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The author wishes to express her thanks to Professor Jeffrey M. Colon for his encouragement and thoughtful comments.

NOTES

SIERRA CLUB: RATIONALIZING THE ROYALTY EXCEPTION TO THE UNRELATED BUSINESS INCOME TAX

*JENNIFER ANNE SPIEGEL**

The obligation attached to a gift itself is not inert. Even when abandoned by the giver, it still forms a part of him. Through it he has a hold over the recipient . . . .[1]

INTRODUCTION

Tax exemption is a subsidy that society confers on certain nonprofit organizations.[2] There are many reasons for granting tax-exempt status to nonprofit organizations.[3] For example, nonprofit organizations may be financially unable to fulfill their nonprofit objectives without the subsidy that tax exemption provides.[4] Similarly, tax exemption assists a nonprofit in performing a function that the government

* The author wishes to express her thanks to Professor Jeffrey M. Colon for his encouragement and thoughtful comments.

1. Marcel Mauss, The Gift: Forms and Functions of Exchange in Archaic Societies 9 (Ian Cunnsion trans., 1967).

2. A tax-exempt entity is synonymous with a nonprofit institution. The term nonprofit, however, can be misleading. The designation "nonprofit" means that an entity is prohibited from distributing its net earnings to the individuals who control the entity; it does not imply that the entity may not earn a profit. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 Yale L.J. 835, 838 (1980) [hereinafter Hansmann, *Nonprofit Enterprise*]. Under § 501(a) of the Internal Revenue Code, a trust that forms a qualified pension, profit-sharing or stock bonus plan as well as organizations listed in § 501(c) and § 501(d) are exempt organizations. I.R.C. § 501(a)(1995). Examples of organizations qualifying for exemption under § 501(c) are fraternal societies, recreation clubs, labor organizations, civic leagues, corporations organized to promote amateur sports or competition, and most importantly, § 501(c)(3) organizations, corporations organized exclusively for religious, charitable or scientific purposes. *Id.* § 501(c). A § 501(c)(3) organization, a charitable organization, can be distinguished from other nonprofit or tax-exempt institutions. For example, a donor may generally deduct contributions made to a charitable organization pursuant to § 170, but may not deduct contributions to other § 501(c) organizations. *See* Tax-Exempt Organizations: Organization, Operation and Reporting Requirements, Tax Mgmt. (BNA), No. 464-3rd, at A-1 (July 13, 1992). Throughout the remainder of this Note, references to exempt organizations or nonprofits will include charitable organizations.

3. *See* Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 Yale L.J. 299, 304 (1976); Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 Yale L. J. 54, 55 (1981) [hereinafter Hansmann, *Rationale for Exemption*]; Hansmann, *Nonprofit Enterprise*, *supra* note 2, at 843-45.

4. *See* Hansmann, *Rationale for Exemption*, *supra* note 3, at 74; James T. Bennett, *Unfair Competition and the UBIT*, 41 Tax Notes 759, 762 (1988) ("Unless they receive government subsidies, for-profit firms will not produce pure public goods because of the 'free rider' problem."); *see also* Hansmann, *Nonprofit Enterprise*, *supra*

would otherwise be forced to undertake itself, such as health care or aid to the poor.[5] Moreover, tax exemption is an appropriate subsidy because nonprofits, which are prohibited from distributing their profits to their owners, are more trustworthy providers of goods and services than are for-profits.[6] Finally, nonprofits confront social problems using innovative approaches that, because of bureaucratic and political constraints, government would not be free to pursue.[7] Whatever the specific rationale for tax exemption may be, the public that confers a subsidy through tax exemption expects a service to society in return for this subsidy. The unrelated business income tax ("UBIT") ensures that tax exemption will be used to fulfill this expectation by limiting the privilege of exemption to income derived from activities related to a nonprofit organization's exempt purpose.[8]

Income is subject to UBIT[9] where a nonprofit (1) engages in a trade or business that (2) is regularly carried on and (3) is not substantially related to the organization's exempt purpose.[10] Exempt purposes encompass a large variety of objectives, including education, health, scientific research, and professional association.[11] Congress enacted UBIT, sections 511 through 514 of the Internal Revenue

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note 2, at 848-49 (arguing that profit-seeking firms are not as trustworthy providers of public goods as are nonprofits).

5. Hansmann, *Rationale for Exemption*, *supra* note 3, at 66. Bittker and Rahdert distinguish between two types of exempt organizations, "public service" organizations and "mutual benefit" organizations. *See* Bittker & Rahdert, *supra* note 3, at 305-06. Public service organizations include charitable organizations, educational institutions, social welfare organizations, churches, and other religious organizations. *Id.* at 305. Mutual benefit organizations, on the other hand, are formed primarily so that members may pursue their own objectives. *Id.* at 306. Mutual benefit organizations include social clubs, labor unions, and trade associations. *Id.* at 305-06.

6. According to Bennett:

> When consumers find it difficult to judge a product's quality before purchasing it—as with health care, for instance—consumers are said to be at the mercy of suppliers and the market is said to "fail." In such cases, profit-seeking firms supposedly will take advantage of consumer ignorance and increase their profits by offering lower-quality and higher-priced goods and services. Because of this tendency, nonprofits are widely held to be a more appropriate vehicle for the provision of certain types of services.

Bennett, *supra* note 4, at 761; John Copeland & Gabriel Rudney, *Business Income of Nonprofits and Competitive Advantage*, 33 Tax Notes 747, 748 (1986). This lack of reliability of for-profits has been described as "contract failure." With nonprofits there is no "contract failure," because nonprofits "have no compelling requirement to distribute profits to owners, and have less opportunity and incentive to 'exploit' consumers than for-profit firms." *Id.* (citation omitted).

7. Copeland & Rudney, *supra* note 6, at 749.

8. *See* I.R.C. §§ 511-513 (imposing a tax on revenue generated by activities unrelated to an exempt entity's exempt purpose).

9. *Id.* If the organization is a corporation, it will be subject to the corporate rate of taxation under § 11 on any UBI. *See id.* § 511(a). If the exempt organization is a trust, however, it will be subject to tax on any UBI at the rate applicable to taxable trusts, namely § 1(e). *See id.* § 511(b).

10. *See id.* §§ 511-512.

11. *See id.* § 501(c).

Code, to prevent nonprofit organizations from gaining any unfair competitive advantage over for-profit organizations through the higher after-tax profit margins that tax exemption creates.[12]

Congress did not impose this tax without exception, however. Congress carved out several exceptions to UBIT for those activities it deemed to be "passive"—that is, those activities not tending to incite competition between for-profit and non-profit organizations.[13] One example of passive income is royalty payments. This as well as the other exceptions were rationalized on the same grounds as the UBIT tax as a whole—to control competition between for-profit and nonprofit organizations.

The Tax Court's decision in *Sierra Club, Inc. v. Commissioner* (*Sierra Club II*)[14] has made it doubtful that the unfair competition rationale will remain a plausible justification for UBIT and its exceptions. Even prior to this decision, it was questionable whether the prevailing interpretation of the exceptions to UBIT could be reconciled with the underlying rationale originally expressed by Congress for the UBIT provisions.[15] The *Sierra Club II* decision will force commentators to revisit the question of whether a more sound justification for UBIT may be offered.[16]

In *Sierra Club II*, the Tax Court held that the proceeds received by the Sierra Club in exchange for the use of its logo on an affinity card marketed by Chase Lincoln First Bank were not subject to UBIT, because the proceeds were royalties and thus fell within the passive income exception to UBIT.[17] The decision, however, represents such an expansive interpretation of the royalty exception to UBIT that the

12. *See* H.R. Rep. No. 2319, 81st Cong., 2d Sess. 36-37 (1950), *reprinted in* 1950-2 C.B. 380, 408-09; S. Rep. No. 2375, 81st Cong., 2d Sess. 28-29 (1950), *reprinted in* 1950-2 C.B. 483, 504-06.

13. *See* S. Rep. No. 2375, 81st Cong., 2d Sess. 28 (1950), *reprinted in* 1950-2 C.B. 483, 506: "Dividends, interest, royalties, most rents, capital gains and losses, and similar items are excluded from the base of the tax on unrelated income *because your committee believes that they are 'passive' in character and are not likely to result in serious competition for taxable businesses having similar income.*" (emphasis added).

14. No. 8650-91, 1994 U.S. Tax Ct. LEXIS 62 (Aug. 24, 1994).

15. *See, e.g.*, A.L. Spitzer, *Reform of the UBIT: An Open Letter to Congress*, 43 Tax Notes 195, 197-98 (1989) (arguing that taxing royalty income derived from a nonprofit's rental of its name and logo would represent a "substantial policy shift" for UBIT); Thomas A. Troyer, *Changing UBIT: Congress in the Workshop*, 41 Tax Notes 1221, 1226 (1988) (suggesting that the elimination of unfair competition between for-profits and nonprofits falls "short of a complete justification" for UBIT).

16. At least one commentator has already raised this question. *See* Paul Streckfus, *Sierra Club: Latest Nail in the UBIT Coffin*, Tax Notes Today 176-82, Sept. 7, 1994, *available in* LEXIS, Fedtax Library, TNT File. *But see* Leonard J. Henzke, Jr. & Vicki Robinson, *Tax Court Holds That Card Payments Are Nontaxable Royalties*, 6 J. Tax'n Exempt Orgs. 132, 135 (1994) (emphasizing the positive aspects of the expansive interpretation of the royalty exception).

17. *Sierra Club II*, 1994 U.S. Tax Ct. LEXIS 62, at *71 ("Such items are intangible property, and . . . [s]uch consideration thus constitutes royalties within the meaning of 512(b)(2).").

exception threatens to swallow the rule.[18] As one commentator noted, "We have just about reached the day when any tax attorney who has a tax-exempt client paying unrelated business income tax (UBIT) is probably guilty of malpractice."[19]

While the exception upon which the Tax Court relied in the *Sierra Club* decision is only one narrow exception to the unrelated business income tax, it has become an increasingly important one. Many nonprofit organizations have entered into similar endorsement arrangements over the past two years. Oregon State University, for example, is currently challenging the Internal Revenue Service's (the "Service") determination that proceeds received from an affinity arrangement with United States National Bank of Oregon is taxable as unrelated business income.[20] Other universities engaged in similar programs may find such arrangements are not worth continuing if the programs will subject them to UBIT.[21] The construction of the royalty exception will also affect other types of arrangements. For example, the Arthritis Foundation is awaiting approval from the Service for the exemption of income from an arrangement whereby the Foundation endorses aspirin and other over-the-counter medicine marketed by the Johnson & Johnson Foundation.[22]

This Note examines the application of the UBIT royalty exception to name and logo licensing arrangements between nonprofit and for-profit organizations. Part I of this Note examines the legislative origins and purpose of the UBIT provisions and demonstrates how the UBIT provisions typically have been applied by courts and the Service. Part II focusses on the application of the royalty exception, emphasizing the broad manner in which the *Sierra Club II* court interpreted the royalty exception under section 512(b)(2) of the Code. Part III discusses various academic criticisms of the legislative rationale for UBIT, concluding that the unfair competition rationale is no longer a practicable objective for UBIT. Part IV assesses the expansive construction of the royalty exception in light of the broader goals both of tax exemption in general and, more specifically, the goal of the UBIT provisions. This part explains how a broad interpretation allows nonprofits to rely on revenue generated by unrelated activities, thus discouraging nonprofits from pursuing related activities more vigorously. This part also evaluates proposals that have been made to reform UBIT and its exceptions.

18. *See* Streckfus, *supra* note 16.
19. *Id.*
20. *See Petitioner's Brief in Oregon State Alumni Association Case*, Tax Notes Today 251-25, Dec. 23, 1994, *available in* LEXIS, Fedtax Library, TNT File.
21. Other universities offer similar credit cards: Fordham University, Brown University, and Columbia University, to name a few.
22. *See* Lee A. Sheppard, *Aspirin and the Ultimate Tax Shelter*, 64 Tax Notes 420, 420 (1994).

This Note concludes that the elimination of unfair competition does not provide the best rationale for UBIT, because there is no consensus among scholars and practitioners that exemption creates an unfair competitive advantage. This Note suggests that accountability provides a better rationale for UBIT. By taxing a nonprofit on income derived from unrelated activities, UBIT ensures that a nonprofit is held accountable to the public for the subsidy it has conferred on the nonprofit. Neither the current drafting of the royalty exception nor the Tax Court's expansive interpretation of the royalty exception in *Sierra Club II* furthers this goal. This Note proposes that the royalty exception should be modified with a view to compelling nonprofits to account for the manner in which they use the privilege of tax exemption.

I. UBIT and Its History

Prior to the enactment of UBIT in 1950, nonprofits were subject to more lenient treatment by the Service than they are today. Some nonprofits exploited their exemption from federal income tax laws by acquiring entities in the for-profit sector. The abusive behavior of nonprofits under this lax regime explains in part the concerns that motivated the enactment of the UBIT provisions. Under the current UBIT provisions, the Service no longer permits the exemption of all unrelated business income earned by nonprofits.

A. *Pre-1950 Treatment of Unrelated Business Activity of Tax-Exempt Organizations*

Prior to 1950, the "destination of income" test governed the taxation of unrelated business income earned by exempt organizations.[23] Under this test, any revenue used to further a tax-exempt purpose was exempt, regardless of the activity from which the revenue derived. The Supreme Court, in *Trinidad v. Sagrada Orden de Predicadores*,[24] applied the "destination of income" test to an exempt religious organization that owned property used to produce wine, chocolate, and other luxury articles. The Court held that because the proceeds were destined to support the religious order, they were properly exempted from taxation. The Court concluded that "destination [is] the ultimate

23. The plain language of the provisions of the Internal Revenue Code prior to 1950 required only that a nonprofit apply the income it earned to further an exempt purpose in order for the organization to qualify for exemption. *See* Note, *The Macaroni Monopoly: The Developing Concept of Unrelated Business Income of Exempt Organizations*, 81 Harv. L. Rev. 1280, 1280 (1968) [hereinafter Note, *Macaroni Monopoly*]; *see also* Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 Va. L. Rev. 605, 608 (1989) [hereinafter Hansmann, *Unfair Competition*]; Nathan Wirtschafter, Note, *Fourth Quarter Choke: How the IRS Blew the Corporate Sponsorship Game*, 27 Loy. L.A. L. Rev. 1465, 1469 (1994).

24. 263 U.S. 578 (1924).

test of exemption," and thus, all that mattered was that the income was used to advance an exempt purpose.[25]

The destination of income test applied even to income earned indirectly by an exempt organization through a wholly owned for-profit subsidiary.[26] If an exempt organization acquired a for-profit organization, the proceeds earned by the organization would also be exempt provided they were destined to further an exempt purpose. Thus, through acquisition of a for-profit organization, an exempt organization could effectively convert a taxable entity into an exempt one.[27] Such converted entities were commonly referred to as "feeder" organizations, because the income earned by the for-profit was used to "feed" the nonprofit.[28]

In *Roche's Beach, Inc. v. Commissioner*,[29] the Second Circuit upheld the exempt status of feeder organizations.[30] In *Roche's Beach*, decedent Edward Roche had created a corporation through which another charitable foundation could manage and collect income from his property after his death.[31] The income-producing property consisted mainly of a bathing beach business in Queens County, New York: Roche's Beach, Inc.[32] Although Roche's Beach carried on no charitable activities, the court ruled that it fell within section 103(6),[33] which granted exempt status to corporations "organized and operated exclusively for . . . charitable . . . purposes . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual."[34] The court construed the "organized and operated exclusively" standard to permit the exemption of income earned by wholly owned for-profit corporations, reasoning that "[t]he destination of the income [was] more significant than its source."[35] In his dissent, Judge

25. *Id.* at 581.

26. *See* C.F. Mueller Co. v. Commissioner, 190 F.2d 120 (3d Cir. 1951); Bittker & Rahdert, *supra* note 3, at 317.

27. In fact, prior to 1969, a tax-exempt organization could effectively "sell" the use of its tax exemption to an unrelated business. *See* Commissioner v. Brown, 380 U.S. 563 (1965). Section 514, enacted in 1969, precludes such a sale by extending UBIT to passive income to the extent such income is derived from debt-financed property, the use of which is not substantially related to the organization's exempt purpose. *See* *Ways and Means Oversight Subcommittee UBIT Recommendations*, Daily Tax Report L-4, L-14 (June 24, 1988) [hereinafter *UBIT Recommendations*].

28. *See* Bittker & Rahdert, *supra* note 3, at 317.

29. 96 F.2d 776 (2d Cir. 1938).

30. *Id.* at 779; *see also* Lichter Found., Inc. v. Welch, 247 F.2d 431, 436-37 (6th Cir. 1957) (upholding exemption of income from masonry business destined to support nonprofit organized for purpose of aiding needy students).

31. *Roche's Beach*, 96 F.2d at 776.

32. *Id.* The revenue derived primarily from bathhouse, suit and towel rentals, refreshment sales, etc. *Id.* at 777.

33. Section 103(6) was the predecessor to § 501(c)(3). *See* Revenue Act of 1928, § 103(6).

34. *Roche's Beach*, 96 F.2d at 778 (quoting 26 U.S.C.A. § 103(6)) (alteration in original).

35. *Id.*

Learned Hand urged that, with limited exceptions, any income obtained by an exempt organization through the profit-making activities of a subsidiary should be taxed.[36] Yet twelve years passed before Hand's critique was codified through the enactment of the UBIT provisions. Until then, the "destination of income" test enabled exempt organizations to pursue profit-making activities without jeopardizing their exempt status.[37]

B. *Enactment of the UBIT Provisions*

The UBIT provisions were enacted as part of the Revenue Act of 1950 and imposed for the first time an income tax on the unrelated business income of exempt organizations.[38] Congress enacted the UBIT provisions in response to the successful exploitation of the "destination of income" test by New York University Law School.[39] NYU had used its higher after-tax profit margins to acquire for-profit companies whose activities were entirely unrelated to legal education.[40] In *C.F. Mueller Co. v. Commissioner*,[41] the Service challenged the exempt status of one of these companies, C.F. Mueller Co.[42] Because Mueller was a subsidiary of NYU, it did not pay a tax on its profits,[43] thereby enjoying a higher after-tax profit margin than other rival macaroni companies.[44] This higher profit margin presumably allowed Mueller to reinvest and expand more rapidly.[45]

The higher profit margin also provided, however, an opportunity to engage in predatory pricing[46] and monopoly.[47] Because nonprofits pay no tax on their profits, given the same priced product offered in

36. *Id.* at 779.

37. *See, e.g.*, Estate of Simpson v. Commissioner, 2 T.C. 963, 966 (1943) (finding nonprofit educational institution's rental of property did not jeopardize exempt status); Unity Sch. of Christianity v. Commissioner, 4 B.T.A. 61, 70 (1926) (upholding exemption of a religious corporation's earnings from publications and from an inn); Sand Springs Home v. Commissioner, 6 B.T.A. 198, 217 (1927) (upholding exemption of income from a greenhouse, cotton gin, and an electric generating plant).

38. Revenue Act of 1950, Pub. L. No. 81-814, 1950 U.S.C.C.S. (Predecessor of U.S.C.C.A.N.) (64 Stat. 906) 479.

39. *See* Wirtschafter, *supra* note 23, at 1469.

40. *See id.* By 1947, NYU Law School owned the Mueller Macaroni Company, a leather company, a piston ring factory, and a chinaware manufacturing company. *See* Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 Stan. L. Rev. 1017, 1017 n.2 (1982).

41. 190 F.2d 120 (3d Cir. 1951).

42. *See id.* at 121.

43. *See id.*

44. *See* Rose-Ackerman, *supra* note 40, at 1020; *Macaroni Monopoly*, *supra* note 23, at 1281 n.10; Wirtschafter, supra note 23, at 1469.

45. *See* Note, *Macaroni Monopoly*, *supra* note 23, at 1282.

46. *See* Louisiana Credit Union League v. United States, 693 F.2d 525, 539 (5th Cir. 1982). Predatory pricing refers to a market participant's adjusting its price downward to undersell its competitors and eventually drive competitors out of business. *See* F. M. Scherer & David Ross, Industrial Market Structure and Economic Performance 450-51 (3d ed. 1990).

the same market, nonprofits enjoy a higher after-tax profit margin than competing for-profits. For example, if product A sells for $5 and the cost of production is $4, a nonprofit earns and retains a $1 profit. The for-profit, however, pays a tax at the rate of 35 % on the $1 profit and thus retains a profit of only $.65 for every sale of product A. Because of this higher profit margin, nonprofits could potentially offer the same goods and services as competing for-profits at a lower price.[48] By underselling competing for-profits in this manner, nonprofits could drive for-profits out of business and monopolize a market.[49] Thus, with the advantage of tax exemption, Mueller could undersell its competitors while still maintaining the same profit margin as for-profit macaroni competitors previously had. Theoretically, this advantage eventually would enable Mueller to monopolize the macaroni market.[50] Despite these concerns over unfair competition, however, the court in *C.F. Mueller* followed *Roche's Beach*'s interpretation of the destination of income test and upheld the tax-exempt status of Mueller.[51]

Congress enacted UBIT to preclude the possibility of nonprofit market monopolies similar to NYU's alleged macaroni monopoly.[52] The Senate discussed the House Bill for the proposed tax in the following terms:

> The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of section [501] organizations enables them to use their profits tax-free

47. *See* United States v. American College of Physicians, 475 U.S. 834, 837; DAV I, 650 F.2d 1178, 1181 (Ct. Cl. 1981); Veterans Found. v. United States, 281 F.2d 912, 914 (10th Cir. 1960).

48. *See* Rose-Ackerman, *supra* note 40, at 1023; William A. Klein, *Income Taxation and Legal Entities*, 20 UCLA L. Rev. 13, 65 (1972).

49. Prepared Statement of the YMCA of the USA Presented by Michael P. Graves, President YMCA of Delaware, Subcommittee on Procurement, Taxation and Tourism, House Small Business Committee, Federal News Service (June 16, 1994) (discussing competition between for-profit athletic clubs and nonprofit YMCAS); Michael S. Moriarity et al., *Small Businesses and Nonprofits Continue Quarrel Over UBIT Reform*, 42 Tax Notes 1419, 1420 (1989) (discussing competition by nonprofit YMCAs and noting "when those entities start providing racquetball and squash courts and integrated fitness programs to a relatively small clientele, the 'community service' aspect begins to fade").

50. *See* Note, *Macaroni Monopoly*, *supra* note 23, at 1281.

51. *C.F. Mueller Co.*, 190 F.2d at 122.

52. *See* Note, *Macaroni Monopoly*, *supra* note 23, at 1281. *See also* Boris Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts 103-9 (2d ed. 1989). During the Congressional debate preceding the enactment of UBIT, Representative Dingell admonished his colleagues that "[i]f something is not done. . ., the macaroni monopoly will be in the hands of the universities." *Hearings on Revenue Revision of 1950 Before the House Comm. on Ways and Means*, 81st Cong., 2d Sess. 579-80 (1950) (statement of Rep. Dingell), *quoted in* Rose-Ackerman, *supra* note 40, at 1017.

> to expand operations, while their competitors can expand only with the profits remaining after taxes.[53]

The same policy concerns over unfair competition also determined which exceptions to UBIT were to be allowed:

> Dividends, interest, royalties, most rents, capital gains and losses and similar items are excluded from the base of the tax on unrelated income because your committee believes that they are "passive" in character and are not likely to result in serious competition for taxable businesses having similar income.[54]

Thus, Congress created the royalty exception because a royalty was a passive source of income and, therefore, was not likely to incite competition between for-profits and nonprofits. A passive source of income implies that the income derives not from the nonprofit's active operation of a trade or business but rather from the return on a nonprofits's investment in a trade or business conducted by another entity. Therefore, to exempt royalty income would not undermine the goal of eliminating unfair competition because the nonprofit does not actively compete with a nonprofit to generate the income but passively receives a return on its investment.

C. *The Mechanics of UBIT*

Although the enactment of UBIT curtailed the ability of a nonprofit to derive income from business activities unrelated to its exempt purpose without paying a tax, the precise scope of the provisions was uncertain. The Treasury Department has since issued a series of detailed regulations[55] intended to guide the application of UBIT and define the precise scope of the provisions. Following the step-by-step analysis implemented through the UBIT provisions and these regulations reveals the difficulty of distinguishing between a nonprofit's taxable and nontaxable income.

1. Identifying Unrelated Business Income

The UBIT provisions and their corresponding regulations identify unrelated business income through a three-step test.[56] A taxpayer applies this test before deciding whether it is necessary to submit a return to the Service documenting its unrelated income. Under step one, the taxpayer determines whether its income derives from a trade or business.[57] Regulation section 1.513-1(b) specifies that "trade or business" has the same meaning as in section 162 of the Internal Rev-

53. S. Rep. No. 2375, 81st Cong., 2d Sess. 28, *reprinted in* 1950-2 C.B. 483, 504.
54. *Id.* at 506.
55. *See, e.g.*, Treas. Reg. § 1.513-1 (as amended July 26, 1983).
56. *See id.*
57. *See id.*

enue Code,[58] that is, "any activity carried on for the production of income from the sale of goods or performance of services."[59]

The Supreme Court's decision in *United States v. American Bar Endowment*[60] further refined the meaning of "trade or business" in the UBIT context. In this case, the Commissioner challenged the exemption of income derived from the Bar Endowment's offer of group insurance to its members.[61] Having conceded that the activity was both unrelated and regularly carried on, the Bar Endowment argued that its insurance services, offered through an agreement with a for-profit insurance company, did not constitute a trade or business.[62] According to the definition applied by the Court, however, the service did constitute a trade or business.[63]

The definition of trade or business adopted by the Court in *American Bar Endowment* focusses on the intent of the taxpayer.[64] The proper inquiry thus becomes whether the nonprofit entered into the activity with the "dominant hope and intent of realizing a profit."[65] Applying this definition, the Court found that the Bar Endowment had conducted the activity with the dominant hope of deriving profit, and thus the proceeds were subject to UBIT.[66] Courts since *American Bar Endowment* have consistently applied this definition in the UBIT context.[67]

Under the second step of the UBIT analysis, the taxpayer decides whether it has "regularly carried on" the trade or business.[68] Generally, an activity is "regularly carried on" if it manifests "frequency and continuity" and is "pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations."[69] The Tenth

58. I.R.C. § 513(c) (1995). Section 162 allows deductions for a taxpayer's trade or business expenses. *See id.* § 162.

59. Treas. Reg. § 1.513-1(b) (as amended July 26, 1983).

60. 477 U.S. 105 (1986).

61. *See id.* at 108.

62. *See id.* at 110.

63. *See id.* at 119. Courts have developed numerous tests to define a trade or business for purposes of taxation. For example, prior to 1987, "carrying on a trade or business" was often defined as "holding one's self out to others as engaged in the selling of goods or services." I Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income Estates and Gifts 20-6 (2d ed. 1989) (citing Deputy v. Dupont, 308 U.S. 488, 499 (1940)). This definition was rejected in 1987, however, because it led to counterintuitive conclusions such as the following: a taxpayer "working throughout his life for a single employer is not engaged in a trade or business because he does not hold himself out to serve all comers in the manner of a merchant, independent contractor, or professional person." *Id.* at 20-6 to 20-7.

64. *See American Bar Endowment*, 477 U.S. at 110 n.1.

65. *Id.* (citing Brannen v. Commissioner, 722 F.2d 695, 704 (11th Cir. 1984)).

66. *See id.* at 116-19.

67. *See, e.g.*, National Water Well Ass'n, Inc. v. Commissioner, 92 T.C. 75, 91-92 (1989) (applying profit motive test to determine whether marketing of insurance to members of exempt business league constitutes a trade or business).

68. Treas. Reg. § 1.513-1(c)(1)(a) (as amended July 26, 1983).

69. *Id.* § 1.513-1(c)(1).

Circuit examined this step in *National Collegiate Athletic Ass'n v. Commissioner.*[70] The court held that the income generated by the NCAA through the sale of advertising space in the souvenir program for its annual three-week long National Collegiate Basketball Championship was not subject to UBIT, because the activity was not "regularly carried on."[71]

Under the third and most problematic prong of the UBIT analysis, the taxpayer determines whether the conduct of the trade or business is "related" to the organization's exempt purpose.[72] Under Regulation section 1.513-1(d)(2), a trade or business is related to an exempt purpose only if the relationship is a "substantial" one.[73] If the production or distribution of goods or the performance of services does not contribute "importantly" to the execution of the exempt purpose, the trade or business is not substantially related.[74] The difficulty in determining what contributes "importantly" to the accomplishment of an exempt purpose is apparent in the context of exempt organizations' advertising activities.

For example, in *United States v. American College of Physicians,*[75] the Supreme Court considered whether advertisements for pharmaceutical and medical supplies appearing in a publication issued by the American College of Physicians generated taxable unrelated business income.[76] The College is an exempt organization formed to "maintain high standards in medical education and medical practice . . . encourage research, . . . and to foster measures for the prevention of disease and for the improvement of public health."[77] Despite testimony that drug advertising performs a valuable function for doctors by disseminating information on recent developments in drug manufacture, the Court determined that the advertising activities were not

70. 92 T.C. 456 (1989), *rev'd*, 914 F.2d 1417 (10th Cir. 1990), *action on decision*, 1991-015 (July 3, 1991).

71. 914 F.2d at 1426. For an analysis of recent trends in the application of UBIT to corporate sponsorship of athletic events, see generally Wirtschafter, *supra* note 23.

According to the regulation followed by the court, Treas. Reg. § 1.513-1(c)(2)(i), "regularly carried on" encompasses regularly conducted seasonal businesses, such as the operation of a horse-racing track several weeks each year, because "such tracks generally are open only during a particular season." *National Collegiate Athletic Ass'n*, 914 F.2d at 1421-22. "Regularly carried on" does not encompass, however, a hospital auxiliary's operation of a sandwich stand for two weeks during a state fair. *See id.* at 1421 (discussing examples provided in Reg. § 1.513-1(c)(2)(i)). The annual basketball championship, the court concluded, was analogous to the sandwich stand example and thus was not "regularly carried on." *See id.* at 1421-24.

72. *See* Treas. Reg. § 1.513-1(d)(2) (as amended July 26, 1983).

73. Treas. Reg. § 1.513-1(d)(2) (as amended July 26, 1983).

74. *Id.*

75. 475 U.S. 834 (1986).

76. *See id.* at 836.

77. *Id.*

substantially related to the College's avowed purpose of furthering medical education.[78]

The perspective from which the Court determined whether the activity was substantially related to the exempt purpose is significant. According to the Court, the relatedness of the activity to the organization's exempt purpose is not to be determined from the perspective of the subscribers, but rather from the perspective of the publishers.[79] Thus, the real question was not whether the members benefitted from the advertisements. Instead, the Court focussed on "whether the publishers of [the journal] have performed the advertising services in a manner that evinces an intention to use the advertisements for the purpose of contributing to the educational value of the journal."[80] Having determined that the organization's primary motive was to make a profit and not to educate, the Court found all three prongs of the UBIT analysis satisfied and the advertising income taxable.[81]

2. Identifying Exceptions to UBIT

Even if the three-part UBIT test has been satisfied, income may still be exempt from taxation if it falls within one of the "modifications" or exceptions to UBIT under section 512(b).[82] Section 512(b) excludes from UBIT income "all dividends, interest, payments with respect to securities loans,"[83] rents from real and personal property,[84] as well as all royalties.[85] These terms are not self-defining, however, and they raise ambiguities in many other areas of the Code as well.[86] Whether an item falls within any of the exceptions provided under section 512(b) must be determined with reference to "all the facts and circumstances of each case."[87] Thus, it is necessary to determine whether an item of income designated as a royalty is truly a royalty or something else, such as compensation for services.

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78. *See id.* at 847-50.
79. *Id.* at 848.
80. *Id.*; *see also* Louisiana Credit Union League v. United States, 693 F.2d 525, 538 (5th Cir. 1982) (noting that where the only relation to the exempt purpose is the generation of income to further the exempt purpose, the relationship is insufficient to qualify as "substantially related"); Texas Farm Bureau v. United States, 822 F. Supp. 371, 376-78 (W.D. Tex. 1993) (discussing definition of substantially related in context of insurance services offered to members of Bureau).
81. *See American College of Physicians*, 475 U.S. at 839-41, 849-50.
82. *See* I.R.C. § 512(b) (1995).
83. *Id.*
84. *Id.*
85. *Id.*
86. *See, e.g.*, Commissioner v. Wodehouse, 337 U.S. 369, 391 (1949) (distinguishing royalty payments from gains on sale of property for purposes of determining source and taxation of income). In his dissent, Justice Frankfurter urged that the plain meaning of royalty should be applied and that fiscal considerations should not alter the meaning of "royalty" to serve the government's interests. *See id.* at 409 (Frankfurter, J., dissenting).
87. *See* Treas. Reg. § 1.512(b)-1 (as amended July 28, 1992).

II. The Royalty Exception to UBIT

The *Sierra Club II* decision has stirred controversy over the interpretation of one of the exceptions to UBIT—the royalty exception. The conventional notion of a royalty denotes a payment for the use of intangible property. Thus, potentially, the royalty exception could exempt a significant amount of revenue made taxable through the UBIT provisions. In the context of UBIT, the royalty exception has been construed at times narrowly and, at other times, very broadly. The Tax Court's interpretation of the royalty exception in *Sierra Club II* represents the most expansive interpretation of the royalty exception thus far. The decision has only exacerbated the debate surrounding the scope of the royalty exception, because the *Sierra Club II* court failed to provide a coherent rationale for its expansive interpretation of the royalty exception.

A. *Defining a Royalty*

The royalty exception covers "all royalties (including overriding royalties) whether measured by production or by gross taxable income from the property."[88] A classic example of royalty income is the proceeds generated by a patent license.[89] Under a patent license, the patent holder grants the licensee the right to use or market the invention in exchange for a payment, either lump sum or contingent, or a combination of both. The licensee then markets the invention without any further involvement by the licensor. Because it is the licensee who uses and markets products incorporating the patent, the licensor's participation in the generation of income from the patent is said to be passive.[90]

A royalty has traditionally been defined as payment for the use of intangible property.[91] An exempt organization's goodwill is one example of intangible property. Goodwill refers to the value of an entity attributable to good customer relations or to a well respected business name that results in greater than normal earning power.[92] A nonprofit's mailing list is a by-product of its goodwill. Thus, when a nonprofit licenses its mailing list, it licenses an intangible asset, the right of access to the nonprofit's membership list.[93] Therefore, payments

88. I.R.C. § 512(b)(2).

89. Disabled Am. Veterans v. United States, 650 F.2d 1178, 1189-90 (Ct. Cl. 1981) [hereinafter DAV I].

90. *See* Bruce R. Hopkins, The Law of Tax-Exempt Organizations 944-45 (5th ed. 1987).

91. *See* Disabled Am. Veterans v. Commissioner, 942 F.2d 309, 315 (6th Cir. 1991) [hereinafter DAV II]; Wm. J. Lemp Brewing Co. v. Commissioner, 18 T.C. 586 (1952).

92. *See* Black's Law Dictionary 694 (6th ed. 1990).

93. *See* Hopkins, *supra* note 90, at 945; Mark A. Turner, *Marketing Charity Membership Lists: Clarifying a Clouded Issue*, 67 Taxes 202, 204 (1989); Richard A. Speizman & John R. Washlick, *Mailing Lists Revisited: The Disabled American Veterans in Tax Court*, 47 Tax Notes 1377, 1377-78 (1990); Edward Gonzales & Charles

made for the use of a nonprofit's mailing list should be excluded from UBIT as royalty income.[94]

Courts have varied widely, however, in their application of the royalty exception.[95] Therefore, it is not self-evident that income from the rental of intangible property is exempt. One court held that the royalty exception could be applied to exempt from taxable income revenue generated by the licensing of an exempt organization's name and logo.[96] Another court, however, found that the royalty exception did not extend to payments made for the use of an exempt organization's mailing list, because the payments did not correspond to the types of passive income enumerated in section 512(b).[97] Thus courts have failed to define the precise scope of the royalty exception.

B. *Delineating the Scope of the Royalty Exception: Revenue Ruling 81-178*

Because the rental of mailing lists and other intangibles is common between for-profits and nonprofits, the Service has attempted to clarify the tax treatment of such transactions.[98] Revenue Ruling 81-178 addresses the taxation of licensing agreements between a nonprofit

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Barrett, *Chapter I: UBIT Royalty Income and Mailing Lists*, *in* Continuing Professional Education: Exempt Organizations: Technical Instruction Program 114 (1994).

94. *See Wm. J. Lemp Brewing Co.*, 18 T.C. at 597 (holding retention of right of approval over methods of brewing, advertising and marketing of beer not inconsistent with royalty characterization of proceeds for licensing of beer formulae and trade name).

95. *Compare* DAV I, 650 F.2d 1178, 1189-90 (Ct. Cl. 1981) (retaining distinction between active and passive royalty income in rejecting application of royalty exclusion) *with* Sierra Club I, No. 8650-91, 1993 Tax Ct. Memo LEXIS 202, at *10 (emphasizing that excludable royalty income is not limited to passive forms of income). The Service also has varied widely in its application of the royalty exception. *Compare* Tech. Adv. Mem. 93-09-002 (Oct. 23, 1992) (rejecting application of royalty exception to advertising revenue) *with* Tech. Adv. Mem. 94-36-001 (Sept. 24, 1994) (finding royalty exception cannot be applied to exempt advertising revenue earned by nonprofit); Priv. Ltr. Rul. 93-49-024 (Sept. 15, 1993) (upholding exemption of income from nonprofit's marketing of insurance program through application of royalty exception); Tech. Adv. Mem. 94-04-003 (Sept. 30, 1993) (recognizing exemption of income earned by nonprofit through logo licensing to market cash/risk management funds through application of royalty exception).

96. *See* Sierra Club II, No. 8650-91, 1994 Tax Ct. Lexis 62 (Aug. 24, 1994).

97. *See DAV I*, 650 F.2d at 1189-90.

98. Rev. Rul. 81-178, 1981-2 C.B. 135-37. A Revenue Ruling is an administrative interpretation published in the Internal Revenue Bulletin for the guidance of taxpayers and Service personnel, but it is not entitled to deference by a court. Rev. Proc. 95-1, 1995-1 I.R.B. 9. A letter ruling is a written statement in response to a request by a taxpayer issued by the Service interpreting and applying the tax laws to the taxpayer's specific set of facts. *Id.* The Service also offers technical advice to its district offices in the form of memoranda in response to any questions that arise in the interpretation and application of tax laws, treaties, regulations or other precedents. Rev. Proc. 95-2, 1995-1 I.R.B. 64. Technical advice memoranda are often issued upon the examination of a taxpayer's return or upon examination of a taxpayer's claim for refund. *Id.*

and a for-profit for the use of the nonprofit's intangible rights.[99] The Ruling exempts proceeds from the rental of an exempt organization's trademark and similar intangible rights, such as a mailing list, through the application of the royalty exception, but only where there are no services offered in conjunction with the license.[100] Where payments received by the nonprofit are coupled with payment for personal appearances or for services provided by the nonprofit, such payments no longer constitute royalties but instead constitute, in their entirety, compensation for personal services.[101] Although the Service uses the provision of services to distinguish between active and passive royalties, this distinction does not have explicit support in either the plain language or the legislative history of the statute.

Despite the distinction Revenue Ruling 81-178 draws between payment for intangible rights and payment for personal services, the Ruling permits an exempt organization to retain a right of quality control over its own publications. This quality control would not indicate too active a role on behalf of the exempt organization, because characterization of a payment as a royalty does not preclude an organization from reserving the contractual right to approve the quality or style of the licensed products or services.[102] This quality allowance lends some flexibility to the standard set out in the Ruling. It also introduces, however, new ambiguities, because there is no clear distinction between taxable compensation for services and nontaxable payments for quality control activities performed in conjunction with the licensing of an intangible asset.

C. *Towards a Broader Interpretation of the Royalty Exception*

Although Ruling 81-178 attempted to distinguish between purely passive and nonpassive royalty arrangements and thus define the scope of the royalty exception more precisely, the Service has applied it inconsistently,[103] and courts have essentially ignored it.[104] To some

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99. Rev. Rul. 81-178, 1981-2 C.B. 135-37.

100. *See id.* at 136.

101. *See id.* at 136-37. To preserve a portion of the proceeds as exempt income, a license agreement could divide the proceeds generated by the licensing of the intangible asset into (1) the proceeds received for the use of the intangible right; and (2) the proceeds received for the services offered in connection with the licensing. *See* Marlis L. Carson, *Practitioners Offer Advice for Avoiding UBIT on Mailing List, Affinity Credit Card Income*, Tax Notes Today 187-4, Sept. 22, 1994, *available in* LEXIS, Fedtax Library, TNT File. In this manner, a portion of the income can properly be qualified as royalty income. Most agreements have not been bifurcated in this manner, however, and the presence of personal services has permitted both courts and the Service to characterize all of the income earned as compensation for personal services.

102. *See* Rev. Rul. 81-178, 1981-2 C.B. 135, 136.

103. *See* Priv. Ltr. Rul. 93-49-024 (Sept. 15, 1993) (finding income earned by nonprofit in exchange for promoting certain governmental self-insurance pools not subject to UBIT). *But see* Tech. Adv. Mem. 94-36-001 (Sept. 24, 1994) (finding advertising revenue cannot qualify as royalty income).

nonprofits, the Ruling signaled a sharp change in the Service's interpretation of permissible royalty income, exempting proceeds from the sale of mailing lists and other intangible assets where previously they had been taxed.

The Disabled American Veterans Society, for example, attempted to argue that the Ruling significantly changed the scope of the royalty exception.[105] Prior to the issuance of Revenue Ruling 81-178, in *Disabled American Veterans v. Commissioner* (*DAV I*),[106] the Society had challenged the Service's determination that the rental of its mailing lists to certain for-profit organizations was subject to UBIT.[107] Referring to the legislative history of the royalty exception, the Court of Claims reasoned that the rentals did not correspond to the types of "passive" income envisaged by section 512(b).[108] By concluding that the licensing of the list was not passive, the court also implied that the activity would in fact incite competition, because Congress originally defined passive income as income not likely to incite competition.[109]

In *Disabled American Veterans v. Commissioner* (*DAV II*),[110] the Society attempted to relitigate this same issue, arguing that the Ruling reflected a dramatic change in the Service's position. The Society argued that collateral estoppel[111] should not bar it from relitigating the royalty issue because of a significant legal development: Revenue Ruling 81-178. To ignore this change, the Society argued, "would contravene an overriding public policy and result in manifest injustice."[112] The Sixth Circuit conceded some change in the Service's attitude towards royalty income, but denied that the Ruling constituted a legal development significant enough to prevent the application of the collateral estoppel doctrine.[113] The court consciously avoided determining whether royalty income was limited to "royalties that are 'passive' in nature," thus avoiding stating what the proper role of the original

104. The Tax Court, however, has followed the rationale of the Ruling. *See, e.g.*, National Collegiate Athletic Ass'n v. Commissioner, 92 T.C. 456, *rev'd* 914 F.2d 1417; DAV II, 94 T.C. 60 (1990), *rev'd on other grounds* 942 F.2d 309 (6th Cir. 1991).

105. DAV I, 650 F.2d 1178 (Ct. Cl. 1981); *see also* DAV II, 942 F.2d 309 (6th Cir. 1991).

106. 650 F.2d 1179 (Ct. Cl. 1981).

107. *See id.* at 1180-81.

108. *See id.* at 1189-90.

109. *See id.*

110. 942 F.2d 309 (6th Cir. 1991).

111. Under the doctrine of collateral estoppel, "[w]hen an issue of ultimate fact has been determined by a valid judgment, that issue cannot be again litigated between the same parties in future litigation." Black's Law Dictionary 261 (6th ed. 1990) (citation omitted).

112. *DAV II*, 942 F.2d at 313.

113. *Id.* at 314 (disagreeing with the Tax Court's remark that Revenue Ruling 81-178 " 'casts doubt on the soundness of the analysis that only income from passive sources qualifies as royalties that are excluded from UBTI' " and leaving "open the question as to whether a revenue ruling ever effects a significant enough change in the 'legal climate' to bar collateral estoppel" (citation omitted)).

rationale for UBIT was in defining the scope of the royalty exception.[114]

In *Sierra Club I*, the Sierra Club also litigated a claim for royalty treatment of proceeds from the rental of mailing lists.[115] In its decision, the Tax Court maintained the same position as it had in *DAV II*, urging an unequivocal rejection of the traditional notion of royalties as "passive sources" of income.[116] In addition, the court stated that "[t]he 'activity' or 'passivity' of a taxpayer vis-a-vis its income-producing activities is not determinative of the issue of whether a particular item of income is the type which Congress intended to exempt from UBTI."[117] The court then concluded that the scope of the royalty exception is not limited to passive sources of income. Thus, the proceeds the Sierra Club earned from the rental of the mailing list remained exempt from taxation. With this holding, the court made explicit an expansive interpretation of the royalty exception.[118]

Sierra Club II[119] also followed this expansive reading of the royalty exclusion. In that case, the Tax Court applied a liberal interpretation of the royalty exception and held that consideration received in exchange for the use of the Club's name and logo to endorse an affinity card was exempt as payment for the use of intangible property.[120] Thus, because the Tax Court applied a broader definition of royalty, it reached the opposite result in *Sierra Club II* than the Court of Claims had reached in *DAV I*.[121]

In 1986, Congress enacted section 513(h), which clarified the application of the royalty exception to the sale or exchange of mailing lists. Section 513(h) modifies the definition of unrelated business income to exclude from taxation proceeds generated by the exchange of names and addresses of donors between nonprofit organizations, implying that the exchange between nonprofits and for-profits remains subject

114. *Id.* at 315 n.4.

115. *See* Sierra Club I, No. 8650-91, 1993 Tax Ct. Memo LEXIS 202 (May 10, 1993).

116. *See id.* at *10.

117. *See id.* at *17 (quoting Respondent's Memorandum).

118. *See id.* at *10 ("We rejected respondent's arguments that . . . the term 'royalties' included only royalties from passive sources.").

119. No. 8650-91, 1994 U.S. Tax Ct. LEXIS 62, *58 (Aug. 24, 1994).

120. *See id.* at *71.

121. Despite this latter decision, the Tax Court did not concede any change in the scope of the royalty exception when the Veterans Society attempted to relitigate its royalty claim a third time. In Disabled American Veterans v. Commissioner, 68 T.C.M. (CCH) 915 (1994), the Society relied upon the *Sierra Club II* decision as an indication of a significant legal development that should preclude the application of the collateral estoppel doctrine. The court refused to acknowledge a substantial change in legal climate, and the Society was thus barred by collateral estoppel from relitigating its claim. *See also* Marlis L. Carson & Paul Streckfus, *Would You Believe DAV III?-Or, Once More Into the Royalties Fight*, 64 Tax Notes 563, 564 (1994) (summarizing Society's third attempt to litigate royalty issue).

to UBIT.[122] Although section 513(h) resolves the specific question raised by *DAV I* and *DAV II*, the DAV litigation remains significant. In *DAV II*, by explicitly avoiding comment on whether a distinction exists between active and passive royalty income, the Sixth Circuit flagged the controversy surrounding the active/passive distinction.[123] Because the active/passive distinction provides a direct link to the original unfair competition rationale, the court also intimated that this rationale rested on shaky ground. In *Sierra Club I* and *Sierra Club II*, the Tax Court definitively abandoned the active/passive distinction, thereby severing any link to the original justification for the passive income exception—the elimination of unfair competition between nonprofits and for-profits.[124] Thus, although section 513(h) clarified the taxation of the rental of mailing lists by tax-exempt organizations,[125] the proper standard by which excludable royalty income is determined in other contexts, such as name and logo licensing, is less certain than ever.

D. *Sierra Club II*

No standard articulated by the Service clearly characterizes the proceeds received by the nonprofit from the rental of its name and logo. The *Sierra Club II*[126] decision represents the most significant development in the application of the royalty exception since the DAV litigation first began in 1981.[127] In *Sierra Club II*, the Tax Court applied the definition of royalty originally urged by the Tax Court in *DAV II* yet ultimately rejected by the Sixth Circuit—payment for the use of intangible property.[128] By adopting the conventional definition of royalty, *Sierra Club II* sanctioned an expansive notion of royalty income.[129]

The royalty income at issue in *Sierra Club II* derived from the Sierra Club's endorsement of an affinity card piloted by the predecessor of

122. *See* I.R.C. § 513(h) (1986). In *DAV II*, the Sixth Circuit suggested that through § 513(h), "Congress was responding to the court of claims decision in *DAV I*." *DAV II*, 942 F.2d at 317 (Martin, Jr., J. concurring); *see also* H.R. Conf. Rep. No. 481, 99th Cong., 2d Sess., pt. 2, at 822 (1986), *reprinted in* 1986-3 (Vol. 4) C.B. 822, *and in* 1986 U.S.C.C.A.N. 4075, 4910.

123. *See DAV II*, 942 F.2d at 315 n.4.

124. *See Sierra Club I*, 1993 Tax Ct. Memo LEXIS 202, *10-13 ; *Sierra Club II*, 1994 U.S. Tax Ct. LEXIS 62, *58.

125. Section 513(h) does not exempt, however, the exchange of mailing lists between exempt and for-profit institutions. *See* Tech. Adv. Mem. 95-02-009 (Jan. 13, 1995) (finding exchange of mailing lists between nonprofit and for-profit subject to UBIT); *see also* D. Benson Tesdahl, *IRS Taxes Indirect Mailing List Rentals*, 10 Exempt Org. Tax Rev. 1427 (1994) (noting that the Service continues to take the position that income from rental of nonprofit mailing list to for-profits is subject to UBIT).

126. No. 8650-91, 1994 U.S. Tax Ct. LEXIS 62 (Aug. 24, 1994).

127. *See infra* notes 128-58 and accompanying text.

128. *See Sierra Club II*, 1994 U.S. Tax Ct. LEXIS 62, at *58.

129. *Id.* at *18.

American Bancard Services.[130] Eventually, Chase Lincoln First Bank N.A. became the participating financial institution in the arrangement.[131] In the typical affinity arrangement, the affinity group enters into a contract with the financial institution to issue credit cards to the affinity group's members and supporters.[132] In exchange for encouraging members to use the cards, the financial institution pays the affinity group a percentage of the monthly sales volume generated by purchases made with the card.[133]

The role of the affinity group may vary widely. Among the services and activities the Sierra Club offered under its affinity agreement with Chase, and which the Court found indicative of the Sierra Club's level of participation, was "cooperation" with the financial institution on a continuing basis "in the solicitation and encouragement of SC members to utilize the Services" provided by American Bancard Services.[134] The agreements also provided an option by which the Sierra Club could "pay for the production and mailing costs associated with direct mail or other solicitations to its members."[135] The royalties schedule provided for an upwards adjustment in the event the Sierra Club elected to pay any or all of these production costs.[136]

Applying *DAV II*'s definition of "royalty," the Tax Court found that the payments received by the Sierra Club were properly characterized as royalty income and thus exempt from taxation.[137] According to the Tax Court, the agreements reflected nothing more than payment for the use of a valuable intangible right, the Sierra Club name and logo.[138] The Tax Court rejected the Commissioner's argument that the Sierra Club had become either a joint venturer with Chase in promoting the use of credit cards or a sole proprietor of a credit card business with Chase as its agent.[139]

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130. *Id.* at *5-6.
131. *Id.* at *6.
132. *See id.*
133. *See id.* at *6. The Royalty Fee Schedule states the premium as one half of one percent of the Total Cardholder Sales Volume. *Id.* at *13-14.
134. *Id.* at *7.
135. *Id.* at *9.
136. *Id.* at *9, *13.
137. *Id.* at *19.
138. *See id.* at *60.
139. *See id.* at *56-57. The Service has pursued an agency analysis in the past. Through an agency analysis, the Service has transformed the active/passive analysis. Instead of isolating the role of the exempt organization to determine whether its role is passive, the Service has begun to focus on the relationship between the nonprofit and the for-profit. *See, e.g.*, Tech Adv. Mem. 94-36-001 (Sept. 24, 1994). In Technical Advice Memorandum 94-36-001, the Service found that the level of participation of the nonprofit in an advertising arrangement had risen to the level of an agency relationship. The specific factors upon which the Service based its agency finding were: (1) the exempt organization controlled circulation of the journal; (2) the organization determined the number of editions; and (3) the exempt organization determined which persons or organizations were to receive the journal. *Id.* If a for-profit is an agent of the nonprofit and subject to the nonprofit's control, the nonprofit's role, by

In assessing the relationship between the Sierra Club and Chase, the court looked for any evidence of benefit and control that would indicate an intent to form a joint venture.[140] The agreements allowed the Sierra Club only contingent compensation, measured by total cardholder sales volume, rather than any share in the net profits of the program.[141] Also, because there was a floor established for the Sierra Club's profit percentage, the Sierra Club did not share in the credit risks.[142] With respect to any control exercised by the Sierra Club over the credit card program, the Sierra Club's role was limited to one of "cooperation."[143] Although in previous letter rulings the Service has found mere cooperation sufficient to suggest an active role in generating advertising revenue,[144]the Tax Court concluded that the requirement of "cooperation" on behalf of the Sierra Club signalled a low level of participation.[145]

Although the Sierra Club's written consent, which permitted the use of its name and logo, might also suggest some level of control, this consent indicated to the Tax Court nothing more than the sensible safeguarding and preservation of the "worth of petitioner's good name."[146] The Tax Court rejected the idea that this consent represented a control access measure or that the Sierra Club's quality control put it in the business of marketing credit cards.[147] Therefore, because no agency or partnership relation had been formed, the Tax Court concluded that the payments fell easily within the scope of the royalty exception.[148]

definition, is active. Because the original reference to royalty income in the legislative history implies a passive role for a nonprofit, it is apparent that if an agency relationship exists between the nonprofit and the for-profit, this relationship precludes characterization of advertising revenue as passive royalty income.

140. *See Sierra Club II*, 1994 U.S. Tax Ct. LEXIS 62, at *31-33, *38-40.

141. *See id.* at *37. The court later noted that a "net profits (and loss) interest in such efforts would indicate that petitioner shared in the risks and rewards of marketing." *Id.* at *50. A gross profit interest, however, is not inconsistent with the characterization of proceeds as royalty. *Id.* at *51 (citing Sabatini v. Commissioner, 98 F.2d 753, 755 (2d Cir. 1938)).

142. *See id.*

143. *See id.* at *40.

144. *See* Tech. Adv. Mem. 92-47-001 (Oct. 8, 1991) (relying upon contractual requirement to cooperate as evidence of active role of nonprofit in generating advertising revenue from journal related to nonprofit's organization); Tech. Adv. Mem. 93-09-002 (Oct. 23, 1992).

145. *See Sierra Club II*, 1994 U.S. Tax Ct. LEXIS 62, at *42.

146. *Id.* at *65.

147. *See id.* at *69. In addition, SC had chosen not to exercise its right to contribute to the operating or development costs of the program, which may have changed the nature of SC's participation. The mere existence of a provision allowing for increased compensation in exchange for contributions to production costs of advertising would signal an active role to the Service or to a court adhering to the distinction between active and passive royalties. For example, in Technical Advice Memorandum 92-47-001 even the unexercised rights of control provided in the agreement suggested too active a role. *See* Tech. Adv. Mem. 92-47-001 (Oct. 8, 1991).

148. *See Sierra Club II*, 1994 U.S. Tax Ct. LEXIS 62, at *71.

This generous reading of the royalty exception in *Sierra Club II*, however, is not consistent with prior letter rulings and technical advice memoranda issued by the Service in connection with name and logo licensing and underscores the continuing debate over the scope of the royalty exception.[149] In the majority of its recent rulings, the Service has concluded that payments for the use of a name and logo cannot be considered royalty payments, because the services offered in connection with the license implicate an active role by the nonprofit.[150] The Service has rarely reached the opposite conclusion.[151] Thus the Ser-

149. *See* Tech. Adv. Mem. 94-04-003 (Sept. 30, 1993). Commentators noted the broadening scope of the royalties exclusion as applied to name and logo licensing well before the *Sierra Club*. For example, John Copeland, former officer of Tax Analysis for the Treasury Department, observed the following in 1991:

> Another concern with the exclusion for royalties is that in many cases, such as where the organization licenses the right to use its name or trademark, the licensing agreement is in essence an endorsement of a commercial product. We are concerned that the current broad scope of the passive income royalty exception may permit organizations to avoid tax liability on activities that the UBIT is intended to reach.

John Copeland, *Some Suggestions for Revision of Tax-Exempt Organization Rules*, 51 Tax Notes 911, 915 (1991) (citation omitted).

150. *See* Tech. Adv. Mem. 94-40-001 (June 17, 1994) (finding advertising revenue could not qualify as royalty income and was thus subject to UBIT); Tech. Adv. Mem. 93-21-005 (Feb. 23, 1993) (finding that payments for the use of a nonprofit's name and logo to endorse a credit card were inseparable from payments for services rendered by nonprofit and thus could not constitute royalty income); Priv. Ltr. Rul. 93-16-045 (Jan. 28, 1993) (finding payment for use of name and logo to endorse insurance program could not constitute royalty income); Priv. Ltr. Rul. 93-06-030 (Nov. 18, 1992) (finding payments for use of logo inseparable from payments for use of mailing list and therefore subject to UBIT); *see also* Gen. Couns. Mem. 39,827 (Aug. 20, 1990) (finding that "payments to exempt organizations for use of name and logo, although denominated 'royalties' " are in fact compensation for services). *But see* Tech. Adv. Mem. 94-36-001 (Sept. 24, 1994) (stating that publication of names may not be subject to UBIT because publication does not necessarily constitute an advertisement); *see also* Gen. Couns. Mem. 38,083 (Sept. 11, 1979) (finding that payments for the use of a nonprofit's name and logo to endorse for-profit commercial activities were exempt for UBIT as royalty income); Gen. Couns. Mem. 37,416 (Feb. 14, 1978) (finding that a "limited amount of business activity by an exempt organization does not automatically rule out characterization of income as royalty"); Gen. Couns. Mem. 37,292 (Oct. 6, 1977) (finding endorsement income comes within the meaning of royalties under § 512(b)(2)).

151. In Technical Advice Memorandum 94-04-003, for example, a nonprofit educational organization entered into a licensing agreement with several cash/risk management funds, granting each the use of its name and logo to promote the funds' services. The licensing agreement stated that the organization would *not* provide services. An affidavit, however, confirmed that the nonprofit had reviewed financial documents for the funds, reviewed payments to monitor compliance with the agreements, and consulted with the funds with respect to how and when the endorsements of the funds should be marketed. *See* Tech. Adv. Mem. 94-04-003 (Sept. 30, 1993). Despite this involvement in the marketing of the funds, the Service characterized the payments received under the licensing agreements as royalty payments. *See id.*

This ruling was revoked by Tech. Adv. Mem. 94-04-004, but solely on the grounds that the royalties derived from a controlled entity and thus the proceeds could not qualify as royalties pursuant to § 512(b)(13). *But see* Tech. Adv. Mem. 93-21-005 (Feb. 23, 1993) (characterization of name and logo licensing agreement denied vice has adhered to a narrow construction of the royalty exception while the Tax Court has insisted on a more expansive interpretation.

Some commentators have responded with alarm to the result reached in *Sierra Club II*.[152] To some, the decision indicates that the term "royalty" may now "be construed in almost any fashion."[153] The real import of the decision, however, is that there is still no rationale for UBIT upon which both courts and the Service consistently rely.[154]

Prior to *Sierra Club II*, the active/passive distinction suggested a means to separate exempt royalties from taxable royalties.[155] In *Sierra Club II*, however, the Tax Court rejected the notion that the royalty exception was limited to passive forms of income. Instead, it focussed on the relationship between the nonprofit and the for-profit, concluding that where a partnership or agency relationship exists the nonprofit loses the benefit of the royalty exception. This suggests that a higher level of activity is necessary before a nonprofit's role in generating royalty income will subject it to UBIT. Thus, where an agency relationship exists, the nonprofit is taxed as if it were engaged in a trade or business. The trade or business concept, however, may be just as awkward and artificial a means of distinguishing taxable and nontaxable income of nonprofits as the active/passive distinction is.

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although only service indicated was inclusion of endorsement messages in the for-profit's marketing materials).

152. *See, e.g.*, Streckfus, *supra* note 16; *see also* Robert A. Wexler, *Affinity Card Income Was Royalty, Not UBI*, 81 J. Tax'n 316 (1994) (summarizing holding of *Sierra Club II* and commenting on expansive interpretation of royalty exception).

153. *See* Streckfus, *supra* note 16 ("[O]ne can ask why he has taken such a liberal position in both his Sierra Club opinions. It may be that a statute with a thousand loopholes deserves no respect."). This concern is exaggerated, because the royalty exception has been construed broadly only in the context of name and logo licensing. The exception still does not apply to proceeds from the sale of advertising. *See, e.g.*, Tech. Adv. Mem. 93-09-002 (Oct. 23, 1992) (finding that a for-profit publisher was acting as the nonprofit organization's agent, and thus denied the exclusion of advertising revenue as royalties).

154. *See* Marlis L. Carson, *Practitioners Offer Advice for Avoiding UBIT on Mailing List, Affinity Credit Card Income*, Tax Notes Today 187-4, Sept. 22, 1994, *available in* LEXIS, Fedtax Library, TNT File (noting that the *National Water Well* decision provides the only clear example of the "type of involvement that will give rise to UBIT").

155. A similar distinction exists for purposes of taxation of United States multinationals. Under § 954 of the Code, the United States taxation of royalty income earned by foreign subsidiaries of United States multinationals depends on whether the royalty income is active or passive. Where a foreign subsidiary actively markets an intangible, the royalty income derived from the intangible is considered active royalty income. Active royalty income of the subsidiary is not foreign personal holding company income, and consequently, not subject to current United States taxation. Congress justified this exclusion on the grounds that a taxpayer cannot readily manipulate the source of income generated through an active business in an effort to avoid taxation in the United States. A taxpayer can easily manipulate passive royalty income, however, by choosing "to invest liquid funds overseas in passive investments, thereby eroding the U.S. income tax base." *See* Erik G. Nelson, *Royalty Tax Committee's Testimony at Finance Hearing on Foreign Tax Proposals*, Tax Notes Today 92-82, April 28, 1993, *available in* LEXIS, Fedtax Library, TNT File.

Furthermore, it is unclear what rationale the Tax Court was attempting to implement when it supplanted the active/passive distinction with an agency analysis, thereby broadening the scope of the royalty exception. It is unclear, for example, how a broad or narrow reading of the exception furthers the original rationale of eliminating any unfair competition. Nor is it clear that courts have interpreted the royalty exception with a view to furthering this purpose.

As will be discussed in part III, neither practitioners nor academics agree over what is the best rationale for UBIT. Because there is no consensus as to the proper objective of UBIT, application of the UBIT provisions has led to inconsistent results. On the one hand, revenue from advertisements for medical equipment in a medical journal is fully taxed, despite its educational function.[156] On the other hand, according to *Sierra Club II*, proceeds received by a nonprofit for its endorsement of a credit card is subject to no tax at all.[157] Even if preventing unfair competition were still the guiding rationale for application of the UBIT provisions, it could not explain these inconsistent results. Perhaps the unfairness in the present regime lies in the lack of a uniform rationale for applying UBIT and its exceptions to similar types of unrelated business income generated by nonprofits.[158]

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156. *See supra* notes 75-81 and accompanying text.

157. *See supra* notes 128-58 and accompanying text. A nonprofit's rental of its name or logo can be distinguished from the typical nonprofit advertising arrangement. In most advertising arrangements, the nonprofit initiates the agreement by soliciting the advertisement from the for-profit. *See* William Lehrfeld, *The Unfairness Doctrine: Commercial Advertising Profits as Unrelated Business Income*, 23 Tax Lawyer 349, 356-57 (1970). The nonprofit benefits primarily from the payments made by the for-profit for the advertising space. The for-profit, in turn, benefits from the nonprofit's endorsement before a specialized group of consumers. On the other hand, the nonprofit will not attract any of the for-profit's clientele merely because the for-profit advertises in the nonprofit publication. The benefit of access to a new clientele runs in only one direction in these licensing arrangements.

Under a logo licensing arrangement, however, the endorsement benefits are mutual. For example, a bank marketing an affinity card on which the logo of a nonprofit appears may attract a broader clientele because of the nonprofit's endorsement. Similarly, the nonprofit benefits from the exposure of its name and logo to subscribers of the bank's credit card who otherwise might not be aware of the nonprofit. More importantly, the nonprofit benefits from the indirect contributions made by subscribers of the card each time the credit card is used.

It is arguable, however, that the difference between an advertisement and an endorsement does not warrant such dramatically different tax consequences. If one accepts the proposition that advertising revenue is nothing more than royalty income from a for-profit publisher for the right to exploit the nonprofit's name in conjunction with the publication of a journal, then advertising revenue differs little from endorsement revenue. Although the role of the Fraternal Order in generating advertising revenue was too active to qualify as royalties in Fraternal Order of Police v. Commissioner, 833 F.2d 717 (10th Cir. 1987), the Tax Court was amenable to the argument that advertising revenue constitutes royalty income. *See* Fraternal Order of Police v. Commissioner, 87 T.C. 747, 758 (1986).

158. *See* Hansmann, *Unfair Competition*, supra note 23, at 613 ("[P]roblems of unfair competition generally arise only in transitions from one tax regime to another

III. Assessing The Unfair Competition Rationale

Congress originally used the active/passive distinction to identify passive income as income derived from activities that would not incite competition between for-profits and nonprofits.[159] By rejecting the active/passive distinction, *Sierra Club II* implicitly rejected the unfair competition rationale. In the wake of *Sierra Club II* courts may be uncertain as to what the appropriate rationale for UBIT should be. Since 1950, courts have derived their explanation for UBIT's objective from the relatively unambiguous remarks contained in the legislative record.[160] Thus, courts that have adhered to the unfair competition argument have had explicit support for their position. Those few courts that have questioned the argument rest on shaky ground.

Although courts have generally deferred to the legislative record's reference to unfair competition in asserting an objective for UBIT, courts have not applied UBIT with a view to furthering this objective. Academics, on the other hand, have examined and criticized the unfair competition rationale in a thorough and detailed fashion, but have failed to develop an alternative rationale upon which courts and the Service may rely. Thus, both courts and academics have contributed to the demise of the unfair competition rationale, leaving no guiding principle for the application of UBIT and its exceptions. A new and more practicable rationale for UBIT may be crafted by reconciling the conflicting views over the now defunct unfair competition rationale.

A. *Courts' Assessment of the Unfair Competition Rationale*

The notion that an exempt organization's ability to engage in profit-making activities leads directly and necessarily to unfair competition has been repeated so often that it is held by courts to be a fundamental tenet of tax jurisprudence.[161] Courts have cited concerns over unfair competition in simplistic terms, explaining that, without being subject to the corporate income tax, an exempt organization can expand more rapidly and undersell its competitors.[162] This advantage presumably enables a nonprofit to achieve a monopoly within an in-

because that is usually the only time at which substantial unforeseeable tax-induced losses can arise.").

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

160. *See* United States v. American College of Physicians, 475 U.S. 834, 838 (1986); Veterans Found. v. United States, 281 F.2d 912, 914 (10th Cir. 1960); United States v. Community Servs., Inc., 189 F.2d 421, 426 (4th Cir. 1951); J.E. & L.E. Mabee Found., Inc. v. United States, 389 F. Supp. 673, 677 (N.D. Okla. 1975).

161. *See* Bittker & Rahdert, *supra* note 3, at 320 ("Whether the fear of 'unfair competition' was rooted in reality or in fantasy, it carried the day.")

162. *See infra* note 164.

dustry.[163] There is no evidence, however, that nonprofits have ever behaved in this manner.[164]

NYU Law School's successful implementation of the pre-UBIT "destination of income" standard incited fears of monopoly. Although a perfectly legal exercise of its investment strategies at that time, NYU's alleged macaroni "monopoly"[165] has come to symbolize the potential of a nonprofit to abuse its exempt status.[166] For example, one commentator responding to the *Sierra Club* decision conjured up the NYU macaroni monopoly to express his renewed concerns over unfair competition,[167] questioning: "[I]s there any doubt that NYU could structure a business arrangement with Mueller Macaroni that would result in nontaxable royalty income to NYU?!"[168]

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163. *American College of Physicians*, 475 U.S. at 837 (1986); Louisiana Credit Union League v. United States, 693 F.2d 525, 539 (5th Cir. 1982); *DAV I*, 650 F.2d at 1181; *Veterans Found.*, 281 F.2d at 914; United States v. Community Servs., Inc., 189 F.2d 421, 425 (4th Cir. 1951).

164. One commentator has aptly illustrated why nonprofits are unlikely to behave in this manner:

> It is apparent that A's absolute advantage over B declines proportionately as prices are cut lower and lower. Of course it may be possible for A to maintain its price-cutting policy until B goes out of business, and then raise prices again. But it will be a severe drain on A's financial resources so long as the price war continues. And it seems unlikely that exempt institutions like universities and hospitals, which are clamoring for funds, will forego current income on the risk that they can drive out a competitor after a lengthy price war. No evidence was adduced before Congress to show price cutting on the part of businesses owned by exempt institutions.

Comment, *Colleges, Charities, and the Revenue Act of 1950*, 60 Yale L.J. 851, 876 (1951).

165. No one has yet demonstrated that NYU's control over Mueller had any adverse effects on Mueller's primary noodle rival at the time, Ronzoni, or even on any other less formidable competitors. *See* Rose-Ackerman, *supra* note 40, at 1020 (stating "it is obvious that the ultimate impact of N.Y.U.'s pasta activities was not felt by the Ronzoni Company.").

166. *See American College of Physicians*, 475 U.S. at 837 ("The statute was enacted in response to perceived abuses of the tax laws by tax-exempt organizations that engaged in profit making activities."); DAV I, 650 F.2d 1178, 1181 n.3 (Ct. Cl. 1981) (noting that the primary purpose for UBIT was to eliminate unfair competition and that C.F. Mueller is the example cited the most often to demonstrate unfair competition); Clarence LaBelle Post No. 217, Etc. v. United States, 580 F.2d 270, 272 (8th Cir. 1978); J.E. & L.E. Mabee Found. v. United States, 389 F. Supp. 673, 676 (N.D. Okla. 1975) ("The purpose of the enactment of the 'unrelated business income' provisions of the Code was to eliminate this 'unfair' competition on the part of the exempt organizations.").

167. *See, e.g.*, Streckfus, *supra* note 16 (discussing Tax Court's expansive interpretation of royalty exception in *Sierra Club II*).

168. Streckfus, *supra* note 16. This reaction is extreme in light of the fact that under the current UBIT provisions, a feeder organization's income could never be excluded as royalty income. Under section 512(b)(13), if a nonprofit owns eighty percent or more of a for-profit company, any royalty income received for the for-profit will be subject to UBIT, despite the royalty exception. *See* I.R.C. § 512(b)(13); *see also* Tech. Adv. Mem. 94-04-004 (Sept. 30, 1993). Section 512(b)(13) does not impose a tax, however, on dividends paid by a controlled for-profit subsidiary. Also, there are ways to circumvent § 512(b)(13). For example, the exempt organization may use

Only a few courts have questioned whether elimination of unfair competition truly motivated the enactment of the UBIT provisions.[169] In *Clarence LaBelle Post No. 217, Etc. v. United States*, for example, the Eighth Circuit suggested an alternative motive for the provisions. The issue in *Clarence* was whether income from bingo games conducted by the nonprofit taxpayer was subject to UBIT.[170] The taxpayer, a patriotic veterans organization, sought to introduce a test whereby income earned by an exempt organization would be taxable "only if the trade or business competes directly with a taxpaying entity."[171] The court rejected the taxpayer's invitation to establish a standard based on the competitive effects of the activity.[172] The court suggested that unfair competition was not the primary rationale for UBIT[173] and that UBIT had been intended to eliminate a perceived loophole and broaden the tax base to generate more revenue for the Korean war.[174] Drawing large inferences from President Truman's remarks concerning the need for more revenue,[175] the court intimated that Congress itself had alternative motivations for enacting the UBIT provision when it remarked:

> [The] Internal Revenue Service has ruled that activities which are not conducted in competition with commercial activities of taxpaying organizations are *nevertheless* considered to be unrelated trade or business activities which are subject to the unrelated business income tax.[176]

tiered subsidiaries to avoid direct ownership of the for-profit subsidiary making payments to the exempt parent. If the exempt parent owns 100% of a for-profit subsidiary that in turn owns 100% of a second-tier for-profit subsidiary, any payments made by the second-tier for-profit will not be subject to tax under § 512(b)(13), because the exempt parent does not have direct control over the second-tier for-profit. *See* Tax-Exempt Organizations: Organization, Operation and Reporting Requirements, Tax Mgmt. (BNA) No. 464-3rd, at A-130 (July, 13, 1992).

169. *See, e.g.*, Clarence LaBelle Post No. 217, Etc. v. United States, 580 F.2d 270 (8th Cir. 1978).

170. *Id.* at 271.

171. *Id.*

172. *Id.* at 272-74. *See also* Fraternal Order of Police v. Commissioner, 833 F.2d 717, 722 (7th Cir. 1987) (rejecting a finding of unfair competition as a prerequisite for the imposition of UBIT).

173. *See Clarence LaBelle Post No. 217, Etc.*, 580 F.2d at 272.

174. *Id.* (citing President's Message to Congress, 96 Cong. Rec. 769, 771 (1950)). *But see* Hansmann, *Unfair Competition*, *supra* note 23, at 621-22 ("To be sure, the UBIT itself yields few tax dollars, and probably always will no matter how it is reformed.") Hansmann also states that in 1986, tax revenue generated by UBIT was only $53 million. *Id.* at 622 n.47 (citation omitted); *see also*, Suzanne Rose-Ackerman, *supra* note 40, at 1017 n.4 (emphasizing that very little income had been collected through UBIT and citing a study finding that the revenue collected represented only .05% of corporate income tax for the years 1976-1982).

175. *See Clarence LaBelle Post No. 217, Etc.*, 580 F.2d at 272.

176. *Id.* at 273 n.8 (citing S. Rep. No. 94-938, 94th Cong., 2d Sess. 2 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3439, 4026) (emphasis added).

Thus, the court suggested that UBIT was nothing more than an effort to broaden the tax base.[177]

Despite *Clarence*, few courts have attempted to refute either Congress's original intent for enacting UBIT or the legitimacy of Congress's concern for unfair competition.[178] In his dissent in *United States v. American Bar Endowment*,[179] however, Justice Stevens claimed that there was absolutely no danger of unfair competition evidenced by the Bar Endowment's agreement to use a for-profit insurance agency to provide insurance for its members.[180] Conjuring up the image of NYU's alleged macaroni monopoly, Justice Stevens questioned whether the Bar Endowment's insurance activities created any unfair competitive advantage:

> The unrelated business income tax was passed to avoid a certain kind of evil. . . . So you go back and look at what evil there is in the market. What was Congress trying to do . . . when the. . . tax was passed, and one comes to the frequently-asked question, "Who is Ronzoni."[181]

Justice Stevens's insistence on concrete evidence of unfair competition suggests that fears of unfair competition created by exempt organizations might be unfounded.[182] Notwithstanding these isolated voices of skepticism, courts generally have deferred to fears of unfair competition in upholding the imposition of UBIT without any tangible evidence that the nonprofit adversely affected competition.[183]

B. *Moving Beyond the Unfair Competition Argument: Academic Criticism of the Unfair Competition Rationale*

Most courts have accepted the elimination of unfair competition between exempt organizations and for-profits as a legitimate rationale for UBIT.[184] Several legal scholars have argued, however, that fears

177. *See id.* at 272-73. Similarly, in *Louisiana Credit Union League v. United States*, the court pointed out that Congress had purposes other than preventing unfair competition for enacting the UBIT provisions. Louisiana Credit Union League v. United States, 693 F.2d 525, 540 (5th Cir. 1982). The court made much of the fact that, for over 30 years, Congress had declined to make competition a prerequisite for taxation. *Id.* at 541.

178. *See, e.g.*, United States v. American Bar Endowment, 477 U.S. 105 (1986); Fraternal Order of Police v. Commissioner, 833 F.2d 717 (7th Cir. 1987); *see also* Smith-Dodd Businessman's Ass'n, Inc. v. Commissioner, 65 T.C. 620, 624 (1975) (noting that "unfair competition plays a relatively insignificant role in the application of the amended unrelated business tax").

179. 477 U.S. 105 (1986).

180. *Id.* at 121.

181. *Id.* at 122 n.4 (quoting trial court's oral opinion).

182. *See id.* at 122.

183. *See* United States v. American College of Physicians, 475 U.S. 834, 838-39 (1986); *Louisiana Credit Union League*, 693 F.2d at 538-42; DAV I, 650 F.2d 1178, 1181 (Ct. Cl. 1981); Veterans Found. v. United States, 281 F.2d 912, 914 (10th Cir. 1960); United States v. Community Servs., 189 F.2d 421, 425 (4th Cir. 1951).

184. *See supra* note 166.

of unfair competition are unfounded.[185] Yet there is no consensus over *why* these fears are unfounded. Although some argue that tax exemption creates no significant competitive advantage and that the UBIT provisions should be repealed,[186] others suggest that unfair competition may exist but offers a poor rationale for UBIT.[187] The academic criticisms of the rationale for UBIT suggest that concerns over unfair competition probably are unfounded. Thus, if no alternative rationale for UBIT existed, it would be appropriate to repeal UBIT. There are, however, other reasons for retaining UBIT, and an alternative rationale for UBIT may be developed that would remove UBIT from the center of a potentially unresolvable debate over whether nonprofits compete unfairly with for-profits.

1. The Extreme View

At least one scholar has argued for the repeal of the UBIT provisions based strictly on an economic analysis.[188] According to Suzanne Rose-Ackerman,[189] not only do fears of unfair competition offer a poor rationale for UBIT and its exceptions, but the UBIT provisions actually exacerbate any competitive advantage that an exempt organization might have over a for-profit.[190] Another scholar, William Klein,[191] also argues that fears of unfair competition are unfounded,[192] but suggests that Congress should alter the tax scheme imposed on for-profit corporations instead of altering UBIT.[193]

Rose-Ackerman points out several analytical errors underlying the unfair competition rationale for UBIT. First, commentators confuse perceived unfair competitive advantage with the actual exercise of a marketplace advantage in an unfair manner.[194] A for-profit company may perceive that, because of a nonprofit's larger after-tax profit margin, a non-profit competitor is capable of underselling the for-profit,

185. *See* Bittker & Rahdert, *supra* note 3, at 320; Hansmann, *Unfair Competition*, *supra* note 23, at 609-12; Klein, *supra* note 48, at 68; Rose-Ackerman, *supra* note 40, at 1036-39.

186. *See, e.g*, Rose-Ackerman, *supra* note 40, at 1022.

187. *See, e.g.*, Hansmann, *Unfair Competition*, *supra* note 23, at 634-35.

188. *See* Rose-Ackerman, *supra* note 40, at 1038. While the major scholarly contributions to this topic have come from law and economics scholars, this approach may provide too narrow a perspective on such a broad policy question as is raised by the rationale for the UBIT provisions. *See* Robin West, *Economic Man and Literary Woman: One Contrast*, 39 Mercer L. Rev. 867 (1988) (arguing that law and economics theory over-emphasizes rationality and ignores empathy).

189. Henry R. Luce Professor of Jurisprudence, Law and Political Science, Co-Director of Center for Studies in Law, Economics and Public Policy, Yale University.

190. Rose-Ackerman, *supra* note 40, at 1037-38.

191. Professor Emeritus, University of California, Los Angeles.

192. *See* Klein, *supra* note 48, at 68 (commenting that "fears expressed by competitors are paranoid rather than rational").

193. *Id.* at 74.

194. *See* Rose-Ackerman, *supra* note 40, at 1020.

and, thus, the for-profit deems the tax exemption unfair.[195] A nonprofit, however, will not necessarily use its higher profit margin to undersell its competitors.[196] It is just as plausible that the nonprofit will sell at the same price but use its tax exemption to retain a greater percentage of its profits than will its competitors.[197] Tax exemption creates only the potential for unfair competition. There is no concrete evidence that nonprofits have used this potential to compete unfairly. Furthermore, it is not "unfair" to subsidize a nonprofit when a nonprofit faces significant disadvantages in raising capital.[198] Thus, Rose-Ackerman urges that a clearer notion of "fairness" be developed.[199]

Rose-Ackerman argues further that UBIT actually exacerbates the potential competitive advantage created by exemption. Because UBIT discourages nonprofits from engaging in unrelated activities, it forces nonprofits to concentrate themselves in markets related to their exempt purposes. Under these circumstances, one market may have no nonprofit participants while others are overpopulated by nonprofits. The excessive entry[200] of nonprofits in one industry represents a greater threat to competition within an industry than does predatory pricing.[201] If many nonprofits enter a market already adequately served by for-profits, the effect on the market price in that industry may be similar to that of predatory pricing.[202] As a result, the for-profits may want to leave the overpopulated market and enter a less

195. *See id.*

196. *See id.* The Treasury recognized in 1987 that this alleged unfair competitive advantage may be nothing more than an unexercised advantage:

> [A]lthough tax exemption may provide an organization with the ability to underprice taxable competitors, the actual effect of the tax exemption on an organization's commercial behavior is not clear. While some exempt organizations may price their goods and services at less than what the market will bear, others may seek to maximize financial returns because of concerns such as funding or expansion.

Copeland, *supra* note 149, at 917.

197. Rose-Ackerman, *supra* note 40, at 1021 ("[N]onprofits are no more likely to engage in predatory pricing than for-profits.")

198. While commentators continue to make claims of unfair competition, they do not substantiate them with proof of underpricing. *See, e.g.*, James T. Bennett & Thomas J. Di Lorenzo, Unfair Competition: The Profits of Nonprofits (1988).

199. Rose-Ackerman, *supra* note 40, at 1020. Using the NYU-Mueller scenario, Rose-Ackerman points out:

> The different tax treatment of competing organizational forms does not imply that Ronzoni and N.Y.U. would charge different prices for their macaroni or pay different wages to their workers. It implies only that N.Y.U. would keep a larger share of Mueller's profits than would Ronzoni's owners . . . . Why must a fair tax code treat students and scholars who are the beneficiaries of Mueller's profits as if they were 'equal to' Ronzoni's investors?

Id.

200. Excessive entry refers to a large concentration of participants in one particular market. *See id.* at 1027 n.32.

201. *See id.* at 1026.

202. *Id.* at 1026.

densely populated market where they can enjoy a larger share of the market. For-profits cannot, however, simply leave the first market and apply their resources to a less saturated market.[203] Once both human and capital resources have been invested in one market, they cannot readily be transferred to another.[204] Instead, the prohibitive cost of exiting an industry forces a for-profit to remain in a market and attempt to compete with nonprofits, which are capable of offering goods at a lower price.[205] Consequently, the for-profit will earn lower profits than it had before the nonprofits' excessive entry.[206] Thus, the market price will be adversely affected whenever it becomes advantageous for non-profits to concentrate themselves within a particular industry. According to Rose-Ackerman, it is precisely this incentive for concentration that the UBIT provisions create, rather than prevent: "Tax-exempt firms must now concentrate their profitable endeavors in those few lines of business judged to be 'related.' "[207]

A second argument advanced by for-profits supporting the unfair competition rationale is that tax exemption immunizes nonprofits from the risk of bankruptcy.[208] They argue that, because of tax exemption, nonprofits will expand and accumulate earnings more quickly, and thus will be less vulnerable to bankruptcy.[209] Rose-Ackerman claims that this argument oversimplifies the risk of bankruptcy.[210] In addition to accumulated earnings, the ability to carry over losses will also determine a corporation's solvency.[211] A corporation can generally only use losses to the extent that the corporation has taxable income (not including the losses) in the current year.[212] If a corporation's ability to recognize its losses is limited to the year in which they are incurred, it may lose the benefit of offsetting taxable income in subsequent or prior years. If, however, the corporation is allowed to carry these losses forward to future years, it can take a loss from year one and use it to offset any taxable income earned in the next fifteen years or backwards to the prior year.[213] Thus, although

203. *See id.*
204. *See id.*
205. *Id.*
206. *Id.* Rose-Ackerman suggests that "excessive" entry will occur "when nonprofits have excess cash to invest and the return they can obtain by lending their money on the bond market is lower than the rate of return on active, entrepreneurial investments." *Id.* at 1027-28.
207. *Id.* at 1038. Rose-Ackerman suggests that such concentration has already developed in gift shop and vacation tour industries. *Id.*
208. *See id.* at 1035.
209. *See id.* at 1034-35.
210. *See id.* at 1035.
211. *See id.*
212. *See* I.R.C. § 172 (1995).
213. *See id. See also* Rose-Ackerman, *supra* note 40, at 1035. Because of the relatively generous provisions concerning carryovers, according to Rose-Ackerman:

> For-profits will only be disadvantaged when they have a run of losses that lasts more than eighteen years with major losses in the middle of the pe-

exemption may enable a nonprofit to accumulate earnings more rapidly than a for-profit, this ability alone will not insulate it from bankruptcy.[214] Because the ability to carry over losses, an ability shared by nonprofits and for-profits alike, will minimize the advantage of a nonprofit in maintaining higher profit margins, exemption does not give nonprofits any disproportionate advantage with respect to avoiding bankruptcy.[215]

While the potential for an unfair competitive advantage of nonprofits over for-profits may not be illusory, it may occur in a manner different than is generally understood by for-profits complaining of unfair competition, namely through excessive concentration in one market rather than through predatory pricing. Thus, according to Rose-Ackerman, the UBIT provisions are not the proper response to the potential of an unfair competitive advantage and, therefore, should be repealed.[216]

Professor William Klein raises economic arguments similar to those of Rose-Ackerman.[217] Klein adds to these arguments his general skepticism that nonprofits would choose to expand with surplus retained earnings rather than apply the profits to charitable purposes.[218] Klein points out that fears of unfair competition are based on a series of assumptions concerning behavior of nonprofits in the market place, such as the inclination of nonprofits to undersell.[219] Klein concludes that "fears expressed by competitors are paranoid rather than rational [and] the persistence of the myth of unfair competition, even among intelligent, unbiased experts, may suggest that sound economic analysis is simply beyond the capacity of the public and Congress to comprehend."[220] Klein's observations have proven accurate; most courts have regurgitated the unfair competition argument originally articulated in 1950 without any recourse to rigorous economic analysis.

2. The Moderate View

In contrast to the recommendations of Rose-Ackerman and Klein, some scholars favor retaining the UBIT provisions, albeit in a modified form.[221] For example, Professor Henry B. Hansmann,[222] although

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riod—more than three years after the last profit in the past and more than fifteen years before the first profit in the future.

Id.

214. *See id.*
215. *See id.*
216. *See id.* at 1039.
217. Klein, *supra* note 48, at 61-68.
218. *See id.* at 65.
219. *See id.*
220. *Id.* at 68.
221. *See, e.g.*, Hansmann, *Unfair Competition*, *supra* note 23, at 634-35 (advocating that UBIT provisions be retained because they encourage diversity in investment).
222. Harris Professor of Law, Yale School of Law.

also very critical of the unfair competition argument, suggests that UBIT be retained for other reasons, such as the incentive UBIT provides for nonprofits to diversify their investments.

The UBIT provisions encourage diversification in two ways. First, they encourage a nonprofit in one market to reinvest its profits in another market, rather than to expand indefinitely in the first market. Second, because there is no longer any tax advantage to wholly owning a company, UBIT encourages nonprofits to spread their investments over a larger number of markets. Diversification is generally thought to be a safer investment strategy than concentrating investments in one market. If a corporation concentrates its investments in a single industry and that industry suffers from economic factors beyond the control of the corporation, the corporation could lose more than if it had spread its investments over diverse industries.[223]

Like other law and economics scholars, Hansmann suggests that fears of unfair competition are unfounded.[224] Hansmann argues that tax exemption provides no incentive for nonprofits to engage in price-cutting activities.[225] A nonprofit takes better advantage of its tax-exempt status by maximizing the price-cost difference in a particular industry.[226] If a nonprofit undersells its competitors, it has a smaller profit margin and does not take full advantage of its tax-exempt status.[227]

Suppose an exempt organization sells a product in market A at the average market price of $5 and the cost of production is $4. The exempt organization retains a profit of $1. If, on the other hand, it chose to undersell its competitors by selling its product at $4.50, it would only retain a profit of $.50. Presumably, if the exempt organization can offer product A at a lower price, it will attract a larger share of the market. Once the organization gains wider control of the consumers in market A, this larger market share will compensate for the smaller profit margin created by lowering its price. A nonprofit is not likely, however, to sacrifice the current opportunity to achieve a higher profit margin for the promise of a larger market share in the future.[228]

The organization could choose instead to reinvest the profits from market A in market B, leaving both the price and profit margin in market A intact. According to Hansmann, tax exemption encourages

223. *See* Hansmann, *Unfair Competition*, *supra* note 23, at 613-20. This argument overlooks the possibility, however, of repealing UBIT in part but maintaining a prohibition against feeder organizations.

224. *See id.* at 609.

225. *Id.* at 609-12. *But see* Bennett, *supra* note 4, at 760 ("Research has shown that nonprofits have used these economic advantages to underprice their for-profit counterparts." citation omitted)).

226. Hansmann, *Unfair Competition*, *supra* note 23, at 611.

227. *See id.*

228. *See supra* note 164.

a nonprofit to pursue the latter course.[229] Reinvesting its profits in another market lessens the organization's need to hold a greater share of market A to compensate for a smaller profit margin. Therefore, a nonprofit would have no incentive to drive competitors out of a market through underselling.[230] Contrary to Rose-Ackerman's theory, Hansmann's theory suggests that UBIT creates an incentive to diversify rather than to concentrate investments in one market.[231]

The NYU-Mueller scenario appears to substantiate Hansmann's theory of nonprofit market behavior.[232] There is no evidence that Mueller undersold Ronzoni, a prominent competitor in the macaroni market.[233] Furthermore, apparently aware of the advantages of tax exemption, NYU chose to invest in diverse companies manufacturing such items as chinaware and piston rings, rather than concentrating its investments in macaroni.[234] Thus, the competitive advantage allegedly created through tax exemption did not in fact harm NYU's for-profit competitors, but instead encouraged NYU to follow more prudent investment strategies, spreading its risks over diverse markets.

Hansmann suggests that the unfair aspect of the current regime is not necessarily the competitive advantage exemption supposedly creates, but rather the inconsistent tax treatment of nonprofits under UBIT.[235] Even assuming nonprofits will use exemption to undersell for-profit competitors within a market, this need not pose a threat to a for-profit. If a for-profit firm can anticipate competition from a nonprofit in a particular market, it can decide, before committing its resources, to enter another market in which it could make a profit.[236] Under the current UBIT provisions, however, it is not always clear when a nonprofit will be subject to tax and when it will not. Thus, for-profits cannot anticipate which markets nonprofits will choose to enter. Hansmann suggests that unfair competition occurs when for-profit firms suffer such unforeseeable losses.[237] Therefore, "problems of unfair competition generally arise only in transitions from one tax regime to another because that is usually the only time at which sub-

229. *See* Hansmann, *supra* note 23, at 611 ("[T]he nonprofit leaves undisturbed the price that prevails when only for-profit firms compete, and thereby maximizes the difference between cost and sales price.")

230. *Id.* at 612.

231. *See id.* at 609-12.

232. *See* Comment, *supra* note 164, at 851-2; *see also* Hansmann, *Unfair Competition*, *supra* note 23, at 615 n.33; Rose-Ackerman, *supra* note 40, at 1017 n.2.

233. One student unearthed records of NYU's profits before and after the acquisition of Mueller macaroni, but did not produce any evidence of below-cost pricing. *See* Comment, *supra* note 164, at 863 n.57.

234. *See* Rose-Ackerman, *supra* note 40, at 1017 n.2.

235. *See* Hansmann, *Unfair Competition*, *supra* note 23, at 613-14.

236. Even if UBIT were repealed, therefore, a for-profit would on average attain a higher rate of return as long as it could adjust its expectations to protect itself against the possibility of competition from nonprofits. *See id.* at 609-13.

237. *See id.* at 613.

stantial unforeseeable tax-induced losses can arise."[238] Rather than urging repeal, Hansmann advocates consistency in the application of the current UBIT provisions, thus retaining an incentive for diversification of nonprofit investments.[239]

Moreover, Hansmann discerns values of UBIT other than diversification of investment. For example, he suggests that the UBIT provisions prevent nonprofits from straying too far from their tax-exempt purposes.[240] The further a nonprofit entity strays from activities related to its exempt purpose, the more it will be taxed. Thus, UBIT functions as a check on the activities of nonprofits, fostering both accountability and dependency on public support for the furtherance of their activities.

Accountability is even more significant than Hansmann suggests. If the incentive for a nonprofit to engage in unrelated activities is limited, the nonprofit is forced to rely on contributions. Soliciting contributions serves a dual purpose of generating revenue and encouraging society to contemplate the value of the services of the exempt organization. An exempt organization's inability to muster minimal support through charitable donations may indicate that society no longer values the services of the exempt organization. If society no longer places a high priority on these services, then perhaps the tax-exempt status of the organization is no longer justified. Although complete dependency on public support may not be a realistic market goal, exempt organizations should be encouraged to maximize their dependence on public support. If an exempt organization were allowed to derive as much income as it chose from unrelated activities, it would have little incentive to solicit contributions from society.[241]

According to Hansmann, even if the advantages of the current UBIT provisions would not alone have been enough to motivate its original enactment, repealing the provisions would trigger additional difficulties.[242] In the absence of the UBIT provisions, for example, nonprofits would have an incentive to own entire companies, just as before 1950.[243] This could represent a large loss of tax revenue for the government. Under pre-UBIT law, a wholly owned for-profit subsidiary would have been considered an unrelated exempt business and

238. *Id.* at 613.

239. *See id.* at 620-21.

240. *Id.* at 621; *see also* Copeland, *supra* note 149, at 918.

241. Critics of public television arguing against continued federal subsidization of WNET have advanced a similar argument. They suggest that oversubsidization quashes an organization's incentive to fund itself: " 'WNET doesn't need a dime of federal funding . . . . They have gotten so fat sucking on the Federal teat that they can't function like normal people. Well, it's time to put them on a diet.' " Bill Carter, *WNET Braces for Cuts or Worse*, N.Y. Times, Jan. 25, 1995, at C13 (quoting Lawrence Jarvik, a fellow at the Center for Popular Culture).

242. *See* Hansmann, *Unfair Competition*, *supra* note 23, at 618-23.

243. *See id.* at 622.

would not be subject to taxation on its profits.[244] Thus, owning an entire company as opposed to a small percentage would maximize a nonprofit's advantage. NYU apparently maximized its advantage of tax exemption in precisely this manner. NYU chose the option of wholly owning a few companies instead of owning a small percentage of a larger number of companies.[245] NYU chose to invest in companies outside of the macaroni market, thus leaving the prices in the macaroni market intact and maximizing its profit margin in the macaroni market. Because there is no longer any advantage to wholly owning a for-profit,[246] exempt organizations have an incentive to diversify their investment resources. The same profits that would have been used to purchase an entire company are now used to invest in several different companies and industries.

Hansmann's explanation of how UBIT encourages diversification of investment and fosters accountability offers a cogent reason to retain UBIT. Despite the insightful criticisms raised by Hansmann, Rose-Ackerman and Klein, the academic debate surrounding the UBIT provisions generally has done little to inform the congressional commentary over the continued viability of the UBIT rationale.[247]

3. Measuring Unfair Competition

Scholars have raised valuable criticisms of the widespread belief that unfair competition is a legitimate rationale for the UBIT provisions.[248] Nonetheless, no one has provided a thorough empirical study of the impact of tax exemption on competition between for-profits and nonprofits. To date, only a few studies have been undertaken.[249] The lack of empirical evidence does not mean, however, that complaints of unfair competition should simply be dismissed. It may be that the impact of tax exemption cannot be known with certainty be-

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244. Under our current system of taxation, a tax is imposed on a corporation when it earns income and again on a shareholder when the corporation distributes a dividend to its shareholders. *See* I.R.C. §§ 11, 301 (1995); Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders, 1-8 to 1-9 (6th ed. 1994).

245. *See* Rose-Ackerman, *supra* note 40, at 1017 n.2. Apparently, the Sagrada Orden pursued the same investment strategy. *See* Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578 (1924). Had this practice continued, it could have resulted in a shrinkage in the U.S. tax base, because of the large number of for-profits wholly owned by exempt organizations. *See* Hansmann, *Unfair Competition*, *supra* note 23, at 621-24 (discussing tax base shrinkage).

246. *See* I.R.C. § 512(b)(13); *see also* Tax-Exempt Organizations: Organization, Operation and Reporting Requirements, Tax Mgmt. (BNA) No. 464-3rd, at A-130 (July 13, 1992).

247. Proposals set forth by Treasury officers will be discussed in part IV, *infra*.

248. *See supra* part III.B.1-B.2.

249. *See* James T. Bennett & Thomas J. DiLorenzo, Unfair Competition: The Profits of Nonprofits (1989); Harrison Wellford & Janne Gallagher, The Myth of Unfair Competition by Nonprofit Organizations (1985).

cause of the numerous variables affecting nonprofit behavior in the market place.[250]

Litigants attempting to base claims on an alleged competitive advantage, for example, have failed.[251] In *Structure Probe, Inc. v. Franklin Inst.*,[252] plaintiff Structure Probe, a for-profit corporation, brought suit against a tax-exempt organization, The Franklin Institute, under the Sherman Antitrust Act.[253] Structure Probe claimed that the Franklin Institute attempted to monopolize a local market for Scanning Electron Microscope services.[254] The plaintiff was unable to prove a sufficient market share to sustain an antitrust claim under 15 U.S.C. § 2, because, as the court observed, "[B]elow-cost price alone is not sufficient to prove predatory pricing."[255]

Structure Probe demonstrates the difficulty of substantiating a claim of unfair competition by a nonprofit. Measuring claims of unfair competition with an antitrust measuring stick may not be the best approach to assessing unfair competition by nonprofits.[256] A company's competitive behavior may be unfair without rising to the level of an antitrust violation. Thus, the antitrust standard may be too high a threshold by which to judge competitive effects. The antitrust analysis does have the advantage, however, of being more developed than other means of measuring competition.[257]

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250. *See UBIT Recommendations*, *supra* note 27, at L-15 ("The damage of unfair competition is difficult to assess because the problem is national in scope but local in impact." (Testimony of Joseph O'Neil, Chairman, Business Coalition for Fair Competition, June 22, 1987)).

251. *See* American Soc'y of Travel Agents v. Blumenthal, 566 F.2d 145 (D.C. Cir. 1977) (association of travel agents bringing action against Secretary of Treasury for failure of federal tax authorities to assess tax on income received by certain exempt organizations); Structure Probe, Inc. v. Franklin Inst., 450 F. Supp. 1272 (E.D. Pa. 1978).

252. 450 F. Supp. 1272 (E.D. Pa. 1978).

253. *See id.* at 1274.

254. *See id.*

255. *Id.* at 1288 (citation omitted).

256. Other approaches to addressing the alleged competitive advantage have been pursued, but without success. In American Soc'y of Travel Agents, Inc. v. Blumenthal, 566 F.2d 145 (D.C. Cir. 1977), plaintiff attempted to sue federal tax authorities based on their failure to assess taxes upon income received by the American Jewish Congress. *Id.* at 147. In dismissing the complaint for lack of standing, the District of Columbia Circuit followed Justice Stewart's concurrence in Simon v. E. Ky. Welfare Rights Org., et al., in which he observed that he could not "imagine a case, at least outside the First Amendment area, where a person whose own tax liability was not affected ever could have standing to litigate the federal tax liability of someone else." *American Soc'y of Travel Agents, Inc.*, 566 F.2d at 147 (citing Simon v. Eastern Ky. Welfare Rights Org., 426 U.S. 26, 46 (1975)).

257. No adequate means of monitoring a nonprofit's effect on competition has yet been developed. The Federal Trade Commission, responsible for enforcing the Federal Trade Commission Act and the Uniform Deceptive Trade Practices Act, does not have jurisdiction over most nonprofits because the Act defines "corporation" narrowly "as a for-profit entity or trade association representing for-profit entities." Bennett, *supra* note 4, at 760.

Perhaps a competitive advantage may exist in limited circumstances. Before developing a viable solution to the present problems with the UBIT provisions, Congress and the Service should consolidate their efforts through a comprehensive study of the impact of tax exemption on the competition between nonprofits and for-profits.[258] Because no adequate study has yet been undertaken,[259] it is impossible to determine whether the unfair competition rationale should influence the development of an alternative rationale for UBIT. Until an adequate study has been accomplished, diversification of investment and accountability of nonprofits to the public offer better justifications for UBIT. Without a clearly articulated rationale, the current terms used in UBIT and its modifications cannot properly be defined as functions of an underlying rationale. Furthermore, without a clearer expression of the justification for UBIT, it will be in possible to achieve any consistency in its application.

IV. The UBIT of Tomorrow

Legal scholars have urged that unfair competition is not the best rationale for the UBIT provisions.[260] The Service and the courts have paid lip service to the rationale but have not applied UBIT with a view to furthering this purpose.[261] Since 1987, the need to revise and amend the UBIT provisions has become apparent.[262] UBIT is in need of a fundamental overhaul, beginning with the underlying rationale

258. *See* Spitzer, *supra* note 15, at 199 ("Congress should work with the Internal Revenue Service and other interested parties to develop Forms 990 and 990T that will elicit helpful information that can be compiled in a systematic manner. . . .") Even if, in certain cases, a competitive advantage is found to exist, it is not clear when this advantage is, in fact, "unfair."

259. In reviewing the Oversight Committee's draft report on UBIT reform, Thomas Troyer remarked that the proposals advanced for reform were "based upon limited, imperfect, and in many ways idiosyncratic information about the world for which it would establish law." Troyer, *supra* note 15, at 1227; *see also* Bittker & Rahdert, *supra* note 3, at 319 ("These predictions of unfair competition were rarely subjected to close analysis, and we know of no empirical examination of the results of such acquisitions.").

In 1990, the Service initiated a study, the results of which are still being assessed. *See Advice for Exempt Organizations: Stay Alert, Stay Alive*, Tax Notes Today 111-10, May 24, 1990, *available in* LEXIS, Fedtax Library, TNT File.

260. *See supra* part I.

261. *See supra* part II. *See also* Streckfus, supra note 16 ("The original intent of the UBIT provisions, as first enacted, has long since been lost.").

262. *See generally* Marlis L. Carson, *Exempt Organizations Still Waiting for Significant Guidance*, Tax Notes Today 2-7, Jan. 4, 1995, *available in* LEXIS, Fedtax Library, TNT File (noting that there is an "extreme lack of 'precedential' guidance in the [exempt organizations] area" and citing the application of the royalty exception as an area of uncertainty); Copeland, *supra* note 201, at 919; Copeland & Rudney, *supra* note 6, at 750-55; Hansmann, *Unfair Competition*, *supra* note 23, at 635-35; Spitzer, *supra* note 15, at 196; Troyer, *supra* note 15, at 1222; Wirtschafter, *supra* note 23, at 1467-68.

for UBIT and extending to the exceptions to UBIT.[263] Several proposals have been made to change the current UBIT provisions and cure the fatal inconsistencies in their application. This part concludes that the principle of accountability, whereby nonprofits are compelled to justify the use they make of the subsidy of tax exemption, offers a more practicable rationale for the taxation of nonprofits' unrelated business activities than does the unfair competition rationale. Under the principle of accountability, when a nonprofit does not use its subsidy to further an exempt purpose, it should be made to account for the misuse of the subsidy by paying a tax. This rationale should be implemented to guide the application of UBIT and define the scope of the royalty exception.

A. *Reviving Concerns of Unfair Competition*

The rulings and opinions discussed above underline the discord between the original rationale for UBIT and the manner in which it is currently being applied. Although a commerciality standard has been rejected repeatedly by courts,[264] efforts have been made to revive the unfair competition rationale for UBIT through a commerciality test.[265] Under this test, those "inherently commercial" ventures undertaken by exempt organizations would be taxed.[266] This standard is nothing more than a modern expression of concerns over unfair competition. Furthermore, the proposal overlooks the legitimate criticisms that have been raised with respect to the unfair competition rationale. As yet, there is no consensus that tax exemption is unfair to for-profits.[267] Also, the proposal fails to specify how "commerciality" is to be defined. Commerciality could be determined by the motive of the nonprofit or by the impact of the activity on the market. Nor does the proposed test explain why organizations should be taxed on "inherently commercial" ventures if the proceeds are used to further charitable purposes. Critics of the unfair competition rationale have struggled with these questions for decades. Until these questions can be answered any commerciality standard must fail.

263. *See, e.g.*, Bennett, *supra* note 4, at 759 ("Nearly four decades of experience with this law . . . have shown the UBIT to be ineffectual in eliminating or even substantially reducing unfair competition . . . Congress is so lost in the UBIT trees that it cannot find the forest."); *see also UBIT Update: The View from the Hill*, 2 The Exempt Org. Tax Rev. 142 (1989) (reviewing legislative proposals to change UBIT).

264. *See* Louisiana Credit Union League v. United States, 693 F.2d 525, 538-42 (5th Cir. 1982); Clarence LaBelle Post No. 217, Etc. v. United States, 580 F.2d 270, 272-74 (8th Cir. 1978).

265. *See* Bennett, *supra* note 4, at 764; James Bennett & Gabriel Rudney, *A Commerciality Test to Resolve the Commercial Nonprofit Issue*, 36 Tax Notes 1095, 1095-98 (1987); Troyer, *supra* note 15, at 1222.

266. *See* Troyer, *supra* note 15, at 1222.

267. *See* Bennett, *supra* note 4, at 760; Copeland & Rudney, *supra* note 6, at 749. *But see* Bittker & Rahdert, *supra* note 3, at 319-20; Klein, *supra* note 48, at 68.

Even if one could prove that tax exemption is unfair to for-profits, there may be better ways to address this problem.[268] One option would be to tax an exempt organization on income earned through attempts to use its advantage unfairly. For example, a tax could be imposed on that revenue generated through price-cutting. It would be difficult, however, to arrive at a definition of price-cutting that both allows for market fluctuation and does not exert too much control over a nonprofit's attempt to compete within a market. In any event, as long as scholars and practitioners disagree over whether exemption creates an unfair advantage, the elimination of unfair competition will remain an impracticable objective for UBIT. If exemption creates no unfair advantage, then UBIT cannot and should not be implemented or interpreted to eliminate unfair competition. Instead, an alternative rationale must be developed to guide the application of the UBIT provisions.

B. *The Economic Efficiency Rationale*

Economic efficiency has also been proposed as an alternative rationale for UBIT.[269] According to this rationale, the government should allow tax exemption only where the income derives from an activity performed more efficiently by an exempt organization than by a for-profit.[270] Under this standard, the government would not allow any exemption where the goods or services provided "are the same as and adequately supplied by for-profit businesses."[271] A museum's reproduction of paintings in its collection is one example of the efficient function of a nonprofit.[272] When a museum licenses a for-profit to make and market reproductions of pieces from the museum, the proceeds generated by the license should be exempt. Because of the capital outlay required to make original art works available for viewing, once the collection is already in existence, reproducing the works "is not an activity that a for-profit firm could perform instead . . . . [E]xempting such profits produces a subsidy that is neatly proportioned to the publicly valuable service that the museum provides,

268. As Rose-Ackerman has suggested, this would require a refinement of the notion of market "fairness." *See* Rose-Ackerman, *supra* note 40, at 1020-21.

269. *See* Hansmann, *Unfair Competition*, *supra* note 23, at 626-33; *Ubit Recommendations*, *supra* note 27, app. C (Testimony of Hon. O. Donaldson Chapoton, Deputy Assistant Secretary (Tax policy), Department of the Treasury, before the Subcomm. on Oversight, Comm. on Ways and Means (May 9, 1988)).

270. *See* Hansmann, *Unfair Competition*, *supra* note 23, at 613-17.

271. Troyer, *supra* note 15, at 1227; Copeland, *supra* note 201, at 916 ("Thus, tax exemption for public charities should be restricted to those areas where the quality or quantity of goods and services that would be produced strictly through market forces is inadequate.") (Testimony of Hon. O. Donaldson Chapoton, Deputy Assistant Secretary (Tax policy), Department of the Treasury, before the Subcomm. on Oversight, Comm. on Ways and Means (June 22, 1987)).

272. *See* Hansmann, *Unfair Competition*, *supra* note 23, at 629-34.

which is acquiring expensive art works for display at low or no fees."[273]

Unfortunately, this scenario does not help resolve the difficult questions raised by a nonprofit's licensing of its name or logo to endorse an affinity credit card. When it endorses an affinity credit card, a nonprofit is not necessarily performing a function that a for-profit could not perform. Its function can only be considered peculiar to its status in that the bank sponsoring the credit card may attract more subscribers because subscribers realize that through purchases made with the card, they make an indirect donation to the nonprofit involved.[274] Consider, for example, how Columbia University advertises its affinity card:

> You are, no doubt, deluged with credit card offers. So how do you choose which one to carry? The Columbia Visa Card makes that choice very simple. A portion of every charge you make with this card will go toward financial aid for Columbia students. *At absolutely no additional cost to you.* And there's no annual fee.[275]

When a nonprofit endorsement of a credit card is compared with an airline's endorsement of a credit card, the role of the for-profit is clearly different. When a consumer subscribes to a credit card endorsed by an airline, the consumer chooses the services of both companies. The consumer does not choose the joint arrangement because he wishes to make an indirect contribution to the airline. The consumer chooses it to build up frequent flier miles. From this perspective, there is no for-profit parallel to an exempt organization's endorsement of an affinity credit card.

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273. *Id.* at 631. Professor Hansmann explains that while for-profits may provide the same charitable services, it may be difficult for purchasers of such services, or charitable donors, to judge the quality of the same service when provided by a for-profit organization. As a result of this uncertainty, "ordinary market competition may be insufficient to police the performance of for profit firms, thus leaving them free to charge excessive prices for inferior service." Consequently, "consumers often turn to nonprofit providers, which, owing to the nondistribution constraint, have less opportunity and incentive to exploit consumers than do for-profit firms, and thus serve as fiduciaries of a sort for their consumers." Hansmann, *Rationale for Exemption*, *supra* note 3, at 69. Reliance on a nonprofit, however, does not completely eliminate the risk of funds being siphoned off by higher compensation for executives.

274. An affinity card endorsement should be distinguished from a practice often referred to as "cause related funding." The Ways and Means Subcommittee explains the distinction in the following manner:

> Under this practice, charitable contributions . . . are made by a business which merely has informed the public that an amount will be donated to the charity based on the sales of its products or use of its services, and has not entered into a contractual arrangement with the charity under which the business receives any consideration from the charity (such as the exclusive right to use the charity's name or logo on a particular type of product).

See UBIT Recommendations, *supra* note 27, at L-21.

275. Columbia: The Magazine of Columbia University, Fall 1994, back cover page.

According to the efficiency rationale, when there is no for-profit parallel, the nonprofit performs this endorsement function more efficiently. If the nonprofit is the more efficient provider, the income generated therefrom should be exempt. It would follow that all income derived from all affinity card arrangements endorsed by nonprofits should be exempt from taxation. Many might be uncomfortable with this result, however, if the nonprofit had become a joint venturer with a bank and actively marketed credit cards. This would permit a nonprofit to maintain its exempt status despite an aggressive foray into a business unrelated to its exempt purpose. Thus, the efficiency rationale is inadequate, because it does not distinguish between nonprofits whose level of participation and control differ widely. The efficiency rationale may be more reasonably grounded in economic reality than is the unfair competition rationale and is well adapted to explain the taxation of certain arrangements, such as museum gift shops. It does not, however, answer questions raised by other nonprofit unrelated activities. Thus, economic efficiency may not provide an underlying rationale broad enough in scope to guide the application of UBIT.

C. *The Accountability Rationale*

The imposition of a tax on unrelated business activity of nonprofits may provide a means of holding the nonprofit accountable to the public.[276] To the extent that a nonprofit engages in activities unrelated to its exempt purpose, it violates its agreement with the public to undertake activities related to its exempt purpose in exchange for exemption from taxation. After all, it is the public who, through the legislature, ultimately confers the tax benefit.[277]

In a for-profit corporation, shareholders have an incentive to monitor the policies and decisions of the directors and officers of the corporation through the shareholder voting process. Because shareholders of a nonprofit corporation may not receive any portion of the earnings and profits of the corporation in the form of dividends, however, no such analogous policing incentive exists. In fact, prior to 1950, the only check on a nonprofit's expansion into unrelated activities was the threat of complete revocation of its exempt status. There was no intermediate measure to ensure that a nonprofit was using its subsidy to further an exempt purpose. Although revocation is still a potential penalty under current law, UBIT offers the opportunity for an inter-

276. *See, e.g.*, Copeland, *supra* note 149, at 917; Hansmann, *Unfair Competition*, *supra* note 23, at 629.

277. *See* Hansmann, *Unfair Competition*, *supra* note 23, at 621 ("Subsidies for nonprofits should be structured to encourage them to expand their *related*, not their unrelated, activities."); *see also* Copeland, *supra* note 149, at 917 ("[R]ules limiting the scope of tax exemption may appropriately encourage the exempt organization to concentrate on activities and investments that do not distract from its exempt function.")

mediate check on the nonprofit. UBIT deters a nonprofit from straying too far from its exempt purpose; as long as a nonprofit will be taxed as a for-profit when the nonprofit engages in unrelated activities, the incentive to expand into unrelated activities is significantly diminished. Thus, by taxing a nonprofit on its income generated through unrelated activities, UBIT holds a nonprofit accountable to the public that has granted the nonprofit exempt status.

Among the underlying rationales proposed thus far, accountability offers the soundest and most practical guiding principle for determining the taxation of unrelated business income. Accountability is particularly important, because, generally, exempt organizations are less accountable than for-profits.[278] With respect to for-profit organizations, "[c]ompetitive pressures in product markets, labor markets, and markets for managerial control assure consumers that businesses will be reasonably responsive."[279] Exempt organizations, because of the accumulation of tax privileges, are more isolated from these competitive pressures, and therefore, exempt organizations are less accountable to the public.[280]

More government supervision may be necessary to ensure that the grant of tax exemption is fulfilling public goals.[281] Thus, "rules limiting the scope of tax exemption may appropriately encourage the exempt organization to concentrate on activities and investments that do not distract from its exempt function."[282] This supervision could be implemented by levying a tax when the nonprofit fails to expend for exempt purposes, or by setting aside at least five percent of the assets gained through unrelated activities for exempt purposes to be pursued in the future.[283] The function of the penalty may be expressed in simple terms: "[S]ince society granted exemption of the income, society should get a minimum return in the form of social welfare expenditures for the tax given up."[284] While the penalty would encourage accountability, to administer the penalty the Service would have to police the activities of nonprofits more strictly. The Service could, for

278. *See* Bennett, *supra* note 4, at 763.
279. *Id.*
280. *See id.* One could argue, however, that exempt organizations should be immune from these competitive pressures. Extending this reasoning one step further, perhaps exempt organizations should not be held strictly accountable to the public, because if they are, people might choose not to subsidize charitable activities. Whether the public should be allowed to choose on its own what is best for society depends upon whether one endorses a paternalistic notion of government. *See* David L. Shapiro, *Courts, Legislatures, and Paternalism*, 74 Va. L. Rev. 519, 521 (1988) (discussing the problematic nature of paternalism as a guide for legislatures and courts); Margaret Jane Radin, *Market-Inalienability*, 100 Harv. L. Rev. 1849, 1898-99 (1987) (explaining that a paternalistic notion of government assumes that freedom is "negative liberty" and thus individuals do not know what is best for themselves).
281. *See* Copeland, *supra* note 149, at 918.
282. *Id.* at 917.
283. *Id.* at 919.
284. *Id.*

example, require nonprofits to file more comprehensive returns than are presently required, detailing the sources of their income regardless of whether they have earned unrelated business income in the past. Thus, accountability may provide an objective to guide the application of UBIT as well as an opportunity to gather information on the behavior of nonprofits.

D. *Implementing the Accountability Rationale*

While accountability may offer a promising rationale for UBIT, the specific contours of the rules that would have to be developed in accordance with this rationale have yet to be delineated. To hold a nonprofit accountable for the benefit of tax exemption is to ensure that this benefit is being used to further the exempt purpose that originally justified the nonprofit's exemption. The specific consequences that would flow from an accountability rationale remain unclear, but it is arguable that there should be no per se exemption from taxation for royalty income. Instead, the royalty exception should be revised to exempt only royalties arising from certain types of transactions. The royalty provision should be amended to permit taxation of impermissible royalties regardless of whether the nonprofit is considered to be engaged in a trade or business.[285]

Accountability would suggest, for example, that the royalties the Sierra Club derives from its endorsement of an affinity credit card should be subject to taxation. An exempt organization would escape accountability if it were allowed to build up goodwill through the benefit of tax exemption, license this goodwill through the rental of its name and logo to a for-profit organization and still retain the proceeds free of any tax. As a nonprofit organization builds its reputation and goodwill, it is assisted by the higher profit margin that tax exemption provides. Not until a nonprofit has achieved a certain level of recognition as a charitable provider does its name or logo become marketable as a for-profit endorsement vehicle. Thus, having built a solid reputation through the help of tax exemption, an exempt organization exploits the privilege conferred upon it by the public when it licenses its name or logo to a for-profit instead of using this advantage to further an exempt purpose.[286] In other words, it has taken its subsidy and

285. Typically a court finds first that the nonprofit is engaged in an unrelated trade or business and then considers whether the proceeds are exempt under the royalty exception of 512(b)(2). *See, e.g.*, Louisiana Credit Union League v. United States, 693 F.2d 525 (5th Cir. 1982) (determining first whether income derived from an unrelated trade or business and, second, whether proceeds could be characterized as royalty income). In *Sierra Club II*, however, the Tax Court reversed this analysis by finding that the Sierra Club was not engaged in a trade or business, because the proceeds it received constituted royalties. Sierra Club II, No. 8650-91, 1994 U.S. Tax Ct. LEXIS 62, *2.

286. Copeland seems to suggest this when he observes that "consideration should be given to excluding from the definition of a royalty, situations where an exempt

licensed it to a for-profit organization that uses the subsidy to further a purpose for which the subsidy was not originally intended. If a nonprofit is to be held accountable for its subsidy, it should be permitted to use this subsidy only to further its exempt purpose and should not be allowed to redistribute the subsidy, tax-free, to for-profit organizations through the license of its name and logo.[287]

The royalty that the licensing of a name and logo generates is one type of royalty payment. The royalty payment arises out of the rental of an asset created by the nonprofit with the aid of the government subsidy that tax-exemption provides. Compare the type of royalty generated by a self-created asset with the type of royalty arising from the donation of intangible property to a nonprofit. Suppose a third party donates to a nonprofit a patent, which is then licensed to another entity. If the nonprofit receives royalty payments for the use of the patent, this would not violate any principle of accountability. Presumably when the donor makes a contribution, the donor has already determined that the manner in which the nonprofit is operated warrants a contribution to support the entity.[288]

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organization is exploiting goodwill and other intangibles generated by its exempt purposes." Copeland, *supra* note 149, at 915 (citing O.D. Chapoton, Deputy Assistant Secretary (Tax Policy), Before the Subcommittee on Oversight of the Committee on Ways and Means, June 22, 1987 and May 8, 1988); *see also UBIT Recommendations*, *supra* note 27, at L-22 (suggesting that income derived from the licensing of a nonprofit's property should be subject to UBIT if the tax-exempt organization created the property right being licensed).

The nature of a nonprofit's goodwill may provide an even stronger argument for taxing these proceeds. If, as some commentators have suggested, the goodwill of a successful exempt organization is qualitatively different than that of a successful for-profit, then the licensing of its name and logo may appear abusive. *See* Bennett, *supra* note 4, at 760 ("[E]ven if we put aside possible tax advantages, the nonprofit entity has an unfair advantage . . . *owing to the public image of nonprofit status*." (citing Marc Lane, Legal Handbook for Nonprofit Organizations 273 (1980) (emphasis added))); *see also UBIT Update: The View from the Hill*, 2 The Exempt Org. Tax Rev. 142 (1989) ("If you've got that halo and you can go out and raise money through contributions or donations, tax-free and tax-deductible, and take that same money and use it to compete with a tax-paying subsidiary, then you've got a great advantage over that tax-paying subsidiary.").

287. Not every license of a self-created asset, however, would violate the principle of accountability. For example, where the license of an intangible asset remains related to the nonprofit's purpose, the royalties generated therefrom should remain exempt. Suppose the Sierra Club produced a book on endangered species in North America. If the Sierra Club obtained a copyright and then licensed this copyright to a for-profit publisher, the royalty payments made by the for-profit publisher to the Sierra Club should be exempt, because the asset and the licensing of the copyright for the asset are related to the Sierra Club's exempt purpose. The licensing of the Sierra Club's name and logo to endorse a credit card, however, is not related to its exempt purpose.

288. Suppose, however, the magnitude of the donation is significantly greater. Suppose, for example, instead of donating a copyright, a donor donates several copyrights. When the contribution reaches this magnitude, the nonprofit will be forced to use its personnel or even hire new personnel to manage the income-producing intangible property. It is questionable whether, once the nonprofit's role in the generation

No such opportunity to evaluate the operation of a nonprofit exists where a tax-exempt entity licenses a self-created asset for a use that is not related to its exempt purpose. Unless the nonprofit alters its underlying purpose or manner of operation, it will continue to receive the benefit of tax exemption. Also, although the Service may revoke a nonprofit's exempt status under some circumstances, there is no opportunity to continually assess the value of the nonprofit's role in society. In other words, once an entity has qualified for tax exemption, exemption itself provides a continuing subsidy without the same periodic determination of whether the subsidy is still justified.

Yet another type of royalty would arise if a nonprofit purchased an intangible instead of receiving it as a gift or creating it itself. Suppose a nonprofit purchased a copyright to a book. If the royalties generated through the sales of the book required little effort or involvement on behalf of the nonprofit, then it may be appropriate to exempt these royalties from taxation. The level of participation of the nonprofit is not the only factor in determining whether the royalties should be exempt or not. It is also critical to ascertain from where the proceeds to purchase the copyright came in the first place. Although direct tracing of funds would be too problematic a method to implement this rationale, accountability does require focus both on the initial investment in the royalty-producing property and on the manner in which the royalty-producing property is managed. If, for example, the nonprofit uses a significant percentage of its accumulated profits to purchase the copyright, then it is more likely that the nonprofit is misusing the higher profit margin it has benefitted from because of tax exemption. The royalty derived from the purchase of intangible property, therefore, is similar to the royalty derived from the self-created intangible asset, and both should be subject to tax. Only the royalty proceeds derived from the donation of intangible property to the nonprofit should be exempt from taxation. Distinguishing among self-created, purchased and donated royalties is one way to implement the accountability rationale.

Another way to implement the accountability rationale would be to establish a ceiling for the percentage of a nonprofit's income that may be derived from unrelated business activities. A percentage based on income may not be entirely appropriate, because income alone does not take into account the different expenses that different nonprofits may incur. A more useful measure might be established by comparing the relationship of a nonprofit's unrelated income to either its assets base, gross receipts, equity or some combination of the preceding.

A percentage limit would serve as a check on an exempt organization that begins to stray too far from its exempt purpose. This solu-

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of the income has become this significant, the royalty payments should still be entirely exempt. Perhaps an upward limit on the amount of a nonprofit's income from royalty payments from unrelated activities could be established.

tion also would avoid the difficulty of administration present in other proposals. If all exempt organizations were required to fill out more comprehensive forms documenting the sources of their income, then the Service would have both valuable data about exempt organizations' investment activities and a simple way to apply the percentage test. Once the percentage limit is determined, the value of this rule is apparent; the test can be applied mechanically. The Service need only make a straightforward mathematical determination.

Exactly how this percentage limit should be established is a more problematic question. The arbitrariness of any set percentage could be minimized by establishing industry-by-industry profit percentage ceilings. For each industry, at least two preliminary determinations would have to be made: (1) the potential amount of support the organization could get from the public if it were operated efficiently; and (2) the ceiling on the percentage of income from unrelated business activities that would compel an exempt organization to maximize its dependence on public support. Implementing a percentage limit would require more in depth knowledge of nonprofit behavior than is currently available. Nonetheless, a percentage limit could eventually eliminate some of the difficult, and perhaps insurmountable, interpretive questions raised by the current UBIT regime.

Finally, another means of implementing the accountability rationale would be to revive the principle of the pre-1950 "destination of income" test yet retain the substantially related test, as guided by the principle of accountability. The "destination of income" test has often been posited as the antithesis of the current UBIT provisions, when in fact the two may coexist. Focussing on the use to which an exempt organization's income is put, rather than focussing exclusively on the effect of its activities on the market, responds directly to concerns of accountability. Even if an exempt organization derives almost all of its income from related activities, the organization does not fulfill its promise to the public to further an exempt purpose if this income is not applied properly. The Service continues to use this test to determine an organization's eligibility for the underlying exemption.[289] It may therefore be logical to extend this rule to determine the taxation of income generated through unrelated activities. Under section 501(c)(3), for example, an organization must be operated "exclusively" for exempt purposes to qualify for tax exemption.[290] In addition, this section prohibits private inurement.[291] Under the regulation corresponding to section 501(c)(3), an organization may operate a trade or business as part of its activities so long as such trade or busi-

289. *See* Ellen P. Aprill, *Lessons from the UBIT Debate*, 45 Tax Notes 1105, 1107 (1989).
290. *See* I.R.C. § 501(c)(3)(1995).
291. *See id.* § 501(c)(3) (stating that no part of the net earnings of the nonprofit may inure to the benefit of any private shareholder or individual).

ness furthers an exempt purpose.[292] To determine whether the trade or business furthers an exempt purpose, the Service generally examines how the funds generated by the trade are used.[293] This examination of the use of an organization's funds should be extended to the use of an organization's unrelated funds.

Congress has already considered expanding its focus on the use of funds for the purpose of determining the underlying exemption of a nonprofit. For example, in 1993 the Oversight Subcommittee of the House Ways and Means Committee explored proposals to impose stricter regulation of public charities.[294] One of the proposals set forth required sanctions, short of revocation of exemption, for the excessive compensation of nonprofit executives.[295] Similarly, the attention on the reform of UBIT should be focussed on the use of a nonprofit's funds as well as the source of its funds. For too long commentators have focussed only on how nonprofits derive their funds; yet they have overlooked an equally important issue, where these funds are destined. For example, only one of the commentators who have written about NYU's macaroni monopoly has discussed or documented *where* the macaroni profits went.[296] Furthermore, no one has proven that Ronzoni suffered from NYU's foray into the macaroni market.[297] Only the derivation of these funds has been discussed. Absent a finding of adverse impact on NYU's competitors, perhaps the legislature should have responded to the alleged macaroni monopoly by refining and expanding the destination of income test.

CONCLUSION

The unfair competition rationale has proven to be an impracticable guiding principle for the imposition of UBIT and its royalty exception. The need to establish a workable rationale for the UBIT provisions will only increase with time. If an expansive interpretation of the

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292. *See* Treas. Reg. § 1.501(c)(3)-1 (as amended Aug. 30, 1990).

293. *See* Rev. Rul. 64-182, 1964-1 C.B. 186; *see also* Aprill, *supra* note 289 (explaining that to determine whether an organization qualifies for exemption from taxation the Service relies in part on a "destination of income" analysis).

294. *See* Robert A. Boisture & Milton Cerny, *Second Oversight Subcommittee Hearing Explores Need for Intermediate Sanctions and More Disclosure*, Tax Notes Today 188-42, Sept. 10, 1993, *available in* LEXIS Fedtax Library, TNT File.

295. *See id.*

296. *See* Comment, *supra* note 164, at 863 n.57. This is not to say that a tracing rule should be implemented. Because money is fungible, any standard should reflect what percentage of a nonprofit's gross income the unrelated income comprises. Suppose 90% of all unrelated income were required to be applied to further exempt purposes. Thus if a nonprofit derived 50% of its income from unrelated activities, then only five percent of its total gross income from related and unrelated activities could be reinvested in unrelated activities.

297. *See* United States v. American Bar Endowment, 477 U.S. 105, 122 n.4 (1986) (Stevens, J. dissenting).

royalty exception is upheld on appeal of *Sierra Club II*,[298] this may create a large loophole encouraging nonprofit and for-profit organizations to disguise their proceeds from joint ventures as royalty payments. This loophole could eventually represent a large loss of tax revenue to the Treasury.

Until Congress reforms UBIT and expresses an objective upon which both courts and the Service can rely, it will be difficult to determine how the royalty exception should be applied to innovative unrelated activities such as affinity card endorsements. Accountability offers a clear and rational objective for the provisions without having to rely on economic theories over which scholars conflict and that courts simply do not entertain. Furthermore, accountability provides a measure by which both the derivation and destination of a nonprofits's revenue may be assessed. Accountability suggests that the public should receive a benefit in exchange for the subsidy it has conferred through tax exemption. UBIT and its royalty exception need to be revised with a view to furthering the goal of accountability.

298. The Service appealed the decision on January 18, 1995. *See Report on Tax Court Cases on Appeal*, Tax Notes Today 22-64, Feb. 2, 1995, *available in* LEXIS, Fedtax Library, TNT File.