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Reforming Internal Revenue Code Provisions on Commercial Activity by Charities

Cover Page Footnote

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REFORMING INTERNAL REVENUE CODE PROVISIONS ON COMMERCIAL ACTIVITY BY CHARITIES

*John D. Colombo**

INTRODUCTION

In a 2002 article, Stephanie Strom of *The New York Times* reported that in the previous year, the Metropolitan Museum of Art had revenues of $96.6 million from its shops, restaurants, and parking garage, almost three times the revenue generated by admission and membership fees.[1] That same year, the Yale School of Management announced that it had secured grants totaling $4.5 million from the Pew Charitable Trusts and the Goldman Sachs Foundation to establish a program to help charities develop business plans for entering commercial markets.[2] A 2003 article in *Forbes* magazine reported on the wide-ranging business activities of "megachurches";[3] a 2001 article in *The Wall Street Journal* struck a similar note, commenting on how churches across the country were opening restaurants, Starbucks franchises, and private gyms.[4] Even the academic world has noticed the trend: In 1998, economist Burton A. Weisbrod and several of his colleagues published an entire book about the growing

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* Albert E. Jenner, Jr., Professor of Law, University of Illinois. My thanks to Evelyn Brody for her comments on an earlier draft of this article.

1. Stephanie Strom, *Nonprofit Groups Reach for Profits on the Side*, N.Y. Times, Mar. 17, 2002, at A32.

2. Press Release, Yale Sch. of Mgmt., Yale School of Management Receives Twin Grants Totaling $4.5 Million from the Goldman Sachs Foundation and the Pew Charitable Trusts to Foster Business Growth Among Nonprofit Organizations (Feb. 8, 2002) *available at* http://www.ventures.yale.edu/pr_2_6_02.asp.

3. Luisa Kroll, *MegaChurches, MegaBusinesses*, Forbes.com, Sept. 17, 2003, http://www.forbes.com/2003/09/17/cz_lk_0917megachurch.html.

> World Changers Ministries, for instance, operates a music studio, publishing house, computer graphic design suite and owns its own record label. The Potter's House also has a record label as well as a daily talk show, a prison satellite network that broadcasts in 260 prisons and a twice-a-week Webcast. New Birth Missionary Baptist Church has a chief operating officer and a special effects 3-D Web site that offers videos-on-demand. It publishes a magazine and holds Cashflow 101 Game Nights. And Lakewood Church, which recently leased the Compaq Center, former home of the NBA's Houston Rockets, has a four-record deal and spends $12 million annually on television airtime.

Id.

4. Elizabeth Bernstein, *Holy Frappucino!*, Wall St. J., Aug. 31, 2001, at W1.

commercial activities of charities,[5] and another book on the subject is forthcoming from the Urban Institute Press.[6]

Charities are not just conducting more commercial activities themselves, however. It is increasingly common to find charities engaged in a variety of economic activities through for-profit subsidiaries, joint-venture partnerships, and contractual arrangements. The health-care sector is perhaps the most visible in its use of complex structures, but they are also found in education and other traditionally charitable activities.[7]

Commercial activity by charities, therefore, seems to be an entrenched and growing phenomenon. Since other contributions to this Symposium will discuss the current trends regarding commercial activity by charities and whether that activity is desirable as a policy matter, I will confine this essay to a discussion of the federal income tax rules surrounding commercial activity and some suggestions on how to harmonize those rules depending on one's policy objectives.

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5. To Profit or Not to Profit (Burton A. Weisbrod ed., 1998).

6. Nonprofits and Business: A New World of Innovation and Adaptation (Joseph J. Cordes & C. Eugene Steuerle eds., forthcoming).

7. One of the more famous recent cases illustrating a complex structure was *Geisinger Health Plan v. Commissioner*, 100 T.C. 394 (1993). As explained by the U.S. Tax Court,

> Petitioner owned and operated a health maintenance organization (HMO) under the Pennsylvania Health Maintenance Organization Act .... Petitioner was one of nine related organizations. The eight other organizations, referred to collectively as the Geisinger system and described below, were the Geisinger Foundation (the foundation), Geisinger Medical Center (GMC), Geisinger Clinic (the clinic), Geisinger Wyoming Valley Medical Center (GWV), Marworth, Geisinger System Services (GSS), and two professional liability trusts. Each of these eight entities was recognized by the Internal Revenue Service as an exempt organization described in sections 170(b)(1)(A)(iii), 501(c)(3), and 509(a)(1).
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> The foundation controlled petitioner and the other entities in the Geisinger system, as well as three for-profit corporations. The foundation had the power, under the articles of incorporation and bylaws of petitioner, GMC, GWV, GSS, the clinic, and Marworth, to appoint the corporate members of those entities, who in turn elected their respective boards of directors. The foundation's board of directors was composed of civic and business leaders who were representative of the general public in northeastern and north-central Pennsylvania and were public-spirited citizens. The foundation raised funds for the Geisinger system's numerous charitable purposes and activities.

Id. at 395–96. Although a large percentage of complex structures come from the health-care sector, they exist in other sectors as well. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 95-06-046 (Nov. 17, 1994) (ruling on a case in which a business league exempt under § 501(c)(6) established first- and second-tier subsidiaries to construct and operate a golf course); I.R.S. Gen. Couns. Mem. 39,776 (Jan. 24, 1989) (analyzing a situation in which an exempt university controlled a § 501(f) organization that in turn controlled a taxable subsidiary). *See generally* Frances R. Hill & Douglas M. Mancino, Taxation of Exempt Organizations ¶¶ 27-1, 27-46 (2006) (discussing exempt organizations' use of complex structures of related exempt and taxable entities); James J. McGovern, *The Use of Taxable Subsidiary Corporations by Public Charities—A Tax Policy Issue for 1988*, 38 Tax Notes 1125 (1988) (discussing use of taxable subsidiaries by exempt organizations).

I. THE CURRENT TAX RULES[8]

Federal tax rules regarding commercial activity involve two main issues and two subsidiary ones.[9] The first main issue is whether the activity jeopardizes the charity's tax exemption under § 501(c)(3) of the Internal Revenue Code (Code). Commentators have referred to this first issue as the "commerciality doctrine."[10] The second main issue is whether, if commercial activity does not jeopardize exemption, it nevertheless should be taxed. This issue is covered by the Unrelated Business Income Tax (UBIT) in §§ 511 to 514 of the Code, established in 1950. The two subsidiary issues are (1) whether commercial activity undertaken by entities related to a charity (e.g., a subsidiary of a charitable parent, a sibling for-profit corporation, or a partnership in which a charity is a partner) will be imputed to the exempt entity for purposes of determining their tax-exempt status, and (2) how the Internal Revenue Service (IRS) uses the private benefit doctrine to police economic transactions with for-profit entities or individuals outside the charitable class. This part of the essay describes the current doctrine applicable to each of these issues.

A. *The Commerciality Limitation Versus the UBIT*

Though § 501(c)(3) states that an organization will qualify for exemption only if it is "organized and operated *exclusively*" for a charitable purpose, the statute has almost never been interpreted literally. As early as 1924, the U.S. Supreme Court held that a religious order would not lose exemption because of its limited sales of wine and chocolate.[11] Over time, this and subsequent cases established what was known as the "destination of income" test for exemption: An organization could engage in unlimited amounts of commercial activity as long as the revenues from that activity were used for charitable purposes.[12] Even organizations whose only activity was running a commercial business were exempt if they paid over their revenues to charities.[13]

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8. Parts of this section are copied or adapted from John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 Wm. & Mary L. Rev. 487 (2002) [hereinafter Colombo, *Commercial Activity*], and John D. Colombo, *Regulating Commercial Activity by Exempt Charities: Resurrecting the Commensurate-in-Scope Doctrine*, 39 Exempt Org. Tax Rev. 341 (2003) [hereinafter Colombo, *Commensurate-in-Scope*].

9. *See generally* James J. Fishman & Stephen Schwarz, Nonprofit Organizations 593–96 (3d ed. 2006); Colombo, *Commercial Activity*, *supra* note 8, at 491.

10. Fishman & Schwarz, *supra* note 9, at 593; Bruce R. Hopkins, The Law of Tax-Exempt Organizations 727–41 (9th ed. 2007); Colombo, *Commercial Activity*, *supra* note 8, at 491.

11. Trinidad v. Sagrada Orden, 263 U.S. 578, 582 (1924).

12. Fishman & Schwarz, *supra* note 9, at 596; Hill & Mancino, *supra* note 7, ¶ 21.01; Hopkins, *supra* note 10, at 732; Colombo, *Commercial Activity*, *supra* note 8, at 498–99.

13. *See, e.g.*, C.F. Mueller Co. v. Comm'r, 190 F.2d 120 (3d Cir. 1951) (finding that a corporation that made macaroni was exempt from paying income tax because revenues were paid to New York University's law school).

The destination of income test was overruled by Congress (at least in part) in 1950, when it passed the UBIT and prohibited exemption for "feeder" organizations.[14] These laws made taxable the revenues from commercial activities that were unrelated to charitable purposes, and also prohibited exemption for the entity whose sole activity was operating a commercial business, even if the revenues were paid over to charity.[15] But Congress said nothing in the UBIT and related legislation about whether commercial activity by an organization that otherwise had a bona fide substantial charitable purpose should affect exemption. One could argue, in fact, that the adoption of the UBIT was an implicit blessing for charities to engage in significant amounts of commercial activity, since unrelated activity now would be taxed and related activity (presumably) was not viewed as a problem.[16]

The final regulations adopted by the IRS in 1959, however, are confusing. The UBIT uses a relatedness test for determining taxability. Under the UBIT, commercial activity is taxable if it is not "substantially related" to the organization's exempt purpose.[17] According to the regulations implementing the UBIT, an activity is "substantially related" if "the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption."[18] The key phrase in this regulation is the parenthetical "other than through the production of income." That is, it is clear from the UBIT regulations that a commercial activity whose purpose is simply to provide a revenue stream for charitable activities is not related and therefore is taxable. Instead, relatedness is a functional concept focused on how the

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14. I.R.C. §§ 502, 511–514 (2000). A "feeder" is an entity that operates a commercial business but is obligated to pay the net revenues of that business over to an exempt charity. *See* Fishman & Schwarz, *supra* note 9, at 596.

15. Fishman & Schwarz, *supra* note 9, at 596; Hill & Mancino, *supra* note 7, ¶ 27.04; Hopkins, *supra* note 10, at 720; Colombo, *Commercial Activity*, *supra* note 8, at 500.

16. Indeed, Professor Ethan Stone has argued that the UBIT was largely political symbolism. His review of the history of the UBIT indicates that there was little complaint about unfair competition prior to the enactment of the UBIT, and that the law really was a political response to for-profit firms using charities as tax shelters, along with some highly publicized cases of charities undertaking decidedly uncharitable activities. Thus, he argues that the UBIT was largely designed to keep charities from wandering too far from traditional good works that defined the charitable sector. *See generally* Ethan Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 Emory L.J. 1475 (2005). Stone's analysis supports the proposition that related business activity should have no bearing on exempt status, and that Congress believed it adequately responded to the threat of unrelated activity by taxing it, rather than revoking exemption because of it. *Id.* at 1505. The counterargument here is that if Congress really did view the UBIT as mostly a "border-patrol" measure (a phrase first used by Professor John Simon in describing the various tax rules applicable to exempt organizations), then perhaps excessive unrelated business should cause loss of exemption due to inappropriate border crossing.

17. I.R.C. § 513(a) (2000). For a more extensive discussion of the UBIT rules, see Michael S. Knoll, *The UBIT: Leveling an Uneven Playing Field or Tilting a Level One?*, 76 Fordham L. Rev. 857 (2007).

18. Treas. Reg. § 1.513-2(a)(4) (2006).

underlying nature of the commercial activity integrates with the exempt entity's charitable purpose, not on where the revenues from the commercial activity end up. But these regulations say nothing about whether commercial activity, related or unrelated, should affect exempt status.

With respect to the exempt status issue, Treasury Regulation § 1.501(c)(3)-1(b)(1)(i) state that an exempt charity's organizational document (e.g., articles of incorporation or trust agreement) may not empower it to "engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes."[19] A couple of paragraphs later, the regulations warn that an organization will fail to qualify for exemption "if more than an insubstantial part of its activities is not in furtherance of an exempt purpose."[20] But an even later part of the regulations (§ 1.501(c)(3)-1(e)) states that an organization may qualify for exemption even if

> it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business.[21]

It appears from these regulations, therefore, that the key concept in determining the effect of commercial activity on exempt status (as opposed to whether the commercial activity is taxable under the UBIT) is the concept of "in furtherance of." The regulations, particularly Treasury Regulation § 1.501(c)(3)-1(e), seem to say that unrelated business activities that are in furtherance of can be substantial without endangering exempt status; activities that are not in furtherance of, however, must be insubstantial in order to retain exemption.

The problem is that the regulations under § 501(c)(3) do not tell us anything about when a commercial activity is or is not considered in furtherance of an exempt purpose. Thus, one possible interpretation of the regulations is that in furtherance of is equivalent to substantially related under the UBIT. Or, put the opposite way, one might conclude that any unrelated activity under the UBIT is not in furtherance of, and any substantial amount of unrelated commercial activity therefore creates exemption problems.[22] Certainly, one cannot see related activity as creating exemption problems; if an activity is related for UBIT purposes, then by definition it must functionally advance the organization's exempt purpose, and hence must be viewed as being in furtherance of that purpose. But the contrary proposition (that unrelated activity automatically is not in furtherance of) is not necessarily true. In fact, if this proposition were

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19. *Id.* § 1.501(c)(3)-1(b)(1)(i)(B).
20. *Id.* § 1.501(c)(3)-1(c)(1).
21. *Id.* § 1.501(c)(3)-1(e)
22. *See* Jessica Pena & Alexander L.T. Reid, *A Call for Reform of the Operational Test for Unrelated Commercial Activity in Charities*, 76 N.Y.U. L. Rev. 1855, 1863–64 (2001).

correct, then the statement in Treasury Regulation § 1.501(c)(3)-1(e) quoted above, that an organization may operate a business as long as the primary purpose is not carrying on an unrelated business, makes no sense. If any unrelated business were viewed as not being in furtherance of, then any unrelated business that was substantial would cause an organization to lose exempt status. A substantial business is presumably well short of one that is a primary purpose; therefore, the reference in Treasury Regulation § 1.501(c)(3)-1(e) to an organization losing exemption when an unrelated business becomes its primary purpose would be completely meaningless, because any substantial unrelated business would cause loss of exemption even if that business was not the primary purpose.

The only sensible harmonization of these regulations, therefore, is that in enacting the UBIT Congress did not intend to alter the destination of income test for the purpose of granting exemption to an entity in the first instance.[23] That is, unrelated business activity is taxed, but if the proceeds are used to support charitable activities, the organization in question is still entitled to an exemption (for its other income). It is only when the operation of the unrelated business becomes the entity's primary purpose that it loses exempt status, because at that point (obviously) the entity's primary purpose is no longer charitable. Put another way, "in furtherance of" has two meanings: Commercial activity may be in furtherance of an exempt purpose by being functionally related to that purpose (for example, the music school of an exempt university puts on concerts for which it charges admission fees) or by being a source of revenue to expand charitable outputs.

Early interpretations of the regulations by the IRS seemed to support the notion that even substantial unrelated business activity would not endanger exempt status as long as the revenues from that activity (which, of course, would be taxable under the UBIT) were used for charitable purposes. In Revenue Rule 64-182,[24] the IRS considered a case in which an exempt organization derived its revenues largely from renting space in a commercial office building; the revenues were used to make grants to other charitable entities. Concluding that the rental activity was unrelated for purposes of the UBIT, the IRS nevertheless ruled that the organization was entitled to retain its exempt status as an organization described under § 501(c)(3) because it was carrying on a charitable program "commensurate in scope" with its financial resources.[25]

The background to the 1964 revenue ruling, however, is more revealing than the ruling itself in interpreting the "commensurate in scope" language. Prior to approving the 1964 revenue ruling, the general counsel's office referred the issue in the proposed ruling to the Exempt Organizations

23. *See* Ellen P. Aprill, *Lessons from the UBIT Debate*, 45 Tax Notes 1105, 1107 (1989).

24. 1964-1 C.B. 186.

25. *Id.* at 187.

Council for analysis. The council's analysis, attached to General Counsel Memorandum 32,689,[26] contained two primary conclusions. First, "the amount of expenditures of an organization for charitable purposes must be taken into consideration in equating business activities with charitable activities" under the primary purpose test of § 1.501(c)(3)-1(c). Second, if after considering such expenditures "an organization is shown in fact to be carrying on a real and substantial charitable program reasonably commensurate in financial scope with its financial resources and its income from its business activities and other sources," then the organization would be considered as having a charitable primary purpose.[27] According to the council's analysis, the primary purpose test "becomes a test of whether there is a real, bona fide, or genuine charitable purpose . . . and not a mathematical measuring of business purpose as opposed to charitable purpose."[28] Or in other words, (1) primary purpose cannot be determined by a mathematical comparison of size based upon number of employees, space utilized, or similar factors—there is no specific mathematical limit on unrelated business activities, and (2) the dedication of net revenues from an unrelated business to charitable purposes is a necessary part of the analysis of the effects of unrelated business activity on tax exemption, and such dedication itself is evidence that an organization's primary purpose is charitable. On the other hand, the council indicated that when the operation of a substantial unrelated business did not result in cross-subsidization, the organization was no longer being operated primarily for charitable purposes.[29] By implication, the council's analysis seemed to be that dedication of revenues from commercial activity to charitable activities was in furtherance of a charitable purpose.

A later general counsel memorandum further illuminated the commensurate in scope idea. This memo provides perhaps the best analysis of the doctrine and related issues of any IRS document. Reaffirming the original view of the Exempt Organizations Council that there were no bright-line tests in determining whether unrelated business activity was consistent with exempt status, the memo stated,

> [A]side from express statutory limitations on business activity, such as section 502 and the newly enacted provisions relating to private foundations, there is no quantitative limitation on the "amount" of unrelated business an organization may engage in under section 501(c)(3), other than that implicit in the fundamental requirement of charity law that charity properties must be administered exclusively in the beneficial interest of the charitable purpose to which the property is dedicated.

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26. I.R.S. Gen. Couns. Mem. 39,862 (Oct. 9, 1963).

27. *Id.*

28. *Id.*

29. As summarized by the counsel's office in General Counsel Memorandum 34,682 (Nov. 17, 1991), "the Council's supporting Appendix also indicated that, aside from the 'primary purpose' requirement of the regulations, the better logic in cases in which the business activity does not in fact provide any significant funds for charitable use is that the organization is not being operated exclusively for charitable purposes."

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> [F]or some time now it has been increasingly apparent that our earlier approach to the problem of permissibility or nonpermissibility of business activities of charities has been based on a misconception that somehow in the enactment of the provisions for exemptions of charities from income tax, Congress intended an implied restriction on the extent of their engagement in business activities. In the years past, the Service sought by ruling and by litigation to deny the right of charities to engage in business, insisting that somewhere, somehow in the enactment of the exemption provisions Congress must have intended to limit the classification of exempt charities to those charities not engaging to any substantial extent in commercial endeavors.
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> Exhaustive research of legislative history from the earliest enactment of the charitable provisions of our income tax laws fails to provide support for such proposition. To the contrary, the evidence is clear that the first provision for exemption of charities from imposition of tax under the Corporation Excise Tax of 1909, from which the present income tax exemption provisions derive, was accompanied not by any intention to limit exemption to charities not engaged in business, but an intention to assure exemption of certain charities that were engaged in business.[30]

The memo also addressed the issue regarding what should happen in cases in which the operation of an unrelated business either produced no profit to subsidize charitable activities or in which the profit was purposely reinvested to grow the unrelated business, as opposed to dedicated to expanding charitable outputs. As to the former case, the memo agreed with the original position of the council that "the better logic in cases in which the business activity does not in fact provide any significant funds for charitable use is that the organization is not being operated exclusively for charitable purposes."[31] With respect to the latter case, the memo observed,

> [W]e think that if an organization devotes its resources to business use which produces a reasonable return on the investment, but refuses to apply any significant part of its profits or resources to any charitable program and the condition prevailed for an unwarranted long time, a prima facie case could be made out that the organization is not administering its properties exclusively in the beneficial interest of charity since it is neither accomplishing any short range or any long range charitable purpose in respect to the beneficial use of its properties.[32]

The memo cautioned, however, that each such case would need to be resolved on its particular facts and circumstances.

Despite what seems to be the clear indication of the Treasury Regulations and the general counsel memoranda that even substantial amounts of unrelated commercial activity should not necessarily result in loss of

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30. I.R.S. Gen. Couns. Mem. 34,682 (Nov. 17, 1971) (footnotes omitted).
31. *Id.*
32. *Id.*

exempt status, the IRS has been wildly inconsistent in analyzing the effects of commercial activity in actual litigated cases and even in its own internal rulings. The problem is that the IRS tends to analyze cases as either UBIT cases or exemption cases, rather than asking whether a particular activity is (1) subject to the UBIT, and if so, then (2) asking whether it should affect exempt status. Moreover, these cases almost universally ignore the key question posed by Treasury Regulation § 1.501(c)(3)-1(e)—that is, whether a commercial activity is in furtherance of an exempt purpose. Instead, the case law has evolved into asking whether a particular activity has a commercial hue, and if so, whether it is substantial. Positive answers to these questions generally lead to loss of tax exemption, though even here the analysis is variable.

For example, in *Scripture Press Foundation v. United States*,[33] the taxpayer, Scripture Press, was formed primarily to improve the quality of teaching texts for Protestant Sunday schools.[34] Soon, the company found itself highly successful in preparing and selling a variety of religious literature, accumulating over $1.6 million in surplus earnings by 1957.[35] As a result, the IRS revoked exempt status for the organization, claiming that it in effect was nothing more than a for-profit publisher and hence no longer was operated primarily for charitable purposes.[36] The U.S. Court of Claims agreed with the IRS, noting that Scripture Press priced its products similarly to for-profit competitors and amassed significant profits.[37] Though it had an educational program aimed at promoting and expanding Sunday school instruction, the court found that expenditures on educational activities were "unaccountably small" in comparison to the surplus that Scripture Press accumulated annually.[38] Accordingly, the court concluded that Scripture Press was not operated primarily for charitable purposes.[39] Subsequently, the U.S. Tax Court and federal district courts upheld the IRS's revocation of exemption in a number of other publishing cases.[40]

As a result of *Scripture Press* and subsequent cases, by the early 1980s the Tax Court had developed the view that an organization that conducted a significant activity with a commercial hue risked losing exempt status. Factors which painted an activity with this impermissible hue included the presence of substantial overall profits, using commercial pricing methods

33. 285 F.2d 800 (Ct. Cl. 1961).
34. *Id.* at 802.
35. *Id.* at 804.
36. *Id.* at 802 ("The defendant contends with equal vigor that plaintiff's purpose is the preparation and sale of religious literature, and that it is therefore not 'operated exclusively' for religious and charitable purposes.").
37. *Id.* at 804–05.
38. *Id.*
39. *Id.* at 806.
40. Inc. Trs. of Gospel Worker Soc'y v. United States, 510 F. Supp. 374, 381 (D.D.C. 1981), *aff'd*, 672 F.2d 894 (D.C. Cir. 1981); Elisian Guild, Inc. v. United States, 292 F. Supp. 219 (D. Mass. 1968), *rev'd*, 412 F.2d 121, 126 (1st Cir. 1969); Fides Publishers Ass'n v. United States, 263 F. Supp. 924 (N.D. Ind. 1967); Presbyterian & Reformed Publ'g Co. v. Comm'r, 79 T.C. 1070 (1982), *rev'd*, 743 F.2d 148, 159 (3d Cir. 1984).

with substantial net profit margins, and competing with for-profit firms in the same sector.[41] In 1991, the U.S. Court of Appeals for the Seventh Circuit in *Living Faith v. Commissioner* adopted this basic analysis in the context of an organization affiliated with the Seventh-day Adventist Church that operated vegetarian restaurants and health food stores, ostensibly to advance church doctrine relating to diet.[42] In reviewing a Tax Court opinion denying exempt status to the organization, the Seventh Circuit identified several factors leading to a conclusion that the organization violated the commerciality doctrine. These included (1) direct competition with commercial firms, including similar locations (in shopping centers) and similar hours of operation; (2) a pricing structure designed to produce a profit; (3) extensive advertising and use of commercial advertising materials; and (4) a lack in the record of any showing of donations to the organization or significant relief of the poor.[43]

Unfortunately, neither *Scripture Press, Living Faith*, or the myriad commercial hue cases in between answer (or even ask) the key question—whether the operation of the commercial activity was in furtherance of the organization's exempt purpose. Indeed, these cases seem to invariably confuse charitable purpose with the activities undertaken in pursuit (arguably) of that purpose. If promoting religion is a charitable purpose (as § 501(c)(3) seems to make it), then it is unclear why publishing religious books (*Scripture Press*) or selling health foods (*Living Faith*) in order to spread the faith are not considered functionally in furtherance of an exempt purpose.

On the other side of the ledger, in 1984 the U.S. Court of Appeals for the Third Circuit reversed the revocation of exempt status for a religious publisher in *Presbyterian & Reformed Publishing v. Commissioner*,[44] a case substantially similar to *Scripture Press*. The taxpayer in *Presbyterian & Reformed Publishing* was a highly profitable nondenominational religious publisher that priced its products at market. Though the Tax Court upheld an IRS revocation of exempt status on the ground of impermissible commercial hue based primarily on the large profits generated by the taxpayer's publishing business,[45] the Third Circuit reversed, noting that "success in terms of audience reached and influence exerted, in and of itself, should not jeopardize the tax-exempt status of organizations which remain true to their stated goals."[46] A charitable organization, according to

41. *Presbyterian & Reformed Publ'g Co.*, 79 T.C. at 1083.

42. Living Faith v. Comm'r, 950 F.2d 365, 367 (7th Cir. 1991) ("According to its articles of incorporation, Living Faith was established for the purpose of keeping with the doctrines of the Seventh-day Adventist Church.... Good health, according to Seventh-day Adventists, promotes virtuous conduct, and is furthered by a vegetarian diet and abstention from tobacco, alcohol, and caffeine.").

43. *Id.* at 373–75.

44. 743 F.2d 148.

45. *Presbyterian & Reformed Publ'g Co.*, 79 T.C. at 1083.

46. *Presbyterian & Reformed Publ'g Co.*, 743 F.2d at 158.

the Third Circuit, should be able to make money to expand its audience and influence, and doing so does not make the organization any less charitable.

Similarly, the Tax Court itself approved exemption in several resale shop cases—situations in which a nonprofit enterprise primarily operated a business selling crafts produced by a particular group. In the late 1970s, for example, the Tax Court approved exemption for an organization that imported, purchased, and sold artists' crafts;[47] an organization that purchased and sold products manufactured by blind individuals;[48] and an organization that operated two public art galleries.[49] A federal appellate court also reversed a lower court ruling upholding a revocation of exemption on commerciality grounds when the taxpayer, a publishing company, showed that it had no "operational profits."[50]

Even the IRS itself has approved charities engaging in activities with decidedly commercial hues—for example, hospitals and educational organizations can operate health clubs that charge fees similar to for-profit competitors without endangering exempt status, although the income from these activities may in part be subject to taxation under the UBIT.[51] Some recent private rulings, moreover, have reverted to commensurate in scope analysis, approving exemption for an organization that published textbooks for religious schools, even though revenues from the publishing business accounted for over half of the organization's total revenues and enjoyed 75% profit margins;[52] for an organization that helped developmentally

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47. Aid to Artisans, Inc. v. Comm'r, 71 T.C. 202 (1978). The organization claimed that its charitable purposes were "(1) [h]elping disadvantaged artisans in poverty stricken countries to subsist and to preserve their craft; and (2) furnishing services to tax-exempt museums by providing museum stores with representative handicrafts from disadvantaged countries." *Id.* at 209.

48. Indus. Aid for the Blind v. Comm'r, 73 T.C. 96 (1979). The charitable purpose was to provide employment for the blind and thus came within the regulations' statement that a charitable purpose includes "[r]elief of the poor and distressed or the underprivileged." *Id.* at 101. *See* Treas. Reg. 1.501(c)(3)-1(d) (2006).

49. Goldsboro Art League v. Comm'r, 75 T.C. 337 (1980).

50. Elisian Guild, Inc. v. United States, 412 F.2d 121, 125 (1st Cir. 1969).

51. *See generally* Virginia Richardson, Roderick Darling & Marvin Friedlander, *Health Clubs*, *in* IRS, Exempt Organizations Continuing Professional Education (CPE) Technical Instruction Program for Fiscal Year 2002, at 2, 13–14 (2001), *available at* http://www.irs.gov/pub/irs-tege/eotopica00.pdf (noting that the operation of a health club by a university or hospital generally does not affect exempt status and that income from memberships sold to the general public—as opposed to students and faculty or patients and staff—is generally taxable under the UBIT).

52. I.R.S. Tech. Adv. Mem. 96-36-001 (Jan. 4, 1995). The organization started its publishing activities to supply its own schools with textbooks, but soon expanded to provide religious-oriented textbooks to schools worldwide. Revenues from the publishing business constituted over half the total gross revenues of the organization, and its profit margins were as high as 75%, though expenditures on the publishing business were less than half the organization's total expenditures. Finding that the publishing activities were virtually indistinguishable from those of a commercial religious publisher and that they were not substantially related to the educational activity of operating its own religious schools, the Internal Revenue Service (IRS) concluded that the profits of the activity were subject to the UBIT. At the same time, however, the IRS concluded that the obviously substantial nature of the publishing business did not endanger the taxpayer's exempt status because "[t]here is

disabled children, despite receiving 98% of its gross income from bingo games;[53] and for an organization formed to give financial assistance to needy women that produced 66% of its revenues from the operations of a gift shop and tearoom.[54] Nevertheless, the IRS has continued to push the commercial hue test in litigation,[55] and several recent applications for exempt status have been rejected by the IRS on grounds that the organization's activities were no different from commercial enterprises.[56]

In short, the Treasury Regulations, IRS interpretations and litigating positions, and court cases all seem to be inconsistent in judging when commercial activity should result in loss of exempt status. In particular, neither the IRS nor the courts have analyzed consistently the main issue

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no evidence that any of the funds generated by [the publishing business] were not properly used to further the organization's education purposes in some manner." *Id.* Accordingly, the taxpayer was entitled to exemption "because it [was] carrying on an exempt program commensurate in scope with its financial resources." *Id.*

53. I.R.S. Tech. Adv. Mem. 97-11-003 (Nov. 8, 1995); *see also* D. Benson Tesdhal, *Letter Ruling Alert: IRS Applies Liberal Primary Purpose and Commensurate Tests*, 16 Exempt Org. Tax Rev. 617 (1997). The organization represented that 50% of its time and resources were dedicated to bingo games, although over 95% of its gross income was used for bingo operations; expenditures on charitable activities ranged from about 1.4% to 3.5% during the years in question. Nevertheless, the IRS summarily dismissed the notion that this organization had any commensurate problems, noting that for thirty years the organization had been assisting developmentally disabled children and spent over 40% of its time and resources doing so. Accordingly, the commensurate in scope test "would not be applicable since the Association has a substantial charitable program in addition to its fundraising activities." *Id.* at 628. In the ruling, the IRS noted that although income from bingo games was specifically excluded from the UBIT in I.R.C. § 513(f) (2000), that exclusion "was not intended to result in exemption for organizations whose primary activity is the conduct of bingo. Bingo remains an activity unrelated to exempt purposes and alone cannot support exemption . . . ." *Id.* at 627.

54. I.R.S. Priv. Ltr. Rul. 2000-21-056 (Feb. 8, 2000). In this ruling, the IRS reasoned that an unrelated business that is used as a fund-raiser for an overall charitable purpose was operated in furtherance of a charitable purpose and did not constitute a substantial nonexempt purpose. *Id.* ("One way in which a trade or business may be in furtherance of exempt purposes is to raise money for the exempt purposes of the organization, notwithstanding that the actual trade or business activity may be taxable under sections 511 through 513."). Similarly, in I.R.S. Field Service Advice 1999-10-007 (Nov. 24, 1998), the IRS concluded that an organization operating a sports tournament whose net proceeds were turned over to another charity met the commensurate in scope requirement. For additional analysis of the checkered history of the commensurate in scope test, see Evelyn Brody, *A Taxing Time for Bishop Estate: What Is the I.R.S. Role in Charity Governance?*, 21 U. Haw. L. Rev. 537, 575–76 (1999).

55. *See, e.g.*, Airlie Found. v. IRS, 283 F. Supp. 2d 58 (D.D.C. 2003) (holding that an organization that rented conference facilities to other charities and helped with conference logistics is not exempt because its activities were conducted in a commercial manner).

56. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2007-04-041 (Oct. 30, 2006) (finding that an organization that provided down-payment assistance to U.S. Department of Housing and Urban Development-qualified home buyers was not exempt). "The manner in which you operate your down-payment assistance program indicates that you facilitate the sales of homes in a manner that is indistinguishable from an ordinary trade or business." *Id.*; *see also* I.R.S. Priv. Ltr. Rul. 2006-51-037, at 6 (Sept. 28, 2006) (holding that an organization formed to sell items for individuals and to transfer proceeds to the charity of an individual's choice was performing services as an agent for a donor "which are characteristic of a trade or business and ordinarily carried on by for-profit commercial businesses").

raised by the regulations: when (particularly unrelated) commercial activity will be considered in furtherance of an exempt purpose as opposed to simply primarily an unrelated business.

B. *Complex Structures*

The conflict between relatedness and in furtherance of is not the only inconsistency in the commercial activity realm. IRS positions on how complex structures affect exempt status are also conflicting. In general, the IRS adheres to the view that corporate entities stand on their own for tax-exemption purposes—that is, the activities (charitable or commercial) of one corporate entity will not be imputed to a related entity for either good (obtaining exempt status) or ill (revoking exemption). This "separate corporate identity" rule is a long-standing feature of corporate tax law, where treating an entity as a bona fide, separate business container is necessary to protect the corporate tax base.[57] When it comes to joint ventures conducted in a partnership form (or in a limited liability company taxed as a partnership), however, the IRS position is that the partner is deemed to be in the same trade or business as the partnership—that is, the partner is deemed to be conducting directly the business of the partnership.[58] This aggregate view of partnerships is also a long-standing rule of general tax law.[59]

In one sense, therefore, the IRS has been perfectly consistent in adopting for tax exemption the same rules that apply in general tax law regarding the separateness of entities. In a larger sense, however, these rules mean that

57. Moline Props., Inc. v. Comm'r, 319 U.S. 436 (1943). In *Moline Properties*, the taxpayer argued that a corporation that sold certain real estate should be disregarded, and the proceeds of sale should be taxed directly to the corporation's sole shareholder. The U.S. Supreme Court ruled that the tax system must respect the separate identity of a corporation formed for valid business reasons, thus protecting the integrity of the corporate income tax. In General Counsel Memorandum 39,326 (Jan. 17, 1985), the IRS applied the *Moline Properties* doctrine in assessing the exempt status of a nonprofit parent that owned a for-profit subsidiary, concluding that the subsidiary's activities would not be imputed to the nonprofit parent. *See* Colombo, *Commercial Activity*, *supra* note 8, at 515. For an extended discussion of the *Moline Properties* doctrine in the context of tax exemption, see Hill & Mancino, *supra* note 7, ¶ 27.02.

A subsidiary corporation of an exempt parent can sometimes claim tax exemption as an integral part of the parent's exempt activities. In general, the IRS position is that the integral part test is available only to captive subsidiaries that perform services exclusively for the exempt parent, such as a subsidiary that generates electrical power for its parent. Treas. Reg. § 1.502-1(b) (2006). For general discussions of the integral part doctrine, see Hill & Mancino, *supra* note 7, ¶ 27.04; John D. Colombo, *The IHC Cases: A Catch-22 for Integral Part Doctrine, A Requiem for Rev. Rul. 69-545*, 34 Exempt Org. Tax Rev. 401 (2001).

58. *See, e.g.*, Rev. Rul. 98-15, 1998-1 C.B. 718, 720–21.

59. *See, e.g.*, Butler v. Comm'r, 36 T.C. 1097, 1106 (1961) (holding that a partner in a partnership was engaged in the business of the partnership and therefore qualified for a bad-debt deduction). "By reason of being a partner in a business petitioner was individually engaged in a business." *Id.* For a general discussion of the aggregate concept in partnership taxation, see William S. McKee, William F. Nelson & Robert L. Whitmore, Federal Taxation of Partnership and Partners ¶ 1.02 (4th ed. 2007).

the effects of a particular business activity on exemption and the potential that such activity will be taxed can be dramatically altered by the form of the container in which the business is conducted. For example, under current rules, an exempt entity could sit at the top of an extensive for-profit corporate business pyramid, and the corporate isolation rule would mean that the exempt parent would be essentially immune from claims that the overall activities of the group were not charitable.[60] By comparison, a charity that operated a substantial business enterprise via a partnership would place its exempt status at risk under the current version of the commerciality doctrine described above.[61] At the same time, an exempt organization that isolated a particular business activity in a corporate container for regulatory or liability reasons would lose any possibility of arguing that the business was related to the exempt organization's charitable purpose, since the parent's charitable activities could not be attributed downstream to the subsidiary corporation.[62] At one time, even the Treasury

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60. One private ruling issued in 2004 suggests (in the mode of the commensurate in scope doctrine discussed above) that an exempt parent must somehow use revenues or assets of its for-profit subsidiaries to further its charitable purpose, or else it may run afoul of the primary purpose test. In Technical Advice Memorandum 2004-37-040 (June 7, 2004), the IRS examined whether large accumulations of value in a for-profit subsidiary of an exempt church would result in loss of exempt status. While the IRS ruled that it would not under the particular facts presented, its analysis suggests an ongoing obligation for an exempt parent to use revenues/assets from a for-profit subsidiary to expand charitable outputs, à la the commensurate in scope doctrine. In this private ruling the IRS stated,

> In post-audit years, it appears that the subsidiary grew rapidly—perhaps beyond X's expectations. It is now worth several times X's investment in the subsidiary, although it apparently had not earned an operating profit through * * *. This growth presents a continuing obligation on X to translate this valuable asset into funds, and use those funds for the expansion of its charitable religious activities. For example, X may have to give consideration to selling some of the subsidiary's assets, or selling a portion of the stock of the subsidiary, to an unrelated party. The proceeds of such transactions must be used to fund or expand X's charitable or religious activities. The subsidiary should give highest priority to repaying X's investment loans once it begins generating cash flow or earnings and profits, so that these funds can be used for X's charitable or religious activities. X cannot be allowed to focus its energies on expanding its subsidiary's commercial business and assets, and neglect to translate that financial success into specific, definite and feasible plans for the expansion of its charitable religious activities. . . . The fact that the assets are being accumulated in a for-profit company under the formal legal control of X does not excuse X from using such assets for charitable religious purposes.

I.R.S. Tech. Adv. Mem. 2004-37-040 (June 7, 2004).

61. *See supra* Part II.A.

62. For example, we know from recent case law that a contract-model HMO will find it difficult to obtain exemption under 501(c)(3) if the HMO business is in a separate corporation. *See, e.g.*, IHC Health Plans, Inc. v. Comm'r, 325 F.3d 1188 (10th Cir. 2003). It is not clear, however, whether revenues from an HMO that was operated as a division of a nonprofit corporation that operated an exempt acute care hospital would be taxable or not; one could certainly argue that such revenues are substantially related to the hospital's exempt purpose of providing health care for the general benefit of the community, although some older IRS rulings suggest that if a hospital receives revenues from persons other than hospital patients, such revenues would be unrelated. *See, e.g.*, I.R.S. Gen. Couns. Mem. 39,830 (Aug. 30, 1990) (suggesting that an HMO might be considered an unrelated business

itself questioned the wisdom of these rules,[63] although there are no current legislative proposals to change them.

C. *Private Benefit*

The final issue that comes up repeatedly in the commercial-activity sphere is the private benefit doctrine. Even trying to summarize the private benefit doctrine is hazardous, but from a variety of IRS rulings and litigated cases, one might conclude that private benefit is a benefit (usually economic) that flows to some person or entity outside the charitable class as a result of serving the charitable class. Whether such a benefit creates exemption problems is judged on a balancing test. The best statement from the IRS regarding the doctrine comes from a 1987 general counsel memorandum, which stated,

> An organization is not described in section 501(c)(3) if it serves a private interest more than incidentally. . . .
>
> A private benefit is considered incidental only if it is incidental in both a qualitative and a quantitative sense. In order to be incidental in a qualitative sense, the benefit must be a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by benefiting certain private individuals. . . . To be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity.[64]

Although the IRS has used the private benefit doctrine in a wide variety of contexts, it has been a particular fixture of IRS analysis of commercial transactions undertaken by exempt charities with for-profit entities or individual investors. Thus, the IRS has applied the concept to partnerships between hospitals and doctors,[65] low-income housing partnerships with private investors,[66] down-payment assistance programs in which a charity

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in the hands of a hospital corporation since the HMO provides services to persons who are not patients of the hospital).

63. As part of hearings on the UBIT in the late 1980s, known as the Pickle hearings, the Oversight Subcommittee of the House Ways and Means Committee circulated a draft report that recommended aggregating the activities of a parent nonprofit and any eighty-percent-owned subsidiary for purposes of applying the "primary purpose" test of exemption. *See generally* Hill & Mancino, *supra* note 7, ¶ 27.03[4]; Aprill, *supra* note 23, at 1106; Evelyn Brody, *Business Activities of Nonprofit Organizations: Legal Boundary Problems*, *in* Nonprofits and Business: A New World of Innovation and Adaptation, *supra* note 6.

64. I.R.S. Gen. Couns. Mem 39,598 (Jan. 23, 1987).

65. *See, e.g.*, I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991).

66. *See, e.g.*, Jerry O. Allen & Alan D. Duffy, *Solving the Low-Income Tax Credit Housing Partnership Dilemma*, 49 Exempt Org. Tax Rev. 319 (2005); J. Christine Harris, *Tax-Exemption and Low-Income Housing Ventures: Irreconcilable Differences?*, 47 Exempt Org. Tax Rev. 329 (2005); J. Christine Harris, *Tax Law Professors Say Recent Joint Venture Ruling Doesn't Break Ground in Housing*, 47 Exempt Org. Tax Rev. 21 (2005) [hereinafter Harris, *Tax Law Professors*]; Michael I. Sanders & Celia A. Roady, *EO Practitioners Suggest Way to Expedite Exemptions for Low-Income Housing Orgs*, 37 Exempt Org. Tax Rev. 127 (2002).

acts as an intermediary between a real estate developer and a potential charitable client,[67] and similar transactions.[68] Because of the breadth of the doctrine as currently applied by the IRS, any significant economic transaction between an exempt charity and a nonexempt entity or individual outside the charitable class is subject to private benefit attack, and the balancing approach means that the line between permitted and problematic private benefit is unclear.[69]

II. MAKING TAX LAW COHERENT

A. *A Taxonomy of Commercial Activity and the Policy Objectives of Regulating It*

Part II.A of this essay recounts the inconsistent positions the IRS has taken with respect to whether commercial activity should affect exempt status. In order to get a handle on how best to revise federal tax law on this front, it is helpful to think about how different kinds of commercial activity impact policy objectives relating to such activity.

In a prior article, I identified several policy concerns with charities conducting commercial activities. Those concerns are (1) avoiding unfair competition between exempt and for-profit entities, (2) limiting erosion of the corporate tax base by having charitable organizations buy taxable activities that become nontaxable in the charity's hands, (3) limiting the extent to which the attention of management is diverted from charitable activities into running for-profit businesses, (4) promoting economic efficiency, (5) guarding against over-subsidizing charitable activities by letting charities self-subsidize through the acquisition of commercial businesses, and (6) limiting the business risk exposure of charitable assets that might accompany running a business from the same container (corporation or trust) that houses charitable assets.[70] Some of these policy concerns are more significant than others. For example, economists have almost uniformly rejected the notion that charities engage in unfair competition, at least if that phrase is limited to predatory pricing techniques or inappropriately using exempt revenues to subsidize commercial activity.[71] Similarly, exposing charitable assets to business risk can best be

67. *See, e.g.*, Rev. Rul. 2006-27, 2006-21 I.R.B. 915.

68. *See generally* John D. Colombo, *In Search of Private Benefit*, 58 Fla. L. Rev. 1063 (2006).

69. In 2004, the IRS did clarify that certain ancillary partnerships between an exempt charity and a for-profit company would not create private benefit problems, though the ruling is largely devoid of analysis and leaves open as many questions as it answers. Rev. Rul. 2004-51, 2004-22 I.R.B. 974. *See generally* Colombo, *supra* note 68, at 1077–79; Harris, *Tax Law Professors*, *supra* note 66.

70. Colombo, *Commercial Activity*, *supra* note 8, at 529–46.

71. *Id.* at 529–30. Professor Michael S. Knoll's contribution to this Symposium, in fact, questions whether there is any economic advantage to a nonprofit engaging in a commercial business. *See* Knoll, *supra* note 17.

handled through insurance and proper diversification; tax law should have little to say about this policy issue.[72] On the other hand, protecting the corporate tax base, limiting managerial diversion, promoting economic efficiency, and limiting possible over-subsidization of charitable activities (which could be viewed as simply a subset of promoting economic efficiency) do seem to be significant concerns.

Commercial activity also has its benefits, however. The obvious benefit is that it permits charitable organizations to expand (or maintain) their outputs in an environment in which the availability of direct government grants may be shrinking and competition for both the available government money and private donations is increasing exponentially along with the sheer numbers of exempt charities.[73] In some cases, moreover, commercial activity may permit a charity to earn a return on capital investments made primarily for charitable purposes, but which by their nature may be underutilized for purely charitable outputs. Thus, a conclusion that commercial activity by exempt charities is uniformly bad is not correct.

Instead, it may be useful to try to categorize the kinds of commercial activities charities engage in and analyze whether the concerns with commercial activity outweigh the potential benefits. In general, one can separate commercial activity into five categories:

- *Category One*: commercial activity that is also the primary exempt activity;
- *Category Two*: commercial activity that is functionally related to the organization's exempt purpose (e.g., substantially related activity under the UBIT);
- *Category Three*: unrelated commercial activity that exploits excess capacity;
- *Category Four*: unrelated commercial activity that does not exploit excess capacity but the revenues from the activity are directed to charitable outputs; and
- *Category Five*: unrelated commercial activity that becomes empire building for its own sake.[74]

First, charities may engage in commercial activity because that is their primary charitable activity. The classic example is a nonprofit hospital, engaged in the activity of selling health-care services for a fee, at prices

72. *Id.* at 544–46.

73. *See* Burton A. Weisbrod, *The Nonprofit Mission and Its Financing: Growing Links Between Nonprofits and the Rest of the Economy*, *in* To Profit or Not to Profit, *supra* note 5, at 1–7.

74. *See* Fishman & Schwarz, *supra* note 9, at 593; Colombo, *Commercial Activity*, *supra* note 8, at 525–29. The empire-building concern is what led the Treasury to propose an aggregation rule for determining if a particular nonprofit had a primary charitable purpose in the Pickle hearings in the late 1980s. *See* Brody, *supra* note 63, at 32–33.

virtually identical to for-profit hospitals in similar markets. There is little doubt that nonprofit hospitals are engaged in commercial activity; in this case, however, the specific commercial activity in which they are engaged has been approved (under the correct ancillary conditions)[75] as a primary charitable activity. Low-income housing partnerships are another example of a charitable organization engaging in a commercial enterprise (building and renting housing) as its primary charitable activity. In these cases, therefore, the key question is whether the activity undertaken by the nonprofit will be considered charitable in itself. If so, there is nothing more to discuss; if not, then the organization presumably has no charitable activities at all, and therefore no grounds for exemption.[76]

Second, charities may engage in commercial activities that are functionally related to their exempt purpose—activity that would be substantially related under the current UBIT. Such related activities may be a concern for tax-base erosion, but little else. Since the activities are functionally related to the exempt purpose, they bear little risk of managerial diversion (after all, management is engaging in these activities as an integral part of their exempt activities). Moreover, as Professor Henry Hansmann has noted, these activities raise few, if any, economic efficiency problems since one would assume these activities involve some kind of economies of scope (e.g., the capital asset has already been purchased or employees are already trained to do these activities).[77] For example, one would expect that the music school that puts on concerts by for-profit

75. *See, e.g.*, IHC Health Plans, Inc. v. Comm'r, 325 F.3d 1188 (10th Cir. 2003); John D. Colombo, *The Failure of Community Benefit*, 15 Health Matrix 29, 30–37 (2005).

76. This category is one where confusion over the difference between charitable purposes and charitable activities is most problematic. One might argue, for example, that a nonprofit pharmacy has a charitable purpose to promote health. *See, e.g.*, Rev. Rul. 69-545, 1969-2 C.B. 117 (stating that promotion of health for the general benefit of the community is a charitable purpose). If none of its activities can be classified as charitable, however, then it seems obvious that its primary purpose is not charitable but something else. *See, e.g.*, Fed'n Pharmacy Servs. Inc. v. Comm'r, 625 F.2d 804 (8th Cir. 1980) (holding that a nonprofit pharmacy, which sells drugs at cost to the elderly and poor, is not exempt because such activity is a commercial activity, not a charitable one); *see supra* notes 33–39 and accompanying text. Similarly, this conflation of charitable purpose and charitable activities can explain the different results in the *Scripture Press* and *Presbyterian & Reformed Publishing* cases discussed in the text. In *Scripture Press*, the U.S. Claims Court appeared to view religious publishing as not being a charitable activity, at least when conducted with a commercial hue, despite the fact that publishing religious texts would seem to functionally advance a charitable purpose of promoting religion. *See supra* notes 33–39 and accompanying text. In contrast, the Court of Appeals for the Third Circuit in *Presbyterian & Reformed Publishing* clearly did view religious publishing as a charitable activity that promoted a religious purpose. *See* Presbyterian & Reformed Publ'g Co. v. Comm'r, 79 T.C. 1070 (1982), *rev'd*, 743 F.2d 148, 158 (3d Cir. 1984) ("Although we recognize that the Tax Court is entitled to deference in determining the existence of a substantial, non-exempt purpose, that court must focus on facts which indicate a purpose falling outside the ambit of section 501(c)(3). In this case, the Tax Court focused primarily on two factors—the lack of affiliation with a particular church and the accumulation of profits. As we have shown, neither factor indicates the presence of a non-exempt purpose here.").

77. Henry Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 Va. L. Rev. 605, 626–28 (1989).

groups already has personnel experienced in concert planning and execution. There may be some risk of undue self-subsidization by charities if these related activities are financially successful, but given that these activities are by definition a functional part of the charitable program, the chances of these activities becoming serious moneymakers likely are small.

Third, charities may undertake unrelated commercial activities because they have excess capacity from capital investments made for charitable purposes. The classic example here is a university that rents its stadium facilities to a professional football team for the summer or that leases unused supercomputer time to for-profit research groups.[78] Commercial activities falling within this category also should not raise exemption problems. In this kind of case, the law should positively encourage charities to avoid letting assets simply lie fallow. Doing so is a waste of invested capital. There may be some concern that the law not encourage charities to consciously over-invest in capital facilities or in employees simply to use them in commercial businesses, but to the extent that investments are made at a level necessary to conduct charitable activities, earning a profit through maximum utilization of that investment would seem to be a desirable and efficient outcome. Moreover, if the capital investment is made in the first instance to pursue charitable activities, there is little reason to think that there is much risk to the corporate tax base (since the activities for which the investment was made likely would not have been undertaken by the private market). Managerial diversion also would be limited, because if the capital assets used in the commercial activity were primarily meant for charitable purposes, any commercial activity by definition will be subordinate to commercial use. For example, the empty athletic stadium is only available to rent when the university's teams are not using it—generally, this means the summer only. Likewise for the unused supercomputer time—commercial use will by necessity be subordinate to academic use.

Fourth, charities may undertake commercial activities that do not exploit economies of scope, but generate returns above the market rate on stocks and bonds that in turn will be used to expand charitable outputs. The church that opens a Starbucks franchise probably has no significant economies of scope to exploit in that activity, but may (in some cases correctly) conclude that investing in the Starbucks will produce a rate of return significantly higher than a diversified portfolio of stocks and bonds. There may be programmatic reasons as well: luring former churchgoers back to Sunday services with the promise of good coffee or trying to expand the number of patrons of the local museum by having after-hours cocktail parties.

These Category Four activities raise mixed issues. On the one hand, it seems that we should not impede the ability of charities to develop alternative resources to expand charitable outputs. Other commentators

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78. *See id.* at 627–28.

have noted the modern pressures on funding sources for charities.[79] If investing wisely in certain commercial activities produces a premium rate of return for charities to expand charitable outputs, it seems as though that would be a generally good thing. Engaging in these activities, therefore, likely should not affect exempt status as long as the revenues from the commercial activity are used to subsidize charitable outputs. Yet there are some countervailing concerns. Unlike Category Two or Category Three activities, those in Category Four are far more likely to result in managerial diversion, since the commercial activity is not subordinate to any charitable use of the underlying assets. The church that runs a Starbucks to supplement the collection plate will almost certainly need to invest significant managerial time in running the Starbucks. Category Four activities also raise questions of protecting the corporate tax base, economic efficiency, and over subsidization, particularly if these activities are not subjected to the general corporate income tax. If these activities are not taxed, charities can earn a premium rate of return on them simply because they can avoid the corporate-level tax, not because managerial or other efficiencies produce a premium rate of return.[80] Thus, failing to tax these activities would encourage charities to invest money in direct commercial activities even if such activities would be worse investments on an after-tax basis than a diversified portfolio. This incentive would in turn result in charities undertaking more such activities, withdrawing those assets from the corporate tax base (the tax-base protection issue), and would result in charities essentially self-subsidizing their operations even if doing so resulted in an oversupply of the particular charitable good or service that the commercial activity was subsidizing. The proper policy response to Category Four activities, therefore, would be to tax them, but not have them affect underlying exempt status.

Finally, charities may become involved in commercial activities that take on a life of their own, where revenues are largely reinvested in the activity itself, instead of being used to subsidize expanding charitable outputs. In a 2004 technical advice memorandum dealing with an exempt church that owned a for-profit subsidiary, the IRS raised precisely these empire-building concerns, cautioning the exempt parent that it "cannot be allowed to focus its energies on expanding its subsidiary's commercial business and assets, and neglect to translate that financial success into specific, definite and feasible plans for the expansion of its charitable religious activities."[81] One might argue that Division I college basketball and football programs

79. *See* Weisbrod, *supra* note 73, at 1–7.

80. Corporations pay entity-level tax on their earnings at a maximum rate of thirty-five percent, whereas proprietorships and partnerships (or limited liability companies that choose to be taxed as partnerships) pay no entity-level tax. That means that in theory, a corporation must earn a higher pretax return on equity to compete with other investments in the market on an after-tax basis. If a charity could acquire a corporate business and avoid the corporate-level tax, it would be able to capture this higher pretax rate of return for itself simply as a result of the ownership change.

81. I.R.S. Tech. Adv. Mem. 2004-37-040 (June 7, 2004).

may also present these problems, at least in individual cases. Recent headlines such as the University of Alabama's hiring of Nick Saban for $32 million over eight years[82] surely make one wonder whether Alabama is rationally seeking to maximize football revenues to subsidize other charitable (e.g., educational) outputs or whether running a successful Division I football program has simply become an end unto itself. In these cases, management of the charity may need a forceful reminder of its underlying mission—and there is no more forceful reminder than the threat of losing tax exemption.[83]

B. *Suggested Reforms*

The above analysis suggests five separate reforms that are necessary to make the tax laws coherent when dealing with commercial activity. First, only Category One and Category Five cases should create exemption problems. In Category One, the issue is simply whether commercial activity is an appropriate way to carry out a charitable purpose. All one can ask for here is that the IRS adopt a consistent approach to analyzing these cases: If publishing religious texts in a manner similar to commercial publishers is not in furtherance of a religious purpose, then one wonders why operating a hospital in a manner similar to for-profit hospitals justifies exemption. I certainly have no problem with the IRS taking the position that no commercial activity can support exemption standing alone[84] (e.g., apart from cases in which the commercial revenues are used to support some other charitable activities), but if that is going to be the approach, it needs to be applied consistently.

Categories Two, Three, Four, and Five, on the other hand, all presuppose that the organization in question has some charitable activities apart from its commercial activity. Of these, only Category Five activity should result in a loss of tax exemption. These empire-building cases present the greatest threat of managerial diversion and of nonprofits becoming for-profits in disguise. Accordingly, exemption should be a risk only in cases in which the commercial activity is not functionally related to the organization's exempt purpose and revenues from commercial activity are not used to substantially cross-subsidize charitable outputs. Put another way, the IRS needs to make clear that the key concept in the regulations on this issue—

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82. *See* Jodi Upton, *Contract Could Bring Congressional Inquiry*, USA Today, Jan. 4, 2007, at 9C.

83. Of course, if one believes that big-time college football and basketball programs are themselves charitable activities, then this example is really a Category One case, not a Category Five case. An issue that arises with the analysis in the text is exactly how one distinguishes between a commercial activity and a charitable activity that produces revenue. For a discussion of this issue, see *infra* text accompanying notes 90–91.

84. I have in the past suggested that tax exemption is appropriate only in cases of combined market failure and government failure; if a "charity" is engaged in an activity that is simply participating in a private market, there is no market failure and no need for exemption. *See generally* John D. Colombo & Mark A. Hall, The Charitable Tax Exemption (1995).

the in furtherance of concept—can mean either that the activity is functionally related to an exempt purpose (e.g., substantially related as defined in the UBIT) or else that the activity provides revenues to subsidize other charitable outputs (in effect, a retention for exemption purposes of the destination of income test). As noted below, this approach is completely consistent with taxing commercial revenues under the current or an expanded UBIT; the in furtherance of concept relates only to exempt status.

The second suggested reform, therefore, is for the IRS to formally resurrect the 1964 version of the commensurate in scope doctrine; that is, the IRS should issue either new regulations or a new revenue ruling that makes clear that as long as revenues from commercial activities are being used to conduct a substantial charitable program, the activity will be considered in furtherance of an exempt purpose, and the organization's tax-exempt status is not at risk. One possible refinement to the commensurate in scope test would be to provide a safe-harbor provision for exactly how much subsidy a commercial business must provide to charitable activities to avoid exemption issues. I have previously suggested that one might use the short-term or midterm applicable federal rate (AFR) as a safe-harbor rate of return for this purpose—for example, if the short-term AFR is four percent, then a charity would know that if a commercial activity provided at least a four percent return used to subsidize charitable activities, the commensurate in scope test would be met automatically, and no exemption issues would arise from operating this commercial activity.[85]

The third reform would be to jettison the relatedness test for the UBIT and impose tax on all commercial activities by charities, whether related or not.[86] There are several reasons that call for this approach. First, the analysis in Part III.A indicates that while commercial activities in Categories Two, Three, and Four should not affect exemption, such activities (particularly those in Category Four) do present some significant risks to the corporate tax base, of managerial diversion, and of economic inefficiency and excessive self-subsidization. Taxing all commercial activities obviously would more completely protect the corporate tax base than the current system, since no commercial activity (even if it is related) would escape taxation. Second, taxing all commercial activity would promote economic efficiency, because charities could not earn a premium rate of return on a particular activity simply by avoiding the income tax that would otherwise be due. Under this proposed system, a charity presumably

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85. Colombo, *Commensurate-in-Scope*, *supra* note 8, at 351–52.

86. This proposal is not new. The idea of replacing the substantially related test with a commerciality test stretches back at least to the Pickle hearings by the Oversight Subcommittee of the House Ways and Means Committee in the late 1980s. *See* Brody, *supra* note 63; *see also* James Bennett & Gabriel Rudney, *A Commerciality Test to Resolve the Commercial Nonprofit Issue*, 36 Tax Notes 1095 (1987). The proposed rationale for this reform at the time, however, was to prevent unfair competition by nonprofit charities, which to the small business community really meant any competition. As noted in the text, several other policy concerns present better rationales for taking this step. *See supra* text accompanying notes 70–72.

would choose to invest in a direct commercial activity only if the after-tax rate of return it could earn would be greater than the market rate on a diversified portfolio of investment assets—that is, the charity would have to make a decision that it could earn a premium rate of return by efficient operation of the commercial enterprise, and not just by avoiding taxes.[87] It is likely, therefore, that if all commercial activity were taxed, charities would concentrate on commercial activities for which they enjoy some economies of scope with respect to either capital investments or employees or which had some other kind of synergy with their charitable programs, which in turn would also help curb empire-building tendencies and avoid managerial diversion.[88]

The fourth reform follows from the second and third reforms. If commercial activity is essentially unlimited provided that it is used by the exempt organization as a source of funding for charitable outputs and if all commercial activity is taxed, then there is no tax reason to distinguish between the activities of different pieces of a complex enterprise for tax-exemption purposes. That is, whether a specific nonprofit within a related group of organizations meets the primary purpose test for exemption should be tested based upon the aggregate activities of a complex group, not on an entity-by-entity basis.[89] Either the group as a whole would have a primary charitable purpose (and operating commercial businesses to fund this primary purpose would be perfectly acceptable under my proposals) or it does not. Exemption should follow this group analysis and not rest upon arbitrary distinctions regarding the kind of economic container in which specific activities are carried out. Note, however, that if the first and second reforms suggested above are adopted, then the IRS should give exempt status rather freely: Any nonprofit organization that can make a credible claim to a bona fide substantial charitable purpose should be granted

87. *See* Hansmann, *supra* note 77, at 627. Taxing all commercial activity also should satisfy Susan Rose-Ackerman's concern that the current system distorts economic activity by encouraging nonprofits to invest more in related than unrelated activity. Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 Stan. L. Rev. 1017, 1038 (1982). Rose-Ackerman suggested getting rid of the UBIT because of this distortion, but subjecting all commercial activity to taxation should also eliminate this problem.

88. Making all commercial activities subject to taxation, rather than just unrelated activities, might also reduce the ability of charities to game the system by allocating costs from charitable and related businesses to unrelated businesses, thereby reducing (often eliminating) any tax liability for unrelated activities. *See, e.g.*, Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 Tenn. L. Rev. 687, 733 (1999); Joseph J. Cordes & Burton A. Weisbrod, *Differential Taxation of Nonprofits and the Commercialization of Nonprofit Revenues*, *in* To Profit or Not to Profit, *supra* note 5, at 97–100; Robert J. Yetman, *Tax-Motivated Expense Allocations by Nonprofit Organizations*, 76 Acct. Rev. 297 (2001).

89. Once again, this proposal is not new and harkens back to the Pickle hearings of the late 1980s. The Treasury proposal at that time suggested aggregation for eighty-percent-owned subsidiaries. *See supra* note 63. I have suggested a far broader test of aggregation based upon the supporting organization tests in I.R.C. § 509(a)(3) (2000). Colombo, *Commercial Activity*, *supra* note 8, at 565.

exemption, since all of the commercial activities of that organization would be subject to taxation in any event.[90]

Finally, the IRS desperately needs to better define the role of the private benefit doctrine in policing exempt organizations, particularly in the realm of revenue-generating activities carried on in partnership with for-profit organizations or private investors. These transactions often are used to expand charitable outputs, or as revenue generators for exempt activities, and therefore should not automatically be subject to private benefit attack. I have recently suggested that private benefit should be used by the IRS to guard against transactions in which charities arguably waste charitable resources, primarily in transactions in which a charity outsources core services or enters into long-term contracts with for-profit entities that confer a competitive advantage on the for-profit.[91] Limiting private benefit in this manner would make clear that economic transactions with for-profit entities that enhance a charity's ability to serve its charitable class (a feature of many partnership transactions that the IRS has viewed dimly in the past) are not exemption problems.

The reforms suggested here, however, are dependent on a final issue: being able to distinguish revenue-producing charitable activities from commercial ones. If a nonprofit theater sells tickets to the public, is the ticket revenue from a commercial activity? How about sales of drinks and food to theater patrons? For the answer, we should turn back to the main policy issues surrounding commercial activity, including protecting the corporate tax base, managerial diversion, and economic efficiency. In particular, it seems that if these are the main problems with charities engaging in commercial activity, then an activity should not be labeled commercial unless it is competing with substantially similar for-profit goods or services. An activity that would not be conducted in the for-profit market is not a worry for the corporate tax base, because no tax would be collected on that activity in any event. Nor would such an activity seem to be a managerial diversion concern—in fact, it seems that nonprofits should be providing exactly those services not part of the for-profit market. Finally, if the for-profit market cannot or will not produce a particular good or service, then by definition there is no more efficient way to produce it than through the government or the nonprofit sector, and if the government will not do it, that leaves only the nonprofit sector. Thus, whether the theater's ticket sales are a commercial activity should depend on whether the theater is producing the same kinds of plays as for-profit theaters and hence is competing in the for-profit theater market. Food and drink sales, on the other hand, are easy to classify as commercial since all sorts of for-profit restaurants, vending machine companies, and so forth are in that same

90. I do not mean to suggest here that for-profit entities in a complex structure would somehow be converted for tax purposes to nonprofit status. Rather, I mean only that any nonprofit organization in a complex structure would be tested for its primary purpose based upon the activities of the group as a whole, and not on their individual activities.

91. Colombo, *supra* note 68, at 1088–90.

business.[92] For cases in the middle, the commercial hue analysis developed by the courts and the IRS (but inappropriately applied to the decision to grant exemption[93]) might be a good starting point for analyzing whether a particular activity is, in fact, a commercial one.

CONCLUSION

The current provisions of the Code regarding commercial activity by charities and the IRS's interpretations of those provisions have created needless confusion and uncertainty, particularly regarding the effects of commercial activity on exempt status. Part of this needless confusion can easily be corrected internally, by applying a consistent analysis to "commercial activity as primary charitable activity" cases;[94] by the issuance of new regulations or a new revenue ruling that provides specific guidance on the in furtherance of test of the regulations, essentially reestablishing the commensurate in scope approach to analyzing how commercial activity impacts exemption; and by adopting a more restrictive view of private benefit. The other two reforms suggested in this essay (expanding the UBIT to tax all commercial activities and granting exempt status on a group, rather than individual entity, basis) probably would require some legislative change, but if the Code is ever going to take a coherent approach to commercial activities by charities, such change is necessary.

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92. Of course, as with all other legal tests, there will be inevitable disagreement at the edges. For example, are Division I college football and basketball programs commercial under this test? They certainly produce substantial revenues for their schools, but whether they compete with substantially similar for-profit goods and services (e.g., professional for-profit sports) is an open question. The Supreme Court, for example, has suggested in the antitrust context that college football does not compete with professional football. *See* NCAA v. Board of Regents, 468 U.S. 85, 101–02 (1984). Of course, tax law would not necessarily have to adopt precedents from antitrust law for this purpose. Particularly in light of the policy concerns of managerial diversion and economic efficiency, one could argue that the test for what is a commercial activity in the tax-exemption world should be somewhat broader than what the courts may find to be competing products in the antitrust field. Viewing markets and competing goods narrowly in antitrust law generally has the effect of protecting competition, which is the purpose of antitrust law. Drawing similar narrow lines in tax-exemption law does not similarly advance the policy concerns noted above with commercial activity by charities.

93. *See supra* text accompanying notes 41–43.

94. *See supra* text accompanying notes 75–76.

Notes & Observations