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Social Impact Bonds and the Private Benefit Doctrine: Will Participation Jeopardize a Nonprofit's Tax-Exempt Status?

Peter G. Dagher Jr.

SOCIAL IMPACT BONDS AND THE PRIVATE BENEFIT DOCTRINE: WILL PARTICIPATION JEOPARDIZE A NONPROFIT'S TAX-EXEMPT STATUS?

*Peter G. Dagher Jr.**

In August 2012, the first social impact bond in the United States was implemented, introducing a revolutionary framework that aligns the incentives of the participants and provides nonprofits with a steady source of long term funding to scale up social projects. In the prevailing social impact bond structure, private investors essentially place a bet with a government agency that the selected nonprofits will accomplish measureable goals through a comprehensive project designed to reduce public costs. If the program fails to reach these goals, the investors lose the bet and their entire financial commitment to the social impact bond. If the program succeeds, the government agency repays the initial investment plus a profit margin to the investors. This Note examines social impact bonds from a nonprofit's perspective and answers the question whether the profit margin that the private investors may achieve would qualify as an impermissible private benefit that would allow the IRS to revoke a participating nonprofit's tax-exempt status.

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* J.D. Candidate, 2014, Fordham University School of Law; B.S., 2010, Georgetown University McDonough School of Business. I am extremely indebted to Professor Linda Sugin for her critical advice and encouragement from the very early stages of writing this Note through its publication. I am also grateful to Professor Richard Squire for his initial guidance. I owe my parents Peter and Cornelia and my sister Charlotte many thanks for their love and support, which has granted me every opportunity to follow my dreams. Lastly, Julia Engel deserves a special thank you for her never-ending love, support, and patience.

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> "We currently call charity giving money away and business as business, [but] this is somewhere in between."[1]

INTRODUCTION

A social impact bond (SIB) is a new financing mechanism gaining widespread international attention, where private investors provide access to large amounts of working capital money to nonprofits.[2] In return, the government promises to repay this amount plus interest if the nonprofits meet specified outcomes that result in public savings.[3] This device creates a quasi–equity instrument through a unique agreement structure among the participants (investors, government, and nonprofits).[4] If the nonprofits are successful in reaching the outcomes agreed upon in the SIB, private investors will receive a profitable payout—potentially raising issues with the participating nonprofits' tax-exempt status.[5] If unsuccessful, the government is not obliged to pay, leaving the financial risk with the investors.[6]

On August 2, 2012, New York City Mayor Michael Bloomberg announced that Goldman Sachs agreed to loan MDRC[7] $9.6 million in the first-ever SIB in the United States.[8] The SIB was designed to implement a comprehensive recidivism prevention program for former juvenile prisoners on Rikers Island that aims to reduce reincarceration rates and the associated

1. Lucas Kavner, *Social Impact Bonds Help Investors Bridge Philanthropy and Business Goals*, HUFFINGTON POST (Oct. 18, 2012, 4:27 PM), http://www.huffingtonpost.com/2012/10/18/social-impact-bonds-investing-philanthropy_n_1979614.html (quoting Sonal Shah, former White House Director of the Office of Social Innovation and Civic Participation).

2. *See* MCKINSEY & CO., FROM POTENTIAL TO ACTION: BRINGING SOCIAL IMPACT BONDS TO THE US 7, 12–16 (2012) [hereinafter MCKINSEY REPORT], *available at* https://mckinseyonsociety.com/downloads/reports/Social-Innovation/McKinsey_Social_Impact_Bonds_Report.pdf. SIB literature usually uses the term "service providers" to refer to the role typically performed by nonprofits because the term is more inclusive and SIBs could also potentially work with a for-profit entity taking on the same responsibilities as nonprofits. This Note discusses the issues faced by nonprofits involved in SIBs and, as such, will exclusively refer to "service providers" as nonprofits.

3. *See id.*

4. *See* Esmé E. Deprez & Michelle Kaske, *Goldman Sachs Inmate Bet Fuels Social-Impact Bonds: Muni Credit*, BLOOMBERG (Aug. 21, 2012, 12:00 AM), http://www.bloomberg.com/news/2012-08-21/goldman-sachs-inmate-bet-fuels-social-impact-bonds-muni-credit.html.

5. Charitable nonprofits that pay out profits could lose their tax-exempt status. *See* Thomas Kelley, *Rediscovering Vulgar Charity: A Historical Analysis of America's Tangled Nonprofit Law*, 73 FORDHAM L. REV. 2437, 2473 (2005).

6. *See* MCKINSEY REPORT, *supra* note 2, at 12.

7. MDRC is a tax-exempt nonprofit under section 501(c)(3) of the Internal Revenue Code that provides educational and social services for disadvantaged populations. *See* MDRC FINANCIAL STATEMENTS TOGETHER WITH REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS 5 (2011), *available at* http://www.mdrc.org/sites/default/files/img/mdrc_2011_audit_report.pdf.

8. *See* David W. Chen, *Goldman To Invest in City Jail Program, Profiting If Recidivism Falls Sharply*, N.Y. TIMES, Aug. 2, 2012.

costs to the government.[9] This innovative new investment was the second of its kind in the world[10] and marks what could be a major shift in the way that nonprofits, the government, and the private sector interact with one another.[11]

The Rikers Island SIB is structured as a $9.6 million loan from Goldman Sachs to MDRC, the managing nonprofit, which has contracted with the Osborne Association and the Friends of Island Academy to establish the Adolescent Behavioral Learning Experience (ABLE) program.[12] ABLE is designed to reduce the recidivism rates for former juvenile inmates from the Rikers Island Prison, where an alarming 50 percent of young offenders are imprisoned again within a year of release.[13] The Vera Institute of Justice will provide an independent assessment of whether the project successfully reaches its benchmarks.[14] The New York City Department of Correction has agreed to pay MDRC if the target population's recidivism rate decreases by at least 10 percent over four years.[15] If successful, MDRC would then repay Goldman Sachs the principal amount plus a variable rate of return up to 20 percent.[16] Even if the program fails to reach the targeted 10 percent reduction in recidivism, Bloomberg Philanthropies, Mayor Bloomberg's own nonprofit organization, supplied MDRC with a $7.2 million grant to be held as a guarantee for that portion of Goldman Sachs's

9. *See id.*

10. The first ever SIB was developed in 2010 between a consortium of charitable and private investors, a collection of nonprofits, and the British government. *See* JITINDER KOHLI ET AL., WHAT ARE SOCIAL IMPACT BONDS? AN INNOVATIVE NEW FINANCING TOOL FOR SOCIAL PROGRAMS 3–4 (2012), *available at* http://www.scribd.com/doc/86267243/What-Are-Social-Impact-Bonds; Tina Rosenberg, *The Promise of Social Impact Bonds*, N.Y. TIMES (June 20, 2012, 7:00 AM), http://opinionator.blogs.nytimes.com/2012/06/20/the-promise-of-social-impact-bonds/. For additional information on this SIB, see *infra* notes 200–08 and accompanying text.

11. *See* Max Rivlin-Nadler, *Goldman Sachs Looks To Turn a Profit on a Program To Fight Recidivism*, NATION (Aug. 20, 2012), http://www.thenation.com/article/169472/goldman-sachs-looks-turn-profit-program-fight-recidivism.

12. ABLE is a multifaceted program to provide helpful intervention services to sixteen to eighteen year olds at Rikers Island and after release. The program is designed to decrease participant recidivism through improved decision making, problem solving, and self-control training. ABLE plans to assist roughly 3,000 adolescents each year for the four-year term of the SIB. *See* Presentation, Mayor of N.Y.C. Michael Bloomberg, Bringing Social Impact Bonds to New York City 5 (2012), http://www.nyc.gov/html/om/pdf/2012/sib_media_presentation_080212.pdf [hereinafter Bloomberg Presentation].

13. *See* Kristina Costa & Jitinder Kohli, *Social Impact Bonds: New York City and Massachusetts To Launch the First Social Impact Bond Programs in the United States*, CENTER FOR AM. PROGRESS (Nov. 5, 2012), http://www.americanprogress.org/issues/economy/news/2012/11/05/43834/new-york-city-and-massachusetts-to-launch-the-first-social-impact-bond-programs-in-the-united-states/.

14. *See* Bloomberg Presentation, *supra* note 12, at 4.

15. *See id.* at 7.

16. The variable rate of return to be paid is determined by the reduction in recidivism rates. *See id.* at 6–7 (showing that if recidivism is reduced by 20 percent, the Department of Correction will pay MDRC $11,712,000 to repay Goldman Sachs plus interest); *see also* M.S., *Social-Impact Bonds: I'll Put $2.4m on Recidivism To Fall*, ECONOMIST (Aug. 6, 2012, 12:32 PM), http://www.economist.com/blogs/democracyinamerica/2012/08/social-impact-bonds.

investment.[17] This unique feature[18] of the Rikers Island SIB limits Goldman Sachs' exposure to only a $2.4 million downside if the program fails to reduce recidivism by 10 percent.[19]

While the Rikers Island program was the first SIB in the United States, SIBs are gaining national attention with additional programs planned in numerous other locations in the United States.[20] The potential market for SIBs may represent "a multi-billion dollar source of growth capital for the social sector."[21]

Numerous types of programs have been identified as compatible with SIBs; however, the initial projects have been implemented to reduce recidivism.[22] In the United States alone, over $6 billion taxpayer dollars are spent each year to incarcerate juveniles.[23] SIBs are well suited to tackle this problem, since the effects of past social service programs in the field have been easy to monitor and result in quantifiable savings to the government.[24] Other potential programs must be able to show that the government would be capable of saving money from outcomes that are easily observed and measured.[25] In particular, homelessness programs have been identified as another future SIB application.[26] Homelessness is an area where the U.S. government spends several billons of dollars per year on remedial programs but very little in preventive programs that are compatible with the SIB model.[27] In fact, additional projects have been planned in Massachusetts to address juvenile justice and homelessness.[28] SIBs have also been suggested for projects improving preventive

17. *See* Bloomberg Presentation, *supra* note 12, at 4.

18. The guarantee provided in the Rikers Island SIB to cover downside risk is not a typical component of the conventional SIB structure. *See* Costa & Kohli, *supra* note 13.

19. *See* Deprez & Kaske, *supra* note 4. For a detailed illustration of how the SIB functions, see Costa & Kohli, *supra* note 13.

20. Massachusetts, Connecticut, and Ohio have also contemplated initiating SIBs. *See* Chen, *supra* note 8; *see also* KOHLI ET AL., *supra* note 10, at 10.

21. SOCIAL FINANCE, A NEW TOOL FOR SCALING IMPACT: HOW SOCIAL IMPACT BONDS CAN MOBILIZE PRIVATE CAPITAL TO ADVANCE SOCIAL GOOD 32 (2012), *available at* http://www.socialfinanceus.org/sites/socialfinanceus.org/files/small.SocialFinanceWPSingle FINAL_0.pdf.

22. *See* KRISTINA COSTA ET AL., FREQUENTLY ASKED QUESTIONS: SOCIAL IMPACT BONDS 17 (2012), *available at* http://www.americanprogress.org/wp-content/uploads/2012/12/FAQ SocialImpactBonds-1.pdf.

23. Drew von Glahn & Caroline Whistler, *Translating Plain English: Can the Peterborough Social Impact Bond Construct Apply Stateside?*, COMMUNITY DEV. INVESTMENT REV., 2011, at 58.

24. *See* JEFFREY B. LIEBMAN, SOCIAL IMPACT BONDS: A PROMISING NEW FINANCING MODEL TO ACCELERATE SOCIAL INNOVATION AND IMPROVE GOVERNMENT PERFORMANCE 21 (2011), *available at* http://www.americanprogress.org/wp-content/uploads/issues/2011/02/pdf/social_impact_bonds.pdf; von Glahn & Whistler, *supra* note 23, at 58, 61.

25. *See* JITINDER KOHLI ET AL., FACT SHEET: SOCIAL IMPACT BONDS: A BRIEF INTRODUCTION TO A NEW FINANCING TOOL FOR SOCIAL PROGRAMS 2 (2012), *available at* http://www.americanprogress.org/wp-content/uploads/issues/2012/04/pdf/sib_fact_sheet.pdf.

26. *See* MCKINSEY REPORT, *supra* note 2, at 22.

27. *See id.*

28. *See* Costa & Kohli, *supra* note 13.

healthcare,[29] workforce development,[30] and early education programs.[31] Accordingly, there are many possible applications for SIBs to assist the underprivileged and lessen the government's burden.

The question remains: How can tax-exempt nonprofits participate in SIBs when federal laws deny tax-exempt status to organizations that confer substantial benefits on private interests not among the charitable class?[32] This Note will examine the impact of nonprofit SIB participation through analysis of the private benefit doctrine—the primary IRS method to police third-party profit taking.[33] Despite the benefits to each SIB participant,[34] the arrangement is likely to implicate private benefit issues because private investors stand to receive their principal plus interest-like profits depending on the success of the nonprofit service providers.[35]

Part I begins with an explanation of the relationship between the government and nonprofits by examining the contours of the federal tax exemption. This Note then briefly examines the process for a nonprofit to obtain the federal tax exemption and focus on one of the main limitations on the exemption[36]—the private benefit doctrine.[37] Next, this Note attempts to organize the various forms of private benefit identified by the IRS and the courts into three general categories. Lastly, Part I explains the specifics of the SIB structure in detail, followed by an examination of the potential benefits and risks to the government, private investors, and nonprofits.

Part II addresses this Note's central issue: how nonprofit participation in a SIB may violate the private benefit doctrine and result in the loss of the tax exemption.[38] This part explains how SIBs present a challenge to the status quo of the private benefit doctrine, defying simple analogy to the

29. The city of Fresno is contemplating a SIB to reduce the rate of asthma-related emergencies. *See* Manuela Badawy, *California City Seeks To Cut Asthma Rate via Bond Issue*, REUTERS (Oct. 19, 2012, 10:50 AM), http://www.reuters.com/article/2012/10/19/us-investing-impactbonds-health-idUSBRE89I0U120121019.

30. *See* KOHLI ET AL., *supra* note 10, at 2, 5.

31. *See* Chen, *supra* note 8.

32. *See* BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 537 (10th ed. 2011).

33. *See* Darryll K. Jones, *Third-Party Profit-Taking in Tax Exemption Jurisprudence*, 2007 B.Y.U. L. REV. 977, 984.

34. *See* discussion *infra* Part I.B.2.

35. *Cf.* Christopher C. Archer, Comment, *Private Benefit for the Public Good: Promoting Foundation Investment in the "Fourth Sector" To Provide More Efficient and Effective Social Missions*, 84 TEMP. L. REV. 159, 188 (2011).

36. This Note focuses on private benefit—the main issue that may arise for nonprofits participating in SIBs. This Note does not address unrelated exemption limitations.

37. If a prohibited private benefit is found, a nonprofit will either lose its tax-exempt status or fail to qualify for the exemption. *See* HOPKINS, *supra* note 32, at 536–37.

38. This Note explores the question whether an impermissible private benefit occurs in SIBs; it does not purport to address what options may be available to nonprofits that do in fact lose or fail to qualify for the tax exemption. For further discussion on the potential recourse available to such nonprofits, see generally Richard L. Schmalbeck, Declaratory Judgments and Charitable Borders (2011) (unpublished manuscript) (on file with the Fordham Law Review).

established private benefit doctrine. Part II compares the potential private benefit occurring in SIBs with the categories identified in Part I.A.3. Juxtaposing these recognized private benefit transactions with the new issues presented by SIBs will indicate whether the similarities are strong enough to fall within the outer limits of the doctrine. Ultimately, this part seeks to answer the question: Given what is known about the private benefit doctrine, would participation in a SIB jeopardize a nonprofit's tax-exempt status?

Part III recommends how and why the private benefit doctrine should be modified to promote SIBs. Finally, this part suggests methods to structure SIBs in a manner that could mitigate the private benefit threat.

I. OVERVIEW OF THE FEDERAL TAX EXEMPTION & SOCIAL IMPACT BONDS

This part of the Note covers two distinct topics. Part I.A offers background on the federal tax exemption and the private benefit doctrine. Part I.B examines the SIB concept, highlighting how they are designed to be implemented and how they would impact the participants.

A. Tax-Exempt Status Requirements and the Private Benefit Doctrine

First, this section describes how nonprofits operate and how the IRS awards the tax exemption. Next, it details the private benefit doctrine as one of the main limitations on the federal tax exemption. Finally, this section traces the development of the private benefit doctrine and organizes its application into several categories.

1. Federal Tax Exemption Basics

What separates a nonprofit entity from a for-profit entity is that nonprofit entities cannot distribute profits for the private benefit of another person.[39] A nonprofit is an entity that is organized to pursue a recognized social purpose, while for-profits seek to further the economic interests of their owners.[40] To establish a nonprofit, an organization must first be a corporation, charitable trust, unincorporated association, or limited liability company.[41] Among these alternatives, each structure carries different documentation, governance, tax, and liability effects.[42] Obtaining tax-exempt status however, is an entirely separate undertaking.[43]

39. *See* EVELYN BRODY & JOHN TYLER, HOW PUBLIC IS PRIVATE PHILANTHROPY? SEPARATING REALITY FROM MYTH 18 (2d ed. 2012); *see also* Henry Hansmann, *Economic Theories of Nonprofit Organization*, *in* THE NONPROFIT SECTOR 27–28 (Walter W. Powell ed., 1987) (describing this limitation as the "nondistribution constraint").

40. *See* CHERYL SOROKIN ET AL., NONPROFIT GOVERNANCE AND MANAGEMENT 3–4 (3d ed. 2011).

41. *See* LISA A. RUNQUIST, THE ABCS OF NONPROFITS 1–7 (2005).

42. *See id.* at 8–9.

43. *See id.* at ix.

Contrary to common belief,[44] nonprofits may be either taxable or tax exempt.[45] Recognizing this distinction, it is important to note that not all nonprofits are tax exempt, but all tax-exempt organizations are nonprofits.[46] Obtaining and keeping the tax exemption is very important to nonprofit organizations due to the substantial advantages that come with it.[47] First, nonprofits avoid the obligation to pay most taxes—allowing them to focus solely on providing services to beneficiaries.[48] Second, certain tax-exempt organizations are permitted to receive tax-deductible contributions.[49] This key fundraising tool is codified separately,[50] but it carries essentially the same criteria as that required for the tax exemption.[51] The deduction feature allows private individuals to pay less income and estate taxes when they donate, creating a strong incentive to support nonprofits.[52] Finally, the federal tax exemption allows nonprofits to both issue bonds with tax-free interest, and achieve intangible benefits from an improved public image.[53]

To receive the federal tax exemption, nonprofits must comply with section 501 of the Internal Revenue Code (I.R.C.) to gain approval from the IRS.[54] Under section 501(a),[55] nonprofits must be organized and operated for a specific philanthropic purpose and comply with section 501(c) to obtain the exemption.[56] Specifically, the requirements for charitable or social service nonprofits[57] are defined under section 501(c)(3).[58] This "charitable" purpose that confers exempt status is intended to be divorced

44. The public often confuses the terms "nonprofit" and "tax-exempt," assuming they share the same meaning. Evelyn Brody & Joseph J. Cordes, *Tax Treatment of Nonprofit Organizations: A Two-Edged Sword?*, *in* NONPROFITS AND GOVERNMENT: COLLABORATION AND CONFLICT 142 (Elizabeth T. Boris & C. Eugene Steuerle eds., 1999).

45. *See* BRODY & TYLER, *supra* note 39, at 17, 20.

46. *See* NICHOLAS P. CAFARDI & JACLYN FABEAN CHERRY, UNDERSTANDING NONPROFIT AND TAX EXEMPT ORGANIZATIONS 2 (2006).

47. *See* SOROKIN ET AL., *supra* note 40, at 52.

48. *See* Brody & Cordes, *supra* note 44, at 142–44; *see also* Christyne J. Vachon, *Blurring. Not Fading. Looking at the Duties of Care and Loyalty As Nonprofits Move into Commercialism*, 12 TRANSACTIONS: TENN. J. BUS. L. 37, 39–40 (2011).

49. Elizabeth T. Boris, *Nonprofit Organizations in a Democracy: Varied Roles and Responsibilities*, *in* NONPROFITS AND GOVERNMENT: COLLABORATION AND CONFLICT, *supra* note 44, at 4–5.

50. 26 I.R.C. § 170 (2006).

51. *See* BRODY & TYLER, *supra* note 39, at 55.

52. *See* Brody & Cordes, *supra* note 44, at 143.

53. *See* Peter Molk, *Reforming Nonprofit Exemption Requirements*, 17 FORDHAM J. CORP. & FIN. L. 475, 487 (2012).

54. *See* CAFARDI & CHERRY, *supra* note 46, at 63.

55. I.R.C. § 501(a).

56. *Id.* § 501(c).

57. Besides charitable nonprofits, other organizations are capable of receiving the federal tax exemption and are detailed in the other sections of 501(c). *See* SOROKIN ET AL., *supra* note 40, at 52 (listing the various tax-exempt organizations).

58. In relevant part, section 501(c)(3) states: "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual . . . ." I.R.C. § 501(c)(3) (2006).

from the pursuit of economic benefit for nonprofit founders and financial contributors.[59] To support this legislative scheme on a local level, many states and municipalities extend tax-exempt status to nonprofits under criteria identical to the federal standards.[60] Most states will extend the exemption to income and property taxes.[61] As a monitoring mechanism, the IRS requires tax-exempt organizations to annually file a Form 990 to ensure that nonprofits continue to comply with the exemption requirements.[62]

The policy justification for the tax exemption is "based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burdens which would otherwise have to be met by appropriations from other public funds."[63] In other words, nonprofits are able to obtain tax-exempt status because they provide the government with a "public benefit" by providing resources and services the government would otherwise have to finance with taxpayer money.[64] Supplementing this rationale, there are four prevailing arguments in support of the government's tolerance of tax-exempt organizations.[65] Each of these theories is based on the assumption that a nonprofit's activities will not confer individual economic wealth.[66]

2. Private Benefit Implications on the Tax Exemption

Even if a nonprofit has a tax-exempt purpose under section 501(c)(3) and obtains tax-exempt status, "'what the government giveth' it can also take away."[67] There are certain transactions that can result in intermediate sanctions[68] or a loss of the tax exemption.[69] No statute or regulation

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59. *See* Vachon, *supra* note 48, at 39–40.

60. *See* BRUCE R. HOPKINS & VIRGINIA C. GROSS, NONPROFIT GOVERNANCE: LAW, PRACTICES, AND TRENDS 3 (2009); Brody & Cordes, *supra* note 44, at 142.

61. *See* Brody & Cordes, *supra* note 44, at 144.

62. *See* SOROKIN ET AL., *supra* note 40, at 52.

63. Bob Jones Univ. v. United States, 461 U.S. 574, 590 (1983) (quoting Congressional Hearings of the Revenue Act of 1938, H.R. Rep. 75-1869, at 19 (1938)).

64. *See* Barbara K. Bucholtz, *Doing Well By Doing Good and Vise Versa: Self-Sustaining NGO/Nonprofit Organizations*, 17. J.L. & POL'Y 403, 411 (2009).

65. The four theories are (1) Hansmann's contract failure theory, (2) Atkinson's altruism theory, (3) Colombo and Hall's donative theory; and (4) Crimm's risk compensation theory. *See* Darryll K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 VA. TAX REV. 575, 585–86 (2000).

66. *See id.* at 586. For a further discussion, see generally Rob Atkinson, *Theories of the Federal Income Tax Exemption for Charities: Thesis, Antithesis, and Syntheses*, 27 STETSON L. REV. 395 (1997).

67. Brody & Cordes, *supra* note 44, at 142.

68. The IRS can apply intermediate sanctions, in the form of penalty fees, to "excess benefit transactions" involving insiders rather than revoking the tax exemption. *See* I.R.C. § 4958 (2006).

69. To maintain tax-exempt status, a nonprofit must report and pay taxes on unrelated business income and may not (1) engage in private inurement, (2) confer private benefit, or (3) participate in a political campaign or lobbying activities. *See* Gail A. Lasprogata & Marya N. Cotton, *Contemplating "Enterprise": The Business and Legal Challenges of Social Entrepreneurship*, 41 AM. BUS. L.J. 67, 76–77 (2003). Put another way, these

explicitly defines "private benefit"; however, the doctrine is arguably grounded in Treasury Regulation section 1.501(c)(3)-1(d)(1)(ii).[70] According to the regulation, a nonprofit has the burden to prove "that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests."[71] If a prohibited private benefit is found, the nonprofit's tax-exempt status may be denied or revoked.[72] In fact, private benefit is one of the most common reasons for revocation of the exemption.[73] The IRS can even apply this doctrine on the speculative belief that private benefit "*might* or *could* occur."[74]

The contours of the doctrine have developed over time. Early cases in the 1970s interpreting the private benefit doctrine confused it with private inurement[75] or failed to recognize it altogether.[76] Later, the Tax Court defined a prohibited private benefit broadly as any "[a]dvantage; profit; fruit; privilege; gain; [or] interest."[77] These divergent interpretations underscored the early confusion surrounding the private benefit doctrine up until the late 1980s.

In 1987, IRS General Counsel Memoranda (GCM) 39,598[78] clearly separated private benefit from private inurement and roughly defined the

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requirements can be broken down into four main tests: (1) the Organizational Test; (2) the Operational Test; (3) the Private Inurement Test; and (4) the Political Activities Test. *See* CAFARDI & CHERRY, *supra* note 46, at 63–84.

70. The private benefit doctrine is derived from Treasury Regulation section 1.501(c)(3), which states that an organization will not qualify as serving an exempt purposes "unless it serves a public rather than a private interest." Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (as amended in 2008). *See* Jones, *supra* note 33, at 998; Jill S. Manny, *Nonprofit Payments to Insiders and Outsiders: Is the Sky the Limit?*, 76 FORDHAM L. REV. 735, 746 (2007).

71. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii). *See, e.g.*, Basic Bible Church v. Comm'r, 74 T.C. 846, 848 (1985) (illustrating how a nonprofit addressed this issue in its charter).

72. *See* RUNQUIST, *supra* note 41, at 70; MICHAEL I. SANDERS, JOINT VENTURES INVOLVING TAX-EXEMPT ORGANIZATIONS § 5.1(a) (3d ed. 2007).

73. *See* RUNQUIST, *supra* note 41, at 86.

74. *See* HOPKINS & GROSS, *supra* note 60, at 17.

75. Private inurement occurs when income or assets from a tax-exempt organization flow to individuals with direct control over the organization. *See* Manny, *supra* note 70, at 744, 746. Private inurement is different from private benefit in three main respects (1) private inurement only applies to organizational insiders while private benefit applies also to disinterested persons; (2) private inurement is absolute and will not be excused for an insignificant amount while private benefit is permissible when incidental; (3) private inurement can result in the loss of tax-exempt status or intermediate sanctions, while private benefit may only result in the loss of tax-exempt status. *See id.* For a broad discussion of the private inurement doctrine, see generally Jones, *supra* note 65.

76. *See, e.g.*, Harding Hosp. v. United States, 505 F.2d 1068 (6th Cir. 1974); B.H.W. Anesthesia Found., Inc. v. Comm'r, 72 T.C. 681 (1979).

77. Retired Teachers Legal Fund v. Comm'r, 78 T.C. 280, 286 (1982).

78. In relevant part, the memo reads,

> An organization is not described in section 501(c)(3) if it serves a private interest more than incidentally . . . . A private benefit is considered incidental only if it is incidental in both a *qualitative and quantitative sense*. In order to be incidental in a *qualitative* sense, the benefit must be a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by

scope of the doctrine.[79] In the GCM, the IRS stated there is a line between a permissible incidental private benefit and a prohibited private benefit, dependent upon a weighing of the qualitative and quantitative nature of the benefit conferred.[80]

Then, in 1989, the notable *American Campaign Academy v. Commissioner*[81] case departed from the earlier unclear judicial treatment of the private benefit doctrine from the 1970s and early 1980s by recognizing private benefit as a distinct limitation on the federal tax exemption.[82] In *American Campaign Academy*, the Tax Court essentially adopted the IRS's functional test in GCM 39,598[83] and noted that courts must examine private benefit independent from private inurement.[84]

In 1999, the Seventh Circuit's decision in *United Cancer Council v. Commissioner*[85] further clarified the distinction between private inurement and private benefit. In this case, a tax-exempt charity granted an exclusive fundraising contract to a for-profit entity, which ended up retaining $26.5 million out of the $28.8 million that it raised.[86] The Tax Court upheld the IRS's revocation of the nonprofit's tax-exempt status due to private inurement.[87] On appeal, the Seventh Circuit reversed and rejected the prevailing argument that the private fundraising company should be considered an "insider" for private inurement purposes, concluding that the Tax Court should have conducted a private benefit analysis instead.[88] Judge Posner penned the decision and noted that "the usual 'private benefit' case is one in which the charity has dual public and private goals."[89] However, this decision did little to clarify how the private benefit at issue should be analyzed.[90]

The boundaries of the private benefit doctrine remain poorly defined. Noted nonprofit scholar John Colombo argues that the line between an incidental and prohibited private benefit remains hazy, describing it as an

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> benefiting certain private individuals . . . . To be incidental in a *quantitative* sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity.

I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987) (emphasis added) (citations omitted).

79. *See* John D. Colombo, Private Benefit: What Is It—and What Do We Want It To Be? 1, 6–7 (2011) (unpublished manuscript) (on file with the Fordham Law Review).

80. *See id.*; *see also* Manny, *supra* note 70, at 746.

81. 92 T.C. 1053 (1989).

82. The court denied the exemption through recognition of an impermissible private benefit, despite an absence of any traditional indicia of private inurement. *See id.* at 1073–79; *see also* Colombo, *supra* note 79, at 8.

83. *See* Colombo, *supra* note 79, at 8.

84. *See* Archer, *supra* note 35, at 180–81.

85. 165 F.3d 1173 (7th Cir. 1999).

86. *Id.* at 1174.

87. *Id.* at 1175.

88. *Id.* at 1179–80.

89. *Id.* at 1179.

90. The court left the private benefit determination to remand, but the district court never addressed the issue because the IRS entered into a settlement to resolve the dispute. *See id.*; SANDERS, *supra* note 72, at 294.

amorphous "I know it when I see it" test[91] that forces charities to "operate in analytical darkness."[92] Further, since the 1989 decision in *American Campaign Academy*, the private benefit doctrine has become the IRS's primary tool to "police the activities of charitable organizations under Code Section 501(c)(3)."[93] The IRS's eagerness to utilize the private benefit doctrine, coupled with the doctrine's ambiguity, puts significant pressure on tax-exempt nonprofits when contemplating transactions with private parties.

There have been several rationales advanced to support the use of the private benefit doctrine. At a superficial level, the doctrine is very closely related to the nonprofit prohibition of profit distributions.[94] Basic tax-exempt nonprofit policy dictates that organizations should operate for a public benefit rather than a private one in order to justify their exemption.[95] One scholar recognizes the evolution of the private benefit doctrine as a means to ensure that tax-exempt nonprofits remain true to their charitable purpose and avoid excessive commercialization.[96] Tax Professor Darryll Jones views the private benefit doctrine as a means to "distinguish[] charitable endeavors from other endeavors not deserving tax-exemption."[97] Professor Colombo argues that the private benefit doctrine is a method to ensure that nonprofits remain committed to the pursuit of charity and serve a broad charitable class.[98] Renowned economist and nonprofit policy expert, Burton Weisbrod, suggests that the private benefit doctrine developed as a means for the IRS to police nonprofits that have become "for-profits in disguise," where serving the charitable purpose has become a secondary goal.[99] Judge Posner offered another interpretation in *United Cancer Council*, stating that the private benefit doctrine could be used as a way to guard nonprofits against "bad deals" with for-profit entities.[100] Despite these varied policy arguments, they share the common goal of protecting the nonprofit's charitable purpose against intrusions from private interests.

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91. *See* Colombo, *supra* note 79, at 2.

92. *See* John D. Colombo, *In Search of Private Benefit*, 58 FLA. L. REV. 1063, 1105 (2006).

93. Colombo, *supra* note 79, at 1; *see* Jones, *supra* note 33, at 984.

94. *See* Darryll K. Jones, *"First Bite" and the Private Benefit Doctrine: A Comment on Temporary and Proposed Regulation 53.4958-4T(A)(3)*, 62 U. PITT. L. REV. 715, 718 (2001).

95. *See* SANDERS, *supra* note 72, at 46.

96. *See* Vachon, *supra* note 48, at 37.

97. *See* Jones, *supra* note 65, at 615–16.

98. *See* Colombo, *supra* note 92, at 1081.

99. *See* Burton A. Weisbrod, *The Nonprofit Mission and Its Financing: Growing Links Between Nonprofits and the Rest of the Economy*, *in* TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NONPROFIT SECTOR 11 (Burton A. Weisbrod ed., 1998) (citation omitted).

100. *See* Colombo, *supra* note 79, at 21.

3. Different Categories of Private Benefit Transactions

As the doctrine has developed, certain interactions with private parties[101] can be organized into three general categories of private benefit transactions: (1) incidental private benefit, (2) likely private benefit, and (3) joint venture private benefit. Incidental private benefit transactions are not prohibited and do not destroy the tax exemption.[102] The IRS and courts have also identified certain transactions likely to violate the private benefit doctrine and have employed an entirely different framework to analyze private benefit in joint ventures.[103]

a. Incidental Private Benefit

If a transaction falls within the first category—incidental private benefit—a nonprofit will not lose its tax-exempt status.[104] This inquiry is guided by the balancing test in GCM 39,598, where the IRS introduced the dual qualitative and quantitative requirements.[105] In the memo, the IRS explained that "[i]f an activity serves both exempt and nonexempt purposes, the organization will be exempt only if the predominant motivation underlying the activity is an exempt purpose."[106] A transaction will be considered qualitatively incidental if the public benefit cannot be achieved without necessarily benefiting private individuals.[107] The quantitative prong is satisfied when the private benefit is insubstantial in relation to the public benefit conferred by the specific activity undertaken, not the overall public benefit accomplished by the nonprofit.[108] Neither the IRS nor the courts applying this balancing test have announced any bright-line methods to measure these factors.[109]

As a result, the IRS has much discretion when utilizing the qualitative and quantitative balancing test to determine incidental private benefit.[110] There are numerous examples of IRS rulings where an incidental private benefit is either found[111] or rejected[112] without establishing any clear

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101. The list that follows is not exhaustive as the IRS has issued numerous revenue rulings with varied approaches to the private benefit analysis. The categories discussed cover the main instances of private benefit identified by scholars.

102. *See* Manny, *supra* note 70, at 745–46.

103. *See* discussion *infra* Parts I.A.3.b–c.

104. *See* Archer, *supra* note 35, at 178.

105. *See* I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987).

106. *Id.*

107. *See* SANDERS, *supra* note 72, at 45, 281–82.

108. *See id.* at 45.

109. *See* HOPKINS, *supra* note 32, at 538–40 (discussing the application of the incidental balancing test).

110. *See id.* at 540.

111. *See, e.g.*, Rev. Rul. 70-186, 1970-1 C.B. 129; I.R.S. Priv. Ltr. Rul. 06-06-042 (Feb. 10, 2006); I.R.S. Priv. Ltr. Rul. 01-03-083 (Jan. 19, 2001); I.R.S. Priv. Ltr. Rul. 96-15-030 (Apr. 12, 1996).

112. *See, e.g.*, Rev. Rul. 77-206, 1977-1 C.B. 149; I.R.S. Priv. Ltr. Rul. 09-44-053 (Oct. 30, 2009); I.R.S. Priv. Ltr. Rul. 08-49-017 (Dec. 5, 2008).

guidelines how the qualitative or quantitative prongs were weighed, essentially "leaving [nonprofits] completely at sea."[113] Since the balancing test from GCM 39,598 is not a mandatory method to analyze incidental private benefit, the malleable nature of the doctrine allows the IRS to assess private benefit in a very pliable manner.[114] Accordingly, the IRS has generously dismissed private benefit as incidental in some circumstances and aggressively sought tax exemption revocation in others.[115]

b. Likely Private Benefit

There are certain general nonprofit financial activities that may violate the private benefit doctrine. Tax-exempt nonprofits cannot have stockholders or provide equity distributions like dividends.[116] Nonprofits have more flexibility when it comes to debt instruments.[117] Issuing loans from a nonprofit's charitable assets to private parties will only result in a prohibited private benefit if the terms are unreasonable and the loan fails to further an exempt purpose.[118] Also, nonprofits can issue sophisticated tax-exempt bonds without violating the private benefit doctrine as long as less than 10 percent of the proceeds are diverted to noncharitable individual use.[119]

Shared revenue stream arrangements between nonprofits and private entities were identified as a likely violation of the private benefit doctrine in GCM 39,862.[120] The IRS explained that a revenue-sharing agreement between a tax-exempt hospital and a number of affiliated doctors ran afoul of the private benefit doctrine.[121] The planned arrangement specified that the hospital would cede control of certain facilities to the doctors in return for a share of their profits in the hopes of increasing the hospital's overall referrals and revenues.[122] The hospital's exemption was revoked since the private benefit from the shared revenue stream agreement could not be considered incidental to the concurrent public benefit to the community.[123] This decision mirrored older iterations of the private benefit where, despite the fact that a charitable purpose was served, the benefit to private interests

113. Colombo, *supra* note 92, at 1065.
114. *See* Jones, *supra* note 94, at 724–25 (describing the IRS's "informal articulation" of the incidental balancing test).
115. *See* HOPKINS, *supra* note 32, at 540.
116. *See id.* at 523.
117. *See* SANDERS, *supra* note 72, at 290.
118. *See id.*
119. This 10 percent threshold can be higher when the private noncharitable use is necessary to accomplish a public benefit. *See* Darryll K. Jones, *Restating the Private Benefit Doctrine for a Brave New World*, 1 NW. J. TECH. & INTELL. PROP. 1, 23 (2003).
120. I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991).
121. *See* SANDERS, *supra* note 72, at 295.
122. *See* Colombo, *supra* note 92, at 1074.
123. *See* SANDERS, *supra* note 72, at 295.

was too great to be considered incidental, and the tax exemption was forfeited.[124]

The IRS has also identified circular cash flow arrangements as an impermissible private benefit. In Revenue Ruling 2006-27, the IRS analyzed an agreement where a tax-exempt organization received money from individual home sellers and later used that money to provide down payment assistance to poor individuals to buy the home sellers' properties.[125] Although the nonprofit served an exempt purpose benefitting the poor, the IRS found the arrangement violated the private benefit doctrine in light of the circular cash flow—the money transfer from the home sellers to the nonprofit to the poor buyers and then back again to the sellers.[126] Professor Colombo has suggested that there must be a deeper motivation behind Revenue Ruling 2006-27 because there is nothing inherently wrong when nonprofits act as a "conduit to connect needy families with housing sellers."[127] Colombo contrasts the perceived innocence of this transaction with a situation where a nonprofit is used as a "front" to increase a seller's market share through exploiting the charitable class.[128]

When a private purpose dominates a nonprofit's operation, the tax exemption may be revoked despite a coexisting charitable purpose.[129] Similar to Professor Weisbrod's private benefit policy rationale,[130] the IRS may utilize the private benefit doctrine when the tax-exempt purpose becomes secondary to private interests.[131] In *American Campaign Academy*, the Tax Court noted that even if a nonprofit serves a valid tax-exempt purpose, when there is a substantial "secondary" benefit, the nonprofit will not qualify as a tax-exempt organization.[132] Clarifying this stance, the court noted that the tax exemption would be lost if secondary beneficial effects are "earmarked for a particular organization or person."[133]

The IRS has established that, when secondary benefits are broadly distributed to a variety of organizations or individuals, the benefits will be considered incidental.[134] The reciprocal argument holds that if a secondary benefit is consistently conferred to a single entity it will always be "substantial" and improper.[135] The IRS raised this reciprocal argument in *American Campaign Academy* and, while the Tax Court did not accept this

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124. *See* Jones, *supra* note 33, at 991.
125. *See* Rev. Rul. 06-27, 06-1 C.B. 915.
126. *See* Colombo, *supra* note 92, at 1080.
127. *See id.* at 1096.
128. *See id.* at 1097.
129. *See* SANDERS, *supra* note 72, at 281.
130. *See supra* note 99 and accompanying text.
131. *See* SANDERS, *supra* note 72, at 282–83.
132. *See* Am. Campaign Acad. v. Comm'r, 92 T.C. 1053, 1073–74 (1989).
133. *Id.* at 1074.
134. *See* SANDERS, *supra* note 72, at 45, 283 (explaining that the Academy had provided benefits to a concentrated group of individuals, eventually resulting in the loss of their tax-exempt status).
135. *See* Jones, *supra* note 33, at 1002.

proposition, the court has consistently deferred to the IRS following this case.[136]

While the courts have not utilized the secondary benefit analysis since *American Campaign Academy*, some practitioners have raised concerns that it could be applied in other situations; however, tax lawyer Michael Sanders believes this framework will only be utilized on a limited basis in similar situations.[137] Professor Colombo takes a more skeptical stance on *American Campaign Academy*, stating the decision simply "makes no sense,"[138] echoing the legal community's view that the case was decided incorrectly.[139]

Aside from the likely private benefit transactions already discussed, the IRS's Treasury Regulation section 1.501(c)(3)-(d)(1)(iii) spells out three examples that would violate the private benefit doctrine.[140]

The regulation's first example focuses on the basic question of whether the charitable class is sufficiently large enough that the nonprofit is providing a public benefit rather than an impermissible private benefit to select individuals.[141] This form of private benefit closely mirrors the definition of a "charity," which requires a nonprofit to provide services that benefit the community at large.[142] This simple charitable class-size inquiry served as the basis for the private benefit doctrine up until the late 1970s.[143] Similar to the 1978 *Callaway Family Ass'n v. Commissioner*[144] decision, the first example states that an impermissible private benefit would occur when tax-exempt educational nonprofits primarily serve the private interests of a single family.[145] The courts have applied this concept beyond the education industry, as the Third Circuit in *Geisinger Health Plan v. Commissioner*[146] ruled an HMO was not entitled to tax-exempt status, because it only provided benefits to its members and not the greater community.[147]

In the second example, the regulation notes that the private benefit doctrine would be violated in transactions initiated by nonprofits that result in grossly disproportionate private commissions.[148] Much like the first

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136. *See id.* at 1002 n.112.

137. *See* SANDERS, *supra* note 72, at 45, 283–84 ("The IRS will most likely limit the holding in *American Campaign Academy*, with regard to its application of the secondary benefit concept, to similar fact patterns.").

138. *See* Colombo, *supra* note 92, at 1099.

139. *See* SANDERS, *supra* note 72, at 283–84.

140. *See* HOPKINS, *supra* note 32, at 545 (describing the content and application of the examples listed in the regulation).

141. *See* JODY BLAZEK, TAX PLANNING AND COMPLIANCE FOR TAX-EXEMPT ORGANIZATIONS: RULES, CHECKLISTS, PROCEDURES 514 (4th ed. 2004).

142. *See* Jones, *supra* note 65, at 615–17.

143. *See* Colombo, *supra* note 92, at 1069.

144. 71 T.C. 340 (1978).

145. *See* Treas. Reg. § 1.501(c)(3)-1(d)(1)(iii) (as amended in 2008).

146. 985 F.2d 1210 (3d Cir. 1993).

147. *See id.* at 1219.

148. *See* Treas. Reg. § 1.501(c)(3)-1(d)(1)(iii).

example, prior precedent served as the basis for this example. In *St. Louis Science Fiction Ltd. v. Commissioner*,[149] the Tax Court found a tax-exempt nonprofit was impermissibly operated for private benefit when it paid back 85 percent of the sale price of artwork to the private artists and dealers that had supplied the products.[150] Following closely from this case and a previous IRS ruling,[151] the second regulatory example states a categorical private benefit would occur if a nonprofit sells artwork to the public and retains only a 10 percent commission while returning 90 percent of the value to the individual artists.[152]

The third example concerns a professional training education program that violates the private benefit doctrine.[153] The example details an arrangement where a tax-exempt nonprofit's sole responsibility is to carry out training exercises while the for-profit entity controls the rights to any course materials developed and sets the price of tuition.[154]

While these regulatory examples spell out certain instances where private benefit definitely occurs, Professor Colombo argues that these three narrow examples fail to establish the limits of the doctrine and are too varied to give proper guidance to analyze other types of transactions.[155] If one were to merely read the three examples listed, the problems inherent in equity distributions, revenue sharing agreements, circular cash flows, and impermissible secondary benefits are not evident and could be easily overlooked.[156]

c. Joint Venture Private Benefit

When nonprofits engage in joint ventures with for-profit entities they will usually fail the incidental balancing test; however, in this case, the exemption is not automatically lost because the IRS analyzes the private benefit under a separate framework.[157] While the IRS initially considered joint ventures with for-profit entities a per se private benefit,[158] the *Plumstead Theatre Society, Inc. v. Commissioner*[159] decision rejected this stance[160] and served as the basis for later doctrinal development. Although there was a limited partnership agreement between a nonprofit and a for-

149. 49 T.C.M. (CCH) 1126 (1985).

150. *See id.* at 1128.

151. *See* Rev. Rul. 76-152, 1976-1 C.B. 151 (denying a tax exemption to an art gallery engaged in excessive private benefit for transmitting 90 percent of the sale price to a small number of artists).

152. *See* Treas. Reg. § 1.501(c)(3)-1(d)(1)(iii).

153. *See id.*

154. *See* Colombo, *supra* note 92, at 1104.

155. *See id.* at 1065.

156. While the preceding list of transactions that are likely to result in private benefit is not exhaustive, it does illustrate the broad reach of the doctrine.

157. *See* Colombo, *supra* note 92, at 1078.

158. *See* Nicholas A. Mirkay, *Relinquish Control! Why the IRS Should Change Its Stance on Exempt Organizations in Ancillary Joint Ventures*, 6 NEV. L.J. 21, 35–36 (2006).

159. 74 T.C. 1324 (1980).

160. *Id.* at 1330–31.

profit corporation in *Plumstead*, the court ruled that there was no private benefit violation since the for-profit entity was paid a reasonable price and had no control over the tax-exempt nonprofit.[161] The decision forced the IRS to accept the principle that joint ventures between private parties and tax-exempt nonprofits are compatible in some instances.[162] Since *Plumstead*, the IRS has adopted a cautious approach where it "closely scrutinizes" situations where a nonprofit participates in a partnership or joint venture with a for-profit entity.[163]

In GCM 39,005, the IRS established a two part test to determine private benefit in joint ventures by examining (1) whether the objective of the joint venture serves or furthers the exempt organization's charitable purpose, and (2) if the partnership allows the tax exempt organization to act exclusively for their exempt purpose and not for the benefit of the for-profit partners.[164] Essentially, this memo introduced another functional test to determine whether a prohibited private benefit occurs in joint ventures with for-profit entities by comparing the public benefits with the private benefits that individual investors accumulate.[165] However, in the late 1990s, the two-part private benefit analysis from GCM 39,005 was partially abandoned in favor of different standards for whole-entity joint ventures and ancillary joint ventures.[166]

In the context of whole-entity joint ventures—where a nonprofit commits all of its assets to a joint venture with a for-profit entity—the issue of whether nonprofits could retain their exemption was addressed in Revenue Ruling 98-15.[167] In the ruling, the IRS added an additional factor to the original two-part test, stating the private benefit determination depends on an analysis of whether (1) a charitable purpose is being served, (2) the nonprofit is able to act exclusively in furtherance of the charitable purpose and not for the benefit of the for-profit parties, and (3) the nonprofit maintains control over the joint venture's management.[168]

Embracing the Revenue Ruling 98-15 analysis, the Tax Court in *Redlands Surgical Services v. Commissioner*[169] roughly adopted the IRS's position.[170] In *Redlands*, the court upheld the IRS's decision to deny the exemption due to the occurrence of an impermissible private benefit.[171] Specifically, the court noted how the tax-exempt nonprofit had "ceded effective control" over the joint venture, resulting in a significant private benefit to the for-profit partners who were able to put personal gains ahead

161. *See id.* at 1333–34.
162. *See* Jones, *supra* note 33, at 992.
163. *See* SANDERS, *supra* note 72, at 291–92.
164. *See* I.R.S. Gen. Couns. Mem. 39,005 (June 28, 1983).
165. *See* Colombo, *supra* note 79, at 6–7.
166. *See id.* at 12–13.
167. *See* SANDERS, *supra* note 72, at 14.
168. *See id.* at 14–16; Mirkay, *supra* note 158, at 23, 42.
169. 113 T.C. 47 (1999).
170. *See* Archer, *supra* note 35, at 183.
171. *See Redlands*, 113 T.C. at 78.

of charitable purposes.[172] While the lack of control in *Redlands* was dispositive and resulted in the revocation of the exemption, the court stated that it did not "view [this] one factor as crucial."[173] The Fifth Circuit in *St. David's Health Care System v. United States*[174] took a narrower view focused on the control prong, deciding that a per se private benefit occurs when a tax-exempt nonprofit lacks majority voting control in a joint venture with a for-profit entity.[175] Both of these decisions indicate that the courts have accepted the IRS's expansion of the private benefit doctrine beyond GCM 39,005 and adopted the Revenue Ruling 98-15 framework, which includes the control factor.[176]

The IRS further refined its private benefit analysis for nonprofit joint ventures with private entities in Revenue Ruling 2004-51.[177] Apart from the whole-entity joint venture analysis, the IRS introduced a different approach for ancillary joint ventures—where nonprofit involvement may be significant but falls short of requiring total asset contribution.[178] In the ruling, the IRS determined that a tax-exempt university engaging in a joint venture with a for-profit company to provide supplemental educational services would not lose its exemption because the school's participation only constituted an insubstantial portion of its activities.[179] This decision suggests that ancillary joint ventures are distinct from whole-entity joint ventures and typically will not endanger the federal tax exemption when the enterprise does not constitute a substantial part of a nonprofit's activities.[180]

Revenue Ruling 2004-51 has also been interpreted to dispose of the control requirement for ancillary joint ventures, an important distinction versus whole-entity joint ventures.[181] Despite this, doubts remain over the precedential value of this ruling.[182] Notably, the IRS did not explicitly use the private benefit doctrine in Revenue Ruling 2004-51's exemption analysis, although it was clearly at issue.[183] This inconsistency has been debated among legal academics, leading to divergent explanations.[184] Tax Professor Nicholas Mirkay embraces a straightforward interpretation, arguing that the IRS is not concerned with joint venture control when participation is only a minor part of a nonprofit's activities.[185] Professor Colombo offers a slightly more complex interpretation, stating that the control analysis is relaxed when nonprofits retain control over the charitable

172. *See* Mirkay, *supra* note 158, at 45.
173. *See Redlands*, 113 T.C. at 92.
174. 349 F.3d 232 (5th Cir. 2003).
175. *See* Mirkay, *supra* note 158, at 48.
176. *See id.* at 48–49.
177. Rev. Rul. 04-51, 04-1 C.B. 974, 975.
178. *See* Mirkay, *supra* note 158, at 26.
179. *See* Rev. Rul. 04-51, 04-1 C.B. 974, 975–76.
180. *See id.*
181. *See id.*; SANDERS, *supra* note 72, at 16–17.
182. *See* Mirkay, *supra* note 158, at 23–24.
183. *See* Archer, *supra* note 35, at 184.
184. *See id.* at 185.
185. *See* Mirkay, *supra* note 158, at 25–26.

portions of the joint venture.[186] However, the ancillary joint venture private benefit analysis remains mainly speculative, as it appears the IRS was attempting to avoid establishing a clear precedent in Revenue Ruling 2004-51.[187]

In sum, when nonprofits engage in joint ventures with for-profit entities, they can expect the IRS will closely scrutinize the arrangement.[188] Despite this, the different approaches to analyze whole-entity and ancillary joint ventures both allow some nonprofits to retain their exemption when private interests do not dominate the charitable purpose.

B. Social Impact Bonds and the Relationships Between the Private Investors, the Government, and the Nonprofits

This section will provide an overview of the prevailing SIB framework. After it details the mechanics of how SIBs are designed to operate, the section will discuss each participant's various benefits and risks.

1. Social Impact Bond Overview

A SIB[189] is a new financing mechanism[190] where nonprofits are able to scale-up their operations through funding provided by private investors who stand to make a return—paid out by the government—if the nonprofits' outreach work successfully accomplishes predetermined benchmarks.[191] In the prevailing model,[192] a SIB is an arrangement between private investors, social service nonprofits, government administrators, and an independent assessor.[193] Under a SIB agreement, nonprofits receive a long-term funding commitment to implement or expand a social program capable of delivering large, quantifiable savings to a local, state, or federal government agency.[194] Private investors provide the money to support the program by

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186. *See* Colombo, *supra* note 92, at 1079 n.81.

187. *See id.* at 1079; Mirkay, *supra* note 158, at 59.

188. *See supra* note 163 and accompanying text.

189. Some government administrators refer to SIBs and "pay for success" contracts interchangeably, but these two terms have developed slightly different meanings. *See* KOHLI ET AL., *supra* note 10, at 2 (comparing and contrasting pay for success contracts and SIBs); MCKINSEY REPORT, *supra* note 2, at 19 (differentiating SIBs from pay for success contracts).

190. Use of the term "social impact bond" is somewhat of a misnomer since a SIB is not a bond in the conventional sense of the term; rather it is a series of contracts between the investors, nonprofits, and government. *See* KOHLI ET AL., *supra* note 10, at 5; MCKINSEY REPORT, *supra* note 2, at 12–13. For a sample of what draft language could look like in a conventional bond, see JITINDER KOHLI ET AL., INSIDE A SOCIAL IMPACT BOND AGREEMENT: EXPLORING THE CONTRACT CHALLENGES OF A NEW SOCIAL FINANCE MECHANISM 3–19 (2012), *available at* http://www.americanprogress.org/wp-content/uploads/issues/2012/05/pdf/sib_agreement_brief.pdf.

191. MCKINSEY REPORT, *supra* note 2, at 4.

192. The Peterborough SIB and the Rikers Island SIB share a similar structure. *See* Chen, *supra* note 8. However, there are proposals for other methods of arranging SIBs. *See* COSTA ET AL., *supra* note 22, at 10–11.

193. *See* MCKINSEY REPORT, *supra* note 2, at 14–16.

194. *See id.*

allowing nonprofits to draw down funds throughout the term of the SIB.[195] In turn, the participating government agency agrees to repay the investors, plus a variable interest if the preselected benchmarks, monitored by an independent assessor, are fulfilled by the end of the SIB term.[196] If the program falls short of the benchmarks, the investors lose their money, but the government escapes with no financial penalty, avoiding costs on the taxpayers.[197] If the program is successful, the government saves money, investors make money, and the charitable class benefits from the expansion of nonprofit operations and implementation of the SIB.[198] At the conclusion of the SIB, the government may continue to support the participating nonprofits by either funding them directly or executing another SIB.[199]

The first ever SIB was developed for the Peterborough Prison in the United Kingdom and was established in a September 2010 agreement between a collection of philanthropic investors,[200] four U.K. nonprofits led by Social Finance,[201] and the U.K. Justice Ministry.[202] The investors provided roughly $8 million[203] in funding to implement a program designed to help former inmates adapt to life after confinement.[204] If the nonprofits are able to reduce the recidivism rates of Peterborough's former short-term prisoners, the investors will be repaid their initial investment plus up to 13 percent interest.[205] While the term ends in 2018 and the data will not be partially analyzed until 2014,[206] the Peterborough SIB was seen as a good template for replication in the United States.[207] This proved true two years later in the similarly structured Rikers Island SIB.[208]

SIBs "flip [the] traditional government funding structures [for nonprofits] on their head," allowing the government to only commit funds to successful social programs, instead of paying nonprofits upfront, regardless of the outcome.[209] This presents an entirely new method for the government to support nonprofits without excessive risk to taxpayers. Investors bear the

195. *See id.*

196. *See id.*; Bloomberg Presentation, *supra* note 12, at 2.

197. *See* Caroline Preston, *Getting Back More Than a Warm Feeling*, N.Y. TIMES, Nov. 9, 2012, at F1.

198. *See* SOCIAL FINANCE, *supra* note 21, at 11.

199. *See id.* at 13.

200. The main investors in the Peterborough SIB were the Rockefeller Foundation, the Barrow Cadbury Charitable Trust, and the Esmée Fairbairn Foundation. *See id.* at 9.

201. The participating nonprofits in the Peterborough SIB were St. Giles Trust, Ormiston Trust, the YMCA, and Supporting Others Through Volunteer Action. *See* MCKINSEY REPORT, *supra* note 2, at 20.

202. *See* LIEBMAN, *supra* note 24, at 13.

203. The investors provided £5 million, which roughly equates to $8 million. *See* von Glahn & Whistler, *supra* note 23, at 59.

204. *See id.* at 60.

205. *See id.* at 61.

206. *See* LIEBMAN, *supra* note 24, at 13–14.

207. *See* von Glahn & Whistler, *supra* note 23, at 61.

208. *See supra* notes 12–19 and accompanying text.

209. *See* KOHLI ET AL., *supra* note 10, at 1.

chief financial risk when implementing a SIB, while the government is only required to commit funds when public savings have been achieved from the successful completion of the desired SIB outcomes.[210] SIBs are clearly distinguishable from the conventional sources of nonprofit funding, such as when the government provides grants to or contracts directly with nonprofits to provide services to desired communities.[211] While the SIB concept is still in its infancy, and it is unclear how well they will work and how widely they will be implemented, SIBs offer strong incentives to each of the three main participants—investors, government agencies, and nonprofits.[212]

2. The Participants

This section will examine the likely SIB participants and the inherent benefits and risks associated with entering into a SIB.

a. Investors

Initially, the investors who are likely to provide the capital in SIBs are either philanthropic investors or private investors willing to take a higher level of risk at below market returns.[213] Interested investors should also have a high risk tolerance and interest in social benefit instead of pure financial returns[214] because SIBs essentially carry "equity-like risk with bond-like returns."[215] Some have taken an optimistic outlook on SIBs, as the head of global wealth and retirement solutions at Bank of America Merrill Lynch, Andrew Seig, stated, "I'm very bullish about the concept of social impact bonds."[216] Also, risk can be hedged in SIBs through the use of a guarantee similar to the one utilized in the Rikers Island SIB.[217] On the other hand, with no clear revenue streams to support a SIB, some investors will be hesitant to participate until the model becomes more standardized and proves to be a worthwhile bet.[218]

Financing a SIB offers an attractive blended investment—allowing investors to achieve a meaningful social impact and net financial returns.[219] Even if the SIB fails to reach its minimum targets, investors will have

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210. MCKINSEY REPORT, *supra* note 2, at 4.

211. *See* Steven Rathgeb Smith, *Government Financing of Nonprofit Activity*, *in* NONPROFITS AND GOVERNMENT: COLLABORATION AND CONFLICT, *supra* note 44, at 181–82.

212. MCKINSEY REPORT, *supra* note 2, at 4.

213. *See id.* at 9, 39.

214. *See id.* at 39.

215. *See* LIEBMAN, *supra* note 24, at 28.

216. *See* Preston, *supra* note 197.

217. Goldman Sachs is the private investor in the Rikers Island SIB and is protected with a guarantee from Bloomberg Philanthropies that significantly limits its downside risk. *See supra* notes 17–19 and accompanying text.

218. Discussing the potential future of SIBs, former wealth manager Ron Cordes noted, "Putting my investor hat on, what we need now is a number of pilots that demonstrate they work." *See* Preston, *supra* note 197.

219. *See* SOCIAL FINANCE, *supra* note 21, at 11; Preston, *supra* note 197.

contributed funds in a philanthropic manner to support social projects aimed to improve the lives of vulnerable individuals.[220] Such giving could result in positive externalities in light of studies that have suggested corporate social responsibility contributions end up conferring a beneficial effect on bottom-line profits from normal operations.[221] Goldman Sachs has publicly stated that it views the participation in the Rikers Island SIB as an investment;[222] however, they have also received much positive press as a result of the SIB and commentators have noted the potential publicity benefits from participation.[223]

There are also several downsides facing potential investors in SIBs. Since the financial risk of funding nonprofits shifts from the government to the investors in SIBs, the investors remain exposed to a major loss if the SIB fails.[224] By virtue of the conventional SIB structure, investors stand to lose their entire capital contribution if the nonprofits do not reach the preset benchmarks.[225] Investors can approach this risk in two manners. First, if the SIB investment fails, it could simply be written off as a loss, yet participation would still have a positive reputational impact akin to conventional philanthropic giving.[226] Alternatively, at the outset, investors could seek to add a guarantor, limiting their downside to only a portion of their overall SIB investment.[227]

b. Government

SIBs are an option for federal, state, or local government administrators.[228] However, since most social service programs in the United States are funded at the state and local level, it is more likely that city and state governments will implement SIBs.[229] To get SIBs off the ground, strong executive leadership from a government official is noted as a key component.[230] For example, Mayor Bloomberg championed the Rikers

220. *See* MCKINSEY REPORT, *supra* note 2, at 15, 18.

221. *See* BARUCH LEV ET AL., MAKING THE BUSINESS CASE FOR CORPORATE PHILANTHROPY 2–4 (2011) (describing how corporate philanthropy can be a valuable business activity). *But see* Milton Friedman, *The Social Responsibility of Business Is To Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32 (claiming that corporate social responsibility expenditures would be met with disapproval from stockholders and result in lower profits).

222. Alicia Glen, a managing director at Goldman Sachs, has stated that the company's participation in the Rikers Island SIB is viewed as a "double bottom line investment where the firm expects a blended social and financial return." *See* Rivlin-Nadler, *supra* note 11.

223. *See* Kavner, *supra* note 1.

224. *See supra* note 197 and accompanying text.

225. *See supra* note 197 and accompanying text.

226. *See* Badawy, *supra* note 29.

227. *See supra* note 217 and accompanying text.

228. *See* MCKINSEY REPORT, *supra* note 2, at 9.

229. *See* LIEBMAN, *supra* note 24, at 5.

230. *See* MCKINSEY REPORT, *supra* note 2, at 35; Presentation, Social Fin. Dir. Lisa Barclay, Developing a Social Impact Bond 14 (2012), http://www.socialfinance.org.uk/sites/default/files/bristol_conference_-_developing_a_sibvfinal.pdf [hereinafter Barclay Presentation].

Island SIB and also leveraged his own nonprofit to guarantee a large portion of the investment at risk.[231] Likewise, Massachusetts Governor Deval Patrick has publicly supported SIBs and is in the process of arranging several for the state.[232]

As previously mentioned, SIBs provide a notable advantage to the government—eliminating responsibility for the financial risk in funding nonprofits.[233] If the benchmarks for measuring government savings are properly measured and the interest premiums are properly structured, the government agency will never spend more than it saves when participating in a SIB.[234] If the SIB fails, the government would be cash neutral, as they would not be obligated to repay the investors.[235] If the SIB succeeds, the government would only provide the investors a portion of the savings achieved by the social work.[236] This is especially valuable during periods of fiscal constraint, where nonprofit funding might otherwise be cut altogether.[237]

SIBs allow the government to transition from supporting remedial programs to less costly preventive solutions,[238] such as the programs designed to reduce recidivism rates. The government's taxpayers also benefit from SIBs since private investors provide capital for social programs, which the government might have otherwise paid for itself.[239] Further tax savings would occur if the preventive programs financed by the SIBs allow the government to reduce their obligations, such as closing unused portions of a prison.[240]

While SIBs present a number of benefits to the government, there are some issues that must be considered prior to agreeing to a SIB. The most difficult aspect of forming a SIB is to properly define measureable outcomes that will translate into tangible savings—a primary incentive for government participation.[241] While a SIB is intended to avoid saddling the government with a net loss, the government agency may end up with an opportunity cost: paying more than it would in a conventional nonprofit service contract.[242] The diffuse benefit problem has been identified as another issue—where it may be difficult for a government agency to

231. *See supra* notes 12–19 and accompanying text (detailing the Rikers Island SIB and the role played by Bloomberg Philanthropies).

232. *See* Costa & Kohli, *supra* note 13.

233. *See* KOHLI ET AL., *supra* note 10, at 3; MCKINSEY REPORT, *supra* note 2, at 16.

234. *See* Barclay Presentation, *supra* note 230, at 6.

235. *See id.*

236. *See id.*

237. *See* Bloomberg Presentation, *supra* note 12, at 3.

238. *See* MCKINSEY REPORT, *supra* note 2, at 17–18.

239. *See* KOHLI ET AL., *supra* note 10, at 10; *see also* Bucholtz, *supra* note 64, at 409 (discussing the effects of government cutbacks on social service funding).

240. *See* MCKINSEY REPORT, *supra* note 2, at 18.

241. *See* KOHLI ET AL., *supra* note 10, at 7.

242. Overall, SIBs are more expensive because the private investors must be paid a premium if the SIB is successful and there may be additional management fees. *See* Barclay Presentation, *supra* note 230, at 6.

determine realized cash savings because the benefits of a SIB may accrue to multiple levels of government, not just the participant.[243] This diffuse benefit problem becomes more of an issue for programs serving underprivileged groups, such as the homeless, where the federal, state, and local governments often share funding responsibilities.[244] Lastly, some government officials have expressed concern that participation could lead to a public backlash, viewing the arrangement as a way to give government savings away to wealthy investors.[245]

c. Nonprofits

The nonprofits selected to provide services in SIBs are likely to be those that have previously qualified for government contracts.[246] Investors will favor providing capital to nonprofits with a strong reputation or those with an easily traceable program in place, since unproven intervention programs carry additional risk.[247] SIBs are well tailored to benefit nonprofits with a proven track record by allowing them to significantly scale-up their operations by providing access to a secure source of long-term funding.[248]

Fundraising is crucial to the viability of many nonprofits.[249] Nonprofits face the chronic problem of finding new and consistent sources of revenue beyond private and governmental donors.[250] Further exacerbating this challenge, traditional sources of funding[251] for nonprofits have been in decline for the past two decades.[252] Private donations, as a percentage of total nonprofit revenue, have decreased since the late 1970s, and donations have failed to keep pace with inflation for some human service nonprofits.[253] Despite cuts in government spending and declines in philanthropic donations since the 2008 financial crisis, the number of nonprofits created has continued to grow, which further constricts funding options in the industry.[254] As a result of this decreased federal spending and increased competition for public and private donations, nonprofits have been encouraged to find new sources of financing.[255] These economic and political developments have forced nonprofits to become more entrepreneurial, resorting to increased commercial operations or even

243. *See* KOHLI ET AL., *supra* note 10, at 8.
244. *See* MCKINSEY REPORT, *supra* note 2, at 37.
245. *See id.*
246. *See id.* at 9.
247. *See* SOCIAL FINANCE, *supra* note 21, at 17.
248. *See* MCKINSEY REPORT, *supra* note 2, at 8; SOCIAL FINANCE, *supra* note 21, at 4.
249. *See* SOROKIN ET AL., *supra* note 40, at 53.
250. *See* Mirkay, *supra* note 158, at 22.
251. Traditional sources of funding for social service nonprofits include government grants, private donations, and fees for service. *See* Lasprogata & Cotton, *supra* note 69, at 68.
252. *Id.* at 71.
253. *See* Smith, *supra* note 211, at 193.
254. *See* Diane L. Fahey, *Taxing Nonprofits Out of Business*, 62 WASH. & LEE L. REV. 547, 547 (2005); Vachon, *supra* note 48, at 41.
255. *See* SOCIAL FINANCE, *supra* note 21, at 7; Smith, *supra* note 211, at 184–85.

considering entering into joint ventures with private corporations.[256] While these entrepreneurial possibilities have broadened nonprofit funding options, it places nonprofits at risk of incurring federal tax liability[257] or losing their tax-exempt status.[258]

SIBs have introduced a new and exciting source of entrepreneurial funding that could mark a revolution in the way nonprofits are financed.[259] Nonprofits that participate in SIBs gain access to a consistent source of funding throughout the term of the program, without fear of potential interruptions such as governmental budget cuts.[260] Further, if the SIB is successful, the managing nonprofit potentially stands to gain a share of the governmental savings, depending on how the SIB is structured.[261] Aside from the potential loss of compensation[262] and reputational damage[263] when a nonprofit fails to meet the SIB benchmarks, nonprofit participation carries a far more serious risk—the potential loss of tax-exempt status.[264]

II. HOW NONPROFITS PARTICIPATING IN SOCIAL IMPACT BONDS MAY VIOLATE THE PRIVATE BENEFIT DOCTRINE

This part discusses the potential clash between the profits paid to investors in SIBs and the private benefit doctrine. Part II.A discusses the specifics of how the private benefit doctrine could be an issue for nonprofits participating in SIBs. Parts II.B–D then analyze how the private benefit issue in SIBs compares with the different categories of private benefit identified in Part I.A.3. Lastly, Part II.E offers some conclusions from the preceding analysis.

A. The Inherent Private Benefit Problem in Social Impact Bonds

Professor Colombo recently stated, "I fear the IRS sees every innovative deal between an exempt charity and some third party outside the charitable

256. *See* Lasprogata & Cotton, *supra* note 69, at 69.

257. Under Treasury Regulation section 1.513, a tax-exempt nonprofit will be forced to pay an unrelated business income tax (UBIT) for regularly carried on activities that produce income but are not substantially related to the nonprofits tax-exempt purpose. *See* Treas. Reg. § 1.513-1 (1967).

258. *See supra* Part I.A.2 (discussing the private inurement and private benefit doctrines).

259. *See* MCKINSEY REPORT, *supra* note 2, at 7–8.

260. *See* Bloomberg Presentation, *supra* note 12, at 3.

261. *See* Kathi Jaworski, *"Pay for Success" Experiment Launches in Massachusetts*, NONPROFIT Q. (Aug. 1, 2012), http://www.nonprofitquarterly.org/management/20806-pay-for-success-experiment-launches-in-massachusetts.html.

262. *See id.*

263. If a SIB is unsuccessful, the participating nonprofits may be perceived as ineffective and face difficulties when trying to raise donations in the future. *See* SOCIAL FINANCE, *supra* note 21, at 22.

264. While this issue will be examined throughout Part II, tax-exempt nonprofits are prohibited from paying out "profits" to private parties. This principle, referred to as the "non-distribution constraint," is the line that separates nonprofits from for-profits. *See* Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980).

class as an issue of private benefit."[265] In fact, most of the private benefit cases occur when nonprofits enter contractual relationships with for-profits that confer economic benefits to the for-profit organization.[266] For participating nonprofits, SIBs are not a simple, no-strings-attached source of funding, considering that the investors agree to provide financing conditioned on the expectation of positive returns on the project.[267]

The question that arises in the context of SIBs is whether or not the investor's returns, which derive from the successful work of nonprofits in the SIB, equate to a distribution of profits akin to other transactions that result in an impermissible private benefit. It seems similar to what Judge Posner described as "the usual 'private benefit' case . . . in which the charity has dual public and private goals."[268] In light of this uncertainty, participating in a SIB may place nonprofits in an uncomfortable position. If a nonprofit accepts, it might lose its tax-exempt status. If a nonprofit declines, it would be turning down a major source of funding that would allow the organization to impact far more lives and obtain greater recognition.

To gain a better idea of how engaging in SIBs may result in a prohibited private benefit, the following sections compare the effect of participating in a SIB with the various forms of private benefit discussed in Part I.A.3. It is unclear whether only successful SIBs would raise private benefit concerns, since if the benchmarks are not met at the end of the SIB term, the private investors would lose their investment and incur a loss.[269] If the IRS adopts an *ex ante* approach to analyze the private benefit, examining the SIB's prospective value and initial expected payout, it is less likely that there would be an impermissible private benefit.[270] Even if the IRS uses the more restrictive *ex post* analysis—focusing retrospectively on the interest paid in successful SIBs—it is debatable whether these investor "profits" would violate the private benefit doctrine. There is a strong argument that the profits which investors stand to earn in SIBs are entirely divorced from private benefit concerns since the profits flow from governmental savings rather than directly from nonprofit operations.[271] Only if we are to believe that the "profits" occurring in SIBs are similar enough to direct payments from nonprofits to third parties does the private benefit issue persist. Considering these arguments to the contrary, while it may be difficult for

265. Colombo, *supra* note 79, at 17 n.64.

266. *See id.* at 23.

267. *See* COSTA ET AL., *supra* note 22, at 12–13.

268. *See* United Cancer Council v. Comm'r, 165 F.3d 1173, 1179 (7th Cir. 1999); *see also supra* note 89 and accompanying text.

269. As noted in Part I.B, in unsuccessful SIBs, the private investors lose their loaned principal and any potential interest as they have taken on the risk of the charitable work. If this occurs, there is no *ex post* private benefit issue since the private investors realize a net loss rather than profiting.

270. Using an *ex ante* approach would lead to a lower probability that there would be a significant private benefit sufficient to satisfy the quantitative prong of the balancing test. *See* discussion *infra* Part II.B.

271. *See* COSTA ET AL., *supra* note 22, at 13 (illustrating the money flows in a SIB).

the IRS to determine that SIB participation would violate the private benefit doctrine, they could conceivably analyze the issue in the following manner.

B. Comparison of Social Impact Bonds with Incidental Private Benefit Transactions

To begin the private benefit analysis, the SIB structure should be measured against the balancing test to determine whether the potential investor profits should be considered incidental.[272] Since the IRS has acknowledged that tax-exempt nonprofits may generate incidental private benefits and retain their exemption, the balancing test offers a threshold determination that can eliminate the need for further private benefit analysis.[273] Although the balancing test remains shrouded in ambiguity,[274] assessing SIBs within the framework could be illustrative of how the IRS would view the private benefit issue.

To pass the qualitative incidental benefit prong, the private benefit occurring must be necessary to achieve a charitable public benefit.[275] SIBs seem to satisfy this requirement. In SIBs, the private benefit, in the form of profits to private investors, is tied directly to the success of the participating nonprofits' ability to serve a charitable class likely to result in governmental savings.[276] The expansion of nonprofit capabilities from SIB funding allows nonprofits to either provide their services to more individuals or better serve their existing constituency.[277] This rapid growth is often not possible through the traditional sources of nonprofit funding, underscoring the necessity of SIB participation to make a greater impact.[278] It is highly likely that SIBs would pass the qualitative prong since the economic realities and fundraising difficulties facing nonprofits make participation necessary to achieve a greater public benefit.[279]

The quantitative prong dictates that an incidental private benefit must be "insubstantial" in comparison with the overall public benefit achieved by the activity.[280] This requirement is difficult to interpret since the IRS has avoided utilizing a consistent method to analyze this prong.[281] While the IRS has not clearly defined what level of private benefit in excess of public

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272. *See supra* notes 105–09 and accompanying text (defining the quantitative and qualitative aspects of the balancing test).

273. *See* Archer, *supra* note 35, at 196.

274. *See* Colombo, *supra* note 92, at 1065.

275. *See* I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987); *see also* FRANCES R. HILL & DOUGLAS M. MANCINO, TAXATION OF EXEMPT ORGANIZATIONS ¶ 4.02[2] (2003).

276. *See supra* note 198 and accompanying text.

277. *See supra* note 198 and accompanying text.

278. *See supra* notes 259–60 and accompanying text.

279. *See supra* notes 251–55 and accompanying text (detailing the increased competition over conventional sources of funding in the nonprofit industry).

280. *See* I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987); *see also* HILL & MANCINO, *supra* note 275, ¶ 4.02[2].

281. *See* HILL & MANCINO, *supra* note 275, ¶ 4.02[2].

benefit would qualify as "insubstantial," the interest paid in SIBs could arguably be construed either way.

In SIBs, it is relatively simple to measure the amount of private benefit that occurs. Successful SIBs will repay investors their initial investment that financed the nonprofit's social program and distribute a variable rate of return depending on how successful the program was at accomplishing its goals.[282]

Valuing the public good, however, is much more challenging as it leaves room for interpretation. If the IRS adopts a narrow interpretation of the public good—only considering the government's cost savings from the SIB's success—SIBs are more likely to fail the quantitative prong, since a sizable portion of the savings are passed along to pay the investors their investment principal and variable interest.[283] Using this narrow perspective of the public good, it would be very difficult to categorize the private benefit as "insubstantial" in comparison with the public benefit. On the other hand, if the IRS uses a broader approach to determine public good, nonprofits could make a strong claim that the resulting private benefit in SIBs is "insubstantial" in comparison with the public benefit. Beyond the mere public benefit from governmental savings, successful SIBs will have delivered substantial intangible benefits to the charitable class served by the nonprofits. It is difficult to value the intangible benefits on a social level when SIBs help individuals to avoid reincarceration and recidivism.[284] However, if the IRS uses this broader view of the resulting public benefit, it is very likely that SIBs would satisfy the quantitative test.

While SIBs seemingly qualify as both qualitatively and quantitatively incidental, there are no guarantees the IRS will agree with this interpretation. After all, the IRS has proven to inconsistently apply the private benefit doctrine and the incidental two-prong test from GCM 39,598 is not binding.[285]

C. Comparison of Social Impact Bonds with Likely Private Benefit Transactions

Beyond the incidental balancing test, the IRS could try to analogize SIB participation to other activities that have resulted in a prohibited private benefit. These past examples of private benefit identified in Part I.A.3.b exhibit some commonalities with SIBs.

The private profits in SIBs resemble the payments associated with both nonprofit debt financing and equity distributions. While a tax-exempt nonprofit may borrow money from private lenders to finance their

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282. *See supra* notes 191–96 and accompanying text.

283. For example, the government officials in the Rikers Island SIB have quantified the possible savings and premium payment that may occur if the SIB is successful. At most, the government will end up saving 22 percent in excess of the repaid principal and interest to the private investors. *See* Costa & Kohli, *supra* note 13.

284. This kind of sociological valuation analysis is beyond the scope of this Note.

285. *See supra* note 114 and accompanying text.

activities, they may not distribute profits as a return on capital to private individuals.[286] Nonprofit debt instruments will not automatically violate the private benefit doctrine,[287] while equity distributions will.[288] Although called a "bond," SIBs are more of a debt-equity hybrid that is not backed by hard assets or cash.[289] SIBs resemble debt due to their fixed term and capped maximum return; however, like equity, the returns will vary depending on the nonprofits' performance.[290] This ambiguity underscores the difficulty in claiming that the private profits in SIBs are more similar to the permissible payouts in tax-exempt bonds or the prohibited dividends in an equity arrangement. As a result, any insights from this comparison seem inconclusive to the overarching question whether SIBs would violate the private benefit doctrine.

At first blush, the profits in SIBs appear similar to a shared revenue stream agreement. Much like the prohibited shared revenue streams, certain SIBs allow managing nonprofits to "share" in the governmental savings with private investors as they both stand to receive a payout if the benchmarks are met.[291] In GCM 39,862, the IRS struck down a shared revenue agreement where a nonprofit essentially outsourced some of its work to private individuals in return for a portion of their earnings.[292] The shared payout possible in SIBs is far different from the arrangement at issue in GCM 39,862. First, the participating nonprofits scale-up their operations to develop comprehensive treatment programs rather than passing off responsibilities to private parties.[293] Second, the profits that private investors may achieve in SIBs occur in a one-off discrete payment from the government,[294] not as a continuing share of revenues as was the case in GCM 39,862.[295] Most importantly, SIBs do not directly generate revenues; rather, they generate governmental savings through programs designed to reduce recidivism or homelessness.[296] Given these differences, it is very difficult to analogize the private benefit transaction exemplified in GCM 39,862 to SIBs.

SIBs also superficially resemble impermissible circular cash flow arrangements to an extent. Much like Revenue Ruling 2006-27,[297] the private investors in SIBs provide money to directly help the charitable class and later stand to reap the benefit from the class's improved social outcomes.[298] However, SIBs are not a true circular cash flow arrangement.

286. *See* BLAZEK, *supra* note 141, at 11.
287. *See supra* notes 116–19 and accompanying text.
288. *See supra* notes 116–19 and accompanying text.
289. *See* SOCIAL FINANCE, *supra* note 21, at 14.
290. *Id.*
291. *See* MCKINSEY REPORT, *supra* note 2, at 16.
292. *See* Colombo, *supra* note 92, at 1074.
293. *See* MCKINSEY REPORT, *supra* note 2, at 4, 7–9.
294. *See supra* notes 196–98 and accompanying text.
295. *See supra* note 122 and accompanying text.
296. *See* COSTA ET AL., *supra* note 22, at 4, 15.
297. *See supra* notes 125–26 and accompanying text.
298. *See* KOHLI ET AL., *supra* note 10, at 4, 7–8.

While the private investors do front the money to the nonprofits in SIBs,[299] the nonprofits do not merely act as a conduit to transfer money to the charitable class.[300] Instead, SIBs use the money provided by the private investors to implement a comprehensive program designed to achieve socially beneficial outcomes aimed at improving their constituents' lives.[301] The profits occur indirectly, from eventual governmental savings,[302] rather than directly from the nonprofit's operations as in Revenue Ruling 2006-27. Unlike a circular cash flow arrangement, the charitable class in SIBs does not receive money from the private investors—they receive the benefits of the investment through improved treatment and outreach programs provided by the nonprofits.[303] SIBs clearly do not result in a private benefit like the agreement in Revenue Ruling 2006-27.

If the IRS seeks to use the broad conceptualization of private benefit doctrine from *American Campaign Academy*, SIB participation could endanger the tax exemption. In *American Campaign Academy*, the court noted that a secondary benefit would be impermissible if it is "earmarked for a particular organization," rather than broadly distributed among an industry.[304] SIBs seem to run afoul of this formulation, since the private investors are singled out to receive a variable rate of return if the program successfully meets its preset performance targets.[305] Before concluding that SIBs will always result in an impermissible private benefit, it is important to note that *American Campaign Academy* is recognized as a highly questionable decision that has not been relied upon in subsequent cases.[306] Also, the legal community has widely disregarded the decision as improper and carrying little precedential value.[307] While the private benefit definition from *American Campaign Academy* seems to present a major issue for nonprofits participating in SIBs, the skepticism over the integrity of the doctrine suggests it may not be utilized again.

None of the three examples of private benefit enumerated in Treasury Regulation section 1.501(c)(3)-(d)(1)(iii) would reasonably apply to SIBs. The first example found a private benefit when the charitable class was insufficiently small.[308] It is highly unlikely that nonprofits participating in SIBs will serve an insufficiently small charitable class. SIBs are designed to introduce or scale-up current charitable programs to serve a constituency large enough to result in meaningful government savings.[309] Considering

299. *See* COSTA ET AL., *supra* note 22, at 13.
300. *Cf. supra* text accompanying note 127.
301. *See* SOCIAL FINANCE, *supra* note 21, at 11–12.
302. *See supra* notes 196–98 and accompanying text.
303. *See* Rosenberg, *supra* note 10.
304. *See* Am. Campaign Acad. v. Comm'r, 92 T.C. 1053, 1074 (1989).
305. *See* SOCIAL FINANCE, *supra* note 21, at 12.
306. *See supra* note 138 and accompanying text.
307. *See supra* note 137 and accompanying text.
308. *See* Treas. Reg. § 1.501(c)(3)-(d)(1)(iii) (as amended in 2008).
309. *See supra* Part I.B.

the complexity and costs inherent in the SIB structure,[310] it would not be feasible to merely benefit a small group of people as those in the first regulatory example. SIBs also do not match up with the second regulatory example, which resulted in a clearly disproportionate commission to private parties without serving meaningful charitable goals.[311] This does not occur in SIBs, which will only pay private investors a portion of governmental savings if the charitable class is properly served by the nonprofit.[312] Lastly, example three, which details the retention of assets in a professional training agreement between a nonprofit and a for-profit entity,[313] is simply not applicable to SIBs. While the regulatory examples clearly describe three transactions that violate the private benefit doctrine, none of them are similar enough to the profits paid in SIBs to provide meaningful assistance in this analysis.

In conclusion, the various forms of likely private benefit discussed fail to clearly address the SIB private benefit issue. The superficial similarities in shared revenue streams and circular cash flow arrangement lack depth, the broad *American Campaign Academy* interpretation lacks support, and the regulatory examples altogether fail to capture the essence of the potential issues in the SIB's payout structure.

D. Comparison of Social Impact Bonds with Joint Venture Private Benefit Transactions

The separate private benefit framework utilized by the IRS when nonprofits enter into joint ventures with private parties may provide further guidance to analyze the private benefit issue in SIBs.

Yet, before approaching the private benefit question, it is important to determine if SIBs are similar enough to joint ventures to warrant comparison. A joint venture can be implied even when the cooperating parties fail to explicitly recognize their arrangement as such.[314] While SIBs do not precisely fit the tax law definition of a joint venture,[315] there are several resemblances between the two. Joint ventures are enterprises between parties with (1) a shared interest in a common purpose, (2) a shared interest in the subject matter, (3) shared control over policy, and (4) shared profits.[316]

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310. *See* COSTA ET AL., *supra* note 22, at 12, 16.

311. *See* Treas. Reg. § 1.501(c)(3)-1(d)(1)(iii) (as amended in 2008).

312. For example, investors in the Peterborough SIB and Rikers Island SIB are only paid when recidivism is successfully lowered—benefitting the former prisoners and assisting their reintegration into society. *See supra* notes 200–08 and accompanying text.

313. *See* Treas. Reg. § 1.501(c)(3)-1(d)(1)(iii).

314. *See* Jones, *supra* note 65, at 620–21.

315. For tax purposes, a joint venture requires the presence of four factors: (1) express or implied agreement between the parties to establish a business venture, (2) joint control and proprietorship, (3) mutual contribution of assets to the venture, and (4) shared profits. *See id.* at 623.

316. *See* Mirkay, *supra* note 158, at 25 (citing Harlen E. Moore Charitable Trust v. United States, 812 F. Supp. 130, 132 (C.D. Ill.), *aff'd*, 9 F.3d 623 (8th Cir. 1993)).

The first factor appears to be met in SIBs because the private investors and nonprofits share the same purpose of successfully providing charitable services, which will eventually lead to profits for the private investor.[317] The second factor is also plausibly satisfied in SIBs. Although the subject matter in SIBs—serving a charitable class—may be of more interest to the nonprofits, for-profit entities have previously demonstrated an interest in social responsibility.[318] In terms of the third factor, private investors do not directly share control with nonprofits in SIBs. Investors usually will have little say in how the nonprofits should fulfill the SIB, although they may exert some control over which nonprofits are chosen to fulfill the SIB.[319] Lastly, the final factor of shared profits could be met in SIBs that extend a performance bonus to the managing nonprofit in addition to paying investors when successful.[320] Much like joint ventures between private parties and nonprofits, participation in a SIB would allow a nonprofit to further its exempt purposes, diversify its sources of revenue, and obtain needed capital in an increasingly competitive environment.[321] While the SIB model does not exactly mirror that of joint ventures, the appearance is similar enough to warrant consideration of the accompanying private benefit analysis.

Following the whole-entity joint venture framework established in Revenue Ruling 98-15 and *Redlands*, the IRS uses a three-factor test to determine when nonprofits may preserve their exemption even when some private benefit occurs.[322] The three factors look to whether a nonprofit can show that it (1) is serving a charitable purpose, (2) is able to act exclusively in furtherance of the purpose, and (3) retains control over management decisions.[323] The first factor is not a problem because a nonprofit's role in SIBs is to provide services to a targeted charitable class.[324] The second factor may be an issue in SIBs, considering that the charitable purpose is inseparable from the investor's underlying profit component—which depends upon the successful execution of the program's charitable purpose.[325] Lastly, the third factor of control is unlikely to be an issue in SIBs. Unlike joint ventures, the nonprofits and private parties in SIBs are not bound to decisions from a board.[326] In SIBs, the participating nonprofits are bound to serve a specified class, yet they are capable of

317. *See supra* notes 198, 210 and accompanying text.

318. *See generally* LEV ET AL., *supra* note 221.

319. *See supra* note 247 and accompanying text (noting how investors are likely to require that proven nonprofits are selected to justify participating in the SIB).

320. *See supra* note 291 and accompanying text.

321. *See* Mirkay, *supra* note 158, at 25.

322. *See* SANDERS, *supra* note 72, at 14–16.

323. *See id.*

324. *See* discussion *supra* Part I.B.1.

325. *See* Costa & Kohli, *supra* note 13 (explaining the cash flows and connections between the SIB parties).

326. *See* Mirkay, *supra* note 158, at 23 (noting the importance for nonprofits to control the board of directors in private joint ventures).

retaining control to formulate and implement the program to fulfill the SIB.[327]

Altogether, the three factors seem to weigh in favor of allowing nonprofit SIB participants to maintain their tax-exempt status. As noted in the *Redlands* and *St. David's* decisions, the importance of retaining control is a key factor in determining private benefit in joint ventures.[328] Since nonprofits in SIBs serve a charitable purpose and are capable of exercising control over their operations, it is unlikely that participation would result in an impermissible private benefit if the IRS were to analyze the issue under the whole-entity joint venture framework.

If the IRS were to utilize the ancillary joint framework instead, the exemption would even face less scrutiny because control over operations is not required and the IRS takes a more deferential approach.[329] Complicating this possibility, it is somewhat more difficult to analogize SIBs to ancillary joint ventures.

Ancillary joint ventures are often designed to continue or expand charitable services with minimal financial risk to the charitable entity.[330] The typical ancillary joint ventures have been utilized in situations where large nonprofit institutions, such as schools and hospitals, partner with a private entity to operate small side projects together.[331] SIBs may require the participating nonprofits to direct most or all of their assets to pursue their targeted goals, given the advantages of selecting proven nonprofits capable of scaling-up successful operations to a larger charitable class.[332] Yet, a SIB could be structured more like an ancillary joint venture by dividing up the program between multiple nonprofits, where each nonprofit provides a portion of the services required in a comprehensive outreach program.[333] If this were the case and the IRS were to use the Revenue Ruling 2004-51 analysis, nonprofits in SIBs could avoid the private benefit problem if participation would only account for an insubstantial portion of the organization's overall activities.[334] Regardless, the precedential value of Revenue Ruling 2004-51 is tenuous considering private benefit is never explicitly mentioned in the text and academics continue to debate its proper interpretation.[335]

Since SIBs are not quite the same as joint ventures, there is no guarantee the IRS will employ either joint venture private benefit framework to determine the issue. Despite this, if the IRS chooses to scrutinize the private benefit occurring in SIBs similar to either the whole-entity or

327. *See* COSTA ET AL., *supra* note 22, at 3–5, 7–8.
328. *See supra* notes 170–75 and accompanying text.
329. *See* SANDERS, *supra* note 72, at 16–17.
330. *See* Colombo, *supra* note 92, at 1094.
331. *See id.* at 1095.
332. *See* SOCIAL FINANCE, *supra* note 21, at 17.
333. *See* COSTA ET AL., *supra* note 22, at 10–11.
334. *See supra* note 179 and accompanying text.
335. *See supra* text accompanying notes 182–87.

ancillary joint ventures, participating nonprofits stand a good chance of retaining the tax exemption.

E. Conclusions

Having examined the SIB's private benefit issue in comparison with incidental private benefit transactions, likely private benefit transactions, and joint venture private benefit transactions, this part has illustrated how the IRS may view the issue. It is important to remember that the majority of the preceding analysis assumes that the IRS would seek to use a more aggressive *ex post* approach to scrutinize the profit payout to private investors.[336] If the IRS takes the broader *ex ante* view of SIBs, the threat of a private benefit issue is very attenuated.[337] Even under the *ex post* approach, there is a strong argument that the private benefit possible in SIBs should be deemed incidental and not similar enough to any of the likely private benefit transactions.[338]

Despite these indications to the contrary, private benefit could persist as an issue since the doctrine remains an ad hoc tool, which the IRS has used "even when charitable purposes might globally outweigh a private benefit transaction."[339] Some valuable charitable goals can only be achieved by conferring third-party profits, however this fact does not excuse application of the private benefit doctrine.[340] While it would be difficult to find a prohibited private benefit in a conventional SIB arrangement, the lingering private benefit specter may deter certain nonprofits from engaging in a SIB if it could jeopardize their tax exemption. If SIBs become implemented on a widespread basis, it could result in a push to modify the current private benefit framework in force.

The impact of SIBs is just beginning to be felt as more programs are being finalized and more investors become comfortable with the model.[341] In the wake of further expansion, the nonprofit industry and regulators could be forced to face the lurking private benefit issue identified and analyzed in this Note. While the IRS may not have a problem with SIBs in their current promising infancy, perhaps its stance will change when Goldman or other institutional investors begin to realize the profits from the successful work of nonprofits participating in SIBs.

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336. *See* discussion *supra* Part II.A.
337. *Id.*
338. Aside from the perceived conflict with the questionable *American Campaign Academy* analysis.
339. *See* Colombo, *supra* note 92, at 1083.
340. *See* Jones, *supra* note 33, at 985.
341. *See* COSTA ET AL., *supra* note 22, at 11–12.

III. RECOMMENDATIONS FOR NONPROFITS PARTICIPATING IN SOCIAL IMPACT BONDS TO AVOID THE PRIVATE BENEFIT ISSUE AND RETAIN THEIR EXEMPTION

This part seeks to offer solutions to the private benefit issue in SIBs and ensure that nonprofit participants will not jeopardize their tax-exempt status. Part III.A suggests how nonprofits could seek a legislative or regulatory exemption to the private benefit doctrine. Part III.B offers recommendations on how SIBs can be structured in a specific manner to mitigate the potential private benefit issue.

A. Seek Legislative or Regulatory Changes to the Private Benefit Doctrine

First, this section examines the debate over whether protecting nonprofit participants in SIBs from private benefit concerns would be a sound policy choice. Then, it closes by discussing how a governmental change to the private benefit doctrine could be accomplished.

1. Whether the Government Should Protect Social Impact Bonds from the Private Benefit Doctrine: The Social Impact Bond Policy Debate

While none of the implemented SIBs have matured at this point, there has already been much commentary supporting or criticizing the concept.[342] To better understand the magnitude of the private benefit issue, it is important to consider the positive and negative policy implications of SIBs.

If SIB advocates decide to seek governmental support against private benefit, there are several arguments why SIBs deserve protection. As previously discussed in Part I.A.2, one of the main policy rationales for the existence of the private benefit doctrine is to ensure that the charitable purpose is preserved.[343] Since SIBs are designed to clearly serve a charitable purpose,[344] despite the accompanying potential for private profits, using the private benefit doctrine to revoke the tax exemption for participating nonprofits would be counterproductive. In addition, if a nonprofit loses the exemption, it will normally reduce or eliminate the amount of charitable goods and services provided.[345] While SIBs may confer profits on private investors, the concurrent public good is likely to be far greater—a justification that should spare nonprofits from vulnerability to the private benefit doctrine. Unless the government can offer some protection for nonprofits contemplating SIBs, fears over losing the federal tax exemption could prevent further participation and limit the execution of major social programs for the poor. Without the risk of revocation, SIBs could lead to increased capital contributions to nonprofits and more

342. *See supra* notes 20, 229 and accompanying text.
343. *See supra* notes 95–96 and accompanying text.
344. *See* COSTA ET AL., *supra* note 22, at 6–7 (detailing the various possible SIB applications to address social challenges).
345. *See* Jones, *supra* note 94, at 716.

effective charity work.[346] Lastly, it is important to solve this issue because if it remains unanswered, potential interference from the amorphous private benefit doctrine could "discourage efficiency and ultimately harm charitable beneficiaries."[347]

Several commentators have taken a skeptical approach to SIBs, concerned that participation could lead to nonprofit "mission drift."[348] One writer has noted that mingling nonprofit goals with for-profit ones could end up corrupting the underlying good being accomplished.[349] Professor Mark Rosenman echoed these views when asked about the potential effects of SIBs, stating, "When we seek to introduce the profit motive, we begin to abandon who we are as a people and abandon our responsibility for the common good in pursuit of private profit."[350] Raising a separate issue, some nonprofit leaders worry that nonprofit giving would shift toward profit-driven SIBs and away from outright donations.[351]

Despite these potential negatives, SIBs provide an innovative method to expand funding to nonprofits that benefits a large charitable class without requiring immediate governmental financial commitments or close oversight.[352] Each SIB participant's interests are aligned to ensure that the charitable purpose is properly served throughout the term of the SIB, leaving the profit motive in the background.[353] SIBs are not intended to be a complete replacement for governmental grants or donations,[354] limiting concerns that SIBs could divert money away from conventional funding methods. Further, SIBs will always be more expensive for the government than conventional nonprofit funding methods because of the potential interest payment to investors and the associated costs in developing and tracking the performance metrics.[355] Ultimately, SIBs attempt to bring together successful nonprofits, socially conscious investors, and governmental agencies to remedy serious social issues and reduce government obligations.[356] If this proposition is accepted, it is clear that nonprofits participating in SIBs should have their tax-exempt status protected from the private benefit doctrine.

346. *See* Archer, *supra* note 35, at 161–62.

347. *See* Jones, *supra* note 65, at 589 (discussing the negative impact from the vague limits of the private inurement doctrine, which equates closely to the poorly defined private benefit doctrine).

348. Mission drift has been defined as the cultural shift from a nonprofit purely motivated by charitable ends to one driven by profitable means. *See* Bucholtz, *supra* note 64, at 434.

349. *See* M.S., *supra* note 16.

350. *See* Preston, *supra* note 197.

351. *See id.*

352. *See* COSTA ET AL., *supra* note 22, at 6, 9; MCKINSEY REPORT, *supra* note 2, at 7.

353. *See* MCKINSEY REPORT, *supra* note 2, at 7, 57.

354. *See* Preston, *supra* note 197.

355. *See* MCKINSEY REPORT, *supra* note 2, at 49.

356. *See supra* note 198 and accompanying text.

2. How the Government Could Limit the Private Benefit Issue

While the IRS seemingly would have a hard time finding a valid private benefit in SIBs,[357] the issue could linger and raise doubt unless there is a clear indication to the contrary from the government. Even following the September 11th attacks, a governmental response was required to allay private benefit concerns relating to relief payments for victims and their families.[358] Since cash grants to disaster victims not classified as "poor" could result in a prohibited private benefit, the IRS responded with Notice 2001-78 to quell any possible issues.[359] In the notice, the IRS claimed that such grants would be considered for an exempt purpose if made "in good faith using objective standards."[360] Even this assurance from the IRS was not enough to dispel private benefit concerns and Congress enacted legislation that effectively removed the private benefit analysis from September 11th disaster relief payments.[361] Lacking even the assurances of an IRS statement akin to Notice 2001-78, nonprofits that participate in SIBs will remain vulnerable to the private benefit doctrine.

Given the lessons from the September 11th donations, supporters of SIBs could lobby the government to waive the private benefit issue for participating nonprofits. While it may be difficult to mobilize legislation to support SIBs as they remain in their infancy, a supportive statement or regulation from the IRS could be sought instead. In fact, Congress delegated authority to the IRS to determine when third-party profit taking is consistent with the federal tax exemption.[362] The IRS could be pressured to use this authority to waive private benefit analysis for nonprofits that participate in SIBs. Even a nonbinding pronouncement similar to Notice 2001-78 that the IRS will not pursue private benefit challenges against nonprofits in SIBs would be beneficial.

Going a step further, the private benefit issue in SIBs could present a good opportunity for the IRS to overhaul the private benefit doctrine. Professor Jones has suggested that the private benefit doctrine should be simplified to a deferential business judgment rule analysis when a nonprofit organization confers profits to third parties indispensable to the charitable goal.[363] This approach argues that the IRS "should not substitute its judgment for that of nonprofit managers regarding the degree to which accomplishing the charitable goal is worth explicit third-party profit-taking."[364] Utilizing this framework in the SIB context, participating

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357. *See supra* Part II.E.

358. *See* Colombo, *supra* note 92, at 1101.

359. I.R.S. Notice 01-78, 01-2 C.B. 576.

360. *Id.*

361. Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107-134, § 104, 115 Stat. 2427, 2431 (codified as amended in scattered sections of 26 U.S.C.); *see also* Colombo, *supra* note 92, at 1101.

362. I.R.C. § 4958(c)(4) (2006); *see* Jones, *supra* note 33, at 995.

363. *See* Jones, *supra* note 33, at 987.

364. *Id.*

nonprofits would likely receive the deferential business judgment rule because the successful fulfillment of charitable goals is indispensable to achieving private profits.[365] Given the purported merits of SIBs,[366] the benefits of adopting Professor Jones's approach could provide a much-needed limit on the boundless private benefit doctrine.

Although Congress has acknowledged that nonprofit legislation is outdated and in need of reappraisal,[367] there have been no clear indications they will take action to change this anytime soon. Perhaps the emergence of SIBs will provide an extra impetus for changes to the private benefit doctrine as both the government and nonprofits would stand to achieve significant benefits if SIBs are supported.[368]

B. Structure the Social Impact Bond To Mitigate Private Benefit

To avoid the costs, difficulty, and slow pace of lobbying for doctrinal changes, an easier solution would be to simply structure SIBs in the manner least likely to run afoul of the private benefit doctrine. The remainder of this part provides a few suggestions on how to accomplish this.

First, the government originating a SIB should attempt to set the expected payout to private investors at zero or less. The government is likely to have control over this because they typically are the party responsible for initiating a SIB once it has identified a specific public outreach goal that will result in cost savings.[369] Since private investors stand to lose 100 percent of their investment if there is no supportive guarantee[370] and the benchmarks are not met,[371] SIBs can carry a negative expected payout, despite the potential interest to be paid. Setting an expected payout at zero or less would consequently limit the kinds of investors likely to be interested in SIBs to those who prioritize philanthropy over financial profits.[372] This solution may prove particularly effective if the IRS uses an *ex ante* approach[373] to frame the private benefit issue. Assuming this were to be the case, the expected negative value to investors as a whole suggests that the private benefit would almost certainly be deemed incidental and the tax exemption would be undisturbed.

Second, SIBs should be designed to ensure that no money passes through the nonprofits, other than that necessary to implement the program or scale-up operations. If a tax-exempt nonprofit directly participates in the

365. *See supra* notes 197–98 and accompanying text.
366. *See supra* Part III.A.1.
367. *See* Bucholtz, *supra* note 64, at 445 n.146.
368. *See supra* Part I.B.2.
369. *See* COSTA ET AL., *supra* note 22, at 7.
370. In contrast, the Bloomberg Philanthropies guarantee in the Rikers Island SIB limited the downside investment risk for the private investors. *See* text accompanying notes 17–19.
371. *See* Costa & Kohli, *supra* note 13 (explaining how the money flows and returns are paid in a SIB).
372. *See* MCKINSEY REPORT, *supra* note 2, at 39–40 (discussing the types of investors likely to be interested in SIBs).
373. *See supra* note 270 and accompanying text.

exchange of funds with the government and investors as in a "self-implemented" SIB,[374] private benefit is more likely to be an issue. It would be preferable to keep this money-transferring role separate from the nonprofits that provide the services to the charitable class in the SIB. This can be accomplished by utilizing an independent intermediary organization to disburse funds to the nonprofits and transfer money from the government to the private investors[375]—further isolating the tax-exempt nonprofits from the for-profit components of the SIB. While the inclusion of a separate intermediary organization would not entirely eliminate a participating nonprofit's connection to private profits, it would diminish the already tenuous argument for finding a private benefit in SIBs.

Lastly, the participating nonprofits should be given control over how they will interact with the charitable class and implement the SIB program. Given the lessons from *Redlands* and *St. David's*, control in whole-entity joint ventures has become a crucial component to determine private benefit.[376] To account for this, a government agency could implement a SIB by specifying the desired outcome and timeframe but leave the details on how to accomplish this to the participating nonprofits.[377] If nonprofits in SIBs retain control over their day-to-day operations, it is less likely the private investors' tangential profit motive will interfere with their charitable goals. Since the private benefit doctrine seeks to ensure that the charitable purpose is not overly disturbed by third-party profit-taking,[378] allowing participating nonprofits to retain control could be an important step to avoid revocation of the tax exemption.

While each of these structural suggestions could prove beneficial to nonprofits attempting to avoid the private benefit issue, they also create friction with other SIB participants. Lowering expected payouts will turn away certain investors,[379] using a separate intermediary organization will increase costs to the government,[380] and ceding too much control to nonprofits will increase the risk that the SIB may fail to accomplish the desired social outcomes.[381] As a result, nonprofits should expect to face some difficulty when bargaining for these or other structural solutions that could mitigate private benefit concerns.

374. For a clear graphical representation of how the participants interact in a "self-implemented" SIB, see COSTA ET AL., *supra* note 22, at 10.

375. *See id.* at 13.

376. *See supra* notes 172–75 and accompanying text.

377. *See* COSTA ET AL., *supra* note 22, at 3–4 (suggesting that the government should not mandate how nonprofits should accomplish the desired outcomes).

378. *See supra* Part I.A.2.

379. *See supra* note 372 and accompanying text.

380. *See* MCKINSEY REPORT, *supra* note 2, at 40–41, 48 (noting that intermediaries will likely require management fees).

381. *See* COSTA ET AL., *supra* note 22, at 16.

CONCLUSION

SIBs present an important new method to implement major social programs and scale-up successful nonprofits by changing the conventional social service funding paradigm—shifting the financial risk of failed programs from the government to private investors. Private benefit remains a threat to nonprofits participating in SIBs mainly due to muddled interpretations that have allowed the doctrine to apply to a wide variety of transactions where a private party profits in connection with nonprofit activities.

While it is possible to compare SIBs with past forms of private benefit, the SIB structure defies convention and cannot be simply analogized. Overall, the risk of violating the private benefit doctrine is low in SIBs considering there are strong indications that the IRS would consider any private profits incidental to the overreaching charitable purpose; however, this is no guarantee. Ideally, the government should take action to dispel the specter of private benefit embedded in SIBs to encourage further nonprofit SIB participation, which is capable of expanding services to the poor and needy. Until this is accomplished, nonprofits should take the risk that SIB participation will not violate the private benefit doctrine and seek to mitigate this possibility by bargaining for certain structural protections.