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Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption (symposium)

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Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption

Evelyn Brody*

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I. INTRODUCTION

Why are charities tax exempt? This question has been discussed in general theoretical terms of whether the exemption is, on the one hand, a "subsidy" or, on the other, an acknowledgment that charitable activity falls outside the "right" tax base.¹ Consider other tax exemptions. Congress from time to time grants exemption to infant industries to spur economic investment. By contrast, household production goes untaxed because it has never occurred to Congress to impose tax on our imputed income when we clean our

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1. Yet a third theory, one of administrative convenience, best explains such tax rules as those granting a charitable contribution deduction only for donations to *organizations* recognized as exempt. After all, a private donation to a homeless person has the same social value, and effects everyone's consumption the same, as a donation made through a charity. This denial of a deduction is presumably justified on the ground that private contributions would be difficult to substantiate and police.

house or care for our children. Uniquely, exemption for charitable activity has been justified on *both* subsidy grounds and “base-defining” grounds.

These opposing theories of the tax treatment of charity, however, share a common perspective. This Article proposes that a “sovereignty” view of the charitable sector underlies the tax exemption. Clearly, a sovereignty view is easier to see in a base-defining approach: Charities go untaxed because Caesar should not tax God (or the modern secular equivalent). But a sovereignty view also explains why a subsidy would take the form of tax exemption rather than the more logical form of direct grants: For all its imprecision, tax exemption keeps government out of the charities’ day-to-day businesses, and keeps charities out of the business of petitioning government for subvention.

Moreover, current tax exemption is not absolute. A sovereignty perspective illuminates those rules in the tax scheme that operate to curtail rather than enhance the economic strength of the charitable sector. After all, rival sovereigns rarely feel comfortable letting the other grow too powerful.² Indeed, John Simon uses the sovereign-sounding term “border patrol” to describe the function of statutory provisions that limit charities’ political and lobbying activities, and that tax income from commercial activities.³ Thus, thinking of charity as a co-sovereign to the state explains not just blanket exemptions based on organizational form, but also those seemingly peculiar tax rules that, paradoxically, reduce the reach and effectiveness of tax exemption.

To identify subsidy and base-defining explanations for the current tax exemption is not to suggest that such theories consciously motivated legislators. Indeed, for a variety of historical and political reasons, we find that subsidy and base-definition theories—influenced to a greater or lesser degree by sovereignty concerns—have operated simultaneously to produce the American federal and state exemption schemes. Part II of this Article contrasts the subsidy and base-defining theories, and the influence of a sovereignty perspective on each. To illustrate the tension between these theories, Part III turns to an old American tax regime: the state property tax. Property-tax exemption also raises a true sovereignty concern: The exemption is granted at the state level, while the burden falls on local municipalities. Accordingly, we examine the municipalities’ response: to demand that exempt charities make “voluntary” payments in lieu of taxes (PILOTs).

Part IV looks at the federal corporate income-tax exemption. Here we see the schizophrenic impact of a sovereignty view most clearly: Seemingly technical provisions

2. Most starkly, laws limiting land-holding by the Church are not only a matter of dusty history. Henry VIII’s seizure of monastic property was echoed in modern Mexico, which amended its constitution to recognize the right of churches to own property only in 1992. See Evelyn Brody, *Charitable Endowments and the Democratization of Dynasty*, 39 ARIZ. L. REV. 873 (1997) [hereinafter Brody, *Charitable Endowments*].

3. John Simon, *The Tax Treatment of Nonprofit Organizations: A Review of Federal and State Policies*, in *THE NONPROFIT SECTOR: A RESEARCH HANDBOOK* 67, 89-94 (Walter W. Powell ed., 1987). For example, the prohibition in section 501(c)(3) of the Internal Revenue Code against taking sides for or against a candidate for public office provides a clear example of the sovereignty approach. See *id.* at 90-91. The Code contains more limited restrictions on legislative lobbying activities (while imposing an absolute bar for that subset of charities known as “private foundations”). Compare I.R.C. § 501(h) with § 4945(e). Section 501(h) permits publicly supported charities to elect a safe harbor for lobbying activities based on a percentage of its income; Simon, *supra*, at 92, notes that surprisingly the “right to elect these percentage limitations is denied to churches—at their own request.” To some degree this scheme has an analogue in the rules that limit business deductions for lobbying costs. See I.R.C. § 162(e). For a discussion of the tax treatment of commercial activities by charities, see Part III, below.

operate both to limit and to promote the growth of charities in ways explainable only by government's view of charity as a parallel sovereign. Specifically, we examine long-standing rules that subject debt-financed investments to the unrelated business income tax ("UBIT"), even though a leveraged investment produces no tax advantage to a tax-exempt investor if it borrows at market interest rates. Surprisingly, then, in 1997 Congress granted charities the right to issue unlimited amounts of tax-exempt bonds for constructing exempt-function facilities;⁴ the ability to issue cheap debt does provide charities a tax-arbitrage opportunity, and it has the greatest advantage precisely to those charities with the largest endowments. Yet in the same legislation as this generous allowance, Congress applied an "aggregation" notion to a charity and its taxable subsidiaries in a way that can increase the charity's tax liability, again even in the absence of any tax advantage. Defenders of taxes on the business or investment activities of charities occasionally assert that such limits are necessary to hold charity managers "accountable" to the public—a border-patrolling concept that makes sense only as a limit on charities' sovereignty, rather than to preserve the integrity of the tax system.

Having identified a sovereignty approach to tax exemption, I believe that policy makers should resist the lures of this approach in order to reform the tax treatment of charity. What would happen if we reject not only the base-defining justification for exemption, but also tax exemption itself as the appropriate form of subsidy? I am now exploring the likely consequences of reforming subsidies by replacing the tax schemes with direct expenditure programs.⁵

II. A SOVEREIGNTY PERSPECTIVE ON SUBSIDY AND BASE-DEFINITION

A. The Sovereignty Perspective

Tax exemption presupposes a tax system. It might appear that a conception of charity must antedate a conception of the tax treatment of charity. However, various forms of taxation have existed as long as organized communities have formed governments. Whether couched in terms of tribute,⁶ feudal dues,⁷ property tax,⁸ or corporate income tax⁹—as appropriate to the prevailing economic system—public finance schemes have always had to take account of a nontaxable sector. As discussed in Parts III and IV, however, policy makers did not at the outset express a rationale for any of these exemptions, and a variety of rationales are now articulated to defend them.

4. See *infra* note 148 and accompanying text. This change had a distinct sovereignty flavor: Proponent Senator Moynihan feared that private research universities would fall behind similar public institutions, whose states could bond-finance their facilities.

5. See Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert* (March 25, 1998) (manuscript on file with the author).

6. See *Genesis* 47:24 ("Joseph made it a law over the land of Egypt unto this day, that Pharaoh should have the fifth part; except the land of priests only, which became not Pharaoh's....").

7. See Brody, *Charitable Endowments*, *supra* note 2, at 899-909 (discussing the mortmain laws).

8. See *infra* Part III.

9. See *infra* Part IV.

There is no doubt that the sovereign view of charity can be traced to the first organized provider of nongovernmental charity—the church.¹⁰ While “charity” has always been only a part of the services of religion, it is the problematical aspect of religion that has prevented us from thinking straight about the question of the tax treatment of charity in post-Constitutional America. For purposes of this Article, however, we need not dwell on the religious issue. After all, when charity became secularized in Tudor England, and privately organized philanthropy complemented public poor relief, no one bothered to make fine distinctions between the work of the state and the work of charity.¹¹

Of course, the notion of “sovereignty” should not be conflated with the notion of “sector.” The modern U.S. political economy is traditionally described in terms of three sectors: the public sector (government), the proprietary sector (business), and the non-profit sector (private, but with public purposes).¹² No one would argue that the nonprofit sector enjoys true co-sovereignty with the public sector, because the nonprofit sector lacks the compulsory powers that inhere in a sovereign.¹³ Nevertheless, tax exemption carries with it a sense of leaving the nonprofit sector inviolate, and the very concept of sovereignty embodies the independent power to govern. Indeed, a major trade association of charities takes a most sovereign-sounding name, calling itself “The Independent Sector.”¹⁴

10. For the early American experience, *see generally* D.B. ROBERTSON, SHOULD CHURCHES BE TAXED? 40-88 (1968) (Chapter II, The Establishment of Religion in the Colonial Period; Chapter III, Pains of Transition: From Establishment to Separation of Church and State; Chapter IV, After Disestablishment: Or, How Separate Was “Separation”?). Alfred Balk observed:

Exemptions probably are as old as taxes. For it is venerable logic that a king does not tax himself or submit to taxation without his consent. Thus governmental immunity began. Church-property exemptions, too, date to the earliest tax systems, for the ancient priesthood in effect was part of incipient governmental forms.

ALFRED BALK, THE FREE LIST: PROPERTY WITHOUT TAXES 20 (1971).

11. *See* BALK, *supra* note 10, at 22 (discussing the Tudor laws exempting the colleges and universities of Oxford and Cambridge, and, later, charitable hospitals and almshouses). Because private poor relief lessened the burdens on government, Elizabethan England offered favorable legal status to philanthropy. The famous Statute of Charitable Uses set forth a mechanism for the enforcement of charitable trusts. 43 Eliz. I, ch. 4 (1601) (Eng.). *See generally* Brody, *Charitable Endowments*, *supra* note 2. Of course, the proprietary sector is also occasionally granted tax benefits to stimulate desired economic activity. Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433, 440 (1996).

12. *See* Brody, *Institutional Dissonance in the Nonprofit Sector*, *supra* note 11 (discussing the porous boundaries of these sectors, and the fact that in different times and in different places the same types of activities have been conducted in different sectors or in more than one sector).

13. *But see* ROBERTSON, *supra* note 10, at 59 (“Corporate powers in the colonial period had often included the power to tax; one has to remember the explosive import of taxation in pre-Revolutionary colonies.”).

14. Discussions of the third sector often use the terms “charity” and “nonprofit” interchangeably. In today’s complex society, many organizations not necessarily engaging in charitable activities organize without stock ownership under state nonprofit law. In recognition of the mutual (as opposed to altruistic) benefits provided by social clubs, labor organizations, trade associations, and other non-charitable forms of collective action, the government generally offers fewer tax benefits to non-charities. Thus, the typical state property tax scheme grants exemption only to churches, schools, and other charitable organizations. The federal income tax law grants exemption to most nonprofit organizations for earnings derived from activities related to their exempt purpose. (Social clubs, though, must pay income tax on their net investment income. *See* I.R.C. § 501(c)(7) (1997).) However, only charities may offer donors income-tax-deductibility for contributions. (Dues

To test the sovereignty hypothesis, consider a clearer set of examples: the federal tax treatment of state and local governments. The federal income tax excludes from gross income "income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof."¹⁵ States and municipalities that borrow may generally issue bonds whose interest is tax-exempt in the hands of the bondholders.¹⁶ Payments of state and local income and property taxes are deductible from income.¹⁷ However, user fees paid to governments are treated as nondeductible payments for services.

Each of these inter-governmental tax treatments finds an analogue in the tax treatment of charities. Charities are exempt from the corporate (or trust) income tax.¹⁸ However, income from the performance of business activities unrelated to the charity's exempt purpose is subject to tax.¹⁹ Charities may issue tax-exempt bonds.²⁰ Contributions made to charities are generally deductible from income.²¹ However, payments made to a charity for a particular service (such as tuition or for hospital care) are not deductible.

might be deductible under other tax provisions; for example, members of labor unions and trade associations might be able to deduct dues as business expenses. See I.R.C. § 162 (1997) (but see I.R.C. § 162(e), which denies the deduction for the portion of dues used for lobbying and political activities.) Such distinctions might appear to confine the most-favored "circle" of tax-benefited organizations to a small portion of the nonprofit sector. See Simon, *supra* note 3, at 68-73. Historically, instead, "charity" has been broadly defined—thus embracing many activities that have a mutuality flavor, such as education or religion—and only a small fraction of charitable activity focuses on poor relief. See Brody, *Institutional Dissonance in the Non-profit Sector*, *supra* note 11.

15. I.R.C. § 115(1) (1997). More precisely, states are not taxpayers under the Internal Revenue Code. If a state sets up a separate instrumentality, the income is excluded if attributable to an essential governmental function and the income is distributed to the state. *Id.* Alternatively, the state can establish a separately incorporated entity, which obtains the normal recognition of exemption under Code section 501(c)(3). See generally Ellen P. Aprill, *Excluding the Income of State and Local Governments: The Need for Congressional Action*, 26 GA. L. REV. 421 (1992); Ellen P. Aprill, *The Integral, the Essential, and the Instrumental: Federal Income Tax Treatment of Governmental Affiliates*, 23 J. CORP. L. 803 (1998) (this issue).

16. I.R.C. § 103 (1997); but see I.R.C. §§ 141 (taxing private activity bonds), 148 (taxing arbitrage bonds), & 149 (taxing unregistered bonds), and §§ 56(b)(1)(C)(iii) & 57(a)(5) (including interest on private activity bonds as an item of tax preference under the alternative minimum tax).

17. I.R.C. § 164(a) (1997). Since 1986, the list of deductible taxes excludes sales taxes (which may be added to basis). To claim the benefit of these deductions, individual taxpayers must itemize, rather than claim the standard deduction. In addition, for individual taxpayers, the 1990 act adopted a floor (equal to 3% of the amount by which the taxpayer's adjusted gross income exceeds a base amount—in 1998, \$124,500 on a joint return) under most itemized deductions, including the deduction for state and local taxes. I.R.C. § 68; Rev. Proc. 97-57, 1997-52 I.R.B. 20, § 3.05 (inflation-adjusted amount for 1998).

18. See I.R.C. §§ 501(a) & (c)(3) (1997).

19. See I.R.C. §§ 511-515 (1997).

20. See I.R.C. §§ 103, 145 (1997); see also discussion *infra* Part IV.

21. See I.R.C. § 170 (1997). The deduction for charitable contributions is an itemized deduction, available subject to the same floor described earlier. See *supra* note 17. The economists' studies of the efficiency of the deduction — examining the donors' elasticity of giving — are a refined version of the subsidy approach discussed when Congress first created the deduction. Concerned that the high marginal rates enacted to finance World War I would deter donations, Congress permitted individuals to reduce up to 15% of their taxable net income by charitable contributions. See TREASURY DEPARTMENT REPORT ON PRIVATE FOUNDATIONS 12 (Comm. Print, Feb. 2, 1965) (printed for the use of the Committee on Ways and Means, 89th Cong., 1st Sess.). Later increased (generally, to 20% of adjusted gross income (AGI) in 1952, to 30% of AGI in 1954 for donations to churches, schools, and hospitals and, in 1964, for publicly supported or governmentally supported organizations, and to 50% of AGI for all such entities in 1969), the percentage-of-income limits are

B. Contrasting Subsidy and Base-Defining Theories

Subsidy theories have been articulated for over a century, while base-defining theories are of surprisingly recent origin. Under the subsidy theory, tax exemption functions as an inducement to charities to undertake specific activities or to engage in behavior a certain way.²² For example, under the classic conception of this “quid-pro-quo” approach, the state bestows tax exemption in recognition of charities’ lessening the burdens of government.²³ The subsidy theory, however, places charities in a position subordinate to the state, which can decide which particular activities lessen its burdens.²⁴ To the ex-

inconsistent with a base-defining explanation. See Simon, *supra* note 3, at 75. Indeed, the legislative history reflects a clear subsidy motivation. In the 1969 Act, for example, Congress declared that the 50% limit will “strengthen the incentive effect of the charitable contribution deduction.” JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, at 75 (JCS-16-70, Dec. 3, 1970) [hereinafter 1969 BLUEBOOK]. In 1983 testimony on private foundations (which still suffer under lower limits), the Treasury described the “longstanding policy” as favoring “certain essential service organizations ... and charitable organizations that can be expected promptly to spend contributions directly in the conduct of charitable activities.” Statement of John E. Chapoton, Assistant Secretary (Tax Policy), Department of the Treasury, Before the Subcomm. on Oversight of the House Ways & Means Comm. 12 (June 27, 1983). Obviously, taxpayers’ subsidy of contributions varies with income tax rates, and commentators observed that the percentage-of-income limits rose as tax rates rose. See Paul R. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 TAX L. REV. 377 (1972), reprinted in IV RESEARCH PAPERS SPONSORED BY THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS 2025, 2532 n.278 (1977) [hereinafter IV FILER COMM’N RES. PAP.], discussing Edward H. Rabin, *Charitable Trusts and Charitable Deductions*, 41 N.Y.U. L. REV. 912, 917 (1966).

22. See Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 606 n.292 (1990) (setting forth numerous statements of this rationale for tax exemption).

23. As discussed in Part III below, few recorded expressions exist of legislative intent for enacting a tax benefit for charity. A rare exception appears in the legislative history to Congress’s 1938 decision that charity begins at home, the House Ways and Means Committee stating:

The bill provides that the deduction ... be also restricted to contributions made to domestic institutions. The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.

H.R. REP. NO. 1860, 75th Cong., 3d Sess. 19 (1938). Harvey Dale objects to this declaration as “bad history, because there is no indication that the tax exemption, afforded since the end of the nineteenth century, was predicated on the quid pro quo rationale.” Harvey Dale, *Foreign Charities*, 48 TAX LAWYER 657, 660-61 (1995) (footnote omitted). Moreover, exemption is granted for religious activities that the government itself constitutionally cannot undertake. As a technical matter, “lessening the burdens of government” is only one route to federal income tax exemption as a charity under Internal Revenue Code section 501(c)(3). Treas. Reg. § 1.501(c)(3)-1(d)(2) (1997). To come within that provision, the organization must demonstrate that the government considers the organization’s activities to be its burden. See Dean E. Criddle & Steven C. Malvey, *Ensuring Exemption for Lessening the Burdens of Government*, 8 J. TAX’N OF EXEMPT ORGS. 243 (May/June 1997); see generally Lars G. Gustafsson, “Lessening the Burdens of Government”: Formulating a Test for Uniformity and Rational Federal Income Tax Subsidies, 45 KAN. L. REV. 787 (1997).

24. See, e.g., *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 117 S. Ct. 1590, 1609-10 (1997) (Scalia, J., dissenting) (describing case upholding denial of exemption to a wildlife preserve whose “prohibition on deer hunting conflicted with state policy on game management;” see *Holbrook Island Sanctuary v. Brooksville*, 214 A. 2d 660 (Me. 1965)).

tent the state is unhappy with—or simply uninterested in subsidizing—certain charity activities, the state can fine-tune the exemption.²⁵ By contrast, the base-defining theory deems charitable activity not even to rise to the level of taxable activity. For example, if the income tax base consists of income from business activities, then charities not engaged in business necessarily fall outside the tax system. A base-defining theory accordingly accepts the challenge to ascertain which activities conducted by the entity should be entitled to “charitable” status, and which should be cast into the world of taxable activity.

Without applying a sovereignty perspective, neither the subsidy theory nor the base-defining theory can fully explain the current tax-exemption scheme for charities.²⁶ Beginning with the base-defining approach, under which the public sector treats the charitable sector almost with comity, charities are entitled to earn income and own property free of tax because the state considers the charitable sector to be another sovereign. A pure base-defining rule, though, would not explain why exemption extends to the “commercial” charities, such as hospitals, whose easily-measured economic activity cannot be distinguished from that of proprietary enterprises.²⁷

A sovereignty thread runs through subsidy theory as well. After all, instead of blanket tax exemption, the state could determine the type and extent of the services it wants to “purchase,” and make the necessary subsidy by targeted direct payments to charities.

25. See generally JENNIFER R. WOLCH, *THE SHADOW STATE: GOVERNMENT AND VOLUNTARY SECTOR IN TRANSITION* 217 (1990).

A final and perhaps most troubling dilemma of the shadow state is that the voluntary sector may become a puppet or pawn in the service of goals that are antithetical to their organizational mission. Organizations that do not conform or are not “ideologically correct” from the perspective of the state at a given historical moment may be denied access to direct and even indirect resources.

Id. Less ideologically but more likely given our capitalist economy, government may believe that it need not pay for nonprofit activity supplied in the proprietary sector. As the Treasury Department testified in 1987:

Although the [lessening-the-burdens-of-government] rationale for exempting public charities and their activities from taxation remains as strong today as when the income tax was first enacted, limits on the scope of such tax exemption are appropriate and necessary. This nation has prospered through its reliance on a private, market-based economy to supply necessary goods and services. The role of government generally has been restricted to those socially important activities not adequately supported by the private sector. The role of the quasi-governmental, not-for-profit sector should similarly be restricted to that of supplementing, not supplanting, the activities of for-profit businesses. Thus, tax exemption for public charities should be restricted to those areas where the quality or quantity of goods and services that would be produced strictly through market forces is inadequate.

Statement of O. Donaldson Chapoton, Deputy Assistant Secretary (Tax Policy), Dept. of Treas., before the Subcomm. on Oversight, House Ways & Means Comm. 15 (June 22, 1987) [hereinafter Statement of O. Donaldson Chapoton].

26. Consider even the language used to bestow the federal income tax exemption. While most charities must register with the Internal Revenue Service, technically the charity is not applying for tax exemption, but rather is *notifying* the Service of its application for *recognition* of tax exemption. I.R.C. § 508 (1997). The statute exempts churches and small charities from having to obtain recognition of exemption.

27. See Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54 (1981).

Many charity proponents believe that the fiscal tool of tax exemption is superior to a program of equivalent direct grants because the state best encourages the social worthiness of charitable activity by simply leaving charities alone.²⁸

Moreover, unhappily for charity, current tax exemption schemes—whether at the state or federal level—contain conditions and limitations on the freedom of charities to own untaxed property and to engage in untaxed commercial enterprises. To the extent these limitations go further than necessary to preserve the correct tax base, only the sovereignty perspective can explicate these echoes of the old mortmain prohibitions.²⁹

While most observers have described tax exemption as a subsidy,³⁰ a zero rate of tax differs qualitatively, not just quantitatively, from a one-percent rate of tax. Tax exemption maintains an independent distance between charities and the state.³¹ Similarly,

28. In addition, a sovereignty approach explains an alternative view of the quid-pro-quo in subsidy theory: The exemption is provided to charitable institutions which exist to provide community benefit. See John D. Colombo, *Why Is Harvard Tax-Exempt? (And Other Mysteries of Tax Exemption for Private Educational Institutions)*, 35 ARIZ. L. REV. 841, 864-68 (1993). Compare Chauncey Belknap's conception, written in 1954:

[T]he quid pro quo explanation of tax exemptions, although it has achieved a wide currency and has gained in validity with the broadening of governmental functions, is not adequate as a justification of the privilege [of charity tax exemption] in some of the most important segments of the general area under discussion. It is evident that the tax exemption privilege has much deeper roots than the quid pro quo theory would admit.

The true explanation, and the only principle that affords a complete justification covering the entire field of exemptions..., is that government relieves from the tax burden religious, educational, and charitable activities because it wishes to encourage them as representing the highest and noblest achievements of mankind.

Chauncey Belknap, *The Federal Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy* (1954), reprinted in John P. Persons et al., *Criteria for Exemption Under Section 501(c)(3)*, in IV FILER COMM'N RES. PAP., supra note 21, 2025, app. at 2033-34.

29. See *infra* Part III.

30. See, e.g., *Regan v. Taxation Without Representation*, 461 U.S. 540, 544 (1983) ("Both tax exemptions and tax deductibility are a form of subsidy that is administered through the tax system."); Colombo, *supra* note 28, at 861 n.125 (citing similar expressions by academics).

31. One of the most complete and eloquent statements appears in Lawrence M. Stone, *Federal Tax Support of Charities and Other Exempt Organizations: The Need for a National Policy*, 1968 U. SO. CAL. TAX INST. 27. Professor Stone wrote:

First, the role played by nonprofit organizations is not only desirable but may very well be a prerequisite to the continuation of a democratic society. It is through such institutions that we harness the energies and finances of our private citizens to humane, experimental, creative, and controversial purposes.... [Charity] is often a unique pathfinder in social welfare and the sciences to be followed only at a later date by governmental or profit-oriented resources. It affords our citizens the opportunity to participate in public service while maintaining private employment. It organizes parts of our society for social purposes through nongovernmental means where governmental action is inappropriate, would be inconsistent with our way of life or is not possible because the purpose is too controversial. It allows individuals to voluntarily tax themselves in time and money to advance the good of society according to their individual preferences. In an increasingly complex world, where the individual feels frustrated because of his apparent inability to influence the policies of government, charity affords a clear arena in which an individual can act and make his influence felt for the social good. It provides a unique and flexible form of social organization that coun-

exemption differs in an important political way from an equivalent system of direct grants. Over a century ago, in defending Harvard's property-tax exemption before the Massachusetts legislature, university president Charles Eliot contested the view that an institution's tax exemption "is the same thing as to grant it money directly from the public treasury. This statement is sophistical and fallacious." Eliot described how tax-exempt status removes charities from the political arena:

The exemption method is comprehensive, simple and automatic; the grant method, as it has been exhibited in this country, requires special legislation of a peculiarly dangerous sort, a legislation which inflames religious quarrels, gives occasion for acrimonious debates, and tempts to jobbery. The exemption method leaves the trustees of the institutions fostered untrammelled in their action, and untempted to unworthy arts or mean compliances.

....

The exemption method is emphatically an encouragement to public benefactions. On the contrary, the grant method extinguishes public spirit. No private person thinks of contributing to the support of an institution which has once got firmly saddled on the public treasury. The exemption method fosters the public virtues of self-respect and reliance; the grant method leads straight to an abject dependence upon that superior power—Government.... The exemption is wholesome while the direct grant is, in the long run, pernicious.³²

terbalances the vast power of government and the concentrated wealth of the private sector. Therefore, in regulating the conduct of the exempt sector and in its provisions for tax benefits, the purpose of government should be to maintain a maximum of freedom of action and the continued healthy growth and survival of this sector.

Id. at 39-40. Interestingly, Professor Stone then continued by emphasizing the "responsibility on the part of government not to provide tax and other financial benefits that might create an imbalance between [government's] needs for tax revenues and the benefits provided the exempt sector." *Id.* at 41. Specifically, he worried that:

A democratic society can be threatened by overcentralization of uncontrolled economic power in any sector. It is ironic, for example, that the combination of the federal estate tax, which has as one purpose the prevention of too great concentrations of wealth in private families, and an unlimited deduction for charitable bequests may be resulting in concentrations of uncontrolled wealth in exempt institutions.

Id. See also *infra* Parts III and IV (postulating that this ambivalence of one sovereign to the power of another has led to certain otherwise inexplicable curtailments of the tax exemption).

32. CHARLES WILLIAM ELIOT, VIEWS RESPECTING PRESENT EXEMPTION FROM TAXATION OF PROPERTY USED FOR RELIGIOUS, EDUCATIONAL AND CHARITABLE PURPOSES 392 (1874), *quoted in* Belknap, *supra* note 28, at 2038-39. In the 1950s and 1960s—in reaction to congressional investigations of those family-dominated, grant-making charities known as private foundations—the charities reiterated the value to the body politic of a tax-supported, yet independent, philanthropic sector. As the Rockefeller Foundation's legal counsel observed in 1954:

The basic motive for these [long-standing] tax favors has been a wish to encourage activities that were recognized as inherently meritorious and conducive to the general welfare. In some cases it was also true that the exempted organizations performed activities that government would otherwise be forced to undertake, but it is believed that governmental saving has not

To some observers, the income tax exemption scheme for charities is both a crude mechanism to match foregone revenue to desired outputs and is unacceptably open-ended. However, such criticisms make sense only under a subsidy approach, rather than under a tax-base approach. Under a nonsubsidy approach, the inability to target or control the growth of the tax exemption follows from the premise of an untouchable base.

Taking issue with the subsidy approach, scholars in recent decades have attempted to cast every aspect of the tax-favored regime for charities into tax-base-defining terms.³³ In 1976, Boris Bittker and George Rahdert insisted that the “income” of charities cannot be measured in profit-seeking terms, and thus falls outside the bounds of the proper income tax base.³⁴ William Andrews argued that the charitable-contribution deduction is necessary to properly measure the donor’s ability to pay tax.³⁵ John Simon made a similar argument with regard to the estate tax.³⁶ Thomas Heller described how the state prop-

been the decisive factor influencing the exemption of charitable activities from tax.

....

The essence of the advantage of this system is that it is automatic. The government does not control the flow of funds to the various organizations; the receipts of each organization are determined by the values and the choices of private givers. The donors determine the direction of their own funds, and the distribution of “tax savings” as well.... Since all of these operations are out of the hands of government under the exemption and deduction statutes, the beneficiary organizations receive their governmental aid without having to petition for it.

Belknap, *supra* note 28, at 2039.

33. See Simon, *supra* note 3, at 73-74.

34. Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Tax*, 85 YALE L. J. 299, 307-14 (1979); see also *id.* at 333 (“the exemption of these organizations from income tax is not a preference or a special favor, requiring affirmative justification, but an organic acknowledgment of the appropriate boundaries of the income tax itself” (footnote omitted)). Bittker and Rahdert also raised the “wrong rate” argument, asserting that to the extent the charity functions as an intermediary between donors and low-income beneficiaries, the charity should be taxed at the beneficiaries’ marginal income-tax rate (presumably zero). *Id.* at 314-16.

35. See William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972). Charity proponents have long lobbied to move the charitable contribution deduction from below-the-line to above-the-line, so that it would be available to all taxpayers regardless of whether they itemized their deductions. For example, one fundraising consultant recently wrote:

Most important, non-profit leaders must give up the idea that the charitable deduction is a government-sponsored “incentive” to make charitable gifts. That argument is inflammatory to many people and can be seen as using the tax system for social engineering — a dangerous position to hold in the current political climate.

Instead, we must begin lobbying to change the Internal Revenue Service’s very definition of income to exclude all or a portion of funds given to legitimate charitable purposes ... much as business expenses currently are treated....

... [A]ll taxpayers would benefit equally, ending the argument that today’s charitable deduction is skewed in favor of the relatively small percentage of taxpayers who now itemize their deductions and reap greater savings on gifts to charity on account of their higher tax brackets.

Robert F. Sharpe, Jr., *Charitable Giving and Taxes: The Next Steps*, CHRON. PHILANTHROPY, Aug. 21, 1997, at 34-35.

36. See John G. Simon, *Charity and Dynasty Under the Federal Tax System*, 5 PROBATE LAWYER 1, 22-23 (Summer 1978); Simon, *The Tax Treatment of Nonprofit Organizations*, *supra* note 3, at 68.

erty tax exemption for charity could be consistent with a normative conception of the real-estate tax base.³⁷

Later scholars have rejected these income-measuring difficulties.³⁸ However, some debate remains over which tax-favored rules for charity constitute subsidies as opposed to being part of the properly-measured tax base. The rigorous study of the subsidy theory of tax rules can be traced to the pathbreaking work of Harvard law professor and Treasury Assistant Secretary (Tax Policy) Stanley Surrey. In the late 1960's Surrey pioneered the theory of "tax expenditures," which analyzes tax subsidies by recasting them as direct expenditure programs in order to ascertain their equity and efficiency effects. Ever since the Congressional Budget Act of 1974, the administration must annually list all tax expenditures, defined as "revenue losses attributable to exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."³⁹ Even the federal "tax-expenditure budget," however, includes only the charitable-contribution deduction; the income-tax exemption of charities is treated instead as a normative component of the tax base, and the foregone revenue attributable to the income-tax exemption remains unestimated. The staff of the congressional Joint Committee on Taxation describes the distinction:

With respect to ... charities, tax-exempt status is not classified as a tax expenditure because the nonbusiness activities of such organizations generally must predominate and their unrelated business activities are subject to tax. In general, the imputed income derived from nonbusiness activities conducted by individuals or collectively by certain nonprofit organizations is outside the normal taxbase. However, the ability of donors to such organizations to claim a charitable contribution deduction is a tax expenditure (because such contributions do not generate income to the donor), as is the exclusion from income granted to holders of tax-exempt financing issued by charities.⁴⁰

Stanley Surrey was not pleased by this official reticence to classify as a tax expenditure the exemption of income earned by nonprofit organizations from related business activities and investment. In a comprehensive treatment, Surrey and his co-author, Paul McDaniel, asserted that:

37. See Thomas C. Heller, *Is the Charitable Exemption from Property Taxation an Easy Case? General Concerns About Legal Economics and Jurisprudence*, in *LAW AND ECONOMICS OF LOCAL GOVERNMENTS* 212-25 (Daniel Rubinfeld ed., 1979).

38. See Hansmann, *supra* note 27, at 58-62 (discussing corporate income-tax exemption); Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an "Ideal" Income Tax and Why They Fit Worse in a Far From Ideal World*, 31 *STAN. L. REV.* 831 (1970) (discussing charitable-contribution deduction); Mark P. Gergen, *The Case for the Charitable Contributions Deduction*, 74 *VA. L. REV.* 1393 (1988) (same).

39. JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1998-2002 (JCS-22-97) (Dec. 15, 1997), available in Lexis, Fedtax Library, Tax Notes Today File, as 97 TNT 241-4 (Dec. 16, 1997), at ¶5 (quoting section 3.3 of the Congressional Budget and Impoundment Control Act of 1974 (P.L. 93-344)). See generally Victor Thuronyi, *Tax Expenditures: A Reassessment*, 1988 *DUKE L.J.* 1155.

40. Joint Committee on Taxation, *supra* note 39, at ¶ 30.

[t]o the extent that this exempt income is utilized to provide consumption for the beneficiaries of the organizations, and to the extent that the consumption is untaxed, significant amounts are excluded from the tax base....

Some tax-exempt organizations appear to conform to the model of the typical for-profit corporation. Hospitals represent one rather clear example of this type. When the corporate model is appropriate, the tax expenditure list should include the nontaxation of the business and investment income of the organization. Under this approach, no deduction should be allowed to the organization for distributions to beneficiaries, because it is not administratively feasible to include the charitable benefits in the income of the various beneficiaries. This treatment is akin to the second-best approach adopted for certain types of corporate gifts and fringe benefits.⁴¹

Surrey and McDaniel concluded: "Because it is likely that the revenue cost of the exemption for nonprofit organizations is substantial, the omission from the U.S. tax expenditure list is a serious one and should be rectified."⁴²

In a recent argument using subsidy analysis, Henry Hansmann suggested that the corporate income-tax exemption is justifiable on efficiency grounds, in order to compensate nonprofits for their inability to access the capital markets by issuing stock.⁴³ Even in this age of tax-expenditure analysis, though, base-defining theories with sovereignty overtones continue to appear. At the state level, Peter Swords defended the property-tax exemption against the argument that it constitutes a subsidy, emphasizing "the advantages of pluralism that flow from having a voluntary sector of charitable organizations operating parallel to our governmental system, a sector able to discover new needs and experiment in providing ways of meeting them in a manner that simply is not possible for government agencies."⁴⁴ Unique in recent scholarship is the work of Rob Atkinson, whose theory of the "metabenefit of altruistic production" conducted in "communities" of charity comes closest to identifying a sovereign theory of exemption.⁴⁵

41. STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES 219-20 (1985).

On the other hand, some exempt organizations may appropriately be viewed as partnerships of individuals joining together for a common purpose. The social club is a typical example. In such cases, the value of the untaxed consumption to those who benefit from the organization's business and investment income should be classified as a tax expenditure.

Id. at 219-20. Note that contrary to the authors' suggestion, social clubs must pay tax on their investment income and income from non-member sales. I.R.C. § 512(a)(3) (1997).

42. SURREY & MCDANIEL, *supra* note 41, at 220.

43. Hansmann, *The Rationale for Exempting Nonprofit Organizations*, *supra* note 27, at 72-75. Note that in the Taxpayer Relief Act of 1997, Congress increased the subsidy for charity capital needs by removing the \$150 million cap on "section 501(c)(3) bonds" issued by non-hospital charities for capital improvements. See *infra* Part IV.

44. PETER SWORDS, CHARITABLE REAL PROPERTY TAX EXEMPTIONS IN NEW YORK STATE 18 (1981).

45. Atkinson, *supra* note 22, at 617-20 (synthesizing the traditional subsidy view with Bittker and Rahdert's "structural uniqueness" view by expanding the tax preference to encompass nonprofits' "altruistic provision of goods and services"); Rob Atkinson, *Reforming Cy Pres Reform*, 44 HAST. L. J. 1111, 1142-48 (1993) (suggesting that altruism most desirably takes the form of radically independent, self-sustaining communities). A similar theory with more of a subsidy flavor has been offered by John Colombo and Mark Hall.

III. PROPERTY-TAX EXEMPTION

Property-tax exemption for religious, educational, and charitable institutions “has existed from ‘time out of mind.’”⁴⁶ The treatment of churches clearly explains this long-standing American tax exemption.⁴⁷ Moreover, other charities traditionally arose from religious activities or impulses. Educational institutions, such as Harvard and Yale, originated as divinity schools and could not be separated from religious institutions.

To say that charity property has always gone untaxed is not, however, to say that charities have always enjoyed tax *exemption*. Jens Jensen found that the modern American property tax “probably never existed in Europe, and certainly did not prevail in England when the colonial settlers transplanted her tax system to the new world.”⁴⁸ The scanty historical data “established that property in the colonies was originally supplementary, as a tax base, to the poll and to an ill-defined income-earning capacity of certain persons, usually called ‘faculty,’ ... [and that] property taxes were frequently imposed only upon selected types of property, the list of which was gradually extended.”⁴⁹ It is thus difficult to ascribe an “original” motivation to exempting charity from the property tax⁵⁰; exemption, when eventually specified, was often granted out of a vague desire for “encouragement.”⁵¹

Moreover, it is difficult to defend the continuing practice of exemption on subsidy grounds: Such a crude mechanism does little for labor-intensive charities, and has its highest value to owners of the most highly-taxed assets, thus inducing overinvestment in high-taxed, inner-city real estate.⁵² Fairness as well as efficiency is implicated: “Since

See JOHN D. COLOMBO & MARK A. HALL, *THE CHARITABLE TAX EXEMPTION* (1995) (collecting and expanding on a series of law review articles they wrote urging that tax exemption be limited to organizations receiving at least one-third of their ongoing support in the form of donations from members of the public).

46. L. Richard Gabler & John F. Shannon, *The Exemption of Religious, Educational, and Charitable Institutions from Property Tax Exemption*, in IV FILER COMM’N RES. PAP., *supra* note 21, at 2535, 2536.

47. See ROBERTSON, *supra* note 10.

48. JENS PETER JENSEN, *PROPERTY TAXATION IN THE UNITED STATES* 26 (1931).

49. *Id.* at 26-27. For example, in New Hampshire, “the notion of income as an underlying basis was definitely abandoned, and the taxation of ‘every person according to his estate’ was substituted.” *Id.* at 29-30.

50. Stephen Diamond, “Of Budgets and Benevolence: Philanthropic Tax Exemptions in Nineteenth Century America” (N.Y.U. School of Law, Program on Philanthropy, Conference on Rationales for Federal Income tax Exemption, October 1991): “[T]here never was such a beginning point, a moment when the social compact was created, or when the primal tax calculations were made. The original colonists brought exemptions with them.... No one decided, on a clean slate, that exemptions were appropriate.” *Id.* at 4 (footnote omitted). Moreover, because general property tax statutes did not initially exist, general categories of exemption, particularly for churches, were not enacted in some states until many decades after the Revolution. See *id.* at 7-11; ROBERTSON, *supra* note 10, at 64-88.

51. See JENSEN, *supra* note 48, at 125 (“Teachers and ministers of the gospel were freely exempted; and many types of property were exempt for ‘encouragement.’”).

52. Henry Aaron observed: “Since this particular subsidy is available in proportion to the use of real estate but not of other factors of production, schools and universities, hospitals, other [exempt] property owners, and cities themselves are encouraged to produce their services by methods that are more real-estate intensive than would otherwise be desirable.” HENRY J. AARON, *WHO PAYS THE PROPERTY TAX? A NEW VIEW* 84-85 (1975). However, economists have by and large found only a slight correlation between nonprofit market shares and property-tax exemption. See Henry Hansmann, *The Effect of Tax Exemption and Other Factors on the Market Share of Nonprofit Versus For-Profit Firms*, 40 NAT’L TAX J. 71, 77, 79-80 (1987) (noting that the effects of state sales-tax and, particularly, corporate-tax exemption are strong, but effects of property-tax ex-

the bulk of charitable property is located in urban centers, the overpaying group is likely to be relatively poorer than the proper donor class which benefits from charitable activities."⁵³ By the same token, exemption can be a useful subsidy to stimulate needed capital investment. Thus, from colonial times, states have also granted exemptions to infant *business* industries,⁵⁴ a practice enjoying a resurgence as states deliberately choose the tool of property-tax exemption to entice business relocation.⁵⁵ To the extent charities engage in job-creating "desirable" industries, such an input subsidy makes sense for them as well.

In contrast to subsidy theory, a tax-base-defining theory cannot describe property-tax exemption for charities: After all, by definition, charities that own property have property in their base. If charities are to be exempt because they do not engage in business activities, then how does the base-defining theory account for the fact that residential property forms the backbone of any property-tax scheme?⁵⁶ If instead charities are to be exempt because their property does not benefit from local expenditures funded by the property tax (such as schools), then why should business owners pay property tax?⁵⁷ And

emption are weak; "cities with high property tax rates do not have a significantly higher proportion of non-profit firms than cities with low tax rates, indicating that the locational decisions of nonprofits are not particularly responsive to local property taxes"); Cyril F. Chang & Howard P. Tuckman, *Do Higher Property Tax Rates Increase the Market Share of Nonprofit Hospitals?*, 43 NAT'L TAX J. 175 (1990) (finding that the non-profit market share is not increased by the property-tax exemption); O. David Gulley & Rexford E. Santerre, *The Effect of Tax Exemption on the Market Share of Nonprofit Hospitals*, 56 NAT'L TAX J. 477, 482-83 (1993) ("Eliminating the property tax subsidy implies that the nonprofit market share will fall [from 70.7 percent] to 69 percent. Taken together, eliminating both the corporate and property tax subsidies implies that the non-profit market share will fall from 70.7 to 66.1 percent at the state level."). Gulley and Santerre attribute the apparent small effect of property-tax exemption to the capitalization of the tax into property values. "For-profit hospitals, on the other hand, are indifferent to higher property taxes if they are completely capitalized into lower property values. They pay higher taxes but face a reduced price for property." *Id.* at 484. In addition, Gulley and Santerre observe that over the last 20 years, property-tax rates have been declining, contributing to the growth in market share for for-profit hospitals from 4.2% to 9.7%. *Id.* at 481.

53. Heller, *supra* note 37, at 211.

54. JENSEN, *supra* note 49, at 125.

55. For discussions of the "New Economic War Between the States," see, e.g., Walter Hellerstein & Dan T. Coenen, *Commerce Clause Restraints on State Business Development Incentives*, 81 CORNELL L. REV. 789 (1996), and Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377 (1996).

56. Professor Heller suggested that the property tax operates as a complement to the federal personal income tax, which fails to tax the imputed rental value of owner-occupied housing. He then asserted that no such complement is needed for charities, because they would owe no federal income tax in any event. See Heller, *supra* note 37, at 216-17.

57. For example, in the 19th century, when property taxes typically extended to personal property as well as to real estate, Professor Diamond observed:

The exemptions that emerged from this process of legislative, constitutional and judicial tailoring usually exempted the church and land on which it sat, but not any other property. In particular, church land earning rental income was not exempt, nor typically was any endowment.... Educational institutions likewise were taxed on any rent-producing property, although some states exempted their endowments....

This pattern of partial exemption, with the critical criterion being whether or not the property was being commercially exploited, suggests yet again that exemption was not being conceived as a subsidy. With a subsidy, the critical question is not the use of specific property, but the ul-

certain services—such as police, fire, and trash collection—directly benefit all property owners.⁵⁸

A sovereignty perspective thus might best fit the charity property-tax exemption. The largest percentages of untaxed property belong to federal, state, and local governments. States (and their subdivisions) do not tax their own property;⁵⁹ states do not tax federal property;⁶⁰ and, as a general rule, states do not tax the property of private, non-profit organizations engaged in charitable activity.⁶¹

Moreover, a sovereignty perspective can also explain those state provisions that limit the amount or type of property a charity can own tax-free. For centuries England

timate dollar value of the exemption.... It was later feared that exempting rental property would permit unfair because unequal competition against fully taxpaying businesses. Initially, the argument was simpler: if income existed, there was something to tax. There was also a frequently expressed concern that general exemption would lead to vast ecclesiastical holdings, such as those confiscated in England by Henry VIII.

Diamond, *supra* note 50, at 12-13 (footnote omitted). See also *infra* Part IV, discussing the issue of unfair competition in the context of income-tax exemption.

58. Given that the property tax is traditionally conceived of as a “benefits tax,” Dick Netzer examined whether the property tax is a good user charge (“a revenue device for the support of particular services under which individuals’ tax liabilities accord rather well with their consumption of the specific services”). DICK NETZER, *ECONOMICS OF THE PROPERTY TAX* 59 (1966). He found that:

[M]ost local public services financed from property tax revenues are designed to yield their benefits to residents primarily in some other capacity than as users of real property — as parents of schoolchildren, as welfare recipients (and philanthropically inclined, more affluent citizens), as users of transport facilities, and so on. But these services do enhance the usefulness and value of real property, as do more obviously property-oriented public services, notably police and fire protection, water supply and sewerage, refuse removal, and transportation services (some of which are amenable to direct user charges...). The problem is that there is no real way of distinguishing between services to property as such and services to residents.

Id. at 214.

59. See JENSEN, *supra* note 49, at 139 (criticizing the maxim that the state should never tax its own property: “The state is regarded as a simple unit, while, as a matter of fact, the state is a complex organization with many subordinate units, among all of which substantial justice must be maintained.”). Because distributional problems can be minimized by such methods as enlarging the local taxing jurisdiction, *id.* at 145, Jensen advocated taxation of public property only on three grounds: “first, that there is considerable concentration of exempt property; second, that such concentration produces discrimination in tax burdens on local property; and third, that there are no adequate offsets to such discrimination.” *Id.* at 143.

60. See *McCulloch v. Maryland*, 17 U.S. 579, 4 Wheat. 316 (1819) (declaring the constitutional immunity of federal property).

61. Consistent with a sovereignty view, one 1938 study noted some examples of almost military rhetoric in the debate:

Much of the discussion of the subject has been more fervent than reasoned. A spokesman for the colleges of Massachusetts described local attempts to tax college dwelling houses by stating that the municipalities *attacked* the colleges... Former President Eliot of Harvard referred to the *barbarous* character of the proposition to tax property devoted to educational purposes. One writer emphasizes the necessity of preventing houses of worship from being desecrated and secularized by taxation. In answer, another voice states that it detracts from the glory and independence of true religion to be a pauper and a leech upon the State.

Lucy Winsor Killough, *Exemptions to Educational, Philanthropic and Religious Organizations*, in *TAX EXEMPTIONS* 23, 27-28 (Tax Policy League Symposium, Dec. 28-30, 1938) (1939) (footnotes omitted).

enforced mortmain proscriptions on the ability of charities to hold land, to prevent them from becoming too strong an economic force.⁶² Similar attempts were urged in this country.⁶³ In his 1875 message to Congress, President Ulysses S. Grant railed against the estimated \$1 billion in local taxes lost to the property-tax exemption for churches. Grant declared:

So vast a sum, receiving all the protection and benefits of government without bearing its portion of the burdens and expenses of the same, will not be looked upon acquiescently by those who have to pay the taxes. In a growing country, where real estate enhances so rapidly with time, as in the United States, there is scarcely a limit to the wealth that may be acquired by corporations, religious or otherwise, if allowed to retain real estate without taxation.... I would suggest the taxation of all property equally, whether church or corporation, exempting only the last resting place of the dead and possibly, with proper restrictions, church edifices.⁶⁴

While Grant failed to obtain broad taxation, acreage limits can still be found in some state exemption statutes.⁶⁵ Calls for change occasionally recur. As recently as 1996, voters in Colorado resoundingly defeated a proposal to amend their state constitution to repeal the tax exemption for nonprofit organizations, including churches.⁶⁶

As nonprofit organizations become more "commercial," property-tax exemptions have begun to be denied on an ad hoc basis, either for an individual charity or for a type of charity.⁶⁷ Challenges are most commonly brought against hospitals, health mainte-

62. See Brody, *Charitable Endowments*, *supra* note 2, at 899-906.

63. See *id.* at 906-09.

64. 2 THE STATE OF THE UNION MESSAGES OF THE PRESIDENTS, 1790-1966, at 1296-97 (Fred L. Israel ed., 1966) (Grant's seventh state of the union message), quoted in BALK, *supra* note 10, at 25. See ROBERTSON, *supra* note 10, at 78-83 (giving an extended discussion of Grant's proposed constitutional amendment to allow for the taxation of church property); *id.* at 83-88 (noting its transformation into the amendment proposed by James G. Blaine (congressman from Maine) to prohibit the use of public funds for "any religious sect or denomination").

65. See, e.g., Wis. Stat. § 70.11 (1995-1996) (under subsection (3), up to 80 acres are exempt for colleges and universities; under subsection (4), up to 10 acres for educational, religious, or benevolent associations, but up to 30 acres for churches and religious associations; under subsection (10), up to 40 acres for Y.M.C.A. or Y.W.C.A. training camps or assemblies; under subsection (10m), up to 40 acres for Lions foundation camps for visually handicapped children; and under subsection (11), up to 30 acres for Bible camps). Some state laws deny exemption for property used by the charity in an unrelated trade or business. See, e.g., Wis. Stat. § 70.11(8) (1995-1996). Such a limitation can also be explained under a pure application of the subsidy theory.

66. See Grant Williams, *A "No" Vote on Taxing Charities*, CHRON. PHILANTHROPY, Nov. 14, 1996, at 35 (reporting that the measure failed by 83% to 17%); Grant Williams, *A Holy War Against Tax Exemptions*, CHRON. PHILANTHROPY, Aug. 8, 1996, at 1 (describing talk-show host John Patrick Michael Murphy's campaign—under the banner "God Isn't Broke"—to make Colorado the first state to force charities to pay property taxes).

67. For a current survey and state-by-state summary of recent developments, see Janne G. Gallagher, *When Local Governments Come Calling: The Movement to Tax Charities*, EXEMPT ORG. TAX REV., Oct. 1997, at 25. Several governmental and private studies have examined exempt property (both governmental and private). See, e.g., Richard D. Pomp, *Testimony Before the State Fin. Comm. Subcomm. on Tax-Exempt Property* (Nov. 21, 1977), reprinted in GREATER HARTFORD CHAMBER OF COMMERCE, PROPERTY TAX EXEMPTIONS FOR NON-PROFIT INSTITUTIONS: PROBLEMS AND PROPOSALS (1979); Louisiana Bureau of Governmental Research, *Property Taxes in New Orleans: Who Pays? Who Doesn't? And Why?* (Oct. 1996),

nance organizations, housing facilities, nursing homes, and other income-producing enterprises against which for-profit businesses compete. Jurisdictions bringing these challenges explicitly premise exemption on the requirement that charitable organizations provide benefits to the poor and relieve the burdens of government.⁶⁸ Similar quid-pro-quo views are accepted by at least four of the current members of the U.S. Supreme Court.⁶⁹ In a recent decision, the Court struck a Maine property-tax statute that granted exemption only to charities primarily serving Maine residents; in so doing, the 5-member majority accepted the claim that charitable activity is entitled to commerce-clause protection, over the strenuous objection of four justices who could not conceive of charities as businesses.⁷⁰ The dissenters adopted a subsidy theory, and would have permitted Maine to target exemption by matching the foregone revenue tax to charity services that lessen the burdens of state government.⁷¹

Within the states, a true sovereignty battle rages. Property-tax exemptions are enacted at the state level (often in the state constitution). However, property ownership by charities tends to cluster in center cities.⁷² Because property tax units are local (either

available in LEXIS, Fedtax Library, State Tax Notes File, as 96 STN 227-22 (Nov. 22, 1996); BUREAU OF PUBLIC ADMINISTRATION, DIV. OF RESEARCH AND PUBLIC SERVICE, UNIVERSITY OF MAINE AT ORONO, INSTITUTIONAL PROPERTY TAX EXEMPTIONS IN MAINE (1975); WILLIAM J. HEIDELMARK, NEW YORK STATE BOARD OF REAL PROPERTY SERVICES, EXEMPTIONS FROM REAL PROPERTY TAXATION IN NEW YORK STATE: 1995 COUNTY, CITY & TOWN ASSESSMENT ROLLS (Apr. 1997); STATE BOARD OF EQUALIZATION AND ASSESSMENT, LOCAL OPTION PROPERTY TAX EXEMPTIONS IN NEW YORK STATE: A STUDY OF THE ADOPTION OF EXEMPTIONS FOR THE AGED, VETERANS, AND BUSINESS PROPERTY (Sylvia Adams, May 1992); *Report of the [Philadelphia] Mayor's Special Committee on Payments-In-Lieu-of-Taxes (PILOTs) and Services-In-Lieu-of-Taxes (SILOTs)* (June 30, 1997) [hereinafter *Mayor's Special Committee*], available in LEXIS, Fedtax Library, State Tax Notes File, as 94 STN 132-28 (July 11, 1994); STATE OF WISCONSIN LEGISLATIVE AUDIT BUREAU, A REVIEW OF PROPERTY TAX EXEMPTIONS (Rep. 87-1) (Jan. 21, 1987).

68. See, e.g., *Utah County v. Intermountain Health Care, Inc.*, 709 P.2d 265 (Utah 1985); *Hospital Utilization Project v. Commonwealth*, 487 A.2d 1306 (Pa. 1985).

69. See *Camps Newfoundland/Owatonna, Inc. v. Town of Harrison*, 117 S.Ct. 1590, 1608 (1997) (Scalia, J., dissenting, joined by Justices Rehnquist, Thomas, and Ginsburg).

70. See *id.* at 1614 (suggesting a "domestic charity" exemption to the negative commerce clause). See also Evelyn Brody, *Hocking the Halo: Implications of the Charities' Winning Briefs in Camps Newfoundland/Owatonna, Inc.*, 27 STETSON L. REV. 433 (1997) (Howard Oleck Memorial Nonprofit Symposium Issue).

71. While it never directly held that tax exemptions constitutionally differ from direct grants, the Supreme Court's assertion of a difference has been severely criticized. See, e.g., Edward A. Zelinsky, "Of Women's Colleges, Summer Camps, Printing Costs, Dairy Farms, Subsidized Indecencies, and School Vouchers: Are Tax 'Benefits' Constitutionally Equivalent to Direct Expenditures?," 112 Harv. L. Rev. (forthcoming Dec. 1998); Donna D. Adler, *The Internal Revenue Code, the Constitution, and the Courts: The Use of Tax Expenditure Analysis in Judicial Decision Making*, 28 WAKE FOREST L. REV. 855 (1993); E.C. Lashbrooke, Jr., *An Economic and Constitutional Case for Repeal of the I.R.C. Section 170 Deduction for Charitable Contributions to Religious Organizations*, 27 DUQ. L. REV. 695 (1989). Defenders include Hellerstein & Coenen, *supra* note 55, at 868 and 870, and Enrich, *supra* note 55, at 442. Professor Zelinsky believes that the two camps have been speaking past each other because they are asking different questions: "What is the particular recipient receiving?" is a different inquiry than "What is the government giving?" Zelinsky, *supra* (June 1998 draft at 57).

72. See, e.g., JENSEN, *supra* note 48, at 128.

Doubtless there is a general relationship between the percentage of real property exempt and the density of the population. Not only do governmental functions and therefore public property tend to be concentrated in centers of population, but this seems to be true also of such privately

municipal, county, or special districts, such as school districts), the burden of exemption is distributed unevenly throughout the state.⁷³ As Henry Aaron observed: "In general, the system by which exemptions are granted and extended in most states seems almost deliberately designed to promote irresponsible legislative behavior."⁷⁴ Worse, the same municipalities that host a disproportionately high share of nonprofit property often suffer a disproportionately high demand for public expenditures.⁷⁵

The local governments are fighting back, using the limited tools at their disposal, such as zoning approval.⁷⁶ In 1996 the city of Hartford, Connecticut, "imposed a temporary moratorium on the siting or expansion of all nonprofit social service facilities, and then followed it up with permanent zoning changes that have the effect of making it difficult for new social service providers to set up shop."⁷⁷ In their quest for revenue, municipalities have been increasing demands that exempt property owners make voluntary "payments in lieu of taxes," or "PILOTs."⁷⁸ The term has long been in use to refer to payments made to affected municipalities by the federal government⁷⁹—and even by state governments.⁸⁰

Some charities have been willing to negotiate PILOTs (usually at a small fraction of the amount they would pay in taxes) to win local goodwill. Assent often (but not necessarily) relates to obtaining a zoning waiver for expansion. For example, PILOTs meas-

owned exempt enterprises as schools, churches, and hospitals.

Id.

73. *But see* Heller, *supra* note 37, at 237. Professor Heller argues that, because of legislative log rolling, programs should not be viewed in isolation from each other: "Excessive charity costs in property tax ought to be measured against compensating gains from other taxes supporting a variety of programs that may excessively benefit cities." *Id.*

74. AARON, *supra* note 53, at 84.

75. *See* NETZER, *supra* note 59, at 121 ("concentrations of poorer people in an urban environment tend to be associated with high levels of public expenditure for welfare and health services, for law enforcement and correction, and for other 'human services'").

76. At one nonprofit management conference I attended in July 1997, a church manager complained that the town officials where her church wished to buy property told her they would prefer a Wal-Mart.

77. Rob Gurwitt, *Dueling With Do-Gooders*, GOVERNING MAGAZINE, May 1997, at 32. *See also, e.g.*, William Glaberson, *In Era of Fiscal Damage Control, Cities Fight Idea of "Tax Exempt"*, N.Y. TIMES, Feb. 21, 1996, at A1 ("In Ithaca, N.Y., state officials recently withheld building permits from Cornell University and in October won an unusual agreement under which the university will increase its annual payments to the city from \$147,000 in 1994 to \$1 million a year by 2007.").

78. *See* Woods Bowman, "The Uneasy Case for the Nonprofit Property Tax Exemption," presented at the Annual Conference of the Association for Research on Nonprofit Organizations and Voluntary Action (Indianapolis, Dec. 1997). Another approach has been to impose fees for particular city services that relate to the property. *See also* Janne Gallagher, *supra* note 68, at 29-30.

79. *See* ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, PAYMENTS IN LIEU OF TAXES ON FEDERAL REAL PROPERTY (Sept. 1981); Joan E. O'Bannon, *Payments from Tax-Exempt Property*, in PROPERTY TAXATION USA 187, 190-203 (Richard W. Lindholm ed., 1967).

80. *See* Bowman, *supra* note 79, at 8 (citing to a research response prepared by Charles L. Minert, Illinois General Assembly, Legislative Research Unit (Feb. 10, 1997) describing the practices in 16 states that have adopted PILOTs for state-owned property). State payments often fall short of amounts due. *See, e.g.*, COMMONWEALTH OF MASS., AUDITOR OF THE COMMONWEALTH, DIV. OF LOCAL MANDATES, A REVIEW OF THE FINANCIAL IMPACT OF THE C.58 PAYMENTS-IN-LIEU-OF-TAXES (PILOT) PROGRAM ON MASSACHUSETTS CITIES AND TOWNS (Oct. 27, 1994), available in LEXIS Fedtax Library, State Tax Notes File, as 94 STN 220-38 (Nov. 15, 1994) (estimating that over the last seven years, cities and towns received about 50% of the amount called for in the statutory formula).

ured by the value of the property being taken off the rolls can be traced back to 1928, when Harvard University began making PILOTs to Cambridge, Massachusetts.⁸¹ The PILOT technique recently turned nasty in Pennsylvania. After the state supreme court declared that exemption is premised on the charity's providing a substantial degree of gratuitous service, the City of Philadelphia offered to forego challenges to exemption in return for "voluntary" payments equal to 40% of the tax otherwise due (33% if the charity acted quickly).⁸² In 1997 the state strengthened the benefits of voluntary agreements in legislation designed to clarify the constitutional definition of an "institution of purely public charity."⁸³

In applying PILOTs, the charities that look most attractive to local governments are those that have "income" (excluding, in general, only donations),⁸⁴ preferably from patrons outside the taxing jurisdiction.⁸⁵ Accordingly, taxing the nonprofit can be viewed in part as a proxy for taxing the nonresident patrons of the organization. Currently, the municipalities' practice of challenging exemption or seeking PILOTs focuses on hospitals and institutions of higher education. Under the same theory, municipalities could extend this policy to museums and performing arts organizations—and even to break-even social service nonprofits, thus passing their costs on to government funders (state and federal).⁸⁶

81. See BALK, *supra* note 10, at 174-75 (describing the second 20-year payments agreement between Harvard University and Cambridge, Massachusetts, covering the period 1948-1968 (subsequently replaced)).

82. See Executive Order No. 1-94, Edward D. Rendell, Mayor of Philadelphia, *Payments in Lieu of Taxes*, (June 30, 1994), available in LEXIS, Fedtax Library, State Tax Notes File, as 94 STN 132-26 (July 11, 1994); *Mayor Rendell Announces Formation of New PILOTs/SILOTs Advisory Board to Address the Tax-Exempt Status of City Nonprofits* (Press Release, June 30, 1994), available in LEXIS, Fedtax Library, State Tax Notes File, as 94 STN 132-27 (July 11, 1994); *Mayor's Special Committee*, *supra* note 68. See Pamela J. Leland, "Philadelphia's PILOT Program: A Case Study," presented at the Annual Conference of the Association for Research on Nonprofit Organizations and Voluntary Action (New York City, Nov. 1996) (Philadelphia contacted about 500 nonprofit organizations but entered into only 42 agreements, the rest enjoying "home-free" status; only about \$3 million a year is being collected). The Pennsylvania Supreme Court recently upheld the exemption of Washington & Jefferson College. See *City of Washington v. Washington & Jefferson College*, 704 A.2d 120 (Pa. 1997); see also Carolyn D. Wright, *Are Pennsylvania Courts Applying Charity Exemption Requirements Too Narrowly?*, 16 EXEMPT ORG. TAX REV. 15 (Jan. 1997).

83. Act 55, 181st Leg., Reg. Sess. (Pa. 1997). See Janne G. Gallagher, *Pennsylvania Charitable Exemption Bill: An End to Litigation?*, available in LEXIS, Fedtax Library, State Tax Notes File, as 97 STN 227-17 (Nov. 25, 1997). Gallagher finds the extra credit afforded voluntary payments "mystifying": "What the legislature is saying is that the public derives a greater benefit from a dollar given to government than from a dollar spent directly on the service for which the charity was created." *Id.*

84. As early as 1971, Alfred Balk identified this trend. BALK, *supra* note 10, at 137 ("And Pittsburgh ... imposed an 'institution tax' affecting, among other exempt properties, hospitals, nursing homes, colleges, universities, veterans' posts, recreational centers, and other organizations that charge fees to the public."). Pennsylvania case law relating to the exemption challenges shows that this focus continues throughout the state. See generally, Joseph C. Bright, *The Charitable Exemption in Pennsylvania*, 16 EXEMPT ORG. TAX REV. 65 (Jan. 1997). Cf. *Conference Hour Discussions*, in PROPERTY TAXATION USA, *supra* note 79 at 267-71 (discussing a similar trend to use a gross-receipts tax to tax the improvements of business property).

85. For some charities—such as universities, art institutions, and certain hospitals—the patrons might come from out of state, if not out of the country. See, e.g., Cindy Schreuder, *U.S. Hospitals Try to Fill Beds With Foreigners*, CHI. TRIB., Oct. 27, 1997, §1, at 1 (noting that hospitals, squeezed by managed care plans, "are actively recruiting [foreign] patients, whether for special procedures unavailable in their own lands or for more general high-quality care, by creating entire teams to develop foreign health care markets").

86. Such a theory might provide a non-constitutional explanation of why municipalities have not sought

The haphazard and controversial practice of PILOTs might pressure the states to adopt more systemic reforms.⁸⁷ What if the states simply repealed property-tax exemption for charities?⁸⁸ Those residents who benefit from the activities of local nonprofits will see their costs of charitable services rise,⁸⁹ but this would be offset by the reduction in their property tax resulting from the broader base. Alternatively, states could compensate their urban centers by making transfer payments to compensate for taxes foregone on local charitable property.⁹⁰ As a study for the Commission on Private Philanthropy and Public Needs (the "Filer Commission") observed: "[S]ince state payments would go to the locality rather than to the institution, there would be no interference by the state in the activities of the tax-exempt recipients", thus avoiding "several of the serious pitfalls that have effectively stood in the way of proposals to do away with the tax-exempt device and to replace it with a program of direct state subsidies to the recipient institutions."⁹¹ Finally, states could adopt a systematic fee-in-lieu-of-taxes program, perhaps as suggested by economist Woods Bowman, in a way that "internalize[s] the positive externalities generated by the intermediate collective good by having the government charge the nonprofit organization for the incremental cost of resources used in its production."⁹²

A final level of sovereignty issues exists under the U.S. Constitution. In the Supreme Court decision described above striking Maine's discriminatory tax-exemption scheme, the Court suggested that it would likely uphold a statute providing a direct subsidy of Maine camps based on residents served. Accordingly, revenue-pressured states might seek to repeal exemptions statutes they view as overly generous to nonresidents and replace them with direct benefits schemes for residents. However, the Supreme Court has long avoided having to apply First Amendment prohibitions on government support

to tax churches, which rely primarily on donations, and whose benefits are primarily local.

87. But reform, even if desired, would likely be slow. Scholars have long lamented the lock-in effect of state constitutions mandating exemption. *See, e.g.*, Killough, *supra* note 62, at 34 ("The people should have the right to change their views by legislation as conditions change.").

88. *See, e.g.*, O'Bannon, *supra* note 80, at 207 ("Institutions which teach morality, respect for law, good health practices, and so forth, do much good for society, but they do not necessarily have any greater claim to a state property-tax exemption than do parents who teach their children such things.").

89. Peter Swords observed that the individuals affected by the tax include not just those who receive the charity's outputs, but also those who make donations to the charity. SWORDS, *supra* note 44, at 205-16.

90. Laws in a few states already require the state to make these payments, subject to appropriation. Actual payments, however, have fallen far short, not just of the tax otherwise due, but also of the legislated amounts. *See, e.g.*, *Report of State of Connecticut Property Tax Reform Commission* (Jan. 1, 1995), available in LEXIS, Fedtax Library, State Tax Notes File, as 95 STN 34-11 (Feb. 21, 1995) (stating that payments "are at a fraction of the payment that would be made if an equally valued use of another type with no exemption were substituted"); Karen Pallarito, *Conn., R.I. Subsidies Lessen Demand to Justify Tax Status*, MODERN HEALTHCARE, Oct. 8, 1990, at 45 (noting that Rhode Island's payments to compensate for local concentrations of exempt hospitals and colleges "vary depending on action by the Legislature and haven't reached the full [legislated] 25%"). For an analysis of such an approach, see Rebecca S. Rudnick, *State and Local Taxes on Nonprofit Organizations*, 22 CAP. U. L. REV. 321, 340-42 (1993) (suggesting that "the execution of such a logical plan would require much administrative expansion and would open the door to new questions of equity"). For example, Rudnick identifies such difficulties as "the need for a proper and regular assessment of the exempt property, the need to determine the proportion of the exemption that state residents outside of the locality must bear, ... and the question of whether wealthier local areas should benefit from the subsidies to the same extent as poorer ones." *Id.* at 341.

91. Gabbler & Shannon, *supra* note 46, at 2556.

92. Bowman, *supra* note 79, at 19 (dubbing his proposal "Compensation for Capacity Stretching").

of religion by declaring that property-tax exemption for churches cannot be legally equated to direct subsidies.⁹³ Scholars, however, are currently debating whether a constitutional distinction between tax subsidies and direct subsidies can be sustained.⁹⁴

IV. FEDERAL CORPORATE INCOME-TAX EXEMPTION AND THE UNRELATED BUSINESS INCOME TAX

The first federal income tax statute, enacted to finance the Civil War, applied only to individuals, and exempted trustees of charitable trusts.⁹⁵ Just a year later, however, a revenue-hungry Congress expanded the income tax and extended an excise tax to corporations, making no general exemption available to charities.⁹⁶ However, when Congress enacted a broad income-tax statute in 1894, without explanation it exempted all charities from tax.⁹⁷ Again in the corporate excise tax statute of 1909, Congress exempted charities.⁹⁸ This time Congress explicitly considered the possibility of a surplus-generating

93. See *Walz v. Tax Comm'n of City of New York*, 397 U.S. 664 (1970):

Obviously a direct money subsidy would be a relationship pregnant with involvement and, as with most governmental grant programs, could encompass sustained and detailed administrative relations for enforcement of statutory or administrative standards, but that is not this case....

The grant of a tax exemption is not sponsorship since the government does not transfer part of its revenue to churches but simply abstains from demanding that the church support the state. No one has ever suggested that tax exemption has converted libraries, art galleries, or hospitals into arms of the state or put employees "on the public payroll." There is no genuine nexus between tax exemption and establishment of religion.

Id. at 675.

94. See *supra* note 71. See also Mark P. Gergen, *The Selfish State and the Market*, 66 TEX. L. REV. 1097 (1988).

95. "The income of literary, scientific, or other charitable institutions, in the hands of trustees or others, is not subject to income tax." Commissioner Decision 110 (May 1863), in GEORGE S. BOUTWELL, A MANUAL OF THE DIRECT AND EXCISE TAX SYSTEM OF THE UNITED STATES 275, 276 (1863). This first income tax applied only to individuals, not to firms. *Id.*

96. Act of June 30, 1864, Ch. 173, 13 Stat. 223 (1864) (repealed 1939). Professor Diamond explained that because the corporate excise tax was imposed on the "privilege of doing business," churches and many charities "would presumably not have been included within the terms of the tax." Diamond, *supra* note 50, at 15. However, revenue-producing philanthropies such as hospitals apparently were taxed. Congress rejected a subsequent proposal to exempt hospitals treating U.S. soldiers. The committee report explained: "to begin to make exceptions would lead to infinite confusion; the amount would be very large in the end; every effort would be made to bring cases within the principle, [if] we tried to adopt a principle in reference to it, and we thought it would be entirely unsafe." *Id.* (citing the Cong. Globe, 42d Cong., 2d Sess. 1672 (1869)).

97. The 1894 statute exempted "corporations, companies, or associations organized and conducted solely for charitable, religious, or educational purposes ... [and] stocks, shares, funds or securities held by any fiduciary or trustee for charitable, religious, or educational purposes...." Rev. Act of 1894, ch. 349, § 32, 28 Stat. 556 (declared unconstitutional in *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601 (1895)), quoted in JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS: CASES AND MATERIALS 308 (1995). Professors Fishman and Schwarz suggest that "Congress, preoccupied with the wisdom and constitutionality of an income tax, appears to have been acting based on some intuitive sense that it was simply not appropriate, as a matter of history or tax policy, to tax charitable organizations." *Id.* at 315.

98. The Corporation Excise Tax of 1909, ch. 6, § 38, 36 Stat. 112 & 113, debated at 44 Cong. Rec. 4150, 4151, 4154-55 (1909).

activity, and as a condition of exemption imposed a prohibition on the “inurement” of the entity’s profits to the private benefit of any person.⁹⁹

During the early decades of the income tax, the federal system followed a “destination of income” test.¹⁰⁰ In this golden era, an active business enjoyed charity tax exemption so long as the profits were dedicated to charitable purposes.¹⁰¹ In 1950, prompted by the infamous case of the Mueller Macaroni Company, owned by and operating tax-free for the benefit of the New York University Law School, Congress imposed tax on “feeder organizations” and adopted the “unrelated business income tax” (“UBIT”).¹⁰² Thus, for the past half century, a business has been taxable regardless of its ownership, and a charity must pay tax on the profits of directly conducted business activities that are not “substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational or other purpose or function constituting the basis of its exemption....”¹⁰³ Moreover, while passive investments generally escape taxation, since the UBIT was expanded in 1969 it has generally applied to income earned by a charity on investments it finances with borrowed funds.

The UBIT’s constriction of blanket exemption can be justified under either a subsidy or a base-defining theory of exemption focused on charitable activity. Income tax exemption for “related” business activities, though, has the greatest value to those charities operating at the highest profit levels. The UBIT also puts pressure on the distinction between related (exempt) business activities and unrelated (taxable) business activities.

As described below, however, in several ways the form of the UBIT can be explained only by adopting a sovereignty perspective. And as we have previously seen, a sovereignty attitude simultaneously benefits and harms charities. Like the inspiration for the mortmain laws, fears of an unstoppably expanding charitable sector underlie the taxability of debt-financed investments. Yet nearly all of the post-1969 legislative changes narrow the reach of the UBIT,¹⁰⁴ particularly for debt-financed investments. Most nota-

99. See *id.*; Gen. Couns. Memo. 34,682 (Nov. 17, 1971) (text accompanying note 4); see also David A. Hyman, *The Conundrum of Charitability: Reassessing Tax Exemption for Hospitals*, 16 AM. J. L. & MED. 327, 348-49 (1990).

100. A few circuits, however, instead focused on a source-of-income test. See *University Hill Foundation v. Comm’r*, 446 F.2d 701 (9th Cir.), *cert. den.* 405 U.S. 965 (1961); *Ralph H. Eaton Found. v. Comm’r*, 219 F.2d 527 (9th Cir. 1955); *United States v. Community Services, Inc.*, 189 F.2d 421, 424-25 (4th Cir. 1951); *Universal Oil Products Co. v. Campbell*, 181 F.2d 451, 461 (7th Cir. 1950).

101. See *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924); *Roche’s Beach, Inc. v. Comm’r*, 96 F.2d 776 (2d Cir. 1938); *C.F. Mueller Co. v. Comm’r*, 190 F.2d 120 (3d Cir. 1951); *Willingham v. Home Oil Mill*, 181 F.2d 9, 10 (5th Cir. 1950); *Lichter Found. v. Welch*, 247 F.2d 431, 436 (6th Cir. 1957); *Boman v. Comm’r*, 240 F.2d 767, 770-71 (8th Cir. 1957); *Sico Co. v. United States*, 102 F. Supp. 197 (Ct. Cl. 1952).

102. *C.F. Mueller Co.*, 190 F.2d at 120. While the appeals court held for the taxpayer, Congress had the year before passed the 1950 Act. Internal Revenue Code section 502—appropriately called “feeder organizations”—provides that an “organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation under section 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation under section 501.” I.R.C. § 502 (1997). The UBIT appears in Code sections 511 through 515.

103. I.R.C. § 513(a) (1997). Not until the Tax Reform Act of 1969 did Congress extend the UBIT to churches.

104. See, e.g., Fred Stokeld, *EO Reps Like Corporate Sponsorship Provision — For the Most Part*, TAX

bly, Congress just removed the “cap” on the amount of tax-exempt bonds a charity may issue for capital expenditures, apparently willing to overlook the fact that most charities able to issue large quantities of low-rate debt are sitting on massive endowments and thus are effectively earning arbitrage profits. Meanwhile, though, in the late 1980’s Congress considered a proposal to “aggregate” a charity’s exempt and taxable subsidiaries in determining the entitlement of the parent charity to exemption. Such an aggregation cannot be defended on base-defining or subsidy grounds: When all the entities are paying the right amount of tax, only fears of the rival sovereign could explain depriving the non-profit parent of its exemption. Thus, the recent “tightening” of the rules on controlled taxable subsidiaries (in the same statute that removed the bond limit) makes no sense at all from the perspective of collecting the proper amount of tax: Henceforth, charities will pay income tax on the interest, rent, royalties and annuities they receive from more-than-50%-owned businesses, but not from portfolio (diversified) investments.

A. Debt-Financed Investments

1. Seeking a Rationale for the UBIT

In enacting the UBIT in 1950, first and foremost Congress feared “unfair competition” by exempt organizations. As later described in regulations promulgated by the Treasury Department: “The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete.”¹⁰⁵ Thus, some courts believe that in order to get excited about taxing a particular “Mueller’s”, there has to be a “Ronzoni.”¹⁰⁶

NOTES, Sept. 2, 1997, at 1143 (describing observation of attorney William Lehrfeld that nearly all 20 UBIT amendments have expanded the ability of exempt organizations to earn income through unrelated activities without payment of tax). Attorney Lehrfeld commented that Congress based its actions on an inaccurate picture of the nonprofit sector:

You get episodic or anecdotal information in front of the Congress, and ... you’re left with this notion of the big, bad IRS beating up on this little, teeny, sweet organization.... In fact, when you look at the universe, at what business activities the nonprofit sector is deeply and profitably involved in, you see that the range has digressed significantly from perhaps some of the basic concepts of what is charity, what is education, and what is science.

Id.

105. Treas. Reg. § 1.513-1(b) (1967).

106. See *United States v. American Bar Endowment*, 477 U.S. 105, 122 n.4 (1986) (Stevens, J., dissenting) (describing the “macaroni-selling competitor who had been harmed by New York University’s tax-free entry into the business”). Justice Stevens quotes from the oral opinion of the Claims Court at the end of the ABE trial:

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

Id. (ellipses in Justice Stevens’ opinion).

As Harvey Dale pointed out, though, a charity still operates free from income tax so long as the business activity is “substantially related” to its exempt purpose. Thus, for example, a nonprofit hospital pays no tax on its profits, regardless of how “unfair” this appears to a competing proprietary hospital. Professor Dale observed: “The choice of the relatedness test, rather than a competitiveness test, is nowhere discussed [in the legislative history]. It is a sure sign of an inadequate rationale when a diagnosis of a tax disease is followed by a legislative prescription which aims at a quite different target.”¹⁰⁷ Moreover, most courts do not require the identification of a specific injured competitor, but rather are satisfied simply by finding an unrelated activity conducted in a commercial manner for the production of profit.¹⁰⁸

During the consideration of the 1950 act, tax writers also expressed revenue concerns—specifically, preservation of the corporate income-tax base.¹⁰⁹ Congressman Dingle complained that without reform, “[e]ventually all the noodles produced in this country will be produced by corporations held or created by universities ... and there will be no revenue to the Federal Treasury from this industry. That is our concern.”¹¹⁰ In the words of an appeals court twenty-five years later:

The impetus for the original legislation lay in fears occasioned by a rash of acquisitions like New York University’s of the Mueller Macaroni Co., of a spiraling cycle in which exempt institutions would acquire unrelated businesses on favorable payout terms and use their exemptions to undercut commercial competitors, forcing some out of business and increasing the tax burden on the remainder.¹¹¹

On subsidy grounds, many economists (as opposed to politicians) have trouble seeing why law makers granting tax exemption to charities should care about the source of income. Similarly, as a base-defining matter, why *shouldn’t* destination of income be the preferred legal standard? Presumably, after all, the right income-tax rate for a charity is zero, whether in order to encourage growth of the sector or in recognition of its autonomy. Furthermore, how is a charity’s lower tax rate on profits supposed to result in unfair

107. Harvey P. Dale, *About the UBIT...*, 19th N.Y.U. Conference on Tax Planning for 501(c)(3) Organizations § 9.02 (1990), reprinted in FISHMAN & SCHWARZ, *supra* note 97, at 726, 727. Similarly, the recent Pennsylvania legislation regarding property-tax exemption generally denies exemption to an “institution of purely public charity” if it conducts a “commercial” business. “Commercial” is defined as the “sale of products or services that are principally the same as those offered by an existing small business in the same community” other than, in general, (1) businesses “intended only for the use of its employees, staff, alumni, faculty, members, students, clients, volunteers, patients or residents”, or (2) investments. Act 55, *supra* note 83, at §§ 3 & 8. Existing commercial businesses are grandfathered, so long as they don’t expand. *Id.* at § 8(h).

108. See generally Donald L. Sharpe, *Unfair Business Competition and the Tax on Income Destined for Charity: Forty-Six Years Later*, 3 FLA. TAX REV. 369 (1996).

109. See Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 615 n.33 (1989) (discussing why, before 1950, charities did not sell all of their common stocks and invest entirely in wholly owned, and thus untaxed, businesses).

110. Richard L. Kaplan, *Intercollegiate Athletics and the Unrelated Business Income Tax*, 80 COLUM. L. REV. 1430, 1433 & n.17 (1980), quoting Revenue Revision of 1950: Hearings Before the House Comm. on Ways and Means, 81st Cong., 2d Sess. 580 (1950) (remarks of Rep. Dingell).

111. *Massachusetts Med. Soc. v. U.S.*, 514 F.2d 153, 154 (1st Cir. 1975).

competition? An income-tax exemption is not an input subsidy; it does not reduce the charity's *cost* of purchasing goods. Viewed this way, the zero rate for charity is no more "unfair" to a 35%-taxed competitor than are the graduated tax rates for small corporations, or the progressive income tax rates on individuals who conduct business activities in a sole proprietorship or through a partnership, limited liability company, or S corporation. As Susan Rose-Ackerman once asked: "[D]ifferent tax treatment ... implies only that N.Y.U. would keep a larger share of Mueller's profits than would Ronzoni's owners.... Why must a fair tax code treat students and scholars who are the beneficiaries of Mueller's profits as if they were 'equal to' Ronzoni's investors?"¹¹² Henry Hansmann, however, views the UBIT as necessary to provide a one-level-of-tax-result regardless of whether a charity conducts an unrelated business directly or invests in stock of a taxable corporation.¹¹³

2. Applying the UBIT to Leveraged Investments

The UBIT statute permits charities to earn many different passive types of investment income tax-free. During the House debate over the 1950 Act, Congressman Lynch declared:

The receipt of interest, dividends, and royalties does not constitute carrying on an active business. In general, the receipt of rent is also considered a proper activity for these organizations and is not taxed. Historically, the colleges and other exempt organizations have often invested their endowments in rental property—and the bill does not tax this.¹¹⁴

Unfortunately, Congress did not simply say: "Business activity is taxable and investment activity is not."¹¹⁵ Rather, Congress enumerated specific items, such as interest and dividends, that a charity may earn free of UBIT.¹¹⁶ Congress's failure to articulate principles for distinguishing "good" income from "bad" income continues to hamper a sensible analysis of the UBIT.¹¹⁷

Most perplexing is the set of rules subjecting debt-financed investment income to UBIT. The legislative history does not convincingly identify the evil of debt-financed investing in terms of a misplaced subsidy or miscalculated base. It's particularly hard to see the "unfair competition" in the context of leveraging passive investments not otherwise viewed as giving rise to this threat. Nor is it easy to identify the erosion of the cor-

112. Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017, 1020 (1982).

113. See Hansmann *supra* note 109, at 614-17.

114. 96 CONG. REC. 9366-67 (1950).

115. Pure investment activities can, theoretically, rise to the level of a trade or business, see Gen. Couns. Memo. 39,615 (Mar. 12, 1987), but as a practical matter the specific exclusions in Code section 512(b) will obviate the need to differentiate between an investment activity and a trade or business. See Gen. Couns. Mem. 37,513 (June 17, 1986).

116. I.R.C. § 512(b) (1997).

117. See, Thomas J. Gallagher, *When Is a Business Not a Business? Exploiting Business Opportunities and Enhancing Economic Returns by Capitalizing on the Income Tax Exemption of Tax-Exempt Organizations*, 75 TAXES 928 (Dec. 1997).

porate income-tax base: After all, if the charity borrows money to buy stock, and the stock were to produce untaxed income, then the charity could not claim an interest-expense deduction.¹¹⁸ Thus, economically, not taxing the income but not allowing the deduction should provide the charity no greater an advantage than a taxable investor has in being taxed on the income but being permitted the deduction.¹¹⁹ Nor does the presence of tax-exempt investors in the marketplace result (as discussed below) in a “selling” of their exemption. While charities might outbid other buyers, a charity is not going to pay more than it would have to in order to beat not only the other bidders (taxable and tax-exempt) but also its next best investment opportunity; that is, wealthy exempt investors affect the price of investments assets, but because of their market power, not because of their exemption.¹²⁰ Ironically, the real way a charity can exploit its exemption—by borrowing at a lower rate than a taxable investor—was just made easier. In the Taxpayer Relief Act of 1997, Congress reopened an arbitrage opportunity for well-endowed charities by removing the cap on issuing tax-exempt bonds.¹²¹

a. The “Bootstrap” Sale-Leasebacks

The UBIT rules on debt-finance owe their genesis primarily to a type of tax-arbitrage transactions whose particular abuses Congress has long since cured in other ways.¹²² In the 1950 enactment of UBIT, Congress adopted a provision that treated as “unrelated business income” the leveraged rental income from long-term leases.¹²³ Legislators found the apparent widespread use of “bootstraps leases” alarming. In leases of this type, an exempt organization acquired retail stores or other types of real property and fixed assets, leased the assets back to the seller, and agreed to pay the purchase price only out of the lease payments.¹²⁴ The House and Senate committee reports stated: “it

118. See Suzanne Ross McDowell, *Taxing Leveraged Investments of Charitable Organizations: What Is the Rationale?*, 39 CASE W. RES. L. REV. 705, 733-34 (1988-89).

119. A noncorporate taxable investor is, however, subject to the net-investment-income limitations of I.R.C. § 163(d) (1997).

120. See McDowell, *supra* note 118 at 743 (comments of Harvey Dale to McDowell). “Harvard University might get outbid by MIT, and in the long run that would tend to make the untaxed rate of return in the nonprofit sector equivalent to what it would be in the for-profit sector after tax, depending on how much entry can occur.” *Id.* at 745 (comments of Richard Steinberg).

121. I.R.C. § 145(b)(5) (1997). See Brody, *supra* note 2, *Charitable Endowments*, at 890-91.

122. Even the Mueller acquisition was debt-financed. See *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120, 121 (3rd Cir. 1951).

123. The debt-financed investment rules now appear in I.R.C. § 514 (1997). The 1950 Act imposed UBIT only on leveraged leases of more than 5 years. See Conference Report, *Revenue Act of 1950*, H.R. Rep. No. 3124, 81st Cong., 2d Sess. 33-34 (1950), *reprinted in* 1950-2 C.B. 580, 589 (Amendment No. 143).

124. In the 1947 hearings on the UBIT, the sole business representative devoted “[t]he bulk of his testimony [to] the income universities were deriving from their acquisition of business enterprises in sale-leaseback transaction.” W. HARRISON WELLFORD & JANNE G. GALLAGHER, UNFAIR COMPETITION? THE CHALLENGE TO CHARITABLE TAX EXEMPTION 81 n.35 (discussing *Proposed Revisions of the Internal Revenue Code Before the House Ways and Means Comm.*, 80th Cong., 1st Sess., at pt. 5, 3410-12 (1947) (statement of Leonard J. Calhoun, National Tax Equality Ass’n)). However, the rules apply regardless of whether the seller and the lessee are the same person. “Hence, the tax will apply in cases which do not conform strictly with the lease-back plan but which raise the same problem of unfair competition which the lease-back itself produces...” House Ways and Means Comm., H.R. 8920, *Revenue Act of 1950*, H.R. Rep. No. 2319, 81st Cong., 39-40 (1950), *reprinted in* 1950-2 C.B. 380, 411; Sen. Fin. Comm., *Revenue Act of 1950*, S. Rep. No. 2375,

has already become big business and a recent writer has characterized it as 'the most noteworthy, financial device of the present century.'"¹²⁵ The reports cited one real-estate broker who had concluded \$40 million worth of sale-leasebacks and was in the process of completing \$100 million more.¹²⁶

The committee reports described three principal objections to leveraged leasebacks:

First, the tax-exempt organization is not merely trying to find a means of investing its own funds at an adequate rate of return but is obviously trading on its tax exemption, since the only contribution it makes to the sale and lease is its tax exemption. Therefore, it appears reasonable to believe that the only reason why it receives the property at no expense to itself is the fact that it pays no income tax on the rentals received.

The second objection to the lease-back is that it is altogether conceivable that if its use is not checked, exempt organizations in the not-too-distant future may own the great bulk of the commercial and industrial real estate in the country. This, of course, would lower drastically the rental income included in the corporate and individual income tax bases. The fact that under present law an exempt institution need not use any of its own funds in acquiring property through lease-backs — borrowed funds may represent 100 percent of the purchase price — indicates that there is no limit to the property an exempt institution may acquire in this manner.... Where an exempt organization uses its own funds, the expansion of its property holdings through the lease-back device must necessarily proceed at a much slower pace.

A third reason ... is the possibility which exists in each case that the exempt organization has in effect sold part of its exemption. This can occur either by the exempt organization paying a higher price for the property or by charging lower rentals than a taxable business could charge. Proof, of course, is difficult to obtain because the purchase price, or rental charge which a taxable business would agree to pay, is unknown....

...[I]n the case of the lease-back arrangements the sellers seem to take the position that they will not sell at all unless they receive better terms than a taxable business can offer, and the exempt organization, because of its tax-free status, can afford to pay the higher price and still make a profit ... especially ... where the exempt organization is presented an arrangement which does not require the commitment of any of its own funds.¹²⁷

81st Cong., 32 (1950), *reprinted in* 1950-2 C.B. 483, 507. The conference also adopted amendments in the Senate bill excluding "related" leases: leases of premises in a building primarily occupied by the lessor organization; certain long-term leases of portions of the premises where both the long-term rents are less than 50% of total rents and no tenant rents more than 10%; and certain grandfathered bequests. Conference Report, *supra* note 123, at 589-90 (Amendments 146 and 149).

125. House Report, *supra* note 124, at 38, 1950-2 C.B. at 410; Senate Report, *supra* note 124, at 31, 1950-2 C.B. at 506.

126. *Id.*

127. House Report, *supra* note 124, at 38-39, 1950-2 C.B. at 410; Senate Report, *supra* note 124, at 31-32, 1950-2 C.B., at 506-07.

A dozen years later, the notorious *Clay Brown* case revealed the narrowness of the 1950 debt-financed rules. *Clay Brown* involved the bootstrap acquisition of an active business.¹²⁸ To simplify somewhat, in such a transaction:

1. The owner of a business sold his stock to a charity—producing capital gain to the seller, since the Code had not yet been amended to treat part of the deferred payments as ordinary interest income;¹²⁹
2. The charity liquidated the corporation—which, at the time, resulted in no corporate-level tax;
3. For a term of 5 years or less, the charity leased back the assets to a new corporation formed by the owner—the owner obtaining a deduction for the rental payments, and the charity excluding the payments, because the 1950 act treated rental income only from longer-term real-estate leases as UBI; and
4. The charity paid the purchase price only out of the rental payments—that is, payments were contingent on rental income, and were secured only by the property, with no recourse to the charity's other assets.¹³⁰

When *Clay Brown* reached the Supreme Court, the majority held that such a transaction qualified as a sale because the exempt buyer would be able to do what it wished with the business assets upon the expiration of the lease.¹³¹

The appellate court in *Clay Brown* had declared that “[t]here is no question that this transaction took the form that it did because the Institute is a tax-exempt corporation and that the price to be paid was *probably greater* for that reason.”¹³² The Supreme Court disagreed, finding that the purchase price was *not* excessive.¹³³ However, the majority opinion identified the one aspect of a sale-leaseback with an exempt buyer that could produce an economically better result for a seller: Where the purchase price is paid solely out of rental income, an exempt buyer-lessor can pay the purchase price at a faster rate, because the pre-tax rental stream is available for payment.¹³⁴ Nevertheless, the three dis-

128. *Commissioner v. Brown*, 380 U.S. 563 (1965) (“Clay Brown”).

129. The promissory note in *Clay Brown* purported to be non-interest bearing, even though the “deferred payment plan” grossed up the sale price “with a 6% interest figure.” *Id.* at 572. In a footnote, the Supreme Court observed that then-new Internal Revenue Code section 483—which recharacterizes capital gain as ordinary income to the extent it represents embedded interest —“would apparently now apply to a transaction such as occurred in this case.” *Id.* at 578 n.9.

130. The Court indicated it was aware of the tax-avoidance potential, citing numerous law review articles on the bootstrap technique. *Id.* at 566 n.2.

131. The Court deferred to Congress to reform the tax treatment of a transaction as common as an installment sale of a business. *Id.* at 579.

132. *Commissioner v. Brown*, 325 F.2d 313, 316 (9th Cir. 1963), *aff'd* 380 U.S. 563 (1965) (emphasis added).

133. *Clay Brown*, 380 U.S. at 573.

134. *Id.* at 574. See also John H. Hall, *The Clay Brown Case and Related Problems*, 18TH ANN. U. SO. CAL. LAW CENTER TAX INST. 337 (1966):

Writers have stated, and the Commissioner has strongly insisted, that such arrangements would only occur at grossly excessive prices, but the cases suggest that the more usual price has been approximately the fair market value plus a reasonable time-price differential.

senting justices endorsed the Tax Court's view that Clay Brown "would have been unable to sell the stock at as favorable a price to anyone other than a tax-exempt organization."¹³⁵ The dissenters continued:

Indeed, this latter supposition is highly likely, for the Institute was selling its tax exemption, and this is not the sort of asset which is limited in quantity. Though the Institute might have negotiated in order to receive beneficial ownership of the corporation as soon as possible, the Institute, at no cost to itself, could increase the price to produce an offer too attractive for the seller to decline. Thus it is natural to anticipate sales such as this taking place at prices on the upper boundary of what courts will hold to be a reasonable price—at prices which will often be considerably greater than what the owners of a closed corporation could have received in a sale to buyers who were not selling their tax exemptions. Unless Congress repairs the damage done by the Court's holding, I should think that charities will soon own a considerable number of closed corporations, the owners of which will see no good reason to continue paying taxes at ordinary income rates.¹³⁶

The dissent continued in a footnote: "[A]fter the payout is complete the Institute presumably would have a basis of \$1,300,000 in a business that in reality cost it nothing. If anyone deserves such a basis, it is the Government, whose grant of tax exemption is being used by the Institute to acquire the business."¹³⁷

In 1969, because of *Clay Brown* and similar cases, Congress severely tightened the UBIT rules on property rentals.¹³⁸ Once again, the legislative history suggested that

Where this is true, the only tax benefit to the sellers not present in any installment sale of a business is the conversion of the economic equivalent of interest income—the time-price differential—into capital gains[, an advantage eliminated by the new Code section 483].... [H]owever, sellers enjoyed the important business benefit of having a ready buyer able to pay a reasonable purchase price far faster than the same amount could have been saved from after-tax earnings.... [S]ince the cases show that charities had no difficulty in buying businesses at reasonable prices, and because grossly excessive prices create a number of problems to all parties concerned, grossly excessive prices were probably less prevalent in practice than some commentators have assumed.

Id. at 343-44 (footnotes omitted). Cf. William L. Cary, *Corporate Financing Through the Sale and Lease-back of Property: Business, Tax, and Policy Considerations*, 62 HARV. L. REV. 1, 23 (1948) (mentioning that there are no available cases of overvaluation).

135. *Clay Brown*, 380 U.S. at 588 (quoting *Clay Brown v. Commissioner*, 37 T.C. 461, 485 (1961)).

136. *Id.* (Goldberg, J., dissenting).

137. *Id.* at 590 n.6. Ironically, in the early 1980's a tax abuse arose from sale-leasebacks in the other direction. Exempt organizations could not use depreciation deductions and investment tax credits. As a result, Bennington College arranged to sell its campus to its alumni and lease it back. When the Navy began doing the same with its battleships, Congress enacted rules providing that property used by a tax-exempt entity (including a government) is not eligible either for accelerated depreciation or the investment tax credit. See JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1984, at 36-84 (Dec. 31, 1984) (discussing the history and effect of these tax rules); Thomas W. Lippman, *House Group Tightens Reins on Tax Credits*, WASH. POST, July 28, 1983, at E1 (describing grandfathered transactions).

138. For example, Congress enacted restrictions proposed by the Senate on rents measured by net income regardless of whether the property is debt-financed. See Conference Report, *H.R. 13270, Tax Reform Act of 1969*, H.R. REP. NO. 91-782, 91st Cong., 1st Sess. 290 (1969); I.R.C. § 512(b)(3)(B)(ii) (1997).

charities were “frequently [paying] more than the market price.”¹³⁹ Similarly, the Treasury Department asserted that “tax-exempt organizations are uniquely suited to pay a considerably higher price than other purchasers can afford; their exemption makes it possible for them, in effect, to pay to the former owners of the business the money which a taxable purchaser would have to pay to the Government in taxes.”¹⁴⁰

b. The Uses and Abuses of Debt

In 1969, for the first time in the UBIT debate, the Treasury Department raised a regulatory argument for taxing all debt-financed investment:

[U]se of the exemption in transactions of the *Clay Brown* variety permits exempt organizations to grow altogether without reference to the amount of contributions or membership fees which they receive from the public, or the income produced by investment of their own funds. It permits, in other words, growth which has no relation to public approval of the activities or purposes of the organization but rather arises from the organization’s selling its exemption.¹⁴¹

The Treasury described the 1950 debt-financed rule as seeking to restrict tax exemption “to earnings arising from the exempt entity’s own assets, so as to eliminate the abuses and artificial incentives attendant upon exemption of income produced by borrowed

139. 1969 BLUEBOOK, *supra* note 21, at 62. One 1969 study declared that churches, for example, “have in places been bombarded by business interests seeking to make a sale. Churches can obviously offer a higher price than the ordinary businessman taxpayer.” ROBERTSON, *supra* note 10, at 129. Robertson continued:

The point is made in a Prentice-Hall newsletter, *Executive Tax Report*. An article with the caption, “Have You Put a Price on Your Business? You May Be Able to Double It by Selling to a Charity.” “An ordinary buyer is interested only in earnings after taxes — that is all he gets to see, ... but a tax-exempt buyer keeps a hundred cents on the dollar. So a fair price for a charity would be ... twice what you figured.”

Id. (citing BALK, *supra* note 10, at 71).

140. U.S. TREASURY DEPT., TAX REFORM STUDIES AND PROPOSALS, JOINT PUBLICATION OF H. WAYS & MEANS COMM. AND SEN. FIN. COMM., 91st Cong., 1st Sess. 306 (Part 3) (Comm. Print, Feb. 5, 1969). Note that this study was written by the Johnson Treasury, but released, for discussion purposes, after President Nixon took office. See generally JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 166 (1985).

141. U.S. TREASURY DEPT., *supra* note 140, at 306-07. Note that the lack-of-accountability argument can also be raised against investments even in the absence of debt finance. Indeed, George Break and Joseph Pechman have urged that at least some tax rate should apply to all charity receipts other than receipts from charitable contributions:

Investment income in moderate amounts does indeed provide both independence and valuable protection against unforeseen contingencies, but in large amounts it may serve mainly to protect the recipient institution from any market test of the value of its activities. A moderate tax on this investment income, then, would not destroy the protected position of highly endowed philanthropies, but it would reduce their ability to finance activities that are not directly supported by the public.

George A. Break & Joseph Pechman, *Relationship Between the Corporation and Individual Income Taxes*, 28 NAT’L TAX J. 341, 344 (1975), adapted from FEDERAL TAX REFORM: THE IMPOSSIBLE DREAM? (ch. 4) (1975).

funds.”¹⁴² Nevertheless, Congress failed to adopt this “public accountability” justification¹⁴³ (or any other) when in 1969 it extended the UBIT to all investment property acquired with debt.

Under the Internal Revenue Code, a charity has taxable income in proportion to the ratio of average acquisition indebtedness to the average adjusted basis of the property.¹⁴⁴ These rules are highly technical and detailed, and susceptible to manipulation. For example, a charity with pre-existing investments may borrow against them without producing “acquisition indebtedness,” as long as the subsequent borrowing was not “reasonably foreseeable” at the time the investment was made.¹⁴⁵ In addition, the statute excludes leveraged acquisitions of property used in the charity’s related exempt activities.¹⁴⁶ The bond-financing rules make it similarly easy for a charity to issue tax-exempt debt for related capital expenditures without having to rebate investment income to the government under the anti-arbitrage requirements: By adopting a tracing rule on the use of debt proceeds, the statute ignores bonds not actually secured by endowment or other investment assets.¹⁴⁷ This explains why universities and other charities can maintain large endowments while borrowing at low rates to build facilities. The Taxpayer Relief Act of 1997 made this easier by removing the \$150 million limit on bonds issued by a non-hospital charity. In sponsoring this provision, Senator Daniel Patrick Moynihan made the sovereign-sounding argument that private research universities should have the same access to the credit markets as do public universities.¹⁴⁸

Indeed, this liberalization is only the most recent in the unrelated debt-financed income regime. Over the years, Congress has expanded the list of UBIT-exempt investments, and Treasury regulations and administrative pronouncements have further pushed

142. U.S. TREASURY DEPT., *supra* note 140, at 307.

143. McDowell, *supra* note 118, at 726-27. Agreeing with such a role for the tax system, one commentator asked, “Are charitable organizations paying so much attention to being clever with their investments that they lose sight of their charitable mission?” *Id.* at 749 (discussant remarks of Laura Chisolm).

144. I.R.C. § 514(a) (1997).

145. I.R.C. § 514(c)(1)(C) (1997).

146. See Robert H. Swart, *Using (or Abusing) an Exempt Organization's Tax Exemption*, TAXES, Dec. 1996, at 1034, 1037-38.

147. See Brody, *supra* note 2, at 888-892.

148. 143 CONG. REC. S 481, S 499 (Jan. 21, 1997) (discussing S. 121, The Higher Education Bond Parity Act, introduced by Sen. Moynihan); 143 CONG. REC. S 8415, S 8418 (July 31, 1997) (remarks of Senator Moynihan). In praising the inclusion of the removal of the \$150 million cap in the debate over the Taxpayer Relief Act of 1997, Senator Moynihan stated:

Now, we have earlier on enabled the private universities, colleges, and nonmedical health facilities to borrow money on a tax exempt basis, which puts them partially on an equal footing with the State institutions which obtain money directly from the taxpayers, from tax revenue, and can issue tax exempt bonds because they are public institutions.

And we capped that amount, and more and more of our institutions have reached it. And having done that, they are no longer in a position to build what you could call the capital intensive science facilities and suchlike facilities that you need in the area of research on the edges of knowledge in this country today.

143 CONG. REC. at S 8418. When he sponsored the proposal, Senator Moynihan pointed out that 34 of the leading colleges and universities were already at or near the \$150 million cap, which was put in place in the Tax Reform Act of 1986. 143 CONG. REC. at S 499.

the envelope.¹⁴⁹ In particular, charities need not worry about UBIT when engaging in securities lending,¹⁵⁰ short sales¹⁵¹ or arbitrage transactions,¹⁵² or from holding futures contracts¹⁵³ or notional principal contracts (swaps).¹⁵⁴

The sophisticated world of institutional investing exploits these rules to the hilt—but not, as feared, in order for the charity to grow uncontrollably so much as to squeeze the maximum investment return. Debt plays an important role under modern portfolio theory, as endowment managers use securities lending, short selling, and notional principal contracts (such as interest-rate swaps) to enhance returns. For example, *Forbes* magazine analyzed Harvard University's investment practices in 1995, and found that the endowment went “long \$21.5 billion in stocks and bonds and short \$13.8 billion” at a time when its actual endowment assets were worth \$7.7 billion.¹⁵⁵ “Leverage and locking in of market anomalies ... has been worth 370 basis points annually to [Harvard's domestic bond] portfolio.”¹⁵⁶

Specifically, modern portfolio theory concludes that increased return comes from taking on increased risk, where the “riskless” return is that earned on Treasury securities.¹⁵⁷ However, only a certain type of risk is compensated through higher returns: the risk that the market will go up or down (systemic or systematic risk). The risk from holding any particular publicly traded stock enjoys little compensation, because all but its market risk can be diversified away. In an artificial but fundamental model, the only way to increase return is to shift assets from Treasury bills to stock; additional risk can be taken on by borrowing and buying more stock. Borrowing—indeed, the notion of increasing risk—has traditionally been *verboten* to trustees; however, the *Restatement (Third) of Trusts (The Prudent Investor Rule)* reverses this rule.¹⁵⁸ The way to reduce

149. Rev. Rul. 78-88, 1978-1 C.B. 163 (describing a nonstatutory “passive investment income” exception for “ordinary and routine investment”), *formalized in* Treas. Reg. § 1.512(b)-1(a)(1) (1992) (exempting additional items “to the extent determined by the Commissioner”—*i.e.*, for new types of investment, prospectively only).

150. A 1978 amendment to Internal Revenue Code section 512(a)(5) and (b)(1) excludes the returns from securities loans from tax.

151. See Rev. Rul. 95-8, 1995-1 C.B. 108, discussed in T. Gallagher, *supra* note 117, at 939 n.110.

152. See T. Gallagher, *supra* note 117, at 948 & n.185 (citing Gen. Couns. Mem. 39,547 (June 17, 1986) and Priv. Ltr. Rul. 88-32-052 (May 18, 1988)).

153. See, *e.g.*, Priv. Ltr. Rul. 80-44-023 (Aug. 5, 1980) (concluding that a futures contract is not debt-financed property, despite the existence of initial and variation margin).

154. Treas. Reg. § 1.512(b)-1(a) (as amended by T.D. 8423, July 28, 1992).

155. Robert Lenzner & Stephen S. Johnson, *Harvard is Knee-Deep in Derivatives*, *FORBES*, Nov. 20, 1995, at 106, 112 (cover story).

156. *Id.* at 112.

157. This paragraph draws substantially from Part III of Evelyn Brody, *The Limits of Charity Fiduciary Law*, 56 MD. L. REV. (forthcoming 1998).

158. RESTATEMENT (THIRD) OF TRUSTS (THE PRUDENT INVESTOR RULE) § 191, at 154 (1992); see also *id.* § 227 cmt. *h* (Prudent investment: theories and strategies), at 29 (“Borrowing may play an inverse role to that of lending and is permissible for trustees, provided the tactic is employed selectively and cautiously.”). John Langbein and Richard Posner commented:

In most cases where borrowing has been at issue, the trustee was using trust funds to carry on a business. But the trustee who levers a market fund, like a trustee who buys levered common stock, remains a passive investor.... Obviously, leverage increases the risk of the trust assets.... But the proper question is whether the risk is excessive, not whether it is achieved by leverage.

risk is to shift from stock to Treasuries, or to lend against stock. A fiduciary's most important investment decision is selecting a level of risk and the appropriate asset allocation.¹⁵⁹

Thus, subjecting leveraged returns to UBIT deprives exempt organizations of potentially prudent and beneficial portfolio management techniques.¹⁶⁰ Many restrictions remain, despite the liberalizations just described and a liberalization in the ability of universities to make debt-financed investments in real estate.¹⁶¹ One recent commentator,

John H. Langbein & Richard A. Posner, *Market Funds and Trust-Investment Law*, 1 AM. B. FOUND. RES. J. 1, 33 (1976).

159. See William T. Spitz, *Selecting and Evaluating an Investment Manager* 3, 7 (NACUBO 1992) (advising that "endowment trustees should be spending the majority of their time on investment objectives and asset allocation because tactical considerations, such as security selection, are of minor importance").

160. Cf. William H. Weigel, *Unrelated Debt-Financed Income: A Retrospective (and a Modest Proposal)*, 50 TAX LAW. 625 (1997):

Excluding Nonrecourse Sale-Leasebacks ..., leveraged investments are leveraged both on the "up" and the "down" side, and debt financing can lead to a dramatic diminution of an exempt organization's assets as well as an increase.... Why should tax policy interfere with this basic fact of economic life? The legislative history lacks any suggestion that Congress had a paternalistic intention to protect exempt organizations from the "down" side risks of leveraged investments.

Id. at 655 (footnote omitted).

161. See, e.g., I.R.C. § 514(c)(9) (1997) (enacted in 1980 and amended several times since). Extended in 1984 to colleges and universities, section 514(c)(9) originally covered only qualified pension trusts, permitting them to make certain leveraged investments in real estate free of UBIT (regardless of whether the investments were made directly or through a partnership whose allocations meet specified requirements). The legislative history appears in the Senate Finance Committee Report to the Miscellaneous Revenue Act of 1980, S. Rep. No. 96-1036 (Nov. 25, 1980). This report described the reasons for loosening the rules to such a significant degree:

While the "Clay Brown" provisions were designed in part to prevent uncontrolled growth of exempt organizations through investments financed with debt, the exemption for investment income of qualified retirement trusts is an essential tax incentive which is provided to tax-qualified plans in order to enable them to accumulate funds to satisfy their exempt purpose — the payment of employee benefits. Accordingly, the committee believes that it is inappropriate to continue the present law restrictions on debt-financed income to the extent that they discourage prudent debt-financed real estate investments by these trusts.

Trustees of these plans are desirous of investing in real estate for diversification and to offset inflation. Debt-financing is common in real estate investments.... The committee also believes that, in order to alleviate a competitive problem [because UBIT-free investments could already be made through a financial intermediary, such as an insurance company segregated asset account], it is appropriate to allow qualified plans to make debt-financed investments directly....

The committee believes it is appropriate to limit this change to real estate investments of qualified retirement trusts because ... the assets of such trusts will ultimately be used to pay taxable benefits to individual recipients whereas the investment assets of other organizations exempt under Code section 501(a) are not likely to be used for the purpose of providing benefits taxable at individual rates.

Id. at 29. This last point, however, expresses the common misconception that pension funds merely defer tax: Taxing the nominal amount of distributions from a qualified trust captures only the time value of the tax savings attributable to the deductions for the original contributions (assuming no rate change), and the inside

observing that the class of sale-leaseback transactions that can exploit the rules “has become exceedingly narrow,” calls for the repeal of the unrelated debt-financed income rules.¹⁶² Such a blanket scheme can no longer be justified under either a subsidy approach or a base-defining approach. Nor is there credible evidence for claims that charities were overpaying for these investments, thus transferring the value of their exemptions to others. The only possible explanation for retaining the 1969 legislation is the fear of the power of a well-endowed charitable sector.¹⁶³ Bolstering this sovereignty view was one satisfied reaction to the 1969 act: “the preferred tax status traditionally accorded charitable organizations does not include a license to build financial empires—at least not in the same way that taxpaying entities might do so.”¹⁶⁴

B. Aggregation and Controlled Subsidiaries

A large part of the 1969 reform focused on the subset of charities known as private foundations, whose funding comes primarily from a single donor or family, and whose assets typically consist primarily of investment assets. One significant legislative change obligates private foundations to divest stock in controlled businesses; Congress feared that foundation donors or managers were using the foundation to pursue private business interests.¹⁶⁵ As the Treasury Department explained, “where a foundation becomes heav-

build-up is *never* taxed. As Thomas Gallagher observed, “The Service has successfully established the principle that maximizing the investment yield of a pension fund through the purchase of securities on margin is *not* an activity substantially related to the exempt function of the pension fund.” Gallagher, *supra* note 117, at 948 & n.180 (citing *Elliot Knitwear Profit Sharing, et al. v. Commissioner*, 614 F.2d 347 (3d Cir. 1980); *Ocean Grove Corp. Retirement Plan v. U.S.*, 657 F. Supp. 776 (S.D. Fla. 1987)).

When the Deficit Reduction Act of 1984 extended section 514(c)(9) to educational institutions, no explanation was offered as to why colleges and universities, but not other charities, should be able to leverage real estate investments without tax. The Treasury opposed the “piecemeal” repeal of this form of UBIT. See McDowell, *supra* note 118, at 716-18.

162. Weigel, *supra* note 160, at 657 and 658. This practitioner observes:

Once created, these rules became a fixture in the law and expanded in scope, and today they constitute one of the important constraints that complicate almost every substantial transaction involving exempt organizations. Thus, the history of the [unrelated debt-financed income] rules reveals that, inertia being what it is, congressional misperception of micro-economics has had very extensive and long-lasting ramifications.

Id. at 626.

163. Cf. Stone, *supra* note 31, at 49 (agreeing that the size and economic power of charities could inappropriately grow in a “theoretically unlimited fashion” if they could debt-finance investments). Professor Stone objected: “One of the principal factors assuring some limits on the relative sizes of the tax-exempt and taxable sectors — the sacrifice of the after-tax value of donations — is missing.” *Id.* (footnote omitted).

164. H. Neil Beller, *Exempt Organizations: Taxation of Debt-Financed Income*, 24 TAX LAW. 489, 520 (1971). Similarly, Professor Stone wrote: “Control by nonprofit organizations of active business enterprises creates the potential for serious tax-subsidized competition with private enterprise, subtle and varied forms of self-dealing and private benefits, and possible distraction of the aims of the organization from its philanthropic purposes to commercial empire building.” Stone, *supra* note 31, at 51. Similar complaints against empire-building were raised in the lead-up to the 1950 UBIT legislation. See Weigel, *supra* note 160, at 639 & n.57.

165. See generally TAX REFORM ACT OF 1969, HEARINGS BEFORE THE COMM. ON FIN., U.S. SENATE, 91st Cong., 1st Sess. 726-37 (Part 1) (Sept. 4 & 5, 1969) (Statements and Recommendations of the Department of the Treasury).

ily involved in business activities, the charitable pursuits which constitute the real reason for its existence may be submerged by the pressures and demands of the commercial enterprise.... Business may become the end of the organization; charity, an insufficiently considered and mechanically accomplished afterthought.”¹⁶⁶ The 1969 Act requires private foundations to divest control stock, permitting them, generally, to own no more than 20 percent of an unrelated business (reduced by the percentage owned by “disqualified persons”).¹⁶⁷

This fear of private foundation “empire building” extended to the entire charitable sector in the late 1980s during a push to apply the UBIT to all nonprofit commercial activity. The debate initially focused on traditional claims of unfair competition. Soon, though, reformers embraced an “aggregation” proposal that would have deprived a charity of its tax-exemption if the charitable activities were outweighed by the activities of for-profit affiliates. The nonprofit sector ultimately forestalled the UBIT reform package, including the aggregation proposal. However, as described below, another similar proposal to tax certain passive income received from controlled subsidiaries surprisingly became law in 1997.¹⁶⁸

UBIT reform became an issue in the mid-1980’s when small business lobbyists identified unfair competition by nonprofits as one of their top complaints.¹⁶⁹ Small business found a sympathetic ear in Congressman Jake Pickle, chair of the House Ways and Means Committee Subcommittee on Oversight. Five days of hearings in July 1987 were followed by a proposal from the Treasury Department, and then a set of discussion options drafted by Oversight staff. Both small business and the nonprofit sector generated letter writing campaigns that filled a 950-page volume printed by the Oversight Subcommittee.¹⁷⁰ Congress faced a difficult choice between two important constituencies, each wearing a white hat.

166. *Id.* at 733. Identical language had appeared in an earlier Treasury report. *See* TREASURY DEPT. REP. ON PRIVATE FOUNDATIONS, *supra* note 21, at 35. To the extent Congress was motivated by the “‘diversion’ of the foundation managers’ attention to business affairs, ‘away from their charitable duties,’” John Simon observed that “the diversified portfolio of a *non*-corporate-controlling foundation may require just as much financial attention as the single predominant investment of a corporate-controlling foundation.” Statement submitted to Subcomm. on Foundations, Comm. on Fin., U.S. Senate (Oct. 2, 1973), *in* THE ROLE OF FOUNDATIONS TODAY AND THE EFFECT OF THE TAX REFORM ACT OF 1969 UPON FOUNDATIONS: HEARINGS BEFORE THE SUBCOMM. ON FOUNDATIONS, Comm. on Fin., U.S. Senate, 93d Cong., 1st Sess. 175, 185 & n.2 (Comm. Print Oct. 1 & 2, 1973) (Statement of John G. Simon, Professor of Law, Yale University).

167. *See* I.R.C. § 4943 (1998) (taxes on excess business holdings). Specifically, a foundation can own up to 20% of the voting shares of any one business, reduced by shares held by disqualified persons; if a third party has effective control of the business, the foundation and disqualified persons may together own up to 35%. I.R.C. § 4943(c)(2).

168. *See* notes 200-212, *infra*, and accompanying text.

169. *See* U.S. SMALL BUSINESS ADMINISTRATION, UNFAIR COMPETITION BY NONPROFIT ORGANIZATIONS WITH SMALL BUSINESS: AN ISSUE FOR THE 1980’S (1984); GAO, COMPETITION BETWEEN TAXABLE BUSINESS AND TAX EXEMPT ORGANIZATIONS (1987).

170. *See* WRITTEN COMMENTS ON DISCUSSION OPTIONS RELATING TO THE UNRELATED BUSINESS INCOME TAX: SUBCOMM. ON OVERSIGHT, COMM. ON WAYS & MEANS, 100th Cong., 2d Sess. (Comm. Print WMCP: 100-30) (Apr. 21, 1988) [hereinafter 1988 COMMENTS]. One business league found itself uncomfortably on *both* sides of the issue, given that the proposals would have extended to all non-profits, not just charities. *See id.* at 830 (Letter from Albert D. Bourland, Vice President Congressional Relations, U.S. Chamber of Commerce: “We recognize the particular problems of smaller businesses, and support the third recommendation of the White House Conference on Small Business to eliminate unfair competition between for-profit and non-

Even at the time, small business's complaint that tax exemptions "allow the non-profit to lower the price of the goods or services" charged to customers sounded disingenuous.¹⁷¹ Either nonprofits underprice proprietary firms or they don't. If they do, isn't that what they're *supposed* to do? How can business be heard to complain if charities offer their exempt-purpose goods and services at as close to cost as possible? Moreover, for *unrelated* business activities, no theory or evidence would suggest that nonprofits find it in their interest to earn a lower return on their investment capital than the market will bear.¹⁷² Of course, the more entrants in an industry, the more prices will be driven down.¹⁷³ In the end, it appears that to small business, any competition is by definition unfair.¹⁷⁴

profit entities.")

Finally, the Chamber is very concerned that the discussion options appear to go further than necessary in order to eliminate unfair competition. For example, it is our understanding, based upon testimony received during the original hearings, that most of the criticism was directed at only a few 501(c)(3) organizations. The discussion options, however, would affect all Section 501(c) organizations, including trade associations, labor unions, social welfare organizations and chambers of commerce. The Chamber believes this far-reaching solution is inappropriate based on the prior testimony.

Id. at 831.

171. HEARINGS BEFORE THE SUBCOMM. ON OVERSIGHT, HOUSE WAYS AND MEANS COMM., 100th Cong., 1st Sess. 217-20 (Ser. 100-26, 1987) (statement of Joseph O'Neil, Chairman, Business Coalition for Fair Competition).

172. *See, e.g.,* Bittker & Rahdert, *supra* note 34, at 319 (finding no reason to believe that nonprofits will behave any more unfairly in their active business investments than they have in their passive investments, which are not subject to the UBIT). *See also, e.g.,* WELLFORD & GALLAGHER, *supra* note 124, at 101 & nn.188, 189 (stating there is no reason to expect that nonprofits are more likely to engage in predatory pricing).

173. *See* Richard Steinberg, "Unfair" Competition by Nonprofits and Tax Policy, 44 NAT'L TAX J. 351, 358 (Sept. 1991).

174. Small businesses were amply represented, particularly by for-profit sellers of hearing aids, who supported a proposal to treat the sale of medical equipment to out-patients as taxable. One passionate proprietor wrote, in part:

Forty years ago I graduated from college and bought this hearing aid office in Texarkana, borrowing the money from a loan on my G.I. Insurance, having been in the U.S. Navy from 1943 until 1946. Fitting and dispensing hearing aids has been hard work, requiring long hours every week to make a go of it. Even though we have paid city, county, school and state taxes on the business and our home, there has been great satisfaction in seeing our hard of hearing friends use their hearing aids to hold jobs and live normal lives.

It really gauls [sic] us at this time that the Temple Treatment Center can receive United Way funds and draw on Easter Seal money here in Texarkana, all the while selling hearing aids and batteries for profit, yet pay no city, county or school taxes. We couldn't stay open if we sold instruments \$200 below suggested retail prices as they do. We KNOW what unfair competition from 'nonprofit' organizations can do for you. Rather, TO you.

We *praise* the House Ways and Means Oversight Subcommittee for a very fine package of reform measures.

1988 COMMENTS, *supra* note 170, at 21 (Letter from A.L. Burns, Jr., Acousticon of Texarkana, Apr. 11, 1988) (emphasis in original).

The charities compellingly cited recent increased pressure to seek new sources of revenue.¹⁷⁵ For example, the Museum of Fine Arts in Boston described their museum shop and mail order sales as follows:

I can assure you that we are not undercutting to take business away. That is not our purpose because we are in the business to make a profit as well, and that profit is returned to the institutions to support cultural programs.

We believe the real reason for such concern on the part of the business community is that we have been *successful* in competing with them—a good old American Tradition.... However, our success has come from lots of hard work, just as theirs has, and *not* from exemption from taxation. We have had to create the sales, provide the quality of product and the level of service, just like any other business, and this costs money, time and expertise. And, we have had a lot more restrictions along the way as well. We have always sought to create and offer quality products in our shop that relate to the collection, by both our own criteria and because of current IRS standards. We cannot arbitrarily enlarge our product line like our colleagues in the business community. We cannot add a radio to hang in a shower or a digital VCR to our product line just to sell more.... Yet, we compete, and compete effectively, and that is the heart of the matter.¹⁷⁶

In adopting a scorched-earth strategy, most of the charities' letters suggested that taxes on profits from certain activities constitute punishment.¹⁷⁷ Often the charities were

175. Typically, one charity wrote:

At a time when the federal government has reduced direct aid to the nonprofit museum community, eliminated the individual taxpayers [sic] deduction for charitable gifts if they do not itemize, and raised nonprofit postage rates; the thought of further curtailment of income to nonprofits seems unthinkable.

The nonprofit community of museums is struggling now—particularly the smaller local organizations—to fulfill the national need for cultural, scientific and nature related research, education and exhibition. Areas such as museum gift shops, tours and travel programs and off premises sales are one small but significant way that we can remain viable.

I urge you to carefully consider the options. Please do not curtail further one of the few ways nonprofits can support themselves and remain a viable part of American society. The alternative is to have fully federally subsidized institutions, which just doesn't seem like our way of doing things.

Id. at 742 (Letter from Richard A. Horton, Director, Shaker Lakes Regional Nature Center, Apr. 12, 1988).

176. *Id.* at 235 (Letter of Ross W. Farrar, Deputy Director, Museum of Fine Arts, Apr. 13, 1988).

177. For example, one wrote:

As a civic, not-for-profit 501(c)(3) corporation ... and as you know ... revenues from any sources do not benefit any person. If we are fortunate enough to enjoy revenues in excess of expenses, which has not occurred in recent memory, those revenues would be used for capital improvements, programming, or other organizational needs or activities. Any taxes would only jeopardize present activities and future planning.

We serve a broad segment of our community, including people who enjoy our performances for as little as \$3.00 and who *could not* enjoy such a contribution to their quality of life if Starlight

as, if not more, concerned about a consequent loss of state or local tax exemption.¹⁷⁸ Some charities recognized the specific benefits of continued federal tax exemption (one mentioned the ability to attract donations, as well as to issue “section 501(c)(3) bonds”¹⁷⁹). Others were unable to view tax subsidies as equivalent to government funds.¹⁸⁰ Several charities expressed the belief that “the public *supports* allowing non-profits [the unrelated-business] methods of meeting rising and ever-demanding costs of staying viable,”¹⁸¹ the UBIT be damned:

In the non-profit theatre at least, I have difficulty even understanding the concept of “Unrelated Business Income.” As I understand the legal organization of our institution, we are non-profit and all income generated by the institution goes back into its programs and activities. No individuals disproportionately benefit from the income generating activities of a non-profit institution. If a non-profit is generating earned income and returning it to achieve the institution’s mission it should be congratulated, not taxed.¹⁸²

The Oversight Subcommittee’s most radical reform proposals had absolutely nothing to do with UBIT reform, if that term means ensuring that charities and their affiliates pay the proper amount of tax on taxable activities. Internal Revenue Code section 501(c)(3) requires that an exempt entity be organized and operated “exclusively” for a charitable purpose, but the regulations soften this by requiring the entity to be engaged

Theatre closed. Thus, our activities are critically important to the very social fabric of our community, and the many smaller surrounding communities which we serve. If any existing revenues are lost ... and any tax will cause their loss ... our very existence will be threatened.

Id. at 794, 795 (Letter from Robert M. Rohlf, General Manager/Producer, Starlight Theatre, Apr. 13, 1988).

178. *See, e.g., id.* at 829 (Letter from Terrie Cornell, Director, U.S. Border Patrol Museum, Apr. 11, 1988) (“And finally, if the Federal Government removes these tax exemptions for non-profits, the State of Texas and City and County of El Paso stand ready to do the same. Please do not restrict the non-profits’ tax-exempt status.”).

179. *Id.* at 270, 271 (Comments on Behalf of Butterworth Health Corporation About Discussion Options Relating to the Unrelated Business Income Tax: “Among the many reasons why exemption is essential is the continuing need of the organizations for tax deductible donations. Also, Butterworth Hospital used tax exempt bond financing for the construction of some of its facilities and loss of exempt status would constitute a default under the agreements governing the bonds.”)

180. One wrote:

The United Ostomy Association, like many other voluntary health organizations, depends largely on dues from its members, or on contributions raised through a variety of fund raising efforts. (We are not, and have never been, the recipient of federal, state, or local financial assistance.) To have such income taxed, and the net proceeds thereby lessened, we would have to consider some heretofore undesirable alternatives such as increasing dues to our members, a large majority of whom are senior citizens on fixed incomes. Please consider the application of special exemptions to non-profit voluntary health organizations.

Id. at 846 (Letter from Linda K. King, Secretary and Chairman, Government Affairs Comm., United Ostomy Association, Apr. 14, 1988).

181. *Id.* at 407 (Letter from William Hinman, President, North Carolina Museums Council, Apr. 11, 1988).

182. *Id.* at 382, 383 (Letter from Roche Schulfér, Producing Director, The Goodman Theatre, Apr. 8, 1988).

“primarily in activities which accomplish one or more of such exempt purposes...”¹⁸³ Moreover, the regulations de-emphasize activities in favor of purpose. An organization may still qualify for exemption under 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.¹⁸⁴

This has become known as the “primary purpose” test. The Oversight Subcommittee’s “aggregation proposal” would have required the Ways and Means Committee, in consultation with the Treasury Department, to develop objective tests for ascertaining when the activities of the charity’s *subsidiaries* should be reviewed in applying the primary purpose test to the charity.¹⁸⁵

The aggregation proposal must be read against the backdrop of the Service’s frustrating litigation experiences in trying to revoke the exemption of charities which engage in “too much” business activity.¹⁸⁶ The Service effectively conceded failure as early as 1964. Discussing Revenue Ruling 64-182,¹⁸⁷ a 1971 General Counsel’s Memorandum explained that the primary purpose test requires a determination of the charity’s *purposes* for engaging in the business activity; “a comparison of the relative physical size and extent of organizational activities devoted to business endeavors and to charitable endeavors in which the ends to which the beneficial use of an organization’s resources are applied are disregarded.”¹⁸⁸ That is, the “destination of income test” survives in testing the entity’s basic entitlement to exemption, even if particular activities wind up being subject to tax.¹⁸⁹ “The fact is,” continued the 1971 General Counsel’s Memorandum, “that business purpose and the devotion of charity property to business use to produce income in the administration of charity properties can be perfectly compatible with and fully in

183. Treas. Reg. § 1.501(c)(3)-1(c)(1) (1959).

184. Treas. Reg. § 1.501(c)(3)-1(e)(1) (1959).

185. *Ways & Means Oversight Subcommittee’s UBIT Recommendations*, June 23, 1988, available in LEXIS, Fedtax Library, Tax Notes Today File, as 88 TNT 132-5, June 24, 1988 (containing aggregation proposal in Part VI (Recommendations), part G) [hereinafter *Oversight Subcommittee’s UBIT Recommendations*].

186. Gen. Couns. Memo. 34,682, *supra* note 99: “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.” Footnote 3 to this statement cites to Kenneth C. Eliasberg, *Charity and Commerce: Section 501(c)(3) — How Much Business Activity?*, 21 TAX L. REV. 53 (1965), which details the Service’s unsuccessful litigation history on this issue.

187. Rev. Rul. 64-182, 1964-1 (Part 1) C.B. 186 (holding that a charitable corporation deriving its income principally from the rental of space in a large commercial office building, and making grants to other charities, is entitled to retain its exemption “where it is shown to be carrying on through such contributions and grants a charitable program commensurate in scope with its financial resources”). It has become common knowledge that the subject of this ruling is the Field Foundation, and the ruling is referred to as “the Field Foundation ruling.” Indeed, Gen. Couns. Memo. 34,682, *supra* note 186, at one point slips up and makes such a reference.

188. Gen. Couns. Mem. 34,682, *supra* note 99.

189. See Ellen P. Aprill, *Lessons from the UBIT Debate*, 45 TAX NOTES 1105, 1107 (1989). See, e.g., Priv. Ltr. Rul. 96-36-001 (Jan. 4, 1996) (ruling that a school conducting substantial publishing activities retains its section 501(c)(3) exemption because it conducts charitable activities commensurate in scope with its resources, but it must pay UBIT on the publishing profits).

furtherance of exclusively charitable purpose in the administration of such properties.”¹⁹⁰ Indeed, the memorandum continued by discussing the *obligation* of charity managers to make investment assets productive.

As charities in the 1980’s adapted to the wrenching financial forces that pushed them into more and more fee-generating activities, the Service encouraged charities to transfer unrelated business activities into separate, for-profit subsidiaries.¹⁹¹ Such a mechanism provides a clean structure for separating nontaxable (related and investment) activities from taxable activities. However, some of the resulting complex holding-company organizational charts resonated of big business, and invited unwanted attention.¹⁹²

The problem faced by proponents of the aggregation test was one of line drawing. Given the desirability of an objective standard, should “excess” business be defined by the percentages in the private foundation prohibition? The Oversight Subcommittee’s recommendation did not specify a maximum, but would have applied aggregation only to high-percentage investments (using an 80% ownership threshold). In addition, it enumerated five factors that should be taken into account in developing objective tests:

- (1) the time, attention, and importance given by the parent organization’s board of directors to tax-exempt activities as compared with unrelated business activities,
- (2) the organization’s expenditures for exempt activities as compared with expenditures for unrelated business activities,
- (3) income derived from the different activities,
- (4) reasonable expectation of earning a profit, and
- (5) staff time spent on different activities.

The Oversight Subcommittee’s report, though, did not specify the degree to which satisfying one or more of the criteria tips the balance.¹⁹³

190. Gen. Couns. Mem. 34,682, *supra* note 99.

191. The Oversight Subcommittee acknowledged this history, and suggested:

Inasmuch as some exempt organizations have stated that the IRS, in reviewing the structure of their operations, did not object to proposals to spin off substantial unrelated activities into controlled subsidiaries as a means of not jeopardizing their exempt status, the Subcommittee recommended in particular that the Committee develop phase-in rules or other appropriate provisions to accommodate such existing arrangements.

The Oversight Subcommittee’s UBIT Recommendations, *supra* note 185 at VI.G. See generally James J. McGovern, *The Use of Taxable Subsidiary Corporations by Public Charities—A Tax Policy Issue for 1988*, 38 TAX NOTES 1125, 1128 (Mar. 7, 1988) (stating that “the Service issued 593 private letter rulings to section 501(c)(3) organizations that operated in tandem with taxable subsidiary corporations between 1977 and 1986. In comparison, there were only 8 equivalent rulings issued in the previous ten year period.”). As McGovern explained, the restructuring nonprofit hospitals could no longer rely on the original ruling letters recognizing their exemption. “But for these major structural changes,” he observed, “the Service may not have been apprised of the scope of the use of taxable subsidiary corporations.” *Id.* at 1129.

192. The Internal Revenue Service shared with the Oversight Subcommittee the organizational chart of one hospital system with an exempt parent, 3 exempt subsidiaries, and 33 taxable subsidiaries. The then-IRS Assistant Chief Counsel (Employee Benefits and Exempt Organizations) called this “a bizarre creature where the exempt tail was wagging the taxable dog.” *The Booming Nonprofit Health Care Industry: How Much is Too Much?*, EXEMPT ORG. TAX REV. 148, 149 (April-May 1989) (remarks of James J. McGovern at the March 10, 1989 session of the 25th Annual Washington Non-Profit Tax Conference).

193. The Oversight Subcommittee, *supra* note 185, made several additional related recommendations. First, an existing rule taxes an exempt organization on the interest, annuities, royalties and rents it receives

Most fundamentally, however, was the issue of *why is aggregation a federal tax concern if all the proper tax is collected under the existing regime?* The Oversight Subcommittee declared:

The Subcommittee was informed that some organizations claiming tax-exempt status have incorporated multiple controlled subsidiaries in order to operate new, or purchase existing, unrelated trades or businesses. Tax-deductible funds or tax-exempt earnings received by the parent may be used to capitalize the subsidiaries, which then engage in business activities in competition with firms capitalized with after-tax funds of nonexempt owners. Disregarding these trade or business activities merely because they were operated through controlled subsidiaries would be elevating form over substance. The parent organization claiming tax-exempt status in essence could become a holding company owning a controlling interest of stock in numerous subsidiaries and undertaking exempt activities only when and to the extent the subsidiaries declare dividends; the managers of the parent could devote their attention to maximizing business profits, rather than their exempt missions. To avoid this incongruous result, the Subcommittee concluded, activities of a parent organization and its 80-percent controlled subsidiaries should be viewed as an integrated enterprise when applying the primary purpose test.¹⁹⁴

Accordingly, to the drafters of this recommendation, the tax-exemption rules go beyond collecting the “right” amount of tax to performing the “accountability” function¹⁹⁵ in the context of debt-financed passive income.¹⁹⁶ One commentator, shortly af-

from controlled subsidiaries (these are items deductible by the taxable payor); the proposal would have lowered the “control” threshold from at least 80% of voting stock to more than 50% percent by vote or value. (As discussed below, Congress enacted this proposal in 1997.) Second, the Oversight Subcommittee proposed that a controlled taxable subsidiary’s income could be no less than the UBI that would have resulted had the exempt parent conducted the activity directly. This would prevent, for example, the exempt parent from dropping a money-losing exempt activity down into the taxable subsidiary in order to soak up otherwise taxable profit. Third, for assets used partially in an exempt activity and partially in a taxable activity (such as a university football stadium leased for unrelated activities), an exempt organization could allocate a proportionate share of only the marginal costs of the dual-use assets to the taxable activity, thus losing depreciation and general overhead deductions. Exempt organizations criticized these proposals on the ground that rather than creating parity between exempt and taxable entities, the proposals would overtax exempt entities, and that existing rules of reallocation between related parties under Code section 482 can adequately police abuses. See, e.g., American Council on Education, *Unrelated Business Income Tax: Response to Discussion Options*, Apr. 15, 1988, in 1988 COMMENTS, *supra* note 170, at 84, 89-90; Letter of American Hospital Association (Apr. 15, 1988), in 1988 COMMENTS, *supra*, at 111, 118-20; Statement of the American Medical Association, Apr. 15, 1988, in 1988 COMMENTS, *supra*, at 132, 134-36; *Independent Sector, Position on “Discussion Options” for Changing the Unrelated Business Income Tax, As Listed by the Oversight Subcommittee of the House Ways and Means Committee*, April 15, 1988, in 1988 COMMENTS, *supra*, at 439, 444-45. See also Written Statement of the American Institute of Certified Public Accountants (May 9, 1988) (discussing “control” definition in the context of subsidiaries and joint ventures), in DISCUSSION OPTIONS ON THE UNRELATED BUSINESS INCOME TAX: HEARING BEFORE THE SUBCOMM. ON OVERSIGHT OF THE HOUSE COMM. ON WAYS & MEANS, 100th Cong., 2d Sess. 213, 219-221 (Serial 100-74, 1989).

194. See *Oversight Subcommittees UBIT Recommendations*, *supra* note 185, at part G.

195. See *supra* notes 141-143 and accompanying text.

196. The Treasury Department, however, acknowledged the limits of this role for the federal tax system:

ter leaving the staff of the Treasury Department in 1989, defended the aggregation proposal. "Management's sense of identity and focus shifts when unrelated activities are present, whether carried on directly or through a subsidiary, because of the irresistible attractions of empirebuilding."¹⁹⁷

I joined the Treasury Department's Office of Tax Policy staff shortly after the subcommittee's recommendations were issued. I confess that I never understood the federal tax concern behind the aggregation proposal: I couldn't find the leakage in the tax system when a charity conducts unrelated businesses through properly reporting taxable subsidiaries. I also did not buy the "empire-building" worries. Such concerns are best addressed by state law, which imposes obligations on fiduciaries of charitable organizations to exercise the twin duties of loyalty and care.¹⁹⁸ However, I do believe that the aggregation proposal can be explained by a sovereignty perspective. Once again, this perspective illuminates a proposal based more on suspicion than upon a rational determination to tailor appropriate subsidies or to accurately measure the tax base.

The aggregation proposal died, along with the rest of the UBIT proposals, in 1991.¹⁹⁹ However, Congress revived another one of the 1988 recommendations in the Taxpayer Relief Act of 1997.

There are of course limits on the extent to which the tax laws can be used to ensure accountability of tax-exempt organizations. For example, determining whether contributed funds are used wisely and efficiently is not a function of the tax law. Such accountability might be aided by fuller public disclosure required by the tax rules or by state authorities.

See Statement of O. Donaldson Chapoton, *supra* note 25, at 36.

197. Aprill, *supra* note 189, at 1108. Professor Aprill also suggested that the aggregation proposal might have been prompted by a fear that charities were using taxable subsidiaries to skirt the prohibition in Code section 501(c)(3) against private inurement. She then asked, however, "if parent and subsidiary are to be treated as one entity for purposes of the private inurement prohibition, should they be so treated for purposes of the prohibition on political activity and limits on lobbying activity?" *Id.* at 1107.

198. See generally Brody, *The Limits of Charity Fiduciary Law*, *supra* note 157. Compare with the following discussion in the 1971 General Counsel Memorandum:

We are speaking here of that aspect of the rule of charity law that requires the administration of charity property solely in the interest of accomplishing the charitable purposes for which it is held.... Closely related and perhaps logically inseparable ... are the "loyalty rule" and the "prudent man" rule to which fiduciaries are subject in the administration of charity property. However, except as embodied in express provisions of the Code ..., the Service has generally ignored these two aspects of operating requirements of charities and has seldom, if ever, attempted to require compliance with either of them as conditions of charitable qualification for federal income tax purposes.

Gen. Couns. Memo. 34,682, *supra* note 99, in footnote 5.

199. After a political dance between Congress and the Treasury Department, the Treasury finally took the public step of ending that round of UBIT reform. The then-Assistant Secretary of the Treasury wrote to key congressmen:

Turning now to the policy question, as you know, we reviewed the proposals of the task force in detail last year and spent considerable time with outside groups and Congressional staffs in an attempt to formulate an overall approach which could be enacted by Congress. That review and those consultations developed no set of proposals which would significantly improve tax administration with respect to UBIT and command a broad base of support. Accordingly, we make no specific proposals to the Committee.

Under Code section 512(b)(13) as enacted in 1969, Congress extended UBIT to apply to an exempt organization that receives income in the form of interest, royalties, rents and annuities from a “controlled” corporation. This rule arose from Congress’s belief that controlled subsidiaries could reduce or eliminate taxable income by making inflated payments of these deductible items, while the exempt parent would claim the corresponding UBIT exclusions for such classically passive items. (By contrast, dividends are not deductible by the paying corporation, and so no inclusion rule is needed to ensure one level of tax on this income stream.²⁰⁰) Under longstanding law, the definition of “control” required at least 80 percent ownership (and no attribution rules applied to reach stock owned indirectly).²⁰¹ Policy makers believed that if an outsider owned more than 20 percent of the stock, the outsider would police the fairness of the rental and similar payments.²⁰² However, such a loose definition of control easily permitted exempt organizations to avoid Code section 512(b)(13) by, for example, issuing multiple classes of stock, or by dropping the business down into a second-tier subsidiary. One of the 1988 UBIT reforms would have amended section 512(b)(13) by reducing the control requirement to more-than-50% of vote or value, by attribution-of-ownership tests, and by tightening the calculation of includible payments. At that time, observers objected to the pro-

We are, however, aware of certain specific complaints by small business concerning unfair competition by nonprofit organizations. To the extent Congress undertakes to address these issues by drawing brighter lines of demarcation between related activity and activity subject to UBIT, we would not oppose reasonable targeted provisions to provide such demarcation.

Letter from Kenneth W. Gideon, Assistant Secretary of the Treasury (Tax Policy), to Dan Rostenkowski, Chairman, Comm. on Ways & Means, and to J.J. Pickle, Chairman, Subcomm. on Oversight, Comm. on Ways & Means (May 23, 1991), *available in* LEXIS, Fedtax Library, Tax Notes Today File, as 91 TNT 152-1 (July 19, 1991).

200. As a general matter, Congress fears that purported debt is occasionally disguised equity, and thus “interest” payments actually constitute nondeductible dividends. In 1989, Congress enacted Code section 163(j), which denies a deduction for certain interest paid to exempt persons. *See* Prop. Treas. Reg. §§ 1.163(j)-0 through -10, 56 Fed. Reg. 27907-27 (1991). In general, this “earnings-stripping” rule will not apply until debt exceeds 60% of the paying corporation’s capitalization, and then applies only to “excess” interest expense (basically, the net interest expense in excess of 50% of the corporation’s taxable income). *Id.* Taxing the recipient rather than denying the deduction would not have achieved Congress’s goal of collecting a single-level of tax on the payments from Congress’s primary target—foreign investors not subject to U.S. tax.

201. *Compare* I.R.C. § 512(b)(13) (prior to amendment by P.L. 105-34) *with* I.R.C. § 512(b)(13)(D) (1997) (definition of control).

202. *See* Comments of the Council on Non-Profit Organizations (Apr. 15, 1988), *in* 1988 COMMENTS, *supra* note 170, at 324, 330:

Congress believed, however, that if at least 20 percent of the voting stock, or 20 percent of all other classes of the subsidiary’s stock, were held by unrelated parties, the subsidiary’s management would recognize the risk of violating their fiduciary duty to the outside shareholders and avoid agreements to pay above-market rents, interest, etc. The evil addressed by §512(b)(13) is not excessive control, but inflated payments. There is certainly no duty to avoid arm’s length payments, and exempt organizations ought not be punished for dealing with their subsidiaries at arm’s length.

Id.

posed changes; one observer charged that documented cases of continuing abuses are "rare" and that the actual frequency of abuse "probably is negligible."²⁰³

The years after the death of UBIT reform highlighted the weaknesses of Code section 512(b)(13). Most conspicuously for charities, the National Geographic Society obtained a private letter ruling from the Internal Revenue Service blessing National Geographic's creation of a holding company subsidiary to hold its taxable television ventures. The Service ruled that the second-tier subsidiary would not be a controlled subsidiary.²⁰⁴

Apparently out of the blue, however,²⁰⁵ Congress reformed Code section 512(b)(13) in the Taxpayer Relief Act of 1997 in the manner suggested in the earlier failed UBIT reform.²⁰⁶ The new law will begin affecting National Geographic, and other similarly situated exempt organizations with binding contracts, in the year 2000.²⁰⁷ Perhaps, as the *New York Times* suggested, National Geographic was lucky to escape repeal of its exempt status altogether,²⁰⁸ as happened in 1986 to Blue Cross/Blue Shield and other commercial insurance companies, and to TIAA-CREF in the Taxpayer Relief Act of 1997.²⁰⁹

The question remains, though, whether section 512(b)(13) makes sense. A stream of income will henceforth bear tax that would not bear tax if paid from an uncontrolled entity to the exempt organization. If, indeed, the payments of interest, rent, royalties or annuities represent fair value for the use of the exempt organization's assets, then Congress is overtaxing the arrangement.²¹⁰ Exempt organizations, for their part, will have to decide whether they should divest control of these entities to avoid the tax.²¹¹ More fun-

203. Scott A. Taylor, *Taxing Public Charities Out of Business: A Solution in Search of a Problem*, TAX NOTES, May 9, 1988, at 756.

204. Priv. Ltr. Rul. 95-42-045 (July 28, 1995) (unidentified exempt entity transferred its film library, trademark, subscription list, and other assets in return for stock and a promissory note; the exempt entity then contributed this stock to a holding company in return for the holding company's voting common stock); see Marlis L. Carson, *Exploring UBIT's Frontier: A National Geographic Production*, TAX NOTES, Dec. 18, 1995, at 1432, 1434 ("So long as the tax-exempt parent can show that it does not directly control the taxable subsidiary engaged in unrelated business activity, there seem to be no limits on the use of subsidiary arrangements.")

205. See Carson, *supra* note 204, at 1434 ("IRS officials say Treasury and the Service have interpreted the lack of congressional interest in amending the code as evidence of approval of the Service's liberal ruling approach.")

206. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, sec. 1041(a) (1997).

207. Taxpayer Relief Act of 1997, sec. 1041(b)(2); see Constance L. Hays, *Seeing Green in a Yellow Border*, N.Y. TIMES, Aug. 3, 1997, § 3, at 1, 11 ("Fine print in last week's tax package forces the society to begin paying taxes on millions of dollars of rents and royalties it collects from its for-profit subsidiary as of Jan. 1, 2000. 'We are strongly, negatively impacted by it,' Suzanne Dupre, the society's general counsel, said of the tax bill.")

208. See Hays, *supra* note 207, at 11.

209. See Brody, *Charitable Endowments*, *supra* note 2, at 947 n.383.

210. I have an easier time seeing the abuse in the case of royalties, where splitting the transaction across two entities would allow a deduction for a payment that could not be claimed if the charity conducted the unrelated business activity directly. See, e.g., Statement of O. Donaldson Chapoton, *supra* note 25, at 48 (sweatshirt embossed with exempt organization's logo). Other proposals in the 1988 UBIT package would have addressed the royalties issue more broadly, generally to apply UBIT to income from licensing self-created property (such as the entity's name or logo) in an unrelated business.

211. See, e.g., Fred Stokeld, *EO Specialists Have Doubts About Section 512(b)(13) Modification*, TAX

damentally, it is fair to ask why Congress took the blunt approach here, when it is willing to police transactions between related taxable parties under its broad powers to reallocate tax items between commonly controlled entities.²¹² Once again, legislation imposing mandatory tax in lieu of examining transactions for fairness can be explained only by an irrational suspicion of the charitable sector.

V. CONCLUSION

Policy makers at all levels of government have consistently failed to satisfactorily explain why they grant tax exemptions to charities. Nor do the existing schemes of exemption and exceptions form a principled framework. A sovereignty perspective allows us to see how government simultaneously defers to and restricts charitable activity. I suggest in this Article that underlying some of the more perplexing rules limiting the scope of exemption is an unarticulated vestigial fear of a too-powerful nonprofit sector, traceable to earlier periods when the most powerful charity was the church. At the same time, proposals to target subsidies meet with resistance in large part because efficiency claims cannot always be reconciled with sovereignty beliefs.

NOTES, July 21, 1997, at 319-20 (quoting attorney Celia Roady).

212. See I.R.C. § 482 (1997).

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