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KNOWING AN “EDUCATIONAL INSTITUTION” WHEN YOU SEE ONE: APPLYING THE COMMERCIALITY APPROACH TO TAX EXEMPTIONS FOR UNIVERSITIES UNDER § 501(c)(3)

I. INTRODUCTION

Beginning with the earliest colonial schools, educational institutions have had a consistent presence in America, challenging both their students’ intellects and the federal government, which must implement laws to define and monitor the roles of educational institutions.¹ As colleges and universities have proliferated, particularly over the last century, they have “changed from small, regionalized educational schools to large, government-funded institutions with multi million-dollar budgets and endowments.”² In many cases, these monolithic schools can impact how a community functions or governs itself, often by serving as the primary interest group or employer in their towns.³ Yet, even before the colossal growth and expansion of contemporary universities occurred, when schools were smaller entities, the federal government recognized the

1. *See* *Walz v. Tax Comm’n of N.Y.*, 397 U.S. 664, 704–05 (1970) (Douglas, J., dissenting). In this case, the Supreme Court outlined a brief history of tax exemptions for universities. *Id.* at 703–04. The Court noted that the issue often presented itself in relation to religious institutions, which even the Founding Fathers felt they needed to address. *Id.* at 704–05. As early as 1784, James Madison attempted to pass a bill in Virginia stating that if a tax exemption could not be used for churches, it should be used in support of the state’s educational institutions. *Id.*; *see also* John D. Colombo, *Why Is Harvard Tax-Exempt? (and Other Mysteries of Tax Exemption for Private Educational Institutions)*, 35 ARIZ. L. REV. 841 (1993).

2. John M. Bello, Note, *Economics 101: A Study of the Tax-Exempt Status of Colleges and Universities*, 34 SUFFOLK U. L. REV. 615, 616 (2001).

3. *See id.* at 626. For example, Cornell University has approximately 22,000 enrolled students who can find employment locally through the school. CORNELL CAREERS, <http://careers.hr.cornell.edu> (last visited Oct. 24, 2014), *archived at* <http://perma.cc/9SJ2-ZME7>; *see also* *Conducting a Job Search in the Ithaca Area*, CORNELL CAREERS, https://www.hr.cornell.edu/jobs/ithaca_job_search.html (last visited Oct. 28, 2014) (recommending ways for Cornell University students to find local employment). Yet, the population of Ithaca, New York, the town where the school is located, has only slightly more than 30,000 people located in it. *State & County QuickFacts: Ithaca, New York*, U.S. CENSUS BUREAU, <http://quickfacts.census.gov/qfd/states/36/3638077.html> (last revised July 8, 2014), *archived at* <http://perma.cc/K9B4-TTVQ>. Thus, because of its presence as the local supermajority, Cornell University functions as both the biggest interest group, impacting how the town governs itself, as well as the largest supplier of labor, given its large student body, in the Ithaca community.

value of higher education⁴ and sought to support it with the hope of encouraging academic endeavors within the populace.⁵

Over time, these efforts culminated in the creation of Internal Revenue Code § 501(c)(3),⁶ which outlines the parameters for determining tax exemptions for non-profit organizations, including educational institutions.⁷ Given the tremendous size and scope of contemporary universities, however, this statute appears to be overly generous in its applications and definitions.⁸ Colleges, in an increasing number of facets, are beginning to more closely resemble businesses than educational entities driven solely by academic pursuits.⁹ As a result, numerous

4. See Colombo, *supra* note 1, at 844. Because many of the first universities in America—such as Yale, Dartmouth, Brown, and William & Mary—began as “quasi-public” schools, the colonies had an interest in expanding these institutions to educate their citizens because they existed for the enhancement of their populaces. *Id.* at 845. Thus, for example, some colonies “extended local tax exemption to the professors who taught in colleges or universities as well as their students” to encourage involvement and participation from community thought leaders and academics. *Id.* at 844. This trend has become engrained in the American approach to educational institutions to the point where today “virtually every state has either a constitutional or statutory provision exempting educational institutions from state and local property and income taxes.” *Id.* at 845.

5. The tax exemptions can be “[v]iewed as subsidies,” serving as tacit support from the government for the continued existence of these entities. Evelyn Brody, *All Charities Are Property-Tax Exempt, But Some Charities Are More Exempt than Others*, 44 NEW ENG. L. REV. 621, 639 (2010). The government believed that the use of financial aid would be one of the most expedient mechanisms it could offer to help enable the proliferation of educational institutions. *See id.* (explaining that favorable tax treatment can provide additional funds to operate and maintain a business or organization); *see also* *Regan v. Taxation with Representation of Wash.*, 461 U.S. 540, 544 (1983) (establishing that “[b]oth tax exemptions and tax deductibility are a form of subsidy that is administered through the tax system” because tax exemptions effectively have the same financial impact “as a cash grant to the organization of the amount of tax it would have to pay on its income”). Essentially, “insulating educational institutions from the economic burden of taxation would allow them to spend more of their revenue on infrastructure and academic pursuits.” Bello, *supra* note 2, at 617–18.

6. I.R.C. § 501(c)(3) (2010). Throughout this Note, this legislation will be referred to as “§ 501(c)(3).”

7. Under this statute, “corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes” are entitled to tax exemptions from the government. *Id.* (emphasis added).

8. See Bello, *supra* note 2, at 615–16 (noting the substantial growth in size of universities over time). Many scholars argue that universities no longer fit within the confines of the law as it is written because of their tremendous size, capabilities, and involvement in their communities. *Id.* In addition, though the legislation applies to “any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes,” this note will only address the pertinent concerns regarding tax exemptions for colleges. I.R.C. § 501(c)(3) (2010) (emphasis added).

9. Schools are no longer purely educational in nature. Contemporary universities pursue pecuniary endeavors in athletics, research, marketing, and multiple other areas. Essentially, universities are being unjustly rewarded with tax exemptions for labeling themselves as educational institutes when in fact they are more akin to multi-million (or even multi-billion) dollar corporations that compete in the various markets as any other company would. *See* Oksana Koltko, *Chasing Profits—Disregarding Values: Legal Persona of Elite Schools and Their Destructive Tax-Exempt*

frameworks have been created for determining whether an educational institution is actually educational in nature because the line between a business and a school has been blurred.¹⁰ Essentially, modern universities have evolved to the point where they can no longer be considered purely educational institutions as defined by federal law. Instead, as they exist today, universities function more like businesses, which should preclude them from receiving the tax exemptions that the government affords to charitable institutions.

This Note will examine the appropriateness of allowing tax exemptions for educational institutions to universities and argue that modern colleges have begun to more resemble businesses rather than schools given their tremendous scope, size, and profit-making capabilities. Part II provides a historical survey and genesis of tax exemption legislation to understand the basic principles, justifications, and goals behind the creation of these laws. Part III outlines four frameworks that have been created to determine if an entity, specifically a university, is an educational institution. This Part will enumerate multiple components and criteria that are used to evaluate organizations, concluding that the use of quantifiable measurements under the commerciality approach makes it the most useful and appropriate framework for the government to employ. Part IV analyzes the applicability of using the commerciality approach by demonstrating the multiple profitable business ventures that contemporary universities are involved in. Finally, Part V offers comprehensive proposals for adopting the commerciality approach and addresses problems that may arise during their implementation.

II. BACKGROUND

The concept of university tax exemption precedes American history, dating back to medieval Europe.¹¹ Though colleges were originally “no more than relatively spontaneous, informal, and unstructured associations of teachers and students who combined into communities . . . analogous to

Status, 42 J. MARSHALL L. REV. 1073, 1074 (2009). Furthermore, there is only limited legislative history available “to provide guidance in delineating the precise intended scope and limits” of what even defines an educational institution. Lynn Lu, *Flunking the Methodology Test: A Flawed Tax-Exemption Standard for Educational Organizations That “Advocate[] a Particular Position or Viewpoint”*, 29 N.Y.U. REV. L. & SOC. CHANGE 377, 380 (2004). This ambiguity enables many institutions to unjustly enrich themselves under the facade of academia.

10. Colombo, *supra* note 1, at 848–57.

11. The idea of a university providing education and knowledge to students has been present for centuries. *Id.* at 844–45; see also John A. Beach, *The Management and Governance of Academic Institutions*, 12 J.C. & U.L. 301, 309–10 (1985).

the trade guilds,” their positive contributions to society gained significant appreciation and recognition over time.¹² For example, in the Preamble to the Statute of Charitable Uses Act of 1601, which enumerates purposes and activities that the British Crown believed were beneficial to society and deserving of private contributions, “Schooles of Learninge, Free Schooles and Schollers in Univsities”¹³ are included, demonstrating that the English government understood the importance of educating the populace and wanted to foster the growth of the developing concept of a university.¹⁴ Consequently, the English government, as well as other governments throughout Europe,¹⁵ recognized that the expansion of these institutions could be expediently accomplished by offering them tax exemptions.¹⁶ By being free of the requirement to contribute to the government’s maintenance via taxation, the universities could instead use the money for the education of students.¹⁷

The United States, on the other hand, would not codify tax exemptions for schools in federal law¹⁸ until centuries later in 1894, when Congress passed the first corporate income tax law.¹⁹ This legislation contained a broad exemption for “corporations, companies, or associations organized and conducted solely for charitable, religious, or educational purposes.”²⁰ Furthermore, it appears that this segment of the law pertaining to tax

12. Beach, *supra* note 11, at 304.

13. The Statute of Charitable Uses Act, 1601, 43 Eliz. I, c. 4 (Eng.). Though educational institutions were featured on this list, other places, such as orphanages and churches, were also included in the legislation. It was intended to serve as a guideline for what the Crown considered to be important. This list has developed and grown further through English case law over the last few centuries to formally define the parameters of which entities and organizations qualify for tax exemptions. *Id.*

14. Universities had unofficially existed in the United Kingdom long before this statute was passed. Beach, *supra* note 11, at 309. Students and teachers from all over the world would congregate together to study and teach different subjects. For example, the University of Oxford can trace its origins back to the dynasty of King John in the late 12th century; however, the government did not officially charter it as a corporate entity until 1570 during the reign of Queen Elizabeth I. *Id.*

15. Universities were not only operating in England during this time period. Similar institutions, such as the University of Toulouse (France), University of Bologna (Italy), and Trinity College (Ireland), were concurrently holding classes and teaching students. *Id.* at 305 n.23.

16. *Id.* at 314 (explaining that tax exemptions provide “freedom from the burden of enforced contribution to the expenses and maintenance of government,” which gives the institution additional money to use for its own purposes).

17. *Id.*

18. State property tax exemptions for schools and churches had existed before the federal law was enacted. Koltko, *supra* note 9, at 1089.

19. See *Details of the Income Tax: The Internal Revenue Bill as Finally Completed*, N.Y. TIMES, Jan. 23, 1894, at 3 (reporting the passage of a new law that imposed a tax on the income of corporations as well as individuals).

20. Revenue Act of 1894, ch. 349, § 32, 28 Stat. 556 (1894); see also Colombo, *supra* note 1, at 845.

exemption was passed without much controversy or debate, emphasizing the universality of its congressional approval.²¹ At the time, this law was predominantly viewed as confirmation of the framework of university tax exemptions that had already been in place “at the state and local level” of government.²²

Since then, Congress has continued down the path of exemptions for universities, utilizing its powers under the Taxing Clause²³ and enabling the proliferation of legislation that gives tax benefits to universities.²⁴ Initially, educational activities that fell within tax-exempt status were loosely defined and widely applicable, such that assorted broad or eclectic academic pursuits would be included within the law.²⁵ This extremely generous labeling, however, has been significantly modified and narrowed over time.²⁶ In particular, one of the most important landmarks in the genesis of tax exemptions was § 501(c)(3),²⁷ which was “introduced in its current form in 1954.”²⁸ This law has been the paradigmatic piece of legislation for guiding the government’s allowance of university tax exemptions, outlining the contours and requirements that institutions must meet to qualify for these benefits.²⁹ Yet, even with the guidelines it

21. See Colombo, *supra* note 1, at 845. The 1894 law would ultimately be deemed unconstitutional one year later, but now all subsequent federal income tax legislation offers a similar exemption for educational institutions. *Id.*

22. *Id.* By the late 19th century, many states had recognized the value of providing tax exemptions to nonprofit organizations, which included universities. State and local governments recognized the value that these organizations could bring to their communities, and many commentators believe that the first federal tax exemptions were therefore simply mimicking this recognition of schools’ contributions to society. *Id.*

23. U.S. CONST. art. I, § 8, cl. 1. (“The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises . . .”). Essentially, this clause grants the federal government the ability to levy taxes to raise revenue for itself; however, this power has since been expanded through Supreme Court jurisprudence to include regulatory, prohibitive, and protectionist taxes (and tariffs). See, e.g., *United States v. Butler*, 297 U.S. 1 (1936). The extensive power and judicial history of the Taxing Clause will not be further discussed in this Note though as it is outside the scope of the issue of tax exemptions for educational institutions.

24. See Lu, *supra* note 9, at 377–79 (discussing congressional ability to grant tax exemptions).

25. In the 1920s, there was an extremely expansive definition of education. Among other endeavors, “the IRS concluded that the educational exemption applied to activities as diverse as studying ruffled grouse, maintaining wild bird sanctuaries and forest land, and disseminating geographic knowledge.” Colombo, *supra* note 1, at 846 (citations omitted). Furthermore, some courts applauded ambitious citizens striving to learn more about diverse topics and encouraged them to follow academic pursuits. See, e.g., *State v. Carleton Coll.*, 191 N.W. 400, 402 (Minn. 1923) (noting that citizens’ educational pursuits laid the foundation for substantiating the existence of university tax exemptions).

26. See Colombo, *supra* note 1, at 846–47 (introducing the difficulty that defining the term “education” has historically presented).

27. I.R.C. § 501(c)(3) (2010).

28. Lu, *supra* note 9, at 385.

29. See Treas. Reg. § 1.501(c)(3)-1(d)(3)(i) (2008). According to this regulation, an educational

articulates, there is still a tremendous amount of debate surrounding what constitutes “education” and who is allowed to claim that they are “educating” others via their services.³⁰

Therefore, Congress has attempted to remedy some of the problems caused by the ambiguity with even more legislation.³¹ As a result, unlike during the late 19th and early 20th centuries, there is now no longer immense, unrestrained freedom in defining what constitutes an educational institution because the government recognized the dangers of unchecked organizations.³² In particular, the government did not want tax-exempt groups to gain unfair competitive advantages in the market, which has led to the taxation of unrelated business activities.³³ Essentially, the relevant laws establish that charitable organizations that would be “exempt from federal income taxation pursuant to Section 501(c) of the Internal Revenue Code are, nevertheless, subject to taxation on income derived from any trade or business regularly carried on by them which is unrelated to their exempt purposes.”³⁴ This law reflects the congressional desire to allow tax-exempt organizations to pursue commercial ventures while limiting them with the same competitive restrictions that their tax-paying counterparts in the market face.³⁵

For example, when an esteemed tax-exempt scientific organization exploits its reputation by selling endorsements of laboratory equipment to aid manufacturers, the income derived from that transaction does not

institution can be defined by its primary tax-exempt purpose. If “(a) [t]he instruction or training of the individual for the purpose of improving or developing his capabilities; or (b) [t]he instruction of the public on subjects useful to the individual and beneficial to the community,” the entity can argue that it should be tax-exempt. *Id.* Broad examples of organizations that meet these requirements are enumerated in the regulation. *Id.* § 1.501(c)(3)-1(d)(3)(ii). These entities include traditional universities, or other schools, that have “a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on” as well as “forums, panels, lectures, or other similar programs” and “[m]useums, zoos, planetariums, [and] symphony orchestras.” *Id.*

30. Colombo, *supra* note 1, at 846.

31. *See* I.R.C. §§ 512–13 (2013). These laws are meant to clarify what education is and they have successfully helped eliminate some confusion; however, they have also opened the door to other concerns such as distinguishing exempt charitable activities from non-exempt business activities. “Specifically, income of non-profit organizations generally is exempt from federal and other income taxes, while the for-profit business must pay taxes on the same income from the same type of activities.” Rita Marie Cain, *Marketing Activities in the Non-Profit Sector—Recent Lessons Regarding Tax Implications*, 36 AM. BUS. L.J. 349, 350 (1999).

32. Bello, *supra* note 2, at 618.

33. I.R.C. § 513 (2013).

34. Donald C. Haley, *The Taxation of the Unrelated Business Activities of Exempt Organizations: Where Do We Stand? Where Do We Seem to Be Headed?*, 7 AKRON TAX J. 61, 61 (1990).

35. *Id.* at 61–62.

“contribute importantly to the accomplishment of” its exempt purpose, which is research and development.³⁶ Thus, the income derived from the endorsement would be taxed as unrelated business income under the law.³⁷ Furthermore, the courts have attempted to support congressional efforts to define and maintain these tax exemptions.³⁸ “[C]ase law has slowly shifted in favor of the taxpayers because courts have begun to scrutinize the composition and the operations of exempt institutions,” minimizing the ambiguity present in the statutes.³⁹ Essentially, courts are attempting to resolve loopholes in the tax exemptions afforded to universities to prevent systematic abuse.⁴⁰

Yet, despite the government’s considerable efforts, there is still tremendous disagreement regarding the vagueness presented by undefined terms in the law.⁴¹ As a result, scholars have created multiple frameworks to aid in the evaluation and definition of an “educational institution”⁴² that can be applied to universities.⁴³

III. STANDARDS FOR EVALUATING § 501(C)(3)

To qualify as tax-exempt, there are a few basic bureaucratic hurdles that an organization must surpass.⁴⁴ Satisfying these conditions is rarely a

36. Treas. Reg. § 1.513-1(d)(4)(iv) (2013).

37. *Id.* The regulation additionally provides multiple instances that illustrate other qualified tax-exempt organizations that obtain income related to the purpose of their tax exemption. *Id.* For example, when a tax-exempt performing arts school for children charges admission to a show staged by its students, the profit from the tickets does not constitute unrelated business because the performance is an essential part of the children’s development as performers. *Id.* § 1.513-1(d)(4) (2013). Thus, the income the school derives from the performance is not taxed because it contributes to the dance studio’s recognized tax-exempt purpose: fostering the study and creation of art. *Id.*

38. *See, e.g.*, *United States v. Am. Coll. of Physicians*, 475 U.S. 834, 848–49 (1986) (elaborating on the shifting judicial standards, specifically that scrutiny is moving away from educational content and toward conduct); *State ex rel. Wis. U. Bldg. Corp. v. Bareis*, 44 N.W.2d 259, 261 (Wis. 1950) (noting the use of tax exemptions “to produce all possible opportunity to those seeking the advantages of the university”).

39. Bello, *supra* note 2, at 618.

40. *Id.*; *see also Rensselaer Polytechnic Inst. v. Comm’r*, 732 F.2d 1058, 1061 (2d Cir. 1984) (explaining that Congress wanted to limit the inherent unfair competitive advantages given to tax-exempt entities).

41. *See generally* Laura B. Chisolm, *Exempt Organization Advocacy: Matching the Rules to the Rationales*, 63 IND. L.J. 201, 206 (1987) (explaining various concerns presented by ambiguity in the law).

42. I.R.C. § 501(c)(3) (2010).

43. *See generally* Koltko, *supra* note 9, at 1099–1101.

44. The basic bureaucratic standards establish that the institution must hold organizing documents that limit the entity’s purpose and operations to a charitable function, which includes education. Treas. Reg. § 1.501(c)(3)-1(b)(1) (2008); *see also* Colombo, *supra* note 1, at 845–46. In addition, the entity’s operations must actually pursue that charitable goal while still complying with

challenge though, as most entities meet these requirements in the course of their daily operations.⁴⁵ Instead, most litigation pertains to having a court decide whether an educational institution is barred from a tax exemption because its activities are not legitimately educational in practice.⁴⁶ Not surprisingly, both the Internal Revenue Service and the courts have had trouble creating a definition that can be uniformly applied.⁴⁷ This ambiguity has led to the creation of four different frameworks for analyzing whether an “educational institution” is eligible for a tax exemption.⁴⁸

A. Inurement/Private Benefit Approach

The inurement/private benefit standard is a two-part scheme that stems from the language “no part of [an educational institution’s] net earnings of which inures to the benefit of any private shareholder or individual”⁴⁹ in § 501(c)(3).⁵⁰ The first facet of the test, inurement, has been relatively uncontroversial and straightforward because violations of it typically involve clear abuse of the benefits derived from the tax exemption.⁵¹ It refers to scenarios where an educational institution’s funds or economic benefits are diverted from the class of people the group is supposed to help, such as students, and instead used to benefit the organization or its leadership and employees.⁵² Tax-exempt entities are not supposed to distribute profits to their owners, directors, or anyone with ownership-like authority, which this approach recognizes as a disqualifier for tax-exempt

limits on political lobbying and campaign activity so it does not demonstrate bias or corrupt its charitable purpose. Treas. Reg. § 1.501(c)(3)-1(b)(1); *see also* I.R.C. § 501(h).

45. *See generally* Brody, *supra* note 5; Chisolm, *supra* note 41. Most of the debate surrounding tax exemptions pertains to an entity’s scope, charitable activities, or the extent of its unrelated business income. The ability to form a charitable organization is rarely contested in the courtroom. Chisolm, *supra* note 41, at 256–61.

46. I.R.C. § 501(c)(3). For example, tax-exempt organizations can have “no part of [their] net earnings [that] inures to the benefit of any private shareholder or individual” as well as “no substantial part of the activities [that] is carrying on propaganda, or otherwise attempting, to influence legislation . . . on behalf of (or in opposition to)” candidates for public office. *Id.*

47. *See* Colombo, *supra* note 1, at 846–48.

48. *Id.* at 848–55.

49. I.R.C. § 501(c)(3).

50. *See* Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (2008); *see also* Colombo, *supra* note 1, at 850–51.

51. Colombo, *supra* note 1, at 850.

52. *Id.*

status.⁵³ For example, inadequate rent charged by the entity to an officer of the company would constitute inurement.⁵⁴

The second component of the test, private benefit, is less comprehensible.⁵⁵ It refers to “the situation in which an entity’s benefits appear to flow primarily to a narrow group, rather than to the general community.”⁵⁶ Essentially, if the class of people that the organization is believed to be helping is too small, the tax exemption cannot apply under this framework.⁵⁷ This approach stems from the belief that the community, rather than one class of people, should be benefiting from tax-exempt organizations.⁵⁸ Yet, while advocates of this approach laud its simplicity and supposedly straightforward enforcement, critics counter by noting that the effects and endeavors of tax-exempt organizations are difficult to define and quantify.⁵⁹ It becomes exceedingly difficult to draw a line in determining where the impact of the efforts undertaken by a tax-exempt organization ends, especially for universities.⁶⁰ As a result, this approach cannot apply to educational institutions because schools are involved in diverse, overlapping activities with wide-ranging impacts.⁶¹ It is unclear when a school’s benefits stops applying solely to its students and affects its entire community.⁶²

53. Darryll K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 VA. TAX REV. 575, 577 (2000). See also Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980). This understanding has also received judicial recognition. See also *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 585 (1997).

54. Colombo, *supra* note 1, at 850. There have been multiple instances of people pursuing litigation over unfair benefits given to the leaders of tax-exempt organizations. See, e.g., *Harding Hosp., Inc. v. United States*, 505 F.2d 1068, 1078 (6th Cir. 1974) (illustrating an example of rent advantages given to an entity’s officers).

55. Colombo, *supra* note 1, at 850–51.

56. *Id.* at 850.

57. For example, an organization disseminated information through a newsletter and engaged in litigation to protect the finances for a teachers’ retirement system. *Id.* at 851 (citing *Retired Teachers Legal Def. Fund, Inc. v. Comm’r*, 78 T.C. 280 (1982)). The court decided that the entity was not exempt because it primarily served the private interests of its members, the teachers, rather than the community at large. See *id.*

58. Colombo, *supra* note 1, at 850–51.

59. See *id.* at 851 (exemplifying the trouble courts have had in trying to quantify the effects of a particular action).

60. See *id.* at 851.

61. Universities are “engaged in ‘training the individual,’” which many consider to be “too private” of an activity for community benefit. *Id.* For example, liberal arts students may not necessarily use the education that they get in school to directly benefit the community. Their training in research and analysis may be tangentially useful but it is difficult to determine what extent the education from school actually played a role in their contributions. Thus, the inurement/private benefit approach suffers from the inability to create clear distinctions utilizing quantifiable factors. See *id.*

62. See *id.*

Thus, meeting both components of the inurement/private benefit approach is difficult to accomplish. Adherence relies too heavily on immeasurable factors and ambiguous guidelines, failing to adequately describe what can constitute education.⁶³

B. Public Policy Approach

The second framework is the public policy approach, which is outlined in *Bob Jones University v. United States*.⁶⁴ In this case, the Supreme Court held that “an institution seeking tax-exempt status must serve a public purpose and not be contrary to established public policy,” meaning that the organization should further a community cause so that it does not undermine the conferral of any benefits to society.⁶⁵ Applying this approach, the Court decided that racially discriminatory admissions policies were sufficiently against the public interest, which justified the university losing its tax exemption.⁶⁶ Yet, even the Supreme Court recognized that this standard would be difficult to apply in more ambiguous situations.⁶⁷ It declared that denying an institution a tax exemption can be done “only where there can be no doubt that the activity involved is contrary to a fundamental public policy.”⁶⁸ Thus, this framework suffers from a similar vagueness problem as the inurement/public benefit standard.

Proponents of this approach highlight its noble virtues and valiant moral efforts; however, they fail to acknowledge its limited applications.⁶⁹ While some public policy concerns can involve inimical practices or standards, such as racial discrimination or segregation,⁷⁰ that society largely agrees to reject, other disputes could arise where people differ in opinion regarding the severity of the issue, making it difficult to decide

63. *Id.* at 851.

64. 461 U.S. 574 (1983).

65. *Id.* at 586. Though this case outlines a framework for determining the allowance of a tax exemption, it is also often cited as a First Amendment case because it addresses whether a religious university is allowed to enforce racially discriminatory policies for admissions. *See generally id.* at 602–604. This Note will not address any of the free exercise of the First Amendment concerns presented by this case.

66. *Id.* at 591–96.

67. *See id.* at 592 (recognizing that the “charitable” designation is a “sensitive matter[.]” that can present significant ambiguity).

68. *Id.*

69. *See Colombo, supra* note 1, at 854–55 (enumerating examples of ambiguity).

70. *See, e.g., Brown v. Bd. of Educ.*, 347 U.S. 483 (1954).

which actions actually serve a helpful public purpose.⁷¹ For example, all-girls colleges could potentially fail to meet this standard for serving a public policy because, regardless of any of their other attributes or qualities as institutions, they do not admit men and some officials could see this as an unjust practice and seek to deny a tax exemption.⁷² Furthermore, some commentators fear that this line of reasoning could be extended, given its inherent ambiguity, to designate extreme or simply unpopular philosophies as contrary to public policy, even though the inclusion of these fringe ideas is necessary for the continuation of an open, diverse society.⁷³ Thus, if the public policy approach is followed, the Internal Revenue Service would have a tremendous, undue amount of power in determining which ideas should be proliferated via its decisions in allotting tax exemptions to institutions.⁷⁴

C. Methodology Approach

Third, some courts employ the methodology approach to determine if an educational institution advocates a particular viewpoint without offering information on contrary opinions, which, if applicable, would disqualify it as a tax-exempt entity.⁷⁵ There are four factors that courts will consider when utilizing this approach:

- (1) whether the presentation of viewpoints unsupported by a relevant factual basis constitutes a significant portion of the organization's communications;
- (2) whether, to the extent viewpoints purport to be supported by a factual basis, the facts are

71. See *Bob Jones Univ.*, 461 U.S. at 592 (showing segregation as an example of behavior that is contrary to the enforcement of justice); see also Colombo, *supra* note 1, at 854–55.

72. Most courts have held that gender discrimination, particularly in non-educational cases, is not a sufficient basis for denying an organization a tax exemption though. Colombo, *supra* note 1, at 855; see, e.g., *Junior Chamber of Commerce, Inc., v. U.S. Jaycees*, 495 F.2d 883 (10th Cir. 1974).

73. See *Bob Jones Univ.*, 461 U.S. at 606–11 (Powell, J., concurring).

74. Many commentators believe that the Internal Revenue Service already has too much discretion in determining which fringe viewpoints are too extreme for consideration. “For example, the IRS uses a public policy analysis in determining whether demonstrations, economic boycotts, strikes and picketing are permissible activities by charitable organizations.” Colombo, *supra* note 1, at 855 n.89.

75. *Id.* at 851. This test does not have widespread following or approval within the court system. See, e.g., *Nat'l Alliance v. United States*, 710 F.2d 868 (D.C. Cir. 1983). To qualify for a tax exemption under the methodology test approach, advocacy groups, including educational institutions, must present “a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion” because “an organization is not educational if its principal function is the mere presentation of unsupported opinion.” Treas. Reg. § 1.501(c)(3)-1(d)(3)(i) (2008).

distorted; (3) whether the organization makes substantial use of particularly inflammatory and disparaging terms, and expresses conclusions based more on emotional feelings than on objective factual evaluations; and (4) whether the approach to a subject matter is aimed at developing an understanding on the part of the addressees, by considering the extent of their prior background or training.⁷⁶

By weighing these four components, courts essentially attempt to determine whether an institution is educational based predominantly on its conduct.⁷⁷ This framework can be helpful when applied to advocacy groups,⁷⁸ but it is not as useful in relation to universities. Similar to the other frameworks, the methodology test is based on the unquantifiable measure of behavior, making it especially difficult to apply to schools.⁷⁹ Universities are premised on the notion of teaching students about all different types of ideas and philosophies, many of which are new or unsubstantiated, and the line between educating and advocating can easily become blurred.⁸⁰ Thus, implementing the methodology test could force universities to curtail discussions on new or novel concepts to ensure that none get any special or unequal treatment compared to others.⁸¹ Yet, one of the foremost goals of universities is to cultivate ideas and limiting the discussion of any concepts could hinder this purpose.⁸² Thus, the lack of objective criteria similarly hinders the usage of the methodology test approach.⁸³

76. Tommy F. Thompson, *The Availability of the Federal Educational Tax Exemption for Propaganda Organizations*, 18 U.C. DAVIS L. REV. 487, 505–06 (1985); see also *Big Mama Rag, Inc. v. United States*, 631 F.2d 1030 (D.C. Cir. 1980); Jeffrey I. Tilden, Note, *Big Mama Rag: An Inquiry into Vagueness*, 67 VA. L. REV. 1543 (1981).

77. See Colombo, *supra* note 1, at 852.

78. The Internal Revenue Service used this approach to deny a tax exemption to an organization that openly advocated for a race war, which was not conduct the Service wanted to support. See generally *Nat'l Alliance*, 710 F.2d at 868.

79. See Colombo, *supra* note 1, at 853.

80. See *id.* Additionally, “[m]ore than a few educators, in fact, view the noblest purpose of universities as nurturing unpopular ideas that may, at least in the beginning, have little factual foundation.” *Id.*

81. See *id.* (noting that the discussion of various points of view is “an inherent part of the democratic process”).

82. See *id.* (emphasizing the difficult distinctions schools may be forced to make in defining activities).

83. *Id.*

D. Commerciality Approach

The final framework is the commerciality approach.⁸⁴ Arising from an “interpretation of the exemption requirement that an organization pursue exclusively a charitable purpose,” this framework essentially looks at tax-exempt organizations, including educational institutions, as if they were businesses that provide charitable services.⁸⁵ Known as the “primary purpose” test, if an organization is effectively running as a for-profit business, which is a decision made by the Internal Revenue Service, its tax exemption can be denied.⁸⁶ Thus, an organization with a trade or business can be tax-exempt so long as the enterprise is “insubstantial” or “in furtherance of the organization’s exempt purpose.”⁸⁷ This requirement reinforces the notion that schools are meant to be educational rather than for-profit because it inherently attempts to detach money from education.⁸⁸ The other approaches do not recognize such a separation.⁸⁹

Furthermore, the use of profits provides a quantifiable measure of how big a particular endeavor within a university is.⁹⁰ Critics of this approach claim that it is too nebulous to be uniformly applied to tax-exempt institutions.⁹¹ Yet, this concern can be remedied by having lawmakers establish an amount of revenue money, either a percentage or an absolute dollar total, which would demarcate an institution as commercial rather than educational (discussed in Part V). If there were too much expense or funding being attributed to a for-profit venture, the educational institution

84. *Id.* at 848.

85. *See id.*; *see also* I.R.C. § 501(c)(3) (2010).

86. Colombo, *supra* note 1, at 848.

87. Treas. Reg. § 1.501(c)(3)-1(c), (e) (2008). To date, many of the organizations that have been denied tax exemptions by the Internal Revenue Service under this approach lost the benefit because they were deemed to be commercial publishers. Colombo, *supra* note 1, at 848. For example, an organization that published Biblical teaching materials for classes was deemed to be operating primarily for profit. *Id.* (citing *Scripture Press Found. vs. United States*, 285 F.2d 800, 805–06 (Ct. Cl. 1961), *cert. denied*, 368 U.S. 985 (1962)). Based on its activity, it appeared that education was only secondary to the group’s mission, which disqualified it as a tax-exempt organization. *Id.* Publishing, however, has not been the only activity that can prohibit an educational institution from receiving a tax exemption. An organization that facilitates educational pursuits such as seminars and lectures was denied tax-exempt status because it was “part of a franchise system which is operated for private benefit and its affiliation with this system taints it with a substantial commercial purpose.” *Id.* at 848–49 (quoting *Est. of Haw. v. Comm’r*, 71 T.C. 1067, 1080 (1979), *aff’d*, 647 F.2d 170 (9th Cir. 1981)). The appearance of an educational institution was only a facade because the court deemed the organization to be simply one part of a larger for-profit entity. *Id.*

88. *See* Colombo, *supra* note 1, at 848–49 (noting that “an organization pursue exclusively a charitable purpose” to receive a tax exemption).

89. *See id.* at 850–55.

90. *See id.* at 848.

91. *See id.* at 849.

would accordingly be denied a tax exemption. Therefore, the commerciality approach provides a useful mechanism for evaluating the legitimacy of the tax exemptions granted to universities.⁹²

Given the monumental scope, expansive contributions, and extensive services that contemporary universities provide to their students, communities, and the world around them, it is necessary to assess schools' tax exemptions in consideration of their commerciality because their multiple profit-generating enterprises suggest that these institutions are not focused primarily on educational endeavors.

IV. ANALYSIS

Under the commerciality approach, § 501(c)(3) should not include universities as tax-exempt "educational institutions" because schools generate significant profits and endeavor to create business relationships in industries unrelated to education.⁹³ Contemporary colleges have become multi-faceted behemoths that engage in activities unrelated, or, at best, loosely related, to their supposed educational missions.⁹⁴ Thus, upon investigation, it becomes clear that universities are more akin to businesses than educational entities.⁹⁵

A. Athletics

First, the existence of the highly profitable marketing monolith known as "college athletics" casts doubt on the inclusion of many schools as educational institutions under § 501(c)(3).⁹⁶ Perhaps one of the most visible components of some universities, especially Division I⁹⁷ schools,

92. See Daniel Shaviro, *From Big Mama Rag to National Geographic: The Controversy Regarding Exemptions for Educational Publications*, 41 TAX L. REV. 693, 722–28 (1986). There are multiple positives and pitfalls regarding the commerciality approach, which will be investigated in the following section.

93. See I.R.C. § 501(c)(3) (2010).

94. See Risa L. Lieberwitz, *The Marketing of Higher Education: The Price of the University's Soul*, 89 CORNELL L. REV. 763, 764 (2004) (reviewing DEREK BOK, *UNIVERSITIES IN THE MARKETPLACE: THE COMMERCIALIZATION OF HIGHER EDUCATION* (2003)).

95. See *id.*

96. Peter D. Blumberg, Comment, *From "Publish or Perish" to "Profit or Perish": Revenues from University Technology Transfer and the § 501(c)(3) Tax Exemption*, 145 U. PA. L. REV. 89, 109–10 (1996). See also I.R.C. § 501(c)(3) (2010).

97. In college sports, schools are monitored by the National Collegiate Athletic Association (NCAA), which regulates competition between universities to ensure that they are fair. One of the organization's main oversight functions is to ensure that students do not receive financial incentives from schools or outside benefactors to play for a particular institution. The NCAA's stated goal "is to maintain intercollegiate athletics as an integral part of the educational program and the athlete as an

college sports not only attract students to its campus but also generate tremendous amounts of money.⁹⁸ Throughout an entire season, a top-tier athletic program can generate millions of dollars in revenue stemming from sources such as ticket sales, concessions, television broadcasting rights, and advertisements.⁹⁹ Division I schools focus significant amounts of attention on strengthening their athletic programs, sometimes making budget cuts in academic areas to secure funding.¹⁰⁰ Even during economic recessions, money is continually found to ensure that a school's athletic teams have the necessary resources to play their games.¹⁰¹

integral part of the student body and, by so doing, retain a clear line of demarcation between intercollegiate athletics and professional sports.” Lee Goldman, *Sports and Antitrust: Should College Students Be Paid to Play?*, 65 NOTRE DAME L. REV. 206, 209–10 (1990) (citing 1989–90 NCAA MANUAL 1 (1989)). Thus, the NCAA does not want student-athletes to forsake their education by receiving payment for playing sports. *See id.*

In furtherance of this goal, the NCAA splits universities into three different categories: Division I, Division II, and Division III. Bigger schools' sports teams, typically large state universities, are placed in Division I while smaller schools' athletic programs, usually liberal arts institutions, are labeled as Division III. Division II is an intermediary designation. These labels are based largely on how competitive the school desires to be in athletic contests, which is often a function of how much money it assigns to its sports programs. Division I schools allocate more money to their teams, specifically in the form of athletic scholarships to students. This allotment of funds enables Division I schools to obtain higher caliber recruits to participate in their programs. As Division I schools typically attract the best athletes, this effort translates to increased competition and higher quality play on the field. Consequently, games generate additional media attention and tremendous opportunities for schools to profit from home games against other competitive schools, especially for football and basketball games. Thus, the tremendous revenue that schools derive from marketing their players and important games, such as matches between rival institutions or even managing parking facilities on game day, seems to be unrelated to the educational institution tax exemption. *See generally id.*; *see also* Blumberg, *supra* note 96, at 110.

98. Blumberg, *supra* note 96, at 110.

99. For example, Ohio State University in Columbus, Ohio, a Division I school that has historically allotted tremendous amounts of money and attention to its athletic programs, can generate over \$50 million in revenue during its football season when it has eight games played at its home arena, Ohio Stadium (also known as “the Horseshoe”). Kristi Dosh, *A Close Look at Ohio State's Football Revenue*, FORBES.COM (May 31, 2011, 4:18 PM), <http://www.forbes.com/sites/sportsmoney/2011/05/31/a-close-look-at-ohio-states-football-revenue/>, archived at <http://perma.cc/EG8K-DWUE>. Even for such a large school like Ohio State, this amount of money constitutes a tremendous amount of revenue that is unrelated to education but is still included under the school's tax exemption. *See* Blumberg, *supra* note 96, at 109–10. Similarly, the 2008 NCAA men's basketball tournament generated approximately \$143 million in revenue for college and university athletic departments throughout the country. Christopher L. Tazzi, Note, *To Tax, or Not to Tax, That is the Question: Searching for a Solution to the Increasing Commercialization of Intercollegiate Athletics*, 38 J.C. & U.L. 381, 387 (2012) (citing CONG. BUDGET OFFICE, TAX PREFERENCES FOR COLLEGIATE SPORTS vii (2009)).

100. *See* Koltko, *supra* note 9, at 1076.

101. For example, in early 2009, only a few months after the beginning of one of America's most significant economic recessions, the University of Kentucky invested “\$32 million in a well-traveled but highly successful basketball coach” even after the state was forced to “cut \$20 million in aid to the university, and . . . its trustees voted to cut 15 staff members and eliminate 170 unfilled jobs.” Joshua Rhett Miller, *Cash Strapped States Pay Millions for Basketball Coaches*, FOXNEWS.COM (Apr. 2,

As a result, many observers believe that these schools are not only focusing more attention on athletics than academics, but also that universities are managing this tremendous source of revenue as a commercial enterprise,¹⁰² overshadowing the university's obligation to prioritize educational endeavors for its student body. This is substantiated by the fact that most "funds from the revenue producing sports go to athletic departments rather than academic budgets."¹⁰³ Thus, the university effectively runs a semi-professional, commercial sports enterprise that would otherwise be taxed because it is generating a profit for the school; however, because the endeavor happens to be run through a university, it instead receives a tax exemption.¹⁰⁴ Observers find this discrepancy tough to justify, which has led universities to scramble to substantiate their tax exemptions.¹⁰⁵

One justification that schools have used for their large sports programs is labeling the athletic activities as a type of physical education; however, this argument fails to consider the reality of the modern universities.¹⁰⁶ Colleges argue that students with majors which require that they partake in some form of physical activity utilize the facilities, allowing schools to claim that there is an academic purpose for the buildings.¹⁰⁷ Yet, this

2009), <http://www.foxnews.com/story/2009/04/02/cash-strapped-states-pay-millions-for-basketball-coaches/>, archived at <http://perma.cc/QJ4C-4LZK>. This was also coupled with a five percent increase in tuition for students. *Id.* Though this salary, worth "more than 35 times what the governor earns," is funded significantly by revenue from media and advertisement sales broadcasted during their games, the state still contributes a significant amount of money to pay for the coach. *Id.*

102. See Lieberwitz, *supra* note 94, at 789. One of the biggest concerns surrounding Division I sports is that the schools are essentially becoming farm systems to provide training for potential future professional athletes, particularly for the National Football League and National Basketball Association. *Id.* Essentially, students can play for a school to hone their skills until they are eligible to play at the professional level. Meanwhile, the university can market and hype the student to increase ticket sales, helping both the school and the athlete. Division I competitors are given a venue to demonstrate their skills to professional sports scouts while the school can market the athlete, such as selling sports paraphernalia, to generate revenue. Yet, there seems to be no connection to academics in this symbiotic relationship. *See id.*

103. Goldman, *supra* note 97, at 248.

104. Professional sports teams, which are largely analogous commercial entities except that their players are paid, do not receive tax exemptions. For example, the 32 teams in the National Football League, which make \$9 billion annually, are not tax-exempt. Bill Briggs, *Legal Procedure: Critics Cry Foul as NFL Defends Nonprofit Status*, NBCNEWS.COM (Oct. 27, 2013, 4:41 AM), <http://www.nbcnews.com/business/business-news/legal-procedure-critics-cry-foul-nfl-defends-nonprofit-status-f8C11412804>, archived at <http://perma.cc/MN8B-Z3BF>.

105. See generally Goldman, *supra* note 97.

106. See, e.g., *Trs. of Ind. Univ. v. Town of Rhine*, 488 N.W.2d 128 (Wis. Ct. App. 1992).

107. A student-athlete is defined as "one who engages in a particular sport for the educational, physical, mental and social benefits derived therefrom and for whom participation in that sport is an avocation." Goldman, *supra* note 97, at 210 n.38 (citing 1989-90 NCAA MANUAL 82-83 (1989)). On the other hand, some schools offer majors in physical education unrelated to actually competing on a

contention fails to consider the typical usages of many athletic facilities.¹⁰⁸ For example, football stadiums are predominantly used for practices and home games (which only occur on five or six weekends during the entire year).¹⁰⁹ Furthermore, universities often rent these buildings out to people who are not students at the school.¹¹⁰ Thus, even though the athletic facilities could have some inherent educational value for students with specialized, kinesiological majors, such as physical education, in practice these buildings do not have extensive non-commercial applications, demonstrating that contemporary universities are not purely educational entities.

B. Research

One of the foremost functions of a university is the promulgation of research advances and developments, typically in the sciences.¹¹¹ Yet, this endeavor has also historically created one of the biggest commercial enterprises from which a school can generate money.¹¹² With access to tremendous amounts of scientific equipment and resources, especially as new and more sophisticated technology rapidly started to develop during the mid-20th century, universities began “accepting large sums [of money] from the firms that were interested in receiving scientific help in their own research projects . . . [which] also enabled science professors to find ways to supplement their professorial income with lucrative activities on the side.”¹¹³ This was a mutually beneficial relationship as university employees received funding to continue working on the forefront of scientific development while the companies could use the labor to obtain

school sports team. This includes classes in kinesiology, marketing, and biology. *See, e.g., Physical Education Major*, DEPAUL UNIVERSITY, <http://www.depaul.edu/academics/undergraduate/majors/Pages/physed.aspx> (last visited Oct. 7, 2014), *archived at* <http://perma.cc/CG3B-FEYK>.

108. *See* Goldman, *supra* note 97, at 248. Stadiums are often used by schools’ athletic departments as a means to entice and attract prospective student-athletes to choose their team. *See id.* A luxury stadium is potentially a useful factor to be used distinguishing schools from each other. *Id.*

109. *See id.* (emphasizing the exorbitant costs which can go into the facilities for college athletics coupled with their limited use). Every game on a college football team’s schedule is not played in their home stadium. Thus, when the team is traveling to face an opponent the stadium is not in use.

110. Often, the people seeking to rent out school facilities are university alumni. In addition, the money generated from these rentals will occasionally be used to finance maintenance and upkeep of the building or field; however, the usage is still not educational in nature for students because it is, at its core, a profit-generating use of the facility, making this usage suspect at best regarding its inclusion in validating a school’s tax-exempt status. *See, e.g., Trs. of Ind. Univ.*, 488 N.W.2d at 129.

111. *See* Beach, *supra* note 11, at 319 (noting that one of a university’s main purposes is to pursue “education and research for the general public’s benefit”).

112. *See* Koltko, *supra* note 9, at 1076–78.

113. *Id.* at 1077.

novel products to market.¹¹⁴ As a result, schools began patenting their ideas and inventions, leading to the implementation of the Bayh-Dole Act¹¹⁵ in 1980.¹¹⁶ Essentially, this legislation simplifies the process for colleges to obtain patents and collect royalties and licensing fees from their creations.¹¹⁷

Thus, because schools were becoming more involved in commercial research, the goal of the legislation “was to encourage participation of businesses in academic research as well as to stimulate cooperation between commercial entities and, among others, universities.”¹¹⁸ Ideally, this research would be conducted in an educational manner that could be used to teach university students with the collateral benefit of creating patentable ideas or products; however, this legislation has instead led to rampant commercialization, which generates tremendous revenue for the school separate from its educational mission.¹¹⁹ Given the significant amount of money colleges derive from the research deals, it is difficult to look at these enterprises as purely educational in nature, especially as the number of patent applications for universities has significantly increased since the passage of the Bayh-Dole Act.¹²⁰

For example, in 1989, Harvard University agreed to an \$85 million offer from the Shiseido Company,¹²¹ a leading Japanese skincare business, for the exclusive right to sell health and beauty products developed by Harvard scientists.¹²² The deal did not mention educational

114. *See id.* (highlighting the mutually beneficial relationship between research companies and universities).

115. 35 U.S.C. § 200 (2006). The statute explains that its goal is “to promote collaboration between commercial concerns and nonprofit organizations, including universities; to ensure that inventions made by nonprofit organizations and small business firms are used in a manner to promote free competition and enterprise without unduly encumbering future research and discovery.” *Id.*

116. Koltko, *supra* note 9, at 1077.

117. *Id.*

118. *Id.* at 1078.

119. *Id.* “[T]he Bayh-Dole Act was instrumental in encouraging universities to commercialize their research through contracts with industry, including the exclusive licensing of university-owned patents to for-profit corporations.” Lieberwitz, *supra* note 94, at 780.

120. Koltko, *supra* note 9, at 1078. For example, “[i]n the fiscal year 2000, universities filed 8,534 patents—a 300% increase from 1980; royalties increased by 520%. By the end of year 2005, a total of 48,612 utility patents were granted to U.S. colleges and universities.” *Id.*; *see also* U.S. PATENT AND TRADEMARK OFFICE, U.S. COLLEGES AND UNIVERSITIES—UTILITY PATENT GRANTS, CALENDAR YEARS 1969–2012, *available at* http://www.uspto.gov/web/offices/ac/ido/oeip/taf/univ/cls_gr/all_univ_clg.htm (last modified Mar. 26, 2014), *archived at* <http://perma.cc/44JF-RABP> (listing the number of utility patents assigned to American colleges and universities annually).

121. *See* SHISEIDO, <http://www.shiseido.com/> (last visited Oct. 25, 2014). Shiseido is one of the world’s leading skincare companies with sales over three billion dollars annually. Koltko, *supra* note 9, at 1079 n.41.

122. Koltko, *supra* note 9, at 1079–80.

prerogatives for students.¹²³ Similarly, “[i]n 2007, Berkeley signed a ten-year contract with BP, establishing an Energy Bioscience Institute with the purpose of developing safer biofuels and discovering alternative energy . . . worth \$500 million.”¹²⁴ Over time, these types of research deals between companies and universities have become exceedingly commonplace.¹²⁵ Thus, it appears that many schools have been “cashing in” on research funding and royalties from these deals.¹²⁶

Yet, these research agreements seem to contravene the primary purpose of universities, which is to educate its students.¹²⁷ Contemporary colleges cannot be educational institutions as defined by § 501(c)(3) because their academic values are often compromised by the research contracts they make with companies.¹²⁸ For example, some of these deals require “‘excessive secrecy,’ permitting corporate influence over research findings, or providing for publication delays of more than three months after completion of research,” which goes against the aforementioned ideals of an educational institution.¹²⁹ Furthermore, university collaboration with companies gives businesses an enhanced ability to determine the research agendas in school laboratories.¹³⁰ Often, a component of these agreements is that the corporation may appoint a representative to join to university research committee, which not only grants that representative access to the school’s facilities, but can also sometimes entitle that person to help select faculty proposals for funding grants.¹³¹ As a result, these “partnerships” give commercial companies a significant, noticeable presence in university research leadership and facilities, questioning the non-profit status of these colleges.¹³²

123. See Steven R. Weisman, *Harvard and Japanese Cosmetics Maker Join in Skin Research*, N.Y. TIMES, Aug. 4, 1989, at A8.

124. Koltko, *supra* note 9, at 1080.

125. *Id.*

126. Bello, *supra* note 2, at 624.

127. See Beach, *supra* note 11, at 319 (stating that a university’s “purposes are education and research for the general public’s benefit”).

128. Lieberwitz, *supra* note 94, at 786–87.

129. *Id.* at 787 (citations omitted).

130. *Id.* at 788.

131. *Id.*

132. *Id.* There are multiple instances of universities partnering with companies to generate products for the marketplace. For example, “the 1982 Washington University-Monsanto agreement for \$23.5 million of corporate funding over five years in exchange for exclusive licensing rights to patents resulting from the biomedical research” as well as “the 1997 MIT-Merck agreement for \$15 million of corporate funding over five years in exchange for licensing rights to resulting patents” demonstrate schools working with businesses in a deal likely to result in a profit. *Id.*

Thus, if schools are seeking to make money from these agreements, it is counterintuitive to offer them tax exemptions for being a non-profit and to provide them with an unfair competitive advantage over other companies that are in the research and development industry.¹³³ These agreements have come to represent “a symbiotic relationship between academia and industry,” demonstrating that these schools have a striking resemblance to businesses, rather than educational institutions, that disqualify them from tax exemptions under § 501(c)(3).¹³⁴

C. University Bookstores and Miscellaneous Other Commercial Ventures

While athletics and research have an arguably tangential connection to academia, universities often engage in activities that are solely intended to market the school’s brand name.¹³⁵ These endeavors lack any connection to academic pursuits, but they still receive the same tax treatment as if they were educational in nature.¹³⁶ One of the most conspicuous examples of such commercialism is a university bookstore.¹³⁷

Often, campus bookstores are owned and operated by private companies, or these shops negotiate deals with universities whereby they can utilize the university’s brand name or logo to attract customers.¹³⁸ The stores usually do not exclusively sell academic materials, such as textbooks.¹³⁹ Clothing, coffee mugs, and other merchandise with a

133. *Id.* at 792 n.213.

134. Koltko, *supra* note 9, at 1082.

135. See James Piereson & Naomi Schaefer Riley, Opinion, *Why Shouldn't Princeton Pay Taxes?*, WALL ST. J. (Aug. 19, 2013, 7:16 PM), <http://online.wsj.com/article/SB10001424127887323477604579001294219967488.html> (listing for-profit activities universities can engage in). Many administrators even admit that their universities’ involvement in commercial enterprises lacks even the facade of academic interest. These efforts are driven by monetary concerns that the university fiercely protects. *Id.*

136. *Id.*

137. Colombo, *supra* note 1, at 849. Furthermore, “[i]f the focus of the commerciality doctrine is that goods and services provided by for-profit businesses are not appropriate subjects for tax-exemption, then any activity in an area populated by for-profit enterprise ought to lose exemption.” *Id.* Yet the fact that this is not the law shows the lack of uniformity in enforcement of tax exemptions for universities. *Id.*

138. For example, Barnes and Noble, a large book retailer, has agreements in place to operate nearly 700 stores at various universities throughout the United States. *College Partners*, BARNES & NOBLE COLLEGE, <http://www.bncollege.com/college-partners/> (last visited Oct. 7, 2014), archived at <http://perma.cc/X6QX-TQ2P>. They “serve almost 4.5 million students and over 250,000 faculty members” under the umbrella of the local school. *Id.*; see also Colombo, *supra* note 1, at 849.

139. See Treas. Reg. § 1.513-1(c)(2)(ii) (2009). In these cases, “casual sales in the course of such activity which do not qualify as related to the exempt function involved” will not be treated as a regular activity that would substantiate a tax break. *Id.*; see generally *Stanford Univ. Book Store v. Helvering*, 83 F.2d 710 (D.C. Cir. 1936).

school's name on it are commonplace purchases that generate tremendous amounts of profit for the store.¹⁴⁰ Yet, because they are operating as part of the school, the company can qualify for tax exemptions.¹⁴¹ Many municipalities, however, have sought to prevent or curtail these tax benefits from being bestowed on private businesses.¹⁴² Instead of pursuing litigation, many college towns have reached settlement agreements with campus bookstores, forcing the businesses to limit the tax benefits they get from their university affiliations.¹⁴³ Therefore, the commercial nature of these endeavors is apparent while connections to educational pursuits seem to be missing.¹⁴⁴

Other pieces of property with only tangential connections to education and the university, such as presidential mansions¹⁴⁵ or fraternities,¹⁴⁶ additionally substantiate the argument that schools are commercial entities. Universities, have also acquired or inherited commercial businesses with no ostensible connection to academics.¹⁴⁷ Many of these companies would be able to function independently.¹⁴⁸ Yet, by managing these enterprises, schools enable tax exemptions that yield a significant competitive advantage over others in the marketplace.¹⁴⁹ As a result, there

140. Companies will often "license the use of the universities' names in order to put them on sweatshirts, mugs, and other paraphernalia and sell them . . . at the campus bookstores. This technique proved to be of great significance in raising revenue . . . that universities' bookstores give better shelving to trifling memorabilia than to academic publications." Koltko, *supra* note 9, at 1082 n.57 (citation omitted). Furthermore, "[s]imilar to Chanel and Dior, universities such as Oxford, Harvard, Yale, New York University, etc. have become 'couture' in the sphere of education," meaning companies can generate a lot of money from aggressive marketing of merchandise featuring a school's logo. *Id.* at 1082.

141. *See* I.R.C. § 501(c)(3) (2010).

142. For example, Syracuse University reached a settlement agreement with the city of Syracuse to avoid litigation regarding the tax status of its bookstore. *See* Ryan Delaney, *Syracuse OK's 30-Year Tax Break for University Bookstore*, INNOVATIONTRAIL (July 9, 2012, 7:31 PM), <http://innovationtrail.org/post/syracuse-oks-30-year-tax-break-university-bookstore>, archived at <http://perma.cc/VW8T-W4F3>.

143. *See, e.g., id.*; *see also* Piereson and Riley, *supra* note 135.

144. *See* Delaney, *supra* note 142; Piereson and Riley, *supra* note 135.

145. *See, e.g.,* *Trs. of Boston Univ. v. Bd. of Assessors of Brookline*, 416 N.E.2d 510 (Mass. App. Ct. 1981).

146. *See* Colombo, *supra* note 1, at 858 n.103.

147. *See id.* at 849 (noting the difficulty in drawing the line between a business and a tax-exempt organization because "a number of activities in the educational area clearly are capable of being run as stand-alone businesses").

148. *Id.*

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

is inherent unfairness and no horizontal equity¹⁵⁰ between competitors in the same industry.¹⁵¹

For example, in 1948, the New York University School of Law (“NYU Law”) bought the C.F. Mueller Company (“Mueller Macaroni”) with its own funds and contributions from wealthy alumni in an agreement that dictated the school would manage the business and consequently receive any profits it generates.¹⁵² NYU Law hoped that its purchase would provide the school with additional funds to enable it to expand and flourish.¹⁵³ As a result, for nearly thirty years until the company was sold in 1976,¹⁵⁴ NYU Law was a successful competitor in the pasta industry in addition to its academic pursuits.¹⁵⁵ Initially, the tax exemption for the operation of the pasta company was upheld,¹⁵⁶ but such generous inclusion has since been limited to include only a school’s more “related” business ventures.¹⁵⁷ Again, this nebulous term has been widely applied since its implementation to cover many different facets of university undertakings.¹⁵⁸ Schools still “continue to sell housing and meals, perform contract research and testing, and operate publishing houses” as well generate tremendous revenue from sporting events.¹⁵⁹ Though university endeavors are typically no longer quite as markedly unrelated to academia as pasta production, enterprises such as bookstores, fraternities, presidential mansions, dormitories, and many other campus installations exist with tax exemptions intended for educational institutions despite the

150. *Id.* at 1019 n.14 (“Horizontal equity is the principle that taxes should be equal for entities in equal positions.”). In practice, this argument contends that businesses in the same industry should have equal tax treatment, prohibiting any additional, unfair advantages for one business against its competitors in the same industry.

151. *Id.* at 1020.

152. *Id.* at 1017; *see also* John Brooks, *The Marts of Trade: The Law School and the Noodle Factory*, THE NEW YORKER, Dec. 26, 1977, at 48. Specifically, the agreement outlined that “no part of [Mueller Macaroni’s] income or property shall inure to the private benefit of any stockholder . . . other than New York University for the exclusive benefit of its School of Law.” *Id.* Furthermore, the law school sought to keep the money only for itself, rather than let the central university utilize any of the funds too, because the company was so profitable. *See id.* at 49.

153. *See id.* at 48 (noting that the law school used the funds to construct a new building for its campus).

154. *See id.* at 50–53.

155. *See id.* at 48–49.

156. *See* C.F. Mueller Co. v. Comm’r, 190 F.2d 120 (3d Cir. 1951). The court believed that, as the law stood at the time, NYU Law was allowed to include Mueller Macaroni within its tax exemption. *Id.* at 122–23.

157. *See* Revenue Act of 1950, I.R.C. §§ 502–14 (2012). *See also* Boris I. Bittker & George K. Rabdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 318–19 (1976).

158. *See* Rose-Ackerman, *supra* note 149, at 1017–18.

159. *Id.* at 1018.

fact that they have little (or nothing) to do with academics. Thus, to claim that contemporary universities are, on the whole, educational institutions ignores the reality of the situation surrounding all of the commercial enterprises in which schools are involved. While components of a school can be educational in nature, the sum of the parts fails to satisfy the definition of an “educational institution.”¹⁶⁰

V. HOW TO ENABLE CONTEMPORARY UNIVERSITIES TO QUALIFY AS “EDUCATIONAL INSTITUTIONS”

To appropriately apply tax exemptions to contemporary universities as “educational institutions,” the government should utilize the commerciality approach instead of any of the other existing frameworks because money constitutes a quantifiable measure in which legislators and courts can draw a line establishing where a non-profit entity ends and a business begins.¹⁶¹ Though they both present considerable practical concerns, either of two different courses of action can be used to implement the commerciality approach and curtail the variance in defining an “educational institution.”¹⁶²

A. *Line of Demarcation*

First, Congress could create an objective, unambiguous dollar or percentage (of revenue) amount that, when surpassed, would designate a university as a business rather than school.¹⁶³ The core appeal of this proposal is its apparent simplicity: if a university is generating more than a predetermined amount of money from its daily operations, the school would no longer qualify for a tax exemption under § 501(c)(3).¹⁶⁴ Yet, this approach is limited in its applicability because defining “daily operations” presents the same issues as defining an “educational institution.”¹⁶⁵ There are a seemingly infinite number of components that can constitute a school’s daily operations so that enumerating all of them would be impossible.¹⁶⁶

160. See I.R.C. § 501(c)(3) (2010).

161. *Id.*

162. *Id.*

163. See Colombo, *supra* note 1, at 846–49 (explaining past attempts to separate exempt and non-exempt university activities).

164. See *id.* at 847–48 (noting that some university activities are occasionally “insubstantial” such that they should not affect the school’s tax-exempt status).

165. *Id.*

166. See *id.* (demonstrating the wide variety and scope of activities that universities are capable of providing).

Similarly, it would be difficult to determine where the line of demarcation should be drawn because of the inherent variations in type and scope of universities throughout the country (even after ignoring all of the political posturing and considerations that would inevitably come into play).¹⁶⁷ Accounting for differences in factors such as student body size, location, or endowment could lead to disparities or inequities in enforcement of tax exemptions.¹⁶⁸ For example, many liberal arts schools have small athletic departments because their sports teams are not as popular on campus, and they consequently lack demand from students and alumni to expend resources to bolster their programs.¹⁶⁹ Though smaller school athletic teams are still regulated in the same way as their bigger counterparts,¹⁷⁰ factoring their profitability into any equation is unlikely to yield fair results when compared to other schools, especially if they are only using athletics for educational purposes rather than generating revenue.¹⁷¹

B. Fragmentation

The second possible approach would be to split universities into separate entities so that the tax-exempt functions are separate from the commercial ones.¹⁷² “Under an amendment made by the Tax Reform Act of 1969, the Internal Revenue Code gives the [Internal Revenue] Service authority to ‘fragment’ the activities of an . . . exempt organization.”¹⁷³ Essentially, the government has the power to monitor the size of tax-

167. *See id.*

168. *See id.* at 849 (suggesting that there could be “inexplicable variations in result[s]” when applying the commerciality approach to various entities).

169. *See* Goldman, *supra* note 97, at 237 (stating that Division I games “attract far greater attendance and television ratings than” their Division III counterparts). Furthermore, there is tremendous variation in the size of college athletic programs throughout the country, making a university’s budget allocation toward its sporting teams a consideration in determining whom a school will compete with. *See generally id.* at 209 n.29.

170. *Id.* at 228 (“[M]any members of the smaller athletic associations are also members of the NCAA. Those schools, as well as all schools in NCAA division II and division III, are subject to NCAA regulations and control. They cannot offset NCAA power.”). *See generally* NCAA v. Bd. of Regents of the Univ. of Okla., 468 U.S. 85 (1984).

171. Goldman, *supra* note 97, at 237 (noting the tremendous disparity in attendance at athletic events between schools in Division I, II, and III).

172. *See* Erik M. Jensen, *Taxation, the Student Athlete, and the Professionalization of College Athletics*, 1987 UTAH L. REV. 35, 44–54.

173. *Id.* at 56.

exempt entities and split them if they become too big or cumbersome.¹⁷⁴ In relation to universities, this adjustment would mean creating independent corporate units for the schools' various components, which would most likely then be under the supervision of a larger administrative entity.¹⁷⁵ Many universities have already begun to comply with the bureaucratic changes necessitated by the fragmentation approach.¹⁷⁶

Although many colleges' athletic departments carry on their routine functions, they are now separate from their schools' main branches.¹⁷⁷ It is unlikely, from a practical standpoint, that students or faculty would (or even could) know that there has been any change since these technical adjustments have only occurred on paper for tax purposes.¹⁷⁸ Thus, under the commerciality approach, this severance would be a valid step toward maintaining the integrity of a university as an educational institution because the commercial parts of the new entity would no longer be directly connected to the educational ones seeking the tax exemptions.¹⁷⁹

174. *See id.* (noting that the government has the power to fragment though it has primarily been used to prevent entities from diversifying into unrelated business activities in the past). *See also* I.R.C. § 513(c) (2010).

175. Jensen, *supra* note 172, at 56. From a practical perspective though, most of these changes occur only on paper. *Id.* at 57. Yet, creating separate entities is not the only way to fragment the school. It is possible to subdivide any products the school sells. For example, sales at the bookstore could be "fragmented into educational and noneducational components" to assess tax consequences of each transaction. *Id.*

176. Schools such as the University of Michigan, the University of Georgia, and Stanford University, among others, have all incorporated their athletic departments into separate, distinct legal entities. *See id.* at 44 n.38. Furthermore, "[t]hese departments . . . are expected to be economically self-sufficient, paying their universities for services provided but otherwise making no cash contributions that directly affect academic departments." *Id.* This creates a discrepancy between the university and the money in college sports that is not related to educational pursuits, preserving the basis for the tax exemption.

177. *Id.*

178. *See id.* at 56–57 (noting that most of these changes are unnoticeable in practice because they are accounting techniques). Similarly, the National Football League ("NFL") is also currently taking advantage of the fragmentation approach. The thirty-two NFL teams are not considered tax-exempt organizations; however, the league office, one fragment of the NFL bureaucracy, has been given tax-exempt status as a nonprofit trade association. *See* I.R.C. § 501(c)(6) (2010). Thus, the league office, which collects membership dues from the teams (which they must pay to be eligible to compete against each other under the NFL's framework and brand) that can collectively result in as much as \$250 million in revenue, is tax-exempt. As a result, there is little, if any, noticeable effect on the product that the NFL is offering, specifically the broadcasting of professional football games, and the league office has successfully shielded some of its money from the Internal Revenue Service.

On the other hand, given the NFL's tremendous size and profitability, Congress has been considering whether to strip the tax exemption because it does not want to have taxpayer dollars subsidizing a commercial sports league. This argument is bolstered by the public's perception of the NFL. Many football fans believe that the NFL already makes enough money (approximately \$9 billion in a given year) and should not be entitled to a tax exemption that enables it to make even more of a profit. *See* Briggs, *supra* note 104.

179. *See* Jensen, *supra* note 172, at 56.

Fragmentation, however, can lead to logistical problems that need to be resolved to make the approach useful and frugal.¹⁸⁰ As every product that a university creates would potentially need to be labeled as educational or non-educational to determine whether the tax exemption applies, there could be a tremendous amount of time and transaction costs when implementing this system.¹⁸¹ Taking this approach to its extreme could lead to excessive, unnecessary subdivisions within a school or within a school's products. For example, "the [Internal Revenue] Service has ruled that an exempt blood bank's commercial sales of blood plasma had to be further subdivided: plasma acquired for resale generated income from an unrelated trade or business, but plasma produced as a by-product of providing blood products to hospitals did not."¹⁸² Fortunately, though it will not be a simple task, splitting a college into multiple components is unlikely to present this logistical nightmare because a university could be feasibly split into larger fragments.¹⁸³

Even though they have some potential, both of these methods present substantial problems that would hinder their implementation, substantiating the notion that contemporary universities cannot qualify for tax exemptions because installing the necessary measures to enable them to lawfully obtain such benefits would be practically impossible.

VI. CONCLUSION

As has been shown throughout this Note, labeling contemporary universities as "educational institutions"¹⁸⁴ is inappropriate and misguided. As colleges have changed from simply groups of people with a shared interest to colossal programs on large campuses, they have begun to more closely resemble businesses rather than schools. Their expansive scope and involvement in profitable enterprises outside of the classroom disables their ability to obtain a tax exemption under § 501(c)(3).

To address the changing nature of contemporary universities, numerous frameworks have been offered to help decide whether a school is no longer educational in nature. With factors ranging from how a university spends its money to the values it espouses, these methods offer varying viewpoints of when a school has become a business. Yet, of these

180. *See id.* at 56–57.

181. *See id.*

182. *Id.* at 56.

183. *See id.* at 55–57 (noting that universities often are involved in large enterprises and expansive activities so fragmenting them may not ultimately necessitate such minute distinctions).

184. I.R.C. § 501(c)(3) (2010).

methods, the commerciality approach provides for the most consistent analysis. Because it focuses primarily on the amount of money a university spends or earns to determine whether the entity is a non-profit business, this approach utilizes a quantifiable, objective measure to label a school while the other frameworks are mired in subjective criteria that cannot be uniformly applied.

Yet, despite their extensive commercialism, which is fueled predominantly by college athletics, research, and bookstores, universities may still have the ability to qualify as educational institutions. Multiple methods have been created that could divide the profitable components of schools from the educational ones. In particular, the line of demarcation and fragmentation approaches could enable schools to monitor or separate their commercial enterprises from their academic facets, potentially preserving the tax exemption for the entity's educational pursuits. Unfortunately, it is doubtful that these methods will be pursued because they present inherent logistical problems, which could force schools to incur significant costs in implementation.

Though contemporary universities still aspire to educate their students, these efforts have been overshadowed by profitable business ventures and partnerships with companies who seek to make money by exploiting colleges. Thus, unless the law is changed, universities should no longer qualify as educational institutions that warrant a tax exemption under § 501(c)(3).

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