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Taxing Social Impact Bonds

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TAXING SOCIAL IMPACT BONDS

by

Orly Mazur*

ABSTRACT

An exciting new way to fund social services has recently emerged. This new financing mechanism, called a social impact bond (SIB), has the potential to help us tackle some of our nation's most challenging social problems. Broadly speaking, a SIB is a type of "pay-for-success" contract where private investors provide the upfront capital to finance a social program, but only recoup their investment and realize returns if the program is successful. Like any new financing instrument, SIBs create numerous regulatory challenges that have not yet been addressed. One unresolved issue is the tax implications of a SIB investment. This Article argues that the current law allows for multiple possible characterizations of the SIB arrangement for tax purposes. This uncertainty as to the correct characterization of a SIB investment can affect a private investor's ultimate tax liability and subject the investor to an unnecessary audit risk. A SIB investment can also expose a nonprofit investor to additional taxes or, possibly, even cause it to lose its tax-exempt status. Despite the potentially substantial tax implications of a SIB investment, no guidance exists on this issue. This Article is the first to analyze the federal income tax consequences to investors who participate in a SIB-funded program. It concludes that SIB arrangements should generally be classified

* Assistant Professor of Law, SMU Dedman School of Law. I am grateful to the participants of the Southeastern Association of Law Schools, the Texas Tax Faculty Workshop, and the Junior Tax Scholars Workshop for their helpful feedback. I also want to extend my gratitude to Christopher Hanna, Susan Morse, Shu-yi Oei, Bret Wells, and Sharon Sulami for their insightful comments on various drafts and to Hannah Mason, Cassie DuBay, and Timothy Gallina for their research assistance. I would also like to thank the John C. Biggers Faculty Research Fund and the SMU Dedman School of Law Dean Jennifer Collins for their valuable support in this research. Finally, I would like to thank Clayton Fuller for introducing me to social impact bonds and asking the simple question, "How are these instruments taxed?"

as contingent debt instruments under the current tax law but that it may be appropriate to bifurcate the transaction in the case of nonprofit investors. To address the substantial tax uncertainty created by the current law, this Article also argues that Internal Revenue Service guidance is ultimately necessary and suggests ways to structure the SIB arrangement to minimize the risk of any negative tax implications until such guidance is issued. Doing so will hopefully encourage investors to invest in SIBs and thereby unlock an additional source of capital to fund much needed social services.

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INTRODUCTION

Unemployment, healthcare, education, homelessness, and crime are among the most pressing problems facing our nation today.¹ Yet, because of budget constraints, political pressures, inefficient use of existing resources, and ineffective programs, we are not likely to solve, or even adequately address, these social problems anytime soon. The good news is a new way to fund social services has emerged, which may help improve social outcomes and tackle these issues. This innovative financing mechanism is called a social impact bond (SIB), and it has recently gained popularity both in the United States and abroad.²

Broadly speaking, a SIB is a type of “pay-for-success” contract.³ It is an arrangement where private investors provide the upfront capital to finance

1. See Sir Ronald Cohen & Matt Bannick, *Is Social Impact the Next Venture Capital?*, FORBES (Sep. 20, 2014, 11:00 AM), <http://www.forbes.com/sites/realspin/2014/09/20/is-social-impact-investing-the-next-venture-capital/#340521c32b90>; Lydia Saad, *Cluster of Concerns Vie for Top U.S. Problem in 2014*, GALLUP (Jan. 2, 2015), <http://www.gallup.com/poll/180398/cluster-concerns-vie-top-problem-2014.aspx> (describing the top issues that Americans view as the country’s most important problems in 2014).

2. See Ron Davies, *Social Impact Bonds: Private Finance That Generates Social Returns*, BRIEFING (Eur. Parliamentary Research Serv.), Aug. 28, 2014, <http://www.europarl.europa.eu/EPRS/538223-Social-impact-bonds-FINAL.pdf> (noting that SIB-financed programs have been launched in the United States, Australia, and the United Kingdom and are beginning to be created in other European countries, including the Netherlands, France, and Germany).

3. Benjamin R. Cox, *Financing Homelessness Prevention Programs with Social Impact Bonds*, 31 REV. BANKING & FIN. L. 959, 964 (2012); John Hartley, *Social Impact Bonds Are Going Mainstream*, FORBES (Sep. 15, 2014, 1:59 PM), <http://www.forbes.com/sites/jonhartley/2014/09/15/social-impact-bonds-are-going->

a social program but only recoup their investment and realize returns if the program is successful.⁴ Unlike the traditional method of funding social services with government funds, a SIB uses private sector funds to provide the initial capital to finance social programs.⁵ The government is only liable for repaying these investors if the social program is successful in achieving predetermined social outcomes, which generally also have the added advantage of producing public sector savings and benefits.⁶ But if the program does not achieve the agreed-upon policy goals, the government retains its funds and the investor loses its capital.⁷

Like any new financing instrument, SIBs create numerous regulatory challenges that have not yet been addressed.⁸ One such challenge is determining how SIBs are taxed. Currently, the federal income tax

mainstream/#17ad409217d5; Ashley Pettus, *Pay for Progress: Social Impact Bonds*, HARV. MAG., Jul.–Aug. 2013, at 12, <http://harvardmagazine.com/2013/07/social-impact-bonds>. Although the terms “SIB” and “pay-for-success” bond or contract are often used interchangeably, they are not always synonyms. JITINDER KOHLI ET AL., CTR. FOR AM. PROGRESS, WHAT ARE SOCIAL IMPACT BONDS: AN INNOVATIVE NEW FINANCING TOOL FOR SOCIAL PROGRAMS 2 (2012), http://cdn.americanprogress.org/wp-content/uploads/issues/2012/03/pdf/social_impact_bonds_brief.pdf. A SIB is a type of pay-for-success contract because the investors’ returns are tied solely to successful outcomes. *Id.* at 2. However, a pay-for-success contract is not necessarily a SIB because a pay-for-success contract does not always involve outside investors. It instead may be a performance-based agreement directly between the government and the service provider. *See id.* Moreover, only a portion of the government payments may be tied to accomplishing successful outcomes rather than the entire amount of government funds, such as in the case of traditional performance contracting where bonus payments are available to service providers that meet certain performance benchmarks. *Id.*

4. *See* KOHLI ET AL., *supra* note 3, at 1; SOC. IMPACT ARCHITECTS, AN OVERVIEW OF SOCIAL IMPACT BONDS IN THE UNITED STATES (2012), <http://socialimpactarchitects.com/wp/wp-content/uploads/2013/01/Overview-of-Social-Impact-Bonds-111122.pdf>.

5. KOHLI ET AL., *supra* note 3, at 1.

6. *See* Cox, *supra* note 3, at 961; *Pay for Success Financing*, 9 COMMUNITY DEV. INV. REV., no.1, 2013 (issue containing various articles regarding pay-for-success transactions, including SIBs); SOC. IMPACT ARCHITECTS, *supra* note 4.

7. *See* KOHLI ET AL., *supra* note 3, at 1.

8. SIBs also raise numerous policy issues that are beyond the scope of this Article. The focus of this Article is primarily on the tax treatment of SIBs. For a discussion of various tax policy issues, including whether favorable tax treatment should be extended to SIBs, see Orly Mazur, *Social Impact Bonds: A Tax-Favored Investment?* (Mar. 14, 2017) (unpublished manuscript) (on file with author).

consequences to investors who participate in a SIB-funded program are unclear, and no guidance or scholarly discussion exists on this issue.⁹

This Article fills the gap in the literature by examining the tax consequences that result from investing in SIBs. It does so by comprehensively analyzing how investments in SIBs are potentially taxed under the current law from a doctrinal perspective and discussing the tax uncertainties that SIB investments raise. Specifically, it argues that although the tax consequences to private investors who participate in a SIB-funded program significantly depend on the characterization of the transaction for tax law purposes, the current law allows for multiple possible tax characterizations of the SIB arrangement. Plausible characterizations of a SIB arrangement include a debt instrument, a corporate equity instrument, a joint venture, and a derivative instrument. These various characterizations will result in key tax differences that could significantly impact the private investor's bottom-line profits and may result in similarly situated taxpayers being taxed differently. A SIB investment also creates potential conflicts with the private inurement doctrine, the private benefit doctrine, and the various excise taxes applicable to private foundations, which means that a SIB investment could also expose a nonprofit investor to additional taxes or, possibly, even cause it to lose its tax-exempt status.

9. Because these instruments are just now emerging, substantial scholarship has not yet been generated discussing the many issues that SIBs raise. To date, the scholarship has primarily focused on issues relating to the implications for nonprofits' involvement in SIBs, securities laws issues, the potential implications of SIBs, and the potential pitfalls. *See, e.g.,* 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 (2013) (examining SIBs from the perspective of a nonprofit organization and answering the question of whether the profit margin that the private investors may achieve would qualify as an impermissible private benefit that would allow the Service to revoke a participating nonprofit's tax-exempt status); Kevin W. Humphries, Comment, *Not Your Older Brother's Bonds: The Use and Regulation of Social-Impact Bonds in the United States*, 76 *L. & CONTEMP. PROBS.* 433 (2014) (discussing the likely characterization of SIBs for purposes of securities law and arguing that SIBs may require the issuance of new regulations to ensure the optimization of public SIB investment and reduce the likelihood of fraud in the offering of SIBs and the implementation of SIB-financed projects).

In addition, no publicly available tax opinions exist with respect to any of the currently launched SIB projects. Thus, it is also unclear how practitioners are approaching this issue. The author's discussion with various parties involved in SIB projects launched in the United States also reaffirms that a lot of uncertainty exists in determining the income tax implications of a SIB investment.

As SIBs continue to grow in popularity, there is a pressing need to resolve this issue to prevent the tax law from discouraging investments in SIBs and to ensure that the appropriate amount of tax revenue is collected from SIB investments. Thus, given the potential importance of SIBs to the public sector and the social policy goals that they fund, the Internal Revenue Service (Service) should issue a Notice or Revenue Ruling that confirms the tax results for SIBs. Until such guidance is issued, this Article argues that, although these instruments contain features that are indicative of debt, equity, and charity, SIBs should generally be classified as contingent debt instruments under the current tax law and that it may be appropriate to bifurcate the transaction in the case of nonprofit investors. The Article also suggests methods to structure the SIB arrangement to minimize some of the negative tax implications that a SIB investment potentially raises for investors.

The Article proceeds as follows: Part I describes the traditional SIB model. It discusses some possible modifications to the traditional model and provides an example of a SIB-financed project that has been launched in the United States to illustrate the tax issues that a SIB investment raises. Part II applies the traditional debt-equity analysis to argue that the current law allows for multiple possible characterizations of the SIB arrangement for tax purposes. Parts III and IV analyze the federal income tax consequences to private investors and nonprofit investors, respectively, who invest in SIBs under the traditional SIB model.¹⁰ Finally, Part V concludes with recommendations as to the most appropriate tax treatment under the current law and tax planning suggestions. By doing so, this Article seeks to minimize the substantial tax uncertainty that SIB investors face and thereby encourage participation in this innovative financing mechanism. With this additional source of capital, SIB-financed programs can potentially make a meaningful impact on some of our nation's most challenging social problems.

I. WHAT IS A SOCIAL IMPACT BOND?

Although SIBs may be structured in various ways, the majority of the SIBs launched in the United States have a similar structure.¹¹ This Part

10. This Article discusses the relevant tax considerations related to SIBs in an attempt to add to the scholarly discussion in this area. However, investors are encouraged to seek advice about their specific tax consequences from their tax advisor.

11. See, e.g., John Olson & Andrea Phillips, *Rikers Island: The First Social Impact Bond in the United States*, 9 COMMUNITY DEV. INV. REV., no.1, 2013, at 97, 99 (describing the SIB launched in New York City that utilized MDRC, an intermediary, to oversee the project implementation and manage the service providers); FACT SHEET: THE MASSACHUSETTS JUVENILE JUSTICE PAY FOR SUCCESS INITIATIVE, <http://www.goldmansachs.com/our-thinking/trends-in-our-business/massachusetts->

describes the currently prevailing SIB model, as well as some common modifications to the model. It then discusses a SIB that has been launched in the United States to illustrate the tranche investment structure that is often used in practice and to highlight the tax issues that these new instruments raise.

A. *The Traditional SIB Model*

Under the most common SIB model, a government agency enters into a contractual agreement with an intermediary organization to implement a SIB-funded program to address a particular social problem.¹² For instance, a government entity might decide it wants to reduce recidivism at a certain prison or jail or it wants to reduce homelessness in a particular area. Its contractual agreement with the intermediary would specify the objectives of this program, the specific target populations, the method and amount of funding, the duration of the SIB-funded program, and the terms of the investment.¹³ Importantly, the agreement would also specify that the government is to transfer funds to the intermediary if the program is successful

social-impact-bond/MA-juvenile-justice-pay-for-success-initiative.pdf (last visited Apr. 29, 2017) [hereinafter MASS. FACT SHEET] (providing that Third Sector Capital Partners, an intermediary, will effectively serve as the prime contractor for the SIB launched in Massachusetts).

12. See Cox, *supra* note 3, at 965; SOC. IMPACT ARCHITECTS, *supra* note 4. Generally, the government agency initiates a SIB by selecting the social issue that it wants to address with SIB financing. See EMILIE GOODALL, BRIDGES IMPACT+, CHOOSING SOCIAL IMPACT BONDS: A PRACTITIONER'S GUIDE 13 (2014), https://data.gov.uk/sib_knowledge_box/sites/default/files/Bridges%20SIB%20Report%20-%20a%20Practitioner's%20Guide.pdf. However, it is also possible for an intermediary organization or a service provider to reach out to the relevant government agency about addressing a particular social problem through a SIB-funded program. The government agency would then decide whether to launch a SIB to address this social problem. See *id.*

13. See e.g., 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> [hereinafter Mass. Contract] (defining the terms of the SIB launched in Massachusetts to target juvenile recidivism); Pay for Success Intermediary Agreement between N.Y. State Dep't. of Labor, Soc. Fin., Inc., & Soc. Fin. N.Y. State Workforce Re-Entry 2013 Manager, Inc. (Oct. 1, 2013), http://www.payforsuccess.org/sites/default/files/resource-files/pfsmainagreement_sched_0314.pdf [hereinafter N.Y. Agreement] (defining the terms of the SIB contract between N.Y. State Department of Labor and the intermediary to improve social outcomes).

and would identify the performance thresholds, method of performance evaluation, and the payment schedule, among other key payment terms.¹⁴

The intermediary, typically a nonprofit organization, often serves in a dual role of fiscal agent and project manager.¹⁵ As fiscal agent, the intermediary raises capital from investors to fund the social services.¹⁶ It does so by selling to private investors and philanthropic organizations an instrument whose repayment is contingent upon the success of a particular social program.¹⁷ The investors thereby provide the upfront financing for the social program and assume the financial risk if the targeted social outcomes are not met by the service provider(s).¹⁸

The intermediary, in its role as project manager, essentially also serves as the prime contractor for the project. It is generally responsible for selecting the qualified service provider(s), typically nonprofit agencies,¹⁹ to deliver the

14. See KOHLI ET AL., *supra* note 3. The contractual agreement specifies how the government will fund the payments if the program is successful. In some cases, the federal government or a philanthropic organization may finance a portion of these costs. See, e.g., MASS. FACT SHEET, *supra* note 11 (describing that any success payments will be paid by the Commonwealth of Massachusetts's Social Innovation Trust Fund and supplemented by a U.S. Department of Labor pay-for-success grant); INVESTING IN WHAT WORKS: "PAY FOR SUCCESS" IN NEW YORK STATE: *INCREASING EMPLOYMENT AND IMPROVING PUBLIC SAFETY*: FACT SHEET (2014), http://social.finance.org/content/uploads/PFSFactSheet_0314.pdf [hereinafter N.Y. FACT SHEET] (stating that if the program is successful a portion of the funds paid to the intermediary will be financed by a grant awarded to New York State by the U.S. Department of Labor). The government generally is also responsible for paying administrative costs, such as the intermediary's service fees, regardless of whether the program is successful. See ADRIANA BARAJAS ET AL., PRINCETON UNIV. PUB. POLICY & INT'L AFFAIRS PROGRAM, *SOCIAL IMPACT BONDS: A NEW TOOL FOR SOCIAL FINANCING* (2014), <https://www.princeton.edu/sites/default/files/content/Social%20Impact%20Bonds%202014%20Final%20Report.pdf>.

15. See Cox, *supra* note 3, at 966; Pettus, *supra* note 3; see also, e.g., MASS. FACT SHEET, *supra* note 11 (describing the intermediary's role as fiscal agent and project manager); GOODALL, *supra* note 12, at 39 (describing the intermediary's role as working with the government to structure the SIB, selecting the service providers, and providing ongoing performance management services).

16. See BARAJAS ET AL., *supra* note 14, at 13.

17. See Cox, *supra* note 3, at 966.

18. See SOC. IMPACT ARCHITECTS, *supra* note 4; Nonprofit Finance Fund, *Basics*, PAY FOR SUCCESS, <http://www.payforsuccess.org/learn/basics/> (last visited Apr. 29, 2017).

19. The SIBs currently implemented in the United States generally have utilized nonprofit entities as the service providers. See, e.g., INVESTING IN WHAT WORKS: "PAY FOR SUCCESS" IN NEW YORK STATE: *INCREASING EMPLOYMENT AND IMPROVING PUBLIC SAFETY*: DETAILED PROJECT SUMMARY 16 (2014), <http://doc>

SIB-financed social services to the target population. In this role, the intermediary also coordinates the multiple SIB stakeholders and oversees the operation of the SIB-funded program.²⁰

Finally, after a fixed period of time, an independent evaluator measures the success of the program according to a predetermined rigorous evaluation methodology.²¹ If the evaluator determines that the social service provider is successful in achieving the agreed-upon outcomes, then the government repays the investors their original capital plus a return on their investment.²² The financial return often depends on the extent to which social outcomes improve and on the expected public sector savings.²³ However, if the program is unsuccessful, then the government pays the investors nothing and the investors lose their entire investment.²⁴

The following diagram illustrates the structure of the currently prevailing SIB model in the United States.²⁵

player.net/8280615-Investing-in-what-works-pay-for-success-in-new-york-state-increasing-employment-and-improving-public-safety.html [hereinafter N.Y. PROJECT SUMMARY] (identifying the service provider as Center for Employment Opportunities, a nonprofit employment service agency for formerly incarcerated individuals); FACT SHEET: THE CUYAHOGA PARTNERING FOR FAMILY SUCCESS PROGRAM, http://www.thirdsectorcap.org/wp-content/uploads/2014/12/141204_Cuyahoga_PFS_Fact-Sheet.pdf [hereinafter CUYAHOGA FACT SHEET] (identifying FrontLine Service, a nonprofit entity, to provide services to address homelessness). However, this role can technically also be performed by for-profit entities.

20. See Nonprofit Finance Fund, *supra* note 18.

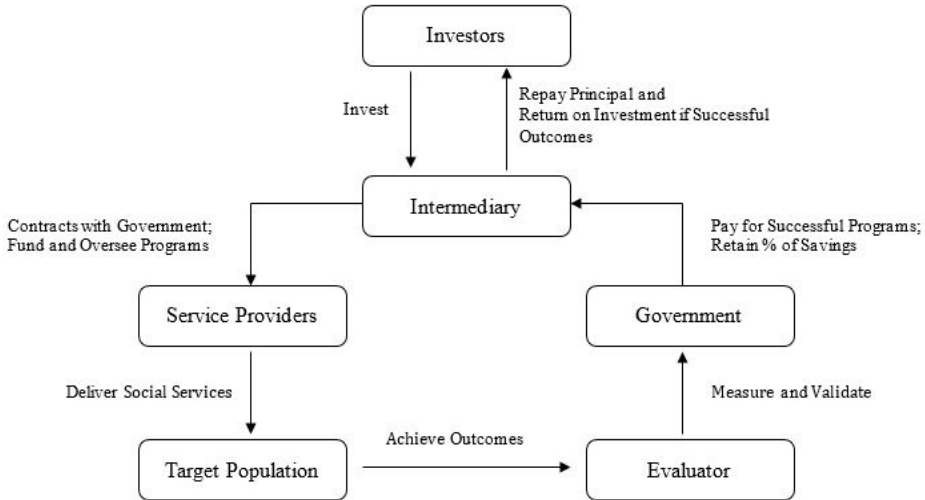
21. See BARAJAS ET AL., *supra* note 14, at 14; Nonprofit Finance Fund, *supra* note 18. The evaluator is generally selected by the government and intermediary together but paid for directly by the government. See BARAJAS ET AL., *supra* note 14, at 14. In addition to an evaluator, an independent third party generally validates that the evaluator accurately measured the results of the program. See Sarah Gillespie, *6 Ways to Strengthen PFS Evaluations*, URB. INST., <http://pfs.urban.org/pay-success/pfs-perspectives/6-ways-strengthen-pfs-evaluations> (last visited Apr. 29, 2017).

22. See KOHLI ET AL., *supra* note 3, at 2; Davies, *supra* note 2, at 3.

23. See LISA BARCLAY & TOM SYMONS, SOC. FIN., *A TECHNICAL GUIDE TO DEVELOPING SOCIAL IMPACT BONDS* (2013), <http://www.socialfinance.org.uk/wp-content/uploads/2014/05/Technical-Guide-to-Developing-Social-Impact-Bonds1.pdf>; SOC. IMPACT ARCHITECTS, *supra* note 4.

24. See KOHLI ET AL., *supra* note 3, at 3.

25. Diagram based on Nonprofit Finance Fund, *supra* note 18.



B. Common Modifications

The managed SIB structure, which is the SIB model described above, is currently the prevailing model in the United States, but it is not the only way to structure a SIB. Even though SIBs share some common attributes, they are not all identical. Moreover, additional variations are likely to result as the SIB model continues to evolve.

For instance, other emerging SIB structures worldwide include the direct SIB structure and the intermediated SIB structure.²⁶ Both variations eliminate or minimize the use of a project intermediary.²⁷ In the direct SIB structure the government enters into a contract directly with the service provider instead of through an intermediary organization.²⁸ Similarly, in the intermediated SIB structure, the arrangement also generally forgoes the use of an intermediary because the government enters into a contract directly with investors through an investor-owned special purpose vehicle that is set up specifically to deliver the SIB program.²⁹ This type of SIB is often structured as an equity investment in a social impact entity.

Another common variation to the SIB model is a SIB arrangement that uses two separate intermediaries instead of one organization that performs the dual role of fiscal agent and project manager.³⁰ Under this variation, one

26. See GOODALL, *supra* note 12, at 20.

27. See *id.*

28. See *id.*

29. See BARCLAY & SYMONS, *supra* note 23; GOODALL, *supra* note 12, at 20.

30. See Nonprofit Finance Fund, *supra* note 18.

entity, such as an investment bank, placement agent, or other type of financial intermediary, would serve as the fiscal agent and raise the capital to finance the SIB project. A separate entity would act as the project manager that oversees the service providers and manages the different SIB stakeholders. It is possible for a for-profit organization, such as a professional management company, to undertake this role instead of using the traditional nonprofit entity as the project intermediary.³¹

In addition, a SIB structure may deviate from the traditional SIB model outlined above by including various risk mitigating provisions. One common risk-mitigation provision is a guarantee that limits the investors' downside exposure. For instance, the SIB launched in New York State in 2013 included a first loss guarantee facility provided by a third party that limited an investor's potential loss from an unsuccessful program to 90% instead of 100% of its initial investment.³² Similarly, the SIB launched in New York City in 2012 also included a guarantee, which served to significantly limit an investor's exposure to only a 25% loss of investment.³³ Other possible risk-mitigating provisions include the provision of collateral in an adequately valued asset, an interest in reserve funds, first-loss provisions, and other credit-enhancing methods.

C. Massachusetts SIB: The Tranche Loan Structure

As of February 2016, 11 SIB-funded projects have been announced in the United States with many more anticipated to launch in the near future.³⁴

31. See Cox, *supra* note 3, at 966–67; THIRD SECTOR CAPITAL PARTNERS, PAY FOR SUCCESS/SOCIAL IMPACT BONDS: RFI 5 (June 10, 2011), http://www.thirdsectorcap.org/wp-content/uploads/2012/07/Third-Sector-RFI_response.pdf.

32. See N.Y. PROJECT SUMMARY, *supra* note 19, at 5, 17. However, the terms of the guarantee provided that the first loss protection did not apply to all investors but only to non-national or regional foundation investors. See *id.* at 5.

33. See Olson & Phillips, *supra* note 11, at 99.

34. Olson & Phillips, *supra* note 11, at 97; see CONNECTICUT FAMILY STABILITY PAY FOR SUCCESS PROJECT: FACT SHEET, [http://www.ct.gov/DCF/lib/DCF/socialimpactbonds/pdf/ct_family_stability_pfs_fact_sheet_vfinal_\(2\).pdf](http://www.ct.gov/DCF/lib/DCF/socialimpactbonds/pdf/ct_family_stability_pfs_fact_sheet_vfinal_(2).pdf); CUYAHOGA FACT SHEET, *supra* note 19; FACT SHEET: DENVER SOCIAL IMPACT BOND PROGRAM TO ADDRESS HOMELESSNESS, <http://www.csh.org/wp-content/uploads/2011/12/Denver-SIB-FactSheet.pdf>; MASS. FACT SHEET, *supra* note 11; N.Y. FACT SHEET, *supra* note 14; FACT SHEET: PROJECT WELCOME HOME, http://www.thirdsectorcap.org/wp-content/uploads/2015/08/150811_SCC-CH-PFS_Fact-Sheet.pdf (Santa Clara County, California); FACT SHEET: SOUTH CAROLINA NURSE-FAMILY PARTNERSHIP PAY FOR SUCCESS PROJECT, https://www.scdhhs.gov/sites/default/files/2-16-16-SC-NFP-PFS-Fact-Sheet_3.pdf; FACT SHEET: THE UTAH HIGH QUALITY PRESCHOOL PROGRAM: AMERICA'S FIRST "RESULTS-BASED FINANCING" FOR EARLY

The majority of the SIBs currently launched in the United States have been structured as loans from investors to the project's intermediary organization, which then disburses the funds to the service provider(s). The SIB-funded program that was recently launched in Massachusetts (the Massachusetts SIB) was structured in this manner.³⁵ More specifically, the Massachusetts SIB used a tranche loan structure. The following section describes its key investment terms.

The Massachusetts SIB was launched in order to reduce recidivism and improve employment outcomes for former juvenile inmates.³⁶ To finance the project, investors³⁷ commit to transfer approximately \$18 million to the intermediary, referred to as the "borrower," in the form of loans and/or grants, which the intermediary will periodically disperse to the service provider for a period of approximately six years.³⁸ These investors include Goldman Sachs

CHILDHOOD EDUCATION, <https://hceconomics.uchicago.edu/sites/default/files/pdf/events/Salt%20Lake%20City%20PFS%20Fact%20Sheet%20%20%28FINAL%2010-28-13%29.pdf> [hereinafter UTAH PRESCHOOL FACT SHEET]; see also CONNECTICUT FAMILY STABILITY PAY FOR SUCCESS PROJECT: FREQUENTLY ASKED QUESTIONS, http://www.ct.gov/dcf/lib/dcf/socialimpactbonds/pdf/ct-family-stability-pfs_faq_vfinal.pdf; Press Release, Mayor's Press Office, City of Chi., Mayor Emanuel Announces Expansion of Pre-K to More Than 2,600 Chi. Public School Child. (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; Press Release, Office of the Governor, Massachusetts Launches Pay for Success Initiative to Reduce Chronic Individual Homelessness, (Dec. 8, 2014), <http://archives.lib.state.ma.us/bitstream/handle/2452/217588/ocn795183245-2014-12-08b.pdf?sequence=1&isAllowed=y>.

35. The Commonwealth of Massachusetts launched its Juvenile Justice SIB in 2014 in partnership with Youth Services Inc. as the intermediary, Roca Inc. as the service provider, and several private investors. See Mass. Contract, *supra* note 13, at 1. Youth Services Inc. is a not-for-profit corporation created by Third Sector Capital Partners, Inc. to serve as its supporting organization for this specific project. See MASS. FACT SHEET, *supra* note 11; Mass. Contract, *supra* note 13, at 1, 9, 32, H-1. Third Sector Capital Partners will assist Youth Services Inc. by providing project management and advisory services. Mass. Contract, *supra* note 13, at H-2. New Profit Inc., a national venture philanthropy fund and social innovation organization, is working with the intermediary to provide additional fiscal support for the project. MASS. FACT SHEET, *supra* note 11.

36. See MASS. FACT SHEET, *supra* note 11; Mass. Contract, *supra* note 13, at 1.

37. The project documents collectively refer to the investors as "funders" or the "funding parties." See MASS. FACT SHEET, *supra* note 11; Mass. Contract, *supra* note 13.

38. See MASS. FACT SHEET, *supra* note 11; Mass. Contract, *supra* note 13, at A-2, A-3, app. H. Specifically, the funds will be used by the intermediary to pay the

(the Senior Lender), which is providing up to nine million in senior loan financing, subject to a five percent annual stated interest rate.³⁹ An additional three million in financing will come from two philanthropic foundations (the Junior Lenders) in the form of multiple-draw subordinate loans, bearing a two percent annual stated interest rate.⁴⁰ Six million dollars in financing will come in the form of philanthropic grants from the Laura and John Arnold Foundation, New Profit, and The Boston Foundation.⁴¹ Moreover, the intermediary and service provider are also contributing to the project in the form of deferred service fees. Specifically, each has agreed to defer a portion of its service fees so that they are only paid if the performance thresholds are met.⁴²

The Senior Lender and Junior Lenders (collectively, the lenders) have agreed to bear the majority of the financial risk associated with the program implementation.⁴³ According to the project documents, the Commonwealth of Massachusetts will only make payments to the intermediary, which will then be disbursed to the investors, if the project is determined to be successful based on predetermined performance metrics.⁴⁴ If the project satisfies the agreed-

service provider agreed-upon fees related to the project. Mass. Contract, *supra* note 13, at app. H.

39. MASS. FACT SHEET, *supra* note 11; Mass. Contract, *supra* note 13, at H-2. Goldman Sachs is providing the funds through its wholly owned entity, Goldman Sachs Social Impact Fund, L.P. See Mass. Contract, *supra* note 13, at H-2. The investment is structured as a multiple draw social impact loan. See *id.*

The duration of the investment is 25 quarters, or six years and three months. Mass. Contract, *supra* note 13, at app. H. However, the duration of the loan may be less if an event of default occurs or if the lenders exercise their option to discontinue the funding. See *id.*

40. MASS. FACT SHEET, *supra* note 11; Mass. Contract, *supra* note 13, at H-2.

41. MASS. FACT SHEET, *supra* note 11; Mass. Contract, *supra* note 13, at H-2.

42. MASS. FACT SHEET, *supra* note 11; Mass. Contract, *supra* note 13, at app. H.

43. By deferring the receipt of their service fees, the intermediary and service provider have also taken on some of the financial risk associated with the project. See Mass. Contract, *supra* note 13, at app. D.

44. See MASS. FACT SHEET, *supra* note 11; Mass. Contract, *supra* note 13, at 12 (“All of the Commonwealth Success Payments made under this Contract are contingent on the achievement of specific outcomes related to reductions in incarceration and improved job readiness and employment outcomes for the Roca Youth. . .”). The Commonwealth of Massachusetts will partially fund these success payments from the proceeds of a grant awarded to the Commonwealth from the U.S. Department of Labor and partially from the Commonwealth’s Social Innovation Financing Trust Fund. MASS. FACT SHEET, *supra* note 11; Mass. Contract, *supra* note 13, at 12–13. The Social Innovation Financing Trust Fund was created by the Massachusetts Legislature to provide the Commonwealth with funds with which to

upon minimum performance thresholds, then the Commonwealth of Massachusetts will make a predetermined payment to the intermediary.⁴⁵ To the extent that these performance metrics are exceeded, the government will make additional payments calculated on a sliding scale on the basis of the expected government budgetary savings from reducing incarceration and increasing employment.⁴⁶ To partially mitigate the investors' risk of repayment, the project documents also provide the lenders a lien and security interest on payments the intermediary receives and has a right to receive from the government.⁴⁷

enter into pay-for-success contracts. *See* MASS. FACT SHEET, *supra* note 11; Mass. Contract, *supra* note 13, at 1, 12–13. These funds are backed by the full faith and credit of the Commonwealth. Mass. Contract, *supra* note 13, at 12.

45. According to the contractual agreement, before any payments will be made by the government and transferred to the lenders, certain performance metrics must be met. Specifically, the agreement requires: (1) at least a 5.2% reduction in the days of incarceration of the target population or (2) an increase in employment by a program participant as compared to the control group. MASS. FACT SHEET, *supra* note 11; Mass. Contract, *supra* note 13, at 13–27. In addition, the government makes payments to the intermediary when a third performance metric is met: an increase in job readiness. This metric is considered achieved when a project participant engages with a Roca youth worker nine or more times. Mass. Contract, *supra* note 13, at 43, A-1. However, any success payments made by the Commonwealth on the basis of this performance metric will be deposited by the intermediary into a separate account and used exclusively by the intermediary to pay the service provider its fees. *Id.* at D-1, app. H. Any remaining funds will be available to pay to the lenders any amounts due to them only at the termination of the contract (the 25th quarter, unless terminated earlier). *Id.* at D-1, app. H. Moreover, although the success payments are technically based on these three performance metrics: reduction in days of incarceration, increases in job readiness, and increases in employment, the majority of the success payments depend on the extent the recidivism outcome metric is satisfied. MASS. FACT SHEET, *supra* note 11; Mass. Contract, *supra* note 13.

46. MASS. FACT SHEET, *supra* note 11.

47. Mass. Contract, *supra* note 13, at app. D, H-4. Specifically, the project documents provide that the intermediary will direct the government to deposit the success payments related to the incarceration outcome metric and employment outcome metric into a separate controlled account. *Id.* The Senior Lender will have a first priority lien and security interest in this controlled account and in the intermediary's right to receive these success payments under the terms of the pay-for-success contract with the Commonwealth of Massachusetts. *Id.* The Junior Lenders will have a second priority lien and security interest in this account. The purpose of these liens and security interest is to secure the intermediary's obligations to the lenders under the contract. *Id.* The intermediary will have the right to withdraw amounts from this account to be paid to the investors and other parties according to the contract terms; provided, however, if an event of default occurs then the Senior

The intermediary will disburse these payments to the investors as follows: on the last business day of each quarter, to the extent of available funds, the intermediary will first pay the Senior Lender any interest that has accrued on the senior loan and then pay the Junior Lenders any interest that has accrued on the junior loan.⁴⁸ Then in the last few quarters of the project, the intermediary will use its available funds to first pay the Senior Lender any additional interest that is due and then to pay interest due to the Junior Lenders.⁴⁹ Any remaining funds will first be used to repay the Senior Lender its principal funding.⁵⁰ If sufficient success payments remain after repaying the senior loan in full, the Junior Lenders will recoup their investment.⁵¹ According to the project terms, the Senior Lender and the Junior Lenders will only recoup their entire capital investment if the third-party evaluator determines that the project has resulted in a 40% decrease in the days that the target population is incarcerated.⁵² Moreover, in the event that the program exceeds this performance threshold, the investors will also receive an additional return on their investment in the form of success fees from the government.⁵³ Specifically, depending on the level of the program's success, the Senior Lender will receive up to approximately one million in success fees and the Junior Lenders collectively will receive up to approximately \$600,000 in success fees.⁵⁴

Lender will have the authority to cause 100% of the amounts in these accounts to be paid to the parties in the order and priority described in the contract. *Id.*

48. *Id.* at app. H.

49. *Id.* Specifically, these additional payments will be made in quarters 18, 19, 21, and 23 of the project. *Id.* The intermediary will not transfer any success payments related to increases in job readiness to the parties. These funds, to the extent remaining, will only be transferred upon the maturity date (i.e., the 25th project quarter). *Id.*

50. *Id.*

51. MASS. FACT SHEET, *supra* note 11.

52. *Id.* The service provider and intermediary will also receive their deferred service fees if at least this level of success is reached. *Id.*

53. *Id.* However, the intermediary will pay the service provider and Third Sector Capital Partners their deferred service fees before the lenders are entitled to payment of any success fees. Mass. Contract, *supra* note 13, at app. H. These payments will be made in quarters 18, 19, 21, and 23, if total success payments made by the government exceed \$14,750,000 and in quarter 25 if total success payments exceed \$14,615,000. *Id.* at app. D, H-12.

54. MASS. FACT SHEET, *supra* note 11; Mass. Contract, *supra* note 13. In addition to the payments made to the lenders, if the project exceeds its target impact and enough funds are available, the service provider will also be paid up to \$1 million. Any remaining success payments will be used to recycle philanthropic funding to support future pay-for-success initiatives and to support the scaling of the project's

II. CHARACTERIZATION OF SIBS

Like any new financing instrument, SIBs create numerous regulatory challenges that have not yet been addressed. One such challenge is determining how the current law taxes SIBs. Although the tax consequences to private investors who participate in a SIB-funded program significantly depend on the characterization of the transaction for tax law purposes, the character of these instruments is not clear under current tax law. Below, I analyze the threshold question of whether SIBs are debt for tax law purposes, and then, having found that the answer is uncertain, I explore alternate possible characterizations under current tax law.

A. Are SIBs Debt?

The determination of whether a financial instrument is debt, equity, or something else for U.S. federal income tax purposes is not always an easy determination to make.⁵⁵ This is especially true in the context of SIBs. Even

service provider. *Id.* at app. D, H-16; *see also* FREQUENTLY ASKED QUESTIONS: THE MASSACHUSETTS JUVENILE JUSTICE PAY FOR SUCCESS INITIATIVE (2014), <http://www.thirdsectorcap.org/wp-content/uploads/2015/03/MA-JJ-PFS-Frequently-Asked-Questions-Revised-Final.pdf>. The total success payments made to all of the parties are capped at \$28 million, thus limiting the funders' potential return on investment. MASS. FACT SHEET, *supra* note 11; Mass. Contract, *supra* note 13, at 12.

55. There is no bright line rule that distinguishes between debt and equity under our tax law, and financial instruments frequently contain a hybrid of debt and equity features. *See* *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968); STAFF OF THE JOINT COMM. ON TAX'N, 113TH CONG., JCS-3-13, REPORT TO THE HOUSE COMMITTEE ON WAYS AND MEANS ON PRESENT LAW AND SUGGESTIONS FOR REFORM SUBMITTED TO THE TAX REFORM WORKING GROUPS 58 (2013); STAFF OF THE JOINT COMM. ON TAX'N, 112TH CONG., JCX-41-11, PRESENT LAW AND BACKGROUND RELATING TO TAX TREATMENT OF BUSINESS DEBT (2011) [hereinafter JOINT COMM. ON TAX'N, BUSINESS DEBT]; Michael S. Farber, *Equity, Debt, Not—The Tax Treatment of Non-Debt Open Transactions*, 60 TAX LAW. 635, 636 (2007); Edward D. Kleinbard & Erika W. Nijenhuis, *Everything I Know About New Financial Products I Learned from DECS*, in 26 PLI CORPORATE TAX PRACTICE SERIES ch. 392 (2010); Bret Wells, *Tax Consequences of Participations in International Trade Finance*, 13 TAX NOTES INT'L 23 (Dec. 2, 1996). Moreover, despite a specific statutory mandate, the Treasury has not yet issued regulations offering general guidance in distinguishing between equity and debt, although it has recently issued regulations requiring documentation for and recharacterization of certain financing arrangements entered into by large, multi-national enterprises. I.R.C. § 385(a); Reg. §§ 1.385-1 to -4T. To further complicate matters, the Service also will ordinarily not

though the capital-raising arrangement between investors and the intermediary in a SIB-funded program is referred to as a “bond,” this label is not dispositive. Instead, to properly characterize for tax purposes the arrangement between the investors and the project intermediary requires an analysis of all of the facts and circumstances related to the arrangement.⁵⁶

In distinguishing debt from equity, factors that are generally considered include:⁵⁷ (1) the parties’ intent, (2) the existence of an unconditional promise to pay at a fixed maturity date, (3) the provision of fixed interest rates, (4) participation in profits, (5) the adequacy of the interest, (6) the source of payments, (7) participation in management, (8) the extent of subordination to the claims of general creditors, (9) the identity of interest between holders of the instrument and owners, (10) satisfaction of the independent creditor test, and (11) the use of the funds.⁵⁸ The goal of this analysis is to determine whether the instrument represents “risk capital entirely subject to the fortunes of the venture,” which would be characterized as equity or, alternatively, whether the instrument represents “an unqualified promise to pay a sum certain on a specified date with fixed interest,” which would be characterized as debt for tax purposes.⁵⁹

The SIB financing transactions launched thus far contain features of both debt and equity. The following analysis describes the factors above and applies each of the factors to the Massachusetts SIB to determine whether SIBs may be characterized as debt under current tax law.

issue advance rulings with respect to whether an interest should be classified as debt or equity. Rev. Proc. 2017–3, at § 4.02(1), 2017–1 I.R.B. 130.

56. See *Fin Hay Realty*, 398 F.2d at 695 (applying a facts and circumstances analysis to determine whether the investment represents debt or equity for tax purposes); JOINT COMM. ON TAX’N, BUSINESS DEBT, *supra* note 55, at 15 (noting that “[c]ourts generally agree that the proper characterization of an instrument requires a facts and circumstances analysis”); Notice 94–47, 1994–1 C.B. 357 (listing factors that may be considered in characterizing a financial instrument for federal income tax purposes).

57. The foregoing list contains a nonexhaustive list of factors that courts generally consider. Different courts may apply a slightly different list of factors to distinguish debt from equity. See JOINT COMM. ON TAX’N, BUSINESS DEBT, *supra* note 55, at 16.

58. See, e.g., I.R.C. § 385(b) (listing possible factors to be set forth in regulations); *Roth Steel Tube Co. v. Comm’r*, 800 F.2d 625 (6th Cir. 1986) (using an 11-factor test); *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972) (applying a 13-factor test); *Fin Hay Realty*, 398 F.2d at 696 (applying a 16-factor test); Notice 94–47, 1994–1 C.B. 357 (outlining eight factors that the Service may consider in classifying an instrument as debt or equity).

59. JOINT COMM. ON TAX’N, BUSINESS DEBT, *supra* note 55, at 15.

1. *The Parties' Intent*

In the case of the Massachusetts SIB, the parties' intentions and the form of the instrument initially points toward debt characterization.⁶⁰ The investment is referred to as a loan from the investors to the project intermediary, and the investors are referred to as "lenders."⁶¹ Moreover, if the intermediary were to issue notes or another instrument of indebtedness, this would strengthen the weight of this factor in favor of debt classification.⁶² Conversely, an absence of notes or other instruments of indebtedness is a strong indication that the instrument is not bona fide indebtedness.⁶³ It is unclear from publicly available documents whether any instrument of indebtedness was issued to the investors of the Massachusetts SIB.

60. The subjective intent of the parties will not change the characterization of an instrument, but the objective facts surrounding an advance will be considered in determining whether the parties intended the advance to constitute debt or equity. *See In re Lane*, 742 F.2d 1311, 1316 (11th Cir. 1984) (quoting *Estate of Mixon*, 464 F.2d at 407).

61. Although the agreement between the investors and the project intermediary is not publicly available, the Pay for Success Contract among the Commonwealth of Massachusetts, the service provider, and the project intermediary provides some evidence of the manner in which the agreement between the project intermediary and the investors is structured. *See* Mass. Contract, *supra* note 13, at app. H (providing an overview of the terms of financing related to the project).

The intent of the parties regarding the treatment of the instrument for nontax purposes, such as regulatory, ratings agency or financial accounting purposes, is sometimes also considered in characterizing the instrument. *See, e.g., Roth Steel Tube*, 800 F.2d at 631 (applying an 11-factor test, that does not include consideration of the nontax treatment of the instrument, to characterize the transaction in question); Notice 94-47, 1994-1 C.B. 357 (indicating the Service considers this factor in distinguishing debt from equity); Paul Carman & Kelley Bender, *Equity or Other: Applying a Binary Analysis in a Multidimensional World*, 107 J. TAX'N 17 (2007) (explaining that this factor is controversial). There is no public information available that indicates how the project intermediary treats the SIB for nontax purposes, but it appears that it is most likely not treated as debt for purposes of the securities laws. *See* Humphries, *supra* note 9.

62. *See Roth Steel Tube*, 800 F.2d at 625; *Estate of Mixon*, 464 F.2d at 403. However, the issuance of notes or bonds would not guarantee debt treatment if the other factors are sufficiently adverse so as to indicate the substance of the instrument is equity. *See Fin Hay Realty*, 398 F.2d at 697-98; William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 461 (1970).

63. *See Roth Steel Tube*, 800 F.2d at 625; *Estate of Mixon*, 464 F.2d at 403.

2. Existence of an Unconditional Promise to Repay at a Fixed Maturity Date

An important consideration in the debt-equity analysis is the existence of an unconditional promise to repay a sum certain at a fixed maturity date.⁶⁴ In the Massachusetts SIB, the investment has a set term of approximately six years.⁶⁵ Generally, the presence of a fixed maturity date to repay principal that is in the reasonably foreseeable future is indicative of debt.⁶⁶ However, in the Massachusetts SIB, the intermediary does not unconditionally promise to repay the investors. Instead, the repayment of principal is contingent on the project satisfying predetermined performance metrics, at which point the government makes payments to the intermediary, which are later disbursed to the investors.⁶⁷ Thus, it is unclear whether this requirement is met.

Moreover, even advances with a maturity date can be characterized as equity when they will not be paid by the due date but instead only when sufficient funds are available, as is the case with the Massachusetts SIB.⁶⁸ The case law also indicates that the existence of a sinking fund to provide for the ultimate repayment of the purported debt or the existence of a security interest in the issuer's funds may suggest that repayment is reasonable and thus debt was intended, unless security is grossly inadequate.⁶⁹ In the Massachusetts SIB, the project documents provide the investors with a security interest in the success payments that the intermediary receives and has a right to receive. But the amount of these payments may be considered inadequate given that the right to these payments is speculative and dependent on the success of the SIB-

64. See *TIFD III-E, Inc. v. United States (Castle Harbour)*, 459 F.3d 220, 235 (2d Cir. 2006); *Stinnett's Pontiac Serv., Inc. v. Comm'r*, 730 F.2d 634, 638 (11th Cir. 1984); *Estate of Mixon*, 464 F.2d at 404; Notice 94-47, 1994-1 C.B. 357; Plumb, *supra* note 62, at 413.

65. Technically, the maturity date is 25 project quarters. Mass. Contract, *supra* note 13, at app. H. However, depending on the availability of funds, some or all of the principal may be repaid prior to this date in quarters 18, 19, 21, and 23. Mass. Contract, *supra* note 13, at app. H.

66. See Notice 94-47, 1994-1, C.B. 357. See also *Stinnett's Pontiac*, 730 F.2d at 638; *Estate of Mixon*, 464 F.2d at 404.

67. See *supra* notes 32-52 and accompanying text.

68. See *Du Gro Frozen Foods, Inc. v. United States*, 481 F.2d 1271, 1272 (5th Cir. 1973); *Wood Preserving Corp. v. United States*, 347 F.2d 117, 119 (4th Cir. 1965); *Provost v. Comm'r*, T.C. Memo 2000-177, 2000 WL 687889, at *7; JAMES S. EUSTICE & THOMAS BRANTLEY, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 4.05[2][b][ii] (2017) (noting that "the greater the risk of default when the day of reckoning finally arrives, the more the purported creditor is locked into the corporation's fortunes in the same manner as a shareholder").

69. See Plumb, *supra* note 62, at 467, 469.

funded project. Because these conditions may indicate that the repayment of the SIB investment is dependent on the success of the venture rather than based on an unconditional promise to repay the debt at a fixed maturity date, it is possible that this factor may support equity characterization.⁷⁰

3. *The Provision of Fixed Interest Rates*

Similarly, a provision for a fixed rate of interest that is paid regardless of whether the entity has profits or losses is another factor the courts consider as indicative of debt.⁷¹ The Massachusetts SIB provides for the payment of interest that accrues at a rate of five percent with respect to the advances made by the Senior Lender and two percent with respect to the advances made by the Junior Lenders. Payment of this interest is contingent on the availability of funds resulting from a successful SIB-financed project. However, even though the certainty of these returns on the investment is not absolute, this factor does not impair the debt status of an instrument because the contingent return becomes absolutely enforceable, and not subject to the discretion of the board of directors, once the condition is satisfied.⁷² In other words, the right to these interest payments becomes absolute and does not depend on any discretionary action on the part of the intermediary when the project achieves a sufficient

70. See, e.g., *In re Larson*, 862 F.2d 112, 117 (7th Cir. 1988); *Wood Preserving Corp.*, 347 F.2d at 119; *Gilbert v. Comm'r*, 248 F.2d 399, 406–07 (2d Cir. 1957); F.S.A 2001-33-013 (May 16, 2001) (noting that while “every creditor looks to some extent to the debtor’s earnings for payment,” current earnings should reasonably be expected to continue instead of expecting payment upon the hope that an untried business will succeed); *Plumb, supra* note 62, at 414–15. *But see, e.g., TIFD III-E, Inc. v. United States (Castle Harbour)*, 459 F.3d 220, 241 (2d Cir. 2006) (holding that a personal guaranty by a stable corporation and a requirement that 110% of the amount due be kept in liquid assets decreases the amount of risk associated with the transaction and is indicative of debt); *Harlan v. United States*, 409 F.2d 904, 909 (5th Cir. 1969); *Ortmayer v. Comm'r*, 265 F.2d 848, 854–55 (7th Cir. 1959).

71. See *John Kelly Co. v. Comm'r*, 326 U.S. 521, 525 (1946); *Roth Steel Tube Co. v. Comm'r*, 800 F.2d 625, 631 (6th Cir. 1986); *Portage Plastics Co., Inc. v. United States*, 470 F.2d 308, 312 (7th Cir. 1972); *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968); *Curry v. United States*, 396 F.2d 630, 634 (5th Cir. 1968); *Tribune Publ'g Co. v. Comm'r*, 17 T.C. 1228, 1234 (1952); *Third Scottish Am. Trust Co. v. United States*, 37 F. Supp. 279, 283 (Ct. Cl. 1941); *Brush-Moore Newspapers, Inc. v. Comm'r*, 37 B.T.A. 787, 792 (1938); *Plumb, supra* note 62, at 431.

72. See *Plumb, supra* note 62, at 431; see also, e.g., *John Kelly Co.*, 326 U.S. at 525; *Fin Hay Realty*, 398 F.2d at 696; *Ortmayer*, 265 F.2d at 855; INTERNAL REV. SERV., PUB. NO. 4220, APPLYING FOR 501(C)(3) TAX-EXEMPT STATUS 6 (2014).

amount of success to trigger payments. As a result, this factor is likely inconclusive and does not necessarily weigh against debt characterization.

4. *Participation in Profits*

Generally, a right to participate in the profits of the entity beyond the amount invested suggests an equity investment.⁷³ However, under certain circumstances, creditors may also share in the success of an enterprise, in which case a participation in profits is not indicative of equity.⁷⁴ In the case of the Massachusetts SIB, the contract documents provide for both purported interest payments, which accrue at a fixed rate, as well as additional payments, up to a maximum amount, if the project satisfies a higher performance threshold. The amount of these additional payments, referred to as “success fees,” are calculated on the basis of the cost savings realized by the ultimate payor, the government, as a result of the SIB-funded program.⁷⁵ In other words, the greater the project’s success, the greater the investors’ return on investment. Thus, on the one hand, this factor should weigh in favor of equity characterization because the investors share in the profits of the enterprise. In addition, because investors stand to lose their entire investment in the event of failure, the investors also share in the losses of the enterprise. A participation in losses may be further indicative of equity because it undermines the requirement of an unconditional promise to pay a sum certain.⁷⁶ On the other hand, the case law provides that even if a purported lender participates in the profits of the enterprise, an instrument may be characterized as debt if, in the absence of additional equity features, there is a reasonable floor or ceiling on participation and the participation is not in the discretion of the payor.⁷⁷ In the

73. See Plumb, *supra* note 62, at 442 (noting that equity is indicated when “an investor truly stands to gain an unlimited amount based on the profits of the enterprise”); IRS PUB. No. 4220, *supra* note 72, at 7.

74. See Plumb, *supra* note 62, at 436 (noting that the payment of a return that varies with the borrower’s profits has been treated as debt); see also Rev. Rul. 68–54, 1968–1 C.B. 69; EUSTICE & BRANTLEY, *supra* note 68, ¶ 4.05[2][b][vi] (stating that “[t]he right of investors to participate in the success of an enterprise is not necessarily inconsistent with a debtor–creditor relationship”).

Instead, in the absence of additional adverse factors, this factor is generally a neutral factor in the debt-equity analysis. See Rev. Rul. 68–54, 1968–1 C.B. 69; Plumb, *supra* note 62, at 436.

75. See *supra* notes 32–54 and accompanying text.

76. See EUSTICE & BRANTLEY, *supra* note 68, at ¶ 4.05[2][b][vii].

77. See Plumb, *supra* note 62, at 437–38 (citing *New Eng. Lime Co. v. Comm’r*, 13 T.C. 799, 804 (1949); Rev. Rul. 68–54, 1968–1 C.B. 69).

Massachusetts SIB, the upside potential of any additional payments is capped and the payment is not discretionary once the contingency is met. Thus, it is plausible, but not absolute, that this factor may indicate that the SIB arrangement is equity.

5. Adequacy of Interest

The provision for a reasonable rate of interest is another factor courts may consider in characterizing a purported debt instrument.⁷⁸ In determining reasonableness, the courts will usually consider whether or not the rate provided for is commensurate with the risks involved and reflects the amount that would be charged by an independent creditor.⁷⁹ As discussed above, the Massachusetts SIB provides for both a stated interest rate and success payments as potential compensation for the use of the investors' funds. The downside risk for investors is that they lose their entire investment, while the upside potential is capped.⁸⁰ Given the contingent nature of these payments and the limited upside potential, the financial rate of return on the investors' investment is likely not commensurate with the risks involved.⁸¹ However, most investors currently invest in SIBs not only for the financial return but also for a social return on their investment. They are therefore willing to accept a lower financial rate of return.⁸² Moreover, in entering into the Massachusetts

Similarly, in the first *Castle Harbour* appellate decision, the Second Circuit concluded that an ability to participate in profits was consistent with a debt characterization when the upside potential was capped at less than 2.5% of the investor's capital. See *TIFD III-E, Inc. v. United States*, 459 F.3d 220, 233–35, 241 (2d Cir. 2006).

78. See *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 698 (3d Cir. 1968); *Curry v. United States*, 396 F.2d 630, 634 (5th Cir. 1968); Rev. Rul. 83–98, 1983–2 C.B. 40.

79. See *Fin Hay Realty*, 398 F.2d at 697; *Curry*, 396 F.2d at 634; Rev. Rul. 83–98, 1983–2 C.B. 40. Generally, courts tend to find a rate of return that is significantly higher than the market rate of interest as indicative of equity because such a high rate would indicate a return for entrepreneurial risk, suggesting, unlike debt, a sharing of profits. See *Fin Hay Realty*, 398 F.2d at 698; *Curry*, 396 F.2d at 634.

80. The disproportionate risk-to-return ratio is especially true for the Junior Lenders in the Massachusetts SIB, who receive a lower rate of return than the Senior Lenders. Generally, a subordinate lender is entitled to a higher rate of return because it bears a greater risk that it will not get repaid.

81. However, this does not take into account the nonfinancial return that comes in the form of a charitable nature.

82. See MCKINSEY & CO., FROM POTENTIAL TO ACTION: BRINGING SOCIAL IMPACT BONDS TO THE US 39 (2012), http://mckinseysociety.com/downloads/reports/Social-Innovation/McKinsey_Social_Impact_Bonds_Report.pdf (describing

SIB, independent parties have agreed to these terms, which further indicates that the rate is arm's length. These factors suggest that this is a reasonable rate of return and, therefore, weighs in favor of debt characterization.

6. Source of Payments

The expected source for repayment of a purported debt is another factor that courts consider in determining whether to characterize an instrument as debt or equity.⁸³ Generally, if the source of repayment is solely from the earnings of the entity or if the most likely source of repayment is the liquidation of the enterprise's assets, then the courts view this factor as indicative of equity.⁸⁴ With respect to the Massachusetts SIB, the terms of the agreement provide that the project intermediary will use its liquid assets to pay the lenders their outstanding interests, principal balance, and any success payments, which would generally be indicative of equity.⁸⁵ However, the SIB agreement essentially guarantees the project intermediary's solvency for the SIB investors, because it contractually obligates the Commonwealth of Massachusetts to pay the project intermediary if certain conditions are met. This backstop of state government funding effectively removes the risk that the intermediary will only have a limited source of funds to repay investors. Accordingly, this factor suggests that the Massachusetts SIB may be more akin to debt than equity.

7. Extent of Rights to Participate in Management

The presence or absence of management rights is generally only a marginal factor in the debt-equity analysis.⁸⁶ Management rights, such as

the types of investors that SIBs are likely to attract as philanthropic funders and "impact first" investors).

In computing the rate, both stated and unstated interest are taken into account. *See, e.g.,* Potter Elect. Signal & Mfg. Co. v. Comm'r, T.C. Memo 1960-30, 1960 WL 1025, *aff'd*, 286 F.2d 200 (8th Cir. 1961) (Tax Court decision about an obligation issued at a discount).

83. *See* Estate of Mixon v. United States, 464 F.2d 394, 405 (5th Cir. 1972).

84. *See* Roth Steel Tube Co. v. Comm'r, 800 F.2d 625, 631 (6th Cir. 1986); Stinnett's Pontiac Serv., Inc. v. Comm'r, 730 F.2d 634, 638-39 (11th Cir. 1984); *Estate of Mixon*, 464 F.2d at 405. *See also* Creston Corp. v. Comm'r, 40 T.C. 932, 938 (1963); IRS PUB. No. 4220, *supra* note 72, at 10.

85. *See* Mass. Contract, *supra* note 13, at app. H.

86. *See* IRS PUB. No. 4220, *supra* note 72, at 9.

voting rights, are held by owners of an entity.⁸⁷ However, creditors often also have voting and other rights in place to protect their interests.⁸⁸ Thus, the existence of management rights does not necessarily give rise to an equity interest.⁸⁹ Similarly, the absence of voting rights does not necessarily give rise to a debt instrument.⁹⁰ In the case of the Massachusetts SIB, the investors take on a passive role.⁹¹ These investors are not given rights to participate in the active management of the program, but their consent is required to make certain modifications, such as changes to the project fees, funding schedule, and number of program participants.⁹² These rights are limited and are consistent with rights often given to lenders. Thus, this factor is likely to be only slightly in favor of debt characterization.

8. *Extent of Subordination*

Another factor courts consider in characterizing an instrument is whether the instrument is subordinate to, or has preference over, any indebtedness of the corporation.⁹³ Because creditors' claims on income and on assets generally have priority over those of the owners or shareholders, courts have recognized subordination as a factor indicative of equity.⁹⁴ The weight given to the subordination factor depends on the degree to which an interest is

87. See *Stinnett's Pontiac*, 730 F.2d at 639; *Estate of Mixon*, 464 F.2d at 406; *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968); Notice 94-47, 1994-1 C.B. 357; IRS PUB. No. 4220, *supra* note 72, at 7.

88. See *Helvering v. Richmond, Fredericksburg & Potomac R.R. Co.*, 90 F.2d 971, 974-75 (4th Cir. 1937); *Plumb*, *supra* note 62, at 447-49.

89. See *Baker Commodities, Inc. v. Comm'r*, 48 T.C. 374, 399-400 (1967), *aff'd*, 415 F.2d 519 (9th Cir. 1964); IRS PUB. No. 4220, *supra* note 72, at 7.

90. For instance, some equity interests, such as preferred stock or a partnership interest, may lack voting rights but nevertheless constitute a capital investment. See *TIFD III-E, Inc. v. United States (Castle Harbour)*, 459 F.3d 220, 238 (2d Cir. 2006) (noting that "the denial of participation in management to an investor is a factor which tends, even if only slightly, to favor a conclusion that the interest resembles debt"); *Plumb*, *supra* note 62, at 449.

91. This may not always be the case. A SIB may also be structured to give the investors an active role in managing the service providers and SIB-funded program.

92. See *Mass. Contract*, *supra* note 13, at app. H (providing that the lenders will generally not have voting rights with respect to actions taken by the oversight and operating committees).

93. See I.R.C. § 385(b); *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968); Notice 94-47, 1994-1 C.B. 357.

94. See *Portage Plastics Co., Inc. v. United States*, 470 F.2d 308, 315 (7th Cir. 1972); Notice 94-47, 1994-1 C.B. 357.

subordinated, but generally is not itself determinative.⁹⁵ In the Massachusetts SIB, the rights of the lenders during the last few project quarters generally have preference over the claims of any other creditors of the intermediary.⁹⁶ Specifically, according to the agreement, during these project quarters, the Senior Lender, and then the Junior Lenders, are entitled to receive interest payments and a return of their principal first before any other party receives payments from the project intermediary.⁹⁷ Thus, during these quarters, the lenders have a payment priority relative to the other claimants.⁹⁸ However, upon the maturity date, the lenders' rights to receive any remaining outstanding principal and interest payments are subordinate to the rights of the other creditors to receive outstanding project fees incurred in connection with the project, including the payment rights of the project's evaluator, the project's validator, Third Sector Capital Partners, and the service provider.⁹⁹ Because the lenders' rights to payment are not subordinate to the other claimants during the majority of the investment's duration, and any subordination upon maturity is to the claims of specific creditors, this factor is most likely to favor debt characterization.¹⁰⁰

9. Other Factors

Some factors, such as the identity of the interest between the holders of the instrument and the owners of the entity, the satisfaction of the independent creditor test, the existence of thin capitalization, and the use of the funds, are generally only relevant in situations involving non-arm's length instruments.¹⁰¹ Thus, these factors are irrelevant in the case of the

95. See *Estate of Mixon v. United States*, 464 F.2d 394, 410 (5th Cir. 1972); *Tomlinson v. 1661 Corp.*, 377 F.2d 291, 298 (5th Cir. 1967); *Liflans Corp. v. United States*, 390 F.2d 965, 969 (Ct. Cl. 1968).

96. However, the rights of the Junior Lenders are subordinate to the claims of the Senior Lender. See *Mass. Contract*, *supra* note 13, at app. H.

97. See *supra* notes 32–52 and accompanying text.

98. See *Mass. Contract*, *supra* note 13, at app. H. Specifically, the lenders have a right to receive these payments before the deferred service fees are paid to the intermediary's owner, Third Sector Capital Partners, and the service provider, as well as any other claimant. See *id.*

99. See *id.*

100. See *Plumb*, *supra* note 62, at 424–25 (indicating that the case law suggests that “subordination to mortgage debt . . . to bank credit or to the claims of other specific creditors” does not adversely affect an obligation's purported debt status whereas subordination to the claims of general creditors is a strong indication of equity).

101. See, e.g., *Estate of Mixon v. United States*, 464 F.2d 394, 409 (5th Cir. 1972); *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968); *Fischer*

Massachusetts SIB because no related parties are involved. In addition, depending on the particular jurisdiction, other factors may be considered when analyzing the character of a transaction.

10. Summary of Factors

In applying the above factors to the Massachusetts SIB, it is not entirely clear whether or not the instrument should be respected as debt for tax purposes. On the one hand, several factors point towards debt characterization: (1) the parties' intent that the instrument be treated as debt, (2) the adequacy of the interest provided by the SIB, (3) the source of repayment, (4) the limited rights to participate in management, and (5) the payment preference that the lenders have over the other claimants. Moreover, the existence of a contingent, rather than fixed, rate of interest does not necessarily prevent a debt designation.¹⁰² On the other hand, the absence of an unconditional promise to pay the principal at a fixed maturity date and the investors' participation in the profits and loss of the enterprise are two factors that may favor an equity characterization. Because no particular factor is conclusive in distinguishing debt from equity, different courts may weigh the factors differently and reach different conclusions as to the correct characterization of the SIB arrangement.¹⁰³

v. United States, 441 F. Supp. 32, 38 (E.D. Pa. 1977). For instance, the identity of ownership factor looks to whether advances made by the owners of the entity are proportional to their respective equity interest in the entity. See I.R.C. § 385(b); *Fin Hay Realty*, 398 F.2d at 696; Notice 94-47, 1994-1 C.B. 357. The more disproportionate the holdings, the more likely the parties are acting as independent third parties and the more likely the purported debt form of a transaction will be respected. See, e.g., *Fin Hay Realty*, 398 F.2d at 696-97. The independent creditor test looks to the ability of the entity to obtain funds from third-party lenders on similar terms at the time the advance is made. "Thin capitalization is strong evidence of a capital contribution where: (1) The debt-to-equity ratio was initially high; (2) the parties realized that it would likely go higher; and (3) substantial portions of these funds were used for the purchase of capital assets and for meeting expenses needed to commence operations." *Provost v. Comm'r*, T.C. Memo 2000-177, 2000 WL 687889, at *7.

102. See *supra* notes 76-80 and accompanying text. See also Shu-Yi Oei & Diane Ring, *Human Equity? Regulating the New Income Share Agreements*, 68 VAND. L. REV. 681, 719 (2015).

103. See *John Kelley Co. v. Comm'r*, 326 U.S. 521, 530 (1946); *Richmond, Fredericksburg & Potomac R.R. Co., v. Comm'r*, 528 F.2d 917, 919-20 (4th Cir. 1975); *Estate of Mixon*, 464 F.2d at 402; *Helvering v. Richmond, Fredericksburg & Potomac R.R. Co.*, 90 F.2d 971, 974 (4th Cir. 1937); Notice 94-47, 1994-1 C.B. 357.

B. Are SIBs Equity?

Based on an analysis of the above factors, a SIB arrangement may also potentially be treated as creating an equity interest. In general, an equity interest may be treated as: (1) a corporate equity interest or (2) a partnership or joint-venture interest.¹⁰⁴

1. Corporate Equity Interest

Whether the SIB model creates a corporate equity interest depends on how the SIB arrangement is defined. On the one hand, the SIB may be framed as a contract between the project intermediary and the project investors. For instance, in the Massachusetts SIB, the investors enter into an agreement with the project intermediary rather than with the government or the service provider. The documents refer to the intermediary as the “borrower,” or the recipient of the funds. In exchange for the funds, the intermediary promises to repay the investor its capital plus a return on investment if the project meets certain performance thresholds, which the intermediary plays a key role in managing. Furthermore, the project documents also provide that the investor is entitled to seniority in repayment and a pre-negotiated, although contingent, rate of return. Accordingly, one possibility is that this arrangement is equivalent to the intermediary corporation issuing an equity interest in the form of preferred shares with limited voting rights and a capped return that is contingent on the success of the business.¹⁰⁵ However, this characterization of the traditional SIB model may be problematic to the parties involved. In the SIBs launched to date in the United States, the organization serving as the project intermediary has generally been a tax-exempt entity. If the intermediary is treated as accessing capital from and distributing profits to equity investors, it can lose its tax-exempt status, thereby subjecting it to tax liability.¹⁰⁶

Alternatively, the SIB arrangement may instead be defined as a series of contracts between the government, the service providers, and the investors, with the intermediary linking the multiple stakeholders together.¹⁰⁷ Under such an arrangement, the intermediary may merely be serving as the conduit

104. See Oei & Ring, *supra* note 102, at 720.

105. See *id.* at 722 (discussing how income share agreements could be characterized as an equity-like preferred stake in a specific person or the transaction that the person has undertaken).

106. See Camden Hutchinson, *The Historical Origins of the Debt-Equity Distinction*, 18 FLA. TAX REV. 95 (2015); Benjamin M. Leff, *Preventing Private Inurement in Tranche Social Enterprises*, 45 SETON HALL L. REV. 1, 24 (2015).

107. See MCKINSEY & CO., *supra* note 82.

through which funds flow from the government to the investors if the project is successful. In particular, under the traditional SIB model, the intermediary enters into an agreement with both the government and the investors. Its agreement with the government generally provides that the intermediary will provide funds to the service providers and manage the project in exchange for an agreed service fee. In its agreement with the investors, the intermediary promises to transfer any government payments to the investors minus the intermediary's management fee and related expenses. Thus, in effect, the SIB investors transfer funds *through the intermediary* to pay the nonprofit service providers, and the government agrees to pay any success fees to the project investors indirectly *through the intermediary*.¹⁰⁸ Moreover, if a SIB, such as in the case of the Massachusetts SIB, provides the investors with a lien and security interest in the intermediary's right to the payments from the government, this further supports treating the intermediary as a conduit for the project funds. If the SIB arrangement is framed in this manner, then it is less likely that the SIB creates an equity interest in any corporate intermediary.

Ultimately, however, this determination depends on the role that the intermediary plays in the arrangement. In cases where the intermediary plays an integral role in managing the project and coordinating the parties, then corporate equity treatment may be a more plausible characterization.¹⁰⁹ Alternatively, in cases where the intermediary only serves as the fiscal agent through which funds flow, then equity characterization may not make sense.

2. Partnership or Joint Venture Interest

Alternatively, SIB arrangements may potentially give rise to a partnership or joint venture. In fact, a SIB has often been defined as "a multistakeholder partnership,"¹¹⁰ and the original idea was to refer to a social impact bond as a "social impact partnership."¹¹¹ Moreover, a partnership

108. *See id.* at 15.

109. *See* Oei & Ring, *supra* note 102, at 722–23 (concluding that an income share agreement is more similar to corporate equity where "(1) funds have been raised to support the funding of the recipient's business venture, . . . and/or (2) an intermediate entity actually plays a key role in the arrangement").

110. *See, e.g.*, Social Impact Bond Act, H.R. 4885, 113th Cong. (2014) (describing the proposed Social Impact Bond Act as a bill "[t]o encourage and support *partnerships* between public and private sectors to improve our nation's social programs, and for other purposes") (emphasis added); *see also* MCKINSEY & CO., *supra* note 82, at 13 (defining a SIB as "a multistakeholder partnership managed through a series of contracts" between the government, the service providers, the investors, and the intermediary).

111. *See* MCKINSEY & CO., *supra* note 82, at 13.

characterization may more accurately describe the economic substance of the SIB arrangement. Thus, if the Service concludes that the debt-equity analysis applied above gives rise to partnership equity rather than a debtor-creditor relationship, the Service may recharacterize the transaction as creating a separate partnership entity for tax purposes.¹¹²

In particular, a separate partnership entity can arise for tax purposes if participants “carry on a trade, business, financial operation, or venture and divide the profits therefrom.”¹¹³ A partnership includes a “syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on.”¹¹⁴ Because SIBs currently are designed to address one specific social problem, one partnership that may arise from the series of contracts between the multiple parties involved in a SIB is a joint venture between the investors and the project intermediary.¹¹⁵

In general, to constitute a joint venture for tax purposes, the following attributes must be present: (1) an express or implied contract to form a business venture, (2) the contribution of assets or services by each of the parties, (3) joint control and proprietorship, and (4) an agreement to share profits.¹¹⁶ The majority of these factors appear to be met under the traditional SIB model.

For instance, in the Massachusetts SIB, the investors and project intermediary join together to establish a venture that aims to reduce recidivism

112. See *TIFD III-E, Inc. v. United States (Castle Harbour)*, 459 F.3d 220, 231–32 (2d Cir. 2006); *Am. Underwriters, Inc. v. Comm’r*, T.C. Memo 1996-548, 1996 WL 726365, at *5; *Provost v. Comm’r*, T.C. Memo 2000-177, 2000 WL 687889, at *8–9; Rev. Rul. 90–27, 1990–1 C.B. 50; Oei & Ring, *supra* note 102, at 744; Elliot Manning, *Partnerships—Conceptual Overview*, 710-3d TAX MGMT. PORT. (BNA) § II.E.2.

113. Reg. § 301.7701–1(a)(2). However, a joint venture to share expenses and mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purposes. See *id.*

114. I.R.C. §§ 761(a), 7701(a)(2). Although not controlling, a partnership has been similarly defined for state law purposes to include “an association of two or more persons to carry on as co-owners a business for profit.” UNIF. P’SHIP ACT (1997) § 102(6) (UNIF. LAW COMM’N 2013).

115. See *Brady v. Comm’r*, 25 T.C. 682, 688 (1955) (recognizing that “[o]ne of the characteristics of a joint venture is that it usually is formed to handle a single transaction, rather than to carry on a continuing business.”); Manning, *supra* note 112, at § II.E.2 (noting that “a joint venture is usually an arrangement for a single project”).

However, in the future, it is possible that a SIB will address multiple projects, rather than just one project, in which case, this arrangement may not create a joint venture but still give rise to a partnership.

116. See *S. & M. Plumbing Co., Inc. v. Comm’r*, 55 T.C. 702, 707 (1971), *acq.*, 1971-2 C.B. 1; *Brady*, 25 T.C. at 688; Dagher, *supra* note 9, at 3510.

and improve employment outcomes for former juvenile inmates in a particular area. The investors and intermediary share the same goal, and achieving this goal will lead to profits, in the form of success payments and services fees from the government, which suggests that this first factor is satisfied.¹¹⁷ The second attribute also appears to exist, because there is a mutual contribution of assets or services to the venture. The investors provide the capital or cash to finance the social intervention, and the project intermediary provides general contractor-type services by managing the service provider(s) and the SIB project.

However, the third attribute, which requires joint proprietorship and control, is not necessarily present. In the current SIB model, the investors and intermediary do not share control of the project.¹¹⁸ Instead, the intermediary exerts the majority of the control over the project, while investors generally have little input as to how the program is managed or implemented.¹¹⁹ Nevertheless, this may not always be the case. It is possible for a SIB-financed project to involve investors that take on a more active role in managing the project. Also, some investors currently may influence which service providers are selected to implement the SIB-financed project.¹²⁰

Finally, as one commentator has noted, “the fourth factor of shared profits could be met in SIBs that extend a performance bonus to the project intermediary in addition to paying investors when successful.”¹²¹ Thus, in SIBs where both the investors and the intermediary are entitled to a return if certain performance thresholds are met, this factor may be satisfied. In other words, if the venture is sufficiently successful, then both parties to the venture receive a share of the profits. This does not appear to be the case with the Massachusetts SIB, but based on the foregoing, it is not inconceivable that the Service could treat a SIB arrangement with these terms as a joint venture, and therefore, a partnership for tax purposes.

A partnership characterization is also more likely in cases where no intermediary is used. For instance, in some SIB models, the service provider that delivers the intervention to the target population acquires funds from outside investors with repayment contingent on the service provider’s success. This situation looks like multiple partnerships between the service provider, as the service partner, and each investor, as the capital partner.¹²² Moreover,

117. See Dagher, *supra* note 9, at 3511.

118. See *id.*

119. See *id.*

120. See *id.*

121. *Id.*

122. However, if the arrangement is structured so that the service provider delivering the intervention funds the project upfront from its own funds and is reimbursed by the government with a small return if it is successful, the arrangement

in other SIB models, the government may raise funds from the investors directly and transfer the funds to the service provider. This situation looks like a partnership between the government and the private investor to achieve a particular social outcome.

C. If Not Debt or Equity, What Are They?

The foregoing discussion reveals that a SIB arrangement does not necessarily fall into the debt or equity characterization for U.S. tax purposes. Thus, it is possible that a SIB arrangement is treated as neither debt nor equity but as something else, such as a derivative instrument or a charitable donation.¹²³

1. Derivative Instrument

One possibility is that a SIB constitutes a type of derivative financial instrument. Broadly speaking, a derivative is a “risk-shifting financial contract . . . whose payment terms are determined by or *derive* from the value of the underlying transaction.”¹²⁴ A SIB arrangement is also essentially a “risk-

would likely not be classified as a partnership but as a service contract. This arrangement looks more like a pay-for-success contract between the government and the service provider with no SIB element.

123. According to a leading commentator, Michael S. Farber, in addition to debt and equity, there exists a third way to characterize financial instruments. He refers to this third characterization as “non-debt open transactions (NOTs).” Farber, *supra* note 55, at 636. Generally, instruments that should be characterized as NOTs are fully paid instruments that have features that prevent an equity characterization but also lack most of the classic features of debt, such as an unconditional right to receive back the principal amount or to receive noncontingent stated or discounted interest. *Id.* at 637. In other words, an instrument is a NOT if the instrument is not taxed as simple debt or equity. *Id.* at 637, 643 (arguing that prepaid forwards, credit-linked notes, and reverse and mandatory exchangeables are examples of NOTs). Because a SIB arrangement lacks an unconditional right to the payment of its principal and the SIB’s stated interest, but also has a term to maturity and other features that may preclude characterization as equity, a SIB may fall into this NOT characterization. Once an instrument is determined to be a NOT, the next step is to determine how it is taxed. *Id.* at 637. Under current law, a NOT is potentially subject to several different tax regimes. *Id.* at 638.

124. 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)). Neither the Internal Revenue Code nor the Treasury Regulations define the term “derivative” for tax

shifting financial contract,” because by entering into a SIB, the government shifts the performance and financial risks associated with funding certain social service activities to investors.¹²⁵ Moreover, the terms of the SIB specify that the payment rights and obligations of the parties derive from the value of an underlying transaction.¹²⁶ The underlying transaction in this case is the implementation of a particular social program that has been funded with the investors’ capital. The value of this underlying transaction derives from the program’s achievement of or failure to reach predetermined objective target outcomes. Generally, this value is translated into monetary terms by taking into account the amount of expected government savings that would potentially result from the achievement of these target outcomes. Thus, it is possible that a SIB arrangement constitutes a derivative instrument.

If a SIB arrangement is considered a derivative instrument, the next question is what type of derivative is it? The current tax law does not tax all derivative instruments consistently but rather employs a “cubbyhole” system.¹²⁷ As a result, the tax treatment of a SIB as a derivative instrument will depend on how it is categorized for tax purposes.¹²⁸ Common types of derivative instruments include options, futures, forwards, and notional principal contracts.¹²⁹ Although a SIB arrangement does not neatly fall into

purposes. Yoram Keinan, *United States Federal Taxation of Derivatives: One Way or Many?*, 61 TAX LAW. 81, 88 (2007).

125. Max Liang et al., *An Overview of Social Impact Bonds*, 13 J. INT’L BUS. & L. 267, 274 (2014); Davies, *supra* note 2, at 5; N.Y. FACT SHEET, *supra* note 14.

126. The fact that the entire value of the payment rights derives from the value of the underlying transaction, rather than from the creditworthiness of the SIB’s project intermediary or the government, also suggests that the SIB arrangement may be characterized as something other than indebtedness. See F.S.A. 2001-31-015 (May 2, 2001); F.S.A. 2001-30-010 (Apr. 23, 2001); Kleinbard & Nijenhuis, *supra* note 55.

127. See STAFF OF THE JOINT COMM. ON TAX’N, 110TH CONG., JCX-21-08, PRESENT LAW AND ANALYSIS RELATING TO THE TAX TREATMENT OF DERIVATIVES 12 (2008); Edward D. Kleinbard, *Equity Derivative Products: Financial Innovation’s Newest Challenge to the Tax System*, 69 TEX. L. REV. 1319, 1320 (1991); Edward D. Kleinbard, *Risky and Riskless Positions in Securities*, 71 TAXES 783, 799 (1993) (recognizing that the tax law relies on formalistic measures to determine the tax consequences of derivative instruments).

128. See JOINT COMM. ON TAX’N, *supra* note 127. The tax rules for derivatives are comprised of various common law rules that have developed over time and piecemeal statutes and regulations that have been issued to address specific problems created by the common law rules. BITTKER & LOKKEN, *supra* note 124, ¶ 57.1.

129. BITTKER & LOKKEN, *supra* note 124, ¶ 57.1. Under some circumstances, it may also be possible to bifurcate a derivative instrument into its

any of the existing categories under current law, for the reasons discussed below, a SIB arrangement potentially may be treated as a notional principal contract and taxed accordingly.¹³⁰

A notional principal contract is a “financial contract that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index [based on objective financial information] upon a notional principal amount in exchange for a specified consideration or a promise to pay similar amounts.”¹³¹ A prepaid swap is a type of notional principal contract whereby one party generally pays upfront the present value of the total amount of fixed future payments, while the other party is contractually obligated to pay an amount that varies based on the value of the underlying property at a particular date.

A SIB arrangement shares some important features with a prepaid swap. A SIB arrangement is also a financial contract that obligates one party to make variable payments at specified future times according to prespecified conditions and requires the other party to prepay a fixed amount. Specifically, pursuant to the terms of a SIB arrangement, the government generally pays the investor an amount that varies based on whether and to what extent an objective performance threshold is met by a particular date. The other party, the investor, indirectly prepays the government (through its payments to the project intermediary to finance the social services) on the effective date of the contract a fixed, predetermined amount. In addition, similar to a swap agreement, SIB arrangements may have multiple payout dates.¹³² However, this is not a feature that is shared by all SIB arrangements.

As with all analogies, the analogy of a SIB to a prepaid forward contract is not perfect. For instance, a SIB’s payout is not based on a notional amount but rather is based on the actual amount of funds that the investor

various components and subject each to a different tax regime. *See* Farber, *supra* note 55, at 638.

130. A SIB arrangement would not be treated as an option because investors are not paying for the right to purchase or sell an asset at a specified price in the future. *See* David F. Levy, *Towards Equal Tax Treatment of Economically Equivalent Financial Instruments: Proposals for Taxing Prepaid Forward Contracts, Equity Swaps, and Certain Contingent Debt Instruments*, 3 FLA. TAX. REV. 471, 485 (1997). A SIB arrangement also does not fall into the “futures” category because futures contracts are exchange-traded agreements rather than privately negotiated or over-the-counter agreements. *See* JOINT COMM. ON TAX’N, *supra* note 127, at 6.

131. Reg. § 1.446-3(c).

132. *See, e.g.*, N.Y. Agreement, *supra* note 13, at 15, 18 (providing that measurement and performance-based payments are made at two different periods of time); UTAH PRESCHOOL FACT SHEET, *supra* note 34 (indicating that the performance metrics are evaluated and generate a success payment on an annual basis).

transferred to the SIB intermediary prior to the time that the objective financial information is available. Moreover, the SIB arrangement likely does not create the timing abuses that the tax regime for notional principal contracts is intended to address.¹³³ Finally, it is unclear whether these differences are significant enough to preclude a SIB from being treated as a prepaid swap.

Alternatively, a SIB arrangement may potentially be treated as a cash-settled prepaid forward contract. A traditional forward contract is a privately negotiated bilateral agreement that entitles the purchaser to a fixed quantity of a specified asset at a fixed price for delivery at a specified maturity date.¹³⁴ A cash-settled prepaid forward contract is a type of forward contract that: (1) entitles the investor to receive the cash value of the referenced asset, rather than the asset itself, at a fixed future date; and (2) requires the investor to pay the issuer at the time the parties enter into the contract.¹³⁵ In other words, if the value of the underlying property increases, the issuer repays the investor its initial investment plus the amount by which the asset increased in value. If the value of the underlying property decreases, then the issuer does not repay the investor its entire initial investment, but some lesser amount.

On the one hand, a SIB arrangement is also comparable to a cash-settled prepaid forward contract. For instance, consider the Massachusetts SIB described above. Pursuant to the terms of the Massachusetts SIB agreement, an investor is required to make an upfront payment. In exchange, the government (through the intermediary) will repay the investor that amount if the specified social program meets certain objective performance metrics. To the extent that the program exceeds those performance metrics, the government will transfer an additional amount of cash to the investor calculated on a sliding scale on the basis of the expected government budgetary savings from the social program's success.¹³⁶ Thus, like a cash-settled prepaid forward contract, the SIB arrangement involves an upfront payment and entitles the investor to a cash payment, the amount of which depends on the value of the underlying transaction. If the program fails to

133. See Philip Robin Cleary, *Predicting the Taxation of Prediction Markets*, 27 VA. TAX. REV. 953, 974 (2008) (concluding that prediction markets do not constitute notional principal contracts for similar reasons).

134. See JOINT COMM. ON TAX'N, *supra* note 127, at 6–7.

135. See *id.* at 7. One common example of a prepaid forward contract is the S&P Forward. Generally, on the date the instrument is issued, the investor pays the issuer an amount of cash that is equivalent to the present value of a certain amount of S&P stock. In exchange, the investor acquires the right to receive at some future date the cash value of an equivalent amount of S&P stock that is calculated as of the maturity date. JOINT COMM. ON TAX'N, *supra* note 127, at 7–8; Farber, *supra* note 55, at 640.

136. See *supra* notes 32–54 and accompanying text.

satisfy the minimum performance threshold, then the value of the transaction is deemed to be zero and the government does not repay the investor any of its capital.

On the other hand, SIBs also differ from cash-settled prepaid forward contracts in several respects. First, the SIB arrangement is not a bilateral executory contract. Instead, a traditional SIB arrangement involves the government, the intermediary, and the investors. This difference should not preclude characterization as a prepaid forward contract. It is plausible that the intermediary may be viewed as an agent or conduit, in which case the essence of the transaction is between the government and investors. Alternatively, the arrangement may be viewed as two separate prepaid forward contracts: one between the government and intermediary and the other between the intermediary and investors, in which case the contracts become bilateral executory contracts.

Second, a potentially more significant difference is that the payout from a SIB arrangement does not depend on the value of a specific asset. Instead, it generally depends on the projected value of the government savings resulting from a specific social program and the satisfaction of predetermined performance metrics. This raises the question: does the success of a particular social program constitute property? In other words, does a SIB arrangement have underlying property? It may be possible to argue that the right to be paid a certain amount based on whether or not an event occurs in a particular time period is not entirely unlike a property interest.¹³⁷ Thus, this right, which has value but no physical substance, may constitute intangible property.¹³⁸ But there is also a strong argument that objective performance metrics do not constitute an asset for these purposes.

In conclusion, even though the parties refer to the transaction as a “loan” from the investor to the intermediary, this transaction may be classified either as a prepaid swap arrangement or a cash-settled prepaid forward contract for tax purposes.¹³⁹ Both instruments may resemble a contingent or variable-rate loan, which makes them especially similar to a typical SIB arrangement and to each other. Both instruments also differ from SIB arrangements in

137. See Cleary, *supra* note 133, at 968–71 (concluding that the right to payment generated by prediction derivatives or informational futures may represent the underlying property of the transaction and therefore qualify the transaction as a novel kind of prepaid forward contract).

138. See *id.* (reaching this conclusion with respect to prediction derivatives or informational futures).

139. See Kleinbard & Nijenhuis, *supra* note 55, at ch. 392–66 (recognizing that the issuance of a financial instrument in the form of debt for corporate law purposes should not preclude the parties from treating it in accordance with its economic substance).

several respects so that neither instrument is a perfect analogy to a SIB arrangement. In particular, as described above, one significant variation is that a SIB arrangement, unlike a forward contract, does not reference underlying property that is readily identifiable property. Thus, this Article argues that if a SIB arrangement is classified as a derivative instrument, it may more likely be treated as a prepaid swap agreement for tax purposes. However, unless and until Service guidance is issued, the correct classification of a SIB arrangement for tax purposes remains uncertain.

2. Charitable Donation

Even if a SIB arrangement does not constitute debt or equity, it is not likely to give rise to a charitable donation. To qualify as a charitable donation for which an income tax deduction is allowable, the contribution of funds generally must meet four requirements: (1) the contribution must involve a completed transfer of money or property, (2) the contribution must be to a permissible recipient, (3) the transfer must be voluntary and not trigger an economic benefit to the donor, and (4) the contribution must be in the correct form.¹⁴⁰

A traditional SIB arrangement generally satisfies the first two requirements. In a SIB arrangement, the investor transfers money to the project intermediary, thereby meeting the first requirement.¹⁴¹ The second requirement is also met because the SIBs launched to date in the United States have a qualified nonprofit entity as the project intermediary. For instance, one intermediary used in several SIB arrangements is Third Sector Capital Partners, Inc., a section 501(c)(3) nonprofit entity, whose mission, according to its website, is to build "evidence-based initiatives to address society's most persistent challenges." By providing funds to the intermediary as part of a SIB arrangement, investors effectively support this mission to finance a particular social program. Moreover, most nonprofit organizations organized and operated exclusively for charitable purposes constitute qualified organizations

140. Barbara L. Kirschten & Carla Neeley Freitag, *Charitable Contributions: Income Tax Aspects*, 863-3d TAX MGMT. PORT. (BNA) § II.A.

141. To satisfy this requirement, the transfer must generally pass actual dominion and control over the funds to the donee. *Id.* at § II.B. This means that the contribution must be made to, or for the use of, a qualified organization and not be set aside for use by a specific person or subject to other restrictions concerning their application. See I.R.C. § 170(c); Reg. § 1.170A-8(a)(2); Kirschten & Freitag, *supra* note 140, at § IV.C. Generally, in a SIB, the intermediary organization, rather than the investor, selects the service provider(s) to which it will ultimately transfer the funds. Thus, it is plausible that the funds are not set aside for a specific person but rather are under the control of the project intermediary.

for these purposes.¹⁴² Thus, funds contributed to a nonprofit project intermediary, such as Third Sector Capital Partners, Inc., are transferred to a permissible donee.¹⁴³

Even if a qualified organization operates as the project intermediary, the third requirement that the transfer does not involve the receipt of economic benefit likely precludes a SIB arrangement from qualifying as a deductible charitable contribution. To satisfy this requirement, the donor must (1) intend to make a gift to the charity in an amount that exceeds the fair market value of the goods or services received by the donor, and (2) in fact make a payment in an amount that exceeds the fair market value of the goods or services.¹⁴⁴ Under the current SIB model, the investor potentially receives a financial return if the program is successful. This means that the investor receives a return benefit, in the form of a cash payment, from the project intermediary that exceeds its initial transfer of money to the intermediary, thereby disqualifying it from the charitable contribution deduction.

However, an investor may not necessarily recoup its initial capital or receive any other return benefit as a result of transferring funds to the project intermediary. The SIB arrangement is purposefully structured so that if the project is unsuccessful, the investor does not recover its investment and receives nothing in return for the use of its funds. In other words, if the program were unsuccessful, the investor would have transferred money that exceeds the value of any return benefit. It is plausible that the investor intended to make a gift of these funds. Given the binary and speculative nature of these new SIB arrangements, which currently offer investors a below-market, risk-adjusted rate of return, SIBs often attract investors that, at least partially, seek a nonfinancial return on their investment. For instance, investors appear to invest in SIBs for reasons that include a desire to create meaningful social change through investment, “to be seen as doing good for society and burnish

142. See I.R.C. § 170(c).

143. The Service lists Third Sector Capital Partners, Inc. as a public charity that is a qualified organization to which deductible contributions under Code section 170(c) may be made. See *Exempt Organizations Select Check*, IRS.GOV, <https://apps.irs.gov/app/eos/pub78Search.do?ein1=46-1301032&names=Third+Sector+Capital+Partners&city=&state=All...&country=US&deductibility=all&dispatchMethod=searchCharities&submitName=Search> (last visited Mar. 16, 2017). However, if a for-profit project intermediary is used, as is expected in the future, then the transfer to the intermediary will not qualify as a charitable contribution even though a nonprofit service provider, which uses the funds for a charitable purpose, is the ultimate recipient of the funds.

144. Reg. § 1.170A-1(h)(1); Kirschten & Freitag, *supra* note 140, at § II.E.1.a.

their reputations,” or to generate the greatest charitable yield out of every dollar.¹⁴⁵ This suggests some element of donative intent.

Despite the foregoing, “it is the expectation of a benefit, not whether the expectations are ultimately realized” that governs whether the transaction satisfies this third requirement.¹⁴⁶ Thus, regardless of whether or not the SIB project is successful, the investor is treated as receiving an economic benefit to the extent of its expected economic return at the time of the transfer. The actual economic return that it ultimately does or does not receive is irrelevant. Accordingly, in the case of individual investors, the transaction is likely not to qualify for the charitable contribution deduction.¹⁴⁷

In sum, SIBs are hybrid instruments that have debt, equity, and charitable features. They do not fit neatly into any existing characterization for tax law purposes. As a result, it is difficult to definitively conclude how they should be treated under current law. Each of the alternatives discussed above are plausible characterizations.

III. TAX CONSEQUENCES TO PRIVATE INVESTORS

The tax consequences to investors of a SIB investment ultimately depend on its characterization for tax purposes and whether the investor is a private or nonprofit investor. Based on the foregoing discussion, several potential options exist for how traditional SIB investments are characterized under current law. Moreover, modifications to the traditional SIB model may

145. GOODALL, *supra* note 12, at 11; Davies, *supra* note 2, at 5; *Making an Impact with Philanthropy*, MERRILL LYNCH PRIV. BANKING & INV. GROUP, <https://www.pbig.ml.com/articles/making-an-impact-with-philanthropy.html> (last visited May 4, 2017).

146. Kirschten & Freitag, *supra* note 140, § II.E.1.b.2; *see also* Stubbs v. United States, 428 F.2d 885, 887 (9th Cir. 1970); Singer Co. v. United States, 449 F.2d 413, 424 (Ct. Cl. 1971). Under the traditional SIB model, the investor receives the economic benefits directly from the project intermediary and indirectly from the government. However, it does not matter whether the economic benefits are received from the donee or a third party. *See Singer*, 449 F.2d at 423; C.C.A. 2002-38-041 (July 24, 2002); Kirschten & Freitag, *supra* note 140, at § II.E.1.b.5.

147. To the extent that this expected economic benefit does not exceed the investor’s contribution to the project intermediary, the investor’s contribution may qualify for the charitable contribution deduction if the transferor intended to make a gift of this excess to the project intermediary. But the difficulty lies in determining the amount of the investor’s *expected* economic benefits at the time of the transfer given the speculative and novel nature of the SIB arrangement. As a practical matter, if the transferor is unable to determine the value of the return benefit received, the transferor cannot calculate the amount deductible as a charitable contribution. *See Kirschten & Freitag*, *supra* note 140, at § II.E.1.b.5.

alter the economics of the transaction and the character of the transaction. Thus, the tax consequences to a private investor in the SIB arrangement will vary depending on how the transaction is ultimately characterized. Below, I briefly describe the resulting tax consequences of a debt, corporate equity, partnership, and prepaid swap agreement characterization.

A. Debt Instrument

If the SIB arrangement were treated as a debt instrument, then participating in the SIB investment may generate interest income to the investors.¹⁴⁸ In particular, under the traditional SIB model, investors are entitled to receive a predetermined return on their investment if certain performance thresholds are satisfied. For instance, the Massachusetts SIB, described above, provides that the project intermediary will pay the Senior Lender a five percent return on its investment on a quarterly basis to the extent of available funds. Accordingly, if the advance is considered a loan to the project intermediary, then this return will constitute interest income to the Senior Lender. Because interest income is treated as ordinary income, this income will be subject to tax at a marginal tax rate of 39.6% for high-income taxpayers.¹⁴⁹ This income may also be subject to a 3.8% surtax that is imposed on net investment income, thereby increasing the effective rate of tax on this income to 43.4%.¹⁵⁰

However, unlike a traditional bond investor, a SIB investor generally will not receive any incremental payments from the intermediary prior to the point in time that the project is deemed successful. Moreover, the SIB investor's right to these payments is contingent on the project reaching certain performance thresholds. Nevertheless, regardless of the project's ultimate success, the investor may have to recognize interest income, and be subject to tax, on an annual basis under the noncontingent bond method. This method may be deemed to apply because one or more payments are not fixed, but are

148. See Rev. Rul. 69-188, 1969-1 C.B. 54 (defining interest as "the amount one has contracted to pay for the use of borrowed money, and as the compensation paid for the use or forbearance of money").

149. I.R.C. § 1. A SIB, as currently structured, would likely not constitute a municipal bond that generates tax-free municipal bond interest under Code section 103. See VALERIE DAO ET AL., PRACTICUM TEAM, UNIV. OF CHIC. HARRIS SCH. OF PUB. POLICY STUDIES, SOCIAL IMPACT BONDS: A FEASIBILITY ANALYSIS OF THE WYMAN TEEN OUTREACH PROGRAM, <http://128.135.46.110/sites/default/files/practica/spring2012-report2.pdf> (last visited May 5, 2017).

150. I.R.C. § 1411 (imposing a 3.8% surtax on the lesser of a taxpayer's net investment income or the excess of the taxpayer's modified adjusted gross income over a specified threshold).

instead contingent, when the instrument was issued.¹⁵¹ Pursuant to this method, interest would be required to be taken into account regardless of whether the amount of the payment is fixed or determinable in the taxable year.¹⁵² If the actual amount of the contingent payment differs from the amount included in income for the year, then appropriate adjustments are made to reflect the difference at that time.¹⁵³

The SIB investor is likely also to have tax consequences at the termination of the SIB project. If the project is successful, then any payments that the investor receives on the retirement of the debt instrument to the extent of its basis in the instrument will be a nontaxable return of capital.¹⁵⁴ In addition, any payments that the investor receives in excess of its “interest” and principal repayment would likely be treated as capital gain under the noncontingent bond method.¹⁵⁵ If the project is unsuccessful and the investor loses its investment, then the investor will likely recognize a capital loss.¹⁵⁶

B. Corporate Equity

If the SIB arrangement instead were characterized as an equity interest in a corporation, then the resulting tax consequences may differ in several respects. From the investor’s perspective, one difference is the timing of when the investor has to recognize income for tax purposes. As discussed above, if the SIB arrangement is characterized as debt, then the investor may have to recognize any return on investment as income prior to the time that it receives any payments. But if the instrument is characterized as corporate equity and the return on investment represents dividend income, then generally the investor will only be subject to tax at the time the dividend is distributed. Moreover, the income that the investor receives from its SIB investment will

151. Reg. § 1.1275-4(a) (stating that this method applies to certain debt instruments that provide for one or more contingent payments).

152. Reg. § 1.1275-4(b)(2).

153. Reg. § 1.1275-4(b)(3).

154. *See* I.R.C. § 1271(a)(1).

155. I.R.C. § 1271(a)(1) (treating the “retirement” of a debt instrument as an exchange of the instrument, which means that if the amount received exceeds the basis in the debt instrument and the debt is being held as a capital asset, then a capital gain may arise).

156. *See* I.R.C. §§ 166(d)(1)(B) (providing that “where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year”), 1271(a)(1). In the event that the SIB investment is evidenced by a security, then the loss may give rise to a long-term capital loss. *See* I.R.C. § 165(g).

be subject to different tax rates depending on the instrument's characterization. In particular, if the return on investment represents qualified dividend, income then it generally will be subject to tax at the preferential tax rates applicable to capital gains, while interest income is treated as ordinary income.¹⁵⁷

There may also be differences with respect to the recovery of the investment. Specifically, a holder of a debt instrument will generally receive the repayment of their initial advance tax free, but a shareholder in a corporation will not always receive the same amount tax free. Instead, current distributions from a corporation generally will be treated as dividends to the extent of the earnings and profits of the distributing corporation.¹⁵⁸ This means that the investor may have taxable income even though the payments may represent the repayment of their initial investment. However, this is not always the case. Under some circumstances, such as a complete redemption of the investor's interest in the corporation, the investor will recover its basis tax free and any excess will be treated as a capital gain.¹⁵⁹ Thus, upon the termination of the SIB investment, the investor is likely to receive capital gain treatment.

In the event that the SIB investment generates a loss, an equity holder is likely to be subject to tax treatment similar to that for a debt holder. Specifically, if the SIB-financed project is unsuccessful and the investor loses its entire investment, then, regardless of whether the investment is characterized as debt or equity, the investor will have a capital loss to the extent of its capital investment.¹⁶⁰

C. Partnership Interest

Alternatively, if the SIB arrangement were characterized as giving rise to a partnership interest, then different tax consequences would result. For instance, the SIB "partnership" would have to separately compute its taxable income and file an annual information tax return.¹⁶¹ Each partner would then report its allocated share of the partnership profits or losses on its own tax return, even if nothing were distributed.¹⁶² This means that if the SIB project

157. I.R.C. § 1(h)(11). This gain will likely be subject to a 23.8% rate of tax because of the additional 3.8% surtax imposed on net investment income. I.R.C. § 1411.

158. I.R.C. §§ 301(c), 316(a).

159. *See* I.R.C. § 302(a)–(b).

160. *See* I.R.C. §§ 165(g), 1221, 1222.

161. *See* I.R.C. §§ 703(a), 6031.

162. I.R.C. § 702. A partner's distributive share of partnership income, gain, deduction, loss, and credit are generally determined by the partnership agreement. I.R.C. § 704(a). But if the partnership agreement does not provide for the allocation or lacks substantial economic effect, then the allocation is determined by each

were successful and the government were to make success payments to the project intermediary, the amount of those payments that were allocable to the investor would be income to the investor even prior to the time that the investor receives any payment. At the time that the investor finally receives distributions, if any, from the deemed partnership, the investor will not have any tax consequences unless the investor's basis in the partnership is less than the amount of the cash distribution.¹⁶³

To illustrate, consider the results if the Massachusetts SIB were characterized as a partnership. In that case, if the SIB-financed program met the minimum performance thresholds to trigger success payments from the government, then those payments would first be allocable to the Senior Lender until it received a five percent return on its investment. This would constitute taxable income to the Senior Lender at the time the government transferred the funds to the project intermediary. Then, each quarter, as the partnership distributes these amounts to the Senior Lender, the Senior Lender would receive the payments tax free. Similarly, the Junior Lender would be subject to tax on its allocable share of any partnership income at the time the government makes the success payment to the project intermediary.

The character of this income that the investors receive is determined at the partnership level.¹⁶⁴ Because the partnership is arguably in the business of delivering a social outcome, it is possible that the success payments the partnership receives from the government will constitute ordinary operating income in the hands of the partnership. Therefore, this would also be treated as ordinary income to the investor.¹⁶⁵ Alternatively, the business of the partnership may be viewed as *investing* in social outcomes, in which case the success payments may constitute capital gains to the partnership and the partners. Accordingly, the investor's returns instead may be subject to preferential tax rates.¹⁶⁶

partner's "interest in the partnership" under all the facts and circumstances. I.R.C. § 704(b); Reg. § 1.704-1(b).

163. See I.R.C. §§ 721-22, 731-32. In general, the investor's basis in the partnership is the amount of funds it transferred to the project intermediary, increased by the investor's allocable share of partnership income and reduced by the investor's allocable share of any partnership losses and any distributions made to that investor. See I.R.C. §§ 705(a), 722. Thus, distributions from the partnership to the investor will generally be tax free unless § 737 or § 751(b) applies.

164. I.R.C. § 702(b).

165. See *id.* (preserving the character of each item of partnership income, gain, loss, deduction, or credit in the hands of the partners).

166. Individual investors may also be subject to the 3.8% Medicare surtax, which is imposed on the lesser of "net investment income" or the excess of adjusted gross income over a threshold amount. I.R.C. § 1411(a). "Net investment income"

If at the termination of the SIB, the SIB-financed project fails to meet the minimum performance thresholds or does not generate sufficient success payments to repay the investors their entire initial investment and any accrued interest, then the investors may recognize a capital loss at that time.¹⁶⁷ The amount of the loss will be the amount by which the investor's basis in the partnership exceeds any money distributed to it.¹⁶⁸

D. Derivative Instrument

As discussed above, a SIB arrangement may potentially be characterized as a prepaid swap agreement. This characterization gives rise to tax consequences that are substantially similar to the tax implications that arise when an investor acquires a debt instrument with contingent payments.

Specifically, the noncontingent swap method, which is comparable to the noncontingent bond method described above, generally governs the tax consequences of an investor in a swap arrangement.¹⁶⁹ Under this method, an investor must recognize any nonperiodic payments over the term of the contract under a reasonable amortization method regardless of when the payment is actually received.¹⁷⁰ Accordingly, if a SIB arrangement is

includes income generated by a partnership in which the taxpayer is a passive partner. I.R.C. § 1411(c).

167. See I.R.C. § 731(a)(2) (providing that any loss recognized on a liquidating distribution will be considered a loss from the sale or exchange of a partnership interest of the distributee partner).

168. *Id.* Because the investors do not materially participate in the deemed partnership, the immediate deductibility of the loss may be limited by the passive activity loss rules. I.R.C. § 465. These rules provide that a passive loss generally may only offset income generated from the taxpayer's passive activities. Thus, to the extent that the investor does not have other passive income, the losses from the SIB investment will be carried forward to a subsequent year. However, because the loss from a SIB investment generally only arises at the termination of the SIB, which terminates the joint venture, these losses will be allowed to the extent they exceed the taxpayer's net income or gain from all passive activities for that year. See I.R.C. § 469(g)(1).

169. See Reg. § 1.446-3. A "nonperiodic payment" is any payment made or received with respect to a notional principal contract that is not payable at intervals of one year or less during the entire term of the contract and is not a termination payment. Reg. § 1.446-3(f)(1). Thus, if a SIB arrangement is classified as a prepaid swap agreement, any success payments made by the government pursuant to a traditional SIB arrangement likely constitute nonperiodic payments.

170. See Reg. § 1.446-3(f)(1). In the case of swaps, nonperiodic payments are generally allocated over the term of the contract in accordance with the values of a series of cash-settled forward contracts that reflect the specific index and the notional

characterized as a prepaid swap, the investor may have to recognize a portion of any potential success payments on an annual basis. These payments would most likely be taxed as ordinary income.¹⁷¹

However, if the SIB arrangement is treated as a prepaid forward contract instead, then the tax consequences vary significantly. In particular, a forward contract is generally treated as an open transaction, which means it does not give rise to any income or loss until the investor terminates or settles its rights or obligations under the contract.¹⁷² Thus, unlike a prepaid swap and contingent debt, any income generated by the arrangement will likely not be recognized until the project is deemed successful and the government transfers funds to the project intermediary. Similarly, as with contingent debt, any loss will only be recognized at the termination of the contract. In other words, the investor will recognize gain or loss upon the cash settlement of the contract rather than over the term of the SIB arrangement. This is likely the result even though the SIB arrangement involves a prepayment of cash by the investor.¹⁷³

With respect to the character of any income or loss, the tax law generally looks to the character of the underlying property involved in the

principal amount. Reg. § 1.446-3(f)(2). Alternatively, a taxpayer may allocate a nonperiodic payment, other than an upfront payment, by treating the contract as though it provided for a single upfront payment equal to the present value of the nonperiodic payments and a loan from the recipient of the nonperiodic payment to the payor. Reg. § 1.446-3(f)(2)(iii). The deemed upfront payment is amortized by assuming that the payment represents the present value of a series of equal payments made throughout the term of the contract based on available market information. This amortized amount together with the time value component of the assumed loan are recognized as additional periodic payments. *Id.* However, for contracts entered into after November 3, 2015, the transaction may need to be bifurcated into two separate transactions: (1) an on-market, level payment swap and (2) an embedded loan. Temp. Reg. § 1.446-3T(g)(4)(i). Pursuant to the temporary regulations, “[t]he time value component associated with the loan is not included in the net income or net deduction from the swap . . . , but is recognized as interest for all purposes of the code.” *Id.*

171. See STEVIE D. CONLON & VINCENT M. AQUILINO, *PRINCIPLES OF FINANCIAL DERIVATIVES: U.S. & INTERNATIONAL TAXATION* § B1.09 (2017).

172. See *Va. Iron Coal & Coke Co. v. Comm’r*, 37 B.T.A. 195, 198 (1938); Rev. Rul. 2003-7, 2003-1 C.B. 363; JOINT COMM. ON TAX’N, *supra* note 127, at 17. The tax law applicable to derivative instruments, including forwards, is not fully developed but instead relies on a collection of unsystematic common law rules. See BITTKER & LOKKEN, *supra* note 124, ¶ 57.1.

173. See JOINT COMM. ON TAX’N, *supra* note 127, at 17; Rev. Rul. 2003-7, 2003-1 C.B. 363; Robert W. Wood, *Prepaid Forward Contracts: What’s All the Fuss?*, M&A TAX REP., <http://woodllp.com/Publications/Articles/pdf/Prepaid.pdf> (last visited May 4, 2017).

forward contract.¹⁷⁴ This depends on whether we can identify any underlying property for the SIB arrangement. If we treat the right to be paid a certain amount based on the eventual reality of an event's occurrence or nonoccurrence as intangible property upon which the SIB arrangement relies, then this property would constitute a capital asset.¹⁷⁵ Accordingly, any income generated by the SIB arrangement would be characterized as a capital gain and any loss would be characterized as a capital loss.¹⁷⁶

IV. TAX CONSEQUENCES TO NONPROFIT INVESTORS

In general, a charitable organization is exempt from federal income taxation.¹⁷⁷ Accordingly, if a philanthropic investor qualifies as a section 501(c)(3) organization, then any returns that it earns through its investment in a SIB will be nontaxable. This means that the majority of the tax consequences discussed above generally will not be relevant to nonprofit investors.

To qualify for tax-exempt treatment, a charitable organization has to satisfy certain requirements.¹⁷⁸ This Part discusses how the economics of the SIB arrangement may affect a nonprofit investor's ability to meet some of these requirements and may, therefore, jeopardize its tax-exempt status. It also discusses the potential excise taxes that may apply to private foundations that invest in a SIB.

A. Loss of Tax-Exempt Status

Under certain circumstances, a nonprofit organization that invests in a SIB may potentially lose its tax-exempt status by violating the private inurement doctrine. The private inurement doctrine, also referred to as the non-distribution constraint, prohibits a charitable organization from distributing the organization's net earnings to individuals who exercise control over it as a condition to maintaining its tax-exempt status.¹⁷⁹ This provision potentially affects these organizations when investing in ventures that have equity

174. See I.R.C. § 1234A.

175. See Cleary, *supra* note 133, at 969 (discussing a similar issue that arises with respect to prediction markets).

176. See I.R.C. §§ 1221, 1222, 1234A.

177. See I.R.C. § 501(a), (c)(3).

178. See I.R.C. § 501(c)(3).

179. See Reg. § 1.501(c)(3)-1(c)(2); Hutchinson, *supra* note 106, at 838; Leff, *supra* note 106, at 24.

investors.¹⁸⁰ This means that, under certain circumstances, a nonprofit organization that invests in a SIB may lose its tax-exempt status, thereby subjecting its returns to the same tax treatment that applies to private investors, as discussed above.

In particular, this situation may arise if a tax-exempt organization invests in a social enterprise¹⁸¹ owned by one or more insiders and if the investment constitutes an “excessive benefit.”¹⁸² Take for instance the Massachusetts SIB described above. Because of the tranche investment mechanism employed by the Massachusetts SIB, if the private investor, the Senior Lender, were related to the tax-exempt investors (i.e., the Junior Lenders or the grantors), this arrangement may violate the private inurement doctrine.

Pursuant to the terms of the SIB, the advances made by the Senior Lenders are subject to a higher rate of return and have the right to payments before any returns are paid to the Junior Lenders, while the Junior Lenders take on a greater risk but receive a lower, below-market return on their investment. In effect, the higher returns, which are closer to a market-rate return, may be offered to the private investors because the nonprofit investors are willing to accept lower returns.¹⁸³ Thus, in effect, the tax-exempt investors may be partially subsidizing the payments made to the Senior Lender.¹⁸⁴ If the Senior Lender is considered to have some sort of influence or control over the Junior Lenders, then this investment structure may violate the private inurement doctrine and the Junior Lenders will lose their tax-exempt status.¹⁸⁵

180. See Leff, *supra* note 106, at 24. As a result of this requirement, tax-exempt organizations cannot directly access capital from equity investors. See Hutchinson, *supra* note 106; Leff, *supra* note 106, at 24.

181. A social enterprise has been defined as an entity “organized and operated for the dual purpose of engaging in profit-making activity and furthering a social good.” Linda O. Smiddy, *Corporate Creativity: The Vermont L3C & Other Developments in Social Entrepreneurship*, 35 VT. L. REV. 3, 5 (2010) (quoted in Leff, *supra* note 106, at 2). With respect to the first requirement, a SIB-funded program does not technically engage in a profit-making activity. However, it generally seeks to create government savings, which arguably may be considered a form of profit. A SIB-funded program clearly meets the second requirement of furthering a social good because its goal is to address a social problem, such as homelessness or recidivism, among other issues that are typically addressed by governments or charitable organizations.

182. Leff, *supra* note 106, at 27.

183. Similarly, the grantors are willing to risk having a zero return on their investment because they want to promote the social goals of the project.

184. See Leff, *supra* note 106, at 18.

185. However, “it is not entirely clear what type of relationship constitutes influence or control or what type of benefit constitutes inurement.” *Id.* at 27. Even if

Similarly, the SIB arrangement potentially may be treated as violating the private benefit doctrine, which could also cause a nonprofit investor to lose its tax-exempt status. The private benefit doctrine provides that a tax-exempt organization is prohibited from being organized or operated for the benefit of private individuals, even if the benefited party is a disinterested person.¹⁸⁶ If the private benefit is substantial enough that it overwhelms the charity's public purpose, the nonprofit organization can lose its tax-exempt status.¹⁸⁷ Unfortunately, there is a lot of ambiguity in this area and it is unclear what constitutes an "insubstantial" private benefit that does not violate the private benefit doctrine.¹⁸⁸ For instance, it is possible that the Service may deem a SIB arrangement to violate this doctrine when nonprofit investors participate as Junior Lenders that subsidize the senior lenders' return on investment. This would occur if the Service interprets the private benefit doctrine to apply "to any economic transaction in which charitable assets are improperly diverted to someone other than the charitable beneficiaries."¹⁸⁹ However, it is also possible that the Service may interpret the doctrine to only apply where a "non-charitable purpose has overwhelmed the charitable purpose of the organization so that the organization no longer really serves its charitable goals."¹⁹⁰ In this case, a nonprofit organization could participate as a junior lender in a SIB

the transaction is not treated as violating the private inurement doctrine, under certain circumstances, the tranche investment structure creates the risk that the Service will treat the investment in a SIB as an "excess benefit transaction" and impose penalties pursuant to Code section 4948. For a more thorough discussion of whether investment in a tranching social enterprise violates the private inurement doctrine or creates an excess benefit transaction, see Leff, *supra* 106.

186. The private benefit doctrine is not explicitly contained in the Code. Instead, it is derived from Regulation section 1.501(c)(3)-1(d)(1)(ii), which requires that a charitable organization be organized and operated exclusively for a charitable purpose. See Bruce R. Hopkins, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 537 (10th ed. 2011); Dagher, *supra* note 9, at 3488; Leff, *supra* note 106, at 48. This doctrine differs from the private inurement doctrine in that the private benefit doctrine applies even when the person who receives the income or assets from the tax-exempt organization is a disinterested person, provided that the benefit is considered excessive. See Leff, *supra* note 106, at 24.

187. See Leff, *supra* note 106, at 48.

188. *Id.* at 49 (noting also that "[t]he IRS has taken the position that a private benefit must be 'insubstantial' and that insubstantiality should be measured both 'qualitatively' and 'quantitatively'") (footnotes omitted).

189. Leff, *supra* note 106, at 50.

190. *Id.* at 51.

arrangement as long as its investment is insignificant relative to its overall activities.¹⁹¹

If the SIB arrangement is characterized as a joint venture,¹⁹² then the Service will evaluate the private benefit doctrine under a separate framework.¹⁹³ Unfortunately, this framework is just as ambiguous as the one described above.¹⁹⁴ Under this framework, it is possible that a nonprofit investor in a SIB with a tranche investment structure may be deemed to violate the private benefit doctrine if it does not maintain sufficient control over the parts of the joint venture relevant to its tax-exempt purpose.¹⁹⁵

B. Unrelated Business Income Tax

Even if a SIB arrangement is not treated as violating the private benefit doctrine with respect to its nonprofit investors, the transaction may potentially result in taxable income to the nonprofit investor if the SIB arrangement is characterized as a joint venture. Specifically, tax is imposed on income derived by a nonprofit entity from any unrelated trade or business regularly carried on by that entity (UBIT).¹⁹⁶ If the tax-exempt entity “is a partner in a partnership, the organization’s [unrelated business taxable income] includes its distributive share of the income of any business carried on by the partnership that is not related to the organization’s exempt purposes.”¹⁹⁷ Thus, if the SIB

191. *See id.* The private benefit doctrine potentially also comes up in the SIB context if the investors’ returns, which derive from the successful work of the nonprofits, constitute a distribution of profits. *See Dagher, supra* note 9, at 3504. If this is the case, a tax-exempt organization that serves as the intermediary or service provider with respect to a SIB-funded program may potentially lose its tax-exempt status. *See id.* For an in-depth analysis of whether a nonprofit participating in a SIB violates the private benefit doctrine, see *Dagher, supra* note 9.

192. The Service broadly interprets what constitutes a joint venture for these purposes. *See Leff, supra* note 106, at 51–52.

193. *See Dagher, supra* note 9, at 3495; *Leff, supra* note 106, at 51–52.

194. *See Leff, supra* note 106, at 51.

195. *See Dagher, supra* note 9, at 3495; *Leff, supra* note 106, at 51. The Service imposes a different analysis depending on whether the joint venture is a whole-entity joint venture or ancillary joint venture. *See Dagher, supra* note 9, at 3495; *Leff, supra* note 106, at 51. It is not entirely clear whether or not a control requirement exists for ancillary joint ventures and if so, what type of control is necessary. *See Dagher, supra* note 9, at 3496–98; *Leff, supra* note 106, at 53–54.

196. *See* I.R.C. §§ 511, 512. Generally an activity carried on by an exempt organization with a profit motive is sufficient to constitute a trade or business. *See BITTKER & LOKKEN, supra* note 124, ¶ 103.4.2.

197. *BITTKER & LOKKEN, supra* note 124, ¶ 103.6.10; *see also* I.R.C. § 512(c).

arrangement is treated as a joint venture between the investors and the project intermediary, then the tax-exempt investors must be cautious that all of the activities carried on by the venture are substantially related to the charitable purposes of their organizations. However, if the SIB arrangement is characterized as debt or equity, then any interest or dividend payments will not give rise to any UBIT. The statute specifically excludes from the UBIT certain types of passive income, such as dividends, interests, royalties, and rents.¹⁹⁸

Despite the foregoing, even if the SIB arrangement is characterized as a joint venture, UBIT will not necessarily result. Consider for instance the Massachusetts SIB. If this arrangement is characterized as a joint venture, it will not likely give rise to UBIT, because the purpose of the venture is to provide relief to underprivileged individuals and promote social welfare by addressing juvenile delinquency.¹⁹⁹ These goals are consistent with the charitable purposes shared by the tax-exempt investors.²⁰⁰

C. Excise Taxes

In addition to the potential tax implications discussed above, if a philanthropic investor that qualifies as a tax-exempt organization constitutes a private foundation,²⁰¹ then any returns that it earns through its investment in a SIB may be subject to additional taxes. Specifically, these private foundations potentially may be liable for excise taxes on: (1) net investment income, (2) investments that jeopardize charitable purposes, (3) a failure to distribute income, and (4) excess business holdings.

198. See I.R.C. § 512(b).

199. See Mass. Contract, *supra* note 13, at app. H.

200. Specifically, one of the tax-exempt investors, the Kresge Foundation, seeks to “promote human progress” by expanding opportunities nationwide in “arts and culture, education, environment, health, human services, and community development.” *Who We Are*, KRESGE FOUND., <http://kresge.org/who-we-are> (last visited May 4, 2017). Similarly, the second tax-exempt investor, Living Cities, is an organization comprised of numerous foundations and financial institutions that seeks to “improve the economic well-being of low-income people.” *Who We Are*, LIVING CITIES, <https://www.livingcities.org/about> (last visited May 4, 2017).

201. A private foundation includes all 501(c)(3) organizations other than: (1) organizations to which contributions qualify for the 50% charitable contribution deduction allowed by Code section 170(b)(1)(A) (other than in clauses (vii) and (viii) of that section); (2) organizations that are broadly supported by the public; (3) supporting organizations performing the functions of related charities; and (4) organizations organized and operated exclusively for testing for public safety. I.R.C. § 509(a).

1. Net Investment Income

Private foundations are not entirely exempt from taxation. Section 4940 of the Code generally imposes an annual excise tax equal to two percent of a private foundation's net investment income for the taxable year.²⁰² Net investment income includes both (1) income from interest, dividends, rents, payments with respect to securities loans, royalties, and similar sources, to the extent that the income exceeds any expenses paid or incurred in earning it; and (2) capital gain net income from the sale or other disposition of property held by the private foundation.²⁰³ Therefore, regardless of whether the investment in a SIB is classified as a loan generating interest income, an equity investment generating dividends, or a payment with respect to a prepaid forward contract, the income generated by a SIB investment will likely be subject to this excise tax.²⁰⁴ Moreover, if the SIB-funded program is unsuccessful and the private foundation loses its entire investment, then this transaction may potentially be treated as a loss from the sale or other disposition of property, in which case capital losses will only be allowed to the extent of gains from such sales or other dispositions.²⁰⁵

2. Jeopardizing Investments

Because SIB-funded programs potentially generate both a social and financial return, philanthropic foundations that invest in SIBs may face additional tax consequences.²⁰⁶ In particular, these investors—and under

202. I.R.C. § 4940(a). However, this excise tax does not apply to private foundations that qualify as an “exempt operating foundation,” as that term is defined in Code section 4940(d)(2), for the taxable year. I.R.C. § 4940(d)(1)–(2). Moreover, the excise tax is reduced to one percent where the private foundation meets certain distribution requirements. I.R.C. § 4940(e).

203. I.R.C. § 4940(c); *see also* Reg. § 53.4940–1(f). Any income that is subject to the UBIT imposed by Code section 511 is not subject to this excise tax. I.R.C. § 4940.

204. However, capital gains and losses from the sale or disposition of program-related investments, as defined in Code section 4944(c) and discussed below, are not taken into account. Reg. § 53.4940–1(f).

205. I.R.C. § 4940(c)(4)(C). No capital loss carryovers or carrybacks are allowed. I.R.C. § 4940(c)(4)(C).

206. In addition to the nondistribution constraint and other requirements, private foundations are subject to additional restrictions that are not imposed on public charities. *See* I.R.C. § 501(c)(3); *see also* J. Haskell Murray & Edward I. Hwang, *Purpose with Profit: Governance, Enforcement, Capital-Raising and Capital-Locking in Low-Profit Limited Liability Companies*, 66 U. MIAMI L. REV. 1, 24 (2011). Pension

certain circumstances, their managers—may be subject to a two-tier excise tax regime if they make risky investments.²⁰⁷ The Code provides that an excise tax will apply to a private foundation that makes investments that jeopardize the carrying out of the private foundation's exempt purposes.²⁰⁸ An investment is considered a jeopardizing investment if the foundation managers failed to exercise ordinary business care and prudence in making the investment to provide for the financial needs of the foundation to carry out its exempt purpose.²⁰⁹ This determination requires a facts and circumstances analysis by the foundation managers, which may take into account the expected return, the risks of rising and falling price levels, and the need for diversification within the investment portfolio.²¹⁰

An investment in a SIB may be considered a jeopardizing investment, thereby subjecting the foundation to this excise tax. SIBs are often structured so that philanthropic foundations that invest in the SIB-funded program

funds also face similar concerns about investing in ventures that produce social as well as financial returns because of the U.S. Department of Labor's view that sections 403 and 404 of the Employee Retirement Income Security Act (ERISA) do not permit fiduciaries to promote collateral goals at the expense of the economic interests of plan participants. *See* 29 C.F.R. § 2509.2015-01 (2015). However, the Department of Labor recently clarified that pension plan fiduciaries may consider economic, environmental, social, and governance concerns in addition to a financial return when making investments. News Release, Emp. Benefits Sec. Admin., New Guidance on Economically Targeted Investments in Retirement Plans from US Labor Department (Oct. 22, 2015), <https://www.dol.gov/opa/media/press/ebsa/ebsa20152045.htm>; *see also* 29 C.F.R. § 2509.2015-01 (2015); RICHARD L. FOX, TAXATION OF CHARITABLE GIVING AND EXEMPT ORGANIZATIONS § B1.01 (2d ed. 2009).

207. *See* I.R.C. § 4944; FOX, *supra* note 206, § B1.01.

208. I.R.C. § 4944(a)(1). The amount of the excise tax imposed on the foundation is ten percent of the amount of the jeopardizing investment made that year. I.R.C. § 4944(a)(1). In addition, the investment is subject to an additional tax, payable by the foundation, equal to 25% of the investment amount if the investment is not removed from jeopardy within the taxable period. I.R.C. § 4944(b)(1). If the excise tax is imposed on the foundation, a foundation manager may also be subject to an additional excise tax of ten percent of the invested amount, up to a maximum tax of \$10,000, if the foundation manager knowingly (but not willfully or due to reasonable cause) made the investment in such a manner as to jeopardize the carrying out of any of the foundation's exempt purposes. I.R.C. § 4944(a)(2), (d)(2). A foundation manager subject to the excise tax may also be subject to an additional tax of five percent of the amount of the investment, up to a maximum tax of \$20,000, if such manager refuses to remove the investment from jeopardy. I.R.C. § 4944(b)(2), (d)(2).

209. Reg. § 53.4944-1(a)(2)(i).

210. *Id.* However, once an investment is determined not to constitute a jeopardizing investment, the investment will not later be considered a jeopardizing investment even if the investment later results in a loss to the foundation. *Id.*

receive a lower rate of return than private investors. Consider for instance the Junior Lenders in the Massachusetts SIB. The Junior Lenders are private foundations that make an investment in the SIB that is both riskier and less profitable than the Senior Lender's investment. Moreover, these investors stand to lose their entire investment if the program is unsuccessful. Thus, given the disproportionate risk to return ratio, it is possible that an investment in a SIB-funded program may constitute a high-risk, speculative investment that does not satisfy the requisite standard of care and prudence. If this is the case, then investing in a SIB-funded program may subject a foundation's investment to the jeopardy investment excise tax.

One way that a private foundation can avoid this excise tax on jeopardizing investments is by demonstrating that the foundation managers exercised ordinary business care and prudence and made an investment that furthers the foundation's charitable purpose. In light of the recent guidance issued by the Service, which effectively expanded the opportunities for mission-related investments by private foundations, investments by private foundations in SIBs can most likely satisfy this requirement.²¹¹ In Notice 2015-62, the Service clarified that in determining whether an investment is prudent, foundation managers may consider the relationship of the proposed investment to the foundation's charitable purpose.²¹² Accordingly, foundation managers may make an investment at an expected rate of return that is less than what the foundation might obtain from an investment that is unrelated to its charitable purpose.²¹³ Pursuant to this guidance, the foundation managers of the Junior Lenders in the Massachusetts SIB will likely be considered to have acted with ordinary business care and prudence in making the SIB investment even though the anticipated investment returns are less than what otherwise could be earned on market investments. This is because the goal of the Massachusetts SIB-financed project to provide relief to underprivileged individuals and promote social welfare by addressing juvenile delinquency is consistent with the charitable purposes shared by the Junior Lenders.²¹⁴ Thus, the investment in the Massachusetts SIB will likely qualify as a mission-

211. See Notice 2015-62, 2015-39 I.R.B. 411.

212. *Id.* The guidance also clarified that the list of facts and circumstances that foundation managers must consider in making the investment is not exhaustive. *Id.* As a result of this Notice, the prudent-investor standard for jeopardy investments is now better aligned with the state standards applicable to charitable investments under the Uniform Prudent Management Institutional Funds Act. See FOX, *supra* note 206, at § B1.01.

213. See Notice 2015-62, 2015-39 I.R.B. 411.

214. See Mass. Contract, *supra* note 13, at app. H. In fact, the intermediary, Third Sector Capital Partners, the service provider, and the grantors also share these same charitable purposes. See *id.*

related investment that is not subject to the excise tax on jeopardizing investments.

Alternatively, a private foundation can also avoid the excise tax on jeopardizing investments if the investment is considered a “program-related investment.”²¹⁵ To qualify as a program-related investment, a debt, equity, recoverable grant, or other type of investment made by a private foundation must meet three requirements: (1) the foundation must be motivated primarily by a desire to accomplish its exempt charitable purpose, (2) the production of income or the appreciation of property may not be a significant factor behind the foundation’s investment, and (3) only limited lobbying purposes and no electioneering may be served by the investments.²¹⁶ If a private foundation that invests in a SIB-funded program meets these three criteria, it can potentially escape the excise tax regardless of whether or not it meets the “prudent man” rule described above.

Unfortunately, given the limited Service guidance on acceptable program-related investments, it is unclear whether an investment in a SIB-funded program will satisfy these criteria.²¹⁷ In particular, a potential issue arises with respect to whether the investment meets the second requirement: that the production of income is not a significant factor behind the foundation’s investment. In determining whether the production of income is a significant factor, a relevant consideration is “whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation.”²¹⁸ On the one hand, the production of income is arguably not a significant factor behind the foundation’s investment in SIB arrangements structured as a tranche investment, such as the Massachusetts SIB. Because the private foundation’s investment receives a lower rate of return and is subordinate to the Senior Lenders’ investment, this suggests that an investor whose sole motivation is the production of income would likely not make the investment on the same terms as the private foundation.²¹⁹ Even if the SIB-funded program is successful and the private foundation realizes a profit, this does not change this result in the absence of other factors, especially

215. I.R.C. § 4944(c); Reg. § 53.4944-3.

216. Reg. § 53.4944-3(a).

217. See Reg. § 53.4944-3(a)(2)(iii); see also Murray & Hwang, *supra* note 206, at 26.

218. Reg. § 53.4944-3(a)(2)(iii).

219. For example, the Treasury has noted that a private foundation does not have a significant purpose involving the production of income or the appreciation of property when it provides a loan to a business to be used in a manner to further the accomplishment of its exempt activities and the loan bears interest at a rate less than that charged by financial institutions that have agreed to lend funds to the business., Reg. § 53.4944-3(b), Ex. 6.

given the fact that all SIBs today have a capped maximum return.²²⁰ The Junior Lenders in the Massachusetts SIB appear to take the position that their SIB investment qualifies as a program-related investment.²²¹

Furthermore, even if a private foundation invests on the same terms as a private investor, it is possible that the investment constitutes a program-related investment. To qualify as a program-related investment, the investment generally must have an expected rate of return that is below- market on a risk-adjusted basis.²²² SIBs that have currently launched in the United States are expected to yield a return that is substantially lower than a similar investment due to the risky nature of the preventative programs employed by the nonprofit service providers. Investors appear willing to accept the risks and expected lower returns for nonfinancial reasons, such as charitable agendas or improved public relations.²²³ Investors who were solely motivated by financial gains would likely not invest in these SIBs. Thus, the Service may conclude that the production of income was not a significant factor in making the investment in the SIB.²²⁴ However, this reasoning may no longer apply once SIBs gain greater acceptance and are able to offer a higher rate of return.

220. See Reg. § 53.4944-3 (noting that the fact that an investment produces significant income or capital appreciation is not conclusive evidence that this was a significant purpose of the foundation in entering into the investment); see also P.L.R. 2006-10-020 (Dec. 13, 2005) (stating that the Service has determined that proposed investments that place a cap on the maximum investment return, among other features, constitute program related investments).

221. See MASS. FACT SHEET, *supra* note 11.

222. See FRANCIE BRODY ET AL., CURRENT PRACTICES IN PROGRAM-RELATED INVESTING (2002), <http://community-wealth.org/sites/clone.community-wealth.org/files/downloads/article-brody-mcqueen.pdf>. This rate of return is generally from one and four percent. See *id.* at 2.

223. See BARAJAS ET AL., *supra* note 14, at 13; JEFFREY B. LIEBMAN, CTR. FOR AM. PROGRESS, SOCIAL IMPACT BONDS: A PROMISING NEW FINANCING MODEL TO ACCELERATE SOCIAL INNOVATION AND IMPROVE GOVERNMENT PERFORMANCE (2011), https://cdn.americanprogress.org/wp-content/uploads/issues/2011/02/pdf/social_impact_bonds.pdf.

224. See, e.g., P.L.R. 2006-10-020 (Dec. 13, 2005) (concluding that a private foundation's investment in a limited liability company on the same terms as the other members, none of which is investing solely for profit, and which is expected to yield a substantially lower return than a typical angel investment due to the requirement that the entity invest in low-income communities that have been unable to obtain conventional financing, satisfies the requirement that no significant purpose of the investment is the production of income or the appreciation of property).

3. Failure to Distribute Income

A private foundation is also subject to a separate excise tax on its undistributed income.²²⁵ A foundation can generally avoid this tax by making qualifying distributions that are at least five percent of the net value of its investment assets.²²⁶ Qualifying distributions include amounts paid to accomplish its exempt charitable purposes, amounts paid to acquire assets held for use in exempt activities, program-related investments, and certain set-asides for future expenditures in particular charitable projects.²²⁷ Therefore, if the SIB investment qualified as a program-related investment, the private foundation investors would not only avoid the excise tax on jeopardizing investments but would also be able to treat the investment as a qualifying distribution for purposes of meeting the private foundation's five percent annual minimum distribution requirement.

4. Excess Business Holdings

Finally, a private foundation is also subject to tax on the excess business holdings that it has in a business enterprise.²²⁸ A business enterprise excludes: (1) a business that is substantially related to the foundation's exempt purposes, (2) a business that is functionally related to its exempt activities, (3) a program-related investment, or (4) a business that derives at least 95% of its gross income from passive activities.²²⁹ Therefore, if the SIB investment constitutes a program-related investment, then the investment will not trigger this tax.

Even if the SIB investment does not qualify as a program-related investment, the tax on excess business holdings may not apply under certain circumstances. For instance, if the SIB investment is characterized as debt, then this tax is not applicable because a debt obligation is not an interest in a business enterprise.²³⁰ Moreover, even if the interest were recharacterized as an equity interest in a corporation or joint venture, then the tax would not apply if the business were substantially related to the foundation's exempt purpose or if the foundation's equitable interest exceeded 20% of the corporation's

225. I.R.C. § 4942(a). However, operating foundations are exempt from these taxes. *See* BITTKER & LOKKEN, *supra* note 124, ¶ 101.5.

226. I.R.C. § 4942; *see also* BITTKER & LOKKEN, *supra* note 124, ¶ 101.5.

227. I.R.C. § 4942(g); Reg. § 53.4942(a)-3(a)(1); *see also* BITTKER & LOKKEN, *supra* note 124, ¶ 101.5.

228. I.R.C. § 4943(a).

229. I.R.C. § 4943(d)(3); Reg. §§ 53.4943-1 & -10(b), (c); *see also* BITTKER & LOKKEN, *supra* note 124, ¶ 101.6.

230. Reg. § 53.4943-10(a)(2).

voting stock or the partnership's profits interest. This is essentially the same definition that is used to determine if the foundation has unrelated business taxable income.²³¹ As discussed above, currently launched SIBs, such as the Massachusetts SIB, most likely do not generate unrelated business taxable income and, therefore, a SIB investment most likely does not constitute a business holding in a business enterprise.²³²

V. RECOMMENDATIONS

As the above analysis demonstrates, investors in a SIB face substantial tax uncertainty. Currently, no direct guidance exists as to how to characterize SIB arrangements for tax purposes. Instead, current law potentially allows investors to characterize the SIB arrangement as debt, corporate or partnership equity, or a prepaid swap arrangement, which may result in similarly situated taxpayers being taxed differently. This uncertainty also increases audit risk for private investors, as the Service and taxpayer may disagree as to the correct characterization of a SIB. Similarly, nonprofit investors face uncertainty as to whether investing in a SIB exposes them to additional taxes or, possibly, even causes them to lose their tax-exempt status.

This Part seeks to determine the most likely tax implications of investing in a SIB. Specifically, this Part argues that SIBs should generally be classified as contingent debt under current tax law but that it may be appropriate to bifurcate the transaction in the case of nonprofit investors. However, as discussed above, these conclusions are not entirely free from doubt. Thus, to encourage SIB investments and ensure the appropriate collection of tax revenue, this Part concludes that the Service should issue guidance that clarifies the tax treatment of SIBs and recommends ways to structure the SIB arrangement to minimize some of the negative tax implications that a SIB investment potentially raises until such guidance is issued.

A. *Contingent Debt Treatment*

Despite the different potential alternatives, this Article argues that the current law weighs in favor of treating a SIB arrangement that is structured like the Massachusetts SIB as a contingent debt instrument for several reasons. First, the parties' intentions and the form of the instrument initially points toward debt characterization. As discussed above, the parties refer to the investment as a "loan" from the investors to the project intermediary, the

231. See BITTKER & LOKKEN, *supra* note 124, ¶ 101.6.

232. See *supra* notes 196–200 and accompanying text.

investors are referred to as “lenders,” the agreement provides for a stated rate of interest, and repayment is generally unsubordinated. These factors weigh in favor of a debt characterization instead of an equity or derivative instrument characterization. The intermediary may also issue a note or other instrument of indebtedness, which would further support the parties’ contention that the SIB arrangement creates a debt instrument.

Second, labeling the instrument as debt binds the issuer and all holders of the instrument to this characterization.²³³ Thus, under these circumstances, the SIB arrangement will likely be recharacterized as something other than debt only if the Service decides to challenge the characterization of the instrument.²³⁴ Practically speaking, however, the Service is unlikely to challenge the debt characterization in most instances because it generally results in unfavorable tax consequences to the private investors from a timing and tax rate perspective. In particular, because the payment of interest and principal is contingent on the success of the SIB, characterizing the instrument as debt means the SIB arrangement constitutes a contingent debt instrument subject to the contingent debt rules. As a result, the SIB investors have to account for any potential return on investment on an annual basis and characterize any return as ordinary income.

Third, the fact that a SIB arrangement does not provide an unconditional promise to pay the principal at a fixed maturity date but is instead contingent on the success of a particular social program does not necessarily preclude debt characterization. For the contingent debt rules to apply, the Treasury Regulations require that the instrument constitute “debt” for tax purposes.²³⁵ Neither the Code nor the Treasury Regulations define “debt” for these purposes.²³⁶ However, the Service’s ten-year effort to construct a tax regime for contingent debt instruments suggests that the Service believes that some instruments that are contingent as to principal and interest can constitute debt instruments.²³⁷

In addition, some authorities suggest that an instrument may be characterized as debt if the investor *reasonably expects* the return of his

233. See I.R.C. § 385(c).

234. See *id.*; Estate of *Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972); I.R.S. Notice 94-47, 1994-1 C.B. 357. Such label will be respected unless a sufficient basis exists for disregarding the form of the transaction into which the parties cast their dealings. See *Stinnett’s Pontiac Serv., Inc. v. Comm’r*, 730 F.2d 634 (11th Cir. 1984); *Piedmont Corp. v. Comm’r*, 388 F.2d 886 (4th Cir. 1968).

235. See Reg. § 1.1275-4.

236. See *id.*; ANDREA S. KRAMER, FINANCIAL PRODUCTS: TAXATION, REGULATION, AND DESIGN § 50.07[A] (3d ed. 2008).

237. See Levy, *supra* note 130, at 500.

investment.²³⁸ In the case of the Massachusetts SIB, the service provider implemented an evidence-based, high-impact intervention during the 25 years prior to the launching of the SIB.²³⁹ The program also has a proven track record of reducing incarceration rates among the highest-risk individuals.²⁴⁰ Thus, the investors may reasonably expect a return of their investment. Similarly, a SIB arrangement may also be structured so that the investors receive greater protections from downside risks. For instance, several SIBs that have been launched provide for a guarantee that ensures that the investors are repaid a certain amount of their investment.²⁴¹ Similarly, a SIB arrangement may provide for collateral in an adequately valued asset, an interest in reserve funds, first-loss provisions, and other credit-enhancing methods. These types of provisions increase the investor's reasonable expectation of repayment and insulate the investor from some of the risks associated with the SIB structure. In these cases, the contingent nature of the instrument is even less problematic.

Finally, the totality of the factors does not support a finding that the SIB investor has an ownership interest in the business of providing or managing social services or in any other business or going concern. Instead, the burdens and benefits of this business remain with the government, the social service provider, and the project intermediary. For instance, pursuant to the Massachusetts SIB project documents, the service provider receives payments for providing the specified social services and receives additional compensation if it exceeds certain performance thresholds. Similarly, the project intermediary is paid a service fee for the services that it provides as a fiscal agent and project manager. The SIB investors are not entitled to a portion of any of these fees and do not participate in any benefits or burdens related to these businesses. Thus, although equity characterization is possible under some circumstances, a SIB that is structured like the Massachusetts SIB has too many equity-like features that are missing and should be characterized as debt rather than equity.

238. See Farber, *supra* note 55, at 665. However, there remains a lot of uncertainty regarding whether the existence of an economic likelihood of repayment is sufficient to support a debt characterization of an instrument when the specific terms of the instrument do not provide an unconditional right to a sum certain. See *id.*

239. See MASS. FACT SHEET, *supra* note 11.

240. See *id.*

241. See *supra* notes 32–33 and accompanying text.

B. Bifurcation for Nonprofit Investors

This article also argues that in a SIB structured as a tranche investment like the Massachusetts SIB, the SIB investment should be bifurcated into two transactions with respect to the Junior Lenders. Specifically, the investment should be bifurcated as follows: (1) the issuance of a financial instrument that bears a market rate of return, and (2) the issuance of a financial instrument that is not entitled to any return. The first transaction should be treated as contingent debt for the same reasons discussed above with respect to the private investors. The second transaction should be treated as a charitable contribution of the foregone interest. Together, these two transactions are economically equivalent to a subordinated investment that bears a below-market rate of return in a SIB with a tranche investment structure. This characterization should be permitted for several reasons.

First, the subordinated investment made by the Junior Lenders is most likely charitable in nature. Consider for instance the Massachusetts SIB. As discussed above, these investors are philanthropic foundations, which transfer funds in the form of subordinated loans. These loans bear a lower rate of return on their investment as compared to the Senior Lender even though the Junior Lenders take on greater risk.²⁴² This is contrary to a typical market transaction where more risky investments are awarded with a higher potential rate of return. Instead, the Junior Lenders' willingness to accept this below-market financial return likely stems from their interest in maximizing social impact, rather than profit.²⁴³ This is especially likely given the fact that the Junior Lenders are private foundations; their mission aligns with that of the SIB-financed program and the risk-absorbing nature of their investment.

Second, even though the case law currently disfavors bifurcating a financial instrument into separate components, at least one case stands for the proposition that a single instrument with both equity-like and debt-like features can be bifurcated into two instruments.²⁴⁴ Moreover, given the charitable component of the Junior Lenders' investment, this is not purely a financial instrument, and bifurcation of a transaction into its separate components has been permitted in other contexts under current law. Thus, this may be another situation where bifurcation is permissible. Even if the current

242. See *supra* notes 32–54 and accompanying text.

243. See MCKINSEY & CO., *supra* note 82, at 39.

244. See Farber, *supra* note 55, at 659 (citing to *Farley Realty Corp. v. Comm'r*, 279 F.2d 701, 703–04 (2d Cir. 1960), which addresses a case where bifurcation was permitted for an instrument with both equity-like and debt-like features); see also JOINT COMM. ON TAX'N, *supra* note 127, at 13.

law does not support this treatment, the Junior Lenders can accomplish this result with some advanced planning, as further discussed below.

Third, bifurcation of the transaction is preferable to the alternative of either (1) trying to fit this novel investment into an existing, imperfectly fitting characterization or (2) enacting legislation that creates a new characterization for SIB investments. Although the contingent debt characterization is the most accurate way to characterize SIB investments for the reasons discussed above, this characterization does not accurately reflect the economic substance of the SIB arrangement with respect to the Junior Lenders when a tranche investment structure is used. Specifically, it fails to take into account that a rational, profit-motivated investor would not accept a subordinated loan that bears a lower rate of interest than the senior loan. Instead, there is a charitable purpose motivating this transaction. In addition, treating this transaction solely as contingent debt would potentially result in economically similar instruments being taxed differently because, as discussed further below, investors can formally bifurcate the transaction with advance planning and achieve this result. Enacting legislation that creates a new characterization for SIB investments may also inadvertently treat economically similar instruments differently and create distortionary results.²⁴⁵ It may also be difficult to create a new characterization that accurately captures the economic substance of the SIB arrangement given the fact that all SIB arrangements are not identical. Moreover, as with many financial instruments, any specific characterization contemplated for the SIB arrangement would quickly become outdated as the SIB structure continues to evolve.²⁴⁶ Therefore, applying a component analysis would most accurately characterize these instruments from an economic perspective especially in comparison to the available alternatives.²⁴⁷

C. Planning Recommendations

Until the current tax law governing financial instruments is changed or direct guidance is issued by Congress or the Treasury, the uncertainty surrounding the tax implications of SIB investments will remain. This Section suggests ways to structure the SIB arrangement in the meantime to minimize the negative effects of this uncertainty.

Many of the unfavorable tax consequences that private investors in a SIB potentially face are most likely to arise if the SIB investment is

245. See JOINT COMM. ON TAX'N, *supra* note 127, at 13; Shu-Yi Oei & Diane M. Ring, *The New "Human Equity" Transactions*, 5 CAL. L. REV. CIR. 266 (2014).

246. See JOINT COMM. ON TAX'N, *supra* note 127, at 13.

247. See Farber, *supra* note 55, at 683 (reaching a similar conclusion with respect to other financial instruments that are neither debt nor equity).

characterized as contingent debt or as a prepaid swap arrangement. This is because both the noncontingent bond method and the noncontingent swap method would accelerate the investors' recognition of income and subject that income to ordinary tax rates. An investor may be able to mitigate these negative tax implications under some circumstances if the SIB arrangement is formally structured as a cash-settled prepaid forward contract instead. Because both a contingent debt instrument and a prepaid swap are equivalent to a cash-settled prepaid forward contract in both form and substance, this would not change the economics of the transaction.²⁴⁸ In both cases, the purchasers of the debt instrument receive the same legal rights that they would have received if they had purchased a cash-settled prepaid forward contract on the projected value of the government savings resulting from a successful social program.²⁴⁹ In other words, in both cases, the purchaser is entitled to receive a right to a payment in the future only if a specific social program is successful. Thus, the parties can achieve this structure merely by altering the label of the investment. If the Service does not challenge this characterization, then the parties may be able to benefit from a deferral of any income recognition until the termination of the SIB arrangement as well as capital gain treatment.

Even if this characterization is challenged, under some circumstances the prepaid forward contract characterization may be respected as the correct characterization of the SIB arrangement. In particular, in situations where the SIB arrangement is not merely paying to scale a social program that has already proven to be effective but instead is financing a new and untested method, the prepaid forward contract characterization may better reflect the economics of the arrangement.²⁵⁰ In these cases, the expected likelihood of

248. See *supra* notes 123–139 and accompanying text. See also Levy, *supra* note 130, at 522.

249. See Levy, *supra* note 130, at 522 (concluding that a gold note and a cash-settled prepaid forward contract on gold are practically identical because in both cases the purchaser only receives creditor's rights against its respective counterparty).

250. One of the purported benefits of the SIB arrangement is that it encourages innovation in the public sector. See GOODALL, *supra* note 12, at 7; KOHLI ET AL., *supra* note 3; Liang et al., *supra* note 125, at 272. Specifically, 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. See Davies, *supra* note 2, at 5; Liang et al., *supra* note 125, at 274; N.Y. FACT SHEET, *supra* note 14. 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. See KOHLI ET AL., *supra* note 3; GOODALL, *supra* note 12, at 7; Esha Chhabra, *Social Impact Bonds: The "It Girl" of Muni Finance*, NEXTCITY (Jun. 23, 2014), <https://nextcity.org/features/view/social-impact-bonds-public-private-solution>

repayment significantly decreases and the transaction becomes much more speculative. Thus, it is more appropriate to treat the transaction as an open transaction and wait until the event occurs before imposing taxes on the investor.

With respect to nonprofit investors, SIB arrangements should be structured in a manner that minimizes the risk of (1) jeopardizing the nonprofit entity's tax-exempt status and (2) incurring any additional taxes. This is particularly important in SIBs that are structured as tranche investments like the Massachusetts SIB. As discussed above, these investments run the risk of losing their tax-exempt status as a result of violating the private inurement doctrine and the private benefit doctrine. To minimize this risk, the parties need to ensure that the private senior lenders are not related to the nonprofit Junior Lenders or to any nonprofit grantors. This would prevent the Junior Lenders and any grantors from running afoul of the private inurement doctrine.

However, this would not minimize the risk of violating the private benefit doctrine. This doctrine is more ambiguous and does not have any "insider" requirement. As a result, it is more difficult to manage this risk. Without a change in the law to confine the scope of the private benefit doctrine, this doctrine has the potential to substantially limit the feasibility of tranche investment strategies as well as many other beneficial investments. Thus, as numerous commentators have already recognized, the private benefit doctrine is in need of reform.²⁵¹

To further minimize the risk of any additional taxes, a private foundation in a SIB with a tranche investment structure should also consider structuring its investment in a manner that ensures it is treated as a bifurcated transaction for tax purposes. For instance, instead of making a subordinated loan to the project intermediary that bears a subsidizing, low rate of return, the foundation can make two separate investments. One investment would take the form of a loan that bears a market rate of interest. The second investment would take the form of a recoverable grant, which would provide for repayment of the investor's funds only if the project is successful. Together

-social-problems-cities ("[I]nvestor dollars provided through SIBs don't have the limitations of project grants or government dollars; they offer a new freedom.").

251. See, e.g., Leff, *supra* note 106, at 47 (noting that the private benefit doctrine has "the potential to severely restrict the workability of tranced investment strategies" and recommending that the private benefit doctrine should be narrowed to apply only in certain clearly defined situations that (1) do not include any subsidizing investments by market-tranche investors, and (2) do not require a nonprofit that invests in a social enterprise that "constitute[s] a relatively small share of a charity's total operational budget . . . [to] maintain ongoing formal control over the organization"); see also Dagher, *supra* note 9, at 3514-18.

these two investments would be economically equivalent to a subordinated SIB investment that carries a below-market rate of interest.

By bifurcating the investment, the investor would further minimize any possibility that the excise tax on jeopardizing investments would apply to its SIB investment. With respect to the first investment, the investment should easily satisfy the “prudent man” standard because the investment bears a market or near-market rate of interest. Thus, the foundation managers would likely be able to demonstrate that they exercised ordinary business care and prudence in making an investment to provide for the financial needs of the foundation to carry out its exempt purpose.

Moreover, the second investment, the recoverable grant, would likely be respected as a program-related investment and, therefore, not be subject to the excise tax on jeopardizing investments. Specifically, an investor that makes a recoverable grant that bears no rate of return to support a SIB-financed program is more likely concerned with social impact over financial benefits. Thus, it provides taxpayers with more certainty that the production of income is not a significant factor behind the foundation’s investment. So as long as the investment in the SIB-financed program is consistent with its exempt charitable purpose and no lobbying or electioneering purposes are served by the investments, this portion of the SIB investment should qualify as a program-related investment. Qualifying as a program-related investment would also provide additional benefits to a private foundation that invests in a SIB. For instance, the investment would be treated as a qualifying investment for purposes of meeting the private foundation’s five percent annual minimum distribution requirement, which would help the foundation avoid the excise tax on undistributed income. The investment would also escape the tax on excess business holdings.

CONCLUSION

SIBs have the potential to provide an additional source of capital to finance critical social services. However, the current law creates substantial tax uncertainty for potential SIB investors. With respect to private investors, this uncertainty primarily arises because a SIB arrangement does not clearly constitute debt or equity but instead is a hybrid instrument that contains debt, equity, and charitable features. With respect to nonprofit investors, the uncertainty stems from the potentially broad application of the private benefit doctrine, as well as the limited guidance defining acceptable program-related investments.

In applying the current law to these instruments, this Article argues that it is generally most appropriate to treat a SIB as a contingent debt instrument for tax purposes. In addition, under certain circumstances, it may

be appropriate to treat a nonprofit entity's investment partially as an interest in a financial instrument and partially as a charitable contribution. Moreover, with advance planning, potential investors can limit the extent of the uncertainty surrounding a SIB investment. Nevertheless, this Article concludes that if SIBs become more prevalent and continue to evolve, they are likely to continue to challenge our tax system. Accordingly, unless guidance is issued and changes to the law are made, the current taxation of SIBs may deter private and philanthropic investors from seeking out SIB investments, thereby creating a significant hurdle to the development of SIB-funded programs in the United States.²⁵²

252. For a discussion of some ways the current tax law may be modified to extend favorable tax treatment to SIBs, see Mazur, *supra* note 8.