

GOOGLE.ORG, FOR-PROFIT CHARITABLE ENTITY:
ANOTHER SMART DECISION BY GOOGLE?

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ABSTRACT

This paper examines Google.org, Google's for-profit charitable entity. Rather than forming a charitable foundation, Google decided to forgo the benefits of nonprofit status and channel its philanthropic efforts through a for-profit division within Google. This paper interprets Google's uncommon decision, and ultimately concludes that Google's decision to create Google.org as a for-profit entity rather than a nonprofit foundation will not only benefit Google and Google.org, but also benefit society as a whole.

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I. INTRODUCTION

In the fall of 2006, Google gained media attention with the creation of Google.org, a for-profit charitable arm of Google. True to form, the entrepreneurial founders of Google have taken an innovative, uncommon approach to corporate philanthropy. Rather than forming a charitable nonprofit foundation, which has been the prevailing approach to corporate philanthropy, Google decided to forgo the benefits of nonprofit status and instead channel its philanthropic efforts through a for-profit division within Google.

Google's decision raises the question: why did Google choose a for-profit form for Google.org? Historically, corporations formed charitable nonprofit foundations because foundations possessed certain benefits that for-profit alternatives lacked. First, and most importantly, nonprofit organizations under the United States tax code enjoy certain tax advantages.¹ Not only do donors to nonprofit organizations receive a tax deduction, but the nonprofit organization itself is immune to state and federal corporate taxes.² Second, under the "halo effect," the founding corporation enjoys an enhanced public image through its association with charitable causes.³ This enhanced image, in turn, often leads to increased business. Third, nonprofit foundations are generally subject to less stringent monitoring and regulations than for-profit entities, especially since the passage of the Sarbanes-Oxley Act.⁴ As a result, nonprofit, private foundations have much more operational flexibility than for-profit corporations.

This paper argues that for Google and Google.org, the traditional benefits of nonprofit status do not create significant value, because they would either come with costly restrictions, or would be superfluous given Google's needs. Moreover, this paper contends that Google and Google.org in fact gain certain benefits from for-profit status. These benefits include increased flexibility in pursuing philanthropic goals, generation of losses to shield profits, improved ability to avoid accumulated earnings tax liability, and increased business diversification. Finally, this paper concludes that Google's decision to create Google.org as a for-profit entity rather than a nonprofit foundation will not only benefit Google, but will also provide Google.org with the best vehicle to accomplishing its charitable mission.

Section II provides brief background information on Google and

1. See Comment, *The Modern Philanthropic Foundation: A Critique and Proposal*, 59 YALE L.J. 477, 486-87 (1950); 26 U.S.C. § 501(c)(3) (2006); 26 U.S.C. § 170 (2006).

2. See 26 U.S.C. § 501(c)(3) (2006); 26 U.S.C. § 170 (2006).

3. See Nancy J. Knauer, *The Paradox of Corporate Giving: Tax Expenditures, The Nature of The Corporation, and The Social Construction of Charity*, 44 DEPAUL L. REV. 1, 57-60 (1994).

4. See Ronald Chester, *Improving Enforcement Mechanisms in the Charitable Sector: Can Increased Disclosure of Information be Utilized Effectively?*, 40 NEW ENG. L. REV. 447, 455-56 (2006).

Google.org. Section III examines the benefits and limitations of nonprofit status. Section IV discusses the benefits of for-profit status. Section V concludes.

II. BRIEF BACKGROUND ON GOOGLE AND GOOGLE.ORG

Incorporated in 1998⁵, Google started as an internet search engine and has since grown dramatically, now offering an array of web-based services that compete with other internet giants. Part of Google's success is because of its favorable brand image. The company has become known for its "innovative, egalitarian," and socially conscious decisions.⁶

One example is Google's choice for its Initial Public Offering ("IPO"). Instead of using the traditional book-building approach, Google chose to run it using an on-line auction format. The auction was praised as being a more egalitarian approach to initial offerings, because it prevented investment banks from favoring larger investors, thus giving smaller investors a chance to participate.⁷ In addition to its IPO, one of Google's corporate mottos is "you can make money without doing evil."⁸ In support of its philosophy, Google's founders, Larry Page and Sergey Brin, have pledged approximately 1% of Google's stock and profit to charitable causes.⁹ Given the current value of Google's stock, this commitment is approximately \$1 billion.

Google.org was established to manage Google's philanthropic efforts. Google.org is unique in that it was created as a unit within Google's for-profit business, rather than as a separate nonprofit entity.¹⁰ Unlike a for-profit business unit, however, profits from Google.org projects will be reinvested in future charitable projects, instead of being distributed to shareholders.¹¹ Google.org's mission is to focus on charitable causes such as "global development, global public health and climate change."¹²

Although few of its specific projects are known, Google.org has expressed interest in funding projects that are more entrepreneurial and market-based than traditional charitable projects.¹³ For example, one of

5. Google.com, Google Corporate Information: Google Milestones, <http://www.google.com/intl/en/corporate/history.html> (follow 1998 hyperlink).

6. Victor Fleischer, *Brand New Deal: The Branding Effect of Corporate Deal Structures*, 104 MICH. L. REV. 1581, 1584 (2006).

7. *Id.* at 1594-96.

8. Google.com, Google Corporate Information: Our Philosophy, <http://www.google.com/corporate/tenthings.html>.

9. Katie Hafner, *Philanthropy the Google Way: Not the Usual Way*, N.Y. TIMES, Sept. 14, 2006, at A1.

10. Nicole Wallace, *Blending Business and Charity*, CHRON. OF PHILANTHROPY, Sept. 28, 2006, available at <http://philanthropy.com/free/articles/v18/i24/24001401.htm>.

11. *Id.*

12. See Google.org, <http://google.org/>.

13. Hafner, *supra* note 9.

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Google.org's planned projects is to develop an "ultra-fuel-efficient plug-in hybrid car engine that runs on ethanol, electricity, and gasoline."¹⁴ In pursuit of its goal to reduce oil dependency and combat global warming,¹⁵ Google.org has begun to organize scientists and auto industry experts to create a car for public use that can travel more than 100 miles per gallon of fuel.¹⁶ Additionally, Google.org founders Brin and Page have also invested in a company that is developing an electric sports car.¹⁷

III. LIMITATIONS TO NONPROFIT BENEFITS

A. Limitations to Nonprofit Benefit #1: Nonprofit Tax Benefits

A primary reason that corporations choose to channel philanthropic efforts through nonprofit foundations is to receive tax benefits. Nonprofit foundations enjoy two types of tax benefits. First, foundations are "granted statutory immunity from virtually all income and property [taxes]."¹⁸ Under this exemption, foundations are able to accrue profits without being taxed. Second, founders, as charitable donors, can claim statutory deductions from state, inheritance, gift, and income taxes for their donations.¹⁹ Founders' immunity not only allows the founding corporation to deduct all of its contributions to its foundation, but it also creates an incentive for wealthy third parties to donate, as their donations are tax deductible.

1. Tax Benefit A: Corporate Income Tax Immunity

Under 26 U.S.C. § 501(c)(3), "corporations, and any community chest, fund, or foundation, organized and operated exclusively for [certain charitable causes]" are exempted from federal income taxes.²⁰ In addition, "all states with a corporate tax provide an exemption for nonprofit charitable organizations" meeting the requirements of § 501(c)(3).²¹ Moreover, state constitutional and statutory provisions exempt nonprofits from real and personal property taxation.²²

The benefits of tax exemption can be quite valuable, especially in states

14. *Id.*

15. *Id.*

16. *Id.*

17. Michael Kanellos, *Electric Sports Car Ready to Challenge Porsche?*, CNET NEWS.COM, June 5, 2006, [http://news.com.com/Electric+sports+car+ready+to+ challenge+ Porsche/2100-11389_3-6080269.html](http://news.com.com/Electric+sports+car+ready+to+challenge+Porsche/2100-11389_3-6080269.html).

18. *The Modern Philanthropic Foundation: A Critique and Proposal*, *supra* note 1, at 487; *see also* 26 U.S.C. § 501(c)(3) (2006).

19. *The Modern Philanthropic Foundation: A Critique and Proposal*, *supra* note 1, at 488; *see also* 26 U.S.C. § 170 (2006).

20. *See* 26 U.S.C. § 501(c)(3).

21. *Developments in the Law: Nonprofit Corporations*, 105 HARV. L. REV. 1578, 1619 (1992).

22. *Id.*

with a corporate tax. For example, federal marginal corporate tax rates range from 0-39% and state marginal corporate tax rates range from 0-12%.²³ Therefore, a § 501(c)(3) organization could potentially avoid a 51% marginal tax rate on portions of its corporate income and realize additional tax savings from the property tax exemption.

a. Limitations to Corporate Income Tax Immunity

The tax code imposes a host of restrictions and regulations on tax exempt organizations. First, under § 501(c)(3), nonprofit corporations must be operated “exclusively for charitable purposes.”²⁴ Second, nonprofits are subjected to the unrelated business income tax, which taxes all income derived from unrelated commercial activity under the ordinary corporate rate.²⁵ Third, § 501(c)(3) prevents nonprofits from intervening in political campaigns and engaging in substantial lobbying.²⁶ Finally, the tax code divides all charitable organizations into two categories: private foundations and public charities, and treats private foundations less favorably, subjecting them to additional restrictions that are not applied to public charities.²⁷

This section discusses these limitations in more detail and argues that if Google.org, given its entrepreneurial approach, were to apply for nonprofit status, these limitations would prevent or severely limit the income tax benefits it derives from nonprofit status.

i. Limitation #1: Nonprofits Must be Operated Exclusively for Charitable Purposes

Section 503(c)(3) requires that the nonprofit organization be operated exclusively for charitable purposes in order to qualify for tax-exempt status.²⁸ An ordinary reading of “operated exclusively for” exempt purposes would be that any charity that engaged in activities unrelated to the charity’s charitable purposes would fail the operational test. The IRS, however, has interpreted “exclusively” to mean that the charity must be operated “primarily” for charitable purposes.²⁹

Treasury Regulation § 1.501 states that an organization will not receive tax-exempt status “if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.”³⁰ In other words, the regulation suggests that tax exempt status is not threatened so long as (1) the organization’s commercial (non-charitable) activity is not substantial, or (2) if the

23. Scott A. Hodge & Chris Atkins, *U.S. Lagging Behind OECD Corporate Tax Trends*, May 5, 2006, available at <http://www.taxfoundation.org/news/show/1466.html>.

24. See 26 U.S.C. § 501(c)(3) (2006).

25. See 26 U.S.C. § 512(a)(1) (2006).

26. See 26 U.S.C. § 501(c)(3) (2006).

27. See 26 U.S.C. § 509 (2006).

28. 26 U.S.C. § 501(c)(3).

29. John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV 487, 495-96 (2002).

30. Treas. Reg. § 1.501(c)(3)-1(c)(1) (2006).

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organization is engaged in substantial commercial (non-charitable) activity, the commercial activity is “in furtherance of an exempt purpose.”³¹

The implementation and interpretation of this regulation has been painfully unpredictable. Jurisprudence in this area has left entrepreneurial charities, which engage in substantial levels of commercial activity, with little guidance on how much and what kind of commercial activity might cause them to lose their tax-exempt status.

Two factors contributing to the doctrine’s unpredictability are (1) the IRS and the courts have not developed a clear framework for determining what constitutes substantial commercial, non-charitable activity and (2) courts have inconsistently applied the “in furtherance of” exception included in the regulations.³²

Substantial Commercial Activity: Facts and Circumstance Test

The facts and circumstances test, which is endorsed by the IRS, is the predominant analysis used by courts to determine whether an organization’s commercial activities are substantial.³³ This test requires the courts to consider all the relevant factors that indicate the scope and substantiality of the organization’s unrelated commercial activity.³⁴ If the court determines that a substantial portion of the organization’s activity has a “commercial hue,” then the court will deny tax-exempt status to the organization under § 501(c)(3).³⁵

Under this test, courts often consider the following factors: types of clients receiving services, funding sources, expenditures, advertising, sources of revenues, the charity’s corporate structure, “presence of substantial overall profits, use of commercial pricing methods with substantial net profit margins, and competition with for-profit firms in the same sector.”³⁶ The test, however, provides no guidance on how to identify additional relevant factors, or how to weigh each factor when making a substantiality determination.³⁷ Courts often take an ad hoc approach, considering only factors that support an outcome reflective of the adjudicator’s subjective notions about what amount of commercial activity is permissible.³⁸ As a result, this test has been implemented inconsistently.

For example, in *Scripture Press Foundation v. United States*, 285 F.2d 800 (1961), the court revoked tax exempt status from a publisher that was formed to improve the quality of teaching text for Protestant Sunday schools.

31. Colombo, *supra* note 29, at 504-05.

32. *Id.* at 504-05; Jessica Peña & Alexander L.T. Reid, *A Call for Reform of the Operational Test for Unrelated Commercial Activity in Charities*, 76 N.Y.U. L. REV. 1855, 1872-74 (2001).

33. Peña & Reid, *supra* note 32, at 1867-68.

34. *Id.* at 1869.

35. Colombo, *supra* note 29, at 502.

36. *Id.*

37. Peña & Reid, *supra* note 32, at 1869.

38. *Id.*

The publisher jeopardized its nonprofit status by accumulating significant profits from sales of non-educational religious literature. The court found that although the publisher had an educational program aimed at promoting Sunday school instruction, the publisher's expenditures on educational activities were "unaccountably small" in comparison to its annual income.³⁹

On the other hand, in *Presbyterian & Reformed Publishing Co. v. Commissioner*, 743 F.2d 148 (1984), construing similar facts, the reviewing court came to a different conclusion. In *Presbyterian*, the tax court, like the court in *Scripture*, revoked the publisher's tax exempt status based in part on its accumulated profits. In reversing the tax court's decisions, the Third Circuit first acknowledged that "no regulation or body of case law has defined the concept of [exempt] 'purpose'. . . with sufficient clarity to protect against arbitrary, ad hoc decision-making."⁴⁰ It then concluded that the accumulation of profits based on the success of the publishing company was in accord with § 501(c)(3) requirements, so long the organization remained "true to their stated goals."⁴¹ Thus, while the presence of accumulated profits was enough to revoke tax exempted status in *Scripture*, it was insufficient in *Presbyterian*.

In-Furtherance of Qualifier

As discussed earlier, even if a nonprofit is engaged in substantial commercial activity, a plain reading of the regulations suggests that the nonprofit should not be denied tax-exempt status, as long as the commercial activity is in furtherance of a charitable exempt purpose. Courts, however, have been very inconsistent in interpreting this clause. Courts often confuse the purpose towards which activities are directed with the nature of the activity itself.⁴² Under this approach, courts often focus solely on the facts and circumstances test and look at the nature of the activity without asking how the activity relates to the charity's purpose; thus, essentially reading out the "in furtherance of" exception in the regulation.⁴³

For example, in *Nonprofits' Insurance Alliance of California (Alliance) v. United States*, 32 Fed. Cl. 277 (1994), the court explicitly acknowledged the "in furtherance of" doctrine, but failed to apply the doctrine in its analysis. The issue was whether the administration of a group self-insurance risk pool for nonprofit organizations was an exempt activity. Applying the facts and circumstances test, the court held the organization's activity constituted a "substantial nonexempt commercial purpose," and thus revoked the organization's tax-exempt status.⁴⁴ In its analysis, the court failed to answer the question whether the organization's activities were in furtherance of its nonprofit purpose of providing reasonable insurance to nonprofit members.

39. See Colombo, *supra* note 29, at 501-02.

40. *Presbyterian & Reformed Publ'g Co. v. Comm'r*, 743 F.2d 148, 156 (3d Cir. 1984).

41. *Id.* at 158.

42. Peña & Reid, *supra* note 32, at 1870.

43. *Id.* at 1869-1871.

44. *Nonprofits' Ins. Alliance v. United States*, 32 Fed. Cl. 277, 287 (1994).

The court essentially ignored the “in furtherance of” prong of the analysis.⁴⁵

On the other hand, the broad reach of the “in furtherance of” doctrine is exemplified in the famous case of *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951), where the Third Circuit upheld an exemption for Mueller Macaroni Company. In this case, Mueller, the largest pasta producer at the time, claimed tax exempt status because it was established for the sole benefit of the New York University School of Law, an exempt nonprofit.⁴⁶ Mueller argued that since all the profits from the company were directed to the University, Mueller’s profits were in furtherance of charitable purposes. The court employed a strict, plain meaning interpretation of the “in furtherance of” exception, and sided with Mueller. It held that Mueller qualified for the tax exemption, despite Mueller having no non-commercial activity.⁴⁷

Effects of Uncertainty in the Commerciality/Operation Doctrine

If Google.org were to apply for § 501(c)(3) status, it is unclear whether it would be eligible, given its business plans. As discussed earlier, Google.org, unlike traditional nonprofits, intends to target entrepreneurial, market-based projects, such as the development of a high mileage car.⁴⁸ If this is the case, the IRS might argue that a court should deny § 501(c)(3) status under the facts-and-circumstances test, given the commercial nature of its projects. Market-based ventures, such as the high mileage car project, pose issues with § 501(c)(3) tax exempt status because they often have many of the characteristics of a for-profit enterprise. For example, the high mileage car project has the potential for substantial net profit margins; the project’s main competitors are for-profit companies such as Toyota and General Motors;⁴⁹ and the project’s main customer base is the general public, rather than a disadvantaged population. A judge, based upon these for-profit characteristics, might find that Google.org has a substantial “commercial hue,” and thus deny tax-exempt status.

On the other hand, Google.org may argue that, under a plain reading of the regulations, Google.org should be granted tax exempt status, so long as it uses the profits from its commercial activity in furtherance of a charitable purpose. Although this statement is true under a technical reading of the regulation, many courts, as discussed above, have confused the purpose

45. Peña & Reid, *supra* note 32, at 1871.

46. *Id.* at 1866 n.45; *see also* Colombo, *supra* note 29, at 499, *C.F. Mueller Co. v. Comm’r*, 190 F.2d 120 at 120-21 (1951).

47. *C.F. Mueller Co. v. Comm’r*, 190 F.2d 120, 122-23 (1951), *See also* Thomas Kelley, *Rediscovering Vulgar Charity: A Historical Analysis of America’s Tangled Nonprofit Law*, 73 *FORDHAM L. REV.* 2437, 2485 (2005) (explaining the “in furtherance of” test is also referred to as the commensurate-in-scope test. The commensurate-in-scope test essential asks whether the organization’s commercial activities are conducted in furtherance of the organization’s charitable purposes).

48. Hafner, *supra* note 9.

49. Amanda G. Little, *Virgin Green*, *SALON.COM*, Sept. 30, 2006, <http://www.salon.com/opinion/feature/2006/09/30/muckraker/>.

towards which activities are directed with the nature of the activity itself, and have incorrectly denied tax exempt status. Therefore, given the inconsistency with which the “in furtherance” prong has been implemented, Google.org has no guarantee that § 501(c)(3) status would be granted, even if all its profits were directed toward charitable purposes. Furthermore, if Google.org reinvests its profits into similar quasi-commercial projects, the reinvested funds may not be considered in furtherance of an exempt purpose. Finally, as discussed below, even if Google.org obtains tax exempt status, the profits from projects such as the high mileage car will likely be taxed under the unrelated business income tax.

The best way for Google.org to ensure nonprofit status would be to dramatically change its investment strategies and limit its projects to traditional charitable causes that lack a significant commercial element. Under this approach, however, Google.org would not be able to invest in entrepreneurial projects, such as the high-mileage car. As a for-profit entity, however, Google.org is free from these restrictions and can invest freely without being concerned with losing tax-exempt status.

ii. Limitation #2: Tax on Unrelated Business Income

In response to companies such as Mueller Macaroni, Congress passed legislation that taxed income derived from regularly carried on trade or business and is unrelated to the charity’s exempt purposes.⁵⁰ The tax was referred to as the unrelated business income tax (“UBIT”). Specifically, 26 U.S.C. § 512(a)(1) defines the unrelated business taxable income as “the gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it. . . .”⁵¹ Section § 513(a) defines “unrelated trade or business” as “any trade or business the conduct of which is not substantially related. . . to the exercise or performance by such organization of its charitable, education, or other purpose or function constituting the basis for its exemption under section 501. . . .”⁵²

To determine if a business activity is substantially related, the IRS suggests an examination of “the relationship between the activities that generate income and the accomplishment of the organization’s exempt purpose.”⁵³ For an activity to be substantially related, the “conduct of the business activities” must have a substantial “causal relationship to achieving exempt purposes (other than through the production of income).”⁵⁴ If the activity generates income, the activity must also “contribute importantly to the organization’s exempt purposes to be [considered] substantially related.”⁵⁵

50. Peña & Reid, *supra* note 32, at 1865-67.

51. 26 U.S.C. § 512(a)(1) (2006).

52. 26 U.S.C. § 513(a) (2006); *See also* Peña & Reid, *supra* note 32, at 1855.

53. I.R.S., “Substantially Related” Defined, [http://www.irs.gov/charities /article /0,,id=158843,00.html](http://www.irs.gov/charities/article /0,,id=158843,00.html) (last visited Sept. 24, 2007).

54. *Id.*

55. *Id.*

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The IRS's guidance, however, still leaves "substantial" undefined and courts have struggled with defining "substantial," unable to create a bright line rule when a trade or business activity is "substantially" related to the nonprofit's charitable purpose.⁵⁶

Courts have often looked to the legislative purpose of the UBIT for guidance. Legislative history suggests that the UBIT was primarily created to curb the unfair competitive advantage charities had over for-profit companies.⁵⁷ Congress explained that the tax was designed to "eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations on the same tax basis as the nonexempt business endeavors with which they compete."⁵⁸ In other words, Congress believed that Mueller Macaroni, whose sole business activity was producing pasta, should not be given an exemption just because it was owned by a tax-exempt organization, the New York University ("NYU"). Tax exemption gave Mueller an unfair and undeserved competitive advantage against other pasta producers.

Following the passage of the UBIT, NYU still retained its tax exempt status, but Mueller's income was considered unrelated business income, and therefore subject to the UBIT and taxed at the ordinary corporate tax rate. Therefore, even if an organization is able to pass the operational/commerciality test and receive tax exemption, exemption does not extend to income derived from commercial activities that are unrelated to the organization's exempt purposes.

Effects of UBIT on Google.org

Assuming that Google.org obtains and maintains tax exempt status without dramatically changing its investment strategies, the UBIT could severely limit the benefits of tax exemption by taxing all income derived from unrelated activities. Google.org may have difficulty proving that its entrepreneurial, market-based projects are substantially related to its charitable causes because the presence of generated profits and for-profit competitors often suggests an economic purpose rather than a charitable purpose. Thus, for many of its projects, Google.org will likely have to prove to the IRS that these efforts have a "substantial relationship" to a charitable cause.

For example, it is unclear whether the UBIT would apply to Google.org's high mileage car project. The primary issue is whether the development and sale of these cars are substantially related to the charitable goal of conserving and improving the environment. On one hand, the IRS can argue that the main purpose of this project is to develop a car for commercial consumer use, which is not a charitable purpose. The fact that the car's fuel efficiency improves the environment is merely a byproduct of the project. Furthermore, the IRS can

56. Kelley, *supra* note 47, at 2483-84.

57. Peña & Reid, *supra* note 32, at 1865-66.

58. *Id.* at 1866 (quoting Treas. Reg. § 1.513-1(b) (1983)).

argue that the main competitors to this project are for-profit car companies such as Toyota and other smaller start-ups. Therefore, since the UBIT was specifically designed to prohibit nonprofits from gaining an unfair advantage over commercial competitors, it should apply in this case. On the other hand, Google.org can argue that the main purpose of the high-mileage car project is developing fuel efficient technology to improve the environment. The actual use of these cars will directly contribute to curbing pollution and conserving fossil fuel. The fact that hybrid cars have commercial viability is incidental.

Regardless if Google.org wins this argument, it will have to expend time and money to prove the high mileage car is substantially related to its charitable purpose. Further, if Google.org fails to prove its case, it will result in both litigation costs and the UBIT. As a for-profit entity, Google.org can invest freely without worrying about the UBIT.

iii. Limitation #3: Restrictions on Political Lobbying

Section 501(c)(3) restricts the political expression of nonprofit entities.⁵⁹ Under § 501(c)(3), if a nonprofit entity intervenes in political campaigns or devotes a substantial portion of its activity to legislative lobbying, it will lose its tax-exempt status.⁶⁰ Nonprofit entities, however, can engage in, or fund, activities designed to promote political awareness in a nonpartisan manner.⁶¹ For example, a nonprofit can promote general voter turnout by sponsoring informational seminars and programs regarding how and why one should vote. The nonprofit cannot, however, endorse a particular political candidate or commit a substantial part of its activities to supporting specific legislation to change particular voting laws.

Under the “substantial” part test, a court must determine (a) whether a nonprofit organization has attempted to influence legislation, and (b) whether such attempts constitute a substantial part of the organization’s activities.⁶² Courts have failed to delineate a clear rule for determining when an organization’s attempts are substantial enough to violate § 501(c)(3). Some courts have used the absolute dollar amount spent on lobbying as a dispositive factor, while others have employed a balancing test that compares the amount spent on lobbying with its total expenditures.⁶³ Moreover, regardless of the test, courts are inconsistent regarding what percentage of its income a nonprofit must spend on lobbying before its efforts will be deemed substantial.⁶⁴ Even if the foundation’s political expenses are insubstantial, and thus allowed under § 501(c)(3), the expenditures will be taxed under 26 U.S.C § 4955, which taxes all political expenditures made by a foundation.⁶⁵

59. See 26 U.S.C. § 501(c)(3) (2006).

60. *Id.*

61. *Developments in the Law: Nonprofit Corporations*, *supra* note 22, at 1661.

62. *Id.* at 1662.

63. *Id.*

64. *Id.*

65. See 26 U.S.C. § 4955(a)-(b) (1996) (requiring that a foundation is subject to a 10% tax

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Effects of Restriction on Political Lobbying

One of Google.org's primary purposes is to better the environment. A strategy that Google.org may want to pursue is to lobby congress for legislation, such as tougher environmental laws or credits for developing energy-efficient transportation; or to support political candidates that champion environmental causes. Under § 501(c)(3), this strategy would be limited, as any substantial lobbying would result in revocation of its tax exempt status. Furthermore, any allowable lobbying would be taxed under § 4955. By choosing a for-profit form, Google.org can avoid these restrictions and have more flexibility in pursuing different legislative and political strategies.

iv. Limitation #4: Additional Restrictions on Non-operating Private Foundations

Under the tax code, not all § 501(c)(3) nonprofits are treated equally.⁶⁶ Chapter 26 U.S.C. § 509 provides language that divides § 501(c)(3) entities into two broad categories: private foundations and public charities.⁶⁷ Private foundations are further divided into operating and non-operating foundations.⁶⁸ These classifications are important because the tax code treats each classification differently. As discussed below, non-operating foundations receive the least favorable tax treatment and are subject to numerous restrictions not faced by public charities or operating foundations. This section contends that even if Google.org qualified as a nonprofit, it would be classified as a non-operating foundation, and therefore, be subject to many restrictions.

Definition of a Private Foundation

Under § 509, a § 501(c)(3) entity is considered a private foundation, unless it qualifies as one of the exceptions listed in §§ 509(a)(1)-(3).⁶⁹ If the entity satisfies an exception, then it is considered a public charity.⁷⁰ Since Google.org likely does not meet any of the exceptions outlined in §§ 509(a)(1)-(3), it would probably be categorized as a private foundation.

Under the § 509(a)(1) exception, which references § 170(b)(1)(A), an entity may qualify as a public charity based on either (1) the function of the entity or (2) the origins of the entity's financial support.⁷¹ Organizations that satisfy the functions requirement include churches, conventions of churches,

on any political expenditures, and a foundation manager is subject to a 2.5% tax for knowingly making those expenditures, and furthermore, if the improper political expenditure is not corrected, a foundation is subject to a 100% tax and the manager is subject to a 50% tax.).

66. See 26 U.S.C. § 501(c)(3) (2006).

67. See 26 U.S.C. § 509 (2006).

68. *Id.*

69. Nina J. Crimm, *Through a Post-September 11 Looking Glass: Assessing the Roles of Federal Tax Laws and Tax Policies Applicable to Global Philanthropy by Private Foundations and Their Donors*, 23 VA. TAX REV. 1, 58 (2003).

70. *Id.*

71. *Id.* at 63; see also U.S.C. § 509(a)(1) (referencing 26 U.S.C. § 170(b)(1)(A)); 26 U.S.C. § 170(b)(1)(A) (2006) (stating the function and financial support tests).

associations of churches, schools, medical care and medical research institutions, and government units.⁷² A charitable entity may satisfy the financial support requirement in § 509(a)(1) if it receives broad financial support from the general public.⁷³ Under the “financial support test” of § 509(a)(1), an entity is generally considered a public charity if it can demonstrate that it receives “at least one-third, but in some circumstances as little as 10%, of its total revenues from gifts or contributions [from] a broad cross-section of the general public.”⁷⁴

Similar to § 509(a)(1), the § 509(a)(2) public charity classification is based on a financial support test.⁷⁵ However, § 509(a)(2) is unique because it recognizes that some public charities, such as museums, rely on income from the performance of their exempt functions.⁷⁶ In other words, § 509(a)(2) broadens the scope of § 509(a)(1) to include “admissions fees, sales proceeds from educational material, and income from other similar exempt functions.”⁷⁷ Under § 509(a)(2), however, exempt income, donations, and grants must be at least one-third of the organization’s total funding, and the organization’s investment income may not exceed one-third of its total funding.⁷⁸

Under § 509(a)(3), “supporting organizations” are considered public charities.⁷⁹ A supporting organization is any entity that financially supports or carries on activities that support the charitable activities of one or more other exempt organizations.⁸⁰ Supporting organizations are not subject to a “financial support” test.⁸¹ To qualify as a supporting organization, the entity must be (1) “organized exclusively for the benefit” of a public charity as defined in § 509(a)(1)-(2); (2) “operated, supervised, or controlled by, or in connection with”, a public charity defined in § 509(a)(1)-(2); and (3) cannot be controlled by a “disqualified person” as defined in § 4946.⁸² “Disqualified persons” includes substantial financial contributors to the entity.⁸³

If organized as a nonprofit, Google.org would not satisfy any of these

72. Crimm, *supra* note 69, at 63.

73. *Id.*

74. *Id.*; see also Tanya D. Marsh, *A Dubious Distinction: Rethinking Tax Treatment of Private Foundations and Public Charities*, 22 VA. TAX. REV. 137, 154 (2002) (stating that the 10% exception applies when: (1) at least 10% of the organization’s total support comes from the government or public; (2) the organization is designed to attract future support from the government or public; and (3) the organization’s operations suggest that it should be considered a public charity).

75. See 26 U.S.C. § 509(a)(2) (2006).

76. Crimm, *supra* note 69, at 63.

77. *Id.*

78. *Id.*

79. *Id.*; see also 26 U.S.C. § 509(a)(3) (2006).

80. Crimm, *supra* note 69, at 63-64.

81. *Id.*

82. I.R.S., INTERNAL REVENUE MANUAL pt. 7, ch. 26, § 5 (1999) available at <http://www.irs.gov/irm/part7/ch11s05.html>.

83. See 26 U.S.C. § 4946 (2006).

exceptions. Google.org would not meet the functional criteria or public support test under § 509(a)(1) because it neither serves as one of the listed functions under § 170(b)(1)(A), nor does it receive more than 30% of its funding from the general public. Google.com provides almost all of Google.org's funds. Similarly, Google.org would not qualify under § 509(a)(2) because it does not have broad public financial support. Finally, Google.org would not qualify as a supporting organization, as outlined under § 509(a)(3), because it neither exclusively serves nor is controlled by a qualified public charity. Therefore, Google.org would likely be considered a private foundation rather than a public charity.

Operating v. Non-operating Private Foundations

Private Foundations are divided into two categories: operating and non-operating foundations.⁸⁴ Operating foundation status is favored because, although subject to private foundation restrictions, operating foundations are treated like public charities for certain purposes.⁸⁵ For example, operating foundations are exempt from private foundation taxes imposed by §§ 4942 and 4940, are treated like public charities for gift and estate tax purposes and with respect to donor deduction rules.⁸⁶

To qualify as an operating foundation, the private foundation must meet an income test, and one of the following ancillary tests: the assets test, the endowment test, or the support test.⁸⁷ If a foundation does not qualify as an operating foundation, then it is considered a private non-operating foundation, or a grant-making foundation.⁸⁸ A grant-making foundation generally provides grants to other entities or individuals to support charitable or other exempt purposes.

The income test is satisfied if the private foundation “spends at least 85% of its adjusted net income or its minimum investment return, whichever is less, directly for the active conduct of its exempt activity.”⁸⁹ For expenditures to be considered “directly for the active conduct,” the foundation must either conduct exempt activity itself, or maintain some significant involvement in the recipient organization conducting the exempt activity.⁹⁰

The assets, endowment, and support tests are somewhat complicated, but they essentially require the following. The asset test requires a minimum level

84. I.R.S.: Definition of Private Operating Foundation, <http://www.irs.gov/charities/foundations/article/0,,id=136869,00.html> (last visited Sept. 24, 2007).

85. I.R.S., *supra* note 82, at pt. 7, ch. 26, §6.

86. *Id.*

87. *Id.*; *see also* 26 U.S.C § 4942(j)(3)(A) (2006).

88. I.R.S., Grant-Making Foundations, <http://www.irs.gov/charities/foundations/article/0,,id=149418,00.html> (last visited Sept. 24, 2007).

89. I.R.S., *supra* note 82; *see also* 26 U.S.C. §§ 4942(e)-4943(f) (2006) (defining “minimum investment return” and “adjusted net income”).

90. I.R.S., Directly for the Conduct of Exempt Activities, <http://www.irs.gov/charities/foundations/article/0,,id=136872,00.html> (last visited Sept. 24, 2007).

of the private foundation's assets be devoted to the direct active conduct of the exempt activity.⁹¹ The endowment test requires a minimum level of the private foundation's distributions be devoted to the direct active conduct of the exempt activity.⁹² The support test requires that the private foundation receive the majority of its financial support from a broad selection of contributors, in effect preventing the foundation from being funded by one source.⁹³

It is unclear whether Google.org would qualify as an operating foundation. A major issue would be whether Google.org's program-related investments would be considered qualified distributions "directly for the conduct of exempt activities" under the income test. Google.org's expenditures may qualify if Google.org maintains "significant involvement" in the funded program. If, however, Google.org does no more than select, screen, and investigate applicants for grants, under which the recipients perform their work or studies alone or without significant input from Google.org, the grants will not be treated as "qualifying distributions." Given its ambitious and wide-ranging goals, it is hard to imagine that Google.org will remain heavily involved with all of its projects.⁹⁴ From a practical standpoint, Google.org will likely fund an organization and then leave the day-to-day operations to the organization's leaders.

The Additional Requirements of Non-operating Foundations

Assuming Google.org was classified as a non-operating foundation, it would face additional restrictions not presented to public charities or operating foundations. The harsher treatment of non-operating foundations grew out of a concern that private foundations were being used by wealthy families as tax shelters and possessed too much control over both the financial and political sectors.⁹⁵ The negative perception regarding private foundations led to the passage of the 1969 Act. This Act introduced many of the restrictions that private foundations face today. In the years following the 1969 Act, however, Congress has relaxed some of the original restrictions because the original restrictions were too harsh. Even in its current form, many argue that the restrictions are too limiting.⁹⁶

The current law subjects non-operating foundations to the following restrictions: excise taxes on investment income; limits on self-dealing; minimum distribution requirements; restrictions on excess business holdings; prohibitions on speculative investments; and restrictions on the deductibility of

91. I.R.S., Private Operating Foundation—Assets Test, <http://www.irs.gov/charities/foundations/article/0,,id=136873,00.html> (last visited Aug. 31, 2007).

92. I.R.S., Private Operating Foundation—Endowment Test, <http://www.irs.gov/charities/foundations/article/0,,id=136874,00.html> (last visited Aug. 31, 2007).

93. See I.R.S., Private Operating Foundation—Support Test, <http://www.irs.gov/charities/foundations/article/0,,id=136875,00.html> (last visited Aug. 31, 2007).

94. See Google.org <http://google.org/> (last visited Aug. 31, 2007).

95. See Marsh, *supra* note 74, at 150.

96. *Id.* at 180-186.

charitable contributions.

26 U.S.C. § 4940: Excise Tax on Investment Income

Under § 4940(a), foundations are subject to a 2% excise tax on net investment income.⁹⁷ “[F]oundations, whose qualifying distributions exceed their historical average in any given year receive a favorable 1% rate.”⁹⁸ When it was first passed in 1969, this excise tax was justified as a “charge or audit fee” to “share some of the burden of paying the cost of government.”⁹⁹

26 U.S.C. § 4941: Prohibitions on Self-Dealing

Section 4941 aims to prevent private foundations from being used as a vehicle to funnel benefits to related and interested parties.¹⁰⁰ Specifically, it “imposed a penalty tax of five [or ten] percent on acts of self-dealing between the private foundation and certain ‘disqualified persons’, which include substantial contributors to the foundation, a foundation manager, and an owner of more than twenty percent of a corporation that is a substantial contributor to the foundation, and certain government officials.”¹⁰¹ If the prohibited transaction is not rectified, an additional 200% tax on the value of the transaction is imposed.¹⁰² The penalty tax is imposed not only on the foundation, but also on the participating foundation manager if he or she knows that the act is an act of self-dealing and engages in it willfully and without reasonable cause.¹⁰³

The following transactions constitute self-dealing: certain sales or leases of property between disqualified persons and foundations, and any “transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.”¹⁰⁴

26 U.S.C. § 4942: Minimum Distribution Requirements

Section 4942 creates a minimum distribution requirement for non-operating foundations.¹⁰⁵ The rule essentially requires non-operating foundations “annually to pay out ‘qualifying distributions’ of 5% of average asset value. . . .”¹⁰⁶ If foundations fail to meet this requirement, the foundation is taxed 30% on the difference between the minimum required distributions and the actual distributions.¹⁰⁷ Not only is the foundation taxed on the

97. See 26 U.S.C. § 4940(a) (2006).

98. Marsh, *supra* note 74, at 157. Accord 26 U.S.C. § 4940(e) (2006).

99. Marsh, *supra* note 74, at 156 (quoting STAFF OF JOINT COMM. ON INT. REV. TAX, 91ST CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969 (Comm. Print 1970)).

100. See 26 U.S.C. § 4941 (2006).

101. Marsh, *supra* note 74, at 157; 26 U.S.C. § 4941.

102. See 26 U.S.C. § 4941(b)(1) (2006).

103. See *id.* § 4941(a)(2).

104. Robert A. Boisture, *Private Foundations and Choices in Giving*, SD32 A.L.I.-A.B.A. 93, 110 (1998) (quoting § 4941(d)(1)(A)-(C), (E) (2006)).

105. See 26 U.S.C. § 4942 (2006).

106. Crimm, *supra* note 69, at 72. See also 26 U.S.C. § 4942 (2006).

107. 26 U.S.C. § 4942(a) (2006).

shortfall, if the foundation fails to make the distributions needed to meet the minimum requirement, the foundation is taxed again at 100% on the amount of the shortfall.¹⁰⁸

“Qualifying distributions” by a private foundation are amounts paid to accomplish purposes described in section 170(c)(2)(B), including charitable purposes.”¹⁰⁹ Payments made to an organization controlled by the foundation, to disqualified persons or to other non-operating foundations do not constitute qualified distributions, unless the recipient redistributes the amount to a qualified grantee within the taxable year.¹¹⁰

Payments made to foreign charitable organizations may constitute “qualifying distributions” under two circumstances.¹¹¹ First, payments could be made to a foreign organization that is certified by the IRS as a § 501(c)(3) entity.¹¹² However, IRS certification rarely occurs, because the certification process is costly and time consuming.¹¹³ Alternatively, the “grant-making domestic private foundation can make its own ‘good faith determination’ that the foreign organization would qualify as a public charity under section 501(c)(3).”¹¹⁴ Making a “good faith determination” requires the grant-making organization to conduct a substantial due diligence and documentation review of the recipient organization.¹¹⁵

26 U.S.C. § 4943: Limits on Ownership of Business Enterprises

Section 4943 places limits on a private foundation’s control of a business enterprise.¹¹⁶ Private foundations generally cannot control more than 20% of the voting stock of any business enterprise.¹¹⁷ The limits may increase to 35% if the foundation can establish that a third party has effective control of the business.¹¹⁸ The foundation is taxed 10% on any holding above these limits, and an additional tax of 200% is imposed if the foundation does not divest these investments in the required time period.¹¹⁹

26 U.S.C. § 4944: Tax on Investments that Jeopardize Charitable Purpose

Under § 4944, if the foundation makes investments in “such a manner as to jeopardize the carrying out of any of its exempt purposes,” the foundation as well as the manager responsible for making the investment will be subjected to

108. *See id.* § 4942(b).

109. Crimm, *supra* note 69, at 72.

110. *Id.* at 72-73.

111. *See id.* at 75-76.

112. *Id.* at 75.

113. *Id.*

114. *Id.* at 75-76, *See also* Treas. Reg. § 53.4942(a)-3(a)(6) (as amended in 1986).

115. Crimm, *supra* note 69, at 75-76.

116. 26 U.S.C. § 4943 (2006), *See also* Boisture, *supra* note 104, at 121.

117. *See* 26 U.S.C. § 4943(c) (2006).

118. *See id.*

119. 26 U.S.C. §§ 4943(a)(1), (b) (2006).

a tax equal to 10% of the investment value.¹²⁰ Furthermore, if the jeopardizing investment is not removed, the foundation and the manager responsible for the investment will be subject to an additional tax equal to 25% of the value of the investment at issue.¹²¹ This section imposes its own “prudent man” rule on foundation investments.¹²² Foundations and their managers cannot make highly speculative investments that place the foundations assets at risk.¹²³

Deductibility of Donations

Under 26 U.S.C. § 170, donors of private non-operating foundations are limited to a smaller percentage deduction for their charitable gifts when compared to donors of public charities and operating foundations.¹²⁴ Donors to public charities can deduct up to 50% of their adjusted gross income for cash donations and up to 30% for donations of property, whereas donors to private foundations can only deduct up to 30% for cash donations and up to 20% for donations of property.¹²⁵ The corporate limits are the same for both private foundations and public charities; corporations can deduct up to 10% of their adjusted gross income.¹²⁶

The deduction rules of gifts of appreciated property are also significantly more favorable when the donee is a public charity or operating foundation. Donors to public charities can fully deduct long-term capital gains from intangible property, such as stocks, while donors to private foundations do not receive such benefits, unless the stock is publicly traded.¹²⁷ Moreover, donors to public charities can deduct long-term capital gains from tangible personal property, if the property is used in a manner related to the charity’s exempt purpose.¹²⁸ Long-term capital gains resulting from personal property, however, cannot be deducted immediately if donated to a private foundation.¹²⁹

Effects of Additional Non-operating Foundation Restrictions

If Google.org were a non-operating foundation, § 4940 would subject Google.org to a 2% tax on its investment income. Given the size of

120. 26 U.S.C. § 4944(a) (2006).

121. *Id.*

122. 1B NICHOLS CYCL. LEGAL FORMS, § 1.2845 rev. ed. 2006) (citing 9 MERTENS LAW OF FED. INCOME TAXATION ch. 34 (2006)).

123. *See* Marsh, *supra* note 74, at 160.

124. *See* 26 U.S.C. § 170(e)(1)(B) (2006).

125. 26 U.S.C. §§ 170(b)(1)(A), (b)(1)(C), (e)(1)(B) (2006); *Id.*, Boisture, *supra* note 104, at 106.

126. 26 U.S.C § 170(b)(2) (2006). Google is unlikely worried about the corporate limitation because it does not plan to deduct more than 10% of its adjusted gross income. As discussed above, Google’s commitment is 1% of equity and profits.

127. 26 U.S.C. §§ 170(b)(1), (e)(1) (2006); Robert A. Boisture and Lloyd H. Mayer, *Weighing the Alternatives to Private Foundations: Vehicles that Escape the Excise Tax Rules on Private Foundations May Involve Different Sorts of Problems*, 11 J. TAX’N OF EXEMPT ORGS. 257, 262, (2000).

128. Boisture, *supra* note 127, at 262.

129. *Id.*

Google.org, this could be a substantial amount.

Section 4941 would place limitations on Google.org's ability to partner with Google, because Google, as the founding organization could not benefit in any way from the foundation's assets. This would prevent Google.org from being able to leverage the power and reach of Google.

Section 4942 would create administrative and financial burdens on grants to foreign organizations. The foreign recipient organization would either have to be certified by the IRS, or Google.org would have to make a "good faith determination" that the foreign organization would qualify as a § 501(c)(3) entity. Given Google.org's mission to address global issues, this section might be especially problematic.

Section 4943 would prevent Google.org partnering up with venture capitalists and investing in the ownership of businesses. Google.org's executive director Larry Brilliant mentioned that as part of Google.org's strategy he wanted to invest in for-profit businesses dedicated to social causes. Under § 4943, Google.org's ownership in these companies would be limited.

Section 4944 would limit the risk-taking ability of Google.org, which goes against Google's culture of taking unprecedented risks. Google.org would not be able to invest foundation assets in risky ideas that a prudent investor would find unreasonable. As a for-profit entity, Google.org is able to avoid these non-operating foundation restrictions.

Finally, the limitations to the deductibility of donations to non-operating foundations will reduce the number third party donors to Google.org because donors are presented with the opportunity to take larger tax deductions when donations are made to public charities

2. Tax Benefit B: Donor Tax Deductions

As discussed in the section above, if Google.org were to apply for nonprofit status, it would likely be considered a private non-operating foundation, and as such would only receive limited donor deduction benefits under § 170. This section, however, argues that even if Google.org were to somehow gain public charity status and thus receive the full deduction benefits afforded by nonprofit status, these benefits have limited value to Google and Google.org.

Under the full benefits of nonprofit status, Google would be able to deduct up to 10% of its adjusted gross income, free of non-operating foundation limitations, for its contributions to Google.org.¹³⁰ Third parties would also be able to deduct, free from non-operating foundation limitations, up to 50% of their adjusted gross income for cash donations to Google.org, and up to 30% for donations of property.¹³¹

130. See 26 U.S.C. § 170(b)(2).

131. See 26 U.S.C. § 170(b)(1).

At first blush, these benefits seem valuable: Google can deduct its contributions to Google.org and Google.org receives increased donations from third parties wanting to take advantage of the tax deduction. Under closer inspection, however, the tax deduction benefits of nonprofit status are hardly more valuable to Google and Google.org than the normal corporate tax laws that would apply if Google.org were a for-profit entity.

a. Limitations to Donor Tax Deductions

Even without nonprofit status and § 170, Google will likely be able to deduct its contribution under 26 U.S.C. § 162. Under § 162, a corporation can deduct all ordinary and necessary business expenses.¹³² Google's contributions can be framed as the business expense of running Google.org, a division of Google, and therefore the expenses can be deducted under § 162, leaving little need for § 170 tax deductions.

Section 162, however, is not a perfect substitute.¹³³ On balance, classifying a donation as a § 170 deduction is slightly more favorable than classifying it as a business expense deduction under § 162.¹³⁴ First, § 162(b) prevents corporations from taking ordinary business expense deductions for any expenditures that can be categorized as charitable donations under § 170.¹³⁵ This prevents a corporation from using § 162 as a spill-over provision when it surpasses its allowable limit on under § 170.¹³⁶ Section 162(b), however, would not affect Google's contributions because Google.org is not a nonprofit, and therefore contributions to Google.org would not be considered donations under § 170.

Second, § 162 also limits the deduction that corporations can take for capital expenditures. Capital expenditures are "generally those expenditures that produce a benefit beyond the taxable year," and "are not immediately deductible."¹³⁷ Under § 162, capital expenditures must be capitalized and deducted over a set period of time.¹³⁸ Under § 170, capital expenditures can be deducted immediately.¹³⁹

Finally, § 162 treats transfers of appreciated property to charity less favorably than § 170.¹⁴⁰ Under § 162, a taxpayer can only deduct the taxpayer's adjusted basis in appreciated property and recognize a gain equal to the difference between the taxpayer's adjusted basis in the property and the full fair market value of the property on the transfer date.¹⁴¹ Whereas § 170 allows

132. 26 U.S.C. § 162(a) (2006).

133. See Knauer, *supra* note 3, at 43.

134. *Id.*

135. See *id.* at 41; see also 26 U.S.C. § 162(b) (2006).

136. See 26 U.S.C. § 162(b).

137. Knauer, *supra* note 3, at 43.

138. *Id.*

139. *Id.* at 43-44.

140. *Id.* at 44.

141. *Id.*

the taxpayer to take the full fair market value of the appreciated long-term capital gain property donated to a public charity.¹⁴² This may prevent Google from transferring funds to Google.org in the form of appreciated stock or appreciated real estate.

The deficiencies in the § 162 deduction, however are more than compensated for by the benefits created by making Google.org a for-profit entity. These benefits are discussed in section IV.

The § 170 tax deduction has only negligible value to Google.org because Google.org does not need to rely upon third party donations. Google.org is backed by Google's commitment to contribute approximately 1% of its equity and profits. Given the robust financial health of Google, this commitment translates into over \$1 billion of funding. Therefore Google.org, though it would certainly welcome donations, does not need the money so long as Google remains financially healthy.

B. Limitations to Nonprofit Benefit #2: "Halo Effect" – Improved Public Image for Founding Corporation

1. Benefits of "Halo Effect"

Tax breaks are not the only reason why corporations engage in philanthropic activities.¹⁴³ Corporations also engage in corporate philanthropy for its perceived positive impact on business.¹⁴⁴ The idea is that by associating with charities or charitable causes, corporations are able to enhance their public image and thus increase customer base. This phenomenon is known in marketing industry as the "halo effect."¹⁴⁵ The "halo effect" attaches to a corporation when it makes a transfer to charity and its name becomes associated with the charity or charitable cause.¹⁴⁶ In essence, the goodwill and public admiration of the charity rubs off on the corporation.

Studies have shown that the "halo effect" has real influence on corporations and their customers. For example, a consumer survey done in 1990 showed that "52% of the consumers asked would pay 10% more for a product that was 'socially responsible.'"¹⁴⁷ Corporations can also use the "halo effect" to mask or compensate for questionable social or environmental records. For example, the Coors Company has had a poor image among certain consumer groups, because of its conservative views on political and social issues.¹⁴⁸ In attempts to improve its image, it launched a campaign to

142. *Id.* at 44-45.

143. *See id.* at 52-53.

144. *Id.* at 53.

145. *Id.* at 57.

146. *Id.* at 58.

147. *Id.* at 59.

148. *Id.* at 61.

combat illiteracy in women.¹⁴⁹ The company's goal, in part, was to improve its public image in hopes of capturing consumers who may not share Coors' conservative views but who do champion literacy campaigns.¹⁵⁰ Furthermore, a favorable public image not only improves business, but it also boosts the morale of employees and investors.

a. Limitations to the "Halo Effect" Benefit

Google does not need the "halo effect" as much as the average for-profit corporation. Google already has a favorable public image. According to a consumer survey, Google had the highest positive impact brand from 2005-2006 in the world.¹⁵¹ As discussed earlier, Google has strategically fostered its favorable public brand image. With business decisions such as its on-line IPO auction and its commitment to "doing no evil," Google has become known for making smart and innovative decisions in line with the global conscience.¹⁵² Therefore, when Google announces that its charitable giving will be managed by a for-profit entity, its decision is largely accepted with very little skepticism.

Google's situation can be contrasted to Microsoft's charitable efforts in the late 1990s. Partly because of Microsoft's long-running legal problems and its unfavorable public image of having monopolistic powers, Microsoft has made great efforts to make its corporate philanthropy seem genuine.¹⁵³ Thus, the Gates Foundation, a foundation that Microsoft gives to that its former CEO founded, carefully chose philanthropic projects that could not be seen as ones that could help boost demand for Microsoft products.¹⁵⁴ Microsoft did not have the option, practically speaking, to create the Gates Foundation as a for-profit entity. This is because Microsoft needed to improve its public image and the public would be suspicious of a Microsoft charitable entity that was for-profit. Google is simply not faced with a similar unfavorable public image problem.¹⁵⁵

Google's decision to adopt a for-profit form for Google.org may even strengthen Google's brand image. Google is expected to make innovative and iconoclastic moves. A \$1 billion for-profit charitable entity is not only in line with its branding expectation, but also serves to reinforce its entrepreneurial nature. A standard nonprofit charitable foundation would not generate as much buzz. Therefore, Google has essentially been able to receive the benefits

149. *Id.*

150. *Id.*

151. Robin D. Rusch, *The Search is Over: Google Wins in 2005*, BRANDCHANNEL.COM, Jan. 23, 2006 http://www.brandchannel.com/start1.asp?fa_id=298, see also Anthony Zumpano, *Similar Search Results: Google Wins*, BRANDCHANNEL.COM, Jan. 29, 2007 http://www.brandchannel.com/boty_results/global_2006.html.

152. Fleischer, *supra* note 6, at 1583-84.

153. Daniel Gross, *Philanthropy Smackdown: Google vs. Gates for the World Charity Championship*, SLATE, Sept. 18, 2006, <http://www.slate.com/id/2149877/>.

154. *Id.*

155. *Id.*

of the “halo effect” without having to adopt the nonprofit status.

Google, however, should not completely ignore the “halo effect.” As the company grows into a market giant, it will have to remain conscientious about its public image to avoid the “bully” perception that has plagued large market leaders, like Microsoft.

C. Limitations to Nonprofit Benefit #3: Less Stringent Regulation of Nonprofits

1. Benefits of Less Stringent Regulation

The duties of nonprofit managers are enforced less rigorously than equivalent duties of for-profit managers.¹⁵⁶ As a result, private foundations have much more operational flexibility than for-profit corporations. State law is the primary source of authority for regulating the nonprofit sector.¹⁵⁷ Under state common law, only readily ascertainable beneficiaries and the attorney general have standing to sue for the enforcement of the manager’s fiduciary obligations.¹⁵⁸ Since many foundations do not have ascertainable beneficiaries, this leaves the attorney general as the exclusive regulator of foundations.¹⁵⁹

State attorney generals are often inattentive when policing charities and their internal behaviors.¹⁶⁰ This lack of attention is due in part to the fact that attorney generals are often short staffed, and concentrate much of their energy on pursuing corporate misconduct, especially in the post-Enron era.¹⁶¹ Another reason is that attorneys general are elected, and cracking down on public charities could elicit negative public reactions.¹⁶² A general consensus exists that harassing charities that are “doing good” is unpalatable and will drive away future philanthropy.¹⁶³

The IRS to a lesser extent also regulates private foundations. Private foundations must file Forms 990, 990 EZ, or 990PF tax returns to show that they are complying with the related tax restrictions for nonprofits.¹⁶⁴ In addition, as discussed above, private foundations under the tax code are subject to anti-abuse rules designed to prevent self-dealing.¹⁶⁵ Enforcement of these restrictions, however, has been minimal, and has decreased in recent years.¹⁶⁶

156. See Nina J. Crimm, *A Case Study of a Private Foundation’s Governance and Self-interested Fiduciaries Calls for Further Regulation*, 50 EMORY L.J. 1093, 1140 (2001).

157. Chester, *supra* note 4, at 455 (2006).

158. *Id.* at 458.

159. *Id.* at 451.

160. *Id.* at 452.

161. *Id.* at 466.

162. *Id.* at 452-53.

163. *Id.*

164. *Id.* at 460.

165. *Id.* at 459.

166. *Id.* at 460.

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Indeed, from 1993 to 2001, the percentage of returns that were examined from tax-exempt organizations decreased from 2.5% to 0.7%, and remained at 0.7% until 2003.¹⁶⁷

For-profit corporations receive much closer monitoring, especially in the post-Enron era. First, the for-profit sector is subjected to the Sarbanes-Oxley Act, which instituted a host of requirements aimed at improving corporate governance. Requirements include disclosure of certain financial records, independent audit committees, prohibitions on certain transactions between the corporation and managers, and increased civil and criminal penalties for securities fraud.¹⁶⁸ Second, as discussed above, attorney generals are more focused on corporate misconduct and thus monitor for-profit corporations much more closely than nonprofits.¹⁶⁹ Third, for-profit corporations are subject to more regulators than nonprofit entities. In addition to state attorney generals and the IRS, the Securities and Exchange Commission and the United States Department of Justice monitor the for-profit sector.¹⁷⁰ Furthermore, unlike foundations, for-profit corporations are generally liable to their shareholders, beneficiaries, and corporate members.¹⁷¹ Each group has standing and self-interest in monitoring the actions of the corporation.

The difference in the level of monitoring has several effects. First, it is costly to comply with for-profit requirements, especially post-Sarbanes-Oxley. One survey reports that corporations spend on average \$105,000 annually on corporate governance procedures, a 26% increase compared to the period before Sarbanes-Oxley.¹⁷² Second, if an entity engages in misconduct, the likelihood of getting caught is higher as a for-profit entity because of the closer monitoring of nonprofit entities.

a. Limitations to Benefits of Relaxed Monitoring

Aggressive monitoring and regulation is not an issue for Google.org. Google, as a publicly traded company, must already comply with all the regulations placed on for-profit corporations. Google.org would just be an additional variable cost in its compliance budget. Indeed, if it were to adopt tax-exempt status, it could cost Google even more money. Google would need to develop new infrastructure to comply with nonprofit restrictions. As a result, new expertise would likely need to be hired and systems likely overhauled to comply with new nonprofit regulations.

167. *Id.*

168. Pub. L. 107-204, 116 Stat. 745 (2002).

169. *See* Chester, *supra* note 4, at 466.

170. *Id.* at 467.

171. *Id.* at 451.

172. Richard S. Savich, *Cherry Picking Sarbanes-Oxley*, J. ACCT, June 2006, at 71, 73.

IV. BENEFITS OF FOR-PROFIT STATUS

A. For-Profit Benefit #1: Flexibility in Pursuing Philanthropic Goals

The biggest benefit of a for-profit status is that Google.org can operate freely from the restrictions and costs imposed by nonprofit status. This gives Google.org more flexibility in pursuing its charitable goals. Dr. Larry Brilliant, the executive director of Google.org, explains that as a for-profit “Google.org can . . . start companies, build industries, pay consultants, lobby, give money to individuals and make a profit.”¹⁷³

Society benefits from Google.org’s flexibility as well. First, Google.org will be able to invest in projects that traditional nonprofits would normally pass over because of fear of jeopardizing their tax exempt status or of triggering the UBIT. With Google.org as the investor, instead of a typical for-profit corporation, society benefits because the profits from a Google.org project are reinvested in charitable causes rather than being distributed to shareholders. Furthermore, Google.org may possibly provide funding for charitable projects that neither nonprofits (because of the fear of losing nonprofit status), nor for-profits (because of insufficient returns) would normally fund. Google.org, as a for-profit entity, is also able to lobby Congress for policy changes that could have a positive impact on society, as well as support political candidates that champion similar causes.

B. For-Profit Benefit #2: Google.org Losses Can be Used to Shield Google Gains

As a division of Google, Google.org’s losses can be categorized as business expenses under § 26 U.S.C. 162, and can be used to offset profits in other divisions of Google.¹⁷⁴ Google.org’s commercial projects, such as the high mileage car, involve substantial research and development, and therefore, it is likely that these projects will generate losses in the early years of production. These losses can serve as a legitimate tax shelter for income generated in more profitable Google divisions.

C. For-Profit Benefit #3: Avoidance of Accumulated Earnings Tax

Google.org’s for-profit status also allows Google to retain control over how its profits are invested, while avoiding potential tax liability under 26 U.S.C. § 532. Section 532 prevents individual stockholders from avoiding income tax by accumulating profits in a corporation.¹⁷⁵ In effect, the tax prevents corporations from shielding its shareholders from income tax liability

173. Hafner, *supra* note 9.

174. *See* 26 U.S.C. § 162 (2006).

175. *See* 47A C.J.S. *Internal Revenue* § 382 (2007); *see also* 26 U.S.C. § 532 (2006).

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by keeping profits in corporate coffers.

The most essential factor in determining whether the accumulated earnings tax shall apply is whether the corporation has a reasonable business need for accumulating profits.¹⁷⁶ If the corporation cannot prove a reasonable business need, then the corporation's accumulated profits shall be taxed.¹⁷⁷ To determine whether a corporation has a reasonable business purpose for accumulating profits, in depth analysis of the corporation's financial records and business plans is necessary.¹⁷⁸

Although no thorough investigation has been done to determine whether Google's accumulated profits would trigger § 532, cash-rich tech companies, such as Google and Microsoft, often have substantial amounts of accumulated earnings that would put them close to the § 532 threshold. For example, in 2002, Microsoft faced an accumulated profits problem when the company was "sitting atop \$36 billion in cash and short-term securities."¹⁷⁹

Google could avoid the accumulated profits tax by increasing the dividend amount distributed to shareholders, or making charitable donations. Both distributions would lower Google's accumulated profits. These options, however, also require that Google give up control of its money. Google.org allows Google to use the money how it wants to, and reduce accumulated profits simultaneously. Of course, Google could also retain control of the investments by creating additional business reasons to spend down its profits. This option, however, does not carry the added benefit of the "halo effect" that Google.org investments provide. In sum, with Google.org, Google is able to retain control of how profits are invested, avoid potential accumulated earnings tax liability, and enhance its public image.

D. For-Profit Benefit #4: Increased Business Diversification

Google.org also helps Google diversify its business. Google.org will likely be investing in market-based projects that have potential to earn significant profits. Although Google has pledged to reinvest all of Google.org's profits in charitable causes, Google.org projects could become another source of income for Google in desperate times, such as in the seemingly-unlikely event that its internet business fails. Google could also become a developer of environment friendly technology. This would require Google to break its promise to reinvest Google.org's profits in charitable causes, but in a financially dire situation Google.org might be able to sustain

176. 47A C.J.S. § 382 *supra* note 175; *see also* Boris Bittker & Lawrence Lokken, *Accumulated Earnings Tax*, in FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ch. 99.1 (Warren, Gorham & Lamont, 3d ed. 2005).

177. *See* Bittker & Lokken, *supra* note 176.

178. *Id.*

179. Rebecca Buckman, *Microsoft Has the Cash, and Holders Suggest a Dividend*, WALL ST. J., Jan. 2, 2002, at C1.

Google's business.

V. CONCLUSION

Google's decision to create a for-profit charitable entity was well planned. Google had little to lose by foregoing nonprofit status, and much to gain from electing for-profit status. Given its plans to invest in entrepreneurial, market-based projects, it is unclear whether Google.org could have even qualified for tax exemption; and if it did qualify, it is unclear how much of its income would have escaped the UBIT. Furthermore, the tax deduction for donations has little value, since Google can deduct its expenditures under § 162 and Google.org is not in need of third party donors. In addition, Google's favorable public brand image makes the "halo effect" benefits less important. Finally, Google.org would not have benefited from less stringent regulations as a nonprofit, because Google.org already has the infrastructure established to comply with for-profit requirements.

On the other hand, for-profit status gives Google.org much more flexibility in its philanthropic efforts. As a for-profit entity, it frees itself from all the requirements and restrictions associated with being a nonprofit, including the extra restrictions associated with being a non-operating foundation. This freedom allows Google.org to invest in projects nonprofits normally would avoid, as well as pursue a wider range of political strategies. This flexibility ultimately benefits society. In addition, for-profit status helps Google avoid tax liability under the accumulated earnings tax and helps Google diversify its business activities.

Google.org, however, is unlikely to revolutionize the world of corporate philanthropy because the for-profit charitable approach would not be the best choice for every corporation. Corporations with poor public images that need the "halo effect" benefits will more likely opt for traditional nonprofit status. In addition, corporations with more traditional charitable goals will likely choose nonprofit status, since their projects, unlike Google.org's market-based project, will unquestionably receive tax exempt treatment. Finally, large, broadly-held companies with a weaker social mission are less likely to create a for-profit charity, like Google.org, because these companies will have difficulty justifying the "double bottom-line" to shareholders who are primarily concerned about profits.¹⁸⁰ Therefore corporations should assess their needs and their philanthropic goals before deciding whether or not to implement the Google.org model.

180. Although broadly-held, when it went public, Google clearly gave notice to prospective investors of its 1% commitment to charitable causes. The company's prior warning protected it from a shareholder derivative suit against the managers.