

Taxing Income from Mailing List and Affinity Card Arrangements: A Proposal

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I. INTRODUCTION

The courts¹ and the Internal Revenue Code (“Code”)² presently treat

1. The term “courts” here refers to federal, not state, courts; this is due to the fact that trials concerning tax matters occur only in the U.S. Tax Court, U.S. Court of Claims, and district courts. See JAMES J. FREELAND, DANIEL J. LATHROPE, STEPHEN A. LIND & RICHARD B. STEPHENS, *FUNDAMENTALS OF FEDERAL INCOME TAXATION: CASES AND MATERIALS* 28–31 (11th ed. 2000); GAIL LEVIN RICHMOND, *FEDERAL TAX RESEARCH: GUIDE TO MATERIALS AND TECHNIQUES* 120–21 (5th ed. 1997) (stating that the United States Bankruptcy Court is another venue for tax litigation, although a district court judge reviews each decision).

2. The “Code” refers to the Internal Revenue Code found in Title 26 of the United States Code. The Internal Revenue Code is divided and applied to tax-exempt organizations as follows: title (26), subtitle (A - income taxes), chapter (1 - normal taxes and surtaxes), subchapter (F - exempt organizations). See I. RICHARD GERSHON, *A STUDENT’S GUIDE TO THE INTERNAL REVENUE CODE* 1 (4th ed. 1999). After subchapters the Code is further divided into parts, subparts, sections, subsections, paragraphs, subparagraphs, sentences, and clauses. See GERSHON, *supra*, at 3–4, 7. This paper will primarily use sections (e.g., § 501) and subsections (the number or letter after the section number (e.g., (a)), and paragraphs. Generally, a number will be followed by a smaller

income received by a tax-exempt organization for affinity card programs³ and mailing list rentals⁴ similarly; neither type of income is subject to taxation.⁵ This Article asserts that equal treatment should not be the case. Because donors have not consented to sell their personal information, the exception for royalty income from the unrelated business income tax ("UBIT") should not permit the tax-free rental of a nonprofit organization's mailing list. Affinity card income, on the other hand, should continue to be nontaxable since any income received from these programs comes from the donors themselves and therefore should be treated as a form of nondeductible contribution.

Organizations qualified under section 501 of the Internal Revenue Code are known as "tax-exempt" or "nonprofit" organizations.⁶ Both descriptions are misleading. The term "tax-exempt" is inaccurate because section 501 organizations are subject to taxation in certain cases; most notable for this Article is the taxation of unrelated business income under section 511.⁷ The term "nonprofit" gives the impression

case letter, then by a number, then by a larger case letter. See GERSHON, *supra*, at 8 n.4. For example, § 501(c)(25)(A)(iii)(I) refers to section 501, subsection (c), paragraph (25), subparagraph (A), sentence (iii), and clause (I). I.R.C. § 501(c)(25)(A)(iii)(I) (2000).

3. Affinity cards are typically credit cards which bear a name and logo of a group or organization. *Sierra Club, Inc. v. Comm'r*, 86 F.3d 1526, 1528 n.2 (9th Cir. 1996); *Miss. State Univ. Alumni, Inc. v. Comm'r*, 74 T.C.M. (CCH) 458, 459 (1997).

4. Unless specified otherwise, references to mailing list rentals or exchanges describe those persons or entities which have not specifically authorized such activity. For the types of personal information contained on mailing lists, see *infra* note 21. For information on "opt in" versus "opt out" provisions of mailing lists, see *infra* note 350.

5. For the exclusion of income from mailing lists and affinity cards, see *infra* text accompanying notes 270–326.

6. These organizations compose the "third sector." The first two sectors comprise government and private businesses. Donald L. Sharpe, *Unfair Business Competition and the Tax on Income Destined for Charity: Forty-Six Years Later*, 3 *FLA. TAX REV.* 367, 369 (1996). Aside from "tax-exempt" and "nonprofit," other terms which are used to describe organizations qualifying under § 501 are "charitable sector" (focusing on how their support is received), "independent sector" (focusing on the fact that these organizations are neither businesses nor government), and "voluntary sector" (focusing on the use of volunteers for management and operations). LESTER M. SALAMON, *AMERICA'S NONPROFIT SECTOR: A PRIMER* 6–7 (1992).

7. I.R.C. § 511 (2000). Unless otherwise specified, all references in this Article to a section of the Code are to the Internal Revenue Code of 1986, as amended. See also I.R.C. § 501(b) (2000); 4 BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* 100-3 (2d ed. 1992) (stating that the term "exempt" is "a misnomer because most exempt organizations are taxed on 'unrelated business income'" and are subject to other forms of taxation); Charles T. Cloufelter, *Tax-Induced Distortions in the Voluntary Sector*, 39 *CASE W. RES. L. REV.* 663 (1988–1989) (suggesting that both the unrelated business income tax and the deduction permitted under I.R.C. § 170 (2000) create tax-induced distortions in the allocation of resources for

that these organizations never make a profit and/or always distribute their gains. However, “nonprofit” organizations can, and do, make and keep profits, although distributional constraints are imposed on the money received.⁸

In fact, as a group these organizations have substantial revenues. In 1995, section 501(c)(3) organizations alone, excluding churches and small section 501(c)(3) organizations, had revenues of \$663.4 billion and held total assets worth over one trillion dollars.⁹ In 1995, section 501 organizations had total revenues equal to eleven percent of the United States gross domestic product; this share increased to twelve percent by 1999.¹⁰

The amount of income earned by nonprofits is extraordinary, and their growth is also amazing. In 1986 a total of only \$300 billion in revenues was reported by nonprofits, which accounted for just seven percent of the gross national product at that time.¹¹ Going back another ten years shows even more growth for the nonprofit sector. In the period between 1975 and 1995 the revenues of nonprofit organizations tripled, while the gross domestic product increased by only seventy-four percent.¹²

These large and growing revenue streams have attracted the attention of Congress, which is ever mindful of possible new revenue sources.¹³ Affinity card income received by tax-exempt organizations is one area

itemizers versus nonitemizers).

8. 4 BITTKER & LOKKEN, *supra* note 7, at 100-3. On the other hand, an organization which maintains that it is not organized and operated for-profit will not automatically be exempted from federal income taxation. Treas. Reg. § 1.501(a)-1(a)(2) (1998) (as amended in 1992).

9. Cecelia Hilgert & Melissa Whitten, *Charities and Other Tax-Exempt Organizations, 1995*, 18 SOI BULL.: Q. STAT. INCOME REP. (I.R.S.) 105, 105-06 (1998-1999).

10. Marlis L. Carson, *Revenue Thirst Could Lead Lawmakers to Eye Tax-Exempts, Owens Says*, 69 TAX NOTES 954, 954 (1995); Martin K. Pelcin & Fred Stokeld, *Owens Discusses Unrelated Business Income Issues, IRS Restructuring*, 83 TAX NOTES 631 (1999) (reporting statement of director of the IRS Exempt Organizations Division that tax-exempt organizations had more than \$1.9 trillion in assets and \$899 billion in revenues). Some authors give larger assessments of income of tax-exempt organizations. See John M. Strefeler & Leslie T. Miller, *Exempt Organizations: A Study of Their Nature and the Applicability of the Unrelated Business Income Tax*, 12 AKRON TAX J. 223, 227 (1996) (attributing \$750 billion in revenues and fifteen percent of the nation's GNP to tax-exempt organizations).

11. *House Ways and Means Oversight Subcommittee UBIT Recommendations*, DAILY TAX CONGRESSIONAL DOCUMENTS, June 24, 1988, at 3035 [hereinafter UBIT RECOMMENDATIONS].

12. Jane Bowling & Sindhu G. Hirani, *IRS Scrutiny of Tax-Exempt Organizations Likely to Increase, Agency Official Predicts*, 67 U.S. L. WK. (BNA), June 1, 1999, at 2718. The director of the IRS Exempt Organizations Division stated that the “[e]conomic activity in tax-exempt organizations is exploding in comparison to economic activity as a whole.” *Id.*

13. See Pelcin & Stokeld, *supra* note 10, at 631.

which has been set apart for review by Congress for additional tax revenue.¹⁴

Generally, affinity card arrangements provide credit cards which indicate the cardholder's preference toward the group, individual, or organization named on the card.¹⁵ Affinity cards of tax-exempt organizations are sponsored by an organization, like a university alumni association or the Sierra Club, which permits its name and logo to be used on a credit card.¹⁶ Tax-exempt organizations allow their names and/or logo to be used on the cards since they make money from such arrangements, typically a portion of the fee charged by banks to merchants who take the cards.¹⁷ With this "easy" money to be made,

14. *See id.*

15. Andrew Stark, *Selective Affinities: Who Are You, Anyway? For Starters, Check the Logo on Your Credit Card*, WALL ST. J., Feb. 4, 2000, at W13. Affinity cards are now present in 63 million homes in the United States. *Id.* Stark points out that the oddity of affinity cards is that cardholders can only show their "affinity" by using the card, primarily done only when purchasing an item. *Id.* This means they are advertising to salespersons and vendors. *Id.*

16. *Or. State Univ. Alumni Ass'n v. Comm'r*, 193 F.3d 1098, 1099 (9th Cir. 1999); *Sierra Club, Inc. v. Comm'r*, 86 F.3d 1526, 1528 n.2 (9th Cir. 1996).

17. Banks impose a charge of approximately three percent of the purchase price to merchants who accept credit cards. *Credit Cards for Causes*, CONSUMER REP., March 1988, at 190, 190. This three percent is split between the merchant's bank and the card-issuing bank. *Id.* In affinity card agreements the card-issuing bank's share of the three percent charge is divided between the bank, the organization, and the marketer who promoted the idea and arranged the contract between the bank and organization. *Id.* Typically, an organization will receive 50 cents for every \$100 charged to the card. *Should You Get an Affinity Card?*, CONSUMER REP., Sept. 1999, at 8, 8. To review an affinity card agreement, see *Sierra Club, Inc. v. Comm'r*, 103 T.C. 307, 312-15 (1994), *aff'd in part and rev'd in part*, 86 F.3d 1526. Normally, however, individuals are not able to determine the exact amount the nonprofit organization will receive through their use of the affinity card. David Evans, *A Closer Look at What Charity Credit Cards Issuers Won't Tell*, HOUSTON CHRON., June 21, 1999, at D1.

Banks enter into affinity card arrangements for several reasons. First, these arrangements allow additional entry into a crowded credit market. *Credit Cards for Causes*, *supra*, at 190. Second, cardholders with affinity cards tend to charge more on their affinity cards. *Id.* The cards have also historically carried higher annual percentage interest rates on outstanding credit card balances. *Should You Get an Affinity Card?*, *supra*, at 8. It is also a way to market credit cards to college students. Marcia Vickers, *Big Cards On Campus*, BUS. WK., Sept. 20, 1999, at 136. College students are a desirable market segment since many carry debt on their credit cards, they are a lower risk since parents often pay their bills, and the card issuer has an entry to market other products (e.g., first mortgages, car loans, or debt consolidation loans) to those students. *Id.* at 136-37.

Nonprofits can make substantial sums from affinity card programs. For example, the Oregon State and University of Oregon alumni associations made over \$500,000 each in a two-year period, while the Sierra Club made over \$300,000 in the first two years of its

many tax-exempt organizations look toward affinity cards to raise revenue.¹⁸ These cards are extremely popular, accounting for one-third of all credit cards.¹⁹

The other source of income discussed in this Article is that earned by permitting other nonprofit organizations or businesses the use of a tax-exempt organization's mailing list.²⁰ The mailing lists are typically composed of names, addresses and other information pertaining to the members, donors, and other supporters of the organization.²¹ This sale to other nonprofit or for-profit organizations is normally done without the consent of those on the mailing list. The rental or exchange of a mailing list between organizations whose donors are allowed to deduct their contributions is specifically exempted by the Code from taxation.²²

program. *Or. State Univ. Alumni Ass'n*, 193 F.3d at 1099; *Sierra Club*, 103 T.C. at 320. See also Evans, *supra*, at D5 (reporting that the University of Southern California Alumni Association, with a database of 175,000 people, earns about \$1.2 million annually from its affinity card program); Vickers, *supra*, at 136 (describing the University of Tennessee's agreement with a credit card issuer in which the university received \$16 million over seven years and 0.5% of each transaction in return for allowing use of its logo and school's picture on a credit card).

18. Kenton D. Swift, *The Tax Treatment of Royalty Income from Affinity Card Programs*, 73 TAXES 575, 575 (1995) (stating that "thousands" of tax-exempt organizations are using affinity cards to make money). "Tax-exempt organizations are finding it very lucrative to market the sentimental kind of affinity card, while lenders, whose image has never been cute or cuddly, seek a competitive advantage by associating their services with a good cause." Lee A. Sheppard, *Time to Revisit the UBIT Royalty Exception?*, 71 TAX NOTES 858, 858 (1996).

19. *Should You Get an Affinity Card?*, *supra* note 17, at 8. MBNA, "[t]he Wilmington, Del., bank . . . has some 4,500 [affinity card] programs." *Id.*

20. The Sierra Club received mailing list rental income of \$142,636, \$317,579, and \$452,042 in the tax years 1985, 1986, and 1987, respectively. *Sierra Club*, 86 F.3d at 1528. The Disabled American Veterans made over \$16 million from 1974 to 1985. *Disabled Am. Veterans v. Comm'r*, 94 T.C. 60, 67 (1990). "Non-profit organizations also rent the names and personal information of their contributors to other direct mail solicitors, in both the for-profit and non-profit sectors. In conjunction with list rentals, non-profit organizations may lend their name to a for-profit activity for a percentage of the profits." Rita Marie Cain, *Marketing Activities in the Non-profit Sector—Recent Lessons Regarding Tax Implications*, 36 AM. BUS. L.J. 349, 349 (1998–1999). See also GILBERT M. GAUL & NEILL A. BOROWSKI, *FREE RIDE: THE TAX-EXEMPT ECONOMY* 32 (1993) (stating that a large part of the twelve billion fund-raising letters sent each year is a result of the "renting" of mailing lists); Leslie G. Espinoza, *Straining the Quality of Mercy: Abandoning the Quest for Informed Charitable Giving*, 64 S. CAL. L. REV. 605, 610, 678–83 (1991) (discussing the costs of fund raising and asserting that the public should be provided with information about such costs to make "informed giving decisions").

21. *Sierra Club*, 86 F.3d at 1527. The mailing list for Common Cause, a section 501(c)(4) organization, contained information such as name, address, gender, frequency of contribution, date of recent contributions, amount of contributions, and ethnicity. *Common Cause v. Comm'r*, 112 T.C. 332, 334, 336–37 (1999).

22. I.R.C. § 513(h)(1)(B) (2000). Congress added § 513(h)(1)(B) in 1986 in an attempt to make some mailing list income subject to taxation. Commenting on the results, one nonprofit tax practitioner stated, "Congress didn't do a very good job when

Generally, however, the courts have excluded from taxation any income received from the rental of mailing lists.²³

If the underlying rationale of the nonprofit tax exemption is applied to these nonprofit income sources, Congress has it totally reversed, while the courts have it half-right. Congress has exempted certain mailing list income and seeks to tax affinity card income. In general, the courts have excluded both sources of income from taxation. This Article proposes the taxation of mailing list rental income, while those amounts received from affinity card programs should remain excluded from the UBIT.

The remainder of this Article is divided into four sections. Part II discusses which organizations are exempt from taxation and how that is accomplished in the Code. Part III reviews the major rationales given for the tax exemption provided for qualifying nonprofit organizations and suggests that the underlying rationale for all non-economic theories is based on the public's trust of those organizations. Part IV looks at the history and statutory requirements of the unrelated business income tax. This section also includes the exceptions/exclusions from the UBIT and how the courts have applied the royalty exclusion to the mailing list and affinity card income of nonprofit organizations. Finally, the Article will propose that when the underlying rationale of the nonprofit tax exemption, public trust, is applied to mailing list and affinity card income, it results in taxation of the former but the continued exclusion of the later.

II. BASIC STATUTORY ANALYSIS OF THE TAX EXEMPTION

The tax-exempt status of certain charitable and religious organizations dates back to 1601 and the English Statute of Charitable Uses.²⁴ In the

they tried to make certain mailing lists subject to tax; they failed miserably." Carolyn Wright & Fred Stokeld, *Sierra Club Wins Again in Tax Court*, 82 TAX NOTES 1898, 1899 (1999).

23. *Common Cause*, 112 T.C. 332; *Planned Parenthood Fed'n of Am., Inc. v. Comm'r*, 77 T.C.M. (CCH) 2227 (1999); *Sierra Club, Inc. v. Comm'r*, 103 T.C. 307 (1994), *aff'd in part and rev'd in part*, 86 F.3d 1526. For income from affinity cards excluded from the UBIT, see *Oregon State University Alumni Association*, 193 F.3d 1098, 1099. For cases excluding income from mailing lists, see *Common Cause*, 112 T.C. 332; *Planned Parenthood Federation*, 77 T.C.M. 2227; *Sierra Club*, 103 T.C. 307.

24. 4 BITTKER & LOKKEN, *supra* note 7, at 100-2. For a copy of the preamble to the Statute of Charitable Uses, see JAMES J. FISHMAN & STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS: CASES AND MATERIALS* 27 (2d ed. 2000) (quoting the Preamble to the Statute of Charitable Uses, 1601, 43 Eliz., c. 4 (Eng.)). See also Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A*

United States, this exemption has been included in every income tax act since 1894.²⁵

Subchapter F of subtitle A of the Internal Revenue Code sets out the basic rules for determining tax-exempt status.²⁶ Specifically, the exemption from taxation is set forth in section 501(a).²⁷ That section provides that only organizations described in subsection (c) or (d) of section 501 will be granted an exemption from federal income tax.²⁸ If an organization does not meet one of the prescribed purposes found in these subsections, it will be subject to taxation, and the amount of tax due depends on the category into which the organization is classified

Theory of Risk Compensation, 50 U. FLA. L. REV. 419, 425 (1998); Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L.J. 1379, 1384 (1991). For an excellent discussion on the early English and American history of the tax exemption of nonprofit organizations, see Chauncey Belknap, *The Federal Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy*, in IV RESEARCH PAPERS SPONSORED BY THE [FILER] COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS 2025 (1977).

25. The exemption from tax was first enacted in the Tariff Act of 1894, ch. 349, § 32, 28 Stat. 509, 556 (1894). The tax was passed on August 15, 1894 and was entitled “An Act To reduce taxation, to provide revenue for the Government, and for other purposes.” *Id.* It was later declared unconstitutional in *Pollock v. Farmers’ Loan & Trust Co.*, 157 U.S. 429 (1895). See Kevin M. Yamamoto, *A Proposal for the Elimination of the Exclusion for State Bond Interest*, 50 FLA. L. REV. 145, 162 n.83 (1998). The exemption was later placed in the Tariff of 1909, ch. 6, § 38, 36 Stat. 112 (1909) and Tariff Act of 1913, ch. 16, § II(G)(a), 38 Stat. 114, 172 (1913). 4 BITTKER & LOKKEN, *supra* note 7, at 100-2. For additional history on the tax exemption in American history of nonprofit organizations, see Belknap, *supra* note 24, at 2025-26; John D. Colombo, *Why is Harvard Tax-Exempt? (And Other Mysteries of Tax Exemption for Private Educational Institutions)*, 35 ARIZ. L. REV. 841, 844-45 (1993) (giving the history of tax exemption for educational institutions); Crimm, *supra* note 24, at 427-29 (providing a brief history of the tax exemption for nonprofits). See also Erika King, *Tax Exemptions and the Establishment Clause*, 49 SYRACUSE L. REV. 971, 973 (1999) (maintaining that the tax exemptions granted to religious institutions and organizations do not violate the Establishment Clause ban on direct aid to religion).

The first income tax was enacted by Congress in 1861 to finance the Civil War. See PAUL R. MCDANIEL ET AL., *FEDERAL INCOME TAXATION: CASES AND MATERIALS* 3 (3d ed. 1994); RANDOLPH E. PAUL, *TAXATION IN THE UNITED STATES* 9-11 (1954); SIDNEY RATNER, *AMERICAN TAXATION: ITS HISTORY AS A SOCIAL FORCE IN DEMOCRACY* 65-68 (1942). The tax was only on taxable income greater than \$600 and was three percent of the first \$10,000 and five percent on all income thereafter. Yamamoto, *supra*, at 162 n.83. The rate was reduced in 1867 and 1870, and repealed completely in 1872. *Id.*

26. I.R.C. §§ 501-528 (2000).

27. *Id.* § 501(a). “Exemption from taxation. An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503.” *Id.*

28. Section 501(d) covers certain religious organizations and will not be discussed in this Article. See *id.* § 501(d). The organization must also not be a “feeder organization” under § 502(a) or, for a narrow group of organizations, may not engage in a list of prohibited transactions. See I.R.C. §§ 502(a), 503(a)-(b) (2000). A “feeder organization” is one that pays all of its profits to an exempt organization under § 501. *Id.* § 502(a).

under the statutory scheme.²⁹

Section 501(c) contains prescribed purposes,³⁰ listing twenty-five different types of organizations which may qualify for tax exemption.³¹ While there are many different types of organizations listed in section 501(c), they can primarily be grouped into two classes: public service organizations and mutual benefit groups.³² Public service organizations include charitable organizations, private foundations, and social welfare organizations.³³ Mutual benefit groups include social clubs, labor unions, and homeowners' associations.³⁴

The largest and most desirable classification for tax exemption is found in section 501(c)(3).³⁵ These organizations receive a host of special benefits, not the least of which is allowing donors to the organization to deduct their donations.³⁶ To qualify under section 501(c)(3) an organization must be organized and operated for one of the

29. I.R.C. § 1(e) (2000) (taxation of trusts); I.R.C. § 11 (2000) (corporate taxation).

30. I.R.C. § 501(c)(1)–(25).

31. *Id.* Some examples of qualifying organizations are: civic leagues, *id.* § 501(c)(4); professional football leagues, *id.* § 501(c)(6); certain cemetery corporations, *id.* § 501(c)(13); and organizations formed before 1880 to provide insurance and other benefits for a group—seventy-five percent of which are in the Armed Forces, veterans, or their dependents, *id.* § 501(c)(23). For additional information on the various classifications of § 501(c), see James J. McGovern, *The Exemption Provisions of Subchapter F*, 29 TAX LAW. 523, 527–42 (1976).

32. 4 BITTKER & LOKKEN, *supra* note 7, at 100-4.

33. *Id.*

34. *Id.* at 100-5.

35. See FISHMAN & SCHWARZ, *supra* note 24, at 57 tbl. 1.4 (showing that of the approximately 1.2 million section 501(c) organizations listed with the Internal Revenue Service in 1997, over fifty-six percent were listed under section 501(c)(3)).

36. See I.R.C. § 170(a) (2000) (income tax deduction); I.R.C. § 2055(a)(2) (2000) (estate tax deduction); I.R.C. § 2522(a)(2) (2000) (gift tax deduction). Other benefits of § 501(c)(3) status include, but are not limited to, the ability to issue tax-exempt bonds, I.R.C. § 145 (1994); exemption from federal unemployment taxes, I.R.C. § 3306(c)(8) (2000); more advantageous tax-deferred retirement plans for their employees, I.R.C. § 403(b) (1994); no minimum wage requirement, 29 C.F.R. § 779.214 (1998); and lower postal rates, 39 C.F.R. § 111.1 (2000). For other lists of benefits, see FISHMAN & SCHWARZ, *supra* note 24, at 330; Crimm, *supra* note 24, at 421 n.3; Bazil Facchina et al., *Privileges & Exemptions Enjoyed by Nonprofit Organizations*, 28 U.S.F. L. REV. 85 (1993) (a complete discussion of the various benefits to section 501(c)(3) organizations); Henry Hansmann, *The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?*, 39 CASE W. RES. L. REV. 807, 810–11 (1988–1989). While tax-exempt organizations qualify for lower postal rates, mailed items which support an affinity card program (mailings which contain the word(s) "Visa" or "MasterCard") do not qualify for the lower rates. Fred Stokeld, *Postal Service Clarifies Exempts' Affinity Credit Card Mailings*, 74 TAX NOTES 724 (1997).

prescribed purposes,³⁷ must not inure to the benefit of private parties,³⁸ may engage only in very limited legislative activity,³⁹ and must totally abstain from political campaigning.⁴⁰

37. To qualify under section 501(c)(3) an organization must operate "exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals." I.R.C. § 501(c)(3). See also *Bob Jones Univ. v. United States*, 461 U.S. 574, 585-92 (1983) (holding that public policy can deny tax-exempt status to schools that racially discriminate). While the statute says "exclusively," an organization may still qualify under section 501(c)(3) if the unrelated activity is "insubstantial." See *Treas. Reg. § 1.501(c)(3)-1(b)(1)(b)* (as amended in 1990). See also *Ind. Retail Hardware Ass'n v. United States*, 366 F.2d 998 (Ct. Cl. 1966) (revoking section 501(c)(6) business organization's exemption for "substantial" unrelated activities); BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 646 (7th ed. 1998). But see *Comment, Preventing the Operation of Untaxed Business by Tax-Exempt Organizations*, 32 U. CHI. L. REV. 581 (1964-1965) (stating that unrelated activities should not cause the loss of the tax exemption, but should be taxed as unrelated business income under I.R.C. § 511(a)). To obtain a letter ruling from the Internal Revenue Service determining the status of a section 501(c)(3) organization the unrelated activities must be "*de minimis*." See Carolyn M. Osteen & A.L. Spitzer, *When Nonprofits Make a Profit: The Taxation of UBI*, 20 EXEMPT ORG. TAX REV. 261, 262 (1998) (stating "*de minimis*" as being less than five percent).

While the listed "purposes" for section 501(c)(3) are few, they encompass a wide range of organizations. Examples include one-room soup kitchens, large hospitals, museums, and art galleries, day-care centers, and a host of other specialized institutions. Nancy J. Knauer, *How Charitable Organization Influence Federal Tax Policy: "Rent-Seeking" Charities or Virtuous Politicians?*, 1996 WIS. L. REV. 971, 981.

38. I.R.C. § 501(c)(3) (2000) ("[N]o part of the net earnings of [may inure] to the benefit of any private shareholder or individual . . ."). "[T]he private inurement doctrine forbids the flow or transfer of income or assets of a tax-exempt organization . . . [to] persons associated with, or for the benefit of one or more persons with some significant relationship to, the organization, for nonexempt purposes." HOPKINS, *supra* note 37, at 428. If any private inurement is present, an organization may be forced to pay penalties, known as "intermediate sanctions" since they are in lieu of losing tax-exempt status. See I.R.C. § 4958 (2000). See also FISHMAN & SCHWARZ, *supra* note 24, at 512-18.

The nondistributional constraint applies to all tax-exempt organizations. See Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 501 (1981). See also Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 458 n.8 (1996) (citing as examples of the nondistributional constraint CAL. CORP. CODE § 5410 (West 2000); N.Y. NOT-FOR-PROFIT CORP. LAW § 102(a)(5) (McKinney 1997); REV. MODEL NONPROFIT CORP. ACT § 13.01 (1987)). For additional information on the rationale for the nondistributional constraint, see Hansmann, *supra*, at 501-03.

39. "[N]o substantial part of the activities [may include] carrying on propaganda, or otherwise attempting, to influence legislation" unless allowed for by section 501(h). I.R.C. § 501(c)(3) (2000).

40. The organization may "not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office." *Id.* Congress enacted the ban on nonprofit political activity to codify *Slee v. Commissioner*, 42 F.2d 184 (2d Cir. 1930). In *Slee*, Judge Learned Hand wrote, "Political agitation as such is outside the statute, however innocent the aim Controversies of that sort must be conducted without public subvention" 42 F.2d at 185. See also 4 BITTKER & LOKKEN, *supra* note 7, at

III. RATIONALES FOR THE TAX EXEMPTION

A. Introduction

Why does the federal government forego so much potential taxable revenue by allowing certain organizations an exemption from taxation of their income? The answer to this question was never fully expressed when the first exemption statute was passed, nor in reenactments of the tax exemption, thus leaving the exact reason up to conjecture.⁴¹

Many theories have been put forward as a rationale for the nonprofit tax exemption.⁴² This Article will present the theories in three groups: (1) social and public policy theories,⁴³ (2) economic theories,⁴⁴ and (3) hybrid theories (part social, part economic).⁴⁵ There have been other attempts at grouping the numerous theories to provide a rationale for the federal tax exemption under section 501, but the following taxonomy, the author believes, is simpler and more descriptive.⁴⁶

100-50.

41. See Belknap, *supra* note 24, at 2031 (stating that the first federal tax exemption "was enacted without debate and virtually without comment . . . The exemption provision was accepted as a matter of course."); 4 BITTKER & LOKKEN, *supra* note 7, at 100-3, 100-4; Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 302-04 (1976); Hall & Colombo, *supra* note 24, at 1382 n.4.

42. See *infra* text accompanying notes 48-150.

43. See *infra* text accompanying notes 48-60.

44. See *infra* text accompanying notes 62-85.

45. See *infra* text accompanying notes 86-150.

46. Some other groupings of theories include:

(1) James T. Bennett, *Unfair Competition and the UBIT*, 41 TAX NOTES 759 (1988). Bennett presented six rationales for the tax exemption, three economic and three noneconomic. The economic theories were "thin markets"; "market failure," see *infra* text accompanying note 121; and transaction in public goods by nonprofit organizations. See Bennett, *supra*, at 761-62. The noneconomic theories were that nonprofits promote equity, are more accountable to the public, and existed in certain industries before any for-profit providers. *Id.* at 762-63. Bennett criticizes all six theories.

(2) BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 57-66 (6th ed. 1992). Hopkins breaks down the rationales into four groups: (a) technical corporate law (looking to how the organization is structured); (b) policy-oriented rationale (looking at what the organization program activities are); (c) tax-oriented rationale (the activities of nonprofits are not taxable events); and (d) rationale from another body of law (like employee benefits law). *Id.*

(3) Crimm, *supra* note 24, at 430-39. Unlike the previous sources mentioned in this footnote, Professor Crimm presents only those rationales which have been discussed in law review journals. She divides the theories into three parts: (a) basic notions (early rationales); (b) subsidy theories (federal government provides the tax exemption since

This overview will show that the public's increased trust in these organizations is the common theme throughout all nonexclusively economic rationales. This central premise of public trust will be used later as the determinant of whether mailing list or affinity card income should be taxable to these organizations.⁴⁷

B. Social and Public Policy Rationales

The social and public policy rationales focus on the effect a nonprofit organization has on society as the reason, or reward, for being given the exemption from taxation. Discussed first is the traditional historical rationale for why nonprofits are afforded tax exemptions, followed by the "altruism" theory originated by Rob Atkinson.

1. Traditional Social and Public Policy Rationales

Among the first rationales expressed for exempting certain organizations from taxation was that government had a "higher regard" for these activities.⁴⁸ The exemption was therefore allowed in order to

nonprofits relieve a government burden); and (c) alternatives to subsidy theories (all other academic theories). *Id.*

(4) SALAMON, *supra* note 6, at 7–10. Salamon breaks the rationales into five categories: (a) historical (volunteer organizations predate government); (b) market failure (*see infra* text accompanying note 121); (c) government failure (government action requires majority support; nonprofits exist so smaller groups can address needs that the majority does not support, or has not yet begun to support); (d) pluralism/freedom (encourage pluralism); and (e) solidarity (allows for unified joint action). *Id.*

For additional critiques of the various rationales for allowing tax exemption, see Rob Atkinson, *Theories of the Federal Income Tax Exemption for Charities: Thesis, Antithesis, and Syntheses*, 27 *STETSON L. REV.* 395 (1997).

An additional way in which the rationales for tax exemption might be broken down is by their various perspectives, whether they are internal or external. "Internal" theories are those which focus on how the donors, members, or the public views the organization. Examples of "internal" theories are Hansmann's capital subsidy theory or the donative theory of Hall & Colombo. *See infra* text accompanying notes 89–129. "External" theories are those which look to the effect of the nonprofit organization on the public, but it does not matter what the public's perception is of the organization. An example of an "external" theory is Atkinson's altruism theory. *See infra* text accompanying notes 52–60.

47. *See infra* text accompanying notes 327–392.

48. Belknap, *supra* note 24, at 2033 (stating that a controlling motive of government in granting the tax exemption was its "higher regard for public benefit"). *See also* 4 BITTKER & LOKKEN, *supra* note 7, at 100-4 (stating that part of the reason the tax exemption was granted was due to the "benevolent spirit animating their activities"); Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 *J. CORP. L.* 585, 586 (1998) (using "sovereignty" as the rationale for the tax exemption since "Caesar should not tax God"); McGovern, *supra* note 31, at 526 (postulating that morality played a part in the tax exemption since Congress felt it was "simply wrong to tax certain types of organizations"). Another early rationale was

encourage the activities of certain favored organizations or institutions.⁴⁹ This early rationale for exempting nonprofits is sometimes confused with subsidy theory, an economic theory.⁵⁰ The difference between the two will be examined when subsidy theory is discussed below.⁵¹

2. Altruism Theory

One of the newer rationales, a “neo” social and public policy theory, is the altruism theory advanced by Rob Atkinson.⁵² Under this theory those actions that are “positive acts” or that provide “metabenefits” would be tax-exempt.⁵³ The altruism theory is very broad in scope and would allow more organizations to qualify for the exemption than are now exempt from taxation.⁵⁴

Under the altruism theory, most, if not all, of the present exempt classifications allowed under the social and public policy theories would be permitted (charities, education, etc.) since those organizations engage

income based: Congress felt that the tax revenue from these organizations was not worth the trouble and expense of collecting or forcing the group to keep records. *See* 4 BITTKER & LOKKEN, *supra* note 7, at 100-4. Assuming that Congress did not want to go against historical precedent is another early rationale for the tax exemption. *See id.* For additional discussion of early nonprofit rationales, see Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 606 n.292 (1990); Bittker & Rahdert, *supra* note 41, at 305-06 (critical of early rationales since they did not distinguish between the various forms of nonprofit organizations); McGovern, *supra* note 31, at 525-27.

49. “The true explanation . . . is that government relieves from the tax burden religious, educational, and charitable activities because it wishes to encourage them as representing the highest and noblest achievements of mankind.” Belknap, *supra* note 24, at 2033-34. A proposed House subcommittee report on the unrelated business income tax stated that the exemption was provided since:

Nonprofit organizations are a part of the basic fabric of this country. Their value, whether put in terms of serving the public benefit or easing human suffering or lessening the burdens of Government, is much heralded, and rightly so. . . . The Federal government has responded in kind. Special benefits and exemptions are afforded to nonprofit organizations throughout the Federal government . . . to foster and encourage their existence.

UBIT RECOMMENDATIONS, *supra* note 11, at 3035.

50. *See infra* text accompanying notes 62-64.

51. *See infra* note 64.

52. *See* Atkinson, *supra* note 48. For additional discussion of the altruism theory, see FISHMAN & SCHWARZ, *supra* note 24, at 343-44; Atkinson, *supra* note 46; Crimm, *supra* note 24, at 435.

53. *See infra* text accompanying notes 55-58.

54. *See* Atkinson, *supra* note 46, at 423-24 (admitting that the theory “makes for an exemption that is extremely, perhaps shockingly, broad” and much wider than any other theory under present law).

in “preferred services.”⁵⁵ The theory adds to the traditional framework the inclusion of organizations which provide “metabenefits” to society.⁵⁶ These “metabenefits” are derived not from *what* an organization does, such as aiding the poor or sick, but from *how* the goods or services they provide are produced or distributed.⁵⁷ Both classes, positive acts and provision of metabenefits, are considered altruistic; therefore, organizations which provide either should be exempt from taxation.⁵⁸

Atkinson’s theory has not been without its detractors. The altruism theory has been criticized on the grounds that an organization’s founders might not have had an “altruistic” motive when creating the nonprofit.⁵⁹ Additionally, Atkinson provides no mechanism to reevaluate an organization if its purpose is to change over time.⁶⁰

As can be seen from the above discussion, the social and policy rationales focus on the benefits that nonprofit organizations provide to the public. These benefits can be most simply described as organizations doing good for society. If this is the justification for the tax exemption for nonprofits, it is not only important for the public to be able to place its trust in the various organizations, but also for those organizations to refrain from acts that are less than noble and good. This element of public trust in nonprofit organizations will be shown to be a major factor in determining which sources of income should be taxed or exempt from taxation.

55. See Atkinson, *supra* note 48, at 618 (allowing for the exemption because “favorable tax treatment of altruistic nonprofits is an affirmative preference for something they provide”).

56. *Id.* at 618, 628–30. As Atkinson writes, the altruism theory “builds on the traditional theory’s insight that the desirable attributes include not only primary benefits, but also metabenefits.” *Id.* at 618.

57. See *id.* at 605 & n.291. Examples of organizations which promote metabenefits are those which foster “voluntarism,” “pluralism,” “a pioneering element,” “diversity of views and approaches,” and “experimentation in new untried ventures.” *Id.* at 605 n.291. See also Crimm, *supra* note 24, at 435.

58. See Atkinson, *supra* note 46, at 424 (“[A]ltruistic supply of a good or service—any good or service—is a metabenefit worthy of consideration for tax preference.”). Atkinson does not discuss why an altruistic organization should be provided a tax exemption, stating only that to do so would be “too ambitious.” Atkinson, *supra* note 48, at 628. See also Colombo, *supra* note 25, at 873 (criticizing altruism theory on this point).

59. See Colombo, *supra* note 25, at 872. Colombo proposes that organizers might just have the desire to be able to distribute more of the income to salaries. See *id.* See also Bennett, *supra* note 46, at 762. Bennett brings up the same issue with respect to the capital subsidy theory. See *infra* note 107.

60. See Colombo, *supra* note 25, at 872–73. See also Crimm, *supra* note 24, at 457–60 (recognizing that a nonprofit’s motives may change over time as the organization evolves).

C. Economic Rationales

These theories cover those rationales based on purely economic reasoning to support the nonprofit tax exemption.⁶¹ Economic theories have been severely criticized in academic circles. The first of these is the subsidy theory, and the second is the income measurement theory of Boris Bitker and George Rahdert.

1. Subsidy Theory

The subsidy theory postulates that a tax exemption is granted as a way for the government to compensate nonprofits for the goods or services they provide.⁶² This theory assumes that if nonprofit organizations were not present in society, the government would be required to perform their functions.⁶³ And, while it might be possible for the government to provide these types of goods or services, it would do so only at a much greater cost.⁶⁴

Subsidy theory has been much criticized. Some cite the fact that many

61. "Economic" is meant in the sense that consumers are assumed to make decisions in a rational manner. See JERALD SCHIFF, CHARITABLE GIVING AND GOVERNMENT POLICY: AN ECONOMIC ANALYSIS 2 (1990). The term, as used here, is also meant to apply to those theories which do not use any social policy as justification for the nonprofit tax exemption.

62. One congressional report stated it like this:

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

H.R. REP. NO. 1860, at 19 (1938). The above statement was called a "rare Congressional pronouncement on the matter" of a rationale for federal tax exemption of nonprofits. Sharpe, *supra* note 6, at 376. Other authors add to the tax subsidy theory by saying that the tax exemption is required since nonprofits provide public goods which would be underproduced in the private sector, and not produced at all in the public sector without government subsidy. See Dennis Zimmerman, *Nonprofit Organizations, Social Benefits, and Tax Policy*, 44 NAT'L TAX J. 341, 342 (1991).

63. For other papers discussing the subsidy theory, see HOPKINS, *supra* note 46, at 58–60 (referring to the subsidy theory as "program rationale"); Crimm, *supra* note 24, at 430–31; Janne G. Gallagher, *The Case for the Charitable Tax Exemption*, 41 TAX NOTES 765 (1988) (stating that the government saves money by the work nonprofits do and that nonprofits foster volunteerism which additionally helps the government); Sharpe, *supra* note 6, at 376–77.

64. See Sharpe, *supra* note 6, at 376–77. The subsidy theory is different from the traditional social theories in that social theory allows for the tax exemptions based on the government's "higher regard" for certain activities irrespective of the economic impact. See *supra* text accompanying notes 48–49.

nonprofits perform functions which would not be contemplated by government if nonprofit organizations were not present, such as missionary work in foreign countries.⁶⁵ The purely religious activities engaged in by these organizations (e.g., “preaching the gospel”) are services that the federal government could not provide since it is prohibited by the Constitution from the establishment of religion.⁶⁶ Another criticism is that the subsidy rationale is based on a tax expenditure analysis,⁶⁷ which has its own inherent problems.⁶⁸

2. *Income Measurement Theory*

Boris Bittker and George Rahdert wrote the first major academic paper on the rationale for tax exemption for nonprofits.⁶⁹ The paper espoused a theory which is now known as the income measurement theory.⁷⁰ While the theory has not been widely accepted as justification

65. See Belknap, *supra* note 24, at 2033. This criticism assumes that missionaries only proselytize their religious beliefs. However, many missionaries provide critical social services such as education, medical care, clean water, shelter, and farming methods which the federal government can, and does, provide.

66. U.S. CONST. amend. I (“Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof . . .”). See also Belknap, *supra* note 24, at 2033.

67. Tax expenditures are any “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide special credit, a preferential rate of tax, or a deferral of tax liability.” Congressional Budget and Impoundment Control Act of 1974, Pub. L. No. 93-344, § 3(3), 88 Stat. 297, 299. Tax expenditures are estimated each year and placed into the federal budget. See STAFF OF J. COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1998–2002 2 (J. Comm. Print 1997).

68. See *Developments in the Law—Nonprofit Corporations*, 105 HARV. L. REV. 1578, 1620–21 (1992). The article notes that tax expenditures are inefficient in allocating government resources, inequitable since they provide the greatest benefit to those that least need the assistance, and force the executive branch, not Congress, to make critical decisions about implementation. See *id.* at 1621. See also Crimm, *supra* note 24, at 431.

69. Bittker & Rahdert, *supra* note 41. George Rahdert was a student of Bittker. Mark A. Hall & John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307, 385 (1991). Mr. Rahdert was also an editor on the YALE LAW JOURNAL; he now practices law in St. Petersburg, Florida. 6 MARTINDALE-HUBBELL LAW DIRECTORY FL1276B (2000).

70. The first mention of the theory as “income measurement” is in Hall & Colombo, *supra* note 69, at 313 n.12. The income measurement theory does not apply to “mutual benefit” organizations. See Bittker & Rahdert, *supra* note 41, at 348. Mutual benefit organizations “are operated to provide goods and services to their members at cost,” *id.*, and include social clubs, I.R.C. § 501(c)(7) (2000); consumer cooperatives, I.R.C. §§ 521, 501(c)(8)–(10) (2000); labor unions, I.R.C. § 501(c)(5) (2000); or trade associations, I.R.C. § 501(c)(6) (2000). See also Bittker & Rahdert, *supra* note 41, at 306. Bittker and Rahdert suggest mutual benefit organizations should not be taxed, but rather an individual member should be taxed if income earned by the organization is imputed to that member. See *id.* at 306, 348–57.

for the tax exemption, the Bittker and Rahdert article provided a major impetus for research and writing in the area.⁷¹

The income measurement theory is based on two separate grounds. First, nonprofits should not be taxed since “they do not realize ‘income’ in the ordinary sense of that term.”⁷² Second, even if the amount of income could be measured, a tax rate could not be readily found to apply.⁷³ Various authors have discredited both arguments.⁷⁴

On the inability to measure income, Bittker and Rahdert argued that the basic premise underlying the income tax, that organizations seek to maximize profits, does not by definition fit nonprofit organizations.⁷⁵ The article goes into detail about how it is impossible to account for income such as endowments, dues, and gifts which are received by nonprofits.⁷⁶ This difficulty in classifying or categorizing income items also applies to deductions, since if no profit motive exists there can be no deductions for “ordinary and necessary business expenses.”⁷⁷

The second prong of the income measurement theory focuses on the rate of taxation which should be applied to nonprofits. The article states that since the burden of taxation falls on the ultimate beneficiaries, the organization should be taxed at the nonprofit beneficiaries’ personal tax rate.⁷⁸ This would be difficult or impossible since many times the beneficiaries are unknown when the income is received, and tax rates could differ among beneficiaries.⁷⁹

The criticisms of the income measurement theory are relatively simple. Regarding the inability to measure income, critics point to the fact that the wide majority of nonprofit organizations earn the bulk of their income not from donations, but from the sale of goods or services.⁸⁰

71. See FISHMAN & SCHWARZ, *supra* note 24, at 340 (stating that the work “stimulated” interest in the area); Hall & Colombo, *supra* note 69, at 385 (commenting that the article was the “first notable, comprehensive treatment of the federal income tax exemption”); Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 55 (1981–1982) (calling Bittker and Rahdert’s article the “most comprehensive and thoughtful” of the attempts to rationalize the tax exemption up to that time).

72. Bittker & Rahdert, *supra* note 41, at 305, 307–14.

73. *See id.* at 305, 314–16.

74. *See infra* text accompanying notes 80–84.

75. Bittker & Rahdert, *supra* note 41, at 307–08.

76. *Id.* at 308–09.

77. *Id.* at 309.

78. *Id.* at 315.

79. *See id.*

80. Hansmann, *supra* note 71, at 59 n.21 (stating that in 1976 only fifteen percent

Examples of commercial nonprofits include hospitals, nursing homes, and private schools.⁸¹ Since many nonprofits are commercial in nature, it is not a problem to account for their income like any other business.⁸² Accounting for “profits” could also be applied to nonprofit organizations which receive a majority of their income from donations. The donations could be viewed as compensation for services and goods provided to third parties.⁸³

The absence of a tax rate is also criticized summarily. Most critics note that income taxation on corporations is seldom justified based on the ability to pay by those individuals who must bear the ultimate burden of the tax.⁸⁴

Since the income measurement theory does not adequately apply to many nonprofit organizations, other hybrid theories, discussed below, have been postulated.⁸⁵ These theories, while constructed on economic reasoning, also have incorporated social and public policy rationales upon which to base the tax exemption.

D. Hybrid Theories

The hybrid theories are those which combine social and public policy rationales with economic justifications. These theories have been created more recently. They seek to explain the nonprofit tax exemptions while avoiding the weaknesses of those theories based purely on social and public policy or economic rationales. The theories discussed here are the “capital subsidy” theory by Henry Hansmann,⁸⁶ the “donative” theory of Mark Hall and John Colombo,⁸⁷ and the “risk

of nonprofit income was received from donations). See also Atkinson, *supra* note 48, at 614–16 (citing Hansmann in agreement); Colombo, *supra* note 25, at 841 (agreeing with Hansmann); Crimm, *supra* note 24, at 432 (stating that the “theory has not been favored by other academicians” since it does not deal with commercial nonprofits); Sharpe, *supra* note 6, at 375, n.16 (in agreement with Hansmann’s criticisms).

81. Hansmann, *supra* note 71, at 59.

82. Atkinson, *supra* note 48, at 614–16; Colombo, *supra* note 25, at 841; Hansmann, *supra* note 71, at 59.

83. Hansmann, *supra* note 71, at 61. Hansmann uses the Red Cross as an example. Any donation would be treated as income, unless the Red Cross used it for disaster relief in that same tax year. See *id.*

84. Atkinson, *supra* note 48, at 612–14; Colombo, *supra* note 25, at 859; Hansmann, *supra* note 71, at 65.

85. See Hall & Colombo, *supra* note 69, at 386 (calling the income measurement theory “ultimately unconvincing”). Another argument against the income measurement theory was that it did not account for the property tax exemption which was afforded nonprofit organizations by state and local government. See Colombo, *supra* note 25, at 858–59; Hall & Colombo, *supra* note 24, at 1387; *Developments in the Law—Nonprofit Corporations*, *supra* note 68, at 1622.

86. See *infra* text accompanying notes 89–108.

87. See *infra* text accompanying notes 109–129.

compensation” theory of Nina Crimm.⁸⁸

1. Capital Subsidy Theory

Henry Hansmann’s “capital subsidy” theory⁸⁹ is the most widely accepted theory for the tax exemption of nonprofit organizations,⁹⁰ although it has been heavily criticized.⁹¹ The capital subsidy theory was published soon after, and in response to, the income measurement theory of Bittker and Rahdert.⁹² The capital subsidy theory combines elements of both an economic and a social policy nature. The economic element is based on “contract failure,” the idea that nonprofit organizations are the most efficient providers of goods and services in their areas.⁹³ The social policy element is the proposition that economic efficiency is based on the increase in public trust due to the nondistributional constraint on nonprofit organizations.⁹⁴

Hansmann states that the tax exemption compensates nonprofit organizations for their inability to tap into capital markets due to the fact they cannot, by law, distribute profits to members or investors.⁹⁵ This statement, however, can best be understood within the context of Hansmann’s entire theory of nonprofit organizations.

The starting point is that nonprofits, under state and sometimes federal law, are not allowed to distribute the net earnings of the organizations to

88. See *infra* text accompanying notes 130–50.

89. Hansmann, *supra* note 71, at 55, 72–76. See also Hansmann, *supra* note 36, at 813–14; Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980) [hereinafter Hansmann, *Nonprofit Enterprise*] (explaining the economic role of nonprofits); Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605 (1989) [hereinafter Hansmann, *Unfair Competition and the UBIT*] (arguing that the unrelated business income tax is economically efficient).

90. See FISHMAN & SCHWARZ, *supra* note 24, at 47 (calling Hansmann’s work “enormously influential”); Ira Mark Ellman, *Another Theory of Nonprofit Corporations*, 80 MICH. L. REV. 999, 999 (1981–1982) (stating that Hansmann’s “two lengthy articles dominate the field and establish the topics for discussion”); Zimmerman, *supra* note 62, at 341–42 (calling Hansmann’s theory one of two economic theories to explain the existence of nonprofit organizations).

91. For criticisms of the capital subsidy theory, see *infra* text accompanying notes 106–08.

92. See Hansmann, *supra* note 71, at 55 (calling Bittker and Rahdert the “most comprehensive and thoughtful” of the articles rationalizing the tax exemption to date, but “ultimately unsatisfying.”)

93. See *infra* text accompanying notes 98–100.

94. See *infra* text accompanying notes 96–97.

95. Hansmann, *supra* note 71, at 55. See also FISHMAN & SCHWARZ, *supra* note 24, at 341.

officers, directors, or members.⁹⁶ Hansmann calls this the “nondistributional constraint.”⁹⁷ This constraint makes nonprofits the most economically efficient legal entity to provide goods and services in areas where “contract failure” occurs.⁹⁸

Hansmann defines contract failure as occurring:

when, owing to the nature of the service itself or to the circumstances under which it is consumed, the purchasers of the service—whether we style them donors or consumers—are likely to have difficulty in (1) comparing the quality of performance offered by competing providers before a purchase is made, or (2) determining, after a purchase is made, whether the service was actually performed as promised.⁹⁹

Since nonprofits are the most economically efficient providers of certain goods and services, Hansmann believes nonprofits serve an important role in society and should be encouraged.¹⁰⁰

The nondistributional constraint, however, hampers nonprofit formation and expansion. If nonprofits are to grow and expand, they require capital just as for-profit businesses require capital.¹⁰¹ However, the nondistributional constraint prevents nonprofits from raising equity capital, and they are therefore limited to raising capital by debt, donations, or retaining earnings.¹⁰² Hansmann believes that nonprofits cannot adequately expand by debt (they cannot borrow enough) or donations (since they often provide public goods and suffer from free rider problems),¹⁰³ and they, therefore, must depend on retained earnings.¹⁰⁴

96. Hansmann, *supra* note 71, at 56; Hansmann, *Nonprofit Enterprise*, *supra* note 89, at 838. For examples of state laws forbidding the distribution of net earnings see CAL. CORP. CODE § 5410 (West 2000); N.Y. NOT-FOR-PROFIT CORP. LAW § 102(a)(5) (McKinney 1997); REV. MODEL NONPROFIT CORP. ACT § 13.01 (1987). *See also* Brody, *supra* note 38, at 458 n.8.

97. Hansmann, *supra* note 71, at 56.

98. *See id.* at 69–71, 74.

99. *Id.* at 69. Some of the examples Hansmann gives are Red Cross disaster relief, higher education, and those providers of “complex personal services” (day care and nursing homes). *Id.* at 69–70. *See also* SCHIFF, *supra* note 61, at 3 (stating that nonprofit donations are unusual “in that donors often have poor information about the marginal impact of their gift.”)

100. Hansmann, *supra* note 38, at 508–09 (“I am suggesting that the essential role of the nonprofit organization is to serve as a fiduciary for its patrons in situations of contract failure.”).

101. *See* Hansmann, *supra* note 71, at 72.

102. *Id.* at 72–74.

103. The “free rider” problem is a characteristic of public goods. *See* THE MIT DICTIONARY OF MODERN ECONOMICS 163 (David W. Pearce ed., 4th ed. 1992). Since there is no way to prevent those who do not pay to have access to public goods (i.e., national defense or clean air), consumers have an incentive to take a “free ride” while others pay. *Id.*

104. Hansmann, *supra* note 71, at 73.

This is where the tax exemption enters. Capital subsidy theory asserts that government should promote activities in areas of contract failure and thus should not tax a nonprofit's earnings in order to allow nonprofits to accumulate retained earnings more quickly. In this way the tax exemption serves to compensate nonprofit organizations for the effects of the nondistributional constraint. It therefore allows nonprofits to provide goods and services in areas of contract failure where they are the most efficient providers of goods and services.¹⁰⁵

The capital subsidy theory is not without its critics. One of the difficulties of the theory is its reliance on the nondistributional constraint.¹⁰⁶ While this constraint prohibits profits to be directly distributed, profits can be distributed indirectly as salaries, thereby lowering quality or increasing the cost of goods or services provided.¹⁰⁷ Others point out problems in the way the subsidy is provided. They call the tax exemption a "crude mechanism" for providing the subsidy, and say that it is impossible to ascertain which organizations are suffering from a capital formation problem.¹⁰⁸

These criticisms are not completely unfounded. At the heart of the capital formation theory is the concept of the public's trust in nonprofit

105. *Id.* at 74. "[The] rationale is that the exemption serves to compensate for difficulties that nonprofits have in raising capital, and that such a capital subsidy can promote efficiency when employed in those industries in which nonprofit firms serve consumers better than their for-profit counterparts." *Id.* at 72.

106. *See Bennett, supra* note 46, at 762.

107. *See id.* In this way the nonprofits "have wide discretion to promote their own careers and increase their personal wealth." *Id.* *See also* GAUL & BOROWSKI, *supra* note 20, at 114-42 (discussing the pay and fringe benefits received by nonprofit executives).

108. *See Colombo, supra* note 25, at 870-71. Colombo also states that the capital subsidy theory is deficient since it does not account for the state property tax exemptions granted to nonprofits. *Id.* at 871. *See also* Hall & Colombo, *supra* note 69, at 388-89 (discussing the same criticisms).

For an additional criticism, see Brody, *supra* note 38, at 459-60. Brody says the capital subsidy theory is circular since the public goes to nonprofits due to a lack of information, but cannot get any additional information after giving the nonprofit funds. *Id.* Brody's criticism misses the point, however. Capital subsidy theory does not posit that the public will form nonprofits to gain more information, but only that they can be somewhat assured that their donations will not go to make a profit for the organization and their shareholders or members. For other criticisms, see Crimm, *supra* note 24, at 432-34 (criticizing the capital subsidy theory on grounds similar to Brody); Ellman, *supra* note 90, at 1050 (stating that Hansmann's theories should be limited to nonprofits which subsist on donations, but Ellman creates a separate theory for nondonative nonprofits); Sharpe, *supra* note 6, at 375 n.16, 377-80. *But see* Richard Steinberg & Bradford H. Gray, "The Role of Nonprofit Enterprise" in 1993: *Hansmann Revisited*, 22 *NONPROFIT & VOLUNTARY SECTOR Q.* 297, 312-13 (1993) (reviewing and agreeing with Hansmann's contract failure theory).

organizations. If this public trust is breached, these organizations would no longer be the most efficient providers of certain goods and services because they could not be the most economically efficient providers in areas of contract failure. Therefore it is important that nonprofits maintain the public's trust at the highest levels possible.

2. Donative Theory

A second hybrid theory is the donative theory developed by Mark Hall and John Colombo.¹⁰⁹ The donative theory blends social policy, the "deservedness" of an organization,¹¹⁰ and economics (tax-exempt nonprofits should exist only where there is both "government failure" and market failure).¹¹¹ This theory attempts to provide a more solid rationale with which to determine which organizations should be tax-exempt and which should be taxable.¹¹²

The donative theory is easy to state but difficult to understand with all its implications. The theory states that tax exemptions, both federal and state, should be awarded only to those organizations which are able to obtain adequate donations.¹¹³ By linking the tax exemption to the level of donations received, the donative theory would have the general public choose in a market-like fashion which organizations should receive the

109. JOHN D. COLOMBO & MARK A. HALL, *THE CHARITABLE TAX EXEMPTION* (1995); Colombo, *supra* note 25, at 873-88; Hall & Colombo, *supra* note 24, at 1450-73; Hall & Colombo, *supra* note 69, at 389-411. See also FISHMAN & SCHWARZ, *supra* note 24, at 344-50 (excerpt of the law review article discussing donative theory and a short discussion of the donative theory); Crimm, *supra* note 24, at 435-39 (summarizing and questioning theory); Sharpe, *supra* note 6, at 379-80 & n.25 (questioning the validity of application of donative theory); *Developments in the Law—Nonprofit Corporations*, *supra* note 68, at 1623-25 (questioning donative theory).

110. "Deservedness" is defined by those "activities that are both worthy of, and in need of, a social subsidy." Hall & Colombo, *supra* note 24, at 1384.

111. These terms are covered *infra* text accompanying notes 116-21.

112. "Other theories more discriminating in their determination of worthiness are nevertheless flawed under the deservedness criterion because they do not explain why valued activities need support to exist at a socially optimal level." Hall & Colombo, *supra* note 24, at 1385. Hall and Colombo limit their explanation of the tax exemption to only those nonprofit organizations which are exempt under I.R.C. section 501(c)(3). See *id.* at 1382 n.3.

113. "In order to place the exemption on firmer theoretical footing, we then proposed a donative theory of the charitable exemption—one that considers as charities only those institutions that are capable of attracting a substantial level of donative support from the public." Hall & Colombo, *supra* note 24, at 1383-84. This is in part due to the fact that donations as a source of income are becoming less important to nonprofit organizations. See Sharpe, *supra* note 6, at 407 (stating that income from donations for section 501(c)(3) organizations dropped to eighteen percent in 1982 (citing *Unrelated Business Income Tax: Hearings Before the Subcomm. on Oversight of the House Comm. On Ways and Means*, 100th Cong. 139 (1987) (statement of Jennie S. Stathis, Associate Director, General Government Division, U.S. General Accounting Office))).

benefits of tax exemption.¹¹⁴ By looking at the amount of donations which an organization can procure, the public decides what organizations are deserving of special status.¹¹⁵

Hall and Colombo write that tax exemption is warranted only in areas in which there exists “twin failure.”¹¹⁶ “Twin failure” occurs in areas where the goods or services cannot be provided at optimal levels due to both “government failure” and private market failure.¹¹⁷ Government failure occurs when there is a failure to attract a majority of votes (federal, state, or local) to enact a desired government program.¹¹⁸ Therefore, even if a minority of the population greatly desires a certain program, the government will not provide that good or service.¹¹⁹ However, while the majority may not vote for the good or service, they are willing to subsidize it with tax exemptions.¹²⁰ Market failure appears in the for-profit setting since nonprofits are providing public goods which will be undersupplied in a private market due to free rider problems.¹²¹

One major question under the donative theory concerns the “appropriate” level of donations that is required. Hall and Colombo

114. See Hall & Colombo, *supra* note 24, at 1388.

115. The donative theory “reasons that donative institutions deserve a tax subsidy because the willingness of the public to contribute demonstrates both worthiness and neediness.” Hall & Colombo, *Donative Theory*, *supra* note 24, at 1385. In this manner the donative theory is the exact opposite focus of Atkinson’s altruism theory discussed earlier. The donative theory has an interior focus, how the organization is being viewed by the world. The altruism theory has an exterior focus, how the organization affects the general public by the distribution of “metabenefits.” See *supra* text accompanying notes 55–58.

116. Colombo, *supra* note 25, at 874–75; Hall & Colombo, *supra* note 69, at 391–96.

117. Colombo, *supra* note 25, at 874–75; Hall & Colombo, *supra* note 69, at 391.

118. See Colombo, *supra* note 25, at 874.

119. See *id.* at 874–75.

120. See *id.* at 875; Hall & Colombo, *supra* note 69, at 392–94.

Colombo states the subsidy as:

[A]lthough a majority of voters may resist paying the full cost of government directly providing certain goods and services, a majority may be willing for government to “contribute” to such production because, while they do not value the particular good or service enough to pay for all of it, they recognize that they would receive some marginal benefit from increased production and hence would be willing to pay for a portion of that increased production, especially if such agreement would permit a partial cross-subsidy of their own special interest.

Colombo, *supra* note 25, at 875.

121. See Hall & Colombo, *supra* note 69, at 391 & n.301. For the definition of the of “free rider” problem, see *supra* note 103.

would require that at least one-third of an organization's gross revenues be from donations in order to qualify for tax-exempt status.¹²² The reasons for the one-third level are both historical (studies show that this is the average level of donations for nonprofit organizations) and practical (one-third is already used in other areas of federal taxation of nonprofits).¹²³ Presently many organizations receive more than one-third of their income from donations, so their tax exemption would not be disturbed. However, most hospitals¹²⁴ and some educational institutions do not receive this level of donative support.¹²⁵

The donative theory has met with some criticism.¹²⁶ One criticism is that the theory is inconsistent, since when an organization receives one hundred percent of its support from donations, and is therefore very deserving of the tax exemption, the tax exemption is no longer helpful because donations are already excluded from income under present tax law.¹²⁷ Second, only individuals with money to donate can help qualify a nonprofit organization for the tax exemption by helping to meet the donation level required under the donative theory.¹²⁸ Finally, it is noted that the number of donors might be a better indication of public support than the amount of total donations.¹²⁹

The donative theory exemplifies public trust as its paramount aspect. If the public does not trust a nonprofit organization, the organization could not be expected to receive many donations. The public would not elect to provide support to those organizations which they did not trust,

122. Hall & Colombo, *supra* note 24, at 1454–55. “Gross revenues” would be calculated under I.R.C. section 509(d) (2000), although the receipts from the sale or exchange of capital assets would be included in the base. *Id.* at 1452–53.

123. *Id.* at 1454–55. The authors in their later published book on the same topic stated that the one-third requirement could be relaxed to 10% or 20% for organizations which have historically been tax-exempt. COLOMBO & HALL, *supra* note 109, at 200. *But see Developments in the Law—Nonprofit Corporations, supra* note 68, at 1624 (stating that the level of donation required is “inherent arbitrariness”).

124. See Hall & Colombo, *supra* note 69, at 409–10.

125. See Colombo, *supra* note 25, at 887.

126. See Atkinson, *supra* note 46, at 428 (pointing out the paradox expressed by Hall and Colombo that the more donations an organization receives, the less useful the tax exemption becomes); Crimm, *supra* note 24, at 438–39 (asking nine questions about the validity of the theory); Sharpe, *supra* note 6, at 379–80 n.25 (questioning the theory); *Developments in the Law—Nonprofit Corporations, supra* note 68, at 1624–25 (pointing out the arbitrariness of creating a threshold level of donation and that the level of support does not necessarily correlate with the amount of donations received).

127. I.R.C. § 102(a) (2000) (excluding gifts from gross income). See also Atkinson, *supra* note 46, at 428 & n.107 (stating that this inconsistency was pointed out by Hall and Colombo themselves (citing Hall & Colombo, *supra* note 24, at 1453, and Hall & Colombo, *supra* note 69, at 403 n.342)).

128. See *Developments in the Law—Nonprofit Corporations, supra* note 68, at 1624–25. *But see* Hall & Colombo, *supra* note 24, at 1459 (discussing how to account for donated labor).

129. *Developments in the Law—Nonprofit Corporations, supra* note 68, at 1625.

or which acted in an unworthy manner.

3. Risk Compensation Theory

The most recent attempt to provide a unifying theory to tax-exempt organizations is the "risk compensation" theory proposed by Nina Crimm.¹³⁰ The risk compensation theory separates the question of why to permit the exemption from federal taxation from the question of whether an organization should be allowed tax-exempt status.¹³¹ This theory's economic aspect bases the tax exemption on the fact that it provides an economic incentive for organizations to take on "pure risk."¹³² The social portion of the theory is that for an organization to maintain its tax-exempt status it must strive to complete its tax-exempt purpose "in a constructive, progressive, and tolerant fashion."¹³³

Professor Crimm writes that the exemption provides a subsidy to tax-exempt organizations. To Crimm the subsidy is not designed to increase altruism, like Atkinson,¹³⁴ or to aid in capital formation, like Hansmann,¹³⁵ but to provide a subsidy to nonprofits for the increased risk that they face in providing pure public goods or mixed public goods.¹³⁵ Providing pure or mixed public goods is associated with pure risk, that risk which has no upside potential and from which one can only be left at a neutral position or with a loss.¹³⁷ Due to this risk, Crimm states that no for-profit firm would provide these goods without the tax exemption

130. Crimm, *supra* note 24. Professor Crimm limits her explanation of the tax exemption to only those nonprofit organizations which are exempt under I.R.C. section 501(c)(3). *Id.* at 424.

131. *See id.* at 424–25.

132. *See infra* text accompanying notes 137–40.

133. Crimm, *supra* note 24, at 461.

134. *See supra* text accompanying notes 52–60.

135. *See supra* text accompanying notes 89–108.

136. Crimm, *supra* note 24, at 440–41. A "public good" is one in which: (1) the consumption cannot be given to only those who pay (nonexcludability), and (2) one person's use does not interfere with another person's consumption of that same good (nonrivalry). *Id.* at 440; Yamamoto, *supra* note 25, at 150 n.17. A "mixed public good" provides a pure public component, but also directly benefits one group. *See* Crimm, *supra* note 24, at 441. Crimm gives the example of low-cost housing to replace slum housing in an urban renewal program. *Id.* The neighborhood benefits, but the residents of the low-cost housing directly benefit. *Id.*

137. Crimm, *supra* note 24, at 443. Crimm uses theft and fire as examples of pure risk. *Id.* at 443 n.98. "Pure risk" is contrasted to "speculative risk" (outcome can be gain or loss), "systematic risk" (risk which cannot be eliminated by diversification), and "diversifiable risk" (risk which can be reduced and is faced by particular providers of goods and services). *Id.* at 443–44.

since there is no possibility of gain.¹³⁸

Since the government's size and immobility prevent it from providing many pure public goods and services which the public desires, the nonprofit sector is needed to fill in this gap.¹³⁹ The federal tax exemption provides this incentive, or as Professor Crimm states, the exemption is "insurance" which provides a boost to the expected return of the nonprofit organization and helps to offset the risk involved.¹⁴⁰

For Professor Crimm, the question of *why* to permit tax-exempt status for some organizations is a separate issue from *what* organizations should be allowed the privilege of the tax exemption.¹⁴¹ According to her theory, the question of why one is allowed the tax exemption is primarily economic,¹⁴² and all charitable organizations deserve to be tax exempt when they begin operations with donations.¹⁴³ After this initial phase, however, the lack of continuing "deservedness" of an organization might cause the loss of the tax exemption.¹⁴⁴ She goes on to say that under other theories this reexamination is not likely to occur.¹⁴⁵

Public trust pervades the "deservedness" portion of the risk compensation theory. For Crimm, deservedness is based on the "worthiness of the projects carried on,"¹⁴⁶ the "benefits to society,"¹⁴⁷ and how close those activities conform with the organization's original purpose.¹⁴⁸ She also states that any noncharitable activities should either be taxed or cause the organization's tax-exempt status to be revoked.¹⁴⁹ The "worthiness" of an organization, or its "benefit to society," must be reflected in the amount of public trust the organization receives. If a nonprofit organization violated the public's trust, those activities should not be "deserving" and should be taxed.¹⁵⁰

138. *Id.* at 451.

139. *Id.* at 442.

140. *Id.* at 454. "The tax exemption is a charitable organization's return on its investment in the public portion of public goods and services, and its very nature assures non-volatile [stable] returns" which make an investment have lower risk. *Id.* at 456-57.

141. *Id.* at 424-25, 455-56.

142. *Id.* at 462.

143. *Id.* at 455-57. Professor Crimm points out that since the initial income would most likely be from donations, it most likely would be excluded from tax regardless of I.R.C. § 501(a). *Id.* at 455 n.160.

144. *Id.* at 457-58. "I would submit that the moral ethic is cloning—that is, the replication over time of the nonprofit organization and its original purpose—and the tax exemption may not be justified for those organizations that do not continue to 'clone' themselves as time progresses." *Id.* at 458.

145. *Id.* at 459-60.

146. *Id.* at 462.

147. *Id.*

148. *Id.*

149. *Id.* at 461.

150. *Id.*

*E. Summary: Public Trust as the Center of Noneconomic
Nonprofit Tax Exemption Rationales*

While the social and hybrid theories rationalize the federal tax exemption for nonprofit organizations in different ways, all take into account the public's trust and confidence in nonprofit organizations.¹⁵¹ If the notion of public trust is part of the bedrock upon which the tax exemption is based, then it follows that any behavior by nonprofits which decreases the public trust should be either eliminated or taxable.¹⁵² This should be true regardless of what the income is ultimately used for or whether some of the public would not distrust the actions undertaken. However, before examining the income received by nonprofits from mailing list rental and affinity card programs under this microscope, a general overview of the taxation of nonprofits and the history of that tax is in order.

IV. UNRELATED BUSINESS INCOME

A. History

As stated earlier, the term "tax exempt" does not accurately describe section 501(a) organizations.¹⁵³ The term is inaccurate due to the UBIT which is imposed on certain nonprofit income under I.R.C. section 511(a).¹⁵⁴ The UBIT is best understood by looking at its history.

151. See *supra* text accompanying notes 60 (social and policy rationales focus on the benefits nonprofit organizations provide, so public trust is imperative), 103 (capital subsidy theory based on public trust of nonprofit organizations), 129 (public trust paramount to donative theory), and 146–50 (public trust is important to the "deservedness" of an organization). While several of the hybrid theories are said by their authors to only apply to section 501(c)(3) organizations, others attempt to explain the tax exemption of all nonprofit organizations. See Atkinson, *supra* note 48, at 510, 565–66 (stating that the altruism theory applies to all nonprofits, except those which sell goods to members); Hansmann, *supra* note 71, at 93–94 (stating that the capital formation theory applies to all nonprofit organizations, with the possible exception of social clubs). But see Crimm, *supra* note 24, at 424 (applying the risk compensation theory to only charitable organizations); Hall & Colombo, *supra* note 24, at 1382 n.3 (stating that the donative theory only applies "to justify the charitable exemption").

152. See *infra* text accompanying notes 345–72.

153. See *supra* text accompanying note 7.

154. I.R.C. § 511(a) (2000). Section 511(a) imposes a corporate income tax on "unrelated business taxable income" of organizations which are described in sections 401(a) (certain pension plans) and 501(c) and state colleges and universities. *Id.* I.R.C. section 511(b) imposes a tax under section 1(e) on the same income of section 501(a) trusts. *Id.* § 511(b). See also I.R.C. § 512(a) (1994) (defining "unrelated business

Before the UBIT was enacted in 1950 no tax was imposed on the income of nonprofit organizations. The only deterrent against a nonprofit organization venturing into business opportunities and receiving income tax-free was loss of its tax-exempt status under I.R.C. section 501.¹⁵⁵

Loss of tax-exempt status, however, was very unlikely under the “destination of income” test. The test was first enunciated by the Supreme Court in *Trinidad v. Sagrada Orden de Predicadores*.¹⁵⁶ *Trinidad* revolved around a claim for refund brought by an ancient Philippine religious order, which was exempt from taxation under what is now I.R.C. section 501(a).¹⁵⁷ At the time, the Philippine Islands were a territory of the United States and, therefore, under its tax jurisdiction.¹⁵⁸

The government taxed the entire income of the organization, claiming that the religious order was not “operated exclusively” for its exempt purpose.¹⁵⁹ This claim was based on the fact that they had incidental income from the sale of wine, chocolate, and “other articles,” accounting for 2.8% of their income.¹⁶⁰ All of the disputed items were “purchased and supplied for use in its churches, missions, parsonages, schools, and other subordinate agencies.”¹⁶¹ The lower courts held that no tax was due since the organization was exempt from taxation.¹⁶²

The Supreme Court held that the religious order should not lose its tax exemption since the statute granting the exemption made “the

taxable income”); *infra* text accompanying notes 200–47.

155. See *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578, 579 (1924) (superseded by statute as stated in *W. Va. State Med. Ass’n v. Comm’r*, 91 T.C. 651 (1988)). See also HOPKINS, *supra* note 37, at 634; Carla Neeley Freitag, *Estates, Gifts, and Trusts: Unrelated Business Income Tax*, 874 TAX MGMT. A-1 (1993) (stating that before the UBIT “the only potential adverse impact of operating a business was the loss of [tax] exempt status”).

156. 263 U.S. 578 (1924). See also Maurice Finkelstein, *Freedom from Uncertainty in Income Tax Exemptions*, 48 MICH. L. REV. 449, 453–56 (1950) (discussing *Trinidad*).

157. See *Trinidad*, 263 U.S. at 578. The organization was based in the Philippines and was “organized and operated for religious, benevolent, scientific and educational purposes in these Islands and in its Missions in China, CochinChina and Japan.” *Id.* at 579. For references to the organization as an “ancient religious order,” see FISHMAN & SCHWARZ, *supra* note 24, at 754; Sharpe, *supra* note 6, at 380.

The income was earned in 1913, see *Trinidad*, 263 U.S. at 579, the same year the Sixteenth Amendment was adopted, which permitted the enactment of the income tax. See James J. McGovern, *The Use of Taxable Subsidiary Corporations by Public Charities—A Tax Policy Issue for 1988*, 38 TAX NOTES 1125, 1125 (1988).

158. See FISHMAN & SCHWARZ, *supra* note 24, at 754; McGovern, *supra* note 157, at 1125 n.3.

159. *Trinidad*, 263 U.S. at 580–81.

160. *Id.* at 580 n.1.

161. *Id.* at 580.

162. *Id.* at 579. The tax exemption at the time was granted under the statutory equivalent to the present I.R.C. section 501(c)(3). *Id.*

destination [of income] the ultimate test of exemption."¹⁶³ This statement by the Supreme Court was taken by later courts to mean that the only consideration for determining if a nonprofit's income should be taxed was the ultimate use of the income earned, such as a charitable purpose, and not its source.¹⁶⁴ Therefore, this analysis became known as the "destination of income test." While the facts indicate that no sale of wine, etc. was to the public or in competition with others, subsequent courts did not limit the destination of income test to the facts of *Trinidad*.¹⁶⁵

Subsequent case law did not confine the destination of income test only to incidental sales of unrelated goods.¹⁶⁶ One of the more egregious

163. *Id.* at 581. The Supreme Court did look to the *de minimis* nature of the sales of chocolates, wine, etc. in making its decision. Justice Van Devanter wrote for the Court, "the fact that the limited trading, if it can be called such, is purely incidental to the pursuit of those purposes, and is in no sense a distinct or external venture" has no bearing on the tax exemption of the organization. *Id.* at 581.

This led one commentator to say *Trinidad* was "excellent authority" for the proposition that interest, dividends, and rents will not affect an organization's tax-exempt status, but "it is negligible authority for holding that the [tax] exemption extends to organizations which operate ordinary commercial enterprises." Comment, *Colleges, Charities, and the Revenue Act of 1950*, 60 YALE L.J. 851, 853-54 (1951). See also FISHMAN & SCHWARZ, *supra* note 24, at 754 (stating that "[a] close reading of [the case] does not reveal that the religious charity was engaged in any business that was unrelated to its exempt purposes").

164. For the expansion of the destination of income test, see 4 BITTKER & LOKKEN, *supra* note 7, at 103-3 ("From this acorn grew a mighty oak—the . . . destination of income rule . . ."); Osteen & Spitzer, *supra* note 37, at 261; Sharpe, *supra* note 6, at 381 (commenting that the destination of income test would be used for the next twenty-four years); Robert H. Swart, *Using (or Abusing) an Exempt Organization's Tax Exemption*, 74 TAXES 1034, 1035 (1996); Katherine A. VanYe, *Sierra Club v. Commissioner and the Royalty Exemption to the Unrelated Business Income Tax: How Much Is Too Much*, 72 WASH. L. REV. 1171, 1172 (1997); Comment, *Colleges, Charities, and the Revenue Act of 1950*, *supra* note 163, at 854 (stating that later courts used the destination of income test without boundaries); Comment, *Preventing the Operation of Untaxed Business by Tax-Exempt Organizations*, *supra* note 37, at 583 (stating that "business profits [of nonprofits] could not be taxed if used to finance exempt activity"). For criticism of the destination of income test, see John Copeland & Gabriel Rudney, *Business Income of Nonprofits and Competitive Advantage*, 33 TAX NOTES 747, 750 (1986) (criticizing the destination of income test as "permitting: (1) unfair competition with taxable trade or business; (2) loss of tax revenue; and (3) trading on the exemption").

165. See *Trinidad*, 263 U.S. at 582. None of the religious order's sales were made to the public or in competition with other business. The sales of wine, chocolate, etc. were "merely bought and supplied for use within the plaintiff's own organization and agencies." *Id.* Additionally, the income from the sales was "all . . . held and used as sources from which to obtain funds or revenue for carrying on its religious, charitable and educational work." *Id.* at 580.

166. See *Roche's Beach, Inc. v. Comm'r*, 96 F.2d 776 (2d Cir. 1938); *Sand Springs*

examples occurred in *Roche's Beach, Inc. v. Commissioner*, where a corporation ran an extensive business on a section of beach in New York state.¹⁶⁷ The corporation's profits were the sole support of a tax-exempt charitable foundation.¹⁶⁸ The Court of Appeals held that the income from the beach operation was not taxable since the "destination of the income is more significant than its source."¹⁶⁹ It took twelve more years after *Roche's Beach* for Congress to act.¹⁷⁰

The congressional call to action came swiftly after the facts of *C.F. Mueller Co. v. Commissioner* were made public.¹⁷¹ At issue in *C.F. Mueller* was the purchase and subsequent transfer to New York University Law School of the stock of a company that made noodles.¹⁷²

Home v. Comm'r, 6 B.T.A. 198 (1927). For additional cases using the destination of income test, see George R. Blodgett, *Taxation of Businesses Conducted by Charitable Organizations*, in N.Y.U. FOURTH ANNUAL INSTITUTE ON FEDERAL TAXATION 418, 426 n.14 (1946).

167. See *Roche's Beach*, 96 F.2d at 777.

This business was quite extensive. There were 3,000 bath houses to be let to transient bathers; 34 employees were engaged during the summer; as many as 6,000 persons might patronize the beach on pleasant days; suits and towels were rented; caps, belts and shoes were sold; and restaurant, soda and candy concessions were given out.

Id.

168. See *id.* The foundation was formed "for the purpose of establishing a fund for the relief of destitute women and children." *Id.*

169. *Id.* at 778. In holding that the beach operation was not taxable, the court wrote that "[n]o reason is apparent to us why Congress should wish to deny exemption to a corporation organized and operated exclusively to feed a charitable purpose when it undoubtedly grants it if the corporation itself administers the charity." *Id.* at 779.

170. See Sharpe, *supra* note 6, at 381 (stating that *Roche's Beach* dispelled any doubts that the destination of income test would apply to a business). See also FISHMAN & SCHWARZ, *supra* note 24, at 755 (discussing *Roche's Beach*).

171. See *C.F. Mueller Co. v. Comm'r*, 190 F.2d 120 (3rd Cir. 1951), *superseded by statute as stated in* *Rensselaer Polytechnic Inst. v. Comm'r*, 732 F.2d 1058 (2d Cir. 1984). The Court of Appeals actually decided the case *after* the unrelated business income tax was passed. See *id.* at 120 ("What we do here with the problem is of little importance for the future, since Congress has entered the area of dispute and declared the rule for the taxable years commencing after December 31, 1950."). For more information on *C.F. Mueller*, see McGovern, *supra* note 157, at 1125-26 (commenting on *C.F. Mueller* as "one of the most celebrated cases"); Sharpe, *supra* note 6, at 381-82, 394-96 (discussing *C.F. Mueller*).

172. See *C.F. Mueller*, 190 F.2d at 121. At the same time New York University also operated Howes Leather Company (valued at \$35 million), American Limoges China, Inc. (valued at \$3.3 million), and the Ramsey Corporation, a piston ring manufacturer (valued at \$3 million). See Benjamin Fine, *University Dollars Yielding Tax-Free Business Profits*, N.Y. TIMES, Dec. 13, 1948, at A1 (discussing the rise of business and real estate holdings of nonprofit institutions). See also *Revenue Revisions of 1947-48: Hearings Before the House Comm. on Ways and Means*, 80th Cong., 3529, 3540 (1948) (testimony of John Gerdes); Gallagher, *supra* note 63, at 766 n.8; Sharpe, *supra* note 6, at 382 (commenting on *C.F. Mueller*); Comment, *Colleges, Charities, and the Revenue Act of 1950*, *supra* note 163, at 851 n.5, 863 n.57 (giving more particulars on the various transactions of New York University).

The stock was purchased by benefactors of the law school who then donated it to the law school.¹⁷³ The company purchased was the largest noodle maker in the United States.¹⁷⁴ After the stock transfer, the corporation was merged into the law school and the profits from the noodle operation went to support the school's operations.¹⁷⁵ Profits from the noodle operation were tax-exempt under the destination of income test.¹⁷⁶

The effect on Congress was stated to be "galvanic."¹⁷⁷ One Member of Congress was so upset by the facts of *C.F. Mueller* that he stated that if Congress did not act "[e]ventually all the noodles produced in this country will be produced by corporations held or created by universities."¹⁷⁸ However, while New York University business operations were the most publicized, the school was not alone in business operations.¹⁷⁹ It was the extent to which the "acorn" of the destination of income test had grown which caused President Truman to call for change and Congress to act.¹⁸⁰

173. See Note, *The Macaroni Monopoly: The Developing Concept of Unrelated Business Income of Exempt Organizations*, 81 HARV. L. REV. 1280, 1281 (1968).

174. *Id.* at 1281.

175. *C.F. Mueller*, 190 F.2d at 121.

176. *Id.* at 123. "The policy . . . is that the benefit from revenue is outweighed by the benefit to the general public welfare gained through the encouragement of charity." *Id.* at 122 (citing *United States v. Proprietors of Soc. Law Library*, 102 F.2d 481, 482 (1st Cir. 1939)).

177. Note, *The Macaroni Monopoly*, *supra* note 173, at 1281.

178. *Revenue Revisions of 1950: Hearings Before the House Comm. on Ways and Means*, 81st Cong. 579-80 (1950) (statement of Rep. Dingell, D.-Mi.).

Congressman Dingell said in debate for the UBIT:

[T]he advantage of a tax-exempt corporation . . . is so great that, if something is not done to level it off, the macaroni monopoly will be in the hands of the universities or their subsidiary companies. . . . Eventually all the noodles produced in this country will be produced by corporations held or created by universities . . . and there will be no revenue to the Federal Treasury from this industry. . . . There is no question about the fact that the advance of tax-exempt institutions, such as the macaroni concern, is so great that eventually it is bound to put the privately owned noodle corporations out of business.

Id.

179. Educational institutions were said to be operating banking institutions, "haberdasheries, citrus groves, movies, cattle ranches, the Encyclopedia Britannica (owned by the University of Chicago), and a large variety of other enterprises." 96 CONG. REC. 9273-74 (1950). The federal tax due if the income were taxed was reported to be \$173 million. See *id.* at 9274.

180. PRESIDENT HARRY S. TRUMAN, REVISION OF THE TAX LAWS: MESSAGE FROM THE PRESIDENT OF THE UNITED STATES, H.R. DOC. NO. 451, at 5 (1950) (stating that changes to the nonprofit tax exemption should be made to halt "glaring abuses of the tax-exemption privilege"). For additional discussion of the legislative history, see Kenneth

The congressional “remedy” was the unrelated business income tax, or UBIT, applied to all nonreligious nonprofit organizations.¹⁸¹ The bill was drafted and passed by the House of Representatives and sent to the Senate.¹⁸² Due to pressure from nonprofit organizations which opposed the UBIT, the Senate intended not to act on the bill.¹⁸³ However, the start of the Korean War that year put pressure on Congress to raise revenue by closing tax loopholes and the House bill was passed with “few and minor changes.”¹⁸⁴

The UBIT was designed to accomplish two goals: (1) raise revenue, and (2) prevent unfair competition between nonprofit organizations and for-profit businesses. Arguably, the UBIT has failed on both counts. On the revenue side, in its first year the UBIT was expected to generate \$100 million of tax revenues, but raised only \$37.00.¹⁸⁵ To date it has failed to be a significant source of income for the federal government.¹⁸⁶

C. Eliasberg, *Charity and Commerce: Section 501(c)(3)—How Much Unrelated Business Activity?*, 21 TAX L. REV. 53 (1965–1966); Sharpe, *supra* note 6, at 382–85. For previous congressional hearings on nonprofit unrelated business operations, see *Revenue Revision of 1942: Hearings Before the House Comm. on Ways and Means*, 77th Cong., 89 (1942).

181. The UBIT was originally enacted by the Revenue Act of 1950, Pub. L. No. 81-814, §§ 301, 331, 421, 64 Stat. 906, 947–52 (codified as amended at 26 U.S.C. §§ 511, 512). When it was first enacted, the UBIT received negative commentaries. See Comment, *Colleges, Charities, and the Revenue Act of 1950*, *supra* note 163, at 875 (stating that “the Revenue Act of 1950 is a fairly inept piece of legislation” and that “Congress was lenient when it should have been harsh and harsh when it should have been lenient”). See also John H. Myers, *Taxing the Colleges*, 38 CORNELL L. REV. 368, 379–84 (1953) (providing an overview of 1950 legislation).

182. Myers, *supra* note 181, at 376.

183. *Id.* at 376–77.

184. *Id.* at 377.

185. George D. Webster, *Effect of Business Activities on Exempt Organizations*, 43 TAXES 777, 777 (1965); Comment, *Preventing the Operation of Untaxed Business by Tax-Exempt Organizations*, *supra* note 37, at 581 n.2. See also Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017, 1017 (1982) (stating that “[v]ery little money has been collected under [the UBIT]”). But see George Cooper, *Trends in the Taxation of Unrelated Business Activity*, in 2 N.Y.U. TWENTY-NINTH ANNUAL INSTITUTE ON FEDERAL TAXATION 1999, 2019 (1971) (“This drop from expected to actual revenues does not necessarily indicate that the tax failed in its purpose. Rather it could merely indicate that the maximum effect of the tax was in driving business activities out of tax-exempt organizations.”); Hansmann, *Unfair Competition and the UBIT*, *supra* note 89 (arguing for the continuation of the UBIT).

186. The latest estimates show that in 1995 \$277.5 million was collected under the UBIT. FISHMAN & SCHWARZ, *supra* note 24, at 800 (citing Alicia Meckstroth & Paul Arnsberger, *A 20-Year Review of the Nonprofit Sector, 1975–1995*, 18 SOI BULL.: Q. STAT. INCOME REP. (I.R.S.) 149, 165 (1998)). See also Margaret Riley, *Unrelated Business Income of Nonprofit Organizations: Highlights of 1995 and a Review of 1991–1995*, 18 SOI BULL.: Q. STAT. INCOME REP. (I.R.S.) 80, 81 (1999) (reporting a 137.2% increase in UBIT tax liability from 1991 to 1995 and a 44.4% increase from 1994 to 1995).

Several articles have debated the continued enactment or repeal of the UBIT. For articles supporting the UBIT, see Hansmann, *Unfair Competition and the UBIT*, *supra*

While the need for additional revenue might have been the final impetus to push the bill past the Senate, the primary rationale for the UBIT was to prevent unfair competition.¹⁸⁷ As compared with for-profit firms, nonprofits purportedly presented two forms of unfair competition. First, it was assumed that nonprofits would engage in predatory pricing by lowering the amount they charge for goods and services, thereby driving competitors out of the market.¹⁸⁸ However, legal commentators

note 89, at 605, 614–16 (suggesting the continuation of the UBIT since if it were not present nonprofit organizations would be motivated to take over corporations which would decrease diversification and the businesses would be managed inefficiently). For articles critical of the UBIT, see Bitker & Rahdert, *supra* note 41, at 316–26 (questioning the unfair competition rationale and “passive/active” labels for the exceptions to the UBIT); Hall & Colombo, *supra* note 24, at 1442–46 (maintaining that the UBIT is not required under the donative theory since tax-exempt status is allowed only if a certain percentage of the nonprofit’s overall income is from donations); William A. Klein, *Income Taxation and Legal Entities*, 20 UCLA L. REV. 13, 61–68 (1972) (questioning the unfair competition rationale); Rose-Ackerman, *supra* note 185, at 1038 (proposing the repeal of the UBIT since “the tax on unrelated business activity creates more unfairness than it can possibly prevent.”). For additional comments on the Rose-Ackerman article, see Copeland & Rudney, *supra* note 164, at 750 (stating that Rose-Ackerman’s analysis was based on faulty assumptions and criticizing her idea of repeal of the UBIT as impractical); Hansmann, *Unfair Competition and the UBIT*, *supra* note 89, at 613–14 (suggesting that Rose-Ackerman looks at the equity, but not the economic efficiency, of the UBIT).

187. “The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete.” Treas. Reg. § 1.513-1(b) (as amended in 1983). For additional papers which state that unfair competition was the primary rationale, see 4 BITKER & LOKKEN, *supra* note 7, at 103-9, 103-10 (noting that “unfair competition” is not present for finding any UBIT due, even though that was the primary rationale for its enactment); Bennett, *supra* note 46, at 759; Thomas J. Gallagher, *When is a Business Not a Business? Exploiting Business Opportunities and Enhancing Economic Returns By Capitalizing on the Income Tax Exemption of Tax-Exempt Organizations*, 75 TAXES 928, 929–30 (1997); McGovern, *supra* note 157, at 1126; Thomas A. Troyer, *Changing UBIT: Congress in the Workshop*, 41 TAX NOTES 1221, 1226 (1988). See also UNITED STATES GENERAL ACCOUNTING OFFICE, TAX POLICY: COMPETITION BETWEEN TAXABLE BUSINESSES AND TAX-EXEMPT ORGANIZATIONS (1987); UNITED STATES SMALL BUSINESS ADMINISTRATION, UNFAIR COMPETITION BY NONPROFIT ORGANIZATIONS WITH SMALL BUSINESS: AN ISSUE FOR THE 1980S 15–24 (1984) (providing case studies of suggestions for stopping unfair competition of nonprofits with small businesses); Note, *Tax-Exempt Entities, Notional Principal Contracts, and the Unrelated Business Income Tax*, 105 HARV. L. REV. 1265, 1273–75 (1992) (reviewing the importance of unfair competition to the application of the UBIT to a nonprofit’s activities).

188. For articles which state that this is part of the unfair competition rationale, see Rose-Ackerman, *supra* note 185, at 1021; Comment, *Colleges, Charities, and the Revenue Act of 1950*, *supra* note 163, at 876; Note, *The Macaroni Monopoly*, *supra* note 173, at 1281.

have widely refuted the possibility of predatory pricing by nonprofits.¹⁸⁹

The second way in which nonprofits are said to be able to compete unfairly is that they can more easily accumulate capital.¹⁹⁰ This ability to accumulate capital is said to permit nonprofit organizations a greater ability to expand, giving them an unfair advantage over their for-profit counterparts.¹⁹¹ However, while the ability to accumulate capital is one of the supporting rationales for nonprofit organizations, this rationale does not apply to those areas which do not possess incidences of “contract failure.”¹⁹² For-profit firms exist in those areas where contract

189. See Klein, *supra* note 186, at 64–65 (asserting that there are too many factors against predatory pricing by nonprofits to justify the UBIT); Rose-Ackerman, *supra* note 185, at 1038 (proposing that the UBIT actually causes unfair competition since nonprofits “must now concentrate their profitable endeavors in those few lines of business judged to be related” while if the UBIT did not exist the effects of nonprofits would be across the economy where “they would be unlikely to have much competitive impact”) (internal quotation omitted); Comment, *Colleges, Charities, and the Revenue Act of 1950*, *supra* note 163, at 876 (stating that “it seems unlikely that exempt institutions . . . which are clamoring for funds, will forego current income on the risk that they can drive out a competitor after a lengthy price war”); Note, *The Macaroni Monopoly*, *supra* note 173, at 1281–82 (questioning the rationale since traditional economic theory does not treat a profit tax as a cost, and there would be little economic incentive to forego current profits to monopolize markets). See also A.L. Spitzer, *Reform of the UBIT: An Open Letter to Congress*, 43 TAX NOTES 195, 196 (1989) (stating that the competitive advantage of nonprofits is from state and local subsidies (exemption sales and property taxes) and other federal subsidies (e.g., lower postal rates) and that “[i]n many cases these subsidies may be more responsible for creating a competitive imbalance than is tax exemption, and yet they are unaffected by changes to the UBIT”).

190. The Senate report accompanying the bill enacting the UBIT said that the “problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of [section 501] organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes.” S. REP. NO. 2375, at 28 (1950), *reprinted in* 1950-2 INTERNAL REVENUE BULL. 483, 504. See also H.R. REP. NO. 2319, at 36 (1950), *reprinted in* 1950-2 INTERNAL REVENUE BULL. 380, 409.

191. See Comment, *Colleges, Charities, and the Revenue Act of 1950*, *supra* note 163, at 876 (providing as a solution to the unfair accumulation of income the requirement that nonprofits distribute a portion of their income to beneficiaries each year); Note, *The Macaroni Monopoly*, *supra* note 173, at 1282 (stating that the “exempt enterprise will have a greater surplus to invest in production and distribution facilities”). See also Copeland & Rudney, *supra* note 164, at 748 (giving other ways in which nonprofits might have an unfair advantage which is not addressed by the UBIT). Copeland and Rudney suggest that unfair competition exists since nonprofits have a marketing advantage due to public trust, lower labor costs due to the use of volunteer workers, and greater access to subsidies from government grants and private donations. *Id.* But see Klein, *supra* note 186, at 65–68 (disputing that nonprofits would accumulate capital); Comment, *Preventing the Operation of Untaxed Business by Tax-exempt Organizations*, *supra* note 37, at 592 (stating that “the ability to accumulate funds faster would give the exempt organization no advantage because if there is opportunity for profitable expansion taxed businesses will be able to obtain funds in money and capital markets”).

192. See *supra* text accompanying notes 98–100.

failure is not present.

In 1969 the UBIT was expanded to cover all nonprofit organizations under I.R.C. section 501(a).¹⁹³ Except for the expansion of the UBIT in 1969, the changes to the UBIT have not been substantial since its enactment in 1950.¹⁹⁴ In 1986 Congress added a provision exempting income received on the exchange or rental of donor or member lists between organizations whose contributors receive a tax deduction.¹⁹⁵ In 1987 a House Ways and Means subcommittee undertook a comprehensive review of the UBIT.¹⁹⁶ The subcommittee held five days of hearings in 1987 and in addition heard comments in 1988.¹⁹⁷ After the review was completed, a proposal to change the UBIT was drafted but never submitted to the House of Representatives.¹⁹⁸ While never

193. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, § 121(a)(1) (codified at I.R.C. § 511 (2000)). See also H.R. REP. 91-413, at 46, reprinted in 1969-3 C.B. 230; 4 BITTKER & LOKKEN, *supra* note 7, at 103-8; Copeland & Rudney, *supra* note 164, at 750 (stating that the 1969 Act "brought all section 501 . . . organizations under the scope of the [UBIT]"); Gallagher, *supra* note 187, at 930 (stating same); McGovern, *supra* note 157, at 1127 (stating that Congress was concerned that "organizations that were exempted from the unrelated business income rules (including churches) were engaging, or were apt to engage in, unrelated business"); VanYe, *supra* note 164, at 1173 n.17, n.23 (stating same and giving examples of churches' unrelated business activities). For the dates for which the UBIT applies to various nonprofit organizations, see Treas. Reg. §§ 1.511-2(a)(1)(ii), (a)(3)(i), (a)(3)(iii) (as amended in 1979).

The 1969 legislative changes also allowed for one of the most specific and blatant pieces of tax special interest legislation. Section 512(b)(15) allows for the exemption from the UBIT of certain radio stations. Subparagraphs (A)-(C) spell out the station's letters to which the exception was specifically drafted—WWL. 4 BITTKER & LOKKEN, *supra* note 7, at 103-32, -33; FISHMAN & SCHWARZ, *supra* note 24, at 818; PHILIP M. STERN, *THE RAPE OF THE TAXPAYER* 40-41 (1973). See also Sharpe, *supra* note 6, at 403 (saying that "section 512(b)(15) resurrected the 'destination of income'" test).

194. Gallagher, *Exploiting Business Opportunities*, *supra* note 187, at 930 (stating that none of the modifications since 1969 have "been very far reaching"). In the late 1980s a subcommittee of the House of Representatives held hearings on the UBIT. See UBIT RECOMMENDATIONS, *supra* note 11, at 3037-47 (giving the final recommendations, which were not adopted by the subcommittee).

195. I.R.C. § 513(h)(1)(B) (2000). See also VanYe, *supra* note 164, at 1174 (discussing the change); *infra* text accompanying notes 291-97.

196. See UBIT RECOMMENDATIONS, *supra* note 11, at 3028.

197. See *id.* at 3029-30.

198. Though the report was not adopted by the subcommittee, it was published. See *id.* For articles that say the report never made it out of the House Subcommittee, see Michael Moriarty, *Nonprofits Expected to Escape UBIT Reform This Year*, 43 TAX NOTES 783, 783 (1989) (giving several reasons why the report was stalled in the House Ways and Means subcommittee); Ellin Rosenthal, *UBIT Recommendations Likely To Remain in Limbo This Year*, 40 TAX NOTES 328, 328 (1988) (stating that the "recommendations do not address many of the members' specific concerns and thus have not generated the support necessary to pass out of the subcommittee"); Spitzer, *supra*

adopted, the report is beneficial to an understanding of how some in Congress felt after intense study of the issue.¹⁹⁹

B. *The Elements of the Unrelated Business Income Tax*

The UBIT, contained in subtitle A, part III of the Internal Revenue Code, is a complex and somewhat clumsy piece of tax law.²⁰⁰ The sections of the UBIT important to this Article are I.R.C. sections 511, 512, and 513.²⁰¹ The tax itself is actually imposed under section 511.²⁰²

An overview of the UBIT is helpful prior to examining its details. Section 511 imposes a tax on the “unrelated business taxable income” of

note 189, at 195 (commenting on the various proposals in the subcommittee’s report). See also Pat Jones, *Ways and Means Oversight Subcommittee Members Given List of UBIT Proposals*, 39 TAX NOTES 1498, 1498 (1988) (commenting that the subcommittee was under “intense lobbying” by small business, which wanted UBIT reform, and nonprofits, which did not).

199. See UBIT RECOMMENDATIONS, *supra* note 11 (giving the final report issued by the subcommittee). For a discussion of the report’s contents, see Troyer, *supra* note 187, at 1224 (giving as the report’s major recommendations: (1) retain the “substantially related” test, (2) tax sale of articles by mail order or catalog or in gift shops or book stores, (3) tax sales and rentals of certain medical equipment and devices unless they benefit patients, (4) tax all travel tours, (5) tax all affinity card arrangements, and (6) several adjustments regarding the computations of deductions and aggregation rule).

200. For additional discussion of the UBIT and its elements, see *United States v. American College of Physicians*, 475 U.S. 834, 837–39 (1986); 4 BITTKER & LOKKEN, *supra* note 7, at 103–8; John M. Donahue, *Unrelated Business Income of Tax Exempt Organizations*, in 2 N.Y.U. THIRTY-SEVENTH ANNUAL INSTITUTE ON FEDERAL TAXATION 27-1, 27-3 (Nicolas Liakas ed., 1979); FISHMAN & SCHWARZ, *supra* note 24, at 764–829; HOPKINS, *supra* note 37, at 646–49; Gallagher, *supra* note 187, at 930–32; Osteen & Spitzer, *supra* note 37, at 262–63; J. Mark Stanley & David R. Ward, *UBIT May Hit Common Transactions*, 25 TAX ADVISER 557, 557–58 (1994); Swart, *supra* note 164, at 1035–38; Vicky Tsilas, *Sierra Club Inc. v. Commissioner: Why Is the IRS Continuing to Fight a Losing Battle?*, 24 EXEMPT ORG. TAX REV. 487, 487–88 (1999).

There have been many proposals made over the years to change the UBIT. See Bennett, *supra* note 46, at 759 (suggesting that all “commercial activity” [a term not defined in the article] by nonprofits should be through taxable subsidiaries); John Copeland, *Some Suggestions for Revision of Tax-Exempt Organization Rules*, 51 TAX NOTES 911, 912 (1991) (advocating the repeal of most of the exceptions to the UBIT); McGovern, *supra* note 157, at 1130–31 (proposing the repeal of the UBIT and substituting I.R.C. section 4943 (2000) (excess business holding rules) to nonprofit income); Sharpe, *supra* note 6, at 388–89, 404–12 (proposing a mandatory distribution of a set percentage of income received from any unrelated businesses); Eric W. Sokol, Comment, *Making Tax-Exempts Pay: The Unrelated Business Income Tax and the Need for Reform*, 4 ADMIN. L.J. 527 (1991) (proposing that nonprofit organizations which engage in “substantial commercial activity,” i.e., those making more than \$25,000 in unrelated income, be forced to use taxable subsidiaries to create that income).

201. I.R.C. §§ 511, 512, 513 (2000). Part III also contains provisions which cover unrelated debt-financed income and a credit for foreign tax paid. I.R.C. §§ 514, 515 (2000). This Article will not discuss the implications of I.R.C. section 514 or section 515.

202. I.R.C. § 511(a), (b). Organizations use form 990-T to report their unrelated business income to the Service. Osteen & Spitzer, *supra* note 37, at 265.

a nonprofit organization at either corporate or trust income tax rates, depending on the nature of the organization.²⁰³ The term “unrelated business taxable income” is defined in I.R.C. section 512 as any gross income²⁰⁴ from any regularly carried on “unrelated trade or business,” minus associated deductions.²⁰⁵ I.R.C. section 513 defines what constitutes “unrelated trade or business.”²⁰⁶ To complicate matters there are many exceptions and exclusions from the UBIT.²⁰⁷ I.R.C. section 512(b) contains many important exclusions from the UBIT, while section 513(a) contains three exceptions from what is considered “unrelated trade or business.”²⁰⁸

Under I.R.C. section 511 the UBIT is imposed on trusts at the tax rate for trusts under section 1(e), and on all other organizations listed in section 501(a) at the corporate tax rate.²⁰⁹ The UBIT also applies to certain organizations not listed in section 501(a).²¹⁰

203. I.R.C. § 511(b) (2000) (taxation under I.R.C. section 1(e) for trusts exempt from tax under section 501(a)). See I.R.C. § 511(a) (corporate tax rates under section 11 for all other nonprofit organizations); Treas. Reg. § 1.511-2(b)(1) (as amended in 1979); 4 BITTKER & LOKKEN, *supra* note 7, at 103-9. See also Osteen & Spitzer, *supra* note 37, at 262 (stating that the “existence of the unrelated business income tax does not mean that charitable organizations must operate their charitable activities at a loss but merely that income earned outside exempt functions will be taxed at ordinary corporate or trust rates depending upon [an] organization’s structure”).

204. “Gross income” is defined in I.R.C. section 61(a) (2000) as “all income from whatever source derived” unless otherwise provided in subtitle A (Income Taxes) of Title 26 (Internal Revenue Code). I.R.C. § 61(a) (2000). “Income” is defined as the “undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.” *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

205. I.R.C. § 512(a) (2000). See *infra* text accompanying notes 214–47 for additional discussion of section 512.

206. I.R.C. § 513 (2000).

207. I.R.C. § 512(b) (containing nine exclusions from “unrelated business taxable income”); § 513(b)(1)–(3) (listing exceptions to the “trade or business” requirement in section 513(a)). For more discussion of the various exclusions and exceptions, see *infra* text accompanying notes 248–69.

208. I.R.C. §§ 512(b), 513(a)(1)–(3). I.R.C. section 513 contains many other exceptions to what is considered an “unrelated trade or business.” See, e.g., *id.* § 513(d) (excluding certain “public entertainment” and “convention and trade show” activities); *id.* § 513(e) (excluding certain small hospitals); *id.* § 513(f) (excluding certain bingo games); *id.* § 513(g) (excluding pole rentals by mutual or cooperative telephone and electric companies); *id.* § 513(h)(1)(B) (excluding the sale of mailing lists between section 170(c)(3) and (c)(4) organizations).

209. I.R.C. § 511(a), (b) (2000).

210. See *id.* § 511(a)(2)(B) (applying the UBIT to state colleges and universities which are exempt from tax under I.R.C. § 115). See also 4 BITTKER & LOKKEN, *supra* note 7, at 103-8.

1. Unrelated Business Taxable Income

The UBIT is only applied to a nonprofit's "unrelated business taxable income."²¹¹ "Unrelated business taxable income" has three elements, which can be synthesized after reading both I.R.C. sections 512 and 513.²¹² I.R.C. section 513 defines an unrelated trade or business as any trade or business which is not substantially related to any nonprofit purpose, apart from the income being used to further that purpose.²¹³ The unrelated trade or business income is not subject to tax, however, unless it is "regularly carried on" as provided by section 512.²¹⁴ Therefore, the three elements which must be met before any income made by a nonprofit is taxable under the UBIT are as follows: (1) the income must be from a trade or business, (2) which is "regularly carried on by the organization," and (3) is "not substantially related (other than through the production of funds) to the organization's performance of its exempt functions."²¹⁵ Each of these elements will be taken up briefly in turn.

a. Trade or Business

"Trade or business" is defined in two different ways: positively in the Code and by analogy to the same language in the deduction sections of the Code.²¹⁶ The positive Code definition is in I.R.C. section 513(c),

211. I.R.C. § 511(a).

212. I.R.C. §§ 512(a), 513(a).

213. I.R.C. § 513(a). This section states:

The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3))

Id.

214. *Id.* § 512(a). This section states:

Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business

Id.

215. Treas. Reg. § 1.513-1(a) (as amended in 1983).

216. See HOPKINS, *supra* note 37, at 649-50. For additional discussion on the "trade or business" element, see 4 BITTKER & LOKKEN, *supra* note 7, at 103-10, 103-11; HOPKINS, *supra* note 37, at 649-59; Osteen & Spitzer, *supra* note 37, at 262; Sharpe, *supra* note 6, at 412-27 (providing an extensive background into the legislative history, case history, and various regulations which have defined the term "trade or business");

which defines a trade or business as “any activity which is carried on for the production of income from the sale of goods or the performance of services.”²¹⁷ This broad language covers a great many activities of nonprofits.²¹⁸ The regulations, however, by analogy apply the standards of the trade or business deduction of I.R.C. section 162.²¹⁹ In cases which interpret the “trade or business” requirement by using section 162 as an analogy, the courts have had some difficulty in defining “trade or business,” since the definition is so broad, and since there is not a great deal of case law defining “trade or business” under section 162.²²⁰

Stanley & Ward, *supra* note 200, at 557; Swart, *supra* note 164, at 1035.

217. I.R.C. § 513(c).

218. See Deirdre Dessingue Halloran, *UBIT Update*, 36 CATH. LAW. 39, 40–41 (1995) (maintaining that “the IRS treats most activities as constituting a ‘trade or business’”).

219. See Treas. Reg. § 1.513-1(b) (as amended in 1983). Trade or business “has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services.” *Id.* See also Sharpe, *supra* note 6, at 413 (“The Senate Report accompanying the 1950 Revenue Bill offered the assurance, however, that [trade or business] had the same meaning for purposes of the tax on unrelated trade or business as it had elsewhere in the Code, citing as a specific reference the predecessor of section 162 . . .”).

I.R.C. section 162 is entitled “Trade or Business Expenses” and is the primary deduction section for businesses. Deduction under section 162 is permitted for (1) ordinary and necessary (2) expenses (as opposed to capital expenditures), (3) paid or incurred during the taxable year, (4) in carrying on any trade or business. I.R.C. § 162(a) (2000). Even if the basic elements for the section 162 deduction are met, however, there still may be other requirements or limitations. See, e.g., I.R.C. § 162(a)(2) (traveling expenses allowed only if not “lavish or extravagant” and “away from home”); I.R.C. § 274 (2000) (listing limitations for entertainment and education expenses); I.R.C. § 469 (2000) (restricting any “passive” losses).

220. See 4 BITTKER & LOKKEN, *supra* note 7, at 103-11 (maintaining that the reference to I.R.C. section 162 “does little to clarify” if something is a trade or business because there is little litigation defining “trade or business” in the context of section 162—if an expense is not deductible under section 162, it normally will be deductible under section 212, relating to deductions for the production of income); BORIS I. BITTKER & MARTIN J. MCMAHON JR., *FEDERAL INCOME TAXATION OF INDIVIDUALS*, 11-5 (2nd ed. 1995) (stating that “there is no authoritative judicial definition” of “trade or business”). There has been however a great deal of litigation challenging what is, or is not, deductible, under section 162. See, e.g., *United States v. Am. Bar Endowment*, 477 U.S. 105, 110 n.1 (1986).

The case law focuses on the statement in the regulations and attempts to ascertain if the nonprofit activity is a trade or business in the context of I.R.C. section 162. See *Am. Bar Endowment*, 477 U.S. at 110, 116 (applying regulation 1.513-1(b)’s incorporation of section 162 to hold that business activities should be analyzed as a whole, rather than separated into artificial steps); *Am. Acad. of Family Physicians v. United States*, 91 F.3d 1155, 1157–58 (8th Cir. 1996) (holding that UBIT requires both a profit motive and “the general characteristics of a trade or business”); *S.S. Trade Ass’n v. Comm’r*, 757 F.2d 1494, 1497 (4th Cir. 1985) (applying section 162’s profit motive test when tax-exempt

In interpreting the trade or business requirement, the courts have focused on an organization's "profit motive."²²¹ The profit motive is applied activity by activity, and an activity does not lose its identity as a trade or business solely because it is part of a larger trade or business.²²² Once a separate activity is determined, its "profit motive" is tested by looking to see if the activity was commenced "with the dominant hope and intent of realizing a profit" or producing income.²²³

Even if an organization is found to be engaged in a trade or business separate from its charitable purpose, there are three statutory exceptions to the trade or business requirement.²²⁴ The first exception provides that a trade or business as defined by I.R.C. section 513(a) does not include those activities where "substantially all" the work is performed without compensation.²²⁵ The second exception allows untaxed income for

organization performed "comprehensive and essential business services in return for a fixed fee"); *Prof'l Ins. Agents v. Comm'r*, 726 F.2d 1097, 1102 (6th Cir. 1984) (reasoning that the intent to earn a profit is the key inquiry); *Carolinas Farm & Power Equip. Dealers Ass'n. v. United States*, 699 F.2d 167, 170 (4th Cir. 1983) (finding that the plain language of section 513(c) directs that an activity constitutes a trade or business when an exempt organization conducts the activity for the production of income); *La. Credit Union League v. United States*, 693 F.2d 525, 531 (5th Cir. 1982) (finding that section 513(c)'s "trade or business" "generally conveys the same meaning as it does in § 162," then imposing a profit-motive standard).

221. See *Am. Bar Endowment*, 477 U.S. at 110 n.1; *Osteen & Spitzer*, *supra* note 37, at 269.

222. I.R.C. § 513(c) (2000). "[A]n activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization." *Id.* For example, a pharmacy can have one activity selling to the general public and a separate activity selling to the hospital and patients. *Treas. Reg. § 1.513-1(b)* (as amended in 1983). I.R.C. section 513(c) was enacted to reach advertising income of periodicals where the advertising was unrelated to a nonprofit's exempt purpose, but the periodical contained exempt-purpose-related articles and editorials. 4 BITTKER & LOKKEN, *supra* note 7, at 103-11. See also Swart, *supra* note 164, at 1035 (stating that section 513(c) can cause "significant difficulties" for nonprofits in determining if something is subject to the UBIT, accounting for the profits and allocating costs).

223. *Am. Bar Endowment*, 477 U.S. at 110 n.1. See also *Prof'l Ins. Agents*, 726 F.2d at 1102; 4 BITTKER & LOKKEN, *supra* note 7, at 103-11 (discussing *National Water Well Ass'n v. Comm'r*, 92 T.C. 75, 91-92 (1989)); *HOPKINS*, *supra* note 37, at 650-51; *Lee A. Sheppard, Aspirin and the Ultimate Tax Shelter*, 64 TAX NOTES 420, 422 (1994) (relating the profit motive standard to the Arthritis Foundation's marketing of an aspirin product).

224. I.R.C. § 513(a)(1)-(3).

225. *Id.* § 513(a)(1). This is the "volunteers" exception. For example, in one case ninety-four percent of the work being performed by volunteers has been found to be "substantially all." *St. Joseph Farms of Ind. Bros. of Congregation of Holy Cross v. Comm'r*, 85 T.C. 9 (1985). For additional discussion of section 513(a)(1), see 4 BITTKER & LOKKEN, *supra* note 7, at 103-19; *HOPKINS*, *supra* note 37, at 741; *Osteen & Spitzer*, *supra* note 37, at 264.

Some examples of activities which qualify under the volunteers exception are retail stores staffed by volunteers and weekly dances held by a volunteer fire department. See

certain organizations if the trade or business is carried on “primarily for the convenience” of its constituents, as in student dining halls, for example.²²⁶ The final exception, from a trade or business, concerns those in which substantially all of the merchandise sold is received by gift or contribution.²²⁷ The convenience exception can be supported from a policy perspective since growth in these areas is limited (for example, to the number of students at a school).²²⁸ The volunteer and donated goods exceptions to the trade or business rule fit within the broader scope of the basic public trust and support rationale for allowing nonprofit organizations to exist.²²⁹

b. Regularly Carried On

Not all activities with a profit motive and determined to be a “trade or business” are subject to the UBIT. The trade or business must still meet several more requirements, the next being that the “trade or business” must be “regularly carried on.”²³⁰ In viewing whether a trade or business

Treas. Reg. § 1.513-1(e) (as amended in 1983) (retail store operated by orphanage and staffed by volunteers not subject to UBIT); Rev. Rul. 74-361, 1974-2 C.B. 159-60 (volunteer fire department operating weekly public dances not subject to UBIT). *See also* Freitag, *supra* note 155, at A51-A58.

The volunteer exception to “trade or business” is consistent with the policies underlying the UBIT. The volunteers, as a subset of the public, demonstrate a general level of support for the organization through their service. Additionally, volunteers receive neither income nor a deduction for their services. *See* Treas. Reg. § 1.170A-1(g) (as amended in 1996).

226. I.R.C. § 513(a)(2). The Code specifically mentions members, students, patients, officers, and employees. *Id.* *See also* 4 BITTKER & LOKKEN, *supra* note 7, at 103-20; HOPKINS, *supra* note 37, at 742; Freitag, *supra* note 155, at A58-A63; Osteen & Spitzer, *supra* note 37, at 264; Swart, *supra* note 164, at 1037. An example of an activity which is not subject to the UBIT is college and university dining halls for student dormitories. *See* Hansmann, *Unfair Competition and the UBIT*, *supra* note 89, at 631-33 (agreeing with the convenience exception to the UBIT for dining halls since it furthers the academic mission of universities and because they would provide the services, whether or not the UBIT applied, and pass on the additional cost of the tax to students).

227. I.R.C. § 513(a)(3). *See also* 4 BITTKER & LOKKEN, *supra* note 7, at 103-19; HOPKINS, *supra* note 37, at 743; Freitag, *supra* note 155, at A63-A64; Osteen & Spitzer, *supra* note 37, at 264; Swart, *supra* note 164, at 1037.

228. *See* Note, *The Macaroni Monopoly*, *supra* note 173, at 1282-83. *See also* Hansmann, *Unfair Competition and the UBIT*, *supra* note 89, at 631-33.

229. *See supra* text accompanying notes 151-52.

230. I.R.C. § 512(a) (2000). For additional discussion of the “regularly carried on” requirement, *see* HOPKINS, *supra* note 37, at 659-63; Gallagher, *supra* note 187, at 931; Osteen & Spitzer, *supra* note 37, at 262; Sharpe, *supra* note 6, at 412 n.124; Stanley & Ward, *supra* note 200, at 557; Swart, *supra* note 164, at 1035-36. *See also* Mary E.

is regularly carried on, the regulations focus on the frequency and continuity of the income-producing activity and the manner in which the exempt organization conducts the activity.²³¹ The Internal Revenue Service (hereinafter “Service”) takes the position that the time preparing for an activity or event should be included when determining whether the activity is regularly carried on, but courts reviewing the issue have disagreed.²³² Besides the amount of time spent on a particular activity, the regulations suggest determining the frequency and continuity of a trade or business by looking at similar comparable commercial activities of for-profit businesses.²³³ Therefore, a sandwich stand operated for only two weeks at the state fair is not “regularly carried on,” but a parking lot operated once per week is.²³⁴

Monahan, Comment, *Unfair Competition or Fundraising? A Proposal to Modify the Regularly Carried On Test of the Unrelated Business Income Tax*, 10 AM. J. TAX POL'Y 73, 73-74 (1992) (providing for a two-part test to replace the regularly carried on test: (1) whether the purchaser of the goods or services derives more than an insignificant commercial benefit from the purchase, and (2) whether the activity was intended and operated as a fundraiser with full disclosure of profits and approval of the membership of the organization).

231. Treas. Reg. § 1.513-1(c)(1) (as amended in 1983).

232. See *Nat'l Collegiate Athletic Ass'n v. Comm'r*, 914 F.2d 1417 (10th Cir. 1990), *action on dec.*, 1991-015 (July 3, 1991) (in the action on decision the Commissioner “strongly disagreed” with the case’s holding). See also HOPKINS, *supra* note 37, at 662; Gallagher, *supra* note 187, at 931.

In *NCAA*, the 10th Circuit held that advertising in the NCAA basketball program, while a trade or business, was not “regularly carried on” since the tournament only encompassed several weeks on an annual basis. See *NCAA*, *supra*, at 1423-24. The Service contended that the “regularly carried on” requirement should be viewed after considering all the preparatory time required to solicit the advertisements and prepare them for publication. See *id.* at 1422. The 10th Circuit rejected the Service’s inclusion of preparatory time, stating that the “position is contrary to the regulations and to existing case law.” *Id.* at 1422. For additional discussion of *NCAA*, see HOPKINS, *supra* note 37, at 662; Deborah M. Beers, *Affinity Credit Card Income Is Tax Exempt Royalty—Sierra Club v. Comr.*, 36 TAX MGMT. MEMORANDUM 147, 148 (1995); Osteen & Spitzer, *supra* note 37, at 262; Swart, *supra* note 164, at 1036. See also Paul Streckfus, *IRS Staying Tough on Royalty Issues*, 66 TAX NOTES 1761, 1761-62 (1995) (stating that Private Letter Ruling 95-09-0002 indicated the Service was not changing its position on including preparatory time). The Service has maintained for many years that preparatory time must be considered for purposes of determining if a trade or business is “regularly carried on.” See, e.g., Rev. Rul. 73-424, 1973-2 C.B. 190, 190-91 (holding that advertising in a nonprofit’s annual year book was considered “regularly carried on” since it used a commercial service whose activities were year-round to handle the advertising).

233. Treas. Reg. § 1.513-1(c)(1) (as amended in 1983). See also Swart, *supra* note 164, at 1035 (stating that the “operation of a facility one day each week . . . would be considered ‘regularly carried on’ if such conduct is ‘of a kind normally undertaken by non exempt commercial organizations’ on the same basis”).

234. Treas. Reg. § 1.513-1(c)(2)(i) (as amended in 1983).

c. *Not Substantially Related*

If an activity is deemed to be a regularly carried on trade or business, it still will not be taxed unless it is “not substantially related” to the organization’s exempt purpose.²³⁵ The relationship must be one other than the use of the money generated by the trade or business to further the nonprofit organization’s exempt purpose.²³⁶ The not substantially

235. I.R.C. § 513(a) (2000). The tax will be imposed only if the activity is: not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3))

Id. See also HOPKINS, *supra* note 37, at 663–73 (discussing the “not substantially related” requirement); Sharpe, *supra* note 6, at 427–43 (in-depth discussion of legislative history, cases, and regulations on the not substantially related element); James Bennett & Gabriel Rudney, *A Commerciality Test to Resolve the Commercial Nonprofit Issue*, 36 TAX NOTES 1095 (1987) [hereinafter Bennett & Rudney, *Commerciality Test*] (criticizing the relatedness test and providing as a replacement a “commerciality test”).

Bennett & Rudney suggest replacing the “not substantially related” requirement with a “commerciality test” which would tax all activities of a tax-exempt organization found to be commercial in nature. See *id.* at 1095. The commerciality test looks at ten factors: (1) what is being sold (service v. commodity) and to whom (individual, business, government, other tax-exempt organization); (2) the price, if any, for the sale; (3) the amount of other available options a purchaser has for the service or commodity; (4) the tax-exempt organization’s options on price; (5) whether the price will be paid by a third party (e.g., government, insurance); (6) other investments of the tax-exempt organization; (7) how the activity is financed (if financed greater than fifty percent by government or donation, the activity would be per se noncommercial); (8) how the income is generated by the activity used; (9) activity must be directed toward a charitable group or purpose deemed charitable; and (10) disregard any public benefit derived from the activity. *Id.* at 1097–98. The factors are meant to ascertain if the “nonprofit activity is commercial if operated in the marketplace.” James T. Bennett & Gabriel Rudney, *Bennett and Rudney Respond to YMCA’s Criticisms of Their Commerciality Test*, 37 TAX NOTES 535, 535 (1987) [hereinafter Bennett & Rudney, *YMCA’s Criticisms*]. No guidance is provided as to which factors are the most important, nor is it stated how the factors interact. The commerciality test has been criticized in several articles. See Gallagher, *supra* note 63, at 765 (stating that the test is unworkable since allowing a tax on all activities where “competition” exists is overly broad); Harrison Wellford & Robert Boisture, *YMCA Takes Issue With “Commerciality” Standard for UBIT*, 37 TAX NOTES 317, 317–18 (1987) (criticizing the commerciality test on several different grounds). For a response to the Wellford & Boisture comments to the commerciality test, see Bennett & Rudney, *YMCA’s Criticisms, supra*, at 535.

236. See I.R.C. § 513(a) (2000). “The organization’s need for money, which is the purpose of fund raising, does not make an activity related to its exempt purposes.” Deirdre Dessingue Halloran, *Show Me the Money: Legal and Prudential Considerations for Religious Organizations Participating in Fund Raising Ventures*, 39 CATH. LAW. 7, 8

related requirement is the most difficult of the three for the courts and the Service to define and for organizations to apply.²³⁷ It, therefore, has generated a significant number of rulings by the Service.²³⁸

Under the regulations one must determine “if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted.”²³⁹ In order to be related, the trade or business must bear a causal relationship to the nonprofit’s exempt purpose, other than merely the production of income.²⁴⁰ To decide whether the causal relationship is substantial, the activity must “contribute importantly” to the nonprofit’s exempt purpose.²⁴¹ Whether the required relationship

(1999) (citing Treasury Regulation § 1.513-1(a)).

237. See 4 BITTKER & LOKKEN, *supra* note 7, at 103-15 (stating that when applying the tests “fine lines and debatable distinctions are virtually unavoidable”); Gallagher, *supra* note 187, at 931 (“This prong of the test is one in which the IRS can become enamored of the finest and most minute details of the tax-exempt organization’s activities.”).

A proposed House Subcommittee report on the UBIT stated “the ‘relatedness’ standard in its current form is often vague, difficult to administer and even harder to ensure voluntary compliance.” UBIT RECOMMENDATIONS, *supra* note 11, at 3036. Even though the Subcommittee believed the test was difficult to apply, the report recommended its continued use. See *id.* at 3037. This was due to the fact that any new standard would “generate uncertainty” as to the application of the regulations, IRS revenue and private letter rulings, and cases interpreting the “substantially related” standard. See *id.* at 3038. Accord Troyer, *supra* note 187, at 1222 (reporting that the “Subcommittee was presented with a variety of alternative formulations . . . which added no certainty or predictability to the tax—but which effectively wiped away” much of the existing cases and commentary on the UBIT).

238. Stanley & Ward, *supra* note 200, at 557. “The majority of the rulings issued by the IRS on unrelated business income issues focus on whether the activities in question are substantially related to the organization’s exempt purposes . . .” *Id.*

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

240. See *id.* “[T]he nature and extent of the business activities engaged in must bear a reasonable nexus to the tax-exempt function which they serve or support.” Gallagher, *supra* note 187, at 931.

241. Treas. Reg. § 1.513-1(d)(2) (as amended in 1983). The legislative history gives the following examples of “substantially related” activities: athletic activities of schools (e.g., basketball tournament); school income from dining halls, restaurants, and dormitories operated for the convenience of students, and income from a university press. S. REP. NO. 2375 (1950), reprinted in 1950-2 INTERNAL REVENUE BULL. 483, 505. See also H.R. REP. NO. 2319 (1950), reprinted in 1950-2 INTERNAL REVENUE BULL. 380, 409 (stating same). The only Supreme Court case to deal exclusively on the “relatedness” issue is *United States v. American College of Physicians*, 475 U.S. 834 (1986). The case held that the proper inquiry focuses on the conduct of the entity claiming relatedness, rather than on the quality of the specific activity. See *id.* at 848-49. Here, the College, a section 501(c)(3) organization, claimed that income arising from drug advertisements published in its periodical was related to educating its members and subscribers. See *id.* at 848. In imposing a UBIT on the advertising income, the Court reasoned that “the advertising in Annals does not contribute importantly to the journal’s educational purposes.” *Id.* at 849. See 4 BITTKER & LOKKEN, *supra* note 7, at 103-17 (discussing the case); Frank Oliveti & Vincent P. Belotsky, Jr., *Careful Use of Royalties May Reduce Unrelated Business Income from*

exists is not determined solely upon the basis of a particular activity, but the Service may bifurcate activities into related and nonrelated uses.²⁴² An example of this is a university golf course.²⁴³ While the income generated from the use of the golf course by students and faculty would be related, income from nonstudent or faculty use would be unrelated, unless excluded by another provision, and would be subject to the UBIT.²⁴⁴

The regulations expressly point out that when a nonprofit organization “exploits” its nonprofit status the income will not be considered as related to its exempt purpose.²⁴⁵ Examples in the regulations of how a nonprofit can exploit its nonprofit status include an exempt scientific organization selling endorsements of scientific instruments,²⁴⁶ and the mailing of advertisements to the general membership of a nonprofit organization.²⁴⁷

C. Exclusions from Unrelated Business Income

If the three elements set forth above are met, there are several “modifications” (as they are titled in the Code) which act as exclusions from the UBIT.²⁴⁸ There are many exclusions of income from UBIT: dividends,²⁴⁹ interest,²⁵⁰ annuities,²⁵¹ royalties,²⁵² rents,²⁵³ capital gains,²⁵⁴

Advertising, 19 TAX ADVISOR 196 (1988) (discussing various methods for nonprofits to avoid taxation from advertising in light of the holding in *American College of Physicians*).

242. See Gallagher, *supra* note 187, at 931.

243. See Priv. Ltr. Rul. 96-45-004 (July 17, 1996).

244. See *id.*

245. See Treas. Reg. § 1.513-1(d)(4)(iv) (as amended in 1983). See also 4 BITTKER & LOKKEN, *supra* note 7, at 103-18; HOPKINS, *supra* note 37, at 668.

246. See Treas. Reg. § 1.513-1(d)(4)(iv) ex. (1) (as amended in 1983).

247. See *id.* § 1.513-1(d)(4)(iv) ex. (3) (as amended in 1983).

248. See I.R.C. § 512(b) (2000). For additional discussion of the various exclusions, see 4 BITTKER & LOKKEN, *supra* note 7, at 103-27, 103-35; FISHMAN & SCHWARZ, *supra* note 24, at 802-18; HOPKINS, *supra* note 37, §§ 27.1, 27.2.

249. I.R.C. § 512(b)(1) (2000). The exclusion of dividends from UBIT does not apply to “debt financed property,” I.R.C. §§ 512(b)(4), 514; amounts paid from a controlled corporation, *id.* § 512(b)(13); or from certain real estate investment trusts (REITS), I.R.C. § 856(h)(3)(C) (2000). For additional discussion of the dividend exclusion exception see 4 BITTKER & LOKKEN, *supra* note 7, at 103-27; HOPKINS, *supra* note 37, at 726; Gallagher, *supra* note 187, at 932 (exploring the use of subsidiaries to avoid UBIT); Hansmann, *Unfair Competition and the UBIT*, *supra* note 89, at 624-25 (agreeing with the exclusion of dividends from UBIT since it encourages nonprofits to diversify).

250. I.R.C. § 512(b)(1). The exclusion of interest from the UBIT does not apply to

and income from certain research projects, to list a few.²⁵⁵ The royalty exclusion is important to this Article because nonprofits are excluding their income received from mailing list rentals and affinity card programs under the “royalty” exception in I.R.C. section 512(b)(2).²⁵⁶ The royalty exclusion will be examined in more detail now.

The exclusion for royalty payments is provided under I.R.C. section 512(b)(2) and reads: “There shall be excluded all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income.”²⁵⁷ The Code and regulations do not define the term

“debt financed property,” I.R.C. §§ 512(b)(4), 514, or amounts paid from a controlled corporation, *id.* § 512(b)(13). For additional discussion of the interest exclusion, see 4 BITTKER & LOKKEN, *supra* note 7, at 103-27; HOPKINS, *supra* note 37, at 726-27; Gallagher, *supra* note 187, at 933-35.

251. I.R.C. § 512(b)(1). The exclusion of annuities from the UBIT does not apply to “debt financed property,” I.R.C. §§ 512(b)(4), 514, or amounts paid from a controlled corporation, *id.* § 512(b)(13). For additional discussion of the annuity exclusion, see 4 BITTKER & LOKKEN, *supra* note 7, at 103-27; HOPKINS, *supra* note 37, at 726. I.R.C. section 512(b)(1) also excludes from the UBIT payments made with respect to securities loans. For additional discussion of the payments with respect to the securities loans exclusion, see HOPKINS, *supra* note 37, at 727; Gallagher, *supra* note 187, at 941-42.

252. I.R.C. § 512(b)(2). The exclusion of royalty payments from the UBIT does not apply to “debt financed property,” I.R.C. §§ 512(b)(4), 514, or amounts paid from a controlled corporation, *id.* § 512(b)(13). See *infra* text accompanying notes 256-69 for additional discussion of the royalty exclusion.

253. I.R.C. § 512(b)(3). The exclusion of rents from the UBIT does not apply to “debt financed property,” I.R.C. §§ 512(b)(4), 514, or amounts paid from a controlled corporation, *id.* § 512(b)(13). For additional discussion of the exclusion of rents, see 4 BITTKER & LOKKEN, *supra* note 7, at 103-28, 129; HOPKINS, *supra* note 37, at 731-34; Gallagher, *supra* note 187, at 935-40; Hansmann, *Unfair Competition and the UBIT*, *supra* note 89, at 625 (stating that the exclusion of rental income is “harder to justify”).

254. I.R.C. § 512(b)(5). For additional discussion of the exclusion of a nonprofit’s capital gains see 4 BITTKER & LOKKEN, *supra* note 7, at 103-31, 132; HOPKINS, *supra* note 37, at 735-36.

255. See I.R.C. §§ 512(b)(7)-(9). For additional discussion of the exclusion for certain research income, see HOPKINS, *supra* note 37, at 736-38.

256. See *Or. State Univ. Alumni Ass’n v. Comm’r*, 193 F.3d 1098, 1099 (9th Cir. 1999) (affinity card income); *Sierra Club, Inc. v. Comm’r*, 103 T.C. 307 (1994), *aff’d in part and rev’d in part*, 86 F.3d 1526 (9th Cir. 1996) (mailing list and affinity card income); *Common Cause v. Comm’r*, 112 T.C. 332 (1999) (mailing list income); *Planned Parenthood Fed’n of Am., Inc. v. Comm’r*, 77 T.C.M. (CCH) 2227 (1999) (mailing list income); *Miss. State Univ. Alumni, Inc. v. Comm’r*, 74 T.C.M. (CCH) 458 (1997) (affinity card income).

257. I.R.C. § 512(b)(2). An “overriding royalty” is defined as follows:

As applied to an existing oil and gas lease is a given percentage of the gross production payable to some person other than the lessor or persons claiming under him. Royalty interest carved out of working interest created by oil and gas lease, and is interest in oil and gas produced at surface free of expense of production and its outstanding characteristic is that its duration is limited by duration of lease under which it is created.

BLACK’S LAW DICTIONARY 1104 (6th ed. 1990). For additional discussion on the royalty exclusion, see 4 BITTKER & LOKKEN, *supra* note 7, at 103-27, 103-28; HOPKINS, *supra*

“royalty.”²⁵⁸ The regulations state that whether an exclusion exists can be determined only after reviewing all the “facts and circumstances” of the case.²⁵⁹ The Service has provided a definition of “royalty,” one which officials of the Service probably regret, in Revenue Ruling 81-178.²⁶⁰ In the Revenue Ruling the Service defines “royalty” as any payment received that is related “to the use of a valuable right.”²⁶¹ The ruling goes on to say that payments made “for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property, are ordinarily classified as royalties for federal tax purposes.”²⁶² However, royalty cannot “include

note 37, at 728–30; Gallagher, *supra* note 187, at 942; T.J. Sullivan, *Unrelated Business Income: Recent Developments, Planning Strategies for Multi-Corporate Entities, and Selected Health Care Issues*, 22 EXEMPT ORG. TAX REV. 447, 448 (1998); Swart, *supra* note 164, at 1038–39.

Many writers believe the royalty exemption is too broad. See FISHMAN & SCHWARZ, *supra* note 24, at 804 (“Because the royalty concept is so elastic, exempt organizations have been encouraged to enter into licensing arrangements to exploit their valuable forms of intangible property rather than developing them directly.”); Paul Streckfus, *Sierra Club: Latest Nail in the UBIT Coffin*, 64 TAX NOTES 1365, 1365 (1994) (commenting about the royalties exclusion that “[w]e have just about reached the day when any tax attorney who has a tax-exempt client paying unrelated business income tax (UBIT) is probably guilty of malpractice”).

Due to its wide scope, several papers have reviewed the royalty exclusion from the UBIT and suggested changes. Generally, the authors writing on the royalty exclusion have felt it was too broad and inconsistent with the rationale of the UBIT. See Jennifer Anne Spiegel, *Sierra Club: Rationalizing the Royalty Exception to the Unrelated Business Income Tax*, 63 FORDHAM L. REV. 1697, 1701 (1995) (proposing an “accountability” rationale upon which to base any exceptions to the UBIT); VanYe, *supra* note 164, at 1188–90. VanYe suggests two methods to determine if royalty payments would be taxable. The first is to use the same tests as either those used for sale of a patent, I.R.C. § 1235, or transfers for property by controlling ownership to a corporation, I.R.C. § 351, to determine any exclusions from the UBIT. The second is to “consider the relative value of the services and property transferred.” If the services are less than ten percent of the value of the property, the income would be tax-exempt. VanYe, *supra* note 164, at 1188–90.

258. See *Common Cause*, 112 T.C. at 339; *Planned Parenthood*, 77 T.C.M. (CCH) at 2230. See also Richard A. Speizman & John R. Washlick, *Mailing Lists Revisited: The Disabled American Veterans in Tax Court*, 47 TAX NOTES 1377, 1377 (1990) (stating that “royalty” is undefined in Code and regulations); VanYe, *supra* note 164, at 1175, 1176 (stating same).

259. Treas. Reg. § 1.512(b)-1 (as amended in 1992). “Whether a particular item of income falls within any of the modifications provided in section 512(b) shall be determined by all the facts and circumstances of each case.” *Id.* See also Rev. Rul. 81-178, 1981-2 C.B. 135 (stating that all the facts and circumstances must be reviewed before determining if a payment is a royalty).

260. Rev. Rul. 81-178, 1981-2 C.B. 135, 135.

261. *Id.*

262. *Id.*

payments for personal services.”²⁶³

This definition of a royalty as a payment related “to the use of a valuable property right” has been adopted by the courts in cases involving income received by nonprofits that the nonprofits designate as royalties.²⁶⁴ However, the various courts that have interpreted the royalty exclusion have not been consistent.²⁶⁵

The legislative rationale for the royalty exclusion, and many of the other exclusions listed in I.R.C. section 512(b)(1)–(2), is that these sources of income were thought by Congress to be “passive” in nature.²⁶⁶ The allowance for excluding passive sources of income from the UBIT was due to Congress’s belief that such sources of income would not take the organization any time to run and not create any serious threat to for-

263. *Id.*

264. See *Sierra Club, Inc. v. Comm’r*, 86 F.3d 1526, 1531–32 (9th Cir. 1996); *Texas Farm Bureau v. United States*, 53 F.3d 120 (5th Cir. 1995) (finding no royalty payment since by the language of the agreement the payment received by the nonprofit was for services and not for a property right); *Nat’l Collegiate Athletic Ass’n v. Comm’r*, 92 T.C. 456, 469 (1989) (holding income from sales of programs at annual basketball tournament not to be royalty payments), *rev’d*, 914 F.2d 1417 (10th Cir. 1990). For additional discussion of *Texas Farm Bureau*, see Tsilas, *supra* note 200, at 489–90; VanYe, *supra* note 164, at 1179. Many secondary legal authorities have also cited Revenue Ruling 81-178 as authority for the definition of “royalty.” See 4 BITTKER & LOKKEN, *supra* note 7, at 103-28; HOPKINS, *supra* note 37, at 728; Beers, *supra* note 232, at 148 (stating that while Revenue Ruling 81-178 has broad language, the Service on its own seldom finds royalty income); Osteen & Spitzer, *supra* note 37, at 267 (citing Revenue Ruling 81-178 for the proposition that retaining the right to approve quality or style does not prevent finding of royalty income); Tsilas, *supra* note 200, at 488–89; VanYe, *supra* note 164, at 1176.

265. See HOPKINS, *supra* note 37, at 728 (noting a difference in the interpretation of the definition in Revenue Ruling 81-178 between the Tax Court and Ninth Circuit); VanYe, *supra* note 164, at 1186 (noting same).

266. The House Report stated the following:

The tax applied to unrelated business income does not apply to . . . royalties Your committee believes that . . . “passive” income should not be taxed where it is used for exempt purposes because investments producing incomes of these types have long been recognized as proper for educational and charitable organizations.

H.R. REP. NO. 2319, at 38 (1950), *reprinted in* 1950-2 INTERNAL REVENUE BULL. 380, 409.

The Senate Report gave a similar rationale for the royalty exclusion:

[R]oyalties . . . are excluded from the base of the tax on unrelated income because your committee believes that they are “passive” in character and are not likely to result in serious competition for taxable businesses having similar income. Moreover, investment-producing incomes of these types have long been recognized as a proper source of revenue for educational and charitable organizations and trusts.

S. REP. NO. 2375, at 30–31 (1950), *reprinted in* 1950-2 INTERNAL REVENUE BULL. 483, 506. See also HOPKINS, *supra* note 37, at 724–26 (stating that the rationale for certain exclusions was that the income was passive in nature); Gallagher, *supra* note 187, at 929, 930 (stating same); VanYe, *supra* note 164, at 1173.

profit businesses.²⁶⁷ In this way the activities could provide income to the nonprofits but would not take time from the tax-exempt operations of the organization, which is the actual reason the organization was provided with the tax-exempt status.²⁶⁸

While the “passive” versus “active” income distinction by Congress evolved from a desire to reduce unfair competition by nonprofits, an examination of unfair competition is not required in the Code.²⁶⁹

1. *Specific Application of the Royalty Exclusion Under Section 512(b)*

This section will discuss how the royalty exclusion of I.R.C. section 512(b) has been applied by the courts to both mailing list and affinity card income received by nonprofit organizations.²⁷⁰ Except in one

267. The Senate Report on the UBIT exclusions stated:

The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of section [501(c)] organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes. Also, a number of examples have arisen where these organizations have, in effect, used their tax exemptions to buy an ordinary business. That is, they have acquired the business with little or no investment on their own part and paid for it in installments out of subsequent earnings—a procedure which usually could not be followed if the business were taxable.

S. REP. NO. 2375, at 28–29 (1950), *reprinted in* 1950-2 INTERNAL REVENUE BULL. 483, 504. The House Report contains similar language. *See* H.R. REP. NO. 2319, at 36–37 (1950), *reprinted in* 1950-2 INTERNAL REVENUE BULL. 380, 409.

268. *See* Note, *The Macaroni Monopoly*, *supra* note 173, at 1283. The article suggests Congress allowed “passive” income since:

there was an underlying concern that excessive participation in business affairs caused a diversion of energy from exempt purposes. . . . Income-producing techniques which did not seem to involve this splitting of attention generally remained exempt from taxation under the revision. The most important categories of income thus exempted—rents, royalties, capital gains, and dividends—were characterized as “passive,” suggesting that their production was not considered business activity at all.

Id.

269. *See* 4 BITTKER & LOKKEN, *supra* note 7, at 103-10.

270. The cases that involve either mailing list or affinity card income are: Mailing list: *Sierra Club, Inc. v. Comm’r*, 86 F.3d 1526 (9th Cir. 1996) (finding income from mailing list rentals excluded as royalty from UBIT); *Disabled Am. Veterans v. United States*, 650 F.2d 1178 (Ct. Cl. 1981) (finding income from mailing list rentals taxable UBI); *Common Cause v. Comm’r*, 112 T.C. 332 (1999) (finding income from mailing list rentals excluded as royalty from UBIT); *Planned Parenthood Fed’n of Am., Inc. v. Comm’r*, 77 T.C.M. (CCH) 2227 (1999) (finding income from mailing list rentals excluded as royalty from UBIT).

Affinity card: *Or. State Univ. Alumni Ass’n v. Comm’r*, 193 F.3d 1098 (9th Cir. 1999) (finding income received from affinity card program excluded as royalty from UBIT);

instance, all the courts which have looked specifically at the royalty issue have found that the organizations are receiving payments relating “to the use of a valuable right” and have found royalty income.

a. *Income Received from the Rental or Exchange of Mailing Lists*

The cases which involve mailing list income can be broken down into two main categories. On the one hand, there is the *Disabled American Veteran* line of cases, where the income from mailing list rental activity was not excludable from the UBIT.²⁷¹ On the other hand, there are all the other mailing list cases, the first being *Sierra Club*, which excluded the income received from the UBIT.²⁷²

2. *Disabled American Veterans (DAV) Mailing List Cases*

The exclusion of mailing list income from the UBIT first was heard by the Court of Claims in *Disabled American Veterans v. United States*.²⁷³ The Disabled American Veterans have litigated the taxation of mailing lists in three different cases.²⁷⁴ The first was in the Court of Claims, the

Sierra Club, Inc. v. Comm’r, 103 T.C. 307 (1994), *aff’d in part and rev’d in part*, 86 F.3d 1526 (9th Cir. 1996) (finding income received from affinity card program excluded as royalty from UBIT); *Miss. State Univ. Alumni, Inc. v. Comm’r*, 74 T.C.M. (CCH) 458 (1997) (finding income received from affinity card program excluded as royalty from UBIT).

271. See *Disabled Am. Veterans v. Comm’r*, 942 F.2d 309 (6th Cir. 1991) (reversing the Tax Court’s decision on collateral estoppel); *Disabled Am. Veterans v. United States*, 704 F.2d 1570 (Fed. Cir. 1983); *Disabled Am. Veterans v. Comm’r*, 68 T.C.M. (CCH) 915 (1994).

272. See *Sierra Club*, 86 F.3d 1526; *Common Cause*, 112 T.C. 332; *Planned Parenthood*, 77 T.C.M. (CCH) 2227.

273. 650 F.2d 1178, *aff’d and remanded*, 704 F.2d 1570 (Fed. Cir. 1983). For additional discussion of the Court of Claims opinion, see Beers, *supra* note 232, at 148 (providing a short summary of facts and holding); Richard Holbrook, Note, *The Royalties Exception to Unrelated Business Income: Sierra Club v. Commissioner*, 49 TAX LAW. 517, 518–19 (1996) (summarizing all the DAV cases); Speizman & Washlick, *supra* note 258, at 1377–78 (discussing the congressional reaction to the Court of Claims opinion in *Disabled Am. Veterans*, 650 F.2d 1178); Swift, *supra* note 18, at 576–77 (providing a short summary of facts and holding); Tsilas, *supra* note 200, at 489 (summarizing the facts and holding); VanYe, *supra* note 164, at 1171 (stating that *Disabled Am. Veterans*, 650 F.2d 1178, was “the first case in which a court considered . . . if income derived from renting and exchanging mailing lists” could be excluded as royalty payments from the UBIT).

274. See *Disabled Am. Veterans*, 650 F.2d 1178 (Court of Appeals affirmed the Court of Claims’ decision and remanded for allocation of expenses between taxable and exempt income); *Disabled Am. Veterans v. Comm’r*, 94 T.C. 60 (1990), *rev’d*, 942 F.2d 309 (6th Cir. 1991); *Disabled Am. Veterans*, 68 T.C.M. (CCH) 915. See also David A. Brennan, *What’s in a Name: IRS’s Attempts to Tax Nonprofits on the Exploitation of the Organization’s or Its Members’ Names*, 4 COMMUNITY TAX L. REP. 7, 8–9, 22 (2000) (discussing the three DAV cases).

second and third in the Tax Court.²⁷⁵ For simplicity and clarity this Article will refer to the different cases as *DAV I*,²⁷⁶ *DAV II*,²⁷⁷ and *DAV III*.²⁷⁸

The facts for each of the *DAV* cases are similar. The Disabled American Veterans are a section 501(c)(4) organization whose primary activity is to hire and train disabled veterans who then represent other veterans before the Veteran Administration Board with respect to their benefits.²⁷⁹ The group had an extensive mailing list of contributors that contained a wealth of information.²⁸⁰ The mailing list took "considerable time, effort and expense" to maintain, and two paid employees were fully devoted to its maintenance and the rental activities.²⁸¹

The group used the mailing list for two reasons. First, the Disabled American Veterans solicited their own contributions.²⁸² Second, they allowed other nonprofit and commercial groups and organizations to use the *DAV* mailing list for a fee.²⁸³ The reason the group rented the list was to "gain additional revenue" especially "in the light of the substantial costs [*DAV*] incurred in the regular maintenance of its donor list."²⁸⁴ These rental transactions were completed through a list broker or

275. See *Disabled Am. Veterans*, 650 F.2d 1178 (Court of Claims); *Disabled Am. Veterans*, 94 T.C. 60 (Tax Court), *rev'd*, 942 F.2d 309; *Disabled Am. Veterans*, 68 T.C.M. (CCH) 915 (Tax Court).

276. *Disabled Am. Veterans*, 650 F.2d 1178 [hereinafter *DAV I*].

277. *Disabled Am. Veterans*, 94 T.C. 60 [hereinafter *DAV II*], *rev'd*, 942 F.2d 309 (6th Cir. 1991).

278. *Disabled Am. Veterans*, 68 T.C.M. (CCH) 915 [hereinafter *DAV III*].

279. *DAV I*, 650 F.2d at 1182.

280. The list could "identify individual donors and segment them according to several categories such as geographic locale, amount of contribution (for example, \$1, \$5, \$10), recency of contribution (for example, contribution within the last 6 months, contribution within the last 1 year), and other selections." *DAV II*, 94 T.C. at 63.

281. *DAV I*, 650 F.2d at 1182; *DAV II*, 94 T.C. at 66. The maintenance of the list was not provided by volunteers of the organization. *Disabled American Veterans*, 942 F.2d at 311 (reversing *DAV II*).

282. *DAV I*, 650 F.2d at 1182-84.

283. *id.* at 1184-85. Mailing lists are valuable commodities since "they are collections of names and addresses of people with similar characteristics such as willingness to respond to solicitations received by mail and interest in supporting certain types of tax-exempt organizations." *Planned Parenthood Fed'n of Am., Inc. v. Comm'r*, 77 T.C.M. (CCH) 2227, 2228 (1999). The price the Disabled American Veterans charged to use the list was higher for nonprofit than for commercial organizations. *DAV I*, 650 F.2d at 1184-85. See also GAUL & BOROWSKI, *supra* note 20, at 33 (calling the Disabled American Veterans "one of the largest participants in the mail-list business").

284. *DAV I*, 650 F.2d at 1184. In a typical rental transaction the party seeking to use the mailing list will pay the owner of the mailing list for a right to use the mailing list for one mailing. See *Common Cause v. Comm'r*, 112 T.C. 332 (1999); *DAV II*, 94 T.C.

list manager who marketed the list and provided rate information.²⁸⁵

DAV I was based on a claim for refund of tax liability imposed for the tax years 1970 through 1973 on the income received by DAV from allowing other organizations and businesses to use the mailing list of the Disabled American Veterans.²⁸⁶ The additional tax liability related to the DAV's mailing list activities during those years was over four million dollars.²⁸⁷

The *DAV I* opinion first discussed whether the income received was unrelated business taxable income.²⁸⁸ The judge found the mailing list income was from a trade or business, regularly carried on, which was unrelated to its exempt purpose.²⁸⁹ After finding the mailing list income to be unrelated business taxable income, the judge held that the payments were not "royalty" income due to all the work which the Disabled American Veterans put into maintaining the list.²⁹⁰

Congress did not agree with the *DAV I* opinion and sought to change the outcome for certain cases in the future by legislation.²⁹¹ Congress

at 65-66. Any individuals or entities on the mailing list who respond to the mailing become the property of the mailer, and they may continue to send mail to that individual or entity without paying the list owner. *Common Cause*, 112 T.C. at 334. To prevent the later misuse of the mailing list by list users the owners of the mailing list frequently "seed" the mailing list with their employees' names and addresses to see if any unauthorized mailings occur. *See id.* at 334-35.

285. *See Disabled Am. Veterans*, 942 F.2d at 311. A list broker serves as an intermediary between the nonprofit organization with a mailing list to rent and the party wishing to use it. *See* Anthony Giorgianni, *The Donor Name Game*, *CHRON. PHILANTHROPY*, Aug. 12, 1999, at 21, 22. A list manager is a private firm which is hired by the nonprofit organization to manage and maintain the organization's mailing list. *See id.*

286. *See DAV I*, 650 F.2d at 1180. The other two Disabled American Veterans cases involved a claim for refund for the tax liability imposed on mailing list income from different tax years. *DAV II* involved the tax years 1974 through 1985, except 1976. *DAV II*, 94 T.C. at 61. *DAV III* involved the same mailing list income issue but was for the tax years 1986 and 1987. *DAV III*, 68 T.C.M. (CCH) at 915.

287. *DAV I*, 650 F.2d at 1180.

288. *Id.* at 1181.

289. *Id.* at 1185-89.

290. *Id.* at 1189. "DAV's list rentals are the product of extensive business activity by DAV and do not fit within the types of 'passive' income set forth in section 512(b)." *Id.*

291. The House Report stated:

The U.S. Court of Claims held in 1981 that income received by the Disabled American Veterans from other exempt organizations and commercial businesses for the use of its mailing lists constituted unrelated business income, and did not constitute "royalties" expressly exempted from the tax under section 512(b)(2)

.....

The Congress concluded that the unrelated trade or business income tax should not be imposed on income from exchanges or rentals of donor or member lists among tax-exempt organizations eligible to receive charitable contributions

decided that the best way to accomplish this was by enacting section 513(h)(1)(B), which excludes from the term "unrelated trade or business" any exchange or rental income made in transactions between organizations to which donations are deductible.²⁹² These organizations are charities, churches and educational institutions, or certain veterans organizations, the last of which includes the Disabled American Veterans.²⁹³

While Congress somewhat closed the door to finding unrelated business income from mailing lists by enacting I.R.C. section 513(h)(1)(B), the Service tried to use the new Code language to its advantage. The Service interpreted the section to mean that income from mailing lists exchanged or rented between the organizations not listed within the new section 513(h)(1)(B) was nonexcludable unrelated business income.²⁹⁴ The Service argued this in several cases, but to date

STAFF OF THE J. COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, 1324-25 (Comm. Print 1987) [hereinafter GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986].

The Senate Report for the bill contained similar language stating that the "committee believes that the unrelated trade or business tax should not be imposed on income from exchanges or rentals of donor or member lists among tax-exempt organizations eligible to receive charitable contributions." *Tax Reform Act of 1986, Report of the Committee on Finance*, S. REP. NO. 99-313, at 884 (1986).

292. I.R.C. § 513(h)(1)(B) (2000) reads:

(h) Certain distributions of low cost articles without obligation to purchase and exchanges and rentals of member lists

(1) In general

In the case of an organization which is described in section 501 and contributions to which are deductible under paragraph (2) or (3) of section 170(c), the term "unrelated trade or business" does not include—

....

(B) any trade or business which consists of—

(i) exchanging with another such organization names and addresses of donors to (or members of) such organization, or

(ii) renting such names and addresses to another such organization.

Id.

For cases which state that section 513(h)(1)(B) was passed in reaction to *DAV I*, see *Common Cause v. Comm'r*, 112 T.C. 332, 348 (1999); *Planned Parenthood Fed'n of Am., Inc. v. Comm'r*, 77 T.C.M. (CCH) 2227, 2235 (1999). For additional sources saying the same, see *Osteen & Spitzer*, *supra* note 37, at 268; *Speizman & Washlick*, *supra* note 273, at 1377. See also *GAUL & BOROWSKI*, *supra* note 20, at 34 (stating that only twenty percent of all mail list rental transactions are to for-profit firms).

293. See I.R.C. § 170(c)(2), (c)(3) (2000).

294. See *General Counsel's Memoranda 39827*, [1986-1990 Transfer Binder] IRS Positions (CCH) ¶ 2222, at 7612 (Oct. 5, 1989) (commenting that "section 513(h)(1)(B) is the sole exemption from taxation of mailing list income"); Bree Ermentrout & Charles Barrett, *UBIT: Current Developments*, in CPE TECHNICAL INSTRUCTION PROGRAM

only one concurring opinion has agreed with the Service's interpretation.²⁹⁵ This lack of acceptance by the courts of the Service's position is due to the language in the legislative history and debates which states that no other inference should be drawn from the enactment of I.R.C. section 513(h)(1)(B).²⁹⁶ The list of the cases rejecting the Service's position due to the legislative history is lengthy.²⁹⁷

TEXTBOOK 239, 241 (1996) (stating same). See also *Common Cause*, 112 T.C. at 348 (summarizing the Service position on the effect of section 513(h)(1)(B) as "Congress has agreed with the holding of the Court of Claims in *DAV I* that the mailer's list rental payment in a mailing list transaction is not a royalty that is excludable from UBTI under section 512(b)(2)"); Andrew R. Ben-Ami, *Current Unrelated Business Income Tax Developments*, in 26 N.Y.U. CONF. TAX PLAN. FOR EXEMPT ORG. 4-1, -29, -30 (1998) (discussing Private Letter Ruling 9635001 which ruled that mailing list exchanges which are not between section 501(c)(3) organizations are taxable); Halloran, *supra* note 218, at 46-47 (citing Private Letter Ruling 40-29-047 for the proposition the Service would tax mailing list income).

295. The concurring opinion was by Judge Martin in the Sixth Circuit's review of *DAV II* (Tax Court finding mailing list income an excludable royalty from the UBIT). Judge Martin wrote:

The acceptance of *DAV*'s position that the monies it receives from list rental are royalties under § 512(b)(2) would totally eviscerate section 513(h). Section 513(h) would be reduced to mere surplusage under *DAV*'s interpretation of § 512(b)(2) which would hold that all list rentals, and not just those to other exempt organizations, are excludable from unrelated business taxable income. Although § 513(h) was enacted after the relevant time period at issue in this case, its implications cannot be ignored. . . . There is simply no way to reconcile Congress' intent as evidenced by the enactment of § 513(h) and the position advanced by *DAV*. I would reverse the decision of the tax court and find that the monies received by *DAV* from list rentals are not excludable from unrelated business taxable income as royalties under § 512(b)(2).

Disabled Am. Veterans v. Comm'r, 942 F.2d 309, 317-18 (6th Cir. 1991) (Martin, J., concurring) (*DAV II*).

There has been one law review article also in agreement with the Service's application of section 513(h)(1)(B).

[T]o give section 513(h)(1)(B) meaning, the section 512(b)(2) royalties should be understood as not including mailing list rental income; in 513(h)(1)(B), Congress has specifically chosen to exempt that rental income that would otherwise be UBTI. Since general principles of statutory construction favor interpreting statutes in order to avoid nullifying other statutes and parts thereof, the opinion of the Tax Court that royalty income under section 512(b) includes mailing list rental income must be rejected.

Holbrook, *supra* note 273, at 530 (citations omitted).

296. See GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, *supra* note 291, at 1325 (1987) ("No inference is intended as to whether or not revenues from mailing list activities other than those described in the provision . . . constitute unrelated business income."); 132 CONG. REC. 8361 (daily ed. Sept. 25, 1986) (statement of Rep. Rostenkowski) (commenting that the new legislation "carries no inference whatever that mailing list revenues beyond its scope . . . should be considered taxable to an exempt organization").

297. See *Common Cause*, 112 T.C. at 348-49; *Planned Parenthood*, 77 T.C.M. (CCH) at 2234-35; *Miss. State Univ. Alumni, Inc. v. Comm'r*, 74 T.C.M. (CCH) 458, 468 (1997); *Or. State Univ. Alumni Ass'n, Inc. v. Comm'r*, 71 T.C.M. (CCH) 1935,

While the first mailing list case was a victory for the Service, since then there have been only defeats.²⁹⁸ The second attempt by the Disabled American Veterans (*DAV II*) before the Tax Court to obtain a decision declaring their mailing list income to be excludable from taxation is typical, although the case was later reversed by the Sixth Circuit.²⁹⁹ *DAV II* involved the same mailing list and income made therefrom, but focused upon different tax years.³⁰⁰ While the Service said that collateral estoppel precluded relitigation of the issue, the Tax Court held that a Revenue Ruling issued by the Service shortly after *DAV I* was a “change in the legal climate” which warranted “consideration of [DAV’s] arguments.”³⁰¹ The Revenue Ruling defined a royalty as a payment related “to the use of a valuable right.”³⁰² The Tax Court held that the definition applied to the mailing list income received by the Disabled American Veterans, because “business activity does not transform payments that would otherwise be royalties into something else.”³⁰³ The

1940–41 (1996); *Sierra Club, Inc. v. Comm’r*, 65 T.C.M. (CCH) 2582, 2588–89 (1993).

298. See *Sierra Club, Inc. v. Comm’r*, 86 F.3d 1526, 1535–36 (9th Cir. 1996) (finding mailing list income excluded as royalty); *Common Cause*, 112 T.C. at 347 (finding mailing list income excluded); *Planned Parenthood*, 77 T.C.M. (CCH) at 2235 (finding same); *DAV II*, 94 T.C. at 78, *rev’d*, 942 F.2d 309 (6th Cir. 1991) (on collateral estoppel).

299. *DAV II*, 94 T.C. 60. *DAV II* was reviewed by the entire Tax Court, with twelve judges finding excludable royalty income and four judges dissenting. See *id.* at 79, 82. Tax Court cases are tried before only one judge who then submits his or her opinion to the Chief Tax Court Judge. See *RICHMOND*, *supra* note 1, at 121. The Chief Judge then determines if the opinion will stand as written or the Chief Judge can submit the opinion to be reviewed and decided by the full panel of Tax Court judges. See *id.* See also *FREELAND ET AL.*, *supra* note 1, at 29.

300. The tax years involved in *DAV II* were from 1974 to 1985, excluding 1976. See *DAV II*, 94 T.C. at 61. The DAV’s income from its mailing list from the years in controversy was \$16,204,384. See *id.* at 67. Breaking it down year by year the income was: 1974 (\$1,301,971), 1975 (\$1,205,313), 1977 (\$1,025,727), 1978 (\$1,073,186), 1979 (\$1,237,108), 1980 (\$1,267,422), 1981 (\$1,285,408), 1982 (\$1,566,050), 1983 (\$1,956,883), 1984 (\$2,246,875), and 1985 (\$2,038,441). *Id.* The number of names rented in the years 1982 through 1985 was: 1982 (41,685,385), 1983 (49,864,621), 1984 (53,706,024), and 1985 (44,701,712). *Id.*

301. *Disabled Am. Veterans*, 94 T.C. at 69 (*DAV II*). Collateral estoppel is a legal doctrine which prevents the relitigation of the same issue between the same parties or their privies except in certain extraordinary circumstances. BLACK’S LAW DICTIONARY 237 (5th ed. 1979). See also 21 FEDERAL PROCEDURE: LAWYERS EDITION §62:81 (1981) (discussion of pleading collateral estoppel).

302. *DAV II*, 94 T.C. at 69 (quoting Revenue Ruling 81-178). Revenue Ruling 81-178 is discussed *supra* text accompanying notes 260–63.

303. *DAV II*, 94 T.C. at 74. The commentary on the Tax Court’s opinion in *DAV II* was one of shock. See *Beers*, *supra* note 232, at 149 (“*DAV II* represents a significant departure in the treatment of royalty income by the Tax Court.”); *Sheppard*, *supra* note

Tax Court's opinion in *DAV II* was reversed by the Sixth Circuit on collateral estoppel grounds.³⁰⁴

No other cases before the Tax Court have applied the UBIT to mailing list income. All such income has been found to be excludable from the UBIT as a royalty payment.³⁰⁵

18, at 859 (stating that the Tax Court's analysis was a "royalties are royalties' reading," which meant that "commerciality [did] not matter" and breaking "any link between unrelated business and royalties"); Speizman & Washlick, *supra* note 273, at 1377 (calling the decision "somewhat surprising"). See also Tsilas, *supra* note 200, at 489 (giving a short summary of the facts and holding of *DAV II*).

304. *Disabled Am. Veterans v. Comm'r*, 942 F.2d 309, 314 (6th Cir. 1991). The Sixth Circuit did not view Revenue Ruling 81-178 as having any bearing on the case. *Id.* While the Sixth Circuit reversed on collateral estoppel there is *dicta* in the opinion which seems to support the Service's position that for income to be a royalty payment there cannot be an element of services provided. See *id.* at 315 ("Whether revenues received from the use of a donor list could ever be royalties is itself highly questionable."). The concurring opinion of Judge Martin ruled on the merits of the case and taxed the income. See *id.* at 317-18. See also Holbrook, *supra* note 273, at 519 (commenting on Judge Martin's analysis); Swift, *supra* note 18, at 577 ("In its opinion, the Sixth Circuit discussed the merits of the case and concluded that excluding all royalties that constitute unrelated business income from taxation is inconsistent with Section 513(h), which specifically excludes only payments to an exempt organization from another exempt organization for mailing list rentals.").

Because they are not quitters, the Disabled American Veterans tried yet again to have their mailing list income excluded as a royalty payment, re-litigating their case to the Tax Court. See *DAV III*, 68 T.C.M. (CCH) 915 (1994). The facts were the same as in *DAV I* and *DAV II* but involved income from their mailing list for the tax years 1986 and 1987. See *id.* at 915. The Tax Court this time found collateral estoppel applied and the payments remained taxable under the UBIT with no royalty exclusion. See *id.* at 916-17. For a discussion of the case, see Marlis L. Carson & Paul Streckfus, *Would You Believe DAV III?—Or, Once More into the Royalties Fight*, 64 TAX NOTES 563 (1994).

305. There have been three post-*DAV II* mailing list income opinions (in chronological order): *Sierra Club, Inc. v. Comm'r*, 103 T.C. 307 (1994), *aff'd in part and rev'd in part*, 86 F.3d 1526 (9th Cir. 1996), *Common Cause v. Comm'r*, 112 T.C. 332 (1999), and *Planned Parenthood Fed'n of Am., Inc. v. Comm'r*, 77 T.C.M. (CCH) 2227 (1999). A fourth case was settled before a decision was rendered. See Sullivan, *supra* note 257, at 449 (reporting about *American Acad. of Ophthalmology Inc. v. Comm'r*, Tax Ct. Dkt. No. 21657-94). One commentator said of the Tax Court mailing list opinions that he was "disappointed by the decisions" and criticized them for "basically ignoring the statute." Jon Almeras, *Common Cause, Planned Parenthood Prevail in Mailing List Cases*, 83 TAX NOTES 1856, 1857 (1999).

The Sierra Club opinion dealing with mailing list income was the first of two Tax Court opinions involving the Sierra Club and payments which it wanted protected from the UBIT by the royalty exclusion. The second dealt with income received from the Sierra Club's affinity card program. See *Sierra Club*, 103 T.C. 307. The first Sierra Club case involved mailing list income for the tax years 1985 through 1987. See *Sierra Club, Inc. v. Comm'r*, 65 T.C.M. (CCH) 2582, 2583 (1993). The Sierra Club utilized various outside vendors to do the maintenance, updating, solicitation, and renting of its mailing list. See *Sierra Club Inc. v. Comm'r*, 86 F.3d 1526, 1527 (9th Cir. 1996). One vendor maintained the list by adding new names and removing stale names from the list, a "list manager" administered and oversaw the external uses of the lists, and a "list broker" arranged for the rental on behalf of the renting organization. *Id.* The Sierra Club's income on the list was \$142,636 (1985), \$317,579 (1986), and \$452,042 (1987). *Sierra Club*, 65 T.C.M. at 2584. The Tax Court held the mailing list was an intangible

3. Beyond DAV I: Sierra Club

The first case in which a United States Court of Appeals reviewed whether mailing list income could be excluded as royalty payments was the Ninth Circuit in *Sierra Club v. Commissioner*.³⁰⁶ The Ninth Circuit

asset and that any money paid for it would be excluded by the royalty exclusion of 512(b)(2). *See id.* at 2592. As to any services which might have been provided the judge said “[w]e made it clear [in DAV II] that we could distinguish payments for the use of an intangible, which constitute a royalty, from payments for advertising, compensation for services, or other profits masquerading as royalties.” *Id.* at 2585. For additional comments on the first Sierra Club case, see Edward Gonzalez & Charles Barrett, *UBIT: Royalty Income and Mailing Lists*, in CPE TECHNICAL INSTRUCTION PROGRAM TEXTBOOK 122–26 (1994); Holbrook, *supra* note 273, at 523 (stating that the opinion “radically changed the meaning of royalties by omitting previously important factors such as the frequency of transactions and the effect of those transactions on tax-paying competitors”); Sheppard, *supra* note 18, at 859 (disagreeing with the holding); Tsilas, *supra* note 200, at 490–91 (providing an in-depth discussion of facts and holdings of the Tax Court opinions for the mailing list and affinity card income).

The Tax Court decision in *Common Cause v. Commissioner* is much the same in facts and analysis. 112 T.C. 332. Common Cause is a section 501(c)(4) organization “formed for the purpose of improving governmental institutions, processes, and policies by making them more responsive to the needs of the Nation and the will of its citizens.” *Id.* at 333–34. The organization’s mailing list contained the information such as name, address, gender, frequency of contribution, how recent, amount of contributions, and ethnicity. *See id.* at 334, 336–37. The mailing list was maintained and promoted, and the rental transaction handled, by outside vendors. *See id.* at 335. For the tax years in question, 1991 and 1992, Common Cause received \$188,171 and \$243,959, respectively, in mailing list income. *Id.* at 338. The Tax Court held that Common Cause did “not directly engage in any significant activities with regard to a rental list transaction.” *Id.* at 344. The outside vendors were also held not to be agents of Common Cause so their activities were not attributable to the organization. *See id.* at 344–47. After making these findings the Tax Court had no problem finding that the income was excluded as a royalty payment under section 512(b). *See id.* at 347. For additional discussion of the opinion, see Almeras, *supra*, at 1856 (providing advice to practitioners and comments on case and holding); Sullivan, *supra* note 257, at 449 (giving a brief discussion of the case).

The most recent mailing list decision by the Tax Court is *Planned Parenthood v. Commissioner*, 77 T.C.M. (CCH) 2227, and has almost the exact same wording as *Common Cause*. Planned Parenthood is a section 501(c)(3) organization created “for the purpose of assuring quality reproductive health care for women.” *Id.* at 2227. The mailing list was maintained and promoted, and the rental transaction handled, by outside vendors. *Id.* at 2230. For the tax years in controversy, 1991, 1992, and 1993, Planned Parenthood made \$191,415, \$161,273, and \$192,185, respectively, in mailing list rental income. *Id.* at 2235. The Tax Court found, after ruling that no agency relationship was present and that no inference could be made from I.R.C. section 513(h)(1)(B), that the mailing list income was not unrelated business income. *See id.* at 1270. *See also* Sullivan, *supra* note 257, at 449 (giving a brief discussion of the case).

306. 86 F.3d 1526 (9th Cir. 1996). The Sixth Circuit reviewed the *DAV II* decision but reversed on collateral estoppel grounds. *See Disabled Am. Veterans v. Comm’r*, 942 F.2d 309, 314–16 (6th Cir. 1991).

found that while royalties had to be payments for the right to use intangible property, such payments could not be compensation for services.³⁰⁷ After defining “royalty,” the Ninth Circuit then applied it to the Sierra Club’s mailing list income.³⁰⁸ Since the Sierra Club did not provide any services, the court excluded the sums received from the UBIT under the royalty exclusion.³⁰⁹

After its latest string of losses the Service signaled that it will take a different tack and will discontinue litigating many of the mailing list income cases which it previously was pursuing.³¹⁰ A memo issued to area managers directed them to stop litigating all cases involving nonprofit income from the rental of mailing lists unless the facts “clearly point” to the income being unrelated business income.³¹¹ For the facts to “clearly point” to unrelated business income, most likely the mailing list would have to be maintained and updated by the nonprofit receiving the

307. See *Sierra Club*, 86 F.3d at 1532. While the Ninth Circuit adopted the “passive/active” approach to defining royalty, as opposed to the Tax Court’s definition in which the amount of services did not seem to matter, some practitioners thought there was an ulterior motive. See Milton Cerny & Albert Lauber, *Ninth Circuit Rules on Sierra Club Mailing List and Affinity Card Income*, 72 TAX NOTES 353, 354 (1996) (suggesting that the Ninth Circuit adopted the “passive” approach to avoid the possibility of conflict in the Circuits and to lessen the possibility of Supreme Court review of the decision). Several commentators were critical of the Ninth Circuit’s opinion. See Cain, *supra* note 20, at 370 (“Unfortunately, by following the 1970s DAV analysis, the Ninth Circuit adopted an outdated and incorrect approach to list maintenance activities.”); Ermentrout & Barrett, *supra* note 294, at 244 (suggesting that the Ninth Circuit’s decision leaves unanswered the question of what services an exempt organization can perform in connection with mailing list rentals and still treat the income from them as royalty income); VanYe, *supra* note 164, at 1185–86.

The difficulty with the Ninth Circuit’s reasoning is that it fails to resolve adequately the issue of the quantity of services, if any, that can be transferred with “the right to use intangible property” before a tax-exempt organization will no longer qualify for favored tax treatment. After *Sierra Club*, tax-exempt organizations are left only with the knowledge that acceptable levels of activity fall somewhere between that of the Disabled American Veterans and Sierra Club. Because a wide range of activities could fall between these two extremes, an approach is needed that will achieve consistent results when determining whether income related to a tax-exempt organization’s activities in conjunction with a transfer of a property right should be taxed.

Id. (citations omitted).

308. See *Sierra Club*, 86 F.3d at 1535–36.

309. See *id.* at 1536. The opinion states that to find “otherwise would require us to hold that any activity on the part of the owner of intangible property to obtain a royalty, renders the payment for the use of that right UBTI and not a royalty.” *Id.*

310. See *IRS Memorandum to Area Managers on Affinity Card Cases*, 28 EXEMPT ORG. TAX REV. 141, 141 (2000) [hereinafter *IRS Memorandum*]. See also Fred Stokeld, *IRS Memo Tells Area Managers to Stop Litigating Affinity Card, Mailing List Cases*, 28 EXEMPT ORG. TAX REV. 18, 18 (2000).

311. See *IRS Memorandum*, *supra* note 310, at 141. See also Stokeld, *supra* note 310, at 18.

mailing list rental income, as in the *DAV* line of cases.³¹² It will be argued later in this Article that mailing list income should be taxable to the organization and not excluded by the royalty exemption since it does not fit within any existing rationale for a nonprofit's tax exemption.³¹³ Based on this position, the author believes that the cases in this area have been decided incorrectly, and that the Service should continue to litigate the cases and Congress should repeal I.R.C. section 513(h)(1)(B).

*a. Income Received by Nonprofit Organizations from
Affinity Card Arrangements*

The courts have consistently held that the income received by nonprofit organizations from affinity card programs constitutes royalty income.³¹⁴ The first affinity card case heard by any court involved

312. See *supra* text accompanying notes 273–304.

313. See *infra* text accompanying notes 334–75. The analysis for taxing a stream of income due to its negative effect on public trust can also be applied to other UBIT exclusions. However, discussion of that application is beyond the scope of this Article.

314. See *Or. State Univ. Alumni Ass'n v. Comm'r*, 193 F.3d 1098 (9th Cir. 1999); *Sierra Club, Inc. v. Comm'r*, 77 T.C.M. (CCH) 1569 (1999); *Miss. State Univ. Alumni, Inc. v. Comm'r*, 74 T.C.M. (CCH) 458 (1997).

For additional articles discussing the Oregon alumni association cases, see Susan Ruth & Charles Barrett, *UBIT: Current Developments*, in *CPE TECHNICAL INSTRUCTION PROGRAM TEXTBOOK* 129, 131 (1998) (summarizing the facts and holding); Sheppard, *supra* note 18, at 860–62 (summarizing facts and holding of the Tax Court opinion and commenting “[i]t is as though the Tax Court has collectively decided that the destination of the earnings justifies the unfairness of the method of getting them”); Fred Stokeld, *IRS Litigation of Affinity Card Cases Likely to Stop, Owens Says*, 85 *TAX NOTES* 433, 433 (1999) (reporting on comments made by the director of the IRS Exempt Organization Division); Tsilas, *supra* note 200, at 493–94 (discussing the facts and holding of the Ninth Circuit opinion); *IRS Reviewed Briefs: University Alumni Association Received UBIT From Affinity Card Program, IRS Argues*, 11 *EXEMPT ORG. TAX REV.* 767, 767–68 (1995) (discussing the litigation strategies of both sides in the University of Oregon and Oregon State University alumni cases).

For additional articles discussing the Mississippi State case, see Ruth & Barrett, *supra*, at 131 (summarizing facts and holding); James K. Hasson, Jr., *Controversies Old and New Mark Recent UBIT Developments*, 10 *J. TAX'N EXEMPT ORG.* 123, 123 (1998) (providing an overview of the case and commenting that the grounds on which MSU wanted a ruling were that the income received was not unrelated business income under I.R.C. section 513 (2000)); Howard A. Levenson, *Affinity Card Income Not UBIT*, 29 *TAX ADVISER* 7, 10–11 (1998) (providing brief description of facts and holding of the case); Carolyn D. Wright, *Is Miss. St. Alumni the UBIT Case the IRS Has Been Waiting For?*, 76 *TAX NOTES* 1393 (1997) (discussing facts and analysis of opinion and commenting that since MSU updated its own mailing list the Service might prevail if the case were appealed).

payments made to the Sierra Club.³¹⁵ This section of the Article will cover the general aspects of affinity card programs and how the courts have been applying I.R.C. section 512(b) to the nonprofit's income received from this program.

Affinity cards are credit cards that bear the name, logo, or picture of the cardholder's selected charity, college, car, airline, celebrity, or group.³¹⁶ The nonprofit is often contacted by a financial institution or bank about issuing a card to its members and supporters.³¹⁷ The card issuer enters into these agreements to gain access to a nonprofit organization's mailing list and the ability to use their logos, seals, and colors on the credit card and other promotional materials.³¹⁸ The nonprofits enter into the affinity card agreements for various reasons, the primary one being to make money. Typically, a nonprofit receives a certain percentage of each transaction made on the affinity card and a set amount for each new account or renewal fee paid.³¹⁹ The arrangements

315. See *Sierra Club, Inc. v. Comm'r*, 103 T.C. 307 (1994) (*Sierra Club I*), *aff'd in part and rev'd in part*, 86 F.3d 1526 (9th Cir. 1996). Since the affinity card opinion followed the mailing list income opinion, it is known also as "Sierra Club II." See, e.g., Spiegel, *supra* note 257, at 1699; Streckfus, *supra* note 232, at 1762; VanYe, *supra* note 164, at 1183, n.106. Both the mailing list and affinity card income issues were heard by the Ninth Circuit. *Sierra Club, Inc. v. Comm'r*, 86 F.3d 1526 (9th Cir. 1996). For additional articles on various issues involving the Sierra Club's affinity card income, see Ben-Ami, *supra* note 294, at 4-28, 4-29; Marlis L. Carson, 72 TAX NOTES 18, 18 (1996) (reporting exempt organization practitioners celebrated the Ninth Circuit's opinion and hailed it as a victory for nonprofits); Sheppard, *supra* note 18, at 860 (commenting about the Tax Court's holding that the affinity card income was a royalty payment and that "Judge Halpern let the tail of the Sierra Club logo on the credit card wag the dog of the marketing agreement"); Sullivan, *supra* note 257, at 448 (giving holding of case); Wright, *supra* note 314, at 1394-95 (summarizing facts and holding); Wright & Stokeld, *supra* note 22, at 1898-99 (reporting on the Tax Court's opinion in the remanded portion of the case from the Ninth Circuit).

316. See Stark, *supra* note 15, at W13. See also *Sierra Club*, 86 F.3d at 1528 n.2; *Miss. State Univ. Alumni*, 74 T.C.M. (CCH), at 459. See generally Swift, *supra* note 18, at 575 (describing typical affinity card arrangements).

317. See, e.g., *Sierra Club I*, 103 T.C. at 311; *Or. State Univ. Alumni Ass'n*, 71 T.C.M. (CCH) 1935 (stating that the alumni association contacted and then solicited other proposals); *Alumni Ass'n of the Univ. of Or., Inc. v. Comm'r*, 71 T.C.M. (CCH) 2093, 2094 (1996) (same as Oregon State); *Miss. State Univ. Alumni*, 74 T.C.M. (CCH) at 459 (same as Oregon State).

318. See, e.g., *Or. State Univ. Alumni*, 193 F.3d at 1099; *Miss. State Univ. Alumni*, 74 T.C.M. (CCH) at 460 (bank gained access to MSUs mailing list, name and trademark—the walking bulldog). See also *supra* note 17 for additional reasons for banks to enter into affinity card agreements with nonprofit organizations.

319. See, e.g., *Sierra Club II*, 103 T.C. at 314-15 (stating that Sierra Club was to receive 0.5 or 0.6% of each transaction depending on whether certain conditions were met); *Or. State Univ. Alumni*, 193 F.3d at 1099 (the alumni associations received 1% of each transaction and between four and seven dollars for each new account or renewal); *Miss. State Univ. Alumni*, 74 T.C.M. (CCH) at 460 (MSU received 45 cents for each cardholder transaction and three dollars for each card membership or annual fee paid). See also *supra* note 17 for additional particulars on the agreements.

can be quite lucrative.³²⁰ Besides this relatively easy money, nonprofit organizations use affinity cards to keep their members aware of the organization and keep the organization's name before the public.³²¹

The Ninth Circuit in *Oregon State University Alumni Association v. Commissioner* is the only United States Court of Appeals to review the issue of whether affinity card income may be excluded under the royalty exception.³²² The sole issue in the case for the Ninth Circuit was whether “what the bank was paying the alumni associations for was the good will associated with the schools’ names, seals, colors and logos, or whether it was paying them for mailing list management and promotional services,”³²³ which would raise the simple issue of whether the payment is for a property right or for services. The court used the same definition of “royalties” as it had before in the *Sierra Club* case—that royalties are payments for the right to use intangible property but cannot include

320. For example, for the two years in controversy the Sierra Club made over \$300,000, while Oregon State and University of Oregon alumni associations made over \$500,000 in a two-year period. *Sierra Club II*, 103 T.C. at 320; *Or. State Univ. Alumni*, 193 F.3d at 1099.

321. *Or. State Univ. Alumni*, 71 T.C.M. (CCH) at 1936 (stating that the alumni association entered the agreement to “to keep alumni aware of their ties to OSU, to keep OSU’s name before the public, to provide a low-cost credit card to alumni and other OSU supporters”). See also *Alumni Ass’n of the Univ. of Or.*, 71 T.C.M. (CCH) at 2094 (same language as OSU opinion). An article in the Wall Street Journal notes that by using affinity cards to make the public aware of an organization it turns the marketplace “on its ear” since “[c]onsumers advertise to salespersons and vendors.” Stark, *supra* note 15, at W13.

322. 193 F.3d 1098. See also Carolyn D. Wright & Fred Stokeld, *Ninth Circuit Rejects IRS’s UBTI Argument in Oregon Cases*, 85 TAX NOTES 151, 151 (1999) (stating that the Ninth Circuit opinion was “the first time that an appeals court has ruled on the merits of an affinity card case”). One nonprofit practitioner thought that “Judge Kleinfeld must have written the opinion himself . . . because no law clerk would dare submit an opinion that contains no legal citations in the body (and very few footnotes)” and that “[p]erhaps a clerk wrote one opinion, the panel rejected it, and Judge Kleinfeld started from scratch.” *Id.* at 153.

323. *Or. State Univ. Alumni*, 193 F.3d at 1101. This simple analysis was not present in the earlier *Sierra Club I* opinion in which the Service tried many different arguments, which all failed. See *Sierra Club I*, 103 T.C. 307. One was that the nonprofit organization was involved in a joint venture with the financial institution which meant the income would be for its own services. See *id.* at 318, 321–30. For a discussion of the joint venture aspects of the *Sierra Club I* opinion, see Swift, *supra* note 18, at 577–78 (discussing the joint venture analysis in the *Sierra Club I* opinion); Tsilas, *supra* note 200, at 492 (discussing the joint venture analysis in the *Sierra Club I* opinion); *Affinity Card Income Was Royalty, Not UBI*, 81 J. TAX’N 316, 316 (1994) (discussing the joint venture analysis in the *Sierra Club I* opinion). Another was that the financial institution was the agent of the nonprofit organization and, therefore, all its services should be attributed to the nonprofit. See *Sierra Club I*, 103 T.C. at 330, 337.

compensation for services.³²⁴ The court held that the payments were for use of a valuable property right, primarily because of the lack of services that the alumni associations provided to the bank.³²⁵

The Service presently will litigate the royalty exception to affinity card income only when the facts “clearly point” to unrelated business income.³²⁶ As discussed in the next section, the exclusion from taxation of affinity card income agrees with the overall scheme of nontaxation for nonprofit income.

V. A PROPOSAL FOR THE HANDLING OF MAILING LIST AND AFFINITY CARD INCOME

This Article has examined the Code sections permitting federal tax exemption for nonprofit organizations,³²⁷ the major rationales for allowing the federal tax exemption,³²⁸ the history and legal requirements of the UBIT,³²⁹ the exclusions/exceptions to the UBIT,³³⁰ and how the royalty exclusion has been applied by the courts to the mailing list and affinity card income of nonprofit organizations.³³¹ This final section of the Article will review whether mailing list or affinity card income should be taxable. First, this section will discuss why the courts and Congress incorrectly permit an exclusion from the UBIT for income received from the rental or exchange of mailing lists.³³² Next, it will cover why allowing affinity card income to be excluded from the UBIT is appropriate.³³³ The difference in treatment for each source of income

324. See *Or. State Univ. Alumni*, 193 F.3d at 1100–01. While the Sierra Club had an affinity card program and the issue of whether the payments received were royalties was before the Ninth Circuit in that case, the affinity card income issue was reversed and remanded because of a procedural error by the Tax Court in interpretation of the agreement. *Sierra Club, Inc. v. Comm’r*, 86 F.3d 1526, 1536 (9th Cir. 1996).

325. See *Or. State Univ. Alumni*, 193 F.3d at 1101–02. The opinion stressed that it was not believable that the bank would have paid over \$1 million for services which took 50 hours of “mostly secretarial and clerical work.” *Id.* at 1101. If this were true, the bank would have been paying approximately \$22,000 per hour for the services. See *id.*

326. See IRS Memorandum, *supra* note 310, at 141. See also Stokeld, *supra* note 310, at 18. Even before this memorandum was issued the Service had determined not to appeal the ruling in *Miss. State University Alumni*. See Carolyn D. Wright, *Tide Could Be Shifting on IRS Pursuit of Affinity Card UBI*, 78 TAX NOTES 293, 293 (1998) (stating that after the MSU loss in the Tax Court the director of the Exempt Organizations Division said the Service might be “fairly close to the end” of affinity card litigation); Wright & Stokeld, *supra* note 22, at 1898; *Government Won’t Appeal Mississippi State Alumni Affinity Card Case*, 78 TAX NOTES 667, 667 (1998).

327. See *supra* text accompanying notes 24–40.

328. See *supra* text accompanying notes 48–152.

329. See *supra* text accompanying notes 153–247.

330. See *supra* text accompanying notes 248–69.

331. See *supra* text accompanying notes 270–326.

332. See *infra* text accompanying notes 336–75.

333. See *infra* text accompanying notes 376–92.

is based on how it concurs with the underlying rationale for all nonprofit theories for the federal tax exemption—public trust.

A. *Mailing List Income*

When a nonprofit organization distributes mailing list information, without patron consent, for use by other nonprofit or for-profit firms, it violates the privacy of those individuals included on the mailing list.³³⁴ In turn, this violation of privacy causes the public to lose faith in the nonprofit. Since the underlying rationale of all theories for the nonprofit tax exemption is based on the public's trust of these organizations, any activity that undermines this trust should be taxed.³³⁵

1. *Background*

As discussed earlier in this Article, many nonprofit organizations rent or exchange their donor information.³³⁶ These mailing list transactions are between the nonprofit organization and either another nonprofit or a for-profit firm.³³⁷ The lists contain such information as name, address, gender, frequency of contribution, last contribution made, amount of contribution, and ethnicity.³³⁸ The organization which rents the list then takes the information and uses it for its own purposes, usually mailing

334. See *infra* text accompanying notes 345–72.

335. The notion that the public's trust in nonprofit organizations is generally present in all social and hybrid theories should apply even though several authors only specifically apply their rationales to charitable organizations. See *supra* note 151. While it may be said that the public's trust is not an important factor in providing a tax exemption to all nonprofit organizations (i.e., social clubs under I.R.C. section 501(c)(7)(2000)) this should not prevent its use to determine the taxation of mailing list and affinity card income. This is due to the fact that the vast majority of nonprofit organizations are exempt under provisions which are covered by one of the hybrid theories discussed earlier. See *id.*

336. See *Disabled Am. Veterans v. United States*, 650 F.2d 1178, 1184–85 (Ct. Cl. 1981), *aff'd and remanded*, 704 F.2d 1570 (Fed. Cir. 1983); *Common Cause v. Comm'r*, 112 T.C. 332, 334–37 (1999); *Planned Parenthood Fed'n of Am., Inc. v. Comm'r*, 77 T.C.M. (CCH) 2227, 2230 (1999). See *supra* text accompanying notes 271–313 (discussing case law regarding how various courts have treated mailing list income).

337. See *Direct Marketers Being Told to Disclose Data-Sharing; Association Adopts Policy to Better Guard Consumers' Privacy*, BALT. SUN, July 7, 1999, at 3C [hereinafter *Direct Marketers*] (stating that "if you donate money to a charity, you could get a pitch from a music club or a solicitation from a credit card company without ever requesting such information").

338. *Common Cause*, 112 T.C. at 334, 336–37. See also *Disabled Am. Veterans v. Comm'r*, 94 T.C. 60, 63 (1990), *rev'd*, 942 F.2d 309 (6th Cir. 1991).

literature for its cause to the names and addresses on the list.³³⁹

There are two primary reasons why nonprofit organizations rent and exchange mailing lists. The first is to replenish their own mailing lists.³⁴⁰ The other is to generate income, and lots of it.³⁴¹ For example, in 1991 the Smithsonian Institution collected \$3 million in rental income from its mailing list.³⁴² The Disabled American Veterans, who have one of the largest mailing list rental operations, earned over \$16 million in eleven years starting in 1974.³⁴³ The renting of lists to acquire additional funds is done in part because of the decreasing amount of donations received by nonprofits and the increasing competition for those donation dollars.³⁴⁴

339. See *Disabled American Veterans*, 650 F.2d at 1184; *Common Cause*, 112 T.C. at 334; *Planned Parenthood*, 77 T.C.M. (CCH) at 2230. See also Putnam Barber, *How Donors Can Keep a Lid on Charity Costs*, CHRON. PHILANTHROPY, Oct. 21, 1999, at Opinion 51.

Everyone has experienced some variation of fund-raising hell: You donate to a charity or attend one of its events, and then you start receiving a flood of newsletters, membership offers, and pleas for additional support—not only from the organization you supported, but from others you’ve never heard of before. You may politely try to stop those solicitations by contacting the charities through letters, e-mails, and telephone calls, but they just keep coming—a trash-can monument to inattention and waste.

Id. Some mailings have such high overhead that all the money received from the solicitation is used to cover salaries and mailing expenses. See Jane Bryant Quinn, *A Warning to Donors*, NEWSWEEK, Dec. 19, 1988, at 48. See also Espinoza, *supra* note 20, at 635–61 (giving a history of attempted legislation dealing with nonprofit solicitation of funds, including direct mailings).

340. See *Disabled American Veterans*, 650 F.2d at 1183; *Common Cause*, 112 T.C. at 334. See also Giorgianni, *supra* note 285, at 22 (commenting that even groups which do not rent out their own lists rent lists from other groups for mailings).

341. See *Sierra Club Inc. v. Comm’r*, 86 F.3d 1526, 1528 (9th Cir. 1996) (reporting \$912,257 of mailing list income in a three-year period); *Common Cause*, 112 T.C. at 338 (\$432,130 in two years); *Planned Parenthood*, 77 T.C.M. (CCH) at 2230 (\$544,873 over three years).

342. GAUL & BOROWSKI, *supra* note 20, at 34 (also noting that in one year the March of Dimes earned \$1.2 million and the National Audubon Society \$596,000 of mailing list income).

343. *Disabled Am. Veterans v. United States*, 942 F.2d 309, 311 (6th Cir. 1991). See also GAUL & BOROWSKI, *supra* note 20, at 33.

344. A national survey completed by the Independent Sector, a nonprofit organization, found that from 1995 to 1998, after taking into account inflation, the amount of average household contributions decreased slightly. See Independent Sector, *Giving and Volunteering: Key Findings*, http://www.independentsector.org/GandV/ls_keyf.htm (last visited June 25, 2000). The decrease in the amount of donations for any given nonprofit is also caused by increased competition for the pool of donation dollars. See Jill Smolowe, *READ THIS!!!!!!!!*, TIME, Nov. 26, 1990, at 62, 63 (reporting that more money is spent by nonprofits on direct mailings than on all other media advertising (magazines, radio, television) combined. This increase in competition “drives direct-mail marketers ever higher (and lower) to distinguish their message from the rest. To target potential customers more accurately, they compile and swap lists that provide increasingly detailed information about individual consumers, a practice that raises citizen concerns about privacy.”).

2. *Infringes on Donors' Privacy and Trust*

Although Congress and the courts currently permit mailing list income to be excluded from the UBIT,³⁴⁵ mailing list rental income should be taxable. As discussed earlier, a foundational premise of the nonprofit tax exemption is that these organizations are more trustworthy than for-profit firms.³⁴⁶ However, the rental or exchange of donor information violates public trust. The public desires privacy and does not want its personal information exchanged or bartered. The public's trust in nonprofit organizations is not complete and unwavering, and the actions of nonprofits can affect that trust.³⁴⁷ Selling this information is a breach of trust which should not be encouraged by exempting the activity from federal taxation.³⁴⁸

This trading of personal information causes a loss of personal privacy.³⁴⁹ The public is concerned about this loss of privacy,³⁵⁰ and the

345. See I.R.C. §§ 512(b)(2), 513(h)(1)(B) (2000); *Or. State Univ. Alumni Ass'n v. Comm'r*, 193 F.3d 1098 (9th Cir. 1999); *Miss. State Univ. Alumni, Inc. v. Comm'r*, 74 T.C.M. (CCH) 458 (1997).

346. See *supra* text accompanying notes 60 (discussing how social and policy rationales focus on benefits nonprofit organizations provide so public trust is imperative), 108 (discussing capital subsidy theory based on public trust of nonprofit organizations), 129 (stating public trust paramount to donative theory), 146-50 (stating that public trust is important to the "deservedness" of an organization).

347. See Avner Ben-Ner & Theresa Van Hoomissen, *Nonprofit Organizations in a Mixed Economy: A Demand and Supply Analysis*, in *THE NONPROFIT SECTOR IN THE MIXED ECONOMY* 35 (Avner Ben-Ner & Benedetto Gui eds., 1993) (stating that even though nonprofits do not distribute profits "some suspicion regarding the organization's incentives" remains).

348. See, e.g., ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* 12, 84-85 (2d ed. 1995) (discussing taxes as a disincentive to work and driving people from the work force); FREELAND ET AL., *supra* note 1, at 32 ("To impose a tax on a transaction is to some extent to discourage it."); Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417, 437 (1952) (stating that the higher rates of a progressive income tax might "impinge on the productivity of the society . . . by reducing the amount or quality of work put forth").

349. See GAUL & BOROWSKI, *supra* note 20, at 33 ("Buying and selling donor lists comes at a price—the donor's privacy. Most donors have no idea their favorite charities sell their names and addressees to other groups.")

350. See Cain, *supra* note 20, at 363 ("One of the more sensitive issues any organization must face is whether to market its customer list for other direct marketers' use. The income potential for this commodity is significant. Nevertheless, the public is extremely sensitive to concerns about lost privacy from the public sale of such information."). However, some nonprofit organizations rely on donors' and members' knowledge that they can opt out of having their information sold to rationalize the rental and exchange of the nonprofit organization's mailing list. See Giorgianni, *supra* note 285, at 21. See also William J. Fenrich, *Common Law Protection of Individuals' Rights*

desire for privacy is becoming more and more important in the information age.³⁵¹ This rising concern for privacy can be expected to be more of a public priority in the future.³⁵²

The reaction to the discovery of a public television station sharing its mailing lists with the Democratic National Committee is an example of the public's sensitivity toward the exchange of personal information.³⁵³ The transactions were revealed when the Democratic National Committee sent a four-year-old boy fundraising and voting material.³⁵⁴ The boy had been placed on the WGBH mailing list since his mother had included his name with hers when sending a donation to the public

in *Personal Information*, 65 *FORDHAM L. REV.* 951, 962–63 (1996) (discussing the Mail Preference System (MPS) which allows consumers to write or call to request discontinuation of direct mail solicitations); *Direct Marketers*, *supra* note 337 (reporting that in July, 1999 the Direct Marketing Association (“DMA”) required its members to disclose to consumers when they are sharing their information with other marketers. The DMA includes nonprofit organizations and other commercial organizations). While it is true that individuals may opt out of being on an organization's mailing list, those organizations do not want to have an “opt in” requirement. See Holly Hall, *Donors Raise a Red Flag Over Privacy*, *CHRON. PHILANTHROPY*, Mar. 23, 2000, at Fund Raising 1. A spokesperson for the Disabled American Veterans, the largest seller of mailing lists, said that an opt-in requirement would “put [the DAV] out of business” since it would be “like raising a red flag” to donors and members. *Id.* The DAV estimated that only twenty-five percent or less of those on its mailing list would give permission. See *id.* Nonprofit organizations also do not want donors to opt out since it reduces the value of the mailing list and creates administrative problems tracking those who do not want their information released. See Giorgianni, *supra* note 285, at 23.

351. See Jeff Sovern, *Opting In, Opting Out, or No Options at All: The Fight for Control of Personal Information*, 74 *WASH. L. REV.* 1033, 1053 (1999). Sovern cites several sources which give different reasons for the preference for privacy. See *id.* These reasons could be biological, social, or the avoidance of disapproval. See *id.* (citing ALAN F. WESTIN, *PRIVACY AND FREEDOM* 8–11 (1967) (discussing privacy as biological in nature); Charles Fried, *Privacy: Economics and Ethics—A Comment on Posner*, 12 *GA. L. REV.* 423, 477 (1978) (discussing privacy as sociological in nature); Cathy Goodwin, *A Conceptualization of Motives to Seek Privacy for Nondeviant Consumption*, 1 *J. CONSUMER PSYCHOL.* 261, 261 (1992) (stating that consumers desire privacy to avoid disapproval)).

352. See Alan F. Westin, “Whatever Works”—*The American Public's Attitudes Toward Regulation and Self-Regulation on Consumer Privacy Issues*, available at <http://www.ntia.doc.gov/reports/privacy/selfreg1.htm> (visited Oct. 1, 2000). Westin reports surveys showing that the American public has “strong concerns about threats to their personal privacy from both government and business, and this concern is still rising.” *Id.* The surveys also showed that almost 90% of the public was concerned about their personal privacy, of which 55.5% said they were very concerned in 1996. See *id.* This figure was up from 82% and 8%, respectively, just one year earlier. *Id.*

353. See Patricia Wen, *WGBH Swaps Lists with Democrats*, *BOSTON GLOBE*, May 8, 1999, at A1 (originally reporting the exchange of donor lists by WGBH with political organizations). See also Jennifer Moore, *Swapping of PBS Mailing Lists Raises Issue of Donor Privacy*, *CHRON. PHILANTHROPY*, July 29, 1999, at Fundraising 29; Lee Sheppard, *Big Bird Is a Democrat; And the Consequences*, 84 *TAX NOTES* 510 (1999) (discussing the possible tax ramifications of a nonprofit organization exchanging mailing lists with a political organization or candidate).

354. Wen, *supra* note 353, at A1.

television station.³⁵⁵ It was then discovered that WGBH was not the only public broadcasting station involved in the exchange of donor lists with political candidates or organizations. An investigation revealed that a total of fifty-three stations, twenty-nine television stations and twenty-four radio stations, had been involved in similar mailing list transactions.³⁵⁶ The public outcry was enormous and led to congressional hearings into the matter by the House Commerce Telecommunications Subcommittee.³⁵⁷ The exchanges brought out strong emotions from the Chair of the House Subcommittee, Representative Tauzin (R.-La.), who said, "That a publicly supported entity should think for a moment that it has the right to trade private information about the citizens of this country who deign to support it with *any* third party for commercial benefit is outrageous" and that "[i]t should be outlawed."³⁵⁸

355. *Id.*

356. Jon Almeras, *CPB Issues Report on Mailing List Swapping*, 84 TAX NOTES 1577, 1577 (1999) (reporting on the Corporation for Public Broadcasting inspector general's report on public broadcasting stations exchanging mailing lists with political organizations).

357. *Id.* at 1578. See also Peter J. Howe, *Mailing Lists Proving a Booming Business*, BOSTON GLOBE, Aug. 2, 1999, at A1 (reporting on mailing list rentals by nonprofits and stating that WGBH "violated a cardinal rule for nonprofits: Do not expose your supporters to annoying junk mail they can trace back to your group"); Shawne K. Wickham, *Donor List Exchanges: What's The Big Deal?*, N.H. SUNDAY NEWS, Aug. 8, 1999, at 1A (reporting that "[m]uch sound and fury followed" the WGBH story in the Boston Globe); *Time for Charities to Guard Mailing Lists*, VENTURA COUNTY STAR, July 29, 1999, at Opinion B8 ("A charity organization's best policy is to keep its mailing list secret."). The spokesman for Chairman of the House Subcommittee, Representative W.J. (Billy) Tauzin (R.-La.) said that, "More and more people are complaining about the fact that their names are given to other organizations without their permission." Giorgianni, *supra* note 285, at 21.

358. Moore, *supra* note 353, at 29.

Two bills were introduced regarding public broadcasting stations exchanging their donor lists. The bill introduced in the House never made it out of committee. See H.R. 2791, 106th Cong. (1999) (prohibiting any station receiving funds from the Corporation for Public Broadcasting from distributing their donor list unless proscribed by law). A Senate bill sponsored by Arlen Specter (R.-Pa.) originally had language prohibiting funding to any public broadcasting station which exchanged donor lists, but this language was removed before it was voted on in the Senate. See S. REP. NO. 106-166, at 322 (1999) (prohibiting any station receiving funds from the Corporation for Public Broadcasting from selling, exchanging, or otherwise transferring, either directly or indirectly, the names of current or former members or donors to any political organization).

After a study of the issue the Corporation for Public Broadcasting (CPB) issued new requirements on mailing lists for stations receiving CPB grants. See Almeras, *supra* note 356, at 1578. Two of the new requirements were: (1) that the organization not sell, rent,

When an individual's privacy has been violated this can lead to very deep and unpleasant emotional feelings.³⁵⁹ The trading of personal information is distasteful to the public in part because of the perceived lack of control over personal information.³⁶⁰ This feeling of helplessness is only going to increase in the new information age as the amount of electronic information available and the speed with which it can be obtained continue to rise. As the debate grows, and as the amount of information marketers compile on individual buying and internet habits increases, these feelings of helplessness will escalate.³⁶¹ Another reason for the public's displeasure with the sale of mailing list information is that an increase in direct mailings takes time to answer and wastes resources.³⁶²

Although nonprofit organizations realize that the public is concerned about the sale of their personal information, few organizations can resist the income that the rental of their mailing lists provides.³⁶³ However, the

or exchange member or donor names with any candidate, political party, or political organization; and (2) that the organization inform those on the mailing list that their names might be rented or exchanged and give them a method to opt out of such use. *Id.* See also *Controversy over Shared Donor Lists Prompts Broadcast Agency to Revise Rules*, CHRON. PHILANTHROPY, Aug. 12, 1999, at Fund Raising 23 [hereinafter *Controversy*] (reporting the Corporation for Public Broadcasting list of new criteria for the exchange and rental of donor lists).

359. Sovern, *supra* note 351, at 1053 (stating that "[d]eep feelings can be generated by privacy invasions" even when "the data are accurate and they do not suffer any career or social damage").

360. See Westin, *supra* note 352, at 1 (commenting that a growing percentage of the public feel that they have "lost all control over how personal information about them is circulated and used by companies, (from 71% in 1990 to 80% in 1995 and 83% in 1996)" (internal quotation marks omitted)). See also Fenrich, *supra* note 350, at 955.

Public opinion polls and privacy surveys seem to indicate the widespread belief of many Americans that they cannot control information about their personal lives. Many persons believe that they possess an innate right to control personal information, but also feel that they have lost the ability to control that information. Not surprisingly, most Americans seek to gain more control over the dissemination of personal information.

Id. (citations omitted). See also Wickham, *supra* note 357, at 16A (quoting the president of a direct market firm as saying the public might not like their information being exchanged since "[p]eople today are left with the feeling that their privacy is being violated, that they can't move a muscle without some marketer knowing what they're doing").

361. See Margaret Mannix & Susan Gregory Thomas, *Exposed Online: On the Web, Your Personal Life Is Merely Marketable Data*, U.S. NEWS & WORLD REP., June 23, 1997, at 59 (reporting that Internet commerce has been hampered by "consumer concern over privacy").

362. See Sovern, *supra* note 351, at 1054-55 (reporting that "the average professional in the United States will spend [an estimated] eight months sorting junk mail over the course of his or her lifetime" and there are complaints "that important mail [gets] lost in the flood of junk mail").

363. Some nonprofit organizations state bluntly that they know individuals do not like their information distributed. See, e.g., Giorgianni, *supra* note 285, at 23 (quoting

fact that releasing mailing list information would upset those on their lists keeps some nonprofit organizations, and even some for-profit firms, from exchanging their mailing lists.³⁶⁴ Others may simply try to follow the “cardinal rule for nonprofits . . . not [to] expose your supporters to annoying junk mail they can trace back to your group.”³⁶⁵

This violation of donor privacy comes at a cost, a loss of trust and alienation of those individuals whose names have been rented and information released.³⁶⁶ When an individual on the mailing list discovers that his or her information has been released they can respond negatively for several reasons. The first is that this is a violation of their privacy, even though they are usually not aware that not only their name and address, but other information such as the amount and recency of their contribution, ethnicity, and other personal information, were sold.³⁶⁷

the president of the Evangelical Council for Financial Accountability as saying, “When contributors give a name to an organization . . . they don’t expect that it’s going to get bounced all over, especially outside the charitable community”); Hall, *supra* note 350, at 43 (quoting the vice-president of the Disabled American Veterans as saying that twenty-five percent or less of those on its mailing list would give permission to the DAV to rent their names); Honey Meir-Levi, *Some Shocking Advice on Keeping Costs Down*, CHRON. PHILANTHROPY, Dec. 2, 1999, at Opinion 41 (reporting director of a nonprofit stating flatly that “charities should never sell any part of their mailing lists”); Wickham, *supra* note 357, at 16A (reporting that several nonprofit organization directors agreed that “list-swapping leaves a bad taste” with the public, with one calling the practice “dumb”). Another nonprofit director stated, “The more the public understands that what they thought of as private may well not be—and furthermore that it’s being used by parties hoping to raise money from them—people are going to start crying out for some protections.” Hall, *supra* note 350, at 41.

364. See Giorgianni, *supra* note 285, at 22 (reporting that Focus on the Family, one of the largest Christian-based ministries with an extensive following, will not exchange the information on its mailing list); Smolowe, *supra* note 344, at 66 (reporting that, due to sensitivity to customer concerns about privacy, the Red Cross, Reader’s Digest, and AT&T do not rent their mailing lists).

365. Howe, *supra* note 357, at A1.

366. See Cain, *supra* note 20, at 375 (“In addition, an organization needs to avoid short-sighted attempts to pursue an income stream without considering if the marketing program might alienate or offend contributors through its ‘commercialism.’ Such issues might be particularly relevant if the non-profit organization sells contributors’ names without notice or consent . . .”); Giorgianni, *supra* note 285, at 22 (quoting one nonprofit spokesperson as saying, “You don’t develop a good relationship with constituents by violating their trust, even in minor ways”); Hall, *supra* note 350, at 44 (“Due to their reliance on contributions . . . charities cannot afford to alienate donors who tend to hold non-profit organizations to a higher standard than companies when it comes to issues like privacy.”).

367. See *Common Cause v. Comm’r*, 112 T.C. 332, 334, 336–37 (1999). See also *Disabled Am. Veterans v. Comm’r*, 94 T.C. 60, 63 (1990), *rev’d*, 942 F.2d 309 (6th Cir. 1991).

Donors and members respond negatively to the implication that the organization's quality of product is low or that it is losing sight of its organizational purpose.³⁶⁸ Their negative reaction stems from the fact that the organization is spending time on unrelated activities or is in reality just another business trying to maximize profits. In either event, the organization has lost focus on its original nonprofit purpose.

This violation of public trust by one organization is not limited to just the organization which rents the information, but also will be felt by all nonprofit organizations.³⁶⁹ The public perception of the nonprofit ideal

368. Richard Steinberg, "Unfair" Competition By Nonprofits and Tax Policy, 44 NAT'L TAX J. 351, 359 (1991) (stating that the reaction of donors to unrelated commercial activity is either negative or neutral). Steinberg cites other papers which suggest this is due to the fact that either "donors may regard the fact that an organization engages in commercial activity as a signal that the quality of their output is low" or that the nonprofit "is losing sight of its charitable mission." *Id.*

An example of a nonprofit violating the general public's, as well as its members', trust is the Arthritis Foundation's agreement to sponsor pain relievers. In mid-1994 the Arthritis Foundation joined with the McNeil Consumer Product Company and Johnson & Johnson to market the "Arthritis Foundation Pain Reliever" line of products. See Pamela Sebastian, *Nonprofit Group's Name to Go on For-Profit Pills*, WALL ST. J., July 13, 1994, at B1. The products marketed included acetaminophen, ibuprofen, and coated aspirin. *Id.* While Johnson & Johnson distributed the products, their name did not appear on the bottle. Lee A. Sheppard, *supra* note 223, at 421. All of the products were to be sold at a price twenty percent below the price of other national brands and came with a one-year free membership to the Arthritis Foundation. *Id.* at 420. Normally, a twenty dollar fee is required for this membership. See *id.* While the cost for the products was less than name brands, they cost four to six times as much as the generic brands of the same products. *What's in a Name? Credibility and Profit*, 59 CONSUMER REP. 688 (1994). In a letter to its members, the Arthritis Foundation said the benefit of using its brand of pain reliever was that the packaging, advertising, and promotional materials of the product will have the Arthritis Foundation's toll-free number. *Letter to Arthritis Foundation Chair Armin Kuder*, 11 EXEMPT ORG. TAX REV. 78 (1995). The Arthritis Foundation was to receive a guaranteed one million dollars per year. See Sebastian, *supra*, at B1.

Members responded that the licensing agreement "seriously compromises [the Foundation's] image and undermines [the Foundation's] efforts to serve [their] target audience." *Letter to Arthritis Foundation Chair Armin Kuder*, *supra*, at 79. The product was pulled in 1997 after slow sales and a \$2 million settlement by Johnson & Johnson with nineteen states which charged the company with misleading marketing. *Arthritis Foundation Products Pulled*, 62 CONSUMER REP. 9 (1997). For another example of a negative royalty agreement, see Bruce Japsen, *Profit Motive Bad for AMA: Report: Sunbeam Debacle Symptom of Resulting "Tension,"* CHI. TRIB., Nov. 19, 1998, at 1 (reporting on the American Medical Association's (AMA) agreement to endorse Sunbeam products and how it cost the AMA \$20 million due to breach on contract and the dismissal of many of their top executives). See also Jeffrey R. Bennett, *A Look Back at the Year in Health Law*, 7 ANN. HEALTH L. 217, 217 (1998) (reporting same).

369. See *Controversy*, *supra* note 358, at 23 (quoting the text of new criterion for the exchange of mailing lists by stations which receive grants from the Corporation for Public Broadcasting as stating "[a] bedrock principle of public broadcasting is our support from the American people. Because we operate in the public interest, our future relies on a bond of public trust."); Hansmann, *supra* note 36, at 819-20 (stating that "distrust handicaps those organizations in raising funds and otherwise securing the

and the reality of what nonprofits are, or are becoming, is widening.³⁷⁰ As nonprofits go into more commercial enterprises, the public will tend to see them as just that: for-profit businesses. This seems to be a fair assessment since the source of a nonprofit's funding is an important factor for the distribution of its benefits.³⁷¹ Funds which are deemed by donors for a certain objective or project are more likely channeled to an organization's nonprofit purpose.³⁷²

3. *Decreases Need for Donations*

Another reason to tax mailing list income is to decrease such activity by nonprofit organizations.³⁷³ This is a positive step since allowing mailing list income to be received tax-free by nonprofit organizations decreases their reliance on donations.³⁷⁴ This decrease in reliance on donations means that the nonprofit will be less accountable to its donors and more apt to stray from its nonprofit purpose.³⁷⁵

4. *Summary*

Therefore, because the rental and exchange of donor lists abuses the public's trust in nonprofit organizations, which is the primary underlying

commitment and support of the public").

370. Avner Ben-Ner, *Who Benefits from the Nonprofit Sector? Reforming Law and Public Policy Towards Nonprofit Organizations*, 104 YALE L.J. 731, 734 (1994) (book review) (stating that "the gap between our perception and the reality of nonprofit organizations is widening"). Ben-Ner writes that any reforms in nonprofit law should be toward "improving access to the decision-making process of nonprofit organizations by consumers, sponsors, and donors and allowing them to assert more oversight over management." *Id.* at 735.

371. See Charles T. Clotfelter, *The Distributional Consequences of Nonprofit Activities*, in WHO BENEFITS FROM THE NONPROFIT SECTOR? 22 (Charles Clotfelter ed. 1992).

372. See *id.*

373. See *supra* note 348.

374. See Bennett & Rudney, *Commerciality Test*, *supra* note 235, at 1096 ("The accelerated expansion of commercialism among nonprofits, which began as a means of supplementing contributions and government support, is converting the fundamental donative or philanthropic character of public-benefit nonprofits into essentially a commercial one.").

375. See Ben-Ner, *supra* note 370, at 735 (commenting that any nonprofit reform must begin by "improving access to the decision-making process of nonprofit organizations by consumers, sponsors, and donors and allowing them to assert more oversight over management"); Crimm, *supra* note 24, at 458 (stating that organizations should keep to their original purpose to remain exempt from taxation).

rationale for all theories which permit the tax exemption of nonprofits, these activities, or any activity which tends to diminish the public's trust in the nonprofit, should be taxable.

B. Affinity Card Income

The treatment of mailing list income contrasts with the receipt of income from affinity card programs. Income from nonprofit affinity card programs should remain exempt from taxation for two reasons.³⁷⁶ First, these programs do not decrease the public's trust in the nonprofit organizations that allow the use of their names and logos on credit cards. Second, the income received by most programs can be viewed as a voluntary, though indirect, contribution by those who use the cards and does not create any unfair competition with for-profit firms.

1. Background

Affinity cards are credit cards that typically bear the name and logo of a group or organization.³⁷⁷ An independent financial institution contracts with a nonprofit organization to use its name and logo in marketing the credit card to donors and members of the nonprofit organization.³⁷⁸ The amount received by a nonprofit group is normally linked to the amounts which are charged to the card, plus an amount received for each new card or renewal.³⁷⁹ Since the amount received by the nonprofit

376. This assumes that the nonprofit organization supplies very limited services in support of the affinity card program. For the opposite opinion, asserting that affinity card income be taxed by the UBIT, see UBIT RECOMMENDATIONS, *supra* note 11, at 3040 (recommending that affinity card income be taxable); Sheppard, *supra* note 18, at 862 (commenting that the “[l]icensing and collection of royalties is an active business when name and reputation are the most valuable thing the business has to sell” and that “Congress did not intend for exempt organizations to sell the benefit of their exemptions, or to expend their resources marketing and defending their goodwill”). See also Spitzer, *supra* note 189, at 198 (commenting on the UBIT RECOMMENDATIONS above). The subcommittee's draft report did allow for “cause related” funding to be non-taxable. See UBIT RECOMMENDATIONS, *supra* note 11, at 3040–41. After closely looking at the exclusion for cause-marketed income, the only difference between it and affinity card income is the existence of a contract. See *id.* at 3041. However, the presence of a contract in itself should not cause the income to be taxable.

377. See *Sierra Club, Inc. v. Comm'r*, 86 F.3d 1526, 1528 n.2 (9th Cir. 1996); *Miss. State Univ. Alumni, Inc. v. Comm'r*, 74 T.C.M. (CCH) 458, 459 (1997). See also *supra* note 17 (describing typical affinity card arrangements).

378. See *supra* text accompanying notes 15–18.

379. See, e.g., *Or. State Univ. Alumni Ass'n v. Comm'r*, 193 F.3d 1098, 1099 (9th Cir. 1999) (finding that the alumni associations received one percent of each transaction and somewhere between four and seven dollars for each new account or renewal), *aff'd*, 193 F.3d 1098 (9th Cir. 1999); *Miss. State Univ. Alumni*, 74 T.C.M. (CCH) at 460 (stating that MSU received forty-five cents for each cardholder transaction and three dollars for each card membership or annual fee paid). See also *supra* note 17 for

organization directly relates to the amount the card holder charges, affinity card income can be considered an indirect contribution from donors. Although the agreement hinges on the ability of the financial institutions to use a nonprofit organization's mailing list, this is not in itself a reason to subject the entire affinity card income to the UBIT. That portion of the income could be easily separated and taxed using the prevailing rates for mailing list rentals. The rest of the payment can be deemed to be for the use of the nonprofit organization's name and logo.

2. Protects Privacy and Trust

Unlike mailing lists, donors and members of a nonprofit organization can determine whether they would or would not like to accept or use an affinity card.³⁸⁰ Affinity cards are popular because of people's desire to show their loyalty to the nonprofit organization, and the cards provide an easy way to donate.³⁸¹ The ability to choose to sign up for an affinity card and the ability to decide to terminate the card make the transaction voluntary and not coercive, in contrast to rentals of mailing list information.³⁸²

Affinity cards also serve other purposes in addition to providing income for the nonprofit organization. The card reminds the individual of his or her ties to the nonprofit organization.³⁸³ The card also allows

additional particulars on affinity card agreements. The higher the percentage rate charged on the card, the greater the percentage of each transaction received by the nonprofit organization. Evans, *supra* note 17, at D5 (stating "the higher the rates, the more the groups get").

380. See Holbrook, *supra* note 273, at 529 (agreeing that affinity card income should be exempt from taxation since "the Club's members, and the public in general, regard [the nonprofit] as a valuable cause they wish to support, thereby allowing the Club to earn revenues").

381. See Vickers, *supra* note 17, at 138 (stating that affinity cards are popular since "cardholders are more loyal. . . . Part of that loyalty stems from the idea that the cardholder is donating to his or her school or alma mater each time the card is used").

382. See Belknap, *supra* note 24, at 2039. Belknap states that the nonprofit tax exemption should be allowed since the "essence of the advantage . . . is that it is automatic." *Id.* He stresses that the "government does not control the flow of funds to the various organizations; the receipts of each organization are determined by the values and choices of private givers. The donors determine the direction of their own funds, and the distribution of 'tax savings' as well." *Id.* This determination by donors is also present in affinity card arrangements.

383. See *Or. State Univ. Alumni Ass'n*, 71 T.C.M. (CCH) at 1936 (stating that the alumni association entered the agreement "to keep alumni aware of their ties to OSU, to keep OSU's name before the public, to provide a low-cost credit card to alumni and other OSU supporters"), *aff'd*, 193 F.3d 1098 (9th Cir. 1999). See also *Alumni Ass'n of*

individuals to make donations to nonprofit organizations very easily.³⁸⁴ This indirect donation is due to the link between the amounts charged to the card and the payment made to the nonprofit organization.³⁸⁵

Individuals feel good about using an affinity card.³⁸⁶ Unlike the unauthorized release of donor information which produces negative feelings, individuals seem to enjoy using affinity cards. This enjoyment probably accounts for the tremendous growth of the use of affinity cards in the past few years.³⁸⁷

3. *No Unfair Competition Exists*

One of the early rationales for the UBIT claimed that it would prevent unfair competition between nonprofits and taxable entities. However, no unfair competition exists in affinity card arrangements.³⁸⁸ If the nonprofit organization does not offer the credit card itself, it is not in the business of offering credit cards, and therefore does not compete against financial institutions. The majority of affinity cards carry higher interest rates than nonaffinity cards, reducing the demand for such cards.³⁸⁹ Individuals obtaining the card would be doing so primarily out of a desire to associate themselves with the nonprofit organization.

To add to the disincentive of using an affinity card is the fact that any contribution which does eventually go to the nonprofit is nondeductible

the Univ. of Or., Inc. v. Comm'r, 71 T.C.M. (CCH) 2093, 2094 (1996) (same reasons), *aff'd*, 193 F.3d 1098 (9th Cir. 1999). One writer noted that the presence of different affinity cards in one's wallet, some from nonprofits and some from for-profit firms, can create a "strange kind of competitive arena between commercial and nonprofit organizations." Stark, *supra* note 15, at W13 (noting that individuals must decide between giving a donation versus getting some benefit, like frequent flyer miles, for oneself).

384. See *Credit Cards for Causes*, *supra* note 17, at 191 (quoting one nonprofit director as saying, "People feel good every time they use the [Kidcare] card because they know they're raising money for a good cause.").

385. See *supra* note 379.

386. See Holbrook, *supra* note 273, at 529; Vickers, *supra* note 17, at 138 (quoting the CEO of a credit-card tracking service as stating that, "it's like being part of a club. There's pride involved.").

387. See Anita Womack, *Where Can Affinity Programs Take You?*, BANK MARKETING, Aug. 1998, at 8.

388. See Spitzer, *supra* note 189, at 198 (noting that "it seems difficult to make an 'unfair competition' argument with respect to [affinity card] arrangements"). See also *Or. State Univ. Alumni*, 193 F.3d at 1101 (stating that "it is hard to think of a way that charities could unfairly compete with for-profit businesses with respect to royalties in the same way that they can in the sale of goods or services, such as the pasta business").

389. See Evans, *supra* note 17, at D5 (writing that the "average MBNA affinity card [the largest provider of affinity cards] carries a 16.5% interest rate" which means paying \$229 more in interest charges versus a 9.9% if the individual carried an average balance of \$3,474); *Should You Get an Affinity Card?*, *supra* note 17, at 8 (stating that typically affinity cards carry higher interest rates).

by the card holder.³⁹⁰ Only donations which are “charitable contributions” are permitted a deduction from income taxes.³⁹¹ “Charitable contributions” is a defined term in the Code and only includes direct donations to certain organizations; these do not include financial institutions that run affinity card programs.³⁹² By simple economics, an affinity card is no bargain to the user. Individuals choose to apply for and use an affinity card because of their good feelings toward the organization represented on the card.

4. Summary

Since income from affinity card programs does not violate public trust, and does not create any unfair competition, the income from these programs should remain excluded from the UBIT. The positive feelings which these programs foster, plus the fact that individuals are free to choose to sign-up for the program, often against their own economic interests, are important considerations for allowing the continued exclusion of this income from the UBIT.

VI. CONCLUSION

Congress failed to provide a rationale for allowing the nonprofit tax exemption. Many authors have since tried to fill in this void with their own theories for why the tax exemption should exist. Upon closer review the public’s greater trust in nonprofit organizations is a central tenet of the social/public policy and hybrid theories (those which combine social/public policy and economic rationales) rationalizing the federal tax exemption of nonprofit organizations. If the public’s trust in nonprofit organizations is central to the tax exemption, then it follows that activities engaged in by nonprofits that violate this public trust should be taxed under the UBIT. This Article applies this premise to two sources of nonprofit income: (1) the rental or exchange of a nonprofit’s mailing list, and (2) affinity card programs. In doing so it was found that mailing list income, presently excluded from the UBIT in

390. Evans, *supra* note 17, at D1 (noting that “an individual can give more to charity by making a direct donation with the cash saved by using a standard credit card with a lower interest rate” and that such a donation “has the additional advantage of being tax-deductible”).

391. I.R.C. § 170(a)(1) (2000).

392. *Id.* § 170(c)(1)–(5).

most cases, should be taxed. This contrasts with the income received from affinity card programs which should be excluded from UBIT. This proposal, if put into legislation by Congress, will help to decrease the widening gap between the nonprofit ideal and public perception of nonprofits. The taxation of mailing list income would also help to protect the fundamental premise upon which the tax exemption is based: public trust.