Balancing the Equities: Considering the "Flip Side" of the UBIT and Forming a Workable Solution

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

INTRODUCTION

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

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

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

1. Anup Malani & Eric Posner, The Case for For-Profit Charities, 93 VA. L. REV. 2017, 2023 (2007). “The issue we raise is the flip side of the UBIT debate: should for-profit firms be taxed like nonprofit firms (or more precisely, be exempt from taxes like nonprofit firms) when they engage in charitable activities? Our answer is yes, because there is no reason to condition the tax subsidy for charitable activities on organizational form.” Id.
2. Id. at 2029.
3. Id. at 2022.
4. Id. at 2022, 2055.
6. See infra text accompanying notes 12–16.
8. The “nondistribution constraint” is a term coined by Henry Hansmann to describe the prohibition on the distribution of profits generated by nonprofit organizations. Henry B. Hansmann, The Role of Nonprofit Enterprise, 89 YALE L.J. 835, 838 (1980) [hereinafter The Role of Nonprofit Enterprise].
10. See, e.g., id.
charity more precisely, which would stifle experimentation by nonprofits;\(^\text{11}\) (3) profit-making motives would prompt managers and entrepreneurs to sacrifice quality in order to retain a profit, which could go largely unnoticed because of “contract failure”\(^\text{12}\); (4) people would engage in tax avoidance and arbitrage, and as a result, the tax base would be eroded\(^\text{13}\); and (5) an increase in for-profit philanthropy would weaken the public perception that charities are altruistic, which would inhibit the growth and success of the charitable sector\(^\text{14}\).

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

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


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


\(^{15}\) See supra notes 11–15.


\(^{18}\) See Janet E. Kerr, *The Creative Capitalism Spectrum: Evaluating Corporate Social Responsibility Through a Legal Lens*, 81 Temp. L. Rev. 831, 856–57 (2008). Kerr formulates a spectrum of corporate social responsibility. One of the categories on this spectrum, “Compliance-Plus,” encapsulates the sort of activity that this note ascribes to the term “corporate social responsibility.” *Id.* Kerr describes these businesses as those that “abide by current laws relating to social welfare—labor practices, environmental policies, anticorruption measures, and the like—but go beyond mere compliance to integrate socially responsible practices into the model.” *Id.* at 857 (footnote omitted).
organization. Their reasoning, however, does not account for the disparate effects that would result from extending the same tax benefits to these organizations. They take a utilitarian approach; they believe that by rewarding the desired work—as opposed to the organization’s mission—the organization’s output of public goods and efficiency will increase.

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

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

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

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

20. Id. at 2022–23.
21. Id. at 2061.
22. Id. at 2023.
23. Id.
25. Id. at 5.
Posner’s goals of increased production of public goods and efficiency. The externalities created by the application of this type of policy would outweigh the logical benefits. In addition to the adverse effect of this policy on the nonprofit sector, the overall production of public goods would be diminished by the increase in the administrative costs to the government and the potential loss of tax revenue.

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

I. CURRENT DEVELOPMENTS IN FOR-PROFIT PHILANTHROPY

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

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27. See supra text accompanying notes 11,14.
28. See For Profit Charity, supra note 9.
29. See infra Part V.
30. Although there are other ways of categorizing these organizations, for the sake of clarity, this note uses these three categories.
31. Hybrid organizations come in a variety of forms, and scholars refer to them in a variety of ways. Some states have created separate corporate forms under which these organizations may be incorporated. Taylor, supra note 17, at 759. These variations will not be discussed in this note because they do not affect the analysis.
33. See The Role of Nonprofit Enterprise, supra note 8, at 868–69.
34. See id. at 865–68.
35. See Brakman Reiser, supra note 5, at 2448.
A. HYBRID ORGANIZATIONS

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

These organizations take on many forms, ranging from microfinance investment firms39 to retailers.40 For example, Toms Shoes (Toms) is a large shoe production and retail company that donates one pair of shoes to a child living in poverty and in need of footwear for each pair of shoes sold.41 Google.org might also be viewed as a hybrid organization; however, it is substantially different from other types of social enterprises.42 Google.org is a for-profit entity that is funded by its parent company, Google, Inc.43 Although Google.org has retained for-profit status in order to avoid the restrictions placed on nonprofit organizations, its primary concern is not turning a profit.44 In fact, “Google.org views profit as a distant and unlikely possible consequence of its activities.”45

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

37. See id. at 352–55 (explaining that social entrepreneurs are often driven to adopt the for-profit form because it allows them to raise capital in ways that the nonprofit form prohibits, but acknowledging that raising capital is not an easy task for hybrid organizations).
38. See id. at 351.
39. See Brakman Reiser, supra note 5, at 2450 (describing microfinance as “social enterprise”).
41. Id.
42. See Brakman Reiser, supra note 5, at 2446–52 (describing the ways in which Google.org differs from all existing forms of for-profit philanthropy).
44. See Brakman Reiser, supra note 5, at 2452.
45. Id.
46. See Taylor, supra note 17, at 756–58.
47. See For Profit Charity, supra note 9, at 232.
B. FOR-PROFIT SERVICE PROVIDERS

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

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

If nonprofits are eliminated from sectors like education, childcare, and

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48. See The Role of Nonprofit Enterprise, supra note 8, at 868–69.
49. See The Attack on Nonprofit Status, supra note 13, at 1204.
50. See The Role of Nonprofit Enterprise, supra note 8, at 848.
51. See id.
52. See Jill R. Horwitz, Why We Need the Independent Sector: The Behavior, Law, and Ethics of Not-For-Profit Hospitals, 50 UCLA L. REV. 1345, 1346 (2003).
53. See id. at 1352. “[G]eneral hospitals of all corporate forms are very much alike. They operate under the same healthcare regulations, provide inpatient medical care, compete against each other for patients and doctors, derive funding from many of the same sources, and serve seemingly comparable social functions.” Id. (footnote omitted). Horwitz goes on to unpack this notion; she examines the empirical differences in the delivery of certain medical services across the corporate forms and comes to the conclusion that the not-for-profit corporate form is preferable in this industry. Id.
54. Id. at 1346; see also The Attack on Nonprofit Status, supra note 13, at 1204 (discussing examples of alternative proposals).
56. Cf. The Attack on Nonprofit Status, supra note 13, at 1199 (providing data to support the assertion that there is a great deal of competition among nonprofits and between nonprofits and for-profits in industries like healthcare). It stands to reason that if tax benefits were extended to the for-profits in these industries, nonprofits would lose the incentive to maintain a nonprofit form. Id.
57. See The Attack on Nonprofit Status, supra note 13, at 1205–06.
58. See id. at 1202–03.
59. See The Role of Nonprofit Enterprise, supra note 8, at 848–49; see also Schizer, supra note 13.
healthcare, the quality of the services would be more difficult to ensure and would likely decline.60

C. CORPORATE SOCIAL RESPONSIBILITY

CSR can be understood in a variety of ways; however, it generally connotes a company’s dedication to regulatory compliance and ethical practices, and often implies that a corporation engages in activity that advances the interests of the community in which it operates.61 This activity can take the form of company-wide community service outings, partnerships with nonprofit organizations, financial outreach to local communities, or the production of socially conscious products.62 CSR has become essentially a requirement for large companies.63 Over the past few decades, as the public has grown more aware of the environmental and societal impact of manufacturing practices, companies have increasingly infused their products and brands with socially conscious messages.64 Examples of these practices are everywhere. For instance, Target, Inc. (Target) commits 5 percent of its income to various forms of community outreach.65 One example of Target’s community outreach program is its literacy initiative, which provides needy schools with books, supports literacy organizations, and makes grants to community literacy programs.66 Starbucks, Inc. (Starbucks) takes its social responsibility a step further;67 although Starbucks is not a social enterprise willing to sacrifice profit for the greater good, its mission is imbued with social consciousness. Chief among Starbucks’ goals is to sell exclusively ethically sourced coffee, much of which is Fair Trade Certified.68

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

60. See The Attack on Nonprofit Status, supra note 13, at 1201, 1203–05.
61. See Kerr, supra note 18, at 857; see also Taylor, supra note 17, at 745, 747–48.
62. See Brakman Reiser, supra note 5, at 2449.
63. See id. at 2448.
64. See id. at 2448–49.
66. Id. at 5–6.
68. Id.
responsible products, such as Starbucks coffee, or whether it should be limited to income generated from more traditional charitable activities.

II. THE UNRELATED BUSINESS INCOME TAX

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

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

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

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70. Pub. 598, supra note 69, at 3.
72. Pub. 598, supra note 69, at 3.
73. See id.
74. See id.
76. See id.
77. JOINT COMM. REPORT, supra note 24, at 100.
78. Id.
80. Id.
This issue came to a head in the 1940s when Congress observed an uptick in the formation of exempt organizations that were operating as businesses in direct competition with tax-paying corporations. These businesses, termed “feeder” organizations, were avoiding taxes by devoting their profits to charity. For instance, the Second Circuit found that an organization operating a private beach was tax-exempt because its income was designated for charity. 

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

In response to the growing use of this practice, Congress enacted the UBIT as part of the Revenue Act of 1950. The tax was primarily implemented to prevent unfair competition against for-profit organizations operating businesses similar to “feeder” organizations. The tax affected all charitable organizations other than religious organizations, but it did not tax passive investment income.

Congress modified the UBIT in 1969. Chief among the modifications were the extension of the UBIT to all organizations, other than U.S. instrumentalities exempted by §§ 501(c) and 401(a) of the Internal Revenue Code; the expansion of tax liability for debt-financed income derived in

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81. Stone, supra note 75, at 1479.
82. Joint Comm. Report, supra note 24, at 101. “Feeder” organizations are for-profit companies created as a source of income for tax-exempt organizations. Id.
84. Joint Comm. Report, supra note 24, at 101; see also Roche’s Beach, Inc. v. Comm’r, 96 F.2d 776, 778 (2d Cir. 1938).
85. See Stone, supra note 75, at 1483.
86. See C.F. Mueller Co. v. Comm’r, 190 F.2d 120, 120–21 (3d Cir. 1951); see also Stone, supra note 75, at 1483.
87. C.F. Mueller, 190 F.2d at 121.
88. See id. at 122–23; see also Joint Comm. Report, supra note 24, at 101.
89. See Stone, supra note 75, at 1487.
90. See id. at 1487–88.
92. Id.
93. See Stone, supra note 75, at 1487.
leaseback deals between tax-exempt organizations and corporations, and various provisions aimed at limiting the use of taxable controlled subsidiaries by tax-exempt organizations to avoid income tax.96

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

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

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

95. JOINT COMM. REPORT, supra note 24, at 103–04; GENERAL EXPLANATION OF TAX REFORM ACT, supra note 94, at 4.
96. JOINT COMM. REPORT, supra note 24, at 103–04.
97. Id. at 104.
98. Id.
99. Id. at 105.
100. See Stone, supra note 75, at 1488–92; but see id. at 1492–94 (explaining that there are alternative explanations for the enactment of the UBIT that are ignored by the government).
101. “Predatory pricing” refers to the ability of nonprofit organizations to offer lower prices than their for-profit counterparts for the same goods and services as a result of their tax advantages. See John D. Colombo, Commercial Activity and Charitable Tax Exemption, 44 WM. & MARY L. REV. 487, 530 (2002); see also Thomas Kelley, Rediscovering Vulgar Charity: A Historical Analysis of America’s Tangled Nonprofit Law, 73 FORDHAM L. REV. 2437, 2493 (2005) [hereinafter Rediscovering Vulgar Charity].
102. See Colombo, supra note 101, at 530; see also Rediscovering Vulgar Charity, supra note 101, at 2493.
104. See Colombo, supra note 101, at 530; see also Rediscovering Vulgar Charity, supra note 101, at 2495; Abrams, supra note 103, at 899.
105. See Rediscovering Vulgar Charity, supra note 101, at 2494.
Even if one accepts that the concern of unfair competition is legitimate, many critics believe the UBIT is ineffective at solving this problem. First, the UBIT does not explicitly require that all nonprofit business activities that are similar to for-profit activities be taxed. Nonprofits can easily integrate their mission into these commercial activities, rendering them related to the exempt purpose.

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

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

106. See Peña & Reid, supra note 83, at 1866–67.
107. See Colombo, supra note 101, at 532; see also Peña & Reid, supra note 83, at 1866; Rediscovering Vulgar Charity, supra note 101, at 2495. Gilbert M. Gaul & Neill A. Borowski, Nonprofits: America’s Growth Industry, PHILA. INQUIRER, Apr. 18, 1993, at A.1 (citing to a series of news articles detailing the trend among large nonprofit organizations to “mov[e] beyond their core mission into commercial businesses that have little, if anything, to do with their exempt purpose”). Gaul and Borowski attributed this trend to the fact that “[u]nder the tax code, nonprofits are allowed to operate commercial subsidiaries - so long as they pay taxes on that income and those activities don’t overshadow their exempt mission.” Id.
109. See id.
111. See Heather Gottry, Note, Profit or Perish: Non-Profit Social Service Organizations & Social Entrepreneurship, 6 GEO. J. ON POVERTY L. & POL’Y 249, 271 (1999).
113. See Stone, supra note 75, at 1491.
114. See id.
115. See Peña & Reid, supra note 83, at 1867 (footnote omitted) (“Many others have written about the ways in which UBIT has failed not only to regulate commercial activity in charities generally, but even to accomplish the purposes for which it was enacted.”).
activity are more effective at preventing tax-base erosion and unfair competition.\textsuperscript{116}

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

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

Malani and Posner argue that the UBIT was established “to eliminate tax discrimination against for-profits competing against nonprofits in non-community-benefit markets.”\textsuperscript{119} Although the effectiveness of the UBIT at achieving fairness has been questioned,\textsuperscript{120} the UBIT nevertheless provides a useful framework from which to fashion a policy that affords for-profit organizations tax benefits. Under this model, a for-profit organization could file for income tax exemption for income derived from a “trade or business” that is “regularly carried on” and “substantially related to an exempt purpose.” Like the UBIT, this policy would require corporations to determine which activities fall into this category through a self-reporting system\textsuperscript{121} and would require the IRS to be responsible for investigating potential wrongdoing.\textsuperscript{122}

While Malani and Posner did not directly envision the use of a UBIT-like policy, their rhetorical analogy\textsuperscript{123} provides perhaps the most useful policy proposal. The UBIT serves as a useful model for two reasons: (1) it shares Malani and Posner’s goal of achieving a fair result; and (2) it is a policy aimed at activity as opposed to organizational form. The application and interpretation of the UBIT serve as helpful predictors of how the proposal would operate and how its application would vary based on the type of organization at issue. Furthermore, the criticism of the UBIT is useful in analyzing the utility of this proposal and others like it.

\textsuperscript{116} Colombo, supra note 101, at 507; see also Rediscovering Vulgar Charity, supra note 101, at 2495.
\textsuperscript{117} See Stone, supra note 75, at 1494–98 (discussing existing critiques of the UBIT).
\textsuperscript{118} See id.
\textsuperscript{119} See Malani & Posner, supra note 1, at 2061.
\textsuperscript{120} Rediscovering Vulgar Charity, supra note 101, at 2494.
\textsuperscript{121} See Pub. 598, supra note 69, at 2.
\textsuperscript{122} See id.
\textsuperscript{123} See Malani & Posner, supra note 1, at 2061.
IV. APPLICATION OF THE TARGETED TAX-EXEMPTION PROPOSAL

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

A. HYBRID SOCIAL ENTERPRISE

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

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

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

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124. See discussion supra Part I.A.
125. See Brakman Reiser, supra note 5, at 2452.
126. See id.
127. See Taylor, supra note 17, at 756.
131. Id.
struggles of underprivileged communities. The sale of these shoes could also be viewed as “defending human . . . rights.” These arguments, however, are somewhat attenuated.

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

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

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

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134. See Exempt Purposes, supra note 133; see I.R.C. § 501(c)(3).
135. See TOMS FAQs, supra note 132.
136. See Stone, supra note 75, at 1479.
137. JOINT COMM. REPORT, supra note 24, at 101.
139. See id.
140. See Exempt Purposes, supra note 133; I.R.C. § 501(c)(3) (2010).
141. See TOMS Company Overview, supra note 128.
142. See id.
B. FOR-PROFIT SERVICE PROVIDERS

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

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

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

143. See Nicholas A. Mirkay, Relinquish Control! Why the IRS Should Change its Stance on Exempt Organizations in Ancillary Joint Ventures, 6 NEV. L.J. 21, 32 (2005).
144. See discussion supra Part I.B.
145. See The Attack on Nonprofit Status, supra note 13, at 1201–03.
146. Id. at 1201–03.
147. See id. at 1202.
148. See id.
149. See The Role of Nonprofit Enterprise, supra note 8, at 863–65.
150. Id.
151. Id.
152. Id. at 865.
153. See id.
costs for quality or shirk on promises.\textsuperscript{154} As a result, the presence of
nonprofits in these markets prevents for-profits organizations from taking
advantage of unsuspecting consumers.\textsuperscript{155} An increase in for-profit presence
in these sectors would drive out the nonprofit quality controllers.\textsuperscript{156}

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

\textbf{C. CORPORATE SOCIAL RESPONSIBILITY}

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

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

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

\begin{flushright}
\footnotesize
\textsuperscript{154} See id.
\textsuperscript{155} See The Attack on Nonprofit Status, supra note 13, at 1203 (explaining that the presence of
nonprofits in mixed markets positively affects the quality of for-profits in those markets).
\textsuperscript{156} See id.
\textsuperscript{157} Starbucks Global Responsibility, supra note 67, at 5–6.
\textsuperscript{158} See Exempt Purposes, supra note 133; I.R.C. § 501(c)(3) (2010).
\textsuperscript{159} Scientific Certification Systems is an independent certification organization that verifies
“environmental, sustainability, stewardship, food quality, food safety and food purity claims”
made by product manufactures. About Scientific Certification Systems, SCIENTIFIC
\end{flushright}
the economic, social and environmental aspects of coffee production against a defined set of criteria, as detailed in the C.A.F.E. Practices Guidelines. Starbucks defines sustainability as an economically viable model that addresses the social and environmental needs of all the participants in the supply chain from farmer to consumer.160

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

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

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

161 See I.R.C. § 501(c)(3).
164 See Matthew J. Kotchen, Green Markets and Private Provision of Public Goods, 114 J. POL. ECON. 816, 829 (2006) (arguing that the production of goods or services that seek to promote public good is less effective than direct donation to these efforts, and illustrating the counterintuitive effects of the sale of socially conscious goods on the overall social welfare).
167 See Abrams, supra note 103, at 901 (explaining that nonprofit tax exemption is often justified by charities’ need to act as a safety net for those not adequately served by government social service programs). The article refers to charities as partners of the government in providing social services. Id.
practicing CSR generally have a more incidental impact on the community.\textsuperscript{168} Many theorists do not consider nonprofit tax exemption to have an adverse impact on the tax base because nonprofits provide the public goods that the government would otherwise have to fund.\textsuperscript{169} Assuming that this theory is accurate, the effect of nonprofits on the tax base is neutral; a dollar lost in tax revenue is a dollar saved by the government.\textsuperscript{170} Exempting CSR activities, however, would create a net loss in public goods.\textsuperscript{171}

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

\section*{V. THE INEQUITY IN EQUAL TREATMENT}

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

Nevertheless, the flaws of the UBIT standards, which scholars have critiqued for decades,\textsuperscript{175} are the source of many of the problems associated with the targeted tax-exemption policy outlined above. Just as others have observed through the application of the UBIT, the prongs of the test are malleable, and therefore, difficult to apply.\textsuperscript{176} The vagueness of the prongs\textsuperscript{177} is particularly problematic when the policy is applied to for-profits. The application of this policy illustrates the potential for arbitrary and unfair results. These arbitrary results would undermine Malani and Posner’s goals of efficiency and fairness.\textsuperscript{178}

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

\begin{itemize}
\item \textsuperscript{168} See Taylor, supra note 17, at 749–51 (explaining that the shareholder primacy ethos of corporations limit the impact that CSR has on society).
\item \textsuperscript{169} See \textit{Theorizing the Charitable Tax Subsidies}, supra note 12, at 518–20.
\item \textsuperscript{170} See id.
\item \textsuperscript{171} See Galle, supra note 14, at 1230.
\item \textsuperscript{172} See \textit{generally} Malani & Posner, supra note 1.
\item \textsuperscript{173} See Kotchen, supra note 164, at 830–31 (explaining that the infusion of socially conscious goods, such as fair-trade coffee, into the market may cause consumers to purchase green goods and the like as a substitute for the provision of direct aid, reducing the overall social welfare).
\item \textsuperscript{174} But see \textit{The Attack on Nonprofit Status}, supra note 13.
\item \textsuperscript{175} See \textit{generally} Henry B. Hansmann, \textit{Unfair Competition and the Unrelated Business Income Tax}, 75 VA. L. REV. 605, 622 (1989); see also Stone, supra note 75, at 1495–528.
\item \textsuperscript{176} See Gomes & Owens, supra note 112, at 14; see also, Gottry, supra note 111, at 270–72.
\item \textsuperscript{177} See Gottry, supra note 111, at 270–72.
\item \textsuperscript{178} See \textit{generally} Malani & Posner, supra note 1.
\item \textsuperscript{179} Stone, supra note 75, at 1491.
\end{itemize}
argues that basing tax exemption solely on activity, as opposed to a combination of activity and the organizational form, is bad public policy. Furthermore, it argues that implementing a one-size-fits-all policy to deal with inequities in the market is illogical.\(^{180}\)

**A. THE STANDARD IS FLAWED**

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

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

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180. See The Attack on Nonprofit Status, supra note 13, at 1205.
181. See Gottry, supra note 111, at 270–71.
182. See Scally, supra note 71, at 14.
185. See id. (explaining that activities that do not generate a profit are not subject to the UBIT even if they look like a “trade or business”).
186. See Abrams, supra note 103, at 893 (noting the ambiguity of this prong despite the Treasury’s numerous attempts to provide guidance as to its parameters).
187. See Gottry, supra note 111, at 271 (footnote omitted).
188. See Abrams, supra note 103, at 893.
189. See id.
190. See Colombo, supra note 101, at 531.
Similarly, the targeted tax-exemption policy could be manipulated so as to enable for-profit organizations to overreport these activities. For instance, NBC Universal hosts a biannual “green week” on its television channels that seeks to integrate the promotion of green practices into much of its programming.\textsuperscript{191} This activity is a “trade or business” and is “substantially related to an exempt purpose,” but it is only carried on for two weeks per year.\textsuperscript{192} However, because green week is a nationally recognized annual celebration of the green movement, it may qualify as “regularly carried on.”\textsuperscript{193} Furthermore, although the IRS would be empowered to investigate potential inaccuracies in organizations’ filings, the cost of doing so might be greater than the revenue lost through exemption.\textsuperscript{194}

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

Currently, exempt purposes are broadly defined as follows:

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

\begin{itemize}
\item \textsuperscript{191} \textit{Green Interacts Here}, NBC, http://www.nbc.com/green/about/ (last visited, Dec. 20, 2010).
\item \textsuperscript{192} Id.
\item \textsuperscript{193} See Scally, supra note 71, at 14.
\item \textsuperscript{194} See For Profit Charity, supra note 9, 231–33; see also Galle, supra note 14, at 1220.
\item \textsuperscript{195} Brakman Reiser points out that the current trends in for-profit philanthropy, particularly Google.org’s innovative approach to philanthropy, “highlight a more fundamental issue: the utility of the legal boundary between nonprofit and for-profit endeavor.” Brakman Reiser, supra note 5, at 2471. Fundamental to this boundary is the nondistribution constraint. By adopting the proposal explored in this note or one like it, this fundamental boundary is lifted and the question of what is truly charitable is exposed.
\item \textsuperscript{196} See Galle, supra note 14, at 1220.
\item \textsuperscript{197} Exempt Purposes, supra note 133.
\end{itemize}
This broad definition is favorable for nonprofit organizations that require flexibility in defining their missions.\textsuperscript{198} It is problematic, however, when considering extending tax benefits to for-profit organizations that are not subject to the nondistribution constraint.\textsuperscript{199} As seen above, this definition could encompass a broad range of activities, such as the sale of green products, which could easily be undertaken without a true charitable purpose. Without enforcement mechanisms, capable of divining a company’s true purpose\textsuperscript{200} and monitoring the charitable impact of a company’s activities, a policy employing such a broad definition could easily be abused.\textsuperscript{201} For instance, an organization could sell products that are made with recyclable materials because it believes that consumers are more likely to purchase them, and simultaneously, the company could exploit its factory workers. These perverse results highlight the complex problems that arise in applying the third prong of this policy.

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

\begin{itemize}
  \item \textsuperscript{198} See Schizer, supra note 11, at 254–55.
  \item \textsuperscript{199} See For Profit Charity, supra note 9, at 232 (critiquing Malani and Posner’s proposal, Fleisher argues that the current definition of exempt activity under section 501(c)(3) is not defined well enough to prevent its misuse or overuse by for-profit companies).
  \item \textsuperscript{200} Malani and Posner explicitly argue that a company’s motivation for engaging in charitable activity should not matter if the goal is to increase production of public good. See Malani & Posner, supra note 1, at 2064. This argument, however, ignores two important effects of a lack of charitable intent. First, without ensuring the charitable intention of an organization, one cannot ensure that the organization is committed to producing the good or service without creating a negative externality for society to endure. Second, if the company’s intent is not somewhat charitable then it is unlikely that tax exemption will provide a strong enough incentive to engage in the activity.
  \item \textsuperscript{201} See Galle, supra note 14, at 1220; see also For Profit Charity, supra note 9, at 232 (noting that this would require the IRS to significantly increase its expenditure of resources on monitoring tax-exempt organizations).
  \item \textsuperscript{202} See discussion supra Part IV.
  \item \textsuperscript{203} See discussion supra Part IV.A–B.
  \item \textsuperscript{204} See One for One Movement, supra note 40.
  \item \textsuperscript{205} Toms’ entire business model is based on the “One for One Movement,” and thus, it stands to reason that relief from income tax would enable Toms to expand its market and thus provide more relief. Conversely, a tax exemption would not affect Starbucks’ production of public goods.
\end{itemize}
companies like Starbucks, as opposed to Toms, will have a much more severe impact on the tax base.206

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

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

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

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

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206. The greater the income generated by a corporation, the higher the income tax rate imposed on the corporation. I.R.C. § 11 (2010).
207. See infra Part VI (discussing incremental policies that would be more feasible to implement).
208. See The Attack on Nonprofit Status, supra note 13, at 1218.
210. Malani and Posner make this argument; however, they argue that this increased efficiency and output of public goods will be operative in all for-profit firms promoting community-benefit. See Malani & Posner, supra note 1, at 2065.
211. See I.R.C. § 1.
213. See id. at 626–27.
214. See I.R.C. § 1.
Professor Rob Atkinson uses this analogy to illustrate that the perceived lack of fairness remedied by the UBIT is a misconception; he argues that it is equitable to treat like for-profit and nonprofit business activity differently.\textsuperscript{215} Although Atkinson’s analogy is meant to illustrate the problems with the UBIT,\textsuperscript{216} it also suggests that the unequal treatment of nonprofits and for-profits doing charitable work is equitable.\textsuperscript{217} Alternatively, this analogy demonstrates that certain for-profits should be treated more like nonprofits than others in order to achieve an equitable result.\textsuperscript{218}

\section*{VI. AN ALTERNATIVE PROPOSAL TO THE WHOLESALE EXTENSION OF TAX EXEMPTION}

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

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

\begin{footnotesize}
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\item 215. See Atkinson, sub\textsuperscript{ra} note 212, at 627.
\item 216. See id. at 625–27.
\item 217. Cf. id. (extending Atkinson’s logic to the issues raised in this note, it stands to reason that his thesis applies with equal force to the UBIT and to the analogous policy discussed in this note).
\item 218. See id.
\item 219. See The Attack on Nonprofit Status, supra note 13, at 1199–203 (citing studies and explaining that Malani and Posner’s assumption that nonprofits are not as efficient as for-profits is based on the inaccurate notion that the charitable sector is not competitive).
\item 220. See supra text accompany notes 10–14.
\item 221. See supra Part V.
\item 222. The proportionality referred to here regards the ratio between the public good produced and the reduction in tax revenue.
\end{itemize}
\end{footnotesize}
Google.org would enjoy a more favorable tax rate. This scheme, although administratively complicated, would provide tax relief to all organizations doing charitable work, and it would prevent the severe tax-base erosion envisioned above. Furthermore, this conditional tax rate would promote equity; the rate of reduction would vary according to the potential impact of tax relief on an organization’s ability to provide more public goods to its community.

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

**CONCLUSION**

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

Kalle Condliffe

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

224. See supra Part V.


226. Cf. id.

227. Cf. id.

228. Cf. id.

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

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