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NOTES

A Tax Analysis of the Emerging Class of Hybrid Entities

INTRODUCTION

Jeffrey Hollender was ready for a change. He had made a small fortune selling self-help courses, but he did not believe in the work anymore.¹ After an embarrassing appearance on the Phil Donahue Show, where audience members took Hollender to task for the apparent moral bankruptcy of his day job, he began to search for a more meaningful way to spend his life.² Hollender gave up his job at Warner Communications, took a good, long look in the mirror, and started putting together a book called *How to Make the World a Better Place*.³

As Hollender was researching a chapter on the environment, he stumbled across a small catalog called Renew America that specialized in selling environmentally friendly products.⁴ Intrigued, he got in touch with Renew America's owner, Alan Newman.⁵ As the two discussed the catalog, Hollender began to see huge potential: the environmental movement was really beginning to take off, but consumer companies were barely addressing it.⁶ Before long, Hollender convinced Newman to take him on as a partner and devoted himself to aggressively expanding Renew America's business.⁷

Within six years, Hollender had driven the company's annual earnings from \$100,000 to \$6,000,000. Anticipating a

¹ See Joyce Marcel, *Profiles in Business: Jeffrey Hollender and Seventh Generation*, VT. BUS. MAG. (June 1, 2003), <http://www.highbeam.com/doc/1P3-349101541.html>.

² See *id.*

³ See *id.*

⁴ See *id.*

⁵ See *id.*

⁶ See *id.*

⁷ See *id.*

change in the market, however, he sold the catalog and shifted the company's focus to developing environmentally friendly products.⁸ At first, he cultivated relationships with natural foods stores.⁹ But before long, he was able to persuade traditional grocery stores to carry his products.¹⁰ As the business continued to grow, Hollender decided that the company's name ought to reflect its commitment to sustainable products and living.¹¹ After one of his employees introduced him to the Great Law of the Iroquois Confederacy—"[i]n our every deliberation, we must consider the impact of our decisions on the next seven generations"¹²—Hollender renamed the company Seventh Generation.¹³

Over the next fifteen years, Seventh Generation became one of the leaders of an emerging group of businesses dedicated to transforming consumer products.¹⁴ It also became a registered B Corporation, a business mark that designates a company's commitment to social and environmental standards.¹⁵ It is difficult to overstate the company's impact on the widespread availability of environmentally friendly cleaning products. Seventh Generation was one of the earliest environmentally focused companies to push its products into ordinary supermarkets.¹⁶ By doing so, the company helped move sustainable brands beyond a niche and into the mainstream—turning a nascent market in environmentally responsible goods into a profitable alternative to traditional products.¹⁷ Seventh Generation's cleaning products have also had a major influence on its competitors. In 2010, Seventh Generation finally persuaded the American Cleaning Institute's members to implement a voluntary ban on the use of damaging phosphates in dishwasher detergent—a major shift in industry practice that water protectionists are lauding as an

⁸ *See id.*

⁹ *See id.*

¹⁰ *See id.*

¹¹ *See id.*

¹² *Great Law of the Iroquois Confederacy*, FAST COMPANY (Apr. 15, 2004), <http://www.fastcompany.com/blog/fast-company-staff/fast-company-blog/great-law-iroquois-confederacy>.

¹³ Marcel, *supra* note 1.

¹⁴ *Id.*

¹⁵ *B Corporation—Wave of the Future for Business*, SEVENTH GENERATION, <http://www.seventhgeneration.com/learn/blog/b-corporation-wave-future-business> (last visited Oct. 12, 2012). *See infra* Part III.B for a detailed explanation of B Corporations.

¹⁶ Marcel, *supra* note 1.

¹⁷ *Id.*

important step forward for the cleaning products industry.¹⁸ The company's product line is also chlorine free, and the strength of its sales has, in part, prompted traditional competitors to begin offering their own chlorine-free products.¹⁹ Human-health and environmental-safety experts recognize this movement away from chlorine as a substantial market improvement.²⁰

Despite helping to develop the market for environmentally responsible cleaning products, leading its competitors to improve the environmental quality of their product lines, and making important contributions to the water-safety movement, Seventh Generation has never been eligible for favorable federal tax incentives.²¹ As far as the Internal Revenue Service (IRS) is concerned, Seventh Generation is no different from Tide, Cascade, or Clorox.²²

This note considers whether the federal tax scheme for companies like Seventh Generation is appropriate given the benefits they appear to confer on society—an issue that is increasingly more salient as an emerging business sector known as “social enterprise”²³ tests and pushes traditional business boundaries. Social enterprise is characterized by businesses that pursue a dual mission of achieving “social and business goals together, viewing them as synergistic and mutually reinforcing, as equal partners in their business vision.”²⁴ Hemmed in by traditional business entities like for-profit and nonprofit corporations, social entrepreneurs have recently developed a handful of new business entities that attempt to achieve at least three central goals: (1) articulate and pursue a dual mission, (2) gain access to capital, and (3) effectively brand dual-mission businesses.²⁵ The hybrid entities that are most commonly in use today are: the Low-Profit Limited Liability Company (L3C), which is a socially oriented

¹⁸ *Detergent Industry's Landmark Voluntary Phosphate Ban Caps Seventh Generation's Decade-Long Fight*, MARKETWIRE (June 29, 2010), <http://www.marketwire.com/press-release/detergent-industrys-landmark-voluntary-phosphate-ban-caps-seventh-generations-decade-1283540.htm>.

¹⁹ See, e.g., CLOROX, <http://www.clorox.com/products> (last visited Oct. 11, 2012).

²⁰ *Medical Hazards of Chlorine*, CHLORINE FREE PRODUCTS ASS'N, <http://chlorinefreeproducts.org/medicalhazardsofchlorine.html> (last visited Oct. 11, 2012).

²¹ See *infra* Part III.

²² See *infra* Part III.

²³ Dana Brakman Reiser, *For-Profit Philanthropy*, 77 *FORDHAM L. REV.* 2437, 2450 (2009) (internal quotation marks omitted).

²⁴ *Id.*

²⁵ See Dana Brakman Reiser, *Benefit Corporations—A Sustainable Form of Organization?*, 46 *WAKE FOREST L. REV.* 591, 610 (2011).

variant of the traditional limited liability company that state statutes enable companies to adopt; the Benefit Corporation (B Corporation), which is a private designation offered by the nonprofit organization B Lab to third-party organizations that meet a set of qualifying criteria; and the statutory benefit corporation, which is an alternative to the traditional for-profit corporation that state statutes allow qualifying corporations to adopt.²⁶ While there is a healthy debate concerning whether these three entities serve the core social enterprise goals, there has been comparatively little scholarship concerning how they should be taxed. This note helps to develop that discussion by considering to what extent these so-called hybrid entities qualify for favorable federal tax treatment under two traditional theories for nonprofit tax advantages and also under Professors Malani and Posner's broader theory of favorable taxation for socially beneficial activities.²⁷ These theories provide a helpful springboard for this conversation because the core hybrid-entity goal of pursuing social good stands in rough parallel to the socially beneficial objectives of traditional nonprofits.

This note argues that while each of the three most common American hybrid entities demonstrates some characteristics that justify favorable tax treatment, they also lack essential structural features that would warrant entity-based tax advantages. Part I offers a backdrop for the hybrid entity's development by introducing social enterprise and briefly reviewing the corporation, the nonprofit corporation, and the key challenges these forms present for businesses interested in pursuing both public good and profit. Part II explains how for-profit and nonprofit corporations are normally taxed, introduces two traditional rationales for nonprofit tax benefits, and describes Malani and Posner's critique of the current tax regime. Part III then presents the three hybrid entities discussed above and considers to what extent they address the core considerations of the traditional tax rationales and Malani and Posner's theory. This analysis highlights the elements of each hybrid entity that support favorable tax treatment. It also discusses those features that preclude or impede federal tax advantages.

²⁶ See *infra* Part III.

²⁷ Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2022 (2007).

I. SOCIAL ENTERPRISE AND CURRENT ENTITY FORMS

A. *Social Enterprise*

The social enterprise movement has developed over the past two to three decades²⁸ as entrepreneurs have created businesses that use “earned income strategies” to “directly address[] social need[s] . . . through [their] products and services.”²⁹ As such, the “social enterprise ideal”³⁰ typically involves blending traditional business methods³¹ with a “deep and particular commitment to philanthropic endeavor.”³² Achieving this ideal requires the pursuit of the so-called double bottom line, which contemplates both financial and social success.³³ Social enterprise has taken many shapes but commonly fits within one of two models: (1) a profit-driven entity that incorporates socially responsible business choices in some elements of its decision making (a model that bears a good deal of similarity to corporate social responsibility), or (2) a social-value-driven entity that contemplates earning some profits in its business activities.³⁴

The theoretical underpinnings of social enterprise are, at turns, intuitively appealing to the socially minded or practically unsatisfying to the business traditionalist. But whether one is a devotee or an agnostic about the wisdom, value, and utility of social enterprise, its proponents have identified characteristics of traditional business forms that present something of a conundrum for social enterprise.³⁵ As such, social entrepreneurs and legal theorists have advocated the development of new hybrid entities designed to obviate these challenges and serve the dual-mission approach of social enterprise.³⁶ Before turning to the new entities, however, it is

²⁸ See Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 342 (2009).

²⁹ *What is Social Enterprise*, SOC. ENTERPRISE ALLIANCE, <https://www.se-alliance.org/what-is-social-enterprise> (last visited Oct. 11, 2012).

³⁰ Brakman Reiser, *supra* note 23, at 2450.

³¹ SOCIAL ENTERPRISE ALLIANCE, *supra* note 29.

³² Brakman Reiser, *supra* note 23, at 2450.

³³ Kelley, *supra* note 28, at 339.

³⁴ See *id.* at 351-52.

³⁵ See *id.* at 363.

³⁶ *Id.* at 340 (“According to [the proponents of social enterprise], we are in the process of moving beyond the traditional conception of society as divided neatly into three sectors—business, nonprofit, and government—and are witnessing the emergence of a new fourth sector that encompasses elements of both the business and nonprofit sectors.”).

instructive to consider the traditional entity landscape from which they emerge.

B. The For-Profit Corporation

Given the current debate concerning whether new hybrid entities are necessary to facilitate social enterprise, it is interesting to note that the earliest corporations were not organized for commercial activities.³⁷ Instead, they were incorporated for a variety of municipal, community, and charitable purposes.³⁸ Soon, however, the corporation became the entity of choice for commercial business in America.³⁹ As market “demand grew for a form of business organization that could amass and efficiently manage very large and longlived capital investments,”⁴⁰ legislators responded by gradually endowing the corporation with three central components that enabled it to serve this demand: (1) “the right to issue transferable shares,” (2) delegation of shareholder power to management, and (3) limited liability for shareholders.⁴¹ With these features commonly in place, the corporation was able to serve as the mechanism for capital growth and investment that American business demanded.⁴²

As the corporate form developed, so too did the theory of shareholder primacy,⁴³ which many social entrepreneurs and legal theorists consider the largest obstacle to the dual mission of social enterprise.⁴⁴ Shareholder primacy theory stands for the principle that the corporation’s primary fiduciary responsibility is to maximize the value of the corporation for its shareholders.⁴⁵ “If pursuit of this objective conflicts with the interests of one or more of the corporation’s nonshareholder constituencies, management is to disregard such competing

³⁷ MARION R. FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS* 40 (2004).

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ William L. Baldwin, *The Corporation and Society: An Evolutionary/Institutional Approach*, 27 VT. L. REV. 841, 843-44 (2003).

⁴¹ *Id.* at 844.

⁴² See FREMONT-SMITH, *supra* note 37, at 150.

⁴³ D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 296 (1998) (“[T]he shareholder primacy norm was not developed by courts until the 1830s, but evidence of shareholder primacy is abundant in early business corporations. Early corporate charters, general incorporation statutes, judicial decisions, and legal commentary all reflect a commitment to shareholder primacy in the similar treatment of dividends and voting rules.” (footnotes omitted)).

⁴⁴ Kelley, *supra* note 28, at 351-52.

⁴⁵ Smith, *supra* note 43, at 282.

considerations.”⁴⁶ This belief was articulated, perhaps most famously, in the all-too-familiar case of *Dodge v. Ford Motor Co.*, where the Supreme Court of Michigan found that “[a] business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end.”⁴⁷ As stated in *Dodge*, the theory of shareholder primacy became a legal hurdle for corporations that sought to engage in activities expressly for the public good rather than for shareholder value.⁴⁸

In response to criticisms of the shareholder primacy theory,⁴⁹ many states have adopted a so-called constituency statute, which “authorizes, but does not require, the board to take into account the interests of stakeholders such as employees, suppliers, the community, the environment, and shareholders when determining a course of action or making a decision.”⁵⁰ Delaware, where most Fortune 500 corporations are currently incorporated, does not have such a constituency statute.⁵¹ But it does expressly authorize corporations to “[m]ake donations for the public welfare or for charitable, scientific or educational purposes, and in time of war or other national emergency in aid thereof.”⁵² It is unclear, however, to what extent these statutory provisions can facilitate the dual missions of social enterprise. To consider this question, it is

⁴⁶ *Id.*

⁴⁷ *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919).

⁴⁸ See generally Anthony Bisconti, Note, *The Double Bottom Line: Can Constituency Statutes Protect Socially Responsible Corporations Stuck in Revlon Land?*, 42 LOY. L.A. L. REV. 765 (2009). It is worth pointing out that the court’s statement on shareholder primacy in *Dodge* was dicta. Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford*, 3 VA. L. & BUS. REV. 163, 167 (2008). Moreover, Professor Stout argues that the case can be read more profitably as holding that Henry Ford, as a controlling shareholder, had breached his fiduciary duty of good faith to minority shareholders. See *id.* While *Dodge* may not properly be read to articulate the theory of shareholder primacy, it is the theory’s apocryphal root and, as its facts “are familiar to virtually every student who has taken a course in corporate law,” *id.* at 164, it is a helpful heuristic.

⁴⁹ Shareholder primacy theory actually developed into one of the more contentious debates in corporate law’s history. Ian B. Lee, *Efficiency and Ethics in the Debate About Shareholder Primacy*, 31 DEL. J. CORP. L. 533, 535 (2006). Since early debate on the topic in the pages of the Harvard Law Review between Professors Berle and Dodd, scholarship has continually questioned to what degree a corporation’s concerns should be fixed to maximize shareholder value. See Smith, *supra* note 43, at 281-82; see also Marshall M. Magaro, *Two Birds, One Stone: Achieving Corporate Social Responsibility Through the Shareholder-Primacy Norm*, 85 IND. L.J. 1149, 1152-53 (2010).

⁵⁰ Rakhi I. Patel, *Facilitating Stakeholder-Interest Maximization: Accommodating Beneficial Corporations in the Model Business Corporation Act*, 23 ST. THOMAS L. REV. 135, 146 (2010).

⁵¹ See *id.* at 147.

⁵² DEL. CODE ANN. tit. 8, § 122 (2011).

useful to assess the range of activities that constituency statutes have enabled.

C. *Corporate Social Responsibility*

The prevalence of constituency statutes and similar statutory provisions authorizing corporate donations has paved the way for corporations to engage in at least some amount of philanthropic activity.⁵³ *Corporate social responsibility*, as this activity has come to be known,⁵⁴ is now exceedingly commonplace and typically takes one of two forms.⁵⁵ First, corporations use corporate funds to make charitable contributions.⁵⁶ These donations reached a total of \$15.29 million in 2010, a full 5 percent of charitable giving in the United States.⁵⁷ Along the same lines, corporations often elect to make in-kind contributions of property or services.⁵⁸ Corporations choose to make such donations for several reasons, including to develop a corporate image and identity of care and giving, to associate a corporate brand with quality gift recipients, and to improve or influence the communities where the corporation has a presence.⁵⁹

Second, companies may “bring consideration of social impact into the mainstream of their business operations” and make significant strategic and tactical decisions based in part upon their impact on social, community, environmental, and other factors related to the public good.⁶⁰ Starbucks’s decision to support rural coffee farmers around the world by committing to purchase fair trade coffee is one example of this form of corporate social responsibility.⁶¹ These types of supply-chain decisions may not directly improve the net asset value of a corporation’s shares (although they could), but they are viewed

⁵³ See generally Antony Page & Robert A. Katz, *Is Social Enterprise the New Corporate Social Responsibility?*, 34 SEATTLE U. L. REV. 1351 (2011).

⁵⁴ See *id.*

⁵⁵ Brakman Reiser, *supra* note 23, at 2446.

⁵⁶ *Id.*

⁵⁷ GIVING USA, THE ANNUAL REPORT ON PHILANTHROPY FOR THE YEAR 2010: EXECUTIVE SUMMARY 4 (2011).

⁵⁸ See Brakman Reiser, *supra* note 23, at 2447 (“Nor has corporate generosity been limited to cash donations; an estimated one-third to one-half of corporate giving takes the form of in-kind contributions.”).

⁵⁹ *Id.*; see also Henry N. Butler & Fred S. McChesney, *Why They Give at the Office: Shareholder Welfare and Corporate Philanthropy in the Contractual Theory of the Corporation*, 84 CORNELL L. REV. 1195, 1202-03 (1999).

⁶⁰ Brakman Reiser, *supra* note 23, at 2449.

⁶¹ *Being a Responsible Company*, STARBUCKS, <http://www.starbucks.com/responsibility> (last visited Sept. 30, 2011).

as a way for powerful and influential corporations to “spearhead solutions to society’s greatest problems.”⁶²

Corporate social responsibility has traditionally provided the mechanism by which profit-driven corporations can engage in philanthropic activities. But notwithstanding the threat of direct legal challenges that attend corporate decisions made for reasons other than maximization of shareholder profits, even comparatively uncontested corporate philanthropy has its limits.⁶³ First, the discretion to engage in high levels of philanthropic activity is “powerfully limited by managerial profit-sharing or stock options, product market competition, the labor market for corporate officials, the need to raise capital, the threat of takeovers, and the prospect of being ousted by shareholder vote.”⁶⁴ Second, legal limits constrain corporate philanthropy. For instance, the American Law Institute (ALI) states that “managers can devote only a ‘reasonable’ amount of corporate resources to public interest purposes, and can consider ethical principles only to the extent they are ‘reasonably regarded as appropriate to the responsible conduct of business.’”⁶⁵ The ALI recommends looking to two factors to determine reasonableness: (1) decisions “by similar corporations, and (2) the nexus between the public-spirited activity and the corporation’s business.”⁶⁶ Similarly, decisions made pursuant to state statutes authorizing corporate philanthropic activity generally permit only reasonable donations.⁶⁷ As a result of these constraints, corporate social responsibility is not a perfect solution for social-enterprise businesses that wish to aggressively pursue both social good and profits.

D. *The Nonprofit Corporation*

The nonprofit corporation, like the corporation, can also trace its lineage back to ancient times, when most major religions encouraged communities to care for their less fortunate and provide for one another in times of need.⁶⁸ This commitment to charitable community action through association

⁶² Brakman Reiser, *supra* note 23, at 2452.

⁶³ See, e.g., Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 842 (2005).

⁶⁴ See *id.* at 840.

⁶⁵ *Id.* at 842-43 (citation omitted).

⁶⁶ *Id.* at 843 (citation and internal quotation marks omitted).

⁶⁷ See *id.* at 843 n.222 (collecting cases).

⁶⁸ Thomas Kelley, *Rediscovering Vulgar Charity: A Historical Analysis of America’s Tangled Nonprofit Law*, 73 FORDHAM L. REV. 2437, 2440-41 (2005).

evolved into a practicing tradition in America and England, where governments created organizational forms to serve charitable activity during the eighteenth and nineteenth centuries.⁶⁹ Interestingly, in an early foreshadowing of today's entity debate, businesses serving the public good disagreed about the best entity to serve their needs.⁷⁰ Originally, the more common vehicle for charitable activity was the charitable trust.⁷¹ But as the charitable trust came under a cloud of skepticism,⁷² which was one reason among many that the corporation became the dominant organizational form for charitable and other philanthropic purposes by the twentieth century.⁷³

Although organizational forms such as the trust are available for nonprofits, the corporation remains the favored entity for organizations that are dedicated to serving some form of public good.⁷⁴ "[T]he most significant category" of these corporations "is found at [Internal Revenue] Code section 501(c)(3)."⁷⁵ While these nonprofit corporations must comply with a range of statutory requirements, two stand out as most relevant for this discussion. First, nonprofit organizations "must be both organized and operated exclusively for one or more" specified purposes, which include religious, charitable, scientific, testing for public safety, literary, educational, and prevention of cruelty to children or animals.⁷⁶ Second, nonprofits operate under what Professor Hansmann calls the nondistribution constraint,⁷⁷ whereby a nonprofit corporation "is

⁶⁹ *Id.* at 2451-58.

⁷⁰ *Id.*

⁷¹ James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L.J. 617, 625 (1985).

⁷² *Id.* at 628 ("For much of the nineteenth century the use of the charitable trust suffered from widespread fear of the dead hand, particularly the dead hand of the church, from strict construction of trust statutes, and from judicial unwillingness to recognize the charitable trust." (footnote omitted)).

⁷³ *Id.* at 629-37.

⁷⁴ "Most nonprofits of any significance are incorporated." Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980). While "[f]ederal tax exemption law is agnostic among the organizational forms qualifying charities might take," Dana Brakman Reiser, *Charity Law's Essentials*, 86 NOTRE DAME L. REV. 1, 17 (2011), this note agrees with Hansmann's position that the corporation is the most significant corporate entity. Consequently, this note does not discuss the other nonprofit forms at any length.

⁷⁵ I. Richard Gershon, *Tax-Exempt Entities: Achieving and Maintaining Special Status Under the Watchful Eye of the Internal Revenue Service*, 16 CUMB. L. REV. 301, 303 (1986).

⁷⁶ 26 C.F.R. § 1.501(c)(3)-1(a)-(g) (2011).

⁷⁷ Hansmann, *supra* note 74, at 838 ("Since a good deal of the discussion that follows will focus upon this prohibition on the distribution of profits, it will be helpful to have a term for it; I shall call it the 'nondistribution constraint.'"). This requirement

barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees.”⁷⁸ Generally speaking, these requirements are in place to ensure that nonprofits are organized to deliver public (rather than private) benefits and to enforce a nonprofit’s ongoing commitment to this mission. While the purpose requirement may not present a problem for social enterprise, the nondistribution constraint presents a more serious challenge. As Malani and Posner note, any social enterprise that prefers a compensation scheme that permits distribution of profits or equity, rather than a purely salary-based compensation model, will not organize as a nonprofit.⁷⁹

E. The Development of Hybrid Entities

Given these characteristics of for-profit and nonprofit corporations, social entrepreneurs became increasingly frustrated with their entity options. If a social-enterprise business were organized as a corporation, the shareholder primacy theory could always threaten its publicly oriented activities.⁸⁰ On the other hand, if it were organized as a nonprofit corporation, the nondistribution constraint would deny owners any share of the business’s earnings, and it could only pursue an exempt purpose.⁸¹ As a result, social entrepreneurs attempted to carve a middle path between the crossroads of for-profit and nonprofit corporations.

Proposed entity forms have not been in short supply. To date, legal scholars, social business leaders, and legislatures have offered a spate of potential solutions that purport to make social enterprise a more attractive business model, to reconsider the bright-line division between for-profit and nonprofit businesses, or both.⁸² In the United States, the most notable of these entities are the L3C, the B Corporation, and the statutory benefit corporation.⁸³ While these forms differ in

is embedded within the operation test established in the regulations. 26 C.F.R. § 1.501(c)(3)-1.

⁷⁸ Hansmann, *supra* note 74, at 838; *see also* 26 C.F.R. § 1.501(c)(3)-1.

⁷⁹ Malani & Posner, *supra* note 27, at 2019.

⁸⁰ *See generally* Bisconti, *supra* note 48.

⁸¹ Hansmann, *supra* note 74, at 838; *see also* 26 C.F.R. § 1.501(c)(3)-1.

⁸² *See, e.g.,* Dana Brakman Reiser, *Blended Enterprise and the Dual Mission Dilemma*, 35 VT. L. REV. 105, 105 (2010); *see also* Malani & Posner, *supra* note 27, at 2060.

⁸³ *See* Part III *infra* for a detailed discussion on the characteristics of each entity. For further discussion of these three entities, *see* Brakman Reiser, *supra* note 82, at 108-16. Brakman Reiser also notes that the United Kingdom has added the community interest corporation, which was developed exclusively for the purpose of serving its growing community of social entrepreneurs. *Id.* However, as this note

significant respects⁸⁴ and their relative virtues are hotly debated in legal circles,⁸⁵ each attempts, in its own way, to create an entity that can: (1) articulate and pursue a dual mission, (2) gain access to capital, and (3) effectively brand dual-mission businesses.⁸⁶

Because these hybrid entities integrate elements of both for-profit corporations and nonprofit corporations, a question lingers: should the entities qualify for favorable tax treatment? The next section begins to address this question by describing the basic elements of for-profit and nonprofit corporate taxation, introducing two traditional theories for the distinction between taxation of for-profit and nonprofit corporations, as well as Malani and Posner's recent critique of this distinction.

II. TAXATION OF FOR-PROFITS AND NONPROFITS

A. *Taxation of the For-Profit Corporation*

Generally speaking, the federal government imposes an annual tax on corporations.⁸⁷ With several exceptions, corporate income is taxed like individual income.⁸⁸ Thus, under section 63 of the Internal Revenue Code, corporations are taxed on their taxable income, which includes "gross income minus the deductions allowed by this chapter."⁸⁹ Corporations, like individuals, calculate gross income by including "all income from whatever source derived."⁹⁰ Corporations may then claim

focuses on American tax considerations, it will not provide an analysis of the community interest corporation.

⁸⁴ See *infra* Part III.

⁸⁵ See generally Brakman Reiser, *supra* note 82.

⁸⁶ Brakman Reiser, *supra* note 25, at 610.

⁸⁷ I.R.C. § 11 (2006). S Corporations are a key exception to this general rule. BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 6.01 (7th ed. 2012). Congress created the S Corporation in order to "eliminate the influence of the Federal income tax in the selection of the form of business organization which may be most desirable under the circumstances." *Id.* In an S Corporation, which is subject to certain eligibility requirements, the corporation is not taxed on its income; rather, the shareholders are taxed personally on the corporate income even where it is not distributed. *Id.* Traditional corporate taxation and the S Corporation exception illustrate a central tension behind corporate tax policy. On the one hand, the federal government wants to raise revenue by imposing a traditional tax on corporate activity that produces income. On the other hand, the government is mindful that the tax system may err when tax consequences distort optimal decision-making. This same tension is evident throughout the discussion concerning how to tax hybrid entities.

⁸⁸ BITTKER & EUSTICE, *supra* note 87, ¶ 1.01.

⁸⁹ I.R.C. § 63.

⁹⁰ *Id.* § 61.

deductions for “most of the items that are taxable to or deductible by individuals,”⁹¹ as well as a number of special deductions that apply specifically to corporations.⁹² This taxable income is then subject to a progressive tax rate with current top marginal rates of 34-39%.⁹³

B. *Taxation of the Nonprofit Corporation*

Nonprofit corporations, by contrast, are exempt from federal income tax.⁹⁴ The IRS extends this tax privilege as long as the corporation meets the requirements for nonprofit status.⁹⁵ Nonprofit corporations also receive significant benefits from section 170 of the Internal Revenue Code, which allows taxpayers to claim a deduction for contributions made to these businesses.⁹⁶ But this favorable tax treatment is not without limits.⁹⁷ Perhaps most significantly, nonprofit business activities are subject to the “unrelated business income tax” (UBIT).⁹⁸ The UBIT is imposed on “any trade or business” activity that is not substantially related to the nonprofit’s exempt purposes.⁹⁹ The IRS imposes this tax to prevent nonprofits from gaining an unfair competitive advantage over for-profit businesses by using tax-exempt income to generate additional earnings in activities not directly tied to their exempt purposes.¹⁰⁰ This limitation notwithstanding, however, the exemption from federal tax can provide significant benefits for corporations that organize as nonprofits.

⁹¹ BITTKER & EUSTICE, *supra* note 87, ¶ 1.01.

⁹² I.R.C. §§ 241-249.

⁹³ BITTKER & EUSTICE, *supra* note 87, ¶ 1.01.

⁹⁴ I.R.C. § 501(a).

⁹⁵ *See supra* Part I.D; *see also* I.R.C. § 501.

⁹⁶ I.R.C. § 170; *see also* Malani & Posner, *supra* note 27, at 2026.

⁹⁷ Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585, 586 (1998).

⁹⁸ I.R.C. § 513. The IRS also imposes the unrelated debt-financed income tax, which applies to any property that is not substantially related to the nonprofit’s exempt purposes and is subject to debt when the nonprofit acquires it. *Id.* § 514.

⁹⁹ *Id.* § 513.

¹⁰⁰ 26 C.F.R. § 1.513-1 (2012) (“The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete.”); *see also* Daniel Halperin, *Is Income Tax Exemption for Charities A Subsidy?*, 64 TAX L. REV. 283, 299-300 (2011).

C. *Traditional Rationales for the Distinction*

Two common rationales explain why the government provides distinct tax treatment for nonprofit and for-profit businesses. The first rationale emerges out of the underlying principle that the income tax should apply to earnings and be measured in part by a taxpayer's ability to pay the tax.¹⁰¹ These objectives are somewhat difficult to apply to nonprofit organizations, particularly since these organizations do not seek profit to the extent that traditional for-profit businesses do.¹⁰² Furthermore, nonprofits have traditionally distributed most or all of their earnings to beneficiaries through direct public services or grantmaking, which significantly diminishes their ability to pay taxes. Thus, taxing nonprofits may simply be incompatible with major underlying goals of our tax system.

This first principle has animated the tax distinction between for-profits and nonprofits since the earliest federal tax bills.¹⁰³ For instance, the Revenue Act of 1894, one of the earliest pieces of income-tax legislation, imposed a limited income tax on traditional profit-driven corporations, while creating exemptions for "various charitable, religious, educational, and fraternal benefit organizations."¹⁰⁴ Congressional debate of the bill suggests that these exemptions were probably included to prevent taxation of businesses that were not organized to pursue profits.¹⁰⁵ While this bill was later overturned for constitutional reasons,¹⁰⁶ Congress revisited the topic in the Revenue Act of 1913—the first tax legislation

¹⁰¹ See generally Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299 (1976). While this note applies Bittker and Rahdert's theory as articulated, it is important to acknowledge that others have criticized their view as overly narrow. See, e.g., Barbara K. Bucholtz, *Reflections on the Role of Nonprofit Associations in a Representative Democracy*, 7 CORNELL J.L. & PUB. POL'Y 555, 566-67 (1998) ("[A]s Henry Hansmann noted, the Bittker and Rahdert thesis failed to encompass the entire universe of nonprofits. He argued that their thesis omitted nonprofits that derive a substantial portion of their income not from donations but from goods and services they provide. Income to these nonprofits is indistinguishable from income derived from proprietary enterprises in the private sector." (footnotes omitted)).

¹⁰² FREMONT-SMITH, *supra* note 37, at 152.

¹⁰³ See Bittker & Rahdert, *supra* note 101, at 301.

¹⁰⁴ See *id.* at 302. Two earlier federal income tax laws were passed to support the Civil War but expired without renewal shortly thereafter. Stephanie Hunter McMahon, *A Law with A Life of Its Own: The Development of the Federal Income Tax Statutes Through World War I*, 7 PITT. TAX REV. 1, 8-17 (2009).

¹⁰⁵ See Bittker & Rahdert, *supra* note 101, at 303 (citation omitted).

¹⁰⁶ Hunter McMahon, *supra* note 104, at 26-27.

initiated after passage of the Sixteenth Amendment.¹⁰⁷ As Congress explored and defined the parameters of its new taxing power, it continued to treat for-profit and nonprofit organizations differently by imposing an income tax on for-profit corporations while exempting nonprofits.¹⁰⁸ As the bill's author stated during debate, "this bill contains the usual language exempting all corporations of the different kinds mentioned Of course any kind of society or corporation that is not doing business for profit and not acquiring profit would not come within the meaning of the [applicable] taxing clause."¹⁰⁹ This first rationale continues to exercise intuitive appeal.

The second rationale for the nonprofit income-tax exemption is the public goods theory, which asserts that these organizations provide services that the government would otherwise perform.¹¹⁰ Thus, "the government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare."¹¹¹ Moreover, nonprofits may provide these socially desirable activities more efficiently than the government, given that they may be able to respond more quickly and effectively to needs in the population that they serve.¹¹² The potential efficiencies of nonprofits provide another rationale for the government to facilitate nonprofit business activity by reducing their tax liability.

Some argue that these rationales provide coherent reasons for the nonprofit tax exemption, while others believe they result in an unwarranted subsidy to a sizable class of businesses.¹¹³ In either case, it is difficult to ignore that a

¹⁰⁷ Passage of the Sixteenth Amendment enabled Congress to pass comprehensive income tax laws in 1913 and set the tone for the nation's ongoing tax system. Bittker & Rahdert, *supra* note 101, at 303.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.* (quoting 50 CONG. REC. 1306 (1913)).

¹¹⁰ Gershon, *supra* note 75, at 324. There is also a broader view of the public goods theory, which includes benefits beyond those that the government would otherwise perform, including "the social norms of trust, cooperation, and reciprocity that develop through positive citizen interaction and which undergirds the effective functioning of democracy and a market economy." Barbara K. Bucholtz, *Doing Well by Doing Good and Vice Versa: Self-Sustaining NGO/Nonprofit Organizations*, 17 J.L. & POL'Y 403, 442 n.137 (2009) (quoting Janelle A. Kerlin, *Social Enterprise in the United States and Europe: Understanding and Learning from the Differences*, 17 VOLUNTAS: INT'L J. VOLUNTARY & NONPROFIT ORGS. 247, 258 n.6 (2006)) (internal quotation marks omitted).

¹¹¹ Gershon, *supra* note 75, at 323-24 (quoting H.R. Rep. No. 1860, 75th Cong., 3d Sess. 1939-1 (Part II) C.B. 742).

¹¹² *Id.* at 324.

¹¹³ See Halperin, *supra* note 100, at 299-300.

primary effect of the distinction is to reinforce the formalistic division between for-profits and nonprofits. The IRS and Congress are intent on ensuring, on the one hand, that nonprofit tax benefits do not privilege for-profits and, on the other hand, that nonprofits do not use their tax benefits to compete with traditional profit-making businesses. So although social-enterprise businesses may successfully blend nonprofit and for-profit goals, they must either forego the tax advantages of the nonprofit or lose the business privileges of the for-profit. This approach has been subjected to recent criticism that advocates pushing beyond this binary tax distinction.

D. Critique of the Current Tax Distinction

Two of the most prominent critics of the current statutory scheme, Professors Malani and Posner, argue that the tax code should instead provide tax incentives and privileges to businesses engaged in activities that promote the public good, regardless of whether they organize as a nonprofit business.¹¹⁴ Malani and Posner's argument advances on four points. First, they assume that the public goods theory¹¹⁵ is correct and that the government should provide favorable tax treatment for activities that eliminate the need for government action by providing publicly beneficial goods or services.¹¹⁶ But they reason that this theory supports tax advantages for any business that provides these services and cannot logically be restricted to businesses that organize as nonprofits.¹¹⁷ Second, they argue that the risk of principal-agent costs¹¹⁸ is not necessarily eliminated by the nonprofit form. Specifically, an altruistic business manager (the agent) at a publicly oriented for-profit business may not take advantage of the opportunity

¹¹⁴ See Malani & Posner, *supra* note 27, at 2064-65.

¹¹⁵ See *supra* Part III.C.

¹¹⁶ Malani & Posner, *supra* note 27, at 2030.

¹¹⁷ *Id.* at 2031.

¹¹⁸ Professor Evelyn Brody concisely explains the nature and consequences of agency costs:

Agency costs are the heart of the maxim: "If you want something done right, you have to do it yourself." To an economist, agency costs arise because the agent simply does not have the same incentives as the principal. Agency costs include, among other things, the principal's costs of monitoring the agent (against misunderstanding, shirking, and even theft), and the agent's cost of bonding (such as accepting low initial wages to back up the promised performance).

Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 462-63 (1996).

to produce a lower-quality product for his constituents (the principal); conversely, a business manager at a nonprofit may reduce product quality to guard against “risk of job loss or to increase her leisure.”¹¹⁹ Third, they assert that even if tax breaks for nonprofits encourage reduce the cost of public goods for downstream public beneficiaries, an exclusive nonprofit incentive may “crowd out for-profits that produce the charitable good more cheaply than the nonprofits.”¹²⁰ As a result, they argue that the government should use favorable tax treatment to reward businesses that use for-profit business structures to provide publicly beneficial goods and service with improved efficiency. Finally, they posit that even if providing tax incentives exclusively to nonprofits may protect imperfect consumers from unscrupulous businesses that distribute donations improperly,¹²¹ fraud laws already offer this protection.¹²²

Malani and Posner’s entity-neutral theory of federal tax incentives anticipated the rise of social enterprise. At the time that Malani and Posner developed their theory, hybrid entities did not exist. Now that the L3C, Benefit Corporation, and statutory benefit corporation are used more expansively than ever before, Malani and Posner’s theory can be put to new use. By applying their analysis to the new classes of hybrid entities, we can develop a deeper understanding of whether and to what extent the entities deserve federal tax benefits.

¹¹⁹ Malani & Posner, *supra* note 27, at 2035.

¹²⁰ *Id.* at 2045-46. Some scholars have criticized Malani and Posner’s vision of efficiency as being rather stylized: “Instead of relying on empirical evidence, therefore, Malani and Posner theorize that for-profits are more efficient than nonprofits because of intrinsic differences in their compensation schemes.” James R. Hines, Jr. et al., *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179, 1193 (2010). Professor Hines notes: “Knowing whether nonprofits are less efficient than for-profits requires evaluating comparable nonprofits and for-profits—those that, among other things, have the same goals and produce the same goods. Finding comparable institutions is a notoriously difficult exercise.” *Id.* While there is value in this critique of Malani and Posner’s theory, the purpose of this note is to apply Malani and Posner’s articulation of efficiency to the hybrid entities, withholding any criticism of that theory for another day.

¹²¹ Some theorists argue that the charitable tax exemption is provided exclusively to nonprofits as “a way to protect the government from imperfect donors.” Malani & Posner, *supra* note 27, at 2050-51. That is, would-be donors to socially minded businesses who are “insensitive to administrative costs,” including an organization’s distribution of profits to owners, might make donations to organizations that shirk on the quality of goods in order to retain more earnings for their owners. *Id.* By restricting the charitable deduction to the nonprofit form, the government prevents donors from making a choice that could produce this inefficient result. *Id.*

¹²² *Id.* at 2051.

III. APPLYING THE TAX THEORIES TO HYBRID ENTITIES

This note now proceeds to consider how the traditional theories of nonprofit tax exemption and Malani and Posner's broader theory of tax advantages for socially beneficial activities apply to the hybrid entities. This analysis proceeds in three stages. First, the note introduces the hybrid entities and their statutory or structural characteristics relevant to tax treatment. Second, the analysis applies the traditional theories to the hybrid entities and determines how extensively the entities address the policy rationales that generally support favorable tax treatment. Third, the note applies Malani and Posner's theory to the hybrid entities. This portion of the analysis begins by addressing whether and to what extent the hybrid entities deliver a public good that eliminates the need for a government service. It then considers whether and to what extent the hybrid entities create principal-agent problems. This section focuses primarily on the enforcement and regulatory regimes that hybrid entities have adopted to protect against this issue. It then considers whether these hybrid entities may be able to provide public goods and services more efficiently than a traditional nonprofit.¹²³

Through this analysis, the note identifies the statutory and structural provisions of the new hybrid entities that support favorable tax treatment. It also discusses the elements that militate against entity-based tax advantages. Ultimately, the note concludes that each hybrid entity lacks essential features that would help justify federal tax benefits. Nevertheless, the analysis provides a launching point for hybrid-entity boosters and legislatures who may wish to revise statutory and structural provisions of their hybrid forms in order to make a stronger argument for favorable tax treatment. This conversation is especially salient in light of the recent federal trend toward minimizing the tax benefits awarded to nonprofit organizations.¹²⁴

¹²³ Given that Malani and Posner's fourth point is merely that fraud law provides sufficient protection against imperfect consumers in the market to support businesses creating public goods, *see supra* Part II.D, it is unnecessary to provide analysis on this point.

¹²⁴ Suzanne Perry, *Limits on Charity Tax Breaks for Jobs Bill No Longer Likely*, CHRON. PHILANTHROPY (Oct. 7, 2011), <http://philanthropy.com/article/Limits-on-Charity-Tax-Breaks/129325/>.

A. *The Low-Profit Limited Liability Company (L3C)*

1. Entity Structure

The L3C is a variation of the traditional limited liability company¹²⁵ and was initially developed for introduction in state legislatures as a vehicle to channel private foundation investments into for-profit businesses.¹²⁶ The form contemplates a business that is, in the words of its creator Robert Lang, “going to be paying its own way in this world, but . . . may not make a lot of money.”¹²⁷ Like the Limited Liability Company (LLC) that came before it, the hallmark of the L3C is its extreme flexibility.¹²⁸ Consequently, as the form has developed, its sponsors have found that it may be used to accomplish goals beyond Lang’s original purpose.¹²⁹ Perhaps most notably, scholars have suggested that L3Cs may theoretically take advantage of tranching investment structures that would appeal to market investors as well as private foundations.¹³⁰ As the oldest of the American hybrid entities, variations of the

¹²⁵ Robert Lang & Elizabeth Carrott Minnigh, *The L³C, History, Basic Construct, and Legal Framework*, 35 VT. L. REV. 15, 17 (2010).

¹²⁶ *Id.* (“When I first conceived of the L³C, I had a more limited concept in mind than I have now. It was totally concentrated on finding a way to allow foundations to make investments into socially beneficial activities more efficiently and in partnership with commercial investment by creating a vehicle that would encourage foundations to do so.”).

¹²⁷ *Id.*

¹²⁸ Robert R. Keatinge, *LLCs and Nonprofit Organizations—For-Profits, Nonprofits, and Hybrids*, 42 SUFFOLK U. L. REV. 553, 582 (2009).

¹²⁹ See, e.g., Dana Brakman Reiser, *Governing and Financing Blended Enterprise*, 85 CHI.-KENT L. REV. 619, 628 (2010).

¹³⁰ As Professor Brakman Reiser explains:

An equity tranche of members could be tax-exempt private foundations making program-related investments. Because the PRI regulations specifically bar foundations from contemplating a financial return as a motive for investment, this tranche of members would be given scant or very remote rights to distributions. A mezzanine tranche of individuals or entities could purchase L3C memberships as a type of socially-responsible investment. This tranche of investors would agree to operating agreement terms that provided them with some access to distributions, but at a rate lower than market return, presumably doing so in return for the social or psychic value produced by the entity. The L3C’s operating agreement could then provide for a market-like return to a senior tranche of individuals and entities seeking such returns, presumably doing so in competition with other market-rate investment opportunities. The structure of these provisions might be more debt-like or equity-like (though if the latter, more like preferred than common stock), providing either a guaranteed return or a return keyed to the L3C’s profits.

Id. (footnote omitted).

L3C have been adopted in nine states and one Indian Territory, with 658 businesses operating as L3Cs.¹³¹

Today, L3Cs do indeed blend aspects of traditionally profit-making organizations with historically public-oriented organizations. On the one hand, a typical statute authorizing the L3C¹³² resembles a nonprofit corporation. First, the L3C must be organized to further “the accomplishment of one or more charitable or educational purposes,”¹³³ and second, “the production of income or the appreciation of property” cannot be a “significant purpose of the company.”¹³⁴ On the other hand, and in some tension with the foregoing rule, L3Cs are permitted to “produce[] significant income or capital appreciation” if not a “significant purpose of the company.”¹³⁵ Similarly, and perhaps more significantly, an L3C is not bound by the distribution constraint, and the statutes envision that the business will distribute profits to some or all of its members.¹³⁶ Finally, “L3C status appears to be neither a permanent nor a publicly guarded designation,” which means that there is little to ensure that a business organized under the L3C label will enforce the dual mission it was founded to achieve.¹³⁷ If the business changes course, it will simply lose its L3C designation and generally become an LLC.¹³⁸

In this discussion, the L3C is unique for its tax structure. As a subset of the LLC, the L3C is taxed as an LLC.¹³⁹ As a result, its members may elect that the entity be taxed as a partnership or as a corporation. If taxed as a partnership, the L3C itself is not taxed at the organizational level.¹⁴⁰ Rather, its earnings are taxed only after they are distributed and claimed as earnings by its members.¹⁴¹ If taxed as a corporation, then the

¹³¹ *Latest L3C Tally*, INTERSECTOR PARTNERS, http://www.intersectorl3c.com/l3c_tally.html (last visited on Oct. 10, 2012).

¹³² This section will emphasize Vermont’s L3C statutory regime because it was the first of its kind and provides a useful benchmark. Other states’ L3C statutes are substantially similar. *See, e.g.*, 805 ILL. COMP. STAT. 180/1-26 (2011); MICH. COMP. LAWS § 450.4102 (2011); UTAH CODE ANN. § 48-2c-412 (2011); WYO. STAT. ANN. § 17-15-102(a)(ix) (2011).

¹³³ VT. STAT. ANN. tit. 11, § 3001(27)(A) (2011).

¹³⁴ *Id.* § 3001(27)(B).

¹³⁵ *Id.*

¹³⁶ Brakman Reiser, *supra* note 82, at 108-09.

¹³⁷ Brakman Reiser, *supra* note 129, at 629.

¹³⁸ *See, e.g.*, VT. STAT. ANN. tit. 11, § 3001(27)(D).

¹³⁹ *See, e.g.*, VT. STAT. ANN. tit. 32, §§ 5920-5921 (2006).

¹⁴⁰ LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 17:2 (West 2012).

¹⁴¹ *Id.*

L3C is subject to the typical for-profit corporate tax regime.¹⁴² An L3C may even elect to become a tax-exempt nonprofit organization, provided that it meets the statutory requirements of section 501(c)(3) of the Internal Revenue Code.¹⁴³

2. Tax Benefits Under the Traditional Theories

The L3C illustrates that the nature of hybrid entities—borrowing aspects from traditional for-profit and nonprofit organizations—creates both vices and virtues under traditional tax theory. Regarding its vices, the L3C is generally organized to produce earned income, some of which it will retain or distribute to members and owners.¹⁴⁴ As discussed, generating profits is one of the two goals of a dual-mission organization, and L3Cs attempt to realize this goal by, among other tactics, touting the potential for tranching investments in L3C businesses. As such, taxing the entity does not violate traditional tax principles of taxing earned income and profits. Rather, it would be incongruous with traditional tax policy and would create horizontal inequities between L3Cs and typical LLCs if the IRS were to impose tax on the latter while creating favorable tax conditions for the former. Similarly, the L3C has an ability to pay taxes to the extent that it distributes its earnings to owners rather than to public constituents. Thus, the entity has income that appears fairly measurable, and it should have the resources necessary to pay its taxes. At first blush, it does not appear inappropriate to tax the L3C.

As to its virtues, the L3C's statutory provisions expressly require that businesses adopting the entity must be organized to accomplish one of the charitable purposes the IRS has outlined under section 501(c)(3).¹⁴⁵ As such, an L3C business will necessarily operate to pursue one of the goals that the IRS has singled out for favorable treatment. This suggests that L3Cs will eliminate at least some need for services that the government might otherwise need to provide—the second traditional rationale for distinct tax treatment. But an L3C is not required to pursue these purposes exclusively, which creates some uncertainty about the level of government services an L3C business would replace.

¹⁴² *Id.* at § 17:22; *see also supra* Part II.A.

¹⁴³ IRS, LLC GUIDE SHEET, *available at* http://www.irs.gov/pub/irs-tege/llc_guide_sheet.pdf (last visited Oct. 26, 2012).

¹⁴⁴ *See, e.g.*, VT. STAT. ANN. tit. 11, § 3001(27)(B) (2006).

¹⁴⁵ *See, e.g., id.* § 3001(27)(A).

Regarding efficiency, L3Cs will almost surely have the potential to deliver their services more efficiently than the government—and for the same reasons that nonprofits offer an efficient alternative. In particular, L3Cs operate within their communities and have a strong incentive to respond quickly to their constituencies' needs. The L3C's statutory prohibition against producing significant profits as a primary purpose of the business should help ensure that L3Cs remain committed to producing more and better goods or services for their constituents and that they seek additional income for their owners only as a secondary consideration.¹⁴⁶ As such, the L3C does include some characteristics that support favorable tax treatment under the traditional tax theories.

3. Tax Benefits Under Malani and Posner

L3Cs have a stronger argument for tax incentives under Malani and Posner's theory than under the traditional tax theories—but it is still insufficient to justify favorable tax treatment. Under the first and most important element of this theory, L3Cs will eliminate the need for some government services. The fact that an L3C's purposes are statutorily constrained and must address one of the charitable purposes approved under section 170 of the Internal Revenue Code ensures that the primary activities of L3Cs will fully overlap with the primary activities of exempt nonprofits. Thus, the structure of the L3C directs these businesses to produce some form of the public goods and services that the government might otherwise have to provide. That L3Cs may also go on to pursue additional objectives—including the production of distributable income—is perfectly acceptable under Malani and Posner's theory. Indeed, this theory does not require that a business pursue such public goods to the exclusion of all other activities. Relieving the government of some burden is sufficient to warrant favorable tax treatment under this theory.

¹⁴⁶ See John Tyler, *Negating the Legal Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 141 (2010). Tyler argues that the L3C structure is in fact sufficient to ensure that the profit-making motive is subordinate to the public purpose. *Id.* ("[A]t the highest levels, the theory and purposes of the L3C prioritize charitable, exempt purposes as a fiduciary matter. Moreover, characterizing the L3C as 'for-profit' does not refer to the firm's objective, as is the case under normal circumstances for other forms, but instead most properly acknowledges legal permission to earn and distribute profits. . . . Given its purposes, it is probably more appropriate to refer to L3Cs as 'for-charity' . . .").

Under the theory's second element, however, the L3C may create principal-agent problems that militate against favorable tax treatment. First, the statutory provision against making the production of profit a primary purpose will probably limit—but does not eliminate—the incentive for L3C managers to shirk on quality in favor of distributable profits. If the potential for substantial profits is sufficiently high and the L3C can earn them without alienating its constituencies—namely, beneficiaries, employees, members, and creditors—then there would be little incentive not to pursue the profits. Second, the absence of a meaningful penalty on an L3C business or manager for deviating from its primary purpose only exacerbates the risk of entity departure.¹⁴⁷ While an L3C may lose its designation, this outcome is probably of relatively little consequence to a business that has determined it can earn more significant profits without the designation. Third, L3Cs are organized under the laws governing LLCs and, consequently, their activities are not subject to the federal regulatory scrutiny that polices nonprofits.¹⁴⁸ The IRS does not have authority to monitor whether the L3C complies with its state-law entity requirements. While state attorneys general have authority to review the conduct of businesses organized within the state,¹⁴⁹ L3Cs would presumably fall between the regulatory cracks, given that an L3C's deviation from purpose would likely register as a low priority on the list of traditional business malfeasance that attorneys general prosecute.¹⁵⁰ Moreover, the charities bureaus of the attorneys general are notoriously overburdened and underresourced, which suggests that they would not have the capacity to effectively regulate L3Cs' adherence to statutory purposes—even if they had that authority.¹⁵¹ Finally, it is unclear precisely to what extent a regulator should enforce an L3C's commitment to purpose. Businesses utilizing the L3C may value the statutory characteristics that appear to permit such a free transition between the L3C and LLC designations. Thus, L3Cs do

¹⁴⁷ See Brakman Reiser, *supra* note 129, at 629. For a competing view, see Tyler, *supra* note 146, at 141.

¹⁴⁸ Brakman Reiser, *supra* note 23, at 2463 (noting this issue in the context of a pure for-profit philanthropist); see also VT. STAT. ANN. tit. 11, § 3001(27)(A).

¹⁴⁹ See Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937, 946 (2004).

¹⁵⁰ Indeed, as Professor Brakman Reiser points out, Illinois is the only jurisdiction to treat "L3C managers . . . as charitable trustees" whose adherence to a business's approved statutory purpose is monitored by the state attorney general. Brakman Reiser, *supra* note 25, at 616 n.132.

¹⁵¹ Brakman Reiser, *supra* note 23, at 2464; see also Brody, *supra* note 149, at 947.

not warrant favorable tax treatment under the second factor in Malani and Posner's theory.

L3Cs address the third aspect of Malani and Posner's theory directly by providing public goods more efficiently than a nonprofit. First, the statutory language expressly permitting L3Cs to "[produce] significant income or capital appreciation" as long as it is not a "significant purpose of the company" is designed to allow a measure of pure profitability that is simply unavailable to nonprofits.¹⁵² This flexibility becomes especially important in light of the fact that L3Cs are permitted to distribute some portion of their earnings to owners.¹⁵³ The combination of these two structural elements may lead to additional organizational efficiencies: as L3C managers seek to deliver their public goods in the most efficient way possible, they may generate more profits to distribute to owners, thereby achieving the dual-mission ideal. Moreover, an L3C may access traditional market tools for amassing capital—such as equity-investment instruments unrelated to the L3C purpose—that are unavailable to nonprofits.¹⁵⁴ Not only may the L3C invest its own funds in more ways than a nonprofit, but it may theoretically gain access to a larger market of investors who wish to see a return on investments—a return that nonprofits are prohibited from giving.¹⁵⁵ While the size and strength of such a market is the subject of much debate, the L3C's statutory structure nonetheless creates access to whatever market is available.¹⁵⁶ Consequently, L3Cs have efficiency benefits that nonprofits do not. Because providing an exclusive tax benefit to nonprofits ignores these benefits, L3Cs warrant favorable tax treatment under the last factor in Malani and Posner's theory.

4. Conclusions

In light of this analysis, there are persuasive reasons to provide L3Cs favorable tax treatment. The L3C statutory structure ensures that businesses operating as L3Cs will offer some goods and services that the government would otherwise provide. Moreover, L3Cs have the potential to do so more efficiently than both the government and—at least in some

¹⁵² VT. STAT. ANN. tit. 11, § 3001(27)(B); *see also* 26 C.F.R. § 1.513-1 (2012); Hansmann, *supra* note 74, at 838.

¹⁵³ *See* Brakman Reiser, *supra* note 82, at 108-09.

¹⁵⁴ I.R.C. § 513 (2006).

¹⁵⁵ *Id.*

¹⁵⁶ Brakman Reiser, *supra* note 82, at 108-09.

instances—nonprofits. But the L3C faces a significant hurdle in receiving favorable tax treatment since its lack of a strong regulatory framework creates the potential for principal–agent problems that could result in tax abuse. That is, without rigorous monitoring of a business’s commitment to purpose, L3Cs may take advantage of tax benefits designed to incentivize that purpose but ultimately elect to pursue pure profits rather than public benefits. Given the scarcity of resources available for mission enforcement, it is unlikely that the federal government or local governments will be able to take this step alone. Consequently, the L3C does not qualify for favorable tax treatment under either the traditional theories or Malani and Posner’s theory.

B. *The B Corporation*

1. Entity Structure

By contrast to L3Cs, B Lab developed the B Corporation as an independent business mark that “us[es] the power of business to solve social and environmental problems.”¹⁵⁷ B Lab, a nonprofit corporation, is committed to using the B Corporation to develop a community of businesses that aspire “to address society’s greatest challenges” by “harness[ing] the power of private enterprise to create public benefit.”¹⁵⁸ B Lab envisions achieving this goal by requiring its businesses to meet “higher standards of transparency, accountability, and performance.”¹⁵⁹ Unlike L3Cs (and traditional business entities), B Corporations do not carry a legal distinction, and any business may apply to become a certified B Corporation, regardless of its entity.¹⁶⁰ B Lab began certifying B Corporations in 2006,¹⁶¹ and more than 600 businesses currently operate under its mark.¹⁶²

B Corporations blend traditional for-profit and nonprofit forms in two key ways. First, the B Corporation mark is open to all businesses, including all varieties of traditional for-profit

¹⁵⁷ *The Non-Profit Behind B Corps*, B LAB, <http://www.bcorporation.net/what-are-b-corps/the-non-profit-behind-b-corps> (last visited Oct. 11, 2012).

¹⁵⁸ *Why B Corps Matter*, B LAB, <http://www.bcorporation.net/what-are-b-corps/why-b-corps-matter> (last visited Oct. 15, 2012); *The B Corp Declaration*, B LAB, <http://www.bcorporation.net/what-are-b-corps/the-b-corp-declaration> (last visited Oct. 15, 2012).

¹⁵⁹ *Why B Corps Matter*, *supra* note 158.

¹⁶⁰ Steven J. Haymore, *Public(ly Oriented) Companies: B Corporations and the Delaware Stakeholder Provision Dilemma*, 64 VAND. L. REV. 1311, 1313-14 (2011).

¹⁶¹ Brakman Reiser, *supra* note 25, at 594.

¹⁶² *Founding B Corps*, B LAB, <http://www.bcorporation.net/community/founding-b-corps> (last visited Oct. 15, 2012).

entities. But this freedom to embrace entities that support profit-making is tempered by purpose limitations that B Lab imposes through its certification process, which the company enforces with an auditing procedure. The certification process requires businesses to satisfy three requirements. The applicant must: (1) pass a scored impact assessment on its commitment to social good, (2) “amend[] its articles of incorporation and other governing documents” to “institutionalize its [social] commitment,” and (3) submit reporting documents and fees to B Lab, which audits the businesses.¹⁶³ The impact assessment—which has been continuously revised—is developed by an independent Standards Advisory Council tasked with developing rigorous standards for social and environmental performance.¹⁶⁴ Once a business passes the threshold score on the impact assessment, B Lab verifies its responses by reviewing documentation for a portion of the applicant’s responses.¹⁶⁵ Then, B Lab conducts random annual audits of B Corporations to ensure that they comply with the required commitments.¹⁶⁶ Currently, B Lab conducts audits on 20% of its membership every two years.¹⁶⁷

2. Tax Benefits Under the Traditional Theories

Under the traditional theories, B Corporations face immediate obstacles to favorable tax treatment. First, B Corporations are not legally recognized entities and, consequently, the government may be skeptical of awarding favorable tax treatment merely by virtue of a business’s association with B Lab, regardless of how laudable its goals may be. That said, the absence of a legally recognized status is not fatal to B Corporations’ claim to favorable tax treatment, given that the government sometimes awards favorable tax

¹⁶³ Haymore, *supra* note 160, at 1321.

¹⁶⁴ B LAB, TERM SHEET FOR B CORPORATIONS, *available at* http://www.bcorporation.net/storage/documents/term_sheet_non-constituencybenefit.pdf (last visited Oct. 15, 2012).

¹⁶⁵ *How to Become a B Corp*, B LAB, <http://www.bcorporation.net/become-a-b-corp/how-to-become-a-b-corp> (last visited Jan. 24, 2013). B Lab also helps businesses comply with the second requirement by providing basic step-by-step instructions on how to amend its governing documents; obtain approval of the amendments from the business’s governing body; obtain approval of the amendments from shareholders, members, or partners; and, where necessary, file its amended articles. *Legal Roadmap*, B LAB, <http://www.bcorporation.net/become-a-b-corp/how-to-become-a-b-corp/1057-legal-roadmap> (last visited Jan. 24, 2013).

¹⁶⁶ Haymore, *supra* note 160, at 1321.

¹⁶⁷ Brakman Reiser, *supra* note 25, at 602.

treatment based on a third-party designation.¹⁶⁸ Second, typical for-profit businesses can be certified as B Corporations. When they are, these businesses would be able to pursue profit much as ordinary for-profits. As a result, it would be appropriate to tax that profit. Indeed, awarding favorable tax treatment only to B Corporations but not traditional for-profit corporations would create an acute horizontal equity concern. Moreover, for-profit B Corporations have the ability to pay the income tax on their earnings, which avoids the liquidity problems that burden nonprofits. Third, and perhaps most problematically, B Lab certification does not ensure that B Corporations will provide public goods or services that the government would otherwise provide. To begin with, while B Lab's impact assessment includes a purpose requirement, the parameters and even the necessity of this purpose requirement are not articulated with sufficient clarity or rigor.¹⁶⁹ For instance, the impact assessment merely inquires as to whether a business's "products or services are specifically designed to address an economic inequality, improve health, [or] promote the arts/sciences/media."¹⁷⁰ In addition to these permitted purposes, which bear some resemblance to the government-supported purposes under section 501(c)(3), B Lab also allows B Corporations to satisfy this requirement if they "drive capital to purpose-driven enterprises."¹⁷¹ This allows businesses to qualify for the entity designation with an unusually broad list of activities.¹⁷² For example, as long as a business shows that it serves a high percentage of "poor or very poor" constituents,¹⁷³ it may satisfy the purpose requirement by offering such services as "sustainability consulting," making products that "promote healthy living," or "[c]reat[ing] . . . empowerment opportunities."¹⁷⁴ Under B Lab's broad purpose standards, a business that sells yoga mats to out-of-work actors could conceivably qualify as a B Corporation. Therefore, B Corporations cannot guarantee that they relieve the government of the need to provide public goods or services. In light of the

¹⁶⁸ An example discussed at some length is LEED certification, *infra* at Part IV.B.3. See Eileen D. Millett, *Green Building for Dummies: What Is a LEED Certification?*, PRAC. REAL EST. LAW., Jan. 2009, at 41, 45.

¹⁶⁹ *Impact Assessment*, SE1.1, B LAB, <https://b-lab.secure.force.com/bcorp/ImpactAssessment?id=a03C000000AYgPpIAL> (last visited Oct. 15, 2012).

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² See *id.* at SE3.1.

¹⁷³ *Id.* at SE11.7.

¹⁷⁴ *Id.* at SE3.1.

foregoing, B Corporations do not qualify for favorable tax treatment under the traditional tax theories.

3. Tax Benefits Under Malani and Posner

B Corporations face the same hurdle to favorable tax treatment under Malani and Posner's first point as they do under the traditional tax theory. That is, B Corporations cannot demonstrate that they will provide a public good that the government would otherwise have to provide.¹⁷⁵ Indeed, B Lab's broad purpose requirements relate more to the company's subjective and somewhat amorphous notion of positive community purpose rather than to an objective set of purposes that would relieve the government of its need to make costly social investments. Accordingly, B Corporations do not qualify for favorable tax treatment under Malani and Posner's first consideration.

Nevertheless, B Corporations make an important advance over L3Cs under the principal-agent point of Malani and Posner's theory. Whereas L3Cs operate in a regulatory gray area—with no one to ensure that businesses adhere to the purpose requirements articulated under the statute—B Corporations are independently regulated by B Lab.¹⁷⁶ B Lab's commitment to initial certification and its responsibility for ongoing monitoring of all companies that bear its mark offer an intriguing solution to the difficulties of regulating potential tax advantages that would accrue to organizations based on entity type. Indeed, in a similar context, some scholars have argued that independent approaches to enforcing nonprofit law may be more successful than traditional lawmaking.¹⁷⁷

In theory, at least, B Lab plays much the same role for B Corporations that state attorneys general play for nonprofits—ensuring that an applicant business qualifies for the favorable mark, enforcing purpose requirements, and stripping a business of its privileged entity status and

¹⁷⁵ See *supra* Part III.B.2.

¹⁷⁶ Haymore, *supra* note 160, at 1321.

¹⁷⁷ See, e.g., Garry W. Jenkins, *Incorporation Choice, Uniformity, and the Reform of Nonprofit State Law*, 41 GA. L. REV. 1113, 1115 (2007) ("This Article argues that because of the incorporation habits of nonprofit corporations, coupled with the limited governmental resources devoted to the development and enforcement of nonprofit state law, private lawmaking initiatives-independent from government control-provide the primary means for achieving uniformity and reform of nonprofit law. As a result, these private lawmaking projects have even more influence and importance than similar projects affecting other fields of law.").

hypothetical tax advantages where it fails to meet its obligations. B Lab could relieve the federal government of much of its regulatory role without burdening state regulators, who are already overextended in their regulation of nonprofits. There may be some concern that B Lab's audit lottery, which promises to audit only 10% of B Corporations annually, is inadequate to ensure that B Corporations do not deviate from their purpose after taking advantage of related tax benefits. This, however, is ten times the rate that the IRS currently audits taxpayers.¹⁷⁸ As such, B Lab's regulation of B Corporations has the potential to be more effective than the current federal regulation of nonprofits. B Lab's system also compares favorably to other successful, independent regulatory systems such as Leadership in Energy and Environmental Design (LEED) certification. As such, the government might look to LEED as a model for how to treat B Lab and B Corporations.¹⁷⁹

Finally, under the third factor of Malani and Posner's theory, B Corporations cannot necessarily produce goods and services more efficiently than traditional nonprofits. Indeed, a B Corporation may be a traditional nonprofit that has merely grafted the B Corporation designation onto its business. In this sense, a B Corporation would not possess any efficiency advantage over traditional nonprofits but would already qualify for favorable tax treatment. Conversely, a B Corporation may be a traditional for-profit corporation that has a significant efficiency advantage but has committed only to loose social ideas rather than more objectively valuable social purposes. In this scenario, the efficiency gains become moot

¹⁷⁸ *Tax Cheater Warning: Odds Are Against You*, SEATTLE TAX LAW. (Oct. 25, 2011), <http://www.seattletaxlawyers.org/index.php/tag/audit-lottery/>.

¹⁷⁹ LEED is a "nationally accepted third-party certification program" that rates and certifies building projects according to independently developed sustainability standards. Anika E. Leerssen, *Smart Growth and Green Building: An Effective Partnership to Significantly Reduce Greenhouse Gas Emissions*, 26 J. ENVTL. L. & LITIG. 287, 313 n.138 (2011). A building's LEED certifications are, in turn, the qualifying criteria for favorable tax consequences. At this time, B Lab does not have the national recognition of LEED certification. But the organization appears intent on continuing to develop its certification systems and working with governments to ensure its viability. *Passing Legislation*, B LAB, <http://www.bcorporation.net/what-are-b-corps/legislation> (last visited Oct. 15, 2012). This commitment to work with governments augurs well for its potential to become a third party whose certification could trigger tax advantages. In addition, in both B Lab and LEED certification, companies must pay for the costs of certification and monitoring. Leerssen, *supra*, at 313 n.138. Consequently, governments need not incur the expense and businesses will only pursue the designation where it is strategically compelling, financially advantageous, or both. Furthermore, B Lab, like LEED, is a nonprofit organization, which should help to ensure that the expense of certification and monitoring is closely related to its cost. *Id.*

because the government would have little interest in encouraging efficiencies that do not redound to the public good and reduce government spending. As such, the B Corporation's ambivalence to entity form is an impediment to granting favorable tax treatment based upon the entity designation.

4. Conclusions

The challenges that B Corporations face in receiving favorable tax treatment can be viewed as an inverse of the L3C. On the one hand, the B Corporation purpose requirements do not have the clarity or objective value of the L3C. L3C statutes have been tightly constructed and require businesses using the mark to serve the approved nonprofit purposes the IRS has outlined. By contrast, B Lab's certification process utilizes a somewhat ponderous survey and approves an overly broad set of purposes that are largely subjective and bear little relation to purposes that the government encourages with favorable tax treatment. On the other hand, B Lab's independent-certification and regulation model is a desirable alternative to the absence of any meaningful regulation of L3Cs. B Lab's regulatory structure addresses significant principal-agent concerns without burdening the government with administrative cost or complexity. With a successful working model like LEED certification to draw upon, a commitment to adopt successful regulatory practices, and its own funding stream, B Lab may be able to provide a successful system for policing B Corporations. But this regulatory advance will be of little use in securing tax advantages for B Corporations unless B Lab formulates a tighter set of purpose requirements and limits its designation to a defined entity type. Accordingly, at this stage in its development, the B Corporation does not qualify for favorable tax treatment under either the traditional theories or Malani and Posner's theory.

C. The Statutory Benefit Corporation

1. Entity Structure

B Lab's creation has also begun to influence state legislatures, leading to the third hybrid entity option: the statutory benefit corporation. In 2010, Maryland established the

first statutory benefit corporation,¹⁸⁰ which is closely “modeled on B Lab’s concept.”¹⁸¹ Since that time, Vermont, New Jersey, Virginia, Hawaii, California, and New York have all adopted their own versions of enabling legislation that allow businesses to become statutory benefit corporations.¹⁸² These benefit corporations are a “state-sanctioned” form that requires interested businesses to obtain “private certification” of commitments to social value that closely track the three original B Lab requirements.¹⁸³ While the various state versions of the benefit corporation differ in some respects, they share a common core structure.¹⁸⁴ As of this writing, there are few reliable statistics on how many businesses are operating as statutory benefit corporations.

There are three key structural elements of statutory benefit corporations. First, each statute attempts to free businesses operating as benefit corporations from conflicts with shareholder primacy by incorporating language permitting the corporation to consider the interests of several constituencies without prioritizing shareholders.¹⁸⁵ The statutes also expressly state that consideration of these other constituencies will not constitute a breach of fiduciary duty.¹⁸⁶ Second, the statutes require that businesses applying for the designation serve one of several publicly oriented purposes.¹⁸⁷ But the purpose requirements articulated in each of the statutes are more akin to the broad range of standards acceptable under the B Corporation’s certification process than to the narrower set of purposes approved by the IRS for nonprofit status. Acceptable purposes include:

[(1)] Providing low-income or underserved individuals or communities with beneficial products or services; [(2)] Promoting economic

¹⁸⁰ *Maryland First State in Union to Pass Benefit Corporation Legislation*, CSRWIRE (Apr. 14, 2010), http://www.csrwire.com/press_releases/29332-Maryland-First-State-in-Union-to-Pass-Benefit-Corporation-Legislation.

¹⁸¹ Brakman Reiser, *supra* note 74, at 39; *see also* Brakman Reiser, *supra* note 25, at 594.

¹⁸² *See* LA. REV. STAT. ANN. §§ 1801-1832 (2012); S.C. CODE ANN. §§ 33-38-110 to -600 (2012); VA. CODE ANN. §§ 13.1-782 to -791 (2011); VT. STAT. ANN. tit. 11A, § 21 (2011); *see also* Judy Molland, *Care2 Success! New York Establishes Benefit Corporations*, CARE2 (Dec. 18, 2011, 3:00 PM), <http://www.care2.com/causes/care2-success-new-york-establishes-benefit-corporations.html>.

¹⁸³ Brakman Reiser, *supra* note 74, at 39; *see also* MD. CODE ANN., CORPS. & ASS’NS § 5-6C-01 (2011).

¹⁸⁴ *See, e.g.*, LA. REV. STAT. ANN. §§ 1801-1832; S.C. CODE ANN. §§ 33-38-110 to -600; VA. CODE ANN. §§ 13.1-782 to -791; VT. STAT. ANN. tit. 11A, § 21.

¹⁸⁵ *See, e.g.*, VT. STAT. ANN. tit. 11A, § 21.09.

¹⁸⁶ *See, e.g., id.* § 21.11.

¹⁸⁷ *See, e.g.*, LA. REV. STAT. ANN. §§ 1801-1832; S.C. CODE ANN. §§ 33-38-110 to -600; VA. CODE ANN. §§ 13.1-782 to -791; VT. STAT. ANN. tit. 11A, § 21.

opportunity for individuals or communities beyond the creation of jobs in the normal course of business; [(3)] Preserving or improving the environment; [(4)] Improving human health; [(5)] Promoting the arts, sciences, or advancement of knowledge; [(6)] Increasing the flow of capital to entities with a public benefit purpose; and [(7)] Conferring any other particular benefit on society or the environment.¹⁸⁸

Third, the statutes require businesses to secure approval from a third party that has:

a recognized standard for defining, reporting, and assessing corporate social and environmental performance that: [(1)] Is developed by a person that is independent of the benefit corporation; and [(2)] Is transparent because the following information about the standard is publicly available: [(a)] The factors considered when measuring the performance of a business; [(b)] The relative weightings of those factors; and [(c)] The identity of the persons that develop and control changes to the standard and the process by which those changes are made.¹⁸⁹

While none of the statutes state so explicitly, this provision appears to relate directly to B Lab's lobbying efforts. In fact, the rise of the statutory benefit corporation in general is most likely the product of B Lab and its boosters, who have directed significant efforts toward passing each piece of enabling legislation.¹⁹⁰ Consequently, benefit corporations in statutory form bear close resemblance to B Corporations. Finally, as the name might imply, statutory benefit corporations are corporations that must meet both the ordinary formation and operational requirements of for-profit corporations, with the exception of the variations described above.¹⁹¹

2. Tax Benefits Under the Traditional Theories

The traditional rationales that support favorable tax treatment for nonprofit corporations do not offer strong support for providing similar tax treatment to the statutory benefit corporation. First, taxing statutory benefit corporations is not fundamentally at odds with the goals of the tax system. As with both L3Cs and B Corporations, statutory benefit corporations contemplate earning some profit. It is appropriate to tax the corporations on those profits. Moreover, unlike L3Cs,

¹⁸⁸ VA. CODE ANN. § 13.1-782; *accord* LA. REV. STAT. ANN. § 1803(A)(10); S.C. CODE ANN. § 33-38-130(A)(7); VT. STAT. ANN. tit. 11A, § 21.03(a)(6).

¹⁸⁹ VA. CODE ANN. § 13.1-782; *accord* LA. REV. STAT. ANN. § 1803(A)(12); S.C. CODE ANN. § 33-38-130(A)(9); VT. STAT. ANN. tit. 11A, § 21.03(a)(8).

¹⁹⁰ *Passing Legislation*, *supra* note 179.

¹⁹¹ *See, e.g.*, LA. REV. STAT. ANN. § 1802(C); S.C. CODE ANN. § 33-38-130(B); VA. CODE ANN. § 13.1-784; VT. STAT. ANN. tit. 11A, § 21.02(a).

statutory benefit corporations are not restricted to earning only a marginal level of profits. Rather, they may pursue significant profits as long as they also maintain their commitment to the broad purposes outlined by statute. Accordingly, statutory benefit corporations should be able to pay income taxes imposed on their earnings. Unlike B Corporations, statutory benefit corporations are legally recognized entities that individual states have sanctioned. But this characteristic is not alone sufficient to warrant favorable tax treatment under the traditional theory.

Second, it is unclear to what extent statutory benefit corporations will provide goods and services that the government would otherwise need to provide. While the purpose requirements articulate some goals that closely track the IRS's approved purposes for nonprofit exemption, the statutes go on to broaden the scope of permissible purposes by including "[c]onferring any other particular benefit on society or the environment" as an acceptable purpose.¹⁹² This catchall purpose mirrors the expansive purposes that B Lab approves; it does little to ensure that businesses operating as statutory benefit corporations will pursue one of the narrow classes of activities that the government wishes to encourage with favorable tax treatment. In this regard, the enabling legislation is well drafted to funnel statutory benefit corporations into the B Lab fold, but it is poorly designed to justify favorable tax treatment on the basis of the entity.

3. Tax Benefits Under Malani and Posner

As discussed above, the enabling statutes fail to effectively ensure that statutory benefit corporations will produce goods and services that the government might otherwise need to provide. Considering the statutory language more deeply will help to illustrate this point. To begin with, even those statutory-benefit-corporation purposes that track the accepted IRS purposes tend to expand the acceptable range of activity beyond what the government generally encourages with favorable tax treatment. For instance, "Promoting the arts, sciences, or advancement of knowledge" parallels the government's accepted scientific, educational, and literary purposes. But the expanded statutory purpose includes the vague "advancement of knowledge" term, which broadens the

¹⁹² VA. CODE ANN. § 13.1-782; *see also, e.g.*, LA. REV. STAT. ANN. §§ 1801-1832; S.C. CODE ANN. § 33-38-130(A)(7)(g); VT. STAT. ANN. tit. 11A, § 21.02(a); I.R.C. § 501(c)(3) (2011).

scope of the purpose beyond what might ensure the provision of services the government would otherwise have to provide.¹⁹³ Similarly, the purpose of “[p]roviding low-income or underserved individuals or communities with beneficial products or services” tracks the accepted IRS charitable purpose but includes the overly broad term “beneficial products or services,” which is too vague and overinclusive to meet Malani and Posner’s first consideration.¹⁹⁴ The remaining list of approved statutory-benefit-corporation purposes reflects broad social and environmental ideals that the government does not systemically encourage with favorable tax benefits.¹⁹⁵ Consequently, the statutory benefit corporation does not warrant favorable tax treatment under Malani and Posner’s first consideration.

In an attempt to address Malani and Posner’s second concern, the statutory benefit corporation, like the B Corporation, attempts to address principal–agent problems by formally assigning regulatory responsibilities to independent third parties. As discussed above, this system has the potential to provide an efficient regulatory regime by significantly reducing government’s role in regulation, causing businesses to internalize most certification and monitoring costs, and assuring that statutory benefit corporations adhere to a set of approved purposes. Given B Lab’s desire to serve as a major third-party regulator, its growing capacity, and its work with state legislatures, it is possible that B Lab will be able to effectively perform this regulatory function. But it is likely that other third-party standard setters may enter the market to certify and monitor statutory benefit corporations, as well. Given the relative ease with which companies can meet the statutory requirements and become third-party regulators, it is by no means certain that every regulator will adequately fulfill its role and effectively monitor statutory benefit corporations.¹⁹⁶ To

¹⁹³ VA. CODE ANN. § 13.1-782; *see, e.g.*, LA. REV. STAT. ANN. § 1803(A)(10)(e); S.C. CODE ANN. § 33-38-130(A)(7)(e); VT. STAT. ANN. tit. 11A, § 21.03(6)(E); *see also* I.R.C. § 501(c)(3).

¹⁹⁴ VA. CODE ANN. § 13.1-782; *see, e.g.*, LA. REV. STAT. ANN. § 1803(A)(10)(a); S.C. CODE ANN. § 33-38-130(A)(7)(a); VT. STAT. ANN. tit. 11A, § 21.03(6)(A); *see also* I.R.C. § 501(c)(3).

¹⁹⁵ To reiterate, these include “[p]romoting economic opportunity for individuals or communities beyond the creation of jobs in the normal course of business; . . . [p]reserving or improving the environment; . . . [i]mproving human health; . . . [i]ncreasing the flow of capital to entities with a public benefit purpose; and . . . [c]onferring any other particular benefit on society or the environment.” VA. CODE ANN. § 13.1-782; *accord* LA. REV. STAT. ANN. § 1803(A)(10); S.C. CODE ANN. § 33-38-130(A)(7); VT. STAT. ANN. tit. 11A, § 21.03(6).

¹⁹⁶ *See* Brakman Reiser, *supra* note 25, at 601.

the extent that third parties fall short in their regulatory role, there is a risk that their certifications will create a public impression that businesses meet an objective set of favorable criteria without ensuring that they actually do—leading to the very principal–agent problems that the nonprofit designation and IRS enforcement do much to avoid.

Although hardly dispositive as to whether statutory benefit corporations should qualify for favorable tax treatment under Malani and Posner’s theory, these corporations are likely to produce public goods and services more efficiently than nonprofits. As with both the L3C and B Corporations, statutory benefit corporations have access to streams of capital that are not available to nonprofits. This theoretically allows businesses operating under this entity to make the most efficient use of market resources when pursuing their purposes. Furthermore, statutory benefit corporations’ ability to distribute some earnings to owners creates a strong incentive to maximize organizational efficiency in order to increase income for shareholders. As with L3Cs, these efficiency gains may be tempered by the requirement that statutory benefit corporations adhere to the purpose requirements as set forth by statute and monitored by third-party regulators. That said, this potential drag on efficiency is not sufficient to militate against favorable tax treatment under the third consideration of Malani and Posner’s theory.

4. Conclusions

As with both the L3C and B Corporation, the statutory benefit corporation makes an incomplete argument for favorable tax treatment. Under the traditional theory, the entity does not warrant tax advantages because businesses operating under the designation will produce some profit and may not eliminate the need for government services. Under Malani and Posner’s theory, the statutory benefit corporation warrants tax advantages because of its potential to produce goods and services more efficiently than traditional nonprofits and its independent regulatory solution to potential principal–agent problems. As with B Corporations, however, the enabling legislation creates an overly broad set of purposes, which allows statutory benefit corporations to pursue a range of activities far beyond those that would limit the need for government services. Consequently, this entity lacks the essential ingredient necessary for the government to encourage its activities with favorable tax

treatment—and the essential ingredient for support under Malani and Posner's theory.

CONCLUSION

As hybrid entities begin to erode the hard-edged divisions between for-profit and nonprofit entity types, it is instructive to consider how they might similarly blur traditional notions of for-profit and nonprofit taxation. The foregoing note is an attempt to develop this discussion by applying three tax theories to existing hybrid entities: two traditional theories that support nonprofit tax exemption, and Malani and Posner's more recent theory that argues for a broader system of tax advantages for businesses producing social benefits. Under the traditional theories of favorable tax treatment for nonprofits—which share the hybrid entities' goal to produce socially valuable goods and services—the hybrid entities' profit production and distribution imposes a serious challenge to favorable tax treatment. Under Malani and Posner's theory, the hybrid entities make a stronger—albeit unsuccessful—case for favorable tax treatment. L3Cs lack the regulatory structures to enforce their socially valuable purposes. B Corporations and statutory benefit corporations fail to outline a sufficiently rigorous set of business purposes to ensure that they would relieve the government of services it would otherwise need to perform. Accordingly, none of the hybrid entities currently warrant favorable tax treatment.

Moving forward, social entrepreneurs and legislators engaged in the discussion on hybrid entities would be well advised to consider synthesizing elements of each hybrid entity in order to present a stronger argument for favorable tax treatment. Combining the L3C's narrow set of approved purposes, the B Corporation's independent regulatory framework, and the statutory benefit corporation's form would produce an entity that could limit the need for government services, reduce principal-agent concerns, and produce goods and services more efficiently than traditional nonprofits. Such an entity would represent a valuable addition to the spectrum of hybrid entities and would make a strong case for tax advantages. Until this occurs, businesses like Seventh Generation should continue to test traditional tax boundaries

and push tax law to keep pace with today's new generation of hybrid businesses and entities.

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