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## Commercial Activity and Charitable Tax Exemption

John D. Colombo

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## COMMERCIAL ACTIVITY AND CHARITABLE TAX EXEMPTION

JOHN D. COLOMBO\*

### TABLE OF CONTENTS

INTRODUCTION .....	489
I. BACKGROUND: CURRENT LAW & DOCTRINE .....	495
A. <i>The Effect of Direct Commercial Activity on         Charitable Status</i> .....	495
B. <i>The Relationship of the Commerciality Doctrine to the         UBIT and the Commensurate-In-Scope Test</i> .....	507
C. <i>The Effects of Indirect Commercial Activity in         Complex Structures</i> .....	514
1. <i>The Corporate Separate-Identity Rule and the             Integral-Part Test</i> .....	514
2. <i>The Partnership Attribution Rule</i> .....	522
D. <i>Summary</i> .....	523
II. WHY DO WE CARE? PUBLIC POLICY CONCERNS	
REGARDING COMMERCIAL ACTIVITY .....	524
A. <i>Why Do Exempt Charities Engage in         Commercial Activities?</i> .....	525

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<i>B. Policy Concerns with Commercial Activities</i> .....	529
1. <i>Traditional Policy Concerns: Unfair Competition</i> <i>and Erosion of the Corporate Tax Base</i> .....	529
2. <i>Other Policy Concerns</i> .....	534
a. <i>The Diversion Problem</i> .....	534
b. <i>Economic Efficiency</i> .....	538
c. <i>Assessing Worth and Need for</i> <i>Indirect Government Subsidies</i> .....	541
d. <i>Liability Insulation</i> .....	544
III. RECONSTRUCTING THE RULES TO ADDRESS THE POLICY CONCERNS .....	546
A. <i>Controlling the Economic Incentive</i> .....	547
B. <i>Eliminating the Incentive for</i> <i>Direct Commercial Activity by Expanding the UBIT</i> ...	556
CONCLUSION .....	565

## INTRODUCTION

In 1998, Professor Burton Weisbrod and several of his colleagues published a book that chronicled the expanding tendency of nonprofit organizations to engage in commercial activity.<sup>1</sup> In his concluding chapter, Professor Weisbrod offered two striking examples of this trend. Chicago's Art Institute, Shedd Aquarium, and Field Museum began holding after-hours cocktail parties as a sort of upscale bar; and Baptist Hospital, the largest nonprofit hospital in Nashville, built a \$15 million office and training complex to rent to the Tennessee Titans professional football team, partly for the revenue it would generate, but also for the marketing opportunities it offered.<sup>2</sup> Meanwhile, an article in the *Wall Street Journal* in August 2001 noted that churches from Jacksonville, Florida, to Seattle, Washington are opening restaurants, private gyms, and even Starbucks coffee franchises.<sup>3</sup> Underscoring the current trend, the Yale School of Management announced in early 2002 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 entry into commercial markets.<sup>4</sup>

Commercial activity by charities, however, goes even further in scope. While individual charitable organizations still exist in our world, it is now common to find charities engaged in numerous economic activities through a variety of business arrangements including subsidiary corporations, joint ventures, and contractual agreements. The health care sector, in particular, epitomizes the modern charitable organization in a complex structure. The entity that started as a single nonprofit corporation operating a local hospital likely has mushroomed into a multilayered health care

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1. TO PROFIT OR NOT TO PROFIT (Burton Weisbrod ed., 1998).

2. Burton A. Weisbrod, *Conclusions and Public-Policy Issues: Commercialism and the Road Ahead*, in TO PROFIT OR NOT TO PROFIT, *supra* note 1, at 288.

3. Elizabeth Bernstein, *Holy Frappuccino!*, WALL ST. J., Aug. 31, 2001, at W1.

4. *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*, SOM NEWS, Feb. 8, 2002 (on file with the William and Mary Law Review and Yale School of Management).

delivery system, often consisting of a parent holding company with myriad for-profit or nonprofit subsidiaries, contractual agreements with doctors and other service providers, and joint venture participation with other nonprofit and for-profit entities.<sup>5</sup>

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5. One of the more famous recent cases illustrating a complex structure was *Geisinger Health Plan v. Comm'r*, 100 T.C. 394 (1993). As explained by the Tax Court:

Petitioner [GHP] owned and operated a health maintenance organization (HMO) under the Pennsylvania Health Maintenance Organization Act, Pa. Stat. Ann. tit. 40, secs. 1551-1567 (Supp. 1991). 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).

....  
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.

Another famous recent example involved Redlands Health Systems, which litigated the denial of exempt status to one of its wholly-owned subsidiaries, Redlands Surgical Services, that was a partner with a for-profit health care provider that operated a profitable outpatient surgery clinic. *Redlands Surgical Servs. v. Comm'r*, 113 T.C. 47 (1999), *aff'd*, 242 F.3d 904 (9th Cir. 2001). See generally Howard P. Tuckman, *Competition, Commercialization and the Evolution of Nonprofit Organizational Structures*, in *TO PROFIT OR NOT TO PROFIT*, *supra* note 1, at 40-42 (noting how commercialization, particularly in the nonprofit health care sector, has affected business structures).

Although a large percentage of complex structures come from the health care sector, they exist in other sectors as well. See, e.g., Priv. Ltr. Rul. 95-06-046 (Nov. 17, 1994) (ruling on a case in which a business league exempt under section 501(c)(6) established first- and second-tier subsidiaries to construct and operate a golf course); Gen. Couns. Mem. 39,776 (Jan. 4, 1989) (analyzing a situation in which an exempt university controlled a section 501(f) organization that in turn controlled a taxable subsidiary). See generally FRANCIS R. HILL & BARBARA L. KIRSCHTEN, *FEDERAL AND STATE TAXATION OF EXEMPT ORGANIZATIONS* ¶ 9.01 (1998) (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).

Tax policy with respect to commercial activity by charitable organizations leaves much to be desired. The rules on the subject involve three separate but intimately related tax issues. The first is whether commercial activity should adversely affect tax exemption for an organization directly conducting such activity. Commentators in the tax-exemption field generally refer to this issue as the "commerciality" doctrine, which holds that charities engaged in commercial business enterprises can risk their tax-exempt status if their business activities grow too large in relation to their charitable activities.<sup>6</sup> The second issue is whether, if such activity is consistent with underlying tax-exempt status, the commercial activity itself nevertheless should be taxed. This issue has been the province of the unrelated business income tax (UBIT) adopted in 1950.<sup>7</sup> The third issue, which relates more to the first than the second, concerns whether and how commercial activities undertaken by one organization in a complex structure should be "imputed" to related entities in that structure for purposes of judging the related entities' exempt status and conversely whether the charitable activities of related corporations should be "imputed" to the corporation conducting the commercial activity in order to make it tax exempt.<sup>8</sup>

The relationship between these three broad issues has produced some very odd administrative rulings and conflicting court decisions. For example, on the tax-exemption side, the Third Circuit and the Claims Court disagreed on the exempt status of virtually identical nondenominational religious publishers.<sup>9</sup> Meanwhile, because it relies on a "relatedness" concept, the UBIT taxes some (e.g., "unrelated") commercial activity by charitable organizations, but not other (e.g., "related") commercial activity. The UBIT itself, however, provides no guidance on whether commercial activity, even if taxed, should threaten exempt status. On the final issue, the Internal Revenue Service (IRS or Service) has adopted the position

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6. JAMES J. FISHMAN & STEVEN SCHWARZ, *NONPROFIT ORGANIZATIONS, CASES AND MATERIALS* 754 (2d ed. 2000); BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 629-31 (7th ed. 1998).

7. Revenue Act of 1950, ch. 994, § 422, 64 Stat. 906, 950 (1950) (codified as amended at I.R.C. §§ 502, 511-13 (2000)).

8. See *infra* Part I.C.

9. See *infra* notes 44-51, 56-60, and accompanying text.

that individual corporations "stand alone" with respect to charitable status—that is, the activities carried on in a separate corporate entity will not be imputed to corporate parents or siblings and vice-versa.<sup>10</sup> In contrast, the IRS position with respect to partnership and other joint venture arrangements is that each partner is deemed to be in the underlying business of the partnership.<sup>11</sup> These positions create a curious dichotomy in which business activities segregated in a wholly-owned subsidiary corporation do not jeopardize a related entity's exempt status, whereas that status is threatened by the same activities carried on directly or in a joint venture or partnership. At the same time, because the UBIT applies only to "unrelated" business activity, commercial activities carried on by a subsidiary corporation as stand-alone operations might well escape taxation if conducted by a parent as a part of the parent's overall activities if such activity is "related" to the parent's charitable purpose.<sup>12</sup>

Legal academics and economists, like the courts and the Service, have tended to focus only on the individual pieces of these related rules, primarily on the UBIT,<sup>13</sup> without considering how the pieces

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10. See *infra* Part I.C.1.

11. See *infra* Part I.C.2.

12. See *infra* notes 134-37, 144-49, and accompanying text (discussing cases in which this argument was made).

13. Articles regarding the UBIT are legion, spanning theory and practice on both broad and narrow applications. A recent comprehensive survey of the state of the UBIT is contained in Donald L. Sharpe, *Unfair Business Competition and the Tax on Income Destined for Charity: Forty-six Years Later*, 3 FLA. TAX REV. 367 (1996). All the major treatises on tax-exempt organizations contain large sections devoted to the operation of the UBIT. See, e.g., HILL & KIRSCHTEN, *supra* note 5, at ch. 10; HOPKINS, *supra* note 6, at 645-786. Classic articles examining the theory of the UBIT include Harvey P. Dale, *About the UBIT* ..., in 18 NYU CONFERENCE ON TAX PLANNING FOR 501(C)(3) ORGANIZATIONS ch. 9 (1990); Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 316-26 (1976); Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605 (1989); William A. Klein, *Income Taxation and Legal Entities*, 20 UCLA L. REV. 13, 61-68 (1972); Susan Rose-Ackermann, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017 (1982); Richard Steinberg, "Unfair" Competition by Nonprofits and Tax Policy, 44 NAT'L TAX J. 351 (1991). For a rather cosmic summary of the UBIT in the context of an issue that is still a thorn today, see Richard L. Kaplan, *Intercollegiate Athletics and the Unrelated Business Income Tax*, 80 COLUM. L. REV. 1430 (1980).

In contrast, relatively little academic writing exists focusing on the commerciality doctrine, and virtually none on assessing charitable status in complex organizations. On the effects of commercial activity on exempt status, see Robert J. Desiderio, *The Profitable Nonprofit*

fit together as a whole. The purpose of this Article is to take a broader view: to look at how the various tax rules regulating commercial activity by charitable organizations relate or fail to relate, to review how the current rules address the various public policy concerns with commercial activity, and finally to suggest how we might restructure our approach to commercial activity to simplify the doctrinal issues and address the policy concerns at the same time.

The Article proceeds in three separate parts. Part I traces the current doctrinal status of the commerciality doctrine, the relationship of that doctrine to the UBIT, and the tax rules regarding the effects of commercial activity by related corporations or partnerships. This Part concludes that current doctrine is largely a mess, due to the lack of clear rules regarding when commercial activity endangers exemption or when it is taxable even if it does not endanger exempt status, and due to the presence of conflicting rules on how commercial activities within a complex structure should affect tax exemption overall.

Part II builds on this foundation, sorting through the various policy issues raised by commercial activity conducted by charities. This Part begins with an overview of the reasons charities might conduct direct commercial activity as opposed to passively investing in stocks and bonds. It then identifies six potential public policy concerns. The first two are traditional concerns underlying the UBIT: unfair competition and protecting the corporate tax base. The other four are broader policy concerns. First is the possibility that commercial activity diverts the attention of charitable

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*Corporation: Business Activity and Tax Exemption Under Section 501(c)(3) of the I.R.C.*, 1 N.M. L. REV. 563 (1971); Kenneth C. Eliasberg, *Charity and Commerce: Section 501(c)(3) - How Much Unrelated Business Activity?*, 21 TAX L. REV. 53 (1965); Jessica Peña & Alexander L.T. Reid, *A Call for Reform of the Operational Test for Unrelated Commercial Activity in Charities*, 76 N.Y.U. L. REV. 1855 (2001); Norman A. Sugarman & Harlan Pomeroy, *Business Income of Exempt Organizations*, 46 VA. L. REV. 424 (1960); Lawrence Zelenak, *Serving Two Masters: Commercial Hues and Tax Exempt Organizations*, 8 U. PUGET SOUND L. REV. 1 (1984); Comment, *Preventing the Operation of Untaxed Business by Tax-Exemption Organizations*, 32 U. CHI. L. REV. 581 (1965); Note, *Profitable Related Business Activities and Charitable Exemption Under Section 501(c)(3)*, 44 GEO. WASH. L. REV. 270 (1976). For a discussion of the rules regarding assessing charitable status in complex organizations in the context of health care providers, see John D. Colombo, *Health Care Reform and Federal Tax Exemption: Rethinking the Issues*, 29 WAKE FOREST L. REV. 215, 248-53 (1994).



managers from their core charitable mission and, at the extreme, will turn exempt charities into "for-profits in disguise." Second, rules regarding commercial activity should promote economic efficiency. Third, these rules should also provide adequate checks to determine whether an organization is both worthy and in need of the additional indirect government subsidies that direct commercial activities may offer. The final concern is that commercial activity places charitable assets at the risk of liabilities incurred in noncharitable pursuits.

In this Part, the Article observes that the current rules on commercial activity address each of these issues in a limited way. For example, the rules help protect the tax base and limit charitable asset risk by pressuring charities to use separate corporate containers for commercial activities. These rules, in conjunction with the corporate separate-identity rule, almost always result in those separate containers not being eligible for exemption and therefore subject to taxation.<sup>14</sup> At the same time, these separate containers help isolate charitable assets from the liabilities of noncharitable activities and make it more difficult for charities to minimize the taxable income of these separate organizations by cross-allocating expenses of running the charitable organization to the taxable business.

Part III then examines alternative approaches to dealing with commercial activity. The Article notes that there are two general policy paths one might take. The first path is to permit charities to capture premium financial returns on direct commercial activity as a means for providing an additional indirect government subsidy to these organizations. This Article suggests three different approaches to commercial activity along this general path: (1) clarifying the doctrinal structure of current law; (2) enacting new rules overlaying the current ones designed to control the size and use of the indirect subsidy; or (3) radically restructuring the tests for tax exemption to address commercial activity issues at this core stage. The Article concludes that only a radical restructuring of the tests for tax exemption, such as adopting the donative theory that

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14. See discussion *infra* Part II.B.1.d.

Professor Mark Hall and I proposed in the early 1990s,<sup>15</sup> would address all the policy concerns raised by this approach to commercial activity.

The Article then examines a completely different path for dealing with commercial activity. This second path would attempt to eliminate the economic incentive for direct commercial activities by expanding the UBIT into a "commerciality tax" with the simultaneous repeal of the commerciality doctrine and the corporate separate-identity rule.<sup>16</sup> Such a tax, previously suggested by commentators primarily as a means for controlling "unfair" competition, would also address all other policy concerns with commercial activity as well as facilitate simplification of the rules regarding exempt status.

This latter path, however, requires a fundamental threshold decision: that the current policy problems with commercial activity by exempt charities outweigh the benefits of the indirect subsidy that charities currently can capture under our system. The Article concludes that the doctrinal problems with defining the appropriate scope of commercial activity and the empirical evidence of widespread increases in such activity by exempt charities do, in fact, outweigh the benefits of leaving the current system in place. Thus, if we are not prepared to adopt a radical restructuring of the tests for exemption (the best solution to the commerciality issue), then we should seriously consider the second path of expanding the UBIT to cover all commercial activities as an alternative way to address the policy issues raised.

## I. BACKGROUND: CURRENT LAW & DOCTRINE

### A. *The Effect of Direct Commercial Activity on Charitable Status*

The Internal Revenue Code (I.R.C.) is nothing if not amusing. Section 501(c)(3) of the I.R.C. states in no uncertain terms that an organization will qualify for tax exemption as a charitable

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15. See Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L.J. 1379, 1384-89 (1991).

16. See James Bennett & Gabriel Rudney, *A Commerciality Test to Resolve the Commercial Nonprofit Issue*, 36 TAX NOTES 1095, 1095-96 (1987).

organization if it is "organized and operated *exclusively*" for a charitable purpose.<sup>17</sup> This section, however, has almost never been interpreted literally. As early as 1924, the Supreme Court held that a small amount of noncharitable commercial activity was consistent with charitable status,<sup>18</sup> and regulations under § 501(c)(3) adopted the view that "exclusively" does not mean "exclusively" at all—instead, the regulations tell us that "exclusively" really means "primarily."<sup>19</sup> The Treasury Regulations then follow this revelation with a more cryptic statement: "An organization will not be so regarded [that is, regarded as being operated exclusively for a charitable purpose] if more than an *insubstantial* part of its activities is not in furtherance of an exempt purpose."<sup>20</sup> Two subsections later, however, the Regulations inform us:

An organization may meet the requirements of section 501(c)(3) although 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

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Moreover, although all exempt charities must be nonprofit organizations, "nonprofit" does not mean that the organization is prohibited from making an economic profit. Rather, the word refers

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17. I.R.C. § 501(c)(3) (2000) (emphasis added). One should note that § 501(c)(3) is but one of many subsections of § 501 providing tax exemption for specific entities, and that these other exempt organizations also are subject to UBIT. Exempt charities, however, constitute by far the largest dollar piece of the exemption puzzle and enjoy unique tax advantages (primarily the ability to receive tax-deductible donations under § 170 and the ability to issue tax-exempt bonds under § 145) denied to other exempt organizations. See JOHN D. COLOMBO & MARK A. HALL, *THE CHARITABLE TAX EXEMPTION* 7-8, 20-21 (1995). As a result, this Article concentrates solely on the charitable exemption of § 501(c)(3) and related UBIT issues.

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

19. Treas. Reg. § 1.501(c)(3)-1(c)(1) (as amended in 1990) ("An organization will be regarded as 'operated exclusively' ... if it engages *primarily* in activities which accomplish one or more ... exempt purposes ....") (emphasis added).

20. *Id.* (emphasis added).

21. *Id.* § 1.501(c)(3)-1(e)(1) (emphasis added).

to the rule that nonprofit organizations cannot distribute profits to shareholders or other individuals as a return on investment.<sup>22</sup>

Put another way, the regulations appear to say that if commercial activity is conducted directly by an exempt organization but is "insubstantial" in relation to the exempt organization's charitable activities, the commercial activity will not affect exempt status. If the commercial activity is substantial, however, then it potentially jeopardizes exempt status, unless the activity is "in furtherance of" the entity's exempt purpose. Unfortunately, legal doctrine in this area is a morass. As detailed below, the IRS inconsistently invokes the commerciality doctrine and courts rarely, if ever, analyze the issues in the linear manner presented in the regulations. As a result, key issues such as the definition of "substantial" and "in furtherance of" have gone largely unaddressed.

The commerciality doctrine can be traced to a 1924 Supreme Court case, *Trinidad v. Sagrada Orden de Predicadores de la Provincia del Santisimo Rosario de Filipinas*,<sup>23</sup> concerning an exempt religious order that had extensive real estate and stock investments and was engaged in limited sales of wine, chocolate, and other articles. The government challenged the exempt status of the Order on the grounds that these "commercial" activities were

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22. Professor Henry Hansmann coined the phrase "nondistribution constraint" for this limitation. As explained by Professor Hansmann: "It should be noted that a nonprofit organization is not barred from earning a profit. Many nonprofits in fact consistently show an annual accounting surplus. It is only the distribution of the profits that is prohibited." Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980) (footnotes omitted). See generally FISHMAN & SCHWARZ, *supra* note 6, at 2-3. The I.R.C. adopts the nondistribution constraint via its requirement in § 501(c)(3) that, in order to be exempt, "no part of the net earnings [of the organization] ... inures to the benefit of any private shareholder or individual." I.R.C. § 501(c)(3) (2000); see also Treas. Reg. § 1.501(c)(3)-1(c)(2). The Treasury Regulations enforce the no inurement rule by requiring an exempt charity to have a dissolution provision in its governing documents indicating that proceeds of the charity's liquidation will be paid to another exempt charity or to the government. *Id.* § 1.501(c)(3)-1(b)(4).

Note that the nondistribution constraint does not prohibit an exempt charity from engaging in all sorts of economic transactions with private individuals, including payments for services rendered, property sales and rentals, loans, and so forth, as long as such transactions are at arm's length and constitute payments for services rendered or the fair market value of goods received. See, e.g., Gen. Couns. Mem. 39,862 (Nov. 22, 1991).

23. 263 U.S. 578 (1924).

inconsistent with exempt status.<sup>24</sup> Finding that the activities were a "negligible factor"<sup>25</sup> in the operations of the Order, the Court upheld the exemption. Nevertheless, the case sowed the seeds of the commerciality doctrine and at the same time established what became known as the "destination-of-income" test for exemption: if the income from business activities was used to promote charitable purposes, the income would not be taxed.<sup>26</sup> Eventually, courts expanded the "destination-of-income" rule to permit exemption of a separate corporation conducting a business whose profits were distributed to charity.<sup>27</sup> In 1945, however, the Court in *Better Business Bureau v. United States*<sup>28</sup> held that the Better Business Bureau could not escape liability for social security taxes under language in the Social Security Act that mirrored I.R.C. § 501(c)(3) because the organization was not "exclusively" organized for educational purposes. The Court noted that under the statute:

[T]he presence of a single noneducational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes.... [I]t being apparent beyond dispute that an important, if not the primary, pursuit of petitioner's organization is to promote not only an ethical but also a profitable business community. The exemption is therefore unavailable to petitioner.<sup>29</sup>

By the mid-1940s, therefore, two distinct strands of legal analysis came to bear on commercial activities of charities. On the one hand, the destination-of-income test permitted charities to engage in commercial activity free from taxation as long as the profits from

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24. *Id.* at 581.

25. *Id.* at 582.

26. See FISHMAN & SCHWARZ, *supra* note 6, at 754; HILL & KIRSCHTEN, *supra* note 5, at 10-4; HOPKINS, *supra* note 6, at 633-34.

27. See, e.g., *Roche's Beach, Inc. v. Comm'r*, 96 F.2d 776, 779 (2d Cir. 1938) (holding exempt a separate corporation that owned improved beachfront property where the income of the corporation was used to support a charitable foundation). See generally FISHMAN & SCHWARZ, *supra* note 6, at 754-55 (discussing the origin of the destination-of-income rule); HILL & KIRSCHTEN, *supra* note 5, at 10-6 to 10-7 (discussing how the destination-of-income test evolved through case law).

28. 326 U.S. 279 (1945).

29. *Id.* at 283.

that activity were used for charitable purposes.<sup>30</sup> At the same time, in *Better Business Bureau*, the Court indicated that if commercial activity was itself a significant purpose of a nonprofit organization, that organization could not be exempt.<sup>31</sup>

These two analytical strands appeared to be in direct conflict. Given the *Better Business Bureau* precedent, one would think that later court decisions would have prohibited exempting a “feeder” organization created for the sole purpose of operating a commercial business and funneling the profits to a charity. The IRS certainly took the hint. In what is one of the most famous exemption decisions in history, the Service argued that Mueller Macaroni Company, owned at that time by New York University, violated the primary purpose test because it did nothing but operate a for-profit business and funnel revenues to New York University’s law school.<sup>32</sup> The Third Circuit, however, upheld exemption for Mueller and distinguished *Better Business Bureau* on the grounds that the Better Business Bureau’s overall purpose was not charitable, but rather was directed toward benefitting “private interest[s],” such as the commercial business community.<sup>33</sup>

The congressional response to cases like *Mueller* did not clarify the relationship between commercial activity and exempt status. As highly publicized cases of exempt organizations engaging in commercial activities, either directly or through separate related “feeder” corporations, began working their way through the courts, hearings on the issue began in 1942.<sup>34</sup> These hearings quickly zeroed-in on the loss of tax revenue from the acquisition by exempt organizations of previously taxable businesses and unfair competition by nonprofits with for-profits as the major policy problems.<sup>35</sup> In what is perhaps one of the funniest quotes by a legislator on tax policy, Representative John Dingell warned,

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30. See sources cited *supra* note 27.

31. *Better Bus. Bureau*, 326 U.S. at 283.

32. *C.F. Mueller Co. v. Comm’r*, 190 F.2d 120, 121 (3d Cir. 1951).

33. *Id.* at 122.

34. See *Revenue Revision of 1942: Hearings Before the House Comm. on Ways and Means*, 77th Cong. (1942).

35. See *id.* at 89 (statement of Randolph Paul, Tax Advisor to the Secretary of the Treasury); see also FISHMAN & SCHWARZ, *supra* note 6, at 755; Dale, *supra* note 13, § 9.02, at 9-5 to 9-8; Sharpe, *supra* note 13, at 380-83.

"Eventually all the noodles produced in this country will be produced by corporations held or created by universities ...."<sup>36</sup>

To address these concerns, Congress enacted the UBIT in 1950, which imposed a tax on "unrelated" business activities and denied exemption to "feeder" organizations, thus ending the destination-of-income test.<sup>37</sup> Unfortunately, the law adopted by Congress to address these issues did not approach taxation of commercial activities by judging either their competitive effects or their potential for tax base erosion.<sup>38</sup> Instead, Congress adopted a relatedness test that attempted to tax only the revenue from commercial activities "unrelated" to the charitable purpose of the exempt organization.<sup>39</sup> Moreover, in enacting the UBIT, Congress also did not specifically address the underlying issue concerning whether excessive commercial activity should cause a loss of exempt status for the entity conducting that activity, and if so, how much such activity was excessive. The dividing line, therefore, between commercial activity taxed under the UBIT but not affecting underlying exemption and commercial activity that *did* impair underlying exemption, went unresolved. In fact, the enactment of the UBIT in some ways exacerbated the problem because the existence of a separate tax on "unrelated" business indicated that Congress believed some significant level of unrelated commercial activity was nevertheless consistent with underlying exempt status; how much, however, no one was willing to say.<sup>40</sup>

As a result, during the period from 1950 to 1959, the IRS struggled to produce new regulations under § 501(c)(3) to shed light on this issue.<sup>41</sup> The final regulations adopted in 1959 appeared to

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36. *Revenue Revision of 1950: Hearings Before the House Comm. on Ways and Means*, 81st Cong. 580 (1950) (statement of Rep. John Dingell).

37. Revenue Act of 1950, ch. 994, § 422, 64 Stat. 906, 950 (codified as amended at I.R.C. §§ 502, 511-13 (2000)).

38. See John Copeland & Gabriel Rudney, *Business Income of Nonprofits and Competitive Advantage*, 33 TAX NOTES 747, 750 (1986); Dale, *supra* note 13, § 9.04, at 9-11.

39. Revenue Act of 1950 § 422.

40. See Kenneth C. Eliasberg, *Charity and Commerce: Section 501(c)(3)—How Much Unrelated Business Activity?*, 21 TAX L. REV. 53, 79-93 (1965). Eliasberg notes that in enacting the UBIT, Congress did not change the underlying primary purpose test, and that prior to IRS regulations issued in 1959, "it was generally assumed that as long as an organization's 'primary purpose' was one described in ... [§ 501(c)(3)], any amount of unrelated business activity would not endanger exempt status." *Id.* at 93.

41. New regulations were originally proposed in 1956, however, the IRS then took three

accept the view that substantial unrelated business activity was consistent with exempt status, as long as operating an unrelated business was not the "primary purpose" of the organization seeking exemption.<sup>42</sup> Nevertheless, the Service continued to use the commerciality doctrine, by citing the language in the Supreme Court's *Better Business Bureau* opinion,<sup>43</sup> to challenge the exempt status of organizations conducting significant business activities. The IRS did so even though *Mueller*, the enactment of the UBIT, and the IRS' own regulations clearly implied that significant commercial activity should not impair exempt status when the revenues from such activity are dedicated to a charitable purpose.

This revival of the commerciality doctrine began in earnest in 1961 with the first of a series of cases dealing with non-denominational religious publishers. In *Scripture Press Foundation v. United States*,<sup>44</sup> the taxpayer, Scripture Press, was formed primarily to improve the quality of teaching texts for Protestant Sunday schools.<sup>45</sup> The company soon found itself highly successful in preparing and selling a variety of religious literature, accumulating more than \$1.6 million in surplus earnings by 1957.<sup>46</sup> As a result, the IRS revoked exempt status for the organization, claiming that, in effect, it was nothing more than a for-profit publisher and hence no longer was operated primarily for charitable purposes.<sup>47</sup> The Claims Court agreed with the IRS, noting that Scripture Press priced its products similarly to for-profit competitors and amassed significant profits.<sup>48</sup> 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.<sup>49</sup> Accordingly, the

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years to "reconsider" them before issuing a substantially revised version in 1959 as the final regulations. *Id.* at 95-96.

42. T.D. 6391, 1959-2 C.B. 139, 145.

43. See, e.g., Rev. Rul. 71-505, 1971-2 C.B. 232 (citing *Better Business Bureau* and denying exemption).

44. 285 F.2d 800 (Ct. Cl. 1961).

45. *Id.* at 803.

46. *Id.* at 804.

47. *Id.* at 801-02.

48. *Id.* at 805-06.

49. *Id.* at 805.



court concluded that Scripture Press was not operated *primarily* for charitable purposes.<sup>50</sup> Subsequently, the Tax Court and federal district courts upheld the IRS' revocation of exemption in a number of other publishing cases.<sup>51</sup>

As a result of *Scripture Press* and subsequent cases, by the early 1980s the Tax Court had developed the view that an organization conducting a significant activity with a "commercial hue" risked losing exempt status.<sup>52</sup> Factors contributing to this impermissible "hue" included the presence of substantial overall profits, use of commercial pricing methods with substantial net profit margins, and competition with for-profit firms in the same sector.<sup>53</sup> In 1991, the Seventh Circuit 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.<sup>54</sup> 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 parent organization.<sup>55</sup>

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50. *Id.* at 806 ("We think the plaintiff could not make a showing that its *primary* purpose was educational any more than it was able to make a showing that its *primary* purpose was religious.").

51. See, e.g., *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, 221 (D. Mass. 1968), *rev'd*, 412 F.2d 121, 125 (1st Cir. 1969); *Fides Publishers Ass'n v. United States*, 263 F. Supp. 924, 936 (N.D. Ind. 1967); *Presbyterian & Reformed Publ'g Co. v. Comm'r*, 79 T.C. 1070, 1090 (1982), *rev'd*, 743 F.2d 148 (3d Cir. 1984).

52. See, e.g., *Presbyterian & Reformed Publ'g*, 79 T.C. at 1083.

53. *Id.* at 1083-85.

54. *Living Faith, Inc. 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.").

55. *Id.* at 373-74.

Neither the IRS nor the courts, however, have applied this commercial hue analysis consistently. In 1984, for example, the Third Circuit reversed the revocation of exempt status for a religious publisher in *Presbyterian & Reformed Publishing Co. v. Commissioner*,<sup>56</sup> 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.<sup>57</sup> 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.<sup>58</sup> 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."<sup>59</sup> A charitable organization, according to the Third Circuit, should be able to make money to expand its audience and influence; doing so does not make the organization any less charitable.<sup>60</sup> 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,<sup>61</sup> an organization that purchased and sold products manufactured by blind individuals,<sup>62</sup> and an organization that operated two public art galleries.<sup>63</sup> A federal appellate court also reversed a lower court ruling upholding a revocation of exemption on commerciality

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56. 743 F.2d 148 (3d Cir. 1984).

57. *Id.* at 151.

58. *Presbyterian & Reformed Publ'g*, 79 T.C. at 1088-89.

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

60. *Id.* at 158-59.

61. *Aid to Artisans, Inc. v. Comm'r*, 71 T.C. 202, 212, 216 (1978). The organization claimed the following charitable purposes: "(1) Helping 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.

62. *Indus. Aid for the Blind v. Comm'r*, 73 T.C. 96, 97, 103 (1979). The charitable purpose was to provide employment for the blind and thus came within the regulations' statement that a charitable purpose includes "relief of the poor and distressed or underprivileged." *Id.* at 101; see also Treas. Reg. § 1.501(c)(3)-1(d) (as amended in 1990).

63. *Goldsboro Art League v. Comm'r*, 75 T.C. 337, 340, 346 (1980).

grounds when the taxpayer, a publishing company, showed that it had no "operational profits."<sup>64</sup> The IRS itself has approved tax-exempt status for 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.<sup>65</sup>

The commercial hue analysis also is inconsistent with other aspects of exemption. As many commentators have observed, private nonprofit hospitals essentially conduct fee-for-service business enterprises that operate virtually indistinguishably from, and compete directly with, for-profit counterparts.<sup>66</sup> To date, however, neither the Service nor any court has suggested that exempt hospitals suffer from impermissible commercial hue. The inconsistency, moreover, extends in reverse: The Eighth Circuit once held that a pharmacy that clearly was *not* operated in a commercial manner, selling only to the elderly and poor at a fixed rate above cost, was not exempt because a pharmacy was inherently a commercial enterprise not deserving of exemption.<sup>67</sup>

Part of the problem with this area is that neither the courts nor the Service appear to use the analytical framework provided by the regulations—that is, the two-step analysis of "is it substantial" followed by "is it in furtherance of an exempt purpose."<sup>68</sup> Instead,

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

65. See Virginia Richardson et al., *Health Clubs*, in INTERNAL REVENUE SERVICE, EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION (CPE) TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 2002, at 11 (2001) (indicating that the operation of a health club by a university or hospital generally does not affect exempt status, but income from memberships sold to general public, as opposed to students and faculty or patients and staff, is generally taxable under UBIT).

66. See, e.g., Frank A. Sloan, *Commercialism in Nonprofit Hospitals*, in TO PROFIT OR NOT TO PROFIT, *supra* note 1, at 151-68 (analyzing various empirical studies showing that nonprofit hospitals "are similar in provision of uncompensated care, in quality of care, and in adoption of technology"); Mark A. Hall & John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307, 375 (1991) ("For the most significant measures of hospital performance—quality and cost—there is little or no difference between [nonprofit and for-profit hospitals]."); David A. Hyman, *The Conundrum of Charitability: Reassessing Tax Exemption for Hospitals*, 16 AM. J.L. & MED. 327, 333, 351 (1990).

67. *Fed'n Pharmacy Servs. v. Comm'r*, 625 F.2d 804, 809 (8th Cir. 1980).

68. T.D. 6391, 1959-2 C.B. 139, 145.

the predominant doctrinal approach that appears to be used in practice by both the Service and many courts is first to determine whether an activity is conducted in a commercial manner<sup>69</sup> and if so, to determine whether that activity is a substantial purpose of the exempt organization, in which case, exemption is denied. The question of whether the commercial activity, even if substantial, is "in furtherance of" an exempt purpose is usually ignored.

In *Scripture Press*, for example, the Claims Court appeared to accept the proposition that the taxpayer had a valid religious purpose in seeking to promote the growth of its Sunday school. The court, however, then phrased the key issue as whether the operation of the publishing business was "incidental" to promoting Sunday school or the other way around.<sup>70</sup> In other words, the court made "substantiality" the key analytical concept. As a result, the Claims Court considered the case closed once it found the publishing business of Scripture Press was indeed "commercial in nature" and that the profits from the publishing business dwarfed expenditures on the Sunday school activity.<sup>71</sup> The court simply never asked the question contemplated by the regulations as to whether the commercial activity was nevertheless in furtherance of an exempt purpose. If it had, the case would have quickly become very complicated. Courts in several other cases have approved the proposition that disseminating religious doctrine is a valid religious purpose under § 501(c)(3).<sup>72</sup> Accordingly, is not publishing religious literature, even if done as a for-profit business, in furtherance of that purpose? The Third Circuit in *Presbyterian & Reformed Publishing* certainly seemed to think so. Although it failed to rely specifically on the "in furtherance of" concept in upholding exemption for the taxpayer in that case, the court did recognize that

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69. See *Presbyterian & Reformed Publ'g*, 79 T.C. at 1083-85 (outlining the criteria to determine whether an activity is conducted in a commercial manner).

70. *Scripture Press*, 285 F.2d at 804.

71. *Id.* at 807.

72. *E.g.*, *Pulpit Res. v. Comm'r*, 70 T.C. 594, 610-11 (1978) (finding that the publication of sermons and resources for religious preaching is a charitable purpose); *A.A. Allen Revivals, Inc. v. Comm'r*, 32 T.C.M. (P-H) 1623, 1632 (1963) (holding that the promulgation of religious beliefs is a religious purpose and that publication and sale of religious materials advanced that purpose); *St. Germain Found. v. Comm'r*, 26 T.C. 648, 657 (1956) (finding that propagating teachings of the "I AM" religion is an exempt purpose).

a profitable publishing business was not necessarily inconsistent with charitable objectives.<sup>73</sup>

Similarly, courts have sent decidedly mixed signals on the "in furtherance of" language in other commerciality cases. In *Aid to Artisans, Inc. v. Commissioner*,<sup>74</sup> the court found that the import and sale of handicrafts from economically disadvantaged individuals was "in furtherance of" the exempt purpose of helping economically disadvantaged artisans.<sup>75</sup> In *Industrial Aid for the Blind v. Commissioner*,<sup>76</sup> however, the Tax Court found the sale of items produced by blind craftsmen "is an exempt activity in and of itself,"<sup>77</sup> apparently rejecting the notion that the activity was a noncharitable commercial activity because of the relatively small profit produced and the fact that most of this small profit was paid as a salary bonus to the blind workers. Finally, in *Goldsboro Art League v. Commissioner*,<sup>78</sup> the court appeared to conclude that the art galleries operated by the taxpayer were not operated with a sufficient commercial hue to endanger exempt status. Again, this result was apparently due to the very small profit and absence of a commercial focus in selecting art works for exhibition.<sup>79</sup> These cases thus appear to more closely track the commerciality approach of *Scripture Press*, analyzing whether an activity is truly commercial, and if so, whether it was substantial, than the approach of the regulations. The publishing cases, moreover, indicate a similar trend. Aside from *Presbyterian & Reformed Publishing*, the cases supporting exemption for organizations engaged in publishing activities appear to do so either because the publishing activity is not profitable, hence in the courts' view, not really commercial,<sup>80</sup> or

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73. *Presbyterian & Reformed Publ'g*, 743 F.2d at 158; see *supra* text accompanying notes 59-60.

74. 71 T.C. 202 (1978).

75. *Id.* at 214 ("Thus, the sale of handicrafts ... is neither an exempt purpose as argued by petitioner nor a nonexempt purpose as argued by [the IRS]. Rather, such sale is merely an activity carried on by Aid to Artisans in furtherance of its exempt purposes.").

76. 73 T.C. 96 (1979).

77. *Id.* at 101-03.

78. 75 T.C. 337 (1980).

79. *Id.* at 344-45.

80. See, e.g., *Elisian Guild, Inc. v. United States*, 412 F.2d 121, 125 (1st Cir. 1969) (finding that the lack of operational profits indicated lack of commercial purpose and noting that "deficit operation reflects not poor business planning nor ill fortune but rather the fact that profits were not the goal of the operation"); *Golden Rule Church Ass'n v. Comm'r*, 41

because the publishing activity was a minor part of overall revenues and expenses.<sup>81</sup> In contrast, exemption was revoked in cases in which profits were large and only modest amounts of other charitable activity occurred, all with little or no analysis of whether publishing was in furtherance of an exempt purpose.<sup>82</sup>

As a doctrinal matter, neither the courts nor the IRS appear to follow the 1959 regulations' analysis of how commercial activities should affect exempt status. Instead of the 1959 regulations' view that only a primary purpose to operate an unrelated business presents an exemption problem, the case law and IRS arguments presented in litigated cases appear to assert that *any* substantial commercial activity presents an exemption problem. Nevertheless, there are enough significant exceptions to this "is it commercial; is it substantial" approach<sup>83</sup> that making doctrinal generalizations is very hazardous to one's exempt status.

### *B. The Relationship of the Commerciality Doctrine to the UBIT and the Commensurate-In-Scope Test*

Another major problem with determining the effects of commercial activity based on exempt status is that neither the Service nor the courts have specifically defined how the primary purpose test for exemption interfaces with the UBIT. As noted above, the adoption of the UBIT in 1950 (in lieu of banning commercial activity by exempt charities entirely) implicitly recognized that many exempt charities would, in fact, engage in significant commercial activities both related and unrelated to the charities' exempt purpose, and that those activities would not result in loss of

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T.C. 719, 731 (1964) (rejecting the IRS' contention that conducting training programs for a fee violated commerciality doctrine and stating, "we regard consistent nonprofitability as evidence of the absence of commercial purposes").

81. See, e.g., *A. A. Allen Revivals v. Comm'r*, 32 T.C.M. (P-H) 1623, 1632 (1963) (finding that modest profits from publications were spent on advancing religious beliefs and that profit is not a violation of the commerciality limitation).

82. See, e.g., *Inc. Trs. of Gospel Worker Soc'y v. United States*, 510 F. Supp. 374, 378-79 (1981); *Fides Publishers Ass'n v. United States*, 263 F. Supp. 924, 936 (1967); *Scripture Press*, 285 F.2d at 807.

83. See, e.g., *Presbyterian & Reformed Publ'g*, 743 F.2d at 148; *Fed. Pharmacy Servs. v. Comm'r*, 625 F.2d 804, 804 (8th Cir. 1980).

underlying tax exemption.<sup>84</sup> The UBIT, however, operates using a relatedness concept,<sup>85</sup> whereas tax exemption uses the "primary purpose/in furtherance of" test described above,<sup>86</sup> leaving the intersection of these rules unclear.

Case law sheds virtually no light on the overall interface between taxing commercial activity and revoking tax exemption because of it. IRS litigating strategy tends to present cases as either exemption cases or UBIT cases, so courts rarely have had the opportunity to consider the relationship between the two doctrines.<sup>87</sup> Take, for example, the two main religious publishing cases, *Scripture Press* and *Presbyterian & Reformed Publishing Co.*, described above.<sup>88</sup> In each case, the Service sought revocation of exemption, not imposition of the UBIT on the publishing revenues.<sup>89</sup> As a result, neither court analyzed whether the publishing activity was "related" or "unrelated" to the taxpayer's exempt purposes, or whether a better analytical approach would have been to concede that the entities involved had valid religious or educational purposes (and were therefore nominally exempt) but instead concluded that the revenues from the publishing business should be taxed under the UBIT.<sup>90</sup> On the other hand, cases involving the UBIT never consider whether the commercial activity that the Service seeks to tax should result in loss of tax exemption. A perfect example of this is *Carle Foundation v. United States*,<sup>91</sup> where the Service claimed that pharmacy sales to the general public

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84. See *supra* notes 37-40 and accompanying text. Obviously, if any level of commercial activity, related or unrelated, caused loss of exemption, there would be no need for a separate tax on the commercial activities of exempt organizations.

85. See *supra* note 39 and accompanying text.

86. See *supra* notes 19-21 and accompanying text.

87. See Peña & Reid, *supra* note 13, at 184 ("Although the Service recognizes that there is a relationship between the operational test and UBIT .... it is commonplace for the Service to make a UBIT determination without ever questioning whether or not the charity continues to qualify for exemption.").

88. See *supra* notes 44-60 and accompanying text.

89. *Presbyterian & Reformed Publ'g Co. v. Comm'r*, 743 F.2d 148, 151 (3d Cir. 1984); *Scripture Press Found. v. United States*, 285 F.2d 800, 801 (Ct. Cl. 1961).

90. Cf. Tech. Adv. Mem. 96-36-001, 8 (January 4, 1995) (concluding that large scale publishing business by religious educational organization was subject to UBIT but did not endanger exempt status). See *infra* notes 103-08 and accompanying text for a discussion of this memorandum.

91. 611 F.2d 1192 (7th Cir. 1979).

constituted unrelated business income to an exempt hospital.<sup>92</sup> The IRS never raised, and the courts never considered, whether such sales, if “unrelated,” should cause loss of exempt status.

The overall structure of the UBIT does suggest a few answers to this quandary. The regulations under the UBIT define a “related” activity as one that has a “causal relationship” to the achievement of the exempt purpose, excluding that of simply supplying income for use in exempt activities.<sup>93</sup> If such a causal relationship exists, then surely the activity must also be in furtherance of the exempt purpose.<sup>94</sup> Moreover, it is hard to believe that in adopting the UBIT, Congress believed activity escaping taxation under the UBIT should nevertheless create problems for tax exemption. As a result, one can fairly conclude that commercial activity “related” for UBIT purposes ought not have any adverse exemption effects.

If commercial activity is unrelated for UBIT purposes, however, the analysis of the effects of that activity on exempt status is very murky. As noted above, section 1.501(c)(3)-1(e) of the 1959 regulations appears to contemplate that even “unrelated” activity can be in furtherance of an exempt purpose, and that a substantial amount of such unrelated activity can be viewed as consistent with exempt status.<sup>95</sup> If this were not the case, presumably there would be no need for the statement later in the regulation that exemption will be denied where an organization’s “primary purpose” is to operate an unrelated business<sup>96</sup> because section 1.501(c)(3)-1(c)(1) already prohibits any substantial activity not in furtherance of an exempt purpose.<sup>97</sup>

Although the 1959 regulations fail to define the “in furtherance of” concept, several IRS rulings suggest that the key issue in determining whether substantial unrelated business activity is consistent with underlying exemption is whether the revenues from

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92. *Id.* at 1194.

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

94. *See, e.g.,* HOPKINS, *supra* note 6, at 646 (stating that “conventional thinking” is that exempt status is threatened only by unrelated business activity).

95. Treas. Reg. § 1.501(c)(3)-1(e) (as amended in 1990); *see supra* notes 19-21 and accompanying text.

96. Treas. Reg. § 1.501(c)(3)-1(e) (as amended in 1990).

97. *Id.* § 1.501(c)(3)-1(c)(1). This is a threshold presumably far below the “primary purpose” language in regulations section 1.501(c)(3)-1(e). *See supra* note 96 and accompanying text.



such business are used to cross-subsidize charitable activity. This approach, sometimes referred to in Service rulings as the "commensurate-in-scope" doctrine, appears to have originated in a 1964 Revenue Ruling upholding the exempt status of a charitable organization deriving its revenues largely from renting space in a commercial office building.<sup>98</sup> The revenues were used to make grants to other charitable entities, and the IRS ruled that the organization was entitled to retain its exempt status under I.R.C. § 501(c)(3) because it was carrying on a charitable program commensurate in scope with its financial resources.<sup>99</sup> The doctrine appeared again in a 1971 General Counsel's Memorandum, in which the Service cautioned its agents against using unrelated business income as a test for whether an organization was due an underlying exemption:

[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.

....  
... [F]or some time now it has been increasingly apparent that our earlier approach to the problem of permissibility or non-permissibility 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.<sup>100</sup>

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98. See Rev. Rul. 64-182, 1964-1 C.B. 186-87.

99. *Id.*

100. Gen. Couns. Mem. 34,682 (Nov. 17, 1971).

As noted above, however, the admonition in this Memorandum against using unrelated business activity as a basis for revoking exempt status did not appear to filter down to IRS litigators, who throughout the next three decades continued to challenge exempt status for organizations operating commercial businesses, rather than arguing that such businesses should be taxed under the UBIT while leaving baseline exempt status intact.<sup>101</sup>

This schizophrenia apparently exists even today.<sup>102</sup> On the one hand, two unique IRS determinations specifically considering both the exemption and UBIT effects of commercial activity support the view that substantial unrelated business activity will not adversely affect exempt status, provided the revenues from such unrelated activity are used to fund clearly charitable activities. In a 1995 Technical Advice Memorandum, the Service analyzed a case involving an exempt religious organization that published textbooks and other instructional materials for religious schools.<sup>103</sup> The organization started its publishing activities to supply its own schools with textbooks, but soon expanded to provide religious-oriented textbooks to schools worldwide.<sup>104</sup> Revenues from the publishing business constituted more than half the total gross revenues of the organization, and its profit margins were as high as seventy-five percent, although expenditures on the publishing business were less than half the organization's total expenditures.<sup>105</sup>

Finding the publishing activities 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 Service concluded that the profits were subject to the UBIT.<sup>106</sup> At the same time, however, the Service concluded that the obviously substantial nature of the publishing business did not endanger the taxpayer's exempt status because "[t]here is no evidence that any of the funds generated by [the publishing

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101. See *supra* note 43 and accompanying text.

102. See generally 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) (discussing the checkered history of the commensurate-in-scope doctrine).

103. Tech. Adv. Mem. 96-36-001 (Jan. 4, 1995).

104. *Id.*

105. *Id.*

106. *Id.*

business] were not properly used to further the organization's educational purposes in some manner."<sup>107</sup> Accordingly, the taxpayer was entitled to exemption "because it is carrying on an exempt program commensurate in scope with its financial resources."<sup>108</sup>

Similarly, in an early 2000 Letter Ruling, the Service ruled that an organization formed to give financial assistance to needy women would not lose exemption from the operation of an unrelated business (a gift shop and tea room) providing sixty-six percent of the organization's resources.<sup>109</sup> The Service reasoned that an unrelated business used as a fundraiser for an overall charitable purpose was operated in furtherance of a charitable purpose and did not constitute a substantial nonexempt purpose.<sup>110</sup>

On the other hand, the IRS invoked the commensurate-in-scope test to deny exempt status in two recent exemption cases, although ultimately these cases were settled or decided on other grounds. Both cases, however, could be read as broadly consistent with the "cross-subsidization" explanation of the "in furtherance of" requirement of the regulations, since in one case the IRS claimed that large accumulations of surplus were not being spent on charitable purposes and in the other argued that all but four percent of the organization's funds were being paid as fees to professional fundraisers.<sup>111</sup> Thus the IRS' own internal view of the

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107. *Id.*

108. *Id.*

109. Priv. Ltr. Rul. 2000-21-056 (Feb. 8, 2000).

110. *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.").

111. In its April 1999 audit of the Kamehameha Schools Bishop Estate (KSBE) in Hawaii, the IRS apparently raised the issue regarding the taxpayer KSBE's large accumulations of surplus and lack of expenditures for educational purposes as potential grounds for revoking tax exemption. The case was never litigated as both the IRS and KSBE executed a closing agreement on the tax issues. For an in-depth look at the KSBE case and the tax issues involved, see Brody, *supra* note 102. About eight years earlier, the IRS wrote an unpublished Technical Advice Memorandum involving United Cancer Council, Inc. (UCC), which concluded that UCC had failed the commensurate-in-scope test because only about four percent of its revenue was used for charitable purposes, the balance having been paid to a private fundraiser and spent on administrative costs. See 4 EXEMPT ORGANIZATIONS TAX REVIEW 726 (1991) (reprinting the unpublished memorandum). Although UCC's exempt status ultimately was litigated in Tax Court, the actual litigation did not rely on the commensurate-in-scope analysis. See *United Cancer Council, Inc. v. Comm'r*, 109 T.C. 17 (1997); HOPKINS, *supra* note 6, at 75.

validity of the commensurate-in-scope doctrine and its application to the "in furtherance of" test of the regulations is unknown.

In fact, the commensurate-in-scope test could explain many of the results in the commerciality cases even though the doctrine does not constitute the stated grounds for decision. Thus the resale shop cases pass muster under this test because virtually all of the profits generated by the shops were plowed back into the charitable operation.<sup>112</sup> Religious publishers such as Scripture Press that appeared to hoard profits with no expenditures toward significant charitable activity fail the test,<sup>113</sup> whereas publishers that did dedicate profits to other significant charitable activities remained exempt.<sup>114</sup> But the courts have never officially invoked the commensurate-in-scope test as an analytical tool in these cases, and the Service has itself invoked the test only sporadically (and until recently, only in support of exempt status). Moreover, the commensurate-in-scope analysis does not explain why the Third Circuit supported exemption for Presbyterian & Reformed Publishing, which also hoarded significant profits,<sup>115</sup> and does not explain the Eighth Circuit's decision in *Federation Pharmacy Services v. Commissioner* that a pharmacy operated at cost for the poor and elderly (and that was therefore clearly operating commensurate in scope with its charitable purpose) was not tax exempt.<sup>116</sup>

In short, neither the Service nor the courts have developed a consistent doctrinal approach to measure when commercial activity by an exempt charity risks its exempt status. Virtually identical religious publishing operations have been held exempt or not, seemingly dependent on the mood of the reviewing court. A pharmacy not operating in a commercial manner is not exempt, but a hospital operating very much in a commercial manner is granted exemption without question. Resale shops for the blind and poor are tax exempt, but benefitting the poor of the Navajo Nation by leasing oil well drilling equipment is not.<sup>117</sup>

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112. See *supra* notes 61-63 and accompanying text.

113. See *Scripture Press*, 285 F.2d 800.

114. See, e.g., *A. A. Allen Revivals, Inc. v. Comm'r*, 32 T.C.M. (P-H) 1623 (1963).

115. *Presbyterian & Reformed Publ'g*, 743 F.2d at 148.

116. *Fed'n Pharmacy Servs. v. Comm'r*, 625 F.2d 804, 804 (8th Cir. 1980).

117. Compare the resale cases with *Greater United Navajo Dev. Enters. v. Comm'r*, 74

In 1971, the Service cautioned its agents against using the scope of business activity to deny exemption, but even throughout this period the Service continued to litigate denials of exemption on commercial activity grounds and officially invoked the commensurate-in-scope test as a tool for denying exempt status in two instances in the 1990s.<sup>118</sup> Meanwhile, the courts unwittingly may be using a sort of commensurate-in-scope analysis in many of the commerciality cases, but certainly not all of them. Under the circumstances, the best one can divine from the case law and rulings is that the less commercial activity an exempt charity has, the less likely it will face serious exemption problems. The result is a position that is not a very happy circumstance for the administration of the tax laws, nor one that appears to reflect any well-considered underlying public or tax policy approach to the subject.

### *C. The Effects of Indirect Commercial Activity in Complex Structures*

#### *1. The Corporate Separate-Identity Rule and the Integral-Part Test*

The problems with assessing the effects of commercial activity on exempt status extend beyond commercial activities conducted directly by exempt organizations. In fact, precisely because of the exemption risks of direct commercial activities, many charities have adopted complex business structures using separate corporate subsidiaries in an effort to isolate themselves from the exemption risks posed by direct commercial activity.<sup>119</sup>

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T.C. 69 (1980), where the court granted no exemption despite a stated purpose to promote economic development among the poor of the Navajo Nation where the record showed that the main business activity was leasing oil drilling equipment and no Navajo were employed in that activity. The Tax Court held that training of unskilled workers, although charitable, was "of relatively minimal consequence" on the record. *Id.* at 82.

118. See *supra* notes 100-01 and accompanying text.

119. See generally HILL & KIRSCHTEN, *supra* note 5, §§ 9.01-9.10 (discussing the use of complex business structures by charities); McGovern, *supra* note 5, at 1128 ("To survive in a dramatically changing economy, many section 501(c)(3) organizations began to revise their corporate structures. The increased use of taxable subsidiary corporations was a part of this strategy."). A perfect example of this strategy occurred recently when the IRS threatened to revoke tax exemption for an Internet Service Provider (ISP) which had been formed to provide "community access" to the Internet. See Priv. Ltr. Rul. 2002-03-069 (June 11, 2001).

The separate-subsidary strategy relies on a long standing tax rule developed from the Supreme Court decision in *Moline Properties v. Commissioner*<sup>120</sup> that the separate existence of a corporation must be respected for tax purposes, and that activities of a corporation formed for a valid business purpose cannot be attributed to the corporation's shareholder.<sup>121</sup> Although *Moline Properties* was not a tax-exemption case, the IRS followed the separate-identity principle in analyzing exempt status.<sup>122</sup> In fact, the Service has repeatedly noted in the charitable context that "the activities of a separately incorporated subsidiary cannot ordinarily be attributed to its parent organization unless the facts provide clear and convincing evidence that the subsidiary is in reality an arm, agent or integral-part of the parent. This is an evidentiary burden that is not easily overcome."<sup>123</sup>

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When the IRS discovered that seventy-five percent of the organization's revenues came from supplying internet service to the public for a fee, it ruled that the ISP failed the primary purpose test. *Id.* The case was settled by the ISP agreeing to transfer its profit-making activities to a controlled for-profit subsidiary, leaving the "public access" activities in the parent. *Id.*; see also *Internet Service Provider Regains Exempt Status by Forming Taxable Sub*, 25 EOTR WEEKLY 17 (Jan. 28, 2002).

120. 319 U.S. 436 (1943).

121. *Id.* *Moline Properties* was a corporation that held title to certain real estate, and was owned by a single shareholder. *Id.* at 437. When the corporation sold the real estate, it argued that no corporate-level tax was due on the sale because it was merely an agent or alter ego of the shareholder. *Id.* at 440. The Supreme Court held that the tax system must respect the separate-identity of a corporation formed for a valid business reason, a holding which in effect protected the integrity of the corporate tax. *Id.* As noted below in Part III, if one consciously decides *not* to protect the corporate tax base by permitting exempt organizations to capture premium financial returns on direct commercial operations, or if one decides to *better* protect the corporate tax base through application of an expanded UBIT to business income, there is no policy reason to apply *Moline Properties* to the issue of whether a complex charitable enterprise is engaged in a charitable purpose. For an extensive discussion of *Moline Properties* and subsequent cases, see HILL AND KIRSCHTEN, *supra* note 5, ¶ 9.01.

122. In 1985, the IRS considered the case of a tax-exempt charity formed to provide management services to nonprofit hospitals. Gen. Couns. Mem. 39,326 (Jan. 17, 1985). When the organization decided to expand its services to other organizations, including for-profit businesses, on a for-profit basis, it isolated these expanded activities in a controlled for-profit subsidiary. *Id.* The IRS ruled in the Memorandum that the activities of the subsidiary would not be imputed to the exempt parent under the *Moline Properties* doctrine. *Id.*

123. *Id.* Similarly, in a 1986 private ruling the IRS found that even where the subsidiary's entire board of directors was made up of directors and employees of the exempt parent, the separate-identity principle would be observed because "the considerable evidentiary burden required to show that the taxable subsidiary is in reality an instrumentality of the parent is not easily overcome." Priv. Ltr. Rul. 87-06-012 (Oct. 31, 1986).

Just as scholars generally fail to explore the intersection of the UBIT and exempt status with respect to commercial activity, scholars also generally fail to recognize that the separate-identity rule has both "upstream" and "downstream" consequences. On the "upstream" side, the rule means that business activities of a controlled subsidiary generally will not be attributed to the corporate parent (or to sibling corporations) in assessing the exempt status of that parent (or the siblings).<sup>124</sup> Thus, an exempt parent corporation can protect itself from worry about whether commercial activities jeopardize exempt status by isolating such activities in a separate subsidiary. This upstream isolation effect is what often spurs exempt charities to create taxable subsidiaries in order to isolate the effects of commercial activity (which might well be subject to the UBIT in any event) on exempt status.

The corporate separate-identity rule, however, also produces a "downstream" isolation effect. Because of the rule, the charitable activities of a parent or sibling corporation also generally cannot be imputed to a controlled subsidiary in order to classify it as charitable. Current tax doctrine contains one exception to this downstream isolation rule, the integral-part doctrine, but as illustrated below, the integral part exception is extremely limited in its application.

The downstream isolation effect of the separate-identity rule enjoyed relative obscurity until a famous series of cases in the early 1990s dealing with Geisinger Health Plan (GHP).<sup>125</sup> GHP was a subsidiary formed by Geisinger Foundation, the exempt parent of a health care system that operated in Pennsylvania. The Geisinger system included a number of subsidiary corporations, including clinics that employed doctors and two exempt hospital subsidiaries.<sup>126</sup> GHP's sole purpose in this system was to conduct a health maintenance organization (HMO) that enrolled members in Geisinger's service areas.<sup>127</sup> GHP offered no health services to its

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124. Gen. Couns. Mem. 39, 326 (Jan. 17, 1985); FISHMAN & SCHWARTZ, *supra* note 6, at 828; HILL & KIRSCHTEN, *supra* note 5, ¶ 9.02.

125. See *Geisinger Health Plan v. Comm'r*, 62 T.C.M. (CCH) 1656 (1991) (Geisinger I), *rev'd*, 985 F.2d 1210 (3d Cir. 1993), *remanded to* 100 T.C. 394 (1993) (Geisinger II), *aff'd*, 30 F.3d 494 (3d Cir. 1994).

126. *Geisinger Health Plan v. Comm'r*, 985 F.2d 1210, 1212 (3d Cir. 1993).

127. *Id.* at 1213.

members on its own. Instead, it contracted with other members of the Geisinger System, including the two subsidiaries that operated acute-care hospitals, to perform those services.<sup>128</sup>

The Geisinger litigation involved two phases. The first phase involved the Service's conclusion that GHP standing alone did not meet the relevant tests of tax exemption—a classic application of the corporate separate-identity rule.<sup>129</sup> GHP, however, had argued that even if it did not qualify for tax exemption as a stand-alone entity, it should be granted exemption because it was an integral part of the Geisinger Health System, which as a whole met the community benefit standards for exemption.<sup>130</sup> Because the Tax Court had not reached this issue in its original opinion, the Third Circuit remanded the case for further consideration.

Thus, the second phase of the litigation focused on the circumstances under which a subsidiary corporation could claim “derivative” exemption by virtue of its relationship with a parent or sibling entity. As the Tax Court noted, the “integral part” language appears as part of the § 502 regulations, the Code section which *denies* exemption to feeder organizations. This regulation states, “If a subsidiary organization ... would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption will not be lost because ... the subsidiary derives a profit from its dealings with its parent ....”<sup>131</sup> The regulation further states that a subsidiary is not exempt if its primary purpose is carrying on a business that would constitute an unrelated business if conducted by the parent.<sup>132</sup> As an example of integral-part exemption, the regulation offers a subsidiary operated for the sole purpose of furnishing electric power to the parent.<sup>133</sup>

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128. *Id.*

129. After the Service denied GHP's application for exempt status, GHP appealed to the Tax Court, which initially held GHP exempt as a stand-alone entity. *Geisinger I*, 62 T.C.M. 1656 (1991). The IRS then appealed this decision to the Third Circuit, which reversed the Tax Court on the grounds that GHP did not meet the relevant “community benefit” test of exemption for health care providers because it provided little or no free care for the poor and only limited access to Medicaid patients. *Geisinger Health Plan*, 985 F.2d at 1219-20.

130. *Geisinger Health Plan*, 985 F.2d at 1220.

131. Treas. Reg. § 1.502-1(b) (as amended in 1970).

132. *Id.*

133. *Id.*



Prior to *Geisinger I*, the Service and courts had routinely approved derivative exemption for corporations that essentially were "captive" service organizations on the basis of this regulation.<sup>134</sup> Consistent with this approach, the Service's position in *Geisinger II* was that in order to qualify for exemption under the integral-part test, the services performed by a subsidiary of an exempt parent must be "essential" to the charitable purpose of the parent, provided only to the exempt parent, and must not be services that would constitute an unrelated business if carried on by the parent.<sup>135</sup> GHP agreed with the "not an unrelated business" criterion, but took a broader view of the relationship between siblings that would support an integral part analysis.<sup>136</sup> It argued that as long as the subject organization's activities were undertaken under the supervision or control of an exempt parent or sibling, the integral-part test should apply.<sup>137</sup>

The Tax Court's opinion avoided the relationship issue; on the unrelated business issue, it simply found that the record was insufficient to conclude anything much about whether the HMO at issue would have been an unrelated business in the hands of one of the Geisinger System hospitals, and therefore ruled that the taxpayer had not carried its burden of proof on that issue.<sup>138</sup>

Geisinger appealed the Tax Court's decision on the integral-part issue to the Third Circuit,<sup>139</sup> which proceeded to make the integral part test completely unintelligible. Foregoing the UBIT issue, which was the basis of the Tax Court's decision, the Third Circuit instead directly addressed the kind of relationship between affiliated corporate entities that would support integral-part exemption.<sup>140</sup> On this point, the court stated that a subsidiary could claim integral-

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134. See, e.g., *Squire v. Students Book Corp.*, 191 F.2d 1018 (9th Cir. 1951) (approving exemption for a university book store); Rev. Rul. 78-41, 1978-1 C.B. 148 (approving exemption for subsidiary of nonprofit hospital formed to provide self-insurance for malpractice claims against hospital); Rev. Rul. 63-235, 1963-2 C.B. 210 (approving exemption for incorporated law review association that published law review for a related law school). See generally HOPKINS, *supra* note 6, at 552-53 (discussing exemptions for affiliated organizations).

135. *Geisinger II*, 100 T.C. at 402.

136. *Id.*

137. *Id.* at 406.

138. *Id.*

139. *Geisinger Health Plan*, 30 F.3d at 498.

140. *Id.* at 501.

part exemption when “its relationship to its parent somehow enhances the subsidiary’s own exempt character to the point that, when the boost provided by the parent is added to the contribution made by the subsidiary itself, the subsidiary would be entitled to § 501(c)(3) status.”<sup>141</sup> Ultimately, in its second consideration of *Geisinger* in 1994, the Third Circuit suggested that this “boost” was lacking because GHP’s relationship with the system did nothing to enhance GHP’s own delivery of health services—it did nothing more by virtue of its relationship with the Geisinger system than it would have done standing alone.<sup>142</sup>

The *Geisinger* “boost” analysis has been widely and correctly criticized as inconsistent with a long line of cases and rulings prior to *Geisinger* that approved derivative exemption without any apparent “boost” of any sort, and as offering virtually no doctrinal guidance for determining what kind of parent/subsidiary or sibling relationship would support derivative exemption under the integral-part test.<sup>143</sup> A good indication of the near-universal disdain for the Third Circuit’s opinion in *Geisinger* is that no subsequent case has embraced the “boost analysis,” and even the IRS has steadfastly avoided it.

Recently, however, the Tax Court interpreted the “not an unrelated business” aspect of the integral-part analysis in a way that, in conjunction with the Third Circuit’s “boost” analysis, appears to create a superbly crafted Catch-22 for subsidiary corporations seeking exemption under the integral-part test. In *IHC Care, Inc. v. Commissioner*,<sup>144</sup> the court reviewed the issue of whether a “contract” model HMO<sup>145</sup> similar to that in *Geisinger* could meet the integral part analysis.<sup>146</sup> Unlike GHP, this time the taxpayer (IHC)

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141. *Id.*

142. *Id.* at 502-03.

143. See, e.g., HOPKINS, *supra* note 6, at 552-55 (noting inconsistency between “boost” analysis and prior decisions); DOUGLAS M. MANCINO, TAXATION OF HOSPITALS AND HEALTH CARE ORGANIZATIONS § 6.02[2] (2001) (declaring the boost test “an incorrect interpretation of the law ... at variance with virtually every decided case and published ruling”).

144. 82 T.C.M. (CCH) 617 (2001).

145. I use the phrase “contract model” to refer to a structure in which the HMO does not actually employ health care professionals directly or directly own health care facilities; instead, the HMO contracts with doctors and hospitals to provide these services to its members.

146. *IHC Care*, 82 T.C.M. (CCH) at 626.

had provided evidence regarding its member services, so that the integral-part issue could not be disposed of on the basis of the taxpayer's failure to carry its burden of proof.<sup>147</sup> Thus, presented squarely with the integral-part issue, the Tax Court held that the IHC HMO could not meet the integral-part test because it provided substantial services to its members via contracts with doctors who were not employees of IHC's exempt sibling entities.<sup>148</sup> These services were not essential to the exempt entities, and according to the court, therefore not "substantially related" to the exempt purposes of IHC's sibling corporations. Hence, the court concluded that IHC could not pass the "not an unrelated business in the hands of the exempt parent" prong of the integral-part test.<sup>149</sup>

This analysis seems to prohibit integral-part exemption when a subsidiary corporation provides services beyond its sibling group on the grounds that such "beyond the group" services would be an unrelated business. But the Third Circuit in *Geisinger* seem to say that without evidence of some additional services resulting from the relationship between the exempt sibling and the corporation seeking derivative exemption (e.g., the "boost"), integral-part exemption also is unavailable. This "damned if you do; damned if you don't" state of the current law means, in turn, that the integral-part test probably limits derivative exemption to a very narrow class of captive service organizations already approved by the IRS via past precedents. In any event, the integral-part test as currently interpreted provides no general path for siblings to claim derivative exemption, and makes the "downstream" isolation effect of current law impenetrable in all but a very narrow class of captive service subsidiaries.

The lack of any general method for a noncaptive service subsidiary to escape the downstream isolation effect of the corporate separate-identity rule can potentially create some bizarre differences in the tax treatment of commercial activities depending on whether such activities are conducted as a "division" of an exempt parent or in a separate subsidiary. If a particular

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147. See *supra* note 138 and accompanying text.

148. *IHC Care*, 82 T.C.M. (CCH) at 626. The court noted that eighty percent of the physician services provided to IHC members came from doctors not employed by IHC-affiliated exempt entities. *Id.*

149. *Id.*

commercial activity is conducted as a division and considered substantially related to the charitable purpose of the parent, then the revenues from the commercial activity are wholly untaxed. The same commercial activity in a separate subsidiary, however, triggers the downstream isolation effects of the corporate separate-identity rule, causing the subsidiary to be fully taxable. Because the activity itself is not charitable, the only hope for the subsidiary is to qualify for derivative exemption under the integral-part analysis, which, as noted above, is virtually impossible given current interpretations of that doctrine.<sup>150</sup>

## 2. The Partnership Attribution Rule

Another disconcerting bump in the commerciality analysis is that partnerships are treated completely opposite to corporations in

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150. As an example, assume that an exempt hospital operates an outpatient surgery facility. If operated as a division of the hospital, such a facility has no effect on exempt status and is not subject to the UBIT. Priv. Ltr. Rul. 2001-17-041 (Jan. 29, 2001). If conducted in a separate corporate subsidiary, however, it is not clear that such a facility would be entitled to tax exemption standing alone. Particularly if the subsidiary did not provide free care to the poor or treat significant numbers of Medicaid patients, the subsidiary might not meet the community benefit tests of exemption applicable to health care providers (much as the Geisinger HMO did not meet them on a stand-alone basis). See *supra* note 129 and accompanying text; see also *Redlands Surgical Servs. v. Comm'r*, 113 T.C. 47 (1999), *aff'd*, 242 F.3d 904 (9th Cir. 2001) (holding that a subsidiary of an exempt parent that was a partner with a for-profit entity in an outpatient surgery clinic was not tax exempt).

This potential inconsistency was highlighted in a somewhat different way by the IRS in 1990. Gen. Couns. Mem. 39,830 (Aug. 30, 1990). Issued in 1990 prior to the *Geisinger* litigation, this Memorandum previewed the Service's position in *Geisinger*, analyzing whether a contract-model HMO that was part of a large health care system could be exempt under the integral-part theory and noting that the IRS had ruled earlier that the HMO could not separately qualify for tax exemption. *Id.* In the course of its analysis, the Service found that the HMO could not meet the integral part test because it would provide services beyond "captive" services to the parent corporation. *Id.* The Service also opined that the HMO would fail the "unrelated business" portion of the test because of the historic IRS position that any services or products that a hospital provides to persons other than patients constitute an unrelated business. *Id.* Therefore, according to this analysis, the HMO would be an unrelated business in the hands of its exempt-hospital sibling because it would provide services to people who would not necessarily be patients of the hospital. In a footnote, however, the IRS conceded that "as a practical matter, a hospital probably would not pay the unrelated business income tax on revenues from an HMO operated as a division of the hospital ... because the HMO activities would be described in section 501(c)(4)." *Id.* The IRS recognized at the end of the Memorandum that "the result in this case may appear to some as the elevation of form over substance," but opined that the choice of a particular business entity "involves both advantages and disadvantages from a tax standpoint." *Id.*

assessing the effects of commercial activity. Unlike the corporate separate-identity rule, which provides both upstream and downstream isolation for commercial activities, the IRS has ruled that partners in a partnership are deemed to be in the underlying business of the partnership for exemption purposes.<sup>151</sup> This rule, based on the aggregate theory of partnership operations,<sup>152</sup> applies whether the partner is a general or limited partner, and also applies to members of a limited liability company that has chosen to be taxed as a partnership.<sup>153</sup> Like the corporate separate-identity rule, the attribution rule for partnerships developed outside the tax-exemption context.<sup>154</sup>

In assessing charitable status, the attribution rule for partnerships means that an exempt entity that is a partner will be deemed to be in the business of the partnership. The effects of that business on exempt status presumably would be analyzed in the same manner as if the business were conducted by the exempt entity directly—that is, the charitable partner would be at the mercy of the commerciality doctrine and its virtually undefined intersection with the UBIT and, possibly, the commensurate-in-scope test. The attribution rule also means, however, that partnership activities should not suffer from the downstream isolation effects of the corporate separate-identity rule—that is,

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151. Rev. Rul. 98-15, 1998-1 C.B. 718, 720-21; see also Mary Jo Salins et al., *Whole Hospital Joint Ventures*, in INTERNAL REVENUE SERVICE, EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION (CPE) TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 2002, at 13 (2001), available at <http://www.irs.gov/pub/irs-utl/topica.pdf> (last visited Sept. 13, 2002); Rochelle Korman & Dahlia Balsam, *Joint Ventures With For-Profits After Rev. Rul. 98-15*, 27 EXEMPT ORG. TAX REV. 441 (2000).

152. The aggregate theory states that a partnership is simply an aggregate of its individual partners. See, e.g., 1 WILLIAM S. MCKEE ET AL., *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 1.02, at 1-6 (3d ed. 2001).

153. Rev. Rul. 98-15, 1998-1 C.B. 718, 720-21; Salins et al., *supra* note 151 at 13; Korman & Balsam, *supra* note 151, at 441.

154. See *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 bad-debt deduction: "By reason of being a partner in a business petitioner was individually engaged in business") (quoting *Ward v. Comm'r*, 20 T.C. 332, 343 (1953), *aff'd*, 224 F.2d 547 (9th Cir. 1955)). United States taxation principles relating to international businesses and individuals also hold that partners are engaged in the business of the partnership for purposes of determining U.S. source income. I.R.C. § 875 (2000). For a general discussion of the "aggregate versus entity" tension in partnership taxation, see MCKEE ET AL., *supra* note 152, ¶ 1.02, at 1-6 to 1-9; ARTHUR B. WILLIS ET AL., *PARTNERSHIP TAXATION* ¶ 1.04, at 1-62 to 1-68 (2001).

partnership activities might well escape taxation in certain circumstances because, in the context of the overall operations of the exempt partner, the partnership activity might be considered substantially related under UBIT precedents and thus escape taxation completely.<sup>155</sup>

In any event, the aggregation rule for partnerships produces significantly different risks and benefits with respect to tax-exempt status for an exempt parent organization than the corporate separate-identity rule. Because both rules were simply adopted wholesale from tax law developed in cases not dealing with tax-exempt status, however, neither the IRS nor the courts have ever addressed whether these rules make sense in the context of assessing tax-exempt status for individual components of a charitable enterprise.

#### *D. Summary*

The amalgamation of the commerciality doctrine, the UBIT, the “corporate separate-identity” rule and the “partnership attribution” rule has produced doctrinal confusion and contradictory results with respect to commercial activity by exempt charities. On the one hand, the commerciality doctrine holds that a charitable entity directly conducting commercial activities may jeopardize its exempt status.<sup>156</sup> Because the IRS views partners as engaged in the business activities of a partnership,<sup>157</sup> this same risk to exemption results when a charitable organization is involved in commercial activities as a partner or member of a limited liability company taxed as a partnership. Determining exactly what commercial activities produce this risk is, however, exceedingly difficult. The analysis appears to depend first, on whether a given commercial activity would be considered “related” under the UBIT (a question that presents its own doctrinal problems); second, if not related, on

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155. See, e.g., Priv. Ltr. Rul. 2001-17-041 (Jan. 29, 2001) (holding that an ambulatory surgery facility operated in joint venture between two exempt hospitals did not affect exempt status of partners and was not subject to UBIT). See generally John D. Colombo, *A Framework for Analyzing Exemption and UBIT Effects of Joint Ventures*, 34 EXEMPT ORG. TAX REV. 187 (2001) (discussing the application of the IRS exemption analysis to joint ventures).

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

157. See *supra* notes 151-53 and accompanying text.

how "substantial" an unrelated activity is with respect to an organization's charitable activities; and, perhaps, third, whether the organization can prove it is spending revenues from substantial commercial activities on "legitimate" charitable activities, thus meeting the commensurate-in-scope test.<sup>158</sup>

In order to escape this doctrinal uncertainty, and the accompanying terror of potentially losing exempt status, charitable organizations have taken refuge in the upstream isolation of the corporate separate-identity rule, using separate subsidiaries to conduct business activities that may pose a risk to exempt status.<sup>159</sup> The separate-identity rule itself, however, creates inconsistencies because the downstream isolation effect of the rule means that activities that one might logically want to conduct in a separate subsidiary for business reasons, such as limited liability or regulatory issues, could end up being taxable in situations where those same activities conducted by an exempt parent or sibling, might well qualify for exempt status.<sup>160</sup> The next Part of this Article examines the current rules in light of both public policy and tax policy concerns that might surround commercial activity by exempt organizations.

## II. WHY DO WE CARE? PUBLIC POLICY CONCERNS REGARDING COMMERCIAL ACTIVITY

Given the current inconsistencies in the tax rules governing commercial activity by charitable organizations, we should begin evaluating these rules by parsing the public policy concerns that may underlie regulating commercial activities by charities. The question at its core is simple: Why should we be concerned about the apparently growing tendency of exempt charities to engage in a variety of commercial activities either directly or through related business entities?

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158. See *supra* Part I.B.

159. See *supra* note 124 and accompanying text.

160. See *supra* notes 125-50 and accompanying text.

*A. Why Do Exempt Charities Engage in Commercial Activities?*

A useful predicate to examining the public policy concerns raised by commercial activity of exempt charities is to ask why charities engage in direct commercial activities at all. Charities, after all, have a specific charitable mission not directed toward profit maximization, which empirical evidence indicates is taken seriously by nonprofit managers.<sup>161</sup> Exempt charities also must, by law, be nonprofit organizations,<sup>162</sup> which means they cannot have shareholders or owners with an equity stake in the enterprise concerned about profit maximization.<sup>163</sup> So why do they engage in direct commercial activities—as opposed to passively investing excess capital—to begin with?

There are at least three answers to this question. The first is that because of the breadth of the definition of “charitable” in § 501(c)(3),<sup>164</sup> certain commercial activities are themselves considered charitable activities. To take the most prominent example, a nonprofit hospital that essentially conducts a fee-for-service business of providing health care services is nevertheless exempt under § 501(c)(3) as long as it provides those services to a large enough segment of the community to constitute a “community benefit.”<sup>165</sup> In *Presbyterian and Reformed Publishing*, the Third Circuit likewise concluded that a commercial publishing business could be an exempt charitable activity if limited to religious

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161. See Weisbrod, *supra* note 2, at 287, 295 (citing the example of zoos and public television that appear to consciously adopt policies contrary to profit maximization because they view profit maximization as inconsistent with their charitable missions).

162. Treas. Reg. § 1.501(c)(3)-1(c)(2) (2001).

163. As noted earlier, nonprofit organizations are not prohibited from making a profit in the sense of having a net accounting surplus; instead, the “nonprofit” prohibition relates to the universal rule that such profits cannot be distributed to owners or “insiders” of the organization. Henry Hansmann calls this the “nondistribution constraint.” See *supra* note 22 and accompanying text.

164. I.R.C. § 501(c)(3) (2000).

165. See, e.g., Rev. Rul. 69-545, 1969-2 C.B. 117, 118. See generally Mark A. Hall & John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307 (1991) (proposing a donative theory of tax exemption whereby public support for an institution indicates its value to the community, thus making it worthy of a tax subsidy).



materials, presumably because "religious" organizations are exempt under § 501(c)(3).<sup>166</sup>

In the majority of situations, however, an exempt charity carries on a noncommercial charitable mission. The Red Cross, for example, provides disaster relief, a decidedly noncommercial activity. In these cases, then, the reasons an exempt charity would engage in direct commercial activity are grounded in two different financial considerations. Consider first that an exempt charity has essentially two choices when making an investment to produce revenue. The first choice is to passively invest excess capital, perhaps from endowments, in either equity securities or debt. The second choice would be to invest the excess capital in a direct commercial enterprise. If the financial returns on both choices were equal, charities presumably would be indifferent from a financial perspective about whether to invest passively or operate a commercial business.<sup>167</sup> Moreover, given the fact that both charitable managers and their donor constituents may consider the operation of a commercial activity contrary to the charitable mission, there is every reason to believe that in a scenario of financial indifference, a charity will prefer a passive investment.<sup>168</sup> Thus, one can assume that a charity will choose to operate a commercial activity directly only when the financial returns from such activity involve a premium over what the charity could earn on a passive investment.

There are two ways in which such a premium can result. The first is in a situation in which the charity enjoys what economists sometimes refer to as "economies of scope."<sup>169</sup> That is, exempt charities may have excess capacity from capital investments made to pursue their charitable mission that can be used to produce commercial revenues at costs below those incurred by for-profit

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166. *Presbyterian & Reformed Publ'g v. Comm'r*, 743 F.2d 148, 153 (3d Cir. 1982); see *supra* notes 56-60 and accompanying text.

167. See Rose-Ackerman, *supra* note 13, at 1028 n.33 (discussing the relevance of a hypothetical tax imposed on commercial business activities and not on passive investments).

168. See 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 1, at 83, 85-87.

169. See Hansmann, *supra* note 13, at 626-27 (discussing economies of scope in the context of nonprofit organizations).

firms.<sup>170</sup> A classic example of this is a college athletic stadium. Once a university has invested in building the stadium as part of its educational mission,<sup>171</sup> there is essentially zero marginal cost to the university associated with leasing that stadium to a professional football team for summer athletic practices. Leasing unused supercomputer time is another example of a situation in which an exempt charity could exploit an economy of scope to earn a premium return on its sunk investment.<sup>172</sup>

Even if no economies of scope exist, however, current tax policy can provide an exempt charity with a premium economic return from the direct operation of a commercial activity because of the corporate tax system. The existence of the corporate tax means that in corporate commercial enterprises, taxes are paid twice on an equity investment: once at the entity level at the corporate tax rate (currently a maximum of 36%) and then again as income from the corporate business is distributed to shareholders (at a current maximum rate of 39.1%).<sup>173</sup> On the other hand, income from proprietorships or "pass-through" entities such as partnerships is taxed only once, at the individual tax rate.<sup>174</sup> Similarly, because interest payments on debt are deductible business expenses under the Code,<sup>175</sup> there is no corporate-level tax on the earnings a corporation uses to pay interest; thus, an investor's return on corporate debt effectively is taxed only at the individual level. The double-taxation on equity investment inherent in the corporate form means that the tax rate on a dollar invested as equity in a corporate enterprise is roughly 60%, as opposed to the roughly 40% rate applicable to single-taxed investments. In order for corporate equity to be an attractive investment, therefore, a dollar invested in corporate equity must earn a higher rate of return pre-tax than

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170. *Id.*

171. Though whether intercollegiate athletics ought to be considered a charitable activity can be debated. See, e.g., Richard L. Kaplan, *Intercollegiate Athletics and the Unrelated Business Income Tax*, 80 COLUM. L. REV. 1430 (1980).

172. See Hansmann, *supra* note 13, at 627. Note that the assumption here is that it would be costly, if not impossible, for the charity to convert the excess capacity into cash that could then be invested directly. As Rose-Ackerman noted, once capital is in place, investment "choices are limited." Rose-Ackerman, *supra* note 13, at 1025 n.29.

173. I.R.C. §§ 1, 11 (2000).

174. MCKEE ET AL., *supra* note 152, ¶ 9.01[1].

175. I.R.C. § 163 (2000).

a dollar invested in a single-tax enterprise or corporate bonds, so that after-tax returns are similar.<sup>176</sup>

If there were no corporate-level tax, then a charitable enterprise would have no financial incentive to engage in direct commercial activities—other than in the excess-capacity situation described above—because capital markets presumably would equalize investment returns on all capital.<sup>177</sup> With the existence of the corporate-level tax, however, a nonprofit organization can “capture” a premium financial return—essentially the amount the capital markets require to equalize returns on capital in corporate and unincorporated businesses or between corporate equity and debt—if it can conduct a business directly and avoid the corporate tax that otherwise would have to be paid.<sup>178</sup> This income tax premium is compounded if the nonprofit also can escape state property taxation.<sup>179</sup> Exempt charities presumably seek such premium returns in order to enhance the revenue available to spend on their charitable mission. As a result, our system currently can provide a substantial incentive for an exempt organization to operate a

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176. Assume, for example, that one can earn \$10 on a \$100 investment (10%) pretax on either an equity investment in a corporation (e.g., stock) or in a proprietorship. At the maximum tax rates currently in effect, the \$10 pre-tax return on the proprietorship results in approximately a \$6 (6%) return after-tax on that investment (the \$10 pre-tax return less the \$4 personal income tax due at our approximately 40% rate). In the corporate investment, however, the \$10 pretax return is first reduced to \$6.50 by the corporate level tax; the shareholder then owes another 40% personal income tax on this \$6.50, reducing the pretax return to \$3.90. Thus the 10% pretax return in the double-tax corporate world ends up as a 3.9% return. This example illustrates that the effective tax rate on earnings relating to corporate equity is roughly 61%. Corporate businesses, therefore, presumably must earn a premium return on equity to attract investors—in my example, the corporate investment would need to return roughly \$15.40 (15.4%) in order to produce the same after tax return as the proprietorship.

Because interest payments are deductions from taxable income under I.R.C. § 163 (2000), no entity-level tax is paid on the income earned to make an interest payment to a corporate bond-holder. That is, a corporation that earns \$10 and pays it to an investor as interest has a \$10 deduction under § 163, and therefore has zero taxable income and no tax liability. Thus a corporate bond, like an equity investment in a proprietorship or partnership, is a single-taxed investment and does not suffer from the double tax applied to corporate equity investments.

177. See Cordes & Weisbrod, *supra* note 168, at 88-90.

178. See *id.*; see also Hansmann, *supra* note 13, at 610 (“The more compelling view ... is that the corporate income tax *does* affect the cost of capital at the margin and that, everything else being equal, tax-exempt corporations have higher rates of return on investment than those of taxable firms.”).

179. See Cordes & Weisbrod, *supra* note 168, at 89.

commercial enterprise directly, as opposed to simply being a passive investor, if the direct commercial activity would escape the corporate-level tax in the exempt organization's hands.

To summarize, the major reasons for an exempt organization to conduct commercial activities directly, as opposed to being simply a passive investor, are first, that the commercial activity is itself the *raison d'être* for the charitable organization (e.g., the nonprofit hospital); second, that the exempt organization can exploit excess capacity; and third, that the charitable organization might be able to capture a premium financial return even outside the excess capacity situation by avoiding the corporate income tax. The next issue, therefore, is whether legitimate public policy concerns exist with respect to exempt charities engaging in commercial activities on any of these fronts, and how, if at all, our current rules address such concerns.

### *B. Policy Concerns with Commercial Activities*

#### *1. Traditional Policy Concerns: Unfair Competition and Erosion of the Corporate Tax Base*

As noted in Part I, the traditional policy concerns with direct commercial activity by exempt charities centered on the potential for unfair competition with for-profit providers of the same goods or services, and the potential for a significant impairment of the corporate tax base.<sup>180</sup> Unfair competition, in particular, was a major theme that led to the enactment of the UBIT in 1950.<sup>181</sup> We should recognize a difference, however, between "unwanted" competition and "unfair" competition. Any time a charity competes in the marketplace with a for-profit provider, such competition might be unwanted. Small businesses, in particular, are often the most vocal adherents to the notion that any competition by an exempt organization is necessarily bad.<sup>182</sup> The issue, however, is not competition per se; rather, "unfair" competition presupposes that the exempt organization is somehow unfairly using the economic

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180. See *supra* text accompanying notes 34-35.

181. See H.R. REP. NO. 2319, at 36-37 (1950); S. REP. NO. 2375, at 28-29 (1950); Dale, *supra* note 13, § 9.02, at 9-7; Hansmann, *supra* note 13, at 613; Sharpe, *supra* note 13, at 385-86.

182. See Hansmann, *supra* note 13, at 605; Sharpe, *supra* note 13, at 450-51.

benefits of exemption to subsidize their commercial activities. An example would be a sort of "predatory pricing" in which an exempt organization prices its product below its competitors because it does not have to recoup the costs of taxation.<sup>183</sup> Less evil-sounding, but still of significant concern, is the possibility that an exempt organization will unfairly expand market share by using its tax savings to reinvest in its commercial activity, thus expanding the activity with a source of money (tax exemption) unavailable to nonexempt for-profit competitors.<sup>184</sup>

If unfair competition is defined in these traditional terms—such as predatory pricing or subsidized market expansion—then there is a significant question as to whether unfair competition is a valid policy concern at all. In fact, legal academics and economists who have examined the issue have reached an almost remarkable consensus that unfair competition in the form of predatory pricing or predatory market expansion simply is not a serious policy concern.<sup>185</sup> As these commentators have observed, if one assumes that exempt organizations engage in direct commercial activities in order to capture the financial premium discussed above, then no incentive exists for exempt organizations to cut prices in order to maximize market share, in fact, just the opposite is true.<sup>186</sup> Similarly, there is little incentive for these organizations to subsidize the expansion of commercial activities with the tax savings incurred by exemption,<sup>187</sup> presumably, these funds also would be earmarked for expenditure on charitable activities. Thus even though unfair competition was the primary rationale for enacting the UBIT, it in fact may not be a very serious policy concern in practice.<sup>188</sup>

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183. See Hansmann, *supra* note 13, at 610.

184. See Sharpe, *supra* note 13, at 385-86.

185. See Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 318-25 (1976); Hansmann, *supra* note 13, at 613; Klein, *supra* note 13, at 61-68; Rose-Ackerman, *supra* note 13, at 1036-39; Steinberg, *supra* note 13, at 354-55.

186. See Hansmann, *supra* note 13, at 610-12; Klein, *supra* note 13, at 62; Rose-Ackerman, *supra* note 13, at 1024 ("Nonprofit firms engage in tax-exempt business activity to provide funds to subsidize their primary activities. Therefore they want to maximize expected profits."); Steinberg, *supra* note 13, at 362 n.7.

187. See Hansmann, *supra* note 13, at 610-11; Klein, *supra* note 13, at 65; Rose-Ackerman, *supra* note 13, at 1029; Steinberg, *supra* note 13, at 354-55.

188. Note that there may be economic distortions resulting from having exempt charities

Even if unfair competition is a serious policy concern, however, the UBIT standing alone is a very imperfect mechanism for controlling it. In fact, because Congress chose to draw the taxing line at "related" versus "unrelated" activities, the UBIT does not require any showing that the commercial activity involved competes with for-profit providers at all.<sup>189</sup> Moreover, the relatedness test leaves a very large swath of "related" activities exempt from taxation.<sup>190</sup> Hospitals, for example, can sell pharmaceuticals and medical equipment to outpatients fully capable of patronizing a for-profit pharmacy without running afoul of the UBIT.<sup>191</sup> A bit of tax planning, moreover, can go a long way in converting what might look like an unrelated activity into a related one. To take a fanciful hypothetical, one suspects that if New York University's law school implemented clinical legal education offerings related to being corporate legal counsel, and directly operated Mueller Macaroni as a clinical or externship placement vehicle for students, such a business would no longer be "unrelated" under the UBIT.<sup>192</sup>

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enter a market previously populated only by for-profit firms. Specifically, because such exempt charities do not pay income taxes, they might find entry into a particular market cost-effective even if for-profit firms do not. This market entry could result in depressed prices as a result of oversupply and result in bankruptcies of for-profit firms that would not occur in the absence of such entry. See, e.g., Rose-Ackerman, *supra* note 13, at 1026-30; Steinberg, *supra* note 13, at 356-57. I view this issue as an economic efficiency argument, however, and not a traditional unfair competition complaint, at least as the unfair concept was viewed by Congress. For a discussion of economic efficiency concerns regarding commercial activity by exempt charities, see *infra* Part II.B.2.

189. See Dale, *supra* note 18, § 9.04[1].

190. See Weisbrod, *supra* note 2, at 290; Hansmann, *supra* note 13, at 628-29; Sharpe, *supra* note 13, at 427-43.

191. See Rev. Rul. 78-435, 1978-2 C.B. 181 (stating that the sale of hearing aids to outpatients was not an unrelated business). See generally THOMAS K. HYATT & BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT HEALTHCARE ORGANIZATIONS* 447-49 (2d ed. 2001) (discussing the analytical framework employed by the IRS in concluding sales of pharmaceuticals, medical supplies, and other medical services is allowable under UBIT); MANCINO, *supra* note 143, at 15-37 to 15-38 (2001) (explaining case law treatment of pharmaceutical and medical supply sales by exempt hospitals).

192. Cf. Treas. Reg. § 1.513-1(d)(4) (as amended in 1983) (stating that admission charges for performances by students of performing arts school are not unrelated business income); Priv. Ltr. Rul. 78-40-072 (July, 1978) (holding that proceeds generated by college through operation of professional repertory theater open to general public were not unrelated income).

Like unfair competition, tax base protection was another major concern of Congress when it enacted the UBIT in 1950.<sup>193</sup> Moreover, as with unfair competition, the UBIT does a relatively poor job of tax base protection for similar reasons. First, the large swath of "related" activities are not taxed at all. Because of the inherent doctrinal difficulties of defining "related" versus "unrelated" activities, many profit-producing commercial activities are excluded from the operation of the UBIT because they plausibly can be classified as "related" activities.<sup>194</sup> Second, many profit-producing activities are specifically excepted from the UBIT even though one would consider them "unrelated."<sup>195</sup> Third, even when a commercial activity clearly passes into the "unrelated," and therefore taxable, realm, recent empirical evidence indicates that charities can and do strategically allocate deductible business expenses and depreciation disproportionately to "unrelated" business activities in order to reduce or eliminate the actual tax liability on "unrelated" activities that they conduct directly.<sup>196</sup>

What is interesting about the current rules regarding commercial activity by exempt charities is that although the UBIT alone is an imperfect way to address tax base erosion and, to the extent it is a legitimate concern at all, unfair competition, the addition of the commerciality doctrine and the corporate separate-identity rule to

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193. H.R. REP. NO. 2319, at 39 (1950); Dale, *supra* note 13, § 9.02, at 9-5; Sharpe, *supra* note 13, at 393.

194. See Copeland & Rudney, *supra* note 38, at 750-51 (noting the many business activities considered "related" under current law); Cordes & Weisbrod, *supra* note 168, at 85 ("In practice, however, it has proved administratively difficult for federal, state, and local taxing authorities to differentiate taxable and nontaxable commercial activities."); Hansmann, *supra* note 13, at 628-29 ("Because the definitions of exempt functions and the reasons for exempting them have always been vague, and because what it means to be 'related' has never been spelled out well, administration of this standard has not been simple.").

195. My all time favorite is the specific exception in § 513(f) for profits from bingo games, but the addition of corporate sponsorship revenues to the "excluded" list in § 513(i) may have taken over first place. I.R.C. § 513(f) & (i) (2000).

196. See Cordes & Weisbrod, *supra* note 168, at 97-100; Robert J. Yetman, *Tax-Motivated Expense Allocations by Nonprofit Organizations*, 76 ACCT. REV. 297, 298 (noting that while nonprofits as a whole reported \$1 billion in losses on revenues of \$4 billion with respect to taxable activities, they reported profits of "\$50 billion on their tax-exempt activities"). Yetman's analysis suggests that medical and educational organizations, in particular, engage in "creative" expense allocation to reduce unrelated taxable income. *Id.*

this mix does a much better job with respect to these policy concerns; albeit in a very backhanded way. Because of the *in terrorem* effect of the commerciality doctrine and the lack of doctrinal clarity concerning when commercial activities place exemption at risk, the current rules provide a counterbalance to charities taking aggressive positions that a particular activity is "related" to its charitable purpose and therefore not subject to tax. As the consequences of being wrong with respect to whether commercial activity will endanger exemption are so dire, and the doctrinal line so hazy, exempt organization managers must balance the risk of losing exemption against the premium economic returns that might be captured by directly conducting commercial activity. Thus, current doctrine pressures charities to confine these activities to separate corporate containers, where they will be isolated under the *Moline Properties* separate-identity rule, even if these activities arguably might be "related" and therefore not subject to tax. Once isolated in this manner, the downstream isolation effect of *Moline Properties* means that these activities almost always will fail to qualify on their own for tax exemption. Moreover, once these activities are isolated in a separate container, the ploy of disproportionately allocating operational expenses to commercial activities subject to UBIT in order to reduce or eliminate the actual tax paid becomes much more difficult. Thus, in this odd way the combination of the commerciality doctrine and the *Moline Properties* separate-identity rule helps protect the integrity of the corporate tax base by providing a counterbalancing incentive to the financial premium that might otherwise be captured by directly conducting a commercial activity. By isolating these activities in taxable containers, these rules also help protect against potential unfair competition, if it exists at all.

Using doctrinal uncertainty to enforce tax policy, however, does not seem to be the best method to inspire confidence that the tax system is properly achieving its policy goals. In essence, these rules leave charities at the whim of the zealousness of IRS enforcement and the pliability, or lack of understanding, of reviewing courts with respect to the key UBIT concept of relatedness. If we really do believe that we need to protect for-profit providers or the corporate tax base from potential encroachment by exempt organizations,



then surely there is a better way to do so than relying on doctrinal uncertainty and managerial risk aversion to force the issue.

## 2. Other Policy Concerns

### a. The Diversion Problem

Though the twin tax policy concerns of unfair competition and tax-base erosion have generally ruled public debate about the commercial activities of exempt charities, researchers outside the legal field have noted other policy concerns as well. One common non-tax theme regarding commercial activity discussed in the social science literature is what I will label the "diversion" problem. This argument views commercial activity by nonprofits as inherently bad because it diverts the attention of managers and resources away from the core charitable mission and core charitable outputs. For example, the National Geographic Society's recent internal reorganization may have resulted in greater emphasis on profitable activities such as cable television partnerships and documentary films at the expense of field research.<sup>197</sup> Similarly, a school that makes a decision to sell its services in the form of tuition charges runs the risk of pricing its target audience out of the market; museums and zoos charging admission fees may do the same.<sup>198</sup> Another similar concern is that commercial activity will displace core values of "altruism, pluralism and community,"<sup>199</sup> and that charities will turn to a new set of managers that "may be equally likely as for-profit managers to cheat the consumer or donor with respect to output characteristics that are not readily observable. In effect, true nonprofits may be turned into 'for-profits in disguise' as a result of the managerial selection process."<sup>200</sup> Accordingly, under the diversion rationale, commercial activity should be minimized to keep the charitable managers' "eyes on the ball" of providing only truly charitable services. At its base, the diversion rationale

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197. Weisbrod, *supra* note 2, at 294.

198. *Id.* at 294-95.

199. Janne Gallagher, *Peddling Products: The Need to Limit Commercial Behavior by Nonprofit Organizations*, 12 EXEMPT ORG. TAX REV. 1007, 1014 (1995).

200. Estelle James, *Commercialism Among Nonprofits: Objectives, Opportunities, and Constraints*, in TO PROFIT OR NOT TO PROFIT, *supra* note 1, at 271, 281.

assumes the existence of core differences between a firm focused on a charitable mission and a for-profit firm, and that permitting a charitable organization to engage in extensive commercial activity will erode such core differences over time.<sup>201</sup>

The counterargument to the diversion rationale, of course, is that increased commercial activity by charities confers significant benefits on society.<sup>202</sup> At the very least, this activity provides additional revenue sources for charities to utilize in executing their charitable mission.<sup>203</sup> On a broader scale, certain kinds of commercial activity by charities might even be economically efficient and produce better outputs than the private sector, government, or nonprofits could produce standing alone. As Burton Weisbrod observed:

We have found evidence of significant scientific advances resulting from cooperation between universities and private-sector firms .... We have also found evidence, in the higher-education, hospital, and museum industries, that increased commercialism in the form of unrelated business activity is efficient in the sense that it imposes little marginal cost, given the resources already available for production of mission-related activities ...; thus, it would appear to be inefficient to discourage, let alone prohibit, use of those resources even for business activities that are unrelated to tax-exempt missions.<sup>204</sup>

Finally, it appears that managers of charitable entities view their charitable mission as a concrete limitation on the scope of commercial activity. Empirical research, for example, indicates that many charitable organizations do not undertake profit-maximizing strategies where it would make pure economic sense to

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201. See Burton A. Weisbrod, *Modeling the Nonprofit Organization as a Multiproduct Firm: A Framework for Choice*, in *TO PROFIT OR NOT TO PROFIT*, *supra* note 1, at 47, 54. Whether such core differences exist is a matter of some debate. Several years ago, Professor Evelyn Brody opined that there is not much practical difference in economic constraints on for-profit and nonprofit management and that, at least from an economic perspective, one might expect that management styles would ultimately converge. Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 460 (1996).

202. Weisbrod, *supra* note 2, at 288.

203. James, *supra* note 200, at 281.

204. Weisbrod, *supra* note 2, at 288.

do so because such managers view profit maximization as inconsistent with underlying charitable goals.<sup>205</sup> "[I]n at least some industries, such as zoos and public television, it seems clear that admission fees and sale of broadcast airtime are intentionally restricted because of a sense that generating more revenue from those sources would be inconsistent with [sic] mission."<sup>206</sup> Thus, the risks of diversion posed by commercial activity may be fewer than one might imagine, at least where commercial revenues support preferred charitable outputs and the sense of charitable mission is strong. We must also assume that no diversion problem exists in the case of a charity pursuing a commercial activity that itself is considered charitable. In such a case there is by definition no "diversion" of charitable mission; instead, the issue is simply whether the activity itself should be considered charitable.

Initially, one might view the diversion rationale as supporting the current scope of the commerciality rules. For example, the diversion rationale might explain why the UBIT is limited solely to "unrelated" activities. Under this rationale, related commercial activities are an extension of the organization's charitable mission, thus management diversion toward such activities is less a problem than with unrelated activities. The diversion rationale also explains the necessity for the commerciality doctrine. In essence, this doctrine is the final backup rule to guard against granting exemption to an entity that had essentially become a "for-profit in disguise."<sup>207</sup> When a nonprofit's commercial activity becomes indistinguishable from that of a for-profit provider, then there is no longer any charitable mission deserving of subsidy, and exemption should be revoked. Moreover, the *in terrorem* effect of the commerciality doctrine coupled with the corporate separate-identity rule pressures exempt organizations to conduct unrelated commercial activities in separate subsidiaries, presumably isolated from the daily concerns of the managers of the parent charitable enterprise. Finally, a concept akin to the commensurate-in-scope doctrine would help the IRS ensure commercial activities are undertaken primarily to cross-subsidize charitable activities.

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205. See Weisbrod, *supra* note 201, at 47-64.

206. Weisbrod, *supra* note 2, at 295.

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

Adoption of such a concept would recognize that public benefit may result from cross-subsidization, but not in the operation of commercial activities as ends unto themselves.

These initial impressions regarding the propriety of the current legal rules governing commercial activity, however, turn out to be weak on close inspection. In fact, the diffuse nature of charitable missions makes it difficult to distinguish "related" from "unrelated" activities so that whatever constraint the UBIT imposes on diversionary activities is quite limited in practice.<sup>208</sup> Although the commerciality doctrine might provide some protection from egregious cases of "for-profits in disguise," the doctrine in fact provides little guidance for the hard cases such as the religious publishing or nonprofit hospitals cases, in which the core issue is whether the underlying activity should be considered charitable.<sup>209</sup> Moreover, even if commercial activities are confined to controlled subsidiaries to avoid the potential exemption effects on the parent, there is reason to question how much such a structure protects against the diversion hypothesis. This question arises from consideration of the practical dynamics of the parent-subsidiary relationship. Controlled subsidiaries are essentially run by the parent in that management is selected by the parent. Based on this fact, and because of the importance of the financial success of the subsidiary to the parent, one can expect that as much or as little diversion of charitable mission will result whether the nonprofit conducts the business operations itself or through a controlled subsidiary.<sup>210</sup> Finally, the Service's own indecision regarding how and when to employ the commensurate-in-scope test has rendered that test less effective than it might be in ensuring cross-

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208. Weisbrod, *supra* note 2, at 290; Hansmann, *supra* note 13, at 628-29. For an extended discussion of the difficulties of applying the relatedness test, see Sharpe, *supra* note 13, at 427-50.

209. See *supra* notes 44-73, 125-42, and accompanying text (discussing the religious publishing and Geisinger Health Plan cases).

210. The managerial "closeness" between a parent and controlled subsidiary in the world of exempt organizations is well-illustrated by Priv. Ltr. Rul. 87-06-012 (Oct. 31, 1986). In that case, the IRS considered the application of the corporate separate-identity principle to a subsidiary whose entire board of directors was made up of directors and employees of the exempt parent. *Id.*

subsidization behavior by exempt charities operating commercial businesses.<sup>211</sup>

The diversion hypothesis also does not explain the tax law difference in treatment between corporate subsidiaries and partnerships. There appears to be little difference in the diversion potential between a controlled subsidiary and a partnership in which the charitable parent participates as a partner. In fact, if the partnership was managed by a separate, either for-profit or nonprofit, management company, one would expect less, or at least no more, potential for diversion in the partnership than in a controlled subsidiary. Yet current tax law "imputes" the activities of a partnership to a charitable parent, in contrast to the isolation rule applied to corporate subsidiaries.<sup>212</sup> Thus, despite initial impressions, the current amalgam of legal rules does not address the diversion concern well.

### *b. Economic Efficiency*

While traditional unfair competition concerns have focused on potential predatory pricing or expansion behavior by exempt nonprofits, a broader range of issues concerns economic efficiency. Specifically, these issues revolve around whether an exempt charity's operation of a commercial activity creates inefficiencies in the capital markets or the distribution of goods and services that would not result from competition by for-profits only or if nonprofits concentrated their resources solely on production of charitable outputs.

As explained above, the basic source of economic inefficiency in competition between for-profits and exempt charities is the potential for an exempt charity to escape the corporate tax that otherwise would be levied on commercial activities in corporate form.<sup>213</sup> It follows, and economists agree, that the most economically efficient solution for dealing with commercial activity by nonprofits

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211. See *supra* note 102 and accompanying text.

212. The diversion argument is likely weaker when a charitable organization participates in a partnership or LLC that is managed by a separate entity. In this case, the charitable organization is an investor in the business, not an active participant, and one would presume that management would spend no more time worrying about this investment than any other.

213. See *supra* Part II.A.

is simply to repeal the corporate income tax, thus ending the distortion in economic production resulting from the possibility of premium financial returns by nonprofits through exemption while simultaneously eliminating all economic distortions resulting from the corporate income tax.<sup>214</sup> Faced with the reality of the corporate income tax and the likelihood that it will be with us for quite some time, however, these same commentators are divided on how current rules, particularly the UBIT, affect economic efficiency in the context of the coexistence of the tax and the exemption for certain charities.

Writing in 1982, Professor Susan Rose-Ackerman opined that economic efficiency supported repealing the UBIT.<sup>215</sup> She reasoned that in markets where exit costs were high, for-profit firms could be harmed by unexpected competition from exempt firms entering the for-profit market and driving prices down as a result of increased supply.<sup>216</sup> In these cases, high exit costs would prohibit for-profit firms from liquidating their investment and moving to more profitable businesses, thus resulting in a certain level of economic harm to the for-profit investors.<sup>217</sup> Entry by exempt charities into commercial businesses was most likely where premium financial returns were available as a result of the charity escaping the corporate tax.<sup>218</sup> Because of the relatedness distinction in the UBIT, these premium financial returns were available to exempt charities only when their commercial activities avoided taxation by passing the UBIT "related" test. As a result, the existence of the UBIT pressured charities to confine commercial activities to particular segments of the economy rather than to spread those activities over the entire economy. This would cause disproportionate financial harm to for-profit competitors in "related" areas.<sup>219</sup> Repealing the

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214. Cordes & Weisbrod, *supra* note 168, at 88 (noting that a *neutral* tax on commercial profits would render an exempt charity indifferent to investing in direct commercial enterprises versus passive investments); Steinberg, *supra* note 13, at 356; *see also* Hansmann, *supra* note 13, at 618 (noting that "partial exemption" from the corporate income tax—essentially a partial repeal of the tax—for corporations whose stock is held by exempt charities would eliminate some economic inefficiencies).

215. Rose-Ackerman, *supra* note 13, at 1028.

216. *Id.* at 1026-30.

217. *Id.*

218. *Id.* at 1027 n.32.

219. *Id.* at 1038.

UBIT would permit charities to enter any commercial enterprise, thus "spreading" the potential harm across the entire economy and permitting the economy to operate more efficiently.<sup>220</sup>

Professor Henry Hansmann, however, argued that some tax on commercial activities was necessary to promote economic efficiency.<sup>221</sup> Hansmann noted that without such a tax, all corporate enterprises would be worth more in the hands of an exempt charity, which could avoid the corporate income tax, than in the hands of private investors.<sup>222</sup> In order to capture these premium financial returns, therefore, charities would be tempted to invest their excess capital in a few directly-operated commercial enterprises rather than to spread their capital over the financial markets through passive investments.<sup>223</sup> This trend would lead to poor diversification of investments, managerial inefficiency (because nonprofit managers would now also be running for-profit firms), and would pressure charities to save capital to invest in businesses rather than to spend capital on charitable outputs. In contrast, the existence of the UBIT helps channel charitable investments into those areas in which the charity is likely to enjoy economies of scope, thus enhancing efficiency.<sup>224</sup> Economist Richard Steinberg agreed that "[e]xempting commercial activities from taxation when they are undertaken by the [nonprofit] but not the [for-profit] sector is clearly distortionary,"<sup>225</sup> but at least as of 1991 believed that the state of economic and empirical research on capital markets and entry/exit issues made any conclusions about the efficiency effects of the UBIT premature.

To the extent one believes that the UBIT promotes economic efficiency, the combination of the UBIT, the commerciality doctrine and the corporate separate-identity rule would only enhance that effect. As noted above, the *in terrorem* effect of the commerciality doctrine, coupled with the safe haven of the corporate separate-identity rule and resulting likely taxation of separate corporate subsidiaries of exempt charities, limits exempt charities from fully

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220. *Id.* at 1039.

221. Hansmann, *supra* note 13, at 626-27.

222. *Id.* at 612.

223. *Id.* at 614-15.

224. *Id.* at 626-33.

225. Steinberg, *supra* note 13, at 356.

exploiting the potential for premium financial returns through the "related" exception to the UBIT. As a result, such charities are encouraged to invest more heavily in activities that would be considered "related" and thus would more likely be ones that involve economies of scope. Another response, however, that would presumably enhance economic efficiency would be to expand the UBIT to all commercial revenues. The resulting "neutral" tax on commercial activity would eliminate the potential for premium economic returns by exploiting the relatedness test under the UBIT. This approach would eliminate the pressure identified by Rose-Ackerman to channel commercial activities into "related" areas without impeding charities' exploitation of economies of scope, since the enhanced financial returns from economies of scope exist even if a tax is applied to the resulting revenue.<sup>226</sup>

*c. Assessing Worth and Need for Indirect Government Subsidies*

If one agrees that permitting an exempt organization to capture a premium financial return by avoiding the corporate tax on commercial activities is an indirect government subsidy to the exempt organization,<sup>227</sup> another policy issue arises. That issue concerns how we should determine whether charities *deserve* the subsidy they are getting and in fact *need* the subsidy to produce preferred charitable outputs.<sup>228</sup> As Professor Mark Hall and I have noted, an organization can be a "nonprofit" under state corporate law without being tax-exempt; the only reason to grant exemption

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226. See Hansmann, *supra* note 13, at 627.

227. Some disagree with the subsidy characterization of tax exemption. For an overview of non-subsidy theories of exemption, see COLOMBO & HALL, *supra* note 17, at 22-27. The subsidy viewpoint, however, predominates. *Id.* at 26, 30 n.31; Sharpe, *supra* note 13, at 376 n.20. Since the publication of *The Charitable Tax Exemption*, Professor Evelyn Brody, agreeing in general with the subsidy characterization, has observed that tax exemption might best be explained as recognition by federal and state governments of a "third sovereign" in the form of the nonprofit sector. See Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585 (1998). Exemption recognizes the independence of this third sovereign as it performs its functions in its own domain, much as constitutional theory recognizes the fiscal independence of states from the federal government and the prohibition on taxing states directly.

228. The subject of worth and need is considered in detail in COLOMBO & HALL, *supra* note 17, at 9-11 and in Hall & Colombo, *supra* note 66, at 328-30.



(especially for commercial business profits that would otherwise be taxable) is to provide additional financial resources to the exempt charity for it to carry out its charitable mission.<sup>229</sup> Thus, two separate questions arise: Does the charity deserve this subsidy for its mission, and if so, how do we best match the size of the subsidy provided to the need for financial support? To take an extreme example of the "worth" issue, segregated schools were considered exempt charities until the Supreme Court's decision in *Bob Jones University v. United States*<sup>230</sup> that segregation was incompatible with the public policies underlying exemption.<sup>231</sup>

The "need" prong of the issue is more complex, but in the context of commercial activity, one should ask whether the subsidy is being applied to increase desirable charitable outputs, or is simply increasing the supply of a good already being supplied in sufficient quantity by the nonprofit sector, the for-profit sector, or the government. As Henry Hansmann has observed: "There is no reason to believe that the amount of subsidy that is appropriate for a particular nonprofit is proportional to its willingness or ability to invest in unrelated businesses ...."<sup>232</sup>

The operation of I.R.C. § 170, permitting a deduction for charitable contributions,<sup>233</sup> provides a useful comparison to the commercial activity rules on the worth and need issues. In contrast to exemption, this subsidy<sup>234</sup> requires the external decision by unrelated donors to make an economic transfer to a particular

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229. See Hall & Colombo, *supra* note 15, at 1385 (noting that if doctors and patients prefer the nonprofit form for delivery of medical services, they are free to choose that form as a matter of state law even if tax exemption is not provided).

230. 461 U.S. 574 (1983).

231. *Id.* at 592-96.

232. Hansmann, *supra* note 13, at 621.

233. I.R.C. § 170 (2000).

234. Once again, not all commentators characterize the deduction for charitable contributions as an indirect subsidy, although once again this is the predominant view. See generally John D. Colombo, *The Marketing of Philanthropy and the Charitable Contributions Deduction: Integrating Theories for the Deduction and Tax Exemption*, 36 WAKE FOREST L. REV. 657, 667-90 (2001) (explaining various theoretical characterizations of the deductions). The subsidy characterization results from the fact that, for an individual in the highest individual tax bracket, the deduction means that the real after-tax cost of a \$100 donation is approximately \$60 because the donor gets to deduct \$100 from taxable income, which reduces the donor's tax bill by \$40 if one assumes a forty percent tax rate. Thus, the \$100 donation actually is funded in two parts: \$60 from the individual donor, and \$40 from the government in foregone taxes.

charity before the government subsidy “tags along.” Under § 170, therefore, individual and corporate donors perform the external checks and balances function on worth and need through their respective decisions to donate; that act occurs presumably because the donor has determined that a particular charity is both worthy of increased financial assistance and is in need of it.<sup>235</sup>

The current system of rules regarding commercial activities accomplishes part of this checks-and-balances function with respect to commercial activity, but leaves much to be desired. Consider first a world without the combination of the UBIT, the commerciality doctrine and the separate-identity rule. Without the commerciality doctrine as the ultimate check on worth by guarding against subsidizing an organization that operates essentially as a for-profit, any organization organized as a nonprofit with some nominal charitable purpose would be eligible for exemption.<sup>236</sup> Without the UBIT, this organization could control the size of its own government subsidy by acquiring any kind of direct commercial activity and still escape the corporate income tax with essentially no check on whether it deserved or needed such a subsidy. As Hansmann pointed out, charities with funds to invest in unrelated businesses either already have too much capital (in which case, additional subsidies are unnecessary) or are “robbing” charitable outputs to invest in for-profit businesses which would exist in any case (and thus do not need charitable investments to fund appropriate output levels).<sup>237</sup> In either case, the charity presumably is not spending enough on charitable outputs, and thus has a poor claim to additional subsidization. Finally, without the corporate separate-identity rule, this self-subsidization would extend to large corporate conglomerates whose subsidiaries might qualify for derivative exemption based upon the parent corporation’s status, compounding the lack-of-charitable-outputs problem.

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235. In fact, Saul Levmore has characterized the § 170 deduction as a “clever tool” for individuals to express preferences regarding government funding of organizations (charities) that perform social service functions. These “votes” by donors signal to government decisionmakers what organizations are worthy of subsidization. Saul Levmore, *Taxes as Ballots*, 65 U. CHI. L. REV. 387, 406-09 (1998).

236. See Hansmann, *supra* note 13, at 624.

237. *Id.* at 621.

Even *with* these rules, however, there is no effective systemic external check on worth or need as it applies to commercial activities. Again, given the large swath of activities that might be considered "related" under the current UBIT structure, plus the empirical evidence that creative expense allocation can turn even an unrelated activity into a zero-tax investment,<sup>238</sup> the ability of the current rules to properly control for both worth and need is questionable. Instead, the rules act as a sort of "reasonable and proper" speed limit, insuring that at the margin the overall size of any indirect subsidy is limited by the ability of exempt charities to exploit the relatedness test and the separate-identity rule. Charities that drive too fast for conditions (i.e., get too greedy under the system) face the potential withdrawal of exemption under the commerciality doctrine, which serves as the ultimate backstop to subsidizing entities that really are "for-profits in disguise." The problem here is that the concept "too greedy" is very poorly defined in existing law.<sup>239</sup> Although the current combination of rules helps guard against egregious abuse of the potential indirect subsidy resulting from direct commercial activity, the rules suffer from a lack of administrative clarity and perform this function poorly. Again, we should ask where there is a better way.

#### *d. Liability Insulation*

A final possible public policy concern is that if an exempt charity directly operates a commercial activity, it places its charitable assets at risk for the liabilities of the commercial activity and thus runs the risk that such assets will be lost in the pursuit of noncharitable activities. Although I have not seen this particular hypothesis raised as a potential concern in the existing literature on commercial activity by nonprofits, protecting charitable assets from undue risk was the foundation for rules (long since repealed) developed in early English law that limited charitable trustees to certain court-approved investments.<sup>240</sup> This concern conceivably

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238. See *supra* note 196 and accompanying text.

239. See discussion *supra* Part II.A.

240. See BEVIS LONGSTRETH, *MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE* 3-6 (1986). The modern Uniform Management of Institutional Funds Act and the Uniform Prudent Investor Act have both attempted to further liberalize investment rules for

could justify a set of rules similar to the current tax rules in which direct commercial activity by exempt charities is discouraged by the *in terrorem* effect of the commerciality doctrine. Funneling such activities into separate corporate containers where such liabilities can be limited to the commercial assets, however, is encouraged as a result of the upstream isolation provided by the corporate separate-identity rule. Moreover, since general partners are themselves jointly and severally liable for all partnership debts, the asset liability rationale explains why one might treat participation in a partnership (or at least participation as a general partner) as the functional equivalent of directly carrying on the activity, while applying a corporate isolation rule to activities conducted in separate corporate containers.<sup>241</sup>

There certainly is a legitimate public interest in ensuring that charitable assets, the creation of which has been at least partially subsidized by tax-exemption, are not squandered in the operation of noncharitable businesses. All investments, however, carry risk; insurance and diversification are the primary safeguards against such risks in the modern world. Moreover, even if the liability concerns of direct commercial activities were significant, once again the current rules operate very imperfectly. Our current system clearly permits charities to engage in a variety of direct business activities without regard to external liability potential, as long as the charity is reasonably comfortable that the activity is either “related” under the UBIT or, if not related, will be below whatever threshold exists for such activities to endanger exempt status under the “commerciality” doctrine. As a result, the current rules do not provide any core relationship between the danger of general liability and the pressure to isolate commercial activities in separate corporate containers. Further, but for the potential difference in taxation that may arise from conducting activities in separate corporate containers, as opposed to “divisions” of an

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charitable trust managers. FISHMAN & SCHWARZ, *supra* note 6, at 238-39. The “court list” was replaced by the “prudent man” investment rule in the mid-1800s, although courts tended to interpret “prudence” as inversely proportional to risk, and disapproved many kinds of investments (short-selling, options, futures, etc.) thought to be inherently risky. *Id.* at 233 (providing a brief overview of the evolution from the “court list” to “prudent person” rule).

241. Of course, this would not explain why limited partners or members of an LLC, both of whom enjoy limited liability, should be treated in the same manner as general partners.

exempt organization or in partnership form, one would expect the management of an exempt enterprise to pick the container that would best limit business risk to other assets. This, in fact, is, how for-profit managers consistently operate, by forming separate subsidiary corporations in order to isolate liability for newer or riskier parts of the business.<sup>242</sup> Although, unlike their for-profit counterparts, nonprofit managers do not face ultimate accountability to shareholders, they do have interested constituent groups such as donors. In addition, the state Attorney General usually has some supervisory authority over charities. If the tax laws simply were neutral on this issue (for example, if the corporate separate-identity rule did not exist or was applied to partnerships as well as corporations), there is no reason to believe that nonprofit managers would not act to limit liability in the same way their for-profit counterparts do. The overall operation of the commerciality rules, thus, does little to address risk issues even if those issues are considered significant policy concerns.

### III. RECONSTRUCTING THE RULES TO ADDRESS THE POLICY CONCERNS

The above analysis identifies six potential public policy concerns with commercial activity by exempt charities. These six include the traditional UBIT rationales of unfair competition and tax base erosion, and four broader policy concerns: managerial diversion, economic efficiency, checks on subsidy worth and need, and liability insulation for charitable assets. Of these six, the four that appear most compelling are protecting the corporate tax base, limiting diversion, promoting economic efficiency, and providing some check on subsidization worth and need. The UBIT standing alone

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242. See WILLIAM H. PAINTER, *PAINTER ON CLOSE CORPORATIONS* § 2.8, at 2:73 (3d ed. 1991 & Supp. 1999) ("A major purpose of forming more than one corporation may be to attain limited liability and prevent the entire business from being exposed to the risks of each particular phase of the business."). This practice, of course, has spawned numerous cases regarding "piercing the corporate veil" so that creditors of subsidiary corporations could reach the deeper pockets and asset base of the parent corporation. Thus, the historical record from the for-profit sector indicates that if corporate managers are left alone, they aggressively pursue liability limitation. There is no reason to believe that managers of exempt charities would not likewise act to protect charitable assets absent competing tax considerations.

operates, at best, imperfectly to address all four issues, and has particular problems with tax base erosion, managerial diversion, and checking subsidy worth and need. Adding the commerciality doctrine and the *Moline Properties* separate-identity rule to the mix substantially improves tax base protection at the cost of administrative efficiency and legal certainty, but even this combination of rules inadequately addresses diversion concerns or subsidy worth and need, except in the most egregious situations.

The next question, therefore, is whether the tax rules regarding commercial activity can be reconstructed to address the major public policy concerns while improving the doctrinal transparency and providing certainty in application. In this Part, I examine two general approaches to revising the rules on commercial activity and how they would affect the doctrinal rules on commercial activity. The first approach would permit charities to capture premium returns on commercial activities as a method of providing an additional government subsidy to them. It would also attempt to address the four major policy concerns through one of three different techniques: clarification of current doctrinal rules; adoption of new rules as an "overlay" to existing rules; or radical restructuring of the tests for exemption. The second approach takes an entirely opposite view. It would attempt to eliminate the economic incentive for direct commercial activities by taxing all commercial activities of exempt charities.

I prefer the first approach executed by radically restructuring the tests for exemption to adopt the donative theory of exemption that I have previously proposed.<sup>243</sup> In the absence of such a major revision to the core definition of tax exemption, however, the second approach also addresses all the major policy concerns and is preferable to the current doctrinal uncertainty.

### *A. Controlling the Economic Incentive*

As noted in Part II, the best counterargument to the concerns about tax base erosion and nonprofit managerial diversion is that commercial activity provides a source of revenue for conducting charitable activities. Thus, one possible choice for dealing with

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243. See Hall & Colombo, *supra* note 15, at 1384-89.

commercial activity is to consciously permit exempt charities to capture the economic premiums available as a method of providing an additional government subsidy to these organizations. Under this scenario, protecting the corporate tax base is obviously not a policy concern—in essence, we have chosen to give away part of the corporate tax base as an additional subsidy to exempt charities. Although unfair competition and asset liability issues might be exacerbated, the analysis presented in Part III discounts the importance of these issues in forming public policy.

What definitely is of concern, however, is the diversionary potential of such an approach, its effects on economic efficiency, and the lack of external checks of worth and need on the indirect subsidy such a system would provide. As noted above, without the combination of the UBIT, the commerciality doctrine, and the separate-identity rule to provide at least some disincentive to conducting direct commercial activities, the scope of those activities would almost certainly increase dramatically, much as they did during the period between the *Trinidad* decision in 1924 and the adoption of the UBIT in 1950. Charities presumably would undertake commercial activities solely for their premium financial return, whether or not related to economies of scope or other economic efficiencies. Recent empirical evidence suggests that charities are doing just that under our current system.

Three general solutions to these problems exist. The first solution is for the IRS to keep the current scope of the UBIT mostly intact, recognizing that charities will be able to capture premium financial returns on direct commercial activities that can qualify as “related” (and therefore not taxable under the UBIT), but to clarify current doctrine in a manner that would address the major policy concerns raised above. In this clarification vein, two New York University students recently suggested that the regulations under section 501(c)(3) should establish a presumption of “charitability” if the exempt organization met a mathematical test comparing the sum of an exempt organization’s gross income plus expenditures on unrelated activities, to the sum of gross income and expenses from related activities.<sup>244</sup> If the “unrelated” sum exceeded the “related” sum, there would be no presumption of charitability and

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244. Peña & Reid, *supra* note 13, at 1886-95.

presumably the Service could attack exempt status using the same concepts as existing law.<sup>245</sup>

Although I think the note authors were on the right track with this proposal, it is both too complex and too simple. The relative size of commercial activities versus charitable ones is certainly a consideration in controlling both excessive diversion and self-subsidization. Comparing revenues plus expenses, however, is probably unnecessary to this relative size consideration. For example, presumably we would not be terribly concerned under this general approach about the charitable status of an exempt organization that made one million dollars in revenues selling pencils if the profits from those revenues were spent on charitable activities (for example, cross-subsidization), *and if* the pencil business was not consuming more resources from the exempt entity than its charitable program. Thus, I think one could capture the "relative size" issue more simply by requiring that *gross expenditures* on charitable activities must exceed gross expenditures on commercial activities on a rolling three-year average basis. This proposed test is similar to the tests already applied under I.R.C. § 501(h) for determining when excess lobbying expenditures should jeopardize exemption.<sup>246</sup>

The students' suggestion is also too simple because it contains no specific test to ensure that cross-subsidization is the goal of commercial activity. Consider, for example, a situation in which a charity has \$200,000 in noncommercial revenues—to make this simple, the \$200,000 comes from donations—that it spends on charitable activities, and also has invested \$100,000 to operate a commercial activity (for example, a gift shop) whose gross income plus expenses are less than \$400,000. Instead of operating the gift

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245. *Id.* at 1895-96.

246. I.R.C. § 501(h) (2000). I do appreciate, of course, that any comparison test will require extensive regulations to govern allocation of expenses between charitable and commercial activities and that even with such regulations, one can expect some level of "slop" in the system as currently is the case with the UBIT, *see supra* note 195 and accompanying text, or other expense allocation systems (such as the uniform capitalization rules applicable to inventory accounting). It may also require that we develop some way of valuing donated labor in order to insure fair comparisons on "expenditures" in the commercial and charitable activities. Nevertheless, I would prefer this approach to a more general "common law" development of the commensurate-in-scope concept for the reasons of administrability and compliance.



shop, the charity presumably could liquidate it, take the \$100,000 investment and buy \$100,000 in bonds that would return five percent. Note that the hypothetical gift shop meets the proposed "presumption" test. Now assume that although the gift shop produces a five percent annual return, the charity's management, enamored with running a commercial business, reinvests that amount in the gift shop rather than using it to cross-subsidize charitable activities. In this hypothetical case, which illustrates perfectly the diversion problem, the operation of the commercial activity is not "expanding the pie" of charitable services and has simply become an end unto itself for the managers. In this circumstance, regardless of the relative size of the charitable and commercial activities, society presumably would be better off if our exempt charity simply liquidated its investment and bought bonds. Even if management decided to reinvest the annual earnings on the bonds, it would not have the diversionary problems of operating a gift shop—and presumably without that diversion, management would be more likely to spend the five percent on charitable outputs.

Thus to directly attack the diversion problem, part of this "doctrinal clarification" approach should require that, in order for a charity to maintain exemption when it operates a commercial activity, it must demonstrate that revenues from the commercial activity are spent to increase preferred charitable outputs. One mathematical way to do this is to require that a charity's expenditures on its charitable program on average exceed its non-commercial revenues over some medium-term time (three to five years) by a certain percentage tied to an expected baseline annual return (perhaps tied to the long-term federal rate under I.R.C. § 1274(d)) on its investment in its commercial activity. Applying this approach to the above hypothetical, if the gift shop's expected return rate were five percent, then we would demand that the charity spend \$205,000 on its charitable outputs to meet this test. If a charity cannot demonstrate such monetary enhancement to its charitable program on at least some medium-term average basis, then presumably it (and society) would be better off if it simply discontinued its direct commercial activity and moved its money into a passive investment. Failure to make the required showing would indicate that the operation of the commercial activity is

diverting management attention to some degree, the taxing system likely is losing revenues because of it, and there is no offsetting benefit to the charitable program that justifies that diversion or revenue loss.<sup>247</sup>

Finally, as the student Note recognized,<sup>248</sup> a mathematical approach to the commerciality issue would require the Service to address the corporate separate-identity rule as applied to assessing exempt status, because otherwise any charity could easily escape the rule by “sealing off” commercial activities in separate corporations. Frankly, apart from its role as a backhanded method for controlling commercial activity by exempt charities, the corporate separate-identity rule makes no sense in assessing exempt status. The *Moline Properties* separate-identity rule itself was the product of concern about the integrity of the corporate tax base.<sup>249</sup> A person who sets up a corporation subject to the separate tax regime of Subchapter C should not be able to easily argue that one should ignore the separate tax existence of that entity and evade the corporate tax. This issue was at the heart of *Moline Properties*.<sup>250</sup>

If, however, we make a policy choice *not* to better protect the corporate tax base as a means of providing additional indirect subsidies for charitable outputs, we have already addressed the underlying issue of *Moline Properties*. We should then no longer need the combination of the *in terrorem* effect of a doctrinally diffuse commerciality doctrine coupled with the separate-identity “escape hatch” to provide backhanded protection for the corporate tax base.

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247. This proposal is similar in its theoretical intent to the requirement that a private foundation distribute a minimum of five percent return on its investments to avoid excise taxes, I.R.C. § 4942 (2000), though the proposed test is far more demanding in amounts spent on charitable activities. One might well ask why we should not impose a similar test on passive investments of public charities. Perhaps we should—but in the context of this Article, the diversion issue which this test would address is the result of direct commercial activity, not passive investment. Presumably, we are not worried about charitable managers becoming obsessed with their stock portfolio performance and thereby losing the unique nonprofit management ethic as they pour over the daily *Wall Street Journal* reports.

248. Peña & Reid, *supra* note 13, at 1894, 1895 n.176 (suggesting that this issue could be addressed with the existing anti-abuse rule in place under the UBIT in § 512(b)(13), though noting that the existing rule has some problems by rigidly limiting its definition of related entities).

249. See *Moline Props., Inc. v. Comm’r*, 319 U.S. 436, 438-41 (1943).

250. *Id.*

The practical question raised here, of course, is how one would define "related" for purposes of combining entities to apply the suggested tests. I previously suggested in the context of complex health care organizations that we include in the definition of "charitable enterprise" any entity that would be covered by the "supporting organization" rules of I.R.C. § 509(a)(3) that permit derivative public charity status, rather than using specific ownership tests as the Treasury department suggested during the UBIT hearings in the late 1980s.<sup>251</sup> I still believe this is a viable approach, for the following reasons. The § 509(a)(3) tests already include situations in which corporations are under common ownership or management.<sup>252</sup> The only real difference between using the § 509(a) approach and specific ownership tests is the fact that a particular entity *not* under direct common ownership would be subject to inclusion in a "related charitable group" under a "facts-and-circumstances" test as provided in the regulations under § 509(a)(3). Under this test, an organization gets derivative public charity status if it can show that it is "responsive to, and significantly involved in the operations of," the exempt organization.<sup>253</sup> This test generally requires the supporting entity to meet both a "responsiveness" component and an "integral part" component.<sup>254</sup> An entity can demonstrate responsiveness by allocating one board seat to a member of the supported entity or otherwise establishing a "close and continuous working relationship" between the two entities, such as by monetary contributions.<sup>255</sup> The integral-part test is met if the supporting entity carries on activities that otherwise would be carried on by the supported entity.<sup>256</sup>

In the end, the question boils down to whether entities that are "practical" siblings should be included in an expanded charitable group. I would answer that question affirmatively for two reasons. First, such a rule would limit the ability of exempt charities to escape the other proposed rules by simply having a

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251. Colombo, *supra* note 13, at 250-51.

252. Treas. Reg. § 1.509(a)-4(h) (1972).

253. *Id.* § 1.509(a)-4(f)(4).

254. *Id.* § 1.509(a)-4(i)(1).

255. *Id.* § 1.509(a)-4(i)(5) (providing Example 1 in which the responsiveness test is met by an organization whose sole activity was publishing and printing for churches of a particular denomination).

256. *Id.* § 1.509(a)-4(i)(3)(ii).

“cozy” relationship with, rather than direct control of, what is essentially a feeder organization. Remember that the facts-and-circumstances test of § 509(a)(3) described above requires a level of cooperation between the charity and the supporting organization that makes the charity pay attention to what the supporting organization is doing, and makes the supporting organization responsive to the charity’s desires.<sup>257</sup> If an exempt school is raising money through an external organization nominally controlled by the parents of schoolchildren, that operation should be considered part of the expanded charitable entity for purposes of the clarified doctrinal tests proposed in this Article. This flexible approach would also address the problems inherent in using more rigid definitions of relatedness that might easily permit avoidance through creative corporate structures.<sup>258</sup>

Finally, this expanded definition would also work in the opposite direction in that it would appropriately allow an exempt charity to “count” as charitable expenditures activities undertaken on its behalf by a nominally independent entity. Recall that the test under § 509(a)(3) involves proof that the supporting organization is carrying on a program that is an integral part of the program of the exempt charity.<sup>259</sup> In such circumstances, it is entirely appropriate to count those expenditures as part of the overall charitable program in question.

A second general approach to the path of managing incentives for commercial activity is to broaden the scope of the current indirect subsidy while enacting additional rules that would overlay current law in order to specifically address the aforementioned policy concerns. Arguing that current revenue sources are inadequate to support the activities of exempt charities, Professor Donald Sharpe proposed such an approach via an elective credit against the tax that otherwise would be due under the UBIT if business profits are used to support related charitable activities.<sup>260</sup> To address the diversion problem, Professor Sharpe suggested rules that would limit total investments in direct business enterprises to twenty-five percent of a charity’s total investment portfolio and to

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257. See *supra* notes 252-56 and accompanying text.

258. See *supra* note 248 and accompanying text.

259. See *supra* notes 253-56 and accompanying text.

260. Sharpe, *supra* note 13, app. A (describing Professor Sharpe’s proposal).

deny charitable managers the ability to serve as employees or directors of any unrelated business for which the credit is used.<sup>261</sup> To address unfair competition, Professor Sharpe would require a showing that a charity charges competitive prices in its commercial activities.<sup>262</sup>

Professor Sharpe did not consider how his system might affect the commerciality doctrine or the corporate separate-identity rules, but one could imagine combining his system with some of the suggestions for doctrinal clarification of current law made above. Under his system, for example, the commensurate-in-scope test would presumably be jettisoned in favor of the credit to encourage "commensurate" activities. One also could compute Professor Sharpe's twenty-five percent limit by including all "related" entities under a test similar to that proposed above, and the IRS could still clarify the "primary purpose" language to impose a mathematical gross-expenditure test.<sup>263</sup>

Ultimately, however, both the "doctrinal clarification" approach and Sharpe's "elective credit" approach suffer from the same main problems. Neither contains an external check on worth or need for the indirect subsidy provided by commercial activities. Exempt entities could self-subsidize (at least up to the limits proposed by each system) by acquiring direct commercial activities.<sup>264</sup> In each system, therefore, charities could grow internally without anyone ever questioning whether the charitable services provided are in fact useful to or valued by the community, except in the context of revoking exemption. Moreover, neither system would address the problem created when commercial activity itself arguably falls under the definition of "charitable" as is the case with nonprofit hospitals or religious publishers. Finally, neither system really simplifies the law in this area. In fact, either proposal would make the rules more complex.

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261. *Id.* at 404-05.

262. *Id.*

263. It should be noted that I am not certain that Professor Sharpe would agree with these changes.

264. To be fair, this is exactly the result Professor Sharpe prefers; his view is that without additional subsidies, exempt charities are at serious financial risk. Sharpe, *supra* note 13, at 406-09. This, for him, answers the "need" question and, although he does not say so specifically, presumably the initial qualification of an organization as tax exempt answers the "worth" question.

The third approach to managing the incentive for commercial activities, however, would address all of these problems. The solution is to completely restructure the underlying tests for tax exemption so that these issues are addressed as part of the exemption process. In fact, Professor Mark Hall and I proposed such a system in the early 1990s.<sup>265</sup> Under our donative theory, the UBIT would be repealed.<sup>266</sup> Exemption would be granted based upon certain baseline levels of donations (one-third of gross revenues), which would provide a self-correcting system to check the worth and need of organizations seeking indirect subsidies and the size of commercial activities.<sup>267</sup> As commercial revenues increase, the percentage of total revenues represented by donations (assuming they remained constant) would decrease. Accordingly, if charitable managers wanted their organizations to remain tax-exempt, they would have to self-limit the size of non-donative revenues to roughly twice the amount of donations, thus insuring that commercial activity would be limited in overall amounts. Moreover, if organizations "self-subsidized" too much by acquiring direct commercial activities, the absolute level of donations would likely fall as donors perceived reduced worth and need for subsidization. Accordingly, organizations which too heavily invested in direct commercial activities and became "for-profits in disguise" would over time lose exemption through the combination of increasing non-donative revenues and decreasing donations.<sup>268</sup> Thus, although we did not address this specific point in our earlier works, the commerciality doctrine would not be needed to provide the ultimate check against exempting a "for-profit in disguise." Similarly, because donors would likely assess the worth and need of a complex organization as an integrated whole, the system would not need the corporate separate-identity rule. In fact, it would be more appropriate to apply the baseline donative test to a complex

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265. COLOMBO & HALL, *supra* note 17, at 175-79; Hall & Colombo, *supra* note 15, at 1442-46.

266. COLOMBO & HALL, *supra* note 17, at 175-79.

267. *Id.* at 198-99.

268. *See id.* at 129-30 (hypothesizing that there is a "market in altruism" in which donors assess the worth and need of competing charities before making donation decisions).

organization by aggregating all related entities so that the overall revenues were subject to the one-third test.<sup>269</sup>

In addition to directly addressing the issue of worth and need, this system also would directly address the diversion potential of commercial activities by making charitable managers even more sensitive to whether donors believed the organization was pursuing a desirable charitable purpose. A probable indirect by-product of the system, moreover, would be that charities would be most likely to exploit commercial activities with clear economies of scope (thus improving economic efficiency), since those activities could most easily be "sold" to donors either as a natural extension of the charitable mission or as prudent exploitation of excess capacity.<sup>270</sup> Accordingly, this system would address all the significant public policy issues surrounding commercial activity while greatly simplifying the rules in this area. As a result, if managing the incentive for commercial activity by exempt charities is the path we desire to take, the only method to do so that fully addresses all the policy issues involved is a radical restructuring of the standards for exemption along the donative theory lines.

*B. Eliminating the Incentive for Direct Commercial Activity by Expanding the UBIT*

Given that radical restructuring of the tests for tax exemption is unlikely to occur,<sup>271</sup> however, and recognizing that other proposed

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269. See *supra* notes 251-59 and accompanying text for a discussion of my proposed rules for aggregating entities in complex enterprises.

270. Empirical observations of certain nonprofit sectors indicate that commercial activity has a negative impact on donations, although this negative impact does not appear to be true in the nonprofit hospital or university settings. Lewis M. Segal & Burton A. Weisbrod, *Interdependence of Commercial and Donative Revenues*, in *TO PROFIT OR NOT TO PROFIT*, *supra* note 1, at 105-27. Thus, nonprofit managers appear to avoid commercial activity that is arguably inconsistent with their charitable mission because of the fear it will depress donations. See James, *supra* note 200, at 274 ("[Nonprofit managers'] reluctance to rely on sales revenue may stem more from its expected impact on donations ...."). Under the donative approach to defining exemption, one would expect this effect to become more pronounced: managers would engage in commercial activity only when they believed donors would not react negatively—that is, where they could explain to potential donors that the commercial activity was merely an extension of the charitable mission or prudent resource utilization.

271. Despite my conscientious hawking of the donative theory for almost ten years, it appears no closer to adoption than before Mark Hall and I proposed it back in 1991. The last serious congressional discussion of exemption standards was in the context of President

methods of controlling the financial incentives relating to commercial activity have their own problems, perhaps the next best solution is to take a completely different approach: eliminate the premium financial returns available for such activities by expanding the UBIT to cover all commercial revenues. Other commentators have suggested a commerciality-based test for taxation as opposed to a relatedness test to address the unfair competition issue.<sup>272</sup> The real reasons to prefer this approach, however, have less to do with preventing unfair competition—which, as noted above, probably is not a significant policy issue at all—than with (1) addressing the major policy concerns of tax-base erosion, managerial diversion, economic efficiency, and the worth/need issues with self-subsidization and (2) simplifying existing law with respect to the commerciality doctrine and the corporate separate-identity rule.

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Clinton's ill-fated health care reform bill, and even then the discussion was limited to exemption for hospitals and health care providers. I don't need any realism enhancement therapy to recognize that the prospects for fundamental reform of the tests for exemption are zero, although I continue to believe that adopting our donative theory (or some reasonably close facsimile thereof) would create a far more administrable and far simpler tax system in this area while still preserving the essence of pluralism (by relying on donations as the baseline test of exemption) that underlies the charitable sector.

272. Small business advocates strongly pushed an expanded UBIT in the congressional hearings on the UBIT in the late 1980s as a means of controlling "unfair" competition. See, e.g., *Unrelated Business Income Tax: Hearing Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 100th Cong. 105 (1987) (testimony of Frank Swain, Chief Counsel for Advocacy, U.S. Small Business Administration). During this same period, James Bennett and Gabriel Rudney proposed a commerciality test for taxing commercial activities as a replacement for the current relatedness test under the UBIT. Bennett & Rudney, *supra* note 16, at 1095-97. Bennett & Rudney listed eight reasons for adopting a commerciality tax, the first two of which were directly related to unfair competition. Their list did include references to the other policy issues of economic efficiency, unnecessary subsidization, and tax-base erosion, but they did not consider how an expanded commerciality tax would interface with the existing commerciality doctrine and the corporate separate-identity rule and did not address specifically the issue of managerial diversion.



Taxing all commercial activity, of course, would directly address the traditional tax policy concerns of tax-base protection<sup>273</sup> and

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273. This approach, however, still would need to deal with the prospect for creative allocation of expenses between charitable activities and commercial ones in order to minimize taxable income from commercial activities. *See supra* note 196 and accompanying text. Professor Evelyn Brody has suggested that administering a "mixed" system in which nontaxed charitable activities exist side-by-side with taxable activities may be impossible, and may even encourage a kind of "stuffing" behavior in which charities attempt to "pair" profit-making activities with activities producing tax losses in order to minimize taxable income. Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 TENN. L. REV. 687, 733 (1999).

I am obviously more optimistic that this system would work, for several reasons. First, it is not clear that all "related" activities are money-losing ones. In fact, recent empirical work suggests that there are significant profit-making activities which are untaxed because either we have included them (erroneously, I believe) in the core definition of "charitable" or because we have permitted them to fall into the untaxed "related" category. *See, e.g.*, Yetman, *supra* note 196, at 305 (presenting survey results indicating substantial profits are being reported by exempt organizations from nontaxable activities). By eliminating relatedness as a test for non-taxability, the system would pick up these activities as part of the tax-base.

Second, this change would eliminate the possibility that profit-making activities now escaping taxation under the "related" rubric (for example, museum gift shops, university dining halls, bingo games, corporate sponsorship payments) are themselves a source of re-allocable expenses. Say, for example, that a charity has \$200 in overhead expenses that it would incur as a result of its charitable program in any event. It also has two businesses. Business A has \$100 of profit on revenues of \$500 and expenses of \$400, whereas Business B has \$250 in profit on revenues of \$1000 and expenses of \$750. Note that in this scenario, the charity cannot zero-out income from Business B simply by creatively allocating the overhead expenses from its charitable activity (even if it could allocate 100% of such expenses to Business B, which it cannot, it would still show a \$50 profit). If the charity takes the position that Business A is "related" (ergo, not taxable in any event), however, it presumably could creatively allocate some of that business' \$400 expenses to Business B (such an allocation would increase Business A's profit, but because it is "related," that profit would go untaxed anyway), thus producing a zero effect. In this scenario, if the tax law included Business A in the tax base, then the charity could no longer zero-out its income, and an expanded UBIT would affect the financial incentives to engage in both businesses—if we assume that the charity could only reallocate \$100 of its overhead without going "over the edge" on aggressiveness, then presumably the rational charity in this scenario would zero-out its income for Business A, divest itself of Business B (because it cannot now capture a premium financial return by avoiding the corporate income tax), and invest the proceeds in passive investments earning the same after-tax return.

Third, our system probably has room to refine expense-allocation methods to further tighten the noose around the cross-allocation scenario, such as by eliminating the possibility of allocating costs for fixed expenses that would be incurred fully as a result of the charitable activities in any event. *See Cordes & Weisbrod, supra* note 168, at 102 (noting that the current rules permit allocation of costs even where those costs would have been incurred fully in the operation of the charitable activities alone).

Finally, as I note in the text below, it would be unusual to classify as "commercial" an activity that never earned a profit or, indeed, was structured in a manner in which profit was

“unfair” competition if the latter indeed is a concern at all. At the same time, however, this approach would also address the other major policy issues. By eliminating the premium financial return available from “related” activities under current law, exempt charities would presumably have no incentive to engage in direct business activities except when they enjoy significant economies of scope because of excess capacity relating to their charitable outputs. Thus, this approach would address simultaneously the diversion problem by making direct commercial activity an unattractive investment except in economies-of-scope situations;<sup>274</sup> promote economic efficiency for the same reason, and eliminate the worth and need issues of potential self-subsidization by simply eliminating the subsidy. If one believes that asset liability exposure is also a significant concern, this approach indirectly addresses that issue as well. Again, this approach succeeds by largely eliminating the incentive for direct commercial activity and by equalizing derivative tax-exemption treatment for corporate and noncorporate entities so that managers engaging in commercial activities can pursue the best liability-limiting option without worrying about exemption effects.

A serious practical problem of this approach, however, concerns how one draws the line between taxable commercial activities and nontaxable but revenue-producing “charitable” activities. Many charities, for example, impose “user fees” in the form of tuition,

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not a goal. See *infra* notes 281-82 and accompanying text (discussing the case of the pharmacy whose activity was to sell medicines at cost to the poor and elderly). The expanded commerciality tax proposed in the text would not be “elective” so that charities could easily “stuff” money-losing activities into the commercial pot to offset “real” profits. Our system in fact has already dealt with this problem extensively via the requirement of a profit motive in order to qualify an activity for deductible trade or business expenses under § 162, in the hobby loss provisions of § 183, and in the passive activity regulations under § 469. I.R.C. §§ 162, 183, 469 (2000). All of these provide potential models to deal with charitable loss stuffing, if in fact it becomes a problem.

274. See Hansmann, *supra* note 13, at 627 (recognizing that expanding the UBIT should not impair economic efficiency, since charities would have every reason to engage in activities that involved significant economies of scope even if such activities were taxed). Hansmann concludes that the current structure of the UBIT should be left largely unchanged, but he does not consider in his analysis the noneconomic policy issues considered in the text above (such as managerial diversion) nor the opportunity to simplify the existing tax rules by jettisoning the commerciality doctrine and the corporate separate-identity rule. *Id.*

or admission charges. Would these revenue sources be subject to taxation under an expanded commerciality tax?

For the answers, we should return to the policy issues. The problems with commercial activity largely stem from the premium financial returns that result from a charity escaping the corporate-level tax on a particular economic activity. If, however, a particular activity could not be sustained by a for-profit entity in the private market, there is no premium financial return to capture. Such activities would not produce taxable revenues in any event and these cases of "market failure" should be exactly the types of services delivered by exempt organizations.<sup>275</sup> Thus, the heart of the target for a commercial-activity tax should be revenue-producing activities that are no different in essence from those provided by taxable for-profit companies, and which we could reasonably assume would be provided by for-profits in any event. This analysis in turn means that the doctrinal test of a commercial activity should hinge on whether a specific revenue-producing activity competes with for-profit organizations that provide substantially the same good or service.

In some cases, determining whether a product or service competes with for-profit providers will be relatively simple. There are no for-profit primary schools in Champaign County, Illinois. Accordingly, it is not difficult to conclude that the tuition charged by private nonprofit schools is not commercial revenue that should be taxed under an expanded commercial activity tax. Similarly, at the other end of the spectrum, it is not difficult to conclude that a hospital offering a full-service health club to the general community under the guise of a community "wellness" program is competing directly with for-profit health clubs in the same geographic area and thus its health club profits should be taxed.

In many cases, however, the competition factor will require more extensive analysis, particularly in the case of "user fees." Take, for example, the nonprofit community theater that sits across the street from a for-profit theater. If the nonprofit theater charges admission, should it be subject to a commerciality tax on admission revenues if it in fact makes a profit? James Bennett and Gabriel Rudney suggested that this question could best be answered by

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275. See COLOMBO & HALL, *supra* note 17, at 99-104.

requiring the exempt organization to prove that the costs of producing the service in question were at least fifty percent subsidized by "non-sales" revenues such as donations, government grants, and volunteer labor.<sup>276</sup> Although such a bright-line approach is appealing, it misses the core issue, which is to determine whether a particular good or service in fact would be provided by the for-profit sector. Any activity that requires subsidization by definition is not a candidate for an expanded commerciality tax, because, if a subsidy is needed to cover costs, that activity would not produce any taxable income in any event.<sup>277</sup>

Instead, on this issue I prefer a more facts and circumstances approach directed at the ultimate issue of determining whether a good or service is "substantially the same" as that provided by the for-profit sector. In making this determination, much of the Tax Court's current analysis, adopted by the Seventh Circuit in *Living Faith*,<sup>278</sup> regarding what factors make an activity "commercial," is relevant.<sup>279</sup> That is, one might look at an organization's pricing structure and the general conduct of its activity to determine how commercial in nature it really is. For example, if the community theater in my hypothetical routinely chooses productions that are shunned by commercial theaters for their lack of profit potential, then one might well conclude that the community theater does not in fact compete with the for-profit theater because they are not really producing "substantially the same" service.<sup>280</sup> Similarly, contrary to the Eighth Circuit's analysis in *Federation Pharmacy*

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276. Bennett & Rudney, *supra* note 16, at 1097.

277. If one was interested in a bright-line test, the test would not focus on subsidization, but on the rate of return generated—the question is whether the rate of return generated by the nonprofit is equal, or nearly equal, to the rate of return generated by alternative investments of similar risk.

278. *Living Faith, Inc. v. Comm'r*, 950 F.2d 365 (7th Cir. 1991); see also *supra* notes 54-55 and accompanying text (discussing the *Living Faith* case).

279. See *supra* notes 52-55 and accompanying text. Of course, under the proposed test, these factors would be used to determine whether a particular activity is commercial, and therefore subject to taxation, rather than used to determine whether the organization is eligible for baseline tax exemption.

280. See, e.g., *Goldsboro Art League v. Comm'r*, 75 T.C. 337, 343-45 (1980) (holding that operation of an art gallery that did not pick works for commercial exploitation potential was not "commercial"); *Plumstead Theater Soc'y v. Comm'r*, 74 T.C. 1324, 1333 (1980) (holding that a community theater company was not "commercial" based on differences between a community theater and a for-profit theater in selection of works, performance values, etc.).

*Services*,<sup>281</sup> a pharmacy that sells primarily to the elderly and poor at reduced prices sufficient only to cover costs plus depreciation is simply not operating as a commercial pharmacy would, and we might well conclude that this activity is not commercial in the first instance. Such a decision would be based on a policy decision that the activity is, in fact, a kind of preferred charitable output that exemption should encourage, not discourage.<sup>282</sup>

The expanded commerciality tax as implemented above also should eliminate the need for the commerciality doctrine and the corporate separate-identity rule. If no indirect subsidy is available from direct commercial activity in the first place, there is no need for the commerciality doctrine as the ultimate backstop to withdraw exemption from organizations that have become "too commercial" to avoid government subsidization of activities that do not deserve or need it. Put another way, even if an organization had a nominal tax exemption, it would be taxable on all its commercial revenues; ergo, there is little reason from a tax-system perspective to pull exempt status from entities that have some claim to exemption but also engage in significant commercial activity. Moreover, adopting a broad entitlement to baseline exemption would permit organizations to retain tax benefits such as tax-deductible donations for their charitable activity, whatever it may be. For example, if donors wish to make contributions to a nonprofit hospital to support medical research, there is no reason to "punish" the organization with complete repeal of exemption simply because ninety percent of its revenue comes from a commercial activity (the delivery of health services for a fee). Thus I would couple this expanded UBIT approach with a repeal of the primary purpose rule and the commerciality doctrine, making it clear that an entity could

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281. *Fed'n Pharmacy Servs. v. Comm'r*, 625 F.2d 804, 807-09 (8th Cir. 1980).

282. This is another good example of why Bennett & Rudney's commerciality test is misplaced. See Bennett & Rudney, *supra* note 16, at 1097-98. A for-profit firm would not operate a business at zero profit margin, even though this "business" could survive as a nonprofit as long as it covered its costs. One response, of course, is that such a business would not be subject to tax under an expanded UBIT in any event, because it would make no profit to tax. But it is possible that such an operation would in fact produce a profit in any year simply as a result of prudent budget strategy. Realizing that budgeting is imperfect, one would prudently set a price that would provide some small operating "cushion" to cover unanticipated expenses; if these did not occur, the "cushion" would turn into an end-of-year profit.

achieve baseline tax exemption with *any* significant charitable activity while recognizing that all commercial activity profits, related or not, would be subject to tax.

As an illustration, under this approach both Scripture Press<sup>283</sup> and Presbyterian & Reformed Publishing<sup>284</sup> would be entitled to baseline exemption as religious organizations. To the extent, however, that courts in both cases concluded that their publishing businesses were essentially indistinguishable from commercial publishing houses, both entities would be fully taxable on their commercial publishing revenues. Nonprofit hospitals that engaged in some charitable activity such as medical research also would be entitled to a baseline exemption, but taxed on their income from the commercial activity of delivery of health services for a fee, inasmuch as little empirical evidence exists that their range of services or pricing structure differs in any way from for-profit competitors. A YMCA or similar nonprofit organization that operates a high-end health club might have baseline exemption as a result of its education programs or service to the poor, but would be taxed on its downtown health club membership revenues. The publishing houses, the hospital and the "Y" then still could solicit tax-deductible contributions to support their charitable outputs. If donors were convinced of the worth and need of doing so in light of the significant commercial activity, there is no reason for the taxing system to object.

Finally, the corporate separate-identity rule also should be jettisoned under an expanded commerciality tax. Just as we do not need the corporate separate-identity rule in a world where society consciously chooses to let charities capture premium returns from commercial activities as a method of additional indirect subsidization, we also do not need the rule if we make a policy choice to better protect the corporate tax-base in the exempt organizations world via an expanded commerciality tax. Such a tax already addresses the corporate tax-base protection issues that gave rise to *Moline Properties*.<sup>285</sup>

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283. See *Scripture Press Found. v. United States*, 285 F.2d 800 (Ct. Cl. 1961).

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

285. See *Moline Props., Inc. v. Comm'r*, 319 U.S. 436, 438-41 (1943).

Under an expanded commerciality tax, moreover, neither the upstream nor downstream isolation effects of the corporate separate-identity rule make any sense. Upstream isolation is simply unnecessary, since part of the proposed approach would be to permit an organization with *any* significant charitable activity to claim exemption while paying tax on all commercial profits. As a result, it would no longer make any difference to exempt status if a commercial activity were isolated in a subsidiary. As long as the parent were conducting some substantial charitable activity, it would be eligible for baseline exempt status, but both parent and subsidiary would pay tax on all commercial revenues.

Similarly, there is no reason to limit derivative exemption for related entities under a system in which those entities are paying tax on all commercial profits. Take the example of an integrated health care network whose parent is tax-exempt because it engages in medical research. The parent creates a wholly-owned subsidiary to operate an HMO. There is no public policy reason under an expanded commerciality tax approach to deny baseline exempt status to a separately-incorporated subsidiary operating an HMO, because the HMO presumably would pay tax on profits from its "commercial" activity of selling health services for a fee, just as the parent would if it operated the HMO directly. The only real effect of this proposal at the federal tax level would be to permit the HMO to receive tax-deductible contributions directly. Since these contributions could go to the parent anyway (which could then transfer them to the subsidiary at its discretion as a capital contribution without tax consequences), and the parent would have control over the contributions whether they were made to the parent directly or to the subsidiary, who cares if the rules permit the HMO to receive these contributions directly? Finally, eliminating the separate-identity principle with respect to judging exempt status will put all business forms on equal footing for this purpose, avoiding the situation where management's choice of the appropriate business container is constrained solely by issues dealing with how the activities in that container will or will not affect exemption for a related entity.

I would again use the supporting organization tests of § 509(a)(3) for practical implementation of an “expanded” charitable group.<sup>286</sup> As noted above, this test covers both direct common control situations and also includes a facts and circumstances test to permit derivative public charity status under existing laws where two organizations work together for a common goal even if not technically affiliated in a parent/subsidiary relationship. In an expanded commerciality-tax world, it would make sense to permit generous derivative exemption for the same reasons justifying generous baseline exemption. Granting exempt status broadly would not impair the federal tax-base or contravene any of the public policy concerns with commercial activity as all such activity would be taxed and exempt status would provide organizations the ability to solicit contributions for its charitable outputs and enjoy the other tax benefits relating to its charitable activity. Thus, the parent group in my earlier exempt-school hypothetical would receive exempt status because of its close working relationship with the school (even absent a technical control relationship), permitting it to solicit deductible contributions for its work for the school—an entirely appropriate result as long as the group is taxable on its profits from operating a bingo parlor.<sup>287</sup>

### CONCLUSION

The Service, courts, and other commentators generally have approached commercial activity by exempt charities on a piecemeal basis, dealing with the revocation of exemption, or taxability under the UBIT, or “derivative” exemption without considering how these various pieces of the puzzle fit together. The result, as Part I of this Article demonstrates, is a doctrinal mess. The best that can be said of our current rules is that, precisely because they are so vague and unpredictable, they provide a backhanded method of addressing some of the policy concerns with commercial activity by exempt charities (primarily the concern with erosion of the corporate tax-base and, to a lesser degree, economic efficiency) by pressuring risk-

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286. I.R.C. § 509(a)(3) (2000); *see supra* notes 252-56 and accompanying text (discussing the Treasury Regulations implementing this section).

287. Yes, I also would repeal the special UBIT exception for bingo games. I.R.C. § 513(f) (2000).



averse managers to isolate commercial activity in separate corporate subsidiaries, where it will almost certainly be taxed.

Whatever the merits of ambiguity in the law generally, relying on doctrinal uncertainty ought to be a last resort to accomplish policy goals in the tax field, where taxpayer compliance and excessive regulatory discretion are daily concerns. Moreover, the current rules do relatively little to address other major policy issues, such as managerial diversion and assessment of the worth and need for an additional indirect government subsidy.

As a result, this Article has examined two general alternatives to dealing with the policy concerns regarding commercial activity by exempt charities. One such approach would be to make a conscious policy choice to permit charities to capture a portion of the corporate tax as an additional subsidy for their charitable outputs by either leaving the current contours of the UBIT unchanged or repealing it entirely. Without radically restructuring the rules regarding qualification for tax exemption, however, such an approach would need complex statutory provisions to address public policy concerns regarding managerial diversion and to insure that the subsidy was properly used to expand charitable outputs. Moreover, without radical restructuring of the tests for tax-exemption, this approach essentially would permit a charity to "self-subsidize" through the acquisition of commercial businesses, without any external check on whether the charity needs or deserves such subsidy. This outcome would stand in stark contrast to the charitable contributions deduction under I.R.C. § 170, where the government subsidy tracks the individual taxpayers' assessments of worth and need.<sup>288</sup>

As a result, if we are not prepared to radically alter the underlying tests for tax exemption (an approach I prefer), then we should consider eliminating the economic incentives for direct commercial activity by expanding the reach of the UBIT. Under this approach, we would repeal the commerciality doctrine and permit any organization pursuing some charitable purpose to qualify for a baseline exemption. Because the organization would be taxed on all commercial revenues, however, the tax system would not suffer any revenue losses and the incentive to engage in direct commercial

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288. I.R.C. § 170 (2000).

activity would be minimal except in cases in which the charity has significant economies of scope. As a result, this approach should itself produce the desirable side effects of reducing the potential for managerial diversion, promoting economic efficiency, and rendering moot the issue of policing the worth/need for an indirect subsidy. The expansion of the UBIT to a general commerciality tax, moreover, removes whatever tax policy reason exists to enforce the *Moline Properties* separate-identity rule with respect to judging exempt status for parts of a complex charitable organization. Instead, we should permit relatively liberal derivative exemption, knowing that all profits from commercial activities will be taxed, no matter what "container" they come in, while at the same time preserving the benefits of exemption (e.g., the ability to attract deductible donations) for the organization as a whole.

This latter approach, of course, requires one to agree that the policy dangers of expanded commercial activity, including current doctrinal uncertainty, constitute a more serious problem than the loss of the indirect subsidy provided by the current system with respect to activities deemed "related" under the current UBIT. I am certain that not everyone would agree with that conclusion. Regardless of which approach one favors, however, recognizing that commercial activity encompasses more than just the rules on the UBIT is important. Given the current state of the law in this area, adopting *some* integrated approach to commercial activity that would address the scope of the UBIT, the commerciality doctrine, and the corporate separate-identity rule together would be a very worthwhile improvement to the legal climate for exempt charities.