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## Reforming Nonprofit Exemption Requirements

Peter Molk\*

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# Reforming Nonprofit Exemption Requirements\*

Peter Molk

## Abstract

This Article proposes a reform for nonprofit exemption and unrelated business income tax. Current tax law provides unclear guidance and requires exempt organizations to risk their entire exemptions on this guidance, leading them to make the socially inefficient choice to use for-profit subsidiaries to preserve their exemptions. Reforming the tax law will solve this inefficiency while providing exempt nonprofits with the desirable option to undertake efficient nonexempt activities to augment their operating budgets. This reform is particularly timely in light of changes to the healthcare field; reform will enable exempt healthcare organizations to offset rising health costs and decreased reimbursements with other revenue opportunities.

**KEYWORDS:** Nonprofits

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\*J.D., Yale Law School; M.A., Yale (economics). Thanks to Tom Aageson, Howard Abrams, John Colombo, Miranda Fleischer, Henry Hansmann, Jeffrey Kahn, and John Morley for insightful comments and discussions.

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#### INTRODUCTION

Healthcare costs have risen significantly over the past several years. Health expenditures per capita have increased by more than five thousand percent from 1960 to 2008.<sup>1</sup> Government support of exempt activity<sup>2</sup> and private donations<sup>3</sup> have dropped. Yet exempt healthcare

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1. See *National Health Expenditures Aggregate*, U.S. DEP'T OF HEALTH AND HUMAN SERVS., CTRS. FOR MEDICARE AND MEDICAID SERVS., <http://www.cms.gov/NationalHealthExpendData/downloads/tables.pdf> (last visited May 25, 2011). National expenditures have risen from \$147 per capita in 1960 to \$7,845 per capita in 2008. *Id.* Amounts are adjusted to current dollars. *Id.*

2. See MICHAEL I. SANDERS, *JOINT VENTURES INVOLVING TAX-EXEMPT ORGANIZATIONS* 1-2, 5 (3d ed. 2007).

3. See *id.* at 1-2; see also Shelly Banjo, *Donations Slip Amid Anxiety*, WALL ST. J., June 9, 2010, at A2 (documenting decreases in support of nonprofits). Private charitable giving fell in 2008 and again in 2009. *Id.* at A2. Until 2008, charitable giving had fallen only once since 1956. *Id.*

organizations are frustrated by an unclear IRS tax policy that often leads to a high-stakes gamble when they attempt to offset price increases with profitable activity. Other exempt organizations are also faced with the same problem, and are similarly dissuaded from engaging in nonexempt activity that might raise revenue to counter the diminished government and private support.

Tax law, which threatens to revoke exemptions if organizations undertake too much nonexempt activity, places an extremely high penalty on excessive for-profit activity that, when combined with murky tax guidance, drives exempt organizations to use inefficient for-profit subsidiaries instead of conducting activities directly. Unfortunately, there is little coherent policy that justifies these tax policies; instead, their vestigial existence apparently stems from historical events. These events do not justify the continuation of the current system in light of its costs.

The general decision to choose the nonprofit or for-profit organizational form is a topic that has received considerable attention. Whether an organization should incorporate as a nonprofit depends on numerous factors, such as how it will be affected by the non-distribution constraint (the essence of a nonprofit corporation, which is prohibited from distributing profits);<sup>4</sup> whether it would qualify for federal tax exemption (not all nonprofits are exempt);<sup>5</sup> and the public's perception of the value added by being a nonprofit (the simple fact of being a nonprofit may elevate the organization in the public eye).<sup>6</sup> What has

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

5. See, e.g., *Am. Auto. Ass'n v. Comm'r*, 19 T.C. 1146 (1953) (holding that the nonprofit automobile service club - the American Automobile Association - cannot obtain an exemption); see also Hansmann, *supra* note 4, at 881, 883 (observing that the nonprofit form dominates among automobile clubs, despite generally not receiving exempt treatment). It has been estimated that a significant portion of nonprofits are not exempt. See LESTER M. SALAMON, *AMERICA'S NONPROFIT SECTOR: A PRIMER* 21-22 (1992).

6. See BURTON A. WEISBROD, *THE NONPROFIT ECONOMY* vii (1988) (noting that some people think certain nonprofits are "safer" than for-profits); see also *Hearing on Gov't Waste and Tax Abuses by Gov't and Nonprofit Entities Before the Subcomm. on Procurement, Taxation and Tourism of the H. Comm. on Small Business*, 103d Cong. 1 (1994) (statement of Rep. James D. Santini, Chairman, Business Coalition for Fair

been less noted is that even if an organization chooses the nonprofit form, it must still make the same nonprofit/for-profit assessment for many of its activities, which could be performed by the nonprofit parent or placed in a nonprofit or for-profit subsidiary. Nonprofits have been increasingly utilizing for-profit subsidiaries.<sup>7</sup> While the justification for the for-profit subsidiary choice is clear in some cases, such as where the activity is purely for-profit in nature, in other situations, such as joint ventures between nonprofit hospitals and for-profit organizations, the decision to use a for-profit subsidiary may be less obvious, as well as less desirable from an economic efficiency perspective.

Why then are nonprofits making these choices? Tax guidance for situations when for-profit activities threaten a nonprofit's exemption is vague, and the stakes are high. A nonprofit may only engage in a certain amount of nonexempt taxable behavior before losing its exemption,<sup>8</sup> and how much is too much is determined by the IRS on an unpredictable case-by-case basis.<sup>9</sup> In some circumstances, therefore, a nonprofit may place activities that include both for-profit and nonprofit aspects into a for-profit subsidiary, even when those activities could be better performed by the nonprofit directly, in order to ensure that the nonprofit parent's exemption remains safe.<sup>10</sup>

Such behavior is undesirable and socially inefficient, yet it is rational in light of the applicable tax guidance. This Article therefore suggests several reforms to the nonprofit exemption requirements and the Unrelated Business Income Tax ("UBIT") that preserve their purposes while providing nonprofits the flexibility to allocate activities efficiently among nonprofit and for-profit forms. Although some lack of clarity in tax guidance is inevitable, reducing the risks posed by the unpredictability of the current process would eliminate much of the

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Competition), *reprinted in* 94 TAX NOTES TODAY, 117-25 (June 17, 1994) (noting the "halo advantage" nonprofits possess when dealing with the public).

7. See, e.g., James J. McGovern, *The Use of Taxable Subsidiary Corporations by Public Charities – A Tax Policy Issue for 1988*, 38 TAX NOTES 1125, 1128 (1988) (noting nonprofits' increased use of for-profit subsidiaries beginning in the 1980s).

8. See *infra* notes 60-70 and accompanying text.

9. See, e.g., Jessica Peña & Alexander L.T. Reid, Note, *A Call for Reform of the Operational Test for Unrelated Commercial Activity in Charities*, 76 N.Y.U. L. REV. 1855, 1875 (2001).

10. See *infra* Part IV.C.2.

undesirable incentives pushing nonprofits to adopt the inefficient for-profit subsidiary form.

The nonprofit sector accounts for a considerable portion of U.S. economic activity. Nonprofit revenue constitutes 11 to 12 percent of GDP and about 9 percent of employment, with assets well over \$2 trillion.<sup>11</sup> Given the size and importance of nonprofit operations, it is desirable to give them the proper organizational incentives.

This Article proceeds as follows: Part I introduces traditional justifications for choosing the nonprofit corporate form. This discussion will be used later in the Article when analyzing how to modify requirements for exemption and the UBIT. Parts II and III then review the current state of federal tax exemption laws and the UBIT, respectively, showing the high stakes and uncertainty that nonprofits face when predicting how activities with for-profit components will affect their exemption. Part IV examines how nonprofits currently use for-profit subsidiaries in response to this uncertainty, coupled with the high stakes of risking the overall exemption. For-profit subsidiaries are used in three general ways, two of which are socially efficient and one of which is socially inefficient. Part V suggests a reform for nonprofit exemption requirements and the UBIT that eliminates the socially-inefficient use of for-profit subsidiaries, making tax law more neutral with respect to organizational choice. Finally, this Article concludes with an Appendix containing additional information and analysis regarding IRS data and methodologies accompanying the figures throughout the Article.

Although the focus in this Article is on generating efficient incentives for nonprofits, society and nonprofits likely care about other goals as well, such as fulfilling their charitable missions or promoting distributive justice.<sup>12</sup> Nevertheless, to the extent we can maximize

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11. *Overview of the Tax-Exempt Sector, Hearing before the H. Comm. on Ways and Means*, 109th Cong. 7 (2005) (statement of David M. Walker, Comptroller General, U.S. Government Accountability Office); *Statistics of Income Tax Stats – Charities & Other Tax-Exempt Organizations Statistics*, IRS.GOV, <http://www.irs.gov/taxstats/charitablestats/article/0,,id=97176,00.html> (last visited May 25, 2011).

12. See generally Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice*, 87 WASH. U.L. REV. 505 (2010) (arguing that distributive justice issues play an important role in justifying the current system of exemptions).



efficiency without compromising these other goals, we should do so. Such is the objective throughout this Article.

## I. JUSTIFICATIONS FOR THE NONPROFIT FORM

Economic and policy justifications for the nonprofit corporate form have spanned a number of dimensions. Two compelling and complementary explanations in particular have emerged. Some argue that nonprofits fill a role of providing public goods at an efficient level – a level that neither the government nor private firms would match.<sup>13</sup> Others claim that nonprofits solve an asymmetric information problem – consumers find it difficult to monitor the quality of certain goods and services, and nonprofits are able to solve this situation through their non-distribution constraint.<sup>14</sup> This information asymmetry commonly emerges in public good financing through donations, as well as in other situations.

### A. PUBLIC GOODS THEORY

Public goods are those that are nonrival and nonexcludable.<sup>15</sup> This means that consumption of the good by one person does not preclude simultaneous consumption of the good at the same level by others, and people cannot easily be excluded from consuming the good.<sup>16</sup> A prototypical example of a public good is a streetlamp on an open road. The amount of light on the street is not diminished by the passage of pedestrians, and pedestrians cannot easily be excluded from enjoying the light on the street without excluding them from the street altogether.

Because of the nonrivalrous and nonexcludable nature of public goods, the private market will supply them at an inefficiently low level. Once the good is provided, all individuals can consume it regardless of their contribution to the good. Thus, Consumer A can conceal his own demand for the good and wait for someone else to purchase it. Then, A can free-ride on the purchase and consume the good without paying for

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13. *See, e.g.*, BURTON A. WEISBROD, *THE VOLUNTARY NONPROFIT SECTOR* 51-76 (1977).

14. *See* Hansmann, *supra* note 4, at 843-45.

15. *See, e.g.*, ANDREU MAS-COLELL ET AL., *MICROECONOMIC THEORY* 359 (1995).

16. *See id.*

it. These incentives result in an inefficiently low observable demand for the good (in terms of who is willing to pay for it), and hence a socially suboptimal under-provision of the good.<sup>17</sup>

Provision of public goods by the government, instead of by private actors, is often proposed as a solution to this situation. However, if demand for the public good by individuals is non-uniform at a given price, then public choice theory predicts that the government will underprovide these public goods as well.<sup>18</sup> Suppose that the public good costs  $P$  per unit of output provided. Then, assuming that the government requires each individual to pay a percentage  $p$  of this  $P$ ,<sup>19</sup> each individual's level of the quantity demanded, at the associated price  $p \times P$ , is arranged from least to greatest. The rational politician would provide only the median individual's quantity demanded. By doing so, this median individual and those demanding less of the public good are satisfied, securing the politician majority approval.<sup>20</sup>

However, those individuals who demand more of the public good than is provided by the government have residual unsatisfied demand. These individuals could resort to the private market, but under the public goods theory private goods are thought to be an imperfect substitute, not providing as much social benefit per unit as the public good.<sup>21</sup> Instead,

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17. The analysis is similar for public goods that can be provided in varying degrees, rather than either provided or not provided. *See, e.g.*, 5 JAMES M. BUCHANAN, COLLECTED WORKS OF JAMES M. BUCHANAN: THE DEMAND AND SUPPLY OF PUBLIC GOODS 12-15 (1999) (analyzing the demand and supply of public goods).

18. *See, e.g.*, WEISBROD, *supra* note 13.

19. *Id.* at 54. Because of progressive tax rates, this uniform  $p$  across all consumers is unlikely. However, the analysis still works even if individuals are assumed to pay differing shares of  $P$ . Individuals only need to be able to determine their personal quantity demanded of public goods at a given price.

20. Alternative assumptions might imply that the politician would provide other amounts of the good. For instance, if individuals' intensity of demand were taken into account, the amount provided by the politician might change. *See id.* at 54-55. The intuition of the model works, however, as long as the politician does not provide the quantity demanded by the individual who wants the most provided, or, equivalently, that there is some residual demand left unsatisfied by the political process. Practically, such an outcome seems very likely.

21. *See id.* at 58-59; *see also supra* text accompanying note 17. *But see* Hansmann *supra* note 4, at 849 n.46 (questioning whether such a distinction between public and private goods exists).

nonprofits arise to meet this demand by providing additional quantities of the public good. However, because the nonprofit solution may suffer from financing difficulties inherent in public good provision including consumers' ability to free-ride,<sup>22</sup> partial subsidies are provided through methods including tax exemptions and deductibility of donations to these organizations.<sup>23</sup> Left unanswered is the question of why the nonprofit form and its accompanying non-distribution constraint is the requisite form for public good provision. The following theory addresses this point.

#### B. INFORMATION ASYMMETRIES THEORY

Information asymmetries emerge when one party to a transaction possesses information that another party does not. A prototypical example is observed in the used car market – sellers of used cars have better information regarding the quality of their cars than do potential buyers.<sup>24</sup> Asymmetries in information can lead to a market breakdown. In the used car market example, while the sellers know whether the quality of their car is high or low, the buyers do not have that information and will therefore offer a price based on the assumption that the car could be of either low or high quality. The price at which the buyers are willing to buy falls below a high quality car's worth because it takes into account the probability that the car is of lower quality. Sellers of high quality cars will thus refuse to sell their product at this low price. Eventually, only sellers of lower quality cars will remain on the market. The buyers, knowing this, will update the probability that a car is of low quality and drop their price further. This process repeats recursively until only the lowest-quality cars remain in the used car market. The market for high-quality used cars fails.<sup>25</sup>

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22. See *supra* text accompanying note 17.

23. WEISBROD, *supra* note 13, at 66-67.

24. This situation is examined in George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 489-90 (1970).

25. See *id.* Various mechanisms have arisen to counteract this market failure. For instance, warranties for used cars increase a low quality used car's worth to at or above the worth of a high-quality used car, making buyers indifferent to whether they purchase a high- or low-quality used car. Warranties will cost the seller less if his car is of high quality than if it is of low quality. A market equilibrium can emerge where all

Another instance of an information asymmetry occurs when the purchaser of a good or service cannot easily ascertain the quality of the good or service. Charitable donations are an example of this situation. The person who donates money to an organization to relieve poverty in Africa cannot easily determine whether his donation is actually used for poverty relief, or whether it is used to line the pockets of the organization's managers and directors.<sup>26</sup> Professor Henry Hansmann has argued that nonprofit organizations are an effective method of addressing these information asymmetries.<sup>27</sup>

The distinguishing characteristic of a nonprofit corporation, as compared to a for-profit one, is that nonprofits are prohibited from distributing net earnings to their controlling members. This characteristic is referred to as the non-distribution constraint.<sup>28</sup> The non-distribution constraint removes managers' and directors'<sup>29</sup> primary incentive to co-opt the donations in the above charitable donation hypothetical.<sup>30</sup> Instead, managers of nonprofit organizations are left with

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sellers of high-quality cars sell with warranties at a high price, and sellers of low-quality cars sell at a high price with a warranty or a low price without a warranty. See Sanford J. Grossman, *The Informational Role of Warranties and Private Disclosure About Product Quality*, 24 J.L. & ECON. 461 (1981) (developing this point).

26. This situation stems from the general problem of being unable to write an enforceable contract to meet the consumer's (in this case the donor, who is the consumer of charitable services) specifications. The inability to effectively monitor the charitable services provider imposes significant costs that create this problem.

27. Hansmann, *supra* note 4, at 843-45. Hansmann recognized that information asymmetry could be used to justify the existence of nonprofit corporations generally. The information asymmetry problem had previously been discussed in the specific contexts of nonprofit healthcare and daycare organizations. See generally Kenneth J. Arrow, *Uncertainty and the Welfare Economics of Medical Care*, 53 AM. ECON. REV. 941 (1963) (healthcare); Richard Nelson & Michael Krashinsky, *Two Major Issues of Public Policy: Public Policy and the Organization of Supply*, in PUBLIC POLICY FOR DAY CARE OF YOUNG CHILDREN 47 (Dennis R. Young & Richard R. Nelson eds., 1973) (daycare).

28. This definition was formalized in Hansmann, *supra* note 4, at 838.

29. For simplicity, the remainder of the Article will refer to just managers.

30. See Hansmann, *supra* note 4, at 843-44. Although managers may no longer have incentives to pocket donations directly, they may still have incentives to spend the money not in accordance with donors' interests. For instance, managers may derive nonpecuniary utility from controlling larger and more prominent corporations and may therefore spend funding on additional employees in order to increase the corporation's

weaker second-order incentives, such as to carry out their charitable mission, which makes them more likely to act in accordance with donors' desires.<sup>31</sup> Thus, the non-distribution constraint acts as a commitment mechanism that responds to the contracting failure.

The non-distribution constraint is a fairly clumsy form of consumer protection, however. In some respects, the non-distribution constraint renders the nonprofit form less efficient than for-profit analogues.<sup>32</sup> Unlike for-profits, nonprofit firms can use donations as a revenue source; however, they cannot raise funds through equity and must instead rely upon debt issuance, retained earnings, and unpredictable donations as the exclusive methods of revenue financing.<sup>33</sup> Lack of equity financing puts nonprofits at a disadvantage, particularly when their funding advantage—donations—is insignificant.<sup>34</sup>

Furthermore, by removing the profit motive, the non-distribution constraint may lead managers to choose less efficient production methods than their for-profit counterparts, resulting in provision of services at a higher price.<sup>35</sup> Note, however, that the separation of

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size. See Richard Steinberg & Bradford H. Gray, "The Role of Nonprofit Enterprise" in 1993: *Hansmann Revisited*, 22 NONPROFIT & VOLUNTARY SECTOR Q. 297, 301-02 (1993).

31. See, e.g., John Armour, Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategies*, in REINIER KRAAKMAN ET AL., *THE ANATOMY OF CORPORATE LAW* 43 n.30 (2d ed. 2009) (comparing high-powered monetary incentives to low-powered ethical or moral incentives).

32. See generally Hansmann, *supra* note 4, at 877-79 (analyzing the drawbacks of the non-distribution constraint).

33. Recall that the non-distribution constraint prevents equity owners from sharing in profits, making equity offerings not feasible.

34. Nonprofits that receive most revenue through donations are termed "donative" nonprofits. The Red Cross is one example. See Hansmann, *supra* note 4, at 840. Nonprofits that finance themselves primarily through the sale of goods and services are "commercial" nonprofits such as hospitals. Some nonprofit organizations, such as private schools and opera houses, rely on a mixture of donations and the sale of goods and services. *Id.* at 840-41.

In addition, nonprofits that do not entitle donors to a tax-deduction may be less likely to receive significant donation funding. These nonprofits are those that either attempt to influence legislation to any significant extent, that participate in political campaigns to any extent, or that do not pursue exemption. I.R.C. §§ 501(c)(3), 170(c)(2)(D) (2006).

35. See Hansmann, *supra* note 4, at 878.

ownership and control and the accompanying agency problems in typical for-profit organization also dampen the profit motive's influence on for-profit managers' efficiency.<sup>36</sup> Accordingly, there is mixed evidence regarding whether nonprofit organizations are run less efficiently than their for-profit counterparts.<sup>37</sup>

Because of the clumsiness of the non-distribution constraint as a consumer protection device, it is not surprising that the nonprofit form is the efficient organizational choice only when the need for consumer protection is particularly great.<sup>38</sup> Economic efficiency is not the only driving force of organizational choice, however.<sup>39</sup> Tax law affects this

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36. *Id.*

37. Some studies suggest that for-profit hospitals are more efficient than nonprofit ones. *See, e.g.*, Carson W. Bays, *Cost Comparisons of Forprofit and Nonprofit Hospitals*, 13 SOC. SCI. & MED. 219 (1979); Kenneth W. Clarkson, *Some Implications of Property Rights in Hospital Management*, 15 J.L. & ECON. 363 (1972). Others argue that nonprofit hospitals operate more efficiently than for-profits. *See, e.g.*, Yasar A. Ozcan et al., *Ownership and Organizational Performance: A Comparison of Technical Efficiency Across Hospital Types*, 30 MED. CARE 781 (1992). *See generally* Catherine Plante, *The Differentiation Between For-Profit and Nonprofit Hospitals: Another Look*, 12 RES. IN HEALTHCARE FIN. MGMT. 7, 7-9 (2009) (providing a review of recent literature); Pauline Vaillancourt Rosenau & Stephen H. Linder, *Two Decades of Research Comparing For-Profit and Nonprofit Health Provider Performance in the United States*, 84 SOC. SCI. Q. 219 (2003) (surveying empirical studies and finding nonprofit hospitals are generally found more efficient than for-profits). Some of the difference in findings could be attributed to the difficulty in choosing an efficiency measure. For instance, the typical services offered by nonprofit and for-profit hospitals do not completely overlap, making cross-comparisons more difficult. *See* Ozcan et al., *supra* note 37 at 781-82. Finally, the typical consumer may be more concerned with quality of care, rather than with efficiency of operation, although the two may be connected. In other sectors, for-profit daycare centers have been found to be no more efficient than nonprofit centers. H. Naci Mocan, *Cost Functions, Efficiency, and Quality in Day Care Centers*, 32 J. HUM. RESOURCES 861 (1997). For-profit nursing homes were found to be more efficient than nonprofit homes, however. *See, e.g.*, Sajal Chattopadhyay & Dennis Heffley, *Are For-Profit Nursing Homes More Efficient? Data Envelopment Analysis With a Case-Mix Constraint*, 20 E. ECON. J. 171 (1994); John L. FizeL & Thomas S. Nunnikhoven, *Technical Efficiency of For-Profit and Non-Profit Nursing Homes*, 13 MANAGERIAL & DECISION ECON. 429 (1992).

38. *See* Hansmann, *supra* note 4, at 843-45.

39. While these economic efficiency justifications for the nonprofit form are compelling, they may not provide the entire picture even when ignoring tax considerations. There are some activities that seem particularly well suited for the non-

choice, sometimes pushing organizations towards a socially less-efficient form because it is nevertheless efficient from the individual organization's perspective.<sup>40</sup> A combination of unclear tax law and significant stakes at risk drive nonprofits to an inefficient use of the for-profit form. Part II begins an examination of current nonprofit tax law by looking at the requirements for federal tax exemption.

## II. REQUIREMENTS FOR FEDERAL TAX EXEMPTION

Nonprofits must meet specific federal requirements to qualify for the federal tax exemption.<sup>41</sup> Qualifying as a federal tax-exempt charitable organization brings additional statutory benefits beyond exemption of earnings,<sup>42</sup> including the ability to issue tax-exempt bonds,<sup>43</sup> an exemption from federal minimum wage laws,<sup>44</sup> reduced postal rates<sup>45</sup> and tax deductibility of donations<sup>46</sup> (although this latter

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distribution constraint's advantages, yet they are not performed by nonprofits. Pet boarding or pet daycare services are one such example. The justifications for traditional daycare—that children are neither discriminating consumers nor good sources of information—apply to pet boarding or daycare. *See* Hansmann, *supra* note 4, at 865 (discussing the rationale for nonprofit traditional daycare). Pet boarding or daycare likely has even more severe informational asymmetries, since these operations may not be as easily observable as traditional daycare; information may not be spread as easily since pet owners may not form the same tightly-knit social groups that parents do with playgroups; and mistreatment of pets may be more difficult to detect. Yet this field appears overwhelmingly composed of for-profit organizations, unlike traditional daycare which has a significant nonprofit presence. *See* Susan Rose-Ackerman, *Altruistic Nonprofit Firms in Competitive Markets: The Case of Day-Care Centers in the United States*, 9 J. CONSUMER POL'Y 291, 294 (1986) (estimating that between 45 and 60 percent of daycare providers are nonprofit).

40. *See infra* Part IV.C.2.

41. I.R.C. §§ 501, 511-13 (2006).

42. These additional benefits are applicable specifically to charitable entities, as opposed to general exempt entities which receive only exemption of earnings. *Compare* I.R.C. § 501(c)(3) which defines charitable organizations, *with* I.R.C. § 501(c) which provides a general list of exempt organizations. *See also infra* notes 43-46 and accompanying text for examples of these additional benefits.

43. *See* I.R.C. § 145. *See generally* I.R.S. Publ'n. 4077 (Rev. September 2005) (IRS compliance guide for 501(c)(3) tax-exempt bonds).

44. *See* 29 C.F.R. 779.214 (2009) (stating that the Fair Labor Standards Act does not apply to charitable activities performed by charitable organizations).

45. 39 U.S.C. § 3626(a)(1), (e)(1) (2006).

advantage is unimportant for commercial nonprofits that rely on commercial activity rather than donations for revenue). States set their own requirements for additional nonprofit state tax exemption, which may allow nonprofits to avoid state income taxes,<sup>47</sup> sales and use taxes<sup>48</sup> and property taxes,<sup>49</sup> depending on the state.<sup>50</sup> The states' rules for exemption<sup>51</sup> generally mirror the federal requirements, although they may differ in some respects including corporate board structure,<sup>52</sup> as well as certain rights granted to nonprofits.<sup>53</sup> Finally, exempt status may result in other important but unquantifiable benefits, such as an advantage when dealing with the public,<sup>54</sup> or in receiving grants from private foundations or from state or federal agencies.<sup>55</sup>

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46. I.R.C. § 170.

47. See, e.g., N.Y. TAX LAW § 209 (McKinney 2008); N.Y. STATE DEP'T. OF TAXATION AND FIN., FORM CT-247 (2005), available at [http://www.tax.state.ny.us/pdf/2005/fillin/corp/ct247\\_805\\_fill\\_in.pdf](http://www.tax.state.ny.us/pdf/2005/fillin/corp/ct247_805_fill_in.pdf) (providing exemption from corporate income tax, known as the franchise tax).

48. See, e.g., CONN. GEN. STAT. ANN. § 12-412(5) (West 2010).

49. See, e.g., CAL. REVENUE & TAXATION CODE § 214 (West 2008).

50. For example, Washington State generally does not allow nonprofits to avoid business taxes. WASH. ADMIN. CODE § 458-20-169 (2001).

51. The IRS website provides links to state government websites containing information for tax-exempt organizations. *State Links*, IRS.GOV, <http://www.irs.gov/charities/article/0,,id=129028,00.html> (last visited May 25, 2011).

52. Marion R. Fremont-Smith, *Appendices for Working Paper No. 33.8 - The Search for Greater Accountability of Nonprofit Organizations*, HAUSER CTR. FOR NONPROFIT ORGS., available at [http://www.hks.harvard.edu/hauser/PDF\\_XLS/working\\_papers/workingpaper\\_33.8%28Appendices%29.pdf](http://www.hks.harvard.edu/hauser/PDF_XLS/working_papers/workingpaper_33.8%28Appendices%29.pdf) (last visited May 25, 2011) (State Nonprofit Corporation Act Requirements Table).

53. For example, although generally nonprofits cannot distribute their earnings, some states allow nonprofits to make distributions as long as the distributions are to other nonprofits. Compare CAL. CORP. CODE § 5410 (West 2009) (stating that “[n]o [nonprofit] corporation shall make any distribution”), with OR. REV. STAT. ANN. § 65.544(3) (West 2009) (permitting distributions to nonprofit members unless otherwise provided in articles or bylaws).

54. See *supra* note 6 and accompanying text.

55. BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 55 (9th ed. 2007). Private foundation grants to exempt organizations count towards foundation required distributions and, unlike grants to non-exempt organizations, do not require oversight by the foundation to ensure they are spent on exempt purposes. *Id.* at 55, 383. Further, some federal and state grants and contracts are given only to exempt organizations. *Id.* at 55.



To be exempt from federal taxes, an organization must be both (1) organized for and (2) operated exclusively for tax-exempt purposes.<sup>56</sup> These purposes encompass religious organizations, educational institutions, and, of particular note, charitable organizations, so long as (3) net earnings do not inure to the benefit of any private individual.<sup>57</sup> Regarding the first element of the exemption requirement, organizations are treated as “organized” for exempt purposes if their articles of incorporation restrict activity to one or more exempt purposes and allow the organization to engage in only insubstantial, if any, activities not in furtherance of the exempt purpose.<sup>58</sup> The third requirement, that benefits do not inure in whole or in part to private individuals, is met as long as private individuals either do not benefit from the exempt activities at all, or benefit as only an incidental feature of performing the exempt activity.<sup>59</sup>

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56. See I.R.C. § 501 (2006).

57. *Id.* § 501(c)(3). Those who receive private inurement benefits may be subjected to a tax penalty of 25%; their managers to a 10% tax if they possessed knowledge about the inurement; and, if the benefit is not returned, the individuals may be subjected to an additional 200% tax. *Id.* § 4958. Organizations can also lose their exemption if private inurement occurs. See Treas. Reg. § 1.501(c)(3)-1(f)(2)(ii) (as amended in 2008); see also *Church of Scientology of Cal. v. Comm’r*, 83 T.C. 381 (1984), *aff’d*, 823 F.2d 1310 (9th Cir. 1987) (revoking the Church of Scientology’s exemption because of private inurement).

58. Treas. Reg. § 1.501(c)(3)-1(b).

59. See I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987). Note that private individuals can receive a reasonable wage for work performed for an exempt organization, without jeopardizing the exempt status. See, e.g., *Mabee Petroleum Corp. v. United States*, 203 F.2d 872, 876 (5th Cir. 1953). Too much compensation can result in revocation of exemption or significant tax liability. See *Founding Church of Scientology v. United States*, 188 Ct. Cl. 490 (1969) (citing excess compensation as influencing factor when revoking exemption); 26 U.S.C. § 4958 (imposing tax liability for excessive compensation). See generally JEAN WRIGHT & JAY H. ROTZ, REASONABLE COMPENSATION (1993) (IRS Exempt Organizations Continuing Professional Education Technical Instruction Program discussing reasonable and excessive compensation).

The IRS has determined that such incidental benefit must be incidental in both a qualitative and quantitative sense. *Id.* This requirement means that the benefit “must be a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by benefiting certain individuals . . . . To be incidental in a qualitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity.” *Id.*

The second requirement, that the organization be operated “exclusively” for exempt purposes, is perhaps the most interesting. This requirement is commonly referred to as the “primary purpose test,”<sup>60</sup> and gauges what the organization actually does, rather than what it is organized to do. While this operational test provides several restrictions,<sup>61</sup> the focus throughout this Article will be on the limitation on commercial behavior.

The term “exclusively” is not read in its strict sense, but instead has received a variety of interpretations over time. Initially the term was read broadly: as long as revenue was used for charitable purposes, exempt organizations could engage in commercial activity without risking their exemption.<sup>62</sup> Thus commercial activity was treated as exempt if its revenue was eventually used to promote exempt purposes, regardless of how this revenue was earned.<sup>63</sup>

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60. HOPKINS, *supra* note 55, at 79-80.

61. These restrictions include purposes that violate public policy as well as political involvement, including attempts to influence legislation and campaign activity. *See, e.g.*, I.R.C. § 501(c)(3), (h) (restrictions for influencing legislation or political campaign activity); *Bob Jones Univ. v. United States*, 461 U.S. 574 (1983) (upholding exemption revocation on public-policy grounds).

62. An early example of this rule was voiced by the Supreme Court in *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924). In this case, the Court permitted the sale of wine and chocolate, as well as substantial investment income as long as the proceeds were used for exempt purposes, because “[m]aking [exempt] properties productive to the end that the income may be thus used [for exempt purposes] does not alter or enlarge the purposes for which the corporation is created and conducted.” *Id.* at 581.

63. This “destination of income” test was mentioned in *Trinidad v. Sagrada*. *Id.* at 581 (noting that the I.R.C. “says nothing about the source of the income, but makes the destination the ultimate test of exemption.”). The test was later read to exempt a bathing beach corporation from taxes because the profits were used to fund an exempt foundation. *See Roche’s Beach, Inc. v. Comm’r*, 96 F.2d 776 (2d Cir. 1938). Soon after, a celebrated case involved the exempt New York University Law School, which purchased a commercial noodle factory for \$3.5 million and treated the company’s revenue as exempt because it was used to support the school’s exempt purposes. *C.F. Mueller Co. v. Comm’r*, 190 F.2d 120 (3d Cir. 1951), *rev’g* 14 T.C. 922 (1950). Although New York University’s purchase of the noodle company was prominent, it was hardly the only transaction of this form undertaken by the school. During the same period, it also operated as exempt organizations Howes Leather (leather products), American Limoges China (chinaware) and the Ramsey Corporation (piston ring manufacturing), valued at \$35 million, \$3.3 million and \$3 million, respectively.

Congress responded to allegations of unfair business competition stemming from this operation of exempt commercial businesses with the Unrelated Business Income Tax (UBIT) in 1950, which sought to tax commercial activity unrelated to exempt purposes and thereby place for-profits and exempt nonprofits on equal footing.<sup>64</sup> Substantial income derived from commercial activity unrelated to exempt purposes was no longer exempt from taxation, even if the income was used exclusively to further charitable purposes.<sup>65</sup>

Notably, even after the passage of the UBIT, the “operated exclusively for exempt purposes” primary purpose requirement remains as a condition for tax-exempt status today.<sup>66</sup> The UBIT applies only if the organization is already exempt; thus, an organization must first satisfy the primary purpose test before considerations as to whether its unrelated activity will be taxed are examined.<sup>67</sup> As already mentioned, “exclusive” has never been interpreted as its strict plain meaning implies.<sup>68</sup> Instead, under current law, activities do not threaten exemption if they are in furtherance of the exempt purposes, or if they

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*Revenue Revision of 1950: Hearings Before H. Comm. on Ways and Means*, 81st Cong. 799 (1950) (statement of Solomon Barkin). New York University was not the only exempt educational organization to engage in this type of activity, either. For instance, Union College operated as exempt organizations Abraham & Strauss (department stores) and Allied Stores (department stores), valued at \$9 million and \$16.5 million respectively, and several other exempt organizations operated similar commercial businesses exempt from tax. *Id.* at 799-801. See generally Benjamin Fine, *University Dollars Yielding Tax-Free Business Profits*, N.Y. TIMES, Dec. 13, 1948, at A1 (discussing similar activities undertaken by various educational institutions).

64. The UBIT is codified at I.R.C. § 512 (2010). The 1950 House Ways and Means Committee report on the UBIT noted the problem of unfair competition: “The tax-free status of these section 101 [now 501] organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes.” H.R. REP. NO. 81-2319, at 36 (1950). For a complete analysis of the factors leading to the UBIT, see Ethan G. Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 EMORY L.J. 1475 (2005).

65. See I.R.C. §§ 502, 511-14 (2006).

66. See *id.* § 501(c)(3).

67. BRUCE R. HOPKINS, *THE TAX LAW OF UNRELATED BUSINESS FOR NONPROFIT ORGANIZATIONS* 18-19 (2005).

68. See *supra* notes 60-65 and accompanying text.

are insubstantial,<sup>69</sup> but, a single nonexempt purpose or activity, if substantial enough, may be sufficient to lose exemption.<sup>70</sup>

#### A. ACTIVITIES RELATED TO EXEMPT PURPOSES

An organization can conduct as much activity as it wishes without risking revocation of its exemption so long as the activity is related to the organization's exempt purposes.<sup>71</sup> An activity can even be nonexempt itself, without threatening the organization's exempt purposes; it need only be related to the organization's exempt purposes.<sup>72</sup>

The IRS does not offer much guidance regarding what activities qualify as being related to exempt purposes. This lack of direction is troubling, given that an organization's exemption hinges on this determination.<sup>73</sup> Much of the interpretation occurs in the context of the UBIT, which harbors an exemption for activities that are "substantially related" to exempt purposes.<sup>74</sup> However, a comparison of the statutory requirements for exemption<sup>75</sup> and for UBIT<sup>76</sup> suggests that only a subset of the activities that meet the exemption's "related" requirement, also satisfy the UBIT's "substantially related" safe harbor test. Nevertheless, because much of this analysis occurs in the UBIT context, and because the IRS requirements for exemption and UBIT relatedness may be

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69. See Treas. Reg. § 1.501(c)(3)-1(c), (e) (as amended in 2008).

70. See, e.g., *Better Bus. Bureau v. United States*, 326 U.S. 279, 283 (1945).

71. See Treas. Reg. § 1.501(c)(3)-1(c).

72. Treas. Reg. § 1.501(c)(3)-1(e). The tax court has made this point explicitly: The fact that [an organization's] activity may constitute a trade or business does not, of itself, disqualify it from [exempt] classification . . . , provided the activity furthers or accomplishes an exempt purpose. Rather, the critical inquiry is whether [the organization's] primary purpose for engaging in its . . . activity is an exempt purpose, or whether its primary purpose is the nonexempt one of operating a commercial business producing net profits for [the organization].

*B.S.W. Grp., Inc. v. Comm'r*, 70 T.C. 352, 357 (1978) (citations omitted).

73. If a nonprofit engages in too much activity unrelated to exempt purposes, it will no longer be "operated exclusively for exempt purposes" and will lose its I.R.C. § 501(c)(3) exemption. See *supra* notes 60-70 and accompanying text.

74. See I.R.C. § 513(a) (2006).

75. See Treas. Reg. § 1.501(c)(3)-1(c).

76. See I.R.C. § 513(a).

conflated in practice,<sup>77</sup> discussion of this issue will be reserved until consideration of the UBIT in Part III. At this point it will be noted that merely determining when an activity is related (either substantially or otherwise) to exempt purposes is often a difficult process with a great deal of uncertainty.

#### B. INSUBSTANTIALITY DETERMINATION

Even when an organization can determine that an activity is not related to exempt purposes (and is therefore nonexempt), it must still decide whether the activity is substantial or insubstantial. Substantial unrelated activities will cause the organization to lose its exemption on all activities and therefore be subjected to taxation on all its operations,<sup>78</sup> while insubstantial activities can be conducted without risking exempt status.<sup>79</sup>

Unfortunately, as is the case with an activity's "relatedness," the guidance for determining a nonexempt activity's substantiality is unclear. The line between substantiality and insubstantiality has sometimes been determined by examining the portion of expenditures or time devoted to the activities.<sup>80</sup> For example, exemption has been denied when as little as one third of revenues were derived from a nonexempt business.<sup>81</sup> However, although a simple ratio of nonexempt to exempt activities would provide a clear rule, the IRS has not followed such a path; exemption has been upheld in other cases even when the ratio of revenue from nonexempt to exempt activities has significantly exceeded one third,<sup>82</sup> and the IRS has noted that there is no "quantitative limitation" that governs this ratio.<sup>83</sup>

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77. See, e.g., HOPKINS, *supra* note 55, at 721 (noting that exemption and the UBIT share versions of the primary purpose test); Peña & Reid, *supra* note 9, at 1865; see also *infra* note 101.

78. Treas. Reg. § 1.501(c)(3)-1(c).

79. See Treas. Reg. § 1.501(c)(3)-1(c)(1).

80. See HOPKINS, *supra* note 55, at 721-22.

81. See *Orange Cnty. Agric. Soc'y, Inc. v. Comm'r*, 893 F.2d 529 (2d Cir. 1990) (upholding revocation of taxpayer's exemption on two independent grounds, one of which was substantial unrelated income).

82. See, e.g., I.R.S. Priv. Ltr. Rul. 97-11-003 (Nov. 8, 1995) (upholding exemption for organization that derived over 98% of its gross revenue from unrelated activities, spending 50 percent of its time on these activities); I.R.S. Priv. Ltr. Rul. 2000-21-056

It would appear that although relative activity may be relevant, a determination of exempt status ultimately requires an individual inquiry into the particular facts<sup>84</sup> with such indicators as the extent and existence of competition with commercial firms, use of promotional materials, amount of advertising, and plans to solicit from donors all informative pieces that will be used to render a decision.<sup>85</sup>

### C. WHAT IS AT STAKE

While relatedness and substantiality have developed as somewhat nebulous concepts, what is at stake is the very well defined exemption. If activities are too substantial, and are not charitable in their own right or are not sufficiently related to something that is, the organization loses its exemption on all activities, not merely those in question.<sup>86</sup> This loss can be incredibly devastating. Consider for example Harvard College, which claims almost \$2 billion in annual income from charitable activities and tax-deductible donations.<sup>87</sup> A blanket exemption loss would drastically impact its operations.

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(Feb. 8, 2000) (upholding exemption for organization that obtained 66% of its revenue from unrelated activities).

83. See I.R.S. Priv. Ltr. Rul. 2000-21-056 (Feb. 8, 2000).

84. See, e.g., *B.S.W. Grp., Inc. v. Comm'r*, 70 T.C. 352, 358 (1978); *Nationalist Movement v. Comm'r*, 102 T.C. 558, 589 (1994), *aff'd*, 37 F.3d 216 (5th Cir. 1994) (citation omitted).

85. See *Living Faith, Inc. v. Comm'r*, 950 F.2d 365, 373-74 (7th Cir. 1991) (citations omitted). An early case to employ such a facts-and-circumstances approach looked at similar indicators. See *B.S.W. Grp.*, 70 T.C. at 358-60 (citations omitted) (listing as relevant whether prices are set at or near cost instead of below cost; the failure to show lack of competition with for-profit organizations; and that revenue overwhelmingly came from commercial operations). None of these factors is dispositive. *Id.*

86. See Treas. Reg. 1.501(c)(3)-1(c)(1), (e) (as amended in 2008).

87. Harvard's exempt charitable revenue totaled \$1,209,148,774 and its donations (excluding government grants) totaled \$648,555,198 in 2010. See Harvard's Form 990, GUIDE STAR.ORG, Part VIII, <http://www2.guidestar.org/ReportNonProfit.aspx?ein=04-2103580> (last visited May 25, 2011). These figures are for Harvard College only, and do not include additional tax benefits it may receive through related organizations. *Id.*

## D. SUMMARY

Determination of whether an unrelated activity is substantial in nature is often as inexact as determining whether the activity is unrelated in the first place, making predictability difficult.<sup>88</sup> As the Tax Court has noted, “[n]either the Internal Revenue Code, the regulations, nor the case law provides [sic] a general definition of ‘insubstantial’ for purposes of section 501(c)(3),”<sup>89</sup> and an erratic fact-specific inquiry has arisen to provide interpretation.<sup>90</sup> Although organizations can achieve tax guidance from the IRS in the form of a public letter ruling, this process is often impractical due to both its slowness<sup>91</sup> and its cost.<sup>92</sup> If what was risked by this uncertainty were small, then the lack of predictability would not be troubling; however, because an organization’s entire exemption is on the line, this unpredictability is intolerable, driving the use of inefficient, but predictable, for-profit subsidiaries. Before examining this issue further, the UBIT and its overlap with the exemption requirements must be explored.

## III. THE UBIT

Having determined that an exempt organization’s unrelated activities are not substantial enough to revoke its exemption, the next step is to see whether UBIT applies. The overlap between activities that risk exemption (depending on their substantiality) and activities that are subjected to the UBIT is significant but not complete. The UBIT applies

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88. See John D. Colombo, *Reforming Internal Revenue Code Provisions on Commercial Activity by Charities*, 76 FORDHAM L. REV. 667, 672-79 (2007) (providing a thorough history of IRS interpretation of substantiality and coming to a similar conclusion regarding the unpredictability of when an unrelated activity will be deemed substantial).

89. *Living Faith, Inc. v. Comm’r*, 60 T.C.M. (CCH) 710 (1990) (as corrected Sept. 25, 1990).

90. See, e.g., Peña & Reid, *supra* note 9, at 1867-68; *supra* notes 84-85 and accompanying text.

91. See Jeffrey H. Kahn, *Hedging the IRS – A Policy Justification for Excluding Liability and Insurance Proceeds*, 26 YALE J. ON REG. 1, 4, 7-8 (2009) (discussing how this impracticability has led to a rise in “tax insurance”).

92. The current cost for exempt organization private letter rulings is \$10,000 per ruling for most rulings. Rev. Proc. 2010-8, 2010-1 I.R.B. 234.

to “gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it,”<sup>93</sup> subject to certain clear statutory exclusions. Thus, the two tests for UBIT applicability to a non-excluded activity are whether the activity is an unrelated trade or business, and whether the activity is regularly carried on.<sup>94</sup> Both tests must be satisfied before the activity will be subjected to the UBIT.<sup>95</sup>

#### A. UNRELATED TRADE OR BUSINESS

The unrelated trade or business prong, consisting of both an “unrelated” component and a “trade or business” component, is designed to encompass any income-producing activities that do not further exempt purposes.<sup>96</sup> “Trade or business” is defined straightforwardly as “any activity carried on for the production of income from the sale of goods or performance of services.”<sup>97</sup> “Unrelated” is not as clear a concept. The IRS has propounded a requirement for UBIT unrelatedness similar to that used when determining whether activities are unrelated for exemption purposes.<sup>98</sup> In the exemption context, activities are either “related” to exempt purposes (hence not jeopardizing exemption) or unrelated; in the UBIT context, activities are either “substantially related” to exempt purposes (hence avoiding imposition of the UBIT) or not.<sup>99</sup> Thus, to the extent “related” and “substantially related” are treated as different concepts,<sup>100</sup> discussion of unrelated activities in the UBIT context should include all

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93. I.R.C. § 512 (2006).

94. *See id.*

95. *See id.*

96. *See supra* notes 64-65 and accompanying text.

97. Treas. Reg. § 1.513-1(b) (as amended in 1983). The Supreme Court initially viewed the concept of trade or business narrowly, “fall[ing] far short of reaching every income or profit making activity.” *Whipple v. Comm’r*, 373 U.S. 193, 201 (1963); *see also* John M. Strefeler & Leslie T. Miller, *Exempt Organizations: A Study of Their Nature and the Applicability of the Unrelated Business Income Tax*, 12 AKRON TAX J. 223, 249 (1996) (making the same observation). The concept has been broadened since then. *Id.* at 249.

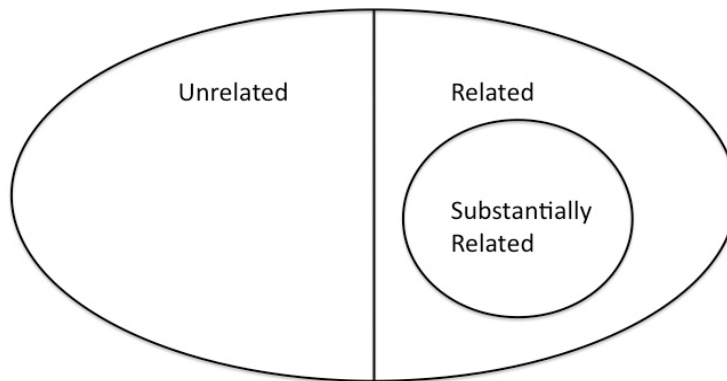
98. *See supra* Part II.A for discussion of unrelatedness in the exemption context.

99. *See* I.R.C. § 513 (2006).

100. Treasury Regulations suggest that such a distinction should be drawn, although in practice it may not be. *See, e.g., infra* note 101 and accompanying text.



activities that are also unrelated in the exemption context, and substantially related activities in the UBIT context should also be related in the exemption context.<sup>101</sup> The following diagram may help in explaining this point.<sup>102</sup> Despite the difference in language, however, the two terms are often treated interchangeably.<sup>103</sup>



101. Theoretically, if the IRS respects the difference between “substantially related” and merely “related,” then there could be some activities that are unrelated in the UBIT context that are related in the exemption context, or, equivalently, the “substantially related” requirement in the UBIT context could not include all “related” activities in the exemption context. Such activities would be related to exempt purposes, but not related enough to be deemed “substantially” related. There is no evidence in the 1950 Congressional Record, however, to indicate that such a difference was recognized or intended during the drafting of the UBIT, and the two concepts are often conflated today. For example, immediately following an informative opening statement by the Internal Revenue Commissioner explaining implementation of the UBIT in a House hearing on the UBIT, the Chairman of the Committee noted that “there is a very unclear gray line between unrelated or related business activity.” *Unrelated Business Income Tax: Hearings Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 100th Cong. 70 (1987) (statement of Chairman J.J. Pickle) [hereinafter *UBIT Hearings*]. The distinction that should have been drawn is between unrelated and substantially related activity. Chairman Pickle previously drew this correct distinction. *Id.* at 9 (noting that the UBIT is “a tax paid on income that is not substantially related to an organization’s tax-exempt purpose.”).

102. The Treasury Regulations make clear that we should consider the primary definition of substantially—“[i]n substance; in one’s or its substantial nature or existence; as a substantial thing or being”—as opposed to its very different secondary definition of “essentially, intrinsically.” OXFORD ENGLISH DICTIONARY (2d ed. 1989) (defining substantially); see *Treas. Reg. § 1.513-1(d)(2)* (as amended in 1983).

103. See *supra* note 101.

The determination of what is substantially related to exempt purposes is largely made on a case-by-case basis. Some bright line rules have been drawn, although they are a long way from providing guidance on all transactions. Activities for which the sole purpose is to provide revenue for exempt purposes are not on that basis related, substantially or otherwise, to exempt purposes.<sup>104</sup> Moving into more nebulous territory, an activity is substantially related if a substantial causal relationship exists between the activity and the achievement of the exempt purpose.<sup>105</sup> In an attempt to elucidate, the Treasury has clarified that for a commercial activity to be substantially related to exempt purposes, it must “contribute importantly to the accomplishment of those [exempt] purposes”<sup>106</sup> and go beyond merely earning profits to be used for an exempt purpose. The predictive power of this guidance is unfortunately quite limited, leaving exempt organizations often guessing which commercial activities will be found substantially related to exempt purposes.<sup>107</sup> For example, sales from a museum-owned restaurant satisfy the “substantially related” requirement if made to employees or patrons,<sup>108</sup> but not if made to non-patrons.<sup>109</sup> Revenue from an exempt hospital-operated pharmacy is substantially related to the extent the pharmacy supplies pharmaceuticals to hospital patients,<sup>110</sup> but not when the pharmacy supplies pharmaceuticals to non-hospital patients of private doctors leasing space within the hospital.<sup>111</sup> The sale of blazer buttons adapted from a medal commemorating George

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104. See Treas. Reg. § 1.513-2(a)(4) (as amended in 1975).

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

106. *Id.*

107. See, e.g., Roger P. Meyers, *Risky Ventures: The Impact of IRS Health Care Joint Venture Policy*, 42 U. MICH. J. L. REFORM 481, 506-07 (2009).

108. See Rev. Rul. 74-399, 1974-2 C.B. 172. The exemption is justified under the theory that making food available on-premises gives patrons more time to view the exhibits and makes the museum staff more efficient. *Id.*

109. See I.R.S. Tech. Adv. Mem. 97-00-002 (May 16, 1997). While the portion of sales to museum patrons and staff would be substantially related to the museum’s exempt purpose, sales to the general public that did not visit or pay admission to the museum were deemed unrelated. See *id.*

110. See *Carle Found. v. United States*, No. 75-2-148, 1978 U.S. Dist. LEXIS 18671, at \*8-9 (E.D. Ill. Mar. 30, 1978).

111. See *Carle Found. v. United States*, 611 F.2d 1192, 1199-1200 (7th Cir. 1979).

Washington's inauguration is taxable, unless the buttons are accompanied by descriptive literature regarding their historical significance.<sup>112</sup>

Activities substantially related to exempt purposes can emerge in unexpected ways despite their seemingly-unrelated or commercial nature.<sup>113</sup> For instance, income from a hospital cafeteria is substantially related to the hospital's exempt purpose because it improves the physical comfort and well-being of its patients, while enhancing efficiency by keeping hospital staff on the premises.<sup>114</sup> A halfway house's furniture workshop is deemed substantially related to the house's exempt purposes, because the shop "affords the residents gainful employment and enables them to develop the ability to cope with emotional problems."<sup>115</sup> A museum gift shop's revenue substantially relates to the museum's exempt purpose to the extent the items it sells "enhance[s] the public's understanding or appreciation of [the museum's field]."<sup>116</sup> The sizable revenue from school athletic programs is exempt under the theory that these programs further the schools' educational purposes.<sup>117</sup>

On the other hand, other activities that might seem substantially related to exempt purposes have been deemed not to be. Some museum gift shop items are not exempt, while others are, and the line between them is determined by the primary purpose of the sale, a standard that often is not particularly clear.<sup>118</sup> For example, the sale by a museum gift

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112. *UBIT Hearings*, *supra* note 101, at 68 (statement by Lawrence B. Gibbs, Comm'r, IRS).

113. The following example, as well as additional ones, are listed in J. Patrick Plunkett & Heidi Neff Christianson, *The Quest for Cash: Exempt Organizations, Joint Ventures, Taxable Subsidiaries, and Unrelated Business Income*, 31 WM. MITCHELL L. REV. 1, 9-10 (2004).

114. Rev. Rul. 69-268, 1969-1 C.B. 160. No mention is made of the treatment of any sales to non-employee, non-patient visitors who make purchases for themselves only, although presumably this revenue would not be substantially related to the hospital's exempt purpose. *See supra* note 109.

115. Rev. Rul. 75-472, 1975-2 C.B. 208.

116. I.R.S. Priv. Ltr. Rul. 2002-22-030 (Mar. 4, 2002).

117. *See* John D. Colombo, *The NCAA, Tax-Exemption, and College Athletics*, 2010 U. ILL. L. REV. 109, 132 (examining this exemption in detail).

118. *E.g.*, *supra* note 116. The Treasury Ruling states that:

shop of a metal pencil box shaped like a mummy is related to the museum's exempt purpose, while the sale of chocolate mummies is not.<sup>119</sup> Drawing these distinctions without the benefit of an individually-tailored IRS ruling is a difficult process.

While some guidance exists about whether an activity will be deemed substantially related to exempt purposes or will instead be taxed as ordinary income, many activities fall within a gray area of uncertainty regarding how they would be classified. This classification effects an activity's profitability due to imposition of a corporate tax on nonexempt activities,<sup>120</sup> and can therefore sway the decision of whether the activity will be undertaken.

#### B. REGULARLY CARRIED ON

An activity must also meet the criterion of being "regularly carried on" before it will be subjected to the UBIT.<sup>121</sup> Because one of the UBIT's original goals was to promote similar tax treatment among for-profit and exempt firms,<sup>122</sup> the UBIT applies only when an exempt firm engages in commercial activity like a for-profit would.<sup>123</sup> On this basis,

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[w]here the primary purpose behind the production and sale of the item is utilitarian, ornamental, a souvenir in nature, or only generally educational in nature, it should not be considered substantially related within the meaning of section 513(a) of the Code. However, where the primary purpose behind the production and sale of the item is to further the organization's exempt purpose, the sale is related, and income earned from that sale is exempt.

*Id.*

119. See I.R.S. Tech. Adv. Mem. 97-20-002 (Nov. 26, 1996). Note that this distinction meets neither the substantially related nor substantially unrelated conditions set forth above. See *supra* note 118. To reach this classification, the IRS adopted the additional requirement that exempt items have "sufficient permanence." See I.R.S. Tech. Adv. Mem. 97-20-002.

120. The marginal federal corporate tax rate at the highest bracket is currently 35%. I.R.C. § 11(b)(1)(D) (2006). States generally impose their own additional corporate taxes as well. For example, Iowa's marginal corporate tax rate at the highest bracket is currently 12%. IOWA CODE ANN. § 422.33(1)(d) (West 2009). A table of state corporate tax rates can be obtained at <http://www.taxfoundation.org/taxdata/show/230.html> (last visited March 18, 2012).

121. See I.R.C. § 512.

122. See *supra* note 64 and accompanying text.

123. See, e.g., Treas. Reg. § 1.513-1(c) (as amended in 1983).

intermittent activity unrelated to exempt purposes will still be excluded from UBIT if the nonprofit does not employ the same competitive and promotional efforts used by for-profit organizations, or if the activity is very infrequent, such as an annual fund-raiser.<sup>124</sup> Other intermittent behavior may be more difficult to classify; an activity that is typically undertaken year-round by for-profit firms can be subjected to the UBIT if engaged in by a nonprofit only once per week, but not if engaged in for a one-time, two-week consecutive period.<sup>125</sup>

Practically, most activities of commercial significance will satisfy the regularity requirement,<sup>126</sup> making its ambiguity less troubling than some of the previously-discussed factors for exemption or applicability of the UBIT. Nevertheless, it is not immediately clear why the UBIT should not apply to *all* unrelated activities, whether or not regularly carried on. This Article will reserve discussion of UBIT reform until Part V when analyzing how changes to the UBIT coupled with modification of initial exemption requirements would provide organizations with clearer guidance, while promoting societal efficiency.

### C. STATUTORILY EXCLUDED ACTIVITIES

In addition to activities that are either substantially related to exempt purposes or not regularly carried on, a variety of additional activities or income are statutorily excluded from income tax.<sup>127</sup> These include passive investment income (dividends, interest payments, annuities);<sup>128</sup> gain on property disposition;<sup>129</sup> royalties;<sup>130</sup> rents from real or personal property;<sup>131</sup> work performed substantially by uncompensated

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124. *Id.*

125. *See id.* § 1.513-1(c)(2)(i).

126. *See id.* § 1.513-1(c) for some examples.

127. *See, e.g., infra* notes 128-141 and accompanying text.

128. *See* I.R.C. § 512(b)(1) (2006).

129. *Id.* § 512(b)(5).

130. *Id.* § 512(b)(2).

131. *Id.* § 512(b)(3); *see also* Rev. Rul. 69-178, 1969-1 C.B. 158 (interpreting the rental exception).

volunteers;<sup>132</sup> activities carried on primarily for the convenience of members, students, patients, officers, or employees;<sup>133</sup> a trade or business consisting of the sale of donated merchandise;<sup>134</sup> activities whose purpose is to attract and educate persons at trade shows, conventions, or fairs;<sup>135</sup> particular hospital services performed by certain qualified hospitals;<sup>136</sup> bingo games;<sup>137</sup> qualified utility pole rentals;<sup>138</sup> distribution of low cost items incidental to charitable contribution solicitations;<sup>139</sup> income from renting member lists to other charities;<sup>140</sup> and sponsorship payments.<sup>141</sup>

As is the case with activities that are performed only irregularly, there is not much economic or other justification behind the exclusion of many of these activities from UBIT.<sup>142</sup> Reforming the treatment of these activities will be discussed along with general UBIT reform, *infra* Part V.

#### D. SUMMARY

Similar to the requirements for federal tax exemption, the criteria for UBIT imposition are fraught with ambiguity, leaving exempt organizations often uncertain of whether an activity will remain exempt

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132. See I.R.C. § 513(a)(1). The voluntary labor must be the primary component to gain exemption from UBIT. Rev. Rul. 78-144, 1978-1 C.B. 168 (long-term leasing of heavy machinery was not exempt from UBIT, even though volunteers performed the work of securing lease contracts). A case-by-case approach is adopted if the volunteers are compensated in kind to determine whether they are deemed uncompensated volunteers. See *Waco Lodge No. 166 v. Comm'r*, 696 F.2d 372, 375 (5th Cir. 1983) (determining that provision of free drinks for which others must pay, but which translated to an effective pay of 63 cents per hour, did not disallow treatment as volunteers).

133. I.R.C. § 513(a)(2).

134. *Id.* § 513(a)(3).

135. *Id.* § 513(d).

136. See *id.* § 513(e).

137. *Id.* § 513(f)(1).

138. *Id.* § 513(g).

139. *Id.* § 513(h)(1)(A).

140. *Id.* § 513(h)(1)(B). These charities must be exempt organizations that enable contributions to them to be deductible. See *id.*

141. *Id.* § 513(i).

142. They could have powerful political lobbyists, however.

from federal tax. The requirement of relatedness to an exempt purpose is common to both the exemptions and the UBIT, and its uncertainty thereby impacts both. This uncertainty is ultimately a significant driving force behind nonprofits' decisions to use for-profit subsidiaries for some activities since nonprofits have much to lose if they incorrectly guess how an activity will affect their exemption. The following Part expands upon this point, examining how and why nonprofits currently use for-profit subsidiaries.

#### IV. USE OF FOR-PROFIT SUBSIDIARIES BY EXEMPT NONPROFIT ORGANIZATIONS

Generally, there are three reasons why exempt nonprofits elect to use taxable for-profit subsidiaries. First, using taxable subsidiaries used to be a way exempt nonprofits could escape tax altogether.<sup>143</sup> Such "income stripping" is largely unavailable today due to legislative changes.<sup>144</sup> Second, for-profit subsidiaries may be used if the activity is one that is entirely for-profit in nature. These activities have no probability of being exempt, and they may gain little if anything from the non-distribution constraint that accompanies the nonprofit form. Finally, and most pivotally for this Article, exempt nonprofits may conduct activities in for-profit subsidiaries even if the activity has a distinct probability of being exempt, for fear that if the activity is deemed nonexempt, the organization would lose its exempt status if the activity were conducted by the parent.<sup>145</sup> The recent rise of joint ventures in the healthcare field provides a good example of this latter behavior.<sup>146</sup>

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143. See, e.g., McGovern, *supra* note 7, at 1126.

144. See *id.* at 1127.

145. See *supra* Part II.C (discussing the potential consequences for a nonprofit when one of its activities is deemed nonexempt).

146. There are other reasons why exempt nonprofits might want to use for-profit subsidiaries. For example, some activities performed by exempt organizations may be subjected to state regulation, leading the exempt organization to isolate these activities within a subsidiary. See, e.g., Nina J. Crimm, *Evolutionary Forces: Changes in For-Profit and Not-For-Profit Health Care Delivery Structures; A Regeneration of Tax Exemption Standards*, 37 B.C. L. REV. 1, 85 (1995) (noting that because some states prohibit the corporate practice of medicine, some hospitals cannot directly own physician practices). Some other reasons for using for-profit subsidiaries may be more

## A. INCOME STRIPPING

An historical use of for-profit subsidiaries was a technique known as income stripping, where the nonprofit avoided taxation on a nonexempt activity by placing it in a for-profit subsidiary. If the subsidiary performed the activity, it could then pay the proceeds from the activity as interest or rent to the parent. The subsidiary gained an offsetting deduction for this rent or interest resulting in no net tax to it, and the parent was not taxed on the interest or rental payments as activity statutorily excluded from UBIT.<sup>147</sup> The net result was that the organization engaged in the taxable activity without paying tax.

The legislature addressed this technique with I.R.C. § 512(b)(15) (now (b)(13)), passed in 1969, which forced parent organizations to include as income any payments received by controlled organizations

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insidious. For instance, while exempt nonprofits must publicly disclose information related to financials and operations via IRS Form 990, private for-profits generally do not. See *Annual Exempt Organization Return: Who Must File*, IRS.GOV, <http://www.irs.gov/charities/article/0,,id=152729,00.html> (last updated Sept. 19, 2011). In some cases, private for-profits may have a similar disclosure duty, such as when they are publicly-traded and must make periodic public disclosures under the federal securities laws. These disclosures are available at <http://www.sec.gov/edgar.shtml> (last visited Oct. 19, 2011). Non-disclosing for-profit subsidiaries thus offer an opportunity to hide compensation, making the nonprofit more acceptable in the public eye while it pays nonprofit officers through its for-profit subsidiary. See Reed Abelson, *Charities Use For-Profit Units to Avoid Disclosing Finances*, N.Y. TIMES, Feb. 9, 1998, at A1. For-profit subsidiaries may also allow nonprofits to shift deductible costs to the for-profit and revenues to the exempt nonprofit, a potential problem the IRS has recognized. See *infra* note 285. Aside from the tax savings, this also has the added advantage of making the nonprofit's operations appear more efficient. Abelson, *supra* note 146 (exposing this and other undesirable behavior). Such behavior is fairly risky, however. Using a for-profit subsidiary to avoid financial disclosures risks public backlash upon exposure; and the practice of shifting costs and revenues between for-profit subsidiaries and their nonprofit parent, is constrained by accounting rules, and could result in penalties if the statements are fraudulent. The IRS also requires costs and revenues among related organizations to be allocated based on actual use and fair market value, and failure to do so can result in exemption revocation. See, e.g., I.R.S. Priv. Ltr. Rul. 93-08-047 (Dec. 4, 1992); I.R.S. Priv. Ltr. Rul. 86-26-102 (Apr. 7, 1986), *modified*, I.R.S. Priv. Ltr. Rul. 86-45-064 (Aug. 13, 1986); I.R.S. Priv. Ltr. Rul. 86-05-038 (Nov. 5, 1985).

147. See I.R.C. §§ 512(b)(1), (b)(3) (2006).



that reduce the controlled organization's tax liability.<sup>148</sup> This restriction was expanded in 1997 to require an organization to include exempt payments from another organization if the two share a common parent.<sup>149</sup> Prior to this 1997 expansion, organizations could still escape taxation by placing activities in indirect subsidiaries; if exempt A controlled exempt B and for-profit C, and C controlled for-profit D, taxation could be avoided by placing activities in D and receiving rent and interest from D,<sup>150</sup> or by placing activities in C or D and having exempt B receive rent and interest payments.<sup>151</sup> Although I.R.C. section 513(b)(13) now eliminates the usefulness of for-profit subsidiaries as an income stripping device,<sup>152</sup> some modern structures could be left over from this period. Other than administrative streamlining, the exempt nonprofit may have little incentive to fold the for-profit subsidiary's activities back into the parent if the activities will then incur equivalent UBIT.<sup>153</sup>

#### B. COMPLETELY NONEXEMPT ACTIVITY

Another reason an exempt nonprofit would use a for-profit subsidiary is if the nonprofit wishes to engage in a nonexempt activity. Nonexempt activities incur UBIT liability and are taxed as if performed by a for-profit organization,<sup>154</sup> so housing the activity within the nonprofit offers no tax advantage. In addition, as previously discussed,

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148. See Act of Dec. 30, 1969, Pub. L. No. 91-172, § 121(b)(2)(C), 83 Stat. 487, 539-40.

149. See I.R.C. § 512(b)(13); see also Revenue Reconciliation Act of 1997, 1997-4 C.B. 1081, 1248-1250 (discussing the reasons for extending the restriction to such constructive indirect ownership).

150. See, e.g., I.R.S. Tech. Adv. Mem. 93-38-003 (June 16, 1993) (stating that rent paid by an organization analogous to for-profit D in order to exempt A would not be taxable to A).

151. See, e.g., I.R.S. Priv. Ltr. Rul. 2007-16-034 (Jan. 26, 2007) (stating that interest received or accrued by Hospital and Parent from the PCs is gross income derived from an unrelated trade or business under I.R.C. § 512(b)(13)(A)).

152. See *supra* note 148 and accompanying text.

153. Such consolidation could even threaten the parent's exemption if it is deemed not insubstantial and not related to exempt purposes—the two operational requirements for federal exemption under I.R.C. § 501(c)(3).

154. See I.R.C. § 512.

nonexempt activities, if performed by the parent, can jeopardize a nonprofit's exempt status if the activities are unrelated to exempt purposes and are not insubstantial.<sup>155</sup> If the activities are performed through a subsidiary, however, the parent's exemption is not risked.<sup>156</sup>

Even when the activity would not threaten the parent's exemption, the parent may have other good reasons to place the activity within a for-profit subsidiary. Choosing the nonprofit form and its accompanying non-distribution constraint entails significant costs, including higher costs of capital and decreased managerial efficiency from loss of the residual profit incentive.<sup>157</sup> Therefore, in cases where the nonprofit form has little benefit to offer in solving agency problems or information asymmetries or in attracting donations, the activity would be more efficiently carried out by a for-profit subsidiary.<sup>158</sup> Such is commonly the case with many commercial activities, which are financed through the sale of goods and services rather than donations, and which often lack the information asymmetries that nonprofits are better positioned to solve. Because the financial cost to incorporate a subsidiary is insignificant,<sup>159</sup> the relative benefits from housing the activity within a subsidiary need only slightly outweigh those from keeping the activity within the parent. Therefore, one would expect to see purely commercial activities, as well as other activities not benefiting from the nonprofit form, conducted by for-profit subsidiaries.

As an example, when the exempt nonprofit College Board<sup>160</sup>—the group that composes and administers standardized tests including the

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155. See *supra* Parts II.A & B (discussing the operational test).

156. The IRS respects the separation between parent and subsidiary in this respect, as long as the subsidiary is viewed as a bona fide separate legal entity, meaning it has some business activity independent from the parent. See I.R.S. Gen. Couns. Mem. 39,326 (Jan. 17, 1985). See generally SANDERS, *supra* note 2, at 236-39 (discussing reasons for using subsidiaries in joint ventures and the bona fide requirement).

157. See *supra* notes 32-37 and accompanying text.

158. If the activity would benefit from the non-distribution constraint but is nevertheless non-exempt, it could be placed in a nonprofit subsidiary.

159. Currently the cost to form a Delaware for-profit or nonprofit corporation is \$89.00. DELAWARE DEPARTMENT OF STATE, DIVISION OF CORPORATIONS FEE SCHEDULE (Aug. 1, 2009), available at <http://corp.delaware.gov/Aug09feesch.pdf>.

160. The College Board's most recent several Forms 990 are available at *College Entrance Examination Board*, GUIDESTAR.ORG, <http://www2.guidestar.org/ReportNon>

SAT and Advanced Placement exams—decided to branch out into serving college applicants through assistance with filling out financial forms, it chose to conduct these activities within a for-profit subsidiary.<sup>161</sup> Assisting with students' completion of forms stood little chance of escaping taxation, and the nonprofit commitment structure has little benefit to offer. The for-profit form, on the other hand, offered several benefits, such as attraction of investor capital as well as pay structures—specifically stock options—that could not be offered by a nonprofit.<sup>162</sup> The College Board is not the only example of this type of behavior.<sup>163</sup> For-profit subsidiaries are the efficient organizational form for such activity from the parent's and society's perspectives, and are not something requiring legislative attention.

### C. MIXED ACTIVITIES

The final use of for-profit subsidiaries by exempt nonprofit parents shares some similarities with the scenario just discussed. Just as in the previous scenario, the activity placed in the for-profit subsidiary has nonexempt components; however, in this mixed activities case, an inseparable portion of the activity also furthers the parent's exempt

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Profit.aspx?ein=13-1623965&name=college-entrance-examination-board# (last visited May 25, 2011).

161. See Jodi Wilgoren, *Aged Upstart, College Board, Is Joining Gold Rush on Web*, N.Y. TIMES, Sept. 25, 1999, at A1.

162. See *id.*

163. For example, the PGA Tour, a nonprofit exempt business league, owns and operates a series of golf courses through its for-profit subsidiary PGA Tour Golf Course Properties. See *Tournament Players Club History*, TCP.COM, <http://www.tpc.com/tpc/courses/tpc.asp?id=3&page=253> (last visited May 25, 2011); *PGA Tour Inc Forms 990*, GUIDESTAR.ORG, available at <http://www2.guidestar.org/organizations/52-0999206/pga-tour.aspx#> (last visited May 25, 2011). Exempt hospitals conduct a variety of activities through for-profit subsidiaries, including catering services, cleaning services at unrelated organizations, home medical supplies, billing and consulting services for doctors starting up new practices, printing services, and medical equipment repair. Michael Abramowitz, *Nonprofit Hospitals Venture into New Lines of Business*, WASH. POST, Feb. 15, 1987, at A1; Richard L. Madden, *For Hospitals, New Ventures and New Profits*, N.Y. TIMES, Jan. 25, 1987, at 1; Wendy Swallow, *Nonprofit Hospitals and Their Profits on the Side*, WASH. POST, Apr. 3, 1985, at 14.

purposes.<sup>164</sup> Here, the decision to use a for-profit subsidiary could still be the efficient form. In many cases, however, the decision to use for-profit subsidiaries is made because nonprofit parents fear losing their exemption, and unpredictable tax guidance makes it difficult to determine how great a threat the activity poses to exemption if conducted by the parent.<sup>165</sup>

### *1. When For-Profit Subsidiaries Are Efficient*

Even if the tax law were entirely predictable regarding whether an activity would result in revocation of an exemption, the most efficient choice for some of these mixed activities might still be to place them within a for-profit subsidiary. Such would be the case if the nonprofit form and its non-distribution constraint were too restricting or if the activity had only a minor charitable component and thus stood little to gain from being housed within an exempt entity.

One such situation might be the College Board example discussed previously.<sup>166</sup> In addition to assistance in completing forms, the College Board also began a lower-cost SAT tutoring program.<sup>167</sup> The non-distribution constraint would have prevented the College Board from attracting equity investors and from using certain compensation

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164. By inseparable, I mean that the exempt and for-profit components could not easily be separated and conducted by different entities. A museum gift shop selling both exempt and non-exempt items is one example. It would not be practical to divide the gift shop operations into two entities: one exempt and one nonexempt.

I am also assuming here that the non-exempt portion does not benefit from being conducted by the nonprofit form and its ability to overcome agency problems. If it did, then it would be housed in a nonprofit subsidiary just like when the activity is entirely non-exempt, and the subsidiary might as well try for an exemption. *See supra* note 158. It may be easier to obtain exempt treatment for this activity if it is kept within the parent rather than when it is in the subsidiary. The entity-level ratio of exempt to nonexempt activities, and hence exemption likelihood, may be lower when the activity is placed within a subsidiary (and is the sole determinant of the ratio) than when it is conducted by the parent (which has other exempt activities to affect the ratio). *See infra* notes 172-176 and accompanying text for additional analysis of this issue.

165. *See supra* Part II.C.

166. *See supra* notes 160-162 and accompanying text.

167. *See* Wilgoren, *supra* note 161.

methods.<sup>168</sup> Any charitable benefits from lower cost tutoring were relatively small compared to the advertising revenue and fees the organization hoped to gain.<sup>169</sup> The nonprofit form also had little benefit to offer, since for activities with readily-ascertainable quality such as SAT tutoring, reputation is an easier and less-costly substitute for the non-distribution constraint commitment. All these considerations push towards a for-profit subsidiary as the efficient organizational tool.

Observe that if performing the activity were only marginally more efficient when done by a for-profit, the exempt parent in a world of clear IRS guidance or low stakes at risk would still likely keep the activity within its parent organization irrespective of how small the exempt component was, as long as the nonexempt portion did not unduly threaten the nonprofit's exemption. By keeping the activity within the parent, the parent would gain an exemption on the charitable component, which would otherwise be taxed at the corporate rate if performed by a for-profit subsidiary. This disparate treatment emerges because of the IRS's refusal to grant partial exemptions to for-profits for the value of their charitable behavior.

Similarly, the exempt parent would also keep the mixed activity within the parent if the activity were better performed by a nonprofit. Activities which have relatively-small charitable components might not qualify for exemption on their own if placed in a nonprofit subsidiary. However, the nonexempt portions of these activities may not be substantial enough to risk the nonprofit's exemption if performed directly by the nonprofit parents. Were these activities performed by a nonexempt subsidiary, they would be taxed in their entirety. On the other hand, by keeping these activities within the exempt parent, the nonprofit can pay taxes on only the nonexempt portion of the activity.<sup>170</sup>

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168. *See id.*

169. *See id.*

170. Placing the activity within a separate organization may still provide some benefits that could cause the parent to use a subsidiary even if the activity would not threaten the parent's exemption. For example, partitioning activities and assets across distinct organizations can result in favorable contracting and financing terms, as well as liability shielding. *See* Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000) (discussing the different types of asset partitioning). Placing different activities within different organizations may also help

Of course, if the mixed activity's charitable component were substantial enough, the parent could just obtain exempt status for the nonprofit subsidiary, which would have the same taxation effect as if the activity had been conducted by the exempt parent itself.<sup>171</sup> In this case, other organizational elements such as asset partitioning, liability shielding, and breadth of the parent's charitable purpose would determine whether the activity should be performed within an exempt nonprofit subsidiary or instead performed by the parent.<sup>172</sup> Thus, when National Geographic acquired the JASON project, which provides educational materials to students on science and technology matters,<sup>173</sup> it chose to operate the project as an exempt subsidiary, rather than within the exempt parent, National Geographic.<sup>174</sup>

## 2. *When For-Profit Subsidiaries Are Inefficient but Are Used Nevertheless*

On the other hand, activities may be placed in a for-profit subsidiary when it would be more socially efficient if they were engaged in by the exempt nonprofit parent. Such might be the case with an exempt parent considering an activity with a significant charitable

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promote accountability for individual activities, increasing overall performance. See Plunkett & Christianson, *supra* note 113, at 17.

171. See Treas. Reg. § 1.501(c)(3)-1(c)(1) (as amended in 2008).

172. See Hansmann & Kraakman, *supra* note 172, for a discussion of asset partitioning.

173. See *What is JASON?*, JASON.ORG, <http://www.jason.org/public/whatis/jason.aspx> (last visited May 25, 2011).

174. *About JASON – National Geographic*, JASON.ORG, <http://www.jason.org/public/WhatIs/AboutNGS.aspx> (last visited May 25, 2011). JASON has continued filing Forms 990 as a self-contained exempt subsidiary. The forms are available at *The JASON Project*, GUIDESTAR.ORG, <http://www2.guidestar.org/organizations/52-1645651/jason-project.aspx#> (last visited May 25, 2011).

One likely explanation for keeping JASON as a separate subsidiary is that JASON previously existed as an independent entity before National Geographic's acquisition, so its creditors would have sought to ensure that JASON's assets remained partitioned and pledged solely for those creditor's claims, rather than for National Geographic's general creditors. See Kenneth Ayotte & Henry Hansmann, *Economic and Legal Entities as Transferable Bundles of Contracts* (draft Sept. 2010), available at [http://www.law.northwestern.edu/colloquium/law\\_economics/documents/Ayotte\\_Hansmann.pdf](http://www.law.northwestern.edu/colloquium/law_economics/documents/Ayotte_Hansmann.pdf).

component in the face of high-risk unclear IRS guidance on whether the activity might result in exemption revocation. By conducting the activity through a for-profit subsidiary, the parent gains the security of a continuing unthreatened parental exemption, at the cost of taxation on the charitable component of the activities placed within the for-profit subsidiary.<sup>175</sup>

Consistent with this idea, Professors Michelle Yetman and Robert Yetman empirically found that exempt organizations are more likely to use taxable subsidiaries for nonexempt activity when the activity provides a greater threat to the parent's exemption.<sup>176</sup> Although the measure of the nonexempt activity's threat was imperfect,<sup>177</sup> the findings nevertheless support the idea that organizations are responding to IRS uncertainty in predictable, but undesirable, ways.<sup>178</sup>

Conducting these mixed activities within a for-profit subsidiary reduces the extent to which the exempt portion is provided. Because the exempt portion is taxed when conducted by a for-profit subsidiary, payoffs to the organization on the exempt portion will be lower when conducted by a for-profit subsidiary than when conducted by an exempt nonprofit parent. Payoffs on the nonexempt portion would be identical, because the UBIT paid by the nonprofit parent equals the corporate tax paid by the for-profit subsidiary.<sup>179</sup> This decrease in provision of exempt services is inefficient if we assume that the charitable exemption serves some function of promoting desirable activity—an assumption without which the charitable exemption is difficult to justify.<sup>180</sup>

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175. This tradeoff is discussed in the hospital joint venture context in Meyers, *supra* note 107, at 492-94.

176. Michelle H. Yetman & Robert J. Yetman, *Why Do Nonprofits Have Taxable Subsidiaries?*, 61 NAT'L TAX J. 675, 677 (2008).

177. The size of non-exempt revenue relative to overall revenue was used as a proxy for threat of exemption revocation. *See id.* at 683. As discussed previously, the IRS has announced that the relative revenue derived from non-exempt activity by itself will not result in revocation. *See supra* notes 80-83 and accompanying text. High ratios of non-exempt revenue to overall revenue may be symptomatic of other factors leading to exemption revocation, however.

178. *See Yetman & Yetman, supra* note 178, at 686.

179. The UBIT tax rate is equal to the corporate tax rate. *See* I.R.C. § 511(a)(1) (2006).

180. *See, e.g., supra* Part I.A (discussing exempt nonprofits' role as providers of public goods); *see also* Henry Hansmann, *The Rationale for Exempting Nonprofit*

Nonprofit hospitals provide an illuminating example of how nonprofits are responding to unpredictable and changing IRS opinions in cases where much is at risk. This area has given rise to much of the current use of for-profit subsidiaries.<sup>181</sup> Confronted with decreased government funding and reimbursements and increased competition for services, hospitals have had to engage in new activities to continue as viable operations.<sup>182</sup> Undertaking these activities as joint ventures with for-profit partners provides a variety of advantages, but their tax treatment is often uncertain.<sup>183</sup> Consequently, as expected, the uncertain

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*Organizations from Corporate Income Taxation*, 91 YALE L.J. 54 (1981) (postulating that the exemption should serve as a subsidy for nonprofits' inability to raise capital as easily as for-profit organizations, but that only those nonprofits that have a comparative advantage to for-profits at supplying a particular good should be exempt). Some academics have argued that for-profits should receive an exemption covering their charitable activities. *See, e.g.*, Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017 (2007). But subsidies for for-profit charitable activities are not necessary to overcome capital constraints, and are also not as justified if we view nonprofits as more "deserving" of public assistance. *See* Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L.J. 1379 (1991).

Of course, while solving the public goods problem is an important aspect of the exemption's justification, there are additional ones. For instance, the exemption may promote distributive justice or pluralism. *See* Fleischer, *supra* note 12 (arguing that distributive justice plays an important role in justifying the current system of exemptions); Saul Levmore, *Taxes as Ballots*, 65 U. CHI. L. REV. 387, 404-08 (1998) (concluding that a virtue of the exemption system is how it allows individuals to allocate federal dollars to exempt nonprofits). These additional justifications do not change the need for reform, however; distributive justice and pluralism goals could be achieved through manipulating what is charitable and what is related. Once these parameters have been set, we still want parent nonprofits to choose the appropriate corporate form in which to conduct these activities and to not have uncertainty regarding overall exempt status unduly affect the decision. These goals can be achieved with a reform as suggested *infra* Part V.

181. Much of this has been in the area of joint ventures. *See* SANDERS, *supra* note 2, at 5-7, 211.

182. *See, e.g., id.* at 5-7, 211; McGovern, *supra* note 7, at 1128-29.

183. The tax guidance on joint ventures is still fairly undeveloped and uncertain, as evidenced by the numerous works attempting to analyze or reform it. *See* John D. Colombo, *In Search of Private Benefit*, 58 FLA. L. REV. 1063 (2006); Meyers, *supra* note 107; Nicholas A. Mirkay, *Relinquish Control! Why the IRS Should Change Its Stance on Exempt Organizations in Ancillary Joint Ventures*, 6 NEV. L.J. 21 (2005);



tax treatment from conducting these ventures directly has pushed hospitals to use for-profit subsidiaries, decreasing the frequency with which desirable joint ventures will occur.<sup>184</sup>

#### D. SUMMARY

As we have seen, nonprofits have a variety of reasons for employing for-profit subsidiaries. While the decision is always economically efficient from the exempt parent's perspective, when the activities have a charitable component but may threaten exemption if conducted by the parent directly, the decision to place them within a nonexempt subsidiary is not socially optimal.

There are two methods of approaching this problem: reduce uncertainty or reduce the stakes at risk. Because of the complex nature of the modern economy, some sort of facts-and-circumstances inquiry by the IRS seems inevitable for determining when exemptions should be revoked. Therefore, it seems unavoidable that the exemption system will have a degree of unpredictability. The best approach, then, may be to reduce the stakes. These suggested reforms are taken up in the following Part.

#### V. REFORMING EXEMPTION AND UBIT LAW

There are two general ways to change exemption and UBIT law that retain their desirable attributes while eliminating the uncertainty that forces nonprofits to use for-profit subsidiaries. First, attaining the exemption could be made more rigorous. This would give the exemption a gate-keeping function that could sift out potential exempt nonprofits that would engage in significant nonexempt activity either directly or through subsidiaries. Under this reform, which retains the same principles of the current system, nonprofits must satisfy predictable limiting rules regarding their charitable and nonexempt activities to

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Plunkett & Christianson, *supra* note 113, at 46-47. Typical of the sentiment regarding joint ventures, it has been noted that "the [IRS]'s formal guidance leaves substantial uncertainty about the boundaries between ventures that exempt organizations can engage in without adverse consequences and those that risk . . . loss of exemption." Meyers, *supra* note 107, at 503.

184. See McGovern, *supra* note 7.

obtain and retain exempt status. This reform thus seeks to increase predictability of the exemption system.

The second reform, which I ultimately advocate, approaches the problem from the opposite direction, by broadening the implementation of the UBIT so that it covers all unrelated non-charitable activities, unlike the patchwork that currently exists. With this change, exemption requirements would be relaxed so that any nonprofit organization desiring exempt status could achieve it.

#### A. REFORM 1: EXEMPTION AS GATEKEEPER

The first reform approach would tighten exemption requirements, making it more difficult for nonprofits to achieve exempt status. A prototypical method of doing so would suggest a rebuttable presumption in favor of exemption when a nonprofit's charitable revenues and charitable expenses exceed its unrelated revenues and expenses by a specified ratio.<sup>185</sup> These revenues and expenses would include nonprofit parent as well as subsidiary figures. When this ratio is not met, the IRS would engage in a facts-and-circumstances inquiry to determine whether exemption is still warranted.<sup>186</sup> The ratio could easily be adjusted to allow a presumption of exemption when organizations engage in relatively more or relatively less unrelated activity.

The reform possesses several virtues. Foremost among them is the safe harbor created for organizations that meet the required ratio of exempt to nonexempt activities. Through the administration of an apparently simple rule, exempt organizations could gain certainty on whether activities threaten their exemption. Thus, if an organization would remain below the pivotal threshold, even if the activity under consideration were deemed unrelated, there would be no reason to conduct the activity outside of the parent; the exemption would be safe.

Proposed versions of the reform provide an additional reason to conduct the activity within the exempt parent, rather than within a subsidiary—the consolidation of subsidiary activities with parent

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185. Peña & Reid, *supra* note 9, at 1890. A simple example would be a one to one ratio, where the rebuttable presumption for exemption arises when charitable activities are at least as great as noncharitable activities.

186. *Id.* at 1895-96.

activities when computing the required threshold ratio.<sup>187</sup> As a result of this consolidation, there would be no incentive to use for-profit subsidiaries in situations where it would be more efficient to have the parent conduct an activity directly.

On the other hand, the reform also has several significant disadvantages. Most importantly, the reform's safe harbor test may not provide the certainty that its simple rule promises, since activities must still be classified as either exempt or nonexempt. This difficulty of classification<sup>188</sup> is the driving force in today's tax system behind many nonprofits' decisions to safeguard their exemption by using for-profit subsidiaries. If the exempt nonprofit is unsure how its activities will be classified, then the ratio's safe harbor provides little certainty.

Compounding this problem is the consolidation aspect of this reform, which takes into account both the parent's and the subsidiaries' activities when computing the ratio. This consolidation means placing activities that might be considered unrelated in a subsidiary that would no longer provide a safeguard for the parent's exemption. Under this consolidation rule, therefore, organizations would have to limit not only for-profit activities for which they possessed a comparative advantage, but also mixed charitable activities with uncertainty regarding their characterization. This outcome is undesirable.

Of course, the consolidation element of this suggested reform is not essential to the idea of using exemption as a gatekeeper. Eliminating consolidation from this reform means that exempt parents could, like today, engage in nonexempt behavior indirectly through subsidiaries without risking the parent's overall exemption. Such behavior is not necessarily undesirable, and will be discussed in greater detail in the context of my suggested Reform 2 proposal. Without consolidation, however, this reform looks very similar to the current regime. The inability to determine definitively *ex ante* what is an exempt activity and what is nonexempt renders the safe harbor largely ineffective.

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187. See *id.* at 1895.

188. See *supra* Parts II.A & III.A (discussing the difficulty in determining whether an activity is related or unrelated to exempt purposes).

## B. REFORM 2: POLICING THROUGH UBIT

The second, and better,<sup>189</sup> option for reform is to recognize that an inexact case-by-case approach is inevitable given the complexities of the modern economy, and that reducing the stakes without jeopardizing the goals of the exemption process is the superior policy.<sup>190</sup> This approach would allow most nonprofit organizations to achieve an exemption and conduct as much nonexempt activity as desired, as long as nonexempt activity was appropriately taxed as UBIT. This reform has the virtue of drastically reducing the exemption risk that nonexempt activity currently poses, which means that subsidiaries will be used only when socially efficient and not as a tool to preserve a parent's exemption. For this reform to be implemented effectively, the UBIT must be modified to encompass all unrelated nonexempt activity.

1. *Broadening the UBIT's Scope*

Currently, under the UBIT, activities that are regularly carried on and that are not substantially related to exempt purposes, are taxed as ordinary income.<sup>191</sup> Several enumerated statutory provisions exempt additional activities from the UBIT that otherwise would qualify.<sup>192</sup> However, even the UBIT's original goal of taxing activity that competes with nonexempt commercial organizations,<sup>193</sup> does not provide a broad enough definition for the suggested reform. It is too narrow to serve the

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189. Such an approach in the tax context has been compared to the property/liability rule distinction in property law. Andrew Blair-Stanek, *Protecting Tax Statuses with Liability Rules and Property Rules*, YLS MOOT CAMP (2011) (on file with author). Blair-Stanek generally recommends liability rule protection in tax law for many of the same reasons as are discussed throughout this Article. *Id.* at 19-24.

190. Professor John Colombo has suggested a similar general type of reform for regulating nonprofit commercial activity that also aims to improve predictability. *See, e.g.*, Colombo, *supra* note 88, at 688-89; John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487, 556-59 (2002). Professor Colombo himself views his type of reform as only second-best. *Id.* at 556-57. I will argue that, while the general idea should be implemented, there are several specifics as outlined in Reform 2 that differ substantially from prior proposals.

191. *See* I.R.C. §§ 513(a), 512(a)(1) (2006).

192. *See supra* notes 127-141 and accompanying text.

193. *See supra* note 64 and accompanying text.

proposed function of taxing all non-charitable activity and ensuring that organizations choose the most efficient form.

Academics have noted that the UBIT promotes economic efficiency by forcing nonprofits to compete with for-profits on equal footing in noncharitable (unrelated) activities.<sup>194</sup> These arguments are applicable irrespective of whether the activity is regularly carried on, whether the activity is a bingo game, and in some cases even whether the activity is related. Without UBIT, exempt nonprofits could operate at margins that for a for-profit would result in losses after taxes.<sup>195</sup> This subsidized exempt activity at the expense of for-profit provision incurs costs such as incentives for exempt nonprofits to not diversify investments,<sup>196</sup> managerial inefficiencies as operations grow and expand outside the nonprofit's area of expertise,<sup>197</sup> excess saving by nonprofits,<sup>198</sup> and providing subsidies to nonprofit firms inversely proportional to their needs.<sup>199</sup> While nonprofits may undoubtedly consider more than just a project's rate of return when deciding which activities to undertake,<sup>200</sup> it must also be true that nonprofits do not ignore returns entirely; they cannot operate with losses forever, and so it is important to ensure these

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194. See, e.g., Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 613 (1989). Professor Colombo also recognizes this concern and addresses it through application of a difficult to define "commercial activity" tax. Colombo, *supra* note 192, at 557-559. His discussion does not consider the statutory exemptions or how they would fare under a "commercial activity" tax.

195. See Hansmann, *supra* note 196, at 610. Nonprofits also need only break even, while for-profits must generally provide a positive return on equity.

196. See *id.* at 614-15. Recall the behavior of New York University, *supra* note 63, which operated several businesses having few, if any, synergies with the University. The University was motivated to wholly own and operate businesses thereby making the businesses exempt, rather than broadly diversifying investments across nonexempt activities.

197. See Hansmann, *supra* note 196, at 616-17.

198. See *id.* at 619-21. This point stems from the incentive to own and operate commercial exempt feeder organizations.

199. See *id.* at 621.

200. See, e.g., Burton A. Weisbrod, *Modeling the Nonprofit Organization as a Multiproduct Firm: A Framework for Choice*, in *TO PROFIT OR NOT TO PROFIT* 47, 52-55 (Burton A. Weisbrod ed., 1998) (noting that nonprofits may take into account more than just profit maximization); Jill R. Horwitz, *Does Nonprofit Ownership Matter?*, 24 *YALE J. ON REG.* 139, 191 (2007) (concluding that profit-making is likely a lower priority for nonprofit hospitals than for for-profits).

economic incentives result in efficient behavior. Let us now apply these insights to activities currently excluded from the UBIT to determine which activities should remain excluded and which should be taxed as ordinary income.

a. Intermittent Activity

Consider first the case of UBIT exemption for activities not regularly carried on. Activities that are not regularly carried on will compete with for-profits, although not as strongly as regularly carried on activities would. Such unfair competition was one of the primary forces behind the UBIT's creation.<sup>201</sup> The idea behind this exemption may be that activities pursued only irregularly will be insubstantial or not pursued assiduously enough to compete in a meaningful way with for-profits that engage in the activity full time. However, that is not always the case.<sup>202</sup> To the extent that exempt nonprofits can engage in irregular activities without having them considered regularly carried on, this exemption promotes inefficiencies in the manners discussed above.

Applying the UBIT to intermittent activities would create administrative implementation and compliance costs that might exceed any economic efficiency gains that would result. However, these administrative costs would likely be small in comparison to the size of many of the involved activities; nonprofit firms could accurately classify some of their sporadic activities as either related or unrelated, and the body of guidance will only grow over time. Annual fundraisers whose function is to raise revenue to further exempt purposes, for example, would clearly be categorized as unrelated and subjected to the UBIT. If irregular activity is meant as a proxy for low-volume activity, an explicit *de minimis* exception from UBIT would be more appropriate than an

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201. See *supra* notes 63-65 and accompanying text.

202. Consider a provocative hypothetical example of a charity occasionally providing investment banking services, yielding millions of dollars in revenue exempt from UBIT because it is not regularly carried on. Peña & Reid, *supra* note 9, at 1888. Such behavior would clearly compete with for-profit investment banking services, and it would provide a significant subsidy to the exempt organization unrelated to its charitable operations. While this particular example may be unlikely to occur, the point remains a good one.

intermittent activity exemption.<sup>203</sup> Thus, activity not regularly carried on should not be exempted from the UBIT.

b. Statutorily-Enumerated Exceptions

While a *de minimis* exception to the UBIT may be appropriate in light of the administrative costs that would otherwise be incurred, many of the statutorily-excluded activities can be substantial in nature and compete with traditional commercial activities. For instance, an exempt organization can run statutorily-excluded bingo operations with annual revenue in excess of \$1 million and remain free from UBIT application.<sup>204</sup> These operations compete with other taxed sources of entertainment. Activities performed by volunteers can also be substantial and compete with for-profit organizations. Despite this, any business where “substantially all the work in carrying on such business is performed for the organization without compensation” would presumably be exempt.<sup>205</sup> As is the case with irregular activities, these exemptions are inappropriate, and subjecting them to UBIT would increase efficiency.

Other statutorily-exempt UBIT activities, although potentially substantial, may not yield increases in economic efficiency if subjected to the UBIT. Royalties from member list rentals are one example. These rentals can be substantial—they can generate revenue in excess of

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203. Recall that such an exception already exists, but only with respect to gifts given incidental to charitable contributions. *See* I.R.C. § 513(h) (2006).

204. *See* I.R.S. Tech. Adv. Mem. 97-11-003 (Nov. 8, 1995). Although the Ruling does not state the annual Bingo revenues, it is possible to calculate the revenue from other information in the Ruling. In 1993, the organization spent \$17,459 on exempt activities. In the same year, 1.41% of its expenditures were spent on “other activities including charitable programs,” meaning it spent at least 0.0141 or \$1.238 million all together in 1993. In addition, 95.14% of its expenditures in 1993 were for the bingo operation, which translates to 0.9514 x \$1.238 million or at least \$1.178 million. *See id.* at 12-13.

205. Treas. Reg. § 1.513-1(e)(1) (as amended in 1983). The Regulation provides as an example of such exempt behavior an exempt organization operating a retail store selling to the general public, with work performed by uncompensated volunteers. Such an operation would appear, in reality, to compete directly with for-profit providers. *See id.* at § 1.513-1(e)(3).

several hundred thousand dollars per year to an organization<sup>206</sup>—yet they are generally a byproduct of a nonprofit's operations. The nonprofit likely incurs minimal extra cost from assembling these lists and engages in minimal additional effort to accumulate members solely for the lists, so its overall behavior should be largely unaffected by whether or not UBIT is imposed.<sup>207</sup> To the extent UBIT could raise desirable tax revenue and avoid excessive tax base erosion, it should be imposed; however, the net economic effect from taxing these activities could be negative because of additional administrative costs<sup>208</sup> associated with UBIT compliance and administration.<sup>209</sup> Sponsorship payments would follow a similar analysis.

Notably, the statutory UBIT exemptions for passive investment income, including dividends, should be retained. Recall that dividends, interest payments, and annuities are excluded from UBIT.<sup>210</sup> Consider the case of dividends.<sup>211</sup> As others have noted, without the dividend exception, exempt nonprofits would have the incentive to conduct businesses directly (incurring taxation on dividends as UBIT once) rather than indirectly through stock ownership (incurring taxation on dividends twice; once when they are earned by the stock company, and once when they are paid to the exempt organization).<sup>212</sup> This incentive

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206. See, e.g., *Sierra Club, Inc. v. Comm'r*, 86 F.3d 1526 (9th Cir. 1996) (affirming exemption of fixed royalty from member list rental, as well as 0.5% royalty of Sierra Club credit card purchases).

207. It is true that nonprofits might devote some resources to building valuable membership lists. If such activity is low-cost, it is relatively harmless because it has no significant economic effect on the efficient mix of resources produced by society. The UBIT exemption would allow the nonprofit to compete on advantageous terms with for-profit list aggregators, but it is not immediately clear how worrisome this potential distortion is.

208. These administrative costs would be reduced to the extent that broader UBIT application is administratively easier; fewer UBIT exceptions means more predictability and easier administration.

209. If UBIT decreases are compensated for by increased tax revenue from other sources, rather than from decreases in public spending, it is unclear whether the deadweight losses from taxing the other sources would be greater or less than the avoided losses from no UBIT imposition.

210. I.R.C. § 512(b)(1) (2006).

211. The argument for interest and annuities is similar. See, e.g., Hansmann, *supra* note 196, at 625-26.

212. See, e.g., *id.*



would persist even when the exempt nonprofit could not conduct the business as efficiently as a for-profit organization, as long as the efficiency difference was less than the tax savings from conducting business directly. The dividend exclusion eliminates this inefficient incentive.

Of course, one might wonder why this special dividend treatment is necessary for exempt nonprofits but not for individuals or for-profit organizations, both of which are taxed twice on dividends.<sup>213</sup> This double taxation gives individuals and for-profit organizations the same undesirable incentive to conduct businesses directly (even if less efficiently) as exempt nonprofits would have, without the UBIT exemption for passive investment income.<sup>214</sup> Are individuals and for-profit organizations also in need of a dividend deduction for an efficient outcome? There are a few possible explanations for why nonprofits may be particularly responsive to these tax differences, and in turn why individuals and for-profit organizations may not require similar treatment as exempt nonprofits. However, the distinction is difficult to draw with respect to for-profit organizations.

With respect to individuals, it is rarely the case that an individual has sufficient funds to undertake a major business directly. Even if they do, they have the option under many circumstances to select an organizational form that allows pass-through (single) taxation, such as a

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213. Dividends are not subject to a complete double tax. For individuals, many received dividends are taxed at a maximum rate of 15%, although at the moment they are scheduled to be taxed at the higher ordinary income rates starting in 2013. *See* I.R.C. § 102(a) (qualified dividends); Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752 (2003). For-profit corporations receiving dividends from other unrelated corporations must include only 30% of the dividend as income, which translates to a 10.5% additional effective taxable rate on dividends for corporations in the highest (35%) tax bracket. *See* I.R.C. § 243(a)(1). If the dividend-issuing corporation is at least 80% owned by the for-profit, however, then the for-profit need not pay taxes on the dividend. *See id.* §§ 243(b)(2), 1504(a).

214. The lower tax rates for individuals' qualified dividends, I.R.C. § 1(h)(11), and for-profits' inter-corporate dividends, I.R.C. § 243, mitigates, but does not eliminate, this distortion. Note that until the repeal of the *General Utilities* doctrine in 1986, this distortion could often be avoided because corporations did not recognize gains or losses on distributions of property to shareholders. *Gen. Utils. Co. v. Helvering*, 296 U.S. 200 (1935); Tax Reform Act of 1986, Pub. L. No. 99-514, § 631, 100 Stat. 2085, 2269 (1986) (repeal of the doctrine).

partnership or limited liability corporation. These facts, coupled with the significant benefits from diversified ownership that can be achieved at low cost with stock ownership,<sup>215</sup> may mean that even with the inefficient tax structure, the benefits of indirect ownership via stocks will outweigh the costs of double taxation to most individuals who would consider direct business ownership in a double-taxed form. Exempt nonprofits, on the other hand, often have sizable endowments<sup>216</sup> and could more realistically consider conducting businesses directly, perhaps even operating a diversified portfolio of them. In addition, if individuals are less inclined to save than are nonprofits, which seems likely,<sup>217</sup> then they would need large incomes before being able to directly operate a business. Nonprofits, on the other hand, are much more likely to be in a position to consider this option.

For-profits have the ability to distribute excess earnings to shareholders via dividends, unlike nonprofits which are prohibited from doing so due to the non-distribution constraint.<sup>218</sup> If a for-profit has used up all corporate opportunities that might exceed the market rate of return, it has the option of distributing excess earnings as dividends to shareholders, rather than investing in other companies through stock ownership. Shareholders may prefer this action (and make their preference known to management) even with the accompanying

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215. Diversification's ability to reduce stock return variance without sacrificing expected return is well known. *See, e.g.*, Paul A. Samuelson, *General Proof that Diversification Pays*, 2 J. FIN. & QUANTITATIVE ANALYSIS 1 (1967).

216. This fact is particularly true of many universities, although other non-educational exempt nonprofits can have significant surpluses as well. *See, e.g.*, Hansmann, *supra* note 196, at 620.

217. Americans' preference for consumption over savings has been well publicized, particularly in light of the recent economic downturn. Americans' savings rates in recent years have dwindled to their lowest levels since data was available. *See* U.S. Table 2.1 Personal Income and Its Disposition, U.S. Dep't. of Commerce, Bureau of Economic Analysis, *available at* <http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=58&ViewSeries=NO&Java=no&Request3Place=N&3Place=N&FromView=YES&Freq=Qtr&FirstYear=2008&LastYear=2010&3Place=N&AllYearsChk=YES&Update=Update&JavaBox=no#Mid> (last visited May 25, 2011).

Nonprofits, on the other hand, seem much more disposed towards savings. *See, e.g.*, Hansmann, *supra* note 196, at 620 (noting nonprofits' "perhaps undesirably strong — tendency to save rather than spend.").

218. *See supra* note 4.

dividend tax, because it allows the individual shareholder to use this excess however he wants, rather than having the for-profit control its disposition. Nonprofits, on the other hand, cannot distribute excess earnings to shareholders.<sup>219</sup> If a nonprofit exhausts opportunities that exceed the market rate of return, the best remaining financial option is to use remaining funds for stock ownership. If dividends from this ownership were taxable to the nonprofit, it would open up additional socially inefficient direct corporate ownership opportunities before the return on these opportunities again equaled the after-tax market rate of return.

Yet the same argument could be applied to taxing dividends accruing to for-profit owner. If there was no difference in behavior between nonprofits and for-profits in this context, then one could argue that they should be treated alike.<sup>220</sup> Perhaps the decision to exempt passive investment income for nonprofit firms represents more a desire to provide additional nonprofit subsidy; fortunately, the decision promotes efficient behavior at the same time.

However, unlike dividends, the UBIT exemption for capital gains tax<sup>221</sup> should be eliminated—a suggestion that heretofore has been neglected in the academic literature. The capital gains exemption promotes the very inefficiency that the dividend exemption avoids. Consider an exempt nonprofit owning stock in another corporation. When that corporation sells a capital asset at a gain, the gain is taxed at the capital gains rates.<sup>222</sup> When this gain (reduced by the capital gains tax) is distributed as a dividend, the exempt nonprofit receives it tax-free because of the UBIT dividend exemption.<sup>223</sup> The net effect is that the exempt nonprofit receives the gain reduced by the capital gains rate.

On the other hand, if the exempt nonprofit conducted the business directly, then the same sale of a capital asset would result in no capital

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219. *See id.*

220. Efficiency rationales would suggest that neither should be taxed on dividends received.

221. *See* I.R.C. § 512(b)(5) (2006).

222. *See id.* § 1(h). The gain discussed here is the gain relative to the purchase price. Any gains reflecting depreciation are subjected to capital gains recaptured and taxed at ordinary rates under I.R.C. § 1250.

223. *Id.* § 512(b)(1).

gains tax to the nonprofit,<sup>224</sup> as long as the capital asset was not debt-financed.<sup>225</sup> This result seems to hold irrespective of whether the activity is otherwise subjected to the UBIT.<sup>226</sup> Thus, the exempt nonprofit's payoff for operating any business directly—whether charitable or not—is higher relative to indirect ownership through stock holdings. The incentive for distortions may be heightened if, as I will recommend, nonprofits could undertake unlimited nonexempt activity without risking their exemption. However, even if the exemption applied just to charitable-related property as another subsidy for charitable activity, we would still have the undesirable situation of pushing exempt nonprofits to conduct charitable activities directly (and to characterize the income from these activities as capital gains) instead of investing in for-profits that may provide an analogous benefit more efficiently.<sup>227</sup> Just as the dividend exemption from UBIT should be kept, so should the capital gains exemption be eliminated.<sup>228</sup>

Note that this elimination should not place undue administrative burdens on charities when disposing of donated property. Donors must report their basis in donated property to the IRS,<sup>229</sup> this information could be passed along to exempt organizations so that they may

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224. See *id.* § 512(b)(5).

225. See *id.* §§ 512(b)(4), 514(a)(1).

226. See *id.* § 512(b)(5) (making no mention of applying in only the case of charitable activity); see also Treas. Reg. § 1.512(b)-1(d) (1992) (not limiting the capital gains exemption to charitable activities).

227. This outcome would be most common where for-profits provide goods and services that are ready substitutes for their charitable counterparts, such as healthcare.

228. The goal should be to create indifference between incurring capital gains directly or indirectly, and eliminating the capital gains exemption for nonprofits would create this indifference. Without a tax on capital gains, however, this inefficiency exists with nonprofits, which unfortunately are arguably the most responsive to these distortions. See *supra* notes 221-223 and accompanying text. For-profits and individuals are still taxed more heavily if capital gains are incurred in an asset they own indirectly through another organization, but the lower tax rates for inter-corporate dividends, I.R.C. § 243, and qualified dividends, I.R.C. § 1(h)(11), are at least steps towards achieving this indifference.

229. See I.R.S. Form 8283, Noncash Charitable Contributions (Dec. 2006), available at <http://www.irs.gov/pub/irs-pdf/f8283.pdf> (requiring individuals and corporations to provide their basis in any noncash donations exceeding \$500).

compute their capital gains on the excess of the sale price over this basis.<sup>230</sup>

Eliminating the distortionary capital gains exemption would disproportionately reduce funding to those organizations that may be particularly well-liked by the public, if public approval is evidenced through willingness to donate. Although these organizations by extension are perhaps the most deserving, they already receive an initial disproportionate benefit through the charitable deduction that promotes donations.<sup>231</sup> These organizations are thus arguably least in need of additional support from a capital gains exemption, due to their relatively large donations in comparison to other exempt organizations. In addition, subsidy arguably is better provided based on the extent of public good provision, and not solely on public popularity.

The remaining statutorily-enumerated exemptions can be disposed of relatively quickly. Still to be considered are rents, work performed by volunteers, activities for members' convenience, the business of selling donated merchandise, trade show activity, certain hospital services, pole rentals, and distribution of low cost items incidental to charitable contribution solicitations.<sup>232</sup>

Rents could be treated similarly to membership lists or sponsorship payments, since their taxation, or lack thereof will not greatly affect the behavior of exempt nonprofits that already have constructed facilities. However, future behavior would be affected by the taxability. Exempt organizations may, for instance, construct more spacious or elaborate facilities than necessary to obtain exempt rental income than they otherwise would have without exemption. This exemption thus inefficiently promotes overuse of exempt rental facilities, and should therefore be eliminated.

Work performed by volunteers should not on its own be exempt from UBIT solely on the basis of when this work results in something sold in the marketplace.<sup>233</sup> Instead, it should be treated as any other

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230. Capital losses should be allowed to offset capital gains.

231. The charitable deduction is found at I.R.C. § 170.

232. See *supra* notes 128-141 and accompanying text for the complete list.

233. This qualification avoids taxing those activities that do not result in something sold in the market, for instance when volunteers paint the interior of a nonprofit structure. This arrangement comports with taxation policy generally, since a homeowner who paints the interior of his house is also not taxed on the value of his

activity of the organization, and it should be exempt only if it furthers a charitable purpose. Of course, once the work is taxed the nonprofit should be able to deduct the cost of inputs, which could be difficult when the volunteers do not receive a wage. A relatively simple, although perhaps not the most accurate, solution would be to allow a deduction for hours worked times the minimum wage.

Such volunteer work should be subjected to UBIT scrutiny because it could easily and inefficiently<sup>234</sup> compete with for-profit firms, as suggested by the Treasury Regulation interpreting the exemption.<sup>235</sup> One might suppose that this volunteer work could represent a subsidy towards particularly deserving exempt organizations, with deservingness evidenced by the degree of volunteer support. However, as previously discussed, there are already other less distortionary ways this outcome will emerge. For instance, deserving organizations already receive subsidy through the deductibility of donations (a measure of deservingness), and additional deductions for deservingness may be unnecessary.

Activities for members' convenience, business comprised of selling donated property, trade show activity, certain hospital services, and pole rentals should all generally not be exempted on their own unless they otherwise further a charitable purpose. Each of these activities has the potential to compete with for-profit organizations, and this competition can produce inefficient behavior.<sup>236</sup> If, for example, an exempt organization operated a food stand for the convenience of its employees,

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work, at least until the house is sold and gain is realized. This is true even though in both cases the painting comes at the expense of a for-profit painting organization.

234. See *supra* Part V.B (discussing the inefficiencies stemming from exempt competition with for-profit firms).

235. Treas. Reg. § 1.513-1(e) (as amended in 1983). The example of exempt behavior is an orphanage's retail store operated by volunteers. No mention is made of what the retail store's operations must be. An orphanage's volunteer-operated sandwich shop in an urban financial district would presumably be exempt under this interpretation, despite the obvious competition with for-profit providers.

236. See *supra* Part V.B (discussing the inefficiencies resulting from exempt competition with for-profit firms). Exemption of coops from pole rentals could be seen as promoting efficient coop ownership, although if coops are the efficient ownership form, perhaps federal subsidies would not be necessary. See generally HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 172 (1996) (observing that electric coops emerged even before federal subsidies).

such activity would presumably be exempt even if it displaced nearby more efficient for-profit food providers.<sup>237</sup> If these activities further exempt purposes, however, then they would be exempt.

The final enumerated exemption, distribution of low-cost items incidental to fundraising activities, should be changed into a general *de minimis* exemption. Any combined UBIT activity generating less than a specified amount of revenue would not be subjected to the UBIT, because for these activities, the administrative costs associated with UBIT compliance are most likely to outweigh efficiency gains. The *de minimis* exception must be applied on an aggregate activity basis to prevent organizations from avoiding it through a series of small activities.

In summary, most of the statutorily-enumerated UBIT exemptions should be eliminated. Of these changes, the exemption for capital gains may be the most important. The exemption for other passive investment income should be retained, and a general *de minimis* exemption should be put into place that will better capture much of the small-level activity at which the statutorily-enumerated exemptions seem targeted.

### c. Related Activity

In contrast to the suggestions above to remove much of the UBIT statutorily-enumerated exemptions, the relatedness exemption should remain.<sup>238</sup> While there are administrative costs with determining whether

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237. See Treas. Reg. § 1.513-1(c)(2)(ii) (as amended in 1983) (exempting an educational institution's bookstore's sales of books or a hospital's pharmacy sales to patients, although the exemption is also couched in terms of intermittent sales); I.R.S. Priv. Ltr. Rul. 2006-25-035 (Mar. 28, 2006) (recognizing convenience as a ground for exemption independent of whether the activity is intermittent or regularly engaged in). Of course, if there are other non-charitable reasons to promote these activities, the nonprofit could always subsidize them, or even operate them at cost and incur no tax liability.

238. But see Colombo, *supra* note 192, at 562-63 (advocating a general "commercial activity" tax so that "all . . . profits, related or not, would be subject to tax."). Professor Hansmann also suggests eliminating the relatedness exemption in certain circumstances. Hansmann, *supra* note 196, at 629-31 (suggesting that certain related behavior that could be performed just as well by for-profit firms could be subjected to the UBIT, saving administrative costs, as well as other costs associated with having provision by subsidized nonprofits).

an activity is related or not,<sup>239</sup> there would also be administrative costs with complying with the UBIT if the relatedness exemption were eliminated. The cost associated with determining relatedness should decrease as precedent continues to grow over time. Further, competitive exempt organizations would respond to elimination of the relatedness exemption with an increase in prices or a decrease in provision of the related activity or the general charitable activity.<sup>240</sup> These price increases may be undesirable to the extent the activities are charitable in nature and require subsidization to reach their optimal consumption.

This last statement raises an important point. Relatedness exemptions should be given to only those activities that actually further an exempt purpose through their connection with the exempt purpose, and not to those activities with a slight relatedness resemblance but no actual charitable relatedness. Nonprofits have the incentive to classify as related as much activity as is possible to escape taxation,<sup>241</sup> and steps must be taken to minimize this.

Under the relatedness analysis, a museum's parking lot revenues from museum patrons should be treated as exempt. Practically, a museum must offer a parking lot for visitors, and even though operating a parking lot generally is not considered an exempt activity, when the parking lot is connected to an exempt museum, its revenues from museum customers should be exempt. On the other hand, it is more debatable whether a hospital's gift shop should be exempt. Hospitals do not require gift shops for effective provision of care; many exempt hospitals function perfectly well without gift shops. Although it has been said that gift shops help charitable provision of care by promoting patients' well-being,<sup>242</sup> it is debatable how much merit that statement has, and in particular how much extra well-being, presumably in the

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239. See *supra* notes 91-92 and accompanying text.

240. This result might also be expected when eliminating any of the current UBIT exemptions. However, the exemptions discussed above that are not charitable or related to charitable purposes in their own right have no charitable component, so an increase in their price or decrease in their provision should not pose significant problems. Any social losses from price increases translated to the general charitable activities would have a better chance of being more than offset by the efficiency gains.

241. See I.R.C. § 512(a) (2006).

242. Rev. Rul. 69-267, 1969-1 CB 160.



form of extra gifts, a hospital-run shop provides over what visitors would otherwise bring on their own.

For the relatedness exemption to continue (as well as for the determination of what is a charitable activity), a facts-and-circumstances test is required. Such a test necessarily imposes uncertainty, but unlike today's system the uncertainty and risk would be confined to the possibly-related activity only. Under this reform, a determination that an activity is unrelated would not in turn threaten exemption, and therefore the parent nonprofit would not have reason to conduct the activity within a subsidiary solely because it risked losing its entire exemption.

Finally, it is worth noting that despite the requisite facts-and-circumstances test with a relatedness exemption, such an exemption may in some ways actually promote ease of administrability compared to the alternatives. Without the relatedness concept, the exemption system may run into difficult issues involving the level of granularity to apply to an exempt activity when determining what portion of its revenue is exempt. Consider again the exempt art museum. The art museum naturally requires a security system to ensure that the art remains in the museum. It is highly unlikely that under the current system the security system would, on its own, be an exempt purpose. One might argue, therefore, that the art museum should bifurcate its ticket revenue and pay UBIT on the portion allocable to the security system's added benefit to the visitors.<sup>243</sup> Much of this tax would be canceled out by the deduction for business expenses.<sup>244</sup> But what if the benefit from the security system exceeded its tax cost for the year?<sup>245</sup> Should this difference be taxable? However, when the security system is seen as related to the art museum's charitable mission, the entire ticket sales could be treated as exempt, and the costs associated with the above inquiry would be avoided.

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243. This idea would be consistent with the "fragmentation rule," where exempt organizations carrying out an activity that is only partially consistent with exempt purposes must fragment the revenue into the portion consistent with exempt purposes and the remainder. Only the portion consistent with exempt purposes is then exempt. *See* Treas. Reg. § 1.513-1(d)(3) (as amended in 1983).

244. I.R.C. § 162(a).

245. This would be particularly likely once the system was fully depreciated.

## 2. *Relaxing Exemption Requirements*

Once the UBIT has been modified to ensure it encompasses all nonexempt activity, the requirements for obtaining exempt treatment can be relaxed. The nonprofit organizational and operational requirements should be broadened to encompass any nonprofit even if only a portion of its goal is exempt.<sup>246</sup> This portion could be significantly smaller than the portion required by today's organized and operated exclusively for exempt purposes requirement. Only revenues generated from activities that further charitable purposes would be exempted from tax.

Policing nonexempt activity through the UBIT instead of the exemption requirements avoids the problem of nonprofits inefficiently choosing to conduct activities through for-profit subsidiaries instead of directly, because the stakes at risk are significantly lower. It also allows nonprofits to undertake any for-profit activities that they may be able to perform more efficiently (after UBIT taxes) than a for-profit firm, without risking their overall exemption. A classic example of such activity is a university that leases its athletic fields for nonexempt purposes, such as a fair. Because the university has already built the fields to further its own exempt purposes, it would be efficient to allow the university to take advantage of economies of scope and use the field for nonexempt purposes as well. The university should not have to worry that the revenues from the lease might threaten its exemption.

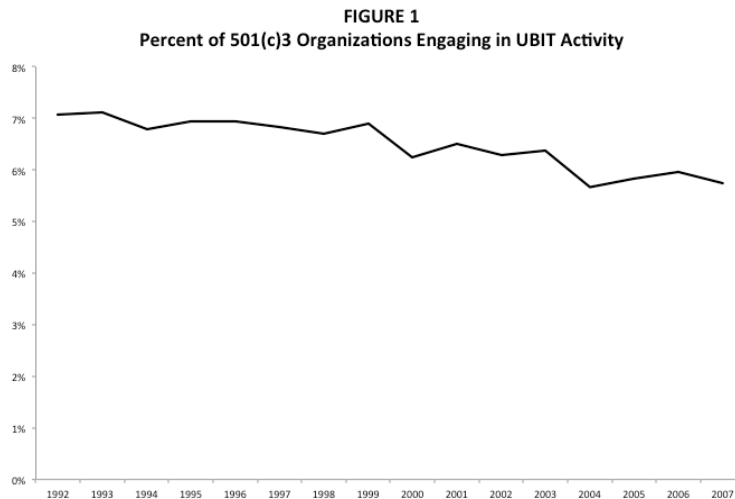
The UBIT exemption on dividends coupled with UBIT liability on capital gains means a nonprofit would undertake these nonexempt activities only when it can earn a rate of return that is higher than the market rate of return on the same activity. In addition, because nonprofits cannot distribute excess earnings,<sup>247</sup> they may be particularly

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246. This is a less restrictive requirement than the one proposed by Professor Colombo. *See* Colombo, *supra* note 192, at 562-63 (suggesting granting a tax exemption when a nonprofit conducts “any significant charitable activity”). In fact, as long as nonexempt activity is taxed as UBIT, there is no reason to require the exempt activity to be significant or, in fact, for there to be any exempt activity at all. In this latter case, the “exempt” nonprofit would function merely as any nonexempt nonprofit, with its income subjected to the UBIT instead of equivalent corporate income taxes.

247. *See supra* note 4.

inclined to have funds available for these efficient for-profit activities.<sup>248</sup> As shown in Figure 1, nonprofits' undertaking of unrelated activities has gradually decreased in recent years, perhaps out of fear of losing their exemptions. Society will be better off if nonprofits were more free to use retained earnings to engage in these activities without risking their exemptions.



It should not matter whether the revenues from for-profit activities are used to cross-subsidize an exempt activity or are instead used to further the for-profit activities, or whether revenues from exempt activities are used to further the exempt activities or are instead used for for-profit purposes.<sup>249</sup> If the exempt activities are worth undertaking, they will be financed with retained earnings that may or may not include earnings from for-profit activities. The tax exemption's goal should be to facilitate the initial provision of charitable goods and services. Once these goods and services have been provided and the accompanying revenues have been earned, it should not matter to what use the revenues are devoted.

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248. See *supra* notes 220-223 and accompanying text. This inability to distribute excess earnings can be one of the worst sources of nonprofit inefficiency. See HANSMANN, *supra* note 239, at 38. Restricting what can be done with these earnings, such as limiting their use in for-profit activities, only worsens the inefficiency.

249. But see Colombo, *supra* note 88, at 689-91 (suggesting that for-profit activity should be allowed only if its revenues are used to cross-subsidize exempt activity).

Exemptions should also be granted to nonprofits that provide services related to other organizations' exempt purposes, whether the other organization is the parent or an unrelated exempt organization. Because these related activities would be exempt if conducted by the parent or by another organization, they should also be treated as exempt if conducted by any nonprofit organization, regardless of relation. This arrangement ensures that parents will efficiently use nonprofit subsidiaries (such as the case when the parent museum conducts parking lot operations through a subsidiary), and it also allows for organizations to take advantage of efficient economies of scale. For example, an organization that owns and operates parking lots for several exempt museums may be more efficient than if these parking lots were owned and operated by the individual museums, perhaps due to efficiencies from administrative expense streamlining. By the above analysis, but not necessarily under current law, the nonprofit parking lot operator should be allowed an exemption.<sup>250</sup> As long as a desired subsidized activity is provided,<sup>251</sup> in this case parking at museums, we should not care whether the revenues are received by the museum or by the parking lot operator.<sup>252</sup>

Although the above discussion demonstrates several advantages to broadening the UBIT and making exemptions easy to attain, there are

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250. The parking lot operator also would not be allowed an exemption under the alternative proposal put forth by Professor Colombo, which recommends expanding the UBIT. His proposal would provide derivative exempt status to organizations that satisfy I.R.C. § 509(a)(3) "supporting organizations" rules, which require the organizations to be organized and operated exclusively to carry out the purposes of a charitable organization. *See* Colombo, *supra* note 192, at 552. Instead, my proposal would provide exemption for activities that would be exempt if conducted by the exempt nonprofit. Essentially, it allows exempt nonprofits to outsource these activities to other nonprofits, without the activities losing their exempt nature.

251. Competition among exempt parking lot operators will ensure that the parking is provided where marginal revenue equals marginal cost, and because the revenues are exempt, the price for parking at exempt parking lots will be below the price for parking at nonexempt parking lots, which is the result that the exemption seeks to obtain.

252. The non-distribution constraint and private inurement and benefit doctrines, of course, keep the parking lot operator (as well as all nonprofit operators) from funneling revenues out for his own personal use. *See supra* note 4; *supra* note 57 and accompanying text.

several aspects of this suggested reform that may raise some concern. These concerns are considered in the following section.

### 3. *Potential Concerns*

Significantly relaxing the requirements for achieving exemption raises a variety of concerns. Making exemptions easy to obtain may increase the incentive for cheating the tax system, erode the tax base, or devalue the “halo” effect that nonprofits possess.<sup>253</sup> Further, allowing unlimited nonexempt activity may increase nonprofit managerial diversion. Finally, for-profit opportunities may open up the possibility for inefficient empire building. Some of these concerns are more pressing than others.

First, policymakers might worry that making exemptions easier to obtain might make it more attractive for organizations to play the exemption lottery; organizations could obtain exempt status and then claim exemptions on nonexempt revenue, in hopes that they will not be audited, or that the fraud will go undetected. Of course, such behavior would be prohibited (as it already is in the current system). Nonetheless, if the reform results in more organizations obtaining exemptions, as well as more activity undertaken by exempt organizations, enforcement would be more difficult. Furthermore, significant fines for violations may prove problematic. Imposing fines could result in penalties to organizations which are attempting to honestly conduct potentially-exempt activity. This is similar to today’s system which threatens loss of overall exemption. Although some deterrent to intentionally claiming for-profit activities as exempt is necessary, it must not be too severe or else the problems contained in the current system will be repeated.

However, the current system audits only a very small portion of all exempt nonprofits. It has been estimated that it would take seventy-nine years to audit all current nonprofits.<sup>254</sup> Furthermore, most applications

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253. *See supra* note 6.

254. JAMES J. FISHMAN & STEPHEN SCHWARZ, *TAXATION OF NONPROFIT ORGANIZATIONS* 9 (2d ed., 2006) (quoting GILBERT M. GAUL & NEILL A. BOROWSKI, *FREE RIDE: THE TAX-EXEMPT ECONOMY* (1993)).

for exemption are met with rubber-stamp approval,<sup>255</sup> suggesting that the suggested reform may not be significantly worse with the exemption lottery problem than the current system. While more exempt nonprofits with more activities would only exacerbate the problem, if the probability of detection is already incredibly small, reducing it further may not significantly affect activity. Essentially, the exemption lottery is already almost a guaranteed win.

In either case, increased enforcement efforts are very likely a good idea, and could potentially be supported by imposing an annual fee on exempt organizations. This fee would also deter for-profits from using the nonprofit form solely in an attempt to classify for-profit activities as exempt. Imposing a penalty of a percentage of claimed-exempt activities found to be nonexempt could provide additional deterrence. A balance must be struck between deterrence, and promotion of efficient entity form; increased deterrence raises the problem of increasing the stakes that hinge upon the uncertain classification process. Greater IRS vigilance could achieve the same result with lower deterrence, but the vigilance incurs administrative costs.<sup>256</sup>

Such enforcement and deterrence efforts of course carry costs, but they should be incurred even under the current system, whose infrequent audits promote playing the exemption lottery. It is also encouraging that, as shown by Figure 2,<sup>257</sup> assessed UBIT as a percentage of gross UBIT has increased while the UBIT tax rate has remained relatively stable, suggesting that IRS vigilance may already be on the rise and resulting in more compliance with classifying activities as subjected to the UBIT. More vigilance certainly appears necessary, since Figure 3<sup>258</sup> shows that

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255. *Id.* An individual with knowledge about the exemption process noted that “something like 95 or 99 percent who apply get approved. It’s like getting your driver’s license.” *Id.*

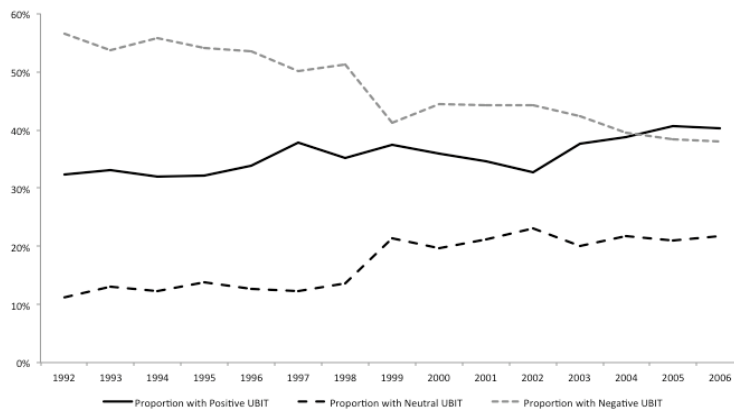
256. In addition, as enforcement increases, so too does the amount of precedent and guidance that helps organizations appropriately characterize their income, making it less costly for them to make these decisions.

257. Data used for this Figure was taken from the IRS website. *SOI Tax Stats – Exempt Organizations’ Unrelated Business Income (UBI) Tax Statistics*, IRS.GOV, <http://www.irs.gov/taxstats/charitablestats/article/0,,id=97210,00.html> (last visited Oct. 17, 2011).

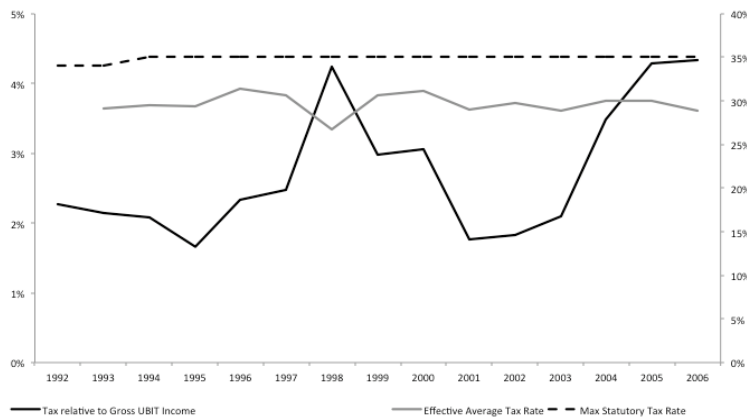
258. Data used for this figure was taken from the IRS website. *SOI Tax Stats – Charities & Other Tax-Exempt Organizations Statistics*, IRS.GOV, <http://www.irs.gov/taxstats/charitablestats/article/0,,id=97210,00.html> (last visited Oct. 17, 2011).

the proportion of nonprofits reporting negative or zero unrelated income remains distressingly high. In particular, it is most unlikely that nonprofits were accurately allocating expenses and charging appropriate market rates in transactions with subsidiaries and parents if one-third of nonprofits with unrelated activities produce neither positive nor negative net income.

**FIGURE 2**  
Proportion of 501(c)(3) Organizations with Positive, Negative, or Zero Net UBIT



**FIGURE 3**  
UBIT Tax Imposed on 501(c)(3) Organizations as a Percentage of Gross UBIT, and UBIT Tax Rate



Policymakers may also worry that relaxing exemption requirements will result in tax base erosion as organizations legitimately avoid taxation. While this result is possible, it is not cause for concern. The

expanded UBIT will tax all nonexempt activity, so that the only tax base erosion will be comprised of activity that was already worthy of exemption, but which was not being exempted. For instance, exempt activity being conducted within a for-profit subsidiary to preserve the parent's exemption would be exempt under the proposed reform if conducted by the exempt nonprofit parent. Thus, the only activity removed from the tax base will be exempt activity that, for policy reasons, should be exempt anyway.<sup>259</sup> And if enforcement efforts increase and the relatedness requirement is effectively policed, the tax base may ultimately expand.

Of perhaps more concern is the fact that granting liberal exemptions and permitting significant unrelated activity could devalue the "halo" that accompanies the exempt nonprofit label. It is unclear whether this effect would occur. On the one hand, if exempt nonprofits come to be viewed merely as a form of profit maximizers, then their halo may fade, leading consumers to patronize for-profit providers or reduce donations.<sup>260</sup> This result may not be all that undesirable if the halo currently encourages consumers to choose an inefficient nonprofit over a more efficient for-profit. Furthermore, even though dispersal of the halo could reduce consumers' perceived well-being, their financial well-being will improve. On the other hand, the suggested reform would not lead nonprofits to conduct their exempt activities any differently. Thus, if consumers view some exempt nonprofit operations as "safer"<sup>261</sup> before the reform, they should continue to see the exempt nonprofits as "safer" after the reform, at least as applied to the exempt activities.

It is also worthwhile to observe that consumers of nonprofits, whether the nonprofit is exempt or not, gain any benefits offered by the

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259. Of course, if the exempt activity was already being conducted by the for-profit subsidiary anyway, then one might argue that exempting it from taxation erodes the tax base; the activity would still be provided but now treated as exempt. However, exempting the activity should result in increased provision of the activity, either in greater quantity by the now-exempt provider or by new providers whose marginal costs just exceeded marginal revenues when not exempt. So even though the activity was already being provided without an exemption, we would expect more provision with the exemption.

260. As with the current system, donations would have to be used for charitable purposes to be deductible by the donor.

261. See *supra* note 6.



nonprofit's binding commitment to its non-distribution constraint.<sup>262</sup> Currently there are no significant restraints to keep nonprofits engaging in for-profit behavior as long as they do not seek exempt status.<sup>263</sup> Thus, the dissipation of any desirable halo effect arises only to the extent that consumers attach it to *exempt* nonprofits, rather than nonprofits in general.

The problem with using exempt status as an indication of quality is that exemptions then have several incompatible goals. Most notably, the public goods theory of exemptions,<sup>264</sup> that an exemption promotes provision of desirable public goods, is unrelated to whether an individual should use the exemption as a positive signal of quality. Other theories of the nonprofit exemption are similarly incompatible with the "halo" effect of exemptions.<sup>265</sup> Perhaps a better solution would be to focus exempt status on achieving these primary goals, while allowing other specialized certification or organizational structures to concentrate on sending a positive signal to consumers.<sup>266</sup>

Another topic of concern is that granting exempt nonprofits an unfettered ability to conduct nonexempt activity may result in undesirable managerial diversion. Managerial diversion refers to the inefficiency that results when managers lose track of their charitable mission because their attention is instead diverted by other activities,<sup>267</sup> which in this case are additional for-profit opportunities. This outcome may be particularly undesirable if nonprofit managers are already relatively inefficient because of the nature of the nonprofit structure.<sup>268</sup>

It is not clear whether managerial diversion will occur and, if it does, it might be outweighed by countervailing benefits. For instance, it

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262. See Hansmann, *supra* note 4.

263. Nonprofits are not necessarily exempt. The American Automobile Association is one example of a nonexempt nonprofit engaging in for-profit activity. See *supra* note 5.

264. See *supra* Part I.A.

265. See Hansmann, *supra* note 182. Exemptions acting as a halo effect are compatible with the donative theory of exemptions proposed by Mark Hall and John Colombo, however. See Hall & Colombo, *supra* note 182.

266. B-corporations and low-profit limited liability companies are just two promising alternatives to the nonprofit exemption for achieving this goal.

267. See, e.g., Colombo, *supra* note 192, at 534.

268. See Hansmann, *supra* note 196, at 616-17.

seems unlikely that a successful nonprofit manager would ignore the nonprofit operations simply because for-profit opportunities are available; indeed, nonprofit managers sometimes ignore profitable for-profit opportunities to focus on their nonprofit missions.<sup>269</sup> Instead, he might hire an additional manager if he finds his oversight is spread too thin.

Further, it is likely that a for-profit activity would not be competing for the manager's attention unless it was as profitable as the exempt activities. To the extent that managerial attention is shifted to more efficiently-performed activities, society is better off.<sup>270</sup> Of more concern may be that additional for-profit activities may increase a firm's operations and require it to adopt a more bureaucratic structure, increasing administrative and other costs. However, the exempt nonprofit would not undertake these new activities unless their return exceeded the market rate by at least this cost increase.

Finally, a policymaker might worry that allowing exempt nonprofits to conduct unlimited nonexempt activity could provide an easy avenue for empire building. The nonprofit manager may decide to undertake inefficient, for-profit activities in an effort to expand the nonprofit's operations and build an "empire," which provides nonpecuniary utility to the manager.<sup>271</sup> Empire building generally is not as large a concern in the for-profit sector, because wayward organizations should be corrected by competition or corporate takeovers.<sup>272</sup> The competitive check may not be as strong in the nonprofit sector,<sup>273</sup> and nonprofit corporate takeovers do not generally occur.<sup>274</sup>

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269. See, e.g., Weisbrod, *supra* note 202, at 47, 52-55.

270. See Colombo, *supra* note 192, at 535.

271. See *supra* note 30.

272. Since empire building reduces a company's value relative to its potential, it will either be outcompeted by other organizations without wasteful empire building (and with cheaper costs) or purchased and run by management that can increase the firm's value by restricting wasteful projects.

273. Unlike for-profit firms, nonprofits can continue indefinitely while earning enough just to break even. For-profit firms generally must earn sufficient profit to provide a return on their equity.

274. Of course, because nonprofits do not have equity, many corporate takeovers in the traditional sense are precluded. See *supra* note 33 and accompanying text.

This unpleasant state of affairs warns of general nonprofit inefficiency, a specific application of which is the potential for empire building. Like general nonprofit inefficiency, however, empire building is likely just as much a problem with the current system as it would be with the suggested reform. Allowing nonprofits to conduct nonexempt activity without risking their exemption provides more avenues for empire building, but even under the current system nonprofits can always engage in empire building with limited for-profit operations as well as with unlimited exempt operations. It is unclear whether additional for-profit avenues would result in more empire building or instead merely in differences in how the empire building is conducted. To the extent that more empire building could result, however, the reform should be met with some caution in this regard.

While there are several potential concerns with relaxing exemption standards and expanding UBIT coverage, only some of these concerns are legitimately troublesome. It seems likely that the losses from these potential inefficiencies would be outweighed by the efficiency gains resulting from a system that does not threaten to impose huge sanctions against exempt organizations conducting potentially nonexempt activity directly.

With so much to be gained by reforming the interaction between exemptions and UBIT, it is worth briefly considering why the IRS has not already done so. Surely institutional inertia may provide some of the explanation. The UBIT was enacted after exemptions had already become the gatekeeper of the exemption process.<sup>275</sup> Perhaps the IRS is also concerned about the increase in manpower necessary to audit and police a system with more for-profit activity carried out by exempt nonprofits. As already mentioned, more IRS oversight is probably a good idea even with the current system. And, while the penalty of losing an entire exemption surely is a good deterrent, it over-deters by promoting inefficient behavior, while at the same time invoking a punishment wholly unrelated to the magnitude of the infraction. The reforms suggested by this Article solve both these problems.

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275. Recall that the UBIT was enacted after the exemption requirement scheme was already in place. *See supra* note 64 and accompanying text.

#### 4. Exemptions for For-Profit Organizations?

Although the suggested reform would allow nonprofits to engage in more nonexempt activity without losing their exemption, it does not tackle the issue raised by other proposals that recommend an exemption be offered to charitable activity performed by for-profit organizations.<sup>276</sup> Consequently, my suggested reform leaves open the potential inefficiency of nonprofits choosing to conduct charitable activity through the nonprofit form when the for-profit form is more efficient. This situation emerges because the charitable activity is exempt from tax only when conducted by a nonprofit, not a for-profit.

Allowing for-profit exemptions would solve this inefficiency,<sup>277</sup> but it would be a considerably more difficult outcome to achieve politically. And, even without the exemption, some organizations have found it worthwhile to form for-profit charities.<sup>278</sup> In addition, for-profit exemptions have certainly not been free from criticism,<sup>279</sup> and to the extent that a tax exemption facilitates funding for nonprofits,<sup>280</sup> which cannot issue equity,<sup>281</sup> the exemption would be unnecessary for for-profits. In any case, for-profit exemptions are beyond the scope of this Article. It is worth noting, however, that while for-profit exemptions

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276. See, e.g., Malani & Posner, *supra* note 182.

277. It would also be particularly attractive because it would allow exempt nonprofits to efficiently outsource exempt activities to for-profit organizations that could perform them cheaper. For example, with exemptions for for-profit organizations, we would not require that the parking lot operator discussed in *supra* notes 47-48 be a nonprofit to obtain a derivative exemption, so long as he undertook parking operations for an exempt museum that would be free from UBIT if it operated its parking lot directly. Allowing an exemption for for-profit operators would open up competition to more organizations and ensure that exempt nonprofits did not waste resources on an activity that could be performed more efficiently by another organization.

278. Google.org is a prominent example. Google.org conducts Google's charitable activities, but unlike most charitable organizations is a for-profit. See Katie Hafner, *Philanthropy Google's Way: Not the Usual*, N.Y. TIMES, Sept. 14, 2006, at A1; *About Us*, GOOGLE.ORG, <http://www.google.org/about.html> (last visited May 25, 2011).

279. See, e.g., James R. Hines, Jr. et al., *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179 (2010); David M. Schizer, *Subsidizing Charitable Contributions: Incentives, Information, and the Private Pursuit of Public Goals*, 62 TAX L. REV. 221, 254-55 (2009).

280. See Hansmann, *supra* note 182.

281. See *supra* note 33 and accompanying text.

solve the problem of inefficiently choosing the nonprofit form for exempt activities, they do not solve the problem of inefficiently choosing the for-profit form for mixed or for-profit activities that is motivated by today's system of uncertainty and high stakes. Thus, a system of for-profit exemptions should not be enacted without the reform of nonprofit exemptions advocated by this Article.

### CONCLUSION

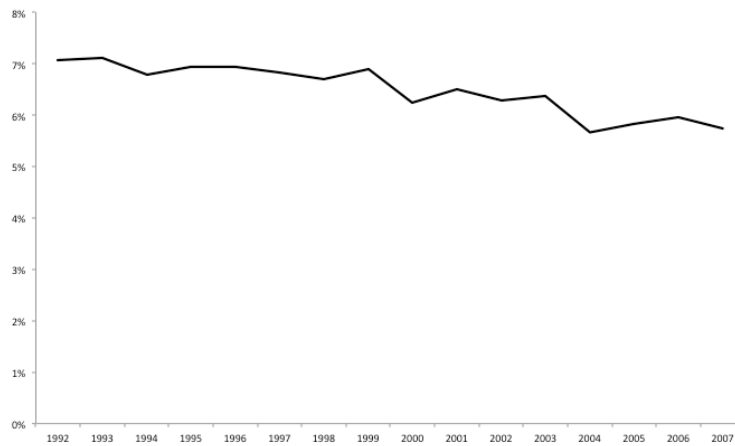
The current IRS guidance on which activities are exempt and which threaten exemptions, combines uncertainty with needlessly high stakes. This incentivizes exempt organizations to make socially-inefficient decisions in their choice of for-profit or nonprofit business form as well as in their use of retained earnings. A reform that would relax exemption requirements and tax all activity unrelated to charitable purposes, would mitigate this problem while providing the requisite flexibility of the current facts-and-circumstances tests.

Additionally, in the current environment of decreased governmental support and reduced private donations, allowing nonprofits to undertake for-profit activities without jeopardizing their exemption provides them with much-needed alternative funding sources. Finally, with the much-publicized state of the healthcare system, granting exempt hospitals the freedom to undertake for-profit activities, including joint ventures, could improve efficiencies through economies of scale and provide additional revenue for cross-subsidization of other healthcare costs, granting relief against the inexorable rise in healthcare costs. While the concepts of private inurement and private benefit in the joint venture contexts still need further development, ensuring that nonexempt activity does not threaten exemptions is a necessary first step.

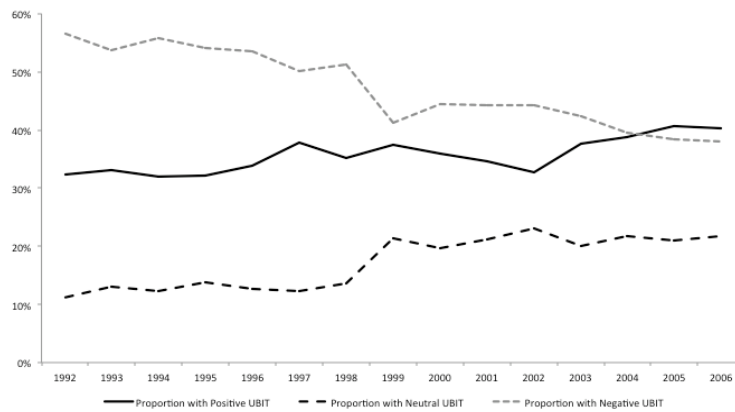
**APPENDIX**

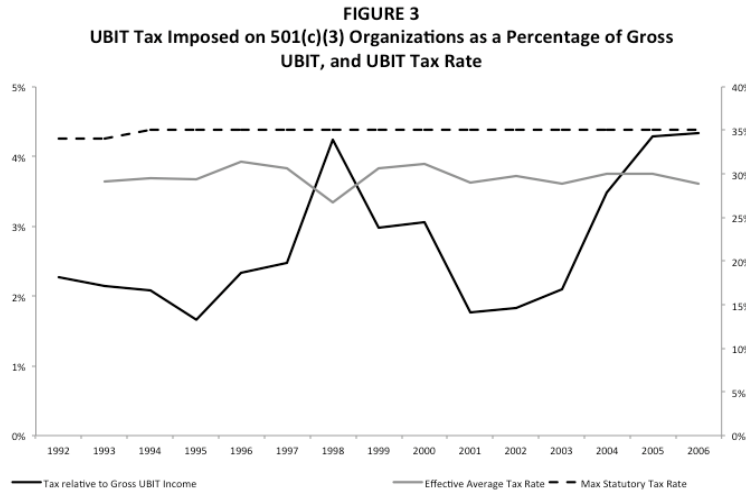
Figures 1 through 3 are reproduced for convenience.

**FIGURE 1**  
**Percent of 501(c)3 Organizations Engaging in UBIT Activity**



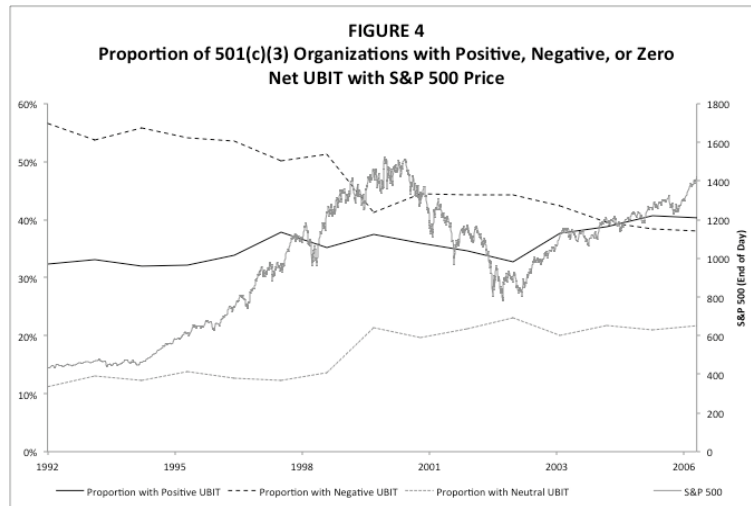
**FIGURE 2**  
**Proportion of 501(c)3 Organizations with Positive, Negative, or Zero Net UBIT**





Data for the total number of 501(c)(3) organizations is available from the IRS at <http://www.irs.gov/taxstats/charitablestats/article/0,,id=97176,00.html>, and remaining data on the number of 501(c)(3) organizations with positive, neutral, and negative UBIT; gross UBIT-taxable income; net UBIT-taxable income; and UBIT tax assessed are available at <http://www.irs.gov/taxstats/charitablestats/article/0,,id=97210,00.html>. Net UBI-taxable income is available only from 1997 to 2006, the last available year of data. The IRS calculates these data based on samples of returns.

As noted in the Article, the amount of UBIT tax paid as a percentage of gross UBIT has increased while the UBIT tax rate (both effective and statutory) has remained relatively steady. Coinciding with this observation, the proportion of 501(c)(3) organizations reporting UBIT activities with net positive revenue has increased. However, overall economic performance as measured by the S&P 500 has fluctuated during this period of increase, suggesting that the increase is not due entirely to an economy-wide increase in project profitability. An alternative explanation is that the IRS has been pursuing UBIT income more assiduously, leading more nonprofits to characterize income appropriately and allocate costs correctly rather than disproportionately to taxable activities. See Figure 4.



Interestingly, the percent of exempt organizations with negative or break-even net UBIT income remains very high. Vertically-integrated exempt organizations have incentives to produce for-profit inputs at a loss or the break-even point, which pushes profit downstream to the final exempt good where they are not subjected to tax. The IRS has expressed concern with shifting tax liabilities to lower-bracket organizations,<sup>282</sup> which should prohibit this type of behavior. It seems that the deterrent is not yet sufficient, however, since it is hard to believe that the majority of UBIT-applicable activities result in losses or no net revenue.

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282. The IRS requires that organizations allocate income and expenses so that they “prevent the evasion of taxes or clearly . . . reflect the income of [the organizations].” I.R.C. § 482 (1986). This section has been explicitly applied to exempt organizations. Treas. Reg. § 1.482-1(i)(1) (as amended in 2009); *see also* I.R.C. § 1551 (preventing corporations from transferring assets, solely for tax reasons, to related corporations with lower marginal tax rates); I.R.S. Priv. Ltr. Rul. 6902199500A (Feb. 19, 1969).

Additionally, costs shared between an exempt and for-profit organization must be allocated based on fair market value and actual use, under penalty of exemption revocation. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 93-08-047 (Dec. 4, 1992); I.R.S. Priv. Ltr. Rul. 86-26-102 (Apr. 7, 1986), *modified*, I.R.S. Priv. Ltr. Rul. 86-45-064 (Aug. 13, 1986).

These restrictions combine to limit the flexibility that organizations should have regarding input prices and allocation of costs and revenue among related entities.