For Profit Charity*, *supra* note 9.

29. See *infra* Part V.

30. Although there are other ways of categorizing these organizations, for the sake of clarity, this note uses these three categories.

31. Hybrid organizations come in a number of forms, and scholars refer to them in a variety of ways. Some states have created separate corporate forms under which these organizations may be incorporated. Taylor, *supra* note 17, at 759. These variations will not be discussed in this note because they do not affect the analysis.

32. See *Law and Choice of Entity*, *supra* note 16, at 340.

33. See *The Role of Nonprofit Enterprise*, *supra* note 8, at 868–69.

34. See *id.* at 865–68.

35. See Brakman Reiser, *supra* note 5, at 2448.

A. HYBRID ORGANIZATIONS

Hybrid organizations are defined by their synthesis of the market principles of business organizations and the charitable aims typical of nonprofit organizations.³⁶ The allure of these organizations is that they are free to invest in the market and are able to distribute profits to managers and investors while simultaneously adopting a charitable mission.³⁷ Unlike for-profit corporations that are driven by the concept of shareholder primacy—considering activities benefitting the community as a secondary means of driving profit—hybrid organizations are created for the purpose of doing good.³⁸

These organizations take on many forms, ranging from microfinance investment firms³⁹ to retailers.⁴⁰ For example, Toms Shoes (Toms) is a large shoe production and retail company that donates one pair of shoes to a child living in poverty and in need of footwear for each pair of shoes sold.⁴¹

Google.org might also be viewed as a hybrid organization; however, it is substantially different from other types of social enterprises.⁴² Google.org is a for-profit entity that is funded by its parent company, Google, Inc.⁴³ Although Google.org has retained for-profit status in order to avoid the restrictions placed on nonprofit organizations, its primary concern is not turning a profit.⁴⁴ In fact, “Google.org views profit as a distant and unlikely possible consequence of its activities.”⁴⁵

These examples illustrate the varying degrees of emphasis that hybrid organizations place on profit making. Whereas retailers who are largely concerned with generating a profit may make incidental contributions to public welfare, others like Google.org explicitly disregard profit as a primary motive.⁴⁶ Although most hybrid organizations are community oriented and display relative indifference towards profits, the potential for exploitation of this model warns against extending tax benefits to hybrid organizations.⁴⁷

36. *Law and Choice of Entity*, *supra* note 16, at 337.

37. *See id.* at 352–55 (explaining that social entrepreneurs are often driven to adopt the for-profit form because it allows them to raise capital in ways that the nonprofit form prohibits, but acknowledging that raising capital is not an easy task for hybrid organizations).

38. *See id.* at 351.

39. *See* Brakman Reiser, *supra* note 5, at 2450 (describing microfinance as “social enterprise”).

40. *See, e.g., One for One Movement*, TOMS SHOES, <http://www.toms.com/our-movement/> (last visited Dec. 20, 2010).

41. *Id.*

42. *See* Brakman Reiser, *supra* note 5, at 2446–52 (describing the ways in which Google.org differs from all existing forms of for-profit philanthropy).

43. *See* Shruti Rana, *From Making Money Without Doing Evil to Doing Good Without Handouts: The Google.org Experiment in Philanthropy*, 3 J. BUS. & TECH. L. 87, 87 (2008).

44. *See* Brakman Reiser, *supra* note 5, at 2452.

45. *Id.*

46. *See* Taylor, *supra* note 17, at 756–58.

47. *See For Profit Charity*, *supra* note 9, at 232.

B. FOR-PROFIT SERVICE PROVIDERS

For-profit service providers are organizations that retain profits for the sale of services commonly produced by nonprofit organizations.⁴⁸ Most often, this category is comprised of organizations that are commercial in nature but provide social services that produce positive externalities or public goods.⁴⁹ A public good is a service or good purchased by an individual or a group but enjoyed by the entire community.⁵⁰ Once purchased, the purchaser cannot exclude others in the community from reaping the benefits of these goods.⁵¹ For example, healthcare might be considered a public good that is provided by for-profit, nonprofit, and government institutions.⁵² Generally, the price of the care is similar across providers, and the quality is comparable.⁵³

Therefore, the question of how to tax these for-profit organizations has vexed legal scholars for years.⁵⁴ Malani and Posner suggest that for-profit and nonprofit organizations should be taxed in exactly the same way, despite their differences.⁵⁵ This is problematic, however, because it would disincentivize the adoption of the nonprofit form.⁵⁶ It is important that nonprofit organizations remain active in these industries because they provide quality control since nonprofits are primarily concerned with serving their constituencies rather than increasing profits.⁵⁷ This mission-driven approach decreases the possibility that nonprofits will cut corners on quality in order to increase profits.⁵⁸ Quality control is particularly important in these industries because of the potential for contract failure.⁵⁹ If nonprofits are eliminated from sectors like education, childcare, and

48. See *The Role of Nonprofit Enterprise*, *supra* note 8, at 868–69.

49. See *The Attack on Nonprofit Status*, *supra* note 13, at 1204.

50. See *The Role of Nonprofit Enterprise*, *supra* note 8, at 848.

51. See *id.*

52. See Jill R. Horwitz, *Why We Need the Independent Sector: The Behavior, Law, and Ethics of Not-For-Profit Hospitals*, 50 UCLA L. REV. 1345, 1346 (2003).

53. See *id.* at 1352. “[G]eneral hospitals of all corporate forms are very much alike. They operate under the same healthcare regulations, provide inpatient medical care, compete against each other for patients and doctors, derive funding from many of the same sources, and serve seemingly comparable social functions.” *Id.* (footnote omitted). Horwitz goes on to unpack this notion; she examines the empirical differences in the delivery of certain medical services across the corporate forms and comes to the conclusion that the not-for-profit corporate form is preferable in this industry. *Id.*

54. *Id.* at 1346; see also *The Attack on Nonprofit Status*, *supra* note 13, at 1204 (discussing examples of alternative proposals).

55. Malani & Posner, *supra* note 1, at 2064–67.

56. Cf. *The Attack on Nonprofit Status*, *supra* note 13, at 1199 (providing data to support the assertion that there is a great deal of competition among nonprofits and between nonprofits and for-profits in industries like healthcare). It stands to reason that if tax benefits were extended to the for-profits in these industries, nonprofits would lose the incentive to maintain a nonprofit form. *Id.*

57. See *The Attack on Nonprofit Status*, *supra* note 13, at 1205–06.

58. See *id.* at 1202–03.

59. See *The Role of Nonprofit Enterprise*, *supra* note 8, at 848–49; see also Schizer, *supra* note 13.

healthcare, the quality of the services would be more difficult to ensure and would likely decline.⁶⁰

C. CORPORATE SOCIAL RESPONSIBILITY

CSR can be understood in a variety of ways; however, it generally connotes a company's dedication to regulatory compliance and ethical practices, and often implies that a corporation engages in activity that advances the interests of the community in which it operates.⁶¹ This activity can take the form of company-wide community service outings, partnerships with nonprofit organizations, financial outreach to local communities, or the production of socially conscious products.⁶² CSR has become essentially a requirement for large companies.⁶³ Over the past few decades, as the public has grown more aware of the environmental and societal impact of manufacturing practices, companies have increasingly infused their products and brands with socially conscious messages.⁶⁴

Examples of these practices are everywhere. For instance, Target, Inc. (Target) commits 5 percent of its income to various forms of community outreach.⁶⁵ One example of Target's community outreach program is its literacy initiative, which provides needy schools with books, supports literacy organizations, and makes grants to community literacy programs.⁶⁶ Starbucks, Inc. (Starbucks) takes its social responsibility a step further,⁶⁷ although Starbucks is not a social enterprise willing to sacrifice profit for the greater good, its mission is imbued with social consciousness. Chief among Starbucks' goals is to sell exclusively ethically sourced coffee, much of which is Fair Trade Certified.⁶⁸

Assessing these activities raises important considerations, including (1) whether it is economically efficient to exempt these organizations' charitable activities if the tax break has a relatively minor impact on the corporations' ability to benefit their communities but a significant adverse effect on the tax base; and (2) whether the potential exemption of these activities should apply to income generated from the sale of socially

60. See *The Attack on Nonprofit Status*, *supra* note 13, at 1201, 1203–05.

61. See Kerr, *supra* note 18, at 857; see also Taylor, *supra* note 17, at 745, 747–48.

62. See Brakman Reiser, *supra* note 5, at 2449.

63. See *id.* at 2448.

64. See *id.* at 2448–49.

65. TARGET, 2009 CORPORATE RESPONSIBILITY REPORT 3 (2009), available at http://sites.target.com/images/corporate/about/responsibility_report/2009/2009_full_report.pdf [hereinafter TARGET CORPORATE RESPONSIBILITY].

66. *Id.* at 5–6.

67. STARBUCKS, GLOBAL RESPONSIBILITY REPORT: GOALS & PROGRESS 2010, available at <http://assets.starbucks.com/assets/goals-progress-report-2010.pdf> [hereinafter *Starbucks Global Responsibility*].

68. *Id.*

responsible products, such as Starbucks coffee, or whether it should be limited to income generated from more traditional charitable activities.

II. THE UNRELATED BUSINESS INCOME TAX

The UBIT imposes a tax on 501(c)(3) organizations for revenue generated by activity that is: (1) “a trade or business”; (2) “regularly carried on”; and (3) “not substantially related to . . . [the] exempt purpose” of the organization.⁶⁹ Even if the profits generated by this type of activity are used in furtherance of exempt programs, the income will be taxed.⁷⁰ In other words, the activity itself must further the exempt purpose in order for the income generated by the activity to be exempt from tax.⁷¹

In determining whether the activity is substantially related to the exempt purpose, the Internal Revenue Service (IRS) considers “the size and extent of the activit[y] . . . in relation to the nature and extent of the exempt function that . . . [the organization] intend[s] to serve.”⁷² For example, if an art program for learning disabled children sells pottery made by the kids, the income generated by the sale of that artwork would not be subject to tax under the UBIT.⁷³ If, however, the teachers at the school sold their artwork as a means of generating revenue for the school, this income might be taxed.⁷⁴

The UBIT is a relatively recent innovation.⁷⁵ Before World War II, little attention was paid to how exempt organizations generated funds; rather, the focus was on how the funds were being used.⁷⁶ Although tax-exempt organizations were required to operate in furtherance of an exempt purpose, they could effectuate that purpose in any number of ways, including the operation of a profit-making business.⁷⁷ This standard was dubbed the “destination of income” test.⁷⁸ The Supreme Court codified this test in *Trinidad v. Sagrada Orden*.⁷⁹ There, the Court found that the income of a religious organization that generated its profits from the sale and lease of land in the Philippines was not taxable because it was used in furtherance of its exempt purpose.⁸⁰

69. I.R.S. Pub., *Tax on Unrelated Business Income of Exempt Organizations*, Pub. 598 at 3 (Mar. 3, 2010), available at <http://www.irs.gov/pub/irs-pdf/p598.pdf> [hereinafter Pub. 598]; see also I.R.C. §§ 511–513 (2010).

70. Pub. 598, *supra* note 69, at 3.

71. Sean P. Scally, *To Pay or Not to Pay*, 37 TENN. B.J. 12, 14 (Oct. 2001).

72. Pub. 598, *supra* note 69, at 3.

73. *See id.*

74. *See id.*

75. See Ethan G. Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 EMORY L.J. 1475, 1479 (2005).

76. *See id.*

77. JOINT COMM. REPORT, *supra* note 24, at 100.

78. *Id.*

79. *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578, 582 (1924).

80. *Id.*

This issue came to a head in the 1940s when Congress observed an uptick in the formation of exempt organizations that were operating as businesses in direct competition with tax-paying corporations.⁸¹ These businesses, termed “feeder” organizations,⁸² were avoiding taxes by devoting their profits to charity.⁸³ For instance, the Second Circuit found that an organization operating a private beach was tax-exempt because its income was designated for charity.⁸⁴

The use of a for-profit business as a source of revenue for New York University highlighted the rising concerns over the proliferation of “feeder” organizations, and their adverse effects on tax-paying organizations and the income tax base alike.⁸⁵ In 1947, a macaroni company began distributing all of its previously taxable income to New York University School of Law.⁸⁶ This practice was challenged on the grounds that the macaroni company was not operating for an exempt purpose.⁸⁷ The court held that the pasta company was tax-exempt because all of its revenue was devoted to a charitable purpose.⁸⁸

In response to the growing use of this practice, Congress enacted the UBIT as part of the Revenue Act of 1950.⁸⁹ The tax was primarily implemented to prevent unfair competition against for-profit organizations operating businesses similar to “feeder” organizations.⁹⁰ The tax affected all charitable organizations other than religious organizations,⁹¹ but it did not tax passive investment income.⁹²

Congress modified the UBIT in 1969.⁹³ Chief among the modifications were the extension of the UBIT to all organizations, other than U.S. instrumentalities exempted by §§ 501(c) and 401(a) of the Internal Revenue Code;⁹⁴ the expansion of tax liability for debt-financed income derived in

81. Stone, *supra* note 75, at 1479.

82. JOINT COMM. REPORT, *supra* note 24, at 101. “Feeder” organizations are for-profit companies created as a source of income for tax-exempt organizations. *Id.*

83. See Jessica Peña & Alexander L.T. Reid, *A Call for Reform of the Operational Test for Unrelated Commercial Activity in Charities*, 76 N.Y.U. L. REV. 1855, 1866 (2001).

84. JOINT COMM. REPORT, *supra* note 24, at 101; see also *Roche’s Beach, Inc. v. Comm’r*, 96 F.2d 776, 778 (2d Cir. 1938).

85. See Stone, *supra* note 75, at 1483.

86. See *C.F. Mueller Co. v. Comm’r*, 190 F.2d 120, 120–21 (3d Cir. 1951); see also Stone, *supra* note 75, at 1483.

87. *C.F. Mueller*, 190 F.2d at 121.

88. See *id.* at 122–23; see also JOINT COMM. REPORT, *supra* note 24, at 101.

89. See Stone, *supra* note 75, at 1487.

90. See *id.* at 1487–88.

91. JOINT COMM. REPORT, *supra* note 24, at 102.

92. *Id.*

93. See Stone, *supra* note 75, at 1487.

94. See JOINT COMM. REPORT, *supra* note 24, at 103; STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 91ST CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969 4 (Comm. Print. 1970) [hereinafter GENERAL EXPLANATION OF TAX REFORM ACT]; see also I.R.C. §§ 401(a), 501(c) (2010).

leaseback deals between tax-exempt organizations and corporations;⁹⁵ and various provisions aimed at limiting the use of taxable controlled subsidiaries by tax-exempt organizations to avoid income tax.⁹⁶

Since the 1969 reforms, Congress has carved out certain exceptions to the UBIT rules.⁹⁷ For example, entities are not taxed on income generated by an exempt organization that gives away low-valued items for the purpose of fundraising, or income generated by renting out donor mailing lists.⁹⁸ Furthermore, fundraising activities, such as charity auctions and galas, are not taxed even if they are themselves not charitable, so long as such activities raise funds for charitable purposes.⁹⁹

Congress submits that the passage of the original UBIT and the subsequent reforms were, for the most part, motivated by the need to prevent unfair competition and tax-base erosion.¹⁰⁰ The most popular rationale for the UBIT is that it prevents unfair competition. This unfair competition comes in two forms: “predatory pricing”¹⁰¹ and the ability of nonprofits to expand their market share by reinvesting otherwise taxable income into their commercial businesses.¹⁰²

One critique of this rationale is that it is simply unfounded.¹⁰³ If organizations operate commercial businesses to capture a financial premium, then they have little incentive to cut prices or expand their market shares because they want to use the money captured through exemption to reinvest in their charitable pursuits.¹⁰⁴ In fact, the tendency for nonprofits to invest income generated by their commercial pursuits in their charitable activities has been supported by qualitative and quantitative research on the subject.¹⁰⁵

95. JOINT COMM. REPORT, *supra* note 24, at 103–04; GENERAL EXPLANATION OF TAX REFORM ACT, *supra* note 94, at 4.

96. JOINT COMM. REPORT, *supra* note 24, at 103–04.

97. *Id.* at 104.

98. *Id.*

99. *Id.* at 105.

100. See Stone, *supra* note 75, at 1488–92; *but see id.* at 1492–94 (explaining that there are alternative explanations for the enactment of the UBIT that are ignored by the government).

101. “Predatory pricing” refers to the ability of nonprofit organizations to offer lower prices than their for-profit counterparts for the same goods and services as a result of their tax advantages. See John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487, 530 (2002); see also Thomas Kelley, *Rediscovering Vulgar Charity: A Historical Analysis of America’s Tangled Nonprofit Law*, 73 FORDHAM L. REV. 2437, 2493 (2005) [hereinafter *Rediscovering Vulgar Charity*].

102. See Colombo, *supra* note 101, at 530; see also *Rediscovering Vulgar Charity*, *supra* note 101, at 2493.

103. See Colombo, *supra* note 101, at 530; see also Stacey Y. Abrams, *Devolution’s Discord: Resolving Operational Dissonance with the UBIT Exemption*, 17 YALE L. & POL’Y REV. 877, 898 (1999).

104. See Colombo, *supra* note 101, at 530; see also *Rediscovering Vulgar Charity*, *supra* note 101, at 2495; Abrams, *supra* note 103, at 899.

105. See *Rediscovering Vulgar Charity*, *supra* note 101, at 2494.

Even if one accepts that the concern of unfair competition is legitimate, many critics believe the UBIT is ineffective at solving this problem.¹⁰⁶ First, the UBIT does not explicitly require that all nonprofit business activities that are similar to for-profit activities be taxed. Nonprofits can easily integrate their mission into these commercial activities, rendering them related to the exempt purpose.¹⁰⁷

Second, the self-reporting system, used to enforce the UBIT, presents opportunities for nonprofits to evade the UBIT.¹⁰⁸ Tax-exempt organizations have a great deal of discretion in determining which income-generating activities are taxable under the UBIT.¹⁰⁹ Not only are the requirements subject to interpretation by the organizations, but organizations may also allocate costs of an exempt activity to an unrelated activity in order to diminish the reported net income.¹¹⁰ Although the IRS may investigate to ensure that the reporting is accurate, it is not always easy to verify the nature of the activity.¹¹¹ Furthermore, exempt organizations have every incentive to avoid reporting unrelated business activity because evidence of too much of this activity has the potential to threaten an organization's 501(c)(3) status.¹¹²

The other rationale offered by Congress for the creation of the UBIT was that it would prevent tax-base erosion.¹¹³ This rationale is also subject to question.¹¹⁴ The UBIT standard is malleable enough, that with good tax planning, the tax revenue generated by the UBIT is not sufficient to justify its existence.¹¹⁵ Furthermore, other rules restricting nonprofit commercial

106. See Peña & Reid, *supra* note 83, at 1866–67.

107. See Colombo, *supra* note 101, at 532; see also Peña & Reid, *supra* note 83, at 1866; *Rediscovering Vulgar Charity*, *supra* note 101, at 2495. Gilbert M. Gaul & Neill A. Borowski, *Nonprofits: America's Growth Industry*, PHILA. INQUIRER, Apr. 18, 1993, at A.1 (citing to a series of news articles detailing the trend among large nonprofit organizations to “mov[e] beyond their core mission into commercial businesses that have little, if anything, to do with their exempt purpose”). Gaul and Borowski attributed this trend to the fact that “[u]nder the tax code, nonprofits are allowed to operate commercial subsidiaries - so long as they pay taxes on that income and those activities don't overshadow their exempt mission.” *Id.*

108. Evelyn Brody & Joseph Cordes, *The Unrelated Business Income Tax: All Bark and No Bite?*, in EMERGING ISSUES IN PHILANTHROPY, at 2 (Urban Inst. & Hauser Ctr., Seminar Series, 2001).

109. See *id.*

110. See Richard Sansing, *The Unrelated Business Income Tax, Cost Allocation, and Productive Efficiency*, 2 NAT'L TAX J. 291, 292 (1998).

111. See Heather Gottry, Note, *Profit or Perish: Non-Profit Social Service Organizations & Social Entrepreneurship*, 6 GEO. J. ON POVERTY L. & POL'Y 249, 271 (1999).

112. See Glenn M. Gomes & James M. Owens, *Commercial Nonprofits, Untaxed Entrepreneurialism, and “Unfair Competition,”* 36 J. SMALL BUS. MGMT. 8, 14 (1988).

113. See Stone, *supra* note 75, at 1491.

114. See *id.*

115. See Peña & Reid, *supra* note 83, at 1867 (footnote omitted) (“Many others have written about the ways in which UBIT has failed not only to regulate commercial activity in charities generally, but even to accomplish the purposes for which it was enacted.”).

activity are more effective at preventing tax-base erosion and unfair competition.¹¹⁶

Since the creation of the UBIT, these arguments have been subject to debate. Advocates of the UBIT feel that it is ill defined and inadequately enforced.¹¹⁷ Meanwhile, critics believe that the UBIT is altogether unnecessary because it does not achieve its purported goals.¹¹⁸ Despite these criticisms and proposals for reform, however, the government continues to uphold the UBIT. For better or for worse, the UBIT is here to stay. The government has maintained its dedication to balancing the interests of the charitable sector and the fairness of the market.

III. THE UBIT AS A MODEL FOR A TARGETED TAX-EXEMPTION POLICY

Malani and Posner argue that the UBIT was established “to eliminate tax discrimination against for-profits competing against nonprofits in non-community-benefit markets.”¹¹⁹ Although the effectiveness of the UBIT at achieving fairness has been questioned,¹²⁰ the UBIT nevertheless provides a useful framework from which to fashion a policy that affords for-profit organizations tax benefits. Under this model, a for-profit organization could file for income tax exemption for income derived from a “trade or business” that is “regularly carried on” and “substantially related to an exempt purpose.” Like the UBIT, this policy would require corporations to determine which activities fall into this category through a self-reporting system¹²¹ and would require the IRS to be responsible for investigating potential wrongdoing.¹²²

While Malani and Posner did not directly envision the use of a UBIT-like policy, their rhetorical analogy¹²³ provides perhaps the most useful policy proposal. The UBIT serves as a useful model for two reasons: (1) it shares Malani and Posner’s goal of achieving a fair result; and (2) it is a policy aimed at activity as opposed to organizational form. The application and interpretation of the UBIT serve as helpful predictors of how the proposal would operate and how its application would vary based on the type of organization at issue. Furthermore, the criticism of the UBIT is useful in analyzing the utility of this proposal and others like it.

116. Colombo, *supra* note 101, at 507; *see also Rediscovering Vulgar Charity*, *supra* note 101, at 2495.

117. *See* Stone, *supra* note 75, at 1494–98 (discussing existing critiques of the UBIT).

118. *See id.*

119. *See* Malani & Posner, *supra* note 1, at 2061.

120. *Rediscovering Vulgar Charity*, *supra* note 101, at 2494.

121. *See* Pub. 598, *supra* note 69, at 2.

122. *See id.*

123. *See* Malani & Posner, *supra* note 1, at 2061.

IV. APPLICATION OF THE TARGETED TAX-EXEMPTION PROPOSAL

The application of the policy outlined above to each of the three types of for-profits will reveal the tensions that underlie this debate and the disutility of applying a uniform policy to all for-profit organizations. Furthermore, it will illustrate the impossibility of conditioning tax exemption solely on the production of public good.

A. HYBRID SOCIAL ENTERPRISE

As discussed above, hybrid organizations bear a strong resemblance to entrepreneurial nonprofits.¹²⁴ The only meaningful differences between nonprofits and these for-profit entities are their abilities to invest in equity, distribute profits, and engage in political lobbying.¹²⁵ Furthermore, although hybrid organizations enjoy the flexibility of managing their profits as they see fit, these organizations are rarely motivated by significant financial gain.¹²⁶

The similarity between nonprofit and for-profit social enterprises makes the application of this policy to these hybrid organizations relatively simple.¹²⁷ Take, for example, Toms. On its face, this company looks like any other shoe manufacturer. It manufactures a unique style of shoes and sells them in stores all over the country.¹²⁸ However, for each pair of shoes sold, the company donates a pair to a child in need living in a developing country.¹²⁹ Toms also partners with healthcare providers and educational organizations already working in the targeted communities.¹³⁰ These organizations give away the shoes and provide the children with the education and healthcare they need.¹³¹

Although Toms was founded with the mission of accomplishing an exempt purpose,¹³² Toms' activities would not be exempt under this policy. The first two requirements are easily met. Toms generates its income through the sale of shoes, which is a "regularly carried on" business by a nonexempt organization. It is unclear, however, whether the activity itself, the sale of shoes, is "substantially related" to Toms' exempt purpose. One could argue that selling the shoes promotes the buyer's understanding of the

124. See discussion *supra* Part I.A.

125. See Brakman Reiser, *supra* note 5, at 2452.

126. See *id.*

127. See Taylor, *supra* note 17, at 756.

128. See *TOMS Company Overview*, TOMS SHOES, <http://www.toms.com/corporate-info/> (last visited Oct. 9, 2011).

129. *One for One*, TOMS SHOES, <http://www.toms.com/one-for-one> (last visited Oct. 9, 2011).

130. *How We Give*, TOMS SHOES, <http://www.toms.com/how-we-give> (last visited Oct. 9, 2011).

131. *Id.*

132. See *FAQs: For-profit or Non-profit*, TOMS SHOES, <http://www.toms.com/eyewear/faq#for-profit-or-non-profit> (last visited Dec. 20, 2010) [hereinafter *TOMS FAQs*].

struggles of underprivileged communities.¹³³ The sale of these shoes could also be viewed as “defending human . . . rights.”¹³⁴ These arguments, however, are somewhat attenuated.

Realistically, Toms is similar to the pasta factory distributing income to New York University School of Law. Just like the pasta factory, Toms is operating a traditional profit-making business so that it can fund its charitable activities.¹³⁵ Although this business is worthy of tax exemption in the sense that its work is laudable, this is precisely the type of business that the UBIT was created to tax.¹³⁶ It is, for lack of a better term, a “feeder” organization.¹³⁷ While the typical “feeder” organization has no substantive relationship to the charity for which it operates (there is no substantive relationship between pasta and law school),¹³⁸ the fact that Toms sells shoes and gives away shoes as part of its charitable mission does not set it apart from other types of “feeder” organizations.¹³⁹

Other types of social enterprises, however, might qualify for tax exemption because the nature of their income-generating activity is substantially related to an exempt purpose. Consider, for example, a business that trains and employs indigent teenagers. The work done by the teens generates the income but is substantially related to multiple exempt purposes, such as aiding the poor, promoting education, and preventing community deterioration.¹⁴⁰ Under the targeted tax-exemption policy, the income generated by the work of the teens would be exempt, and income derived from other activities carried on by the organization would not.

While the second example illustrates the potential strength of this policy, there is something troubling about the disparate impact that the policy would have on these two organizations. Both organizations are designed to serve underprivileged children,¹⁴¹ and both put their social missions before their financial bottom line.¹⁴² These two organizations should not be treated differently, but, under this policy, they would be. In order to remedy this problem, the requirement that the activity be “substantially related” to the exempt purpose would have to be read very broadly. It would have to be read so broadly that it might undermine the

133. *Exempt Purposes - Internal Revenue Code Section 501(c)(3)*, INTERNAL REVENUE SERVICE, <http://www.irs.gov/charities/charitable/article/0,,id=175418,00.html> (last visited Oct. 9, 2011) [hereinafter *Exempt Purposes*]; see also I.R.C. § 501(c)(3) (2010).

134. See *Exempt Purposes*, *supra* note 133; see I.R.C. § 501(c)(3).

135. See *TOMS FAQs*, *supra* note 132.

136. See Stone, *supra* note 75, at 1479.

137. JOINT COMM. REPORT, *supra* note 24, at 101.

138. See *IRC 502 - Feeder Organizations*, in *Exempt Organizations Continuing Professional Education (CPE) (1983)*, available at <http://www.irs.gov/pub/irs-tege/eotopicf83.pdf>.

139. See *id.*

140. See *Exempt Purposes*, *supra* note 133; I.R.C. § 501(c)(3) (2010).

141. See *TOMS Company Overview*, *supra* note 128.

142. See *id.*

purpose of the UBIT,¹⁴³ and inadvertently allow for the exemption of income generated by organizations that are far less committed to public good.

B. FOR-PROFIT SERVICE PROVIDERS

The application of the targeted tax-exemption policy to for-profit service providers presents an entirely different problem. As discussed above, for-profit service providers operate businesses that are nearly identical to their nonprofit counterparts.¹⁴⁴ For example, for-profit hospitals offer the same services as nonprofit hospitals at similar prices.¹⁴⁵ Thus, if the targeted tax-exemption policy were applied to a for-profit hospital, nearly all of its income would be exempt. The business is “regularly carried on,” and the income generating activity is “substantially related to an exempt purpose.” The same could be said of for-profit day-care centers or for-profit theaters.¹⁴⁶

The extension of tax benefits to these for-profits would effectively eliminate the incentive for a service provider of this kind to form as a nonprofit.¹⁴⁷ This is worrisome because these types of services suffer from “contract failure”; the nature of the services makes it nearly impossible for the consumers to measure their quality.¹⁴⁸ For example, nursing home patients are often too sick or unaware of their circumstances to measure the quality of their care or to advocate for themselves if their care is lacking.¹⁴⁹ Moreover, this care is often paid for by a patient’s family or medical insurance provider, which further limits the nursing home’s accountability to the patient.¹⁵⁰ Therefore, the consumer of this care must be able to trust the provider to ensure quality.¹⁵¹ Similarly, parents are unable to fully evaluate the quality of their child’s day-care center.¹⁵² There are basic measures of course, like safety, which are easy to ascertain. Optimal stimulation or social interaction, however, is much more difficult to measure.¹⁵³

Henry Hansmann believes that nonprofits are more trustworthy in these sectors than their for-profit counterparts because they have no reason to cut

143. See Nicholas A. Mirkay, *Relinquish Control! Why the IRS Should Change its Stance on Exempt Organizations in Ancillary Joint Ventures*, 6 NEV. L.J. 21, 32 (2005).

144. See discussion *supra* Part I.B.

145. See *The Attack on Nonprofit Status*, *supra* note 13, at 1201–03.

146. *Id.* at 1201–03.

147. See *id.* at 1202.

148. See *id.*

149. See *The Role of Nonprofit Enterprise*, *supra* note 8, at 863–65.

150. *Id.*

151. *Id.*

152. *Id.* at 865.

153. See *id.*

costs for quality or shirk on promises.¹⁵⁴ As a result, the presence of nonprofits in these markets prevents for-profits organizations from taking advantage of unsuspecting consumers.¹⁵⁵ An increase in for-profit presence in these sectors would drive out the nonprofit quality controllers.¹⁵⁶

In order to exempt a for-profit service provider's income without reaching the result outlined above, the policy would have to place limits on the destination of the income. This is clearly an undesirable result since the purpose of creating a policy like this is to provide tax benefits to for-profit organizations without forcing them to comply with the nondistribution constraint.

C. CORPORATE SOCIAL RESPONSIBILITY

Finally, the application of the targeted tax-exemption policy to CSR might be the most workable, and yet, the most problematic application. Unlike social enterprise that suffers from under-inclusion, or the for-profit service provider that would subsume its nonprofit counterparts, corporations practicing CSR would be well served by the policy, without adversely affecting nonprofits. Exempting CSR activities, however, is more likely to severely erode the tax base.

For example, Starbucks, which sells predominately ethically sourced coffee products,¹⁵⁷ would likely be exempt under this policy. The sale of ethically sourced coffee is a business that is "regularly carried on" and that is "substantially related" to an exempt purpose—"defending human . . . rights."¹⁵⁸ Starbucks designed a set of guidelines to which it holds itself accountable called Coffee and Farmer Equity (C.A.F.E.) Practices. According to Scientific Certification Systems, an independent certification organization that verifies "environmental, sustainability, stewardship, food quality, food safety and food purity claims" made by product manufactures,¹⁵⁹ Starbucks,

initiated C.A.F.E. (Coffee and Farmer Equity) Practices to evaluate, recognize, and reward producers of high-quality sustainably grown coffee. C.A.F.E. Practices is a green coffee sourcing guideline developed in collaboration with Scientific Certification Systems (SCS), a third-party evaluation and certification firm. C.A.F.E. Practices seeks to ensure that Starbucks sources sustainably grown and processed coffee by evaluating

154. *See id.*

155. *See The Attack on Nonprofit Status*, *supra* note 13, at 1203 (explaining that the presence of nonprofits in mixed markets positively affects the quality of for-profits in those markets).

156. *See id.*

157. *Starbucks Global Responsibility*, *supra* note 67, at 5–6.

158. *See Exempt Purposes*, *supra* note 133; I.R.C. § 501(c)(3) (2010).

159. Scientific Certification Systems is an independent certification organization that verifies "environmental, sustainability, stewardship, food quality, food safety and food purity claims" made by product manufactures. *About Scientific Certification Systems*, SCIENTIFIC CERTIFICATION SYSTEMS, http://www.scs-certified.com/about_scs.php (last visited Oct. 27, 2011).

the economic, social and environmental aspects of coffee production against a defined set of criteria, as detailed in the C.A.F.E. Practices Guidelines. Starbucks defines sustainability as an economically viable model that addresses the social and environmental needs of all the participants in the supply chain from farmer to consumer.¹⁶⁰

As this suggests, Starbucks' business is substantially related to more than one exempt purpose.¹⁶¹ By selling ethically sourced coffee, Starbucks benefits poor communities, protects children, and generally seeks to secure human rights.¹⁶² Therefore, all of the income generated by the sale of Starbucks coffee would be exempt.

Like Starbucks, many large companies are incorporating environmentally efficient and socially conscious products into their product lines.¹⁶³ These companies would likely be tax-exempt under this targeted tax-exemption policy. The sale of these products is not as effective as direct financial and in-kind contributions to the underlying movements that these companies seek to benefit.¹⁶⁴ In most instances, however, the sale of environmentally and socially conscious goods is the most efficient way for corporations to participate in social movements because they are limited by their obligation to maximize shareholder wealth.¹⁶⁵

At first glance, this is an appealing policy because it would incentivize more of this behavior by big companies; however, this sort of policy could open the floodgates to substantial tax-base erosion.¹⁶⁶ Moreover, the potential decrease in tax revenue would result in a net loss of public good because it would stymie government efforts to provide social services, conduct research, and stimulate the economy.¹⁶⁷ Furthermore, unlike tax-exempt nonprofits that lessen the burden on the government by providing aid to communities where the government otherwise would, corporations

160. *Starbucks C.A.F.E. Practices*, SCIENTIFIC CERTIFICATION SYSTEMS, http://www.scs-certified.com/retail/rss_starbucks.php (last visited Oct. 27, 2011) [hereinafter *Starbucks C.A.F.E. Practices*].

161. See I.R.C. § 501(c)(3).

162. See *Starbucks C.A.F.E. Practices*, *supra* note 160.

163. *CSR: For Innovative Companies it Leads to Better Financial Performance*, GLOBE-NET, <http://www.globe-net.com/articles/2010/april/10/csr-for-innovative-companies-it-leads-to-better-financial-performance.aspx?sub=11> (last visited Dec. 15, 2010).

164. See Matthew J. Kotchen, *Green Markets and Private Provision of Public Goods*, 114 J. POL. ECON. 816, 829 (2006) (arguing that the production of goods or services that seek to promote public good is less effective than direct donation to these efforts, and illustrating the counterintuitive effects of the sale of socially conscious goods on the overall social welfare).

165. See *Law and Choice of Entity*, *supra* note 16, at 349–51.

166. See Michael D. Gottesman, Comment, *From Cobblestones to Pavement: The Legal Road Forward for the Creation of Hybrid Social Organizations*, 26 YALE L. & POL'Y REV. 345, 355 (2007).

167. See Abrams, *supra* note 103, at 901 (explaining that nonprofit tax exemption is often justified by charities' need to act as a safety net for those not adequately served by government social service programs). The article refers to charities as partners of the government in providing social services. *Id.*

practicing CSR generally have a more incidental impact on the community.¹⁶⁸ Many theorists do not consider nonprofit tax exemption to have an adverse impact on the tax base because nonprofits provide the public goods that the government would otherwise have to fund.¹⁶⁹ Assuming that this theory is accurate, the effect of nonprofits on the tax base is neutral; a dollar lost in tax revenue is a dollar saved by the government.¹⁷⁰ Exempting CSR activities, however, would create a net loss in public goods.¹⁷¹

The adverse effect of this trend on tax revenue would undermine the purpose of Malani and Posner's proposal;¹⁷² it would decrease the overall production of pure public goods, and increase the production of goods and services with a tangential or indirect benefit to the community.¹⁷³

V. THE INEQUITY IN EQUAL TREATMENT

The application of this policy illustrates the potential benefits and detriments of Malani and Posner's proposal. There would likely be an increase in charitable activity if this policy were enacted. In some instances, this activity even has the potential to be more efficient than charitable activity carried out by nonprofits.¹⁷⁴

Nevertheless, the flaws of the UBIT standards, which scholars have critiqued for decades,¹⁷⁵ are the source of many of the problems associated with the targeted tax-exemption policy outlined above. Just as others have observed through the application of the UBIT, the prongs of the test are malleable, and therefore, difficult to apply.¹⁷⁶ The vagueness of the prongs¹⁷⁷ is particularly problematic when the policy is applied to for-profits. The application of this policy illustrates the potential for arbitrary and unfair results. These arbitrary results would undermine Malani and Posner's goals of efficiency and fairness.¹⁷⁸

Moreover, unlike the UBIT, which attempts to curb tax-base erosion,¹⁷⁹ this policy would cause severe harm to the tax base. Consequently, this note

168. See Taylor, *supra* note 17, at 749–51 (explaining that the shareholder primacy ethos of corporations limit the impact that CSR has on society).

169. See *Theorizing the Charitable Tax Subsidies*, *supra* note 12, at 518–20.

170. See *id.*

171. See Galle, *supra* note 14, at 1230.

172. See generally Malani & Posner, *supra* note 1.

173. See Kotchen, *supra* note 164, at 830–31 (explaining that the infusion of socially conscious goods, such as fair-trade coffee, into the market may cause consumers to purchase green goods and the like as a substitute for the provision of direct aid, reducing the overall social welfare).

174. But see *The Attack on Nonprofit Status*, *supra* note 13.

175. See generally Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 622 (1989); see also Stone, *supra* note 75, at 1495–528.

176. See Gomes & Owens, *supra* note 112, at 14; see also, Gottry, *supra* note 111, at 270–72.

177. See Gottry, *supra* note 111, at 270–72.

178. See generally Malani & Posner, *supra* note 1.

179. Stone, *supra* note 75, at 1491.

argues that basing tax exemption solely on activity, as opposed to a combination of activity and the organizational form, is bad public policy. Furthermore, it argues that implementing a one-size-fits-all policy to deal with inequities in the market is illogical.¹⁸⁰

A. THE STANDARD IS FLAWED

The first two requirements—that the activity be a “business or trade” and that it be “regularly carried on”—are problematic standards despite the fact that they are relatively simple.¹⁸¹ In the UBIT context, the term “trade or business” is understood to characterize activities that generate profits and are commercial in nature.¹⁸² This is problematic in the context of this hypothetical policy because some of the most valuable charity work carried out by for-profit organizations does not generate a profit. Therefore, the test is under-inclusive. For instance, a number of large corporations, such as Target and Walmart, have established pro bono programs that provide free goods and services to the needy.¹⁸³ These organizations might be deserving of a benefit, but they will not be eligible for any benefits under this policy because they do not generate a profit by offering those services;¹⁸⁴ the activities do not constitute a “trade or business.”¹⁸⁵

Conversely, the “regularly carried on” standard is so vague that it has the potential to cause overreporting.¹⁸⁶ Under the UBIT, courts tend to assess “the frequency and continuity of the activities, the manner in which they are conducted, and their similarity to comparable activities of nonexempt businesses” in order “to determine whether” the activity is “regularly carried on.”¹⁸⁷ These factors are helpful, but vague. There is little indication of how often or for how long the activity must be carried on.¹⁸⁸ Nor is there a strong indication of how similar an activity must be to the activity of its nonexempt counterpart.¹⁸⁹ As a result, nonprofits have found ways of interpreting this standard in such a way as to underreport these activities.¹⁹⁰

180. See *The Attack on Nonprofit Status*, *supra* note 13, at 1205.

181. See Gottry, *supra* note 111, at 270–71.

182. See Scally, *supra* note 71, at 14.

183. See TARGET CORPORATE RESPONSIBILITY, *supra* note 65; WALMART, WALMART 2011 GLOBAL RESPONSIBILITY REPORT 61 (2011), available at <http://walmartstores.com/sites/ResponsibilityReport/2011/default.aspx>.

184. See Scally, *supra* note 71, at 14.

185. See *id.* (explaining that activities that do not generate a profit are not subject to the UBIT even if they look like a “trade or business”).

186. See Abrams, *supra* note 103, at 893 (noting the ambiguity of this prong despite the Treasury’s numerous attempts to provide guidance as to its parameters).

187. See Gottry, *supra* note 111, at 271 (footnote omitted).

188. See Abrams, *supra* note 103, at 893.

189. See *id.*

190. See Colombo, *supra* note 101, at 531.

Similarly, the targeted tax-exemption policy could be manipulated so as to enable for-profit organizations to overreport these activities. For instance, NBC Universal hosts a biannual “green week” on its television channels that seeks to integrate the promotion of green practices into much of its programming.¹⁹¹ This activity is a “trade or business” and is “substantially related to an exempt purpose,” but it is only carried on for two weeks per year.¹⁹² However, because green week is a nationally recognized annual celebration of the green movement, it may qualify as “regularly carried on.”¹⁹³ Furthermore, although the IRS would be empowered to investigate potential inaccuracies in organizations’ filings, the cost of doing so might be greater than the revenue lost through exemption.¹⁹⁴

The third requirement, that the activity be “substantially related” to an exempt purpose, creates an even more troubling dilemma, which strikes at the heart of nonprofit law: how should the IRS effectively define an exempt or charitable purpose.¹⁹⁵ Without the safety valve of the nondistribution constraint, the question of what charity law truly seeks to promote is exposed.¹⁹⁶ What does society value about charity? Although the answer to this question is beyond the scope of this note, its importance should not be overlooked.

Currently, exempt purposes are broadly defined as follows:

The exempt purposes set forth in section 501(c)(3) are charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty to children or animals. The term *charitable* is used in its generally accepted legal sense and includes relief of the poor, the distressed, or the underprivileged; advancement of religion; advancement of education or science; erecting or maintaining public buildings, monuments, or works; lessening the burdens of government; lessening neighborhood tensions; eliminating prejudice and discrimination; defending human and civil rights secured by law; and combating community deterioration and juvenile delinquency.¹⁹⁷

191. *Green Interacts Here*, NBC, <http://www.nbc.com/green/about/> (last visited, Dec. 20, 2010).

192. *Id.*

193. See Scally, *supra* note 71, at 14.

194. See *For Profit Charity*, *supra* note 9, 231–33; see also Galle, *supra* note 14, at 1220.

195. Brakman Reiser points out that the current trends in for-profit philanthropy, particularly Google.org’s innovative approach to philanthropy, “highlight a more fundamental issue: the utility of the legal boundary between nonprofit and for-profit endeavor.” Brakman Reiser, *supra* note 5, at 2471. Fundamental to this boundary is the nondistribution constraint. By adopting the proposal explored in this note or one like it, this fundamental boundary is lifted and the question of what is truly charitable is exposed.

196. See Galle, *supra* note 14, at 1220.

197. *Exempt Purposes*, *supra* note 133.

This broad definition is favorable for nonprofit organizations that require flexibility in defining their missions.¹⁹⁸ It is problematic, however, when considering extending tax benefits to for-profit organizations that are not subject to the nondistribution constraint.¹⁹⁹ As seen above, this definition could encompass a broad range of activities, such as the sale of green products, which could easily be undertaken without a true charitable purpose. Without enforcement mechanisms, capable of divining a company's true purpose²⁰⁰ and monitoring the charitable impact of a company's activities, a policy employing such a broad definition could easily be abused.²⁰¹ For instance, an organization could sell products that are made with recyclable materials because it believes that consumers are more likely to purchase them, and simultaneously, the company could exploit its factory workers. These perverse results highlight the complex problems that arise in applying the third prong of this policy.

The even more difficult aspect of the third prong, however, is how to access what is "substantially related" to an exempt purpose. As the application of this policy illustrates, the use of the UBIT rubric for this prong of the test leads to strange results.²⁰² Under this policy, the income generated by Starbucks' sale of ethically sourced coffee would be exempt whereas the income generated by Toms would not.²⁰³ Although both organizations should be recognized for their social consciousness, one could argue that Toms is more charitable, as it targets needy communities and provides them with direct aid.²⁰⁴ More importantly, however, it is likely that exempting Toms from income tax would have a stronger impact on the company's ability to affect the lives of its beneficiaries than the impact that exempting Starbucks' income would have on its ability to sell ethically sourced coffee.²⁰⁵ Furthermore, providing income tax exemption for

198. See Schizer, *supra* note 11, at 254–55.

199. See *For Profit Charity*, *supra* note 9, at 232 (critiquing Malani and Posner's proposal, Fleisher argues that the current definition of exempt activity under section 501(c)(3) is not defined well enough to prevent its misuse or overuse by for-profit companies).

200. Malani and Posner explicitly argue that a company's motivation for engaging in charitable activity should not matter if the goal is to increase production of public good. See Malani & Posner, *supra* note 1, at 2064. This argument, however, ignores two important effects of a lack of charitable intent. First, without ensuring the charitable intention of an organization, one cannot ensure that the organization is committed to producing the good or service without creating a negative externality for society to endure. Second, if the company's intent is not somewhat charitable then it is unlikely that tax exemption will provide a strong enough incentive to engage in the activity.

201. See Galle, *supra* note 14, at 1220; see also *For Profit Charity*, *supra* note 9, at 232 (noting that this would require the IRS to significantly increase its expenditure of resources on monitoring tax-exempt organizations).

202. See discussion *supra* Part IV.

203. See discussion *supra* Part IV.A–B.

204. See *One for One Movement*, *supra* note 40.

205. Toms' entire business model is based on the "One for One Movement," and thus, it stands to reason that relief from income tax would enable Toms to expand its market and thus provide more relief. Conversely, a tax exemption would not affect Starbucks' production of public goods.

companies like Starbucks, as opposed to Toms, will have a much more severe impact on the tax base.²⁰⁶

B. THESE FLAWS INHERE TO ANY POLICY THAT EXEMPTS FOR-PROFIT CHARITY

Although one could argue that this hypothetical policy is to blame for the problems that arise out of its application, it is merely illustrative of the inevitable consequences of a broad, sweeping policy that seeks to achieve Malani and Posner's goals.²⁰⁷ The analysis above not only demonstrates the practical inefficiency of this policy, but it also highlights the disutility of treating all for-profits alike *and* all charitable activity alike. It is tempting to succumb to the logic that like things should be treated alike. But it does more harm than good to ignore the differences between the various types of for-profit and nonprofit organizations and the manner in which they produce public goods.²⁰⁸

Notably, the benefit retained by hybrid organizations like Toms, as opposed to Starbucks, is more likely to have an impact on the organization's charitable mission since hybrids generally have more freedom to disregard shareholder primacy.²⁰⁹ That is not to say that hybrid organizations refrain from distributing profits; however, whether money saved through exemption goes towards employee bonuses or director compensation, it will improve the efficiency of the organization, which will theoretically increase the overall public good.²¹⁰

This illustrates that even the most equitable policy is not a one-size-fits-all solution to Malani and Posner's concerns. The government has recognized this logic; personal income tax rates are based on an individual's level of income.²¹¹ While these tax rates are unequal, the government has determined that they are equitable.²¹² If the rationale behind the UBIT were applied to personal income tax rates, all taxpayers would be taxed at the same rate regardless of their wealth.²¹³ The government has recognized, however, that this is illogical and unfair.²¹⁴

206. The greater the income generated by a corporation, the higher the income tax rate imposed on the corporation. I.R.C. § 11 (2010).

207. See *infra* Part VI (discussing incremental policies that would be more feasible to implement).

208. See *The Attack on Nonprofit Status*, *supra* note 13, at 1218.

209. See Jay Milbrandt, Comment, *A New Form of Business Entity is Needed to Promote Social Entrepreneurship: The Not-For-Loss Corporation*, 1 J. BUS. ENTREPRENEURSHIP & L. 421, 438 (2008).

210. Malani and Posner make this argument; however, they argue that this increased efficiency and output of public goods will be operative in all for-profit firms promoting community-benefit. See Malani & Posner, *supra* note 1, at 2065.

211. See I.R.C. § 1.

212. Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 625–36 (1990).

213. See *id.* at 626–27.

214. See I.R.C. § 1.

Professor Rob Atkinson uses this analogy to illustrate that the perceived lack of fairness remedied by the UBIT is a misconception; he argues that it is equitable to treat like for-profit and nonprofit business activity differently.²¹⁵ Although Atkinson's analogy is meant to illustrate the problems with the UBIT,²¹⁶ it also suggests that the unequal treatment of nonprofits and for-profits doing charitable work is equitable.²¹⁷ Alternatively, this analogy demonstrates that certain for-profits should be treated more like nonprofits than others in order to achieve an equitable result.²¹⁸

VI. AN ALTERNATIVE PROPOSAL TO THE WHOLESALE EXTENSION OF TAX EXEMPTION

Malani and Posner's theory that tax exemption will incentivize existing for-profit organizations to engage in "community-benefit" work and prompt the formation of more socially conscious for-profit organizations is likely accurate. Most studies, however, do not support Malani and Posner's assertions that a for-profit presence in the charitable sector increases competition and efficiency.²¹⁹ The hypothetical policy suggested by this note was modeled after the UBIT in order to balance Malani and Posner's goal of increased output with the valid concerns posed by other scholars as to the effects of the more aggressive reforms sought by Malani and Posner.²²⁰ For the reasons discussed above, however, it is clear that even a modest policy like this would undermine Malani and Posner's goals of increasing overall public good.²²¹

One alternative to this policy is a reduced corporate income tax rate for charitable business activity. This rate would vary according to the amount of charitable activity undertaken by a company. A large for-profit corporation, like Starbucks or Target, would have a greater incentive to increase CSR, but the reduced rate would have a more proportionate impact on the tax base than a wholesale exemption of income generated through charitable activity.²²² On the other hand, organizations like Toms and

215. See Atkinson, *supra* note 212, at 627.

216. See *id.* at 625–27.

217. *Cf. id.* (extending Atkinson's logic to the issues raised in this note, it stands to reason that his thesis applies with equal force to the UBIT and to the analogous policy discussed in this note).

218. See *id.*

219. See *The Attack on Nonprofit Status*, *supra* note 13, at 1199–203 (citing studies and explaining that Malani and Posner's assumption that nonprofits are not as efficient as for-profits is based on the inaccurate notion that the charitable sector is not competitive).

220. See *supra* text accompany notes 10–14.

221. See *supra* Part V.

222. The proportionality referred to here regards the ratio between the public good produced and the reduction in tax revenue.

Google.org would enjoy a more favorable tax rate.²²³ This scheme, although administratively complicated, would provide tax relief to all organizations doing charitable work, and it would prevent the severe tax-base erosion envisioned above.²²⁴ Furthermore, this conditional tax rate would promote equity; the rate of reduction would vary according to the potential impact of tax relief on an organization's ability to provide more public goods to its community.

This idea shares some qualities with tax credit policies that refund a percentage of a company's income tax when it engages in certain types of charitable activity, such as renewable energy production.²²⁵ Like tax credits, this reduced rate scheme would reward charitable activity by reducing a company's income tax expenditure.²²⁶ The benefit of the reduced rate scheme, however, is that it would apply to any activity that served an exempt purpose, as opposed to targeting a handful of activities that serve the government's pet interests.²²⁷ Furthermore, this rate reduction would be more efficient than a tax credit because it would vary according to the benefit that it would confer on the community.²²⁸

CONCLUSION

This note argues that the policy proposed by Malani and Posner is unworkable and inequitable. It draws on Malani and Posner's analogy to the UBIT to explain how a policy based on the UBIT principles undermines their laudable goals of increasing the production of public goods and the efficiency of the charitable sector. Finally, this note seeks to find an alternative approach to reaching these goals. Although the proposal above is by no means a perfect solution, it illustrates that a policy which accounts for the differences between organizations and their charitable efforts is more equitable than Malani and Posner's one-size-fits-all approach.²²⁹

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223. These examples are meant to illustrate the application of the policy; however, both are clearly flawed examples because under current tax rates, they would likely generate very little taxable income. See Brakman Reiser, *supra* note 5, at 2453.

224. See *supra* Part V.

225. See I.R.C. § 48 (2010).

226. *Cf. id.*

227. *Cf. id.*

228. *Cf. id.*

229. See *The Attack on Nonprofit Status*, *supra* note 13, at 1218.

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