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RESPONSE

DECOUPLING?

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IN "The Case for For-Profit Charities," Professors Malani and Posner urge an end to the coupling of certain tax benefits and the nonprofit corporate form.[1] Unlike many theoretical essays in taxation, they conclude with rather concrete policy proposals. As a first best option, they suggest that if the government is going to give tax advantages to community-benefit activities, then it should extend those advantages across corporate forms. For the weak of heart, they propose as a second best, less dramatic alternative that the IRS relax constraints on the ability of nonprofits' managers to take incentive pay. Malani and Posner have failed, however, to make the affirmative case for their broad recommendation. The case for relaxing the constraints on incentive pay is stronger, though not, as I suggest below, without problems.

Malani and Posner intend their arguments to generalize to all community-benefit activities, whether charitable or commercial, and often speak generically about "tax breaks." For purposes of this Response—and in keeping with the authors' primary focus in their essay—I will limit my discussion to charitable firms and to the specific federal income tax benefit of the deduction for charitable contributions under Section 170 of the Internal Revenue Code. Malani and Posner conceive of the charitable firm as involving

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[1] Anup Malani & Eric A. Posner, The Case for For-Profit Charities, 93 Va. L. Rev. 2017 (2007).

three parties: a donor, an entrepreneur, and a beneficiary. The charitable firm on this view is essentially a conduit, with the entrepreneur channeling funds from the donor to the beneficiary. Focusing on these parties and on the particular tax benefit of the charitable deduction for contributions to the firm, one can sharpen the authors' policy proposals as follows: Their broad proposal would permit the deduction of contributions to firms even where the nondistribution constraint is relaxed with respect to entrepreneurs *and* donors.[2] The narrower proposal entails that contributions to firms should be deductible where the nondistribution constraint is relaxed with respect to entrepreneurs.[3]

I consider these two proposals below, but as an initial matter I note that the current nonexistence of "for-profit charities" presents something of a puzzle for Malani and Posner. Their argument is one that sounds in efficiency. Tax differentials in the current system, they argue, prevent optimal incentives.[4] They are of the view that removing these distortions could yield substantial efficiency gains. Moreover, the authors claim that "for-profit charities" do not exist because of tax disadvantages (the chief disadvantage being the inability to receive deductible contributions). But this fails to acknowledge important nuances in the charitable deduction under Section 170. For decades that deduction has been capped. Currently, one may not deduct more than 50% of adjusted gross income.[5] Although it is extremely difficult to know how much donors contribute to nonprofit organizations in excess of the cap, it is commonly accepted that at least some donors do so. If the efficiency advantages that Malani and Posner claim for "for-profit charities" in fact have value, then one would expect a sorting of donors and contributions. That is, one would expect at least some contributions that are non-deductible in any event to flow to for-

[2] The "nondistribution constraint" proscribes the distribution of net revenue by nonprofit firms to affiliated persons or employees. See id. at 2018.

[3] The authors are clear that they advocate these positions only insofar as the tax benefit is otherwise available for nonprofit firms (that is, where the nondistribution constraint has not been relaxed). It is sensible to assume that such a tax benefit will in fact be available for the foreseeable future.

[4] See, e.g., id. at 2054–56 (discussing the "inefficient" incentives that the current system has created).

[5] 26 U.S.C. § 170(b)(1)(A) (2000).

profit charities, in light of their supposed advantages. But the form essentially does not exist. Why? I think there are a couple of possible explanations for the puzzle, both of which run against the grain of the basic proposals in the Essay. One possibility is that the form of "for-profit charity" is problematic in terms of corporate law. It would be disfavored, that is, even if the tax law did not disadvantage it. Another possibility, of course, is that the efficiency gains are simply not to be had.

1. THE BROAD PROPOSAL

Malani and Posner identify two chief efficiency costs under current law.[6] But neither of these efficiency costs, even assuming they exist, would justify the broad (as opposed to the narrow) proposal. First, current law is said to allow nonaltruistic entrepreneurs to produce inefficiently in the nonprofit sector because the inefficiency is offset by tax subsidies. Inefficient nonaltruistic entrepreneurs can exist in the nonprofit sector because efficient nonaltruistic entrepreneurs all select into the for-profit sector under current law, where they are not subject to the nondistribution constraint. However, with a relaxation of the nondistribution constraint *strictly for entrepreneurs* (as opposed to donors) for nonprofit firms, we should expect efficient nonaltruistic entrepreneurs to move into the nonprofit sector, thus driving out inefficient competitors. Second, current law is said to steer altruistic entrepreneurs away from charitable enterprises because even the altruistic entrepreneur may have some concern about her own pay. Again, the narrow proposal addresses this problem. As soon as one relaxes the nondistribution constraint for entrepreneurs within the nonprofit sector, the altruistic entrepreneur no longer need flee.

Perhaps the argument for the broad proposal is grounded not so much in an identification of a particular efficiency cost as it is a general argument that the tax law ought not, without justification, distort as between corporate forms. That is, the burden of proof should lie with the proponent rather than the opponent of tax differentials across corporate forms. If this is the argument, then it is a familiar one—and one that drives much of the criticism of the clas-

[6] See Malani & Posner, supra note 1, at 2054–56.

sical corporate income tax, which disfavorably taxes activity undertaken in certain entity forms, as compared to others. But once one introduces the concept of charity, the distinction between for-profit firms and nonprofit firms is not readily analogized to the distinction between, say, corporations and partnerships.

In the absence of a nondistribution constraint the corporate law must, of course, address the very real problem of competing claims on a firm's distributions. Of particular import here is the question regarding the firm's residual claimants. There are three possibilities in this model: the donor, the beneficiary, and the entrepreneur. I put aside, for the moment, the case where the entrepreneur is the residual claimant. Focus on the entrepreneur gets us essentially to the narrow proposal. As between donors and beneficiaries, one can immediately see the unhappy consequences that flow from the marriage of charity and profits. Donors would understandably conceive of themselves as residual claimants of the firm, by analogy to shareholders in the for-profit commercial enterprise. But, by definition, the charitable enterprise is formed to *give* money away to the beneficiaries, who would thus also understandably view themselves as residual claimants.

Put simply, one cannot have two classes of residual claimants without some further rule of profit division. I do not mean to suggest that one could not formulate such a rule. By contractual stipulation perhaps the donor could specify a cap on the percentage contribution that would go to the beneficiary. The donor would retain residual rights to amounts over and above such cap that are not spent on administrative costs. Although this would seem to provide a simple resolution to potential residual claim disputes, it is problematic in other ways. First, this type of contractual stipulation does not seem to mesh naturally with how many donors approach the act of charitable giving. For a donation of a fixed amount, many donors, I surmise, do not have an interest in taking an equity stake in the enterprise. Their goal is to have as much delivered to the beneficiary as possible.[7] Second, and more problematic, such a

[7] Of course, one could choose a contractual relationship that meshes with this desire by stipulating that the beneficiary is the sole residual claimant. But then it will be difficult to justify the broad proposal, as it would no longer be necessary to relax the nondistribution constraint with respect to *donors*.

division rule calls into question the basic efficiency arguments that would motivate the broad proposal in the first place. Suppose that a donor *did* want to claim an equity stake in a charitable firm. For example, a donor might stipulate that 80% of a contribution is to be delivered to the beneficiary, taking a residual claim on profits with respect to the other 20% of the contribution. If this is the legal arrangement, however, then it would seem that the best way to characterize the arrangement from the donor's perspective is as a mixed contribution, part charitable and part for-profit. Yet, under the broad proposal, the authors would envision a deduction for the *full* amount of the contribution. This introduces a new inefficiency into the system because an equal transfer to a traditional for-profit firm would presumably yield *no* deduction. Thus the broad proposal distorts capital allocation as between for-profit ventures.[8]

None of this is to say that the broad proposal is not optimal. It is, rather, to say that the authors have failed to make their case. The specific efficiency costs they identify would seem remediable by the narrow proposal. And the general argument that tax ought not invite distortions between corporate forms is not sufficient by itself insofar as the proposal invites new inefficiencies into the system, thereby making the resolution of the issue essentially an empirical one.

2. The Narrow Proposal

The narrow proposal—essentially that tax ought not distort as between those charitable firms that can distribute profits to entrepreneurs and those that cannot make such distributions—has more immediate appeal than the broad proposal because the asserted efficiency costs of current law all seem to operate at the level of the entrepreneur.[9] The narrow proposal, however, still requires that one be able to define the "profits" of a "for-profit charity."

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[8] One cannot justify this on the ground that the distortion is consistent with the goal of increasing charitable contributions. To make that case one would need an affirmative argument showing why the broad proposal is better than simply increasing tax subsidies focused strictly on the charitable aspect of the transfer.

[9] At one point, Malani and Posner characterize the narrow proposal as a "compromise" in which we "allow[] nonprofits to use some of the incentives that for-profits are permitted to use." Id. at 2065. This makes it sound as if the relevant feature of the

This is a more complicated endeavor than Malani and Posner acknowledge.[10] A simple example will make the point. On the first page of their Article, Malani and Posner define a charity's profits as gross revenue minus costs (including the entrepreneur's salary).[11] Now consider two charities. To borrow from Malani and Posner, each charity states that its charitable purpose is to help sick children in Africa. Each charity receives a single charitable donation of $10 million. The first charity determines that it will make $8 million in grants to medical researchers who will study ways in which childhood vaccinations can be made more effective. The charity spends $2 million to retain some of the best medical researchers in the country to review and evaluate grant proposals. The second charity pays $1 to a relief worker who otherwise happens to be heading to a remote village in Zambia. In exchange, the relief worker will deliver a suitcase with $8 million in cash to the village shaman, who will use the money in his discretion to cure sick children. Under the authors' definition the first charity is running a break-even operation. The second charity has almost $2 million in profits.

Although the hypothetical strains credulity, the underlying point does not. Malani and Posner characterize the "quality" of the charitable enterprise simply in terms of the ability to minimize administrative costs in delivering funds. But that cannot be the full measure of quality in this context. Administrative costs are not pure deadweight loss. Often, of course, those costs *improve* delivery (even for a fixed amount of funds transferred to beneficiaries).

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narrow proposal is that the legal modification occurs with respect to corporate forms currently in the nonprofit world (for example, relaxation of rules applicable to 501(c)(3) organizations) as opposed to changing the tax treatment of firms that are currently in the for-profit world. This cannot be the distinguishing feature of the narrow proposal, however. Once the IRS relaxes rules on the nondistribution constraint the firm *becomes* for-profit under the authors' definitions because they draw the line between for-profit and nonprofit in terms of the nondistribution constraint. Thus I think the better characterization of the narrow proposal is that it concerns the nondistribution constraint as applied to entrepreneurs, rather than entrepreneurs *and* donors.

[10] The authors nod to arguments in the literature on the difficulty of profit definition. See id. at 2029 n.25. The problems, however, run deeper than mere statutory amendment to section 162 of the Code.

[11] Id. at 2018.

This is presumably what the donor cares about in the first place. For similar reasons, the concept of profit, with which we are familiar, does not sit well in the context of the "for-profit charity." This is not surprising. The business model, after all, is to give money away, an activity which we generally think of as inimical to profit. Of course that is not to say that some charities are not better and some worse at the enterprise of giving away money. It is only to suggest that we cannot easily shoehorn the measurement of success here into the concept of "profits." Without a reliable means to measure profits, however, it is difficult to know what to make of the category of the "for-profit charity." The category, in this way, reminds me of an exhibit I recently viewed at the American Museum of Natural History entitled Mythic Creatures: Dragons, Unicorns and Mermaids.[12] I would have liked to have been able to tell my young daughter that unicorns are real, but instead found myself trying to explain the allure of combining various features of existing animals so as to fabricate imaginary ones. The "for-profit charity," I fear, may be its own type of mythical beast. *If* it were to exist, then the narrow proposal for decoupling may well be justified. But before one can advance that conclusion, it would be necessary to elucidate the meaning, and functional import, of "profits" in this context.

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[12] See American Museum of Natural History, Mythic Creatures: Dragons, Unicorns & Mermaids, http://www.amnh.org/exhibitions/mythiccreatures/.