

# Benefit Expenses: How the Benefit Corporation's Social Purpose Changes the Ordinary and Necessary

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## BENEFIT EXPENSES: HOW THE BENEFIT CORPORATION'S SOCIAL PURPOSE CHANGES THE ORDINARY AND NECESSARY

### ABSTRACT

*The recent spread of Benefit Corporations formally challenges the assumption that for-profit companies are strictly profit maximizing entities. Businesses can now incorporate under charitable business purposes that were once restricted to 501(c)(3) non-profit organizations. While incorporating under a charitable purpose is no longer restricted to only non-profit entities, Benefit Corporations are not able to receive the same income tax exemption under the Internal Revenue Code. While for-profit entities do receive some tax benefits for their charitable behavior, such as the charitable donation deduction, the current tax structure does not provide an equal amount of tax benefits for charitable behavior when performed by a Benefit Corporation as it does for a 501(c)(3). This Note argues that the Internal Revenue Code's entity classification for non-profits and for-profits does not accommodate the mixed-purpose structure of the Benefit Corporation. This Note will explore the Internal Revenue Code's treatment of non-profit 501(c)(3)s and charitable behavior by for-profit entities and posits that the Internal Revenue Code attempts to treat the charitable behavior of an entity favorably more than it attempts to treat an entity as a whole favorably. Because charitable behavior is not considered a trade or business under the Internal Revenue Code, Benefit Corporations will now be regularly engaging in charitable behavior, the expense of which will not be categorized as either a charitable deduction or as ordinary and necessary business expenses. This Note suggests that a possible way to give Benefit Corporations the same tax treatment for its charitable behavior as non-profits engaging in the same behavior is to create a "Benefit Expense" deduction akin to the ordinary and necessary business expense deduction currently available to for-profit entities.*

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## INTRODUCTION

In recent years, the business community's interest in social responsibility has grown.<sup>1</sup> Many for-profit businesses have adopted Corporate Social Responsibility (CSR) efforts and departments.<sup>2</sup> Other businesses seek to incorporate socially responsible behavior into their entire business structure so that social responsibility is part of the core business operations.<sup>3</sup> Many of these businesses find themselves in the emerging fourth sector. The fourth sector hosts various hybrids of the existing three sectors: private (for-profit), social (non-profit/NGOs) and public (government).<sup>4</sup> These new businesses are shifting away from the assumption in corporate law that the only purpose a business can have is to generate profit.<sup>5</sup> These new businesses are redefining their business purpose to include both generating profits and generating benefit for the greater public good.<sup>6</sup>

One of the most recent business forms to enter into the fourth sector is the benefit corporation.<sup>7</sup> The benefit corporation was created primarily to address concerns of corporate responsibility, transparency, and accountability.<sup>8</sup> A benefit corporation shifts from the traditional shareholder model of profit-maximization to a stakeholder model, allowing corporations to act in furtherance of broader social concerns.<sup>9</sup> Under the stakeholder model

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<sup>1</sup> Cassady V. Brewer, *A Novel Approach to Using LLCs for Quasi-Charitable Endeavors (A/K/A "Social Enterprise")*, 38 WM. MITCHELL L. REV. 678, 679 (2012); William H. Clark, Jr. & Elizabeth K. Babson, *How Benefit Corporations Are Redefining the Purpose of Business Corporations*, 38 WM. MITCHELL L. REV. 817, 819–24 (2012); Robert A. Katz & Antony Page, *The Role of Social Enterprise*, 35 VT. L. REV. 59, 60 (2010).

<sup>2</sup> Michael R. Deskins, *Benefit Corporation Legislation, Version 1.0—A Breakthrough in Stakeholder Rights?*, 15 LEWIS & CLARK L. REV. 1047, 1057–58 (2011).

<sup>3</sup> Katz & Page, *supra* note 1, at 59, 62.

<sup>4</sup> HEERAD SABETI, FOURTH SECTOR NETWORK CONCEPT WORKING GROUP, THE EMERGING FOURTH SECTOR, EXECUTIVE SUMMARY 3 (The Aspen Inst., 2009), available at <http://www.aspeninstitute.org/publications/emerging-fourth-sector-executive-summary>.

<sup>5</sup> Clark & Babson, *supra* note 1, at 819.

<sup>6</sup> Steven Munch, *Improving the Benefit Corporation: How Traditional Governance Mechanisms Can Enhance the Innovative New Business Form*, 7 NW. J.L. & SOC. POL'Y 170, 170 (2012).

<sup>7</sup> *What Is a B Corp?*, B LAB, <http://www.bcorporation.net/about> (accessed by searching the Internet Archive index for Oct. 14, 2012).

<sup>8</sup> *Business FAQ's*, BENEFIT CORP INFO. CTR., <http://benefitcorp.net/for-business/business-faqs> (last visited Feb. 2, 2013) ("A benefit corporation is a new class of corporation that voluntarily meets higher standards of corporate purpose, accountability, and transparency.").

<sup>9</sup> See generally Clark & Babson, *supra* note 1; Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 5 (The Univ. of Chicago Law Sch., John M. Olin Law & Economics Working Paper No. 304, 2006), available at <http://www.law.uchicago.edu/files/files/304.pdf>; Alissa Mickels, *Beyond Corporate Social Responsibility: Reconciling*

of business purpose, when a corporation makes a decision, it takes more than just its shareholders into account; it also considers the impact on, and interests of, its employees, customers, investors, supply chain, the environment, communities, and more.<sup>10</sup> Benefit corporations have been codified by the legislature of twelve states,<sup>11</sup> and other states are contemplating passing the same or similar legislation.<sup>12</sup> This legislation creates an entirely new choice of entity in states that have enacted the legislation.<sup>13</sup>

The goal of the fourth sector is to create a business structure that lends itself well to serving two purposes: making profit and doing good.<sup>14</sup> One of the many challenges facing the fourth sector is that current corporate law requires for-profit organizations to act primarily in the financial interest of its shareholders and assumes and requires that corporations are profit-maximizing entities.<sup>15</sup> This is a legal problem.<sup>16</sup> Fourth sector businesses

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*the Ideals of a For-Benefit Corporation with Director Fiduciary Duties in the U.S. and Europe*, 32 HASTINGS INT'L & COMP. L. REV. 271 (2009).

<sup>10</sup> Munch, *supra* note 6, at 176–77.

<sup>11</sup> CAL. CORP. CODE §§ 14600–14631 (West 2011); HAW. REV. STAT. § 420D-1 (2012); 805 ILL. COMP. STAT. 40 (2013); LA. REV. STAT. ANN. § 12:1801 (2012); MASS. GEN. LAWS ANN. ch.156E (2012); MD. CODE ANN., Corps. & Ass'ns § 5-6C-01 (West 2011); N.J. STAT. ANN. § 14A:18-1 (West 2011); N.Y. BUS. CORP. LAW §§ 1701-1709 (Consol. 2011); VT. STAT. ANN. tit. 11A, § 21.02 (2011); VA. CODE ANN. § 13.1-782 (2011); PA. H.B. 1616 (2012); 2012 S.C. Laws Act 277 (H.B. 4766) (West); *see State by State Legislative Status*, BENEFIT CORP INFO. CTR., <http://benefitcorp.net/state-by-state-legislative-status> (last visited Feb. 2, 2013).

<sup>12</sup> Legislation introduced in North Carolina, Michigan, Washington D.C., and Colorado. *State by State Legislative Status*, *supra* note 11.

<sup>13</sup> *What Is a B Corp?*, *supra* note 7.

<sup>14</sup> *See generally* Michael D. Gottesman, *From Cobblestones to Pavement: The Legal Road Forward for the Creation of Hybrid Social Organizations*, 26 YALE L. & POL'Y REV. 345 (2007); Janet Mahon, *Joint Ventures Between Non-Profit and For-Profit Organizations St. David's Case—Worthy Destination, but Road Under Construction*, 56 TAX LAW. 845 (2003); Thomas J. Billitteri, *Mixing Mission and Business: Does Social Enterprise Need a New Legal Approach? Highlights from an Aspen Institute Roundtable* (Aspen Inst., Working Paper, Jan. 2007), available at [http://www.fourthsector.net/attachments/15/original/New\\_Legal\\_Forms\\_Report\\_FINAL.pdf?1229660976](http://www.fourthsector.net/attachments/15/original/New_Legal_Forms_Report_FINAL.pdf?1229660976).

<sup>15</sup> Clark & Babson, *supra* note 1, at 825–28 (“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. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.” (quoting *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919))); *see also* Ashley Schoenjahn, *New Faces of Corporate Responsibility: Will New Entity Forms Allow Businesses to Do Good?*, 37 J. CORP. L., 453, 454–57 (2012).

<sup>16</sup> Clark & Babson, *supra* note 1, at 831–32 (“Without clear authority explicitly permitting directors to pursue both profit and a company’s mission, [ ] directors of mission-driven companies ... may be hesitant to ‘consider’ their missions for fear of a fiduciary duty breach.”).

want to do good, but corporate law, and the assumptions within corporate law, are set up for businesses whose goals are primarily, if not entirely, profit oriented.<sup>17</sup> As creators of businesses challenge the concept that businesses are solely for-profit entities, and accept the view that businesses should, or can,<sup>18</sup> “do good,” the laws governing these entities must shift as well. Fourth sector corporations looking to create actual social benefit must find a way to do so in a way that does not violate their duty to shareholders and that allows for social impact to be put ahead of profits.<sup>19</sup> Businesses looking to enter the fourth sector want to operate in a way such that they further social goals and such that un-likeminded investors or changes in ownership will not threaten their businesses’ social mission.<sup>20</sup> Benefit corporations solve some of the challenges facing the fourth sector by eliminating the risk of liability for making decisions that benefit social and environmental purposes over the financial interests of shareholders.<sup>21</sup> This helps to give benefit corporations protection under corporate law theories.

The benefit corporation is not the only innovation in corporate structuring that has been proposed to fix this fiduciary problem, but it is the first state-enacted legislation aimed at doing so for corporations.<sup>22</sup> Some states have similarly adjusted laws for Limited Liability Companies (LLCs) and the 1996 Uniform Limited Liability Company Act allows LLCs to be organized for any legal purpose regardless of whether it is for profit.<sup>23</sup> The

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<sup>17</sup> See LYNN A. STOUT, *THE PROBLEM OF CORPORATE PURPOSE*, 48 *ISSUES IN GOVERNANCE STUD.* 1 (June 2012).

<sup>18</sup> See generally Julie A. Nelson, *Does Profit-Seeking Rule Out Love? Evidence (or Not) from Economics and Law*, 35 *WASH. U. J.L. & POL’Y* 69 (2011).

<sup>19</sup> Schoenjahn, *supra* note 15, at 465 (“One of the purposes of the B Corporation is to circumnavigate the shareholder primacy norm that keeps traditional corporations from pursuing social motives over profit maximization.”).

<sup>20</sup> See Clark & Babson, *supra* note 1, at 826–28 (discussing how the owners of craigslist wanted to create a rights plan to maintain the culture and “community service roots” but “the court noted that the adoption of the rights plan was not reasonably related to the promotion of stockholder value,” and that the owners had “fail[ed] to prove that craigslist’s culture translates into increased profitability for stockholders.”); see also Schoenjahn, *supra* note 15, at 466 (suggesting that the classic example of Ben & Jerry’s having to sacrifice the company’s social culture to sell to the highest bidder could have been avoided if Ben & Jerry’s had been a Benefit Corporation); Deskins, *supra* note 2, at 1060–61 (also discussing the Ben & Jerry’s anecdote).

<sup>21</sup> See Schoenjahn, *supra* note 15, at 458–59.

<sup>22</sup> See William H. Clark & Larry Vranka, *The Need and Rationale for the Benefit Corporation: Why It Is the Legal Form That Best Addresses the Needs of Social Entrepreneurs, Investors, and, Ultimately, the Public*, App. C, *BENEFIT CORP INFORMATION CENTER*, available at <http://benefitcorp.net/for-attorneys/benefit-corp-white-paper> (last visited Feb. 2, 2013).

<sup>23</sup> See David S. Walker, *Consideration of an LLC for a 501(c)(3) Nonprofit Organization*, 38 *WM. MITCHELL L. REV.* 627 (2012); *RULLCA* § 104(b) (2006); see also Brewer, *supra* note 1, at 680.



flexibility of an LLC has led to the L3C, Limited Liability Low-Profit Company, which combines the legal structure of an LLC and the social mission of a non-profit.<sup>24</sup> Other businesses achieve protection from this fiduciary duty liability through hybrid forms created by manipulating existing structures, or by working around these structures.<sup>25</sup> As more business entities allow purposes that are not profit-motivated, attention is drawn to what some say is an outdated assumption in corporate law.<sup>26</sup>

Being a state-recognized entity is powerful for protecting against liability for managers' decisions, but proponents of the fourth sector see a second issue: taxation.<sup>27</sup> Choice-of-entity decisions revolve around the two issues of liability and taxation. Choosing to become a benefit corporations is no exception.<sup>28</sup> Because benefit corporations serve the same social purposes originally thought to be exclusively served by tax-exempt non-profits, the question becomes: should these entities enjoy the same tax exemptions as non-profits?<sup>29</sup> Because benefit corporations are at least partially profit motivated, it is unlikely that benefit corporations will be granted the exact same tax-exempt status as 501(c)(3) non-profits.<sup>30</sup> Rather than seeking preferential tax treatment on the entity level as an exempt organization, it may be more attainable for benefit corporations to receive preferential treatment from the Internal Revenue Code (Code) for the activities carried out that liken them to non-profits.<sup>31</sup> This preferential tax treatment would positively serve benefit corporations and incentivize social responsibility in businesses.<sup>32</sup> This Note will suggest that the Code's view of an entity's status under the Code as non-profit or for-profit clouds the true color and correct nature of a for-profit's activities, and that the Code's failure to adjust its view of business purpose at the same pace as corporate theory, creates complications and contradictions within the Code. This Note will address how having a state-incorporated purpose to create a social benefit in addition to a purpose of profit generation potentially affects the tax treatment of benefit corporations, because the Code determines its treatment of an entity's

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<sup>24</sup> See Schoenjahn, *supra* note 15, 460–61.

<sup>25</sup> Brewer, *supra* note 1, at 685 (“It is possible ... to create a structure that makes use of multiple organizations acting in concert to achieve the goal of blending philanthropic and private dollars to fund a social enterprise.”).

<sup>26</sup> Clark & Babson, *supra* note 1, at 825.

<sup>27</sup> Brewer, *supra* note 1, at 684.

<sup>28</sup> Schoenjahn, *supra* note 15, at 458.

<sup>29</sup> Malani & Posner, *supra* note 9, at 10–11.

<sup>30</sup> *Id.*

<sup>31</sup> See generally Walker, *supra* note 23, at 646–49.

<sup>32</sup> Schoenjahn, *supra* note 15, at 463 (discussing Bill Gates's idea of a “creative capitalism” and how the prospect of profits could incentivize companies to do good).

individual transactions and activities with consideration of the entity's purpose for those transactions.

In some cases, the social benefit created by socially oriented businesses is similar, if not equivalent, to the social benefit created by 501(c)(3)s. 501(c)(3)s are exempt from federal income tax because the purpose of the entity, and the purpose of the entity's activities, is to create social benefit.<sup>33</sup> Although there is a hard line drawn between 501(c)(3)s and for-profit corporations at the entity level for classification purposes, the Code ultimately looks at the behavior of the entity in light of its classification. The Internal Revenue Service (IRS) treats the creation of social benefit, or "good behavior," favorably throughout the Code and associated Regulations and, treats solely profit-motivated activities (even of tax-exempt entities) unfavorably.<sup>34</sup> The IRS closely considers the purpose of a business entity, along with the purpose of the business activity, when determining its tax treatment.<sup>35</sup> For the Code to remain consistent, benefit corporations should receive more favorable tax treatment for their socially beneficial activities than non-benefit corporations who engage in corporate philanthropy.

#### I. SHIFT IN BUSINESS PURPOSE OF FOR-PROFITS

Businesses are already operating in socially responsible ways. Some argue that the risks directors face by setting social objectives instead of pursuing profit maximization are existent but unenforceable.<sup>36</sup> New forms of business, such as the benefit corporation, that want to change the purpose for which they are organized face a greater degree of risk and third party expectation than for-profits participating in only occasional social activities.<sup>37</sup> This is especially true as some consumers wish to *require* businesses to act responsibly, and are unsatisfied with the consolation that businesses are at least now *allowed* to act responsibly.<sup>38</sup> With the increase of access to information, consumers are demanding more transparency from businesses and holding them accountable for their actions.<sup>39</sup> Partly in response to consumer pressures, and partly due to the aspirations of social entrepreneurs, the fourth sector "integrates social purposes with business methods ... [unified by] a motivation to make the world a better place."<sup>40</sup>

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<sup>33</sup> 26 U.S.C. § 501 (2012).

<sup>34</sup> See *infra* Part II.A.

<sup>35</sup> See *infra* Parts III, IV.

<sup>36</sup> Munch, *supra* note 6, at 177–78.

<sup>37</sup> *Id.* at 179.

<sup>38</sup> Deskins, *supra* note 2, at 1074.

<sup>39</sup> SABETI, *supra* note 4, at 1.

<sup>40</sup> *Id.*



The existing structures of each sector confine the functionality of businesses, and the fourth sector seeks to create a new space where an entity's impact is not limited by existing law.<sup>41</sup> Non-profits generally have limited access to capital, as they cannot conduct activity solely for creating profit.<sup>42</sup> For-profits have a duty to act in the financial interest of shareholders, and by definition are created to make a profit.<sup>43</sup> This leaves those who would like both to make a profit and to do good in unclear territory with an unclear legal structure for their business.

As well established in *Dodge v. Ford*<sup>44</sup> and reinforced in *Revlon*,<sup>45</sup> managers could be found in breach of their fiduciary duties to shareholders if they chose to pursue social benefit in place of shareholder wealth maximization. Corporate law “has established profit-maximization as a default rule”<sup>46</sup> and supports the notion that a corporation must act in the financial interest of its shareholders. This is a problem for the fourth sector which, at least sometimes, wishes to do the “right thing” rather than the most profitable thing. The directors and officers of a corporation that act against the financial interest of its shareholders are left vulnerable to shareholder lawsuits for breach of fiduciary duty.<sup>47</sup> Shareholder action is not the only vulnerability to which corporations are exposed if they desire to serve a social purpose.

All corporations are required to declare an incorporated purpose in their articles of incorporation filed with their chosen state.<sup>48</sup> For a non-benefit corporation the incorporated purpose will most likely state a purpose similar to “all legal ways of making a profit.”<sup>49</sup> Taking money out of profits to give to charities goes against the listed incorporated purpose of a for-profit corporation.<sup>50</sup> At one time, a corporation giving money to charity

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<sup>41</sup> Billitteri, *supra* note 14, at 2 (“This new generation of hybrid organizations is taking root in a fertile space between the corporate world, which is constrained by its duty to generate profits for shareholders, and the nonprofit world, which often lacks the market efficiencies of commercial enterprise.”).

<sup>42</sup> See Treas. Reg. § 1.501(c)(3)-1(c).

<sup>43</sup> Dana Brakman Reiser, *Benefit Corporations—A Sustainable Form of Organization?*, 46 WAKE FOREST L. REV. 591, 591 (2011).

<sup>44</sup> *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919).

<sup>45</sup> *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (allowing consideration of non-shareholder constituency during hostile takeover, only where the constituency “rationally related benefits accruing to the stockholders”).

<sup>46</sup> Gottesman, *supra* note 14, at 357.

<sup>47</sup> Mickels, *supra* note 9, at 282.

<sup>48</sup> See 1 CORP. FORMS § 2:1 (2012 ed.).

<sup>49</sup> See Barnali Choudhury, *Serving Two Masters: Incorporating Social Responsibility into the Corporate Paradigm*, 11 U. PA. J. BUS. L. 631 (2009).

<sup>50</sup> See 2 FLETCHER CORP. FORMS § 8:18 (5th ed.).

was considered a breach of its contract with the state.<sup>51</sup> Before Congress passed legislation allowing tax deductions for charitable donations, charitable giving was considered ultra vires, and even remained ultra vires in many states after the federal legislation was passed.<sup>52</sup> While this is no longer the case and a corporation can now freely donate to charities without violating its incorporated purpose (subject to a ten percent limitation),<sup>53</sup> charitable giving is an exception, not a relaxing, of the treatment of fiduciary duty. Corporate law views profit making, and the distribution of those profits, as the primary purpose of a corporation.<sup>54</sup> By passing legislation, charitable donations are no longer ultra vires, but other behavior that lessens a corporation's profits risks being categorized as a breach of fiduciary duty or break of promise with the state.

By passing benefit corporation legislation, the fourth sector seeks to legalize a second and equal incorporated purpose of a business in addition to profit making: the creation of social benefit.<sup>55</sup> Benefit corporation legislation aims to legalize the "stakeholder" model for corporations, which will in turn affect the legal standards for fiduciary duty and state-incorporate purpose inquiries.<sup>56</sup> At the heart of the "stakeholder" model is the desire to expand the duty of a corporation beyond shareholders to individuals, communities, and entities that are impacted, and to expand the actions of corporations beyond purely profit generating actions.<sup>57</sup> As mentioned briefly before, there have been a number of forms that businesses and advocates have chosen as possible model forms for achieving social purpose goals and solving issues of fiduciary duty.<sup>58</sup> Some suggest resolving this challenge by choosing other entity structures, such as LLCs, that have more flexible and alternative default rules;<sup>59</sup> hybrid business forms, such as the Low-Profit Limited Liability Corporation (L3C);<sup>60</sup> or joint operations of for- and non-profits.<sup>61</sup>

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<sup>51</sup> See 1 CORP. FORMS § 10:61 (2012 ed.).

<sup>52</sup> Linda Sugin, *Theories of the Corporation and the Tax Treatment of Corporate Philanthropy*, 41 N.Y.L. SCH. L. REV. 835, 857 (1997); see also Nancy J. Knauer, *The Paradox of Corporate Giving: Tax Expenditures, the Nature of the Corporation, and the Social Construction of the Charity*, 44 DEPAUL L. REV. 1, 8 (1994).

<sup>53</sup> 26 U.S.C. § 170.

<sup>54</sup> See Choudhury, *supra* note 49, at 635.

<sup>55</sup> Schoenjahn, *supra* note 15, at 460.

<sup>56</sup> See *supra* notes 74–79 and accompanying text.

<sup>57</sup> Gottesman, *supra* note 14, at 357; see also Katz & Page, *supra* note 1, at 59, 62.

<sup>58</sup> See *supra* Introduction.

<sup>59</sup> See generally Walker, *supra* note 23.

<sup>60</sup> Brewer, *supra* note 1, at 681–82.

<sup>61</sup> See Schoenjahn, *supra* note 15, at 459–60.

Another option is to contract around the default rules, most commonly by constituency statutes.<sup>62</sup> Constituency statutes are allowed and recognized in just over half of the states,<sup>63</sup> and they permit corporations to add stakeholder interests to their articles of incorporation.<sup>64</sup> This allows the corporation to serve a social purpose in addition to a profit-maximizing purpose and would eliminate the problem of socially motivated activities being considered *ultra vires*. However, the extent to which constituency statements allow for a true stakeholder model is not without criticism. For one, constituency statements only make it permissible to act for a non-profit-maximizing purpose, they do not require a company to do good.<sup>65</sup> Another criticism is that some constituency statements narrowly define stakeholders only as the immediately surrounding parties such as employees and customers but leave out larger stakeholders such as “the environment, the international community, or human rights.”<sup>66</sup> Another criticism is that even though these constituency statutes allow the stakeholder interests to be added to the articles of incorporation, there has been no court ruling on whether the constituency statutes can be legally enforced.<sup>67</sup> Case law has disallowed “commitments beyond profit maximization” when the purposes have *not* been added to the articles of incorporation, but there is no ruling that considers when they have been added.<sup>68</sup> Essentially, constituency statutes allow organizations to state their purpose, but it is still legally uncertain that corporations are able to carry it out.<sup>69</sup>

Benefit corporation legislation improves upon many of the inadequacies of constituency statutes. While the legislation in each of these states varies slightly,<sup>70</sup> the legal framework of each state is greatly influenced by the legal framework given by B Lab:

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<sup>62</sup> See Gottesman, *supra* note 14, at 357; see also Katz & Page, *supra* note 1, at 92; see generally Clark & Babson, *supra* note 1, at 828–34; Munch, *supra* note 6, at 180–83.

<sup>63</sup> See Clark & Babson, *supra* note 1, at 830–31 nn.64–66 and accompanying text. Notably, of the states that have passed benefit corporation legislation, California is the only state not to have recognized constituency statutes prior to passing the benefit corporation legislation. *Id.* at 818 n.1, 830 n.64.

<sup>64</sup> See Gottesman, *supra* note 14, at 357.

<sup>65</sup> Clark & Babson, *supra* note 1, at 832 (“[D]irectors have the permission *not* to consider interests other than shareholder maximization of value.”).

<sup>66</sup> Munch, *supra* note 6, at 181.

<sup>67</sup> See Gottesman, *supra* note 14, at 357.

<sup>68</sup> *Id.* at 356–57.

<sup>69</sup> Clark & Babson, *supra* note 1, at 831–32 (“Without clear authority ... even directors of mission-driven companies in constituency statute jurisdictions may be hesitant to ‘consider’ their missions for fear of a fiduciary duty breach.”). See *Legal FAQs*, BENEFIT CORP INFO. CTR., <http://www.benefitcorp.net/for-attorneys/legal-faqs> (last visited Feb. 2, 2013).

<sup>70</sup> See Clark & Babson, *supra* note 1, at 838.

Objective: Expand the responsibilities of the corporation to include consideration of the interests of employees, consumers, the community, and the environment. Give legal permission and protection to officers and directors to consider all stakeholders, not just shareholders. Create additional rights for shareholders to hold directors and officers accountable to these interests. Limit these expanded rights to shareholders exclusively—non-shareholders are explicitly not empowered with a new right of action.<sup>71</sup>

Benefit corporations are a clear improvement upon constituency statements if the main concern is requiring businesses to act responsibly, as benefit corporations are not just permitted, but required to serve a social purpose.<sup>72</sup> Benefit corporation legislation also expands the stakeholders whose interests the corporation can consider by requiring benefit corporations to include a general public benefit as an incorporated purpose, and by allowing for a specific public benefit.<sup>73</sup>

The goal of benefit corporations is to solve the fiduciary duty problem in the simplest way possible. Two aspects are important to finding a simple solution. The first is including the stakeholder model in its articles of incorporation<sup>74</sup> and the second is making the *entity legitimate under the state law* by passing legislation that recognizes this distinct entity's ability to include the stakeholder model in its articles.<sup>75</sup> This is an important distinction and can be demonstrated by examining the difference between benefit corporations created by state legislation and Certified B Corps certified by B Labs.<sup>76</sup> In many ways, Certified B Corps function like extreme constituency statements.<sup>77</sup> A B Corp's articles of incorporation may be identical to

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<sup>71</sup> *The Legal Framework*, B LAB, <http://www.bcorporation.net/become/legal> (accessed by searching the Internet Archive index for Oct. 3, 2012).

<sup>72</sup> See *Guidance: Considering Stakeholder Interests*, BENEFIT CORP INFO. CTR., <http://www.benefitcorp.net/for-directors/guidance-considering-stakeholder-interests> (last visited Feb. 2, 2013).

<sup>73</sup> See Clark & Babson, *supra* note 1, at 839–42 (“This definition takes a holistic approach and is meant to be both comprehensive and flexible.”).

<sup>74</sup> See Deskins, *supra* note 2, at 1061.

<sup>75</sup> See Munch, *supra* note 6, at 184.

<sup>76</sup> See *Benefit Corp Legislation*, B LAB, <http://www.bcorporation.net/publicpolicy> (accessed by searching the Internet Archive Index for Oct. 3, 2012) (“Both are sometimes called B Corps. They share much in common and have a few important differences. Certified B Corporation is a certification conferred by the non-profit B Lab. Benefit corporation is a legal status administered by the state. Benefit corporations do NOT need to be certified. Certified B Corporations have been certified as having met a high standard of overall social and environmental performance, and as a result have access to a portfolio of services and support from B Lab that benefit corporations do not.”).

<sup>77</sup> See Emily Chan, *What It Means to Be a “B”: B Corp v. Benefit Corporation*, LAW FOR CHANGE BLOG (Mar. 19, 2012), <http://www.lawforchange.org/NewsBot.asp?MODE=VIEW&ID=5220>; Munch, *supra* note 6, at 182.

a benefit corporation's, but without state legislation recognizing the entity, the articles of incorporation act more like a constituency statement akin to a contract with the shareholders.<sup>78</sup> The state legislation creating the benefit corporation as a choice of entity recognizes the articles of incorporation as a contract with the state.<sup>79</sup> State recognition as a legal form of entity provides the benefit corporation protection and certainty under its laws.

A B Lab certified B Corp is not a recognized business entity existing under state law, but a certification.<sup>80</sup> B Labs is a third-party certifier of benefit corporations and has spearheaded the effort to get states to adopt its model legislation.<sup>81</sup> Any business can become certified as a B Corp by taking the "B Impact Test" and scoring a minimum of 80 out of 200 available points.<sup>82</sup> The business must then "adopt the B Corporation Legal Framework to bake the mission of the company into its legal DNA,"<sup>83</sup> which is essentially "retrofitting"<sup>84</sup> the corporation to include the stakeholder model in its articles of incorporation. The B Corp must also "sign a Term Sheet and Declaration of Interdependence" to make the certification official.<sup>85</sup> Each year, B Lab randomly selects ten percent of the current B Corps to audit and will adjust a B Corp's score according to the audit, removing its certification if it no longer qualifies.<sup>86</sup> Certification of a B Corp is similar to certifications such as Fair Trade or LEED, and B Lab serves the same purpose as Transfair and USGBC respectively.<sup>87</sup> Certification as a B Corp certainly adds legitimacy to the business's socially conscious efforts in the eyes of investors and consumers. However, eliminating risk to directors through legitimacy under the law is essential for social entrepreneurs to form these socially responsible businesses, even if certification will help skeptics find their intentions believable.<sup>88</sup> Accordingly, although

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<sup>78</sup> See Chan, *supra* note 77; Munch, *supra* note 6, at 182.

<sup>79</sup> See Chan, *supra* note 77; Munch, *supra* note 6, at 182.

<sup>80</sup> See *Benefit Corp Legislation*, *supra* note 76.

<sup>81</sup> See *The Benefit Corporation: A New Trend in Social Entrepreneurship*, FIRST VENTURE LEGAL BLOG (Dec. 21, 2011), <http://www.firstventurelegal.com/the-benefit-corporation-a-new-trend-in-social-entrepreneurship/>.

<sup>82</sup> See *B Corp Certification Overview*, B LAB, <http://www.bcorporation.net/Certification-Overview> (accessed by searching the Internet Archive index for Oct. 3, 2012).

<sup>83</sup> *Id.*

<sup>84</sup> Munch, *supra* note 6, at 183.

<sup>85</sup> *Make It Official*, B LAB, <http://www.bcorporation.net/become/official> (accessed by searching the Internet Archive index for Oct. 3, 2012).

<sup>86</sup> *Become a B Corp*, B LAB, <http://www.bcorporation.net/become/BRS> (accessed by searching the Internet Archive for Oct. 3, 2012).

<sup>87</sup> See *What Is a B Corp*, *supra* note 7; Brewer, *supra* note 1, at 683.

<sup>88</sup> See Clark & Babson, *supra* note 1, at 824 ("[E]ntrepreneurs that are 'sustainable,' 'green,' or 'socially responsible' may find that it is hard to distinguish themselves from other companies that make similar claims, but do not actually behave as they advertise.").

the B Corp certification process adds accountability to those businesses that pass the test, a certified B Corp that does not live up to its purpose will lose its certification, while an incorporated benefit corporation that does not live up to its purpose could face legal consequences.<sup>89</sup>

Only twelve states have enacted legislation creating benefit corporations as a separate legal entity. The first was Maryland in April of 2010.<sup>90</sup> Vermont, New Jersey, Virginia, Hawaii, California, New York, Louisiana, Massachusetts, Illinois, Pennsylvania, and South Carolina followed.<sup>91</sup> California is of particular significance because, prior to this legislation, its law did not allow constituency statements or the creative, hybrid forms of business used by the fourth sector to lessen the fiduciary duty in a manner that would allow directors to pursue non-profit-maximizing or socially oriented purposes.<sup>92</sup> This means that California law would enforce the profit-maximization standard for fiduciary duty even if the corporation had included a stakeholder model in its articles of incorporation.<sup>93</sup> Additionally, California passed two separate legal entity forms, the Benefit Corporation and the Flexible Purpose Corporation (Flex C); the Benefit Corporation is incorporated for a general social purpose in addition to profit making, and the Flex C is incorporated for an additional specific social purpose.<sup>94</sup> The model legislation for benefit corporations allows for an *optional* specific purpose in addition to the general purpose.<sup>95</sup> The distinction between a general and specific purpose and how that might affect the tax treatment of the entity is discussed further.

An example showing another difference between a certified B Corp and an incorporated benefit corporation is that the City of Philadelphia gave a sustainable business tax credit to Certified B Corps<sup>96</sup> before it

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<sup>89</sup> See Chan, *supra* note 77.

<sup>90</sup> See *Maryland First State in Union to Pass Benefit Corporation Legislation*, THE CORP. SOC. RESP. NEWSWIRE (Apr. 14, 2010), [http://www.csrwire.com/press\\_releases/29332-Maryland-First-State-in-Union-to-Pass-Benefit-Corporation-Legislation](http://www.csrwire.com/press_releases/29332-Maryland-First-State-in-Union-to-Pass-Benefit-Corporation-Legislation).

<sup>91</sup> See *State by State Legislative Status*, *supra* note 11. At the time of writing, there is also pending legislation in Washington, D.C. *Id.*

<sup>92</sup> See *The New ABC's of California Corporations*, KAYE & MILLS, <http://www.kayemills.com/articles/new-abcs-of-california-corporations.html> (last visited Feb. 2, 2013).

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*; see Sheila Shayon, *California Law Creates New "Flexible Purpose" Category of Positive Impact Corporation*, BRANDCHANNEL (Oct. 17, 2011, 11:07 AM), <http://www.brandchannel.com/home/post/2011/10/17/California-Law-Creates-New-Category-of-Positive-Impact-Corporation.aspx>.

<sup>95</sup> MODEL BENEFIT CORP. LEGIS. § 201(b) (2007).

<sup>96</sup> See Leslie Potter, *First U.S. Sustainable-Business Tax Incentive*, URBAN FARM, <http://www.urbanfarmonline.com/sustainable-living/urban-community-building/philly-tax-incentives.aspx> (last visited Feb. 2, 2013).



passed benefit corporation legislation. Therefore, as far as choice of entity is concerned, a B Corp could not file as a benefit corporation with the State of Pennsylvania and thus recognize the benefit of protection by its laws, but a B Corp would still have enjoyed some benefits based on its recognition as a certified business.

States give businesses permission to operate and exist within a state's borders.<sup>97</sup> While there are model or uniform acts that often govern the default rules for the existence and operation of business entities such as partnerships, LLCs, and corporations, it is ultimately up to the state to decide the laws regarding choice of entity and those entities' operations.<sup>98</sup> By passing legislation that introduces the benefit corporation as a new choice of entity available for businesses in that state, benefit corporations are made a legal entity distinct from other corporations and a new area of law under which the new entity will operate is created. This is relevant because the state law in which the business is incorporated or registered under dictates what fiduciary laws apply, and that state's law is also used to help determine what type of entity the business is for federal income tax purposes.<sup>99</sup>

The fact that benefit corporations are a legally recognized entity for doing business under state law is not only important for understanding the significant role that they play in shifting the definition of business purpose,<sup>100</sup> but also for the arguments brought forth in this Note regarding the Code's treatment of a benefit corporation. The policy and theoretical debates over whether a corporation's purpose inherently involves social responsibility, or whether it is strictly profit-maximizing, existed well before states began legitimizing benefit corporations in 2010.<sup>101</sup> The debate that critics and advocates have over fiduciary duty is the same debate regarding the allowance of charitable contributions.<sup>102</sup> Although the support for benefit corporations reflects a desire to change the assumption that all corporations are strictly profit-maximizing entities, it does not necessarily indicate that the change has occurred. In a way, benefit corporations create a refuge for corporations that want to escape the uncertainty of liability for their socially oriented, wealth-reducing activities, but the uncertainty still remains for non-benefit corporations. Benefit corporations legally shifted

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<sup>97</sup> See JAMES D. COX & THOMAS LEE HAZEN, TREATISE ON THE LAW OF CORPORATIONS § 1:2 (3d ed. 2011).

<sup>98</sup> See *id.* § 3:2.

<sup>99</sup> See *id.*

<sup>100</sup> Munch, *supra* note 6, at 184 ("A new form would lend needed certainty and legitimacy to the benefit corporation project.").

<sup>101</sup> See generally Knauer, *supra* note 52.

<sup>102</sup> See *supra* Part I.

their own purpose, but they have not necessarily shifted the theoretical view of corporations as a whole.<sup>103</sup> In general, the questions that this Note addresses are whether having a state-incorporated social purpose removes the profit-maximizing assumption for benefit corporations in regard to fiduciary duty, and whether the removal of that assumption does, or should, have any effect on the Code's view and treatment of benefit corporations.

## II. WHY INCORPORATED BENEFIT CORPORATIONS ARE A SPECIAL BLEND OF FOR-PROFIT AND NON-PROFIT

Benefit corporations may be best examined under the Code by viewing benefit corporations as now having two dual purposes, one to make profits<sup>104</sup> and the other to serve social goals<sup>105</sup> (for the purposes of this Note, "make benefit"), rather than as an adjustment of the definition of a corporation. This accurately demonstrates the hurdle presented by the Code over which the benefit corporation is currently straddled. Tax-exempt 501(c) and 501(d) organizations are exempt from federal income taxes based on whether they are organized and operated exclusively for one of the listed approved purposes.<sup>106</sup> Specifically, the exclusively organized test is met by examining the purposes listed in a corporation's Articles of Organization.<sup>107</sup> This correlation between the importance of a non-profit's incorporated purposes and the benefit corporation's incorporated purposes is what makes the benefit corporation more significant than constituency statements and Certified B Corps.<sup>108</sup> While benefit corporations are not *exclusively* organized and operated for any of the listed purposes, B Corps now make it possible for a

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<sup>103</sup> For the remainder of this Note, where a shift in business purpose is discussed either as a trend or the legal change in purpose for Benefit Corporations, it is mostly used in reference to the fact that States are now allowing and legitimizing the option to have a social purpose.

<sup>104</sup> See Halle Tecco, *Not For-Profit, Not Non-Profit, but Somewhere in Between*, HUFFPOST IMPACT (Jan. 4, 2010, 7:05 PM), [http://www.huffingtonpost.com/halle-tecco/not-for-profit-not-non-pr\\_b\\_411117.html](http://www.huffingtonpost.com/halle-tecco/not-for-profit-not-non-pr_b_411117.html).

<sup>105</sup> See *id.*

<sup>106</sup> See Treas. Reg. § 1.501(c)(3)-1(b).

<sup>107</sup> See *id.* "An organization is not organized exclusively for one or more exempt purposes if its articles expressly empower it to carry on, otherwise than as an insubstantial part of its activities, activities which are not in furtherance of one or more exempt purposes, even though such organization is, by the terms of such articles, created for a purpose that is no broader than the purposes specified in section 501(c)(3)." § 1.501(c)(3)-1(b)(2)(b)(iii).

<sup>108</sup> Even though certified B Corps must amend their articles to include a general public benefit in order to be certified by B Labs, it is the state acknowledged and authorized aspect of the incorporated purpose that gives it more certain legal significance. See *Legal Requirement*, B LAB, <http://www.bcorporation.net/become/legal> (last visited Feb. 2, 2013).

tax-exempt approved purpose to be one of the state-recognized incorporated purposes of a taxable entity.<sup>109</sup> The fact that B Corps now have explicit, although not exclusive, social purposes, and may be held liable for not acting in the interest of those purposes, raises questions regarding whether B Corps should receive the same, or similar, tax treatment as tax-exempt entities.

Benefit corporations have broken the rigid, single profit-seeking entity view for fiduciary duty and corporate law that has been evolving and growing over the years.<sup>110</sup> The Code, however, has not undergone the same evolutionary process and remains quite rigid.<sup>111</sup> The for-profit corporate law default rules and assumptions create an “unbridgeable chasm between for-profit enterprise and the charitable world,”<sup>112</sup> and while that gap is filled for fiduciary duties in benefit corporations, “[e]verybody thinks with their brain in a left-right axis, and it’s divided by the tax code.”<sup>113</sup> An entity is placed into its respective half of the Code according to the purpose for which that entity was organized.<sup>114</sup> If the entity was organized and created to make money, then it is taxable.<sup>115</sup> If the entity was organized for the purpose of working toward a “social” mission, then it is tax-exempt.<sup>116</sup> Benefit corporations challenge the Code’s current categorization of entities because they are legally recognized as being incorporated for both purposes.

Tax preferences are not an explicit goal of benefit corporations, but it is something that representatives of B Labs<sup>117</sup> and other fourth sector speculators are hoping will happen one day.<sup>118</sup> The new legislation passed by states has no impact on the tax status of the organizations.<sup>119</sup> The Model

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<sup>109</sup> See *In Defense of Tax Incentives: A Response to Diana Aviv, President Independent Sector*, B Lab, <http://blog.bcorporation.net/2010/06/in-defense-of-tax-incentives-a-response-to-diana-aviv-president-independent-sector/> (last visited Feb. 2, 2013).

<sup>110</sup> See Sugin, *supra* note 52, at 837.

<sup>111</sup> *Id.*

<sup>112</sup> Billitteri, *supra* note 14, at 7.

<sup>113</sup> *Id.* (comments of Mr. R. Todd Johnson).

<sup>114</sup> See *Business Taxes*, IRS, <http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Business-Taxes> (last visited Feb. 2, 2013).

<sup>115</sup> See *Corporations*, IRS, <http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Corporations> (last visited Feb. 2, 2013).

<sup>116</sup> See *Exemption Requirements-Section 501(c)(3) Organizations*, IRS, <http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Exemption-Requirements-Section-501%28c%29%283%29-Organizations> (last visited Feb. 2, 2013).

<sup>117</sup> See Schoenjahn, *supra* note 15, at 458; Jack B. Siegel, Esq., *B Corporations: A New Form of Business Entity, or Just an Exercise in Branding?*, 2011 Emerging Issues 5757, 6 LEXISNEXIS (July 7, 2011); see also Billitteri, *supra* note 14, at 12.

<sup>118</sup> See Gottesman, *supra* note 14, at 355–58.

<sup>119</sup> See *Business FAQ’s*, *supra* note 8.

Legislation for benefit corporations cites to another subdivision under the same title that determines the applicable law for all matters not addressed in the chapter—applicable tax treatment, for example.<sup>120</sup> This other subdivision is usually the subdivision that determines general corporation law.

The Code is so rigid in how it views the capacity of each side to “do good” that it only acknowledges “good” done by for-profits in the form of charitable contributions to IRS acknowledged tax-exempt entities.<sup>121</sup> The donation must be to an organization the IRS has qualified as a “good doing” organization, or it will not be recognized as a charitable contribution.<sup>122</sup> While the Code is often used to incentivize or disincentivize behavior, and this is certainly the case with charitable contributions and at least some of the justification for tax-exempt status,<sup>123</sup> non-profits are exempt from taxes for reasons other than the fact that the Code wants to cut them a break.<sup>124</sup>

*A. The Internal Revenue Code Favors Good Behavior and Taxes  
Profit-Motivated Income*

The Code ultimately makes the divide that qualifying non-profits will be exempt from federal income tax and for-profit corporations will have their income taxed.<sup>125</sup> Tax-exempt status earns qualifying organizations exemption from federal income tax and some other taxes, but not all taxes.<sup>126</sup> Both non-profits and for-profits earn income, and in fact, both non-profits and for-profits may generate profits. The difference between the incomes and profits is seen when expanding non-profits to their full name: not-for-profits. As mentioned, this reflects that the manner by which the Code categorizes taxable and tax-exempt entities is by their purposes.<sup>127</sup> The income

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<sup>120</sup> MODEL BENEFIT CORP. LEGIS. § 101(c) (2012).

<sup>121</sup> See *Charitable Donation Tax Deductions*, BETTER BUS. BUREAU, <http://www.bbb.org/us/Charity-Tax-Deductions/> (last visited Feb. 2, 2012).

<sup>122</sup> See I.R.S. Publ’n 526, *Charitable Contributions* (2011), available at [http://www.irs.gov/publications/p526/ar02.html#en\\_US\\_2011\\_publink1000229641](http://www.irs.gov/publications/p526/ar02.html#en_US_2011_publink1000229641).

<sup>123</sup> See *Sweetened Charity*, THE ECONOMIST (June 9, 2012), <http://www.economist.com/node/21556570>.

<sup>124</sup> See Terri Lynn Helge, *The Taxation of Cause-Related Marketing*, 85 CHI.-KENT L. REV. 883, 886 (2010).

<sup>125</sup> See 26 U.S.C. § 501(a).

<sup>126</sup> *Tax Exempt & Government Entities Division At-a-Glance*, IRS, <http://www.irs.gov/uac/Tax-Exempt-&-Government-Entities-Division-At-a-Glance> (last updated Sept. 5, 2012) (tax exempt and government entities “[p]ay more than \$220 billion in employment tax and income tax withholding”); see also Brewer, *supra* note 1, 694 nn.58–60 and accompanying text.

<sup>127</sup> See Treas. Reg. § 1.501(c)(3)-1(a)(2).

generated by tax-exempt entities is not intended to be profits,<sup>128</sup> while the income generated by for-profit entities is intended to become profits.<sup>129</sup>

The income that an exempt organization earns is assumed and required to be spent on serving the charitable purpose for which the entity was organized.<sup>130</sup> Alternatively, the IRS views a for-profit corporation as a “profit-maximizing” entity<sup>131</sup> that generates income with the intent of retaining a portion of that income as profits to be distributed for the private benefit for its shareholders. Tax-exempt entities do not generate income for the purpose of creating profits for private benefit or for generating profits at all (to the extent that they are inclined to spend all of their income that *would* be profits). A tax-exempt entity generates income to pay for the expenses necessary to provide a public benefit, and may lose its tax-exempt status if it distributes its income for a private benefit.<sup>132</sup>

As a way to apply the federal income tax only to income motivated by the prospect of creating a profit (profit-motivated income), the Code defines and divides entities according to the entity’s intention, or reason, for generating income.<sup>133</sup> Understanding what type of income the IRS wants to capture under the federal income tax is only one side of the story; there are also reasons the IRS wants to *exempt* a non-profit’s income (as opposed to a lack of desire to tax it).<sup>134</sup> The IRS “wants” the non-profit to work toward its social mission, and taxing the income that it would otherwise spend on achieving that goal is counterproductive. The sector of the IRS that monitors non-profits “is not designed to generate revenue, but rather to ensure that the entities fulfill the policy goals that their tax exemption was designed to achieve.”<sup>135</sup> The Unrelated Business Income Tax (UBIT) is further evidence that the IRS wants to ensure that non-profits achieve their policy goals. The UBIT is a tax placed on income generated by a non-profit through activities that are unrelated to the non-profit’s stated purpose.<sup>136</sup>

<sup>128</sup> See *Non Profit Organizations*, JUSTIA.COM, <http://www.justia.com/business-formation/non-profit-organizations/> (last visited Feb. 2, 2013).

<sup>129</sup> See Joshua Kennon, *Operating Income and Operating Profit Margin*, ABOUT.COM, <http://beginnersinvest.about.com/od/incomestatementanalysis/a/operating-income-operating-margin.htm> (last visited Feb. 2, 2013).

<sup>130</sup> See § 1.501(c)(3)-1(c)(1).

<sup>131</sup> Sugin, *supra* note 52, at 836.

<sup>132</sup> I.R.S. Publ’n 4220, *Applying for 501(c)(3) Tax-Exempt Status* (Rev. Aug. 2009), <http://www.irs.gov/pub/irs-pdf/p4220.pdf>.

<sup>133</sup> Walker, *supra* note 23, at 630.

<sup>134</sup> See Helge, *supra* note 124.

<sup>135</sup> Charles P. Rettig, *At-a-Glance: The Internal Revenue Service, Its Mission and Function*, 8 J. TAX PRAC. & PROC. 47, 52 (2006).

<sup>136</sup> I.R.S. Publ’n 598, *Tax on Unrelated Business Income of Exempt Organizations* (Rev. Mar. 2012), <http://www.irs.gov/pub/irs-pdf/p598.pdf>.

This, together with the concept that the IRS chooses to capture profit-motivated income, supports the notion that the IRS wants to encourage and incentivize “good” behavior, not just give preferential tax treatment to organizations based on their status or entity-categorization alone.

### III. BENEFICIAL TREATMENT UNDER THE CODE

#### A. Tax-Exempt Status

The Code divides qualified tax-exempt organizations into groups determined by the purposes of the organization.<sup>137</sup> The group of tax-exempt organizations most applicable to a discussion of tax treatment for benefit corporations is the 501(c)(3) public charities because the purposes of the benefit corporation are closely related to the purposes allowed for 501(c)(3)s.<sup>138</sup> 501(c)(3) public charities are also the most common 501(c) organization and account for fifty-nine percent of reporting tax-exempt organizations<sup>139</sup> and total more than 1.2 million organizations.<sup>140</sup> The 501(c)(3)-listed purposes are “religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition ..., or for the prevention of cruelty to children or animals.”<sup>141</sup> The “charitable” purpose has been interpreted broadly and will accommodate non-profits seeking tax-exempt status that do not fit the more specific purposes listed.<sup>142</sup> A portion of the definition of “charity” includes:

[r]elief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.<sup>143</sup>

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<sup>137</sup> See 26 U.S.C. §§ 501(c)(1)–(29).

<sup>138</sup> See *supra* Part I.

<sup>139</sup> See Walker, *supra* note 23, at 628 (citing Kennard T. Wing et al., *The Nonprofit Sector in Brief: Public Charities, Giving, and Volunteering*, 2010, URBAN INST. (2010)).

<sup>140</sup> *Id.* at 630.

<sup>141</sup> *Id.* 501(c)(3)s are also distinguished from other listed exempt organizations because they are not allowed to participate in politics (“[N]o substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation ..., and which does not participate in, or intervene in ... any political campaign on behalf of ... any candidate for public office.”). *Id.*

<sup>142</sup> Walker, *supra* note 23, at 631.

<sup>143</sup> Treas. Reg. § 1.501(c)(3)-1(d)(2).



Many of these definitions of charity mirror the same type of activities as those considered for the general public benefit and specific public benefit in which benefit corporations must engage.

*B. Why Give Tax-Exempt Status*

The IRS website and its publications state in many places sentiments that there are strong policy reasons as to why tax-exempt organizations receive this tax preference. One of the reasons to give tax exemptions to 501(c)(3) qualifying organizations is found in the Treasury Regulation defining charity—“lessening of the burdens of [g]overnment.”<sup>144</sup>

A more mechanical explanation is “income measurement theory,”<sup>145</sup> which argues that the individuals that the non-profits serve actually receive the income and that the non-profit is only a conduit through which the funds flow.<sup>146</sup> Therefore, the non-profits do not have income to be taxed, and the charitable services or donations the non-profits make would be taxable income to their recipients. The income measurement theorists recognize the near impossibility of taxing these recipients who are often not known at the time the non-profit performs services or spends funds, and for this reason, it is simplest to avoid the problem by exempting qualifying non-profits from income tax.<sup>147</sup> While avoidance might seem like a practical solution and not a theoretical reason, an argument can also be made that those who receive the actual benefit are typically indigent or in a tax bracket that would receive lesser tax obligations.

As discussed before, the IRS is more interested in using taxation as a means to monitor non-profits and ensure that they are working toward their social purposes than it is in actually monitoring their taxation.<sup>148</sup> Because a tax-exempt organization must be exclusively organized for a qualifying purpose,<sup>149</sup> once a non-profit attains tax-exempt status, the assumption will be that the organization is doing good.<sup>150</sup> The IRS sets up limitations for the formation and structure of non-profits<sup>151</sup> so that it is more likely that they will do “good,” but the IRS continues to monitor the organizations.<sup>152</sup>

<sup>144</sup> *Id.*

<sup>145</sup> Seong J. Kim, Note, *Hiding Behind the Corporate Veil: A Guide to Non-Profit Corporations with For-Profit Subsidiaries*, 5 HASTINGS BUS. L.J. 189, 194 (2009).

<sup>146</sup> *Id.*

<sup>147</sup> *Id.*

<sup>148</sup> Kim, *supra* note 145, at 193; *see generally* I.R.S. Publ’n 557, *Tax-Exempt Status of Your Organization* (Rev. Oct. 2011), <http://www.irs.gov/pub/irs-pdf/p557.pdf>.

<sup>149</sup> Treas. Reg. § 1.501(c)(3)-1(a)(1).

<sup>150</sup> However, non-profits have to reapply for tax-exempt status fairly regularly. *See* I.R.S. Publ’n 557, *supra* note 148.

<sup>151</sup> Treas. Reg. § 1.501(c)(3)-1(b) to -1(d).

<sup>152</sup> I.R.S. Publ’n 557, *supra* note 148.

### *C. Limitations Placed on Tax-Exempt Organizations*

#### *1. Cannot Bestow Private Benefit*

One particularly important limitation placed on non-profits, and an important distinguishing feature between corporations and non-profits,<sup>153</sup> is that non-profits cannot create profit for a private benefit, or they could lose their exempt status.<sup>154</sup> Corporations, including benefit corporations, distribute their profits to their shareholders. The requirement that non-profits cannot give private benefit is so strong that if non-profits do give a private benefit, they could be subject to a punitive excise tax on the “excess benefit transaction.”<sup>155</sup> The IRS imposes this tax as a sanction when the non-profit gives a benefit to a party undesired by the IRS but the benefit bestowed is not so great as to disqualify the non-profit from its tax-exempt status.<sup>156</sup>

Not only must they spend their income on their public purpose, but they must also earn their income in such a way that serves their public purpose.<sup>157</sup> If they earn income in a manner that is more like a for-profit business, then they will be taxed on that income—even if they would have (or already have) spent that income on activities that serve their social purpose.<sup>158</sup> This is reflected in the fact that the two upmost qualifying attributes of an exempt organization<sup>159</sup> are exclusive organization and exclusive operation for one or more exempt purposes.<sup>160</sup> This test can be quite strict.<sup>161</sup>

#### *2. Exclusively Organized*

A non-profit organization must be organized for one of the purposes listed by the IRS.<sup>162</sup> For the exclusively organized test, the IRS will disqualify

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<sup>153</sup> Walker, *supra* note 23, at 630–31.

<sup>154</sup> Treas. Reg. § 1.501(c)(3)-1(c)(2) (“An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.”).

<sup>155</sup> Brewer, *supra* note 1, at 702–03; 26 U.S.C. § 4958 (2006 & Supp. 2009).

<sup>156</sup> Brewer, *supra* note 1, at 702–03 (“The excise taxes ... are punitive in nature so as to discourage certain behavior, and are imposed upon both the offending ‘disqualified person’ and, if a knowing, willful violation occurs, management.”).

<sup>157</sup> Walker, *supra* note 23, at 630–31 (citing Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (2011)).

<sup>158</sup> See *infra* note 176 and accompanying text.

<sup>159</sup> Brewer, *supra* note 1, at 698–99.

<sup>160</sup> Walker, *supra* note 23, at 630–31; Treas. Reg. § 1.501(c)(3)-1(a)(1) (“In order to be exempt as an organization described in section 501(c)(3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.”).

<sup>161</sup> See Brewer, *supra* note 1, at 698–702.

<sup>162</sup> Treas. Reg. § 1.501(c)(3)-1(d)(1).

the organization if “the terms of its articles [list] purposes for which such organization is created [that] are broader than the [charitable] purposes specified.”<sup>163</sup> This means that if any non-exempt purpose is mentioned in its articles, it will not qualify as tax-exempt.<sup>164</sup> Stricter still, the IRS says an organization with a purpose broader than the specified charitable purpose will not meet the exclusively organized test even if “the actual operations of such an organization have been exclusively in furtherance” of the qualifying purposes, or if there is evidence or statements indicating the members intend to operate in such a manner.<sup>165</sup> Furthermore, the incorporated purpose matters so much to receiving tax-exempt status that even if the non-profit is exclusively operated for an exempt purpose, and it just failed to file under that purpose, the entity will not be tax-exempt.<sup>166</sup>

### 3. Exclusively Operated

The exclusively operated test is less sensitive, and organizations will not necessarily lose their status for unrelated activity as long as the activity is not substantial.<sup>167</sup> If the organization’s unrelated activity is not insubstantial then the organization will lose its exemption.<sup>168</sup> The exclusively organized requirement is stricter but clearer. The substantially operated portion, however, is where much of the IRS monitoring will come in as it tries to determine what is “not insubstantial.”<sup>169</sup>

## D. Operational Activities of Tax-Exempt Entities

### 1. Trade or Business

Part of the operational testing is to ensure that the non-profit does not operate like a for-profit. If a tax-exempt entity *does* operate like a

<sup>163</sup> § 1.501(c)(3)-1(b)(1)(iv); see I.R.S., *The Organizational Test Under 501(c)(3), Exempt Organization CPE Text* (1985), at pt. 4, <http://www.irs.gov/pub/irs-tege/eotopicc85.pdf>.

<sup>164</sup> § 1.501(c)(3)-1(b)(1)(i), -1(b)(1)(iii), -1(b)(1)(iv); see *Better Bus. Bureau v. United States*, 326 U.S. 279, 283 (1945) (“[T]he presence of a single non-exempt purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly ... [exempt] purposes.”); Mahon, *supra* note 14, 84 n.9.

<sup>165</sup> *Supra* note 163.

<sup>166</sup> § 1.501(c)(3)-1(b)(1)(iv) to -1(b)(1)(v). I.R.S., *The Organizational Test Under 501(c)(3), Exempt Organization CPE Text* (1985), at pts. 3–4, <http://www.irs.gov/pub/irs-tege/eotopicc85.pdf>.

<sup>167</sup> Kim, *supra* note 145, at 202.

<sup>168</sup> Treas. Reg. § 1.501(c)(3)-1(c)(1) (losing status “if more than an insubstantial part of its activities is not in furtherance of an exempt purpose”).

<sup>169</sup> § 1.501(c)(3)-1(c).

for-profit—operating a trade or business<sup>170</sup>—then the trade or business must be in furtherance of the entity’s exempt purpose or purposes.<sup>171</sup> In order to determine whether the activity falls under the definition of an unrelated trade or business in § 513<sup>172</sup> to the extent that it would jeopardize the tax exemption on the income generated by that activity, the IRS applies a balancing test.<sup>173</sup> The definition of trade or business is the same for the purposes of § 513 (unrelated trade or business), and § 162, which defines what constitutes a trade or business for a corporation.<sup>174</sup>

In a discussion on the potential tax consequences to a tax-exempt organization of participating in an unrelated trade or business, one author wrote:

The term “trade or business” generally includes any activity carried on for the production of income from the sale of goods or performance of services. In evaluating this criterion, courts and the Internal Revenue Service consider whether the organization has a profit motive and whether the organization’s activity competes with that of for-profit enterprises. In determining whether a profit motive exists, significant weight is given to objective factors such as whether the activity is similar to profit-making activities conducted by commercial enterprises.<sup>175</sup>

This concept—taxing the income of a non-profit when it generated that income by behaving like a for-profit—is referred to as Unrelated Business Income Tax (UBIT); the income received is referred to as Unrelated Business Income (UBI), and is taxable.<sup>176</sup> UBIT is applicable when determining the tax treatment of behaviors that are not related to the non-profit’s purpose.<sup>177</sup>

## *2. Unrelated Business Income Tax*

When a non-profit participates in business activities similar to for-profits, such that they are operating in a trade or business, then the income

<sup>170</sup> § 1.501(c)(3)-1(d)(1)(ii) to -1(d)(1)(iii).

<sup>171</sup> § 1.501(c)(3)-1(e)(1) (stating that an otherwise exempt organization will not lose its exempt status if it “operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization’s exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business”).

<sup>172</sup> *Id.*

<sup>173</sup> *Id.* (“In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes.”).

<sup>174</sup> Treas. Reg. § 1.513-1(b). *See infra* Part VI.A.

<sup>175</sup> Helge, *supra* note 124, at 889 (citations omitted) (discussing 26 U.S.C. § 513(c) (2006); Treas. Reg. § 1.513-1(b) (2006)).

<sup>176</sup> Treas. Reg. § 1.513-1(a).

<sup>177</sup> *See* Brewer, *supra* note 1, at 873–75 nn.126–35 and accompanying text.

they receive from those activities will be taxed as UBI.<sup>178</sup> The UBIT<sup>179</sup> regulations were enacted as part of an equalizing measure between non-profits and for-profits to make sure non-profits did not have a tax-free advantage on ordinary trade or business that is typically a profit driven activity rather than one satisfying its 501(c)(3) purpose.<sup>180</sup> Income from an activity of the tax-exempt organization is considered unrelated and therefore taxable if it satisfies these three tests: “(i) the activity constitutes a ‘trade or business,’ (ii) the activity is ‘regularly carried on’ by the organization, and (iii) the conduct of the activity is ‘not substantially related to the performance of the organization’s exempt function.’”<sup>181</sup> To qualify as UBI, the activity must generally meet all of those requirements.<sup>182</sup> For example, selling books is a trade or business,<sup>183</sup> but if a non-profit sells books it is not necessarily taxed on the income generated.<sup>184</sup> If the charitable purpose of the non-profit is to benefit the environment, then income generated from the sale of books will not be unrelated if the books are about saving the environment, but the income generated will be unrelated if the books are about, say, classical art.<sup>185</sup> This demonstrates the balance of the Code to tax all profit-motivated income, unless it was generated in the pursuit of one of its approved social purposes.

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<sup>178</sup> 26 U.S.C. § 512(a) (2006).

<sup>179</sup> Treas. Reg. § 1.513-1(a) (defining unrelated business taxable income as “the gross income derived by an organization from any unrelated trade or business regularly carried on by it .... Section 513 specifies with certain exceptions that the phrase *unrelated trade or business* means ... any trade or business the conduct of which is not substantially related ... to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 ....”).

<sup>180</sup> Treas. Reg. § 1.513-1(b) (“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. On the other hand, where an activity does not possess the characteristics of a trade or business within the meaning of section 162 ..., the unrelated business income tax does not apply since the organization is not in competition with taxable organizations.”).

<sup>181</sup> Helge, *supra* note 124, at 897–98 (“There are other policies supporting the enforcement of the UBIT rules besides unfair competition; however, unfair competition is the most often touted.”).

<sup>182</sup> *Id.* at 897.

<sup>183</sup> Brewer, *supra* note 1, at 705 (explaining “[a] trade or business generally is defined as any activity carried on for the ‘production of income from the sale of goods or the performance of services’” (citing I.R.C. § 513(c) (2006); Treas. Reg. § 1.513-1(b))).

<sup>184</sup> *See id.* at 706.

<sup>185</sup> Brewer, *supra* note 1, at 706.

### 3. *Program-Related Investment*

Although not necessarily applicable to the 501(c)(3)s mainly discussed here, private foundations are allowed to partake in Program-Related Investment (PRI),<sup>186</sup> which is an investment of which the primary purpose “is to accomplish one or more of the purposes described in § 170(c)(2)(B), and no significant purpose of which is the production of income or the appreciation of property.”<sup>187</sup> As a private foundation participating in PRI, the foundation is making a grant-like investment in an organization or activity, but it is still receiving some returns.<sup>188</sup> The other side of PRI is that “[i]f a private foundation invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes,” then the IRS may impose a tax on that investment that varies between ten and twenty-five percent.<sup>189</sup>

PRI is not often used because it takes a good deal of substantiation.<sup>190</sup> The IRS monitors PRI to make sure the private trust is engaging in the activity that the IRS approves of and is doing so in a manner of which they also approve.<sup>191</sup> The private foundation must engage in “expenditure responsibility.”<sup>192</sup> This means that the private foundation must “see that the grant is spent solely for the purpose for which made”; “obtain full and complete reports from the grantee on how the funds are spent”; and give a detailed report on the expenditures to the IRS.<sup>193</sup> PRI shows how the Code allows a non-profit to operate in a manner similar to a for-profit in a long-term manner that supports the public benefiting purpose for which it was incorporated.<sup>194</sup> The Code has allowed flexibilities for the realities facing tax-exempt entities and there are many characteristics of these provisions that could translate to benefit corporations.

## IV. THE CODE’S ASSUMPTIONS REGARDING FOR-PROFITS ARE TROUBLING FOR BENEFIT CORPORATIONS

After understanding how the Code identifies, treats, and monitors the behaviors of non-profits, and understanding how the Code treats “good” behavior differently from “profit-motivated” behavior, this Note now turns

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<sup>186</sup> 26 U.S.C. § 4944(c) (2011).

<sup>187</sup> *Id.*

<sup>188</sup> Brewer, *supra* note 1, at 712–13.

<sup>189</sup> 26 U.S.C. § 4944(a)–(b) (2006).

<sup>190</sup> Brewer, *supra* note 1, at 712.

<sup>191</sup> *Id.*

<sup>192</sup> *Id.* at 712; Treas. Reg. § 53.4945-5(b)(1) (2012).

<sup>193</sup> Treas. Reg. § 53.4945-5(b)(1)(i) to -5(b)(1)(iii).

<sup>194</sup> *See infra* Part IV.



to the identification, treatment, and monitoring of both “good” and “profit-motivated” behavior of for-profits. The Code appears to be unsatisfactorily designed to identify and treat the “good” behavior by benefit corporations. This Note will propose that the key to satisfactory tax treatment under the Code is to have a system designed to capture and deduct the expenses that a benefit corporation spends on creating its general or specific public purpose—its benefit expenses.

#### A. Charitable Contributions

Currently the Code recognizes for-profits as being able to do good only by giving money to exempt organizations through charitable contributions.<sup>195</sup> While charitable contributions have not always been an accepted activity of for-profits, the current approval of charitable contributions by corporations is reflected in the Model Business Corporation Act,<sup>196</sup> common law,<sup>197</sup> and the Code.<sup>198</sup> While it might first seem that charitable contributions are consistent with the benefit corporation’s goal to create public benefit, there are many aspects of charitable contributions that make them an unsatisfying vehicle for receiving favorable tax treatment for its efforts to create public benefit.

The first complication arises with the requirements that a charitable contribution be of a specific donative nature and that the contribution be made with gratuitous intent and not in return for substantial economic value.<sup>199</sup> To be deductible, a charitable contribution must be made as a gift, and not in exchange for an economic benefit.<sup>200</sup> Some interpretations add the requirement that the donor have no expectation of return benefit or that the contribution be made out of “detached and disinterested generosity.”<sup>201</sup> All tests, at a minimum, require that the contribution not be given as a quid pro quo.<sup>202</sup> This requirement is consistent with the Code’s way of categorizing and taxing a transaction based upon the motivations behind it.<sup>203</sup>

<sup>195</sup> See *infra* Part IV.

<sup>196</sup> See COX & HAZEN, *supra* note 97, at § 4:4 n.11 and accompanying text; Model Bus. Corp. Act § 3.02(13) (2007).

<sup>197</sup> COX & HAZEN, *supra* note 97, at § 4:4 nn.8–9 and accompanying text (citing A. P. Smith Mfg. v. Barlow, 98 A.2d 581 (N.J. 1953), *appeal dismissed*, 346 U.S. 861 (1953)).

<sup>198</sup> *Id.* § 4:4 nn.15–16 and accompanying text.

<sup>199</sup> Sugin, *supra* note 52, at 837 n.5. See 26 U.S.C. § 170(c) (2010).

<sup>200</sup> Sugin, *supra* note 52, at 846 (citing Crosby Valve & Gage Co. v. Comm’r, 380 F.2d 146 (1st Cir. 1967); Singer Co. v. United States, 449 F.2d 413 (Ct. Cl. 1971); DeJong v. Comm’r, 309 F.2d 373 (9th Cir. 1962)).

<sup>201</sup> *Id.*

<sup>202</sup> *Id.*

<sup>203</sup> *Id.* at 846 n.55.

Usually, the Code determines the motivations of an entity's behavior by starting with the correlating assumption for non-profits and for-profits. However, because benefit corporations are motivated by both profits and creating benefit, neither assumption leads to a clear and consistent treatment of benefit corporations. After all, benefit corporations were created because this rigid binary structure was found to be inadequate.<sup>204</sup>

The IRS views corporations as “profit-maximizing” entities<sup>205</sup> and some view the recognition of charitable behavior by the Code as inconsistent with the assumptions placed on corporations in all other portions of the Code.<sup>206</sup> The Code assumes that all activities of a corporation are in pursuit of profit-maximization goals, but then allows for a deduction for charitable contributions, only if the contributions were made without expecting anything (profits) in return.<sup>207</sup> This is contradictory, and if the Code's assumptions are correct, corporations will not make charitable contributions because it would breach their fiduciary duty to maximize wealth for the shareholders and leave them vulnerable to ultra vires accusations. However, the laws do allow corporations to make charitable contributions without violating their fiduciary duty or facing ultra vires.<sup>208</sup> Courts have liberalized their view of charitable contributions as ultra vires activities that are against the corporation's duty to its shareholders.<sup>209</sup> Some might argue that because courts stopped finding charitable contributions ultra vires, this is an indication that the purely profit-maximizing assumption is wrong or inadequate.<sup>210</sup> As discussed previously, however, the legality of charitable contributions is an exception to the profit-motivated assumption, not an indication of its lessening.<sup>211</sup>

Another interpretation that comes to similar ends, but is actually supportive of the profit-maximization assumption, is that charitable giving is in fact profit-maximizing (even if in the long run) for corporations, and

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<sup>204</sup> See *supra* notes 5–10 and accompanying text.

<sup>205</sup> Sugin, *supra* note 52, at 836.

<sup>206</sup> *Id.* at 836–37 (“In its treatment of corporate philanthropy, the Code adopts an anthropomorphic conception of the corporate entity that is at odds with the profit-maximizing conception prevalent throughout the rest of the Code. It is also inconsistent with treating the corporation as an entity that is limited by its purposes and consequently not entitled to the rights and powers that humans possess.”).

<sup>207</sup> *Id.* at 846 n.55.

<sup>208</sup> See *supra* notes 195–97.

<sup>209</sup> COX & HAZEN, *supra* note 97 (“A pure gift of funds or property by a corporation not created for charitable purposes is generally unauthorized and in violation of the rights of its shareholders unless authorized by statute.” (citing *Roger v. Hill*, 289 U.S. 582, 591–92 (1933))).

<sup>210</sup> Knauer, *supra* note 52, at 20–22, 20 n.104.

<sup>211</sup> See *supra* notes 50–55 and accompanying text.

therefore not ultra vires to begin with.<sup>212</sup> There need not be any exception to ultra vires to legally allow charitable contributions because it is in the best financial interest of the shareholder.<sup>213</sup> If one begins with the assumption that the managers and directors of a non-benefit, for-profit, corporation act in the best interest of the shareholders, one can conclude that although a charitable contribution might be immediately wealth-reducing, it will ultimately be profit-maximizing if it is in the long-term best interest of the company.<sup>214</sup> Even before the creation of benefit corporations, some suggested that another theory of corporate purpose falls under the “social responsibility model,” which assumes a broader “enlightened self-interest” purpose behind charitable giving and philanthropy.<sup>215</sup> Again, this is still a somewhat troubling inconsistency in the Code because if corporations get something in return for doing good, then there is not the donative intent required to qualify for a deduction.<sup>216</sup>

If charitable contributions must be given entirely as a gift with no return benefit for the benefit corporation, this will be almost impossible, especially given the fact that benefit corporations are now *legally required* to do socially responsible behavior such as give charitable contributions. For example, a valid specific purpose for a benefit corporation is “increasing the flow of capital to entities with a public benefit purpose.”<sup>217</sup> If that were a benefit corporation’s incorporated purpose, it would clearly be receiving some sort of benefit by making charitable contributions, if only by avoiding legal liability for failure to do so. It is because benefit corporations serve two purposes, and simultaneously, through the same action, show that economic and social benefit are not mutually exclusive,<sup>218</sup> that they seem unfit for the charitable contribution provisions.

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<sup>212</sup> See, e.g., Schoenjohn, *supra* note 15, at 463–64 (discussing Bill Gates’s concept of “creative capitalism” where “activities that benefit a social good, would make up for any lost profits by driving up stock prices—through enhanced corporate reputation—and increasing human capital—through attracting higher quality employees”).

<sup>213</sup> *Id.*

<sup>214</sup> Sugin, *supra* note 52, at 858–59.

<sup>215</sup> Knauer, *supra* note 52, at 20 (“If the goal of a corporation is to maximize shareholder profit and gain, then a corporate ‘gift’ must advance that end. On the other hand, if a corporation has responsibilities to constituencies beyond its shareholders (or to society at large), then a corporate ‘gift’ must address these responsibilities.”). *Id.* at 9–10 (“Because corporate giving is inherently self-interested, a corporate transfer to charity cannot qualify as a ‘contribution or gift’ under section 170. This notwithstanding, each year corporations deduct billions of dollars under section 170.”).

<sup>216</sup> See *infra* Part IV.B.

<sup>217</sup> Clark & Babson, *supra* note 1, at 841 n.107 and accompanying text.

<sup>218</sup> *Business FAQ’s*, *supra* note 8.

*B. Goodwill*

One suggestion to fixing this “donative intent” problem is to reclassify charitable contributions as purchases of goodwill.<sup>219</sup> Classifying charitable contributions as a purchase of goodwill<sup>220</sup> would also prevent the government from subsidizing the purchase of goodwill disguised as charitable contributions.<sup>221</sup> An overarching difficulty of this interpretation is that goodwill is an asset,<sup>222</sup> and it seems difficult to imagine that benefit expenses will directly result in a goodwill asset of that amount of value, let alone that it will result in valuable goodwill at all.

One problem with classifying the expenses that benefit corporations use to create “benefit” as purchases of goodwill is that the benefit corporation does not necessarily expect higher profits, or any financial return on that spending. It is more accurate to say they receive a goodwill “halo effect” from their *status* as a benefit corporation, not truly from their activities as a benefit corporation beyond the fact that they have to do those activities in order to keep their status.<sup>223</sup> B Lab openly states that a perk of becoming a benefit corporation is the connotation the label will pass on to the public.<sup>224</sup> Benefit corporations have to pass the test to wear a real halo in order to receive its effects.<sup>225</sup>

#### V. CURRENT TREATMENT OF GOOD BEHAVIOR BY FOR-PROFITS

An understanding of the complications facing benefit corporations, due to the fact that it is difficult to classify and discern the nature and motivations behind the benefit corporation’s behavior, will help understand the discussion on for-profits acting “good” that follows.

*A. Charitable Contributions*

Businesses can currently take deductions for charitable contributions.<sup>226</sup> To qualify as a charitable contribution, certain criteria must be met regarding

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<sup>219</sup> Knauer, *supra* note 52, at 9.

<sup>220</sup> 47A C.J.S. *Internal Revenue* § 152 nn.4–5 (2012); Treas. Reg. § 1.162-20(a)(2).

<sup>221</sup> Knauer, *supra* note 52, at 10.

<sup>222</sup> *See id.* at 7.

<sup>223</sup> *Id.* at 6–7, 9–10.

<sup>224</sup> *Benefits of Becoming a B Corp*, B LAB, [http://www.bcorporation.net/why\\_become\\_a\\_B](http://www.bcorporation.net/why_become_a_B) (accessed by searching the Internet Archive index for Aug. 21, 2012).

<sup>225</sup> *Declaration of Interdependence*, B LAB, <http://www.bcorporation.net/declaration> (accessed by searching the Internet Archive index for Oct. 5, 2012).

<sup>226</sup> 26 U.S.C.A. § 170 (2010).

who receives the charitable contribution<sup>227</sup> and the nature of the contribution (both intent and form).<sup>228</sup> The Code also requires that the contribution be substantiated.<sup>229</sup>

### 1. *Qualifying Donee*

To be deductible, the charitable contribution must be given to an entity qualified to receive charitable contributions according to § 170(c).<sup>230</sup> Generally speaking, this means a 501(c)(3) organization, charity,<sup>231</sup> or government unit.<sup>232</sup> Examples of § 170-permitted charitable contribution recipients include: government entities, domestic charitable organizations, veterans' organizations, domestic fraternal societies, and cemetery companies.<sup>233</sup> If the organization is not listed under § 170(c), then contributions to the organizations are not tax deductible. This includes most social welfare organizations,<sup>234</sup> labor organizations,<sup>235</sup> business leagues and chambers of commerce,<sup>236</sup> and home owners associations.<sup>237</sup> Additionally, for a charitable contribution to be tax deductible, it must be given to a domestic organization.<sup>238</sup>

One of the reasons that charitable contribution deductions will not enable a benefit corporation to deduct all of its benefit expenses is because the recipient of the donation will not always qualify under § 170(c).<sup>239</sup> Where a stakeholder is as broad as "the community," and the benefit corporation chooses to spend money directly on the community instead of funneling it through a non-profit, it might even be difficult to determine who is the recipient of the benefit. This difficulty also supports the rationale for

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<sup>227</sup> *Id.*

<sup>228</sup> *See supra* Part IV.

<sup>229</sup> 26 U.S.C.A. § 170(f)(8) (2010).

<sup>230</sup> STAFF OF JOINT COMM. ON TAXATION, PRESENT LAW AND BACKGROUND RELATING TO THE FED. TAX TREATMENT OF CHARITABLE CONTRIBUTIONS, 6 (2011) (scheduled for a Public Hearing before the Senate Committee on Finance on October 18, 2011) [hereinafter COMMITTEE REPORT].

<sup>231</sup> *See supra* Part III.A.

<sup>232</sup> COMMITTEE REPORT, *supra* note 230, at 1. In 2010, one third of charitable contributions were given to religious organizations. *Id.*

<sup>233</sup> 26 U.S.C. § 170(c). *Exempt Organizations Select Check*, IRS, <http://www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Select-Check> (last visited Feb. 2, 2013) (listing all organizations that have registered as tax-exempt, although it is not a complete list).

<sup>234</sup> Treas. Reg. § 1.501(c)(4) (2012).

<sup>235</sup> § 1.501(c)(5).

<sup>236</sup> § 1.501(c)(6).

<sup>237</sup> COMMITTEE REPORT, *supra* note 230, at 10.

<sup>238</sup> § 170(c)(2)(A).

<sup>239</sup> *Id.*

tax exemption for non-profits.<sup>240</sup> Cutting out the requirement to have a non-profit middleman for funneling funds through could raise the overall efficiency of benefit creation, especially when considering the similarities of the “community” stakeholder and some of the example definitions of charity such as “combat community deterioration,” “relief of the poor and distressed or of the underprivileged.”<sup>241</sup> Additionally, the hope is that benefit corporations’ stakeholders will include those overseas as well as those located domestically and assumedly, then, some of the benefit activities of the benefit corporation would be directed towards foreign locations.<sup>242</sup> This would seem particularly true since a typical concern in social responsibility programs is a sustainable and ethical supply chain, and many goods are manufactured abroad. Under the current law for charitable deductions, the money spent creating benefit overseas will likely not qualify as a deduction because a qualifying donee must be a domestic organization.

### 2. *Form—Must Be Cash or Cash-Equivalent*

The contribution must be in the form of either property or money. Contributions of services are not deductible.<sup>243</sup> If the contribution is property, then the company must donate the entire interest in that property.<sup>244</sup> While all benefit expenses will have to be valued, quantified, and correspond with real financial cost, it is unlikely that a benefit corporation will satisfactorily serve its public benefit by simply writing checks. There are occasions where for-profits and non-profits join together, and the for-profit is actively involved beyond writing a check and the charitable contribution is still valid.<sup>245</sup> One limitation on form, that if applied to benefit corporations might fail to capture the good created, is that a company donating property must donate its entire interest.<sup>246</sup>

### 3. *Good Behavior Beyond Writing Checks*

For-profits and non-profits pair up together to leverage the attributes of the other and to create some social benefit.<sup>247</sup> This is an example of how

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<sup>240</sup> See *supra* Part III.

<sup>241</sup> § 1.501(c)(3)-1(d)(2). See *supra* Part III.A.

<sup>242</sup> Schoenjahn, *supra* note 15, at 461 (stating that “U.S. corporations donated \$7.7 billion to developing countries” in 2008).

<sup>243</sup> 26 U.S.C. § 170.

<sup>244</sup> *Id.*

<sup>245</sup> See *infra* Part V.A.3.

<sup>246</sup> 26 U.S.C. § 170 (f)(3).

<sup>247</sup> Schoenjahn, *supra* note 15, at 467.



difficult it might be to discern and qualify donative intent. For-profits do engage in activities with non-profits, such as marketing campaigns, that clearly create profit while still doing social good. Any corporation can engage in mixed activities, such as an apparel company selling special shirts with a non-profit's logo and, in turn, donating a certain percentage of the proceeds to that non-profit.

#### 4. *Balancing Test*

There are many different instances where a mixed behavior activity could occur. One, like the profit-sharing example above, is a form of cause-related marketing.<sup>248</sup> Here, a for-profit will use the logo and name of a non-profit to help sell an item, hopefully create goodwill (or, more accurately, borrow the goodwill of the non-profit), and boost the overall profits of the company.<sup>249</sup> Because the for-profit gets these perks in return, the percentage of profits given to the non-profit act more as an investment than a donation. On the reverse side, it is as if the non-profit has lent its assets (name and goodwill) to a for-profit and received a fee for its service—a service that does not support its charitable purpose (selling clothing). The non-profit does, in return, get marketing and exposure that might help raise awareness and benefit its cause. The concern is that this activity will be marketed as good behavior deserving favorable tax treatment, but in actuality it will be more profit-motivated. One suggestion is that the test to determine whether this activity can receive any favorable tax treatment is to “ensur[e] that the private benefit to the corporate partner is not substantial in comparison to the benefit the charity receives.”<sup>250</sup>

An example of a mixed behavior where there is a clear divide between the “good” and self-interested behavior is purchasing seats at a charity dinner.<sup>251</sup> The concern for the business is that in order to deduct a charitable contribution, the donor must receive nothing in return and in this example

<sup>248</sup> Helge, *supra* note 124, at 885–86.

<sup>249</sup> *Id.* (“But when the for-profit corporation also receives, in return for its support of the charity, the right to use the name or logo of the charity to directly affect the sale of the corporation’s product, the corporate sponsorship has morphed into cause-related marketing. Cause-related marketing is a more ‘direct effort to sell the [corporation’s] products or services by capitalizing on the public’s desire to leverage their dollars: consumers can buy a product and support a good cause at the same time.’ By engaging in cause-related marketing, ‘the corporation expects its sponsorship dollars to yield a measurable return not just in terms of public image and goodwill, but product sales as well.’”).

<sup>250</sup> *Id.* at 953.

<sup>251</sup> John D. Colombo, *The Marketing of Philanthropy and the Charitable Contributions Deduction: Integrating Theories for the Deduction and Tax Exemption*, 36 WAKE FOREST L. REV. 657, 663 (2001).

the donor is receiving a meal. The IRS has issued a Revenue Ruling<sup>252</sup> that held that the deductible amount is the “excess of the fair market value of the return.”<sup>253</sup> If a business purchases seats at a charity dinner for fifty dollars each and the tickets have a fair market value of twenty dollars, then the business will be able to deduct the difference of thirty dollars. The reason for this is that this amount has no reciprocal benefit to the donor-business (it is as if the business purchased the seats at the fair market value of twenty dollars and then wrote a separate check for thirty dollars). In profit-sharing models between for-profits and non-profits, the profit-motivated behavior of selling apparel risks tainting the preferential tax treatment that would have been given to purely good behavior. The non-profit may risk losing tax exemption on the donated share of profits due to the fact that it is generated from unrelated business activities (in some respects, leasing its goodwill).<sup>254</sup> The for-profit risks the deduction for a charitable contribution due to the fact that they are receiving a direct benefit (the percentage of the profits they are not donating) in return for their contribution. If the non-profit were to do it themselves, not only would it probably cost more, but it could trigger the UBIT, and lead to disqualification of the exempt status.<sup>255</sup>

Even if a benefit corporation objectively creates enough public benefit to qualify an activity as a charitable contribution under a balancing test, the donative intent requirement may otherwise limit its qualification. In *Transamerica Corp. v. United States*,<sup>256</sup> a corporation was denied the classification of a charitable contribution for the expenses spent on the construction of a road it built for the City of Oakland.<sup>257</sup> The court found that by nature of the road being located close to its building location, the corporation intended to receive some benefit from the road’s construction and it did not meet the donative intent requirements.<sup>258</sup> To qualify as a § 170 deduction, the court ruled that a contribution must be that of “detached and disinterested generosity” or that of “affection, respect, admiration,

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<sup>252</sup> *Id.* at 663; see Rev. Rul. 67-246, 1967-2 C.B. 104.

<sup>253</sup> Colombo, *supra* note 251, at 663.

<sup>254</sup> Treas. Reg. § 1.513-1 (2006).

<sup>255</sup> § 1.501(c)(3).

<sup>256</sup> 254 F. Supp. 504, 514–15 (N.D. Cal. 1966), *aff’d*, 392 F.2d 522 (9th Cir. 1968).

<sup>257</sup> *Id.*

<sup>258</sup> *Id.* After the § 170 deduction was denied, Transamerica argued that the expense should be classified as a § 162(a) deduction and the government argued that it should be capitalized because the benefit of the paved road will extend beyond one year. *Id.* Not only might it be complicated to quantify the amount of benefit a benefit corporation receives for a benefit-creating action, it may also be difficult to determine the length of time for which the benefit corporation receives that benefit. The length of time for which the benefit is considered to be enjoyed may impact the tax treatment of the expenses incurred in the activity. See *infra* notes 289–91 and accompanying text.

charity or like impulses.”<sup>259</sup> The paved road would benefit the City of Oakland and the general community, both by providing the community with the use of the paved road as well as alleviating the city from spending the tax money it would have had to spend to pave the road itself.<sup>260</sup> The company’s involvement in building the road appeared to fall under some of the definitions of “charity” included in the Treasury Regulations such as “erection or maintenance of public ... works” and, “lessening of the burdens of Government.”<sup>261</sup> This focus on the subjective intent of the activity instead of the overall benefit created by the activity may restrict the applicability of charitable contributions to many benefit corporations’ activities.

This crossover of a for-profit performing activities for a tax-exempt purpose lends itself well to the similar analysis undertaken in determining the application of UBIT or PRI to tax-exempt organizations engaging in profit-motivated behavior—both to determine if the behavior is related to the public purpose and to what degree the behavior is intended to meet that public purpose.<sup>262</sup>

#### VI. CHARITABLE CONTRIBUTION COMPARED TO OTHER DEDUCTIBLE EXPENSES

Viewing charitable contributions as ordinary and necessary business expenses reconciles some of the problems with trying to apply the model for deductions for charitable contributions to benefit expenses. Even without the incorporated general or specific public benefit purpose, some fourth sector advocates argue that by allowing for good behavior like charitable deductions, the Code legitimizes managers’ choice to make corporate philanthropy “part of the corporation’s trade or business, despite the fact that they are allowed to be wealth-reducing for the corporation.”<sup>263</sup> In other words, philanthropic behavior by corporations is so common that its expenditures could be considered the same as any other incurred by a corporation in its ordinary course of operation and deductible as such.

##### A. Ordinary and Necessary

Corporations are able to deduct under § 162 “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any

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<sup>259</sup> *Id.* at 515 (quoting *Comm’r v. Duberstein*, 363 U.S. 278 (1960); *DeJong v. Comm’r*, 309 F.2d 373 (9th Cir. 1962)).

<sup>260</sup> *Id.*

<sup>261</sup> § 1.501(c)(3)-1(d)(2).

<sup>262</sup> § 1.501(c)(3)-1(d)(2).

<sup>263</sup> Sugin, *supra* note 52, at 858.

trade or business.”<sup>264</sup> For a deduction to be allowable as a trade or business expense under § 162 it must be ordinary and necessary.<sup>265</sup> This provision by the IRS supports the idea that the purpose of taxation is to tax only profit-motivated income.<sup>266</sup> This is because the taxpayer is allowed to deduct the expenses that are incurred while producing profits—the Code matches expenses with income.<sup>267</sup> The income left not matched with a deductible expense is profit and is taxed.<sup>268</sup> While trade or business is typically defined as profit-motivated behavior, this is not applicable for benefit corporations, which in some ways have created a new trade or business.

For an expense to be considered ordinary, it does not have to happen regularly during the lifetime of the business, or be an expense that will occur in all trades or businesses.<sup>269</sup> The goal of this requirement is not to discourage or penalize odd, quirky ways to run a business.

For an expense to be considered necessary, it does not have to be absolutely indispensable to achieving the goals of the trade or business.<sup>270</sup> The expense must just be “appropriate and helpful.”<sup>271</sup> There is also allowance for the differences in business judgment of activities that will help achieve the trade or business.<sup>272</sup>

To understand how charitable contributions could be considered ordinary and necessary for all businesses, it might be appropriate to view the ten percent cap on charitable deductions as the feature that single handedly makes this possible.<sup>273</sup> Applying the relevant theories when non-profits

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<sup>264</sup> 26 U.S.C. § 162 (2012).

<sup>265</sup> *Jefferson Mills, Inc. v. United States*, 259 F. Supp. 305, 313–14 (N.D. Ga. 1965), *aff’d*, 367 F.2d 392 (5th Cir. 1966) (citing *Campbell v. Fields*, 229 F.2d 197 (5th Cir. 1956)).

<sup>266</sup> Rev. Rul. 81-69, 1981-1 C.B. 351.

<sup>267</sup> 26 U.S.C. § 162 (2012).

<sup>268</sup> *Id.*

<sup>269</sup> BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 20.3.2 (1999) (citing *Deputy v. Du Pont*, 308 U.S. 488, 495–96 (1940) (“Ordinary has the connotation of normal, usual, or customary. To be sure, an expense may be ordinary though it happens but once in the taxpayer’s lifetime .... Yet the transaction which gives rise to it must be of common or frequent occurrence in the type of business involved .... [T]he fact that a particular expense would be an ordinary or common one in the course of one business and so deductible under [§ 162] does not necessarily make it such in connection with another business .... One of the extremely relevant circumstances is the nature and scope of the particular business out of which the expense in question accrued. The fact that an obligation to pay has arisen is not sufficient. It is the kind of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling.”)).

<sup>270</sup> *Welch v. Helvering*, 290 U.S. 111, 113 (1933).

<sup>271</sup> *Id.* (citing *McCulloch v. Maryland*, 17 U.S. 316 (1819)).

<sup>272</sup> BITTKER & LOKKEN, *supra* note 269, at ¶ 20.3.2.

<sup>273</sup> 26 U.S.C. § 170 (2012).

participate in a trade or business, the ten percent cap ensures that the wealth-reducing behavior does not become “not insubstantial.” Viewing the ten percent cap as a means to keep corporate donation within a scale that is ordinary and necessary of generally profit-maximizing businesses is also consistent with fiduciary duty views.<sup>274</sup> For example, directors receive vast amounts of deference—the business judgment rule—for determining whether the day-to-day decision-making was in the best interest of the company.<sup>275</sup> The ten percent cap almost guarantees that the company will not donate so much money so as to possibly start serving a public benefit at a financial cost to the shareholders.<sup>276</sup> This is similar to the non-profit standards that disallow a tax benefit for activities routinely engaged in by the non-profit that are unrelated to its exempt purpose.

Viewing charitable contributions as common still renders some inconsistencies under the Code. The conclusion that philanthropic behavior is so commonplace that it is “ordinary and necessary” under § 162<sup>277</sup> conflicts with the Code’s disallowance of deductions under § 162 that would otherwise have been deductible under § 170 if it were not for the ten percent cap on deductions.<sup>278</sup> The solution for benefit corporations then, might be to get rid of § 170 charitable contributions and their ten percent cap and view all benefit expenses as ordinary and necessary to the trade or business of being a benefit corporation. Allowing the directors of a benefit corporation to exercise judgment that reduces shareholder wealth in order to serve its social purpose is exactly the type of behavior that benefit corporations intend to make ordinary and necessary.<sup>279</sup> Directors of benefit corporations open themselves up to liability for *not* doing good, because to act contrary to their state-incorporated general and/or specific public purpose would now be considered *ultra vires*.<sup>280</sup>

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<sup>274</sup> See Clark & Babson, *supra* note 1, at 834–38.

<sup>275</sup> *Id.* (“[C]ourts reviewing decisions made in the day-to-day context will not question rational judgments about how seemingly promoting non-shareholder interests (such as a corporation’s decision to make charitable contributions or to otherwise support the community in which their operations are located) ultimately promote shareholder value.”).

<sup>276</sup> *Id.*

<sup>277</sup> Sugin, *supra* note 52, at 854–55.

<sup>278</sup> 26 U.S.C. § 170 (1988).

<sup>279</sup> Clark & Babson, *supra* note 1, at 835 (“While it is not true that all decisions that reflect consideration of non-shareholder interests lead to a reduction in shareholder value ... it is equally true that some might lead to reduced shareholder value, even over the long term .... [S]ome mission-driven business executives and investors may be comfortable with that result in the pursuit of their social mission”).

<sup>280</sup> Sugin, *supra* note 52, at 854.

Viewing both profit-motivated behavior and socially motivated behavior as ordinary and necessary to a benefit corporation adequately reflects and captures the Benefit Expenses that it will incur throughout its life. Benefit corporations would not have to worry about funneling all of their charitable behavior through a qualified non-profit, or by creating their own in-house non-profit. Google has responded in this way by creating a non-profit entity, Google.org, through which the for-profit entity Google.com can channel its philanthropic efforts.<sup>281</sup> Some for-profits have set up related non-profits and funnel money through those entities.<sup>282</sup> It is likely that larger non-profits, like Google, will never become benefit corporations because it might be difficult for them to find the mass of like-minded investors and shareholders that wish to spend their money on socially oriented businesses that might produce lower profit margins.<sup>283</sup> However, by allowing benefit expenses to be defined as ordinary and necessary, the directors of the likely private and closely held stock corporations that wish to become benefit corporations will have more flexibility and control over serving that social purpose. Additionally, the directors will not be constrained by the degree to which they do so, or by having to rely on a related non-profit to create the benefit as a conduit.

One possible complication with treating benefit expenses as ordinary and necessary is that assets that have a useful life that extends beyond the calendar year must be capitalized.<sup>284</sup> The complication raised by this point is similar to those seen with defining the social benefit created by non-profits—who is the recipient?<sup>285</sup> Benefit expenses would be expenses used toward furthering the specific or general *public* purpose, and not *private* purposes, and the benefit corporation would not actually receive an asset for which it could capitalize.<sup>286</sup> Because the purpose and motivation of benefit expenses is similar to charitable donations, and charitable donations are fully deductible in the year that they are made, a good argument could be made that benefit expenses could also be fully deductible in the year that they are made. Deducting all of the benefit expenses in the year in which they were made would likely be favorable to the corporation, as taxpayers typically prefer to deduct expenses in the earliest year possible.

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<sup>281</sup> Schoenjahn, *supra* note 15, at 460, 468–69.

<sup>282</sup> *See id.* at 459–60.

<sup>283</sup> *See, e.g.*, S.B. 79—A, Reg. Sess. (N.Y. 2011).

<sup>284</sup> 26 U.S.C. § 263A (2012).

<sup>285</sup> *See supra* Part III.

<sup>286</sup> In *Transamerica Corp. v. United States*, the corporation was considered to be the recipient of the benefit and the court determined that because the road had a useful life beyond one year the corporation was required to capitalize the expense. *Transamerica Corp.*, 254 F. Supp. 504, 515 (N.D. Cal. 1966), *aff'd*, 392 F.2d 522 (9th Cir. 1968).



## VII. SUBSTANTIATION

It is easy to imagine criticism arguing that a deduction for “good behavior” as an ordinary and necessary benefit expense, and which rests in part on the deference to the directors, may be too easily taken advantage of and benefit corporations could deduct all expenses, including those that do not actually create real social benefit. This is the same concern that dictates the substantiation of charitable contributions.<sup>287</sup> A written record must be kept of the charitable deduction that lists the name of the donee organization, the value of the contribution, and the date contributed.<sup>288</sup> If the contribution is noncash property and is more than \$500, then the substantiation must include a form that qualifies the contribution with the taxpayer’s return.<sup>289</sup> Substantiation also plays a key role in the balancing test when considering the private and public balance of UBIT and PRI, which is required to be substantiated and monitored in order to meet the expenditure responsibility requirements.<sup>290</sup> Like substantiation for many activities under the Code, each of these situations is based on the specific facts at hand,<sup>291</sup> and this may add to the number of transactions the IRS must monitor and enforce.

The non-profit sector has received similar criticism regarding organizations abusing the tax benefits given to it by the Code.<sup>292</sup> The IRS has requested increased accountability, transparency, and good governance from non-profit organizations<sup>293</sup>—the same increased standards that benefit corporations choose to meet.<sup>294</sup> Fortunately for the IRS, benefit corporations are monitored by a third party and also must issue an annual Benefit Report stating all of the benefit activities it has done that year.<sup>295</sup> While the monitoring third party might not audit every benefit corporation it monitors each year it likely performs regular audits and keeps reports for each benefit corporation, such as B Labs does.<sup>296</sup> This extra set of eyes

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<sup>287</sup> See, e.g., Mark L. Levine, *Appraisal Requirements Charitable Contribution Deductions*, 34 REAL EST. ISSUES 29, 30 (2009).

<sup>288</sup> 26 C.F.R. § 1.170A-13 (2012).

<sup>289</sup> 26 U.S.C. § 170(f)(11) (2012); IRS Form 8283 (2012).

<sup>290</sup> Brewer, *supra* note 1, at 712.

<sup>291</sup> Helge, *supra* note 124, at 902.

<sup>292</sup> Walker, *supra* note 23, at 632–34.

<sup>293</sup> *Id.* at 633.

<sup>294</sup> See Clark & Vranka, *supra* note 22, at 15.

<sup>295</sup> See, e.g., *supra* note 283.

<sup>296</sup> *How Are Companies Certified and Audited As B Corporations?*, B LAB, <http://www.bcorporation.net/index.cfm?fuseaction=modalContent.content&id=f7224b49-ed7f-4037-894c-31c6e3c32178> (accessed by searching the Internet Archive index for Oct. 5, 2012).

and substantiation will help ensure that the expenses incurred by benefit corporations are actually creating real social benefit. This motivation to create real social impact and not just ineffective and exaggerated marketing of social responsibility is the main mission of B Labs,<sup>297</sup> and having that label will help ensure that deductions for benefit expenses are actually going to create social and public benefit as the IRS intends by its favorable treatment. This is similar to an exempt organization status providing that entity with the assumption that their activities will be for social good, and that the activities of a for-profit are for generating profits. Benefit corporations may at least be granted the rebuttable presumption that the Code currently fails to give other for-profits.

#### VIII. FURTHER OPPORTUNITIES

As briefly mentioned earlier,<sup>298</sup> benefit corporations are allowed to adopt a specific public purpose in addition to the general public purpose, such as California's Flexible Purpose Corporations (FlexC).<sup>299</sup> The general public purpose is the broader stakeholder model of benefit corporations<sup>300</sup> and the specific purpose is one that would otherwise qualify as an exempt purpose.<sup>301</sup> If a FlexC were to adopt a special purpose that was same as an exempt purpose under 501(c)(3), the "good behavior" engaged in by the FlexC will even more closely resemble the "good behavior" to which the IRS gives favorable tax treatment. The FlexC legislation explicitly allows for a corporation to be involved in the mixed behavior activities previously discussed,<sup>302</sup> which another corporation would have had to funnel through a non-profit with the FlexC's equivalent specific exempt purpose.<sup>303</sup> Allowing benefit expenses only for those benefit corporations that elect a specific purpose may help put those skeptical of benefit corporations a bit more at

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<sup>297</sup> *Why B Corps Matter*, B LAB, <http://www.bcorporation.net/what-are-b-corps/why-b-corps-matter> (last visited Feb. 2, 2013) ("By voluntarily meeting higher standards of transparency, accountability, and performance, Certified B Corps are distinguishing themselves in a cluttered marketplace by offering a positive vision of a better way to do business.").

<sup>298</sup> See *supra* Introduction.

<sup>299</sup> S.B. 201, Reg. Sess. (Cal. 2012). CAL. CORP. CODE § 2602(b) (2012).

<sup>300</sup> CAL. CORP. CODE § 2602(b)(2)(B) ("[t]he purpose of promoting positive short-term or long-term effects of, or minimizing adverse short-term or long-term effects of, the flexible purpose corporation's activities upon any of the following: (i) The flexible purpose corporation's employees, suppliers, customers, and creditors. (ii) The community and society. (iii) The environment.").

<sup>301</sup> CAL. CORP. CODE § 2602(b)(2)(A) ("One or more charitable or public purpose activities that a nonprofit public benefit corporation is authorized to carry out.").

<sup>302</sup> See *supra* Part I.

<sup>303</sup> CAL. CORP. CODE § 2602(b)(2)(A).

ease. For substantiation purposes, it will be easier to classify and identify whether the expense was related to that specific purpose. For those that are skeptical about the capability of for-profit corporations to create real social benefit and not just engage in social-washing, this might be a more appealing, and limiting, option. A more specific purpose would assumedly better lend itself to transparency and substantiation, and also result in fewer tax deductions.

#### CONCLUSION

Undoubtedly, benefit corporations challenge the existing concept of profit-maximizing corporations. Because benefit corporations clearly remove themselves from the confusion by getting states to legitimize their dual purpose, the treatment of benefit corporations in many areas of corporate law may begin to see the same change originally intended for fiduciary duty. Treatment by the Code is no exception. Benefit corporations legitimize the fourth sector and the Code must accommodate its entrance into state legislation. The Code repeatedly looks to the purpose and intent of transactions in order to determine their treatment, and it treats activities that legitimately benefit society favorably. Benefit corporations are a new class of corporation, which earn their entity status by participating in the same socially responsible activities as a tax-exempt organization, and planning to do so on a regular basis. This regular use of benefit expenses can be viewed as ordinary and necessary to the trade or business of benefit corporations, especially as advocates such as B Labs continue to fight so hard to change the corporate law view of business purpose so that it includes creating public benefit as ordinary and necessary for all corporations.

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