

THE CASE FOR FOR-PROFIT CHARITIES

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INTRODUCTION

CONSIDER the following hypothetical. An entrepreneur wants to establish a charity to improve the health of children in developing countries. Specifically, the business plan envisions developing technology to improve the quality and supply of water in African nations. Running this charity will require the entrepreneur's time and effort, for which she would like to be compensated out of the funds that the organization obtains from donations or revenues from any sales made in developed countries.

Suppose the entrepreneur is willing to take a fixed salary as compensation and promises to abstain from distributing the charity's profits (defined as net revenue, that is, gross revenue minus costs including her salary) to herself or her employees. Then she may charter her organization as a nonprofit firm under state law. The defining feature of a nonprofit firm is that it cannot distribute net revenue to any affiliated persons or employees, a restriction known as the "nondistribution constraint."¹

An important benefit of organizing as a nonprofit firm is that if the firm also benefits the public and thereby complies with the state law definition of a "community-benefit" organization,² the firm will obtain various state tax advantages, such as an exemption from sales and property taxes.³ If the firm also meets a substantially similar community-benefit criterion under Section 501(c)(3) of the federal tax code, it will obtain important federal tax benefits. These include an exemption from the corporate income tax and, more importantly, the ability of donors to deduct their donations from

¹ See James J. Fishman & Stephen Schwarz, *Nonprofit Organizations: Cases and Materials* 2–3 (2d ed. 2000).

² See, e.g., Alaska Stat. § 10.20.005 (2006); Fla. Stat. Ann. § 617.0301 (West 2007); 805 Ill. Comp. Stat. Ann. 105/103-05 (West Supp. 2007).

³ See, e.g., Alaska Stat. § 29.45.030 (2006) (extending tax exemption to properties used for nonprofit religious, charitable, cemetery, hospital, or educational purposes); Fla. Stat. Ann. § 196.012 (West 2007) (defining an exempt use of property for purposes of property tax computation as any predominant or exclusive utilization of said property for, inter alia, charitable purposes); id. § 212.08(5)(q) (West 2007) (offering tax credit to qualified entities that make community contributions to certain eligible program sponsors such as "nonprofit community-based development organization[s]"); 35 Ill. Comp. Stat. Ann. 205/15-65 (West 2006) (exempting property from taxation when its use is charitable or beneficent and its owner is a charitable organization incorporated anywhere in the United States).

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their taxable income.⁴ Since our hypothetical entrepreneur's plan satisfies the community-benefit criterion, it will enjoy all of these tax breaks.

Suppose, however, that the entrepreneur is unwilling to take a fixed salary as compensation. She would like to distribute some of the charity's net revenue to herself. For example, if the charity raises \$10 million from donors but manages to develop a water filtration system at a cost of only \$8 million, the charity will make \$2 million in profits for the entrepreneur to take home. Why might the entrepreneur want to take home the profits, and why might donors permit her to do so? Perhaps the entrepreneur is very talented and could make a great deal of money at a noncharitable start-up company. She would have to turn that income down to form a charity, and while the entrepreneur is kind-hearted, she also cares about maintaining a comfortable lifestyle. Or perhaps the entrepreneur and donors believe she cannot motivate her employees to work hard unless she can offer them a share of the firm's profits.

Unfortunately, under current law, the entrepreneur cannot establish her charity as a nonprofit organization. This means that, although her firm continues to provide safe water to poor countries, and thus otherwise satisfies the community-benefit designation under state law and complies with Section 501(c)(3) of the federal tax code, it cannot obtain the tax breaks offered to similarly situated nonprofit firms. This is the case even though such a restriction means the entrepreneur may not establish a charity at all or that the charity will not be as productive or efficient. Indeed, this is the case even though, but for the inability to deduct their donations from taxable income, donors might prefer to give money to a for-profit charity.

If our charitable entrepreneur's proposal seems fanciful, consider that Google has recently announced, with great fanfare, that it will operate the world's first (to our knowledge) "for-profit charity."⁵ Google's plan appears to be to finance a for-profit business that will, among other things, develop new technology to improve

⁴ See I.R.C. § 170 (2000).

⁵ See Google.org, Welcome to Google.org—The Philanthropic Arm of Google, <http://google.org> (last visited Sept. 22, 2007).

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water supplies in Kenya.⁶ Google's new enterprise is a charity because it is devoted to helping others rather than seeking out the highest rate of monetary return for Google; but it is for-profit because it can distribute profits from its ventures to employees and business partners.⁷ As we will discuss, there are other examples of organizations devoted to charitable goals that skirt the line between for-profit and nonprofit. Google's open embrace of the for-profit model is extreme, but it differs from earlier mixed efforts by degree rather than by kind.

The problem for for-profit charities is that they forfeit all the state and federal tax benefits available to nonprofit charities. Although Google has nonetheless decided to establish a for-profit charity, that charity is partially hobbled by the inability to obtain these tax benefits. For example, even if the Google charity is successful, Google may be reluctant to increase funding of the charity and the charity may have difficulty raising funds from donors because contributions to the for-profit Google charity are not deductible. This raises a puzzle. Why should an organization that is devoted to doing good lose a tax benefit just because it compensates employees with profits rather than with a flat wage? If it turns out that Google's charitable efforts benefit poor countries more effectively than those of nonprofits with similar missions, why should the tax code steer donors to the nonprofits rather than to Google?

The literature contains three explanations for why the nonprofit form is recognized by the law and receives special tax benefits. The *public goods theory* holds that the tax deduction for charitable contributions encourages people to donate to firms that create public goods and this is more efficient than direct government purchase or production of public goods with general tax revenues. The *agency theory* holds that the nonprofit form solves a problem of asymmetric information that arises when donors cannot adequately evaluate the quality of charitable services they would like to purchase. The nondistribution constraint protects these donors from being taken advantage of by profit-seeking charities. Finally, the *altruism theory* holds that the return on tax breaks for the produc-

⁶ Posting of Alix Zwane to Google.org Blog, <http://blog.google.org/2007/07/new-meaning-for-spring-cleaning.html> (July 2, 2007, 03:15 EST).

⁷ See Katie Hafner, *Philanthropy Google's Way: Not the Usual*, N.Y. Times, Sept. 14, 2006, at A1.

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tion of public goods is higher when those tax breaks are targeted at nonprofit firms than at for-profit firms. The reason is that the nonprofit form attracts entrepreneurs who are altruistic, and altruistic entrepreneurs convert more of each dollar of tax breaks into public goods because they derive “warm-glow” consumption value from producing such goods.

In addition, we discuss and criticize two novel explanations for why only nonprofit firms should receive tax benefits. One, which we call the *imperfect consumer theory*, supposes that consumers make mistakes when donating money to charities. They may give money to an organization that pockets donations rather than conveying them to the needy. The restriction that charities cannot get tax breaks if they distribute profits limits the harm from consumers’ poor choices by directing consumers to organizations with fewer options to cheat consumers. Another theory reflects concerns about the *administrability* of Section 501(c)(3). For-profit firms, because of the profit motive, are much more likely to lobby the Internal Revenue Service (“IRS”) in order to persuade it that nontraditional charitable activity should qualify for tax breaks under Section 501(c)(3). This may overwhelm the IRS. Requiring applicants for Section 501(c)(3)-related tax breaks to foreswear distributing profits reduces this pressure on the IRS.

We will argue that none of these theories answers what we will call the *coupling* or *linkage* question, that is, why a particular tax benefit designed to promote charitable activities is conditioned on a particular corporate form (the nonprofit form or, equivalently, the nondistribution constraint). The public goods theory explains why the government should use tax breaks—specifically the deduction for charitable donations—to encourage provision of public goods but fails to explain why the government should deny such tax breaks to for-profit firms that produce these goods. The agency theory explains why people might prefer to donate to a nonprofit firm but not why nonprofit firms should receive a tax benefit. The altruism theory may justify tax breaks for nonprofits that produce public goods, but it relies on questionable assumptions about the costs and prevalence of altruists to deny the same tax breaks to for-profits, which might be more efficient at producing public goods. The imperfect consumer theory cannot explain why traditional consumer protection laws are insufficient protection against fraud

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by charities. Finally, the administrability objection ignores simpler solutions such as charging firms that seek Section 501(c)(3) classification a user fee to fund IRS review.

Because none of these theories justifies coupling the nonprofit form and tax subsidization, coupling should be eliminated. Decoupling would have two important benefits. First, it would improve the efficiency of services provided by nonprofit firms. Former U.S. Senator Bill Bradley and consultants from McKinsey & Company have estimated that the nonprofit sector wastes \$100 billion of value annually.⁸ They argue that it is possible to recover approximately \$60 billion of that loss by improving management and cutting administrative costs.⁹ If the profit incentive explains why for-profit firms are managed more efficiently than nonprofit firms, then decoupling might go some way to reducing this waste by allowing charitable entrepreneurs to reward themselves and employees for efficient delivery of services. To be clear, it might be that under decoupling for-profit firms provide the services that nonprofit firms previously provided, but the key point is that the same services would be more efficiently produced than before.

Second, decoupling may encourage a vast increase in the production of community-benefit goods and services by for-profit firms. The demand for such products is strong and growing. According to researchers, investors increased the amount of assets they have placed in socially responsible funds—defined as funds that restrict investments to for-profit companies that engage in socially worthy activities—by 7% between 2001 and 2003, “as compared to a 4% drop in all professionally managed assets.”¹⁰ In 2003, the total investment was \$2.14 trillion, or roughly 11% of total assets under management in the United States.¹¹ A large component of these funds flow to companies producing “environmentally friendly” products, which accounted for 9.5% of all new product introductions in 1999.¹² Extending the tax break for community-benefit ac-

⁸ See Bill Bradley et al., *The Nonprofit Sector’s \$100 Billion Opportunity*, *Harv. Bus. Rev.*, May 2003, at 94, 102.

⁹ *Id.* at 98, 100–02.

¹⁰ Christopher C. Geczy et al., *Investing in Socially Responsible Mutual Funds 2* (revised ed. Oct. 2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=416380.

¹¹ *Id.*

¹² Matthew J. Kotchen, *Green Markets and Private Provision of Public Goods*, 114 *J. Pol. Econ.* 816, 817 (2006).

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tivities from nonprofits to for-profits would substantially accelerate this trend.

Our Essay is related to an earlier debate about whether or not *nonprofit* firms should be taxed like for-profit firms when nonprofit firms engage in *commercial* activities. For example, a museum rents out gallery space for corporate events. The federal government's current approach is to tax nonprofits the same as for-profits when nonprofits engage in commercial activities. Thus, the museum does not pay taxes on its profits from ticket sales but does (or at least ought to) pay a tax on profits from the corporate events; the after-tax profits can be used to subsidize the museum's operations.¹³ This is implemented via the so-called unrelated business income tax ("UBIT") on nonprofits;¹⁴ the purpose of the tax is to deprive nonprofits of tax advantages when nonprofits compete against for-profit firms in commercial markets.¹⁵ The issue we raise is the flip side of the UBIT debate: should *for-profit* firms be taxed like nonprofit firms (or more precisely, be exempt from taxes like nonprofit firms) when they engage in *charitable* activities? Our answer is yes, because there is no reason to condition the tax subsidy for charitable activities on organizational form.¹⁶

This Essay is organized as follows. Part I provides background on nonprofit law and the organization of nonprofit firms. Part II

¹³ See Note, The Macaroni Monopoly: The Developing Concept of Unrelated Business Income of Exempt Organizations, 81 Harv. L. Rev. 1280, 1281 (1968).

¹⁴ I.R.C. § 512(a) (2000).

¹⁵ See Charles T. Clotfelter, Tax-Induced Distortions in the Voluntary Sector, 39 Case W. Res. L. Rev. 663, 678 (1989); Henry B. Hansmann, Unfair Competition and the Unrelated Business Income Tax, 75 Va. L. Rev. 605, 606 (1989).

¹⁶ Professor Evelyn Brody has written a related article arguing that the behavior of nonprofit and for-profit firms is converging because both types of firms face similar principal-agent problems: between shareholders and managers in the for-profit firm and between donors and managers in the nonprofit firm. She suggests in passing that this convergence in behavior might justify similar tax treatment. See Evelyn Brody, Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms, 40 N.Y.L. Sch. L. Rev. 457, 535-36 (1996). But while her argument is based on fairness, ours is based on efficiency. See also David A. Hyman & William M. Sage, Subsidizing Health Care Providers Through the Tax Code: Status or Conduct?, 25 Health Aff. W312 (June 20, 2006), <http://content.healthaffairs.org/cgi/reprint/25/4/W312> (arguing that tax law should subsidize charitable nonprofit firms only to the extent that their activities benefit the community). Some similar ideas have appeared in the popular media. See Matthew Richter, Utopia Aflame: The Organizations Established to Save Humanity Are Dying. Seriously., *Stranger*, Apr. 27-May 3, 2006, <http://www.thestranger.com/seattle/Content?oid=31985>.

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discusses the theories that support coupling and advances our critique of those theories. Part III addresses some objections to decoupling. Part IV discusses the important case of “mixed charities,” often discussed under the rubric of corporate responsibility. We conclude with a proposal for reform.

I. BACKGROUND

A. *Legal Treatment of Nonprofit Firms*

The laws of every state recognize that a firm may either have for-profit or nonprofit status. A for-profit firm may pay its profits to the owners of the firm. The key constraint and defining feature of a nonprofit firm is the nondistribution constraint: the firm may not pay its profits to the owners of the firm.¹⁷ Instead, the nonprofit must retain its profits or spend excess revenues on its business (in which case it does not have profits). To be more concrete, suppose that an entrepreneur sets up a firm. If the firm is for-profit, the entrepreneur, as the sole owner, retains all profits. If the firm is nonprofit, the entrepreneur may not retain the profits, though she may pay herself a wage. The wage may not be a proxy for profits (for example, bonuses when profits are high); it must be relatively fixed and keyed to the market, so that the entrepreneur earns about the same as an employee would be paid for similar services. For example, the entrepreneur who manages a nonprofit may pay herself a salary equal to the salary received by the manager of a comparable for-profit firm.

Some states limit the scope of business of nonprofits, but as a general proposition they permit for-profit firms to compete in the same market as nonprofits. Thus, we observe for-profit and nonprofit hospitals, for-profit and nonprofit daycare centers, for-profit and nonprofit publishers, and so forth. Federal law recognizes nonprofit status and affords nonprofit firms certain benefits so long as they do not have a commercial purpose. Specifically, under Section 501(c)(3) of the tax code, nonprofits may obtain tax breaks so

¹⁷ See, e.g., Mich. Comp. Laws Ann. § 450.2108(3) (West 2002); Nev. Rev. Stat. Ann. § 82.136(2) (LexisNexis 2004); Ohio Rev. Code Ann. § 1702.01(C) (LexisNexis Supp. 2007).

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long as they engage in charitable, educational, scientific, or artistic activities.¹⁸

The most visible federal tax benefit for nonprofit firms that have Section 501(c)(3) status is their freedom from corporate income taxation. However, one should not overemphasize this benefit. For-profit firms do not pay corporate income taxes if they, like a nonprofit, reinvest their excess revenues and have no proper profits. Moreover, under certain conditions—not having more than 100 shareholders and not being traded on a stock exchange—the IRS permits for-profit firms to elect “pass-through” treatment and

¹⁸ Section 501(c) of the tax code grants tax exemptions for two basic categories of nonprofit organizations. One includes organizations that fall under § 501(c)(3) and are distinguished by the title “community-benefit,” “public-benefit,” or more simply “charitable” organizations. The other category includes all other organizations covered by § 501(c) and are called “mutual-benefit” organizations or “mutuals” for short. They are so called because their primary purpose is to serve their members, not the general public. We use the term “community-benefit” organization interchangeably with Professor Halperin’s (and our) term “public-benefit” organization. Our term “charitable organization” refers to an entity that transfers resources from a donor to a beneficiary. Charitable organizations may be a public-benefit organization or a for-profit organization. But it is unlikely to be a “mutual” because the donor and the beneficiary typically overlap in a mutual. Mutuals are exempt from corporate income tax on income generated from services provided to members, but not on income generated from services provided to nonmembers. See Daniel Halperin, *Income Taxation of Mutual Nonprofits 3–4* (2007) (unpublished manuscript, on file with the Virginia Law Review Association). Only charitable organizations, however, are eligible for the charitable tax deduction and, where applicable, the exemption from property and sales taxes. *Id.* at 5. (One exception is that in certain cases member contributions to trade associations may be deductible to members as business expenses. *Id.* at 4.)

Our analysis focuses on public-benefit organizations, but can be extended to mutual-benefit organizations as well. The latter are also subject to a version of the non-distribution constraint. In particular, they cannot distribute net earnings to members as cash (though they can indirectly distribute them by providing additional services to members). Our basic proposition is that tax breaks should be contingent on preferred activities and not corporate form. As applied to mutuals, our claim would be that the corporate income tax exemption for income earned from members should be extended to the for-profit version of the mutual-benefit organization, also known as the cooperative, or be denied to the mutual-benefit organization. Interestingly, it can be argued that existing law already and de facto takes the first route. The reason is that the cooperative firm can deduct from taxable income certain cash dividends it pays to members, so-called patronage dividends. Just as the corporate income tax exemption for mutual-benefit organizations is limited to net earnings from members, the deduction for patronage dividends is limited to distributions from net earnings from members. See I.R.C. §§ 1382(b), 1388 (Supp. 2004).

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avoid corporate income taxes.¹⁹ Rather than the income tax exemption, the more important tax advantage enjoyed by Section 501(c)(3) organizations is the right of donors to deduct their donations from their income for personal income tax purposes.²⁰ A related benefit is that purchasers of bonds issued by such organizations do not have to pay tax on interest from such bonds.²¹ Beyond these federal tax benefits, qualifying nonprofits also enjoy various state law tax advantages, such as exemption from sales taxes and property taxes.²² We provide a simplified comparison of the tax treatment of for-profit and nonprofit firms in Table 1. (In Part III, we will address some complications.)

Table 1. Tax treatment of charitable activities by corporate form.

		<i>Corporate Form</i>	
		<i>For-Profit</i>	<i>Nonprofit</i>
<i>Corporate Purpose</i>	<i>Commercial</i>	No tax benefits	No tax benefits
	<i>Charitable</i>	No tax benefits	Tax benefits

¹⁹ I.R.C. §§ 1361–1379 (2000 & West Supp. 2007). A nonprofit can earn profits but cannot distribute them. If a for-profit makes profits, it has three options: (1) pay corporate income taxes on the profits and distribute the after-tax profits to owners, who then have to pay personal income taxes on the distribution; (2) pay corporate income taxes on the profits and retain the earnings until the next year; or (3) if it is permitted to choose pass-through treatment, its shareholders would have to pay personal income tax on the profits of the firm, whether the firm distributed profits to its shareholders or retained the earning. In other words, whereas the nonprofit firm can retain its profits in a liquid form from year to year, a for-profit cannot do this without either paying corporate income taxes or personal income taxes. (In the latter case, the shareholders can make a capital contribution to the firm the next year and that would serve the same purpose as retained earnings.) Offsetting the advantage that nonprofit firms can retain earnings without paying any tax is that nonprofit firms cannot distribute profits to shareholders.

²⁰ See I.R.C. § 170 (2000).

²¹ See I.R.C. § 145. Note, however, that gains from the sale of tax-exempt bonds are not exempt from capital gains taxation.

²² Qualifying nonprofits also cannot be subject to an involuntary bankruptcy petition under § 303 of the Bankruptcy Code, 11 U.S.C. § 303 (2000); seem to be preferred when governments contract out functions (consider the relative enthusiasm about nonprofit charter schools compared to the uneasiness about for-profit schools, see, e.g., John Morley, Note, For-Profit and Nonprofit Charter Schools: An Agency Costs Approach, 115 *Yale L.J.* 1782, 1800–05 (2006)); and enjoy other advantages.

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The motivation for this Essay is that, as a result of coupling, the for-profit charity enjoys no tax benefits, as highlighted by the shaded cell in the table. Our argument is that the tax treatment of the activities in the two bottom cells should be identical.

B. Model of a Nonprofit Charity and a For-Profit Charity Under Current Law

Let us examine a hypothetical charity to see how operations and incentives differ depending on its organizational form. Suppose a donor wants to send money to a beneficiary such as sick children in Africa. In our hypothetical, a charitable entrepreneur using her organizational skills and contacts offers to facilitate this transfer. She forms a nonprofit firm and promises that if the donor gives her \$100, she will ensure \$80 reaches the hands of the sick children. The rest will be used to pay administrative costs. Specifically, she will take a salary of \$10 and use \$10 for other expenses.

What would happen if the entrepreneur, instead of taking the nonprofit form, chooses the for-profit form? First, consider what would not change. She could continue to adhere to her promise to send 80% of the donation to sick children. She could spend \$10 on administrative expenses. Whether the entrepreneur chooses a for-profit form that enjoyed pass-through tax treatment or not, she could also continue to enjoy a \$10 salary because her salary is tax deductible for the firm. In other words, after she received \$100 from the donor, she could run her charity the exact same way she did before she took the for-profit form.

Now consider what would change if the entrepreneur took the for-profit form. First, the entrepreneur would have greater incentive to make the charity more efficient by lowering administrative costs.²³ Suppose the entrepreneur, by careful planning, could reduce expenses other than her salary from \$10 to \$8. If the charity were for-profit, she could pocket some of the extra \$2 as profit. (If the for-profit firm qualifies for pass-through tax treatment, then

²³ See Armen A. Alchian & Harold Demsetz, Production, Information Costs, and Economic Organization, 62 *Am. Econ. Rev.* 777, 789–90 (1972); H.E. Frech III, The Property Rights Theory of the Firm: Empirical Results from a Natural Experiment, 84 *J. Pol. Econ.* 143, 144 (1976) (noting this is a natural consequence of the manager's attenuated property rights in the firm's profits).

she could keep all \$2.)²⁴ But if the charity were nonprofit, she would have to leave the \$2 in the firm because the nonprofit form does not permit distribution of profits. This reduces the entrepreneur's incentive to keep expenses down.

Second, the donor would have less incentive to send money to sick children in Africa through the entrepreneur's for-profit firm. If the charity entrepreneur took the nonprofit form, the donor could deduct his donation from his total income when calculating his taxable income (assuming the donor itemized his deductions) for personal income tax purposes. Once the charity becomes for-profit, the donation is no longer deductible. In other words, while one can donate to nonprofit charities using pre-tax dollars, one can only donate to for-profit charities using after-tax dollars. The subsidy for donation to nonprofits is equivalent to the donor's personal income tax rate. If the tax rate is, for example, 33%, while it would cost only \$100 on a pre-tax basis to give \$100 to a nonprofit charity, it would cost 50% more—\$150—on a pre-tax basis to give the same amount to a for-profit charity.

Table 2. Model of nonprofit and for-profit charities.

	(1)	(2)	(3)
	Nonprofit charity	For-profit charity	For-profit charity (after reduction of admin. expenses)
A) Contribution by donor (pre-tax dollars)	\$100	\$150 (33% tax rate)	\$150 (33% tax rate)
B) Money for beneficiary	\$80	\$80	\$80
C) Admin. expenses (other than entrepreneur salary)	\$10	\$10	\$8
D) Entrepreneur's salary	\$10	\$10	\$10
E) Profits distributed to entrepreneur	\$0	\$0	Up to \$2

This simple model of nonprofit and for-profit charities—summarized in Table 2—illustrates our basic hypothesis. The donor must effectively pay more (compare cells 1A and 2A) in order to

²⁴ See *supra* text accompanying note 19.

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have the same charitable effect if the charity is for-profit than if the charity is nonprofit. This is why there are currently no for-profit charities (aside from Google). Yet the for-profit charity might be more efficient—in the sense that its administrative costs are lower because the entrepreneur has stronger incentives to minimize administrative costs (compare cells 1C and 2C to 3C). We will return to this model in the next Part in order to illustrate how the major theories that explain the nonprofit form fit into our analysis.

II. A CRITIQUE OF COUPLING

We now arrive at the core of our Essay. In Sections A–E, we critique the major theories (the public goods theory, the agency theory, the altruism theory, the imperfect consumer theory, and the administrability theory) that might be offered to explain coupling,²⁵ and thereby demonstrate that there is no good reason for conditioning tax subsidies for community-benefit activities on nonprofit status. In Section F, we shall explain the social costs of coupling and thus complete our affirmative argument for decoupling.

A. *The Public Goods Theory*

An old but still prominent view is that the government should subsidize charitable nonprofits because they produce public goods.²⁶ Consider, for example, a nonprofit that takes donations

²⁵ There are other theories that have been proposed, but we find these five better reasoned. For example, Professor Boris Bittker and George Rahtert argue that nonprofit firms should be exempt from the corporate income tax because it is difficult to define the income of nonprofits. Boris I. Bittker & George K. Rahtert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 *Yale L.J.* 299, 307–08 (1976). Their argument rests on the limitation of the § 162 business expense deduction to profit-motivated activities. *Id.* at 310. But if that is relaxed, as it surely would be if for-profit charities were taxed on their income, computing taxable net income would be straightforward. What is more, Bittker and Rahtert assume the only way to decouple is to eliminate the tax breaks for charitable nonprofits. An alternative that completely avoids their criticisms is to extend the same tax breaks to charitable for-profit activities.

²⁶ See Burton A. Weisbrod, *The Nonprofit Economy* 70 (1991); Henry Hansmann, *Economic Theories of Nonprofit Organizations*, in *The Nonprofit Sector: A Research Handbook* 27, 28–29 (Walter W. Powell ed., 1987); Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 *Yale L.J.* 835, 848–49 (1980) [hereinafter Hansmann, *The Role of Nonprofit Enterprise*]. This is also the theory most closely related to Treasury Department's post hoc rationale for the nonprofit tax exemptions. See Unrelated

and uses the money to clean up a park. Suppose that local residents care about the park. In the absence of the nonprofit, people are unlikely to invest the optimal amount to clean up the park. The reason is that although every person benefits from a clean park, one benefits even more if everyone else does the cleaning. If everyone thinks in the same way and free rides on the clean-up efforts of others, the aggregate investment will be less than what is optimal.

The standard solution to this problem is government action. The government taxes everyone and then uses the money to clean up the park. However, a problem with this type of intervention is that the government may have difficulty determining the preferences of citizens. If citizens care about the park a little, the government should invest little in maintaining it; if citizens care about the park a lot, the government should invest a lot. But determining and aggregating preferences is difficult, so the government may end up supplying too little or too much maintenance.

An alternative approach, one that relies on less intrusive government regulation, is tax breaks for donations to charitable nonprofits. The nonprofit takes donations, and because donors receive a tax benefit, they donate more than they would otherwise. At the same time, donation remains voluntary, so people will donate only if they have a relatively strong preference for the collective good supplied by the nonprofit. Thus, greater donation will occur than in the absence of the tax subsidy, and the donation will reflect preferences better than government intervention does. This does not mean that the free-riding problem is solved. Some people who benefit from the park will decline to donate even with the tax break. But the free-riding problem should be reduced.

We take no position on whether this story is correct, although we will assume that it is correct for purposes of our argument. The main lesson of the theory is that the government ought to provide tax breaks for voluntary donations that support the production of public goods. But the theory says nothing about how the government should do this. The theory does not justify giving such tax

Business Income Tax: Hearings Before the Subcomm. on Oversight of the H. Comm. on Ways & Means, 100th Cong. 37 (1987) (statement of O. Donaldson Chapoton, Deputy Assistant Secretary (Tax Policy), U.S. Department of the Treasury).

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breaks exclusively to nonprofit firms that produce public goods. If the theory is correct, the tax deduction for charitable contributions should be made available to any firm—for-profit or nonprofit—that engages in appropriate activities that benefit third parties. This is not a novel idea. We frequently observe government giving tax subsidies to for-profit firms that engage in community-minded activities. Consider the massive subsidies, for example, to alternative energy producers, including automobile manufacturers that develop hybrids and farmers who develop ethanol-based fuel.²⁷ The recipients are for-profits, so why should similar subsidies not be made available to for-profit charities?

Similarly, the public goods theory cannot explain why the government should give tax subsidies to donors who contribute to a nonprofit firm that cleans up parks, but not to donors who contribute to a for-profit firm that does the same. The public goods theory justifies tax breaks to firms that clean up parks, and it does not matter whether the firms are for-profit or nonprofit, or even whether they take donations or simply charge fees. In sum, the public goods theory justifies tax breaks but does not justify the coupling of tax subsidies and the nonprofit form.

B. The Agency Theory

The agency theory holds that the nonprofit form solves an agency problem—for example, that the entrepreneur (the agent) who operates a for-profit charity, or her employees, do not act in the interest of the donors or beneficiaries (the principal).

1. The Model

To understand the argument, consider the three characters in our hypothetical charity: the entrepreneur, the donor, and the beneficiary. The donor gives money to the entrepreneur, and the entrepreneur conveys it to the beneficiary. According to the agency theory, the entrepreneur cares about two things: her own

²⁷ See Energy Policy Act of 2005, Pub. L. No. 109-58, §§ 1344, 1347, 119 Stat. 594, 1052, 1056 (providing tax incentives to ethanol and bio-diesel producers). The government also provides tax credits to drug companies for clinical research under the Orphan Drug Act. See 26 U.S.C. § 45C (2000).

income and benefiting a third party, such as a poor person.²⁸ The literature thus ascribes to the entrepreneur a mix of conventional selfishness and a kind of directed altruism.²⁹ (Later we will address the case where the entrepreneur is not altruistic.) The problem is that the donor cannot verify whether the entrepreneur satisfied her promise to give 80% of his money to the beneficiary. Technically speaking, this means the entrepreneur sells a product (transferring charitable money to a beneficiary) whose quality (getting 80% to the beneficiary) is nonverifiable, that is, cannot be stipulated in a contract that is enforceable by a court. We will say that the product is “high quality” if 80% goes to the beneficiary and “low quality” if less than 80% goes to the beneficiary.

Clearly the donor is willing to pay more—that is, donate more—if the charitable service is of high quality than if it is of low quality. Without loss of generality, we shall assume that the donor is not willing to pay anything at all for low-quality charitable services. The entrepreneur can set up her charity as either a for-profit firm or a nonprofit firm. If she sets up the for-profit firm, she receives (as sole shareholder) all the profits of the firm—donations minus both the amount delivered to the beneficiary and the cost of this delivery. If she sets up the nonprofit firm, she is legally required to accept a relatively flat salary—it cannot be functionally equivalent to equity. The law requires the nonprofit firm to retain earnings or spend it consistently with the firm’s purpose. The entrepreneur may be able to convert some excess income into perquisites such as a nice office, but she values these perquisites less than the income itself. The effect of choosing the nonprofit form over the for-profit

²⁸ We use the model of Professors Glaeser and Shleifer. See Edward L. Glaeser & Andrei Shleifer, *Not-for-Profit Entrepreneurs*, 81 *J. Pub. Econ.* 99 (2001). Professor Hansmann originated the idea that the nonprofit form solves a problem of asymmetric information but did not assume that the entrepreneur was altruistic. See Hansmann, *The Role of Nonprofit Enterprise*, *supra* note 26, at 896–98.

²⁹ We will follow the literature in using the term altruism, but clearly the term is not used synonymously with, say, having a preference to maximize social welfare. See Anup Malani et al., *Theories of Firm Behavior in the Nonprofit Sector: A Synthesis and Empirical Evaluation*, *in* *The Governance of Not-for-Profit Firms* 181, 186 n.5 (Edward L. Glaeser ed., 2003) (synthesizing literature on pure and impure altruism). It means, in this context, that the entrepreneur has a preference for engaging in some activity (producing good operas, helping a type of poor person, etc.) that is shared by the consumer; by contrast, the entrepreneur’s “selfish” preferences, which higher income allows him to better satisfy, are not shared by the consumer.

form is that the entrepreneur's payoff from operating the firm is reduced.

Why, then, would the entrepreneur be willing to choose non-profit status? The answer is that the donor may be willing to pay more for charitable services from a firm that has taken the non-profit form than if it has taken the for-profit form.³⁰ Indeed, in our extreme case the donor is willing to pay nothing for charitable services provided by the for-profit firm. The reason is that the for-profit firm cannot commit itself to produce a high-quality product, that is, deliver 80% of each donation to the beneficiary. Because the entrepreneur receives revenues minus costs, she has strong incentives to produce a low-quality good, that is, convey less than 80%, to reduce costs. For this reason, the donor refuses to buy the charitable services from the for-profit firm. By contrast, the entrepreneur's incentives to shirk on quality are blunted if she chooses nonprofit status. She gains less (ex post) by shirking on quality because the increased "profit" takes the form of low-value perquisites. At the same time, if she shirks on quality, she loses the altruistic benefit of producing a high-quality product. As long as the entrepreneur is sufficiently altruistic and the nonverifiable component of the product's quality is sufficiently high, the entrepreneur will choose nonprofit status and be able to sell charitable services.³¹

The nonprofit form solves a contracting failure that results from the fact that courts cannot verify the quality of charitable services. The nondistribution constraint blunts the incentive of the entre-

³⁰ There is an empirical debate about this issue. See *infra* text accompanying note 40.

³¹ What makes coupling seem so odd in the context of the agency theory is that the nondistribution constraint can be thought of or implemented as a confiscatory tax on the nonprofit firm or the entrepreneur—the opposite of a subsidy for either. The nondistribution constraint—the key to the agency theory—is currently implemented by a promise by the entrepreneur not to distribute profits. If she does, she will lose her nonprofit status and be taxed as a for-profit on the profits. Another way to implement the nondistribution constraint, however, is to tax a firm that takes nonprofit status not at the for-profit tax rate, but at a 100% tax rate. This will discourage profit-making even more effectively than does the current implementation of the constraint because the implicit penalty becomes explicit and greater. A third way to implement the nondistribution constraint is to raise the personal income tax on the nonprofit entrepreneur (or anyone else who controls the assets of the firm). Specifically, the government should tax the entrepreneur's income at a 100% marginal rate above the level that constitutes a competitive salary. This too would reduce any incentive the entrepreneur has to make profits.

preneur to shirk by limiting the return that the entrepreneur receives from the operation of the firm. The government audits the firm and punishes it if, in form or in function, the firm issues equity to the entrepreneur. Suppose, for example, that the entrepreneur pays herself a flat salary plus an annual bonus equal to the difference between the firm's revenues and costs in good years, and takes a pay cut in bad years. Because the entrepreneur has simply disguised her equity interest, the IRS would penalize her by stripping the firm of its nonprofit status and taxing it on its profits.³² Thus, the nonprofit form solves the contracting problem by substituting a verifiable proxy (the firm's receipt of donations and payment of expenses) for the nonverifiable factor (the quality of its product). The proxy is accurate—in the sense that the firm's balance sheet is reliably correlated with quality—because the entrepreneur is partially altruistic and thus can be expected to behave more altruistically (thus enhancing quality in the interest of the consumer) if and only if the sensitivity of income to cost-cutting is reduced.

2. The Problem of the Nonaltruistic Entrepreneur

One problem with the agency theory is that it assumes that only altruistic entrepreneurs will choose the nonprofit form, and that nonaltruistic entrepreneurs will always choose the for-profit form. But this is not necessarily true. A nonaltruistic entrepreneur will choose the nonprofit form if the benefit from tax breaks notwithstanding the nondistribution constraint exceeds the benefit from being able freely to draw profits as income. What are the benefits of tax breaks in light of the nondistribution constraint? Even ignoring perquisites, recall that the nondistribution constraint does not prevent the nonaltruistic entrepreneur from receiving a competitive wage. Tax breaks increase the value of this benefit to the extent that they provide a financial cushion that ensures the gross earnings of the nonprofit always cover the cost of the entrepreneur's wage. This reduces her risk of job loss. This cushion also permits the entrepreneur to devote less effort to organization

³² The IRS now may impose intermediate sanctions by assessing fines and penalties for excessive compensation transactions. See I.R.C. § 4958 (West Supp. 2007).

without sacrificing her wage. In other words, tax breaks can subsidize the entrepreneur's consumption of leisure.

If a nonaltruistic entrepreneur forms a nonprofit firm, the nondistribution constraint cannot guarantee the entrepreneur will not shirk on product quality. She may not do it to increase her cash income, but she can shirk on quality to reduce the risk of job loss or to increase her leisure.³³ This problem can be evaded if donors can distinguish altruists and nonaltruists. But there is no reason to think that donors are any better at distinguishing altruists from nonaltruists than at distinguishing high-quality from low-quality charitable services. Therefore, the possibility that a nonprofit charity is operated by a nonaltruist will reduce the willingness of donors to patronize it. This in turn weakens the attractiveness of the agency theory as a justification for special treatment of nonprofits.

3. Substitutes for the Nondistribution Constraint

Another problem with the agency theory is that it implicitly—and incorrectly—assumes that the nondistribution constraint cannot be established by contract. If this assumption is wrong, for-profit firms can solve the noncontractible quality problem as well as the nonprofit firm can. Specifically, the for-profit can promise donors, by contract, that it will not distribute profits to its managers or workers.³⁴ Unlike quality, profits are verifiable; so this is an

³³ This is just a specific case of a more general problem. The contract failure theory is a version of the multitask principal-agent problem. The principal—the donor—would like the agent—the charity entrepreneur—to engage in two tasks: produce a high-quality product and keep down costs. The problem is that these tasks reflect a tradeoff, that is, one way to lower costs is to produce a low-quality product, and the principal cannot verify quality. The principal can encourage the agent to engage in cost reduction, for example by letting the agent keep the profits of the endeavor. But a lesson of the multitask literature is that if the principal encourages one task but not the other, the agent will only engage in the first task. It is not a complete solution to eliminate the incentive on all tasks, because then the agent will do no work. In the nonprofit context, eliminating the incentive to cut costs may result in less work rather than enhanced quality.

³⁴ This idea is related to Professor Jensen's "free cash flow theory" for why shareholders may prefer the issuance of debt. Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 *Am. Econ. Rev.* 323 (1986). In firms with a lot of uncommitted or free cash flows, there is a risk that managers will use these cash flows to make investments that are not in the interests of shareholders. Therefore, shareholders may prefer that the firm convert equity to debt because servicing debt will consume free cash flows. Equity does not do the same because issu-

enforceable contract. And it achieves the same incentives as the nonprofit form.

What exactly would such a contract look like? There are two possibilities. First, the entrepreneur could start a for-profit firm rather than a nonprofit firm, but hire a manager to run the firm. The entrepreneur would promise donors that the manager would control the firm; that the manager would be paid a fixed wage; that the manager would be prohibited from owning any shares in the firm; and that the entrepreneur would limit the perquisites that the manager could extract from the firm. These promises, along with the firm's product, would be part of the sales contract for that product. The entrepreneur could also hire an auditor such as PricewaterhouseCoopers to police the contract. The auditor would be the private analogue to the state attorney general or the IRS in the nonprofit setting. The entrepreneur—and other investors—would be able to keep the firm's profits after production costs and paying the manager. If the entrepreneur instead funneled profits or provided additional perquisites to the manager, the auditor would blow the whistle, and the donors could sue the entrepreneur for breach of contract.

Another approach would be for the entrepreneur to run the firm herself but offer a cost-plus pricing scheme.³⁵ In this scheme, the donor would pay a final price that reflects costs, plus the entrepreneur's opportunity cost of time. This could be implemented by billing the donor after all costs have been tallied and the product has been delivered. Alternatively, the firm could refund to the donors any profits it makes during the year. Either way, the firm would be the functional equivalent of a purchaser-cooperative with the en-

ance of dividends is optional for managers. The debt in Jensen's theory serves to limit managers' discretion by limiting their resources. The nondistribution contract clause we propose also serves to limit managers' discretion. But the beneficiary is not the shareholder, which in our model is the same as the manager. Rather, the beneficiary is the consumer or donor, who is ensured that the manager will not shirk on quality to raise profits. Moreover, whereas debt limits the resources available to managers to engage in moral hazard, the nondistribution clause curbs the incentives of managers to engage in moral hazard.

³⁵ The cost-plus contract is familiar from the construction industry. Although many people criticize the cost-plus contract in the construction industry because it does not give contractors an incentive to minimize expenses, it should, by the same token, work admirably when the entrepreneur is a partial altruist who also cares about income—our assumptions.

trepreneur taking the role of the manager. The donors, rather than the entrepreneur, would serve as residual claimants. If the entrepreneur instead pocketed the profits, the donors would be able to sue her for breach of contract. Indeed, Professor Henry Hansmann, one of the originators of the agency theory, makes this point—that the cooperative form solves agency problems between the entrepreneur and the purchaser.³⁶ Our observation is simply that the cooperative form is one of several private contract substitutes for the nondistribution constraint.

The key to both the fixed wage and cost-plus contracts is that the person in control of the firm—whether a manager hired by the entrepreneur or the entrepreneur herself—receives a flat wage. This eliminates the incentives to cut costs in a manner that sacrifices quality. So long as the person in control of the firm is altruistic, he or she will substitute higher quality for profits. (Note that where the entrepreneur delegates control to a manager, it is the manager and not the entrepreneur who must be altruistic.)

A possible objection to the contractual implementation of non-profit incentives is that they do not take advantage of the government's power to audit. As we saw before, the nonprofit is monitored by state attorneys general and the IRS, which penalizes the nonprofit if it produces profits for its stakeholders. By contrast, our contractual implementation would require donors to detect breaches themselves or rely on private auditors to blow the whistle, and then the donors would have to take the trouble of filing a lawsuit.

But this objection misses the mark. Monitoring by attorneys general and regulatory agencies is expensive, and monitoring by donors and private auditors is expensive. There is no reason to think that the former is cheaper than the latter.³⁷ Indeed, the evi-

³⁶ Henry Hansmann, *The Ownership of Enterprise* 150, 159, 190, 197–99 (1996). An interesting possibility is that a for-profit firm with a cost-plus contract can reorganize as a cooperative or perhaps mutual. As we explained, *supra* note 18, this yields a partial exemption from corporate income tax. It does not, however, replicate the federal charitable tax deduction or the state property and sales tax exemption. Thus, choosing the cooperative or mutual form is no better than choosing a pass-through entity such as an S corporation or a partnership.

³⁷ Indeed, many statutes authorize private citizens—self-appointed “private attorney[s] general,” *Newman v. Piggie Park Enters., Inc.*, 390 U.S. 400, 402 (1968) (*per curiam*)—to enforce laws intended to promote public policies rather than the interests

dence suggests that state attorneys general rarely prosecute trustees of nonprofit firms for violations of their fiduciary duties and the IRS almost never revokes a firm's nonprofit status.³⁸ The IRS rarely even imposes intermediate sanctions on nonprofit firms who violate the nondistribution constraint.³⁹ It may well be that private auditing and litigation would be superior to the current system, or that some mixed system—in which government auditing supplements private litigation—would be optimal.

In a world without tax preferences for nonprofit firms, some entrepreneurs would choose the nonprofit form and others would choose the for-profit form; among the latter, some would offer to forgo profits by contract and others would not. Donors would sometimes deal with the first type of entrepreneur and sometimes deal with the second or third type. The agency theory can explain why an entrepreneur would choose the nonprofit—to implement a no-profit pledge by means of the nondistribution constraint. It cannot explain, however, why this entrepreneur also needs a tax break. Just as important is that the agency theory cannot explain why such a tax break, even if justified, should not also be extended to for-profit firms that take a no-profit pledge.

Moreover, there is mixed evidence that purchasers in markets with nonprofit firms place value on the noncontractible quality that the nondistribution constraint protects.⁴⁰ Interestingly, the markets

of the private citizens. See, e.g., Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C.) (authorizing private securities fraud actions); False Claims Act, 31 U.S.C. § 3730(b) (2000) (authorizing private qui tam fraud actions); Toxic Substances Control Act, 15 U.S.C. § 2619 (2000) (allowing private citizen suits against violators).

³⁸ John F. Coverdale, Preventing Insider Misappropriation of Not-for-Profit Health Care Provider Assets: A Federal Tax Law Prescription, 73 Wash. L. Rev. 1, 10 (1998) (arguing “the IRS viewed revocation as an extreme penalty, to be invoked only in egregious cases”).

³⁹ See I.R.C. § 4958. Although intermediate sanctions were adopted in 1996, see Taxpayer Bill of Rights 2, Pub. L. 104-168, § 1311, 110 Stat. 1452, 1475–79 (1996), the IRS did not win its first case until 2002, *Caracci v. Comm’r*, 118 T.C. 379, 413–16 (2002), and promptly lost that case on appeal, 456 F.3d 444, 462 (5th Cir. 2006).

⁴⁰ Compare Tomas Philipson, Asymmetric Information and the Not-for-Profit Sector: Does Its Output Sell at a Premium?, in *The Changing Hospital Industry: Comparing Not-for-Profit and For-Profit Institutions* 325 (David M. Cutler ed., 2000) (using data from the nursing home industry and finding no statistically significant difference between the prices of nonprofit and for-profit homes, suggesting that the nonprofit form provides no advantage with respect to noncontractible quality), and Anup Ma-

that are studied—hospitals, nursing homes, and childcare—have a significant for-profit presence. This is possible because these markets do not depend on donations, and therefore for-profit firms are not handicapped by at least one of the tax breaks for nonprofit firms—the exclusive tax deduction for donations to nonprofit firms. But the for-profit presence indicates that for-profit firms can survive even if nonverifiable quality has value, probably because they provide verifiable quality in an efficient manner. Surely that would also be true in the charity market. In other words, some donors may choose nonprofit charities because of their noncontractible quality, but others may choose for-profit charities because they are more efficient. This is yet another reason to avoid tax discrimination against for-profit firms.

4. Irrelevance of Tax Breaks

There is another theory—which we shall call the capital access theory—that attempts to justify tax breaks and that can perhaps be combined with the agency theory to justify coupling these breaks with the nondistribution constraints. According to the capital access theory, firms that comply with the nondistribution constraint face limits raising capital from equity markets because they cannot distribute profits to owners. In order to compete fairly with for-profit firms, which do not face this constraint, they must be given assistance raising money from sources other than capital markets.⁴¹

lani & Guy David, Does Nonprofit Status Signal Quality?, 37 *J. Legal Stud.* (forthcoming Mar. 2008) (finding that most nonprofit firms do not bother to mention their nonprofit status in their marketing, which suggests that nonprofit status may not be a signal of noncontractible quality), with Shin-Yi Chou, Asymmetric Information, Ownership and Quality of Care: An Empirical Analysis of Nursing Homes, 21 *J. Health Econ.* 293, 294 (2002) (finding nonprofit nursing homes provide better care than for-profit nursing homes “when the service is not monitored”), and Maria D. Fitzpatrick, Can Prices Tell Us Anything About Whether a Firm’s Status Is a Signal to Consumers? (2006) (unpublished manuscript, on file with the Virginia Law Review Association) (replicating Philipson’s study and finding a nonprofit price advantage in one of two markets studied).

⁴¹ See Henry Hansmann, The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation, 91 *Yale L.J.* 54, 72–75 (1981); see also Timothy J. Goodspeed & Daphne A. Kenyon, The Nonprofit Sector’s Capital Constraint: Does It Provide a Rationale for the Tax Exemption Granted to Nonprofit Firms?, 21 *Pub. Fin. Q.* 415 (1993). Professors Goodspeed and Kenyon focus their argument on the corporate income tax exemption, but it can be generalized to all other exemptions. To be fair to Goodspeed and Kenyon, they do not argue for a nonprofit income tax break

What are these sources? Donations, bond issuances, loans, and retained earnings. Therefore, donations should be facilitated by a tax deduction for donations to a nonprofit. Bond issuances should be facilitated by allowing bond-holders to deduct interest payments from income. Loans should also be supported this way, but the law takes a more limited step, preventing creditors, including lenders, from pushing the nonprofit involuntarily into bankruptcy.⁴² Finally, retained earnings should be bolstered by ensuring that they will not be taxed away. This implies exemptions from corporate income, property, and sales taxes.

The main problem with the capital access theory is that its assumption that the nondistribution constraint limits access to capital is questionable. For one thing, capital is fungible and mobile. Even if a nonprofit firm cannot legally tap equity markets for capital, it can tap debt markets at rates competitive with equity markets. And in any case, few nonprofits are large enough that it is economical for them to raise capital on equity markets.⁴³

Another problem with the capital access theory is that there is a poor fit between the scope of the nondistribution constraint under the agency theory and the scope of the constraint under both existing law and the capital access theory. The purpose of the nondistribution constraint in the agency theory is to prevent the distribution of profits to any person who exercises control over a nonprofit firm. If such a person were to benefit from greater profit, she might shirk on quality to cut costs and thus increase profits. Nothing in the agency theory requires that persons who do not control the firm be barred from distributions of profit. Therefore, the agency theory is compatible with issuance of a class of shares that give rights to the firm's residual earnings but have no voting or other control rights. Only when this is not feasible, such as when the firm needs both the entrepreneur's capital and her managerial talent, does the nondistribution constraint limit access to capital. Surely

simply to level the playing field, but to promote efficiency. One efficiency benefit of the tax is to prevent bias against use of capital in the nonprofit sector. A second efficiency benefit is that if nonprofit output is a public good, a tax exemption might increase nonprofit output. We addressed the latter point in our discussion of the public good theory for nonprofits, *supra* Section II.A.

⁴² See discussion *supra* note 22.

⁴³ See Goodspeed & Kenyon, *supra* note 41, at 422 (noting that equity accounts for no more than nine percent of capital raised by for-profit corporations).

this is the rare case. Existing law, however, goes beyond the scope of the agency theory, barring the issuance of even nonvoting shares when they are feasible. Only because the actual nondistribution constraint exceeds the scope justified by the agency theory is the capital access theory required to justify some of the tax breaks for nonprofits.

Somewhat consistent with this view, the British government has adopted an alternative strategy to ease access to capital for nonprofit firms: simply relax the nondistribution constraint a bit. Specifically, the Community Interest Company (“CIC”) law establishes a new corporate form that allows a firm engaging in charitable activities (and indeed any firm that the government deems is operating for the “benefit of the community”) to issue stock and grant dividends,⁴⁴ but the implementing regulations cap those dividends at thirty-five percent of total profits.⁴⁵ Moreover, the charitable CIC is not permitted to sell its assets to a for-profit firm unless the firm receives full consideration.⁴⁶ Importantly, the charitable CIC does not receive the tax breaks that traditional British charities receive, that is, the equivalent of the tax breaks for nonprofit firms in the United States. In short, the CIC form allows community-benefit firms to raise limited capital from equity markets but discourages profit-driven shirking by limiting the extent of dividends.

A final problem with the capital access theory is that it supports tax breaks not only for nonprofit firms, but also for certain for-profit firms that take a no-profit pledge. Consider, for example, an entrepreneur who starts a firm, acts as manager, and offers donors a cost-plus contract. Suppose this firm requires start-up or expansion capital that exceeds the revenue that future donors who will benefit from this investment are willing to pay today. This firm may not be able to access capital markets because it cannot promise equity investors sufficient control rights. The capital access theory also supports extending the tax breaks for alternative capital access to this for-profit firm.

⁴⁴ Companies (Audit, Investigations and Community Enterprise) Act, 2004, c. 26 (U.K.).

⁴⁵ Community Interest Company Regulations, 2005, S.I. 2005/1788, art. 22, ¶ 1 (U.K.).

⁴⁶ This is called an “asset lock.”

C. The Altruism Theory

A third theory that might justify coupling relies on the nondistribution constraint selectively attracting charity entrepreneurs who are altruistic to the nonprofit form. Because altruists have a preference for producing public goods, tax breaks to promote public goods have a higher return when they are given to altruists. Given the sorting of altruists into nonprofit firms, the theory supports the targeting of tax breaks at nonprofit firms, that is, coupling tax breaks and the nonprofit form.

Before criticizing this theory, we should say something about its provenance. Economists who have analyzed this theory do not advocate it as a justification for coupling; they are more interested in positive questions such as whether nonprofit and for-profit firms behave differently.⁴⁷ But the positive theory has surface appeal as a normative theory. So in this Section, we convert the positive theory to a normative theory and then criticize the normative theory.

1. Altruism Without Tax Breaks

Suppose there are two types of entrepreneurs: those who care only about their income (nonaltruists), and those who also care about the quality or quantity of products they produce (altruists).⁴⁸ In the charity context, for example, the altruist would care not just about her income, but also about how many beneficiaries her charity served or how well it served those beneficiaries. In the discussion below we shall conceptualize this preference as a desire for

⁴⁷ See, e.g., Darius Lakdawalla & Tomas Philipson, *The Nonprofit Sector and Industry Performance*, 90 *J. Pub. Econ.* 1681 (2006); Joseph P. Newhouse, *Toward a Theory of Nonprofit Institutions: An Economic Model of a Hospital*, 60 *Am. Econ. Rev.* 64 (1970) (considering the effect of a private hospital's nonprofit status on its economic efficiency).

⁴⁸ Standard models of the altruism theory assume an imperfect altruism where the entrepreneur has preferences not directly for the welfare or consumption of beneficiaries, but for the entrepreneur's production of goods that beneficiaries might consume. See Lakdawalla & Philipson, *supra* note 47; Malani et al., *supra* note 29; Newhouse, *supra* note 47. This is usually modeled as entrepreneurs having preferences for the quantity or quality of production. An exception is A.G. Holtmann, *A Theory of Non-Profit Firms*, 50 *Economica* 439 (1983).

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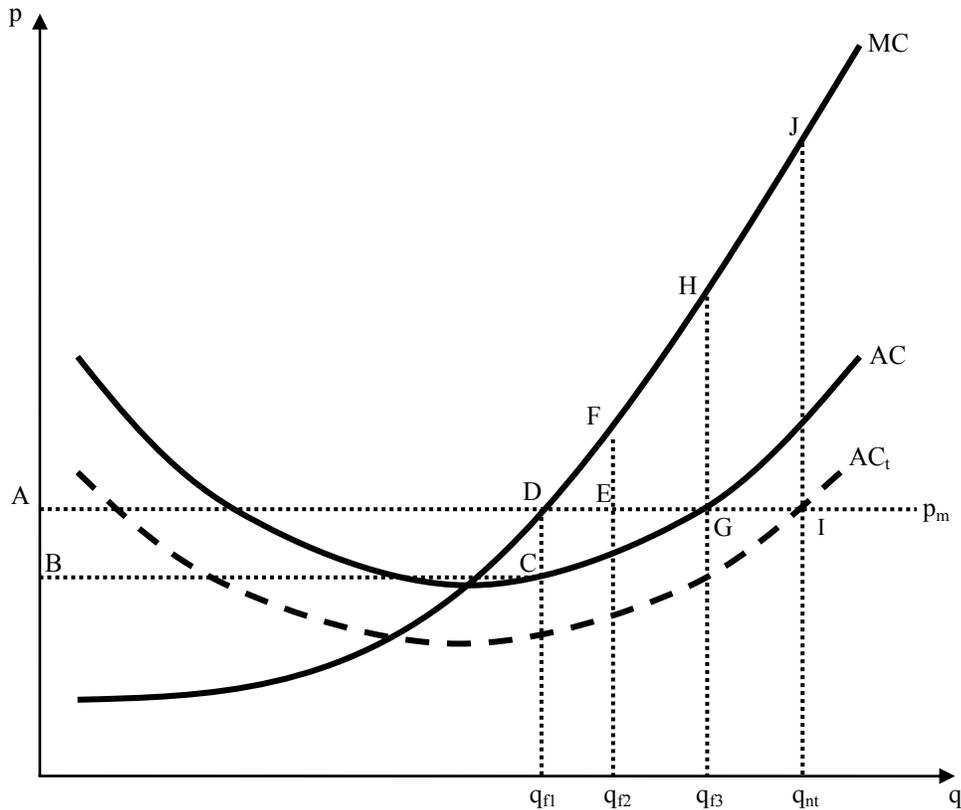
warm-glow consumption from doing good.⁴⁹ In contrast to our assumptions above for the agency theory, here we assume that quality (like quantity) is verifiable and that the entrepreneur cannot take income home as a perquisite. Since it makes no difference to our discussion whether the altruist cares about quality or quantity, to keep things simple we shall proceed assuming the entrepreneur cares mainly about quantity.

Each entrepreneur has to decide whether to form a nonprofit or for-profit firm. If an entrepreneur forms a nonprofit firm, she will receive only a fixed income. If her cost structure is such that she can make profits (revenues minus costs, including her salary) even at the competitive price for her output, she will not be able to take that profit home as income. She can, however, spend her profit on producing more output. If an entrepreneur forms a for-profit firm, she not only receives a salary, but can also take home any profit the firm makes.

Obviously, if an entrepreneur is nonaltruistic, then she will be attracted to the for-profit form. However, if the entrepreneur also cares about product quantity, the choice is a bit more subtle. The for-profit form is flexible. So if an entrepreneur cares just a little about quantity, the for-profit form will allow her to sacrifice a little profit to produce a little more quantity than the nonaltruist. If an entrepreneur cares a lot about quantity and is willing to sacrifice all her profits to produce more quantity, then she will be indifferent between the for-profit form and the nonprofit form. Both forms will allow her to convert all her profits into higher quantity output. The nonprofit form just makes it a requirement, though for a highly motivated entrepreneur, this requirement is not binding.

⁴⁹ For a discussion of imperfect altruism and warm-glow giving, see James Andreoni, *Impure Altruism and Donations to Public Goods: A Theory of Warm-Glow Giving*, 100 *Econ. J.* 464 (1990).

Figure 1. Effect of tax break on quality and costs.



An altruistic entrepreneur's choice is illustrated in Figure 1, which uses solid lines to indicate the marginal cost (MC) and average cost (AC) curves of a given entrepreneur without tax breaks.⁵⁰ The x-axis gives quantity, the y-axis price. The average cost and marginal curves are U-shaped on the uncontroversial assumptions that an entrepreneur has some fixed costs and experiences diminishing returns to scale.⁵¹ If an entrepreneur were nonaltruistic and only cared about income, she would choose the for-profit form and

⁵⁰ We assume technology is linked to the entrepreneur, which is why she is the entrepreneur rather than simply an investor or creditor.

⁵¹ These are standard assumptions in the neoclassical model of the firm, even in the case of quality rather quantity output. See, e.g., Newhouse, *supra* note 47, at 68 fig.1.

produce quantity q_{f1} given by the intersection of the marginal cost curve and the market price line p_m . (Price, in this context, refers to how much a donor is willing to pay to help the beneficiary of the charity.) This would maximize her profit, which is the average per-unit profit of p_m minus average cost at q_{f1} times quantity produced q_{f1} , or equivalently the area of the rectangle $ABCD$.

A moderately altruistic entrepreneur would also choose a for-profit firm, but produce at some quantity q_{f2} to the right of q_{f1} . Because the marginal cost of each unit of production to the right of q_{f1} is greater than the price p_m donors are willing to pay on behalf of the beneficiaries, the moderate altruist is paying out of pocket the triangle DEF to get the additional warm-glow consumption value of $q_{f2} - q_{f1}$. A highly altruistic entrepreneur, in contrast, may be willing to sacrifice a lot more income to obtain additional warm-glow consumption value. If the marginal utility of that consumption is at least as great as the marginal cost at q_{f3} , her break-even point, then she is willing to sacrifice all her income for additional warm glow. Such an entrepreneur would be indifferent between forming a for-profit firm and voluntarily sacrificing all her profits and forming a nonprofit firm that bars her from taking profits.

It is important to note that, whatever the entrepreneur's choice, it is always efficient. Although a highly altruistic entrepreneur's production at q_{f3} entails wasteful production to the extent of the triangle DGH , because that choice was voluntary and the cost is completely borne by the entrepreneur, it must be that the warm-glow value of additional production $q_{f3} - q_{f1}$ is greater than the triangle DGH .

2. Altruism with Nonprofit Tax Breaks

Now assume a tax break for nonprofit firms. The immediate effect is always to lower the cost curves of an entrepreneur choosing the nonprofit form. But the welfare effect of such a tax break depends on whether the output being produced is a public good. If it is not a public good, we shall demonstrate that the tax break generates inefficient production. If it is a public good, one can use the altruism theory to generate a normative argument in favor of nonprofit tax breaks. We shall argue, however, that even when dealing with public goods, the case for subsidizing nonprofits alone is weak. The reason is that the subsidy can crowd out for-profits that

produce the charitable good more cheaply than the nonprofits, even given the cost-absorptive effects of the warm glow.

Consider, first, the case where output is not a public good. As we mentioned, the tax break has the immediate effect of lowering the cost curves of altruists who choose the nonprofit form. Since the nonprofit firm does not permit the entrepreneur to distribute profits, she must produce output at the break-even point, that is, where price equals average cost. Therefore, we can illustrate the effect of a nonprofit tax break in Figure 1 by examining just its effect on the average cost curve of a nonprofit entrepreneur. The nonprofit tax break shifts her curve down to AC_r . This in turn expands the choices available to an altruist. She can choose the for-profit form, produce at any point between q_{fl} and $q_{f\beta}$, and perhaps earn some profits. Or she can choose the nonprofit form and produce at q_{nt} . Depending on how much value different altruists draw from warm-glow consumption, altruists who previously chose the for-profit form and produced more than q_{fl} but less than $q_{f\beta}$ before might convert to nonprofit status so that they can produce at q_{nt} . On the one hand, they lose some profit. On the other hand they get a big boost—from $q_{f\beta}$ to q_{nt} —in warm-glow consumption because of the tax break. If the warm-glow value of this increment is large enough, an altruist will switch from for-profit to nonprofit form.

Unlike the case without tax breaks, however, these “switches” are inefficient. By inefficient we mean that the excess cost of additional production at q_{nt} is not worth the warm-glow consumption it is generating. We say “excess” cost of this production because the marginal cost of production at q_{nt} is greater than the price donors are willing to pay for that production. The total excess cost is the triangle AII . The exact value of the warm-glow consumption is unknown. But we know it is less than the excess cost so long as the altruists’ utility is consistent with standard economic assumptions. Because the marginal cost of production is not decreasing, if the warm-glow consumption value at q_{nt} were greater than its excess cost, then it must also be true that the warm-glow consumption value at $q_{f\beta}$ is greater than its excess cost AGH . But that is clearly not true for altruists who, in the absence of the tax break, would have chosen to produce any quantity less than $q_{f\beta}$. In other words, an altruist who switches from producing less than break-even output before a tax break to nonprofit status after the tax break does

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not experience enough additional warm-glow consumption to justify the additional cost of that consumption.⁵²

3. *With Public Goods*

What if the output being produced is a public good? Then the additional production of quantity by the nonprofit altruist may be efficient. One way to state this is that the tax break modifies an altruistic entrepreneur's costs so that they are more in line with the social value of a good. Another way to state it is that the price that donors pay for additional quantity plus the warm-glow consumption value from the additional quantity do not capture the full public good value of that output. Once that public good value is accounted for, the additional quantity would be worth the costs.

While this argument may justify offering a tax break to nonprofits, it cannot be used to justify coupling because the same argument also justifies offering tax breaks to for-profits that produce a public good. Consider a nonaltruist who runs a for-profit firm that maintains a park with fees it charges visitors and donations by local residents. Because of the collective action problem among local residents, there are insufficient donations to maintain the park at the pristine level that residents would prefer. The firm will "under-produce" the park relative to what it would produce if, for instance, it could tax local residents to cover the costs of a better park. The government can solve this problem by providing tax subsidies to the firm on the logic that a nicer park would benefit local residents and be cost justified. These subsidies would encourage more donations and make existing fees and donations go further in promoting the park. Importantly, the fact that the manager of the park-maintenance firm is nonaltruistic does not undermine the logic of this argument for for-profit tax benefits.

So how might the altruism theory justify coupling if tax breaks for public goods are efficient when given to either nonprofits or

⁵² As for altruists who were producing at the break-even point before the tax break, they may or may not value the additional consumption after the tax break more than the additional cost of that consumption. If these altruists were independently wealthy and would have used that wealth to consume some output q_w to the right of q_m , then the tax break would be net beneficial. If even independently wealthy altruists would have consumed less than q_m , then the incremental consumption from q_w to q_m would be inefficient.

for-profits? The answer relies partly on the observation that, because nonprofits attract altruists and altruists obtain additional warm-glow value from producing public goods, tax breaks targeted at nonprofits go further than those targeted at for-profits. It also relies on the assumption that the government may have a limited budget for tax breaks. To understand the argument, compare two entrepreneurs who have identical production technology, that is, who can produce identical products at identical cost. Assume that one entrepreneur is altruistic and chooses nonprofit status, and the other is nonaltruistic and chooses for-profit status. Whereas the for-profit nonaltruist will spend a part of each dollar tax break on the costs of additional production and convert the rest into profits, the nonprofit altruist will spend the whole dollar on additional production. It is true that decoupling would give both the for-profit and the nonprofit a tax break. Moreover, some altruists would choose the for-profit form under decoupling, and these for-profit altruists would take home less profit per dollar of tax break than nonaltruists. But if we assume the government has a limited budget to support the production of additional quantity, because the return to subsidizing nonprofit production will be greater than the return to subsidizing for-profit production, the government should target tax breaks at nonprofits.

The main weakness of a strictly nonprofit tax break is that different entrepreneurs may not have identical production technology. Some may be more efficient than others and therefore have lower cost functions than others. Moreover, there may not be that many altruistic producers in the market. We can make the point with a simple example. Suppose that donors would like to subsidize soup kitchens. There are many altruistic entrepreneurs who can run soup kitchens, but not enough to feed all of the poor. Although many of the altruists might be quite efficient at keeping down costs, others might be less capable. They care about the poor but they do not know much about buying food in bulk, storing it properly, and finding cheap but convenient locations. Although their altruism will cause them to work hard, their cost is likely to be higher than that of nonaltruists who are more skilled at controlling costs. At some point, aggregate demand for the soup kitchen will reach such a level that donors exhaust the capacity of efficient altruists. But because of coupling, donors will donate to an altruist who runs

a high-cost nonprofit soup kitchen rather than a nonaltruist who runs a lower cost for-profit that is willing to provide food to poor people for free in return for donations from donors.

The technical way of putting this point is that, even assuming that there is no correlation between altruism and cost of production and that all altruists choose the nonprofit form, it is possible that at higher levels of output, because the number of altruists is limited, the *aggregate* supply curve of subsidized nonprofit altruists rises above the *aggregate* supply curve of subsidized nonaltruists. This implies that at higher levels of aggregate demand a nonprofit tax break may be a more costly method of generating additional output than a universal tax break.

We can summarize our discussion of the altruism theory as follows. If output is a public good, the goal of the government is to promote production. For any given level of output, the government ought to enable donors to purchase from the least-cost suppliers. To do otherwise would be to transfer surplus from donors to producers. Even in the case of altruistic producers, that is not a stated goal of the government. Moreover, coupling may entail what economists call deadweight loss because, on the margin, there may be donors who value quantity greater than the social cost of its production, but who do not purchase it because the marginal for-profit producer's private costs are higher than the true social cost of that production.

To elaborate on the least-cost supplier point, although the altruism theory may justify a tax break to a nonprofit producer when costs are held constant, it does not unambiguously justify denying tax breaks to for-profits in the more realistic case that costs are not constant. In the latter case, the relevant considerations are the distribution of costs among altruists and nonaltruists, the relative prevalence of altruists and nonaltruists, and the level of aggregate demand given decoupling. A negative correlation between costs and altruism, a relative abundance of altruists, and a small aggregate demand all lessen the likelihood that harm would result from coupling. But we neither believe that these assumptions are correct nor that they can be verified. We see no reason why altruists would have better technology and thus lower costs than for-profits. Although altruists get warm-glow value from lower costs, nonaltruists get direct income from lower costs. Nor do we know how it could

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be verified that there are sufficient altruists that their competitive advantage from average cost pricing would not be outstripped by aggregate demand.

D. A Theory of Imperfect Consumers

Each of the previous theories assumed that the donor is a well-informed and rational individual. Under the public goods theory, she provides the government with good information on the public goods she values. Under the agency theory, she rationally chooses to donate to a firm complying with the nondistribution constraint because that constraint protects her from shirking. And under the altruism theory, the donor smartly plays along when the government seeks to allocate funding to altruists on the theory that they are lower priced producers of public goods.

Yet donors may make mistakes. This could be a product of limitations on the cognitive ability or capacity of donors. Or it may be the result of deception by charities. When this happens, one may be able to justify the nondistribution constraint as a consumer protection device.

Suppose donors are prone to choosing poorly and are thus insensitive to administrative costs when selecting among charities. Since administrative costs, broadly defined, include distributions, this implies that, all other things being equal, charities which may distribute profits have higher administrative costs than charities which may not. Yet imperfect donors may still patronize charities which may distribute profits. The result is that donors do not get the most public good bang for their buck.

The same problem arises when consumers care about administrative costs but can be deceived by charities. In this case, charities that are allowed to distribute profits may have greater incentive to deceive donors than charities that are not so allowed. This view sounds like the agency theory, but a critical distinction is that the consumer in the agency theory would be savvy enough to select the firm that complies with the nondistribution constraint. Under the theory of imperfect consumers, the donor cannot protect herself from deception by seeking out safe organizational forms. It is for this reason that the government might restrict her choices.

So far, however, the theory is just another justification for the nondistribution constraint. To understand coupling, we need to

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consider the government's tax break for nonprofits. Because the tax break is keyed to the donor's personal allocation to charities, it effectively delegates power over government expenditure to the donor. For the same reason that the donor is a poor decisionmaker for her own allocations, she is a poor agent to control the government's expenditures. This is why the tax breaks must be restricted to firms that cannot distribute profits. It is a way to protect the government from imperfect donors.

We are not persuaded by this argument. For one thing, there are numerous federal and state laws to protect consumers against fraud. We see no need to supplement these with restrictions on the ability of charities to distribute profits. Indeed, unless one felt that donors are more susceptible to fraud by charities than consumers are to fraud by the ordinary firm, such as an automobile repair shop or a drug manufacturer, one would not limit the nondistribution constraint to charities but extend it to all firms. But the idea of requiring all firms to cease distributing profits is out of the question. It would be hard to imagine how a market economy would operate with such a limit.

Even if there were reasons to be uniquely concerned about deception by charities or if one were concerned not about deception, which is the grist for consumer protection laws, but about donors' indifference to administrative costs, there is a simpler solution. The government should not delegate the allocation of its expenditures to donors. This does not imply that it ought not fund charities, but that it should not construct the tax break to "match" donors' contributions. For example, it should not make donations a deductible expense for donors, a direct form of matching private dollars with public dollars. And perhaps it should give tax credits for charitable expenditures (other than fundraising) rather than give a tax exemption from corporate income taxes because the latter indirectly rewards fundraising while the former does not. Even more simply, the government can purchase public goods through ordinary procedures for government procurement, which include competitive bidding. This proposal is consistent with decoupling. The government would no longer need to require that charities comply with the nondistribution constraint to obtain tax benefits, which would be untethered from donations, or to bid on government contracts for production of public goods.

An objection based on the public goods theory might be that the government does not know which public goods the public values. Therefore, it must delegate expenditures to donors because donations give signals about the public's need. But the idea that donors have private information about what the public needs is in some tension with the idea that they are insensitive to administrative costs. Do donors care or do they not? Even if one were to accept this tension, there is a reform that is both better and simpler than the coupling of the nondistribution constraint with tax benefits. That reform would ask people to select, say, on their income tax form, an activity—rather than the organization—they would like to fund and a dollar amount they would like to fund that activity. Then the government would accumulate these dollars and choose an organization to receive such dollars. (Individuals would remain free to donate directly to an organization, but they would only receive a tax deduction for donations to activities, not to organizations.) This procedure would elicit private information about values of public goods, without coupling them to ill-chosen organizations.

E. Administration of Section 501(c)(3)

A final theory that may justify coupling focuses on the problem of policing the boundary between Section 501(c)(3) and other activities. Section 501(c)(3) broadly identifies the types of organizations, such as those operating for “charitable purposes,” that are eligible for certain tax breaks (if they also comply with the nondistribution constraint). The provision delegates to the IRS and the courts the task of fleshing out what specific activities have charitable purposes. This is a challenging task because the IRS has given the term charitable an interpretation that is broader than simply funneling money from a donor to a poor or sick person. It may include providing job placement services for the beneficiary, or it may involve selling healthcare to the beneficiary, and perhaps even the donor, at a discounted price. This expansion, which may be justified by the objective of broadly supporting the production of public goods, has increased pressure on the IRS to decide which specific activities have charitable purposes. It is already plagued with

questions about why pharmacies or fitness centers do not qualify though hospitals do.⁵³

One thing that arguably makes the problem manageable is that there are limited private returns to qualifying for Section 501(c)(3) tax breaks because these breaks only extend to firms that eschew the distribution of profits. If this condition were relaxed, the IRS might get thousands more applications from for-profit firms seeking Section 501(c)(3) tax breaks. This is not just a quantity effect. For-profit firms have a profit incentive to stretch the definition of “charitable” to encompass their activities even when they are probably not charitable. For example, Toyota might seek the exemption for its sale of a hybrid car, or Pfizer might seek the exemption because its researchers carry on some basic scientific research. This would swamp the IRS and drain government coffers of money for public goods that are better or at least more dependent on government funding. From this perspective, the nondistribution constraint could be analogized to a cap on attorney fees to discourage baseless litigation.⁵⁴

Yet it appears to us that there is a more direct solution to the problem of abusive applications than the nondistribution constraint: charge an application fee. If an organization, whether nonprofit or for-profit, seeks Section 501(c)(3) status and its application cannot be approved with a cursory review, then charge a fee for the review. Alternatively, require an organization to pay the IRS’s legal fees if it challenges the IRS’s denial of Section 501(c)(3) status. This will discourage abusive applicants but allow nonabusive for-profit applicants who engage in the same activities as current nonprofit charities. This solution makes more sense because while distribution of profits may predict abuse, it is neither a necessary nor sufficient condition for abusive applications. A better correlate of abuse is an actual IRS decision about the organization’s activities. If the IRS charges applicants the cost of its review, then

⁵³ See, e.g., *Fed. Pharmacy Serv. v. Comm’r*, 625 F.2d 804 (8th Cir. 1980) (denying nonprofit pharmacy § 501(c)(3) nonprofit status and tax exemption because sale of prescription drugs is “presumptively commercial”); *Sioux Valley Hosp. Ass’n v. S.D. State Bd. of Equalization*, 513 N.W.2d 562 (S.D. 1994) (denying hospital-run fitness center that sold memberships § 501(c)(3) nonprofit status).

⁵⁴ Professor David Schizer raises this objection in *The Charitable Deduction and the Private Pursuit of Public Goals* 38–39 (July 30, 2007) (unpublished manuscript, on file with the Virginia Law Review Association).

it should be indifferent to even abusive applications because it does not bear the cost of that review.

Another alternative is for Congress to amend Section 501(c)(3) to flesh out the definition of “charitable” activities or for the IRS to issue ex ante regulations spelling out exclusively which activities qualify as charitable activities and which do not. This would signal to potentially abusive applicants that there is little return to applying for an exemption. After all, the reason Section 501(c)(3) is an attractive nuisance is that it is ambiguous. The most direct remedy for an attractive nuisance is to clean up the nuisance, not to punish those attracted by it.

F. Inefficiencies Resulting from Coupling

If we are correct that no good theory explains the coupling of tax subsidies for community-benefit activities and the nonprofit form, then it follows that current law generates inefficiencies. We briefly survey here the two main sources of inefficiency.

First, coupling encourages inefficient production by rewarding nonaltruistic entrepreneurs who take nonprofit status. Suppose there are three types of entrepreneurs: altruists, efficient nonaltruists, and inefficient nonaltruists. Among the last two, assume that the efficient nonaltruist and the inefficient nonaltruist are identical in all respects except that the inefficient nonaltruist has higher production costs. Finally, assume that the quality of the product is verifiable. The efficient nonaltruist will choose the for-profit form so that she can receive the full return on her investment; she does not need to use the nonprofit form because there is no need to assure the consumer of the quality of a product when quality is verifiable. The inefficient nonaltruist, however, has an incentive to choose the nonprofit form purely because of its tax advantage. Without the tax advantage, the inefficient nonaltruist would not be able to survive in a competitive marketplace. With that advantage, she can not only survive but thereby earn a competitive salary.⁵⁵

⁵⁵ If the nonprofit entrepreneur can also extract profits by drawing perquisites in addition to a competitive salary, then even some marginally efficient but nonaltruistic entrepreneurs will be drawn to the nonprofit form. The reason is that they will be able to supplement their competitive income with perquisites subsidized by nonprofit tax breaks.

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But because the inefficient nonaltruist has higher-than-competitive costs without the tax advantage, the tax advantage simply subsidizes inefficient production.

Second, current nonprofit law discourages talented altruists from establishing charitable enterprises, causing them at the margin to throw in their lot with commercial firms. To see why, recall that the entrepreneur in the original model is both altruistic and self-interested in the sense that she cares about income. Imagine that a particular entrepreneur also is highly talented. In a world in which successful charitable organizations need donors, and donors can receive tax deductions only by donating to qualified nonprofit organizations, the highly talented and altruistic entrepreneur can operate a charitable organization only if she is willing to take a large pay cut relative to what she could receive in the commercial sector. The reason for this is that the IRS enforces the nondistribution constraint by insisting that the entrepreneur receive no more than would a comparable employee in the commercial sector. But a highly talented entrepreneur would have difficulty proving that her market compensation is higher than that of comparable employees in the commercial sector. This may explain why many entrepreneurs devote their early life to amassing wealth in commerce and then start foundations only after they retire. It would be better if these entrepreneurs could amass wealth early in life while helping others by establishing successful for-profit charitable institutions.

An underlying theme of this Essay is that nonprofit firms are less efficient than for-profit firms and that if the law permitted for-profit firms to compete in charitable markets, charitable activity would become more efficient. A natural response to this line of reasoning is the efficiency gains from competition with for-profits can be achieved simply with competition among nonprofits. The logic is that competition for donations already encourages nonprofits to reduce administrative expenses and that further competition from for-profits will yield few additional cost savings. While we favor competition among nonprofits, we do not think it will achieve all the benefits that competition with for-profits can provide.

First, competition for donations among nonprofits only operates as a serious incentive for cost-control in the range of insolvency. Only when costs are so high that a nonprofit charity is about to be dissolved is the manager's job truly threatened. Only then must she

act to improve the performance of the organization. Another way to put this is that there may not be sufficient competition among nonprofits to achieve the gains that further competition from for-profits might encourage. Second, if the objection is correct, it must be that nonprofits are very efficient. Yet the study by former Senator Bradley and consultants from McKinsey & Company suggest otherwise. They find that the nonprofit sector wastes \$100 billion of value annually.⁵⁶ This confirms our intuition that it is generally difficult to prove the claim that more competition is worse, whether or not that competition comes from for-profit firms. Finally, competition among nonprofits only reduces administrative costs, holding talent fixed. The second inefficiency we attribute to coupling—discouraging talented altruists from starting charities—cannot be addressed by competition among nonprofits because, regardless of the level of competition, nonprofits cannot offer wages that compete with for-profit firms in noncharitable sectors. The only way to improve talent in the sector, and to obtain the associated improvements in efficiency, is to offer for-profit wages.

III. DOES EXISTING LAW ALREADY PERMIT DECOUPLING?

One objection to our argument is that entrepreneurs who want to create for-profit charities that will benefit from tax subsidies can do so under current law by engaging in sophisticated legal manipulation. If this objection is correct, then it is not necessary to change the law. In addition, if this objection is correct, it may suggest that the rarity of for-profit charities shows that for-profit charities actually are not viable—they have hidden inefficiencies or offend potential donors. However, we do not believe that this objection is correct.

Suppose that an entrepreneur wants to establish a charity that helps sick children in Africa and also knows that her own incentives will be optimal if the charity is for-profit rather than nonprofit. To see how this might work, recall the example of a nonprofit museum that has a for-profit subsidiary that arranges to lease out its gallery space for corporate parties. Donors to the museum receive tax benefits even though the private event subsidiary makes profits. The reason is that all of that subsidiary's profits

⁵⁶ Bradley et al., *supra* note 8.

must be used by the museum for charitable ends and cannot be distributed to the people who control the museum's activities.

Now return to the charitable entrepreneur who believes that the for-profit form would be most efficient for her charitable firm. Can't she simply set up a nonprofit shell, which wholly owns the for-profit core, which would then have optimal incentives to distribute the charity? Imagine that the for-profit subsidiary receives the donations collected by the nonprofit shell, distributes the donations to the beneficiaries, and obtains "profits" equal to the difference between the fraction of the donor's dollar that are, by contract, assigned to overhead expenses and the fraction actually used for overhead expenses. For example, the "donation contract" provides that eighty cents on the dollar will reach beneficiaries, and be confirmed by an independent audit, and that the for-profit core will be allowed to keep any portion of the twenty-cent balance that is not necessary for expenses.

The defect in this solution is easily seen. Because the nonprofit shell cannot distribute the profits from the for-profit core to its managers, the manager of the nonprofit shell does not have proper incentives to select efficient managers for the for-profit core or to monitor these managers to ensure that they do not shirk. Moreover, if the for-profit core is really doing all the work within the nonprofit shell, the IRS is likely to call the shell a sham and withdraw the shell's tax benefits.

But why then does the museum choose the for-profit form for its private event subsidiary? Perhaps the purpose is to improve the incentives of the subsidiary's manager, though that subsidiary is so small that it is unlikely to use much incentive pay. The more likely reason is that, because of the unrelated business income tax, the nonprofit museum is taxed just as a for-profit museum would be on the profits from its private event activities. Organizing the subsidiary as a for-profit entity simplifies the accounting for purposes of calculating the tax.

IV. COMMUNITY-BENEFIT ENTERPRISES, CORPORATE
RESPONSIBILITY, AND MIXED CHARITIES

A. Community-Benefit Enterprises

In our discussion so far, we have relied on a simplified depiction of the law and of nonprofits in order to keep the exposition as clear as possible. In doing so, we have neglected an important class of nonprofits, and here we address it.

We have generally assumed a firm with three actors: an entrepreneur, a donor, and a beneficiary. In fact, many nonprofits involve just two actors: an entrepreneur and a consumer. Consider, for example, a nonprofit hospital. The patient is the consumer, and the owner of the hospital is the entrepreneur. There is no beneficiary. Museums and schools have a similar structure. Although people can and do make donations to these institutions, donations play a relatively small role in financing their operations. (Universities are a special case. They rely heavily on both the consumer—the student who pays tuition—and the donor—usually an alumnus.)

All of these institutions are entitled to nonprofit status under both state and federal law, though the precise boundaries on the activities of nonprofits may vary across state and federal law.⁵⁷ All of these institutions are eligible for both state and federal tax breaks, though firms such as hospitals and museums that do not attract many donations obtain little benefit from the tax deduction for charitable contributions. Although our discussion thus far has focused on the three-actor firm, the force of our argument extends to the two-actor firm as well.

To help us state this point more precisely, Table 3 provides a simply typology of the activities of firms, the organization of firms, and the tax treatment of firms. There are three dimensions along which to describe firms. One is nonprofit status. The defining feature of all nonprofit firms is that they are barred from dis-

⁵⁷ For example, compare Ind. Code Ann. § 23-17-21-2 (1999) (allowing nonprofit corporations to “make distributions to and confer benefits on a member or an affiliate that is a governmental entity . . . or a member or affiliate that is another nonprofit” in some circumstances), with Mont. Code Ann. §§ 35-2-1401 to -1402 (2005) (prohibiting all distributions except for certain membership repurchases). These can be contrasted with § 501(c)(3) of federal tax code, which limits tax breaks to nonprofit firms that engage in, for example, “religious, charitable, scientific, . . . literary, or educational” activities.

tributing profits to owners, employees, or otherwise affiliated persons. For-profit firms have no such limit (though they can contract to forgo profits). A second dimension along which to describe firms is whether they engage in “community-benefit” (or “public-benefit”) activities.⁵⁸ The unifying feature of community-benefit activities (row A) is that, as the name suggests, they are thought to benefit the community and not just the person paying for the activity. The distinction is relevant to our discussion because only nonprofits that engage in community-benefit activities are eligible for state and federal tax breaks (row E). The third dimension along which to describe firms is whether they involve three actors or two actors. In theory, both three-actor and two-actor firms can engage in community-benefit activities. In practice, however, three-actor firms—firms with a separate donor and beneficiary as opposed to a single consumer—are found only engaging in community-benefit activities. In our discussions to this point, we have called the three-actor firm a “charity”⁵⁹ (row C). For contrast, Table 3 labels two-actor firms “commercial” firms.⁶⁰ To summarize, firms may engage in two categories of activities, community-benefit or not. Among community-benefit organizations there are two types of firm, charitable (column 1) and commercial firms (column 2). Among noncommunity-benefit firms, there are only commercial firms (column 3).

⁵⁸ “Community-benefit” and “public-benefit” are terms used occasionally in state statutes and not at all in § 501(c)(3). However, these are terms used frequently in judicial opinions on both state and federal law. Moreover, when these terms are used, they are thought to correspond quite closely to the precise list of activities in state codes and § 501(c)(3) that are eligible for favorable tax treatment. See, e.g., *Bob Jones Univ. v. United States*, 461 U.S. 574, 591–92 (1983); *IHC Health Plans v. Comm’r*, 325 F.3d 1188, 1194 n.9, 1197–98 (10th Cir. 2003); *McCoy v. E. Tex. Med. Ctr. Reg’l Healthcare Sys.*, 388 F. Supp. 2d 760, 769 (E.D. Tex. 2005); *Amato v. UPMC*, 371 F. Supp. 2d 752, 757 (W.D. Pa. 2005); *Mingledorff v. Vaughan Reg’l Med. Ctr.*, 682 So. 2d 415, 418 (Ala. 1996); see also Rev. Rul. 69-545, 1969-2 C.B. 117 (especially “Situation 2”).

⁵⁹ Other scholars have called these firms “donative” firms. See, e.g., Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. Pa. L. Rev. 497, 502 (1981).

⁶⁰ This is consistent with Hansmann’s usage. See *id.*

Table 3. Distinguishing features of nonprofit firms.

	(1)	(2)	(3)
A) Community-benefit activity?	Community benefit	Community benefit	Not community benefit
B) Public good?	Yes	Generally, yes	Generally, no
C) Charitable or commercial?	Charitable	Commercial	Commercial
D) Donors and donations?	Yes	Generally, no	No
E) Examples	Churches, soup kitchens, medical charities, United Way, Red Cross	Healthcare facilities, childcare facilities, schools	Retail sales, car manufacturing, pharmaceuticals
F) Nonprofit presence?	Yes	Yes	Incidental
G) Tax breaks for nonprofits?	Yes	Yes	Limited (UBIT)
H) For-profit presence?	Rare	Generally, yes	Yes
I) Tax break for for-profits?	No	No	No

The critical observation motivating this Essay is that, aside from the recent entry of Google, there are no important for-profit firms that operate charities (see row H).⁶¹ We believe that this is the result of the discriminatory tax treatment of for-profit firms. More precisely, although nonprofit firms that engage in community-benefit activities are eligible for certain tax breaks, for-profit firms that engage in even the core of community-benefit activities—charity—are not eligible for these tax breaks (see row I). Our contention is not merely that this discriminatory treatment explains the dearth of for-profit charities, but that it reduces social welfare by increasing the overall cost of charitable activities.

⁶¹ For-profit firms may make charitable contributions, but hardly any primarily channel third-party donations to beneficiaries. For example, the investment firms Fidelity and Merrill Lynch have donor services that link individual donors to nonprofit charitable foundations and take a share of the finder's fee. But they do not directly conduct charitable activities. See Jill Lerner, *Merrill Makes Debut in Charitable Fund Niche*, *Boston Bus. J.*, May 30, 2003, available at <http://boston.bizjournals.com/boston/stories/2003/06/02/story4.html>.

Until now, the discussion in this Essay has focused on column 1 and charities. Because the logic of our arguments does not depend on whether a firm is a charity, our normative claim applies with equal force to column 2—commercial firms that engage in community-benefit activities. In other words, the tax treatment of community-benefit activities by commercial firms should not depend on whether they are nonprofit or for-profit. To the extent that “community-benefit” is a synonym for “public good” (row B), we can even go beyond mere nondiscrimination and assert that for-profit commercial firms engaging in community-benefit activities deserve the same tax breaks reserved for nonprofit commercial firms engaging in such activities. Accordingly, for-profit hospitals and schools deserve the same tax breaks as nonprofit hospitals and schools. Indeed, because there is greater competition between commercial nonprofit and for-profit firms engaging in community-benefit activities, the elimination of discriminatory tax treatment may have a larger effect for these firms than for charities. The reason is either that consumers place sufficient value on contractible quality and efficiency or that aggregate demand outstrips the capacity of efficient altruists.

Table 3 also highlights an enlightening correspondence between our claim and the rationale behind the unrelated business income tax (“UBIT”). As row F indicates, nonprofits generally do not compete directly with for-profits outside of community-benefit markets. There is some competition, as when a nonprofit museum has a division that leases out its gallery space for private parties or a university leases its athletic stadium to a local professional sports team. But those activities are limited in part because the UBIT limits the nonprofit tax exemption to non-community-benefit activities that are “substantially related” to the nonprofit’s purpose.⁶² The purpose of the UBIT was substantially to eliminate tax discrimination against for-profits competing against nonprofits in non-community-benefit markets. That is, the purpose was to align the

⁶² See Evelyn Brody, *Business Activities of Nonprofit Organizations: Legal Boundary Problems*, in *Nonprofits and Business: A New World of Innovation and Adaptation* (C. Eugene Steuerle and Joseph Cordes eds., forthcoming 2007) (manuscript at 1–2, on file with the Virginia Law Review Association). Examples of qualifying and thus exempt activities are the nonprofit museum’s gift shop or the nonprofit university’s bookstore.

two shaded cells in column 3. For comparison, this Essay makes an argument for aligning the analogously shaded cells in columns 1 and 2.

B. Corporate Responsibility and Mixed Charities

Our conclusions have larger significance for the increasingly important phenomenon of “corporate responsibility.” Corporate responsibility refers to the practice of many corporations of donating money or services to a charitable cause or refraining from profitable activities that offend moral sensibilities. Firms in the first category include McDonald’s, which provides in-kind grants to Ronald McDonald House, an independent charity,⁶³ and the many firms that donated money and services to victims of the Katrina hurricane disaster.⁶⁴ Firms in the second category include Nike and other clothing manufacturers, which avoid purchasing supplies from sweatshops in foreign countries even though those sweatshops comply with local law; Time Warner and many other companies that support the arts; PricewaterhouseCoopers and other firms that refuse to do business with repressive regimes such as the government of Myanmar; and Starbucks, Whole Foods, and other retailers that purchase supplies from farmers who use ecologically benign production methods or who are poor.⁶⁵ We will call the second category of firms “mixed charities.” This category is our present focus. We argue that just as “pure” for-profit charitable firms

⁶³ See Ronald McDonald House Charities, About Us, <http://www.rmhc.org/rmhc/index/about.html> (last visited Aug. 27, 2007).

⁶⁴ See CNNMoney.com, Companies Pitch In, Sept. 15, 2005, http://money.cnn.com/2005/08/31/news/fortune500/firms_hurricane/ (listing dozens of firms that gave millions of dollars in charity, both in cash and in kind, for hurricane relief aid).

⁶⁵ These firms and many others have web pages devoted to corporate responsibility. See, e.g., McDonald’s Corporation, Our Values, <http://www.mcdonalds.com/corp/values.html> (last visited Aug. 24, 2007); Nikebiz, Responsibility, <http://www.nike.com/nikebiz/nikebiz.jhtml?page=29> (last visited Aug. 24, 2007); PricewaterhouseCoopers, Corporate Citizenship, <http://www.pwc.com/extweb/newcoatwork.nsf/docid/1AB4D9C5A057936B80256C2A003C26DD> (last visited Aug. 24, 2007); Starbucks, Corporate Social Responsibility, <http://www.starbucks.com/aboutus/csr.asp> (last visited Aug. 24, 2007); Time Warner, Active Corporate Citizens in a Global Community, <http://www.timewarner.com/corp/citizenship/index.html> (last visited Aug. 24, 2007); The Walt Disney Company, Corporate Responsibility, http://corporate.disney.go.com/corporate/corporate_responsibility.html (last visited Aug. 24, 2007).

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should receive the Section 501(c)(3) tax benefits, so should for-profit mixed charities, to the extent of their charitable activity.

The argument is based on the assumption that some commercial and charitable operations are likely to benefit from economies of scope—they can be provided more cheaply by the same firm than by separate firms. Suppose that many people believe that poor third-world coffee farmers should receive aid. Currently, a donor can help these farmers by contributing to a pure nonprofit charity, which would then give cash or in-kind help to the farmers. In addition, a donor can help these farmers by purchasing their products from Starbucks and other stores even though the quality-adjusted price of their coffee beans is higher than the price of comparable beans produced by large commercial operations. However, because Starbucks is a for-profit firm, the purchaser of the beans cannot take a tax deduction for the portion of the price that is attributable to the donation (as opposed to the portion that is attributable to the consumption value of the good). This creates a distortion: people will prefer to donate to the pure charity in order to obtain the tax benefit when there is no reason to think that the pure charity produces a greater social benefit than Starbucks. Indeed, to the extent that Starbucks can exploit economies of scope from combining its charitable projects and its commercial coffee bean purchasing operations, the tax subsidy pushes donations from the more efficient charity to the less efficient charity. In sum, if economies of scope are substantial, as they surely are in some cases, then coupling tax breaks and nonprofit status interferes with the efficient production of charitable goods.

There are two main objections to this argument. First, allowing commercial firms to offer tax advantages to consumers whose dollars partially fund charitable activities might seem administratively complex. Starbucks would need to give customers a receipt that distinguishes the charitable and commercial components of the price. If a bag of fair trade coffee beans costs \$10 and comparable nonfair beans cost \$9, then the receipt should show a \$1 donation. The customer could use the receipt as evidence for deductions claimed on her tax return. (Starbucks could also keep track of this information and send customers annual statements.) Meanwhile, Starbucks would need to prove to the IRS that the customer's beans were purchased from a qualified entity. This would also re-

quire extensive recordkeeping. We are agnostic as to whether the benefits justify these administrative costs; however, we should point out that this type of recordkeeping is quite common in related contexts. For example, charities frequently invite donors to dinner receptions, charge them \$ W , and then provide a receipt that shows that some portion of the \$ W price was used to pay for a service (the dinner) and is thus not tax deductible. Given this reality, the administrative costs of our scheme are not likely to be excessive.

Second, many people argue that firms like Starbucks do not engage in “real” charity; their apparently charitable activity is simply a cynical marketing gimmick. Indeed, managers of firms have a duty to maximize the profits of shareholders, and if they really meant to give away the firm’s money, they could be sued. Therefore, it cannot be the case that managers are acting altruistically, and if they are not, then firms should not obtain additional tax benefits.

This argument, however, is seriously mistaken. What matters is not the firms’ motive but the effect of their behavior. To understand why, imagine that Starbucks can increase its profits by exactly the same amount in two ways. First, it can invest in expensive billboards that will bring more customers to its stores. Second, it can provide donations to fair-trade farmers while publicizing this activity, which will bring the same number of customers to its stores as the billboards. Each investment costs \$ X , while bringing in an additional Y customers, who generate increased profits of \$ Z each, where $Y \times \$Z > \X .

Assuming that people generally care about the well-being of farmers, while being indifferent to the existence of billboards, it makes sense to subsidize Starbucks’s fair-trade campaign while not subsidizing the billboard campaign. It does not matter whether Starbucks (or its managers or shareholders) acts from altruistic or selfish motives; what matters is that the resulting activity produces social benefits. This, of course, is a general point, one that applies to all firms that engage in socially desirable behavior.

CONCLUSION: A PROPOSAL

Existing theories of nonprofit status are not persuasive justifications for coupling the nonprofit form and tax breaks for commu-

nity-benefit activities. The government should not condition such breaks on taking the nonprofit form, that is, complying with the nondistribution constraint. Exclusively subsidizing this form distorts entrepreneurs' incentives and encourages inefficient production. We do not take a position on whether governments should subsidize community-benefit activities undertaken by firms; rather our point is that *if* government subsidizes such activities, then the subsidies should be available to for-profit as well as nonprofit firms. This is the case for for-profit charities, and indeed more generally for nondiscrimination against all community-benefit activities by for-profits.

If this reform is too bold to be embraced by policymakers or scholars, we propose a more modest reform that accomplishes some of the goals of decoupling. Currently, the IRS does not permit managers who exercise control over a nonprofit to receive incentive pay keyed to the profits, to the revenues, or perhaps even to the costs of operating the organization.⁶⁶ If the IRS relaxed this restriction, then it could allow nonprofit organizations to give managers with control an incentive to be more efficient. So long as the IRS does not entirely do away with the restriction—permitting sharing of only a fixed fraction of profits—or allows distributions to those in control but does not allow distributions to shareholders, this reform is not tantamount to full decoupling. Rather, it allows nonprofits to use some of the incentives that for-profit firms are permitted to use. In short, if one is uncomfortable with giving for-profits access to nonprofits' tax breaks, a compromise may be to allow nonprofits to access for-profits' incentives.

To those who remain skeptical, we note that there is an important and growing area where the law already permits decoupling: socially responsible investing. Today there are numerous financial funds that invest only in socially responsible companies. Invest-

⁶⁶ Workers that do not exercise control over the organization, such as development officers at universities and, more recently, certain doctors in hospitals, may obtain incentive pay keyed to how much funds they raise or how well they control health care costs. See, e.g., I.R.S. Priv. Ltr. Rul. 200601030 (Oct. 12, 2005); John R. Washlick & John A. Knapp, Hospital/Physician Gainsharing Arrangements: Dead or Alive? (Mar. 1, 2000), http://www.morganlewis.com/pubs/E3554EA7-2713-4143-AF6F68C7010392B0_Publication.pdf.

ment in these funds has increased ten-fold in the last ten years⁶⁷ and now accounts for over ten percent of all assets under management.⁶⁸ The benefit of investing in these funds is that they promote socially worthy causes. The cost is that these funds often earn a lower rate of return than funds that have no restrictions on the targets of their investment. An alternative to investing in these funds is to invest in an unrestricted fund and donate part of one's gains to charities. The latter yields a tax deduction for the donor and a tax exemption for the charity so long as it is nonprofit. But socially responsible investing yields the exact same tax benefits even if the firm running the socially responsible fund is for-profit. The reason is that the socially responsible fund's contribution to social causes is equal to the reduction in its rate of return. The reduction lowers the investor's gains, which is equivalent to a tax deduction because it directly lowers her income. It also lowers the profits of the firm operating the fund, which is equivalent to a tax exemption for that firm. No one, at present, seems to worry that managers of socially responsible funds are driven by their profit incentive to shade investments from more worthy to more profitable firms—even though they face the exact same incentives as the managers of our hypothetical for-profit charity. If one is comfortable with the current tax treatment of socially responsible investing, we contend that one ought to be comfortable with decoupling more generally.

If our fundamental point that coupling distorts firms' incentives is correct, a natural question is why the law currently grants a tax break to nonprofit firms that is not available to for-profit firms. One possible reason is historical accident, but the staying power of this error might be due, we think, to a pervasive confusion in the public mind about motivation and effect. An intuitive view is that nonprofit firms deserve a tax subsidy because nonprofit entrepreneurs are altruistic, whereas for-profit entrepreneurs are greedy—a view reflected in the commonly held notion that corporations engage in charitable activities only for self-interested marketing reasons. But the nonprofit form, by conferring tax advantages, appeals to nonaltruists as well as altruists. The only way for the law to en-

⁶⁷ Social Investment Forum, 2005 Report on Socially Responsible Investing Trends in the United States: 10-Year Review, at iv (2006), http://www.socialinvest.org/areas/research/trends/sri_trends_report_2005.pdf.

⁶⁸ See *supra* text accompanying note 11.

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courage truly altruistic behavior—that is, behavior motivated by a concern for others, not by a concern for oneself—is by *not* rewarding it.⁶⁹ The relevant consideration for the law is not whether the entrepreneur is altruistic but whether the effect of the entrepreneur's action is socially beneficial. If it is socially beneficial, and if ordinary market forces do not provide sufficient incentive for people to engage in that action, then a subsidy may be appropriate. Because the effect of the entrepreneur's behavior is unrelated to her incentives to choose between the nonprofit or for-profit form, the choice of form does not provide grounds for a tax subsidy.

⁶⁹ Cf. Richard Morris Titmuss, *The Gift Relationship: From Human Blood to Social Policy* 200–18 (Ann Oakley & John Ashton eds., expanded ed. 1997) (arguing that voluntary blood donation is superior to commercializing blood transfer on public policy grounds).