

THE SOCIAL BUSINESS: THE VIABILITY OF A NEW BUSINESS ENTITY TYPE

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I. INTRODUCTION

Grameen Bank and Professor Muhammed Yunus won the Nobel Peace Prize in December 2006 for their ground-breaking work in microcredit and poverty reduction.¹ The Bank's mission is to decrease poverty in rural Bangladesh by granting small, collateral-free loans primarily to poor women villagers. The women qualify for loans by presenting a satisfactory business plan, learning how to sign their own names, forming groups with four other would-be borrowers,² and attending a week-long training program where they learn Grameen's social principles.³ A typical loan ranges from \$10-\$300. Business

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1. See Muhammed Yunus, *The Nobel Peace Prize 2006: Nobel Lecture*, 13 L. & BUS. REV. AM. 267, 272 (2007).

2. *Id.* at 104-108; interview with Fais Ahmed, Amdala Branch Manager, Grameen Bank, in Bangladesh (June 24, 2007).

3. The "16 Decisions of Grameen Bank":

1. We shall follow and advance the four principles of Grameen Bank—Discipline, Unity, Courage and Hard Work—in all walks of our lives.
2. Prosperity we shall bring to our families.
3. We shall not live in dilapidated houses. We shall repair our houses and work towards constructing new houses at the earliest.
4. We shall grow vegetables all the year round. We shall eat plenty of them and sell the surplus.
5. During the plantation seasons, we shall plant as many seedlings as possible.
6. We shall plan to keep our families small. We shall minimize our expenditures. We shall look after our health.
7. We shall educate our children and ensure that they can earn to pay for their education.
8. We shall always keep our children and the environment clean.
9. We shall build and use pit-latrines.

plans can be as simple as buying one cow and selling the milk each day at a village market.⁴

Professor Yunus began his microlending program in Jobra Village, situated near Chittagong University, where he taught rural economics.⁵ Chittagong sits on the Bay of Bengal, in the southeastern part of Bangladesh. The region suffers from monsoons and perennial flooding, resulting in severe crop damage and human casualties. In 1974, Professor Yunus personally lent \$27, interest-free, to 42 poor villagers from Jobra, and asked them to repay him whenever they could.⁶ Today, the Bank boasts over seven million borrowers (about forty million total members including borrowers and their families), it has a repayment rate of over 99%, it has seen over 58% of its members cross the poverty line,⁷ and most years it makes a substantial profit.⁸

Grameen Bank has grown and changed significantly since its humble beginnings in Jobra Village. Grameen is now a full-service bank, with the hallmark of its service being that the bank employees come to the borrowers' villages, and even their homes, to receive loan applications, disburse loan funds, and take deposits. The Bank has many different types of loans now, including the basic loan, the home loan, the special investment loan for larger business ventures, and interest-free loans for beggars. Most loans are processed and disbursed

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10. We shall drink water from tubewells. If it is not available, we shall boil water or use alum.
 11. We shall not take any dowry at our sons' weddings, neither shall we give any dowry at our daughters wedding. We shall keep our centre free from the curse of dowry. We shall not practice child marriage.
 12. We shall not inflict any injustice on anyone, neither shall we allow anyone to do so.
 13. We shall collectively undertake bigger investments for higher incomes.
 14. We shall always be ready to help each other. If anyone is in difficulty, we shall all help him or her.
 15. If we come to know of any breach of discipline in any centre, we shall all go there and help restore discipline.
 16. We shall take part in all social activities collectively.

MUHAMMED YUNUS, *BANKER TO THE POOR* 115-116 (1998)

4. Interview with Ahmed Fais, Amdala Branch Manager, Grameen Bank, in Bangladesh (June 24, 2007).

5. YUNUS, *BANKER TO THE POOR*, *supra* note 3, at 11.

6. *Id.*

7. Yunus, *Nobel Speech*, *supra* note 1, at 269. The poverty statistic is based on Professor Yunus's *Ten Indicators to Assess Poverty Level*, available at www.grameen-info.org/bank/tenindicators.htm.

8. Grameen Bank at a Glance, www.grameen-info.org/bank/GBGlance.htm (last visited July 21, 2007).

within one week of the proposal.⁹ The Bank also takes deposits for members' savings accounts, pension schemes, and loan and life insurance.¹⁰ Grameen Bank's success has been internationally recognized and its method is being replicated in many other countries around the world.¹¹

Grameen Bank was created as an independent bank through a special statute passed by the Bangladeshi legislature in 1983.¹² The Bank is currently owned 7% by the government and 93% by its borrowers, who purchase shares per capita for about \$1.50.¹³ The Bank is a nonprofit organization under Bangladeshi law, and it is exempt from income tax under the 1983 ordinance provided that it puts all its profits into a Disaster Fund, to be used for the benefit of its borrowers in the case of a natural disaster.¹⁴

The Bank has also created numerous "sister companies," most of which are organized not-for-profit, and some that are tax-exempt. The sister companies include ventures in preschool education, the garment industry, renewable energy, and fortified yogurt manufacturing. These sister companies all share the Grameen name and the Grameen mission of improving the condition of the rural poor through loan- and business-oriented solutions rather than charity handout programs. These companies have already created 2800 well-paying jobs in a factory adhering to all government safety and benefits standards¹⁵ and equipped over 100,000 rural homes and businesses with clean and reliable solar energy,¹⁶ among a myriad of other social benefits.

Grameen has revolutionized Bangladesh through its focus on women and its philosophy of believing in the capabilities of the poor. Grameen Bank has so many members and such an influential social agenda that it can be said that "Bangladesh has two governments," the

9. Interview with Ahmed Fais, Amdala Branch Manager, Grameen Bank, in Bangladesh (June 24, 2007).

10. *Id.* at 1-2.

11. YUNUS, *BANKER TO THE POOR*, *supra* note 3, at 181-194.

12. The Grameen Bank Ordinance, Ord. XLVI § 1 (1983) (amended 1995); *see also* Interview with Golam Morshed Mohammed, International Programmes Department Coordinator, Grameen Bank, in Bangladesh (July 8, 2007).

13. Interview with Golam Morshed Mohammed, International Programmes Department Coordinator, Grameen Bank, in Bangladesh (July 8, 2007).

14. *Id.*

15. Interview with Redwanul Haque, Manager, Grameen Knitwear, in Bangladesh (July 13, 2007).

16. Interview with Md. Fazley Rabbi, Engineer, Grameen Shakti, in Bangladesh (July 10, 2007).

national government and Grameen Bank.¹⁷ Grameen is completely free from dependence on government grants and now declines all donor funds. It is a self-sufficient financial institution that has created a new and lucrative market in lending as a by-product of its mission to end poverty in Bangladesh. While the beneficial work and success of Grameen Bank is obvious, if the Bank was organized under US law, its tax-exempt status would be precarious, threatening the viability of the entire enterprise as a result.

The current state of US charitable tax exemption law is muddled at best, and impenetrable at worst. In the US, the Bank would be in danger of running afoul of numerous exemption doctrines, including the exempt purpose requirement, the commerciality doctrine, the private benefit doctrine, the prohibition against certain joint ventures, the Unrelated Business Income Tax (UBIT), and the Excess Benefit Tax (EBT). These doctrines and rules will be discussed in turn, however, a general theme emerges that is worth noting initially: these doctrines reflect a policy of preventing charities from behaving too much like businesses. Although the benefit of federal tax exemption should not be available to commercial businesses, such a policy against commerciality in general severely limits the breadth of innovation and potential funding sources accessible to American charities and nonprofit organizations, which provide essential services and employment opportunities to the poorest Americans.

The current legal framework in the US does not encourage, or even allow, many forms of entrepreneurship or profitable activities within exempt organizations. Professor Yunus has proposed the creation of a new type of business entity, called the “social business,” to fill this legal and intellectual gap.¹⁸ Social business may not fit into the popular or legal definitions of “charity” or “business.”¹⁹ Instead, social businesses will be encouraged to pursue both social and economic goals. The bifurcated system of exempt or non-exempt, nonprofit or for-profit, simply does not create a hospitable legal environment for social entrepreneurs to develop private, self-sustaining solutions to poverty and other pressing societal problems that are arguably

17. See STEPHEN C. SMITH, *ENDING GLOBAL POVERTY: A GUIDE TO WHAT WORKS* 66 (2005). While the original quote references BRAC, another micro-credit institution in Bangladesh, the sentiment equally applies to the influence of Grameen Bank.

18. Yunus, *Nobel Lecture*, *supra* note 1, at 272.

19. See Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 *VILL. L. REV.* 433, 467-468 (1996); Bradley Myers, *Revisiting the Commerciality Doctrine*, 10 *J. AFFORDABLE HOUSING & COMMUNITY DEV. L.* 134, 138 (2001).

within the province of the government to fix.²⁰ Charity law in the US is in need of a paradigm shift by which we encourage business-oriented solutions to poverty and social problems, and the creation of a new legal form of business could precipitate this paradigm shift.²¹

In Part II of this article, I will explore the current conundrum of non-profit tax law, and the “double-bind” charities face as government funding continues to wane.²² In Part III, I will explain the shortcomings of the current legal framework for US charities and then discuss Professor Yunus’s proposal to facilitate socially conscious entrepreneurial solutions to social problems. In Part IV, I will suggest some general legal parameters for the social business form, reflecting current U.S. policy toward private charities, and advocating for the adoption of some new policies as well.

II. THE CURRENT STATE OF NONPROFIT LAW AND THE CHARITABLE TAX EXEMPTION

Besides the obvious problem of constant pressure to raise funds for operating expenses, American nonprofit organizations face many challenges and legal uncertainties which presumably decrease their reach and effectiveness. First, despite an increased reliance on nonprofits to provide quasi-governmental social services to the poor, the nonprofit sector’s access to federal funds is severely limited, and has been since federal budget cuts in the 1980s.²³ Second, an increasing number of nonprofits must compete for scant resources to stay afloat.²⁴ Third, and perhaps most important, the current state of the law regarding the charitable exemption from federal income tax is chaotic and unpredictable, causing nonprofit organizations to guess at whether they will be able to obtain tax exemption.²⁵ With corporate tax rates ranging from 15-35 percent,²⁶ an adverse ruling from the IRS regard-

20. See Yunus, *Nobel Speech*, *supra* note 1, at 272 (“By defining ‘entrepreneur’ in a broader way we can change the character of capitalism radically, and solve many of the unresolved social and economic problems within the scope of the free market.”). See also *Bob Jones University v. U.S.*, 461 U.S. 574, 590 (1983) (noting the policy behind providing tax exemption to organizations operating in the traditional sphere of the government).

21. Yunus, *Nobel Speech*, *supra* note 1, at 271.

22. Thomas Kelley, *Rediscovering Vulgar Charity: A Historical Analysis of America’s Tangled Nonprofit Law*, 73 *FORDHAM L. REV.* 2437, 2438 (2005).

23. Heather Gottry, Note, *Profit or Perish: Non-Profit Social Service Organizations & Social Entrepreneurship*, 6 *GEO. J. ON POVERTY L. & POL’Y* 249, 252-253 (1999).

24. *Id.* at 251-255.

25. Kelley, *supra* note 22, at 2473.

26. I.R.C § 11(B)(1)(a)-(d) (2006).

ing exemption could cause of the closure of a nonprofit organization.

The first two challenges facing nonprofits are similar and their analysis can be brief. To combat waning federal funding and to address the issue of competition for financial resources, many nonprofits turn to commercial activity to support their enterprises.²⁷ While the confluence of charity and capital markets intuitively causes dissonance,²⁸ these types of commercially supported social service organizations are well-accepted both popularly and legally.²⁹ For example, Goodwill bases its operations around economic transactions that occur in its retail stores. Goodwill is profitable and competes with other clothing stores and department stores. It seems clear, though, that Goodwill is a charity and not a business as its inventory is based on donations and it routinely employs disadvantaged persons.³⁰ Goodwill is exempt from federal income tax and donations to Goodwill of cash, clothing, and household goods are tax-deductible to the donor.³¹

The Goodwill example makes clear that US law and popular opinion recognize the need for nonprofits to raise funds and pursue their exempt purposes in capital markets—charity law implicitly condones a certain level of commercial activity from charities, and people accept the idea that certain charities act like businesses.³² However, exactly how much commercial activity will be accepted before tax exemption is lost remains subject to vague, inconsistently applied doctrines and a hodgepodge of various facts-and-circumstances tests.

A. Charity Law in the US

Nonprofit organizations provide a range of public services to the poor, including healthcare, job training, employment, legal services, and education. Such organizations qualify for federal income tax exemption under the theory that “the [g]overnment 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. . . .”³³ As government increasingly pulls out of the public service are-

27. Gottry, *supra* note 23, at 255.

28. See generally Brody, *supra* note 19, at 462.

29. See Kelley, *supra* note 22, at 2437-39.

30. Goodwill Industries International – How We Operate, <http://www.goodwill.org/page/guest/about/howweoperate> (last visited July 24, 2007).

31. Goodwill Industries International – Donate, <http://www.goodwill.org/page/guest/about/howweoperate/donate> (last visited July 24, 2007).

32. See generally Brody, *supra* note 19, at 466.

33. H.R.REP. NO. 75-1860, at 19 (1938).

na,³⁴ the nonprofit sector plays a primary role in providing social services to the poor, with the apparent blessing of the government and the general public.³⁵ Thus, the charitable tax exemption performs a vital function in the social service sector in the US. Even though government policymakers clearly want to encourage private social service providers (as evidenced by the charitable tax exemption),³⁶ the IRS is not wont to give up revenue, and therefore has developed a series of rules and tests to create a narrow category of exempt organizations. The voluminous contours and complexities of the charitable tax exemption have been documented by many authors and scholars.³⁷ What follows is a brief overview of the central doctrines and facets of the law most pertinent to the present discussion.

1. The Organizational and Operational Tests

In order to qualify for federal income tax exemption, an organization must be:

[O]rganized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation . . . , and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in oppo-

34. See YUNUS, *BANKER TO THE POOR*, *supra* note 3, at 219 (Professor Yunus goes further to say that governments generally fail at providing social services).

35. See generally Gottry, *supra* note 23, at 251-55. It seems that the government's role in providing social services has waned in recent years, and correspondingly, the role of the government as a provider of social services is looked at with skepticism and even scorn; nonprofit organizations have willingly filled that role. See YUNUS, *BANKER TO THE POOR*, *supra* note 3, at 213-14 (arguing that tax revenues do not actually pay for social services, but rather "only pay for a government bureaucracy that collects the tax and provides little or nothing for the poor").

36. See I.R.C. § 501(c)(3) (2006).

37. See, e.g., Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497 (1981); Kelley, *supra* note 22; Nicholas A. Mirkay, *Relinquish Control! Why the IRS Should Change Its Stance on Exempt Organizations in Ancillary Joint Ventures*, 6 NEV. L.J. 21 (2005).

sition to) any candidate for public office.³⁸

Notwithstanding the prohibition against political involvement, the IRS and the courts generally interpret this Code provision as setting out two independent tests to qualify for exemption: the organizational test and operational test.³⁹ The organizational test relates to the organization's governing documents. It essentially requires that the entity organize for one or more of the permissible exempt purposes listed in the Code, and that the entity dedicate its assets to exempt purposes upon dissolution.⁴⁰ The entity typically satisfies this requirement if it organizes as a nonprofit corporation under state law.⁴¹

Under the operational test, courts look beyond how the entity is nominally organized and instead look at how it actually operates. The operational test has two parts, the primary purpose requirement and the prohibition against private inurement.⁴² The primary purpose requirement directs courts to evaluate whether the entity is "operated exclusively for" one or more permissible exempt purposes.⁴³ The prohibition against private inurement (also called the "nondistribution constraint")⁴⁴ requires that the organization's "net earnings [not] inure in whole or in part to the benefit of private shareholders or individuals."⁴⁵ Most nonprofits meet the requirements of nondistribution by organizing in such a way that no shareholders, members, or employees receive a portion of the profits or a share in any distribution of assets upon dissolution.⁴⁶

Conversely, the operational test, has spawned much uncertainty

38. I.R.C. § 501(c)(3) (2006).

39. *B.S.W. Group, Inc. v. Comm'r*, 70 T.C. 352, 356 (1978).

40. Treas. Reg. § 1.501(c)(3)-1(b)(4) (as amended in 1990); Mirkay, *supra* note 37, at 27.

41. Hansmann, *supra* note 37, at 501-502.

42. Treas. Reg. § 1.501(c)(3)-1(c)(1), (2) (as amended in 1990); Mirkay, *supra* note 37, at 27-28.

43. I.R.C. § 501(c)(3).

44. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980).

45. Treas. Reg. § 1.501(c)(3)-1(c)(2) (as amended in 1990).

46. See, e.g., *Living Faith, Inc. v. Commissioner*, 60 T.C.M. (CCH) 710, 711 (1990) for an example of such a provision:

No part of the net earnings of the corporation shall inure to the benefit of any member, trustee, director, officer of the corporation, or any private individual (except that reasonable compensation may be paid for services rendered to or for the corporation affecting one or more of its purposes), and no member, trustee, director, officer of the corporation, or any private individual shall be entitled to share in the distribution of any of the corporate assets on dissolution of the corporation.

and courts apply a series of tests and doctrines to determine whether an organization in fact “operate[s] exclusively for” one or more exempt purposes.⁴⁷

a. Exempt Purpose Requirement

There are a number of permissible exempt purposes listed in the Code, and the term ‘charitable’ is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax exempt purposes which may fall within the broad outlines of ‘charity’ as developed by judicial decisions.⁴⁸

An organization may conduct numerous types of activities in order to achieve its exempt purposes, and those exempt purposes can be variously defined under the broad term “charitable.” In order to qualify for the charitable tax exemption, an organization’s *primary activities* must further “one or more exempt purposes.”⁴⁹ Additionally, the accomplishment of nonexempt purposes does not preclude tax exemption when furthered by “an *insubstantial part* of the organization’s activities.”⁵⁰

If the organization engages in commercial activity, its exempt status may be challenged under the exempt purpose requirement. In situations where an organization’s primary activities are commercial, the inquiry is whether the “commercial activities [are] an end unto themselves,”⁵¹ because “the presence of profitmaking activities is not per se a bar to qualification of an organization as exempt.”⁵² An organization may operate even a substantial trade or business, but “if the operation of such trade or business is in furtherance of the organization’s exempt purpose or purposes,” the organization will enjoy federal tax exemption.⁵³

In *Aid to Artisans, Inc. v. Commissioner*, the Tax Court considered exemption for an organization whose primary activities were the

47. I.R.C. § 501(c)(3).

48. Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended in 1990); *Indus. Aid for the Blind v. Comm’r*, 73 T.C. 96, 101 (1979).

49. *Aid to Artisans, Inc. v. Comm’r*, 71 T.C. 202, 211 (1978) (emphasis added). *See also* Treas. Reg. § 1.501(c)(3)-1(c)(1) (as amended in 1990).

50. *Aid to Artisans*, 71 T.C. at 211 (emphasis added)..

51. *Id.* at 212.

52. *Id.* at 211.

53. *Indus. Aid for the Blind*, 73 T.C. at 101 (citing Treas. Reg. § 1.501(c)(3)-1(e) (as amended in 1990)).

“[purchase], import, and sale of handicrafts” of disadvantaged artisans, which furthered exempt purposes such as promoting stabilization in developing countries whose economies rely on handicrafts.⁵⁴ Aid to Artisans’s commercial activity did not prevent a finding of exemption because the organization simply used commercial means to further permissible exempt purposes.⁵⁵

The Tax Court also looked at Aid to Artisans’s furtherance of non-exempt purposes, because it was probable that some non-disadvantaged artisans would enjoy the benefits of the programs as well. The court found that the number of non-disadvantaged artisans benefited was low, and affirmed that the “presence of insubstantial nonexempt purposes is no bar to exemption.”⁵⁶ However, this “substantiality” inquiry does not provide an entirely clear guideline.

For example, in *Federation Pharmacy Services, Inc. v. Commissioner*, a nonprofit pharmacy organized to give discounts on prescriptions to elderly and disabled patients was denied tax-exempt status.⁵⁷ The pharmacy provided discounts to an amorphous class of beneficiaries without specific provision for those who could not pay, and the court found that carrying on a regular trade or business with altruistic or charitable motivations was not enough to qualify the organization for exemption.⁵⁸ Federation Pharmacy’s activities were found to substantially further a nonexempt purpose, the sale of prescription drugs for a profit, so it was denied exemption.⁵⁹ While some commercial purpose is allowed, the court has discretion to weigh the substantiality of nonexempt purposes (like profit-making) against exempt purposes.⁶⁰

b. Commerciality Doctrine

Even if an organization that engages in some commercial activity meets the exempt purpose tests, it may still be denied exempt status if it does not meet the ambiguous requirements of the commerciality doctrine. The commerciality doctrine controls “the types of

54. *Aid to Artisans*, 71 T.C. at 212-213.

55. *Id.*

56. *Id.* at 214 (citing *Better Business Bureau of Wash. D.C. Inc. v. United States*, 326 U.S. 279, 283 (1945)).

57. *Fed’n Pharmacy Services, Inc. v. Comm’r*, 625 F.2d 804, 809 (1980).

58. *Id.* at 808-809.

59. *Id.* at 809.

60. *Id.*

businesses that a tax-exempt entity can operate to support its tax-exempt purpose,” and requires that “a ‘commercial enterprise,’ no matter how beneficial its intent, may not be the main purpose of a tax-exempt entity.”⁶¹ It is immediately clear how similar this doctrine is to the exempt purpose rules, and it appears to exist concurrently with and independently of the general exempt purpose rules. The commerciality doctrine first emerged in 1924 in *Trinidad v. Sagrada Orden de Predicadores*.⁶² In this case, the IRS argued that the Sagrada Order should be denied exemption because it operated not only for exempt purposes (religion and education), but also for business purposes (income from real property and selling wine and chocolates).⁶³ The Supreme Court upheld the Order’s exemption on the basis of the now defunct “destination of income” test,⁶⁴ because all the profit from the Order’s commercial ventures went directly toward funding its exempt activities.⁶⁵

In 1945, the Supreme Court reflected a changing view toward the commercial activities of nonprofits in *Better Business Bureau of Washington D.C. v. United States*.⁶⁶ The Supreme Court denied the Bureau’s exemption based in part on the overall “commercial hue” of the organization.⁶⁷ In a later case involving a religious publisher, the court asked whether “the sale of religious literature [was incidental] to the [publisher’s] religious purposes” or whether the publisher’s exempt religious purposes were “incidental to the sale of religious literature.”⁶⁸ The court held that the publisher’s primary purpose was the actual sale of religious literature, and so denied exemption.⁶⁹ Other non-profit organizations have struggled to penetrate the enigmatic test for commerciality,⁷⁰ and in general, if the court finds “unity between the ‘commercial purpose’ and the ‘tax-exempt purpose’ [the entity will lose] tax-exempt status.”⁷¹

61. Myers, *supra* note 19, at 134.

62. 263 U.S. 578 (1924); Myers, *supra* note 19, at 136.

63. *Trinidad*, 263 U.S. at 580-81.

64. Myers, *supra* note 19, at 136

65. *Trinidad*, 263 U.S. at 581-582.

66. *Better Bus. Bureau of Wash. D.C., Inc. v. U.S.*, 326 U.S. 279, 280 (1945).

67. *Id.* at 283.

68. *Scripture Press Foundation v. United States*, 285 F.2d 800, 804 (1961).

69. *Id.* At 805-06

70. See, e.g., *Living Faith, Inc. v. Comm’r*, 950 F.2d 365 (1991); *Plumstead Theatre Soc’y, Inc. v. Comm’r*, 74 T.C. 1324, 1325-26 (1980).

71. Myers, *supra* note 19, at 138.

It appears that the commerciality doctrine embodies a principle, whether popular or legal, that “a lack of commercial or business activity [is] a prerequisite to tax-exempt status.”⁷² Even when commercial activity relates to a charitable purpose,⁷³ or when “commercial means are used to achieve . . . charitable purposes,”⁷⁴ the organization’s tax exempt status may be called into question. It is difficult for organizations to know when or how the commerciality doctrine will be applied, and the fate of tax-exempt organizations who engage in commercial activity “remains largely subject to the whims of the IRS and the courts.”⁷⁵

c. Private Benefit Doctrine

To qualify for exemption, an organization must benefit a charitable class and serve public rather than private interests.⁷⁶ In *Aid to Artisans*, the IRS argued that the organization only served the private interests of the individual artisans whose handicrafts they sold.⁷⁷ The IRS claimed that the organization acted like a commercial import firm and merely bought handicrafts at market prices from artisans.⁷⁸ However, the court rejected this characterization and recognized the broader charitable purposes of a commercial import enterprise, including “the benefit which the public derives” from the employment of disadvantaged artisans and the overall stabilization of fragile economies.⁷⁹ In *Industrial Aid to the Blind v. Commissioner*, the court allowed exempt status for a nonprofit organized to promote employment opportunities for the blind even though the blind employees were given biannual bonus checks based on the performance of the

72. *Id.*

73. *See, e.g., Fed’n Pharmacy Services, Inc., v. Comm’r.*, 625 F.2d 804, 806 (1980) (concerning an organization that had as its mission the operation of a discount pharmacy business).

74. *See, e.g., Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578, 582 (1924) (under today’s law the unrelated commercial business enterprises used to support the charitable mission of the Sagrada Order, would probably be taxed under the UBIT, discussed *infra* Part II.A.2, or jeopardize tax exempt status altogether).

75. Myers, *supra* note 19, at 146.

76. Treas. Regs. § 1.501(c)(3)-1(d)(1)(ii) (as amended in 1990) (“[I]t is necessary for an organization to establish 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.”).

77. *Aid to Artisans, Inc. v. Commissioner*, 71 T.C. 202, 208 (1978).

78. *Id.*

79. *Id.* at 215 (citing *Trinidad*, 263 U.S. at 581).

business.⁸⁰ The court found the practice of giving bonuses incidental to the primary activities of the organization and determined that the bonuses actually furthered the organization's exempt purposes.⁸¹

The IRS also uses the private benefit doctrine to regulate individual transactions between exempt and non-exempt entities.⁸² Under the private benefit doctrine, the IRS balances "public versus private benefit in making case-by-case determinations regarding whether particular transactions [violate] the private benefit doctrine . . . [applied to] any economic arrangement with persons or entities outside the charitable class," and not just to transactions with insiders as under the private inurement doctrine.⁸³

In *American Campaign Academy v. Commissioner*, a school that trained individuals to work on political campaigns was denied exemption even though it was organized for educational purposes under I.R.C. § 501(c)(3).⁸⁴ Although the school did not limit admission, most of the graduates eventually worked for the Republican Party, so the court found that "the school benefited the private interests of the Republican Party to an impermissible degree."⁸⁵ The private benefit rules, however, tend to bleed into the prohibition against private inurement, and "considerable historic confusion regarding the scope of the private benefit doctrine" persists to this day, leading to uncertainty and uneven application.⁸⁶

d. Joint Ventures

Nonprofits may also face challenges to their exempt status if they enter into joint ventures, such as partnerships or LLCs, with non-exempt entities. In basic terms, a joint venture is an enterprise, jointly taken, where all parties agree to contribute some assets or capital, share control, and share in the profits and losses.⁸⁷ A partnership between a nonprofit and for-profit entity highlights the incompatibility of the existing legal framework to the efficient development of the market: the law requires that a nonprofit entity prevent private indi-

80. *Indus. Aid for the Blind v. Comm'r*, 73 T.C. 96, 102 (1979).

81. *Id.*

82. John D. Colombo, *In Search of Private Benefit*, 58 FLA. L. REV. 1063, 1064 (2006).

83. *Id.* at 1072-73 (citing I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987)).

84. *Am. Campaign Acad. v. Comm'r*, 92 T.C. 1053 (1989).

85. Colombo, *supra* note 82, at 1073.

86. *Id.* at 1069.

87. Mirkay, *supra* note 37, at 25-26.

viduals from accruing any benefit from the nonprofit's transactions (through both private inurement for insiders and private benefit for outsiders), while a for-profit entity is bound to its shareholders to maximize profits.⁸⁸

The IRS challenged a community theater's exempt status when it entered into a partnership with two individuals and a for-profit corporation, even though the exempt theater acted as the general partner.⁸⁹ In return for their capital contributions, the limited partners shared 63.5% of the profits of the venture, so the IRS interpreted the arrangement evidence of the nonprofit theater's substantial commercial purpose, and evidence of private benefits to the limited partners.⁹⁰ The court rejected the IRS's argument and upheld the theater's exempt status due to the reasonableness of the partnership agreement and the fact that the limited partners had no control over the operations of the production.⁹¹ The IRS later expanded upon the importance of control in joint ventures,⁹² and the Tax Court created the "control test,"⁹³ which allows joint ventures between exempt and non-exempt organizations if the exempt organization has "control over the joint venture's activities and operations."⁹⁴ The IRS determines on a case-by-case basis the precise amount of control required. Thus, it has become difficult to comprehend the policies behind IRS joint venture rules because it is clear that some joint ventures between exempt and non-exempt entities are expected and even encouraged.⁹⁵ Due to this confusion, nonprofits necessarily struggle to predict whether their

88. *See id.* at 36 (the joint venture "was nothing more than a vehicle for the exempt organization to share the net profits of an income-producing venture with private individuals") (citing I.R.S. Gen. Couns. Mem. 36,293 (May 30, 1975)). *But see id.* at 38 ("an exempt organization, acting as the sole general partner, could fulfill its fiduciary duty of profit maximization to the limited partners while concurrently satisfying the constraints of the Section 501(c)(3) operational test") (citing I.R.S. Gen. Couns. Mem. 39,546 (Aug. 25, 1986)).

89. *Plumstead Theatre Soc'y, Inc., v. Comm'r*, 74 T.C. 1324, 1328 (1980).

90. *Id.*

91. *Id.* at 1333-34.

92. Rev. Rul. 98-15, 1998-1 C.B. 718.

93. *Redlands Surgical Serv. v. Comm'r*, 113 T.C. 47, 78 (1999).

94. *Mirkay*, *supra* note 37, at 44.

95. *See, e.g., Mirkay*, *supra* note 37, at 68 (arguing that the IRS's control standard is "less appropriate" and "economically unrealistic" because "the joint venture is not the exempt organization's primary activity and may only represent an insignificant or relatively small portion of its overall activities whether measured in time, expenditures, or both"); *id.* at 69 (arguing that "the IRS acknowledges in its own internal guidelines that joint ventures are ripe for private inurement risk").

joint ventures threaten their exempt status.⁹⁶

2. *The Unrelated Business Income Tax*

If a nonprofit can meet all the requirements of the operational test and gain tax exemption, it may still be taxed on a certain portion of its income if it engages in certain profit-making activities. Although the IRS and the courts allow nonprofits to engage in a certain amount of commercial activity without losing exempt status, any income derived from a business unrelated to the entity's exempt purpose is subject to tax at prevailing corporate rates, regardless of whether that income goes toward funding an organization's exempt purposes.⁹⁷ In 1950, Congress amended the Tax Code to include the Unrelated Business Income Tax (UBIT), which purportedly responded to the fear that exempt entities had an unfair competitive advantage over their non-exempt counterparts.⁹⁸ The UBIT applies if: the exempt organization has income from a business; the exempt organization regularly carries on the business, and; the business is not substantially related to "the exempt organization's performance of its exempt functions."⁹⁹ Income from passive activities that theoretically would not compete with other entities (e.g., rents, royalties, interest) is not subject to the UBIT.¹⁰⁰

While the stated purpose of the UBIT was to prevent unfair competition following NYU's infamous purchase of the C.F. Mueller pasta factory,¹⁰¹ non-exempt organizations made no specific complaints about instances of unfair competition at the Congressional hearings prior to enactment.¹⁰² Instead, it appears that the idea of a university owning a pasta factory simply made Congress uncomfort-

96. See generally Mirkay, *supra* note 37, at 67 ("the very inability of the IRS and reviewing courts to adopt and apply a clear and consistent standard differentiating between what constitutes 'insubstantial' vs. 'substantial' unrelated business activities under the UBIT seems to support the unlikelihood that any bright-line standard or safe harbor will be adopted with respect to ancillary joint ventures").

97. I.R.C. § 511 (2006). *But see* *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924) (establishing now overruled "destination of income test").

98. Ethan G. Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 EMORY L.J. 1475, 1479 (2005).

99. *Id.* at 1483 (citing I.R.C. §§ 512(a), 513(a); Treas. Reg. § 1.513-1(a) (as amended in 1983)).

100. *Id.*

101. *Id.* at 1483-84.

102. *Id.* at 1547-48.

able.¹⁰³ Because the UBIT does not tax related business income, the argument that its purpose is to prevent unfair competition is somewhat dubious,¹⁰⁴ and an exempt organization will enjoy the tax advantage above other firms in areas related to its exempt purpose (e.g., hospitals). Additionally, exempt organizations may follow certain hiring principles or favor certain unreliable clientele, even in their unrelated business, so the unrelated business may not otherwise truly compete with its non-exempt counterparts.¹⁰⁵

Like the other charitable tax doctrines, many intricacies and tiered tests plague UBIT law. First, the IRS taxes income if it is not “substantially related” to the exempt entity’s performance of its exempt purpose.¹⁰⁶ This substantial relationship exists if a causal relationship between the activity and the exempt purposes is found, and if the business activity “contribute[s] importantly to the accomplishment of those purposes.”¹⁰⁷ Additionally, if an exempt organization pays the UBIT on an unrelated trade or business, the organization will have to discern what level of unrelated activity is actually insubstantial, because if the unrelated activity becomes substantial, the entity will lose exemption altogether.¹⁰⁸ The UBIT reflects a policy that nonprofits should be able to engage in at least some commercial activity related to their exempt purposes.¹⁰⁹ However, the doctrine is based not on actual threats of unfair competition, but instead on popular and legal conceptions of how charities should function (i.e., not like businesses).¹¹⁰

103. *Id.* at 1551 (citing Proposed Revisions of the Internal Revenue Code: Hearings Before the H. Comm. on Ways and Means, 80th Cong. 3536 (1947) (“I know New York University pretty well and there is nothing that they teach in New York University that is incidental to spaghetti.”)).

104. *Id.* at 1495-96.

105. See Gottry, *supra* note 23, at 258-59 (nonprofits have pressure to pay higher, living wages to employees, and often use enterprises as a way to provide employment and job training to disadvantaged individuals, and nonprofits are bound to work toward their social aims, just like corporations are bound to work toward profits).

106. I.R.C. §§ 511, 513(a) (2006).

107. Treas. Reg. § 1.513-1(d)(2) (as amended in 1983).

108. Mirkay, *supra* note 37, at 33.

109. *Id.* at 60 (citing John D. Colombo, *A Framework for Analyzing Exemption and UBIT Effects of Joint Ventures*, 34 EXEMPT ORG. TAX REV., Nov. 2001, at 188). See also Gottry, *supra* note 23, at 250-51 (“[S]ome critics do not believe that the tax adequately addresses the advantage gained from tax-exemption for activities that do fulfill the non-profit’s purpose.”).

110. Stone, *supra* note 98, at 1529; Mirkay, *supra* note 37, at 67.

3. Excess Benefit Transactions

An Excess Benefit Transaction (EBT) is not itself an independent threat to tax exemption, but is an intermediate sanction imposed by the IRS on certain “disqualified persons” who engage in prohibited transactions with “applicable tax-exempt organizations” (ATEOs).¹¹¹ An EBT is “a transaction in which an economic benefit is provided by an ATEO directly or indirectly to any disqualified person and the value of the economic benefit provided by such ATEO exceeds the value of the consideration, including the performance of services, received in return (i.e., the “excess benefit”).”¹¹² In calculating the excess benefit, the IRS examines all transactions between the disqualified person and the ATEO (or its subsidiaries and intermediaries) within a five-year period and then taxes the disqualified person on the excess benefit amount, at a tax rate of 25% (and up to 200% if corrective action is not taken).¹¹³ While the transactions are rebuttably presumed to be permissible compensation arrangements, employees, managers, and directors of nonprofits can be held personally liable for tax payments due to these transactions.¹¹⁴

B. The Fate of Commercial Nonprofits Under Current Law

American charity law is multi-layered and nuanced. It reflects certain ideals about charities that simply are not practical or possible due to the realities of the marketplace,¹¹⁵ and not necessarily expected or desired by the public or lawmakers.¹¹⁶ However, the popular conception and accepted legal definition of “charity” holds the American nonprofit sector in limbo. Nonprofits cannot develop certain revenue opportunities and must avoid certain transactions for fear that they may be taxed or jeopardize their exempt status altogether.¹¹⁷

Under current American nonprofit law, Grameen Bank (and other entrepreneurial charities) would face many challenges. While the organization’s exempt purpose would be aiding the poor and provid-

111. Mirkay, *supra* note 37, at 73-75.

112. *Id.* at 74 (citing I.R.C. § 4958(c)(1) (2004)).

113. *Id.* at 73-76.

114. *Id.* at 75-76.

115. See Brody, *supra* note 19, at 434; Gottry, *supra* note 23, at 250-51; Kelley, *supra* note 22, at 2438.

116. The UBIT, e.g., reflects a policy that charities are expected to engage in some commercial activity. Colombo, *Framework*, *supra* note 109, at 188.

117. See generally Brody, *supra* note 19, at 433-34; Gottry, *supra* note 23, at 261.

ing them with employment opportunities and education, the Bank's main activity is decidedly money-lending: Professor Yunus insists that the poor need only the most minimal training and oversight, and instead simply need access to capital in order to improve their lives.¹¹⁸ Is the Bank's primary activity, lending money at 20% interest, in furtherance of its exempt purpose? Does the commercial purpose of the Bank rise to the level of substantial? The Bank has been commercially profitable since 1995 and rejects all donor funds,¹¹⁹ a sometimes pivotal question for exemption.¹²⁰ Grameen has alliances with for-profit entities, like Dannon Foods,¹²¹ which has French scientists working at the plant in Bangladesh and which will receive back its entire initial investment in the small yogurt factory when the business becomes viable.¹²² Are these factors indicia of Dannon's joint control over the venture? Grameen's 23 sister companies essentially trade interest-bearing loans with each other when they need capital.¹²³ Professor Yunus is the Chairman of the Board of 14 of these companies.¹²⁴ This arrangement is ripe with issues under the private benefit and excess benefit doctrines.

While some might dispute whether Grameen Bank is actually a "charity" in the traditional sense, the Bank clearly provides a desired social benefit.¹²⁵ The US should seek a hospitable legal environment

118. YUNUS, BANKER TO THE POOR, *supra* note 3, at 215.

119. Interview with Golam Morshed Mohammed, International Programmes Department Coordinator, Grameen Bank, in Bangladesh (July 8, 2007).

120. *See Fed'n Pharmacy Services, Inc. v. Comm'r*, 625 F.2d 804, 808 (1980) (citing cases in which "the absence of contributions or of a plan to solicit contributions, which are characteristic of a charitable institution, militated against the finding of tax-exempt status for those respective organizations").

121. Dannon Foods Press Release, *Launching of Grameen Danone Foods Social Business Enterprise*, Mar. 16, 2006, available at http://www.danone.com/cmscache/MYSESSION~C18BEC37655BCF6EC12571330043EC9E/CP_1600306_GB.pdf.

122. Interview with Immamus Sultan, Manager, Grameen Danone, in Bangladesh (July 10, 2007).

123. Interview with Golam Morshed Mohammed, International Programmes Department Coordinator, Grameen Bank, in Bangladesh (July 8, 2007).

124. *Id.*

125. The author is aware that Grameen Bank performs what some might say are quasi-governmental functions (providing subsidies to the poor) in a country where the government does not perform governmental functions as well as the U.S. government does. However, it is clear that the government in any country is not obligated to provide microloans and sustainable business opportunities to the poor. *But see* Interview with Abdul Hai Khan, Program Director, Grameen Trust, in Bangladesh (July 9, 2007) (the Bahrainian government is currently working on a project with Grameen Trust to start a microlending project in lieu of the national welfare

for self-sustaining organizations like Grameen Bank that provide social services and employment opportunities to the poor. However, the popular and legal paradigms for charities and businesses do not create such an environment. Charity law must change in order to encourage a popular paradigm shift that will accommodate the changing social and economic environment in which today's private social service organizations operate.¹²⁶

III. ENTREPRENEURIAL SOLUTIONS TO SOCIAL NEEDS

In order to meet growing social demands and funding needs, nonprofits "must retool to become more like successful commercial enterprises."¹²⁷ Nonprofits are expected to be lean and efficient, establish metrics to measure and ensure organizational outcomes, develop synergistic partnerships with for-profit organizations, identify and exploit their comparative advantages, recruit leadership with vision and entrepreneurial zeal, market themselves effectively, articulate their 'deliverables,' and, often times, find ways to charge fees or otherwise generate earned income so that they can pay their own way.¹²⁸ The economic viability and even success of some nonprofits affirms that "[s]ocial-consciousness-driven enterprises can be formidable competitors in" existing markets.¹²⁹

Unfortunately, the existing capitalistic economy "does not yet provide solutions for all social ills"¹³⁰ and "does not permit collective activity to move freely among various forms of enterprise—public, for-profit and nonprofit—as efficiency and efficacy would appear to dictate."¹³¹ Popular notions about business and charity are strict and bifurcated: "the business sector satisfies market demands for goods and services while returning profits to shareholders[,] and charities satisfy the social needs that fall between the cracks."¹³² To compound the cognitive discontinuity, the existing legal structure of charity law is so muddled as to have a chilling effect on new nonprofit ventures

system).

126. See Yunus, *Nobel Speech*, *supra* note 1, at 271 ("Our theoretical constructs should make room for the blossoming of [entrepreneurs' political, emotional, social, spiritual, and environmental dimensions], not assume them away").

127. Kelley, *supra* note 22, at 2438.

128. *Id.*

129. YUNUS, *BANKER TO THE POOR*, *supra* note 5, at 215.

130. *Id.* at 214.

131. Brody, *supra* note 19, at 433.

132. *Id.* at 434.

that have a commercial aspect, preventing socially desirable services from further development.¹³³

According to Professor Muhammed Yunus, entrepreneurs should act as leaders in poverty eradication and the social service sector. He argues for the abandonment of “the assumption that entrepreneurs are one-dimensional human beings, who are dedicated to one mission in their business lives—to maximize profit.”¹³⁴ Redefining the concept of “entrepreneur” will open channels for new and innovative solutions to poverty and other social problems.¹³⁵ The new entrepreneur, or “social entrepreneur,” will have not only a profit motivation, but also a motivation to promote social benefits in the world.¹³⁶

These dual motivations will spawn a “social business enterprise,” which will essentially operate under the constructs of both a corporation and a nonprofit organization. The social business “*may or may not earn profit*, but like any other businesses they must not incur losses.”¹³⁷ This expanded legal definition of “business” will encourage creativity, self-sufficiency, and a more workable capitalism that provides more opportunities for the poor.¹³⁸

Social business enterprises could either directly aid the poor, or facilitate aid to the poor. The first type of social business is like Grameen Bank, a business owned by the poor.¹³⁹ Poor borrowers purchase Grameen shares and comprise a majority of the Bank’s board of directors, which makes decisions about the direction of the Bank, including the contents of the Sixteen Decisions.¹⁴⁰ Under this model, “[e]ven profit maximizing companies can be designed as social businesses by giving full or majority ownership to the poor.”¹⁴¹ The business attains social objectives by ensuring “that the dividends and equity growth produced by profit maximizing business will go to benefit the poor, thereby helping them to reduce their poverty or even escape

133. See Gottry, *supra* note 23, at 261 (“The choice to engage in profit-making ventures may be relatively easy in the face of severe budget cuts, but the manner in which this is to be accomplished is far more complicated.”).

134. Yunus, *Nobel Speech*, *supra* note 1, at 271.

135. *Id.* at 272.

136. *Id.*

137. Muhammed Yunus, *Social Business Entrepreneurs are the Solution*, www.grameen-info.org/bank/socialbusinessentrepreneurs.htm (last visited August 1, 2007) (emphasis added).

138. *Id.*

139. Yunus, *Nobel Speech*, *supra* note 1, at 273.

140. YUNUS, *BANKER TO THE POOR*, *supra* note 3, at 115-55, 176.

141. Yunus, *Nobel Speech*, *supra* note 1, at 273.

it altogether.”¹⁴²

The other type of social business focuses on “providing a social benefit rather than on maximizing profit for the owners.”¹⁴³ This type of social business is a “non-loss, non-dividend company,” where investors can “get back their investment money, but . . . [p]rofit would be ploughed back into the company to expand its outreach and improve the quality of its product or service.”¹⁴⁴ In this second type of social business, “it is the nature of the products and services that generates the social benefit.”¹⁴⁵

Grameen has also created social businesses of this second type. Grameen Dannon, a yogurt factory in Bogra, Bangladesh, produces and provides fortified yogurt to malnourished children in the villages.¹⁴⁶ A main goal of the project is to price the product affordably—the yogurt cups sell for 5 taka (about 10 cents).¹⁴⁷ While the project struggles to gain momentum and economic sustainability, the business is considered a success as long as it reaches its target customers with the much-needed nutrition.¹⁴⁸ Dannon invests in the project out of its social commitment and is entitled to take its invested money back if it wants.¹⁴⁹ It has no percentage interest in the profits,¹⁵⁰ and it entrusts control over the marketing and management to the local Grameen entity.¹⁵¹

Social business is a natural extension of the existing market structures. It does not ask its investors to abandon profit-maximization, and it simply allows innovative social entrepreneurs to create more and better sustainable solutions to the problems of pov-

142. H.I. Latifee, Director, Grameen Trust, Speech at the Bentley College Symposium on Business Ethics and Corporate Social Responsibility: Social Business, Grameen and Micro-finance 5 (June 18, 2007).

143. *Id.* at 4.

144. Yunus, *Nobel Speech*, *supra* note 1, at 272.

145. Latifee, *supra* note 142, at 5.

146. Yunus, *Nobel Speech*, *supra* note 1, at 273.

147. Interview with Immanus Sultan, Manager, Grameen Danone, in Bangladesh (July 10, 2007).

148. *Id.* The project manager affirmed that if Grameen Dannon wanted to make money, it could bring its product to Dhaka, the capital city, with better delivery systems and more population density, but profit is simply not the goal, so the product remains being delivered door-to-door in remote villages in northwestern Bangladesh. *Id.*

149. *Id.*

150. Dannon has some interest in the profitability of Grameen Dannon—it is not entitled to take back its investment until the company is profitable. *Id.*

151. *Id.*

erty.¹⁵² Corporations must spend money to market their products and services, create positive public relations, and buy necessary goods and services to facilitate their own production.¹⁵³ Social businesses create an ideal channel for corporations to create associations with and purchase goods and services from socially-conscious enterprises that seek to maximize social benefit.¹⁵⁴ The social business represents the ideal meeting point for directing business profits and expenditures toward socially beneficial activities.¹⁵⁵

IV. THE SOCIAL BUSINESS ENTERPRISE IN AMERICAN LAW

Although Professor Yunus argues that the role for government in providing social services is somewhat limited, he argues that the government should decidedly advocate “policy packages encouraging businesses to move in the socially desired direction, providing incentives to social-consciousness-driven enterprises encouraging competitive spirit and strength in the social consciousness-driven sector.”¹⁵⁶ Creating the social business as a new entity distinct from both corporations and nonprofits will give effect to such a policy. The social business will be characterized by the freedom to pursue social goals and also make a profit while engaging in commercial activities.¹⁵⁷ It should receive certain benefits traditionally given to nonprofits to encourage it to seek social goals, but it should also have to adhere to some of the requirements placed upon corporations to prevent corruption and promote transparency.¹⁵⁸ The creation of a new business en-

152. Interview with H.I. Latifee, Director, Grameen Trust, in Bangladesh (July 31, 2007).

153. *Id.*

154. *Id.*

155. *Id.*; Yunus, *Nobel Speech*, *supra* note 1, at 272.

156. YUNUS, *BANKER TO THE POOR*, *supra* note 3, at 219. *See also id.* (promoting “social intervention without government getting involved in business or in promoting service”).

157. *Id.*

158. The United Kingdom has created the “Community Interest Company,” designed specifically to pursue social objectives and dedicate profits to the benefit of society, not to individuals. The Community Interest Company Regulations, 2005, S.I. 2005/1788 (U.K.). The Community Interest Company is different than the following proposal in that it is primarily intended as a vehicle for for-profit companies to ensure their profits go toward public benefit. *Id.* In contrast, the Social Business Enterprise proposed here is conceived of in light of the difficulty nonprofit corporations face in funding their charitable work within the strictures of IRS regulations. Another major difference between the Community Interest Company and the Social Business Enterprise is that the Community Interest Company receives no special tax treatment for its pursuit of otherwise charitable goals. Community Interest Companies –FAQ, <http://www.cicregulator.gov.uk/faq.shtml#eight> (last visited Oct. 25, 2007).

tity will address concerns that nonprofits are becoming too commercial, and it will also encourage more innovative, business-oriented solutions to address social needs.

Social businesses should be taxed at an intermediate level of federal income tax rates, somewhere in between corporate tax rates and complete exemption.¹⁵⁹ Limited taxation will encourage the development of self-sustaining, private solutions to social problems, but will protect federal revenues and curtail concerns about unfair competition with for-profit firms.¹⁶⁰ This intermediate tax would reflect a policy of favoring businesses with social motives over businesses with pure profit motives. However, it is unlikely that the social business will gain an unfair advantage over for-profit firms due to its social motivations, which presumably affect efficiency in some ways.¹⁶¹ Social businesses should follow public disclosure requirements applicable to for-profit firms.¹⁶² Disclosure serves the dual purpose of equalizing auditing expenditures with for-profit firms and providing information to the public, potential investors, and competitors.¹⁶³ Because social businesses will pay taxes and comply with public disclosure requirements like corporations, they will also be allowed to engage in more commercial activity than their tax-exempt counterparts.¹⁶⁴

A. Tax Exempt Purpose, Private Inurement, and Commerciality

The US Tax Code could classify a business as a social business if its primary purposes were one or more of the exempt purposes listed in § 501(c)(3),¹⁶⁵ but the social business will not need to “organize[] and operate[] *exclusively* for” the exempt purposes.¹⁶⁶ The social business necessitates a corollary provision in the tax code stating the dual purpose of the social business to promote the “exempt goals” and also to make a profit.¹⁶⁷ The list of permissible purposes

159. This intermediate tax should address concerns that the nonprofit sector’s commercial activity has trivialized “[t]he traditional justifications for granting nonprofits tax exempt status.” Gottry, *supra* note 23, at 256.

160. See discussion *supra* Part II.A.2.

161. See Gottry, *supra* note 23, at 259.

162. 15 U.S.C. § 7241 (2006); 18 U.S.C. § 1350 (2006).

163. See Yunus, *Nobel Speech*, *supra* note 1, at 273 (such information and investors would be pertinent to Professor Yunus’ proposed social stock market).

164. See discussion *supra* Parts II.A.1.b and II.A.2.

165. I.R.C. § 501(c)(3) (2006).

166. *Id.* (emphasis added).

167. See Yunus, *Nobel Speech*, *supra* note 1, at 272.

could even be expanded for the social business in order to increase its competitiveness in the market because social businesses will pay some tax to the government and will be more transparent than exempt nonprofits due to disclosure requirements.¹⁶⁸

The social business will freely engage in commercial activities, and the commerciality doctrine will not transfer into social business law.¹⁶⁹ Creation of a social business entity that enjoys favorable tax treatment presents the difficult issue of determining and enforcing exactly how much of the business' motivation can be purely profit and how much must be for exempt goals. In order to address this concern, some measure of the private inurement doctrine should apply to social businesses.¹⁷⁰ If the private inurement doctrine applies to social business in exactly the same way that it applies to exempt nonprofits, some of the entrepreneurial motivations may be lost and the social business will suffer inefficiencies.¹⁷¹ However, the oversight function of the private inurement standard as currently applied to exempt nonprofits outweighs the gained efficiency that would come with abolishing private inurement in social business. Because the corporate form, not employees, mandates profit-maximization, a strict private inurement standard should not deter or hinder the growth of the social businesses industry.¹⁷²

B. Private Benefit, Joint Ventures, and EBT

The social business enterprise will also enjoy more leeway than exempt nonprofits in the constraint against private benefit.¹⁷³ This will allow social businesses to serve smaller communities on a smaller scale, providing them more direct and personal benefits than is currently allowed under charitable exemption law.¹⁷⁴ The expanded private benefit requirement will also allow for a greater number of transactions between social businesses and for-profit firms, increasing

168. Although not relevant in a discussion about commercial activity, another fundamental element of exempt status is the restriction on exempt entities' political activities. I.R.C. 501(c) (2006). Perhaps this standard could also be relaxed for the social business.

169. See generally Myers, *supra* note 19, at 134-35.

170. Treas. Reg. § 1.501(c)(3)-1(c)(2) (as amended in 1990).

171. See generally Brody, *supra* note 19, at 433; see Gottry, *supra* note 23, at 258-59.

172. See Yunus, *Nobel Speech*, *supra* note 1, at 271.

173. Treas. Regs. § 1.501(c)(3)-1(d)(1)(ii) (as amended in 1990).

174. See *Aid to Artisans, Inc. v. Comm'r*, 71 T.C. 202, 215 (1978) (applying the private benefit doctrine to Aid to Artisans' activities).

overall market efficiency.¹⁷⁵ Similarly, a social business entity type will allow freer formation of alliances and partnerships with other for-profit (or nonprofit) firms.¹⁷⁶ A major benefit to this greater leeway would simply be the cost saved in having to litigate the fine details of every imaginable type of joint venture arrangement.¹⁷⁷

In the same way, the EBT should not apply as strictly in social business law because the efficiency of the market will increase by expanding the number of potential transactions into which a social business could enter.¹⁷⁸ However, it may be useful to apply some sort of requirement, akin to private inurement or corporate insider trading laws, that regulates transactions with insiders to some degree.

C. UBIT

The UBIT will not apply to social businesses, because one of the aims of social business is to encourage entrepreneurs to approach funding creatively and engage in efficient transactions with all types of entities.¹⁷⁹ A social business will have the freedom to cross-subsidize its charitable work through unrelated business activities.¹⁸⁰ Social businesses will not have an unfairly competitive edge over for-profit firms because social businesses' entire income will be taxed, and they will not operate as efficiently as for-profit firms because they have social goals balancing out profit-making goals.¹⁸¹

D. Raising Capital

All firms, for-profit, nonprofit, and social business, must have access to capital in order to start and maintain their operations. For-profit firms offer investors attractive dividends and profit-sharing arrangements. Nonprofit firms offer their investors the charitable tax deduction. A social business could not offer investors either of these

175. See Brody, *supra* note 19, at 433.

176. See generally Mirkay, *supra* note 37, at 68.

177. See, e.g., Plumstead Theatre Soc'y, Inc. v. Comm'r, 74 T.C. 1324 (1980); Indus. Aid for the Blind v. Comm'r, 73 T.C. 96 (1979); Aid to Artisans, Inc. v. Commissioner, 71 T.C. 202 (1978); Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578 (1924). See generally Mirkay, *supra* note 37.

178. See generally YUNUS, BANKER TO THE POOR, *supra* note 3, at 217 (advocating the social business framework because "the market needs rules for the efficient allocation of resources").

179. See Yunus, *Nobel Speech*, *supra* note 1, at 272

180. See Gottry, *supra* note 23, at 252.

181. See *id.* at 259.

benefits. However, a social business could raise some capital by taking loans, which offers investors at least a reasonable interest rate and a return of the initial investment (assuming the social business becomes profitable).¹⁸² A social business may also consider taking donor funds at the beginning of its existence, but without the incentive of a tax deduction, altruism will probably have to motivate donors to social businesses. In some cases, though, a donation to a social business could form the basis for a strategic alliance between a for-profit firm or another social business and the start-up social business.¹⁸³

Certain investors may actually look to maximize the social benefit of their investments rather than maximize their own profit.¹⁸⁴ This concept is most aptly illustrated by the example of a private foundation, and Grameen actually has its own nonprofit venture capital fund dedicated to supporting social business.¹⁸⁵ It is possible that individuals would move into the market of social investment as well if an infrastructure was in place. Professor Yunus has advocated for the creation of a “social stock market where only the shares of social businesses will be traded.”¹⁸⁶ The social stock market will look similar to the regular stock market, with “rating agencies, standardization of terminology, definitions, impact measurement tools, reporting formats, and new financial publications.”¹⁸⁷ Although investors are currently free to invest in companies with a social mission, such a regulated and standardized social stock market will actually encourage socially beneficial investment. “Anyone who [only] wants to make money will go to the existing stock market.”¹⁸⁸

E. Potential Problems with Social Business

One problem with relying on more private entities to provide social services is that “it is less transparent and participatory than tradi-

182. See, e.g., Interview with Immanuel Sultan, Manager, Grameen Danone, in Bangladesh (July 8, 2007).

183. See, e.g., *Saving the World One Cup of Yogurt at a Time*, FORTUNE, Feb. 19, 2007, at 96, 100. Although Dannon does not receive monetary compensation for its involvement in the project, and all profits go toward expanding and improving, it is obvious that the alliance provides favorable publicity for Dannon and potentially opens up an entirely new market for the French yogurt producer in a developing nation.

184. See Yunus, *Nobel Speech*, *supra* note 1, at 273.

185. Grameen Fund, <http://www.grameen-info.org/grameen/gfund/index.html> (last visited July 24, 2007).

186. Yunus, *Nobel Speech*, *supra* note 1, at 273.

187. *Id.*

188. *Id.*

tional governance and perhaps, less accountable to constituencies being serviced by the public as a whole.”¹⁸⁹ Rather than weakening the reasons for social business, the accountability argument supports the creation of social business. Social services are increasingly being privatized.¹⁹⁰ Encouraging some private social service providers to become social businesses will actually increase the transparency of the private social service sector since social businesses would comply with disclosure requirements.

Lawmakers, lawyers, scholars, and the public may argue against increasing an already complicated area of the law by creating a new hybrid business entity type.¹⁹¹ Because nonprofit law is already practically impenetrable, any change could only serve to simplify its application. Firms that clearly fall within the established parameters of charitable exemption laws would likely gravitate toward the existing nonprofit categorization, and firms that are less clearly exempt may gravitate toward the social business category, where the existing exempt entity standards and tests can be used, but at a more relaxed level.

Another potential argument against social business is that the LLC form already allows businesses to pursue social and profit-seeking goals at the same time. This argument, however, misses the point of the new social business entity. Current law, LLC law included, does not *encourage* charities and social service providers to be entrepreneurial and creative. LLC law allows more flexibility in the motives of the entity, but suffers some hindrances in the ability to raise capital and grow, and does not mandate disclosures or provide any favorable tax treatment for pursuing social goals. The LLC currently represents the most viable option for social entrepreneurs in the US, but it is an imperfect one:¹⁹² a social entrepreneur must choose between the charitable tax exemption and the freedom to structure operations in a commercial way.

Another argument against the creation of social business is that

189. Susan R. Jones, *Current Issues in the Changing Roles and Practices of Community Economic Development Lawyers*, 2002 WIS. L. REV. 437, 438 (2002).

190. See generally Gottry, *supra* note 23, at 251-55.

191. See generally Brody, *supra* note 19, at 490-95 (arguing that the nonprofit sector is already too large).

192. The social entrepreneur who organizes an LLC will likely never reach Professor Yunus' superior status as a "Social Business Entrepreneur," or a social entrepreneur who runs a business with full cost recovery or beyond. Yunus, *Social Business Entrepreneurs*, *supra* note 1376.

nonprofits will lose their market and their resources to the social businesses. This may be true, but the creation of a new business entity means that some nonprofits (and some corporations) will simply become social businesses if that form provides the best options for the entity's efficiency and viability.¹⁹³ Perhaps social businesses will concentrate in particular industries so that the competition factor is not an issue. Additionally, social businesses will pay tax on all their income, which should dispel some concerns about unfair competition with other nonprofits.¹⁹⁴

Corporations may object to the lower tax rate for social businesses. While the countervailing social motivations and disclosure requirements should serve to allay some of these concerns,¹⁹⁵ to an extent, this argument simply becomes a question of what policy American charitable law ought to reflect. I would advocate for a policy that gives businesses with an appropriate social motivation favorable tax treatment. Obviously, as evidenced by the existence of the UBIT, many lawmakers may disagree.¹⁹⁶ However, the ideal of a truly free market is simply an illusion, as it will remain as long as the income of nonprofits is largely untaxed, corporations are taxed on a sliding scale, and some enterprises simply choose to value social goals over profit-maximization.

V. CONCLUSION

The evolution of American charity law evokes a decidedly unhealthy skepticism with regard to the commercial activities of tax exempt organizations. The argument of unfair competition between exempt and non-exempt firms bolsters such wariness. However, nonprofits must increasingly compete for decreasing financial resources, and many nonprofits have turned to commercial endeavors to fund and further their exempt purposes. While the law tolerates some level of commercial activity from charities, the standards for how much and what type are nearly impossible to comprehend. It seems that the varied doctrines and tests are simply a reflection of the vague notion we hold that charities should not act like businesses.

193. *See generally* Brody, *supra* note 19.

194. *See, e.g.*, I.R.C. § 511 (creating the UBIT, which taxes business activity of nonprofits, in order to curb unfair competition).

195. *See* Yunus, *Nobel Speech*, *supra* note 1, at 272 (stating that social business will be motivated by the goal of "doing good to people and the world").

196. I.R.C. § 511 (2006).

American charity law is inhospitable to social-consciousness-driven entrepreneurship.¹⁹⁷ However, creating a new type of business entity could precipitate a paradigm shift in the way we understand charities and the provision of social services. Certain commercial nonprofits would not need to be called “charities,” but could be called “social businesses.” This paradigm shift would free us to think more strategically and entrepreneurially in the fight against poverty and society’s most pressing problems.¹⁹⁸ Social business offers an inspiring solution to the needs the charitable exemption was created to meet. By changing the legal framework of business entity law, we create the opportunity for social entrepreneurs and the poor themselves to eradicate poverty. “Poverty is not created by the poor, it is created by the structures of society, and policies pursued by society. Change the structure . . . and you will see the poor change their lives.”¹⁹⁹

197. YUNUS, BANKER TO THE POOR, *supra* note 3, at 213.

198. Yunus, *Nobel Speech*, *supra* note 1, at 271-72.

199. YUNUS, BANKER TO THE POOR, *supra* note 3, at 215.