

SOCIAL IMPACT BONDS: A TAX-FAVORED INVESTMENT?

Orly Mazur*

Abstract

Social impact bonds (SIBs) have recently generated a lot of excitement nationwide as an innovative way to finance social projects. A SIB is a financing mechanism that uses private capital to fund social services, with the government only repaying investors their capital plus a potential return on investment if improved social outcomes are achieved. As such, it brings together the private, public, and non-profit sectors in a manner that unlocks an additional source of capital to fund social service providers, promotes innovation, encourages interagency cooperation, and creates more accountability. Despite these benefits, tax law likely hinders the development of SIB-funded programs in the United States by discouraging private investment in SIBs.

This Article is the first to consider the role of U.S. tax law in promoting SIB investments by examining the tax implications of a SIB investment from both a doctrinal and policy perspective. It concludes that the current tax system creates unnecessary compliance risks for private SIB investors and unjustifiably treats SIB investments less favorably than comparable investments, thereby increasing administrative complexity, distorting investment decisions, and creating inequities among similarly situated investors. Given the unintended discriminatory tax treatment towards SIBs, this Article argues that Congress should consider enacting legislation to make a SIB investment a tax-favored investment. This change could best be achieved by extending preferential tax rates to SIB earnings, exempting SIB earnings from taxation, or by allowing an upfront deduction for contributions to SIB investments. By modifying the tax law to treat SIB investments more in parity with comparable investments, SIB-funded programs will likely attract additional private capital and allow SIBs to potentially make a meaningful impact on some of our nation's most challenging social problems.

* Assistant Professor of Law, SMU Dedman School of Law. Many thanks to Jessica Mantel, Michael Simkovic, and Anthony Colangelo for thoughtful suggestions and comments on prior drafts and to Timothy Gallina for his research assistance. I am also grateful for the valuable comments that I received from the participants at the Texas Legal Scholars Workshop, the SMU Faculty Workshop, and the Junior Tax Scholars Workshop. Finally, this research was supported by the generous funding from the Marla and Michael Boone Faculty Research Fund.

I. INTRODUCTION.....	143
II. A NEW FINANCING MECHANISM.....	145
A. The Concept of a SIB.....	145
B. The Current Status of SIBs.....	146
C. The Potential of SIBs.....	149
III. TAXATION OF SIBS.....	154
A. Tax Uncertainty.....	154
B. Unavailable Tax Preferences.....	156
1. <i>Preferential Tax Rates</i>	156
2. <i>Tax Exemption</i>	157
3. <i>Upfront Deduction</i>	159
IV. SIBS AS A TAX-FAVORED INVESTMENT?.....	160
A. Traditional Equity Investments.....	161
B. Tax-Exempt Bonds.....	162
V. RECOMMENDATIONS FOR REFORM.....	163
A. Preferential Tax Rates.....	164
B. Tax Exemption.....	167
C. Upfront Deduction.....	170
D. The U.K. Approach.....	171
VI. CONCLUSION.....	174
VII. APPENDIX A.....	175

I. INTRODUCTION

Salt Lake County, Utah, like many other counties throughout the nation, has struggled with finding a meaningful and effective way to address persistent homelessness and high rates of recidivism within the county.¹ Current government funding for programs to address these issues is limited and their effectiveness is often unknown.² The result is costly: 43% of persistently homeless individuals in Salt Lake County become chronically homeless within two years; 74% of high-risk offenders return to county jail within four years of their release; and the Salt Lake County jail is currently operating at full capacity.³ These issues also result in numerous other social and financial costs to society.

In an attempt to address these issues, in December 2016, Salt Lake County launched a million dollar initiative to provide more than 500 of the county's most vulnerable and at-risk population with innovative, evidence-based, preventative services never before available to these residents.⁴ Unlike other social programs, the government (and taxpayers) will not have to pay anything initially.⁵ Instead, investors will provide the upfront capital to finance the program and assume the risk of an unsuccessful program. If the program is successful in achieving pre-determined results, only then will the government repay the investors their initial capital, as well as a small return on their investment.⁶

The structure of the Salt Lake County program is just one example of a new type of financing mechanism that has recently emerged: social impact bonds ("SIBs").⁷ Although still in their infancy, SIBs have generated a lot of excitement. They have received support from the Obama administration, major financial institutions, policy experts, philanthropic organizations, and universities.⁸ As a result, numerous SIBs have

¹ See *SALT LAKE COUNTY PAY FOR SUCCESS INITIATIVE: FREQUENTLY ASKED QUESTIONS*, 1 (2016), http://www.thirdsectorcap.org/wp-content/uploads/2016/12/161214_SLC-PFS-FAQ-FINAL.pdf [<https://perma.cc/VMW7-UTZ7>] [hereinafter SLC FAQ].

² See Michelle Schmidt, *Salt Lake County launches two Pay for Success projects* (Dec. 19, 2016), <http://slco.org/mayor/news/PFS-projects-launch/> [<https://perma.cc/8ESF-49MV>]. For instance, studies reveal that existing programs within Salt Lake County only reach approximately 19% of the persistently homeless population due to budget constraints. SLC FAQ, *supra* note 1.

³ SLC FAQ, *supra* note 1.

⁴ *Id.*

⁵ *Id.*

⁶ *Id.*

⁷ SIBs are often also referred to as pay for success contracts. Although these two terms are often used interchangeably, they are not always synonyms. Benjamin R. Cox, *Financing Homelessness Prevention Programs with Social Impact Bonds*, 31 REV. BANKING & FIN. L. 959, 964 (2012). In a joint SIB and pay for success contract arrangement, the government shifts the risk of economic loss from non-performance to the private investor, whereas in a pay-for-success contract, the risk of loss may also be shifted from the government to the service provider. *Id.* In addition, many variations of the SIB model exist. See Orly Mazur, *Taxing Social Impact Bonds*, 20 FLA. TAX REV. 431 (2017). In this Article, I use the term SIB to refer to "a relatively narrow and truly innovative concept where payment from government is tied solely to outcomes and where government places few controls on the external organization." Jitinder Kohli, Douglas J. Besharoff & Kristina Costa, CTR. FOR AM. PROGRESS, *What are Social Impact Bonds: An Innovative New Financing Tool for Social Programs*, 2 (Mar. 22, 2012), http://cdn.americanprogress.org/wp-content/uploads/issues/2012/03/pdf/social_impact_bonds_brief.pdf [<https://perma.cc/AND7-WK5H>].

⁸ See *infra* notes 24–33 and accompanying text.

already been launched in communities across the country and world to address issues ranging from unemployment and child welfare to education and mental illness.⁹

Despite this initial excitement, SIBs have not yet generated sufficient private capital to truly make an impact in the United States. This Article is the first to argue that U.S. tax law is one factor that significantly contributes to the lack of private SIB investments in the United States. To demonstrate the chilling effect that the tax law has on these potentially powerful investments, I first describe the concept of a SIB, its benefits and limitations, and the likely tax implications to private SIB investors. Against this backdrop, I then consider from a normative perspective whether Congress should modify federal income tax laws to make SIBs a more tax-favored investment for private investors. My conclusion is that a tax policy change is needed.

First, private investors who participate in SIB investments are subject to unnecessary compliance risks. Tax compliance risks arise because the federal income tax consequences to investors who participate in SIB investments are unclear under current law. Given this ambiguity, SIB investors may find it difficult to confidently compute and assess their tax liability. Modifying the tax law would provide investors with additional guidance in this area, thereby minimizing tax uncertainty, taxpayer audit risks, and any accompanying deterrent effects.

Second, SIB investors most likely do not benefit from tax preferences that are extended to comparable investments. For instance, traditional stock investments share many economic features with SIB investments, but are taxed at preferential rates and generally only subject to tax at the time at which the investment is disposed. On the other hand, SIB investments are likely to give rise to lower rates of return that are subject to tax at higher non-preferential tax rates throughout the term of the investment. Municipal bonds are also similar in many respects to SIBs in terms of their goals and rate of return, but unlike SIBs, these bonds are generally exempt from taxation. Thus, SIB investors face an additional tax burden relative to other investors. This high tax cost is likely to disincentivize large-scale private investment in SIBs despite the potential of SIBs to improve the social service system in the United States or at least move us toward a more evidence-based, collaborative delivery of social services.

Lastly, these tax policies, together with the currently relatively low rate of return on risky SIB investments, significantly impact the availability of the private capital required for SIB investments to achieve their goals. However, there is no sound policy basis for these distinctions. Thus, the unfavorable tax treatment of SIB investments unjustifiably increases administrative complexity, distorts investment decisions, and creates inequities among similarly situated investors. Given these negative policy implications, the government should create a more favorable regulatory environment that does not deter private investments in SIBs.¹⁰

In short, this Article proposes several potential tax policy solutions to minimize the current tax burdens imposed on private SIB investors. The tax policy options include subjecting the SIB investment earnings to preferential tax treatment, exempting the earnings from taxation, or granting investors a deduction for income tax purposes at the

⁹ See *infra* notes 21–23 and accompanying text.

¹⁰ To prevent the current tax law from hindering the development of SIBs in the United States, legislative or regulatory action is also needed to address the current limitations on investments by non-profit organizations and private foundations. A discussion of the necessary changes to encourage investments by these entities is beyond the scope of this Article.

time they make a SIB investment. Each alternative would minimize some of the deterrent effects that the tax law currently imposes on SIB investments by treating these investments more in parity with similar investments. As a result, these changes would mitigate some of the risk that investors assume when they invest in these speculative financial instruments and enable SIBs to compete more fairly for a share of private capital.

Part I describes the emergence of this new social financing instrument and its potential to revolutionize how we fund social services as well as its limitations. Part II explains the current tax treatment of SIB investments and illustrates how the current state of the law treats private SIB investments unfavorably relative to other investments. Part III argues that changes to tax policy are needed to prevent the unintended discriminatory tax treatment towards SIB investments and to promote sound tax policy. Finally, Part IV discusses several ways this change could be accomplished. By clarifying the tax treatment of SIBs and removing unnecessary tax barriers to SIB investments, private participation in this innovative financing mechanism is likely to increase and allow SIBs the opportunity to live up to their potential.

II. A NEW FINANCING MECHANISM

This Part describes what SIBs are, their growth, and their current status. It then analyzes the benefits and shortcomings of using SIBs to finance social programs and concludes that if adequately structured and regulated, SIBs have the potential to provide an alternative source of financing to address some of society's long-lasting social challenges.

A. The Concept of a SIB

A SIB, also referred to as a pay-for-success contract, is a multi-stakeholder arrangement, in which private investors provide the upfront capital to fund social services, with the government repaying investors only if certain social outcomes are achieved.¹¹ In a traditional SIB model, a government agency identifies a social issue that it wants to address, such as homelessness, criminal justice, public health, or preschool education.¹² It then enters into an agreement with an intermediary organization.¹³ The intermediary organization both raises the funds from private investors to finance a multi-year social program to address the identified social issue and selects and manages the

¹¹ *An Overview of Social Impact Bonds in the United States*, SOC. IMPACT ARCHITECTS (Oct. 6, 2015), <http://socialimpactarchitects.com/wp-content/uploads/2016/12/Overview-of-Social-Impact-Bonds-100615.pdf> [<https://perma.cc/8GZS-2W97>]; MCKINSEY & CO., *From Potential to Action: Bringing Social Impact Bonds to the U.S.*, 4 (May 2012), http://mckinseysociety.com/downloads/reports/Social-Innovation/McKinsey_Social_Impact_Bonds_Report.pdf [<https://perma.cc/XK64-EPH6>].

A SIB does not have a precise, uniform definition because there are numerous variations of the SIB model. However, the features discussed above are common in most existing SIB structures. See Mazur, *supra* note 7, at 436–41. See Appendix A for diagram of a traditional SIB structure.

¹² See Mazur, *supra* note 7, at 437; SOC. IMPACT ARCHITECTS, *supra* note 11.

¹³ See Mazur, *supra* note 7; SOC. IMPACT ARCHITECTS, *supra* note 11; Emilie Goodall, *Choosing Social Impact Bonds: A Practitioner's Guide*, BRIDGES IMPACT+, 13 (2014), <http://www.bridgesfundmanagement.com/wp-content/uploads/2017/08/Bridges-Choosing-Social-Impact-Bonds-A-Practitioner's-Guide.pdf> [<https://perma.cc/FM43-Y25E>].

service providers that implement the program.¹⁴ After a specified period of time, if the project meets or exceeds pre-determined project outcome metrics, as verified by an independent evaluator, the government pays the investors, through the intermediary, their original investment plus a potential return on investment.¹⁵ The return on investment depends on the outcomes achieved, with the maximum return capped at a contractually agreed-to value. This amount is often calculated based on the projected government savings resulting from a successful program.¹⁶ However, if the program is unsuccessful in producing specific social outcomes, the government does not pay for the social services and the investor loses his or her entire investment.¹⁷

The creation of this new financing mechanism was prompted by the need to increase the pool of capital available to finance social programs and to do so with minimal cost to taxpayers.¹⁸ Specifically, the founders sought to find a solution to “the challenge of financing social action programs, with a specific focus on prevention and early intervention.”¹⁹ SIBs offer the promise of enabling proven and evidence-based programs to scale, creating cost-savings for governments, and encouraging innovation in the social sector, while shifting the political and financial risks of failure to the private sector.²⁰ These promised benefits have sparked a lot of interest in SIBs worldwide.

B. The Current Status of SIBs

In 2010, the United Kingdom originated and launched the first SIB.²¹ Since then, SIBs have become a worldwide phenomenon. Numerous SIBs have been launched in the United States and across the world and many more SIBs are under development.²²

¹⁴ See Mazur, *supra* note 7, at 436–37; Cox, *supra* note 7, at 965–66; Emily Gustafsson-Wright & Sophie Gardiner, *Policy Recommendations for the Applications of Impact Bonds*, BROOKINGS INST. (Nov. 2015), <https://www.brookings.edu/wp-content/uploads/2016/07/SIB20Policy20Brief201web-1.pdf> [<https://perma.cc/BF62-892P>]; Goodall, *supra* note 13, at 20. However, this role may also be performed by two separate parties. Mazur, *supra* note 7, at 440.

¹⁵ See NONPROFIT FIN. FUND, *Financing and Social Impact Bonds*, <http://www.payforsuccess.org/learn/basics/#pay-for-success-financial-and-social-impact-bonds> (last visited Sept. 17, 2017) [<https://perma.cc/XH45-JSGT>]; Adriana Barajas et al., *Social Impact Bonds: A New Tool for Social Financing*, PRINCETON UNIV. PUB. POLICY & INT’L AFFAIRS PROGRAM, 14 (2014), <https://www.princeton.edu/sites/default/files/content/Social%20Impact%20Bonds%202014%20Final%20Report.pdf> [<https://perma.cc/5MMG-3CZB>].

¹⁶ See Lisa Barclay & Tom Symons, *A Technical Guide to Developing Social Impact Bonds*, SOCIAL FIN. (Jan. 2013), <http://www.socialfinance.org.uk/wp-content/uploads/2014/05/Technical-Guide-to-Developing-Social-Impact-Bonds1.pdf> [<https://perma.cc/ESB7-9KR7>]; SOC. IMPACT ARCHITECTS, *supra* note 11.

¹⁷ MCKINSEY & CO., *supra* note 11.

¹⁸ See David Butler, Dan Bloom & Timothy Rudd, *Using Social Impact Bonds to Spur Innovation, Knowledge Building, and Accountability*, 9 CMTY. DEV. INV. REV. 53 (2013); Cox, *supra* note 7, at 965.

¹⁹ Max Liang, Brian Mansberger & Andrew C. Spieler, *An Overview of Social Impact Bonds*, 13 J. INT’L BUS. & L. 267, 268 (2014) (noting that The Council on Social Action, a UK think tank, came up with the idea for a SIB).

²⁰ *Id.*

²¹ This SIB was launched with the aim of cutting the rate of recidivism at Peterborough Prison. See Butler, Bloom & Rudd, *supra* note 18, at 57; Cox, *supra* note 7, at 962. Liang, Mansberger & Spieler, *supra* note 19, at 269.

²² See SOC. ENTERPRISE GREENHOUSE, *Social Impact Bonds Fact Sheet*, http://segreenhouse.org/wp-content/uploads/2013/09/SIB-Fact-Sheet_final.pdf [<https://perma.cc/W9GY-QCPM>]; Goodall, *supra* note 13; Laura Tyson & Lenny Mendonca, *Doing Well by Doing Good*, TIMES OF OMAN (Jan. 29, 2016),

Currently, the United States has more SIBs under development than any other country.²³ One factor that has contributed to the growth of SIBs in the United States is that numerous groups have supported the development of SIBs. For instance, philanthropic organizations, such as the Rockefeller Foundation and Bloomberg Philanthropies have helped launch some of the earliest SIBs by guaranteeing a portion of the investors' funds.²⁴ Philanthropic foundations have also fostered SIBs by providing grants to finance pro bono assistance to help implement SIBs.²⁵ Major financial institutions, like Goldman Sachs, have invested capital in SIB-funded programs, indicating their belief in the potential of SIBs to deliver effective social services.²⁶ Moreover, groups have formed, such as the Harvard Kennedy School Social Impact Bond Technical Assistance Lab and the Sorenson Impact Center at the University of Utah, to assist in the development of SIBs and to foster social innovation through research,

<http://timesofoman.com/article/76393/Opinion/Columnist/The-United-States-is-already-the-largest-pay-for-success-market-in-the-world> [<https://perma.cc/3KLZ-PRBG>]; Barajas et al., *supra* note 15, at 8.

As of June 2016, more than 65 SIB projects were at different phases of development across the United States and, as of February 2017, 15 SIB projects have been launched in the United States. Sindhu Lakshmanan, *Pay for Success: To Invest or Not to Invest?*, LIVING CITIES (Oct. 18, 2016), <https://www.livingcities.org/blog/1129-pay-for-success-to-invest-or-not-to-invest> [<https://perma.cc/8S56-UD4T>]; *Social Impact Bonds 101*, HARV. KENNEDY SCH. GOV'T PERFORMANCE LAB., http://govlab.hks.harvard.edu/files/siblab/files/sibs_101_hks_gpl_2017.pdf [<https://perma.cc/YA63-VGVC>].

SIBs have also been implemented abroad in countries such as Canada, the United Kingdom, Pakistan, India, the Netherlands, Germany, Australia, Rwanda, and Mozambique, among others. Esha Chhabra, *The 'It Girl' of Muni Finance: Are Social Impact Bonds a Fad or a Long-Term Solution for Underfunded Public Programs?*, NEXTCITY (Jun. 23, 2014), <https://nextcity.org/features/view/social-impact-bonds-public-private-solution-social-problems-cities> [<https://perma.cc/8288-K2SY>]; John Hartley, *Social Impact Bonds are Going Mainstream*, FORBES (Sep. 15, 2014), <http://www.forbes.com/sites/jonhartley/2014/09/15/social-impact-bonds-are-going-mainstream/#17ad409217d5> [<https://perma.cc/UDH4-PCE5>].

²³ Tyson & Mendonca, *supra* note 22.

²⁴ See, e.g., *Fact Sheet – Investing in What Works: “Pay for Success” in New York State Increasing Employment and Improving Public Safety* (Mar. 2014), http://www.payforsuccess.org/sites/default/files/resource-files/pfsfactsheet_0314_0.pdf [<https://perma.cc/T8UE-V68J>] [hereinafter State of NY Fact Sheet] (providing that Rockefeller Foundation has provided a first-loss guarantee of up to \$1.3 million to investors in the New York State's SIB); Press Release, Office of the Mayor, City of New York, Mayor Bloomberg, Deputy Mayor Gibbs And Corrections Commissioner Schriro Announce Nation's First Social Impact Bond Program (Aug. 2, 2012), <http://www1.nyc.gov/office-of-the-mayor/news/285-12/mayor-bloomberg-deputy-mayor-gibbs-corrections-commissioner-schriro-nation-s-first#/0> [<https://perma.cc/97WT-44Z8>] (describing Bloomberg Philanthropies' guarantee to protect up to \$7.2 million of investor principal).

²⁵ See, e.g., Ashley Pettus, *Pay for Progress: Social Impact Bonds*, HARV. MAG. (Jul. –Aug. 2013), <http://harvardmagazine.com/2013/07/social-impact-bonds> [<https://perma.cc/C6FT-Z3FC>] (describing how the Rockefeller Foundation funds the Harvard Social Impact Bond Technical Assistance Lab, which helps provide governments with technical assistance in developing and launching a SIB-funded program); GOV'T PERFORMANCE LAB., *supra* note 22, at 5 (noting that The Government Performance Lab receives financial support from multiple philanthropic organizations including Bloomberg Philanthropies, The Corporation for National and Community Service Social Innovation Fund, the Dunham Fund, the Laura and John Arnold Foundation, the Pritzker Children's Initiative, and the Rockefeller Foundation).

²⁶ See, e.g., Office of the Mayor, City of New York, *supra* note 24 (listing Goldman Sachs as the primary investor in the SIB-funded program); GOLDMAN SACHS, *Fact Sheet: The Massachusetts Juvenile Justice Pay for Success Initiative*, <http://www.goldmansachs.com/our-thinking/trends-in-our-business/massachusetts-social-impact-bond/MA-juvenile-justice-pay-for-success-initiative.pdf> [<https://perma.cc/C3CD-U2BN>] (indicating that Goldman Sachs provided \$9 million in senior loan financing through its Social Impact Fund); State of NY Fact Sheet, *supra* note 24 (noting that the project raised the majority of its funds from the clients of Bank of America Merrill Lynch).

advisory, and educational work in understanding and improving the SIB model.²⁷ In addition, community groups, policy experts and leading economists have also supported the development of SIBs in the United States in various other ways.²⁸

The federal government has also played a big role in promoting SIBs in the United States. SIBs have received bipartisan support from politicians. For instance, in June 2016, the House of Representatives unanimously passed legislation to increase federal funding for the creation of SIBs by state and local governments in order to encourage the creation of public-private partnerships and thereby increase the effectiveness of social programs in the United States.²⁹ Although the Senate did not pass the legislation before the end of Congress, a similar bill was introduced in the House of Representatives on January 2017.³⁰ Additionally, financial support has come from several federal agencies including the Social Innovation Fund,³¹ which is planning to provide more than \$13 million in funding for promising SIB projects.³² Similarly, other federal agencies, such as the U.S. Department of Labor, have provided grants to government agencies to help finance any outcome payments to investors of a successful SIB-funded program.³³ Several states have also supported SIBs by advancing legislation to facilitate the exploration and testing of SIBs.³⁴

²⁷ See Pettus, *supra* note 25; GOV'T PERFORMANCE LAB., *supra* note 22 (describing the Harvard Kennedy School's Government Performance Lab's participation in the majority of the SIB projects launched in the United States to date); *Mission*, UNIV. OF UTAH SORENSON IMPACT CENTER, <http://sorensonimpact.com/mission/> (last visited Oct. 30, 2017) [<https://perma.cc/EX22-NLPK>].

²⁸ See Tyson & Mendonca, *supra* note 22, at 1; John Hartley, *Social Impact Bonds are Going Mainstream*, FORBES (Sept. 15, 2014), <http://www.forbes.com/sites/jonhartley/2014/09/15/social-impact-bonds-are-going-mainstream/#17ad409217d5>; Barajas et al., *supra* note 15, at 8.

²⁹ Social Impact Partnerships to Pay for Results Act, H.R. 5170, 114th Cong. (2016). However, because the legislation was not passed by the Senate by the end of Congress, the legislation was not enacted. Similarly, a separate bill that involves pay for success initiatives in education was also introduced and enacted in the Senate in 2015. Every Student Succeeds Act, S. 1177, 114th Cong. (2015).

³⁰ Social Impact Partnerships to Pay for Results Act, H.R. 576, 115th Cong. (2017) (described as, a bill "[t]o encourage and support partnerships between the public and private sectors to improve our Nation's social programs, and for other purposes.").

³¹ *SIF Classic*, CORP. FOR NAT'L & CMTY. SERV., <https://www.nationalservice.gov/programs/social-innovation-fund/our-programs/classic> [perma.cc/PS9S-B3WD]. The Social Innovation Fund was authorized by the Edward M. Kennedy Serve America Act as a federal grant-making initiative of the Corporation for National and Community Service that is intended to support "the growth of effective programs to have greater impact, as well as the development of innovative approaches to address the most challenging social problems." *About the Social Innovation Fund*, CORP. FOR NAT'L & CMTY. SERV., <https://www.nationalservice.gov/programs/social-innovation-fund> (last visited Oct. 30, 2017) [<https://perma.cc/2EGA-YQP3>].

³² *Federal Agency Announces \$13 Million in Funding to Support Pay for Success Projects*, CORP. FOR NAT'L & CMTY. SERV. (Nov. 3, 2016), <https://www.nationalservice.gov/newsroom/press-releases/2016/federal-agency-announces-13-million-funding-support-pay-success> (last visited Oct. 30, 2017) [perma.cc/2JBK-4M2D].

³³ See, e.g., Pay for Success Intermediary Agreement between New York State Department of Labor, Social Finance, Inc. and Social Finance NY State Workforce Re-Entry 2013 Manager, Inc. (Oct. 1, 2013), https://www.budget.ny.gov/contract/ICPFS/PFSMainAgreement_Sched_0314.pdf (providing that the U.S. Department of Labor, Employment and Training Administration would award the New York State government a grant of up to \$12,000,000 to help pay for any outcome payments the state owes investors if the project is successful). GOLDMAN SACHS, *supra* note 26 (describing how the U.S. Department of Labor awarded the Commonwealth of Massachusetts a grant of \$11.7 million to help fund any success payments resulting from the SIB-funded initiative). See Alex Goldmark, *The Most Exciting 0.003% of Obama's Budget: Social Impact Bonds*, FAST COMPANY (Feb. 16, 2011), <https://www.fastcompany.com/1728321/the-most-exciting-00003-of-obama-s-budget-social-impact-bonds> [perma.cc/VX3P-7EF8]. In addition, the

Despite the foregoing, private investors have not responded as quickly to the promise of SIBs.³⁵ However, sufficient private capital is critical for SIBs to have a chance to fully succeed. As further discussed below, the current tax law may be one factor deterring these potential investors.³⁶

C. The Potential of SIBs

SIBs have tremendous potential to help tackle some of society's toughest social problems. At a time when most non-profits are underfunded, the SIB structure brings together public and private actors in a manner that encourages an increase in funding for social service projects by private investors and a more efficient and effective use of that capital. In particular, SIBs unlock an additional source of capital, promote innovation, encourage interagency cooperation and create more accountability, which together can result in a more effective and efficient service model than the traditional manner in which social services are funded and implemented in the United States.³⁷

For instance, the SIB structure incentivizes private investors to help finance social programs by promising both a social and financial return on the investor's investment.³⁸ Social service providers no longer have to solely rely on government funding and philanthropic donations and grants to fund programs, but rather acquire an additional source of capital to fund programs that otherwise might be too expensive to implement.³⁹ In addition, service providers receive this capital upfront, which protects them from unpredictable government budget cuts or a decline in charitable donations.⁴⁰ This, in turn, helps service providers scale successful programs and make a greater social impact.⁴¹

former administration also aimed to support the advancement and testing of SIBs by allocating funds in its budget proposal specifically for this purpose.

³⁴ See Nicole Truhe, *State of Play: Pay for Success and Evidence-Based Policy*, AM. FORWARD (May 2, 2016), <http://www.americaforward.org/state-of-play-pay-for-success-and-evidence-based-policy-aprilmay-2016/> [perma.cc/ZJP8-W6Q4].

³⁵ Ron Davies, EUROPEAN PARLIAMENTARY RESEARCH SERV., *Social Impact Bonds: Private Finance That Generates Social Returns* (Aug. 2014), <http://www.europarl.europa.eu/EPRS/538223-Social-impact-bonds-FINAL.pdf>.

³⁶ See *infra* Part II.

³⁷ See Valerie Dao et al., UNIV. OF CHICAGO HARRIS SCH. OF PUB. POLICY, *Social Impact Bonds: A Feasibility Analysis of the Wyman Teen Outreach Program*, <http://128.135.46.110/sites/default/files/practica/spring2012-report2.pdf> [perma.cc/9LQU-VTTU]; *What is a Social Impact Bond?*, SOC. FIN. (Jan. 22, 2015, 2:14 PM), <http://www.socialfinanceus.org/print/491>; Cox, *supra* note 7, at 967.

The traditional model for delivering social services focuses on inputs or outputs, rather than outcomes or results. Cox, *supra* note 7, at 968; Tyson & Mendonca, *supra* note 22, at 1. As described by one commentator, "A traditional social program is usually judged by volume of services provided, such as the number of people trained or homeless people sheltered. By contrast, in a pay-for-success model, the returns are based on the social benefits achieved or savings reaped by government." *Id.* at 1–2.

³⁸ See Pettus, *supra* note 25; Liang, Mansberger & Spieler, *supra* note 19, at 273; Barajas et al., *supra* note 15, at 17; Goodall, *supra* note 13, at 9; Davies, *supra* note 35.

³⁹ See Chhabra, *supra* note 22, at 3.

⁴⁰ See Peter G. Dagher, Jr., Note, *Social Impact Bonds and the Private Benefit Doctrine: Will Participation Jeopardize a Nonprofit's Tax-Exempt Status?*, 81 FORDHAM L. REV. 3479, 3504 (2013); Cox, *supra* note 7.

⁴¹ See Cox, *supra* note 7, at 970; State of NY Fact Sheet, *supra* note 24.

Moreover, by having private investors, rather than the government, provide the upfront investment capital, the government effectively shifts the performance and financial risks of funding certain social service activities to the private sector.⁴² Given that private investors generally have a higher risk tolerance than government agencies, this shift encourages the pursuit of new and creative methods to solve complex social problems and allows for innovation in the public sector.⁴³ Because ineffective programs cost the government and taxpayers nothing, the SIB structure also provides governments with a risk-free way to implement these new interventions and de-politicizes the funding process so that governments can address issues that are politically unattractive or expensive.⁴⁴ “The aim of the investor for higher returns and requirement that service providers deliver efficient and effect[ive] interventions is what drives further innovation.”⁴⁵

In addition, by tying repayment to outcomes, the SIB structure gives service providers flexibility to experiment with different strategies instead of requiring them to focus on specified inputs or the volume of services provided. This allows governments to purchase social results (e.g., increase in employment) rather than social services (e.g., job training) that may not achieve desired results, thus enabling more effective and efficient use of taxpayer dollars.⁴⁶ This type of outcomes-focused arrangement also provides a method and incentive for multiple service providers to work together to achieve a common goal with the project intermediary overseeing and coordinating the multiple parties.⁴⁷ Similarly, this structure encourages different government agencies to work together to accomplish a broader goal, because SIB-financed programs often result in savings across agencies.⁴⁸ Thus, SIBs have the potential to help overcome government silos and maximize the impact of various social programs.⁴⁹

The SIB structure also incentivizes service providers to invest in preventative programs, rather than more costly remedial programs.⁵⁰ Traditionally, governments tend to prefer remedial programs because of the timing discrepancy between cost and savings inherent in preventative programs.⁵¹ But SIBs change this result because preventative programs are often more effective at achieving the desired project outcome.⁵² Preventative programs also have the added benefit of reducing long-term government spending because they tackle the root cause of a social problem, which creates public savings even after the duration of the SIB-funded project has terminated.⁵³

⁴² See Liang, Mansberger & Spieler, *supra* note 19, at 274; Davies, *supra* note 35, at 5; State of NY Fact Sheet, *supra* note 24.

⁴³ See Chhabra, *supra* note 22, at 2 (noting that “[i]nvestor dollars provided through SIBs do [not] have the limitations of project grants or government dollars; they offer a new freedom.”); Kohli, Besharov & Costa, *supra* note 7; Goodall, *supra* note 13, at 7.

⁴⁴ See Barajas et al., *supra* note 15, at 12, 17; Liang, Mansberger & Spieler, *supra* note 19, at 273; Kohli, Besharov & Costa, *supra* note 7, at 1, 6.

⁴⁵ Liang, Mansberger & Spieler, *supra* note 19, at 272.

⁴⁶ See Cox, *supra* note 7, at 968; Tyson & Mendonca, *supra* note 22.

⁴⁷ See Barajas et al., *supra* note 15, at 17; Kohli, Besharov & Costa, *supra* note 7.

⁴⁸ Pettus, *supra* note 25.

⁴⁹ Kohli, Besharov & Costa, *supra* note 7, at 6.

⁵⁰ See SOC. IMPACT ARCHITECTS, *supra* note 11; Kohli, Besharov & Costa, *supra* note 7, at 2.

⁵¹ Cox, *supra* note 7, at 968.

⁵² See *id.* (recognizing that government authorities “have little political or financial incentive to invest in prevention [initiatives]”).

⁵³ See Goodall, *supra* note 13, at 8.

Finally, the SIB service model also creates more accountability in the social services space, which further contributes to the creation of more effective social programs.⁵⁴ Specifically, by requiring outcomes to be measured, SIBs expand our knowledge about what programs are effective and what programs are ineffective at addressing certain social challenges. It allows for more evidence-based decision making in the social service sector. This also improves government accountability by incentivizing governments to shift funding from ineffective programs towards those that work well.⁵⁵ Moreover, because the investors' return depends on the success of the program, investors are financially incentivized to only support programs that they believe will be effective, rather than programs chosen because of the service provider's political ties.⁵⁶ To manage their risk, private investors often also contribute their financial or managerial expertise in performing due diligence and require certain quality controls to be implemented.⁵⁷ The service providers also have an interest in providing an effective social intervention, because they are often rewarded with a success fee if they reach certain performance thresholds. Service providers that can show that they use any money received to successfully achieve a positive social impact are more likely to attract additional capital to that organization.⁵⁸ "By implementing and using a performance management (measurement) system, organizations can measure, report, learn, improve, and demonstrate ... [the] positive change they are making in the lives of the people they serve."⁵⁹

Thus, the SIB structure brings together multiple stakeholders, who each have an interest in achieving a common goal and who each have something different to contribute. This cross-sector collaboration has the potential to make SIB-funded programs operate more effectively and efficiently.

D. The Limitations of SIBs

Despite these benefits, SIBs are not a panacea and have limitations as well as opponents. For instance, one of the most challenging features of a SIB is the requirement to define and measure social outcomes.⁶⁰ Although this feature is beneficial in providing the government, the public, and the non-profit sector with valuable information about which programs work and which do not, this feature makes SIBs not suitable to address every social issue. Accordingly, SIBs should only be used to finance programs that are capable of objective measurement and assessment, such as addressing homelessness, the

⁵⁴ See Barajas et al., *supra* note 15, at 17.

⁵⁵ See Kohli, Besharov & Costa, *supra* note 7, at 6 (noting that without this publicly available knowledge, governments find it difficult to shift money away from current programs, even if they are ineffective at addressing the problem at hand).

⁵⁶ See Liang, Mansberger & Spieler, *supra* note 19, at 272.

⁵⁷ See *id.*; Davies, *supra* note 35, at 5 (noting that "involving investors who are knowledgeable and experienced in business brings new rigor and discipline to the supply of social services"); THIRD SECTOR CAPITAL PARTNERS, *Pay for Success/Social Impact Bonds: RFI 1, 3, 5* (June 20, 2011) (on file with author).

⁵⁸ See Liang, Mansberger & Spieler, *supra* note 19, at 272; THIRD SECTOR CAPITAL PARTNERS, *supra* note 57, at 3.

⁵⁹ SOC. IMPACT RES., *Root Cause, Improving Nonprofit Performance 7* (2012), <http://www.rootcause.org/docs/Resources/Publications/SIR2012-Performance-Management-Primer.pdf> [<https://perma.cc/3H3G-RYMX>].

⁶⁰ See Davies, *supra* note 35, at 6 (recognizing that measuring social outcomes is difficult especially ensuring a direct correlation between the intervention and the result); Kohli, Besharov & Costa, *supra* note 7.

rate of recidivism, childhood education, unemployment, or preventative health care.⁶¹ However, as information technology continues to evolve, it will become easier to capture administrative data with respect to certain outcomes that can provide us with thorough and reliable measures of social impact.⁶²

Moreover, as with any pay-for-success contract that ties payments to results, there is the risk of the parties manipulating results to maximize payments.⁶³ SIBs help minimize some of this risk by focusing on social outcomes rather than inputs or outputs. Rewarding inputs and outputs creates the wrong incentives by encouraging service providers to pursue more cost-effective methods to increase the volume of these inputs or outputs, irrespective of its actual social impact.⁶⁴ Also, it is often easier to manipulate inputs, such as the number of people enrolled in a job-training course, or outputs, such as the number of job training certificates received.⁶⁵ But it may be more difficult to manipulate outcomes, such as an increase in the employment rate.⁶⁶ SIBs further minimize any potential gaming of the system by requiring an independent evaluator and/or verifier to measure and determine whether the desired outcomes have been achieved as a result of the SIB-financed program. Nevertheless, it is important to note that SIBs are not immune from these types of concerns. Thus, the evaluation must be rigorously performed by independent expert evaluators, with a strong focus on counterfactuals and a power to audit. In addition, the stakeholders must be excluded from the evaluation process. Government regulation is also necessary to minimize collusion between the different SIB parties.⁶⁷

Another potential limitation is the cost of implementing a SIB-financed program. Due to the infancy of the SIB model, the multiple parties involved, and the complexity of identifying and measuring performance outcomes, SIBs are costly to set up.⁶⁸ Therefore, SIBs are best suited for projects that can generate enough cost savings to overcome these additional expenses.⁶⁹ For instance, large-scale projects may be preferable, because the increased economies of scale can help lower the costs of the program and administrative expenses.⁷⁰ As SIBs become a more popular form of financing social projects, it is possible that implementing these projects will become more standardized and less costly.⁷¹

⁶¹ See Kohli, Besharov & Costa, *supra* note 7, at 2.

⁶² THIRD SECTOR CAPITAL PARTNERS, *supra* note 57, at 3.

⁶³ This is a result of Campbell's Law: "The more any quantitative social indicator is used for social decision-making, the more subject it will be to corruption pressures and the more apt it will be to distort and corrupt the social processes it is intended to monitor." Jon Pratt, *Flaws in the Social Impact Bond/Pay for Success Craze*, NONPROFIT QUARTERLY (Apr. 17, 2013, 2:01 PM), <https://nonprofitquarterly.org/2013/04/17/flaws-in-the-social-impact-bond-craze/> [<https://perma.cc/7CXG-KYCY>].

⁶⁴ Cox, *supra* note 7, at 968–69.

⁶⁵ See *Id.* at 968; Barajas et al., *supra* note 15, at 10.

⁶⁶ See Cox, *supra* note 7, at 968; Barajas et al., *supra* note 15, at 10.

⁶⁷ See Cox, *supra* note 7, at 977; Davies, *supra* note 35, at 7; THIRD SECTOR CAPITAL PARTNERS, *supra* note 57, at 6.

⁶⁸ See Barajas et al., *supra* note 15, at 18; Jessica Toonkel, *CORRECTED-Wall Street Not Giving Up on U.S. Social Impact Bonds*, REUTERS (Jul. 29, 2015, 10:22 AM), <http://www.reuters.com/article/2015/07/29/usa-socialbonds-idUSL1N1082S820150729> [<https://perma.cc/3Z7Q-Z6CT>].

⁶⁹ See Barajas et al., *supra* note 15, at 18.

⁷⁰ Liang, Mansberger & Spieler, *supra* note 19, at 274; Barajas et al., *supra* note 15, at 18.

⁷¹ See Toonkel, *supra* note 68.

Finally, at this point, it is unclear whether or not SIBs will live up to their potential. To assess their potential accurately, more evidence is necessary. As of February 2017, only three SIBs launched in the United States have been operating for long enough to have their outcomes evaluated and any success payments calculated.⁷² Of these three, one project was terminated early because the program was unsuccessful in reaching its goal of reducing the recidivism rate at Rikers Island.⁷³ The second one, the Utah High Quality Preschool Program, resulted in a success payment, but the success metrics used to evaluate the results of the program, designed to help at risk kindergarteners, were questionable.⁷⁴ This generated a lot of criticism of the program.⁷⁵ Most recently, the third project resulted in an initial success payment to private investors of a SIB aimed at expanding high quality pre-school education to low-income children.⁷⁶ Although it is too early to evaluate the true success of Chicago's SIB project, some of the evaluation design issues with the Utah program have been addressed in this project.

Despite setbacks, these early projects do not necessarily diminish from the potential of SIBs to address social challenges. On the one hand, the SIB model is not structured to guarantee success, but rather to shift the risk of innovating to private investors.⁷⁷ Thus, the failure of the Rikers Island project to reach its goal of reducing the rate of recidivism has the benefit of using private funds to demonstrate a type of program that is ineffective. Similarly, the controversial results of the Utah program reveal the type of evaluation methodologies that do not work, and reinforce that the SIB model is not suitable for all projects. As one commentator has noted, “[f]ailed efforts are not only inevitable, they are essential to finding real solutions.”⁷⁸ On the other hand, regardless of

⁷² See GOV'T PERFORMANCE LAB., *supra* note 22, at 4. These projects are: (i) New York City's SIB-funded program aimed at reducing the recidivism rate among juveniles detained at Rikers Island, which was the first SIB launched in the United States; (ii) Utah's SIB-funded program targeting early childhood education; and (iii) Chicago's SIB-funded program to provide access to high-quality early childhood education to at-need students. See Press Release, Mayor's Press Office, City of Chicago, Mayor Emanuel Announces Expansion of Pre-K to More Than 2,600 Chicago Public School Children (Oct. 7, 2014), http://www.cityofchicago.org/city/en/depts/mayor/press_room/press_releases/2014/oct/mayor-emanuel-announces-expansion-of-pre-k-to-more-than-2-600-ch.html [<https://perma.cc/632R-6W85>] (describing the City of Chicago's SIB expanding pre-kindergarten to more than 2,600 Chicago public school children); *Fact Sheet: The Utah High Quality Preschool Program*, https://hceconomics.uchicago.edu/sites/default/files/file_uploads/SIB-RBFFact_SheetUtahVersion.pdf [<https://perma.cc/MPK5-W93V>] (describing the Utah High Quality Preschool Program); Toonkel, *supra* note 68; VERA INST. OF SOC. JUSTICE, *Social Impact Bond Evaluation*, <http://www.vera.org/project/impact-evaluation-adolescent-behavioral-learning-experience-program-rikers-island> [<https://perma.cc/3MXU-UZPL>] (describing the program and results of the New York City SIB targeting recidivism).

⁷³ See John Olson & Andrea Phillips, *Rikers Island: The First Social Impact Bond in the United States*, 9 COMMUNITY DEV. INV. REV. 97, 97 (2013); GOV'T PERFORMANCE LAB., *supra* note 22, at 4.

⁷⁴ See GOV'T PERFORMANCE LAB., *supra* note 22, at 4; Nathaniel Popper, *Did Goldman Make the Grade*, N.Y. TIMES, Nov. 3, 2015, B1.

⁷⁵ See GOV'T PERFORMANCE LAB., *supra* note 22, at 4; Popper, *supra* note 74.

⁷⁶ See GOV'T PERFORMANCE LAB., *supra* note 22, at 4; Melissa Sanchez, *Investors Earn Max Initial Payment from Chicago's 'Social Impact Bond'*, CHI. REP. (May 16, 2016), <http://chicagoreporter.com/investors-earn-max-initial-payment-from-chicagos-social-impact-bond/> [<https://perma.cc/KMG8-ERBE>].

⁷⁷ See GOV'T PERFORMANCE LAB., *supra* note 22, at 4 (“The early U.S. PFS projects have demonstrated the model's potential to increase resources dedicated to tackling challenging social problems, while simultaneously minimizing the risk that ineffective programs continue to receive funding year after year.”); Tyson & Mendonca, *supra* note 22.

⁷⁸ Tyson & Mendonca, *supra* note 22, at 2.

success, the SIB model has the potential to increase funding for social programs and encourage evidence-based decision-making.⁷⁹

In sum, a SIB-financed program is not appropriate to address all social issues.⁸⁰ But as already recognized, “where viable ... they present many advantages over traditional grant and appropriation financing.”⁸¹ Thus, if appropriate precautions are taken to minimize collusion or corruptive practices, SIB-financed programs could make a substantial impact on many of the challenging social issues our nation faces.⁸² However, a sufficient number of SIBs need to be implemented and evaluated before we can conclude whether or not SIBs can fulfill their goal of improving the delivery of social services.

III. TAXATION OF SIBS

This Part discusses the current tax treatment of SIBs for U.S. federal income tax purposes.⁸³ Section A briefly explains why the federal income tax consequences to investors who participate in a SIB-funded program are unclear under existing law. Section B demonstrates that the current law does not treat SIBs as a tax-favored investment. In particular, it discusses why SIB investments most likely do not benefit from preferential tax rates, tax-exempt treatment, or an upfront charitable contribution deduction.

A. Tax Uncertainty

Because the taxation of SIB investments is not specifically addressed by existing federal income tax laws, their current tax treatment must be discerned from the general rules governing financial instruments. Under existing law, the tax implications of an investment in a financial instrument significantly depend on how the instrument is characterized for tax purposes.⁸⁴ Courts generally weigh numerous factors in determining an instrument’s characterization.⁸⁵ Under this facts and circumstances analysis, SIBs can

⁷⁹ See Barajas et al., *supra* note 15, at 17; GOV’T PERFORMANCE LAB, *supra* note 22, at 4.

⁸⁰ Davies, *supra* note 35, at 6; Kohli, Besharov & Costa, *supra* note 7, at 8.

⁸¹ Cox, *supra* note 7, at 970.

⁸² See Kohli, Besharov & Costa, *supra* note 7, at 8.

⁸³ For a detailed discussion of the tax consequences to investors who participate in a SIB-funded program, see Mazur, *supra* note 7, at 468–486.

⁸⁴ See *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968); STAFF OF THE J. COMM. ON TAX’N, JCS-3-13, REP. TO THE HOUSE COMM. ON WAYS AND MEANS ON PRESENT LAW AND SUGGESTIONS FOR REFORM SUBMITTED TO THE TAX REFORM WORKING GROUPS 58 (2013); STAFF OF THE J. COMM. ON TAX’N, JCX-41-11, PRESENT LAW AND BACKGROUND RELATING TO TAX TREATMENT OF BUSINESS DEBT (2011); Edward D. Kleinbard & Erika W. Nijenhuis, *Everything I Know about New Financial Products I Learned from DECS*, 553 PLI/Tax 491 (2002); Michael S. Farber, *Equity, Debt, Not—The Tax Treatment of Non-Debt Open Transactions*, 60 TAX L. 635, 636 (2007); Bret Wells, *Tax Consequences of Participations in International Trade Finance*, 13 TAX NOTE INT’L 23 (Dec. 2, 1996).

⁸⁵ The characterization of a financial instrument requires the consideration of numerous factors, such as (i) the parties’ intent, (ii) the existence of an unconditional promise to pay at a fixed maturity date; (iii) the provision of fixed interest rates; (iv) participation in profits; (v) the adequacy of the interest; (vi) the source of payments (vii) participation in management; (viii) the extent of subordination to the claims of general creditors; (ix) the identity of interest between holders of the instrument and owners; (x) satisfaction of the independent creditor test; and (xi) the use of the funds. See I.R.C. § 358(a); *Roth Steel Tube Co. v. Comm’r*, 800 F.2d 625 (6th Cir. 1986), *cert. denied*, 481 U.S. 1014 (1987); *Estate of Mixon, Jr. v. United States*, 464 F.2d 394 (5th Cir. 1972); *Fin Hay Realty*, *supra* note 84; STAFF OF THE J. COMM. ON TAX’N, JCS-

plausibly be characterized in several different ways.⁸⁶ This uncertainty exposes a private SIB investor to tax compliance risks, as well as to an unpredictable tax liability.

For instance, the tax law may treat SIBs as debt instruments. SIBs are referred to as “bonds” and the majority of U.S. SIB arrangements indicate that the parties intend that the instrument be treated as debt.⁸⁷ In addition, several other factors may also weigh in favor of debt characterization. Specifically, the rate of return set forth in a typical SIB arrangement is likely considered a “reasonable” rate of return, thereby supporting debt characterization. The source of repayment also suggests a SIB arrangement is akin to debt because a state or local government generally guarantees the intermediary’s payments to investors upon a successful outcome.⁸⁸ Moreover, the payment preference, which SIB investors often receive over other claimants, likely also favors debt characterization.⁸⁹ Finally, several other factors are inconclusive and do not preclude debt characterization, such as the provision of a fixed rate of interest whose payment is contingent on the success of the project, or weigh only slightly in favor of debt characterization, such as the limited rights of SIB investors to participate in management.⁹⁰

Alternatively, current law may also treat SIBs as equity.⁹¹ Two factors potentially weigh in favor of equity characterization. First, a traditional SIB arrangement does not necessarily provide an unconditional promise to pay the principal at a fixed maturity date, which is a significant factor in the debt/equity characterization analysis.⁹² On the one hand, the SIB investment provides for a fixed maturity date. On the other hand, repayment is contingent on the program’s successful delivery of social outcomes, which undermines the requirement that payment is unconditional. Thus, this factor may point towards an equity characterization.⁹³ Second, SIB investors participate in the profits of the enterprise, which is another factor that favors equity characterization.⁹⁴ Specifically, SIB investors stand to gain an additional return on their investment to the extent the SIB-funded program exceeds pre-determined outcome metrics.⁹⁵ Generally, the amount of these “success payments” is based on the cost-savings the program accrues to the government that initiated the SIB project.⁹⁶ However, SIBs generally also cap the profit potential of the SIB investor and the profit participation is not discretionary once the

3-13, *supra* note 84, at 58; STAFF OF THE J. COMM. ON TAX’N, JCX-41-11, *supra* note 84; I.R.S. Notice 94-47, 1994-1 C.B. 357; Farber, *supra* note 84, at 645.

⁸⁶ For a detailed analysis of how SIBs are likely characterized for tax purposes under current law, see Mazur, *supra* note 7, at 446–66.

⁸⁷ See, e.g., Olson & Phillips, *supra* note 73 (describing the investment structure as a multiple draw term loan to the project intermediary); Pay for Success Contract Among the Commonwealth of Mass., ROCA, Inc., and Youth Servs. Inc. (Jan. 7, 2014), <http://www.thirdsectorcap.org/wp-content/uploads/2015/03/final-pay-for-success-contract-executed-1-7-2013.pdf> [<https://perma.cc/34KL-LLB8>] (referring to the financing of a SIB launched in Massachusetts to target juvenile recidivism as a loan).

⁸⁸ See Mazur, *supra* note 7, at 453.

⁸⁹ See *id.* at 454.

⁹⁰ See *id.* at 453.

⁹¹ If a SIB arrangement is treated as creating an equity interest, it may result in the creation of a corporate equity interest or a partnership interest or joint venture. See *id.* at 457.

⁹² See *id.* at 449.

⁹³ See *id.*

⁹⁴ See William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 442 (1970); Mazur, *supra* note 7, at 451.

⁹⁵ See *supra* notes 10–16 and accompanying text.

⁹⁶ See *supra* notes 10–16 and accompanying text.

performance thresholds are met. Thus, although this factor potentially suggests equity characterization, it does not definitively preclude debt characterization.⁹⁷

It is also possible that a SIB arrangement is characterized as neither debt nor equity, but rather as a derivative instrument. A SIB arrangement has several important features in common with derivative instruments, in general, and more specifically with notional principal contracts. Both SIB arrangements and derivative instruments seek to shift financial risks to another party.⁹⁸ Both instruments also calculate payments based on the value of an underlying transaction.⁹⁹ In addition, like prepaid swaps, a type of notional principal contract, SIBs also require one party to pay a fixed amount upfront, while the other party is contractually obligated to make variable future payments, which are calculated based on the value of the underlying transaction at a particular date.¹⁰⁰

To summarize, a traditional SIB arrangement can arguably be treated as debt, equity or a derivative instrument. There are factors that support each of these characterizations. Taxpayers and the Service may disagree as to the correct treatment for tax purposes, thereby affecting a SIB investor's ultimate tax liability. Moreover, SIBs are not structured uniformly. Certain modifications may change the tax classification, and as SIBs continue to evolve, the characterization analysis also may lead to different results.

B. Unavailable Tax Preferences

The tax preferences that the federal government currently extends to traditional equity investments, municipal bonds, and charitable donations likely do not apply to traditional SIB investments. As a result, private investors who participate in SIBs do not currently enjoy tax benefits, such as preferential tax rates, tax-exempt treatment, or an upfront deduction.

1. Preferential Tax Rates

In general, qualified dividends and capital gains are subject to preferential tax treatment.¹⁰¹ These forms of income are subject to tax at a maximum rate of 20%,¹⁰² rather than the 39.6% tax rate imposed on other forms of income.¹⁰³ Even though a SIB arrangement may be treated as an equity interest under certain circumstances, a traditional SIB arrangement would most likely not be treated as equity for tax purposes.¹⁰⁴ Accordingly, income generated by a SIB investment would not benefit from these preferential tax rates.

⁹⁷ See Mazur, *supra* note 7, at 451.

⁹⁸ See BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 57.1 (2017) (quoting C.T. Plambeck et al., *General Report*, 80b CAHIERS DE DROIT FISCAL INT'L 653, 657 (1995)) (defining a derivative instrument as a "risk-shifting financial contract ... whose payment terms are determined by or derive from the value of the underlying transaction"); Mazur, *supra* note 7, at 462.

⁹⁹ See BITTKER & LOKKEN, *supra* note 98; Mazur, *supra* note 7, at 451.

¹⁰⁰ See Mazur, *supra* note 7, at 463. A SIB instrument also has several features in common with a cash-settled prepaid forward contract. See *id.*

¹⁰¹ I.R.C. § 1(h)(1), (11).

¹⁰² Because of the 3.8% surtax imposed on net investment income, this top federal tax rate on capital gains is effectively 23.8%. See I.R.C. § 1411.

¹⁰³ See I.R.C. § 1.

¹⁰⁴ For a thorough discussion of this conclusion, see Mazur, *supra* note 7 (discussing why a SIB arrangement may potentially be treated as creating a corporate equity interest or a partnership interest and the corresponding tax consequences of each characterization).

A traditional SIB arrangement is more likely characterized as a contingent debt instrument under the existing law.¹⁰⁵ This characterization is especially likely in situations where the parties label the SIB investment as a “loan” and/or issue a note or other evidence of indebtedness.¹⁰⁶ Moreover, as discussed above, the factors that weigh in favor of characterizing a SIB investment as equity, such as the unconditional promise to pay at a fixed maturity date and the SIB investor’s participation in profits do not preclude debt characterization in all cases.¹⁰⁷

As a debt instrument, the SIB investment would likely be subject to the non-contingent bond method.¹⁰⁸ Pursuant to this method, the SIB investment will give rise to interest income, which will be calculated and taxable on an annual basis, even prior to any payments being made.¹⁰⁹ If the actual amounts of the contingent payments differ from the projected amounts, either because the SIB-funded project is unsuccessful or the project satisfies a different level of outcome metrics, adjustments are made to reflect the difference at the time the actual payment amounts are first determinable.¹¹⁰ Moreover, this interest income will be subject to tax at a marginal rate of up to 39.6%, instead of the lower tax rates imposed on capital gains and dividend income.¹¹¹

2. Tax Exemption

Current law provides a federal tax exemption for interest on bonds issued by a state or local government.¹¹² For the reasons discussed below, it is possible that a traditional SIB arrangement would not qualify for this tax-exempt status.¹¹³

¹⁰⁵ Mazur, *supra* note 7, at 486.

¹⁰⁶ The majority of the SIBs implemented in the United States to date structure the SIB arrangement as a loan from investors to the project intermediary. *See id.* at 442. Although the Service is not bound by the debt label given to a SIB instrument, the instrument’s issuer and all holders of the instrument are generally bound by this characterization. *See* Notice 94-47, *supra* note 85.

¹⁰⁷ *See supra* notes 91–97 and accompanying text. *See also* Mazur, *supra* note 7, at 486 (arguing that the totality of the factors weigh in favor of characterizing a traditional SIB investment as debt rather than equity).

¹⁰⁸ *See* Reg. § 1.1275–4(a) (applying the non-contingent bond method to certain debt instruments that provide for one or more contingent payments). Even if the SIB investment is characterized as a prepaid swap agreement, the tax consequences are likely to be similar. *See also* Mazur, *supra* note 7, at 463. The noncontingent swap method, which applies to prepaid swap agreements, is comparable to the noncontingent bond method. *See* Treas. Reg. § 1.446–3. However, if the SIB investment is ultimately characterized as a different type of derivative instrument, such as prepaid forward contract, then the tax implications of a SIB investment will differ significantly. *See* Mazur, *supra* note 7, at 464.

¹⁰⁹ “Under the noncontingent bond method, interest on a debt instrument must be taken into account whether or not the amount of any payment is fixed or determinable in the taxable year. The amount of interest that is taken into account for each accrual period is determined by constructing a projected payment schedule for the debt instrument and applying rules similar to those for accruing OID on a noncontingent debt instrument.” Treas. Reg. § 1.1275–4(b)(2).

¹¹⁰ *See Id.*

¹¹¹ I.R.C. § 1. This rate is effectively 43.4% for income that constitutes net investment income as a result of the 3.8% surtax imposed by Section 1411. I.R.C. § 1411. Similarly, capital gains and dividend income that constitute net investment income and exceed a statutory threshold are also subject to this 3.8% surtax. I.R.C. § 1411.

¹¹² *See* I.R.C. § 103.

¹¹³ However, it may be also possible to structure a SIB arrangement in a manner that may qualify for tax-exempt treatment. Specifically, a SIB may be structured so that it does not satisfy the private use test and the private security or payment test or the private loan financing test and therefore does not constitute an ineligible private activity bond. Moreover, SIB proceeds that are used to pay service providers may be considered working capital expenditures that can qualify for tax-exempt treatment. Nevertheless, the

To qualify for the exemption, the bond issuer has to comply with numerous reporting and filing requirements.¹¹⁴ In addition, no portion of the bond may constitute a private activity bond.¹¹⁵ In other words, the bond proceeds may not benefit a private business or a person that is not a governmental unit.¹¹⁶ One exception to this rule is if the bond constitutes a qualified 501(c)(3) bond.¹¹⁷ In general, a qualified 501(c)(3) bond is a bond issued by a state or local government whose proceeds are used to finance property owned by 501(c)(3) organizations, such as charities or educational organizations, or governmental units.¹¹⁸

Even though the proceeds of a SIB are also generally used to benefit charitable organizations, a traditional SIB arrangement likely does not qualify as a 501(c)(3) bond. A 501(c)(3) bond is disqualified from tax-exempt status if neither a 501(c)(3) organization nor a governmental entity owns all of the property financed by the net proceeds of the bond.¹¹⁹ A traditional SIB arrangement most likely fails to satisfy this requirement because neither a government entity nor a 501(c)(3) organization own any property as a result of the issuance of the SIB.¹²⁰ Unlike most tax-exempt bonds that are issued to finance physical capital projects, such as schools, hospitals, airports, highways, or other types of public infrastructure or government facilities, a traditional SIB is not issued to finance the acquisition or building of any property.¹²¹ Instead, the SIB proceeds are used to finance social services that do not typically result in the creation of any tangible property. Thus, a SIB most likely fails to meet the statutory requirements of the ownership test.

The features of a SIB also differ in several significant respects from current municipal bonds. Generally, a municipal bond is issued as either a general obligation bond or a revenue bond. A SIB does not appear to fall within either of these categories.¹²² A general revenue bond is backed by the “full faith and credit” of the issuing government

uncertainty involved in determining whether SIBs qualify for tax-exempt treatment may be enough to deter some potential investors from claiming the exemption for tax purposes.

¹¹⁴ An issuer also has to comply with requirements related to the “proper and timely use of bond-financed property . . . and arbitrage yield restriction and rebate requirements.” I.R.S. Pub. No. 4079, *Tax-Exempt Governmental Bonds*, 11 (Jan. 2016).

¹¹⁵ I.R.C. § 103. Arbitrage bonds (as defined in Section 141 of the Code) are also ineligible for this tax-exempt status. *Id.* Although this raises interesting issues in the SIB context, it is likely that a SIB arrangement would not be considered an arbitrage bond.

¹¹⁶ See I.R.C. § 141. A private activity bond is a bond that either meets the requirements of (1) the private use test and the private security or payment test; or (2) the private loan financing test. *Id.*

¹¹⁷ I.R.C. § 141(b)(9).

¹¹⁸ See I.R.C. § 145.

¹¹⁹ I.R.C. § 145(a)(1). A 501(c)(3) bond is also disqualified from tax-exempt status if the bond satisfies both the modified private business use test and the modified private payment or security test. *Id.* The private business use test looks to whether more than 5% of the net proceeds of the 501(c)(3) bond issue are to be used for any private business use. I.R.C. §§ 145(a)(1), 141(b)(1). The private payment or security test is satisfied if more than 5% of the payment of principal or interest on the bond issue is either made or secured by payments or property used or to be used for a private business use. I.R.C. §§ 145(a)(1), 141(b)(2).

¹²⁰ See Dao et al., *supra* note 37, at 15; OFFICE OF INV’R EDUC. & ADVOCACY, U.S. SEC. & EXCH. COMM’N, *Investor Bulletin: Municipal Bonds* (June 1, 2012), <https://www.sec.gov/investor/alerts/municipalbonds.htm> [<https://perma.cc/3NSK-MQHN>].

¹²¹ See GRANT A. DRISSEN, CONG. RESEARCH SERV., RL30638, TAX-EXEMPT BONDS: A DESCRIPTION OF STATE AND LOCAL GOVERNMENT DEBT (2016).

¹²² See Dao et al., *supra* note 37, at 16 (concluding that “in attempting to find a home for the SIB in the current municipal framework, we found that there is no existing area of natural fit and believe it is likely that legislation needs to be passed in order to complement the issuance of a SIB”).

entity.¹²³ Although a government entity may guarantee the full repayment of a SIB by its taxing power, this repayment is contingent on a particular social program achieving a certain level of success.¹²⁴ This likely does not satisfy the criteria of a general obligation bond.

A SIB likely also does not constitute a revenue bond. A revenue bond is a bond that is not backed by the full faith and credit of the issuer, but instead is backed by the revenue generated from a specified income-producing project.¹²⁵ A SIB likely also does not fall within this bond category because projects financed by SIBs generally do not generate revenue. Instead, a successful SIB-funded project often generates government cost savings by improving a particular social issue.¹²⁶

In addition, a municipal bond is structured as a debt instrument with fixed or variable interest payments and a promise of the repayment of principal on the maturity date. Unlike a typical municipal bond, a SIB is a hybrid financial instrument that has both debt and equity features. Although it has a fixed maturity date, it does not have fixed interest payments. Instead, the return on investment depends on the success of the project. A SIB also does not provide for a repayment of the principal investment upon the maturity date. Instead, both the “interest” payments and the repayment of principal are contingent upon a social program exceeding certain performance thresholds. Thus, considering the cumulative effect of these differences, it is likely that traditional SIBs do not qualify for tax-exempt status. Instead, specific legislation is likely needed to make SIBs tax exempt.¹²⁷

3. *Upfront Deduction*

Current law also provides a federal income tax deduction for donative transfers to qualified charitable organizations, which meet the requirements of a charitable contribution.¹²⁸ Even though a traditional SIB investment generally involves the transfer of money or property to a qualified charitable organization¹²⁹ and SIB investments by private investors, thus far, have been made primarily for philanthropic reasons,¹³⁰ an

¹²³ U.S. SEC. & EXCH. COMM’N, *Investor Bulletin: Municipal Bonds*, *supra* note 120.

¹²⁴ *See, e.g.*, Pay for Success Contract, *supra* note 87 (providing that the funds the Commonwealth of Massachusetts uses to enter into pay-for-success contracts are backed by the full faith and credit of the Commonwealth).

¹²⁵ U.S. SEC. & EXCH. COMM’N, *Investor Bulletin: Municipal Bonds*, *supra* note 120.

¹²⁶ *See* Dao et al., *supra* note 37, at 19.

¹²⁷ *See id.* at 16.

¹²⁸ I.R.C. § 170. A contribution or gift generally qualifies for the federal income tax deduction if it meets four requirements: (1) it is a transfer of money or property; (2) the recipient is a qualified organization as defined in Section 170(c); (3) the transfer is voluntary, donative in nature and exceeds the value of any actual or expected return benefit; and (4) the contribution is in proper form. *See id.*; Carla Neeley Freitag & Barbara L. Kirschten, *Charitable Contributions: Income Tax Aspects*, 863-3RD TAX MGMT. PORT. (BNA), II(A) (Apr. 11, 2016).

¹²⁹ To date, the organizations that have operated as project intermediaries in U.S. SIBs have been qualified charitable organizations. *See* Mazur, *supra* note 7.

¹³⁰ *See* Liang, Mansberger & Spieler, *supra* note 19 (observing that the primary mission of SIBs is to “promote proven social benefit programs,” while any economic benefit or growth is only of secondary importance); Mazur, *supra* note 7; Robert Millburn, ‘Pay for Success Bonds’ Drum Up Interest, BARRON’S: PENTA DAILY (Jan. 13, 2014, 11:40 AM), <http://blogs.barrons.com/penta/2014/01/13/pay-for-success-bonds-drum-up-interest/> [<https://perma.cc/DC5H-AZG2>] (noting that “[m]uch of the private investor interest, at this point, has come from philanthropic-minded individuals and their foundations.”).

investment in a SIB-funded program is not likely to give rise to a deductible charitable donation.

The tax law provides that a payment does not qualify as a charitable contribution unless the transferor “*intends* to make a payment in an amount that exceeds the fair market value” of any goods or services that it receives from the charitable organization.¹³¹ However, a private investor in a SIB expects a return benefit. This is evident from the terms of the traditional SIB arrangement, which provide that if the SIB-funded program exceeds certain performance thresholds, the investor recoups its initial capital investment and possibly also receives a return on that investment.¹³² In other words, in addition to any social good the investment may generate, an investor generally also expects a financial return from its investment. Thus, it does not matter that the investor may potentially lose its entire investment or that the investor is willing to make this risky, low-financial reward investment.¹³³ This *expectation* of benefits is enough to disqualify an individual investor from deducting its payment upfront as a charitable contribution deduction.¹³⁴ Instead, the SIB investment would generate a capital loss deduction only once (and if) the SIB-financed project fails to meet the pre-determined performance thresholds and the investor loses its investment.

In conclusion, private investors who participate in SIBs do not currently enjoy any tax benefits related to their investment. Instead, these investments likely give rise to ordinary income taxable at non-preferential tax rates throughout the life of the project and only give rise to a limited capital loss deduction at the time an unsuccessful SIB-funded project is terminated.

IV. SIBS AS A TAX-FAVORED INVESTMENT?

Despite the SIBs’ potential to help tackle some of society’s toughest social problems or at least move us toward a more evidence-based, collaborative delivery of social services, the current tax law discourages private investments in SIBs. This situation arises because the current tax treatment of SIBs, like many novel financial instruments, is not clear, due to the difficulties in characterizing the arrangement under the traditional debt/equity analysis.¹³⁵ This ambiguity creates an audit risk that may deter some private investors from investing in SIB arrangements especially given the speculative nature of the investment and the below-market rate of return.¹³⁶

Moreover, potential SIB investors have many options of where to invest their private capital. Among their choices are traditional equity investments and municipal

¹³¹ Treas. Reg. § 1.170A-1(h)(1)(i) (emphasis added). In addition, the payment must also actually exceed the fair market value of the goods or services. Treas. Reg. § 1.170A-1(h)(1)(i-ii).

¹³² See *supra* notes 11-17 and accompanying text.

¹³³ See *Stubbs v. U.S.*, 428 F.2d 885 (9th Cir. 1970); *Singer Co. v. U.S.*, 449 F.2d 413, 424 (Ct. Cl. 1971); Mazur, *supra* note 7; Freitag & Kirschten, *supra* note 128, at II(E)(1)(b)(2).

¹³⁴ However, it is possible that certain SIB arrangements that are structured as a tranche loan structure may be bifurcated so that a portion of the transaction is treated as a charitable contribution with respect to non-profit investors that transfer funds to the SIB as junior lenders. See Mazur, *supra* note 7.

¹³⁵ Although the ambiguity that arises in applying the debt/equity analysis to SIBs is not unique to these transactions, it may nevertheless have a deterrent effect to risk-adverse investors.

¹³⁶ As discussed above, although often structured as a debt instrument, the traditional SIB arrangement does not necessarily constitute debt for tax purposes. See *infra* Part II.A. Moreover, if the investment is treated as an equity interest in the project intermediary, this may cause a non-profit intermediary to lose its tax-exempt status. See Mazur, *supra* note 7.

bonds. This Part argues that despite sharing many similar features with a traditional SIB investment, each of these options receive better tax treatment than a SIB investment, which may further deter private investments in SIB-funded programs. Because no strong justifiable basis exists for discouraging SIB investments, this Part concludes that extending tax benefits to SIB Investments would be a sound policy choice.

A. Traditional Equity Investments

Given the below-market rate of return on a SIB investment and the potentially unfavorable tax treatment of a traditional SIB investment, a rational investor may be more incentivized to invest in a traditional equity investment. Even without considering taxes, a traditional equity investment with similar market risk would likely generate a higher rate of return than a comparable SIB investment and provide investors with more liquidity.¹³⁷

When taxes are taken into account, this disparity in return on investment is exacerbated, because a traditional equity investment generally also results in more favorable tax consequences than a SIB investment. In particular, a profitable equity investment is more favorable from a tax perspective, because it can generate income taxed at preferential tax rates.¹³⁸ A non-corporate investor that receives qualified dividend income from a corporation will pay tax on that income at up to a 20% rate,¹³⁹ whereas a SIB investor would pay tax on the same stream of income at up to a 39.6% rate.¹⁴⁰ The traditional equity investor also benefits from a time value of money perspective. This advantage arises because the recipient of qualified dividend income generally would only be liable for taxes in the taxable year that the dividends are paid to her. A SIB investor, however, would be liable for tax on any projected return on investment prior to the time of actual payment under the non-contingent bond method.¹⁴¹

As a result of these significant differences in tax treatment, the tax law likely distorts the capital market against SIB investments. This is undesirable from a policy

¹³⁷ See Emily Gustafsson-Wright, Katie Smith & Sophie Gardiner, *Public-Private Partnerships in Early Childhood Development: The Role of Publicly Funded Private Provision*, BROOKINGS INST. (2016), <https://www.brookings.edu/wp-content/uploads/2016/11/global-20161129-public-private-partnerships.pdf> [<https://perma.cc/NXE6-6NHY>]. See also Erika K. Stump & Amy F. Johnson, *An Examination of Using Social Impact Bonds to Fund Education in Maine*, UNIV. OF SOUTHERN ME. (2016), https://usm.maine.edu/sites/default/files/cepare/Examination_of_Using_Social_Impact_Bonds_to_Fund_Education_in_Maine.pdf [<https://perma.cc/M84Y-XQWF>] (concluding that “[w]hile many venture market capital investors expect a return of up to 20%, SIB investments usually offer less than a 10% return”).

¹³⁸ See I.R.C. §§ 1(h)(1), 11 (providing for a preferential tax rate for qualified capital gains and qualified dividends).

¹³⁹ This rate is reduced to 15% if the taxpayer is not in the 39.6% tax bracket. In addition, this income may also be subject to a 3.8% surtax if certain income thresholds are met. See I.R.C. § 1411.

¹⁴⁰ See *supra* notes 108–11 and accompanying text (discussing why a SIB investment is most appropriately treated under the non-contingent bond method under the current law, rather than as a corporate equity investment that gives rise to preferential tax rates). This income may also be subject to the 3.8% surtax on net investment income when certain income thresholds are met. See I.R.C. § 1411.

¹⁴¹ Even if both an equity investment and SIB-funded project are unsuccessful, the tax implications to the equity investor are generally more favorable from a timing perspective. In both cases, the investor would recognize a capital loss at the termination of the investment. However, because the non-contingent bond method likely applies to the SIB investment, the SIB investor nevertheless has to report any projected return on investment on an annual basis. The SIB investor only accounts for any difference between the amount of income reported and the amount of the contingent return on investment that the investor receives, if any, at the time the contingent payment is made. See Treas. Reg. 1.1275–4.

perspective for several reasons. First, there is no justifiable reason for the distinction. Even though a SIB shares many features with a traditional equity investment, there is a strong argument that traditional SIB investments are not treated as corporate equity, but instead treated as contingent bond instruments and taxed under the less favorable non-contingent bond method.¹⁴² Second, if SIB investments live up to their potential, they will produce a social good that should be encouraged, or at least not discouraged. Given that SIB investments, unlike traditional investments, are created to generate government cost savings and produce a social benefit, this does not make sense from a policy perspective.¹⁴³ Also, as further discussed below, it is conceptually consistent with the policy behind the dividend and capital gains tax preference to extend similar tax treatment to income generated by SIBs.

B. Tax-Exempt Bonds

Alternatively, a SIB investor could have used its funds to invest in a municipal bond, in which case any interest generated would be exempt from taxation.¹⁴⁴ A municipal bond shares many features with a SIB arrangement. For instance, the proceeds of a qualified 501(c)(3) bond, a specific type of municipal bond, must be used for the benefit of charities, educational organizations, or other 501(c)(3) organizations and governments.¹⁴⁵ Similarly, the proceeds generated by a SIB arrangement are often used for the benefit of 501(c)(3) organizations, because qualified nonprofit organizations generally perform the social services financed by the SIB. Thus, SIBs indirectly provide these nonprofit organizations the capital with which to operate and address a social issue that is aligned with that organization's charitable mission. Moreover, SIBs are also specifically designed for the benefit of governments by funding programs and providing social services that have traditionally been provided by governments. These instruments are also intended to create savings for the government by improving social programs.

Despite these similarities, as discussed above, it is possible that a traditional SIB arrangement does not qualify as a tax-exempt bond.¹⁴⁶ A SIB investment is disqualified primarily for technical reasons. For instance, a SIB arrangement does not generate tax-exempt income, because its proceeds are used to finance services, rather than physical capital projects. Section 501(c)(3) bonds, which qualify for tax-exempt treatment, are generally issued to fund the acquisition, development, or improvement of facilities used for the operation of non-profit organizations. The absence of property in the SIB context is likely one factor that precludes tax-exempt treatment. In addition, a SIB does not take on the form of either a general obligation bond or a revenue bond. Thus, despite the similarities, a SIB arrangement may not qualify for the same tax-exempt treatment.

¹⁴² See *supra* notes 108–11 and accompanying text; Mazur, *supra* note 7.

¹⁴³ See Cox, *supra* note 7, at 981–82 (arguing that “because the government already realizes significant savings upon successful completion of a SIB-funded program, legislators should consider exempting investor SIB earnings from capital gains taxation”).

¹⁴⁴ See I.R.C. § 103.

¹⁴⁵ See I.R.C. § 145. Alternatively, to qualify for tax-exempt treatment, more than 5% of the net proceeds of the 501(c)(3) bond cannot be used for any private business use and more than 5% of the payment of principal or interest on the bond must either be made or secured by payments or property used or to be used for a private business. *Id.*

¹⁴⁶ However, as also discussed above, it may be possible to structure a SIB arrangement in a manner so that it does not constitute a private activity bond. *Supra* note 113.

This disparate tax treatment likely distorts investment decisions away from SIBs and in favor of municipal bonds. Even though both SIBs and municipal bonds benefit the government or a non-profit entity and even though both offer lower rates of returns, a rational investor, who is motivated purely for financial reasons, would be more willing to accept the relatively low interest payments on municipal bonds because they are tax-free.¹⁴⁷ In addition, municipal bonds are generally considered a less risky investment given their relatively low default rates. On the other hand, a SIB investment is a high risk investment. It conditions repayment of principal on the success of a particular social program and has a novel and unique risk profile that is hard to measure. Consequently, SIBs, which do not offer any comparable incentives, carry a high level of risk, and function similarly to municipal bonds, are at a disadvantage relative to municipal bonds.

In summary, as the above discussion demonstrates, the tax consequences to private investors who contribute funds to SIBs are generally unfavorable relative to comparable investments. However, there is no sound policy basis for this distinction. As a result, the current tax law creates unjustified inefficiencies and inequities, limits a SIB's ability to attract private capital to expand in the United States, and prevents governments from effectively studying the true potential of SIBs to advance solutions to challenging social issues.

V. RECOMMENDATIONS FOR REFORM

By increasing compliance risks for SIB investors and granting tax-favored status to comparable investments, the current tax system creates administrative issues, distorts investment decisions, and treats similarly-situated taxpayers differently. Existing tax policies need to be changed to accommodate SIBs and minimize the discriminatory tax treatment towards private investment in SIBs.

There are numerous ways that Congress can minimize the current, unfavorable tax treatment towards SIB investments. This Article focuses solely on tax policy changes that will treat SIB investments more in parity with comparable investments for tax purposes.¹⁴⁸ Thus, in answering the question of which tax benefits enjoyed by other investments should be extended to SIB investments, it is helpful to understand why certain investments enjoy significant tax benefits. This Part briefly summarizes the commonly cited rationales for the tax benefits extended to certain investments and suggests several possible modifications to the federal tax system that would make the SIB arrangement a more tax-favored investment.

¹⁴⁷ See Scott Greenberg, *Reexamining the Tax Exemption of Municipal Bond Interest*, TAX FOUND., (July 21, 2016), <https://taxfoundation.org/reexamining-tax-exemption-municipal-bond-interest/> [<https://perma.cc/4JQS-BCU2>].

¹⁴⁸ For instance, instead of providing a tax incentive, the federal government can incentivize SIB investments by granting money directly to state and local governments for social welfare purposes, which these governments may then use to increase the potential return to investors of SIB arrangements. This method is likely to be a simpler and more effective way to increase the attractiveness of SIBs. However, this Article does not argue that the federal government should promote SIB investments. Instead, this Article argues that the federal government should treat SIB investments similarly to other investments for tax purposes. Doing so would minimize the distortionary effects of the current law and enable the market to better determine whether SIBs make a worthy investment. For these reasons, this Article does not include other types of legislative solutions, such as direct expenditures, even though these legislative changes may better promote SIBs in some instances.

A. Preferential Tax Rates

One option is to extend preferential tax rates to the income generated by SIB investments. Preferential tax treatment for capital gains has been a part of our tax system for nearly 100 years.¹⁴⁹ Hence, it would not be unprecedented to subject the returns on a SIB investment to the same lower rate of tax. As discussed further below, it would also be conceptually consistent with the policy behind this preference to extend similar tax treatment to income generated by SIBs.

The tax preference for capital gains has been justified on numerous grounds.¹⁵⁰ One common justification, and arguably the strongest justification, for the preferential capital gains tax rate is that this benefit will help minimize the lock-in effect.¹⁵¹ The lock-in effect refers to the theory that a tax on capital gains upon a realization event will discourage investors from liquidating assets whose value has appreciated and reinvesting those proceeds in a new investment.¹⁵² Because a taxpayer is only taxed when he or she disposes of the asset, a taxpayer is therefore incentivized to hold onto his or her investments. This phenomenon creates market inefficiencies that “impedes the flow of capital to its most productive uses.”¹⁵³

Proponents of the capital gains preference also argue that the special tax treatment of capital gains is necessary to increase savings and to encourage risk-taking, both of which are necessary to achieve economic growth.¹⁵⁴ This argument is based on the premise that subjecting capital gains to a lower rate of tax would induce more savings by removing some current tax disincentives on savings.¹⁵⁵ Similarly, reducing the effective tax rates on capital gains would minimize the current tax law’s negative effects on risk taking by increasing the expected return from a risky investment.¹⁵⁶

Another popular argument in favor of the capital gains tax preference is that without such preference, a successful investment would result in the bunching of income accrued over multiple years into a single year, thereby unfairly subjecting the income to a higher marginal tax rate.¹⁵⁷ Proponents of a capital gains tax preference also argue that this lower tax rate is necessary, because the gain is not a genuine economic gain in that it does not reflect capital appreciation, but rather largely reflects inflation occurring during

¹⁴⁹ BITTKER & LOKKEN, *supra* note 98, at ¶ 46.1 (2017) (finding that “[s]ince 1921, with the exception of the years 1987 through 1990, capital gains were taxed more leniently than ordinary income . . .”).

¹⁵⁰ For a thorough discussion of the different justifications in favor of the preferential treatment of capital gains, see Walter J. Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247, 252–58 (1957).

¹⁵¹ STAFF OF THE J. COMM. ON TAX’N, JCS-5-05, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS 22–23 (2005); STAFF OF THE J. COMM. ON TAX’N, 95th Cong., GENERAL EXPLANATION OF THE REVENUE ACT OF 1978 252 (2d Sess. 1979); Blum, *supra* note 150, at 252–58; Noel B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319, 344–45 (1993); Calvin H. Johnson, *Taxing the Consumption of Capital Gains*, 28 VA. TAX. REV. 477, 500 (2009).

¹⁵² See Blum, *supra* note 150, at 256–58; Cunningham & Schenk, *supra* note 151, at 344–45; Johnson, *supra* note 151, at 499.

¹⁵³ Cunningham & Schenk, *supra* note 151, at 344–45.

¹⁵⁴ See STAFF OF THE J. COMM. ON TAX’N, JCS-5-05, *supra* note 151; STAFF OF THE J. COMM. ON TAX’N, GENERAL EXPLANATION OF THE REVENUE ACT OF 1978, *supra* note 151, at 252; Blum, *supra* note 150, at 250; Cunningham & Schenk, *supra* note 151, at 340–44; Johnson, *supra* note 151, at 507–08.

¹⁵⁵ STAFF OF THE J. COMM. ON TAX’N, JCS-5-05, *supra* note 151, at 23–24; STAFF OF THE J. COMM. ON TAX’N, GENERAL EXPLANATION OF THE REVENUE ACT OF 1978, *supra* note 151, at 252; Cunningham & Schenk, *supra* note 151, at 331–37.

¹⁵⁶ See Cunningham & Schenk, *supra* note 150, at 340–44.

¹⁵⁷ See Blum, *supra* note 149, at 253.

the period the taxpayer held the asset.¹⁵⁸ Moreover, another justification given is that a lower tax rate is necessary to minimize the “tax-induced distortions in the capital markets”¹⁵⁹ caused by the double tax on corporate income¹⁶⁰ and the tax law’s preference for corporations to use debt rather than equity financing.¹⁶¹ This preferential tax treatment comes in the form of a reduced rate of tax on capital gains, as well as on qualified dividend income.¹⁶² Finally, many other justifications have also been given for the special tax treatment enjoyed by these types of investments including arguments that capital gains are not income, capital gains are unexpected, and that consumption, rather than income, should be taxed.¹⁶³

Not everyone supports the preferential tax treatment extended to capital gains and dividend income. As many commentators have already observed, this tax preference lacks a clear conceptual rationale.¹⁶⁴ For example, there is no clear empirical evidence that supports the argument that this special tax treatment increases investments and stimulates economic growth.¹⁶⁵ Instead, an increase in savings may not necessarily be tied to a lower tax rate on capital gains since many forms of savings do not constitute capital gains and the decision to save is often not solely dependent on the potential rate of return available.¹⁶⁶ In addition, the bunching of income rationale is unpersuasive given that the taxpayers who realize capital gains are often already subject to the highest marginal tax rate.¹⁶⁷ Furthermore, because of the realization requirement, capital gains also enables many taxpayers to benefit from the deferral of income. This deferral may potentially counteract some or all of the additional tax liability created by the bunching of income, as well as the taxation of the portion of the gain attributable to inflation.¹⁶⁸

Despite the foregoing, extending similar tax treatment to income generated by SIBs would neither be unprecedented nor inconsistent with the tax policy behind this preference. Regardless of whether or not one is in favor of or opposed to the capital gains tax preference, the current law provides for this tax preference. In addition, because there is no clear rationale for granting a tax preference to capital gains and dividend income, it is difficult to argue that granting a similar tax preference to SIBs is contradictory to the goals of the capital gains tax rate. Moreover, extending a similar tax benefit to SIB investments is arguably conceptually consistent with some of these rationales. For

¹⁵⁸ See *id.* at 255–56.

¹⁵⁹ STAFF OF THE J. COMM. ON TAX’N, JCS-5-05, *supra* note 151, at 23–24.

¹⁶⁰ Corporate earnings are currently subject to two levels of taxation, because the income is taxed once at the corporate level and then a second time at the shareholder level when the earnings are distributed to the shareholders. See I.R.C. §§ 11, 301.

¹⁶¹ STAFF OF THE J. COMM. ON TAX’N, JCS-5-05, *supra* note 151, at 23–24. The tax law creates a bias against equity financing and in favor of debt financing by allowing corporations a deduction for interest payments, but not allowing a similar deduction for dividend payments. See I.R.C. § 163(a).

¹⁶² See I.R.C. §§ 1(h)(1), 11. In other words, by also extending preferential treatment to dividend income, Congress intended to lower the tax burden on equity investments and thereby minimize the influence that tax considerations place on a corporation’s investment decision and incentivize corporations to make additional investments. See STAFF OF THE J. COMM. ON TAX’N, JCS-5-05, *supra* note 151, at 23–24.

¹⁶³ For a comprehensive summary of the various arguments in favor and against the preferential capital gains tax treatment, see Blum *supra* note 150.

¹⁶⁴ See, e.g., Blum, *supra* note 150; Cunningham & Schenk, *supra* note 151; Daniel Halperin, *A Capital Gains Preference is Not Even a Second-Best Solution*, 48 TAX L. REV. 381 (1993); Johnson, *supra* note 151.

¹⁶⁵ See Blum, *supra* note 150, at 265; Cunningham & Schenk, *supra* note 151, at 378–79.

¹⁶⁶ See Blum, *supra* note 150, at 250; Cunningham & Schenk, *supra* note 151, at 377.

¹⁶⁷ See Cunningham & Schenk, *supra* note 151, at 328.

¹⁶⁸ See *id.* at 328–31.

instance, the binary, speculative and novel nature of SIB investments makes these investments inherently risky. By subjecting the returns on a SIB investment to a lower rate of tax, the expected rate of return on a SIB investment would increase, thereby making a SIB investment more attractive and encouraging risk-taking. Also, SIB investments often require an investor to make an illiquid investment of capital for four to six years, with all or a majority of the payments made towards the end of the investment term. Thus, SIB investments often create a bunching of income, which may result in a higher marginal tax rate for the investor. As with capital gains, this can be minimized with a lower tax rate.

Finally, extending this tax preference to SIB investments is also consistent with sound tax policy. A failure to grant a similar tax benefit to SIB investments distorts the economics of private sector investment decisions and treats SIB investors less favorably than traditional equity investments. But it is unclear why a capital gain or dividend should be singled out for better treatment than other types of capital income, such as income generated by a SIB investment. Given that SIBs explicitly seek to provide not only financial returns, but also create a public benefit, they create a more compelling case for extension of these benefits. Moreover, SIB investments currently are structured so that economically they are more like equity investments than debt investments. In particular, an investment in a SIB shares many features of preferred stock. By allowing investors to recognize any return on their capital at preferential capital gain rates, this treats SIB investors in parity with investors of preferred stock who currently receive preferential tax treatment. Thus, for the foregoing reasons, Congress should consider enacting legislation that grants SIB investors a preferential tax rate on any earnings from the SIB investment at the time of the distribution of that income instead of treating the projected returns on a SIB investment as ordinary income taxable on an annual basis.

Alternatively, Congress should consider enacting a provision that provides successful SIB investments with tax benefits that are comparable to the benefits offered to qualified small business stock. The current tax code grants special preferential tax treatment to investments in qualified small business stock.¹⁶⁹ This tax benefit allows investors of qualified small business stock that is held for more than five years to exclude 50% of that gain from gross income. The remaining gain is subject to tax at a maximum rate of 28%.¹⁷⁰ Together, these provisions effectively tax the gain from qualified small business stock at a preferential tax rate of up to 14%.¹⁷¹ The policy rationale given for this tax preference is that “targeted relief for investors who risk their funds in new ventures, small businesses, and specialized small business investment companies will encourage investments in these enterprises. This should encourage the flow of capital to small businesses, many of which have difficulty attracting equity financing.”¹⁷² Similarly, SIB investments also require investors to take on substantial risk in funding new social program ventures, which creates difficulties in attracting sufficient financing. Thus, based on the same rationale given for the qualified small business stock tax preference, the government can encourage the flow of capital to social projects by granting a similar tax benefit to SIB investments. This change would enable SIB investments to compete more fairly with both tax-exempt bonds and traditional equity financing for investors’ capital.

¹⁶⁹ I.R.C. § 1202.

¹⁷⁰ I.R.C. § 1(h)(4).

¹⁷¹ BITTKER & LOKKEN, *supra* note 98, at ¶ 45.3 (2017).

¹⁷² H.R. REP. NO. 111, 103d Cong., 1st Sess., at 600 (1993).

B. Tax Exemption

A second option is to exempt from taxation any gain that the investor realizes from its SIB investment.¹⁷³ A similar tax exemption currently exists for the interest earned on state or local bonds.¹⁷⁴ The federal income tax exemption for the interest earned on municipal bonds has been a part of the federal tax landscape since the enactment of the first federal income tax.¹⁷⁵ For the reasons detailed below, this Section concludes that expanding the list of activities that qualify as tax-exempt private activity bonds to include the types of social services supported by SIBs is conceptually consistent with the rationale commonly given for this tax preference.

In particular, the primary rationale currently given for the tax exemption of the interest on state and local bonds is that the tax exemption “encourages governments to provide the optimal amount of public services.”¹⁷⁶ According to this economic theory, without this exemption, state and localities may be unwilling to undertake projects which benefit nonresidents who pay minimal tax in that jurisdiction.¹⁷⁷ This tax exemption addresses this issue by lowering the cost of borrowing for state and local governments, which in turn incentivizes more investment in infrastructure and other local projects, regardless of who benefits.¹⁷⁸ Specifically, the tax exemption enables state and localities to offer a lower rate of return than corporate debt and still attract investors who seek to maximize their after-tax returns.¹⁷⁹ As a result, by exempting interest on state and local bonds, the federal government encourages public projects, which also have the added benefit of creating jobs.¹⁸⁰

This same line of reasoning applies in the SIB context. State and local governments are generally responsible for funding various social services, but may be unwilling to address certain social problems because they are politically unpopular, risky, or expensive.¹⁸¹ Often, these types of programs target the poor and marginalized populations, involve high upfront costs, result in future, rather than immediate, cost savings, and may require the use of innovative, untested programs.¹⁸² As a result, state

¹⁷³ Even though the proceeds of certain SIB arrangements may possibly qualify for tax-exempt treatment, the inherent uncertainties involved in determining whether the instrument qualifies for this tax benefit may deter qualified investors from claiming the exemption or potential investors from investing in SIBs. Thus, new legislation specifically including SIBs as tax-exempt instruments would be more effective in treating SIB investments in parity to municipal bond investments.

¹⁷⁴ I.R.C. § 103.

¹⁷⁵ Greenberg, *supra* note 147, at 2; Revenue Act of 1913, 38 Stat. 114, 167–68.

¹⁷⁶ STEVEN MAGUIRE & JEFFREY STUPAK, CONG. RESEARCH SERV., RL30638, TAX-EXEMPT BONDS: A DESCRIPTION OF STATE AND LOCAL GOVERNMENT DEBT (Dec. 23, 2016).

¹⁷⁷ *Id.*

¹⁷⁸ *Id.* In other words, the current justification for the tax exemption is that by subsidizing some borrowing by state and local governments, the federal government is able to incentivize these governments to invest in projects that the government would otherwise not invest in, because they benefit non-residents who pay minimal tax in that jurisdiction.

¹⁷⁹ *Id.*; Greenberg, *supra* note 147.

¹⁸⁰ See Andrew Ackerman, *Hundreds of Local Officials Defend Municipal-Bond Tax Exemption*, THE WALL STREET J. (March 1, 2016), <https://www.wsj.com/articles/hundreds-of-local-officials-defend-municipal-bond-tax-exemption-1456830002> [<https://perma.cc/TG7A-VUM9>].

¹⁸¹ See, e.g., SLC FAQ, *supra* note 1; Barajas et al., *supra* note 15, at 12, 17; Gustafsson-Wright, Smith & Gardiner, *supra* note 137; Kohli, Besharov & Costa, *supra* note 7; Liang, Mansberger & Spieler, *supra* note 19, at 273.

¹⁸² See, e.g., MCKINSEY & CO., *supra* note 11; SLC FAQ, *supra* note 1; Barajas et al., *supra* note 15, at 12, 17; Gustafsson-Wright, Smith & Gardiner, *supra* note 137; Kohli, Besharov & Costa, *supra* note 7;

and local governments may underinvest in the optimal amount and type of social services. For instance, “despite evidence about the effectiveness of preventive services in areas such as health care, education, and homelessness, budget officials and appropriators infrequently direct resources toward them.”¹⁸³ But by extending the tax exemption to SIBs, the federal government could potentially encourage more private investment in SIBs, which would increase the availability of funds to finance these types of social projects and do so in a manner that may more effectively address certain social issues. It would also encourage cross-collaboration, which is necessary for adequately addressing certain challenging social issues.¹⁸⁴

In addition, a particular government entity may be unwilling to undertake certain SIB-funded projects, because it provides benefits that extend outside of the state or local jurisdiction where the program is implemented. This situation creates a “diffuse benefit” or “wrong pocket” problem because the return on investment that a particular government pays to SIB investors is calculated on the basis of budgetary savings and the benefits to society generated by a successful program, which may be partially realized outside that government’s jurisdiction.¹⁸⁵ For instance, the federal government may substantially benefit from SIB-funded programs targeting health issues and homelessness, because successful programs will result in budgetary savings to Medicaid and other federal programs, but a different government entity pays for these benefits.¹⁸⁶ To address this issue, as one commentator has accurately noted, payments should ideally be funded by a combination of agencies that benefit from the outcome being achieved because benefits will accrue across multiple agencies and possibly across different levels of government.¹⁸⁷ By having the federal government offer tax relief to encourage investors to invest in SIBs, this measure may help mitigate the diffuse benefit problem with respect to the federal government and encourage state and local governments to fund these types of social services even if they are not the sole beneficiaries.

Moreover, extending this type of tax benefit to SIB investments may be necessary to treat comparable investments equally and thereby improve the equity and efficiency of our tax system. As discussed above, a SIB investment shares many features in common with a state or local bond investment. Because the federal government already offers tax relief to comparable investments, a failure to offer similar tax benefits to SIB investments may distort investment decisions away from SIBs and disproportionately favor tax-exempt municipal bonds.

For these forgoing reasons, this Article argues that exempting the return on SIB investments from federal income taxation is another acceptable way to grant SIB

Liang, Mansberger & Spieler, *supra* note 19, at 273; Ashley Pettus, *Social Impact Bonds*, HARV. MAG. (July/Aug. 2013), <http://harvardmagazine.com/2013/07/social-impact-bonds> [<https://perma.cc/Z253-7JAT>]; GOV’T PERFORMANCE LAB., *supra* note 22.

¹⁸³ Kohli, Besharov & Costa, *supra* note 7.

¹⁸⁴ See Sindhu Lakshmanan & Tynesia Boyea-Robinson, *Pay for Success: To Invest or Not to Invest? Assessing Collaboration*, LIVING CITIES (Nov. 8, 2016), <https://www.livingcities.org/blog/1145-pay-for-success-to-invest-or-not-to-invest-assessing-collaboration> [<https://perma.cc/6A3T-RPJ4>]; Barbara Ray, *What to Make of Social Impact Bonds*, NONPROFIT FIN. FUND (Mar. 4 2016), <http://www.payforsuccess.org/resource/what-make-social-impact-bonds> [<https://perma.cc/Y3M2-Z4BK>]; GOV’T PERFORMANCE LAB., *supra* note 22.

¹⁸⁵ See Dagher, *supra* note 40, at 3502–03; Kohli, Besharov & Costa, *supra* note 7; MCKINSEY & CO., *supra* note 11 at 37.

¹⁸⁶ See GOV’T PERFORMANCE LAB., *supra* note 22.

¹⁸⁷ Kohli, Besharov & Costa, *supra* note 7.

investments a tax-favored status. Even though the federal income tax exemption for municipal bonds is controversial, extending this benefit to SIBs is a potential policy solution to address the shortcoming of the current law, because this tax benefit currently exists for other investments and is conceptually consistent with the rationale commonly given for this tax preference.¹⁸⁸ Moreover, the SIB structure minimizes some, but not all, of the negative implications of the current tax exemption granted to municipal bonds.

For instance, one drawback of the current tax exemption for the interest on municipal bonds is that it may contribute to more socially wasteful investments. Specifically, opponents of the municipal bond tax exemption argue that this tax exemption creates economic inefficiencies by incentivizing the overinvestment in infrastructure.¹⁸⁹ Because the tax exemption effectively lowers the cost of capital required for qualified projects, the exclusion of municipal bond interest may finance unnecessary state and local spending projects.¹⁹⁰ Similarly, extending the municipal bond tax exemption to SIB investments may also encourage governments to issue SIBs for unnecessary or ineffective social projects. The difference is that in the SIB context, the private market is likely to play a role in partially mitigating this risk. Because an ineffective social program will result in a SIB investor losing her entire capital investment, investors are unlikely to invest in unnecessary and ineffective social programs. Therefore, this criticism of the tax exemption is not as strong in the SIB context.

Another common criticism of the tax exemption for municipal bond interest is that “[tax exemption] imposes greater costs on federal taxpayers than the benefits it confers upon state and local governments.”¹⁹¹ Empirical evidence indicates that approximately only 80% of the federal cost of the tax exemption benefits the intended beneficiaries and thereby subsidizes state and local investment in capital projects.¹⁹² This inefficiency often arises because state and local governments have to issue municipal bonds with higher interest rates in order to economically appeal to an investor who is not in the highest marginal income tax bracket.¹⁹³ As a result, instead of state and local

¹⁸⁸ Opponents of the tax exemption argue that it results in abuse and fraud, creates inequities by favoring high-income taxpayers, creates economic inefficiencies by incentivizing the overinvestment in infrastructure, represents an inefficient subsidy to state and local governments because the middleman often benefits more than the intended beneficiary, and produces a substantial cost to the federal government, among other arguments. See Greenberg, *supra* note 147; Calvin H. Johnson, *Repeal Tax Exemption for Municipal Bonds*, TAX NOTES 1259 (Dec. 24, 2007); MAGUIRE & STUPAK, *supra* note 176. As a result, there have been numerous requests to modify or repeal the tax benefit. These proposals have included recommendations to replace the tax exemption with a federal grant made directly to the state or local government, cap the tax exemption for interest earned on these types of tax-favored bonds, or, alternatively, simply repeal the tax preference. See THE WHITE HOUSE, THE NAT’L COMM’N ON FISCAL RESPONSIBILITY AND REFORM, *The Moment of Truth*, 2010, available at http://momentoftruthproject.org/sites/default/files/TheMomentofTruth12_1_2010.pdf [https://perma.cc/6NKB-ZUAV] MAGUIRE & STUPAK, *supra* note 176; Johnson, *Repeal Tax Exemption for Municipal Bonds*, *supra* note 188, at 1262. A detailed consideration of whether and how the tax exemption for municipal bonds should be reformed is beyond the scope of this Article.

¹⁸⁹ See Greenberg, *supra* note 147; MAGUIRE & STUPAK, *supra* note 176.

¹⁹⁰ Greenberg, *supra* note 147, at 1261; Johnson, *Repeal Tax Exemption for Municipal Bonds*, *supra* note 188.

¹⁹¹ Peter Fortune, *The Municipal Bond Market, Part II: Problems and Policies*, 1992 NEW ENGLAND ECON. REV. 47, 48 (May/June 1992).

¹⁹² Greenberg, *supra* note 147, at 1260–61; Johnson, *Repeal Tax Exemption for Municipal Bonds*, *supra* note 188.

¹⁹³ Fortune, *supra* note 191; Greenberg, *supra* note 147.

governments capturing the benefits of the tax exemption in the form of lower borrowing costs, the extra savings goes to taxpayers in high-income households.¹⁹⁴ Furthermore, even to attract wealthy taxpayers, municipal bonds often have to bear premium interest rates because of inadequate market information, the illiquid nature of many municipal and the numerous alternative types of tax-advantaged investment options available to investors.¹⁹⁵

Although some of these issues may arise if a tax exemption is extended to the interest earned on SIB investments, the concern that a tax exemption is likely to primarily benefit high income investors is not as detrimental in the SIB context. In particular, one of the potential benefits of the SIB structure is that the involvement of investors who have business knowledge and experience could be a valuable asset in improving the delivery of social services.¹⁹⁶ If this is true, then the additional cost to attract these investors may be worthwhile. Moreover, it may not be necessary for a SIB to bear a premium interest rate to attract these investors, since most private SIB investors are willing to accept a lower financial return, given that they already have wealth and that they are also receiving a non-financial return in the form of social benefits.¹⁹⁷

C. Upfront Deduction

A third option is to allow SIB investors to deduct up to a certain amount of their SIB investment on their federal income tax return at the time of the investment and defer the recognition of any income until the time that it is realized. This type of tax preference currently exists for federal income tax purposes for certain investments.

For instance, as discussed above, federal income tax law provides a deduction for qualified charitable contributions.¹⁹⁸ One of the main policy rationales for the existence of this tax benefit is to help fund qualified charitable organizations. As the report of the House Committee on Ways and Means on the Revenue Act of 1938 states: “The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.”¹⁹⁹ Investing in a SIB is consistent with this policy rationale. Although an investment in a SIB does not qualify for the charitable contribution deduction because there exists both a potential return of the contributed funds and a return on investment, a

¹⁹⁴ Fortune, *supra* note 191; Greenberg, *supra* note 147, at 1261.

¹⁹⁵ See Johnson, *Repeal Tax Exemption for Municipal Bonds*, *supra* note 188; Greenberg, *supra* note 147, at 1261.

¹⁹⁶ See *supra* notes 53–58 and accompanying text.

¹⁹⁷ If the SIB structure does not adequately overcome these drawbacks, then an alternative to a tax exemption may be to offer tax benefits similar to those given to Build America Bonds. Build America Bonds are taxable bonds that provide either (i) a direct federal payment subsidy for a portion of the state or local government’s borrowing costs or (ii) a tax credit for the bondholder. U.S. DEP’T OF THE TREASURY, *Treasury Analysis of Build America Bonds Issuance and Savings* (May 16, 2011), <https://www.treasury.gov/initiatives/recovery/Documents/BABs%20Report.pdf> [<https://perma.cc/GM3K-JHKH>]. Although the Build for America Bonds program has expired, this program was overall considered a success. The empirical evidence suggests that these bonds attracted additional bond investors as compared to traditional municipal bond investors, resulted in state and local governments benefitting from significant savings in borrowing costs and improved the efficiency of the delivery of the federal benefit. *Id.*

¹⁹⁸ I.R.C. § 170.

¹⁹⁹ H.R. REP. NO. 75-1860, at 19 (1938), as reprinted in 1939-1 CB (pt. 2) 728, 742.

SIB is used more like a charitable vehicle than an investment vehicle. In particular, SIB investments promote the general welfare and minimize the government's financial burden by funding social services that generally would otherwise be funded by state and local governments. Moreover, given the below-market rate of return that many SIBs offer, SIBs currently primarily attract philanthropically-motivated, rather than profit-seeking, investors.

Federal income tax law also provides an upfront federal income tax deduction to taxpayers that make qualified retirement contributions to a traditional individual retirement account ("IRA").²⁰⁰ Pursuant to the terms of this tax preference, the amount of the contribution that is eligible for the tax deduction is subject to a contribution ceiling of \$5,000, adjusted for inflation.²⁰¹ Any distributions of principal or investment earnings are taxed at ordinary income tax rates unless rolled over into a different IRA or eligible retirement plan for the benefit of such individual within 60 days of the distribution.²⁰² The rationale for this tax preference is to encourage individuals to save for retirement.²⁰³ Similarly, offering this type of tax benefit to SIB investments may also encourage taxpayers to save, but by investing in programs that potentially also produce a social good.

Thus, another viable tax policy option is treating SIB investments similarly to qualified retirement contributions. Pursuant to this type of provision, SIB investors would be permitted to deduct a portion of their SIB investment upfront at the time of the investment and treat the receipt of any payments from the SIB investment as ordinary income subject to tax at the time of receipt. As a result, if the investment is ultimately unsuccessful, the investors are able to write off their losses as a tax deduction at the time of the investment, rather than waiting to take a deduction at the end of the project term. This upfront deduction would help mitigate some of the risk that investors bear when they invest in these speculative financial instruments that currently offer a below-market rate of return. In addition, as with qualified retirement contributions, this type of provision could also allow SIB investors to defer recognition of their gains if they rollover their funds to another SIB investment within a certain period of time. As one commentator has observed, "with traditional philanthropy, you pay for the program and then your money is gone; this way the money comes back and can be recycled into the system to help more people."²⁰⁴ Thus, extending this tax benefit to SIBs would likely encourage reinvestment in SIBs and provide non-profit organizations with a more stable stream of income.

D. The U.K. Approach

Another possible approach to incentivize private investors to invest in SIBs is to enact legislation similar to that of the United Kingdom's Social Investment Tax Relief

²⁰⁰ I.R.C. § 219. Similarly, an employer's contribution to a qualified retirement plan offers the same deferral benefits. *See* I.R.C. § 408(c).

²⁰¹ The 2016 contribution limitation for a traditional IRA is \$5,500 per person and is increased to \$6,500, if age 50 or older.

²⁰² I.R.C. § 408(d). This ability to rollover contributions tax free is subject to limitations, including the requirement that this benefit may only be exercised once in a one-year period. *Id.*

²⁰³ STAFF OF J. COMM. ON TAX'N, 104th Cong., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 104TH CONGRESS 145 (2nd Sess. 1996).

²⁰⁴ Pettus, *supra* note 25, at 3.

Act (“the SITR”), the first of its kind in the world.²⁰⁵ The goal of this legislation is “to support social enterprises seeking external finance by providing incentives to private individuals who invest in them.”²⁰⁶ The SITR provides up to three possible types of tax relief to qualifying individuals who invest in a qualified social enterprise.²⁰⁷ First, it allows investors to reduce their income tax liability by an amount equal to 30% of their investment.²⁰⁸ Second, any gain the investor realizes when it disposes of its investment in the social enterprise is exempt from capital gains tax.²⁰⁹ Finally, an investor may defer its tax on a capital gain that it realizes from the disposal of any kind of asset if the gain is reinvested in a qualified social investment.²¹⁰

Under this legislation, an investment in a SIB-financed program qualifies as a social enterprise eligible for tax relief if the investment is made through an accredited special purpose vehicle entity that is established solely for the purpose of entering into and carrying out a social impact contract.²¹¹ To qualify as an accredited special purpose vehicle, the entity must hold a social impact contract that satisfies the following conditions: (i) includes a government agency as a stakeholder; (ii) defines pre-determined outcomes intended to be achieved that are capable of being objectively measured; (iii) sets forth the method of measurement of these outcomes; (iv) requires periodic progress assessment; (v) makes at least 60% of the potential payments conditional on achieving the defined outcomes; and (vi) has a social or environmental purpose.²¹²

A qualifying investment in this entity may take the form of either an equity investment or a debt investment, provided that the investment meets certain requirements,

²⁰⁵ SOCIAL INV. SCOTLAND ET AL., *Social Investment Tax Relief: A Brief Guide*, http://www.socialinvestmentscotland.com/files/9413/9697/0411/SITR_Guide.pdf [https://perma.cc/C873-AV6D] [hereinafter *Social Investment Tax Relief*].

²⁰⁶ See *Guidance: Social Investment Tax Relief*, H.M. TREASURY, <https://www.gov.uk/government/publications/social-investment-tax-relief-factsheet/social-investment-tax-relief> (last updated Nov. 23, 2016) [https://perma.cc/E5Q2-8TZY].

²⁰⁷ See *Social Investment Tax Relief*, *supra* note 205.

²⁰⁸ *Id.* This is subject to a maximum deduction of about £250,000. *Id.* The reason for this limitation is because these types of investments are subject to the restrictions of the European Commission relating to the giving of state aid. *Id.* However, the government has indicated that it intends to seek permission from the European Commission to offer greater tax relief in the future. *Id.*

²⁰⁹ *Id.* To qualify for this tax exemption, the investment must have qualified for and received the income tax relief under SITR at the time the investment was made. *Id.*

²¹⁰ *Id.*

²¹¹ See *id.*; CABINET OFFICE, *Social Investment Tax Relief: Guidance Concerning Accreditation of Social Impact Contractors* (Jan. 2016), https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/492974/SITRAccreditationGuidanceVersion2forpublicationJan16V2.pdf [https://perma.cc/TE3A-V557]. The special purpose vehicle must be organized as a company limited by shares. *Id.* A qualified social enterprise includes more than solely investments in SIB arrangements. It is defined as (i) a community interest company, (ii) a community benefit society that is not a charity, (iii) a charity, or (iv) any other entity prescribed by the Treasury. *Social Investment Tax Relief*, *supra* note 205. These are entities that are currently regulated in some way. *Id.*

²¹² CABINET OFFICE, *supra* note 211. A social or environmental purpose means: “the relief of those in need by reason of youth, age, ill-health, disability, financial hardship or other disadvantage. The relief of prevention of poverty, the promotion of employment, culture, heritage or sport, the advancement of training and education, the prevention of crime, environmental protection, social housing and the relief of homelessness, the provision of community facilities, the promotion of social inclusion and cohesion, the advancement of citizenship or community development, the improvement of physical and mental health, the provision of long-term care in relation to any infirmity, or any other areas that may reasonably be regarded as analogous to, or within the spirit of, any of the areas listed above.” *Id.*

and must be held for at least three years.²¹³ For instance, one requirement is that any dividend rights must be at a rate that depends on the enterprise's financial success and which does not exceed a reasonable commercial rate.²¹⁴ Similarly, if the investment is structured as a loan, the rate of any interest payable must not be more than a reasonable commercial rate and the principal and any interest must not be secured by any assets and must be subordinate to other debts of the social enterprise.²¹⁵ To be eligible for this tax relief, SITR also imposes additional conditions to ensure that the investor's capital is genuinely put at risk and to ensure that the investor is not related to or in control of the entity.²¹⁶

Although the goals of SITR are commendable, this article argues for a more modest tax incentive that is consistent with how comparable investments are currently treated for U.S. federal income tax purposes. Accordingly, this article argues for a preferential tax rate on investment returns, a tax exemption, or an upfront federal income tax deduction for the SIB investment, but recommends that Congress consider several aspects of the U.K. legislation when drafting legislation in support of a tax-favored status for SIB investments.

First, the U.K. legislation is useful for studying its effects on private investments in SIBs and other social enterprises since it has already been enacted. Second, the U.K. legislation provides several structural elements and requirements that are necessary to properly regulate investments in social enterprises and which Congress should include when modifying the law to grant SIB investments a tax-favored status. For instance, to address concerns of abuse, fraud and collusion with respect to SIBs, this article recommends that Congress adopt the United Kingdom's requirement that SIB investments need to be made through an accredited special purpose entity established for this purpose. In addition, as required by the SITR, any legislation extending tax benefits to SIBs should require that the SIB investment be held for a minimum period of time as a condition for the investor to qualify for the tax relief. This condition is necessary because non-profit service providers need the benefit of capital funding for an extended period of time to effectively implement social service projects.

Moreover, because the purpose of this tax relief is to incentivize investors to invest in SIBs, which are speculative and offer a below-market rate of return, as opposed to more lucrative investments, the tax relief should not be available to SIBs that offer an

²¹³ Social Investment Tax Relief, *supra* note 205. An investor can qualify for tax relief under SITR if it has invested in either: (i) shares issued by the social enterprise in exchange for full payment in cash or (ii) qualifying debt that has been wholly drawn down. *Id.*

²¹⁴ *Id.* Any dividend rights may not be of a fixed amount or at a fixed rate. *Id.*

²¹⁵ *Id.* In addition, in the event the enterprise winds up, the amount due to the shareholders is subordinate to any debts of the enterprise and does not have a preference in relation to any other shares of the enterprise. *Id.* Similarly, the debt investment cannot have a preference in relation to any shares of the enterprise. *Id.*

²¹⁶ *See id.* In particular, the investment will not qualify for tax relief if there is: (i) a pre-arranged opportunity for the investor to exit the investment during the three-year period beginning at the date the investment is made; (ii) a linked loan is made to the investor (a linked loan is defined as any loan which would not have been made on the same terms if the investor had not made the investment); or (iii) a principal tax avoidance purpose for entering into the arrangement. *See id.*; CABINET OFFICE, *supra* note 211.

In addition, the investor is prohibited from being: (i) a partner or trustee of the social enterprise or its subsidiary; (ii) a paid director or employee of the social enterprise, its subsidiary, partner, or partner of a subsidiary of the social enterprise; or (iii) own more than 30% of the social enterprise's ordinary share capital, loan capital or voting rights during the period one year before the investment to the third anniversary of the investment. Social Investment Tax Relief, *supra* note 205.

above-market rate of return or to the extent that the investor's funds are not truly at risk. In particular, as discussed above, the SITR has a provision that requires that the return on investment may not exceed a reasonable commercial rate. A similar provision should also be adopted for purposes of U.S. SIB investments. Similarly, as with the SITR, if an investor's funds are secured by assets or otherwise, the tax relief will also not be available. For instance, some SIBs currently provide a guarantee that ensure that a portion of the investor's funds will be repaid regardless of the project's success. The risk on this type of investment is already mitigated and therefore, should not benefit from the tax relief described above. Finally, regulations should be put in place to minimize collusion between the multiple stakeholders, ensure that the project's outcomes are capable of objective measurement, and to guarantee the independence of the different parties. Some of these conditions are already included in the SITR, which currently imposes specific requirements to ensure that the investor is not related to or in control of the intermediary or non-profit entity.

In summary, modifying the tax law to extend tax benefits, such as preferential tax rates, tax exemption, or an upfront tax deduction, to SIB investments is conceptually consistent with the availability of these tax preferences in other contexts and are possible ways to grant SIBs tax-favored status. For all the reasons detailed above, this article concludes that Congress should consider modifying the tax law to (i) subject the returns on a SIB investment to preferential tax rates similar to that of capital gains or qualified small business stock, (ii) exempt the interest earned on a SIB investment from federal income taxation, or (iii) provide an upfront federal income tax deduction for a certain amount of the private capital invested in a SIB with any returns on investment subject to ordinary income tax rates. In addition, to further encourage capital to remain in a SIB investment, this article also recommends that Congress allow the tax-free rollover of funds from one qualified SIB investment to another. Together these changes, along with legislation to properly regulate these novel instruments, should help prevent the current tax law from discouraging private investors from contributing capital to fund SIB-financed projects aimed at addressing some of our most pressing social problems.

VI. CONCLUSION

The current tax system significantly limits the ability of a SIB-funded program to attract sufficient private capital to establish a viable market in the United States. This is in large part due to the compliance risks that a SIB investment creates, as well as the unfavorable tax treatment of a SIB investment relative to comparable investments.

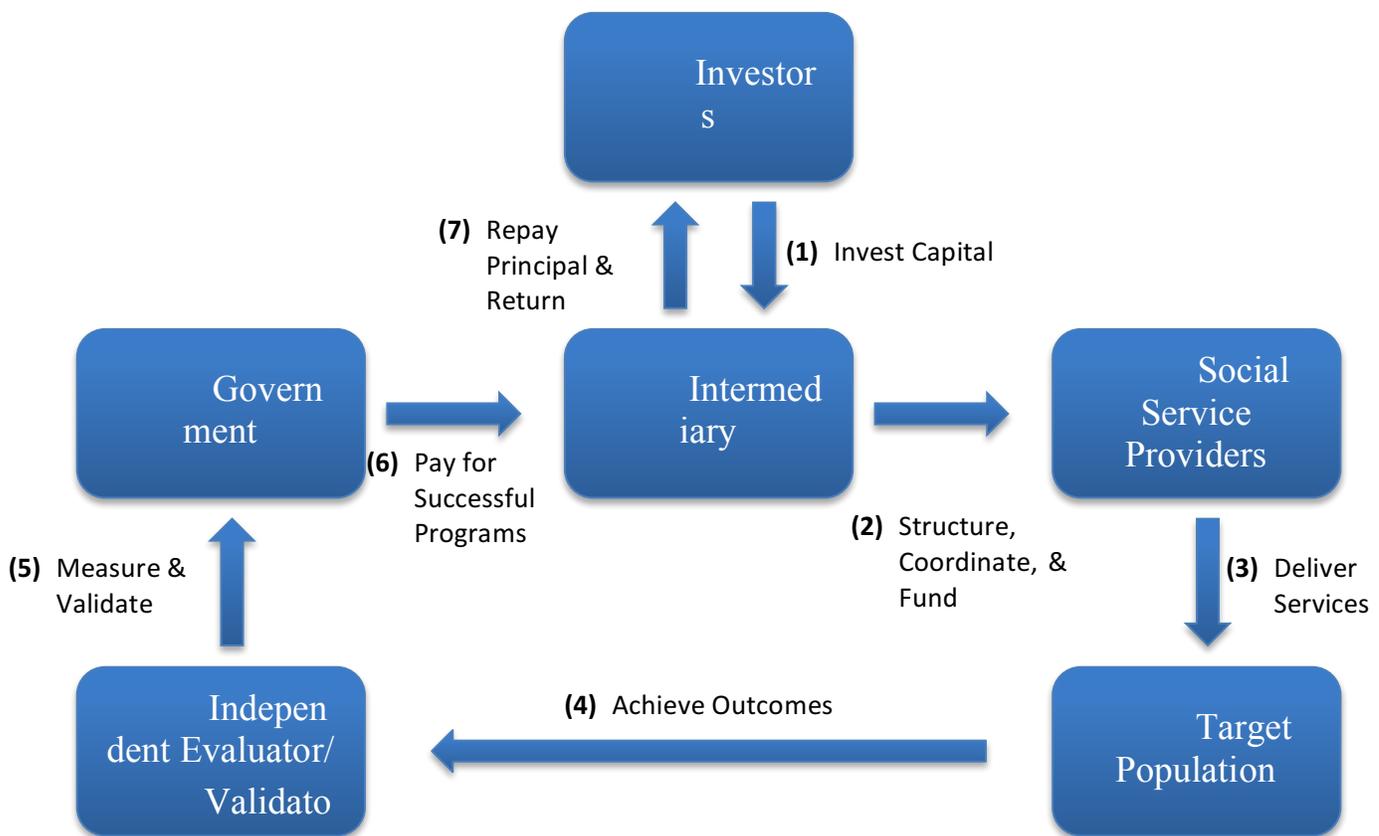
Given the nearly \$210 trillion of unrealized potential that the private markets hold, having access to this type of private capital can be a powerful tool for helping governments test whether SIBs can truly revolutionize the way we provide social services in the United States.²¹⁷ In particular, if SIBs work as intended, they have the potential to improve the efficiency and effectiveness of social programs, thereby providing tremendous social benefit to high-need populations. Thus, this Article argues that legislation is warranted to provide certainty as to the correct tax treatment to private investors who participate in SIBs and to treat SIB investments more equally with current tax-favored investments that share similar features and policy goals. By adopting the

²¹⁷ See Judith Rodin, *Innovations in Finance for Social Impact*, THE ROCKEFELLER FOUND. (Sept. 5, 2014), <https://www.rockefellerfoundation.org/blog/innovations-in-finance-for-social-impact/> [https://perma.cc/PE3B-JZ45].

changes proposed in this Article to make SIBs a more tax-favored investment, the federal government can ensure that the current law does not unnecessarily discourage the growth of this promising financial vehicle and minimize the inequities and inefficiencies that the current law creates. With this additional private capital, the development of SIBs can move forward on a larger scale and create an opportunity for social policy to evolve in a meaningful way.

VII. APPENDIX A

Traditional Social Impact Bond Structure²¹⁸



²¹⁸ Diagram adapted from *What is Pay for Success?*, NONPROFIT FIN. FUND, <http://www.payforsuccess.org/learn/basics/#what-is-pay-for-success> [<https://perma.cc/KX4U-RMME>].