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State and Local Taxes on Nonprofit Organizations

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STATE AND LOCAL TAXES ON NONPROFIT ORGANIZATIONS

REBECCA S. RUDNICK*

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INTRODUCTION

State and local taxation of nonprofit organizations raises interesting conceptual issues regarding the relationship between government and the nonprofit sector. Traditionally, government and nonprofits have worked together with the understanding that the former would grant tax exemptions to the latter as a matter of social policy. Granting property tax exemptions, corporate income tax exemptions, and sales tax exemptions are all options the government exercises in an effort to maintain the plurality of services that can only be provided to society

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with the help of the nonprofit sector.¹ But according to *The Nonprofit Policy Agenda*, a comprehensive survey conducted by the associates of the Union Institute, the traditional relationship between nonprofits and government has been altered by government's need to expand its own revenue sources, which has had a direct impact on the tax status of the nonprofit sector.²

Operating under the assumption that nonprofit organizations provide society with valuable services it could not obtain elsewhere, the Union Institute devoted a section of *The Nonprofit Policy Agenda* to an analysis of the ways in which taxation affects the nonprofit sector's ability efficiently to provide those services. The five recommendations of the Institute, which pertain directly to state and local taxation, are provocative in scope. They attempt to untangle the confusion of governmental taxation policy toward nonprofits and recommend several actions that government might take to make its tax policy towards nonprofit enterprises more appropriate, if not revenue-conscious.

This article analyzes some of the issues raised by the complex relationship of nonprofits to state and local taxes, taking as a point of departure the directives set forth in *The Nonprofit Policy Agenda*. Using second-best analysis,³ it will critically evaluate the Union

1. The term nonprofit sector "posits a single characteristic—tax exempt status under the federal tax code as criterion for inclusion in the sector." PETER DOBKIN HALL, *INVENTING THE NONPROFIT SECTOR AND OTHER ESSAYS ON PHILANTHROPY, VOLUNTARISM, AND NONPROFIT ORGANIZATIONS* 244 (1992). See also ESTELLE JAMES, *THE NONPROFIT SECTOR IN INTERNATIONAL PERSPECTIVE* (1989); ESTELLE JAMES & SUSAN ROSE ACKERMAN, *THE NONPROFIT ENTERPRISE IN MARKET ECONOMICS* (1986).

2. The Union Institute is a university incorporated in Ohio as an independent, nonprofit institution of higher education. Its research and analysis section is the Center for Public Policy. The Union Institute published *The Nonprofit Policy Agenda* to draw attention to the government's role in controlling the nonprofit sector and to caution against regulation that is too restrictive. It argues that it is the government's responsibility to see that the nonprofit sector be given ample opportunity to offer its services to society. The study is conducted under the assumption that nonprofits do provide valuable services to society. DEBORAH KOCH, *THE UNION INSTITUTE, THE NONPROFIT POLICY AGENDA: RECOMMENDATIONS FOR STATE AND LOCAL ACTION* 87 (1992).

3. Second best analysis aims to define optimal policies to cope with distortions and inefficiencies in the marketplace. The theory asserts that the general guidelines for policy provided by welfare economics are not relevant for real-world economics, which are likely to reflect constraints on policy and market distortions. That is, once the world departs from perfect competition, it is unclear whether a policy change one way or the other will be more desirable. See R.G. Lipsey & Kelvin Lancaster, *The General Theory of the Second Best*, 24 *REV. ECON.* (continued)

Institute's recommendations for altering current governmental approaches to the nonprofit sector. It will suggest that a distinction should be made or maintained between commercial nonprofits and charitable nonprofits, given that the latter provide services the government would otherwise be forced to provide itself. Furthermore, this article will propose that governments should discriminate between the commercial and charitable activities of those nonprofits that undertake both.

I. THE RISE OF THE NONPROFIT SECTOR

In the realm of public services, the nonprofit organization has been entrusted with the execution of some of the primary tasks of government. At one point in this government's history, the charitable and philanthropic sector was funded solely by private organizations and individuals received donations only through private contributions. Today, however, government has become the most important source of income for most types of nonprofits, providing twice the resources of private contributions.⁴ Nonprofits have come to include much more than the traditional charitable organizations. Additionally, the extent of government support has grown by leaps and bounds, a significant portion of which has come in the form of tax relief. At the same time, the nonprofit community argues that it bears many "hidden taxes," such as utilities taxes, taxes on motor fuels, surcharges on business taxes, taxes on real estate transactions, and miscellaneous taxes including tax on insurance and alcoholic beverages.⁵

Tax relief is not considered unqualified, altruistic support for nonprofit organizations. Rather, tax relief is perceived as a government subsidy. Under this conception, government provides the subsidy to the particular nonprofit because it offers services to the community that government would offer, if it could do so effectively.⁶ Some commentators have questioned the efficacy and appropriateness of using the tax system

STUD. 11 (1956-57); see also Peter Bohm, *Second Best*, in 4 NEW PALGRAVE DICTIONARY OF ECONOMICS 280 (John Eatwell et al. eds., 1987).

4. Lester M. Salamon, *Partners in Public Service: The Scope and Theory of Government-Nonprofit Relations*, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 99 (Walter W. Powell ed., 1987); see also JOHN H. FILER, THE FILER COMMISSION REPORT (REPORT OF THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS), reprinted in part in THE NONPROFIT ORGANIZATION: ESSENTIAL READINGS 70 (David L. Gies et al. eds., 1990).

5. See HARRIET BOGRAD, HIDDEN TAXES ON NONPROFIT ORGANIZATIONS IN NEW YORK (Nonprofit Coordinating Committee Working Paper, Mar. 4, 1993).

6. See John G. Simon, *The Tax Treatment of Nonprofit Organizations: A Review of Federal and State Policies*, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK, *supra* note 4, at 67, 76; see also FILER, *supra* note 4.

to subsidize the nonprofit sector. Others conclude, however, that the tax system is an efficient point at which to locate the subsidy as it "permits decentralized decision-making through individual taxpayer choice."⁷

Congress has decided to subsidize nonprofit organizations by providing them with tax exemptions, thus encouraging certain desired behavior. The implicit intent of Congress, therefore, may have been to provide nonprofits with certain competitive advantages.⁸ This is, however, an oversimplified view of the legislative process. It assumes that but for government involvement with and preferential treatment of nonprofits, these organizations would not exist in sufficient numbers. It is assumed that nonprofits exist and are socially preferred because they are more efficient than their for-profit counterparts. But the overwhelming weight of the evidence does not exist to support this contention.⁹ In fact, one commentator has noted that "[i]t is fair to say that serious attempts to detect the social rationale for encouraging nonprofits in particular areas of economic activity have been scant and indecisive, at least in industries other than health care."¹⁰

7. Simon, *supra* note 6, at 78.

8. BURTQW WEISBROD, *THE NONPROFIT ECONOMY* 123 (1988). One commentator maintains that a subsidy made by exemption should be a limited subsidy and can be justified only if the activity supported is one which the government would have to perform if the nonprofit did not. In evaluating the exemptions for nonprofit institutions, the important questions are as follows: (1) Is the activity one whose local government costs should be subsidized; (2) To what extent should they be subsidized; and (3) Who should bear the cost of the subsidy? C.K. COBB, JR., *PROPERTY TAX EXEMPTIONS FOR NONPROFIT INSTITUTIONS*, reprinted in OLIVER OLDMAN & FERDINAND P. SCHOETTLE, *STATE AND LOCAL TAXES AND FINANCE* 330-32 (1974).

9. WEISBROD, *supra* note 8, at 123.

10. *Id.* at 124. According to Falcone and Warren, the health care arena is the best area in which to define the conflict between nonprofit organizations and for-profit organizations. They argue that nonprofit hospitals should be seen as a preferred means of giving equal access care without large direct federal subsidies. David Falcone & David G. Warren, *The Shadow Price of Pluralism: The Use of Tax Expenditures to Subsidize Hospital Care in the United States*, 13 J. HEALTH POL. POL'Y & L. 735, 739 (1988). Arrington and Haddock concur, saying that nonprofit hospitals have a higher rate of return in terms of social benefits than for-profit hospitals. Barbara Arrington & Cynthia C. Haddock, *Who Really Profits from Not-for-Profits?*, 25 HEALTH SERVICES RES. 291, 303 (1990). Herzlinger and Krasker present a dissenting view, saying that nonprofit hospitals do not live up to their social promise because, overall, they do not give greater social benefit than for-profits. Regina E. Herzlinger & William S. Krasker, *Who Profits from Nonprofits?*, 65 HARV. BUS. REV. 93; see also Cyril F. Chang & Howard P. Tuckman, *The Profits of Not-for-Profit Hospitals*, 13 J. HEALTH POL. POL'Y & L. 547 (1988).

Many scholars accept the proposal known as the "public goods theory."¹¹ Under this doctrine, nonprofits fill gaps in the market when private producers fail to allocate goods and services efficiently.¹² Government can and does play a major role in regulating market forces, but the political and legal constraints on government make it an imperfect provider of collective goods; it tends to meet the demands of the majority, leaving demands of some minority groups unsatisfied. The public goods theory posits that nonprofits, such as the American Heart Association and the March of Dimes, serve specific communities where the government is unable to provide enough support. "Because nonprofits are free of this political constraint, they may complement government's activities to overcome limitations of the private enterprise."¹³

The fact that nonprofits often produce purely private goods renders the public goods theory questionable. Scholars have therefore developed an alternative theory which holds that nonprofits step in when commercial enterprises fail to live up to their "contract." The consumer feels safer patronizing a nonprofit, which has no reason to economize and therefore no reason to cheat the consumer in the interest of higher profits. For instance, if the public fears that a for-profit day care center is overcharging or economizing on service and the day care loses the confidence of its clients, a nonprofit might be able to hold that confidence more effectively. The nonprofit thus is viewed as a more trustworthy organization because its primary function is not the pursuit of profit. The nonprofit therefore enjoys a competitive advantage among consumers who sense this difference.¹⁴

The altruism theory of tax exemption provides yet a third alternative for understanding favorable tax treatment of nonprofits. It combines primary benefits, metabenefits, and the prohibition on private inurement in a different way.¹⁵ The altruism theory is based on the idea

11. Henry Hansmann, *Economic Theories of Nonprofit Organization*, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK, *supra* note 4, at 28-29.

12. *Id.*

13. WEISBROD, *supra* note 8, at 163 (concentrating on demand as the reason for the rise of the voluntary sector); *see also* Hansmann, *supra* note 11, at 29.

14. Hansmann, *supra* note 11, at 29-30.

15. For a summary of these concepts, see Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501 (1990). The altruism theory synthesizes the traditional subsidy theory and the technical definition theory. According to Atkinson, the traditional subsidy theory views nonprofits as providing two types of benefits—primary public benefits and "metabenefits." Primary public benefits are inherent in an organization's activities. They can be goods or services which are inherently good, or they can be ordinary goods and services provided to the needy. Metabenefits do not concern any specific product, but instead derive from how a product is distributed or produced. This

(continued)

that nonprofits are given a preference (favorable tax treatment) because of the primary and metabenefits they provide.¹⁶ The theory advances the idea that tax-exempt status for nonprofit organizations is not truly necessary, but instead represents a social policy choice that must be made on grounds other than efficiency.¹⁷ Under this theory, the metabenefit of an organization's altruistic production is sufficient to exempt the organization's income, without inquiring into the public benefits to be derived from it.¹⁸

Tax exemptions give nonprofits a competitive advantage over for-profit organizations. Thus, it is probable that tax exemption influences the overall pace of nonprofit development.¹⁹ The pattern of nonprofit development demonstrates that the availability of a tax exemption is not determinative of whether a given activity will be organized in traditional nonprofit fields.²⁰ Yet, distortions in investment choices occur where capital income in various industries is taxed at different rates within the corporate sector, and when tax provisions such as depreciation rules are more favorable to one industry than to another.²¹

The Internal Revenue Service cannot deny a nonprofit entry into the market on the basis that too much competition already exists. Similarly, it cannot encourage organizations to enter into the nonprofit sector, even if such increased activity is deemed desirable.²² Perhaps government could

theory allows the government to encourage organizations to provide goods, thus promoting public welfare through charitable exemption. *Id.* at 605. The technical definition theory extends tax exemption to all forms of public service organizations. This theory rests on the notion that defining such organizations' income and their placement within a tax bracket is inherently difficult. *Id.* at 610-12.

16. *Id.* at 618.

17. *Id.* at 619.

18. *Id.*

19. See Henry B. 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, 79 (1987). The higher the level of a state's taxation of private business, the greater the competitive value a nonprofit receives by the exemption from those taxes. Thus, in states that have higher property tax, sales tax, and corporate income tax rates, nonprofit organizations receive a greater subsidy than do nonprofits in states with lower tax rates. Exemption from property taxation gives nonprofits a particular incentive to locate in city centers, where property tax rates are usually high. *Id.* at 77.

20. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 882 (1980).

21. RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 283 (5th ed. 1989).

22. WEISBROD, *supra* note 8, at 161. Nonprofit firms compete with one another in the markets for donations, memberships, and sales. See Julian
(continued)

indirectly improve the overall market performance affecting the nonprofit sector by employing tax and regulatory levers to control excessive or inadequate competition. It is not clear exactly how nonprofit firms decide whether to utilize cost and revenue advantages to increase their market share, or to build market size or corporate emoluments. In some cases, advantages merely compensate for other disadvantages, such as lack of access to financial capital.²³

The justification for a broad exemption policy may rest on the underlying assumption that, "any measure that expands the domain of one form of institution affects all other forms."²⁴ This is so because of the interdependent nature of the institutions that comprise the nonprofit sector. Accordingly, "there can be no such thing as sound public policy toward nonprofits—because policy can be wisely constructed only if it recognizes the ways that nonprofits interact with other elements of the economic system."²⁵

A free market will always misallocate a few commodities, such as public goods, even without the pressure of tax induced distortions.²⁶ Thus, economic welfare in general will suffer unless public policy can be used to correct the situation.²⁷ Efficiency alone may justify using tax exemptions to subsidize nonprofits.²⁸ In terms of allocation of capital, distortions

Wolpert & Thomas Reiner, *The Not-For-Profit Sector in Stable and Growing Metropolitan Regions*, 20 URB. AFF. Q. 487 (1985). Wolpert and Reiner provide a regional focus on not-for-profit organizations, arguing that such a limited focus leads to a better understanding of the nonprofit sector.

The nonprofit sector competes with for-profit and government sectors in markets for skilled labor, sales, and reduced (or zero) cost service provision. See Richard Steinberg, *Nonprofit Organizations and the Market*, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK, *supra* note 4, at 118-19; see also Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327 (1983).

23. Steinberg, *supra* note 22, at 119, 133.

24. WEISBROD, *supra* note 8, at 160.

25. *Id.*; see also Lee Clarke & Carroll L. Estes, *Sociological and Economic Theories of Markets and Nonprofits: Evidence from Home Health Organizations*, 97 AM. J. SOC. 945 (1992) (discussing the differences between for-profits and nonprofits in terms of the modes of each entity, either as a specialist or a generalist).

26. Charles T. Clotfelter, *Tax-Induced Distortions in the Voluntary Sector*, 39 CASE W. RES. L. REV. 663, 666 (1988) (Welfarist models of tax optimization evaluate tax efficiency in terms of ante- and post-tax distribution of resources, income, or prices: "[d]istortions arise when taxes change the ratio of prices away from the value that would exist in absence of taxation."); see MARTIN FELDSTEIN, *THE SECOND BEST THEORY OF DIFFERENTIAL CAPITAL TAXATION* 2-4 & n.4 (1985).

27. Clotfelter, *supra* note 26, at 666.

28. *Id.*

may appear in some sectors due to the possible "x-inefficiency" of nonprofits.²⁹ Due to the preferential treatment of nonprofits, the overall efficiency of some markets may be impaired. Nonprofit equity itself may also be inefficient,³⁰ although the evidence is mixed.³¹ While distortions exist, even economists critical of nonprofits maintain that a full-scale dismantling of the tax provisions that sustain nonprofits is not justified.³² Exemptions and deductions are supported by the most basic models of welfare economics.³³ If these tax provisions would be eliminated, an immediate concern would arise that society will no longer allocate enough time and resources to such altruistic activities.³⁴ Otherwise, when the public benefit is not a factor, the exemption of nonprofits in a market where nonprofits and for-profits perform alternate activities appears distortionary, raising problems of horizontal equity.³⁵

Most of the aforementioned models have as a prerequisite economic efficiency, as discussed above, and horizontal equity. The equity principle is perceived as the before-tax and after-tax distributional status quo. Alternatively, some authors regard the status quo as a result of an intrinsically justified process.³⁶

Currently, powerful forces are leading the voluntary sector away from its role as a partner in public service. Rather than leading the sector toward a more charitable mode of operation, nonprofits instead are tending to move toward greater integration into the private market

29. *Id.* at 692. The theory of "x-inefficiency" suggests that business entities constrained by vigorous competition have lower production costs than businesses in an industry with little or no competition. Harvey Leibenstein, *Allocative Efficiency vs. "x-Efficiency,"* 56 AM. ECON. REV. 392 (1966).

30. See Howard P. Tuckman & Cyril F. Chang, *Nonprofit Equity: A Behavioral Model and Its Policy Implications,* 11 J. POL'Y ANAL. MGMT. 76 (1992) (noting that nonprofit decision-makers have an incentive to earn and accumulate surpluses of equity yet government does not perceive this as the accumulation of profit, because it is assumed that this surplus will go towards their social mission).

31. See Edwin G. West, *Nonprofit Organizations: Revised Theory and New Evidence,* 63 PUB. CHOICE 165 (1989); see also Dennis Zimmerman, *Nonprofit Organizations, Social Benefits, and Tax Policy,* 44 NAT'L TAX J. 341 (1991).

32. See, e.g., Clotfelter, *supra* note 26, at 693.

33. *Id.*

34. *Id.*

35. *Id.*

36. See Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle,* 42 NAT'L TAX J. 139, 147 (1989). These alternative models regard horizontal equity as generally outside the social framework, a by-product of the optimization process.

economy.³⁷ The notion of the voluntary sector as a last line of defense in cases of "market failure" and "government failure" takes too little account of the inherent strengths and weaknesses of the voluntary sector, particularly the sector's exceptional capabilities as a deliverer of human services. Furthermore, such a notion ignores the inherent difficulties in raising resources and ensuring uniformity of coverage.³⁸

Major changes will likely alter the character of the voluntary sector in fundamental ways. Among the most likely changes, the traditional partnership between government and the nonprofit sector will be removed from its place as the central organizing principle. Additional modifications will include resource constraints, reorganization in the composition of welfare spending, a move from producer subsidies to consumer subsidies, demographic developments, and a shift from cultural to economic explanations of poverty.³⁹

In general, however, with respect to fulfilling society's needs, some sort of alliance between government and the nonprofit sector must be maintained because "the voluntary sector's weaknesses correspond well with government's strengths, and vice versa."⁴⁰ Given the likelihood that the relationship between government and the nonprofit sector will remain fluid, questions of taxation and tax exemption take on a new importance. Several underlying questions remain, such as whether state and local economic development policies will affect the growth in a particular area, or simply how the taxation or tax exemptions will play out.⁴¹ In order to ensure that society's needs are met, the status of nonprofit organizations in general and their status with respect to tax exemption in particular must continually be analyzed.

37. Lester M. Salamon, *The Changing Partnership Between the Voluntary Sector and the Welfare State*, in *THE FUTURE OF THE NONPROFIT SECTOR: CHALLENGES, CHANGES, AND POLICY CONSIDERATIONS* 41 (Virginia A. Hodgkinson et al., eds., 1989).

38. *Id.* at 44.

39. *Id.* at 45-50; see also MICHAEL O'NEILL, *THE THIRD AMERICA: THE EMERGENCE OF THE NONPROFIT SECTOR IN THE UNITED STATES* (1989).

40. Lester M. Salamon, *Partners in Public Service: The Scope and Theory of Government-Nonprofit Relations*, in *THE NONPROFIT SECTOR: A RESEARCH HANDBOOK*, *supra* note 4, at 99, 113.

41. TIMOTHY J. BARTIK, *WHO BENEFITS FROM STATE AND LOCAL ECONOMIC DEVELOPMENT POLICIES?* 58 (1991).

II. GENERAL RECOMMENDATION OF THE UNION INSTITUTE

To qualify for tax exempt status under Section 501(c)(3) of the Internal Revenue Code of 1986, a nonprofit organization must satisfy four initial criteria:

First, an organization must be organized and operated exclusively for one of eight exempt purposes: religious, charitable, scientific, public safety, literary, educational, testing, for fostering amateur sports, or preventing cruelty to children or animals. Second, the organization's net earnings must not inure to the benefit of any private shareholder or individual. Third, an organization must not engage in substantial political activity. Fourth, the organization must not engage in activities violative of established public policy.⁴²

In 1985, 366,000 out of a total of 887,000 nonprofit organizations were considered tax exempt under the conditions elucidated in Section 501(c)(3).⁴³ In 1987, 390,668 organizations enjoyed exemption, while in 1989, 460,289 such organizations were deemed exempt.⁴⁴ The increase from 1987 to 1989 is consistent with the growth in all major code areas.⁴⁵ Since World War II, the nonprofit sector of our economy has doubled, from two percent to four percent of the gross national income.⁴⁶

This enormous growth cannot solely be attributed to an automatic grant of governmental special treatment to nonprofits.⁴⁷ Governments have sounded a broad retreat from favoring the nonprofit organization. Several factors illustrate this curtailment. First, governments have completely withdrawn exemption in certain areas.⁴⁸ Second, tax laws distinguish between the charitable and commercial activities of

42. Trevor A. Brown, *Religious Nonprofits and the Commercial Manner Test*, 99 YALE L.J. 1631, 1632 (1990) (referring to I.R.C. § 501(c)(3) (1986)); see also Bruce R. Hopkins, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 3-29 (6th ed. 1990).

43. WEISBROD, *supra* note 8, at 169.

44. See INDEPENDENT SECTOR STAFF, *THE NONPROFIT ALMANAC 1992-1993* 193 (Virginia Ann Hodgkinson et al. eds., 4th ed. 1993). Table 5.8 indicates that there were 133,336 § 501(c)(4) organizations. *Id.* at 201.

45. *Id.* at 196.

46. WEISBROD, *supra* note 8, at vii.

47. Henry Hansmann, *The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?*, 39 CASE W. RES. L. REV. 807, 818 (1989).

48. *Id.* at 817. For example, the 1983 Social Security Act made Social Security taxes mandatory for nonprofits, whereas in the past these taxes had been voluntary. *Id.*

nonprofits.⁴⁹ Third, tax laws have begun to differentiate among the various types of nonprofit organizations, taking away exemptions from organizations that governments deem unworthy. In some cases, organizations have been given exempt status, whereas other organizations that undertake similar activity have not been granted a tax exemption.⁵⁰ The problem at the federal level is often exacerbated by the vast array of local and state government approaches to the question of who deserves exemption. Henry Hansmann addresses this problem, suggesting that in fiscal law there is a good case for discriminating among nonprofits with respect to the functions they serve. Specifically, he recommends that exemptions to truly charitable organizations should only be given at the federal level. However, he suggests that the use of the federal income tax system to regulate discriminatory standards for nonprofit organizations may actually be a means of constitutionalizing the tax system, eliminating the distortions that occur when a variety of standards are used at the local and state level.⁵¹

Many problems also exist at the state level, where criteria for determining charity-exempt status are not as clearly defined as they are in the Internal Revenue Code. The Model Nonprofit Corporation Act of 1964 remains the prevailing law in most states, but it allows for a wide variety of standards. As a result, the Act was revised and adopted by the American Bar Association in 1987, to which many states reacted favorably by adopting its revisions.⁵² While all states require that a charitable organization produce no personal or private financial gain, state policies vary on other criteria for charitable status. *The Nonprofit Policy Agenda* argues that this lack of a consistent policy impedes the process of determining whether an organization should be considered charitable and therefore tax exempt. To remedy the situation, the Institute makes the first of its taxation recommendations: "State governments should adopt consistent rules governing the determination of charitableness for property tax and other exemption purposes."⁵³

This general recommendation, if applied, might serve as the first step in a more rational use of the tax exemption as a subsidy to organizations that benefit their constituencies. However, many corrupting factors may be present. In addition to the fact that the use of charitableness as a criteria for tax exemption has a common law origin⁵⁴ and that the eligibility of nonprofits for tax exemption is by necessity

49. *Id.* at 817-18.

50. *Id.*

51. See Steinberg, *supra* note 22, at 118.

52. REVISED MODEL NONPROFIT CORPORATION ACT (1988).

53. KOCH, *supra* note 2, at 89 (Recommendation 46).

54. See *Bob Jones University v. United States*, 461 U.S. 574, 575 (1983).

highly fact specific, federalism means that the definition of "charitableness" will by necessity be determined on a state-by-state basis.⁵⁵ Federalism preserves the independence of the states in establishing and implementing basic policies such as tax exemption, the criteria for which cannot so readily be made uniform as the corporate rules for conduct of nonprofits. To say the least, the Union Institute consistency recommendation is ambiguous. Moreover, it is unclear exactly what the Institute proposes should be made consistent. Does the Institute suggest consistency among states, or within states? As the following sections of this article illustrate, consistency within the various taxes (property, sales, and income) involve resolving basic issues as to the nature of an organization's activities that should receive tax exemption.

III. PROPERTY TAX EXEMPTION

A. *Qualification for Exemption*

One writer recently noted that "no other tax varies along so many significant dimensions" as the property tax.⁵⁶ If one delineates the reasons why the property tax is such a complicated revenue source, it becomes clear why reform of the system has been attempted in so many ways. First, the tax is actually an amalgam: property taxes consist of land taxes and structure taxes, which are assessed separately but billed as one.⁵⁷ Second, the property tax is locally assessed, with rates both variably determined by law and variably applied in practice.⁵⁸ While a standard approach may exist for the granting of exemptions, every state has its own particular idiosyncrasies.⁵⁹ Finally, the exemptions to which

55. For a critical look at state and local taxes and federalism, see Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895 (1992).

56. James Heilbrun, *Who Bears the Burden of the Property Tax?*, in THE PROPERTY TAX AND LOCAL FINANCE 57 (C. Lowell Harriss ed., 1983).

57. Walter Rybeck, *The Property Tax as a Super User Charge*, in THE PROPERTY TAX AND LOCAL FINANCE, *supra* note 56, at 143.

58. Heilbrun, *supra* note 56, at 58.

59. Texas includes religious, charitable, scientific, literary and educational purposes in its definition, but then delineates specific acts that each type of organization must undertake to retain its exempt status. [1 Tex.] St. Tax. Rep. (CCH) ¶ 20-142. Furthermore, the organization must be considered nonprofit according to I.R.C. § 501 (C)(3); its operation must not result in the accrual of profits or the realization of private gain beyond reasonable salaries, and it must be defined as a nonprofit according to the Texas Nonprofit Corporation Act. Court opinions, state legislation, and opinions of the state attorney general have amended and refined the state's exemption policies. In general, Texas' (continued)

the property tax is subject can be applied accurately or not, at the whim of the assessor.⁶⁰

For most nonprofit entities, exemption from state and local real property taxes probably provides greater financial significance to the organization than the exemption from the corporate income tax.⁶¹ The development of the property tax exemption seems to have mimicked the growth of nonprofit organizations; the exemption was not a preexisting

approach is consistent with the majority of states. California has established separate standards for religious, educational, and charitable organizations. However, the state recognizes a unique standard for its "welfare exemption," which follows the Texas approach. [2 Cal.] St. Tax. Rep. (CCH) ¶ 20-530. In California, like Texas (and all states without exception), subsequent practice, decisions, and amendments have refined the state's exemption policies. Each of the states has established standards governing exemptions given to charitable organizations that include some reference to the exempt purpose of the property (or sales) in question. Louisiana, for instance, has legislated that "none of the property listed . . . shall be exempt if owned, operated, leased, or used for commercial purposes unrelated to the exempt purposes of the corporation or association." [2 La.] St. Tax. Rep. (CCH) ¶ 90-297. New York has (at least on paper) addressed one of the problems that arise regarding the property tax exemption by allowing municipalities to enact local taxes to make up for revenues lost due to exemptions given to certain organizations (some Bible, fraternal, historical, and other organizations that are not clearly charitable or religious in nature). [2 N.Y.] St. Tax. Rep. (CCH) ¶ 20-250. Florida recently (1991) amended its statutes to give the state more freedom to revoke exemptions. The state can now invoke a "reasonableness" standard when evaluating an organization: the reasonableness of salaries to employees, charges to clients, and other payments are now criteria in the granting or repealing of an exemption. [2 Fla.] St. Tax. Rep. (CCH) ¶ 91-336. Washington separates religious and nonsectarian nonprofits, but within each designation there are requirements that the organizations "undertake eleemosynary" (for religious organizations) or "character building" (for the nonsectarian organizations) activities [1 Wash.] St. Tax. Rep. (CCH) ¶ 20-203b, 20-204, 20-204a. The Indiana Code § 6-1.1-10-16(a), as authorized by the Indiana Constitution, states that "[a]ll or part of a building is exempt from property taxation if it is owned, occupied, and used by a person for educational, literary, scientific, religious, or charitable purpose." *Id.* The court in Indianapolis Elks Bldg. Corp. v. State Bd. of Tax Comm'rs, 251 N.E.2d 673, 681-83 (Ind. App. 1969), held that these enumerated purposes, as used in the property tax exemption statute, are to be defined and understood in their broad constitutional sense, and that for charity, there must be "evidence of relief of human want . . . manifested by obviously charitable acts different from everyday purposes and activities of man in general." *Id.*

60. Paul Corusy, *Improving the Administration of the Property Tax*, in THE PROPERTY TAX AND LOCAL FINANCE, *supra* note 56, at 86.

61. Hansmann, *supra* note 47, at 882.

condition of nonprofit status.⁶² The property tax exemption affords to charitable nonprofit organizations a valuable benefit because it reduces the price of providing a "unit" of charitable services.⁶³ While simultaneously acting as a government subsidy, the property tax exemption makes the cost of the charitable service smaller for the organization. The amount of the subsidy depends on the local property tax rate. Nonetheless, given general public hostility to the property tax, the fact that the subsidy involved is not subject to easy public scrutiny, and the dangers it poses to the coffers of local governments, there have been numerous suggestions to make the exemption more rational, more fair (from the perspective of local government), and more publicly accountable. Many of the topics discussed below in terms of nonprofits are already in vogue in a much broader forum.

While states once relied heavily on revenue from property taxes, today the state property tax is nearly extinct. Municipalities, however, continue to rely on the property tax for much of their revenue.⁶⁴ In 1982, property taxes represented one percent of states' revenues, whereas thirty percent of the revenues of local governments nationwide consisted of monies generated from the property tax.⁶⁵ Thus, it is easy to understand how local efforts to maintain a tax base dependent on property tax revenues are complicated when a state grants an organization an exemption. Local government officials have found themselves in a "Catch-22" situation in which a good portion of their revenue sources is exempted by the state from taxation.

The burden of assessment lies on the local government. Because individual governments have unique physical assessment capabilities, a nonprofit entity exempted from taxes on the state level will benefit to a

62. *Id.* at 839-40. A sampling of states from each region of the United States shows that most begin with the basic assumption that charitable nonprofits must operate in the interests of a sector of society deserving of charity.

63. "A property tax exemption provision that reduces the cost of providing charitable services by, for example, 10% would be expected to have the same effect on charitable giving as a 10% reduction in the tax-defined price of giving a dollar to charity." Charles T. Clotfelter, *Tax Incentives and Disincentives for Charitable Giving, in INDEPENDENT SECTOR, WORKING PAPERS FOR SPRING RESEARCH FORUM: SINCE THE FILER COMMISSION* 347, 358 (1983). A "unit" of charitable services is the set amount of services that a donor intends to allocate his money to provide. The hypothesis suggests that, if the price of providing those services changes, the donor's charitable giving would change by that same amount; a change in the price of providing a service leads to a proportional change in the amount of a donor's contributions. *Id.*

64. Glenn W. Fisher, *Property Taxation and Local Government: Four Hypotheses*, 8 PROP. TAX J. 113, 119-20 (1989).

65. *Id.* at 120.

different degree in its various assessment jurisdictions.⁶⁶ A statewide assessment system might equalize the effect of state legislation on nonprofits in several locations within a state. Such a uniform assessment standard is the ideal to which the system aspires, but as the literature notes, this standard is impossible to achieve.⁶⁷ Courts do not consider the law, where uniformity is the standard, to be the determinative factor in assessing tax fairness.⁶⁸ Instead, courts recognize the standard practice as the determinant.⁶⁹ The nonprofit with several offices in different jurisdictions will benefit or lose because of this variable assessment, and the local government will suffer for its inability to assess adequately properties in its jurisdiction.⁷⁰

These findings are supported by a study on property tax exemptions and local fiscal stress.⁷¹ Using a multi-jurisdictional approach in order to reflect the numerous local tax levies that may affect a single parcel of land, the study finds that broad categories for determining property tax exemption translate into fiscal burdens for local jurisdictions.⁷² This study, however, also suggests that when localities have some control over the effect of a property tax exemption, which is the case when the state grants only a partial exemption, the local government can often easily mitigate the negative fiscal effects.

The above considerations depend on the assumption that a local government will be generally hostile toward the granting of an exemption, especially by the state. But another, perhaps contrary consideration suggests that nonprofits can be a significant benefit locally, thereby offsetting the negative fiscal effects of an exemption. The property tax exemption may encourage firms to locate in large cities and may mean that the core central city would be largely occupied by nonprofits. In a second-best world, there may be significant offsetting effects of nonprofit activity within a city, such as an increase in the price and the attractiveness of other property due to the amenities provided by the nonprofit sector. The question is whether nonprofits generate positive externalities that in fact outweigh the negative impact of reduced property tax collection.

66. John K. Mullen, *Property Tax Exemptions and Local Fiscal Stress*, 43 NAT'L TAXJ. 467 (1990).

67. See e.g., John H. Bowman & John L. Mikesell, *Assessment Uniformity: The Standard and Its Attainment*, 9 PROP. TAXJ. 219, 220 (1990).

68. *Id.*

69. *Id.* at 221.

70. *Id.*

71. Mullen, *supra* note 66, at 467.

72. *Id.*

B. Nonprofit Market Share

The recommendation that states institute a consistent system for determining whether an organization is tax-exempt leads to a variety of reproaches, all of which require further analysis. One current concern with such a system centers around the notion that the property tax exemption creates an unfair market share for nonprofits in any particular area.⁷³ This contention is not necessarily true. For instance, with respect to the effects of property tax exemption on hospital location, higher property taxes do not give rise to a greater nonprofit hospital share. Higher property tax rates raise the chance that there will be only one hospital in a county, but the tax rate does not determine whether the hospital will be for-profit or nonprofit.⁷⁴

Additionally, commentators debate whether a property tax exemption furnishes a rational means to support wealthy organizations. Many of these commentators believe exemptions cause over-investment in property.⁷⁵ Wealthy organizations receive substantial benefit while poor, struggling entities, which in fact may be doing significantly more good work, may not benefit at all because they rent their facilities.⁷⁶

C. Taxpayer Equity

Property tax exemptions also raise fundamental questions of taxpayer equity, specifically whether it is fair to force the taxpayers who reside near the exempt property to pay for the revenue loss when all of the citizens of the region benefit from the nonprofit.⁷⁷ Clearly, when a state grants a property tax exemption to an organization that serves a constituency larger than the locality in which it is located, fairness to the municipality is undermined. In addition, consideration must be given to which activities deserve exemption, thus raising the issue of charitability. Does the nonprofit activity fill a gap in government services and thus deserve in return a government subsidy in the form of a tax exemption? The case for exemption weakens if the activity in question can command sufficient fees to pay for local services, if the

73. Hansmann, *supra* note 19, at 71. Tax exemptions significantly increased the market share of nonprofits in relation to their for-profit counterparts.

74. Cyril F. Chang & Howard P. Tuckman, *Do Higher Property Tax Rates Increase the Market Share of Non-profit Hospitals?*, 43 NAT'L TAX J. 175, 179 (1990).

75. STEPHEN DAVID GOLD, *PROPERTY TAX RELIEF* 175, 242-43 (1979).

76. *Id.*

77. *Id.* at 190; John M. Quigley & Roger W. Schmenner, *Property Tax Exemption and Public Policy*, 23 PUB. POL'Y 259, 259-97 (1975).

activity has no quasi-public features, or if the activity can be directed solely toward middle-income or upper-income individuals because such activities would bring a redistribution of wealth away from the poor.⁷⁸ In other words, the case weakens for commercial nonprofits and for those that do not act as charitable enterprises servicing the area in which they are located.

The evidence is quite clear that nonprofits in the center cities serve the suburbs to an inequitable degree.⁷⁹ In many situations, however, locally financed subsidies may still be inappropriate, even if the decision makers could agree that government subsidy to nonprofits in general is good. For example, because students at a university frequently come from outside the local government area, it would be more appropriate for a state or federal government to finance any subsidy that is warranted. Thus, a property tax exemption that is unaccompanied by a subsidy from the state to the locality may not be appropriate.

Consequently, the tax-exempt institution finds itself responsible for upgrading the neighborhood in which it is located. In this case, a property tax exemption may be warranted in spite of the fact that the enterprise serves a larger population than the locality. There is no guarantee, however, that this property will generate a large enough fiscal surplus to make up the costs of providing services to the tax-exempt buildings.⁸⁰ If most of the expenditures of an organization, for instance a nonprofit, are taken up in taxes or exported by buying outside the community, then the impact on the local economy is lessened. With a smaller tax burden, the expenditures of the nonprofit in the community result in a greater income multiplier.⁸¹ While there will be a direct loss of property tax revenue, the functioning of the nonprofit in the area should balance out this revenue loss. These facts present a strong argument for retention of exempt status for all charitable nonprofits, even if, as in the case of universities or hospitals, the organization serves a much larger area than the jurisdiction in which it is located.

Because of the underlying controversy regarding taxpayer equity, nearly all discussions of the reform of the property tax, especially those relating to the exemption of nonprofits, address inequities in the incidence of the tax. Current discussions on this subject seem to disagree with the argument that exemptions are totally positive for the locale

78. GOLD, *supra* note 75, at 3.

79. For instance, in Bridgeport, Connecticut in 1973, nearly half of the patients using the city's hospitals and two-thirds of the students of the city's universities lived outside Bridgeport. Quigley & Schmenner, *supra* note 77, at 276-77.

80. GOLD, *supra* note 75, at 242.

81. H. CRAIG DAVIS, REGIONAL ECONOMIC IMPACT ANALYSIS AND PROJECT EVALUATION 29-35 (1990).

that grants them. Generally, the debate hinges on how to reform the property tax system, not whether the system is in need of reform. Thus, the focus of the remainder of this article must be on the ways in which state government can reduce the stress levied on localities by providing exemptions to certain organizations.

D. *State and Local Policy Options*

The amount of property allotted tax exempt status continues to grow steadily.⁸² Tax exemption is perceived as an appropriate government subsidy to foster services and activities that are largely public or social in nature.⁸³ Operations accorded tax-exempt status vary among states and include religious, educational, and charitable activities. Public concern over the existence of these tax exemptions can be traced to hostility toward property tax in general.⁸⁴ Though few people advocate repealing the existing property tax exemptions altogether, support can be found for various fiscal alternatives.⁸⁵ These alternatives include retaining exemptions as they currently stand; removing exemptions altogether; instituting reimbursements to local governments to make up for lost revenue due to an exemption granted at the state level; and charging user fees to the exempt nonprofit.

1. *Removing the exemption and substitution theory*

Why, in fact, should government exempt nonprofit organizations? Exemptions benefit the nonprofits by minimizing the government's interference in the private sector and by promoting a pluralist approach in satisfying society's needs. It has been noted that exempt institutions "make a town a good place in which to live."⁸⁶ The payment of property taxes would cause some of the revenue of a nonprofit to go to the government, thereby eluding the maximum charitable impact from the nonprofit's revenue. While there is no question that the property tax exemption is a government subsidy to the nonprofit, scholars debate about the incidence of the tax and whether those who pay for the subsidy should receive relief from a higher source. Should the locality pay for

82. L. Richard Gabler & John F. Shannon, *The Exemption of Religious, Educational, and Charitable Institutions from Property Taxation*, in 4 TAXES, RESEARCH PAPERS BY THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS 2535, 2536-90 (1977).

83. *Id.* at 2542-44.

84. *Id.* at 2548-55.

85. *Id.* at 2546-55.

86. GOLD, *supra* note 75, at 242.

the subsidy, or might the state? Or perhaps should the nonprofit itself return some of the subsidy to the municipality?

One can argue that it would be salutary to remove property tax exemptions altogether.⁸⁷ The general substitution theory provides some support to the proposition that nonprofits should be denied tax exemptions. Substitution theory examines the extent to which the local distribution of economic activity is tied to the problem of distribution of production factors, such as land, labor, and capital. Substitution theory states that movement of an enterprise from the central consumption point to the periphery of the economic field implies the substitution of capital and labor outlays for land use outlays. A move towards the central consumption point will result in the reverse result.⁸⁸ Applied to the nonprofit sector, this theory indicates that if a nonprofit moves to the periphery, the organization will have a smaller outlay in land, and more outlay can be made for labor and capital. This shift would allow a nonprofit to hire more people and provide better services, because its income would no longer go toward property costs and taxes. According to this scenario, as long as the nonprofit has no absolute need to locate in the center of the city in order to fulfill its charitable purpose, the entity should be encouraged to move to the periphery if only to rationalize its own outlay structure. Following this line of argument, the nonprofit should rightly receive no exemption.

A more complex version of the substitution principle takes into consideration two types of substitutions: distance inputs and outlays. With a greater amount of funds put into distance inputs, less money stays available to pay for outlays. A nonprofit that provides help for the poor will have greater distance inputs if it is in the suburbs than if it is in the heart of the poor district of the city. A nonprofit at the central consumption point, where the poor reside, is responsible only for minimal distance inputs, and thus can put more revenue towards outlays. This analysis argues for a more complex set of criteria for nonprofits that takes into account the entity's role as a social provider.⁸⁹

The removal of the exemptions from property would not eliminate all inequities or spur development along the rational lines suggested by the substitution theory. Government property would still enjoy exempt status, which would render the removal of exemptions an inequitable solution. For equity to be served, government action must be coordinated.

87. There is an economically commendable reason to deny exemptions altogether. Eventually, however, the proposal fails for the simple reason that *all* exemptions could never be removed because government-owned property will always remain exempt. WALTER ISARD, *LOCATION ANALYSIS AND GENERAL THEORY* 31 (1990).

88. *Id.* at 31-33.

89. *Id.* at 38-40.

The simple removal of exemptions would seem a crude act, serving only to punish the nonprofit without necessarily solving the problems of local finance that spurred arguments for removal of the exemption in the first place. The removal of exemptions, a measure that would only affect nongovernmental property, might add to the revenues of municipalities, but such a measure would not be fair.⁹⁰

A better approach consistent with substitution theory would be to tax the land but exempt the building. This policy choice is discussed in the following section.⁹¹

2. Reimburse local government for lost revenue

Although property tax exemptions provide implicit subsidies to nonprofits, some commentators suggest that states explicitly subsidize local governments to compensate for lost revenue.⁹² Local and state governments have within their control several ways of rationalizing the processes of granting exemptions. These methods could effectively equalize the impact of the tax exemption across the constituencies of the nonprofits that may benefit, and could make the property taxation of charitable nonprofits more administratively effective in general.⁹³ Some local governments already receive reimbursement from the state or federal government for exempt property; the payments involved usually are relatively small.⁹⁴ Because the state government mandates the exemptions, reimbursement for exempt government property makes good political sense. A parallel system of reimbursement by the state for charitable nonprofits makes similar sense, if we accept the thesis that these nonprofits provide services normally associated with local and state governments. Because the state ordinarily grants the exemption, subsidies to municipalities provide a logical alternative in the case of the nonprofit that serves a larger area than the city in which it is located.⁹⁵ Thus the state would pay, in cash, the price for authorizing the exemption, and the citizens of the city in question would not be punished for providing a needed service to outsiders.

While the thought that states can and should reimburse local governments for their losses through property tax exemptions may appear to be an appealing option, in fact the execution of such a logical

90. Quigley & Schmenner, *supra* note 77, at 280.

91. See *infra* notes 125-32 and accompanying text.

92. *Id.*

93. Gabler & Shannon, *supra* note 82, at 2557-58.

94. GOLD, *supra* note 75, at 243; Quigley & Schmenner, *supra* note 77, at 280-82; Gabler & Shannon, *supra* note 82, at 2555-61.

95. *Connecticut Legislators Consider Nonprofit Tax Measures*, STATE TAX TRENDS FOR NONPROFITS, Winter/Spring 1993, at 3.

plan would require much administrative expansion and would open the door to new questions of equity. In order for a local government to receive a reimbursement, two conditions should be met. First, the state would be required to grant exempt status to the organization. Second, the organization must serve a wider public than that encompassed by the locality. Here, states confront a broad set of difficulties, which include 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, the argument that states should not spend their money in this way, and the question of whether wealthier local areas should benefit from the subsidies to the same extent as poorer ones.

First, exempt property is rarely assessed as thoroughly and regularly as taxable property.⁹⁶ There is little justification for assessing that which is not taxed, at least not in overburdened localities. But, in order to adequately determine the level of a state subsidy to a local government, a regular and adequate assessment must be made of the exempt property. The owner of the property itself would prefer that the assessment not be made regularly, because, unlike the controversy a direct government subsidy to a charitable organization endures, with that of the concomitant political pressures and conflicts, the exemption is a subsidy that is not subject to regular public debate. To insist on a regular and comprehensive assessment of exempt properties would be necessary, but expensive, given the fact that such assessments have been ignored in the past.

Second, the idea of asking the state to equalize the local loss of funds is a difficult one to devise. Although attractive in theory, the idea may not provide a manageable method of determining how much of the local burden the state should take over. Certainly, the local government should remain responsible for that proportion of the exemption that benefits local citizens. Logically, the state then would assume the burden for those individuals who utilize the service of the charitable nonprofit (e.g., schools, hospitals), yet live outside the locality in which the organization is located. But this endeavor would require extensive research to determine the proper proportion. In fact, this research cannot be accomplished without the type of regular assessments described above.

Third, should the state institute a policy of subsidizing overburdened local governments, dissenters likely will question whether this method provides the best or even a reasonable way to spend state money. One can argue that this whole concept merely amounts to a transfer within the state, and therefore it is not a simple outlay.

96. Gabler & Shannon, *supra* note 82, at 2538.

Finally, wealthier cities should not expect a large boost from the state with regard to subsidies. While larger cities may not need the subsidy, poorer metropolitan areas would certainly benefit. Thus, the government subsidy could be used to equalize the differences in wealth across a given state. This injects a subjective element into the argument. If the state undertakes the work necessary to subsidize local governments, poor areas would respond positively, and wealthy ones, which stand to receive less, still would welcome the infusion of state funds.⁹⁷

3. *User or service fees*

Another option under consideration by governments focuses on the imposition of payments-in-lieu-of-taxes, user fees, or service fees on nonprofits. This option is particularly popular when an exempt organization has substantial property holdings. Imposing user fees would be more discrete than removing exemptions, an alternative which might threaten the existence of many nonprofits.⁹⁸ For its statistical compilations, the Bureau of the Census defines user charges as "amounts received from the public for performance of specific services benefitting the person charged and from sales of commodities and services."⁹⁹ Under this concept, municipal utilities (water, electricity, gas, etc.), which also fit the general concept of user charges, report their statistics separately.¹⁰⁰

With the current fiscal problems governments now face, municipalities often find it easier to increase other sources of revenue than to increase taxes.¹⁰¹ But, the Union Institute argues that user fees are equally problematic. *The Nonprofit Policy Agenda* strongly disagrees with the idea of implementing user fees when they are employed solely to compensate for revenue lost through the property tax exemptions.¹⁰² Specifically, the Institute propounds as its second taxation recommendation, namely that "[g]overnment should not employ user fees as revenue raisers. But when government services can be measured and directly benefit a nonprofit organization, that organization ought to be treated like any citizen who uses the service."¹⁰³

97. *Id.* at 2557-58.

98. *Id.* at 2558-60.

99. BUREAU OF THE CENSUS, GOVERNMENTAL FINANCES (1978-79).

100. JOHN L. MIKESSELL, FISCAL ADMINISTRATION: ANALYSIS AND APPLICATIONS TO THE PUBLIC SECTOR 269-70 (1982).

101. H. William Batt, *User Fees: The Nontax Revenue Alternative*, 93 STATE TAX NOTES 64-12 (1993) at 1.

102. KOCH, *supra* note 2, at 93.

103. *Id.* (Recommendation 47).

The option of assessing payments-in-lieu-of-taxes has gained popularity, but for reasons contrary to those that the Union Institute considers valid. These payments have been imposed merely for their potential as revenue-raisers.¹⁰⁴ Despite the randomness of the assessment of payments-in-lieu-of-taxes, this approach continues to gather momentum in various states and localities. The popularity of this option, however, does not emerge from the wisdom of its application. The approach simply provides the quickest and easiest solution for municipalities under budgetary pressure.¹⁰⁵

The Union Institute draws a distinction between user fees, which "are assessed for actual charges incurred for things such as water, sewer usage and waste disposal" and service fees which are "generally charged for municipal services the use of which is less measurable, such as police and fire protection or road maintenance."¹⁰⁶ Thus user fees place charges on goods with an accentuated private characteristic, while service fees are charged for public goods provided by municipalities or states.¹⁰⁷

The most important difference between user fees and taxes lies in the degree of choice for the individual payor. Some user fees are voluntary; an individual or firm can choose not to receive the service, and thus not to pay. On the other hand, taxes by nature are compulsory and are not linked to any government services, individually or separately. User fees seem legitimate and superficially, they are quite simple because the

104. Batt, *supra* note 101, at 2 (noting that nontax revenues have risen to well over 20 percent of total revenues).

105. For a discussion of this development, see *Exemption Challenges Continue*, STATE TAX TRENDS FOR NONPROFITS, Spring 1990, at 6; *Hospital Battles Continue in Pennsylvania*, STATE TAX TRENDS FOR NONPROFITS, Spring 1991, at 9. In another major decision regarding payments-in-lieu-of-taxes, Yale University agreed in 1990 to pay \$2.6 million to New Haven, Connecticut, as well as to place some of its property on the tax rolls and to pay \$2.16 million in additional fees for fire protection and sidewalk refurbishment. This package came as a result of community dissatisfaction with Yale's exempt status. See *Yale Agrees to Pay New Haven For City Services*, STATE TAX TRENDS FOR NONPROFITS, Summer 1990, at 2.

In 1992, the Board of Representatives of Stamford, Connecticut considered a resolution that would require the city to ask nonprofits to contribute five percent of their would-be property tax bill as a payment in lieu of taxes. Stamford estimated that each nonprofit would be asked for from \$300 to \$10,000. See *Stamford May Seek Payments in Lieu of Taxes*, STATE TAX TRENDS FOR NONPROFITS, Winter 1992, at 3.

106. KOCH, *supra* note 2, at 92.

107. MIKESSELL, *supra* note 100, at 269-71; see also Carl S. Shoup, *Rules for Distributing a Free Government Service Among Areas of a City*, 42 NAT'L TAX J. 103 (1989) (discussing findings for distributing inputs and suggestions).

individual pays in proportion to the benefit received.¹⁰⁸ This characteristic makes user fees easier to accept than many taxes. However, sometimes individuals or firms do not receive a right to refuse a service, such as garbage collection and police protection.¹⁰⁹ This may be based on considerations of the negative impact that refusal could have upon the neighborhood. If the charges are not compulsory, the main advantage of user fees over outright taxation is that the fees provide a concrete method to gauge consumers' desires for particular services, while also creating funds to provide those services.¹¹⁰

When land receives an exemption from property tax, the city loses that revenue but the cost to maintain the property, including the use of city services, stays virtually at the same level.¹¹¹ User fees are used by local municipalities in order to offset the cost of the services that have been supplied to property. The payer of the fee receives a tangible and measurable benefit which is associated with the activity. Typically the fee level is structured so that the total monies collected from all payers equals the cost of providing the service to the public. Fees are usually considered as cost liquidators and not as profit-makers for the jurisdictions charging them.¹¹² Employment of user fees at all levels of exempt property may also remove an incentive for tax exempt organizations to hold idle or vacant land that is no longer needed, and may curb the tendency of nonprofits to invest in real estate.¹¹³ In this way, user fees might prompt the same change in behavior that a land tax would create. Economists favor user fees for the same reason they favor the use of prices in the free market: the minimization of waste by consumers and the efficient allocation of resources.¹¹⁴ By adjusting the

108. Batt, *supra* note 101, at 4.

109. MIKESELL, *supra* note 100, at 271-72.

110. *Id.* at 273. When user charges are compulsory, the Union Institute's argument against revenue-raising takes on new importance. For example, legislation that would require charities to pay "user fees" for IRS letters that confirm their status as charitable or that would clarify sections of the law used to determine that status clearly seems to be a means of raising government revenue, since that is information without which the organization could not function as a charity. The Union Institute adamantly refuses to endorse this sort of user charge. *Charities Now Must Pay "User Fees" to IRS*, 21 PHILANTHROPY MONTHLY 18-20 (1988).

111. GREATER HARTFORD CHAMBER OF COMMERCE, PROPERTY TAX EXEMPTIONS AND NON-PROFIT INSTITUTIONS: A STUDY AND ACTION PROGRAM 3 (1978) [hereinafter GREATER HARTFORD CHAMBER OF COMMERCE].

112. John C. Healy, *Can User Fees Provide Property Tax Relief?*, 4 J. PROP. TAX MGMT. 48 (1992).

113. GREATER HARTFORD CHAMBER OF COMMERCE, *supra* note 111, at 7.

114. *Id.* at 10.

fee, the demand for a product or service can be regulated so that optimum levels of consumption can be attained at any time, thus fostering the efficiency of the service not achieved by general taxes.¹¹⁵

User fees become more feasible when a good that is essentially public in nature closely resembles a private good. User fees can be properly implemented when the activities financed meet two conditions: they benefit separately and are chargeable. User fees are most feasible when individuals, rather than the community, benefit from the service. There is a prerequisite, economical method for excluding from a service benefit those who do not pay for the service. Measurability is characteristic to these services, directly or through approximations.¹¹⁶ In other words, if the service in question can be declined by the consumer (for instance, electricity or water), then a charge can easily and fairly be determined.

Service fees which are related to the provision of public goods will not possess these characteristics. For instance, everyone pays for police protection and everyone needs it. In the absence of a right to deny service, and given the inability of the government to place a value on it, this sort of service fee should not be assessed upon the nonprofits.¹¹⁷ As a fellow provider of public goods, nonprofits should not be taxed for these services or pay charges for them.

It is difficult to measure the consumption of certain public services, such as fire or police protection, traffic control, or road maintenance. In

115. Batt, *supra* note 101, at 5.

116. MIKESELL, *supra* note 100, at 272-73. Batt agrees that,

Goods and services that are substantially public in their nature are best financed by general, broad-based taxes—taxes that should be evaluated according to ability to pay. User fees, however, are best used to support the provision of goods and services that are in good part private in their character but that, for whatever reason, are provided by government rather than the private-sector economy.

Batt, *supra* note 101, at 4.

117. The states have experimented with various arrangements. In Massachusetts in early 1993, for example, Boston representatives introduced a bill authorizing municipal governments to assess a fee on tax-exempt property to support "local public safety." The fee would apply to the property of charitable organizations, as well as literary, benevolent, and scientific institutions. See *Municipal Services Fee Proposal Introduced*, STATE TAX TRENDS FOR NONPROFITS, Winter/Spring 1993, at 5. Oregon's legislature attempted to amend the state's constitution so as to allow municipal governments to charge a fee on emergency services, including fire-fighting, law enforcement, and emergency medical services. The fee could not exceed 10 percent of the local tax rate. For a discussion of the proposal, see *Legislature Considering Emergency Services Fee*, STATE TAX TRENDS FOR NONPROFITS, Winter/Spring 1993, at 8-9.

fact, no administratively feasible method exists for measuring the consumption of most publicly-provided services. It has been questioned whether payments for non-utility-type services would be significant because the marginal cost of services is frequently lower than the average.¹¹⁸ One economist suggested that one method of determining the lost service costs is to levy on nonprofits that percentage of the mill rate which is attributable to property-related services. For example, if property-related services constitute one-third of all local government expenditures, then a tax exempt institution would pay a user fee equal to one-third the normal mill rate multiplied by its assessed value. However, the resulting fee is similar to a property tax, and the maintenance of the property tax exemption is the reason for even considering user fees.¹¹⁹

The Wisconsin legislature passed, but the governor vetoed, a user fee on exempt properties because of the apparent inequality in its application to taxable property.¹²⁰ This precedent provides an illustration of an attempt to collect user fees on both tangible (private) and intangible (public) goods. The Wisconsin attorney general noted three provisions which raised constitutional questions: (1) the user fee applied only to exempt property; (2) municipalities could choose to impose it on only some categories of exempt property; and (3) the fee, if implemented, would reflect costs of services, such as fire and police protection, which do not benefit the exempt property directly or exclusively.¹²¹ In essence, the restrictive nature of the fee was perceived

118. GOLD, *supra* note 75, at 243.

119. GREATER HARTFORD CHAMBER OF COMMERCE, *supra* note 111, at 10.

120. KOCH, *supra* note 2, at 93.

121. Healy, *supra* note 112, at 50. Also, Hartford, Connecticut's delegation to the Connecticut state legislature has introduced a number of bills addressing the high number of exempt organizations in the community. One bill would permit municipalities to negotiate with exempt organizations for payments for services; another would increase state aid to localities to compensate for revenues lost to property tax exemptions; yet another would include special service districts in the payment in lieu of taxes program. See *Connecticut Legislators Consider Nonprofit Tax Measures*, STATE TAX TRENDS FOR NONPROFITS, Winter/Spring 1993, at 3. Additionally, Providence, Rhode Island may ask the state assembly for the authority to assess a municipal services fee on university dormitories. See *Providence Considers Municipal Services Fee*, STATE TAX TRENDS FOR NONPROFITS, Winter 1992, at 7. The Pennsylvania League of Cities has demanded that the state legislature allow municipal governments to collect service charges on all exempt property. This is in view of the proliferation of exempt property, the fact that exempt status is rarely reviewed, the fact that exemptions benefit from services, and the fact that nonresidents benefit from the tax-exempt enterprises. The League also calls on the state to re-certify exempt enterprises every five
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as a violation of the Wisconsin uniformity clause because the tax was exacted on a specific type of property. In a general sense, a user fee applied to an exempt organization should charge for only services that directly affect the organization. Charging nonprofits for abstract services, such as police and fire protection which benefit all property owners, would violate the need in the municipality for horizontal equity.

Given that the positive externalities of property tax exemption do not always make up for actual loss of revenue to government, user fees for services become an important factor when determining what the nonprofit sector ought to pay as compensation.¹²² The actual services consumed, such as electricity, water, and sewage processing, ought to be compensated. This is especially true when the nonprofit organization charges a fee to its users for that organization's resources, as in the cases of university tuition or hospital charges.¹²³ At a minimum, the state and local government ought to identify the contribution the nonprofit organization makes to the community and determine which services are consumed. This proposition finds additional support in light of the growing nonprofit economy.¹²⁴ But, as with other possible revisions in the taxation of nonprofits, the question of assessment is overwhelming. How can a city be expected to evaluate adequately the services consumed by an organization when the same city probably cannot even afford to assess exempted property?

Although it is not always clearly specified, the property tax actually has two components: land tax and structure tax. One writer has recently referred to the land tax as a potential "super user charge."¹²⁵ There is a fixed amount of land available, but improvements on that land are not fixed. A tax on land values does not affect the market outcome. However, a tax on structure will alter the outcome of the markets and will lead to fewer improvements than there would be with a tax

years. See *League of Cities Supports Mandatory Municipal Service Charges*, STATE TAX TRENDS FOR NONPROFITS, Spring 1992, at 7.

122. Richard M. Bird & Enid Slack, *Urban Finance and User Charges*, in STATE AND LOCAL FINANCE: THE PRESSURES OF THE 1980s 211 (George Break ed., 1983) (considering financing urban public and social services through user charges and concluding that there is ample evidence to charge for services under some circumstances); Paul B. Downing, *User and Service Fees*, in CRISIS AND CONSTRAINT IN MUNICIPAL FINANCE 160, 160-99 (James Carr ed., 1984) (comparing the effects and efficiencies of a property tax versus a user charge).

123. With respect to tuition and the actual subsidy for education especially by nonprofits, see David S. Davenport, *Education and Human Capital: Pursuing an Ideal Income Tax and a Sensible Tax Policy*, 42 CASE W. RES. L. REV. 793 (1992); Joseph Dodge, *Scholarships Under the Income Tax*, 46 TAX LAW. 697 (1993).

124. WEISBROD, *supra* note 8, at 69-70.

125. Rybeck, *supra* note 57, at 133-47.

exemption.¹²⁶ Thus, advocates of the abandonment of the structure tax argue that only those who improve their properties are punished. Like user fees, the exclusive use of a land tax would render property taxes more subject to the effects of the market. High property taxes result in a slow but steady disinvestment in the housing market, because the landowner spends more money on taxes than on improvements.¹²⁷ In order to make up property tax revenue, either the tax rates on adjoining properties must rise, services must be reduced, or some combination thereof must occur.¹²⁸

The idea of imposing a relatively high land tax and a much lower structure tax, or no structure tax at all, is open to reproach. Some would argue that such a tax system punishes those taxpayers who are least able to pay more than those who can easily pay. However, proponents would use this argument in reverse, rebutting with the assertion that the urban poor rarely own property. If these individuals do own property, they own more building value than land value, since by virtue of their destitution, they cannot afford to live where land prices are high. Ultimately, these proponents argue, the land tax will make the inner city a better place to live by virtue of the fact that the land tax will prompt landowners to improve their lots or sell them.¹²⁹

The argument for eliminating the structure tax in favor of a simple land tax boasts of a long pedigree and seems to have the character of a crusade.¹³⁰ Yet, this should not subtract from the self-evident appeal of the proposal. The proponents of a land tax argue that the owner who develops his property must not be punished with a building tax; the property owner who allows the land to go unused will justly be penalized for allowing nature's gift to sit idle.¹³¹ These proponents believe in the method mainly because it promotes development in cities. They

126. THE URBAN INSTITUTE, PROPERTY TAX REFORM 9 (George E. Peterson ed., 1973) [hereinafter THE URBAN INSTITUTE]; see also TAXATION, RESOURCE AND ECONOMIC DEVELOPMENT COMMITTEE, LAND AND BUILDING TAXES: THEIR EFFECT ON ECONOMIC DEVELOPMENT (Arthur P. Becker ed., 1969); Heilbrun, *supra* note 56.

127. THE URBAN INSTITUTE, *supra* note 126, at 10.

128. GREATER HARTFORD CHAMBER OF COMMERCE, *supra* note 111, at 2.

129. Rybeck, *supra* note 57, at 145.

130. See, e.g., Mason Gaffney, *An Agenda for Strengthening the Property Tax*, in PROPERTY TAX REFORM, *supra* note 126, at 65-84 (arguing that property tax relief is not needed but rather assessment reform is needed as well as a shift of the property tax to the state level in part and a conversion of the property tax into a tax on site value).

131. Arthur P. Becker, *Principles of Taxing Land and Buildings for Economic Development*, in LAND AND BUILDING TAXES, *supra* note 126, at 24-30; Steven B. Cord, *Taxing Land More Than Buildings: The Record in Pennsylvania* in THE PROPERTY TAX AND LOCAL FINANCE, *supra* note 56, at 172.

approach the land tax as a component of a solution to inner city degradation and underdevelopment. After decades of arguing for a land tax, Pennsylvania has tested the idea. As such, the results of the Pennsylvania experiment have been positive.¹³² These results have apparently not prompted more municipalities to move to a higher land tax, although, it is difficult to ascertain whether these municipalities are currently considering the idea.

It is important to note that insofar as nonprofits are concerned, these results testify only to the desirability of taxing land and not to the structure of the property tax exemption should it be modified. In order to reduce the negative impact of empty lots on neighboring properties and to spur nonprofits to release the property, the government must raise taxes. Then the land tax, not the structure tax, should be increased.

Both the assessment of user fees on nonprofits and the idea of state government subsidies to the municipality involve payments from the nonprofit or the state. In the first instance, the nonprofit itself would reimburse the locality for those services that could be enumerated and evaluated. In the second instance, the state government would attempt to alleviate the stress on local governments by subsidizing the existence of those nonprofits that have been granted exemptions by the state without regard for the revenues of the locality. Both options suffer from the same difficulties, although each clearly affects the nonprofit in different ways. Because the word "tax" has a narrow meaning, other revenue-generating devices will become even more important as a method of governmental control over economic behavior, a necessity to meet public policy demands.¹³³

Both government subsidies and user fees flounder on the issue of accurate assessment. Can state and local governments adequately evaluate the cost of an exemption to a nonprofit? And if so, can those governments then be expected accurately to factor into the evaluation the value of the nonprofit itself to society? In other words, the exemption itself has an intrinsic worth that can be translated into actual dollars. But then the value of the services that the nonprofit provides must be considered before a reliable figure for a subsidy can be reached. Similarly, municipalities and nonprofits could hardly be expected to agree on a valuation of services provided to the nonprofit by the city. Nonetheless, since this question is but a part of a much larger discussion

132. Cord, *supra* note 131, at 172-74. Pittsburgh, Scranton, Harrisburg, New Castle, and McKeesport Pennsylvania all altered their property tax structure in the late 1970's. Pittsburgh's property tax had been 4.95% on land and 2.48% on structures in 1978; in 1982, the rates were 13.3% on land and 3.2% on structures. As a result, building permits issues in Pittsburgh rose from 3179 to 4335; the value of the improvements multiplied tenfold.

133. Batt, *supra* note 101, at 794.

of user fees levied on all exempt property, not merely nonprofits, the Union Institute's contention that nonprofits should only be charged for those services that fall under the rubric of "private goods" is a reasonable one. The use of state government subsidies to local governments makes a great deal of sense, if they can be accurately valued.¹³⁴ The use of an exclusive land tax as opposed to the current method of a combined land and structure tax, applies to a much broader sample of properties than just nonprofits. The land tax might rationalize the use of land by all organizations, including nonprofits.

Less apocalyptic possibilities for reform of the exemption system exist for nonprofits. These alternatives include systematic assessment, with yearly revisions to assure that a nonprofit granted an exemption decades before does not remain exempted if it has transformed itself;¹³⁵ regular publication of assessments of nonprofits, to make public discussion more open and fruitful, might lead to the rationalization of the pattern of exemption;¹³⁶ and finally, the simple tightening of the definition of charitability would likely uncover organizations that do not replace government services in any systematic way. The last option has been utilized with positive effect in Pennsylvania. In the 1985 decision *Hospital Utilization Project v. Commonwealth*¹³⁷, the Pennsylvania Supreme Court noted five factors that would determine whether a hospital could properly acquire and maintain charity status. To be considered charitable, a hospital must advance a charitable purpose; must donate a substantial portion of its services; must benefit a substantial and indefinite class of persons who are subjects of charity; must relieve the government of some of its burden; and must not operate with a profit motive.¹³⁸

134. OLIVER OLDMAN & FERDINAND P. SCHOETTLE, STATE AND LOCAL TAXES AND FINANCE 344 (1974). These authors suggest the following notions: "It has been suggested that where the state decides and mandates that particular categories of property are to be exempt from local property taxation the burden of that exemption should be borne by the state as a whole and not the locality in which the property happens to be." *Id.*

135. The Pennsylvania League of Cities has called on the state of Pennsylvania to re-certify exempt enterprises every five years. *League of Cities Supports Mandatory Municipal Service*, STATE TAX TRENDS FOR NONPROFITS, Spring 1992, at 7.

136. Gabler & Shannon, *supra* note 82, at 2562.

137. 487 A.2d 1306 (Pa. 1985).

138. *Id.* at 1317. These rules confused many hospitals and even the courts, which applied the second condition unevenly at best. Thus, in 1991, a bill was introduced in the state legislature to clarify the five-point test. It remains a contentious subject, however. See INDEPENDENT REGULATORY REVIEW COMMISSION, COMMENTS ON DEPARTMENT OF REVENUE REGULATION NO. 15-251

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(1991); *Proposed Sales Tax Exemption Under Attack*, STATE TAX TRENDS FOR NONPROFITS, Fall 1991, at 8. In one case in 1990, a state court found a hospital in Allentown to be charitable according to the above five-point definition. *St. Luke's Hosp. v. Board of Assessment Appeals*, No. 88-C-2691, slip op. at 29-30 (Pa. C.P. Apr. 19, 1990). In a second case in 1992, the exemption was removed because the hospital failed four out of five of the tests. *School Dist. of Erie v. Hamot Medical Ctr.*, 602 A.2d 407, 414-15 (Pa. Commw. Ct. 1992); *see also Hospitals Win One, Lose One*, STATE TAX TRENDS FOR NONPROFITS, Summer 1990, at 3. In the second case, the Hamot Medical Center declined to pay a \$100,000 payment in lieu of taxes, and the municipal government sued. In the end, the center had to pay almost \$5 million in taxes through 1992. *School Dist. of Erie v. Hamot Medical Center*, No. 1319, slip op. at 29-30 (Pa. C.P. Jan. 9, 1992); *see Pennsylvania Hospital Loses Tax Exemption*, STATE TAX TRENDS FOR NONPROFITS, Winter 1992, at 6. Finally, a judge in Lehigh Valley, Pennsylvania ordered a nonprofit hospital to restructure if it wished to retain its tax-exempt status. *See Judge Tells Hospital to Restructure*, STATE TAX TRENDS FOR NONPROFITS, Fall 1990, at 7. The Erie County Board of Assessment Appeals has continued its vigorous challenges in 1993. The board reevaluated 600 exempt parcels and determined that a stunning 597 did not qualify for exemption. Those property owners may agree to pay 50% of their tax bill in payments-in-lieu-of-taxes from 1993 to 1996. After 1996, they will be placed in categories of charitability which will define them as paying 25%, 50%, or all of their property tax bill. This aggressive action in Erie is based on the dire financial situation of the municipality and the interpretation of the five-point definition noted above that was established in 1985. One specific problem in the application of that standard is the second condition requiring that charities must "donate or render gratuitously" their services. In Erie, the board concluded that this stipulation means a charity must give its services at 50% or less of market value (which remains undefined). *See Erie PA Charities Face Widespread Payments in Lieu of Taxes*, STATE TAX TRENDS FOR NONPROFITS, Winter/Spring 1993, at 1.

New Hampshire has redefined "charitable" regarding the property tax exemption: organizations are charitable if they perform services for the public good or welfare for the benefit of the general public or an indefinite segment of it, if they offer no pecuniary profit to officers or members, and if they do not restrict benefits to officers or members. This definition will add benevolent and fraternal organizations to the tax rolls. N.H. REV. STAT. ANN. § 72:23-1 (1993); *see Legislature Defines Charitable*, STATE TAX TRENDS FOR NONPROFITS, Fall 1991, at 7-8.

In addition, the state senate in Colorado passed legislation narrowly defining exempt purposes: charitable, educational, and religious organizations must now prove that they spend over 50% of their revenues on exempt purposes. Co. S.B. 88, 59th Gen. Ass., 1st Sess. (1993); *see Colorado Nonprofits Face Uncertain Future; Possible Restrictions on Property Tax Exemptions*, STATE TAX TRENDS FOR NONPROFITS, Winter/Spring 1993, at 2.

IV. SALES TAX EXEMPTION

In its third taxation recommendation, the Union Institute states that, "Sales tax exemption for either sales or purchases should be extended to all organizations exempt under § 501(c)(3) of the Internal Revenue Code, with the exception of those sales and purchases not substantially related to the organization's exempt purpose."¹³⁹

Because this recommendation is all-encompassing, it opens itself to many reproaches. For instance, some section 501(c)(3) organizations do not remotely resemble a charitable institution.¹⁴⁰ Thus the

139. KOCH, *supra* note 2, at 94 (Recommendation 48).

140. The variations among states regarding sales tax exemptions, which include taxes on sales and purchases, are too complicated to characterize. One must remember that nonprofit organizations include, at the most general level, all § 501(c)(3) organizations. Within that heading is the entire spectrum of nonprofits: religious, educational, charitable, fraternal, scientific, etc. No two states exempt the same organizations in the same way. For instance, six states exempt sales by § 501(c)(3) organizations, with qualifications; eight exempt sales by charitable organizations; eighteen exempt sales by some charitable organizations; thirty-four states exempt sales by educational organizations; fourteen of these (including eleven of those mentioned above) exempt some sales by educational organizations other than schools. All of the above categories include overlaps, and all of them have specific clauses excluding and including organizations that appear to fall under the given heading. See *Sales Tax Exemptions for Charitable, Educational, and Religious Organizations*, 11 STATE TAX TRENDS FOR NONPROFITS Summer 1992 at 1-4. Indiana provides an example of a state which allows sales tax exemptions, allowing exemptions for both sales and purchases if certain conditions are met. Section 6-2.5-5-25(a) of the Indiana Code, dealing with purchases, states:

Transactions involving tangible personal property or service are exempt from the state gross retail tax, if the person acquiring the property or service: (1) is an organization which is granted a gross income tax exemption under IC 6-2.1-3-20, IC 6-2.1-3-21, or 6-2.1-3-22; (2) primarily uses the property or service to carry on or to raise money to carry on the not-for-profit purpose for which it receives the gross income tax exemption; and (3) is not an organization operated predominately for social purposes.

IND. CODE § 6-2.5-5-25(a) (1989).

Thus, the Code excludes from the liberal "any lawful purpose" clause the purpose of social organizations for sales tax exemption. As for sales, §§ 6-2.5-5-26(a) and (b) state:

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recommendation would offer new complications for governments as well as the nonprofits that must follow the often tedious regulations that these complications imply. In addition, one must consider the attitude of those for-profit organizations with which the nonprofits often compete.

While most nonprofit organizations would prefer to produce charitable goods, when their budgets are cut, they often must resort to selling private output to support their charitable activities. As a result, there is good reason for private businesses to be concerned because decreased government funding for nonprofits tends to force the nonprofits into the private markets to compete with private businesses.¹⁴¹ The rise in commercial sales by nonprofits has introduced the important distinction between taxation on sales related and unrelated to the charitable purpose of the nonprofit.

In order to reduce the regressivity of the sales tax, governments make use of exemptions or selective taxation on certain goods. For instance, many states try to solve the welfare problems of low income classes by

Sales of tangible personal property are exempt from the state gross retail tax, if: (1) the seller is an organization which is granted a gross income tax exemption under IC 6-2.1-3-19, IC 6-2.1-3-20, IC 6-2.1-3-21, or IC 6-2.1-3-22 (2) the organization makes the sale to make money to carry on the not-for-profit purpose for which it receives its gross income tax exemption; and (3) the organization does not make those sales during more than thirty (30) days in a calendar year; . . . (b)(2) the seller is not operated predominantly for social purposes; (3) the property sold is designed and intended primarily either for the organization's educational, cultural, or religious purposes, or for improvement of the work skills or professional qualifications of the organization's members; and (4) the property sold is not designed or intended primarily for use in carrying on a private or proprietary business. (c) The exemption provided by this section does not apply to an accredited college or university's sales of books, stationary, haberdashery, supplies, or other property.

IND. CODE § 6-2.5-5-26 (1989).

Here, the legislature has again excluded social purpose organizations from sales tax exemption. Also, sales tax exemption may be granted only if gross income tax is exempted. In addition, in (b)(2), purposes are limited to educational, cultural, or religious from the broad "any lawful purpose" found in the Indiana incorporation statute.

141. WEISBROD, *supra* note 8, at 110-11. For example, a 10% decrease in government support would lead to an increase of nonprofit sales by 1.3%.

exemptions on some basic products, such as food and drugs.¹⁴² Findings that are justified according to the basic principle of charitability suggest a similar rationale for consideration regarding nonprofits. The charitable nonprofits' activities are aimed in a considerable measure to satisfy the demands of lower income classes, either directly or through the provision of public goods. Thus, exemption is justified except for purchases and sales not related to the charitable purpose of the nonprofit.¹⁴³ However, finding an explicit link between the legal criteria for tax-blessed charitable activity and assistance to the poor is a difficult task. The one author who has tried to trace the degree to which charity results in a downward shift of income and wealth concluded that the redistributive effects of philanthropy are incalculable, in the most literal sense of the word.¹⁴⁴

Given the facts that the nonprofits' share in the economy in the last thirty years has doubled and that the nonprofits continue to shift toward commercial operations, many different approaches to taxation of sales and purchases of goods and services by nonprofits have developed.¹⁴⁵ Some adaptations to the new economic realities of sales tax politics vis-à-vis commercial nonprofits would preserve both the revenue base and an optimal balance between sectors. The revisions proposed by one authority draw a distinction between the economic consequences and the

142. LENNOX MOAK & FRANK COWAN, *MANUAL OF SUGGESTED PRACTICE FOR ADMINISTRATION OF LOCAL SALES AND USE TAXES* 59, 61 (1961); JOHN DUE, *SALES TAXATION* 22-29 (1957).

143. Several decisions limited the exemptions that one normally associates with nonprofit status. In Virginia, a nonprofit clearinghouse for services to the needy had to pay sales and use taxes except for those used in its homeless shelter (a division within its operation). There is no general sales tax exemption in Virginia, but homeless shelters have an exemption that will expire in July 1993. Ruling of Commissioner, P.D. 89-312, [2 Va.] St. Tax. Rep. (CCH) ¶ 201-820 (Nov. 7, 1989). In addition, a Virginia taxpayer that is a "ministry" but not a church is not exempt from sales taxes on purchases in spite of its connection with several area churches and its mission, which is AIDS education and church services for victims and their families. Ruling of Commissioner, P.D. 89-313, [2 Va.] St. Tax. Rep. (CCH) ¶ 201-822 (Nov. 7, 1989). Finally, again in Virginia, where no general exemption exists, a nonprofit that operates a "clearing house" and "resource center" for missing and exploited children does not qualify for an exemption on its purchases. Ruling of Commissioner, P.D. 89-213, [2 Va.] St. Tax. Rep. CCH ¶ 201-800 (Aug. 4, 1989).

144. Simon, *supra* note 6, at 83-84.

145. John L. Mikesell & Billy Hamilton, *Sales Tax Policy During the Next Decade*, in *SALES TAXATION, CRITICAL ISSUES IN POLICY ADMINISTRATION* 27 (William F. Fox ed., 1992).

logic for exemption of purchases and sales of nonprofits.¹⁴⁶ There are three specific types of sales taxes under consideration here—sales tax on purchases, sales, and services.

A. *Tax on Purchases*

Theoretically, the sales tax is a tax on consumption, but many states impose a tax on production purchases, ignoring in the interest of increased revenue the original intent of the tax. Given the illogic of the tax on production purchases, a state that taxes these purchases should do so consistently for nonprofit and for-profit organizations. Otherwise, the exemption for the sales tax on production purchases will represent an unwarranted subsidy to the nonprofit and would constitute an interventionist state tax policy. Such a policy would violate horizontal equity, unless the relative loss of revenue of for-profits and/or government is compensated accordingly by the benefits provided by the nonprofits. Exemption for nonprofit purchases should be regarded as a subsidy of the collectivity through its other taxpayers. Generally, exemptions from sales taxes on purchases should be difficult to receive and generally, "a presumption against exemption is appropriate."¹⁴⁷

B. *Tax on Sales of Goods*

The tax exemption of sales by nonprofits is a very delicate matter, principally because its logic cannot be related to charitability in the same way or on the same level as the tax on purchases. It is also a growing issue, given the expansion of the commercial nonprofits. There are two possible solutions: apply the exemption more extensively, or

146. John L. Mikesell, *Sales Taxation of Nonprofit Organizations: Purchases and Sales*, in SALES TAXATION, CRITICAL ISSUES IN POLICY ADMINISTRATION *supra* note 145, at 129 (considering philanthropic nonprofits in light of classic nonprofit theory).

147. *Id.* at 129. Parenthetically, it should be noted that Mikesell proposes that a pass-through exemption be granted to contractors in cases when purchase exemptions are given. This logical suggestion appears to have been adopted in at least two states that did not have a pass-through exemption when Mikesell wrote. Florida and Virginia have both ruled that in cases when the contractor acts as a purchasing agent for an exempt organization, materials purchased for use by the organization are exempt from sales tax on the purchase. Technical Assistance Advisement, No. 89A-053, [2 Fla.] St. Tax. Rep. (CCH) ¶ 202-144 (Revenue Dep't Oct. 18, 1989); Virginia Tax Bulletin 92-2, [2 Va.] St. Tax. Rep. (CCH) ¶ 202-116 (Apr. 1, 1992).

remove the exemption completely.¹⁴⁸ An exemption to the for-profit sector on appropriate products would be a quick but illogical solution to the complaints of unfair competition that have been lodged by that sector.¹⁴⁹

148. North Dakota is currently considering an all-out attack on existing treatment of nonprofits: a repeal of almost all sales tax exemptions for charitable, educational, and religious nonprofits, as well as a sales tax on services. N.D. H.R. 1330 (1993); see *North Dakota Considers Tax on Services; Repeal of Charitable Sales Tax Exemptions*, STATE TAX TRENDS FOR NONPROFITS, Winter/Spring 1993, at 7. In a similar action, Alabama's state house of representatives is considering repealing all sales tax exemptions on charitable sales. Ala. H.R. 245 (1992); see *House Considers Sales Tax Exemption Repeal*, STATE TAX TRENDS FOR NONPROFITS, Winter 1992, at 2. Additionally, the Nevada Attorney General declared that a 1959 opinion of the same office wrongly interpreted Nevada's tax statute when it allowed sales tax exemptions to charitable nonprofits on sales and purchases. Now, the Attorney General has found that only purchases are exempt. This finding will not be applied retroactively. Nev. Op. Att'y Gen. No. 92-7, [1 Nev.] St. Tax. Rep. (CCH) ¶ 200-788 (July 22, 1992); see *Attorney General Reinterprets Charitable Sales Tax Exemption*, STATE TAX TRENDS FOR NONPROFITS, Fall 1992, at 5.

149. Several decisions refused to extend exemptions, e.g., rejecting the right of churches to sell Bibles tax-free. In a South Carolina case, *Thayer v. Tax Comm'n*, 413 S.E.2d 810 (S.C. 1992), a marketing company challenged the right of churches to sell Bibles tax-free. The marketing company hoped to receive the same exemption on its sales. *Id.* at 813. In South Carolina, religious publications had been exempt since 1951, when the sales tax was implemented. However, the court found instead that the sale of Bibles should be taxed: "[A]ny subsidy benefitting religious organizations must result from the natural inclusion of religion within the perimeter of a broad circle of nonsectarian groups also benefitting from the subsidy." *Id.* at 814. The marketing company still had to charge the sales tax on its sales. *Id.* at 815. The loss of the exemption will gain the state approximately \$300,000 in 1993, the commission estimated. News Release, South Carolina Tax Commission, [1 S.C.] St. Tax. Rep. (CCH) ¶ 200-508 (1992); S.C. Information Letter 92-8, S.C. Tax Comm., [1 S.C.] St. Tax. Rep. (CCH) ¶ 200-515 (1992). A parallel ruling was made by the U.S. Court of Appeals in North Carolina, where three members of non-Christian faiths who had paid sales tax on their respective sacred books challenged North Carolina's exemption on the Holy Bible. *Finlator v. Powers*, 902 F.2d 1158 (4th Cir. 1990). The court found that the exemption violated the Establishment Clause of the First Amendment because it discriminated against non-Christians. Additionally, the court found that the application of the exemption required the government to inspect the exempt matter, which violates the Free Press Clause. *Id.* at 1163. See [2 N.C.] St. Tax. Rep. (CCH) ¶ 201-703 (1990). A similar ruling of the New York State Department of Taxation found that Bibles are not specifically exempted. See *Bible Sales Taxable in New York*, STATE TAX TRENDS FOR NONPROFITS, Summer 1991, at 6.

But vertical equity may be regarded as a more important consideration, especially when one recalls that the sales tax shifts toward the final consumer. This particular fact argues for granting an exemption to for-profits who serve the same presumably needy community as the nonprofit. But an approach to nonprofits' sales taxation in terms of horizontal equity and efficiency of distribution leads one to conclude that the exemption should be eliminated rather than extended.¹⁵⁰ Again, the issue is a delicate one and is subject to a great deal of debate. Some authors, however, point out the interdependence between horizontal and vertical equity, insofar as horizontal equity "demands equal treatment only when there is no legitimate basis for inequality."¹⁵¹

Academics have long discussed whether states should rely on exemptions or credits. Exemptions appear much less efficient for reducing regressivity because they relate to price stability, but offer the certainty of tax relief, especially when they are stipulated for application to specific products.¹⁵² The positive externality, namely certainty of tax relief, is skewed in part with respect to sales tax exemptions on purchased goods and sales in furtherance of the nonprofit purpose. It appears that such exemptions might skew the market in favor of third parties, who would receive more property, sales tax free. These exemptions might also lead the consumer to choose to do business with a nonprofit rather than with a for-profit firm. To the extent that the charitable purpose is not well-defined and that the definition of

150. WEISBROD, *supra* note 8, at 110-11. In 1990, Virginia refused to exempt a nonprofit that sold Christmas trees during the Christmas season from the tax on its sales, explaining that it "act[ed] as a competitor with other business[es] which are required to collect tax." Ruling of Comm. P.D. 90-39 (Mar. 19, 1990); see [2 Va.] St. Tax. Rep. (CCH) ¶ 201-860 (1990). Normally, sales held three or fewer times a year would be exempt, but this sale continued for a month. Given that it did compete with other businesses, the commissioner found the nonprofit liable. *Id.* Similarly, Virginia also ruled that a nonprofit preschool would not be exempt from tax on sales if it operated more than three fundraisers per year. Ruling of Commissioner P.D. 91-23 (Mar. 4, 1991); see [2 Va.] St. Tax. Rep. (CCH) ¶ 201-951 (1991). In 1992, these rulings were reaffirmed. Ruling of Commissioner P.D. 92-91 (June 5, 1992); see [2 Va.] St. Tax. Rep. (CCH) ¶ 202-153 (1992). On the other hand, in Maine, where nonprofits could only hold sales eight days out of the year, the legislature passed an amendment allowing unlimited sales as long as the organization holds its sales in bazaars, rummage sales, and picnics. See *Legislature Redefines "Casual Sale,"* STATE TAX TRENDS FOR NONPROFITS, Summer 1990, at 7.

151. Kaplow, *supra* note 36, at 149.

152. Steven D. Gold, *Simplifying the Sales Tax: Credits or Exemptions?*, in SALES TAXATION, CRITICAL ISSUES IN POLICY ADMINISTRATION, *supra* note 145, at 157, 159-60.

unrelated business is therefore unclear, sales tax exemptions can have a distortionary effect that may at times compensate for inefficiency within the sector. While the sector can generate business by its reputation and by the general public perception that it is less likely to cheat the consumer, the production of goods and services remains inefficient within the sector. This loss is partially recouped by a transfer payment in the form of the sales tax exemption. The second-best effects appear unclear. Yet, wholesale exemptions for nonprofits from sales taxes both as purchasers and as sellers should be reconsidered.¹⁵³

C. Tax on Services

Taxation of purchases and sales of tangible goods by nonprofit organizations is a complicated enough issue, but the question of taxing services presents a new set of problems. The fourth tax recommendation by the Union Institute is as follows: "Governments should exempt nonprofit organizations from taxes on services."¹⁵⁴

In the 1980's the most significant trend in state sales tax policies was the effort to include services in the tax base.¹⁵⁵ Because this trend is likely to continue in the next few years, specialists have focused their attention on the theoretical and practical issues related to the desirability and applicability of sales taxation of services. Nonprofit exemption has been analyzed only sporadically, and must be regarded in the light of general considerations of sales taxation and nonprofit theory.

Virtually all nonprofits, and particularly commercial nonprofits are producers of services; they are nearly nonexistent in the industrial sector of the economy. There are three reasons for this phenomenon. First, specifying or evaluating services is inherently difficult. Nonprofits rather than government are therefore entrusted with the responsibility of providing the services. The second reason nonprofits do not exist in the industrial sector may properly be deemed a matter of trust. Because the services provided by nonprofits are often personal, but benefit a second individual or group of individuals rather than the individual who paid for the service, the person who paid must trust that the other person is receiving that which was intended. The third reason centers around the idea that the production of services is often labor-intensive. For nonprofits, which suffer from a lack of capital, the service sector becomes

153. The question is of great interest to for-profit organizations that feel threatened by nonprofit commercial activity. See John J. Motley III, *Stop Unfair Competition from Nonprofits*, 4 SMALL BUS. REP. 27 (1989); see also Comptroller of Public Accounts, Hearing No. 24,625, [1988-1990 Transfer Binder] Tex. Tax Rep. (CCH) ¶ 401-085 (July 20, 1989).

154. KOCH, *supra* note 2, at 91 (Recommendation 49).

155. Mikesell & Hamilton, *supra* note 145, at 31.

the most viable market.¹⁵⁶ Again, it is this nondistribution of profits constraint that limits raising capital in the nonprofit sector and prevents nonprofits from acquiring the ability to sell equity shares. Therefore, nonprofits must rely instead primarily upon donations, retained earnings, and debt for capital.¹⁵⁷

With the spread of "commercial" nonprofits, which are neither donatively supported nor are they considered clubs, the sale of personal services as the primary activity for bringing in income and, in some cases, serves a fiduciary role. Nonetheless, in other cases these nonprofits serve a function that could be served just as well by for-profit firms.¹⁵⁸ For example, seventy-five percent of all general hospitals have been established as nonprofit institutions yet hospitals provide fee-for-services to the public with little or no role in subsidizing its service to the poverty sector.¹⁵⁹ In fact, nonprofit hospitals receive over ninety-five percent of their revenues from payment for services rendered.¹⁶⁰ Many theoreticians agree with John Due's position that, "Acquisition of services by households constitutes consumption expenditure in the same fashion as the purchase of commodities; there is no basic difference between the two that warrants different tax treatment."¹⁶¹

Inclusion of services in the base of sales tax would mean a movement towards a complete consumption tax structure. Economists have argued that a general consumption base is more acceptable than a tax levied on a subset, such as limiting the tax specifically to goods, for achieving horizontal and vertical equity. Another major advantage would be the ability to structure a tax system which minimizes the price distortions that arise when one item, such as a good, is taxed and another close substitute, such as a corresponding service, is not taxed. For example,

156. Hansmann, *supra* note 47, at 835.

157. *Id.* at 877.

158. For example, in 1991, the Louisiana Supreme Court refused to exempt a laundry service set up by several nonprofit hospitals. *Associated Hosp. Servs., Inc. v. Department of Revenue and Taxation*, 588 So. 2d 356 (La. 1991). The laundry served the hospitals, but laundry service sales are taxable in Louisiana law, and there is no statutory exemption for them. The hospitals claimed that the laundry was a subsidiary of their operations, but the Louisiana Supreme Court disagreed. *Id.* at 357. "In light of the fact that transactions between commonly owned legal entities are an everyday commercial reality, we cannot assume that the legislature meant, but simply neglected, to provide an exemption for such situations." *Id.* at 358.

159. Hansmann, *supra* note 47, at 813.

160. WEISBROD, *supra* note 8, at 162.

161. Walter Hellerstein, *Sales Taxation of Services: An Overview of the Critical Issues*, in SALES TAXATION, CRITICAL ISSUES IN POLICY ADMINISTRATION, *supra* note 145, at 42.

usually the purchase of a new refrigerator is subject to tax, but repair of an existing refrigerator is not. Thus, demand will be distorted toward the service. However, historical and social reasons may partially explain why a tax on services cannot be implemented. The distortion described above, in which service on a refrigerator is free from tax, provides one example: the rich buy a new refrigerator; the poor contract to have their refrigerator fixed. A tax on service, therefore, may be perceived as regressive.¹⁶²

Welfare losses from tax distortions have been known to grow more than proportionately to the tax rate. Thus, on the one hand, greater well-being will result if rates are kept low. For a certain amount of revenue, this result can be achieved by using a broader tax base. Many specialists argue that a broader sales tax base would increase elasticity of the tax.¹⁶³ On the other hand, some authors argue that the more remote a service from the tangible good with which it is delivered, the purer it is and therefore pure services have a "vanishing nature" which should not be subjected to sales taxation.¹⁶⁴

With business purchases, the approaches are more uniform. One of the principal concerns raised by extension of the sales tax to services relates to the possibility that it will create additional pyramiding of the sales tax because of its application to services purchased by businesses.¹⁶⁵ Frequently concern arises that many services are consumed primarily by business and that broadening of the base will at least inadvertently be a movement toward greater business taxation rather than toward a larger consumption base.¹⁶⁶ The problem is similar to the case of sales taxation of goods, but is more complex due to the specific nature of services.

Under traditional sales taxation of tangible personal property, pyramiding problems are solved in part by exemption of sales for resale, which is the most widespread and significant area of exclusions for the retail sales tax.¹⁶⁷ Without a broader notion of sale for resale than most

162. John P. James, *Sales Tax on Services: A Tax Administrator's Perspective*, in SALES TAXATION, CRITICAL ISSUES IN POLICY ADMINISTRATION, *supra* note 145, at 69.

163. William F. Fox, *Sales Taxation of Services: Has Its Time Come?*, in SALES TAXATION, CRITICAL ISSUES IN POLICY ADMINISTRATION, *supra* note 145, at 53.

164. Laird Graeser & Allen Maury, *Sales Tax on Services: State Trends*, in SALES TAXATION, CRITICAL ISSUES IN POLICY ADMINISTRATION, *supra* note 145, at 80.

165. Old practice indicates this concern. See MOAK & COWAN, *supra* note 142, at 57.

166. Fox, *supra* note 163, at 51.

167. MOAK & COWAN, *supra* note 142, at 57.

legislation currently incorporates, however, the sales tax on services would not resemble a retail sales tax.¹⁶⁸

In a related issue, service taxation is also complicated by considerations of vertical equity. States often address regressivity issues by adjustments through exemptions to their tax base.¹⁶⁹ In fact, given the diversity of services, the main issue might be not whether to tax services in general, but whether to tax specific services. A persuasive case can be made for broadening the sales tax base to include certain services and an equally persuasive case can be made for exempting another set of services. Other numerous services fall in the middle, and analysts will likely disagree about whether these should be taxed.¹⁷⁰ This controversy is related to the argument that a tax on services means substantial administrative and compliance consequences.¹⁷¹ In order to ensure both efficiency and equity, states would be compelled to define very carefully, and in accordance with their legal and financial means of ensuring compliance, which services should be taxed and which services should be exempt.

Regarding the issue of nonprofit taxation on service purchases in relation to general considerations of charitability, the same conclusions drawn in reference to business purchases of services should be used to decide any action.¹⁷² As for sales of services, which constitute a representative part of nonprofits' activities, charitability seems a relevant argument for exemption.¹⁷³

V. THE QUESTION OF COMPETITION AND FAIRNESS

A. *Competition in the Marketplace*

Nonprofits have always been the object of complaints from the commercial sector, especially when the organizations compete in the marketplace. While tax-exempt status gives nonprofit organizations certain advantages, it also exacts certain costs, such as limitations on the generation and distribution of profit. Thus, quite conceivably, the competition between nonprofit and for-profit organizations will increase without posing a serious challenge to the tax-exempt status of the sector. However, for this to occur, the sector will have to clarify the relative

168. Hellerstein, *supra* note 161, at 45.

169. Graeser & Maury, *supra* note 164, at 81.

170. Fox, *supra* note 163, at 53.

171. *Id.* at 54.

172. Mikesell, *supra* note 146, at 129.

173. *Id.*

advantages and disadvantages of tax-exempt status and develop a rationale for tax exemption that takes account of its changing role.¹⁷⁴

The federal government maintains a distinction between the income that a nonprofit venture earns by virtue of its philanthropic activities and that which it earns as a result of purely commercial activity unrelated to its charitable purpose, known as "unrelated business income." Net income for a nonprofit is taxable if it is the result of an activity not "substantially" related to the purpose which makes the organization exempt under the Internal Revenue Code. Also, the problem of confining the benefit of a tax exemption to an organization's specific exempt operations occurs when otherwise exempt property is used by a private party. The private use gives rise to a property tax assessment necessary to prevent "tax-exempt entities from indirectly gaining—through leasing, for example—the benefits of both tax exemption and the income tax credit."¹⁷⁵ Unrelated business income is fully taxable, and Weisbrod argues that this in itself provides some discouragement to nonprofits from engaging in any activities that would generate it.¹⁷⁶ But the determination of a profit's status as either related or unrelated is as subjective as the determination of whether an organization itself should be exempt.¹⁷⁷ This subjectivity gives rise to complaints from the for-profit community that nonprofits can circumvent the regulations.

Small businesses increasingly complain that nonprofit concerns enjoy advantages over for-profit ventures. Aside from the supposed ability to avoid paying the tax on unrelated business income, nonprofits are accused of charging much of their joint costs to for-profit enterprise, thereby reducing, if not eliminating, taxable unrelated business income even though the activities are actually quite profitable. Donor contributions provide a joint subsidy for all activities including unrelated business, such that contributions to "exempt" activities permit purchase of "joint-use" resources.¹⁷⁸

174. Lester M. Salamon, *supra* note 37, at 41; *see also* Lester M. Salamon, *The Invisible Partnership: Government and the Nonprofit Sector*, 1 BELL ATLANTIC Q. 1 (1984); Lester M. Salamon, *The Voluntary Sector and the Future of the Welfare State*, 18 NONPROFIT AND VOLUNTARY SECTOR Q. 11 (1989).

175. *See* Joan M. Youngman, *The Role of Valuation in Determining Ownership for Tax Purposes*, 43 TAX LAW. 65, 103, n.185 (1989) (quoting STATE OF JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 (1984)).

176. WEISBROD, *supra* note 8, at 114.

177. *Id.* at 114-15.

178. *Id.* at 126-27.

One commentator maintains "that the tax on unrelated business activity creates more unfairness than it can possibly prevent"¹⁷⁹ due to the lack of economic evidence supporting the contentions that nonprofits are able to undersell for-profits and that they benefit from their ability to accumulate capital more quickly because of their exemption. The existence of the tax on unrelated business income actually leads nonprofits to concentrate their activity in areas that would normally not be as well-represented in the economy.¹⁸⁰ Additionally, repeal of the unrelated business income tax, which would permit nonprofits to enter any profit-making industry, would reduce the pressure on for-profit firms in areas that are "related" to the primary activities of nonprofits. While this new freedom could increase the overall level of nonprofit entrepreneurial activity, the diffusion of this activity throughout the economy reduces the chance that an investor in a particular industry will suffer substantial unanticipated losses from nonprofit entry.¹⁸¹ The empirical literature is not sophisticated enough to ascertain the validity of these claims.¹⁸²

Small business would counter these assertions with the argument that nonprofits frequently find creative ways to provide commercial products and services under the tax exempt regime; therefore, they are fighting to maintain a tax on unrelated business income.¹⁸³ And, Congress has pointed out that legislative difficulties could evolve if a repeal were enacted.¹⁸⁴ The behavior of nonprofits is difficult to predict in the market. This inability to precisely calculate nonprofit performance usually sparks discussion on economic modeling techniques that may lead to developing

179. SUSAN ROSE-ACKERMAN, *THE ECONOMICS OF NONPROFIT INSTITUTIONS* 404-05 (1986).

180. Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, in *THE NONPROFIT ORGANIZATION: ESSENTIAL READINGS* 91-108 (David L. Gies et al. eds., 1990).

181. *Id.* at 404-05.

182. See Richard Steinberg, 'Unfair' Competition by Nonprofits and Tax Policy, 44 NAT'L TAX J. 351-64 (1991) (The behavior of nonprofits is difficult to predict in a market, but it is necessary in order to monitor the social benefit of the nonprofits. The article discusses economic modeling techniques that show promise towards developing testable predictions about the behavior of nonprofits, which can ultimately provide guidance in the design of truly empirical studies.).

183. J. Motley, *Stop Unfair Competition from Nonprofits*, 4 SMALL BUS. REP. 26, 26-29 (1989).

184. Elizabeth Wehr, *Revising Non-Profit Rules: A No-Win Undertaking*, 47 CONG. Q. WKLY. REP. 1096-100 (1989).

testable predictions about such behavior and to monitor their social benefit.¹⁸⁵

B. State and Local Tax Incentives to Induce Location

In order to stimulate new or developing business, urban revitalization,¹⁸⁶ or to achieve specific distributional goals, state and local governments use a large number of incentive policies vis-à-vis the for-profit sector.¹⁸⁷ Tax incentives represent only a part of these policies. The tax incentives analyzed in most studies are reductions, exemptions, or credits for purposes of the corporate income tax, sales and use taxes, and the property tax. These categories are sometimes grouped according to their impact on particular business activities and expenses.¹⁸⁸ While incentive effects of state and local taxation upon investment and job creation can be easily identified conceptually,¹⁸⁹ commentators find it far more difficult to quantify them.¹⁹⁰

185. Steinberg, *supra* note 182, at 352.

186. For a discussion of the subject of incentives provided by local governments for public improvements, see Stephen B. Friedman, *Assessing Public Incentives for Private Development*, in SHAPING THE LOCAL ECONOMY, CURRENT PERSPECTIVES ON ECONOMIC DEVELOPMENT (Cheryl A. Farr ed., 1984).

187. THE URBAN INSTITUTE, DIRECTORY OF INCENTIVES FOR BUSINESS INVESTMENT AND DEVELOPMENT IN THE UNITED STATES—A STATE BY STATE GUIDE 9, 12, 41, 42 (1983).

188. *Id.* at 52, 53. Corporate income tax, sales and use taxes, ad valorem property tax exemptions, deductions, credit, and special treatment are reorganized into the following categories: job creation tax credit, investment tax credit, property tax abatement, business inventory, goods in transit, research and development, pollution control equipment, industrial machinery and equipment, industrial fuels and raw materials, energy and fuel conservation measures and other.

189. *Id.* at 59-68.

190. Michael Keischnick, *Taxes and Growth—Business Incentives and Economic Development*, in 11 STUD. DEVELOPMENT POL'Y 12, 15 (Michael Barker ed., 1981). No estimation is possible for preferential assessments to land and buildings used for commercial and industrial purposes given tacitly by many localities. Gary C. Cornia et al., *State-Local Fiscal Incentives and Economic Development*, in URBAN AND REGIONAL DEVELOPMENT SERIES NO. 4, ACADEMY FOR CONTEMPORARY PROBLEMS 4 (1978); Robert W. Wassmer, *Taxes, Property Tax Abatement, Expenditure, and the Composition of the Property Tax Base in Communities within a Metropolitan Area*, 83 NAT'L TAX ASS'N—TAX INST. A.M. 132, 132 (1990). Wassmer discusses the granting of abatements and the effect it has on local fiscal variables in communities within a metropolitan area. The author develops and tests a market-based theory that considers the actions of both communities and firms. The results address five questions: (1) Do local fiscal
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Statistical studies have examined the relationship between state and local taxation on business and the elasticity of investment and employment, but only limited conclusions have been drawn.¹⁹¹ However, empirical research¹⁹² leads to several conclusions.¹⁹³ In spite of tax incentives, most firms making new investments do not even consider locating in any state other than their final choice. Indeed, most firms making new investments in states with tax incentives are unaware that these incentives even exist. In most industries, the general level of business taxation has an undetectable effect on investment patterns, and where an effect can be detected, it is quite small.

Given the very small impact of state tax incentives on the local growth rate and on interstate location decisions, some academics contend that states should "resist the temptation to cut business taxes in order to stimulate development" and that states should take steps to reduce interjurisdictional differences in tax rates so as to reduce interjurisdictional tax competition.¹⁹⁴ Nonetheless, if in the case of nonprofits, state and local tax incentives have an arguable impact upon the market share of the nonprofit sector,¹⁹⁵ one would expect a negative response to these incentives by for-profit business

variables, including property tax abatements, affect local property tax bases? (2) Do local characteristics affect local property tax bases? (3) Why do communities offer tax abatements? (4) What are abatement effects? (5) Do property tax abatements work? Robert W. Wassmer, *Property Tax Abatement and the Simultaneous Determination of Local Fiscal Variables in a Metropolitan Area*, 68 LAND ECON. 263, 263 (1992) (noting that local firm property tax abatements in metropolitan areas are offered to offset noncapitalized profit reducing characteristics and are effective at increasing nonresidential property bases, but at costs, such as decreased home values and increased local property tax rates, that should not be ignored by policy makers).

191. See Keischnick, *supra* note 190, at 46-51.

192. See *id.* at 64-82 (analyzing empirical research undertaken in four areas, based on survey, rough and econometric estimations and benefit-cost analysis of the results).

193. *Id.* at 83.

194. ROGER J. VAUGHAN, *STATE TAXATION AND ECONOMIC DEVELOPMENT* 6-7 (1979).

195. 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, 71 (1987). This is a quantitative analysis of the way in which state and local tax exemptions affect the growing share of the nonprofit sector in health care and education at the state level, and in the largest city in the state. The conclusion is that these exemptions significantly increase the market share of nonprofits vis-à-vis their for-profit counterparts. *Id.* at 79. There are, however, different results at

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The conclusions presented above appear paradoxical when related to the nonprofit sector. These conclusions also shed new light on the increasing complaints of for-profit business against state and local tax incentives provided to charitable nonprofits, even after considering the growing share of nonprofits in "profitable" activities.

In spite of theoretical justifications for removing the tax on the unrelated business income of nonprofit organizations, the political climate today actually supports the strict taxation of all such income of nonprofits, with a tightening of supposed loopholes that allow the firms to "hide" income and take advantage of the system in other ways. For instance, in 1990 one organization, the Business Coalition for Fair Competition¹⁹⁶, proposed a radical revision in state legislation that would forbid all state agencies, institutions of higher education, and nonprofits from competing in markets occupied by private businesses.¹⁹⁷ It appears that politicians see this issue as a popular one so it is likely that this sort of legislation will continue to appear.

the state and largest city level, which points out locational effects of the tax exemptions. *Id.* at 80; see also Cyril F. Chang & Howard Tuckman, *Do Higher Property Tax Rates Increase the Market Share of Nonprofit Hospitals?*, 43 NAT'L TAX J. 175, 185 (1990) (noting that property tax exemptions increase the market share of nonprofit hospitals, but using Probit analysis, reveals that while high property tax rates will increase the probability that only one hospital operates in a region, it does not add to the probability that the hospital will be a nonprofit one). "Probit Analysis involves estimation of an equation to predict the presence of a single hospital in a county because the dependent variable is whether a county has a single hospital (1) or not (0), Probit analysis is used to estimate the contribution of each independent variable to the probability of a county having one hospital." *Id.* at 182.

196. The Business Coalition for Fair Competition ("BCFC") was formed in 1983. It is a coalition of trade associations that argue that they have suffered from competition with nonprofits and state agencies. *Business Group Proposes Barring Nonprofits From Competition*, STATE TAX TRENDS FOR NONPROFITS, Summer 1990, at 1.

197. The proposal is based on an Arizona law that regulates competition by state agencies, community colleges, and universities. *Id.* at 3. The legislation, known as the "Model State Unfair Competition Bill," will allow for some exclusions: nonprofits may remain active if specific state statutes allow it; they may continue activities that are not regularly carried on in the private sector; and they may continue their commercial activity if no private vendor can accomplish the same task. *Business Coalition Update*, STATE TAX TRENDS FOR NONPROFITS, Fall 1990, at 1, 3. The bill will create a Private Enterprise Review Commission ("PERC") having broad powers. Private businesses can appeal to the commission, and if the PERC determines that a nonprofit is behaving improperly, it can compel the nonprofit to stop its activity or ultimately revoke the nonprofit's tax exemption. *Id.* at 3, 4.

In more specific rulings, states and municipalities have been provoked by the arguments of small businesses to differentiate strictly between related and unrelated income. Recently, for example, local governments, at the prompting of for-profit health clubs, challenged on three occasions the exemptions given to YMCA's.¹⁹⁸ Connecticut's legislature proposed a bill to tax the unrelated business income of nonprofits, but, it is one of a few states that still does not tax this particular income.¹⁹⁹

198. In December 1989, the Oregon Supreme Court upheld a finding of the Oregon Department of Revenue that two out of ten Portland YMCA's did not qualify for a property tax exemption because they did not meet the definition of charity: only eight percent of the membership was on scholarship. *Young Men's Christian Ass'n of Columbia-Willamette v. Department of Revenue*, 784 P.2d 1086, 1091 (Or. 1989). The court also found that each YMCA had to qualify separately for exemption. *Id.* at 1092. In March 1992, however, the Oregon Department of Revenue reinstated the exemption for the two YMCA's because they had changed their programming to include more community, family, and youth services. *In re YMCA Columbia-Willamette*, No. 90-1523 (Or. Dept. of Rev. March 23, 1992), *aff'd*, 849 P.2d 567 (Or. Ct. App. 1993). In the second case, for-profit health clubs challenged the exemption given to the Oakland, California YMCA. *Clubs of Cal. for Fair Competition v. Kroger*, 9 Cal. Rptr. 2d 247 (Cal. Ct. App. 1992). The California Court of Appeals found that the club deserved the exemption because of the broad range of services it provided to the community and in spite of the fact that its adult fitness operations were not available to a large segment of the population that could not afford the fee. *Id.* at 254. In the third case, a lower court ruling that the Pittsburgh YMCA was subject to tax was overturned. *Pittsburgh v. Board of Property Assessment*, 564 A.2d 1026, 1031 (Pa. Commw. Ct. 1989). Here the Pennsylvania Commonwealth Court found that the YMCA needed to operate a fitness facility in order to finance its other activities, which were considered more salutary to the community. *Id.* The fact that these cases all deal with YMCA's reflects the fact that the Y has begun to intrude on the for-profit fitness industry, angering that sector and prompting the inquiries.

199. Conn. H.R. No. 465; see *Connecticut to Tax Unrelated Business Income*, STATE TAX TRENDS FOR NONPROFITS, SPRING 1992, at 2. By contrast, the Indiana Code § 6-2.1-3-20(a) exempts gross income for certain § 501(c)(3) organizations. Section (a) states:

[G]ross income received by an (1) institution; (2) trust; (3) group; (4) united fund; (5) affiliated agency of a united fund; (6) not-for-profit corporation; (7) cemetery association; or (8) organization; that is organized and operated exclusively for religious, charitable, scientific, literary, educational, or civic purposes is exempt from gross income tax if no part of the gross income is used for the private benefit or gain of any member, trustee, shareholder, employee or associate of the taxpayer. For purposes of this section, the term "private benefit or gain"

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VI. TECHNICAL ASSISTANCE

The Union Institute's final recommendation states the following: "State governments should provide technical assistance to nonprofit organizations, their accountants, and their lawyers to insure compliance with the tax code regulations."²⁰⁰

This proposed assistance may be justified with respect to market theories such as the Fixed Pie Theory which suggests that there exists a relatively stable set of collective functions to be performed; the larger the portion of our social business undertaken by government, the less that remains for the independent sector.²⁰¹ Consequently, voluntary associations and the state "often have functioned and do function as mutually competitive forces,"²⁰² because the government has been doing more and more of its business through private organizations, many of them not-for-profit.²⁰³ The need for governmental provision of technical advice to the nonprofit sector works against the dislocation of the market such that the government and the voluntary sector will continue to be partners rather than adversaries, a necessity for a more efficient market system.²⁰⁴ Furthermore, it is proposed that nonprofit firms serve as private sector providers of public goods. Nonprofit firms tend to arise where, owing to heterogeneity of demand, governments provide public

does not include reasonable compensation paid to an employee for work or services actually performed.

IND. CODE § 6-2.1-3-20(a)(19) (1994). Courts have applied a strict constructionist view to interpret the statute, holding that "tax laws in general are strictly construed against the state, but all exemption statutes must be strictly construed in favor of tax and against the one seeking the exemption." *State v. Bethel Sanitarium, Inc.*, 332 N.E.2d 808, 810-11 (Ind. Ct. App. 1975) (in response to IND. CODE § 6-2.1-3-22); *Storen v. Jasper County Farm Bureau Co-op Ass'n*, 2 N.E.2d 432 (Ind. Ct. App. 1936).

200. KOCH, *supra* note 2, at 95 (Recommendation 50).

201. The fixed pie theory states that there are only so many people that take on the role of providing collective services in a society. See Paul DiMaggio, *Nonprofit Theories of the Independent Sector* in INDEPENDENT SECTOR, WORKING PAPERS FOR SPRING RESEARCH FORUM SINCE THE FILER COMMISSION 101, 104 (1983).

202. *Id.*

203. *Id.* at 109.

204. KARL POLANYI, *THE GREAT TRANSFORMATION: THE POLITICAL AND ECONOMIC ORIGINS OF OUR TIME* (1957).

goods at a level that is below the desired level of many individuals. Nonprofit firms arise to fill the remaining unsatisfied demand.²⁰⁵

The interaction of the voluntary, nonprofit, private sector, public-interest organizations and institutions with government and business can lead to a confusion of roles. Any of the three sectors can be compromised by borrowing too many of the core values of the other. Some overlap is necessary, as well as desirable, but too much leads to an essential compromise of purpose. In effect, the technical assistance also provides a means of regulation in the nonprofit sector such that, again, the nonprofit sector will function most effectively and efficiently, in turn benefiting all sectors of the community.²⁰⁶

The recommendation for technical assistance also makes sense from a revenue standpoint. If there is no real correspondence with non-profits regarding what is required of them, municipal and state governments could lose large amounts of revenue from non-profits skirting around the rules. The technical assistance gives the government the ability to regulate the non-profits, in order to minimize loss of income. In the laws of the State of New York, for example, there were 130 exemption provisions in 1982, sixty percent of which give full exemptions for an assumed value of \$100 billion. Within these 130 exemptions, subsets were created by multiple provisions which expand the eligibility under these laws. The laws have a large amount of overlap, such as exemptions for "charitable purposes" and also for "benevolent purposes," which sometimes allow organizations to obtain exemption on property that should be taxed.²⁰⁷ The point, however, is that the well-advised know-how to navigate the laws and regulations, leaving those without good advice or long experience to suffer.

CONCLUSION

The Nonprofit Policy Agenda has provided a valuable set of specific recommendations for improving the relationship with respect to taxes between government and the nonprofit sector. While these recommendations are not free of problems and complications, they serve

205. Burton A. Weisbrod, *Toward a Theory of the Voluntary Non-Profit Sector in a Three-Sector Economy*, in ALTRUISM, MORALITY, AND ECONOMIC THEORY, at 190-91 (Edmund S. Phelps ed., 1975).

206. Robert Payton, *Philanthropic Values*, in INDEPENDENT SECTOR, WORKING PAPERS FOR SPRING RESEARCH FORUM: SINCE THE FILER COMMISSION, *supra* note 201, at 41.

207. See generally PETER SWORDS, CHARITABLE REAL PROPERTY TAX EXEMPTIONS IN NEW YORK STATE (1981) (examining New York's real property tax exemption to nonprofits).

as a viable starting point for discussion on the issue of nonprofit taxation at the state and local level.

The recommendations of the institute are logical; they offer practical suggestions towards a more efficient and revenue-conscious tax system regarding nonprofits. The Institute, however, has not questioned the nature of taxation of the nonprofit sector. The Institute's recommendations do not address the rapid growth of commercial nonprofits, which flout traditional definitions of the relationship between nonprofits and government. For example, in Recommendation 48, the Institute suggests that "exempt purpose" should be the measure of whether a nonprofit receives a sales tax exemption. Yet the exempt purpose of many commercial nonprofits does not remotely support or replace government policy initiatives. Thus, Recommendation 48 is too favorable to the nonprofits. New initiatives in the realm of state and local tax policy toward nonprofits should reflect the strict maintenance of the distinction between charitable and commercial nonprofits, instead of focusing on the distinction between exempt purpose and unrelated activity.

The Institute recommendations are valuable but not likely to relax the inherent tension in government-nonprofit relations. This tension exists due to budget shortfalls, highlighting the fact that exemptions usually given to nonprofits reduce revenues available to states and localities. In other words, governments need revenues, and the many nonprofits that do not provide social services can provide those revenues if their exemptions are more thoroughly evaluated.

The Union Institute's first recommendation regarding taxation suggests that states adopt consistent rules for the determination of charitableness for exemption purposes. While laudable for its intent to simplify and clarify state approaches to charitability, the recommendation is neither clear nor easy to apply. One must assume that the Institute suggests consistency among states, since that is where much of the inconsistency lies. However, consistency would be nearly impossible to attain given the current range of rules as well as the historical traditions that often underlie those rules. Ultimately, consistency might clarify the situation of the multistate nonprofit, but would not lead to a solution to the budgetary crisis underlying current reform efforts.

The Institute's second taxation recommendation encourages local governments only to collect user fees where the service involved is measurable and of direct benefit to the nonprofit; localities should not use these fees simply to raise money. This recommendation is linked to the question of property tax reform, because governments usually charge user fees to replace revenue lost to property tax exemptions. Localities have most often chosen to charge fees to the wealthiest organizations, often hospitals, because these institutions appear most likely and able to pay.

Such an approach clearly flies in the face of the Institute's recommendation. A more complicated, yet more effective, strategy would be to reassess the pattern of exemption so that it reflects the charitable/commercial dichotomy. Thus, local governments would be able to maintain their support for those nonprofits that replace or complement government services without withdrawing that support by assessing user fees.

The Union Institute's Recommendations 48 and 49 relate directly to the sales tax, suggesting that nonprofits be exempted from paying taxes on sales and purchases, including services, unless those taxes fall on items or services outside of the organizations' exempt purpose. Once again, the Institute utilizes the "exempt purpose" distinction, while the more relevant distinction might be between charitable and commercial organizations. When granting or re-evaluating exemptions, states and localities should presume against granting such exemptions.²⁰⁸ Generally, the Institute's goal of simplifying the structure of exemptions is laudable, but perhaps it should be reversed. Instead of a blanket exemption, government should establish the opposite standard. Exemptions would be withheld and only granted upon a thorough review.

Finally, the Institute's last recommendation dealing with technical assistance is useful. The recommendation is especially appropriate because the taxation system for nonprofit organizations remains complex.

By suggesting that "exempt purpose" act as the determinant of whether an organization will be taxed or exempted, the Union Institute proposes to treat the current system of exemptions as sacrosanct. A similarly revenue-conscious, and more just, alternative would be to discriminate between types of nonprofits rather than between purposes, since the latter measure does not take social role into account. In other words, government should place discriminatory standards for the behavior of nonprofits before the simplification of the process of exemption, if it wishes to reform the system in such a way as to maximize revenues while maintaining the traditional partnership between government and the charitable, nonprofit sector.

With the application of the Union Institute's recommendations, local and state taxation of nonprofits would be simplified significantly. However, the recommendations would be difficult to apply, and in the view of this writer, they do not represent the most advisable way to proceed. Conceding that any reform of the taxation of nonprofits will be complex, a reform with greater discrimination would be more effective in streamlining the system and alleviating the budgetary difficulties for states and localities. The Union Institute advocates consistency and simplicity, especially regarding Recommendations 46 and 48. Yet, a more

208. See MIKESSELL, *supra* note 100, at 269-70.

detailed treatment of nonprofits which evaluates the entity's social contribution rather than their Internal Revenue Code exemption status may better represent the traditional relationship of government and the nonprofit sector.