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Unfair Business Competition and the Tax on Income Destined for Charity: Forty-Six Years Later

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I. INTRODUCTION

Two sectors in American society, private enterprise and the federal government, are widely recognized as playing indispensable institutional roles, and both are in obvious need of revenue to accomplish their respective goals. The importance of a third sector—those institutions broadly subsumed under the classification of private, nonprofit charitable organizations—should not be undervalued relative to the other two, nor should its equally pressing need for revenue be underestimated. Beginning early in American history, private institutions have played a major role in attending to social needs. In contrast to other countries where major institutions attending to social needs are financed and operated by the government, many of the universities, schools, scientific research organizations, hospitals, libraries, museums, symphony orchestras, and social welfare agencies in the United States are voluntarily supported and operated by private citizens.¹

From the very beginning, tax law in the United States has recognized the unique role played by private, nonprofit charitable organizations by affording them exemption from tax.² Section 501(c)(3) of the Internal Revenue Code exempts from income tax organizations organized and operated exclusively³ for religious, charitable,⁴ scientific, literary, or

1. See Commission on Private Philanthropy and Public Needs, *Giving in America: Toward a Stronger Voluntary Sector* 9 (1975); Note, *Criticized Uses of Federal Tax Exemption Privileges by Charitable Foundations and Educational Institutions*, 98 U. Pa. L. Rev. 696, 696-97 (1950).

2. The Tariff Act of 1894, sec. 32, exempted from tax "corporations, companies, or associations organized and conducted solely for charitable, religious, or educational purposes. . . ." Tariff Act of 1894, ch. 349, sec. 32, 28 Stat. 509, 556. The language was carried over to the Tariff Act of 1913, ch. 16, sec. II(G)(a), 38 Stat. 114, 172. For a history of the charitable exemption, see generally 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); Kenneth Liles & Cynthia Blum, *Development of the Federal Tax Treatment of Charities*, *Law & Contemp. Probs.*, Autumn 1975, at 6.

3. Regulations § 1.501(c)(3)-1(c)(1) (as amended in 1990) relaxes the "operated exclusively" test by providing that an organization must engage primarily in activities which accomplish one or more exempt purposes specified in IRC § 501(c)(3). For a critical analysis of the Treasury Regulations, see Colombo, *supra* note 2, at 845-47.

4. Regs. § 1.501(c)(3)-1(d)(2) provides in part:

The term "charitable" is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of "charity" as developed by judicial decisions. Such terms include: Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social

educational purposes, testing for public safety, or for the prevention of cruelty to children or animals.⁵ No part of the net earnings of such organizations may inure to the benefit of any private shareholder or individual.⁶

Exemption from tax, nevertheless, has historically proved inadequate as the sole means to generate sufficient revenue to enable the charitable sector to make ends meet. In their never-ending quest for revenue, 501(3)(c) organizations⁷ in the early decades of the twentieth century began to turn to the commercial world in search of profitable ventures to support their exempt activities, operating the ventures either directly or through wholly-owned "feeder" corporations. Relying on a series of cases which held that the test of tax exemption is the charitable destination of the income generated by those ventures and not their commercial source, exempt organizations, most especially universities, marched into the private enterprise sector with increasing acceleration in the years following World War II. One of their favorite ventures was the acquisition of real estate with borrowed funds, lease of the property back to the vendor under a long-term lease, and amortization of the loan with tax-free rental income received from the property.

Following hearings before the House Committee on Ways and Means in 1942 and 1947 and hearings before both the House and Senate Committees in 1950 investigating the perceived growing abuse of the tax exemption,⁸ and on President Truman's urging to curb the abuse,⁹ Congress reacted by

welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

5. IRC § 501(c)(3).

6. Additionally, no substantial part of the organization's activities can be carrying on propaganda or otherwise attempting to influence legislation, and the organization cannot participate in, or interfere in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office. IRC § 501(c)(3).

7. For purposes of this article, the term "501(c)(3) organization" means an organization described in § 501(c)(3) that has as its primary function the conduct of an activity in furtherance of its exempt purposes. The term does not include churches and other religious organizations. The claim to exemption for these organizations rests on somewhat different grounds.

8. Revenue Revisions of 1950: Hearings Before the Senate Comm. on Finance on H.R. 8920, 81st Cong., 2d Sess. (1950) [hereinafter Senate Hearings of 1950]; Revenue Revision of 1950: Hearings Before the House Comm. on Ways and Means, 81st Cong., 2d Sess., pt. 1 (1950) [hereinafter House Hearings of 1950]; Hearings Before the House Comm. on Ways and Means on A Bill to Reduce Individual Income Tax Payments, 80th Cong., 1st Sess. 1895 (1947) [hereinafter Hearings of 1947]; Revenue Revision of 1942: Hearings Before the House Comm. on Ways and Means on Revenue Revision of 1942, 77th Cong., 2d Sess. 89 (1942) (statement of Randolph Paul, Tax Adviser to the Secretary of the Treasury).

9. 96 Cong. Rec. 769 (1950) (Message from the President of the United States).

including in the Revenue Act of 1950¹⁰ several solutions. These measures abolished the tax exemption of feeder corporations, imposed an income tax on the taxable income of unrelated businesses conducted directly by certain exempt organizations primarily to raise revenue for their exempt purposes, and taxed specified rents received in connection with the leveraged sale and leaseback of real estate.¹¹

Forty-six years after the enactment of the Revenue Act of 1950, a number of issues remain to be resolved. This article explores the following central questions: Should an income tax exemption be retained for "related" businesses directly furthering the charitable purposes of 501(c)(3) organizations in the face of charges from the small business community of unfair competition? Can 501(c)(3) organizations receive tax-free income from their feeders and "unrelated" businesses without affording such businesses the opportunity to compete unfairly with their taxable counterparts? Have the Treasury Department and the courts applied appropriate criteria to differentiate "related" from "unrelated" businesses conducted by 501(c)(3) organizations? Is the "substantially related" standard administerable? Are there additional measures that can be taken to promote the integrity and financial viability of the private, nonprofit charitable sector?

Central to the thesis of the article is the view, explored in Part II, that the private, nonprofit charitable organization represents generically a better model than the for-profit enterprise to provide the socially essential or important activities enumerated in section 501(c)(3). The tax exemption afforded to the charitable activities of nonprofit organizations is justified as a means of subsidizing and encouraging an institutional system that has historically fostered pluralism, diversity, and democratic decentralization in American society.

Part III of the article describes the concurrent entry of 501(c)(3) organizations into the private enterprise sector and explores the judicial evolution of the "destination of income" theory which protects from tax the income generated by commercial ventures used to support the organization's exempt activities. There follows a broad description of the provisions included in the Revenue Act of 1950 to curb the perceived abuses of the exemption and subsequent amendments added by the Tax Reform Act of 1969. Although several commentators challenge the claim that untaxed feeders and unrelated businesses enjoyed an advantage over their for-profit taxpaying competitors, this article assumes *arguendo* the validity of the unfair competition rationale as justification for imposition of the new taxes.

10. Revenue Act of 1950, Pub. L. No. 81-814, §§ 301, 331, 64 Stat. 906, 947-52 (1950).

11. IRC §§ 502, 511-14 (formerly IRC §§ 101, 421-423).

Two questions underlie the discussion in Part III. First, as an alternative to paying the taxes imposed by the Revenue Act of 1950, and assuming that appropriate limitations and safeguards are built into the statutory system, could not the problem of unfair competition also be resolved 1) by requiring the feeder or unrelated business to charge competitive rates, and 2) by granting the feeder or unrelated business the option to distribute a combined amount equal to its tax liability plus an assumed adequate return on investment to the 501(c)(3) organization to be used exclusively in financing its charitable activities? Second, if such a statutory system were put into effect, would the loss of federal tax revenue be justified by the social benefits anticipated from the additional distribution to the 501(c)(3) organization? Both questions are answered in the affirmative.

Congress unwittingly created the framework for its own affirmative response to the first question when it inserted into the Tax Reform Act of 1969 a piece of special interest legislation designed for the exclusive benefit of radio station WWL, operated by Loyola University. The proposed amendment to the statute, outlined in Appendix A of this article, is an attempt to expand on the innovative motif of this special interest legislation. The amendment does so by granting a feeder or unrelated business maintaining competitive pricing a limited elective credit against tax for certain distributions to its 501(c)(3) owner to cover its current operating losses from the conduct of activities related to the furtherance of its exempt purposes.

Assuming that the elective credit is as effective in eliminating the potential for unfair competition as is payment of the tax to the government, adoption of the credit can be viewed as a measure to replace diminished revenue from public contributions and federal grants with a revenue source that is within the control of the 501(c)(3) organization's wholly-owned business benefactors. Adoption of the credit as a provision of universal application, however, can be justified on the condition that the charitable sector concomitantly addresses certain operational weaknesses in its various subsectors by establishing the type of self-regulatory bodies responsible for planning and oversight more fully described in Part V of the article. Alternatively, the elective credit can be more narrowly employed to enable and to encourage the charitable sector to meet specific social goals such as the delivery of essential goods and services to the needier segments of the public.

The focus in Part IV of the article shifts from an analysis of the solutions offered by the 1950 and 1969 tax legislation regarding the problem of unfair competition to an exploration of the legislative, regulatory, and judicial evolution of two defining elements of the statute itself. First, for purposes of the tax imposed by section 511 on the taxable income of an unrelated trade or business conducted by a 501(c)(3) organization, what is a trade or business? Second, what is an unrelated trade or business?

Inasmuch as a trade or business substantially related to the performance of the organization's exempt purposes should not have as its primary purpose the making of profit, Subpart A of Part IV concludes that the definition of the phrase "trade or business" as it evolved for the purpose of allowing the deduction of business expenses under section 162, viz., an activity conducted with an intent, or primary intent, to earn profit, is an inappropriate standard for purposes of the tax imposed by section 511. Defining trade or business more accurately as the sale of goods or the performance of services at market value from which gross income is derived encompasses activities whether designed principally to further the exempt purposes of the organization or to earn profit. Accordingly, the reference to section 162 in both the legislative history of the tax on unrelated business and in Treasury regulations interpreting the statutory meaning of essential terms have misled the courts into applying the "for profit" test in their attempt to distinguish trade or business activity from other types of endeavors such as fund raising conducted by section 501(c)(3) organizations.

Subpart B of Part IV explores both the primary motive test of the 1958 Treasury regulations and the "substantial causal relationship" tests of the 1967 regulations in their attempt to sort out whether or not a trade or business is related or unrelated to the charitable purposes of the exempt organization. Subpart B concludes that many courts slip back into applying the 1958 subjective standard even after having recited the 1967 objective standard as the one to apply. Subpart B further concludes that the error in applying the "for profit" test to identify trade or business has misled a number of courts into resolving the "related versus unrelated" issue by focusing more on the existence of profit itself than on the causal connection between the activity in question and the accomplishment of the organization's exempt purposes. Additionally, courts have relied on other inaccurate assumptions to conclude that an activity is an unrelated rather than related trade or business. Subpart C of Part IV explores the issue of whether a specific finding of unfair competition with a taxable entity engaged in a similar activity should be a prerequisite to imposing the section 511 tax on an unrelated trade or business.

In June of 1987 the Subcommittee On Oversight of the House Committee on Ways and Means held hearings to review the income-producing activities of organizations exempt from income tax, to determine whether the "substantially related" test was the appropriate one to determine which income-producing activities should be taxed, and to ascertain the degree of compliance with the law. The small business community used the occasion to mount a vigorous attack, challenging the tax exemption afforded to business activities related to the charitable purposes of 501(c)(3) organizations and to question the effectiveness of the "substantially related" test in differentiating related from unrelated business. Part V of the article addresses

the two primary issues presented by the 1987 House Hearings: is the "substantially related" test an appropriate expression of tax policy and is it a workable standard in differentiating exempt from taxable activities? Again, both questions are answered in the affirmative.

The lesson to be learned from the 1987 House Hearings is that tax exemption for "related" activities is no longer sacrosanct. The article concludes with the proposal that the various subgroups of 501(c)(3) organizations establish their own self-regulatory associations for the purpose of formulating planning strategies, operational guidelines, and periodic review procedures to monitor compliance with the law and the degree to which member organizations are efficiently providing social benefits to the public. It is virtually imperative that the charitable sector seize the initiative to demonstrate accountability to the public, to promote understanding of its unique role in American society, and to restore public confidence in the tax exemption it enjoys.

II. JUSTIFYING TAX EXEMPTION FOR THE CHARITABLE ACTIVITIES OF NON-PROFIT ORGANIZATIONS

Apparently acting on the assumption that the legitimacy of the tax exemption afforded to private, nonprofit charitable organizations is self-evident, Congress has through the years reenacted the provision with little explanation for its justification.¹² Although commentators have offered several rationales to support the exemption, none is fully satisfactory. One view, most fully developed by Boris Bittker and George Rahdert, is that the exemption requires no affirmative justification as a special privilege in the tax system.¹³ Rather, nonprofit organizations engaged in charitable, educational, scientific, and social welfare activities are exempt from income tax because the principles used in our tax system to compute gross income less business expenses "rest on the premise that the organization seeks to maximize its profit, and hence are not a satisfactory way of measuring the success of organizations that reject this basic premise."¹⁴ In this view, such organizations do not derive taxable income as presently defined in the tax system. Moreover, according to Bittker and Rahdert, even if charitable organizations realized taxable income, there is no easy method to determine the appropriate tax rate on such income because "the economic burden of the tax will fall on

12. See Colombo, *supra* note 2, at 845.

13. Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 *Yale L.J.* 299, 304 (1976).

14. Bittker & Rahdert, *supra* note 13, at 307.

the organization's ultimate beneficiaries"¹⁵ who are generally unknown at the time the income is received by the organization.¹⁶

Alternative rationales for the tax exemption afforded to 501(c)(3) organizations view the exemption as an indirect governmental subsidy and a concomitant loss of federal revenue that requires affirmative justification.¹⁷

15. *Id.* at 315; see William A. Klein, *Income Taxation and Legal Entities*, 20 *UCLA L. Rev.* 13, 56 (1972) ("In my view, on the other hand, if one focuses (as one should) on the effects achieved by imposing taxes on the income of charitable foundations, it is taxation rather than nontaxation that appears to be unnatural and in need of special justification.").

16. Colombo, citing Henry Hansmann, criticizes this theory on the ground that it is no more difficult to measure the income derived by a nonprofit organization from the sale of goods and services than it is for any other business. See Colombo, *supra* note 2, at 859. Maintaining that tuition and sales revenue received by educational institutions "fall squarely within the definition of § 61," Colombo states: "In addition, aside from the profit motive issue, the expenses of most educational institutions (teacher salaries, maintenance and the like) are classic examples of deductible business expenses under I.R.C. § 162." *Id.* at 860. The profit motive issue was precisely Bitker and Rahdert's point. It may be possible to come up with a number that looks like "taxable income" derived by a nonprofit organization from the sale of goods or services. The problem is that "taxable income" normally measures the results of an enterprise seeking to maximize profits. Bitker & Rahdert, *supra* note 13, at 307.

Hansmann argues that the most satisfactory explanation is to view the exemption as a subsidy in recognition of the fact that nonprofit organizations (a) have difficulty raising capital and (b) supply goods and services that would be undersupplied, or less efficiently supplied, by the private market. Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 *Yale L.J.* 54, 55 (1981). Colombo is also critical of Hansmann's capital subsidy theory. See Colombo, *supra* note 2, at 868-71. Colombo states: "If nonprofit firms face capital formation problems sufficient to warrant government intervention, a far more precise mechanism would be direct government construction grants, government-assisted loans or tax incentives targeted at capital formation." *Id.* at 870. Those who fear overdomination by the federal government and the entrapment of the nonprofit, charitable sector into dependence on the prevailing political view in Washington may prefer to stay with a stable income tax exemption than to rely on government subsidies. See also Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 *B.C. L. Rev.* 501 (1990); Colombo, *supra* note 2, at 871-73 (criticizing Atkinson's altruism theory).

17. The governmental subsidy resulting from tax exemption is not obvious unless the 501(c)(3) organization realizes the equivalent of "taxable income." For example, assume that a 501(c)(3) organization receives \$50x from donations, \$50x interest and dividends from investments, and \$300x gross receipts from the operation of related activities for the taxable year, and incurs \$400x of "deductible" expenses in the operation of such activities. In this case, the entire financial support is ostensibly received from the public and previously received gifts and none from tax exemption. Alternatively, assume the same facts, except that the "deductible" operating expense are \$300x and the applicable tax rate is 35%. The equivalent of taxable income is \$100x and the tax savings resulting from exemption is \$35x. Thus, \$365x financial support is received from the public and previously received gifts and \$35x from the federal subsidy. Compared to a taxable entity with \$100x taxable income, the subsidy resulting from the tax exemption allows the 501(c)(3) organization to lower prices by \$35x or to accumulate that amount. In either case, it is clear that exemption from tax as a governmental subsidy works very imprecisely. See Colombo, *supra* note 2, at 863-64.

In a rare Congressional pronouncement on the matter the House Committee on Ways and Means, in 1938, observed 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.”¹⁸ In other words, the private, nonprofit charitable sector merits the tax savings afforded by the exemption because the money foregone by the government would have to have been appropriated by Congress to meet the very same public needs being met by the charitable sector.¹⁹ One of the difficulties with this quid-pro-quo rationale for the exemption is its failure to address the alternative possibility that the government could revoke the exemption, collect the otherwise foregone tax, and use the revenue to meet the public needs now being met by the 501(c)(3) sector.²⁰ Obviously, the government would have

18. H.R. Rep. No. 1860, 75th Cong., 3d Sess. 19 (1938).

19. “[U]nder this law, in view of the fact that bequests for public purposes operate in aid of good government and perform by private means what ultimately would fall upon the public, exemption from taxation is not so much a matter of grace or favor as rather an act of public justice.” Maurice Finkelstein, *Freedom From Uncertainty In Income Tax Exemptions*, 48 Mich. L. Rev. 449, 451 (1950) (quoting *Harrison v. Barker Annuity Fund*, 90 F.2d 286, 288 (7th Cir. 1937)).

20. Some commentators view the revenue loss resulting from a tax incentive designed to further a social goal (e.g., exemption from tax) as economically equivalent to the government collecting the tax and allocating the revenue as a direct expenditure through grants, loans, and guarantee of loans. These commentators look upon tax incentives with disfavor because the foregone revenue is not explicitly accounted for in the federal budget and there is consequently no public and legislative review of what is essentially a concealed federal subsidy. See Stanley S. Surrey, *Tax Incentives As A Device For Implementing Government Policy: A Comparison With Direct Government Expenditures*, 83 Harv. L. Rev. 705 (1970); Comment, *Tax Incentives As State Action*, 122 U. Pa. L. Rev. 414 (1973). Professors Bittker, Surrey, and Hellmuth have vigorously debated the issue. See Boris I. Bittker, *Accounting For Federal “Tax Subsidies” In the National Budget*, 22 Nat’l Tax J. 244 (1969); Stanley S. Surrey & William F. Hellmuth, *The Tax Expenditure Budget—Response to Professor Bittker*, 22 Nat’l Tax J. 528 (1969); Boris I. Bittker, *The Tax Expenditure Budget—A Reply To Professors Surrey & Hellmuth*, 22 Nat’l Tax J. 538 (1969).

This article views the § 501(c)(3) exemption from tax as a federal subsidy, imprecise as it is, granted to broad classifications of socially essential or important activities conducted by charitable, nonprofit organizations in part as an affirmation of the principle of decentralization of institutionalized power in America. A shift in power from the charity to the federal government implicit in the repeal of the exemption (i.e., the right to decide how to spend the tax collected or whether even to spend it on 501(c)(3) type activities) contravenes this principle. See Liles & Blum, *supra* note 2, at 56 (“Having come this far and having achieved so much under a tax system which encourages private philanthropy, it would be a disaster if we were at this late date to decide to junk the present system in favor of some untried scheme of direct government subsidy or operation of all charity.”); see also James T.Y. Yang, *Collaboration Between Nonprofit Universities and Commercial Enterprises: The Rationale for Exempting Nonprofit Universities from Federal Income Taxation*, 95 Yale L.J. 1857, 1874

to expend amounts far in excess of the foregone tax to meet the same public need now being met by a tax exempt nonprofit charity.²¹

The most appealing rationale for the exemption, but one admittedly resting on value judgments and assumptions that are difficult to test, justifies the tax savings afforded by the exemption as the result of two fundamental hypotheses: (1) profit motivated enterprise cannot be relied upon to meet the essential or important public needs enumerated in section 501(c)(3) that have been historically addressed by the private, nonprofit charitable sector; and (2) any shift in revenue and decision-making power from the charitable sector to the federal government implicit in the repeal of exemption could not be accomplished without endangering the decentralized form of democracy as it has developed in the United States. With respect to the first hypothesis, this view assumes that if a for-profit business undertook to meet a social need traditionally addressed by a 501(c)(3) organization, the primary goal of the endeavor would be profit and the fulfillment of the social need would be but the means to this end. If meeting the public need did not appear to be profitable prospectively, or if it turned out to be unprofitable, the for-profit business would not embark upon the endeavor or would later abandon it.

Moreover, in an effort to maximize the bottom line, the for-profit business may be tempted to sacrifice the quality of the goods and services offered to meet the public need. This point appears to cut against the classic principle that only the best quality of goods and services serving a particular market survive in a competitively free marketplace. The "free marketplace"

(1986) (arguing that universities are a better alternative to conduct basic scientific research than the government because of the relative independence, freedom from sluggish and expensive bureaucracy, encouragement of private philanthropy, and link to training).

The 501(c)(3) exemption from tax does not imply that Congress endorse the policies of any given nonprofit, charitable organization. Comment, *supra*, at 463. "Indeed, to characterize every grant of tax-exempt status as an approval of each underlying activity would be to render the government's § 501(c)(3) approval policies nonsensical since the government would often be endorsing various activities that work at complete cross purposes from one another." Comment, *The Revocation of Tax Exemptions And Tax Deductions For Donations To 501(c)(3) Organizations On Statutory And Constitutional Grounds*, 30 *UCLA L. Rev.* 156, 184 (1982). For example, both Planned Parenthood and "Pro-Life" organizations qualify under § 501(c)(3). *Id.* at 184 n.174.

21. See Bittker & Rahdert, *supra* note 13, at 332; Colombo, *supra* note 2, at 862-64. Colombo states that "[t]he establishment and maintenance of institutions of higher education is certainly not the responsibility of the federal government." Colombo, *supra* note 2, at 863, quoting Chauncey Belknap, *The Federal Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy*, in *Research Papers Sponsored By The Commission On Private Philanthropy And Public Needs 2025, 2033* (U. S. Dep't of the Treasury ed., 1977). Colombo correctly points out that the scope of activities historically exempt from tax as "educational" extends beyond what could be argued as being within the perimeters of governmental responsibility. *Id.* at 864.

principle nevertheless may not work to encourage private enterprise to offer the best quality of goods and services of the type now offered by 501(c)(3) organizations when consumers have difficulty forming an educated judgment as to what they or society is receiving.²² How, for example, would a for-profit university's consumers judge the quality of the university's contribution to literary scholarship or to pure scientific research?

By contrast, the *raison d'être* of private, nonprofit charitable organizations described in section 501(c)(3) is to address a category of public needs designated by Congress as essential or important, and not to earn profit for the benefit of its owners or other individuals. A 501(c)(3) organization is less likely to abandon its activities for lack of profit, and there is far less temptation to sacrifice quality for the bottom line.²³ Further, the amount of public financial support received by a 501(c)(3) organization, an indication of its relevant success in addressing a public need, extends beyond the revenue received from the consumers of its goods and services to include gifts from private citizens, corporations, and foundations and the income derived from the investment of previously received donations.

In this view of the exemption there is an essential democratic decentralization implicit in the opportunity afforded to private citizens of diverse religious, ethnic, and racial backgrounds and with different economic, political, and social agendas to contribute their time and money to the

22. Hansmann calls this "contract failure." See Hansmann, *supra* note 16, at 69; Dennis Zimmerman, *Nonprofit Organizations, Social Benefits, and Tax Policy*, 44 *Nat'l Tax J.* 341, 342 (1991):

Here the problem is one of an essentially private good about which the seller possesses much more information than the buyer, leading to a possibility that the buyer will be taken advantage of by the profit-motivated seller. . . . Nursing homes and mental treatment facilities are thought to be good examples of services that fit this profile. In such instances, the nondistribution constraint on nonprofit organizations (the prohibition against surplus or profit being distributed to board members or managers) supposedly reduces the incentive for the service provider to take advantage of the consumer's informational disadvantage.

Additionally, some commentators argue that private enterprise cannot supply a sufficient quantity of its goods or services in cases where they are consumed collectively by the public. See *id.* at 341-42.

23. For a contrary view, see Colombo, *supra* note 2, at 866 n.149 ("One can argue, in fact, that for-profit institutions are likely to be *more* responsive to community needs, since for-profits rely on customer patronage for financial success, and customer patronage requires selling a product the customer wants."). Colombo argues that "the existence of for-profit private schools also would increase parental choice, educational opportunity and promote diversity." Colombo, *Id.* at 866. The primary problem presented by the private enterprise sector, however, is not lack of diversity, but lack of reliability if the enterprise turned out to be unprofitable.

privately controlled nonprofit charitable organization of their choice in an effort to meet public needs and to promote controversial causes. It is precisely this pluralism, diversity, and opportunity for private philanthropy and public service extending beyond the power structure of the federal government that not only allows for creativity and innovation in the resolution of social issues, but also serves as a counterweight to the power and wealth of both the government and for-profit enterprise.²⁴ In this view, one that is accepted by this article, as a general principle the subsidization, encouragement, and preservation of the private, nonprofit charitable sector as an essential institutional provider of public goods and services justifies the loss of revenue by the federal government resulting from the exemption from tax afforded 501(c)(3) organizations.²⁵ This view of the exemption does not mean to

24. For an eloquent expression of this view, see Lawrence M. Stone, *Federal Tax Support of Charities and Other Exempt Organizations: The Need for a National Policy*, 1968 U.S. Cal. Tax Inst. 27, 39-40; see also Yang, *supra* note 20.

25. Building on Hansmann's theory that nonprofit organizations spring up when the private market fails to function properly, Colombo proposes his donative theory to explain the exemption. See Colombo, *supra* note 2, at 873-87. Under this theory, tax exemption is deserved only when there is both private market failure and governmental failure to provide the desired goods and services at an optimal level. *Id.* at 874. Government failure occurs because the majority of the legislators will not vote for certain goods and services desired by a minority bloc; however, the majority will permit a partial subsidy of such goods and services in the form of a tax exemption in the expectation that they will receive like treatment for their own special interests. *Id.* at 874-75. The best evidence of this twin failure, according to Colombo, is "donations by more than a de minimis number of individuals to a given entity. Where neither the private markets nor the government supplies a good or service at an optimum level of production, high-demanders have no choice but to donate to the supplying entity to encourage more production." *Id.* at 876. Exemption is deserved only when donations constitute a prescribed minimum percentage of the nonprofit organization's total support, e.g., 10 to 33% in the case of educational institutions. The donative theory, according to Colombo, is "the key to an objective, administrable standard for granting exemption." *Id.* at 873-74.

Colombo's theory raises several questions. Why is not the public's purchase of nonprofit organizations' "related" goods and services also an indication of this twin failure? What would happen to the required minimum charitable donation percentage if a flat tax eliminating a deduction for charitable contributions were adopted? Will the minimum required charitable deduction percentage cause charitable organizations to allocate an undue percentage of their budget to fundraising? Colombo asks: "Would Harvard really go out of business if it were not tax exempt?" *Id.* at 867. Why not ask the same question in cases where donations constitute 33% of a university's total support, indicating, in Colombo's view, that the university deserves exemption?

More fundamentally, Colombo is compelled to quantify the standard for exemption because he erroneously tests what he calls the "community benefit theory" against specific nonprofit charitable organizations rather than against the nonprofit, charitable sector as a whole. See *id.* at 864-68. The "community benefit theory" justifies the exemption as the result of two assumptions: (1) private enterprise cannot be relied upon to meet the public needs enumerated in § 501(c)(3); and (2) the shift in revenue and power from the charitable sector

suggest that the federal government should not concomitantly devote its financial resources to the meeting of public needs and the resolution of essential social issues.

III. THE PROBLEM OF UNFAIR COMPETITION AND ITS RESOLUTION: TAX THE INCOME DESTINED FOR CHARITY OR DISTRIBUTE THE TAX WITH THE INCOME?

A. *Bath Houses, Noodles and Piston Rings in the Service of Charity*

In the year 1913, the income of the legal representative of an ancient religious order located in the Philippines consisted primarily of rents from its real estate holdings, dividends from stocks, interest on loans, and negligibly of proceeds from the sale of wine, chocolate, and other articles.²⁶ Stipulating that the legal representative was an exempt charitable organization organized and operated under the predecessor of section 501(c)(3) and that its income was used exclusively to carry out its religious, charitable, and educational work, the tax collector argued nonetheless that the organization was operated

to the federal government implicit in the repeal of the exemption would be an undesirable encroachment upon the form of decentralized power as it developed in the United States. Thus, the "special qualities" or "special ethic" that Colombo seeks can be found in the private, nonprofit, charitable sector as a whole rather than in any particular organization. As an initial matter, a particular nonprofit organization "deserve[s]" the exemption if it is organized and operated primarily to further one or more of the activities enumerated in § 501(c)(3) and complies with the section's additional requirements. *Id.* at 865.

Whether a particular organization is in fact being operated primarily to further its stated purposes, or is in violation of a prohibited rule, is quite another matter that needs to be addressed by compliance procedures. It is also another matter whether Treasury Regulations are sufficiently precise (or an appropriate expression of social policy) in their attempt to delimit the scope of activities that fall within the broad classifications enumerated in § 501(c)(3). It can also be questioned whether the Treasury Department should be the agency issuing the regulations, or whether the Internal Revenue Service should be the agency interpreting the regulations and enforcing compliance.

Rather than audit a particular exempt organization to determine whether it is being operated primarily to further its stated purposes, or is in violation of a prohibited rule, Colombo prefers, and attempts to formulate, a quantitative test for granting and maintaining the exemption to be applied on an entity-by-entity basis. See Colombo, *supra* note 2, at 873-87. But see Richard Steinberg, "Unfair" Competition By Nonprofits and Tax Policy, 44 *Nat'l Tax J.* 351, 361-62 (1991):

The burden of proof should not fall upon each individual [nonprofit] to justify its exemption. [Nonprofit]s innovate and experiment, and not every experiment is a success. Successful innovations (such as day care, hospitals, drug-addiction therapy, and universities) have often been picked up by government or for-profits after [nonprofits] have demonstrated their viability; "inefficient" subsidies may be the price we have to pay for the next breakthrough.

26. See *Trinidad v. Sagrada Orden*, 263 U.S. 578, 579-80 (1924).

also for business purposes and that it should pay tax on the income from its commercial activities.²⁷ The tax collector lost in both the trial and appellate courts.²⁸ The Supreme Court affirmed in *Trinidad v. Sagrada Orden*.²⁹ The case is notable for its governing principle, one that would prevail for the next twenty-four years: the destination, not the source, of the income of a corporation organized and operated exclusively for religious, charitable, scientific or educational purposes is the ultimate test of exemption.³⁰ Charitable activities, the Court observed, cannot be carried on without money.³¹ "Evidently," said the Court, "the exemption is made in recognition of the benefit which the public derives from corporate activities of the class named, and is intended to aid them when not conducted for private gain."³²

If *Trinidad* left any doubt as to whether the destination of income principle applied to a full-blown business operated for the benefit of a charitable organization, the confusion was dispelled by the Second Circuit in *Roche's Beach, Inc. v. Commissioner*.³³ Roche's Beach, Inc. was a feeder corporation organized to operate a bathing beach business and to turn over its profits to a tax-exempt charitable foundation for the relief of destitute women and children.³⁴ The business, operated by 34 employees during the summer, consisted of 3000 bath houses to be rented to transient bathers, plus suit and towel rentals, restaurant and refreshment concessions, and other property rentals.³⁵ Citing *Trinidad*, the Court held that a feeder corporation was exempt from income tax even though it conducted business activities for profit and did not itself engage in charitable endeavors.³⁶

In 1947, a New York University School of Law alumni group orchestrated the purchase of C.F. Mueller Company, one of the country's leading noodle manufacturers, for the benefit of the School of Law.³⁷ The group organized a Delaware corporation for the "charitable" purpose of operating the noodle business and distributing its dividends to the University for the benefit of the School of Law, a tax-exempt educational institution.³⁸ The Delaware corporation borrowed \$3,550,000 under a 15-year loan from the Prudential Insurance Company, purchased all of the outstanding stock of the

27. Id. at 580-81.

28. Id. at 579.

29. Id. at 578.

30. Id. at 581.

31. Id.

32. Id. For an analysis of the case, see Finkelstein, *supra* note 19, at 453-57.

33. 96 F.2d 776 (2d Cir. 1938).

34. Id. at 776-77.

35. Id. at 777.

36. Id. at 779. For an analysis of the case, see Finkelstein, *supra* note 19, at 457-59.

37. C.F. Mueller Co. v. Commissioner, 190 F.2d 120, 120-21 (3d Cir. 1951).

38. Id.

existing taxable New Jersey company for \$3,495,057.60 and then merged the Delaware corporation into itself.³⁹ The Internal Revenue Bureau challenged the tax exemption of the feeder corporation; but the Third Circuit reversed the Tax Court, which had found for the Commissioner, because the Court of Appeals could not distinguish the case from *Roche's Beach*.⁴⁰ Although it was by no means the largest of the acquisitions of taxable businesses for the benefit of a tax-exempt charitable organization, the purchase of a well-known noodle company engineered by benefactors of the N.Y.U. School of Law was perhaps the most notorious. Furthermore, it served as an alarming example for those who were becoming concerned with the rapidity with which tax-exempt organizations, especially colleges and universities, were entering the world of commercial enterprise.

In point of fact, the purchase of C.F. Mueller Company was but one of four acquisitions on behalf of New York University over a relatively few years. The other three were Howes Leather Company, valued at \$35,000,000; American Limoges China, Inc., valued at \$3,300,000; and the Ramsey Corporation, manufacturer of piston rings, valued at \$3,000,000.⁴¹ On December 13, 1948, *The New York Times* ran a story entitled "University Dollars Yielding Tax-Free Business Profits," in which it was reported that other types of businesses had been acquired for the benefit of various educational institutions across the country, including a cattle ranch, an English walnut grove, filling stations, a street car company, a citrus grove, and an airport.⁴²

By far the most widespread practice that had developed during the post-World War II era, however, was the acquisition of commercial real estate by colleges and universities, hundreds of millions of dollars worth of

39. *C.F. Mueller Co. v. Commissioner*, 14 T.C. 922, 923-24 (1950), rev'd, 190 F.2d 120 (3d Cir. 1951).

40. *C.F. Mueller*, 190 F.2d at 121-23, rev'g 14 T.C. 922 (1950); cf. *Willingham v. Home Oil Mill*, 181 F.2d 9 (5th Cir.), cert. denied, 340 U.S. 852 (1950) (corporation originally organized as for-profit entity and later reorganized as not-for-profit held to be tax-exempt); but cf. *Universal Oil Prods. Co. v. Campbell*, 181 F.2d 451, 465 (7th Cir.) (for-profit corporation reorganized into "research fund" trust held to be not tax-exempt), cert. denied, 340 U.S. 850 (1950).

41. See House Hearings of 1950, supra note 8, at 780, 799 (statement of Solomon Barkin).

42. Benjamin Fine, *University Dollars Yielding Tax-Free Business Profits*, *N.Y. Times*, Dec. 13, 1948, at A1, A29. The *Times* article was one of a number of articles publicizing the perceived abuse of the tax exemption. Two years later, both the House Committee on Ways and Means and the Senate Committee on Finance held hearings. House Hearings of 1950, supra note 8; Senate Hearings of 1950, supra note 8; see also Comment, *Colleges, Charities, and the Revenue Act of 1950*, 60 *Yale L.J.* 851, 851 (1951) ("[Congress, however,] lacked precise information . . . regarding the extent to which exempt organizations are operating commercial enterprises."); Note, supra note 1, at 698-700 (providing examples of "criticized activities of educational institutions").

properties that included the real estate of the country's largest department store chain, warehouses, shopping centers, office buildings, and apartment houses.⁴³ Most often, the purchased property was leased back to the seller under a long-term lease. In many cases the educational organization borrowed the entire purchase price for the property and amortized the loan with the tax-free rental income received from the vendor-lessee.⁴⁴ In its report accompanying the bill to enact the Revenue Act of 1950, the House Committee on Ways and Means commented: "The purchase and lease-back arrangement apparently is of recent origin. Nevertheless, it has already become big business and a recent writer has characterized it as 'the most noteworthy, financial device of the present century.'"⁴⁵

B. *The Revenue Act of 1950*

In his message to Congress in 1950, President Truman noted that "[s]ome tax loopholes" had emerged "through the abuse of the tax exemption accorded educational and charitable organizations."⁴⁶ It was not his purpose, said President Truman, to change the policy supporting the exemption. Rather, his concern was that "an exemption intended to protect educational activities [had] been misused in a few instances to gain competitive advantage over private enterprise through the conduct of business and industrial operations entirely unrelated to educational activities."⁴⁷ President Truman urged Congress to close the tax loopholes as part of his plan "to improve the fairness of the tax system, to bring in some additional revenue, and to strengthen [the] economy."⁴⁸

Congress responded by including three measures in the Revenue Act of 1950, designed to curb the perceived abuse of the tax exemption. Effective for taxable years beginning after December 31, 1950, the predecessors to Code sections 511-513 imposed the regular corporate income tax⁴⁹ on the taxable income (gross income less directly connected deductions) of any trade or business regularly carried on⁵⁰ by certain tax-exempt organizations, "the conduct of which is not substantially related (aside from the need of such organization[s] for income or funds or the use [they make] of the profits derived) to the exercise or performance by such organization[s] of [their]

43. Fine, *supra* note 42, at A29.

44. See H.R. Rep. No. 2319, 81st Cong., 2d Sess. 38 (1950).

45. *Id.*

46. 96 Cong. Rec. 769, 771 (1950) (message from the President to the United States).

47. *Id.*

48. *Id.* at 769.

49. See IRC § 511(a)(1). The individual income tax rate was imposed on the unrelated business income of certain tax-exempt trusts. See IRC § 511(b)(1).

50. See *infra* note 124 and accompanying text.

charitable, educational, or other purpose or function constituting the basis for [their] exemption.”⁵¹ Included among the organizations subject to the new tax were religious, charitable, scientific, literary, and educational organizations, and organizations established for the prevention of cruelty to children or animals; but excluded were churches, their integrated auxiliaries, and conventions or associations of churches.⁵²

Also excluded from the reach of the tax on unrelated trade or business was “passive” investment income received by section 501(c)(3) organizations, i.e., all dividends, interest, annuities, royalties (including overriding royalties) whether measured by production or by gross or taxable income, rents from real property (including personal property leased with real property), except certain rents on property acquired with borrowed funds, and gains or losses from the disposition of property other than inventory or property held primarily for sale to customers in the ordinary course of the trade or business.⁵³ A 5% (of unrelated business net income) charitable contribution deduction was allowed in computing the taxable income of the unrelated trade or business, provided the contribution was not made to the organization operating the unrelated business.⁵⁴ A \$1,000 specific deduction was allowed in order to eliminate de minimis cases involving excessive costs of collection and payment.⁵⁵

Under the second measure included in the Revenue Act of 1950, the predecessor to Code section 502, a feeder organization operated for the primary purpose of conducting a trade or business for profit was no longer

51. IRC § 513(a) (formerly IRC §§ 421, 422).

52. See IRC §§ 511(a)(2) (formerly § 421(b)), 501(a), (c)(3), 508(c)(1)(A). Also subject to the tax were certain other categories of exempt organizations, including labor, agricultural, and horticultural organizations and business and trade associations. See *id.* § 501(c)(5)-(6). For a more detailed discussion of the judicial and regulatory developments prior to 1950, and the legislative history of the 1950 Act, see Comment, *supra* note 42. See also John H. Myers, *Taxing the Colleges*, 38 *Cornell L. Rev.* 368 (1953); Kenneth C. Eliasberg, *Charity and Commerce: Section 501(c)(3)—How Much Unrelated Business Activity?*, 21 *Tax L. Rev.* 53 (1965); Liles & Blum, *supra* note 2, at 41-48.

53. See IRC § 512(b)(1)-(5) (formerly § 422(a)). IRC § 512(b)(7)-(9) excludes all income derived from research: for the United States or any of its agencies or instrumentalities, or any state or political subdivision; performed by a college, university, or hospital; or performed by an organization operated primarily for the purpose of carrying on “fundamental” research benefitting the general public. See *id.* § 512(b)(7)-(9) (formerly § 422(a)(7)-(8)(B)). For a discussion of the exclusion for research, see Myers, *supra* note 52, at 381-84.

54. See IRC § 512(b)(10) (formerly § 422(a)(9)(A)). The charitable contribution deduction currently allowed is 10%. *Id.* The requirement that the contribution be made to another charity can be traced to the House and Senate Reports of the Revenue Act of 1950. See H.R. Rep. No. 2319, *supra* note 44, at 111; S. Rep. No. 2375, 81st Cong., 2d Sess. 109 (1950), reprinted in 1950 U.S.C.C.S. 3053.

55. See IRC § 512(b)(12) (formerly § 421(c)).

exempt from income tax on the ground that all of its profits were payable to one or more tax-exempt organizations.⁵⁶

Under the third measure, the predecessor to Code section 514, designed to combat the "lease-back problem," rental income received by a 501(c)(3) organization from the lease of real property for more than five years (including options to extend) was subject to the new tax if, at the close of the lessor's taxable year, there existed unpaid debt incurred by the lessor in acquiring or improving the leased property.⁵⁷ The amount of such rent included in the gross income of the tax-exempt organization was the same proportion of the total rent received during the taxable year as the amount of the borrowed funds at the end of the year bore to the adjusted basis of the property at the end of the year.⁵⁸ A proportionate amount of real property taxes paid during the taxable year with respect to the leased property, interest paid on the debt, and depreciation were allowed in computing the net income from the lease.⁵⁹ The tax applied whether or not the vendor of the property to the exempt organization and the lessee were the same person.

C. *Unfair Competition: The Rationale For the Tax on Unrelated Business Income*

1. *Unfair Competition for Market Share.*—As explained by the House Committee on Ways and Means, the problem that had developed which necessitated the imposition of the tax on unrelated business income of certain otherwise exempt organizations, as well as the elimination of the exemption of feeder organizations, was primarily one of unfair competition; i.e., such businesses were in direct competition with their taxable counterparts: "The tax-free status of these [501(c)(3)] organizations enables them to use their profits tax-free to expand operations, while their competitors can

56. See IRC § 502 (formerly § 101). Educators testifying before Congress did not resist this measure, but vigorously opposed taxing unrelated businesses operated directly by educational institutions. See Comment, *supra* note 42, at 876-77 n.112; Myers, *supra* note 52, at 375. At the same time, the consensus of educators was that their institutions should refrain from engaging in commercial enterprises. See Comment, *supra* note 42, at 877 n.112.

57. See IRC § 514 (formerly § 423).

58. See IRC § 514(a)(1). Assume, for example, that an educational institution purchased property for \$500,000 and leased it for a period of 20 years, and the adjusted basis of such property at the close of the first taxable year was also \$500,000. If the institution borrowed \$200,000 to acquire the property, because this is two-fifths of the adjusted basis, two-fifths of the rental income received from the leased property would enter into the computation of unrelated business net income. If, in a subsequent year, the indebtedness were reduced to \$100,000, assuming the adjusted basis were still \$500,000, one-fifth of the rental income would be included as an item of gross income in computing the unrelated business net income. *Id.*

59. See *id.* § 514(a)(2), (3) (formerly § 423(d)(3)).

expand only with the profits remaining after taxes.”⁶⁰ In confining the scope of the new tax to unrelated business income, Congress chose to leave the basic exemption of the 501(c)(3) organization intact and did not restrict such organizations’ rights to acquire and operate businesses unrelated to their charitable purposes. Only if operating a business for profit became an organization’s primary activity would there be a danger of losing the underlying exemption.⁶¹

The problem thus stated by the House Committee on Ways and Means underplayed the extent of the concern making its way through the Congress of 1950. To illustrate the extent of the perceived problem, assume that a well-recognized university invests one million dollars of its endowment fund by purchasing all of the stock of an ice cream manufacturing corporation. The corporation merges into a new corporation designed to turn over all of its profits to the university, and the new corporation is exempt from corporate income tax under the *Trinidad* “destination of income” test. Assume for purposes of this discussion that taxable income equals cash profit and that both the corporate and individual income tax rates are 35%. If both the feeder organization and a taxable corporate competitor owned by taxable shareholders earn \$100x profit for the taxable year from the sale of ice cream of comparable quality, the feeder obviously has the ability to retain \$35x more than its taxable competitor after the latter’s payment of the corporate income tax. If both the feeder and the competitor are passthrough entities or unincorporated businesses, the feeder still has the ability to retain \$35x additional profit because its university owner is tax-exempt, whereas the competitor presumably will be required to distribute \$35x to the taxable investors to cover their tax on the passed-through income.

60. H.R. Rep. No. 2319, *supra* note 44, at 36. The rationale for exempting § 501(c)(3) organizations from tax also served to justify the continued exemption of related businesses, even though they might compete with taxable entities. See Note, *The Macaroni Monopoly: The Developing Concept of Unrelated Business Income of Exempt Organizations*, 81 Harv. L. Rev. 1280, 1284 (1968) [hereinafter *The Macaroni Monopoly*].

61. Regs. § 1.501(c)(3)-1(e)(1) states:

An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization’s exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513.

For discussion of the potential threat business activity poses to the § 501(c)(3) exemption itself, see Eliasberg, *supra* note 52; Norman A. Sugarman & Harlan Pomeroy, *Business Income of Exempt Organizations*, 46 Va. L. Rev. 424 (1960); Comment, *Preventing the Operation of Untaxed Business By Tax-Exempt Organizations*, 32 U. Chi. L. Rev. 581 (1965); Note, *Profitable Related Business Activities and Charitable Exemption Under Section 501(c)(3)*, 44 Geo. Wash. L. Rev. 270 (1976).

The feeder has several options with respect to its \$35x additional profit. It can temporarily reduce or eliminate the additional profit by selling at a lower price the same quality ice cream as sold by the taxable competitor.⁶² It can maintain its price and allocate the \$35x to research and development, invent a better ice cream, and sell the improved product at the same price as the taxable competitor's product. It can retain the \$35x to tide it over in difficult times. Or it can spend the additional \$35x to modernize production facilities, expand marketing efforts, or improve distribution systems. Accordingly, there is the potential that the exempt feeder will be able to eat into the profits of its taxable competitor, or drive the competitor out of business altogether. The feeder, in fact, may be able to increase market share enough to eat into the profits of several taxable competitors, and perhaps even corner the ice cream manufacturing market by driving all of its tax-paying competitors out of business. If one tax-exempt unrelated business of one university has the potential to accomplish this economic feat, think of what hundreds of tax exempt unrelated businesses of hundreds of universities could do to their taxable competitors. The free enterprise system would move to the top of the list of endangered species.⁶³

62. Commentators disagree as to whether income tax has an impact on the price of a product. See Comment, *supra* note 42, at 876 (noting that the exempt organization's advantage declines proportionately as prices are cut lower and lower); Comment, *supra* note 61, at 591 ("Yet under competitive conditions all firms in an industry produce until the cost of another unit of output equals the additional revenue it will bring. Because an income tax is levied only on profits, it will not be relevant in determining when that equalization point is reached."); The Macaroni Monopoly, *supra* note 60, at 1281 (describing how an exempt organization might win a price war by driving taxable competitors' return on investment so low that investors would restrict their investments to fields in which there were no tax-exempt players; however, a number of factors make such a price war unlikely); Klein, *supra* note 15, at 64-65 (arguing that it is unlikely that feeders will lower prices to drive out competition); Richard L. Kaplan, *Intercollegiate Athletics and the Unrelated Business Income Tax*, 80 *Colum. L. Rev.* 1430, 1465-66 (1980) (§ 501(c)(3) organizations, typically pressed for current income, are unlikely to cut prices to drive out competition). But see Finkelstein, *supra* note 19, at 460:

Profit itself, we are told, enters into the determination to undertake enterprises and is an element in the determination of prices; and if such be the case, it is obvious that a tax levy on profits would be an important element in the consideration of the price structure, and the exemption from the income tax would be a substantial benefit to a competitor.

See Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 *Stan. L. Rev.* 1017, 1023 (1982) (in either a competitive market or an oligopolistic industry the presence of nonprofits could lower prices).

63. Some commentators find this scenario overly simplistic. See Rose-Ackerman, *supra* note 62, at 1022-38 (maintaining that tax-exempts may or may not have an unfair advantage over their taxpaying competition, depending on such factors as the efficiency of capital markets, excessive entry of nonprofits into an industry, the degree to which the business

The basic premise of this scenario is that the exempt feeder will retain all or a part of the additional \$35x profit and reinvest it in business operations or lower prices to the detriment of its taxable competitor. The Commissioner stipulated in *Roche's Beach*, however, that any excess of income over expenses earned by the feeder in that case was in fact turned over to the foundation for its charitable purposes.⁶⁴ Assume that the feeder in the above example distributes its \$100x profit to the university rather than reinvesting any part of it in business operations and the university uses the distributed amount to conduct its educational activities, i.e., does not directly or indirectly reinvest an equivalent amount of cash or property back into the feeder. Having distributed its additional \$35x profit to its university owner, the feeder is no longer in a position to compete unfairly with its taxable competitor for market share. If the feeder were *required* to distribute its entire profit to the university for its educational purposes, the taxable competitor would now in fact be in a position to compete unfairly with the feeder, i.e., the taxable competitor would have available \$65x more than the feeder to reinvest in business operations.

Alternatively, assume that the feeder is required to distribute to the university for its educational purposes only an amount equal to the tax liability of its taxable competitor ("tax equivalent amount"), i.e., \$35x. Although neither business appears at first glance to have retained a competitive advantage over the other, subsequent dynamics could swing the advantage back to the feeder. The feeder, for instance, would regain an advantage if the taxable competitor was impelled to distribute a dividend to its shareholders, e.g., \$15x. In that case the feeder would have available \$65x retained income for business operations compared to the taxable competitor's

activities of nonprofits are diffused, the exit costs faced by taxable businesses from an industry, the foreseeability of nonprofit competition at the time the taxable entity entered the industry, and the degree to which taxable oligopolists are already earning super competitive profits in an industry). The author concludes that the tax on unrelated businesses of nonprofits caused their profitable activities to be concentrated into areas deemed related, which concentration allowed them to inflict losses on their taxpaying competition. *Id.* at 1038. But, why is this undesirable? Presumably, Congress sanctioned the competitive advantage related businesses enjoyed with respect to their taxpaying competition in recognition of the unique role played by the private, nonprofit charitable sector in American society. See *The Macaroni Monopoly*, *supra* note 60, at 1282 ("Even in an industry with inelastic demand the untaxed business will be able to invest in improvements at a faster rate than its competitors."); Klein, *supra* note 15, at 61-64 (Congress "responded to a paranoid delusion" when it bought the unfair competition argument because (a) allowing a feeder to go untaxed will not affect the economic behavior of either the feeder or its taxable competition, (b) investors in a taxable competitor will not shift investments to the feeder because they would have to give their assets to charity to do so, and (c) the feeder will not be induced to expand because the taxable competitor's supply to the market will not decline.).

64. *Roche's Beach, Inc. v. Commissioner*, 96 F.2d 776, 777 (1938).

\$50x (after payment of a \$35x tax to the government and a \$15x distribution to shareholders). In order to eliminate its potential competitive advantage, the feeder would have to distribute to the university not only a tax equivalent amount, but also an additional amount approximating an adequate return on investment to the shareholders of the taxable competitor.

Assume that the feeder is required to distribute to the university both a tax equivalent amount plus an amount representing an adequate return on investment. The university would be in a position to regain its competitive advantage by directly or indirectly reinvesting the tax equivalent amount back into the feeder as a capital contribution or loan. A statutory provision would have to be devised to prevent such a reinvestment. Further, with the university receiving a greater return on investment than the shareholders of the taxable competitor (equal to the tax equivalent amount), the feeder would be in the position to lower its prices and still have the ability to distribute to the university a greater return on investment than could its taxable competition. A further statutory provision, therefore, would have to be devised to insure that the feeder maintained competitive prices.

2. *Capital Market Competition at the Investor Level.*—Apart from the fear of the 1950 Congress that unrelated businesses operated by 501(c)(3) organizations had the potential to compete unfairly with their taxable competitors for market share, was there concern as well with the potential that such tax-exempt organizations were in a position to compete unfairly as investors in the capital markets even if competition for market share at the operational level were made fair?

As explained by the House Committee on Ways and Means, dividends, interest, royalties, rents (other than on property acquired with borrowed funds), and gains on sales were not subject to the tax on unrelated business income because investments producing such "passive" income used for exempt purposes had "long been recognized as proper for educational and charitable organizations."⁶⁵ Furthermore, explained the Senate Committee on Finance, because such types of income are passive in character they "are not likely to result in serious competition for taxable businesses having similar income."⁶⁶

65. H.R. Rep. No. 2319, *supra* note 44, at 38.

66. S. Rep. No. 2375, *supra* note 54, at 30-31, reprinted in 1950 U.S.C.C.S. at 3083. For cases dealing with the "active" versus "passive" income issue, see *Disabled Am. Veterans v. Commissioner*, 942 F.2d 309 (6th Cir. 1991), *rev'g* 94 T.C. 60 (1990); *Fraternal Order of Police, Illinois State Troopers v. Commissioner*, 833 F.2d 717 (7th Cir. 1987), *aff'g* 87 T.C. 747 (1986); *Disabled Am. Veterans v. United States*, 650 F.2d 1178 (Ct. Cl. 1981); *National Collegiate Athletic Ass'n v. Commissioner*, 92 T.C. 456 (1989), *rev'd on other grounds*, 914 F.2d 1417 (10th Cir. 1990); *National Water Well Ass'n v. Commissioner*, 92 T.C. 75 (1989); See also Rev. Rul. 81-178, 1981-2 C.B. 135.

Two conclusions can be drawn from the Committee explanations. First, by creating an artificial distinction between active and passive investments and by categorizing rent received from the lease of real property as passive, the 1950 Congress presumably was unconcerned that an exempt organization's tax free rental income could put it in a position to compete unfairly in the rental market by lowering the rent, improving the property, or paying a higher purchase price for additional real property than could be offered by a taxable investor. Nor was there apparent concern that the combination of tax-free current income and freedom from capital gains tax on an eventual sale of the real property could put the exempt organization in a position to accept a lower sales price.⁶⁷

The second conclusion is that the 1950 Congress was unconcerned that a 501(c)(3) organization's exempt dividends, interest, and capital gains could put it in a position to compete unfairly as an investor in the capital markets by either driving the rate of return down or by outbidding taxable investors for the investment.⁶⁸

67. See Thomas J. Gallagher, III, *The Taxation of Investments By Pension Funds and Other Tax-Exempt Entities*, 67 *Taxes* 981, 990 (1989) ("In Rev. Rul. 69-574 and later in Rev. Rul. 78-88, the IRS supported an 'active' versus 'passive' analysis for determining whether a given level of activity constituted a trade or business for purposes of calculating an entity's UBTI."); see Bittker & Rahtert, *supra* note 13, at 319 ("Moreover, the labels 'active' and 'passive' were accepted as though they denoted self-defining and clear-cut compartments, although in fact the spectrum of profit-oriented activity is not readily bisected.").

68. See Bittker & Rahtert, *supra* note 13, at 319.

Equally mysterious was the unarticulated but widely accepted assumption that charities would compete unfairly with their taxable rivals in "active" manufacturing and mercantile pursuits, but not in "passive" investment areas. No one suggested, for example, that charities would lend their endowment funds or rent their real estate for less than the going rate, and thus drive private investors in these areas out of business. . . . Nor was there any discussion of the possibility that, if charities increased their ownership of active business enterprises, they would correspondingly reduce their ownership of marketable securities and other passive investments and, hence, compete less vigorously with taxable investors for these assets.

Bittker & Rahtert, *supra* note 13, at 319.

For the view that there was no clear rationale for exempting "passive" income, see Kaplan, *supra* note 62, at 1466 ("Thus, the unrelated business income tax lacks a consistent economic underpinning. Rather, it is a political compromise that keeps certain customary sources of income—interests, dividends, rents, and the like—tax-free and eliminates the perceived tax advantages of actively conducting 'unrelated' commercial operations."). See also Note, *supra* note 1, at 705-706; Gallagher, *supra* note 67, at 989-92 (mentioning several alternative theories to support the full or partial exemption of investment income received by § 501(c)(3) organizations: (1) inasmuch as contributions to such organizations are deductible and thus excluded from the tax base, the investment earnings from the contributions should be excluded as well; (2) if a portion of a contribution is not deductible, the same proportion

Thus, although both an incorporated feeder and its incorporated competitor are required to pay corporate income tax subsequent to the Revenue Act of 1950, the 501(c)(3) organization, unlike the taxable shareholders of the competitor, is in a position to receive dividends from the feeder tax-free and to sell its shares of stock in the feeder free of capital gains tax. Similarly, although the section 511 tax imposed by Congress on the income of an unincorporated, unrelated business conducted by a 501(c)(3) organization, or by a wholly-owned pass-through entity, prevented the 501(c)(3) organization from receiving larger distributions of tax-free current income from the business for nonbusiness use than could be received by a taxable investor, the charity was still in a position to realize a higher total return on the investment by eventually selling the noninventory assets of the unrelated business free of capital gains tax.

Assume that the 1950 Congress had elected to level the playing field for market share competition by requiring the feeder to maintain competitive prices and by affording the feeder an option to distribute a tax equivalent amount plus an amount representing an adequate return on investment to the 501(c)(3) organization for its exempt purposes as an alternative to the imposition of the corporate tax. If the feeder in the previous example receives \$100x taxable income from the sale of ice cream and distributes to the university for its educational purposes a tax equivalent amount of \$35x plus an additional \$15x representing an adequate return on investment, the university would receive the entire \$50x undiminished by tax. On the other hand, the taxable shareholders of the competitor who receive an equivalent \$15x return on investment in the form of a dividend would, in the assumed 35% tax bracket, retain only \$9.75x. Had the feeder been required to pay federal income tax and had both the feeder and its taxable competitor declared a \$15x dividend, the exempt university would have retained \$15x of the dividend and the taxable shareholders of the competitor would have retained \$9.75x.

Alternatively, assume that in lieu of the section 511 tax, an unrelated business wholly-owned by a 501(c)(3) organization or conducted through a

of investment earnings therefrom should not be excluded; (3) citing George Break & Joseph A. Pechman, *Relationship Between the Corporation and Individual Income Taxes*, 28 *Nat'l Tax J.* 341, 344 (1975), a moderate tax on investment income would "reduce their ability to finance activities not directly supported by the public"; (4) citing Hansmann, *supra* note 16, the exemption promotes efficiency in areas underserved by the private sector and compensates for nonprofits' lack of access to equity capital). "The contrary argument, that the earnings should be exempt because they are used in furtherance of the entity's exempt purpose recalls the destination of income test rejected in the 1950s legislation." Gallagher, *supra* note 67, at 991. It is the position of this article that Congress should have been able to live with the destination of income test had the problem of unfair competition been resolved through distribution of the tax on feeders and unrelated businesses to the § 501(c)(3) organization for its exempt purposes.

wholly-owned pass-through entity is afforded the same option to maintain competitive prices, and to distribute a tax equivalent amount plus an amount representing an adequate return on investment to the exempt organization for its charitable purposes. If both the unrelated business and the competitor owned by taxable investors earn \$100x taxable income for the taxable year from a sale of ice cream of comparable quality and both distribute \$50x to their respective owners, the university will retain the entire \$50x undiminished by tax and the taxable investors of the competitor will retain \$15x after payment of a \$35x tax. Had the section 511 tax been imposed on the university with respect to its unrelated business taxable income, both investors would have retained \$15x. Thus, whether the ice cream business is operated through an incorporated feeder or as a directly owned unrelated business, allowing the university to retain a tax equivalent amount as an alternative to a tax payment to the government increases its return on investment in the above example by \$35x over what it could receive under the current statute.

While the 1950 Congress may have been unconcerned that a 501(c)(3) organization's traditional portfolio income consisting of dividends, interest, and capital gains could put the organization in a position to compete unfairly as an investor in the capital markets, clearly an increased disparity in current return on investment equal to the tax equivalent amount was not factored into the equation. Little, in fact, would be accomplished by removing the potential for unfair competition for market share at the operational level only to discover an enhanced potential for unfair competition has turned up at the investment level. An additional statutory provision would have to be devised, therefore, to insure that the tax equivalent amount, optionally distributed by the unrelated business to the university as part of a plan to eliminate the business's potential for unfair competition for market share, was used to fund the university's exempt activities rather than used to augment its portfolio of investments. If such additional yield were in fact used to operate the organization's exempt activities, rather than to reinvest back into the unrelated business or add to the endowment fund, the exempt organization's substantially higher return on its investment should be viewed as no more unfair than the organization's underlying tax exemption itself.

3. *Loss of Federal Tax Revenue.*—The House Committee on Ways and Means intended the Revenue Bill of 1950 to reduce substantially war excise taxes that had been in effect since World War II. It was anticipated that the new tax on feeder organizations and on the unincorporated unrelated businesses conducted by certain 501(c)(3) organizations would partially compensate for the loss of revenue. By the time the Bill reached the Senate, the breakout of war in Korea converted this tax legislation into one to raise

revenue to meet an increased defense budget.⁶⁹ Thirty years later courts were still debating the importance of the revenue raising aspect of the new tax, relative to the goal of preventing unfair competition.⁷⁰

The framers of the Revenue Act of 1950 predicted that the tax on unrelated business would generate annual revenues of \$100 million.⁷¹ In its first year of operation the tax raised thirty seven dollars.⁷² By 1985 tax collections had risen to \$39 million;⁷³ by 1990, to \$128 million;⁷⁴ and for the government's fiscal year ending September 30, 1995, to \$294,336,706.⁷⁵ This last figure consists only of tax collections with respect to unrelated businesses reporting on IRS Form 990-T. The figure does not include tax collections with respect to separately incorporated feeders reporting on the regular corporate income tax return, Form 1120, or with respect to "unrelated" joint ventures reporting on the partnership return, Form 1065. The figure, therefore, is an understated amount. The figure may not reflect taxable income derived from unrelated businesses on a composite basis for the additional reason of poor compliance.

Whatever immediate additional revenue was anticipated through imposition of the new tax, of graver concern to the 1950 Congress was the potential future erosion of the tax base if the feared expansion of operations by feeders and unrelated businesses through unfair competition was not put in check.⁷⁶ No Congressional study was published, however, to determine

69. S. Rep. No. 2375, *supra* note 54, at 1, reprinted in 1950 U.S.C.C.S. at 3053.

70. See *infra* p. 444.

71. See George Cooper, *Trends in the Taxation of Unrelated Business Activity*, 29 N.Y.U. Inst. on Fed. Tax'n 1999, 2019 (1971).

72. *Id.*

73. Steinberg, *supra* note 25, at 352.

74. *Id.*

75. Telephone Interview with Peggy Reilly, Office of Taxpayer Services, Internal Revenue Service (May 21, 1996).

76. H.R. Rep. No. 2319, *supra* note 44, at 39; see also House Hearings of 1950, *supra* note 8, at 580 (testimony of Rep. Dingell) ("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.").

When the 1950 legislation was proposed, there was some fear that the acquisition of taxable business enterprises by tax-free feeder corporations would narrow the federal tax base, but this danger seems, in retrospect, overstated if not wholly erroneous. This is because the sellers of the business would presumably reinvest the proceeds of the sale in new enterprises, marketable securities, rental real estate, etc., which would produce a taxable yield to restore the status quo ante. The charitable organization purchasing the enterprise, for its part, would shift its investment from assets producing tax-free dividends, interest, and rent to equally tax-free business profits.

Bittker & Rahdert, *supra* note 13, at 320.

whether and to what extent feeders and unrelated businesses were in fact reinvesting their profits back into the business as opposed to distributing them to the owner 501(c)(3) organizations for their charitable purposes.⁷⁷ Nor was there any study published to compare the loss of tax revenue resulting from the exemption afforded to feeders and unrelated businesses under the destination of income test (reduced by the potential cost of collecting such revenue) with the cost of the social benefits that were being financed by such exempt business profits.⁷⁸

Suppose feeders and unrelated businesses were offered the option to maintain competitive prices and to distribute a tax equivalent amount plus an amount representing an adequate return on investment to their owner 501(c)(3) organizations to be used exclusively to operate their charitable activities as an alternative to payment of the tax to the government. Would the loss of tax revenue be justified by the social benefits anticipated from the additional distribution to the 501(c)(3) organization? Assuming that statutory safeguards are built into the system to prevent the 501(c)(3) organization from directly or indirectly reinvesting the tax equivalent amount back into the business, the distributing business would no longer be in a position to erode the tax base by expanding with tax dollars that are not available to its competition.

Although unfair competition for market share would be beyond reach, there is always the possibility that a feeder or unincorporated unrelated business would still be able to expand with dollars earned through fair competition and/or the effects of inflation, even after having distributed each

77. Bittker & Rahdert, *supra* note 13, at 319.

78. Several reasons additional to unfair competition and loss of tax revenue were offered to justify taxing feeder corporations and unrelated businesses. Commenting on the "destination of income" test as applied to the commercial activities of colleges and other institutions, Secretary of the Treasury John Snyder, in his testimony before the Committee on Ways and Means, stated: "The correction of present abuses, which shift additional burdens to the rest of the population, becomes essential for reasons of equity." House Hearings of 1950, *supra* note 8, at 19. The comment fails to address the degree to which the untaxed income was being used for charitable purposes. There was also concern that preoccupation of 501(c)(3) organizations with commercial ventures would detract from their exempt purposes. See *The Macaroni Monopoly*, *supra* note 60, at 1283; but see *Unrelated Business Income Tax: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means, 100th Cong., 1st Sess. 208 (1987) (statement of the Independent Sector) [hereinafter UBIT Hearings]* ("The traditional argument that running unrelated businesses diverts attention from charity is a bit threadbare—it is not clear why it is any better to have the board worry about fundraising or portfolio management than an unrelated business."). There should be added to the list of reasons justifying the new taxes: (a) the undue risk § 501(c)(3) organizations might be willing to take with respect to their endowment funds by shifting investment funds to more speculative ventures in the hope of obtaining a higher yield; and (b) the concentration of economic power in colleges and universities. See *Hearings of 1947*, *supra* note 8, at 3528.

year a tax equivalent amount to its 501(c)(3) owner. Such an expansion would result in an increasing amount of tax dollars going to the charity rather than to the government. The C.F. Mueller Company, for example, purchased in August 1947 for \$3,495,407 for the benefit of the School of Law of New York University, was sold in 1976 for \$115 million cash, notwithstanding the fact that it was subject to tax on its taxable income in 26 of those 30 years.⁷⁹ Through the sale of the stock of the noodle company, the University was able to add \$47.5 million to its unrestricted endowment, an increase of 200%, and \$67.5 million to its endowment for the benefit of the Law School.⁸⁰ The ability of any given 501(c)(3) organization to enjoy the benefits of such spectacular growth due to the business acumen or luck of its feeder benefactor operating in the free enterprise world is the result of the very freedom the system affords to charitable organizations. The 1950 Congress did not require exempt organizations to dispose of their unrelated businesses or to pay capital gains tax on their eventual disposition, but merely to pay the same tax on operating income as their profit-motivated competition.⁸¹ It is only due to hit-or-miss fortune that the famous noodle company was acquired for the benefit of a well-recognized law school of a large private university rather than for the benefit of a 501(c)(3) organization that did not already derive support in the marketplace from public contributions, endowment funds resulting from such contributions, or income from the sale of goods or services related to its charitable purpose.

C.F. Mueller Company's taxable income increased from \$962,366.75 for 1946⁸² to \$6.1 million for 1975.⁸³ Had C.F. Mueller Company been afforded the option to pay its tax obligation to New York University for the operating budget of its law school rather than to the government, the increasing loss of tax revenue would have to be weighed against the benefit derived from such revenue's support of educational and legal services delivered by the School, e.g., in the form of more money for need-based scholarships, lower tuition, better research facilities, legal services to the disadvantaged, etc., or simply to meet increasing costs or to offset a decline in contributions (perhaps caused by a change in the tax laws) or diminished investment

79. See *C.F. Mueller Co. v. Commissioner*, 14 T.C. 922, 923 (1950), rev'd, 190 F.2d 120 (1951); William J. Ruane, *NYU to Sell Mueller's for \$115 Million, Law School, University to Share Profit*, Wash. Square News, Sept. 29, 1976, at 1.

80. Ruane, *supra* note 79, at 1.

81. See *United States v. American College of Physicians*, 475 U.S. 834, 838 (1986) ("[I]n the 1950 Act [Congress] struck a balance between its two objectives of encouraging benevolent enterprise and restraining unfair competition by imposing a tax on the 'unrelated business taxable income' of tax-exempt organizations.").

82. *C.F. Mueller Co.*, 14 T.C. at 925.

83. *Foremost Agrees to Buy for Cash C.F. Mueller Co.*, Wall St. J., Sept. 29, 1976, at A10.

income due to market conditions. For instance, New York University itself incurred an operating deficit of \$4.4 million for the taxable year ending August 31, 1975 and a deficit of \$2-\$3 million in the subsequent year.⁸⁴

Assuming feeders and unrelated businesses were afforded the option to maintain competitive prices and to distribute a tax equivalent amount plus an amount representing an adequate return on investment to their owner 501(c)(3) organizations to be used exclusively to operate charitable activities, a number of safeguards in addition to those already mentioned would need to be incorporated into the statutory system. First, although it might be argued that any organization qualifying under section 170(b)(1)(A)⁸⁵ as a "50% type" charity by definition receives most of its financial support from the public and therefore demonstrates its responsiveness to social need, in order to justify the loss of tax revenue to the government, the tax equivalent amount the organization may receive from feeders and unrelated businesses should not exceed a limit based on an acceptable ratio of unrelated business gross receipts to gross receipts generated by public financial support.

Second, both to safeguard the federal revenue and to discourage the 501(c)(3) organization from subjecting more than a certain percentage of its investment portfolio to undue risk by investing in, or accepting as contributions, unrelated businesses or feeders, there would need to be a limit imposed on the tax equivalent amount the 501(c)(3) organization may receive from feeders and unrelated businesses, determined by an acceptable ratio of the organization's basis for its assets used in feeders and unrelated businesses to the tax basis of the total investment portfolio. Third, in order to discourage the 501(c)(3) organization from diverting its attention and energies away from its charitable purposes, there would need to be a prohibition against employees of a 501(c)(3) organization receiving compensation from the feeder or unrelated business.

4. *The Sale-Leaseback Problem.*—Although a 501(c)(3) organization anticipating tax-free rental income from the sale and leaseback of real property appears to be in a position to outbid a taxable competitor for the purchase of the rental building or to charge lower rent on the lease of the property back to the vendor, the 1950 Congress did not act to prevent this potential for unfair rental market or investment competition. Of particular concern to Congress was the practice that had developed among certain

84. Id.

85. IRC § 170(b)(1)(A) includes: (i) churches, (ii) educational organizations, (iii) medical, hospital care, medical education, medical research organizations, (iv) college or university related organizations, (v) governmental units, (vi) a governmentally or publicly supported § 170(c)(2) organization, (vii) a private foundation described in § 170(b)(1)(E), or (viii) a § 509(a)(2) or (3) organization.

exempt organizations of borrowing all or a portion of the purchase price and amortizing the loan with its tax-free rental income from the purchased building. Through this practice the exempt organization was in a position to exploit its competitive advantage over and over again without the use of its own funds. The potential for acquisition was thus unlimited by the size of the exempt organization's existing endowment fund. The practice was attractive to the taxable seller/lessee because of the potential for disposing of fully depreciated property at an inflated price and leasing it back for a low, deductible rent.

As explained by the House Committee on Ways and Means, there were three principal objections to the leveraged lease-back transaction. "First, the tax-exempt organization is not merely trying to find a means of investing its own funds at an adequate rate of return but is obviously trading on its exemption, since the only contribution it makes to the sale and lease is its tax exemption."⁸⁶ The second objection stated:

[I]t is altogether conceivable that if its use is not checked, exempt organizations in the not-too-distant future may own the great bulk of the commercial and industrial real estate in the country. This, of course, would lower drastically the rental income included in the corporate and individual income tax bases. . . . Such acquisitions are not in any way limited by the funds available for investment on the part of the exempt institution. This explains why particular attention should be given to lease-backs which involve the use of borrowed funds. Where an exempt organization uses its own funds, expansion of its property holdings through the lease-back device must necessarily proceed at a much slower pace.⁸⁷

The third objection offered was in fact a reformulation of the first one, i.e., "the exempt organization has in effect sold part of its exemption" by purchasing the property at a higher price than a taxable competitor could pay or by agreeing to lower rent on the leaseback.⁸⁸ A fourth objection, not mentioned in the House Report, might have been the use of the leveraged sale-leaseback transaction to enable an exempt organization to accumulate real estate wealth not measured in any way by such organization's responsiveness to social needs.

86. H.R. Rep. No. 2319, *supra* note 44, at 38-40.

87. *Id.* at 39.

88. *Id.*

Had the 1950 Act afforded the 501(c)(3) organization entering into a leveraged leaseback transaction the option to use a tax equivalent amount to finance activities related to its charitable purpose, with some appropriate mechanism to prevent the use of an equivalent amount to pay principal on the acquisition loan, and with the safeguards previously suggested incorporated into the statutory system, the exempt organization would have lost its advantage over a taxable competitor entering into a similar transaction. With the 501(c)(3) organization paying its tax liability by using an equivalent amount to fund its charitable activities, both the exempt organization and its taxable competitor would enter a sale-leaseback transaction with the prospect of an equal amount of after-tax dollars.

D. *The Tax Reform Act of 1969*

In February of 1953 the shareholders of Clay Brown & Company, a corporation engaged in the sawmill and lumber business, sold all of their stock to the California Institute for Cancer Research for a \$1.3 million dollar noninterest bearing note.⁸⁹ The Institute agreed to make a \$5,000 downpayment from the assets of the company and to pay the balance of the purchase price over a ten-year period exclusively out of the income generated by the business.⁹⁰ It was agreed that the company would be liquidated immediately after closing and that the Institute would lease the business assets under a five-year lease to a new corporation, Fortuna Sawmills, Inc., owned by the attorneys for the sellers.⁹¹ Fortuna was to pay 80% of its operating profit before depreciation or taxes to the Institute as rent for the assets and the Institute would pay 90% of its rent as payments on the \$1.3 million dollar note.⁹² Fortuna operated the sawmill and lumber business by taking over Clay Brown & Company's situs and virtually all of its personnel.⁹³

The selling shareholders reported the amounts received on the note as capital gain.⁹⁴ In a 1965 decision, *Commissioner v. Clay Brown*,⁹⁵ the Supreme Court, affirming the Tax Court and the Ninth Circuit, agreed that payments on the note were capital gain and not taxable as ordinary income as claimed by the Commissioner.⁹⁶ The *Clay Brown* decision and a Tax Court case reaching a similar result, *University Hill Foundation v. Commis-*

89. *Commissioner v. Clay Brown*, 380 U.S. 563, 567 (1965).

90. *Id.*

91. *Id.*

92. *Id.*

93. *Id.* at 568.

94. *Id.*

95. 380 U.S. 563 (1965).

96. *Id.*

sioner,⁹⁷ spawned no less than three separate measures included in the Tax Reform Act of 1969 to curb the new abuse of the tax exemption as perceived by Congress.

Fortuna was able to avoid payment of income tax on 80% of its taxable income generated by the lumber business by deducting the rent it paid to the Institute for the lease of its operating assets.⁹⁸ However, the very requirement to pay out a substantial portion of its taxable income to the Institute and the opportunity to retain only 20% of it for working capital left Fortuna in no position to compete unfairly with its taxpaying competition in the lumber market.⁹⁹ Rather, by converting operating income received by Fortuna into "passive" rental income received tax-free by the Institute, the *Clay Brown* lease enabled what was essentially unrelated business taxable income to escape tax at any level. A comparable amount of income received by a competitor pass-through entity would have been taxed once at the investor level. Even with the almost 100% financing afforded the Institute by the sellers of the stock, the Institute's rental income escaped the reach of section 514, the sale-leaseback provision of the 1950 Act, because of that section's limited purpose to tax only rent received from the lease of real property acquired or improved with debt.

The *Clay Brown* transaction presented Congress in 1969 with virtually the identical problem presented by the sale and leaseback of real property financed with debt nineteen years earlier. By financing the purchase of business assets with tax-free earnings generated by those assets, the exempt organization was placed in a unique position to pay a higher price than a taxable investor could afford with after-tax dollars.¹⁰⁰ Not using its own funds to make the purchase and not being limited by the size of its own endowment, the exempt organization could practice this form of unfair investor competition without limitation and without any "relation to public approval of the activities or purposes of the organization."¹⁰¹ Once again, the exempt organization's only contribution to the transaction was in effect the sale of its exemption and once again there was concern that, if unchecked, the *Clay Brown* transaction could result in substantial loss of tax revenue in

97. 51 T.C. 548 (1969), rev'd, 446 F.2d 701 (9th Cir. 1971), cert. denied, 405 U.S. 965 (1972). The *Clay Brown* provisions of the Tax Reform Act of 1969 were adopted prior to the IRS's 1971 victory in the United States Court of Appeals for the Ninth Circuit.

98. *Id.* at 567.

99. *Id.*

100. S. Rep. No. 552, 91st Cong., 1st Sess. 62-63 (1969), reprinted in 1969 U.S.C.C.A.N. 2027, 2091.

101. Hearings before the House Comm. on Ways and Means on the Subject of Tax Reform, 91st Cong., 1st Sess. 5359 (1969) (General Explanation of Treasury Tax Reform Proposals).

the future.¹⁰² What especially rankled the 1969 Congress was the seller's use of the exemption to obtain an inflated purchase price for their business. The seller's ability to convert ordinary income generated by operating assets into capital gain upon receipt of the very same income as installments of the purchase price for the stock only added insult to what was already considered to be an injury to the federal tax structure.¹⁰³

Curiously, the *Clay Brown* case itself was not the best illustration of the multiple potential evils Congress feared could flow from a *Clay Brown* transaction. The Tax Court, for instance, found the purchase price of the stock to be "within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of the corporate assets,"¹⁰⁴ not above market value and presumably not significantly higher than a taxable competitor would pay. Moreover, Fortuna closed its doors after only four years of operations because of a lack of demand for lumber, and the Institute was forced to sell the business for only \$300,000. Allowed to retain a meager 10% of the sales proceeds, the Institute was able to add \$30,000 to its net worth, nowhere near the \$1.3 million that had been contemplated.

Nonetheless, Congress did not stray from its purpose to discourage *Clay Brown* transactions "by eliminating the incentive for owners desiring to sell a business to exploit the tax exemption of nonprofit organizations."¹⁰⁵ Effective for taxable years beginning after December 31, 1969, section 514 was amended to tax income received by any exempt organization¹⁰⁶ in any form (e.g., dividends, royalties, rent) from any type of property (e.g., rental real estate, tangible personal property, corporate stock) unrelated to its

102. H.R. Rep. No. 413, 91st Cong., 1st Sess., pt. 1, at 46 (1969), reprinted in 1970 U.S.C.C.A.N. 1645, 1691.

103. S. Rep. No. 552, supra note 100, at 62-63, reprinted in 1969 U.S.C.C.A.N. at 2091.

104. *Clay Brown v. Commissioner*, 37 T.C. 461, 486 (1961), aff'd, 325 F.2d 313 (9th Cir. 1963), aff'd, 380 U.S. 563 (1965).

105. H.R. Rep. No. 413, supra note 102, at 46, reprinted in 1969 U.S.C.C.A.N. at 1691. For a discussion of developments to and including the Tax Reform Act of 1969, see Cooper, supra note 71.

106. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (1969) (extending the unrelated business income tax to all exempt organizations except United States instrumentalities because many of such organizations had begun to engage in substantial commercial activity).

Some churches are engaged in operating publishing houses, hotels, factories, radio and TV stations, parking lots, newspapers, bakeries, restaurants, etc. Furthermore, it is difficult to justify taxing a university or hospital which runs a public restaurant or hotel or other business and not tax a country club or lodge engaged in similar activity [sic].

S. Rep. No. 552, supra note 100, at 67, reprinted in 1969 U.S.C.C.A.N. at 2096.

charitable functions acquired or improved with debt.¹⁰⁷ Under a formula essentially similar to the one enacted in 1950, the same percentage of total income received by the exempt organization was includable in gross income as the average debt for the taxable year with respect to the property bore to the average adjusted basis of such property.¹⁰⁸ The same percentage of capital gains was taxed on the sale of the property.¹⁰⁹

Assume that taxable investors had entered into a transaction identical in terms to the facts in *Clay Brown*, liquidating the acquired lumber company and leasing the business assets to Operating Company. Assume further that both Fortuna Sawmills and Operating Company earn \$125x profit before depreciation and taxes for the taxable year and distribute, and deduct, 80% as rent, i.e., \$100x, under the terms of the lease. After payment of \$35x tax on the rent received, the taxable investors have available \$65x, 90% of which, i.e., \$58.5x, is required to amortize the acquisition note.

Assume that the California Institute for Cancer Research incurred a \$50x operating loss for the taxable year in the conduct of its 501(c)(3) activities after taking into account unrestricted current contributions and

107. IRC § 514. Under another amendment added by the Tax Reform Act of 1969, a tax-exempt "controlling organization" is taxable on interest, annuities, royalties, and rents derived from either a taxable or tax-exempt "controlled organization." IRC § 512(b)(13)(A)-(B).

108. For example, "[I]f a business or investment property is acquired subject to an 80 percent mortgage, 80 percent of the income and 80 percent of the deductions are to be taken into account for tax purposes. As the mortgage is paid off, the percentage taken into account diminishes." S. Rep. No. 552, supra note 100, at 63-64, reprinted in 1969 U.S.C.C.A.N. at 2092. Two additional weaknesses of the 1950 legislation were addressed: (1) rental income from the lease of property is taxable under amended § 514 regardless of whether the term of the lease exceeds five years, and (2) to eliminate front-loading depreciation deductions in the early years of the debt-financed transaction when a higher percentage of income generated by the property is taxable, only straight-line depreciation is allowed. Section 514(b)(3)(A) exempts from the definition of "debt-financed property" real property acquired by an exempt organization if (1) the principal purpose of the acquisition is substantially related to the exercise or performance of the organization's purposes, (2) the real property is in the neighborhood of other property owned by the organization, and (3) the property is used for such purpose within 10 years of the acquisition. Section 514(c)(2)(B) excludes from acquisition indebtedness a mortgage on real property when such real property was acquired by an exempt organization by bequest or devise, so long as the organization did not agree to assume the mortgage in order to acquire the property. The period during which such mortgage will not be considered acquisition indebtedness may not exceed 10 years from the date of acquisition.

109. IRC § 514(a)(1); Regs. § 1.514(a)-1(a)(1)(v). For a critical view of § 514, see Bittker & Rahdert, supra note 13, at 322-25. For the view that there is lacking "a systematic tax policy analysis supporting the rules regarding the taxation of debt-financed income of exempt organizations," see Gallagher, supra note 67, at 991. "[O]ne must seriously question whether the approach of Section 514 is correct in a non-bootstrap acquisition scenario." Id. at 992; see also id., at 993-96.

income from its portfolio of stocks and bonds. Had Fortuna been required to maintain competitive prices and had the Institute been afforded the option of either paying to the government the \$35x tax imposed by section 514 or using an equivalent amount plus an additional \$6.5x as a return on investment to reduce the operating deficit incurred in the conduct of its related activities, but not to make payments on debt incurred to acquire or improve assets used in activities unrelated to its charitable purposes, both the Institute and the taxable investors would have had available the same \$58.5x with which to make payments on the notes issued to acquire the stock of the respective lumber companies.

E. *Variations on the Theme of Section 512(b)(15)*

It appears from the inclusion of another measure in the Tax Reform Act of 1969 that Congress stumbled upon an alternative solution to counter the threat of unfair competition other than to tax feeder corporations or unrelated businesses conducted directly by 501(c)(3) organizations. In a remarkable bit of special interest legislation designed for the benefit of the religious order operating Loyola University's radio station WWL,¹¹⁰ the 1969 Congress enacted what is now section 512(b)(15). The measure provides in substance that the income and all directly connected deductions of a federally licensed unrelated service business carried on by a religious order (or by an educational organization maintained by the order), in operation before May 27, 1959, is not subject to the tax on unrelated business income if 1) less than 10% of each year's net income from the business was used for activities which were not related to the religious order's exemption and 2) it was established to the satisfaction of the Secretary that the rates or other charges for such services were competitive with those charged for similar services by persons subject to tax.

According to the Senate Committee on Finance, which introduced the measure, "In such a case there are no competitive advantages obtained by the business from the exemption, and where the exempt organization has for a long time depended on this income, to make it forego approximately half of it would constitute a serious hardship."¹¹¹ Not surprisingly, no explanation was offered by the Senate Finance Committee as to why this alternative solution to the threat of unfair competition, i.e., the maintenance of competitive prices and the mandatory distribution of more than 90% of the net income of an unrelated business to the exempt organization for its charitable purposes, would not work as well for the cancer research conducted

110. See Cooper, *supra* note 71, at 2009.

111. S. Rep. No. 552, *supra* note 100, at 70, reprinted in 1969 U.S.C.C.A.N. at 2099.

by the California Institute in *Clay Brown* and for other worthy 501(c)(3) organizations as it would for the religious order that was the exclusive beneficiary of section 512(b)(15).

Admittedly a piece of special interest legislation designed to benefit one radio station operated by a particular university owned by a religious order, section 512(b)(15) carries a message more significant than the 1969 Congress realized. By predicating the radio station's exemption from tax on the distribution of more than 90% of its net income to be used for activities related to the religious order's charitable purposes, section 512(b)(15) resurrected the "destination of income" principle formulated by the Supreme Court forty-five years earlier and abandoned the tax reforms adopted by the Revenue Act of 1950. The charitable destination of income, not its commercial source, is the ultimate test of exemption, the Supreme Court held in 1924.¹¹² By requiring the radio station to charge competitive rates as well as to distribute the bulk of its net income to the religious order, section 512(b)(15) was unique in its attempt to preserve the station's tax-free revenue stream for the benefit of the 501(c)(3) organization without affording the "unrelated" source of that revenue the opportunity to compete unfairly with its taxable competition.¹¹³

112. *Trinidad v. Sagrada Orden*, 263 U.S. 578, 581 (1924).

113. Section 512(b)(15) was not the first attempt to resolve the unfair competition issue by mandating a distribution of income to the charity. John Gardes, an attorney instrumental in New York University's acquisition of the C.F. Mueller Company, was quoted as suggesting:

[T]hat if tax exemption placed a corporation so organized in an advantageous competitive position, a practical remedy would be to amend the Federal tax laws to provide that tax-exempt institutions deriving profit from businesses be compelled to use currently for educational purposes a sum equivalent to the amount which a business concern having the same profits would be compelled to pay in the form of taxes.

N.Y.U. Denies It Is Misusing Tax Exemption, *Herald Trib.*, Jan. 25, 1950, (in author's files). In a provision included in H.R. 2976, 81st Cong., 1st Sess. (1949), which was not enacted, feeder organizations were mandated to distribute 75% of their net income (other than capital gains) each year to the charity, unless the Commissioner approved a plan to accumulate more. See Comment, *supra* note 42, at 876 n.111.

Other solutions to the unfair competition problem had also been suggested, "such as rigid antitrust law enforcement, direct limits on expansion of tax-exempt business, or limits on capital accumulation." *The Macaroni Monopoly*, *supra* note 60, at 1282 n.13.

In *Crosby Valve & Gage Company*, a separately incorporated feeder made a distribution to its parent, a charitable organization, and claimed a deduction under § 170 for a charitable contribution. The United States Court of Appeals for the First Circuit observed that an unrelated business operated directly by a charity is allowed to deduct up to 5% of its taxable income for a charitable contribution to another charity. The Court refused to allow the feeder to deduct the "charitable contribution" made to its own parent because, quoting legislative history, "[i]t is difficult to see why a difference in tax treatment should be allowed

Section 512(b)(15) nevertheless lacks the statutory safeguards and refinements to merit wholesale expansion of its scope to include feeders and unrelated businesses of all 501(c)(3) organizations. The proposed amendment to the tax on feeders and unrelated businesses more fully developed in Appendix A to the article is an attempt to construct a statutory provision based upon the section 512(b)(15) motif, but adding sufficient safeguards to make the provision useful as a fiscal option of broad application. The amendment draws upon the analysis of the effect of distributions on the potential for unfair competition discussed above. The amendment preserves the existing tax, but grants the feeder or unrelated business an elective credit against its income tax liability for distributions made or deemed made during the taxable year to its 501(c)(3) owner on the basis of \$1 credit for a combined distribution of \$1 plus an additional amount (e.g., \$.35) assumed to equal an adequate return on investment that a for-profit competitor would be expected to distribute to its owners. The goal is to leave the feeder or unrelated business in approximately the same "after-tax/distributions to owners" position as its for-profit competition, rather than leaving the feeder or unrelated business at a competitive disadvantage which would be the result if it were required to distribute more than 90% of its net income for the taxable year to its 501(c)(3) owner.

The amendment requires the feeder or unrelated business to establish the competitiveness of its rates or charges, but supplements the facts-and-circumstances approach of section 512(b)(15) by incorporating a set of safe harbor guidelines. The goal is to establish an objective standard to prove competitive pricing without imposing a case-by-case fact-finding burden on the Internal Revenue Service. The amount of the elective credit is subject to a number of additional limitations. In order to assure that the distributed amounts are used by the 501(c)(3) owner to fund its related activities rather than (1) reinvested back into the feeder or unrelated business as a capital contribution, loan, or collateral for a loan; (2) used to augment the 501(c)(3) owner's investment portfolio; or (3) used to amortize debt incurred to acquire

merely because in one case the income is earned directly by an educational or charitable organization, while in the other it is earned by a subsidiary of such an organization." *Crosby Valve & Gage Co. v. Commissioner*, 380 F.2d 146, 148 (1st Cir. 1967), cert. denied, 389 U.S. 976 (1967). Comparing the bottom-line results to the feeder with the results to a "competing business corporation not owned by a charity," the Court correctly observed that the tax savings resulting from allowing the feeder to deduct up to 5% of its taxable income for a distribution to its own parent would leave the feeder with an increased after-tax net profit with which to "finance competition in services, etc." or which would allow the charity to receive a greater return on its investment. *Id.* at 149 at n.3. As a third option, the feeder could cut prices to a level such that its after-tax net profit would still equal its competitor's. *Id.* In the Court's view, this is precisely the unfair competition the 1950 Act attempted to prevent. See also *C.F. Mueller Co. v. Commissioner*, 55 T.C. 275, 297-98 (1970), *aff'd*, 479 F.2d 678 (3d Cir. 1973).

or improve assets used in activities unrelated to its exempt purposes, the elective credit for a taxable year available to a 501(c)(3) owner's feeders and unrelated businesses is limited on a combined basis to an amount equal to the net operating loss incurred by the 501(c)(3) owner for the same taxable year in the conduct of all of its related activities divided by 1.35 (assuming \$1.00 credit for \$1.35 distribution). For this purpose, the net operating loss is determined by adding net investment income and unrestricted gifts received during the taxable year to related activity gross income, excluding noncash items as deductions, but deducting capital expenditures for the acquisition of assets substantially used to further related activities.

In order to cap the potential loss of tax revenue to the federal government, and to discourage the 501(c)(3) owner from subjecting more than 25% of its total investment portfolio to the risks inherent in business ventures, the amount of the elective credit available to each of a 501(c)(3) owner's feeders and unrelated businesses is reduced by four percentage points for each percentage point in excess of 25% that the value of the 501(c)(3) owner's total investment portfolio at the time of acquisition (not including assets substantially used in related activities) consists of investments in feeders and assets used in unrelated businesses.

Further, in order to reduce the danger that a 501(c)(3) owner could use the distributed amounts to fund activities unresponsive to social needs, the amount of the elective credit available to each of a 501(c)(3) owner's feeders and unrelated businesses is reduced by four percentage points for each percentage point in excess of 25% that the 501(c)(3) owner's gross receipts for the taxable year from all sources is derived from feeders and unrelated businesses.

Finally, in order to discourage a 501(c)(3) owner from diverting energy away from its charitable purposes, as a condition to electing the credit, employees and directors of the 501(c)(3) owner are prohibited from being employed by, or serving as a director of, any of such owner's feeders or unrelated businesses.

F. *Is The Elective Credit Sound Tax Policy?*

Essentially, the elective credit against tax described in Appendix A grants a feeder or unrelated business maintaining competitive pricing the option to pay regular tax to the government or to distribute a tax equivalent amount (plus an assumed adequate return on investment) to its 501(c)(3) owner to cover its current operating loss from related activities. Assuming that the elective credit is as effective to eliminate the potential for unfair competition as is payment of the tax to the government, the question remains whether the social benefits anticipated from the additional distribution to the

501(c)(3) organization justify the foregone tax.¹¹⁴ That the amount of the foregone tax cannot be readily determined significantly complicates the answer.¹¹⁵

Assuming that the total amount of the tax lost to the government through exercise of the elective credit proves to be more than minimal, can one persuasively argue pluralism as the rationale for granting feeders and unrelated businesses the option to distribute a tax equivalent amount to their 501(c)(3) owners in lieu of paying the tax to the government? Commentators who justify the exemption afforded related activities directly furthering the charitable purposes of the organization on the grounds of democratic decentralization may be reluctant to extend the same rationale for the benefit of feeders and unrelated businesses indirectly furthering the same purposes. Collection of the tax otherwise lost through exercise of the credit may be justified not only for the reason that the federal government needs revenue, but also in support of the principle that Congress has the duty to allocate the tax dollars collected in accordance with national priorities determined through public debate.

The public debate must, nevertheless, reckon with the fact that two sources of revenue historically relied upon by the nonprofit, charitable sector for financial survival—contributions from the public and grants from the

114. See Bittker & Rahdert, *supra* note 13, at 325-26 (commenting on the taxation of unrelated business income).

By reducing the amount that the exempt organization can apply to its charitable or other purposes, the tax necessarily burdens the beneficiaries of these activities, and their ability to pay ought to be considered in deciding whether and to what extent to impose the tax. Yet it was evidently never suggested during the 1950 and 1969 debates that the tax on the unrelated business income of charitable organizations reflected the ability to pay of those affected by it. Almost certainly, we believe, it did not, and thus made the income tax more regressive.

Id.

The incidence of the UBIT is also of importance for policy analysis. . . . Perhaps some portion of the tax would fall on donors or grantmakers or charitable-service recipients, not just on paying consumers, owners, or suppliers of capital and labor. This subject has, to my knowledge, received no attention in the literature.

Steinberg, *supra* note 25, at 354.

115. Current data applicable to 501(c)(3) organizations is insufficient to determine what the tax liability of feeders and unrelated businesses would be on a composite basis if the maximum 25% of investment assets were invested in feeders and unrelated businesses. Moreover, current data is insufficient to determine on a composite basis (i) the ratio of distributions received from feeders and unrelated businesses to gross receipts received by 501(c)(3) organizations from all sources, and (ii) net operating losses (as defined in Appendix A) incurred by 501(c)(3) organizations in the conduct of their related activities. Cf. Statistics of Income Bulletin, Internal Revenue Service, Spring 1995 and Spring 1996.

federal government—have in recent years diminished as a percentage of total revenue and threaten to shrink even more significantly in the future. Charitable contributions to 501(c)(3) organizations dipped from 36% of total revenue from all sources in 1946 to 18% in 1982.¹¹⁶ Although the cause is not certain, studies indicate that federal taxes, in particular the charitable contribution deduction available to itemizers, the interplay of this deduction with the standard deduction, and, to some extent, marginal tax rates, affect the size of charitable gifts and the type of recipient. Taxpayers in the highest tax brackets are most affected by a decline in marginal rates. The top marginal income tax bracket decreased from 91% in 1946 to 50% in 1982. For taxable years beginning in 1988 the top marginal income tax bracket decreased even further to 28%, with each decrease representing a tax disincentive for a high bracket taxpayer to contribute to a 501(c)(3) organization because of the diminished tax savings generated by the charitable contribution deduction. Proposals to eliminate the charitable contribution deduction altogether through the enactment of a flat tax (without replacing the deduction with a credit) seriously threaten the revenue stream from public and corporate gifts historically relied upon by the charitable, nonprofit sector for financial viability.¹¹⁷

As private donations as a percent of total revenue have diminished, federal government support of activities conducted by 501(c)(3) organizations continues to be dictated by the prevailing political philosophy in Congress and the nation and therefore remains an unreliable source for funding as well. As a case in point, "Between 1982 and 1984, federal spending for activities supported by human service nonprofits declined an estimated \$42 billion."¹¹⁸ Finally, although the size of the average endowment fund of colleges and universities may have increased over the years, there is evidence that such funds have actually decreased in purchasing power based on the Consumer Price Index.¹¹⁹

501(c)(3) organizations have thus been confronted with the task of meeting increasing operating expenses with diminished and unreliable revenue streams from traditional sources. If it was true in 1953, for example, that

116. UBIT Hearings, *supra* note 78, at 139 (statement of Jennie S. Stathis, Associate Director, General Government Division, U.S. General Accounting Office).

117. See Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving* 277 (1995). On the other hand, a decrease in the marginal tax rates increases "the after-tax income from which taxpayers can make contributions." *Id.* at 274. See also, Fred Stokeld, *Charities Fear Loss of Deduction Under Flat Tax Proposals*, 70 *Tax Notes* 935 (Feb. 19, 1996).

118. UBIT Hearings, *supra* note 78, at 239 (testimony of the National Assembly of National Voluntary Health & Social Welfare Organizations); see also *id.* at 158 (statement of Marion R. Fremont-Smith, Board Member, Independent Sector) (discussing the decline in government participation).

119. See *id.* at 369 (statement of the American Council on Education).

“[t]he present financial plight of American colleges and universities is not an acute non-recurring illness but the aggravation of a chronic condition of many years standing,”¹²⁰ then forty-three years later financial suffocation threatens to render the patient terminal absent the discovery of life-saving procedures. Adoption of the elective credit can be justified as a measure to replace diminished revenue for the benefit of 501(c)(3) organizations with sources that are at least within the control of the organization’s wholly-owned business benefactors.

This is not to suggest that the elective credit should be viewed as a panacean replacement for other possible forms of direct and indirect federal government subsidization of the activities of 501(c)(3) organizations. What is more essential than the specific form of the tax subsidy and/or direct expenditure designed to benefit charitable nonprofits and their beneficiaries are the guiding principles employed in the selection. First, of necessity, the financial support afforded the charitable sector in the form of the underlying exemption from tax must remain an indirect federal tax subsidy as opposed to an annually reviewed direct government expenditure as an expression of its purpose to preserve the political independence and continuity of the sector. Second, tax and social policy planners need to come to terms with the fact that the combination of exemption from tax afforded “related” activities and the itemized deduction for private gifts to charitable organizations has historically proved inadequate as measures to ensure sufficient revenue to enable the charitable sector to make ends meet. Additional federal subsidization of the sector is therefore required. Third, the form of the additional federal subsidy must be designed to preserve the charitable sector’s political and financial independence. Fourth, in an attempt to ensure that the additional federal subsidy is utilized to fund activities responsive to social needs, the subsidy should either track the nonprofit organization’s revenues derived from “related” activities and/or gifts from the public, e.g., a federal direct grant program matching gifts received by the organization from private sources (over and above the indirect tax subsidy afforded the charitable contribution), or the subsidy should be targeted for a specific purpose, e.g., a need-based scholarship or loan program, a tax credit for college tuition payments, or a grant program to provide essential services to the poor.

From this perspective, it is not necessary to view the elective credit solely as a life-saving provision of universal application designed to enable the nonprofit, charitable sector as a whole to assume some measure of control over its financial destiny. The credit can be more narrowly utilized as a means to enable and to encourage the charitable sector to meet specific social goals. The utilization of the credit for this purpose is suggested partly in

120. Myers, *supra* note 52, at 368.

recognition of several operational weaknesses, albeit correctable ones, in several of the nonprofit subsectors as the provider of public goods and services. First, a number of nonprofit subsectors providing essential public services, such as health care and higher education, lack a self-regulatory body responsible for overall planning and oversight with authority to enforce compliance with its regulations. Lack of self-regulation allows for inefficiency, waste, violation of the constraint against private inurement, and ad hoc expansion of capacity and subsequent downsizing in reaction to changes in the demand for services.¹²¹

Second, if consumers of public goods and services are willing to pay too high a price to a for-profit enterprise as a result of their inability to judge the quality of what they or society are receiving in exchange, they are willing to pay the same high price to a nonprofit organization as well. In the case of the for-profit enterprise, the effort to maximize price and minimize cost is driven by the purpose to earn profit, a purpose that constitutes an intrinsic defect in the for-profit model as the provider of essential public goods and services. In the case of the nonprofit organization, the effort to maximize price may be driven by the necessity to meet an operating budget inflated by lack of planning, inefficiency, excessive compensation, excessive marketing for consumers of its products and services, and fund raising for a diminished pool of contribution dollars.¹²² These operational failures, while serious, do

121. See Robert C. DeGaudenzi, *Tax-Exempt Public Charities: Increasing Accountability and Compliance*, 36 *Cath. Lawyer* 203 (1995) (tracing recent incidents of self-dealing and other abusive practices involving public charities and the scrutiny they have invited. *Id.* at 204-09). See also Zimmerman, *supra* note 22, at 341-43. Zimmerman discusses two additional sources of voluntary sector failure, viz., (1) "philanthropic paternalism," the definition of community needs determined by the wealthy, who have the means to contribute to charity and thereby to influence the voluntary sector's agenda to serve themselves rather than serve the poor, and (2) "asymmetric information failure," nonprofits providing goods and services with complex characteristics, such as health care, to a wealthy group of clientele, to suggest that the nonprofit is not really delivering a social benefit. Zimmerman admits that "[e]mpirical evidence on voluntary sector failure is somewhat anecdotal." *Id.* at 343. Zimmerman summarizes several studies leading to the conclusion that there are incidences of voluntary sector failure, e.g. Herzlinger and Krasker in 1987: "They found that the nonprofit hospitals were spending much of their tax benefits on behalf of the professional staff of the hospitals ' . . . without providing better, cheaper, or more accessible health care in return.'" *Id.* at 344. "[S]uspicion abounds that some tax revenues are being wasted without commensurate provision of social benefits." *Id.* at 345.

122. Public perception of this type of nonprofit failure among institutions of higher education has been enhanced by negative coverage in the media. The *Philadelphia Inquirer* ran a five-part series from March 31 to April 4, 1996, maintaining that college tuition has almost tripled between 1981 and 1996, more than twice the rate of inflation, not because of a rise in demand, but because of a "Chivas Regal" effect—the more expensive, the better. See Karen Heller & Lily Eng, *Higher Education: How High the Price*, *Phila. Inquirer*, Mar. 31, 1996, at A1. With the last of the "baby boomers" reaching college age in the early 1980s,

not constitute intrinsic defects in the nonprofit model as the provider of essential public goods and services. Nevertheless, establishment of a series of self-regulatory bodies responsible for planning and oversight in the various nonprofit subsectors, further described in Part V of the article, should be viewed as the necessary companion piece of legislation to adoption of the elective credit in the form of universal application described in Appendix A.¹²³

demand, in fact, went down. See *id.* With no outside monitoring and no incentive to cut spending, increasing tuition revenues have supported an explosion in inefficiency and waste rather than an increase in the quality and accessibility of higher education—more administrators, more assistant administrators, more faculty assistants, more fundraisers, more marketers, more student amenities, more building programs. See *id.* As a case in point, between 1980 and 1996, the number of full-time students registered at the University of Pennsylvania increased by 29; the number of administrators and nonteaching staff members increased by 1820. See *id.* With colleges and universities competing against each other for a diminished pool of applicants, a high percentage of their inflated operating budgets have been allocated to marketers and recruiters for students and to other budget lines thought to increase the prestige of the institution, such as fundraising and faculty whose primary strength is published research rather than teaching. See *id.* at A25. College presidents and deans have been chosen not based on how well they govern, but on how well they fundraise. See *id.* Moreover, a high percentage of the gifts and grants received have been allocated to the endowment fund and an insufficient amount into the current operating budget. See *id.* at A24. Saddled with more administrators, faculty, programs, and buildings than are needed to accommodate present demand, colleges and universities are finding downsizing extremely difficult. See *id.* at A24.

The Philadelphia Inquirer series of articles made its point, but overstated the case. Certainly, some percentage of the tuition increase that occurred between 1981 and 1996 was returned to students in the form of necessary increases in faculty salaries and benefits, enhanced counseling and placement services, upgrading of laboratories, libraries, and physical plant, and installation of computer systems and new technology. Additionally, colleges and universities are compelled to comply with a myriad and burgeoning amount of federal regulations. Further, although the authors of this series are correct to point out that some percentage of the tuition increase had occurred because of an increasing budget line for student financial aid, with more student aid being required because of the higher tuition, a spiraling effect squeezing the middle class out of the opportunity to go to college, the phenomenon is the result of lack of social planning that implicates the federal government as much as it does institutions of higher education.

123. There have been legislative proposals to deny tax exemption to a nonprofit entity unless the organization can satisfy a quantifiable test proving the delivery of adequate social benefits. See Zimmerman, *supra* note 22, at 346-48. For the view that a certain degree of nonprofit inefficiency is an expected price to pay for nonprofit innovation, see Steinberg, *supra* note 25, at 361-62. If the delivery of adequate benefits to low-income beneficiaries is implicitly the sole test to be applied to each and every nonprofit organization in order to retain tax exemption, the test reflects a constricted view of the role of nonprofits in American society. The performance of many essential public services by nonprofits, e.g., the conduct of basic and applied research by a university, indirectly benefit all income groups. Further, it is not always easy to determine which income groups benefit from the activities of nonprofits, let alone to quantify the benefit. See Charles T. Clotfelter, *Who Benefits from the Nonprofit Sector?*, The Univ. Of Chi. Press (1992). Additionally, if it is determined that a nonprofit

This is not to infer that there do not already exist vast numbers of 501(c)(3) organizations efficiently delivering reasonably priced high quality goods and services to the public. Nor is it to infer that measures to correct whatever operational deficiencies now exist in certain subsectors of the nonprofit, charitable sector will additionally eliminate their pressing need to acquire a revenue source to replace traditional sources threatening to shrink significantly in the future. It is only to suggest that from the point of view of tax policy efficient utilization of financial resources, planning, and oversight are the necessary companions to a broad-based federal subsidization of the activities of nonprofit charitable organizations.

It is also to suggest that the elective credit can be utilized for purposes other than to address in broad terms the financial crisis confronting the entire charitable sector. The credit can be more narrowly utilized to fund a nonprofit organization's sub-budget specifically targeted to meet social needs that are being inadequately addressed at the present time (in a somewhat modified form from that described in Appendix A). The credit could be made available, for instance, on condition that the required distributions by the feeder or unrelated business to its 501(c)(3) owner be used exclusively to fund need-based college scholarships, with all administrative and overhead expenses necessary to conduct the scholarship program coming from the organization's general budget. Or, revenues generated by the credit could be used in similar fashion to fund sub-budgets exclusively targeted to deliver any number of goods and services to the disadvantaged, such as healthcare, nursing home care, day care centers, legal representation, a trip to a major art museum, or seats at a symphony orchestra concert, with a general budget again supplying the required administrative and overhead support.

subsector is devoting a low percentage of its resources to the needs of the poor, as Lester M. Salamon has determined with respect to the social services, then the question to ask is, "Why is this the case?" See Clotfelter, *id.* at 171. Salamon provides the answer. In order to cope with their dependency on external revenue sources over which they have little control, nonprofit human service agencies have had to broaden their sights "well beyond the needs of the poor. . . ." *Id.* "The one truly effective countervailing force in the system has been the availability of government funding targeted to the poor. Based on our statistical analysis, it has been the availability of such funding that has allowed or encouraged the nonprofit sector to focus on the poor to the limited extent it has." *Id.* If, then, the government cuts back its financial support granted to a nonprofit organization targeted to aid the poor, is the solution to deny tax exemption to the nonprofit entity, or is it to seek a revenue source to enable the entity to aid the poor, including reinstatement of government funding? Similarly, if it is found that "the bulk of the benefits of the activities of nonprofit arts and cultural organizations are realized by people in the upper half of the income distribution . . .", as Dick Netzer has so found (*id.* at 202), is the solution to add to the financial pressures already confronting symphony orchestras and museums by denying them tax exemption, or is it to attempt to find a method to increase access to, and interest in, their benefits for people in the lower half of the income distribution?

It is doubtful that the present resources of federal agencies are up to the task of administering and enforcing the use of the elective credit in this fashion, let alone administering and enforcing the tax on unrelated business income as it currently exists. The vital subject of compliance is explored in Part V of the article.

IV. THE COURTS SEARCH FOR STATUTORY MEANING: FORTY-SIX YEARS WANDERING IN THE DESERT

A. "Trade or Business": In Pursuit of a Definition

Unless one of the specific exceptions is applicable, gross income of a 501(c)(3) organization is "includible in the computation of unrelated business taxable income if (1) it is income from trade or business, (2) such trade or business is regularly carried on by the organization,¹²⁴ and (3) the

124. Regs. § 1.513-1(a) (as amended in 1983). For a discussion of "regularly carried on," see Regs. § 1.513-1(c); *National Collegiate Athletic Ass'n v. Commissioner*, 914 F.2d 1417 (10th Cir. 1990) (holding that NCAA's share of net revenues from the sale of programs and advertising space therein for the Men's Division I Basketball Championship was not derived from a business "regularly carried on."). In 1991 the Internal Revenue Service announced that it would not follow the Tenth Circuit NCAA decision. I.R.S. T.A.M. 91-47-007 (Aug. 16, 1991) ("the TAM"). See James R. Hasselback and Rodney L. Clark, *Colleges, Commerciality, and the Unrelated Business Income Tax*, 74 *Taxes* 335, at 339 (May, 1996). On the other hand, proposed regulations issued in January, 1993 take the position that revenue received from a corporate sponsor by a 501(c)(3) organization conducting a bowl game, where the organization "acknowledges the sponsorship payment by adding the corporation's name to the title of the event," does not constitute advertising "because it does not promote the sponsor's service, facility or product." Prop. Regs. § 1.512(a)-1(e), ex. 2(i). The proposed regulations additionally confirm that the sale to commercial broadcasters of the right to broadcast the bowl game on television and radio, as well as admission fees, are not taxable to the 501(c)(3) organization. *Id.* See Mary E. Monahan, *Unfair Competition or Fundraising? A Proposal to Modify the Regularly Carried On Test of the Unrelated Business Income Tax*, 10 *Am. J. of Tax Pol'y* 73 (1992) (proposing a two-part test to be substituted for the "regularly carried on" test. "The test will first examine whether the purchaser of the goods or services derives more than an insignificant commercial benefit from the purchase. If the commercial benefit is insignificant, the activity would not be commercial and would not be subject to UBIT. If the commercial benefit to the purchaser is significant, the test would then examine whether the activity was intended and operated as a fundraiser with full disclosure of profit and the approval of the membership of the organization. If the activity lacks one of the factors of the second part of the test, it would be a business subject to UBIT." *Id.* at 73-74.).

It is indisputable that intercollegiate athletics has become "big business. In 1988 alone, the 104 Division I-A college football teams made over \$500 million through gate, television, and licensing receipts and \$52 million in bowl game revenues. In 1995, with the so-called 'Bowl Alliance' between the Tostitos Fiesta Bowl, the Federal Express Orange Bowl, and the Nokia Sugar Bowl, the average payout per team per bowl game was over \$8 million." Hasselback and Clark, at 340. Observing that a loss in a late-season game could send a team to a far less lucrative bowl encounter than a win, Malcolm Moran, writing in *The New*

conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions."¹²⁵ The Revenue Act of 1950 provided no definition of the phrase "trade or business" for purposes of the new tax.¹²⁶ The Senate Report accompanying the 1950 Revenue Bill offered the assurance, however, that the term 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 162¹²⁷ which allows as a deduction ordinary and necessary expenses incurred in carrying on a trade or business.¹²⁸ The difficulty with this clarification is that neither the Code nor the Treasury regulations at the time of the enactment of the 1950 legislation or ever after has supplied an all-purpose definition.¹²⁹ Nor can much be gleaned from judicial interpretation of the predecessor of section 162 preceding the Senate Report.¹³⁰

By the time of the enactment of the 1950 legislation the Supreme Court had decided two major cases dealing with the meaning of the phrase "trade or business" as used in the predecessor of section 162: *Deputy v. Du Pont*¹³¹ and *Higgins v. Commissioner*.¹³² Faced with the question of whether a corporate shareholder was engaged in a trade or business when he sold some of his stock short in order to preserve the value of his investment, the majority of the Court in *Du Pont* in effect sidestepped the issue, disallowing the short sale expenses on the grounds that they were neither

York Times, commented: "[N]o college player should have to live with the consequences of a missed extra point that cost his school more than \$7 million." Malcolm Moran, *Bowl Alliance Raises the Stakes Too High*, *The N.Y. Times*, Dec. 2, 1996, at C3.

125. Section 513(a) excludes from the reach of the tax any trade or business:

(1) in which substantially all the work . . . is performed for the organization without compensation; or (2) which is carried on . . . by the [charitable] organization primarily for the convenience of its members, students, patients, officers, or employees . . .; or (3) which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.

IRC § 513(a) (formerly IRC § 422(b) (1939)). An example of the first exception is an "exempt orphanage running a second-hand clothing store" where "substantially all the work is performed by volunteers without compensation." S. Rep. No. 2375, *supra* note 54, at 108, reprinted in 1950 U.S.C.C.A.N. at 3166. An example of the second exception "would be a laundry operated by a college for the purpose of laundering dormitory linens and the clothing of students." *Id.* An example of the third exception is a thrift shop. See Regs. § 1.513-1(e).

126. See IRC § 513(a) (formerly IRC § 422(b) (1939)).

127. IRC § 162(a) (formerly IRC § 23(a) (1939)).

128. S. Rep. No. 2375, *supra* note 54 at 106, reprinted in 1950 U.S.C.C.S. at 3165.

129. See *Commissioner v. Groetzinger*, 480 U.S. 23, 27 (1987).

130. *Id.* The Supreme Court has provided a brief judicial history of the phrase "trade or business." *Id.*

131. *Deputy v. Du Pont*, 308 U.S. 488 (1940).

132. *Higgins v. Commissioner*, 312 U.S. 212 (1941).

ordinary nor necessary. In *Higgins*, however, the Court squarely addressed the issue, holding that an investor who incurred salaries and other expenses in managing his portfolio of stocks and bonds was never engaged in a business no matter how regular and continuous the investor's activity.

Inasmuch as the 1950 Congress had already determined that gross income, less related expenses, derived from most investment activity engaged in by a 501(c)(3) organization was to be excluded from unrelated business taxable income,¹³³ neither Supreme Court decision illuminated the trade or business landscape painted by the 1950 legislation. More prophetic was Justice Frankfurter's attempt at a definition in his concurring opinion in *Du Pont*: "'carrying on any trade or business,' within the contemplation of § 23(a), involves holding one's self out to others as engaged in the selling of goods or services. This the taxpayer did not do."¹³⁴

1. *The 1958 Regulations.*—In the summer of 1958 the Treasury Department adopted a set of regulations interpreting the Code provisions imposing the tax on unrelated businesses.¹³⁵ Echoing the Senate Report's earlier reference to section 23(a), the 1958 regulations provided that "the term 'trade or business' has the same meaning as it has in section 162."¹³⁶ In the eight years that had elapsed between the issuance of the Senate Report and the 1958 regulations, however, little had developed on the judicial horizon to shed further light on the definition as it related to the deduction for business expenses.

What is more significant is the inference that can be drawn from both the Senate Report and the 1958 regulations as to the scope of the term in the context of the tax on unrelated businesses. It is clear that both Congress and the Treasury contemplated that a trade or business conducted by a 501(c)(3) organization could be substantially related to the organization's performance of its exempt purpose as well as substantially unrelated. The Senate Report offered as examples of related businesses "a wheat farm operated by an exempt agricultural college as part of its educational program" and athletic activities conducted by an educational organization.¹³⁷ The 1958 regulations added to the list of substantially related businesses "a university radio station or press . . . operated primarily as an integral part of the educational program of the university" and the sale of articles made by handicapped persons as

133. IRC § 512(b)(1)-(5) (formerly IRC § 422(a)(1)-(5) (1939)).

134. *Du Pont*, 308 U.S. at 499.

135. T.D. 6301, 1958-2 C.B. 197. The 1958 regulations adopted under the 1954 Code were for the most part a re adoption of the 1952 regulations adopted under the 1939 Code. See T.D. 5928, 1952-2 C.B. 181.

136. Regs. § 1.513-1(a)(1) (as amended by T.D. 6301, 1958-2 C.B. 197).

137. S. Rep. No. 2375, supra note 54 at 107, reprinted in 1950 U.S.C.C.S. at 3165.

part of their rehabilitation training.¹³⁸ It appears, therefore, that whatever meaning the term "trade or business" held in the context of the 1950 legislation should apply equally to describe those businesses substantially related to the exempt purposes of the organization as well as to those substantially unrelated.

2. *The 1967 Regulations.*—In December of 1967 the Treasury Department amended the 1958 regulations in an attempt to bring into sharper focus the meaning of the term "trade or business" in the context of the tax on unrelated businesses.¹³⁹ The 1967 regulations contained the following salient provisions relating to the meaning of the term: (1) "for purposes of section 513 the term 'trade or business' has the same meaning it has in section 162";¹⁴⁰ (2) a trade or business "generally includes any activity carried on for the production of income from the sale of goods or performance of services";¹⁴¹ (3) a trade or business for purposes of the tax on unrelated businesses

is not limited to integrated aggregates of assets, activities and good will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code. Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are 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;¹⁴²

and (4) trade or businesses can be related to the purposes for which exemption is granted as well as unrelated to such purposes.¹⁴³

a. *The Reference to Section 162.*—Although it appears at first glance that the 1967 regulations merely repeated earlier references to section 162 without further significance, two circuit court opinions handed

138. Regs. § 1.513-1(a)(4) (as amended by T.D. 6301, 1958-2 C.B. 197).

139. Proposed regulations were announced in Technical Information Release 899 (April 14, 1967). Final regulations were set out on December 11, 1967, effective for taxable years beginning after December 12, 1967. T.D. 6939, 1968-1 C.B. 274.

140. Regs. § 1.513-1(b) (as amended by T.D. 6939, 1968-1 C.B. 274).

141. *Id.*

142. *Id.*

143. See *id.*; Regs. § 1.513-1(d)(2) (as amended by T.D. 6939, 1968-1 C.B. 274). "Trade or business is 'related' to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes. . . ." *Id.*

down subsequent to the 1958 regulations infused new meaning into the 1967 pronouncement that the phrase “trade or business” has for purpose of section 513 the same meaning it has for purposes of the deduction for business expenses. In *Hirsch v. Commissioner*,¹⁴⁴ the Ninth Circuit held that an activity cannot be a business for purposes of the deduction unless the basic and dominant intent behind the activity is ultimately to make a profit, “i.e., taxable income.”¹⁴⁵ The Court refused to allow business expenses claimed by an officer and director of corporation because there was no understanding that the officer/director would be compensated for his activities.¹⁴⁶ Similarly, in *Lamont v. Commissioner*,¹⁴⁷ the Second Circuit found that the taxpayer’s activities as a writer, publisher, and lecturer did not constitute a trade or business because the most important criterion, genuine profit motive, was lacking. Although earlier cases suggested that profit motive was an essential element for the allowance of the business expense deduction, the Ninth and Second Circuit opinions brought this requirement into sharp focus just several years preceding the issuance of the 1967 regulations.¹⁴⁸

One can only conjecture whether the 1967 regulations meant to imply by the reference to section 162 that an activity conducted by a 501(c)(3) organization is not trade or business, related or unrelated, unless the dominant or “genuine” intent behind the activity is to make a profit. The regulations do not use the words “dominant intent” and “profit” in defining the term. Describing a related trade or business as one that contributes importantly to the accomplishment of the organization’s exempt purposes,¹⁴⁹ could the 1967 regulations have possibly meant that the intent behind related business activity is primarily a desire for profit?

b. “[T]he term ‘trade or business’ . . . generally includes any activity carried on for the production of income from the sale of goods or performance of services.”¹⁵⁰—Critical to the meaning of this provision is whether the word “income” means gross income or profit. In other words, is the phrase “activity carried on for the production of income” meant to paraphrase the profit motive test of *Hirsch* and *Lamont*?

Read in their entirety, the 1967 regulations offered a number of indications that the word “income” meant gross income and not profit. In

144. *Hirsch v. Commissioner*, 315 F.2d 731 (9th Cir. 1963).

145. *Id.* at 736.

146. *Id.*

147. *Lamont v. Commissioner*, 339 F.2d 377 (2d Cir. 1964).

148. *Cf. White v. Commissioner*, 227 F.2d 779 (6th Cir. 1955), (disallowing expense deductions because transaction not entered into for profit), cert. denied, 351 U.S. 939 (1956).

149. Regs. § 1.513-1(d)(2) (as amended by T.D. 6939, 1968-1 C.B. 274).

150. *Id.* § 1.513-1(b) (as amended by T.D. 6939, 1968-1 C.B. 274).

illustrating the meaning of the phrase "trade or business," the regulations repeatedly refer to activities of producing or distributing goods or performing services from which "gross income" is derived.¹⁵¹ Moreover, the words "gross income" and "income" are used interchangeably.¹⁵² Additionally, having used the word "profit" a scant two times in the text of the regulations, the drafters in no instance explained the phrase "trade or business" as any activity carried on to derive profit from the sale of goods or the performance of services.¹⁵³

The regulations made it clear that trade or business substantially related to the exempt purposes of the organization can receive "gross income," not just businesses substantially unrelated.¹⁵⁴ Assuming the phrase "activity carried on for the production of income" implies a motive to produce gross income, can it be said that an organization conducting a related trade or business has such a motive? Presumably, a 501(c)(3) organization such as a university that charges tuition in order for students to attend classes, thereby deriving gross income, intended to generate gross income from the performance of services. But this intention does not imply a further intention

151. E.g., *id.* ("Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived. . ."). Regs. § 1.513-1(d)(1) provides: "Gross income derives from 'unrelated trade or business,' within the meaning of [IRC] section 513(a), if the conduct of the trade or business which produces the income is not substantially related . . . to the purposes for which exemption is granted." *Id.*

Regs. § 1.513-1(d)(2) refers to "the conduct of trade or business from which a particular amount of gross income is derived" and states further: "Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved."

152. E.g., *id.* § 1.513-1(d)(1) (as amended by T.D. 6939, 1968-1 C.B. 274) ("Gross income derives from 'unrelated trade or business,' within the meaning of [IRC] section 513(a), if the conduct of the trade or business which produces the income is not substantially related . . . to the purposes for which exemption is granted."); see also *id.* § 1.513-1(d)(4)(iv) (as amended by T.D. 6939, 1968-1 C.B. 274) (Example six of the regulation states: "Therefore, notwithstanding the fact that the production of income from advertising utilizes the circulation developed and maintained in performance of exempt functions, such income is gross income from unrelated trade or business.").

153. E.g., *id.* § 1.513-1(b) (as amended by T.D. 6939, 1968-1 C.B. 274). This regulation uses the word "profit" as follows: "However, where an activity carried on for the production of income constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit." *Id.* Does the sentence indicate that the drafters are using "income" to mean gross income and "profit" to mean an excess of gross income over expenses, or are the two words being used interchangeably? Compare to the last sentence of IRC § 513(c) added by the Tax Reform Act of 1969. See IRC § 513(c).

154. E.g., Regs. § 1.513-1(d)(4)(i) (as amended by T.D. 6939, 1968-1 C.B. 274) ("Gross income derived from charges for the performance of exempt functions does not constitute gross income from the conduct of unrelated trade or business.").

to derive profit from the classroom, as the gross income may be needed to match expenses. Inasmuch as the regulation did not require a dominant intent to produce gross income as the driving force of the activity, a motive to produce gross income can be consistent with a dominant intent to further the exempt purposes of the organization. Moreover, the regulations did not illustrate the phrase "activity carried on for the production of income" in terms of motive. Rather, the phrase is recast—"the production or distribution of the goods or the performance of the services from which the gross income is derived"¹⁵⁵—emphasizing the nature of the activity that generates the gross income rather than the motive behind the activity.

c. *A Trade or Business* ". . . is not limited to integrated aggregates of assets, activities and good will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code."¹⁵⁶—One of the Treasury Department's reasons for issuing the 1967 regulations, if not the primary reason, was to lay the foundation for the taxation of advertising revenue received by an exempt organization even though the advertising is published in a journal that editorially furthers the exempt purposes of the organization.¹⁵⁷ To this end, the regulations fragmented what would otherwise be considered an integrated business, e.g., the publication of the journal, into its component parts, e.g., the advertising, circulation and editorial components, in order to be able to treat the advertising component as a separate business. Hence, the regulations determined the related versus unrelated issue with respect to each activity conducted by an exempt organization rather than with respect to each integrated business.¹⁵⁸

155. Id. § 1.513-1(d)(2) (as amended by T.D. 6939, 1968-1 C.B. 274).

156. Id. § 1.513-1(b) (as amended by T.D. 6939, 1968-1 C.B. 274).

157. See William J. Lehrfeld, *The Unfairness Doctrine: Commercial Advertising Profits As Unrelated Business Income*, 23 *Tax Lawyer* 349 (1970).

158. Regs. § 1.513-1(b) provides:

Thus, for example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes. . . . Similarly, activities of soliciting, selling, and publishing commercial advertising do not lose identity as [sic] trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization.

Id.; see id. § 1.513-1(d)(4)(iv) (as amended by T.D. 6939, 1968-1 C.B. 274) (ex. 6, 7).

The publisher of the *New England Journal of Medicine* challenged the validity of the 1967 fragmentation regulation as contravening Congressional intent. See *Massachusetts Medical Soc'y v. United States*, 514 F.2d 153 (1st Cir. 1975). The First Circuit agreed with the taxpayer. Id. The case was decided after the 1969 Congress codified the fragmentation regulations by enacting IRC § 513(c). The decision, therefore, applied only to taxable years beginning before the 1969 amendment. Id. Regs. § 1.512-1(d)(2), the First Circuit observed,

3. *The Tax Reform Act of 1969.*—Noting the controversy swirling around the issue as to whether the 1950 Congress had intended a scalpel to be applied to an integrated business so that it might be dissected into its component parts, and with the avowed purpose of codifying the scalpel invented by the 1967 regulations,¹⁵⁹ the 1969 Congress added the regulations' fragmentation language to the Code as subsection 513(c):

For purposes of this section, the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services. For purposes of the preceding sentence, an activity does not lose identity as a trade or

allows the excess of expenses attributable to the editorial content of the magazine over income derived therefrom, i.e., a loss produced solely by the exempt related business component of the magazine, to offset advertising taxable income, i.e., the unrelated business component. Observed the Court: "It is doubtful that Congress would have approved such an anomalous result." *Massachusetts Medical Soc'y*, 514 F.2d. Id. at 156.

In *American Medical Ass'n v. United States*, 887 F.2d 760 (7th Cir. 1989), the AMA challenged the validity of Regs. § 1.512-1(a)-(f) governing the allocation of revenue and expenses between a journal's exempt editorial activities and its taxable advertising activities. For a discussion and generally critical view of the fragmentation regulations, see Thomas R. Moore, *Current Problems of Exempt Organizations*, 24 *Tax L. Rev.* 469, 472, 474-76 (1969); Liles & Blum, *supra* note 2, at 50-54; John M. Donahue, *Unrelated Business Income of Tax Exempt Organizations*, 37 *N.Y.U. Inst. on Fed. Tax'n* § 27.06[1] (1979); *The Macaroni Monopoly*, *supra* note 60, at 1291. The author of *The Macaroni Monopoly* acknowledges that if a university radio station whose programs further educational purposes is taxed on its advertising income, the "exemption for the radio station itself is meaningless" because advertising income is usually a radio station's only income. *Id.* Additionally, although exempt publications "compete for advertising, their income from this source is necessarily limited by the size and quality of their readership. When a publication like the *National Geographic Magazine* expands, the expansion would presumably serve the purpose for which the Geographic Society was granted its tax exemption." *Id.* at 1291-92. Nevertheless, the author finds the fragmentation provisions of the 1967 regulations acceptable because the tax will only apply to publications whose total subscription and advertising income exceed expenses. *Id.* at 1292.

159. In 1968 the Senate approved a measure to exempt advertising revenue in exempt journals, but the Conference Committee eliminated it. The Senate also voted down a measure to delay application of the new regulations for a period of one year. S. Rep. No. 1497, 90th Cong., 2d Sess. 11 (1968). In referring to the 1967 regulations, The House Committee on Ways and Means considering the 1969 Tax Reform Act commented:

In general, [your committee] is in agreement with the purpose of the regulations. Your committee believes that a business competing with taxpaying organizations should not be granted an unfair competitive advantage by operating tax free unless the business contributes importantly to the exempt function. It has concluded that by this standard, advertising in a journal published by an exempt organization is not related to the organization's exempt functions, and therefore it believes that this income should be taxed.

H.R. Rep. No. 413, *supra* note 102, at 50, reprinted in *U.S.C.C.A.N.* at 1695.

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. Where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.¹⁶⁰

Although the Supreme Court in *United States v. American Bar Endowment*¹⁶¹ refers to the first sentence of subsection 513(c) as defining a trade or business,¹⁶² the language is presumably not intended as an all-encompassing definition for purposes of a tax on unrelated trade or business. The word "includes" in the first sentence, as originally appearing in the 1967 regulations, most likely is directed at including a component part of an integrated business, i.e., an activity, within the grasp of the tax as well as a whole business.

Keen on wheeling integrated businesses into the operating room for obligatory surgery, the 1969 Congress unfortunately codified the ambiguity of the word "income" in the first sentence as well. Does the use of the word "profit" in the third sentence indicate that Congress knew the difference between "income" and "profit" and deliberately chose not to use "profit" in the first sentence? Is the word "profit" associated only with an unrelated trade or business, whereas "income" is associated with any trade or business, related or unrelated? Or, is subsection 513(c) simply using the two words "income" and "profit" interchangeably?¹⁶³

160. IRC § 513(c). Section 513(c) was added by the Tax Reform Act of 1969. See Tax Reform Act of 1969, Pub. L. No. 91-172, § 502(c), 83 Stat. 487, 576. The Supreme Court, in *United States v. American College of Physicians*, 475 U.S. 834 (1986), did not challenge the validity of the fragmentation rationale embodied in § 513(c).

161. 477 U.S. 105 (1986).

162. *Id.* at 110.

163. The Senate Committee on Finance drafted § 513(c) in narrower terms, to be limited to advertising in otherwise exempt journals, a sale by a hospital pharmacy of drugs to persons other than hospital patients, and the operation of a race track by an exempt organization. S. Rep. No. 552, *supra* note 100, at 76, reprinted in 1969 U.S.C.C.A.N. at 2104. The Senate Committee interpreted "an activity carried on for the production of income" to mean "net income." The Senate Committee further stated:

Under both the House and committee versions of the bill, an organization which publishes more than one magazine, periodical, etc., may treat any of these on a consolidated basis in determining its unrelated trade or business income so long as each such periodical, etc., is 'carried on for the production of income.' The organization, however, would not be permitted to consolidate the losses of a publication not carried on for the production of income with the profits of other publications which are carried on for profit.

4. *Decisions in the 1980s.*—Stepping into the middle of this fugue of statutory interpretation written contrapuntally by Congressional tax committees and the Treasury during the previous three decades, courts in the 1980s were confronted with the meaning of the phrase “trade or business” for purposes of the tax on unrelated businesses with little more than ambiguity to guide them. Faced with the issue in *Louisiana Credit Union League v. United States*¹⁶⁴ of whether a business league exempt under section 501(c)(6) was engaged in a trade or business through the activities of endorsement and promotion of insurance, data processing, and debt collection service, the Fifth Circuit held that the proper test is whether the organization “is engaged in extensive activity over a substantial period of time with the intent to earn a profit.”¹⁶⁵ Noting that section 513(c)—“any activity which is carried on for the production of income”¹⁶⁶—first raises the issue of motive, the court allowed itself to be guided by the regulations to the “familiar jurisprudence of section 162” and in turn to the conclusion that the statutory standard must be a motive for profit.¹⁶⁷ Implicit in the standard formulated by the Fifth Circuit is the requirement that the profit be earned from the sale of goods or the performance of services. Under this standard, the court found that the League was engaged in a trade or business.¹⁶⁸

Finding the “carried on for the production of income” language of subsection 513(c) “quite clear,” the Fourth Circuit in *Carolinas Farm &*

Id. The Conference Committee followed the House bill, but in the third sentence of § 513(c) substituted the word “profit” for “income,” i.e., “Where an activity carried on for profit” rather than “Where an activity carried on for income.” See Conf. Rep. No. 782, 91st Cong., 1st Sess. (1969), reprinted in 1969 U.S.C.C.A.N. 2392, 2406. Presumably, the purpose of the third sentence of § 513(c) is to allow the consolidation of the losses of one periodical published by an exempt organization with the profits of another periodical published by the same organization when the advertising in both is profit-motivated. See Cooper, *supra* note 71, at 2010; see also Kaplan, *supra* note 62, at 1438 (applying § 513(c) to support author’s position that a university’s intercollegiate athletic program can be a trade or business separate from its physical education program). As to whether broadcast revenues can be treated as a trade or business separate from the intercollegiate athletic program, see Kaplan, *supra* note 62, at 1436 n.35.

164. *Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982). Although organizations exempt from income taxation under categories other than § 501(c)(3) are not the focus of this article, the principles developed in cases dealing with the tax on unrelated business applicable to such organizations can be, and have been, applied to the activities of § 501(c)(3) organizations. See *United States v. American Bar Endowment*, 477 U.S. 105, at 110 n.1 (1986) (citing several appellate court decisions dealing with organizations exempt under § 501(c)(6) with respect to the definition of a trade or business in applying the term to the activities of a § 501(c)(3) organization).

165. *Id.* at 532.

166. *Id.* at 531.

167. *Id.* at 532.

168. *Id.* at 534.

*Power Equipment Dealers Ass'n v. United States*¹⁶⁹ also equated that language with the profit motive test to hold a trade association taxable on insurance premium rebates received from a commercial carrier. The Court said: “[D]efining an activity as a trade or business on the basis of the taxpayer’s motive for conducting it arguably effectuates Congress’s intent since an activity conducted with a profit motive and not substantially related to a charitable end ‘presents sufficient likelihood of unfair competition to be within the policy of the tax.’ 26 C.F.R. 1.513-1(b).”¹⁷⁰ Once again, the inference can be drawn that an exempt organization’s primary motive, or at least one motive, for conducting a trade or business substantially related to its charitable purpose is by definition a desire for profit.

In a 1984 decision, *Professional Insurance Agents of Michigan v. Commissioner*,¹⁷¹ the Sixth Circuit explicitly followed the logic of *Louisiana Credit Union League* in holding another business league taxable on its income received from splitting insurance premiums with a commercial carrier in exchange for the organization’s promotion of the insurance product among its membership.¹⁷² Similarly, the Tax Court has either explicitly or implicitly assumed that the word “income” in the first sentence of section 513(c) means “profit” or has extracted that conclusion from the reference to section 162 and the *Hirsch* rationale.¹⁷³ Accordingly, the Tax Court has consistently determined that the proper test to determine the presence of a trade or business is whether the organization is conducting the activity with a predominant motive, or at least a motive, for profit.¹⁷⁴

It was in this judicial setting that the Supreme Court decided *United States v. American Bar Endowment*¹⁷⁵ in 1986. American Bar Endowment

169. 699 F.2d 167, 170 (4th Cir. 1983).

170. *Id.* at 170 (quoting Regs. § 1.513-1(b)).

171. 726 F.2d 1097 (6th Cir. 1984).

172. *Id.* at 1103-04.

173. See *Veterans of Foreign Wars, Mich. v. Commissioner*, 89 T.C. 7, 20 (1987) (“If an activity is carried on for the production of income from the sale goods or the performance of services, then it is a ‘trade or business’ within the meaning of § 513(c). . . . In determining whether petitioner carried on the Christmas card program for the production of income, our inquiry is directed at petitioner’s intent in carrying on the activity. We must determine whether petitioner carried on the Christmas card program with the intent of producing income, or stated another way, whether petitioner had a profit motive.”). See also *National Water Well Ass’n v. Commissioner*, 92 T.C. 75, 84 (1989).

174. See *National Water Well Ass’n v. Commissioner*, 92 T.C. 75, 84-85 (1989); *Veterans of Foreign Wars, Mich. v. Commissioner*, 89 T.C. 7, 20 (1987); *St. Joseph Farms v. Commissioner*, 85 T.C. 9, 20 (1985); *Professional Ins. Agents v. Commissioner*, 78 T.C. 246, 259 (1982), *aff’d*, 726 F.2d 1097 (6th Cir. 1984); see also Kaplan, *supra* note 62, at 1438 (equating the word “income” in § 513(c) with “profit,” and concluding that an activity is a trade or business if at least one of the motives for operating it is the desire for profit).

175. 477 U.S. 105 (1986).

(ABE) is a 501(c)(3) organization devoted to advancing legal research and to promoting the administration of justice. ABE has automatically as its membership all members of the American Bar Association. During the taxable years in question ABE provided group life, health, accident and disability insurance to its members. In return for choosing the insurer, negotiating premium rates, soliciting its members, collecting the premiums, and screening claims for benefits, ABE received all dividends (refund of excess premiums) declared by the insurance carriers. As a condition to participation in an insurance program, members were required to agree to allow ABE to keep the dividends rather than distribute them to the membership.¹⁷⁶

After reciting section 513(c)'s definition of 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" and noting in footnote 1 that "[t]he standard test for the existence of a trade or business for purposes of § 162 is whether the activity 'was entered into with the dominant hope and intent of realizing a profit,'" ¹⁷⁷ the Supreme Court determined that ABE's insurance program "falls within the literal language of these definitions."¹⁷⁸ In order to assure itself that ABE's activities constituted both the sale of goods and the performance of services, and possessed the general characteristics of a trade or business, the Court compared the organization's insurance programs to activities that potentially could be, or in fact are, carried out by taxable entities: "Certainly the assembling of a group of better-than-average insurance risks, negotiating on their behalf with insurance companies, and administering a group policy are activities that can be—and are—provided by private commercial entities in order to make a profit."¹⁷⁹ Because the Claims Court¹⁸⁰ and Court of Appeals for the Federal Circuit¹⁸¹ had determined that ABE lacked a motive for profit in operating its insurance program, much of Justice Marshall's opinion is devoted to dispelling the notion that the dividends received by ABE are voluntary contributions from the membership and therefore can not constitute profits.¹⁸²

176. *Id.* at 107-08.

177. *Id.* at 110 & n.1 (quoting *Brannen v. Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984)).

178. *Id.* at 110.

179. *Id.* at 111.

180. *American Bar Endowment v. United States*, 4 Cl. Ct. 404 (1984), *aff'd* in part and *rev'd* in part, 761 F.2d 1573 (Fed. Cir. 1985), *rev'd*, 477 U.S. 105 (1986).

181. *American Bar Endowment v. United States*, 761 F.2d 1573 (Fed. Cir. 1985), *rev'd*, 477 U.S. 105 (1986).

182. *Id.* at 111-16.

5. *Is Profit Motive the Correct Standard?*.—If profit in a nontax sense is the excess of revenues generated by an activity over allocable expenses, three of the types of activities conceivably conducted by 501(c)(3) organizations—fund raising, investing, and unrelated trade or business—typically are driven by a desire for profit to enable the organization to carry on its exempt purposes. Inasmuch as each of these activities can be conducted with regularity as well, defining the phrase “trade or business” as “extensive activity over a substantial period of time with the intent to earn a profit”¹⁸³ or as an activity “entered into with the dominant hope and intent of realizing a profit”¹⁸⁴ does not serve as a useful guidepost to distinguish business activity from the other two types of endeavors.

Conversely, as the Fifth Circuit observed in *Louisiana Credit Union League*, the fourth type of activity potentially conducted by 501(c)(3) organizations, substantially related trade or business, cannot by the definition within section 513(a) have as its primary function the potential to raise revenue to support the organization’s exempt function.¹⁸⁵ Thus, the Fifth Circuit appears to have concluded that the touchstone of trade or business is profit motive and that a related trade or business by definition can not have a motive primarily to earn profit.

Similarly, in *United States v. American College of Physicians*,¹⁸⁶ another 1986 Supreme Court decision involving the tax on the unrelated business income of a section 501(c)(3) organization, the Court appears to confirm the position that a trade or business is not substantially related to the exempt purposes of the organization if the exempt function it furthers is incidental to its purpose to raise revenue.¹⁸⁷ In this respect the two Supreme Court cases decided in 1986 interpreting the section 511 tax, *American College of Physicians* and *American Bar Endowment*, appear to be inconsistent. To exclude from the category “substantially related trade or business” any activity primarily driven by a desire for profit (*American College of Physicians*) and to adopt the view that a trade or business is an activity involving the sale of goods or performance of service with the dominant intent of realizing profit (*American Bar Endowment*) is to fail to define the phrase “trade or business” as an activity that can be either related or unrelated to the accomplishment of the exempt purposes of the organization.

183. *Louisiana Credit Union League v. United States*, 693 F.2d 525, 532 (5th Cir. 1982).

184. *Brannen v. Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984).

185. *Louisiana Credit Union League*, 693 F.2d at 530.

186. *United States v. American College of Physicians*, 475 U.S. 834 (1986).

187. *Id.* at 848-49. The Court, in affirming the Claims Court and reversing the Court of Appeals, quotes with favor the Claims Court: “[A]ny educational function [the advertising] may have served was incidental to its purpose of raising revenue.” *Id.* at 848.

What both related and unrelated trade or business activities have in common with trade or businesses conducted by taxable organizations, and is not characteristic of either investing or fund raising, is the receipt of gross income from the sale of goods or the performance of services at market value. To add an additional ingredient to the definition in the context of the tax imposed by section 511—that the activity be driven by a motive, or primary motive for profit—is to restrict the scope of the definition to include unrelated, but not related, trade or business. From this perspective the reference to section 162, both in legislative history and the regulations, has misled the courts into infusing the *Hirsch* and *Lamont* profit motive gloss into the meaning of the phrase “trade or business” for purposes of the tax on unrelated business income.

Requiring profit motive to be the touchstone of trade or business activity makes sense if the task is to differentiate an individual taxpayer's business expenses deductible under section 162 from his hobby or other expenditures nondeductible under section 262.¹⁸⁸ The “for profit” criterion may be the proper one as well to determine whether the expenses of a trade or business are deductible under subsection 512(a)(1) to determine unrelated business taxable income. The “for profit” test is misapplied when the task is to differentiate trade or business activity from other types of endeavors conducted by 501(c)(3) organizations.¹⁸⁹

188. See IRC § 262(a) (disallowing deductions for personal, living, or family expenses).

189. The United States Court of Appeals for the District of Columbia Circuit and the United States Court of Appeals for the Seventh Circuit both cite the Supreme Court's decision in *American Bar Endowment* as establishing profit motive as the proper test to determine the presence of trade or business. See *American Postal Workers Union v. United States*, 925 F.2d 480, 481 (D.C. Cir. 1991); *Illinois Ass'n of Professional Ins. Agents v. Commissioner*, 801 F.2d 987, 990-91 (7th Cir. 1986). The United States Court of Appeals for the Federal Circuit also applied the profit motive test in *National Ass'n of Postal Supervisors v. United States*, 944 F.2d 859, 861 (Fed. Cir. 1991).

In concluding that a full-time gambler was engaged in a trade or business within the meaning of § 162, the Supreme Court held that “while the offering of goods and services usually would qualify the activity as a trade of business, this factor, it seems to us, is not an absolute prerequisite.” *Commissioner v. Groetzinger*, 480 U.S. 23, 34 (1987). Further, the Court stated:

We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.

Id. at 35. But the Court refused to supply an all-purpose definition:

But the difficulty rests in the Code's wide utilization in various contexts of the term ‘trade or business,’ in the absence of an all-purpose definition by statute or regulation, and in our concern that an attempt judicially to

Arguably, the majority of courts erroneously applying the “for profit” criterion have nonetheless reached the correct conclusion in their attempt to identify trade or business activity for purposes of the section 511 tax. There is, however, a compelling reason to encourage courts to apply a more accurate definitional test beyond the need to be logical. The “for profit” test is relevant to differentiate unrelated from related trade or business, but not to distinguish trade or business from other types of endeavors such as fund raising. As discussed in Subpart B, *infra*, by injecting the element of profit motive in the attempt to identify trade or business, many courts in effect have resolved the related versus unrelated question before even turning to consider that issue.

6. *Reformulation of the Standard.*—Regulations section 1.513-1(b) should be amended in part to provide that for purposes of section 513 the phrase “trade or business” generally includes any activity (1) involving the sale of goods or the performance of services at market value from which gross income is derived; and (2) which otherwise possesses the characteristics required to constitute trade or business within the meaning of section 162, but without regard to whether or not the activity is engaged in with a motive, or primary motive, to derive profit.

Had the proposed standard been applied to the facts in *American Bar Endowment*, the Supreme Court could have found ABE to be engaged in a trade or business from the basic conclusion that the excess premiums received by ABE from the insurance carriers more likely constituted gross income from the sale of goods and the performance of services at market value than they did charitable contributions from the membership resulting from the members voluntarily paying the higher than necessary premiums ABE negotiated with the carriers. Unfortunately, the Court interjected the element of motive into the inquiry when it identified ABE’s insurance as a trade or business by comparing the activity to similar endeavors actually or potentially carried on by taxable organizations for profit. One can assume that desire for profit is the driving force behind all sales and service activity conducted by taxable organizations and is a necessary component to find such activity to be a trade or business in the hands of an individual. One cannot make the same assumption with respect to all sales and service activity conducted by 501(c)(3) organizations.¹⁹⁰

formulate and impose a test for all situations would be counterproductive, unhelpful, and even somewhat precarious for the overall integrity of the Code.

Id. at 36.

190. In *American Bar Endowment*, the United States Claims Court applied its own test to identify trade or business, *viz.*, whether the activity was conducted in a competitive,

B. Trade or Business: Substantially Related or Unrelated?

The statutory definition of the term “unrelated trade or business” has remained unchanged since the Revenue Act of 1950. Section 513(a) defines the term as “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. . . .”¹⁹¹ The Senate Report accompanying the 1950 Revenue Bill attempted to illuminate this “substantially related” standard by way of example and not by way of explication. Examples offered of substantially related business were a wheat farm operated by an exempt agricultural college as part of its educational program;

commercial manner. 4 Cl. Ct. 404, 411-12 (1984). This test was developed by the United States Court of Claims in *Disabled Am. Veterans v. United States*, 227 Ct. Cl. 474 (1981), wherein a charitable organization sent out books, maps, charts and other premiums in connection with the solicitation of contributions. The government asserted that the activity was engaged in for profit and therefore constituted a trade or business. *Id.* at 486. The Court responded: “[I]t is clear that not all activity engaged in with the expectation of gain constitutes a ‘trade or business’ as that term is utilized with respect to UBTI.” *Id.* The Court pointed out that both S. Rep. No. 552, 91st Cong., 1st Sess. (1969) and subsequently amended Regs. § 1.513-1(b) contain statements to the effect that the sending out of low cost articles incidental to the solicitation of charitable contributions was not to be considered a trade or business. *Disabled Am. Vets.*, 227 Ct. Cl. at 486-87. It is clear that the Court of Claims viewed an activity as being conducted in a competitive, commercial manner when the exempt organization offered the premium items only in exchange for prior contributions in amounts that approached the retail value of the item. On the other hand, a “competitive situation would not be present” when the contribution required for the premium item was greatly in excess of the retail value of the premium. *Id.* at 488-89. Utilized in this way, the “competitive, commercial manner” test employed to identify trade or business is the same criterion proposed in this article, viz., trade or business is the sale of goods or the performance of services at market value from which gross income is derived. Fundraising would include the supply of goods or the performance of services to the extent that the amount voluntarily paid for the goods or services exceeded their market value. If the article sent out is “low cost,” the entire amount remitted to the charitable organization can be considered a contribution. See IRC § 513(h) (added by Pub. L. No. 99-514, 100 Stat. 2766 (Tax Reform Act of 1986)) (providing that in the case of a charitable organization, the term “unrelated trade or business” does not include activities relating to the distribution of low cost articles incidental to the solicitation of charitable contributions). In *American Bar Endowment*, the Claims Court again applied the “competitive, commercial manner” test to conclude that the ABE membership was voluntarily supporting a fundraising effort because “the amount of money ABE is permitted to retain far exceeds the value of any service it may be providing through the operation of the insurance programs. It is quite obvious, then, that this money was not earned from the sale of goods or the performance of services . . . but for some other reasons.” *American Bar Endowment*, 4 Ct. Cl. at 411-12.

191. IRC § 513(a) (formerly IRC § 422(b)).

income of an educational organization from charges for admissions to football games; a nonprofit hospital's income from patients; and income from the sale of articles made by handicapped persons derived by an exempt organization engaged in their rehabilitation.¹⁹² Not surprisingly, the manufacture and sale of automobile tires by a college was offered as an example of a business ordinarily considered unrelated to the exempt purposes of the school.¹⁹³

1. *The 1958 Regulations.*—Although the statute focuses on the relatedness of the *conduct* of business activity to the performance of the organization's exempt purpose, the test under the 1958 regulations was the underlying principal *purpose* driving the activity. Under the 1958 regulations, a trade or business is ordinarily "substantially related to the activities for which an organization is granted exemption if the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption."¹⁹⁴ Two important guideposts were offered to determine an activity's principal purpose: (a) the nature and size of the activity in question compared with the scale of the organization's exempt activity, and (b) the manner in which the activity in question was conducted.¹⁹⁵ Expanding upon an example in the Senate Report accompanying the 1950 Revenue Bill, the 1958 regulations observed that a wheat farm may not be substantially related to the educational program of an agricultural college if it is "operated on a scale disproportionately large" when compared with the exempt activity.¹⁹⁶ According to the regulations:

Similarly, a university radio station or press is considered a related trade or business if operated primarily as an integral part of the educational program of the university, but is considered an unrelated trade or business if operated in substantially the same manner as a commercial radio station or publishing house.¹⁹⁷

2. *The 1967 Regulations.*—As noted above, the 1967 regulations are remembered for their announcement to the charitable sector that the Treasury

192. S. Rep. No. 2375, *supra* note 54, at 107-08, reprinted in 1951 U.S.C.C.S. at 3165-66.

193. *Id.* See also *The Macaroni Monopoly*, *supra* note 60, at 1291 (suggesting that the criterion used in the House and Senate reports to distinguish related from unrelated business was more that between "normal" and "unusual" than a determination of how substantially the activity furthered the organization's exempt purposes).

194. Regs. § 1.513-2(a)(4) (as amended in 1975).

195. *Id.*

196. *Id.*

197. *Id.*

Department had honed a new surgical skill—an ability to dissect an integrated business into its component parts, each of which was to be tested as a separate trade or business to determine that particular component's relatedness or unrelatedness to the exempt purposes of the organization. Thus, under the 1967 regulations, the activities of soliciting, selling, and publishing commercial advertising in an exempt organization periodical was a trade or business separate from the activity of publishing the editorial matter. Similarly, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy was a business separate from the furnishing of supplies to hospital patients.¹⁹⁸

Creating less controversy at the time was the 1967 regulations' reformulation of the standard governing whether a trade or business, fragmented or unfragmented, was related to the exempt purposes of the organization. Under the 1967 regulations, which are still in effect, a business is substantially related if the conduct of the business has a substantial causal relationship to the achievement of the organization's exempt purposes.¹⁹⁹ As the 1967 regulations rephrase it, "the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of" the exempt purposes of the organization.²⁰⁰ In each case the test is one of facts and circumstances.

To determine the issue of substantial relatedness, both the 1958 and the 1967 regulations direct one's focus to the size and extent of the activities in question compared to the nature and extent of the organization's exempt activity.²⁰¹ Under the 1958 regulations, however, objective factors such as the manner in which the activity is conducted are a means to determine the subjective primary purpose of the activity,²⁰² i.e., did the organization intend the activity to contribute importantly to the fulfillment of its exempt purposes? Under the 1967 regulations objective factors are a means to determine whether or not the activity in fact contributes importantly to the accomplishment of the exempt goals.²⁰³

Did the Treasury Department intend a substantive change by adopting in the 1967 regulations a reformulated standard governing the substantial relatedness issue? Perhaps the Treasury Department came to realize that the

198. Id. Regs. § 1.513-1(b) (as amended in 1983).

199. Id. Regs. § 1.513-1(d)(2).

200. Id.

201. See id. Regs. § 1.513-1(d)(3) (1967 regulations); Regs. § 1.513-2(a)(4) (1958 Regulations) (as amended in 1969).

202. See Regs. § 1.513-2(a)(4) (as amended in 1969).

203. See Regs. § 1.513-1(d). One possible difference is that an activity too large relative to the exempt purposes it served was totally taxable under the 1958 regulations and only partially taxable under the 1967 regulations. See Moore, *supra* note 158, at 473-74.

1958 regulations were out of step with the statute by requiring a determination of an exempt organization's subjective primary motive in operating a business activity. Section 513 requires only a determination of whether the conduct of the business is substantially related to the performance of the exempt function, rather than discovery of the principal motive driving the activity. Noticeably absent from the 1967 regulations are references to principal purpose or motive. Did the 1967 regulations mean to imply that an activity could meet the "contribute importantly" test and fail the "principal purpose" test?²⁰⁴

Perhaps the 1967 regulations reflected the Treasury Department's intention to withdraw the principal purpose test of the 1958 regulations, focusing rather on more objective criteria, as a necessary consequence of that regulation's fragmentation of an integrated business into its component parts each of which itself is regarded as a trade or business. Although a business as an integrated whole is likely to be driven by a discernible primary motive, the exempt organization may have failed to formulate a motive, at least on a conscious level, for each of the business's component parts.

Whatever the reason for the reformulation of the standard, it is probable that a court faced with the related versus unrelated issue will come to the same conclusion whether the standard applied is the principal purpose test of the 1958 regulations or the causal relationship test of the 1967 regulations. Both standards require an examination of the same objective facts and circumstances to resolve the issue. Moreover, it can be assumed in the usual case that if the manner in which an activity is conducted contributes importantly to the exempt purposes of the organization, the activity mirrors the principal motive to further those purposes. Nonetheless, the case of a 501(c)(3) organization failing to conduct a business activity in a manner that contributes importantly to its exempt purpose despite its principal purpose to do so is not beyond imagination. Less likely is the case in which the activity contributes importantly to the accomplishment of the organization's exempt purposes notwithstanding a principal purpose to earn profit.²⁰⁵

Is it significant that section 513(c), added by the Tax Reform Act of 1969, codified those portions of the 1967 regulations fragmenting an integrated business into its component parts, but failed to codify those portions dealing with the issue of whether the activity, fragmented or unfragmented, was substantially related to the exempt purposes of the organization?

204. Professor Kaplan assumes this to be the case: "Thus, an activity is 'substantially related' if it 'contributes importantly' to the university's educational mission, even if the activity's principal purpose is financial or is otherwise unrelated to education." Kaplan, *supra* note 62, at 1451. What luck if a university sets out primarily to make money from an activity and the activity also contributes importantly to the university's educational mission!

205. See *infra* note 222 and accompanying text.

Unfortunately, the last sentence of subsection 513(c) casts a lingering doubt as to whether the 1969 Congress intended subjective motive to play a role: "Where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit."²⁰⁶

Whether or not the 1967 regulations were intended to divert attention away from subjective motive, very few courts applying the "contribute importantly" standard to resolve the related versus unrelated issue have been able to avoid sliding back into the principal purpose test of the 1958 regulations, even after having recited the "contribute importantly" standard as the appropriate one.

For instance, in *American College of Physicians*,²⁰⁷ involving facts almost identical to Example (7) of section 1.513-1(d)(4)(iv) of the 1967 regulations, the Supreme Court was faced with the issue of whether the business of selling advertisements containing information about the use of medical products published in *The Annals of Internal Medicine* was substantially related to the educational purpose of the College. Reciting the regulation's direction to examine the importance of the business activity's contribution to the organization's exempt purpose, the Supreme Court agreed with the Claims Court that the manner in which the College selected the advertisements did not establish the necessary causal relationship between the activity and the exemption [e.g., those willing to pay for space got it and there was lacking a comprehensive or systematic presentation of the goods or services advertised].²⁰⁸ But the Claims Court itself slipped into the principal purpose standard of the 1958 regulations when it concluded that any educational function that may have been served by the advertisements was incidental to the College's *purpose* of raising revenue.²⁰⁹ The Supreme Court pursued this theme with the following comment: "This is not to say that the College could not control its publication of advertisements in such a way as to reflect an *intention* to contribute importantly to its educational functions."²¹⁰ Doubtless Example (7) of the regulation itself with its reference to both "governing objective" and "method" contributed to the

206. IRC § 513(c).

207. 475 U.S. 834 (1986).

208. *Id.* at 849.

209. *American College of Physicians v. United States*, 3 Cl. Ct. 531, 535 (1983), rev'd, 743 F.2d 1570 (Fed. Cir. 1984), rev'd, 475 U.S. 834 (1986).

210. *American College of Physicians*, 475 U.S. at 849 (emphasis added). For an analysis of the case, see Note, "Substantially Related"—The Magic Words for Nonprofit Organizations: *United States v. American College of Physicians*, 21 U.S.F. L. Rev. 795 (1987).

Court's attention to the motive of the College as well as to the manner in which the advertisements were selected.²¹¹

In *California Thoroughbred Breeders Association v. Commissioner*,²¹² the Tax Court, citing *American College of Physicians*, understood the Supreme Court to hold that "it would examine the *conduct* and *intent* of the organization,"²¹³ that the Supreme Court "found that the taxpayer did not use or *intend* to use the advertising for the purpose of contributing to the educational value of the journal"²¹⁴ and that the Supreme Court "found that any educational function that the advertisements might serve was only incidental to its *purpose* of raising revenue."²¹⁵ It would appear, therefore, that the principal purpose standard of the 1958 regulations remains in vigorously good health to this day.

3. *Profit and Profit Motive*.—The 1958 regulations did not explicitly provide that if the principal purpose of a trade or business is not to further the exempt purpose of the organization, a fortiori, the principal purpose must be to earn profit (ultimately to be used to further the organization's exempt purpose).²¹⁶ Nor do the 1967 regulations explicitly state that if a business is found not to contribute importantly to the accomplishment of the organization's exempt purpose, the only alternative is to conclude that it is primarily

211. Regs. § 1.513-1(d)(4)(iv) ex. 7. Example 7 provides in pertinent part: Although continuing education of its members in matters pertaining to their profession is one of the purposes for which Z is granted exemption, the publication of advertising designed and selected in the manner of ordinary commercial advertising is not an educational activity of the kind contemplated by the exemption statute; it differs fundamentally from such an activity both in its governing objective and in its method.

Id.

212. 57 T.C. Memo (CCH) 962, T.C. Memo (RIA) ¶ 89,342 (1989).

213. Id. at 967; 58 T.C. Memo (RIA) at 89-1722 (emphasis in original).

214. Id. (emphasis added).

215. Id. (emphasis added). See Note, *Insurance Trade Association Held Subject to Unrelated Business Income Tax: Independent Insurance Agents of Huntsville, Inc. v. Commissioner*, 47 Tax Law. 815 (1994) (interpreting the Supreme Court in *American College of Physicians* to hold that "to contribute importantly (and hence to be substantially related), an activity need only reflect an intention to contribute importantly and not actually do so." Id. at 818. The unstated inference is that the principal purpose standard of the 1958 regulations lies at the heart of the 1967 regulations, notwithstanding the fact that the 1967 regulations focus on the casual relationship between the conduct of an activity and achievement of the organization's exempt purposes. The Note observes that a number of appellate court decisions handed down subsequent to *American College of Physicians*, notably *Huntsville*, focused more on the outcome of the activity in question rather than on the organization's intent as evinced by how the activity was conducted. Id. at 823.

216. See Regs. § 1.513-2(a) (as amended in 1969).

a revenue raiser.²¹⁷ Nonetheless, the inference in both regulations that a business activity must serve one master or the other is unmistakable and the vast majority of courts have assumed this to be the case.

In *Iowa State University of Science & Technology v. United States*,²¹⁸ one of the few cases decided under standards set out during the brief nine-year reign of the 1958 regulations, the Court of Claims was faced with the question of whether the operation of a college television station was related or unrelated to the educational purposes of the University. Repeating the example in the regulation that a university radio station is unrelated if operated in substantially the same manner as a commercial station, the Court observed that the primary purpose of a typical commercial facility is profit.²¹⁹ The Court examined the programming policy of the television station, i.e., the selection of popular entertainment programs to attract the largest number of viewers, as well as the secondary importance of public affairs and educational programs, to support the conclusion that the station was being operated in a manner to maximize revenue.²²⁰ Finding that the primary goal of Iowa State's WOI-TV was revenue maximization, the Court held the University's television business not to be substantially related to the school's exempt purposes.²²¹

Typically, the issue is framed in the manner in which the Seventh Circuit put it in *Illinois Association of Professional Insurance Agents, Inc. v. Commissioner*:

We must ask: do IAPIA's activities in promoting errors and omissions insurance coverage among independent insurance agents evince an intention to use that promotion of E & O coverage for the purpose of contributing importantly to the improvement of conditions in a particular line of business, or do its activities in promoting coverage indicate that any exempt function which is served is incidental to its purpose of raising revenue?²²²

217. See Regs. § 1.513-1(d).

218. 500 F.2d 508 (Ct. Cl. 1974).

219. *Id.* at 517.

220. *Id.* at 518-20.

221. *Id.* at 520.

222. *Illinois Ass'n of Professional Ins. Agents v. Commissioner*, 801 F.2d 987, 994 (7th Cir. 1986); see also *Independent Ins. Agents, Inc. v. Commissioner*, 998 F.2d 898, 902 (11th Cir. 1993) ("IAH's conduct does not evince an intention to use its public insurance activities to contribute importantly to the improvement of conditions in the insurance business or to further its exempt purposes. Instead, its conduct indicates that raising revenue was its primary concern.").

If the parties have stipulated that the activity in question constitutes a trade or business, courts generally approach the related versus unrelated issue by first identifying the exempt purposes of the organization and then by deciding whether the manner in which the activity in question is conducted contributes importantly (or in terms of the 1958 regulations, evidences an intention to contribute importantly) to the accomplishment of those purposes. If the court finds lacking the necessary causal relationship between the conduct of the business and the accomplishment of the exempt purposes, only then is the conclusion reached that the activity is being operated in a manner primarily to raise revenue and therefore the principal underlying motive is profit. The finding of a primary profit motive is the final step in the analysis.²²³

There is a certain logic to the proposition that an activity's principal purpose must either be to further directly the organization's exempt purposes, in which case it constitutes a related business, or the primary motive is profit, in which case the activity is unrelated. One would have thought that it follows from this proposition that every unrelated trade or business is primarily motivated by profit. Apparently there is an exception to every proposition. In *West Virginia State Medical Ass'n v. Commissioner*, 882 F.2d 123 (4th Cir. 1989), a medical association incurred an excess of direct advertising costs over advertising revenue for 21 consecutive years in connection with its monthly medical journal. *Id.* at 125. It was not disputed that the advertising activity was not substantially related to the association's exempt purpose. *Id.* at 124. Since the Court concluded that the advertising activity losses evidenced a lack of profit motive, the losses could not offset the income from another unrelated activity. *Id.* at 125. Why, then, did the medical association continue to sell advertising space? Perhaps the association thought that the advertising directly furthered its exempt purposes or that the readership of the journal would diminish without advertising, i.e., that it was related activity. Perhaps hope springs eternal and the association thought that the advertising might eventually make a profit. Or perhaps the association never gave the matter much thought one way or the other.

Conversely, one would have thought that it follows from the main proposition that an activity primarily motivated by profit cannot be a related trade or business. Professor Kaplan suggests that this may not be the case. See Kaplan, *supra* note 62, at 1451. He speculates that Iowa State University of Services and Technology might have been decided in favor of the taxpayer if the 1967 regulations had been applicable, i.e., the university TV station contributed importantly to the educational purposes of the university notwithstanding its primary purpose to make profit. Kaplan, *supra* note 62, at 1451-52. With the Supreme Court, in *American College of Physicians*, continuing to interject motive into the resolution of the related versus unrelated issue, it appears unlikely that a court would conclude that an activity was primarily motivated by profit, yet contributed importantly to the organization's exempt purposes. See *The Macaroni Monopoly*, *supra* note 60, at 1289 ("An activity operated primarily for profit not only is likely to vitiate concern with exempt purposes, but also will probably be more competitive than an activity which only incidentally produces income."); see also *Louisiana Credit Union League v. United States*, 693 F.2d 525, 537 (5th Cir. 1982) ("Because the League's insurance endorsement is basically a fundraising activity, it is by definition unrelated business activity under section 513(a).").

223. See *United States v. American College of Physicians*, 475 U.S. 834 (1986); *Texas Apartment Ass'n v. United States*, 869 F.2d 884 (5th Cir. 1989); *Hi-Plains Hosp. v. United States*, 670 F.2d 528 (5th Cir. 1982); *Minnesota Holstein-Friesian Breeders Ass'n v.*

Unfortunately, as previously noted, a number of courts faced with both the issue of whether an activity falls within the definition of a trade or business and, if it does, whether the activity is related or unrelated to the organization's exempt purpose, find profit to be the primary motive underlying the activity through a resolution of the former issue rather than the latter. Assuming trade or business for purpose of the section 511 tax to be an activity motivated primarily by profit, these courts often find such a motive by applying the axiom that profit itself constitutes strong evidence of a primary intent to earn it. Thus, by interjecting profit motive into the trade or business issue, these courts have in effect resolved the related versus unrelated issue before even turning to it.²²⁴

For instance, prior to examining whether or not a business league's insurance activities contributed importantly to the exempt purposes of the organization, the Fourth Circuit in *Carolinas Farm & Power Equipment* concluded that the activities were carried on primarily to earn a profit as evidenced by the consistently profitable result of the operations and the proportion of insurance income to total income.²²⁵ Observed the Court: "[W]e think that there is no better objective measure of an organization's motive for conducting an activity than the end it achieves."²²⁶ Similarly, in *American Postal Workers*, the Court of Appeals for the District of Columbia Circuit discounted testimony on behalf of the union to the effect that the

Commissioner, 64 T.C. Memo (CCH) 1319, T.C. Memo (RIA) ¶ 92,663 (1992); *California Thoroughbred Breeders Ass'n v. Commissioner*, 57 T.C. Memo (CCH) 962, T.C. Memo (RIA) ¶ 89,342 (1989).

224. The following decisions (1) apply the profit motive test to determine whether an activity constitutes a trade or business for purposes of the tax on unrelated business income; (2) then infer profit motive wholly or partly from the fact that the activity was profitable; and (3) then turn to the related versus unrelated issue: *Illinois Ass'n of Professional Ins. Agents v. Commissioner*, 801 F.2d 987 (7th Cir. 1986) (in effect applying the profit motive test twice, first to determine whether the activity constitutes a trade or business and second to determine whether the trade or business is related or unrelated to the exempt purposes of the organization); *Carolinas Farm & Power Equip. Dealers Ass'n v. United States*, 699 F.2d 167 (4th Cir. 1983); *Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982); *Texas Farm Bureau v. United States*, 822 F. Supp. 371 (W.D. Tex. 1993), rev'd in part, 53 F.3d 120 (5th Cir. 1995); *National Water Well Ass'n v. Commissioner*, 92 T.C. 75 (1989); *Veterans of Foreign Wars, Mich. v. Commissioner*, 89 T.C. 7 (1987); and *Professional Ins. Agents v. Commissioner*, 78 T.C. 246 (1982), aff'd, 726 F.2d 1097 (6th Cir. 1984). In *National Ass'n of Postal Supervisors v. United States*, 944 F.2d 859, 862 (Fed. Cir. 1991), the Court of Appeals for the Federal Circuit inferred a primary profit motive from profit, but did not have the related versus unrelated issue before it. In *American Postal Workers Union, v. United States*, 925 F.2d 480, 483-85 (D.C. Cir. 1991), the Court of Appeals for the District of Columbia Circuit decided that the activity in question was an unrelated trade or business before deciding that it was a trade or business.

225. *Carolinas Farm & Power*, 699 F.2d at 170-71.

226. *Id.* at 170.

prospect of earning profit had not occurred to anyone even in the face of evidence of substantial net profit.²²⁷ Commented the court: "Apparently, we are invited to believe that the profit received was, as has been said of the British Empire, merely picked up in moments of absentmindedness."²²⁸

While it is obvious that recurrent profit, especially large profit, may indicate a principal motive to earn it, the presence of profit is not conclusive with respect to the issue of motive. Assume, for example, that ten years ago a tax exempt school received \$20 million gross income from student tuition, that both tuition and deductible expenses have increased 6% per annum, and that taxable income has averaged 1% of gross income, i.e., the school has consistently derived taxable income in the range of \$200,000 to \$340,000. Assume further that the performance of the services from which the gross income is derived contributes importantly to the accomplishment of the school's educational purpose and that the school has acted in a manner to indicate that fulfillment of its educational mission is its principal purpose.

Can it be said that substantial and recurrent profit necessarily contradicts this principal purpose? If the market place has afforded the school a recurrent 1% profit, the statute does not require, nor should it require, the school to lower tuition to eliminate the profit by attempting to match more perfectly deductible expenses, a feat which in itself may be difficult to accomplish. While not the driving force underlying a related business activity, profit may legitimately occur and may be needed to tide the school over a period of anticipated decline in enrollment, to cope with inflation, to expand services, to improve staff, to add to the endowment fund, or to finance fund raising efforts or needed capital improvements. In *Iowa State University of Science & Technology*, the Court of Claims observed that, "a profitable

227. *American Postal Workers*, 925 F.2d at 484-85.

228. *Id.* Similarly, Professor Kaplan looks to the presence of profit as evidence of profit motive in order to demonstrate that intercollegiate athletics is a trade or business. Kaplan, *supra* note 62, at 1439-40. Finding many university intercollegiate athletic programs to be profitable, Professor Kaplan observes that universities dropping their intercollegiate football programs because they were losing money shows that such programs were undertaken to make money in the first place. *Id.* at 1444-45. Could not one also conclude that the football program was undertaken to further the university's educational goals, but the university simply could not afford to keep it going? It is, however, essentially the "problematic" connection between intercollegiate athletics and education, and the mania for winning, that leads Professor Kaplan to the plausible conclusion that in many cases intercollegiate athletic programs are not substantially related to the educational goals of the university. *Id.* at 1459-60. Winning means greater revenue from broadcasting, larger gate admissions, and the opportunity to play in bowl games. The inference is that the focus on winning demonstrates a primary goal to derive profit. Are there not, rare as they may be, intercollegiate athletic programs with a tradition of winning that can nevertheless demonstrate a primary purpose to promote educational values by emphasizing cooperation, perseverance, excellence, living up to potential, pride in accomplishment, and playing by the rules, and not simply winning at all costs?

operation may be justified by factors which, on balance, show that the conduct of the business was substantially related to the exempt purpose of the institution.”²²⁹

4. *Competitive, Commercial Manner.*—The notion that a business activity operated by an exempt organization is unrelated if conducted in a manner similar to the operation of a taxable enterprise has its origins in the 1958 regulations, which, as noted supra, provided: “Similarly, a university radio station or press is considered a related trade or business if operated primarily as an integral part of the educational program of the university, but is considered an unrelated trade or business if operated in substantially the same manner as a commercial radio station or publishing house.”²³⁰ The inference underlying the 1958 regulations is that the manner in which an activity is conducted reflects the exempt organization’s principal motive to conduct it, e.g., if the business in question is operated like a taxable business is operated, the likely motive is profit. The Court of Claims misapplied the “commercial manner” test in *Disabled American Veterans* to determine whether an activity was a trade or business rather than to resolve the issue of whether the trade or business was related or unrelated to the exempt purposes of the organization.²³¹ Another court, applying the test to resolve the related versus unrelated issue, observed that the lack of advertising and solicitation “substantiate the essentially non-commercial operation” of the activity.²³² One taxpayer even argued that its farming operation was so inefficient that

229. *Iowa State Univ. of Science & Technology v. United States*, 500 F.2d 508, 518 (Ct. Cl. 1974). One commentator has questioned why a related business activity ever needs to make a profit. See Cooper, supra note 71, at 2020. Setting a fee to earn a profit curtails the “widest possible distribution of the goods or services being provided by the exempt organization.” *Id.* at 2021. According to Cooper:

The only excuse for charging profitable prices is to earn money for support of other activities of the organization. While this is a laudable goal, it is precisely the justification which was advanced for selling advertising space in exempt organization publications. The exempt publishers were merely being alert to the fact that there was profit potential as a by-product of their related publishing businesses. If Congress was willing to bar this form of skimming profits out of a related business, it is not a great step to saying that any business which earns a profit should be taxed.

Id. at 2021.

230. Regs. § 1.513-2(a)(4) (as amended in 1969).

231. See supra note 190.

232. *St. Luke’s Hosp. v. United States*, 494 F. Supp. 85, 91 (W.D. Mo. 1980); see also *Hi-Plains Hosp. v. United States*, 670 F.2d 528, 532 (5th Cir. 1982) (“[The hospital pharmacy] has not sought to expand its market or the type of products it sells. It does not advertise nor does it use display areas to attract customers. In short, it lacks the indicia of a modern commercial drug store. . .”).

it could not possibly be compared to a for-profit enterprise.²³³

Unfortunately, courts attempting to apply the “manner reflects motive” inference underlying the 1958 regulations often fail to differentiate between an activity simply utilizing modern business practices to achieve its exempt goals and one conducted in a manner to maximize profit. Clearly, the distinction between unrelated and related business is not that the former is operated in an efficient, business-like manner and the latter is not. Evidence that a business activity operated by an exempt organization advertises, markets, or promotes its goods or services, prices its goods or services in accordance with what the market will bear, attempts to keep costs down, operates efficiently, makes capital improvements, or engages in other behavior similar to the manner in which a taxable organization behaves is not inconsistent with either a principal purpose to further the organization’s exempt purpose or a finding that the activity contributes importantly to the achievement of that purpose. Exempt organizations offering goods or services to the public often find it imperative to engage in such “commercial” activity with respect to their obviously related businesses in order to survive in a world in which competition for the dollar is fierce and a dollar earned buys less. Evidence of such “commercial” activity does not ipso facto answer the question of whether the manner of operation in its totality indicates a substantial causal connection to the accomplishment of the organization’s exempt purposes or indicates that the activity is essentially a revenue raiser. In *California Thoroughbred Breeders Association v. Commissioner*,²³⁴ the Tax Court was called upon to determine whether an exempt agricultural organization’s auctions of thoroughbred horses was related or unrelated to its exempt purpose. Although the Association’s auctions in many respects resembled those conducted by commercial auction houses, the taxpayer’s expert witness observed, “In summary the CTBA has not acted like a profit maximizer, commercial auction company.”²³⁵

233. *St. Joseph Farms v. Commissioner*, 85 T.C. 9, 20 (1985), nonacq., 1986-2 C.B. 1 (“In support of its contention that the farm is not operated primarily for profit, petitioner cites various operational practices (such as delayed replacement of equipment; failure to use maximum automation; the failure to expand the farm or to borrow money; and loans of equipment, facilities, and the Brothers’ time to neighboring farms) and petitioner’s accounting practices (failure to use accelerated depreciation or to claim investment tax credits) as inconsistent with maximizing profits.”). The Tax Court responded that the mere fact that a trade or business may not be run as efficiently as possible does not negate a primary motive for profit. *Id.* at 20-21.

234. 57 T.C. Memo (CCH) 962, T.C. Memo (RIA) ¶ 89,342 (1989).

235. *Id.* at 969; see Sugarman & Pomeroy, *supra* note 61, at 432-33 n.42 (“If applied literally, [the regulations] would deny exempt treatment to a university station or press operated in a business-like manner. Presumably the statement is directed more to the subject or content of programs or publications than to method of conduct of operations.”).

5. *Identifying Unrelated Businesses by the Activities of Taxable Entities.*—Confronted with whether the activities of a business league exempt under section 501(c)(6) were related to the purposes of the organization, the Fourth Circuit in *Carolinas Farm & Power Equipment Dealers Association*,²³⁶ citing regulations section 1.501(c)(6)-1,²³⁷ concluded that the Association's insurance activities operated to benefit individual members and not the industry as a whole because "the fees charged members for participation in the insurance program are in direct proportion to the benefits received."²³⁸ Observed the Court: "the service provided by the Association is one commonly provided by for-profit entities. . . . Where a service is available in the marketplace, a trade association need not provide it to accomplish an exempt purpose."²³⁹ More recently, a federal district court in Texas expanded the generalization, presumably to apply to all tax exempt entities and not just trade associations or agricultural organizations exempt under section 501(c)(5), with the comment that "[a]n activity is less likely to be substantially related if it is one commonly provided by for-profit entities."²⁴⁰

The Tax Court repeated this proposition in *Florida Trucking Ass'n v. Commissioner*.²⁴¹ Faced with the issue of whether advertisements appearing in the Association's journal, *Florida Truck News*, furthered the tax exempt purposes of another trade association, the Court observed that the sale

236. *Carolinas Farm & Power Equip. Dealer's Assoc. v. United States*, 699 F.2d 167 (4th Cir. 1983).

237. "A business League is an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. . . . Thus, its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons." Regs. § 1.501(c)(6)-1 (as amended in 1990).

238. *Carolinas Farm & Power*, 699 F.2d at 171 (citations omitted).

239. *Id.* at 171-72. But see *United States v. American Bar Endowment*, 477 U.S. 105, 111 (1986) (comparing ABE's insurance activities to the type of businesses conducted by taxable entities in support of the Court's conclusion that the activity was a trade or business, not to demonstrate that the activity was an unrelated trade or business). The Seventh Circuit compared IAPIA's insurance activities to the type of business conducted by for-profit entities both to demonstrate that the activity was a trade or business and to demonstrate that the activity was an unrelated trade or business. See *Illinois Ass'n of Professional Ins. Agents v. Commissioner*, 801 F.2d 987, 992, 994 (7th Cir. 1986) ("Finally, the services performed by IAPIA, and the insurance sold through its efforts are the kind of services performed, and insurance sold, by private commercial entities in order to make a profit. . . . Where services and goods are available in the marketplace, 'a trade association need not provide it to accomplish an exempt purpose.'" (citing *Carolinas Farm & Power*, 699 F.2d at 172)).

240. *Texas Farm Bureau v. United States*, 822 F. Supp. 371, 377 (W.D. Tex. 1993), rev'd on other grounds, 53 F.3d 120 (5th Cir. 1995).

241. 87 T.C. 1039 (1986).

of advertising ordinarily is conducted by for-profit entities and therefore a trade association need not provide it to accomplish an exempt purpose.²⁴² The generalization as applied in *Florida Trucking Ass'n* begins to weaken even as applied to business leagues tax exempt under section 501(c)(6). What the Tax Court meant was that “[t]he entities that paid for advertisements in Florida Truck News presumably could have and did pay for similar or identical advertisements in other magazines or newspapers that were tax-paying entities.”²⁴³ As the Court itself acknowledged, had *Florida Truck News* selected advertisements to appear in its publication on the basis of coordinating the advertising and editorial content of the issue, or selected only advertisements to reflect new developments in the industry, the magazine’s business of selling advertising space may well have furthered the exempt purpose of the organization to enhance the interests of the trucking industry.²⁴⁴ This thought was suggested by the Supreme Court in *American College of Physicians* with respect to the *Annals of Internal Medicine*. Presumably, a for-profit entity would not select advertisements for tires, engines, and trailers with a view to promoting the common business interests of the trucking industry, but rather with an eye primarily on their revenue producing potential.

The axiom that a trade or business is more likely to be unrelated if it is one provided by a taxable entity becomes even less tenable when applied to the activities of a 501(c)(3) organization. The committee reports accompanying the 1950 Revenue Bill and both the 1958 and 1967 regulations recognized that a related business activity may be of the type conducted by both tax-exempt and taxable entities.²⁴⁵ The related versus unrelated issue is not determined by the qualitative nature of the activity; rather, it is decided by whether or not the exempt organization conducts the activity in a manner to further its exempt purposes.²⁴⁶

As noted, the position of the 1958 regulations is that a university radio station or press is a related or unrelated trade or business depending upon the manner in which it is operated.²⁴⁷ Similarly, in *St. Luke’s Hospital*

242. Id. at 1044-45.

243. Id.

244. Id. at 1045.

245. E.g., S. Rep. No. 2375, supra note 54, reprinted in 1951 U.S.C.C.S. at 3165 (offering as examples of potentially related businesses a wheat farm and a football game), Regs. § 1.513-1(d)(4) (as amended in 1983) (adds to the list a trade show, the sale of milk and cream, and the sale of advertising in a newspaper).

246. Early revenue rulings addressing the related versus unrelated issue often decided the issue by finding that the activity in question is normally conducted by taxable entities. For a criticism of this approach, see *The Macaroni Monopoly*, supra note 60, at 1286.

247. Regs. § 1.513-2(a)(4) (as amended in 1969).

v. United States,²⁴⁸ a Missouri federal district court found the hospital's pathology department to be conducting a related business when it performed diagnostic tests for nonhospital patients of staff physicians because the tests contributed to the teaching functions of the hospital.²⁴⁹ Observed the Court, "There can never be too many tests, because the more there are the richer the available instructional material is and the better the teaching program is."²⁵⁰ Likewise, the Fifth Circuit in *Hi-Plains Hospital* found the hospital's pharmacy sales to private patients of the staff doctors contributed importantly to the hospital's exempt purposes because one of the purposes of the establishment of a medical center in Hale Center, Texas, a small town of about 2,250 people, was to induce doctors to practice there. The pharmacy sales in question, said the court, facilitated the practice of medicine in the town and thus furthered the goal of making medical services available there.²⁵¹

The fact that taxable entities operate radio stations, newspapers, medical diagnostic testing laboratories, and pharmacies was irrelevant to the issue of whether the same activity in the hands of a section 501(c)(3) organization was related to the organization's exempt purposes. As the Fifth Circuit noted in *Hi Plains Hospital*²⁵² and as the Supreme Court held in *American College of Physicians*, Congress in considering the Tax Reform Act of 1969 rejected a version of section 513(c) that would have made sales by a hospital pharmacy to nonhospital patients and sales of advertising space by tax-exempt professional journals per se unrelated.²⁵³ It may be that certain activities like pharmacy sales to nonhospital patients, the sale of advertising space in journals, and the farming activities in *St. Joseph Farms* are frequently conducted by taxable entities and are not traditionally considered charitable work, but there is no avoiding ". . . the explicit case-by-case requirement articulated in Treas. Reg. 1.513-1(d)(2). . . ." ²⁵⁴

6. *Identifying Unrelated Businesses by the Potential for Competition with Taxable Entities.*—In *National Water Well Ass'n v. Commissioner*,²⁵⁵ the Tax Court stated:

248. 494 F. Supp. 85 (W.D. Mo. 1980).

249. *Id.* at 93.

250. *Id.* at 90.

251. *Hi-Plains Hosp. v. United States*, 670 F.2d 528, 531 (5th Cir. 1989).

252. *Id.* at 532.

253. *United States v. American College of Physicians*, 475 U.S. 834, 845-47 (1986); *Hi-Plains*, 670 F.2d at 532.

254. *American College*, 475 U.S. at 844.

255. *National Water Well Ass'n v. Commissioner*, 92 T.C. 75 (1989).

In its trade or business determination, the Supreme Court also pointed out that the income from the insurance program constituted UBTI [unrelated business taxable income—ed.] because the taxpayer unfairly competed with other insurance companies. *United States v. American Bar Endowment, supra*, 477 U.S. 114. . . . The Supreme Court held that the facts in the case represented ‘precisely the sort of unfair competition that Congress intended to prevent’ since private commercial entities could have provided the same services for the insurance program that were provided by the taxpayer. 477 U.S. at 114.²⁵⁶

The difficulty with the Tax Court observation is that the Supreme Court in *American Bar Endowment* (ABE) did not have before it the issue of whether a trade or business was related or unrelated to the accomplishment of the exempt purposes of ABE. The parties in the case stipulated that the activity was unrelated. Rather, the issue before the Court was whether the activity was a business or a fund-raiser. The insurance program’s potential for unfair competition with taxable entities led the Supreme Court to the conclusion that the activity was a trade or business and thus, being unrelated by stipulation, was “precisely the sort of unfair competition that Congress intended to prevent.”²⁵⁷ The Supreme Court did not conclude that the insurance program was unrelated as opposed to related because of the potential for competition.

The Supreme Court, in fact, overstated the case with its observation that “[t]he undisputed purpose of the unrelated business income tax was to prevent tax-exempt organizations from competing unfairly with businesses whose earnings were taxed.”²⁵⁸ While the adoption of the tax and unrelated businesses of exempt organizations clearly expressed a Congressional concern about the potential for unfair competition between an unrelated business and its taxable counterpart, Congress never intended the potential for competition to serve as a guidepost to differentiate unrelated from related trade or business. A business activity furthering the exempt purposes of the organization is still able to compete, fairly or unfairly, with its taxable counterparts without itself paying tax. As noted by the Court in *Midwest Research Institute v. United States*, “Tax-exempt organizations do enjoy a competitive advantage when providing the same goods and services as ordinary businesses. . . . Nonetheless, the drafters chose to tax only income from businesses

256. *Id.* at 90, 91.

257. *Id.* at 91.

258. *American Bar Endowment*, 477 U.S. at 114.

that were not 'substantially related' to the exempt purpose of the organization, not all income from activities that competed with private industry."²⁵⁹

C. *Is a Finding of Unfair Competition a Prerequisite to Imposition of the Tax?*

Tax-exempt organizations resisting the Government's efforts to collect the section 511 tax on unrelated businesses on occasion have argued that an activity cannot be a trade or business unless the court finds that the activity competes unfairly with a taxpaying entity.²⁶⁰ The taxpayer in *Louisiana Credit Union League v. United States*²⁶¹ framed the issue more accurately. Assuming that the activity in question *is* a trade or business and *is* unrelated to the fulfillment of the organization's exempt purpose, is a specific finding of unfair competition with a taxable entity engaged in a similar activity nevertheless a prerequisite to imposition of the tax?²⁶² In all cases the taxpayer's argument against taxation under section 511 has been based on an expression of Congressional intent that one of the purposes of the tax is to prevent such unfair competition.

Notable among the decisions in which the taxpayer lost the "no competition/no tax" argument are *Clarence LaBelle Post No. 217, Veterans of Foreign Wars v. United States*²⁶³ and *Louisiana Credit Union League*. In *Clarence LaBelle Post*, the Eighth Circuit held that a 501(c)(4) organization could be taxed on revenues received from the operation of bingo games

259. *Midwest Research Inst. v. United States*, 554 F. Supp. 1379, 1383-84 (W.D. Mo. 1983) (citation omitted), *aff'd*, 744 F.2d 635 (8th Cir. 1984); see also *The Macaroni Monopoly*, *supra* note 60, at 1287; H.R. Rep. No. 413, *supra* note 102, reprinted in 1969 U.S.C.C.A.N. at 1695 ("Your committee believes that a business competing with taxpaying organizations should not be granted an unfair competitive advantage by operating tax free unless the business contributes importantly to the exempt function."). In the case of trade associations, tax exempt under IRC § 501(c)(6) their activities further a common business interest rather than the members in their individual capacities; the government has argued that the fact that the activity competes with those of taxable entities demonstrates that the activity is not unique to the organization's exempt purpose and therefore does not contribute importantly to it. See *Texas Apartment Ass'n v. United States*, 869 F.2d 884, 887-89 (5th Cir. 1989) (in which the government lost this argument because the court found the taxpayer's materials to be "unique").

260. See *Fraternal Order of Police, Ill. State Troopers, Lodge No. 41 v. Commissioner*, 833 F.2d 717, 722 (7th Cir. 1987); *Greene County Medical Soc'y Found. v. United States*, 345 F. Supp. 900, 901 (W.D. Mo. 1972).

261. 693 F.2d 525 (5th Cir. 1982).

262. *Id.* at 539.

263. 580 F.2d 270 (8th Cir.), *cert. dismissed*, 439 U.S. 1040 (1978) [hereinafter *Clarence LaBelle Post*].

even though the games did not compete with taxable organizations.²⁶⁴ Similarly, in *Louisiana Credit Union League* the Fifth Circuit concluded that the presence or absence of actual competition between a taxable business and an unrelated trade or business is irrelevant to the issue of whether the section 511 tax is to be imposed.²⁶⁵

On the other side of the ledger, the Seventh Circuit in *Hope School v. United States*²⁶⁶ declined to tax a 501(c)(3) educational organization on revenues generated by its greeting cards mail-out program to prospective donors because there was no evidence that the school's solicitation campaign competed unfairly with taxable greeting card businesses.²⁶⁷ Likewise, Judge Schatz, dissenting in *Clarence Labelle Post*, vigorously supported the taxpayer's argument that its bingo games could not be taxed because of lack of competition with taxable businesses.²⁶⁸

Both sides of the controversy argued that legislative history supported its position. In *Louisiana Credit Union League*, the Fifth Circuit conceded that the prevention of unfair competition was a goal of the 1950 legislation, but maintained that Congress was equally concerned with two other problems, viz., the loss of revenue resulting from the ownership of unrelated businesses by tax-exempt organizations and the inequity of allowing such ownership at no tax cost.²⁶⁹ Similarly, the Eighth Circuit in *Clarence LaBelle Post* concluded that the goal of eliminating unfair competition "existed only as part of a larger goal of raising revenue."²⁷⁰

As a rejoinder, Judge Schatz, dissenting in *Clarence LaBelle Post*, cited Table 1 of the Senate Report accompanying the Revenue Act of 1950 to make the point that most of the additional revenue to be raised by the Act was projected to come from higher corporate and individual income tax rates.²⁷¹ In fact, as Judge Schatz points out, the Senate bill compared to the House bill substantially decreased the projected additional revenue to be generated by the amendments affecting tax-exempt entities. Thus, in the opinion of the Judge, while Congress desired to raise revenue as an overall objective of the 1950 legislation, the specific goal of the new tax on unrelated businesses was to eliminate unfair competition.²⁷² Judge Schatz's view is

264. *Id.* at 274.

265. *Louisiana Credit Union League*, 693 F.2d at 541-42.

266. 612 F.2d 298 (7th Cir. 1980).

267. *Id.* at 304.

268. *Clarence LaBelle Post*, 580 F.2d at 279-81 (Schatz, J., dissenting).

269. *Louisiana Credit Union League*, 693 F.2d at 540.

270. *Clarence LaBelle Post*, 580 F.2d at 272.

271. *Id.* at 277 (Schatz, J., dissenting).

272. *Id.*

shared by the Supreme Court in *United States v. American Bar Endowment*²⁷³ and is supported by Treasury regulations.²⁷⁴

While Judge Schatz, as well as the Seventh Circuit in *Hope School*, accurately interpreted the legislative history of the section 511 tax, there is little either can glean from the statutory language itself to support the position that a specific finding of unfair competition is a prerequisite to imposition of the section 511 tax. Section 513 defines the term "unrelated trade or business" as *any* trade or business not substantially related to the exempt purpose of the organization.²⁷⁵ As the Fifth Circuit stated in *Louisiana Credit Union League*:

Although the legislative history speaks of competition, those who actually drafted the statute avoided the word as if it were the plague. The statute nowhere requires or even suggests that the presence or absence of competition is a factor to be considered in connection with the unrelated business income tax.²⁷⁶

Carefully avoiding reference to the statute itself, the Seventh Circuit in *Hope School* turned rather to other sources in search of ammunition to support its "no competition/no tax" position, including a 1975 amendment to the Treasury regulations.²⁷⁷ The 1975 amendment provides that the tax on unrelated businesses does not apply when low cost articles are sent out incidental to the solicitation of a contribution because "the organization is not in competition with taxable organizations."²⁷⁸ The Seventh Circuit failed to quote, however, another sentence of the same regulation that appears to establish a conclusive presumption that an unrelated trade or business conducted by a tax-exempt entity competes unfairly:

However, in general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute "trade or business"

273. 477 U.S. 105 (1986). "The undisputed purpose of the unrelated business income tax was to prevent tax-exempt organizations from competing unfairly with businesses whose earnings were taxed." *Id.* at 114.

274. See Regs. § 1.513-1(b) ("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.").

275. IRC § 513(a).

276. *Louisiana Credit Union League*, 693 F.2d at 541.

277. *Hope School*, 612 F.2d at 301.

278. Regs. § 1.513-1(b).

within the meaning of section 162—and which, in addition, is not substantially related to the performance of exempt functions—presents sufficient likelihood of unfair competition to be within the policy of the tax.²⁷⁹

Aware of this last quoted sentence of the regulation, Judge Schatz, dissenting in *Clarence LaBelle Post*, held steadfast in his opinion that the sentence is subservient to the primary purpose of the section 511 tax to eliminate unfair competition, a purpose confirmed by the first sentence of the same regulation.²⁸⁰ Judge Schatz, however, did not, and could not, cite any provision in either the Code or the regulations that explicitly imposes a finding of competition as a condition to taxation under section 511.

As a parting sally the taxpayer in *Clarence LaBelle Post* argued that by enacting section 513(d)²⁸¹ in 1976, Congress provided additional evidence that it intended to exclude from the section 511 tax unrelated businesses that do not actually compete with taxpaying entities. The Senate Report accompanying the 1976 legislation indeed indicated that section 513(d) was adopted as a reaction to Internal Revenue Service rulings—involving horse racing at an exempt county fair association and renting display space at a convention trade show—in which the Service held that the tax applies even though the activity does not compete with commercial endeavors.²⁸² Similarly, the Seventh Circuit in *Hope School* found support for the “no competition/no tax” position with the adoption of section 513(f) in 1978.²⁸³ In specifically overruling the holding in *Clarence LaBelle Post*, subsection 513(f) excludes from the term “unrelated trade or business” the conduct of bingo games where such activity is not ordinarily carried out on a commercial basis in the State in which the exempt organization operates.²⁸⁴ As the House Report accompanying section 513(f) explained,

279. *Id.*; see *Louisiana Credit Union League*, 693 F.2d at 542.

280. *Clarence LaBelle Post*, 580 F.2d at 278 (referring to the first sentence of Regs. § 1.513-1(b): “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 non-exempt business endeavors with which they compete.”).

281. IRC § 513(d) (providing that qualified public entertainment activities or qualified convention and trade show activities are not unrelated trade or businesses).

282. S. Rep. No. 938, 94th Cong., 2d Sess. 602 (1976), reprinted in 1976 U.S.C.C.A.N. at 3439 (indicating that (1) the committee thought that the activities in question were related to the exempt purposes of the organizations that conduct them, and that (2) in any event, there was little opportunity for the activities to compete with those conducted by taxpaying entities).

283. *Hope School*, 612 F.2d at 304.

284. IRC § 513(f).

the basic rationale of the section 511 tax does not apply where taxable organizations are not carrying on the same activity.²⁸⁵

Unconvinced by the taxpayer's argument, the Eighth Circuit in *Clarence LaBelle Post* reasoned that the adoption of section 513(d) provided evidence to support precisely the opposite conclusion. Rather than requiring a finding of competition between the unrelated trade or business and a taxable entity as an across-the-board general rule, argued the Court, Congress, in enacting section 513(d), chose to carve out only two specific exceptions for horse racing at an exempt county fair and renting display space at trade shows.²⁸⁶ The Eighth Circuit's reasoning applies to the adoption of section 513(f) as well, the very provision that subsequently overruled its decision in *Clarence LaBelle Post*. Section 513(f) confines its focus narrowly to bingo games, bypassing the opportunity to exclude from the tax all unrelated trade or business in situations where taxable organizations are not carrying on the same endeavor. As the Fifth Circuit stated in *Louisiana Credit Union League*: "For over thirty years, Congress has had the opportunity to create a requirement of competition with taxable entities as a prerequisite for taxation on unrelated business income. It has declined to do so."²⁸⁷

One would have thought that the Supreme Court put the competition matter to rest with its 1986 decision, *United States v. American Bar Endowment*.²⁸⁸ In determining that ABE's insurance program "presents an example of precisely the sort of unfair competition that Congress intended to prevent,"²⁸⁹ the Court was untroubled by the fact that "ABE prices its policies competitively with other insurance policies offered to the public and to ABE members"²⁹⁰ nor by the failure of the Claims Court to find any taxable entities that compete with ABE. Without subjecting earnings from its insurance program to tax, the Court speculated, ABE was in a position to earn less profit, presumably by lowering prices and still earn the same return on investment as taxable organizations offering group insurance policies to its members. Furthermore, speculated the Court, it was likely that ABE members were also members of such taxable organizations.²⁹¹ As the

285. H.R. Rep. No. 1608, 95th Cong., 2d Sess., 6 (1978), reprinted in 1978 U.S.C.C.A.N. 3716, 3718.

286. *Clarence LaBelle Post*, 580 F.2d at 273.

287. *Louisiana Credit Union League*, 693 F.2d at 541 (footnote omitted); see also *Carolinas Farm & Power Equip. Dealers Ass'n v. United States*, 699 F.2d 167, 170 (4th Cir. 1983).

288. *United States v. American Bar Endowment*, 477 U.S. 105 (1986).

289. *Id.* at 114.

290. *Id.* at 108.

291. *Id.* at 114-15. The Court also stated: "If ABE's members may deduct part of their premium payments as a charitable contribution, the effective cost of ABE's insurance will be lower than the cost of competing policies that do not offer tax benefits." *Id.* at 114. The

Seventh Circuit subsequently noted in its 1987 decision, *Fraternal Order of Police, Illinois State Troopers, Lodge No. 41 v. Commissioner*,²⁹² "In concluding that the American Bar Endowment's insurance program did unfairly compete, the [Supreme] Court relied on hypothetical possibilities, rather than on an actual finding of unfair competition."²⁹³

Given the present statutory framework, the question remains whether Congress should now adopt a general rule requiring a specific finding of unfair competition as a prerequisite to imposing the tax on unrelated business. Assume that Congress adopts such a rule and places the burden of proof on the Government. The Internal Revenue Service subsequently attempts to collect the tax from a very successful ice cream manufacturer operated by a university tax-exempt under section 501(c)(3). The Government is able to establish both the parameters of the market place in which the feeder currently operates and the identity of a taxable competitor attempting to sell ice cream of comparable quality within the same territory.

Having demonstrated actual competition, the Government should not have the additional burden to prove the competition to be unfair. The competition is potentially unfair even if the feeder does not currently take advantage of its newly enacted exemption. Whatever amount the taxable manufacturer is required to pay as income tax, the feeder has available an equivalent amount to add to any budget line it chooses, whether it be sales, marketing, management, production, inventory, capital improvement, investment, training or research, or it can simply lower its prices. Further, if the feeder distributes 100% of its profit to its 501(c)(3) owner, there is nothing in the present statute to prevent the exempt organization from re-contributing an equal amount back to the feeder at a later time. Once the fact of competition has been established, the unfairness of the competition should be presumed.

Should the Government even have the burden to prove the existence of an actual competitor doing business in the same marketplace as the feeder? *United States v. American Bar Endowment* illustrates the difficulties that can

Court then proceeded to eliminate this potential for unfair competition by holding that no portion of the premium payments constituted charitable contributions. *Id.* at 119. For an analysis of the case, see *Charitable Donations or Unrelated Business Income?: United States v. American Bar Endowment*, 21 U.S.F. L. Rev. 817 (1987).

292. 833 F.2d 717 (7th Cir. 1987).

293. *Id.* at 722 (citations omitted). See Donald C. Haley, *The Taxation of the Unrelated Business Activities of Exempt Organizations: Where Do We Stand? Where Do We Seem To Be Headed?*, 7 *Akron Tax J.* 61 (1990) ("[T]he controversy over the relevance of the presence or absence of competition with taxable entities continues." *Id.* at 78. Some of the cases cited by Haley to support this statement focused upon the potential for competition with taxable entities, or the lack of it, to determine whether the activity in question was "unrelated" or "related." *Id.* at 79.).

be encountered in the attempt. By assuming that the ABE membership as a group constituted the marketplace, the Claims Court unsurprisingly was unable to identify any taxable entity competing with ABE for the business of the group as a whole. By contrast, the Supreme Court, realizing that the potential market consisted of ABE's members as individuals rather than as a group, speculated that it was likely that such individuals were eligible to participate in other group insurance programs offered by various taxable entities of which they were also a member. Furthermore, although it cannot be denied that group insurance programs traditionally offers lower rates than individual policies, the argument can be made that every licensed insurance broker residing in the same community as an ABE member potentially competed with ABE's insurance program for premium dollars. Given that the ABE membership is dispersed throughout the country, should not a court be empowered to take judicial notice of the fact that insurance brokerage exists as a trade or business throughout the United States? Or, is it necessary that the Government specifically identify at least one group insurance program sponsored by a taxable organization available to each ABE member, or alternatively at least one insurance agency doing business in his or her community?

Assume that the feeder is able to establish affirmatively that there are no taxable businesses competing in the same territory with its goods or services, e.g., the feeder's brand of ice cream is the only one sold in its corner of the marketplace. Given that ice cream is sold elsewhere, there is the possibility that the taxable ice cream manufacturers have been unable to crack the feeder's market due to the advantages afforded the latter by its exemption from tax. Failure to find an actual taxable competitor, therefore, may be just as indicative of unfair competition as a finding of actual competition in the same marketplace. Nor would it matter significantly if the feeder conducted a business not found anywhere else. It has to be assumed that if a section 501(c)(3) organization finds an unrelated trade or business potentially profitable enough to conduct, it is probable that a taxable entity would regard operating a competing business with equal interest. Inasmuch as any unrelated trade or business invites its own potential taxable competition, one must in all cases reckon with the potential anti-competitive effect of the exemption from tax, whether actual competition is found or not. In rejecting the "no finding of competition/no tax" rule, one is led full circle back to the presumption of unfair competition found in Regulations section 1.513-1(b): any unrelated trade or business "presents sufficient likelihood of unfair competition to be within the policy of the tax."²⁹⁴

294. Regs. § 1.513-1(b).

V. METASTASIS OF THE UNFAIR COMPETITION RATIONALE AND A REGIMEN FOR CONTAINMENT

A. *The Challenge from the Small Business Community*

1. *Competition Between Related Businesses and Taxable Enterprises.*—In June of 1987, the Subcommittee on Oversight of the Committee on Ways and Means held hearings in furtherance of its mandate to reexamine “the policy considerations underlying the appropriate tax treatment of income-producing activities of tax-exempt organizations,”²⁹⁵ in particular to determine how the tax on unrelated business income impacted both tax-exempt organizations and for-profit businesses. Although the witnesses before the Subcommittee representing the nonprofit sector and the small business community, respectively, could agree on very little, both camps were confronted with the irrefutable fact that the number of nonprofit organizations had increased dramatically over the years. Between 1967 and 1987, the IRS

295. UBIT Hearings, *supra* note 78, at 3. O. Donaldson Chapoton, Deputy Assistant Secretary (Tax Policy), Department of the Treasury, was the first witness and, de facto, set the agenda for the hearings. Mr. Chapoton commented on the following items: the “substantially related” standard, which the Treasury Department believes has “conceptual merit as the basis for granting exemption from tax,” *id.* at 24, although there was concern that its “inherent generality is a source of administrative difficulty,” *id.* at 39; the need for an expanded Form 990, i.e., more detailed reporting to improve enforcement and compliance; the need to reexamine the “volunteer” exception to the definition of unrelated business provided by § 513(a)(1); the need to reexamine the “convenience” exception to the definition of unrelated business provided by § 513(a)(2) for an activity carried on primarily for the convenience of the organization’s members, students, patients, officers, or employees; the justification for the “donated property” exception provided by § 513(a)(3); the need for legislation to override *Rensselaer Polytechnic Institute v. Commissioner*, 732 F.2d 1058 (2d Cir. 1984), which allocated fixed costs of the Institute’s field house between related and unrelated uses on the basis of its total hours of use rather than on the basis of comparing the hours used for the unrelated business to the total hours available for use (as contended by the IRS); the suggestion to increase the \$1,000 specific deduction provided by § 512(b)(12) to \$5,000; the necessity of maintaining the “fragmentation rule” provided by § 513(c); the need to broaden the “controlled subsidiary” test provided by § 512(b)(13) to include subsidiaries more than 50% owned, by voting power or value, by the parent exempt organization, using attribution rules; the desirability of including the unrelated business activities of subsidiaries to determine whether the primary purpose of the parent organization is the carrying on of an unrelated business; the desirability of maintaining the exclusion for “passive” income (dividends, interest, annuities, royalties, and rents provided by § 512(b)(1)-(3)); the need to reexamine the definition of “royalty” to make amounts measured by net profits taxable; the need to develop appropriate standards to differentiate exempt from taxable research activities; the need for additional restrictions to prevent improper allocation of partnership deductions between partners who are tax-exempt and taxable; and the need to reexamine the issue of whether a 501(c)(3) organization acting as a general partner in a limited partnership is “incompatible with the prohibition against distribution of earnings to private interests and whether they create a conflict of interest for the exempt organization.” UBIT Hearings, *supra* note 78, at 23-54.

Master File for active tax-exempt organizations had increased from approximately 400,000 to in excess of 850,000.²⁹⁶ Further, although there was insufficient data to draw quantifiable conclusions, it appeared that 501(c)(3) organizations were becoming increasingly reliant on income-producing activities, in particular, revenues from the sale of goods and services, as a source of funding and less reliant on government grants and private donations.²⁹⁷

IRS Master File data show that, in 1946, organizations exempt under section 501(c)(3) obtained 59% of their support from business receipts, interest, dividends, rents, royalties, sales of assets and miscellaneous sources other than government grants, private contributions, dues and assessments; 71 percent from such sources in 1975; and 78% in 1983.²⁹⁸

Views clashed sharply, however, as to the nature of the income-producing activities upon which 501(c)(3) organizations were presumably becoming more reliant and the significance of the meager data that was available. Some members of the small business community were of the opinion that unfair competition between tax-exempt organizations and taxable businesses had intensified primarily due to the former's expansion into areas beyond the traditional role of the non-profit sector—in part due to increased demand for services and excess capacity.²⁹⁹ At least one witness on behalf

296. See UBIT Hearings, *supra* note 78, at 12 (containing statements of O. Donaldson Chapoton, Deputy Assistant Secretary (Tax Policy), U.S. Department of the Treasury). In 1987, there were "nearly 390,000 religious (other than churches), educational, charitable and scientific organizations exempt under section 501(c)(3). . . ." *Id.* at 26. In 1985, operating expenditures of nonprofits totaled \$239 billion, or 6% of GNP, according to an estimate of the Bureau of Economic Analysis. *Id.* "In 1984, 47 percent of current operating expenditures of nonprofits were accounted for by health service organizations, and 22 percent by educational and research organizations." *Id.* at 27.

297. See *id.* at 97 (testimony of Frank S. Swain, Chief Counsel for Advocacy, U.S. Small Business Administration); *Id.* at 129-39 (containing statements of Jennie S. Stathis, Associate Director, General Governmental Division, U.S. General Accounting Office); *Id.* at 134, 139 (statement of Jennie S. Stathis, Associate Director, General Governmental Division, U.S. General Accounting Office); *Id.* at 158, 183 (statement of Marion R. Fremont-Smith, Board Member, Independent Sector); see also *id.* at 160 (statement of Marion R. Fremont-Smith, Board Member, Independent Sector) (discussing how private payments, primarily fees for service, for social services increased in 1984 while governmental payments decreased).

298. *Id.* at 27 (statement of O. Donaldson Chapoton, Deputy Assistant Secretary (Tax Policy), U.S. Department of the Treasury).

299. See *id.* at 134 (statement of Jennie S. Stathis, Associate Director, General Governmental Division, U.S. General Accounting Office) ("[s]ome business people told us that this apparent increase in income-producing activities [by tax-exempt organizations] is a source

of the business community was prepared to admit, however, that increased competition between the two sectors had resulted as much from taxable businesses seeking a foothold in a certain traditionally nonprofit markets such as health care as it had from nonprofits expanding into the domain of taxable business.³⁰⁰ Witnesses on behalf of 501(c)(3) organizations emphasized that third-party and government funding for social services had made it profitable for taxable businesses to enter fields traditionally reserved for nonprofits such as “hospitals, day-care centers, alcoholism treatment centers, homes for the aged, health research, continuing education and even cemeteries.”³⁰¹ Other members of the tax-exempt community viewed the data indicating increased reliance on income-producing activities as simply reflective of the fact that 501(c)(3) organizations as a group were more reliant on charging fees for related goods and services in furtherance of their exempt purposes than on contributions from the public or government funding.³⁰²

of unfair competition.”); *id.* at 218 (statement of Joseph O’Neil, Chairman, Business Coalition for Fair Competition) (discussing increased demand and excess capacity). Of particular concern to the small business community was the entry of nonprofits into the following businesses: paging, answering, cleaning, and laundry services; retail pharmaceuticals; hearing aids; medical equipment; and prosthetics. *Id.* at 100 (statement of Frank S. Swain, Chief Counsel For Advocacy, U.S. Small Business Administration). Other businesses included: “interior decorating, computerized billing for doctors, catering, health and fitness clubs, travel agencies, marketing of frozen foods for the elderly, data processing, day-care centers, and medical hotels for patients who no longer need hospital care but are not ready to return home.” *Id.* (quoting James J. McGovern, Restructured Nonprofit Hospitals, 35 Tax Notes 405, 406 (Apr. 27, 1987)). Mr. O’Neil also listed the following businesses which compete with nonprofits:

Areas in which businesses go head to head with nonprofits include food service, testing laboratories, retail sales of books and computers, travel, recreation, nurseries, day care, hearing aids, veterinarians, blood banks, consulting engineers, medical equipment suppliers, pencil makers, specialty advertisers, hotels, bus operators, printing, construction, laundries, janitorial services, waste hauling, electrical, plumbing, and heating contracting to name a few.

Id. at 218. There was, however, no attempt to identify which of these endeavors were: (1) claimed by the nonprofit to be a “related” activity; (2) claimed by the nonprofit to be nontaxable under the “convenience” exception; (3) reported as an “unrelated” activity; or (4) not reported as an “unrelated” activity.

300. See *id.* at 218 (statement of Joseph O’Neil, Chairman, Business Coalition for Fair Competition).

301. Cf. *id.* at 155 (statement of Marion R. Fremont-Smith, Board Member, Independent Sector).

302. See *id.* at 134 (statement of Jennie S. Stathis, Associate Director, General Governmental Division, U.S. General Accounting Office); *id.* at 241 (testimony of the National Assembly of National Voluntary Health & Social Welfare Organizations) (“Some [nonprofit] organizations do rely heavily on fee income.”). See generally Walter B. Slocombe, *Exempt Organizations: Business and Other Activities in an Uncertain World*, 70 *Taxes* 974 (1992) (discussing a number of issues confronting 501(c)(3) organizations).

Conceding that some percentage of the perceived increased competition confronting for-profits may have found its source in activities directly related to furthering the charitable purposes of the conducting organization, the small business community took the position before the Subcommittee On Oversight that such related activity should nonetheless be taxed.³⁰³ The logic of the argument proceeded as follows: if exemption from tax afforded 501(c)(3) organizations is based on the rationale that such organizations provide the citizenry with governmental type goods and services otherwise unavailable in the marketplace, then there is no justification for the exemption with respect to those goods and services sold by both for-profits and tax-exempts in the same market.³⁰⁴ Further, nonprofits are not necessarily more

On the other hand, the proscription against nonprofit organizations raising equity capital and their inability to borrow at favorable rates had impelled 501(c)(3) organizations to seek capital for their related activities through collaborative joint ventures with for-profit entities. Typically, the charity would act as the general partner in a limited partnership and the for-profit investors would participate as limited partners. Such collaborative enterprises raise a number of issues of their own. Should the 501(c)(3) organization's tax-exempt status be threatened because it operates such a joint venture with a substantial non-exempt purpose, i.e., to further the private interests of the profit-motivated investors? Does the fiduciary duty of the charity acting as general partner to the limited partners create a conflict of interest? Does a distribution to the limited partners violate the prohibition against a charity's earnings inuring to private individuals? Is there unwarranted shifting of tax benefits to taxable partners? Is the charity engaging in unfair competition for invested capital? See *id.* at 51-54 (statement of O. Donaldson Chapoton, Deputy Assistant Secretary (Tax Policy), U.S. Department of the Treasury); *id.* at 416-17, 420-21 (statement of Jeff Carr, Vice Chancellor for University Relations and General Counsel, Vanderbilt University); Michael H. Schill, *The Participation of Charities in Limited Partnerships*, 93 *Yale L.J.* 1355 (1984).

We realized that Vanderbilt had the land and the professional faculty talent to support an additional facility, but not the capital. . . . A collaborative effort with Hospital Corporation of America (HCA) was developed under which an 88-bed Child and Adolescent Psychiatric Hospital would be built on Vanderbilt land, professionally staffed with Vanderbilt faculty, financed by HCA capital, and managed by HCA. . . . Of particular importance is the point that this Child and Adolescent Psychiatric Hospital would not and could not have been built and operated without the unique contributions of both Vanderbilt and HCA.

UBIT Hearings, *supra* note 78, at 420-21 (statement of Jeff Carr, Vice Chancellor for University Relations and General Counsel, Vanderbilt University).

303. UBIT Hearings, *supra* note 78, at 90 (containing statements of Frank S. Swain, Chief Counsel for Advocacy, U.S. Small Business Administration) (suggesting the tightening of the current relatedness test); *id.* at 103-04 (statement of Frank S. Swain, Chief Counsel for Advocacy, U.S. Small Business Administration).

304. See *id.* at 103-04 (statement of Frank S. Swain, Chief Counsel for Advocacy, U.S. Small Business Administration); *id.* at 219 (statement of Joseph O'Neil, Chairman, Business Coalition for Fair Competition).

efficient, more regulated, or more moral than for-profits.³⁰⁵ Moreover, the relationship between volunteerism and nonprofit status, desirable as it is, is not dependent on tax exemption, but on the volunteer's knowledge that his efforts will promote the public good and not private gain.³⁰⁶ Thus, the expansion of for-profits and tax-exempts into each other's markets has "blurred [their] separate identities"³⁰⁷ and reduced the primary distinction between them to one of taxation for the former and an exemption for the latter. This distinction offers tax-exempts an unfair competitive advantage which should be eliminated.³⁰⁸

305. See *id.* at 220 (statement of Joseph O'Neil, Chairman, Business Coalition for Fair Competition).

306. See *id.* at 219-20.

307. *Id.* at 97 (statement of Frank S. Swain, Chief Counsel for Advocacy, U.S. Small Business Administration).

308. See *id.* at 90 (containing statements of Frank S. Swain, Chief Counsel for Advocacy, U.S. Small Business Administration); *id.* at 98 (testimony of Frank S. Swain, Chief Counsel for Advocacy, U.S. Small Business Administration).

The small business community complained that nonprofits enjoyed competitive advantages in addition to federal tax exemption, including Federally subsidized mail rates; numerous state and local tax exemptions; special treatment under various federal laws, including those relating to social security, unemployment insurance, and minimum wage; and a goodwill advantage in marketing their goods and services—referred to as the "halo effect." *Id.* at 98-99.

Additionally, there were complaints that feeders were purchasing supplies at the tax-exempt parent's lower rates; using the parent's personnel and property; and availing themselves of the parent's ability to accumulate tax-free capital. See *id.* at 835 (views of Paul Simmons, President, Health Industry Distributors Association) (discussing recommendations of the U.S. Department of the Treasury). "Even when an activity is considered unrelated and, therefore, taxable, the exempt organization gains a significant advantage because it is able to use untaxed income from other sources, such as dues, contributions of related activity, to fund unrelated commercial activity." *Id.* at 104 (statement of Frank S. Swain, Chief Counsel for Advocacy, U.S. Small Business Administration). In addition to their ability to accumulate tax-free internal capital to fund feeders and unrelated businesses, 501(c)(3) organizations, unlike for-profit investors, can also raise investment capital through gifts, grants, and donations. These advantages, however, may be offset by the inability of 501(c)(3) organizations to raise equity capital or to borrow money as easily as can for-profit investors. See Steinberg, *supra* note 25, at 355. Further, under the present statute:

[W]hen a [nonprofit] invests in active production, it forgoes the opportunity to earn the pre-corporate-tax rate of return from alternative passive investments. In contrast, when a [for-profit] invests in active commercial production, it forgoes the post-corporate-tax rate of return. Thus, [nonprofits] face a higher opportunity cost of active production, and would prefer passive investment unless the active commercial output strongly and directly helps them accomplish the exempt purpose.

Id.

Steinberg also raises a number of nontax issues when a for-profit entity alleges that a nonprofit organization is unfairly competing with it, *viz.*, the degree of the for-profit entity's

The difficulty with this argument begins with its premise, viz, activities directly furthering the charitable purposes of nonprofit organizations should be exempt from tax only when the public goods and services they offer are otherwise unavailable in the marketplace. Comparing the nonprofit and for-profit models, it is the intrinsic defect in the for-profit model, i.e., its focus on the bottom line rather than on continuity and quality, that justifies the exemption subsidy afforded nonprofits in cases where similar essential public goods and services are offered by both nonprofits and for-profits in the same market. Comparing the nonprofit model with the federal government, it is the principles of pluralism and democratic decentralization that add further weight to the legitimacy of the exemption subsidy in cases where similar essential public goods and services are offered by both. The importance of the nonprofit charitable sector to society does not arise only when there is a void left to fill by the twin failures of for-profit enterprise and the federal government. A nonprofit entity organized and operated primarily to further one or more of the activities enumerated in section 501(c)(3), and in compliance with the section's additional requirements, merits exemption as representing generically an essential provider of the type of public goods and services it offers, and not simply as a third-string player.

The problem with the position taken by the small business community is illustrated by one of the case studies of "unfair" competition submitted to the Subcommittee On Oversight by the National Federation of Independent Businesses. In "Non-Profit Case-No. 7" the president of a business consulting firm complained that the "[l]ocal university, the North Carolina Department of Industrial Engineering[,] publishes a listing of course offerings and seminars in direct competition with local consultants and other private businesses with expertise in the same areas."³⁰⁹

Clearly, the for-profit business consulting firm does not through its own course offerings or consultations bring to the marketplace the same

efficiency; whether the nonprofit entity is benefiting from a cost advantage; whether the for-profit entity suffers "from competition only in circumstances where . . . [its] profits would otherwise be exorbitant"; and whether there is a random element to "[nonprofit] successes and corresponding [for-profit] failures. . . . To the extent that success and failure occur for random reasons, [for-profits] are just as likely to succeed and [nonprofits] to fail as vice versa. However, only the former would be reported anecdotally, leaving a biased picture." *Id.* at 352. Additionally, "[i]f [nonprofits] enjoy greater success at the expense of [for-profits], which of the many tax and regulatory differences in treatment of the two sectors are responsible? Elimination of some differences might not help [for-profits] very much, and the different taxes have varying impacts on the broader economy." *Id.* Steinberg concludes that "[w]e do not yet know the impact of tax and regulatory differentials on the behavior and performance of competing [for-profit] and [nonprofit] firms." *Id.* at 361.

309. UBIT Hearings, *supra* note 78, at 291 (statement of John J. Motley, III and Abraham Schneier, National Federation of Independent Business).

character and quality of services brought by the university. The continuing or adult education programs of the university must be viewed as an integral component of the larger institution. The sole purpose of the university is to promote the general welfare, viz, to meet society's "intellectual, cultural, social, economic and technological needs"³¹⁰ through teaching, research, and public service to the local community in which it exists. The primary purpose of the private consulting firm is to make a profit. As a nonprofit organization, the university is forbidden from distributing profits, if it should earn any, to or for the benefit of private persons. The purpose of the private consulting firm is to make such a distribution to its owners. The university is required to make its services available to a broad segment of the community.³¹¹ The private consulting firm has no such mandate. The university as an American institution has existed in excess of 300 years as a preserve of "the legacies of our past through a succession of cultural fads, political changes, and ideological movements";³¹² it has the capacity to conduct its activities without consideration of short-term market demands, and it can continue to serve the community around it through continuing education and assistance programs in depressed economic times on a break-even basis.³¹³ The private consulting firm, guided primarily by market forces, will disappear if the profit opportunity evaporates.

As the United States economy in the past decades has gradually shifted from one based on manufacturing to one based on technology, the central and vital role of the American university in the conduct of basic and applied research, in the transfer of the resultant technological innovation to the business community, and in the transmission of technological information to the public, has grown in importance.³¹⁴ It is not surprising, therefore, that Congress has made a decision to encourage the "related" activities of the university, including continuing education programs, through exemption from income tax and not similarly to subsidize the activities of the private consulting firm that happens to operate in the same community.

Thus, there may be competition between the "related" activities of the 501(c)(3) organization directly furthering the purposes of its mandate and similar activities conducted by a taxable enterprise, but the tax exemption

310. *Id.* at 363 (statement of the American Council on Education).

311. See *id.* at 367 ("Pursuant to . . . legislative mandates . . . colleges and universities provide public services that range from continuing education and adult education programs to technical assistance to low-income health clinics.").

312. *Id.* at 364.

313. See *id.* at 373 (noting that the farming community needs to know that critical services provided by colleges and universities will be around in both good and bad economic times, whether or not the services are profitable to perform).

314. See *id.* at 365, 372.

afforded the former does not render the competition unfair. Rather, the exemption from tax and any competitive advantage that may be the result is an expression of a national policy to encourage and preserve the 501(c)(3) organizations' historic social mission.

2. *The Statutory Standard Revisited.*—From this perspective, the statutory exemption from tax afforded business activities substantially related (“contributing importantly”) to the fulfillment of the organization’s charitable purpose is an appropriate standard in furtherance of this national policy. Proposals offered by the small business community to tax an activity conducted by a 501(c)(3) organization based on the activity’s “commercial” nature rather than its purpose³¹⁵ contravenes this policy. These proposals include taxing any commercial activity conducted by a nonprofit;³¹⁶ taxing a nonprofit if its commercial activity exceeds a specified minimum;³¹⁷ taxing any activity that competes with the for-profit sector;³¹⁸ or imposing a rebuttable presumption of taxability if an activity both earns a profit and competes with a for-profit entity in the same market.³¹⁹

As a fallback position, some advocates on behalf of the small business community urged tightening of the “substantially related” test in part to reverse the statutory expansion of the definition that had occurred since enactment of the original statute in 1950. The Chief Counsel for Advocacy for the U.S. Small Business Administration observed that “[the definition] has been held to encompass the sale of broadcasting rights, the operation of grocery stores, and horse racing tracks, the exchange of mailing lists, and the sale of milled lumber and greeting cards, to name just a few activities.”³²⁰ It is true that a number of legislative amendments to the original statute have removed certain activities from the reach of the tax. For example, the Tax

315. See *id.* at 223 (statement of Joseph O’Neil, Chairman, Business Coalition for Fair Competition).

316. See *id.* at 822 (statement of the American Clinical Laboratory Association).

317. See *id.*; see also *id.* at 90 (containing statements of Frank S. Swain, Chief Counsel for Advocacy, U.S. Small Business Association) (suggesting applying an overall cap on the amount of commercial activity a nonprofit organization can conduct).

318. See *id.* at 104 (testimony of Frank S. Swain, Chief Counsel for Advocacy, U.S. Small Business Administration).

319. See *id.* at 223-24 (statement of Joseph O’Neil, Chairman, Business Coalition for Fair Competition). The Deputy Assistant Secretary (Tax Policy), Department of the Treasury, took the position that the “substantially related” test had “conceptual merit.” See *id.* at 24 (statement of O. Donaldson Chapoton, Deputy Assistant Secretary (Tax Policy), U.S. Department of the Treasury). Also, Internal Revenue Commissioner Gibbs said that the IRS couldn’t determine whether competition was unfair. See *id.* at 69 (testimony of Lawrence B. Gibbs, Commissioner of Internal Revenue).

320. *Id.* at 105 (statement of Frank S. Swain, Chief Counsel for Advocacy, U.S. Small Business Administration).

Reform Act of 1976 exempted specified entertainment activities traditionally conducted at agricultural affairs or educational expositions, as well as activities traditionally conducted at trade shows;³²¹ 1978 legislation exempted bingo games when such games were not ordinarily conducted on a commercial basis;³²² and the Tax Reform Act of 1986 exempted activities relating to distribution of low cost articles incidental to the solicitation of charitable contributions, as well as the exchange or rental of mailing lists among charitable organizations.³²³

On the other hand, the most important amendment to the original statute, the Tax Reform Act of 1969, extended the tax on unrelated business income to include all exempt organizations other than United States instrumentalities,³²⁴ adopted the fragmentation rule allowing each component of an integrated business to be tested against the relatedness standard,³²⁵ expanded the scope of the tax with respect to acquisitions financed with debt,³²⁶ extended the tax to cover income received from a controlled corporation,³²⁷ and narrowed the exclusion of rents received from the lease of personal property in combination with real property.³²⁸ The record of statutory amendments taken in its entirety does not support the generalization that Congress has been chipping away at the reach of the tax on unrelated business.

Frank Swain, Chief Counsel for Advocacy, U.S. Small Business Administration, additionally complained that the existing "substantially related" test left "the boundaries between related and unrelated activities . . . so unclearly drawn that the test has proven difficult for the Service to administer and enforce," it has promoted inconsistency in its application, and has allowed "somewhat related" activities to go untaxed.³²⁹ Mr. Swain, appearing before the Subcommittee On Oversight, pointed to *Hi-Plains Hospital v. United States*,³³⁰ the 1985 Fifth Circuit decision, as an example of "[h]air-splitting court cases illustrative of the fact that 'substantially

321. See Tax Reform Act of 1976, Pub. L. No. 94-455, § 1305(a), 90 Stat. 1716 (adding IRC § 513(d)).

322. See Pub. L. No. 95-502, § 301(a), 92 Stat. 1702 (adding IRC § 513(f)).

323. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 1601(a), 100 Stat. 2766 (adding IRC § 513(h)).

324. See supra note 106.

325. See IRC § 513(c).

326. See supra note 107; see also IRC § 514.

327. See IRC § 512(b)(13).

328. See IRC § 512(b)(3).

329. UBIT Hearings, supra note 78, at 104 (testimony of Frank S. Swain, Chief Counsel for Advocacy, U.S. Small Business Administration).

330. 670 F.2d 528 (5th Cir. 1982).

related' requires subjective decisionmaking,"³³¹ and, since *Hi-Plains Hospital* was one of several decisions holding for the taxpayer on the issue, presumably illustrative of the fact that some courts are willing to apply the standard loosely in favor of the charitable organization.³³²

In his testimony before the Subcommittee, the Commissioner of the Internal Revenue Service, Laurence Gibbs, offered further illustration of the difficulty in enforcing the "substantially related" standard due to its facts-and-circumstance nature by comparing one IRS ruling holding the sale of a Teddy bear to be a substantially related activity "where it was identified as a model of the stuffed toy named after Theodore Roosevelt, and because it introduced children to American history and President Roosevelt,"³³³ with another ruling in which

the sale of blazer buttons adapted from a medal commemorating George Washington's First Inauguration was held to be an unrelated activity because of the utilitarian purpose of the buttons . . . [but] if the blazer buttons were sold with descriptive literature explaining their connection with the original medal, the sales might then be considered related activity.³³⁴

The two rulings can better serve to illustrate just how minuscule the focus of the IRS had become in its efforts to enforce a statute adopted in reaction to fear that major ventures owned by tax-exempt organizations were threatening to drive all their taxable competition out of business.³³⁵

Unfortunately, subjective decisionmaking appears to be endemic to the application of a legal standard, such as "substantially related", to facts and circumstances. The Treasury Department for its part has attempted to offer guidance as to the meaning of "substantially related" by including numerous examples in the 1967 regulations illustrating when and when not, in its view, an activity contributes importantly to the accomplishment of the organiza-

331. UBIT Hearings, *supra* note 78, at 104 (testimony of Frank S. Swain, Chief Counsel for Advocacy, U.S. Small Business Administration) (footnote omitted).

332. See *id.* (noting the decision in *Hi-Plains Hospital*); see also UBIT Hearings, *supra* note 78, at 38 (statement of O. Donaldson Chapoton, Deputy Assistant Secretary (Tax Policy), U.S. Department of the Treasury) ("[T]here are indications [that the standard] has been applied in an overly generous manner.").

333. *Id.* at 67-68 (testimony of Lawrence B. Gibbs, Commissioner of Internal Revenue).

334. *Id.* at 68.

335. See also Rev. Rul. 73-105, 1973-1 C.B. 264 (holding that sales in a museum shop of souvenirs related to the city in which the museum is located constitute an unrelated activity).

tion's exempt purpose.³³⁶ Any inference that the courts have interpreted the "substantially related" test liberally in favor of exempt organizations is controverted by the government's victories with respect to this issue in the Supreme Court,³³⁷ in the Fourth,³³⁸ Fifth,³³⁹ Seventh (twice),³⁴⁰ Eleventh,³⁴¹ Federal³⁴² and District of Columbia Circuits,³⁴³ several times in the Claims Court,³⁴⁴ and numerous times in the Tax Court.³⁴⁵

B. Compliance and Beyond

Apart from their differences with respect to the appropriateness of the "substantially related" standard as an expression of tax policy or as a guide to enforcement of that policy, all witnesses before the Subcommittee agreed that what was needed was more detailed reporting requirements by tax-exempt organizations in order to improve data collection, compliance, and

336. See *supra* text accompanying notes 198-215.

337. See *United States v. American College of Physicians*, 475 U.S. 834 (1986).

338. See *Carolinas Farm & Power Equip. Dealers Ass'n v. United States*, 699 F.2d 167 (4th Cir. 1983).

339. See *Louisiana Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982).

340. See *Illinois Ass'n of Professional Ins. Agents v. Commissioner*, 801 F.2d 987 (7th Cir. 1986); *Carle Found. v. United States*, 611 F.2d 1192 (7th Cir. 1979), cert. denied, 449 U.S. 824 (1980).

341. See *Independent Ins. Agents of Huntsville, Inc. v. Commissioner*, 998 F.2d 898 (11th Cir. 1993).

342. See *National Ass'n of Postal Supervisors v. United States*, 944 F.2d 859 (Fed. Cir. 1991).

343. See *American Postal Workers Union v. United States*, 925 F.2d 480 (D.C. Cir. 1991).

344. See *National Ass'n of Postal Supervisors v. United States*, 21 Cl. Ct. 310 (1990), aff'd, 944 F.2d 859 (Fed. Cir. 1991); *Disabled Am. Veterans v. United States*, 650 F.2d 1178 (Ct. Cl. 1981); *Iowa State Univ. of Science & Technology v. United States*, 500 F.2d 508 (Ct. Cl. 1974).

345. See *National Water Well Ass'n v. Commissioner*, 92 T.C. 75 (1989); *Veterans of Foreign Wars, Dept. of Mich. v. Commissioner*, 89 T.C. 7 (1987); *Shiloh Youth Revival Ctrs. v. Commissioner*, 88 T.C. 565 (1987); *Florida Trucking Ass'n v. Commissioner*, 87 T.C. 1039 (1986); *St. Joseph Farms v. Commissioner*, 85 T.C. 9 (1985), nonacq., 1986-2 C.B. 1; *Professional Ins. Agents v. Commissioner*, 78 T.C. 246 (1982), aff'd, 726 F.2d 1097 (6th Cir. 1984). Subsequent to the conclusion of the UBIT Hearings, on June 23, 1988, the Chairman of the Subcommittee On Oversight, J.J. Pickle, released a draft report to the other members of the Subcommittee containing proposals for legislative reforms, including taxing mail order, gift shop and book store sales, fitness and exercise activities, travel services, veterinary services, and advertising sales under a *per se* rule; repealing the "convenience exception" provided by § 513(a)(2); and reducing the 80% "controlled subsidiary" test to a "more than 50%" test. See Haley, note 293, *supra*, at 82-3.

enforcement.³⁴⁶ Commissioner Gibbs testified that of the approximately 900,000 exempt organizations on the Master File, about 500,000 were not required to file Form 990, the Annual Information Return, either because they were churches or received \$25,000 or less in gross receipts, and of the remaining 400,000, only 27,000 on average filed Form 990-T, which requires reporting of unrelated business gross receipts in excess of \$1,000.³⁴⁷

Unquestionably, present resources of federal administrative agencies are inadequate to supervise the efficient delivery of social benefits by 501(c)(3) organizations, and the inadequacy will markedly increase if the elective credit described in Appendix A to the article is enacted into law. At the same time, commentators have observed that the Internal Revenue Service, an agency devoted primarily to raising revenue and not "to make certain that revenue dollars foregone are wisely spent,"³⁴⁸ is ill-suited to supervise the spectrum of nonprofit organizations concerned with such diverse issues as higher education, health care, research and public policy, wildlife and the environment, housing and employment, youth and the family, disaster relief, and arts, culture, and humanities.

In 1967 Professor Lawrence Stone offered the suggestion that a separate division be created within the Treasury Department to supervise exempt organizations, perhaps emulating in legal structure and function the Securities and Exchange Commission, chaired by a new Commissioner of Charities, a presidential appointee.³⁴⁹ In addition to being required to file an annual report, each exempt organization would be required to register with the Commission and to re-register every three to five years to assure periodic review.³⁵⁰ The Commission would have "equity powers, including the power, with court approval, to remove derelict trustees, add trustees, force the merger of charities whose original purposes have ceased to exist into active charities, and require the restoration to charity of property improperly taken

346. See UBIT Hearings, *supra* note 78, at 24, 27-28, 39 (statement of O. Donaldson Chapoton, Deputy Assistant Secretary (Tax Policy), U.S. Department of the Treasury); *id.* at 69 (testimony of Lawrence B. Gibbs, Commissioner of Internal Revenue). The Chief Counsel for Advocacy, U.S. Small Business Administration, admitted that there was insufficient data to prove anything. See *id.* at 127 (containing statements of Frank S. Swain, Chief Counsel for Advocacy, U.S. Small Business Administration).

347. See *id.* at 70 (containing statements of Lawrence B. Gibbs, Commissioner of Internal Revenue). See also DeGaudenzi, *supra* note 121, at 214-31 (discussing more recent proposals to improve disclosure and to impose sanctions as a means to increase compliance among public charities).

348. Zimmerman, *supra* note 22, at 347.

349. Stone, *supra* note 24, at 63-67.

350. *Id.* at 64.

from it.”³⁵¹ Professor Stone’s suggestion made sense in 1967. It makes even more sense today.

Professor Stone went on to suggest that the Commissioner of Charities have the power to “delegate regulatory authority to states or to private self-regulatory associations,”³⁵² the latter “operating with quasi-governmental powers and subject to some supervision by government.”³⁵³ In the wake of the challenge from the small business community to tax exemption afforded to related activities of 501(c)(3) organizations, and public perception of operational weaknesses within the charitable sector, private self-regulatory associations of the various subgroups of charitable nonprofits are virtually an imperative.

Such self-regulatory associations could formulate codes of behavior for their members; devise planning strategies, such as to avoid overcapacity or undercapacity within a subsector; issue policy directives, such as to determine what percent of gifts and contributions should be allocated to the current budget rather than to the endowment fund; and construct general operational guidelines. They could periodically review a 501(c)(3) organization member to assess its success in fulfilling its social mission; its compliance with the prohibition against private inurement and compensation unreasonable in amount; its degree of inefficiency, waste, and excessive budgeting for fund-raising and marketing for consumers; its maintenance of an arms-length relationship with its feeders and unrelated businesses; its avoidance of abusing the “convenience” exception to the tax on unrelated activities; and its thoroughness in reporting unrelated activities. They could investigate allegations of misconduct or lack of compliance. In the event the elective credit outlined in Appendix A is enacted into law, such self-regulatory associations could enforce compliance with its various conditions, such as the competitiveness of the rates charged by a 501(c)(3) organization’s feeders and unrelated businesses, the computation of the related activity net operating loss limitation, and the computation of the percentage limitations with respect to total gross receipts and the investment portfolio.

VI. CONCLUSION

In 1950 Congress enacted legislation to tax the income generated by feeders and unrelated businesses destined for charity primarily to protect private enterprise from the threat of unfair competition. Assuming *arguendo* the validity of the rationale supporting the 1950 legislation, the statutory

351. *Id.* at 65.

352. *Id.* at 66

353. *Id.* at 67.

solution to retain tax exemption for related businesses and to tax only feeders and unrelated businesses was a commendable attempt to balance the interests of private enterprise and of the nonprofit sector. Retention of tax exemption for activities substantially related to the furtherance of the 501(c)(3) organization's stated purposes was also an appropriate expression of a policy to preserve the unique social mission of such organizations in the pursuit of their charitable endeavors. Notwithstanding administrative and judicial difficulties in accurately defining the statutory phrase "trade or business" and in applying appropriate criteria to differentiate related and unrelated activities, the "substantially related" test, properly applied, is an administrable standard.

With the accuracy of vision that hindsight affords it is clear that the 1950 Congress, while attempting to balance the interests of private enterprise and of the nonprofit sector, failed to appreciate the inadequacy of mere tax exemption as a means to meet the pressing and legitimate need of charitable organizations for revenue. This Congressional failure in perception may not have been simply a case of nearsightedness. The federal government apparently does not view the fiscal soundness of the private, nonprofit charitable sector to be within the ambit of its legitimate concerns. Yet, federal government action has directly and indirectly played a key role in shaping the financial destiny of the charitable sector in the ensuing years. Decreases in federal research grants and health care reimbursements have profoundly impacted the fiscal well-being of universities and nonprofit hospitals. Charitable contributions to 501(c)(3) organizations as a percent of total support have diminished, perhaps in part due to changes in the tax laws affecting the economic result of contributions to donors. As revenue sources have decreased, compliance with a burgeoning quantity of federal legislation and regulations has caused expenses to mount.

Navigating in a society that espouses *laissez faire*, but in fact profoundly affected by the actions of the federal government, the charitable sector has attempted to make ends meet by playing in the "free market" competition game without a compass or a map. In some instances the competition to squeeze revenue out of a shrinking pool of available consumer dollars and contribution funds has led 501(c)(3) organizations to overburden their operating budgets with undue allocations to marketing and fundraising. In other cases the pressure for revenue has led charitable nonprofits to push the "convenience exception" to unrelated business activity beyond its intended limits. At the same time, for-profit enterprises have added to the competitive pressure by finding certain traditionally nonprofit activities to be profitable, at least for the moment.

As a result, forty-six years after the effective date of the 1950 legislation, it is the private, nonprofit charitable sector that now threatens to move to the top of the list of endangered species. It is the position of this article that the species is worth saving as representing an essential ingredient

in the mix of American pluralistic society. Clearly, a plan to secure an adequate and reliable source of revenue to fund the charitable activities of 501(c)(3) organizations will require a collaborative effort on the part of the organizations and the federal government; one that, hopefully, respects the charitable sector's needs for financial and political independence. This article suggests that the charitable sector's need to replace diminished revenue from traditional sources may, to some measure, be achieved through enactment of the elective credit outlined in Appendix A. The elective credit offers the advantage of a revenue source that is at least within the control of the 501(c)(3) organization's wholly-owned business benefactors without compromising the ability of for-profit enterprises to compete fairly with those benefactors.

Finally, the article maintains that the creation of private self-regulatory associations of the various subgroups of charitable nonprofits is virtually an imperative. Such self-regulatory associations, working in tandem with a new Commission of Charities, could go a long way toward promoting the efficient delivery of social benefits by 501(c)(3) organizations, enforcing their accountability to the public, increasing understanding of the unique role played by charitable nonprofits in American society, and thereby restoring public confidence in the tax system as it applies to the charitable sector.

APPENDIX A

1. Subject to the limitations described below, a feeder or unrelated business wholly owned by a 501(c)(3) organization (other than a private foundation as defined in section 509) shall be allowed an elective credit against its income tax for the taxable year an amount equal to distributions made or deemed made during such taxable year to its 501(c)(3) owner on the basis of \$1 credit for (for purposes of illustration) \$1.35 of distributions.

Example 1: Assume that taxable income equals pre-tax cash profit and that the income tax rate is a flat 35%. Feeder, Inc., wholly-owned by University, earns \$100x taxable income for the taxable year on which there is a \$35x tax before application of the elective credit. Feeder, Inc. distributes \$47.25x to University during the taxable year (\$35x tax times 1.35) and elects to claim a \$35x credit against its \$35x tax liability. Thus, Feeder, Inc. may elect to reduce its income tax liability to zero on condition that it distributes the sum of a tax equivalent amount (\$35x) plus an additional amount, in this case \$12.25x (12.25% of taxable income), to University.

Rationale: The assumption is that Feeder, Inc.'s for-profit competitor earning \$100x taxable income and paying \$35x tax will be expected to distribute 12.25% of taxable income to its shareholders as an adequate return on investment. The goal is to leave the feeder with the same "after tax/distributions to owners" dollars as its for-profit competition (\$100x taxable income minus [\$35x plus \$12.25x] equals \$52.75x remaining for each).

2. As a condition to electing the credit, the feeder or unrelated business shall be required to establish the competitiveness of the prices it charges for the sale of its goods or services. Compliance with "safe harbor" guidelines shall be deemed compliance with this condition, e.g., the five-year average of the taxpayer's gross profit margin (or return on equity capital) within an acceptable deviation does not exceed, or is not less than, the industry standard for gross profit margin (or return on equity capital).

Rationale: Absent this condition, Feeder, Inc. in Example 1 could lower its prices by, e.g. 20%, in which case Feeder, Inc.'s taxable income would be \$80x on which there would be a \$28x tax before the elective credit. Feeder, Inc. could elect to reduce the tax to zero

by distributing \$37.8x to University. Although Feeder, Inc.'s "after tax/distributions to owners" dollars would be \$42.2x (\$80x taxable income minus \$37.8x distributions) compared to its for-profit competitors \$52.75x (\$100x taxable income minus the sum of \$35x tax and \$12.25x distributions to its shareholders), University's return on investment (\$37.8x) would still be 3.086 times more than that received by the shareholders of the for-profit competitor pre-tax (\$12.25x).

3. The elective credit allowable on a combined basis to a 501(c)(3) owner's feeders and unrelated businesses shall not exceed an amount equal to the net operating loss incurred by the 501(c)(3) owner for the same taxable year in the conduct of all of its related activities divided by 1.35 (corresponding to a \$1 credit for a \$1.35 of distributions). The amount of the elective credit allowable under this limitation allocable to a particular feeder or unrelated business is hereinafter referred to as Limitation A. For this purpose, net operating loss is determined by:
 - a. Adding the sum of the following items received by the 501(c)(3) owner during the taxable year: (a) net investment income other than from feeders and unrelated businesses; (b) gifts, grants, contributions, and membership fees, excluding any of such items restricted by the donor to a special purpose, to the endowment fund, or to a capital campaign; (c) gross income from the conduct of all related activities; and
 - b. Subtracting from the total of the items in 1, above, the total of the following items paid out by the 501(c)(3) owner during the taxable year: (a) expenses allocable to all related activities, and (b) capital expenditures for the acquisition of assets substantially used to further related activities for which there are no other specially allocated purchase funds.

Example 2: Same as Example 1. Feeder, Inc. is the only feeder or unrelated business owned by University. University incurs a \$47.25x net operating loss for the taxable year. The amount of Limitation A is \$35x (\$47.25x divided by 1.35). Feeder, Inc. may elect to take a credit against \$35x tax by having distributed \$47.25x to University.

Example 3: Same as Example 2, except that University incurs a \$40.5x net operating loss for the taxable year. The amount of Limitation A is \$30x (\$40.5x divided by 1.35). The maximum credit allowable to Feeder, Inc. is \$30x.

Rationale: The purpose of Limitation A is to assure that the equalizing distributions of amounts equal to tax and return on investment are used by the 501(c)(3) owner to fund its related activities rather than (i) reinvested back into the feeder or unrelated business as a capital contribution, loan, or collateral for a loan; (ii) used to augment the 501(c)(3) owner's investment portfolio; or (iii) used to amortize debt incurred to acquire or improve assets used in activities unrelated to its charitable purposes.

4. The elective credit otherwise allowable to each of the 501(c)(3) owner's feeders and unrelated businesses before application of any limitation hereunder shall be reduced by four percentage points for each percentage point (or fraction thereof) the Limitation B percent exceeds 25%. For this purpose the Limitation B percent is

$$\frac{\text{Basis to 501(c)(3) owner, or fair market value at time of gift, of investments in feeders and assets used in unrelated businesses}}{\text{basis to 501(c)(3) owner, or fair market value at time of gift, of all assets (other than assets substantially used in connection with related activities)}} \times 100$$

The values of the numerator and the denominator of the fraction shall be determined at the beginning of the taxable year.

Example 4: Same as Example 3. University's bases for all of its assets at the beginning of the taxable year (not including assets substantially used in connection with related businesses) is \$900x of which \$225x is allocable to feeders and unrelated businesses. The Limitation B percent equals \$225x divided by \$900x, or 25%. Since no more than 25% of University's total investment assets consist of investments in feeders and unrelated businesses, the elective credit is not limited by Limitation B. The maximum credit allowable to Feeder, Inc. is \$30x under Limitation A.

Example 5: Same as Example 3. University's bases for all of its assets (not including assets substantially used in connection with related businesses) is \$900x of which \$270x is allocable to feeders and unrelated businesses. The Limitation B percent equals \$270x divided by \$900x, or 30%. Since the Limitation B percent exceeds 25% by 5 percentage points, the elective credit otherwise allowable to Feeder, Inc. is reduced by 20 percentage points to 80%. 80% times \$35x credit otherwise allowable before application of any limitation equals \$28x. The maximum credit allowable to feeder, Inc. under Limitation B is \$28x.

Example 6: Same as Example 5, except that one half of University's investment assets are allocable to feeders and unrelated businesses. The Limitation B percent is 50%. Since the Limitation B percent exceeds 25% by 25 percentage points, the elective credit otherwise allowable to Feeder, Inc., is reduced by 100 percentage points to zero. The maximum credit allowable to Feeder, Inc. under Limitation B is zero.

Rationale: The purpose of Limitation B is (a) to discourage the 501(c)(3) owner from subjecting more than 25% of its total investment portfolio to the risks inherent in wholly-owned business ventures, and (b) to cap the potential loss of tax revenue to the federal government.

5. The elective credit otherwise allowable to each of the 501(c)(3) owner's feeders and unrelated businesses before application of any limitation hereunder shall be reduced by 4 percentage points for each percentage point (or fraction thereof) the Limitation C percent exceeds 25%. For this purpose the Limitation C percent is

$$\frac{\text{Gross receipts received by the 501(c)(3) owner during the taxable year from feeders and unrelated businesses}}{\text{Gross receipts received by the 501(c)(3) owner during the taxable year from all sources}} \times 100$$

For this purpose, gross receipts received from unrelated businesses means distributions received from unrelated businesses to be used by the 501(c)(3) owner in the conduct of its charitable activities.

Example 7: Same as Example 5. University's gross receipts received during the taxable year from all sources is \$189x of which \$47.25x is received from Feeder, Inc. The Limitation C percent is \$47.25x divided by \$189x, or 25%. Since no more than 25% of University's gross receipts received during the taxable year is derived from feeders and unrelated businesses, the elective credit is not limited by Limitation C. The maximum credit allowable to Feeder, Inc. under Limitation B is \$28x.

Example 8: Same as Example 5. University's gross receipts received during the taxable year from all sources is \$135x of which \$47.25x is received from Feeder, Inc. The Limitation C percent is \$47.25x divided by \$135x, or 35%. Since the Limitation C percent exceeds 25% by 10 percentage points, the elective credit otherwise allowable to Feeder, Inc. is reduced by 40 percentage points to 60%. 60% times \$35x credit otherwise allowable before application of any limitation equals \$21x. The maximum credit allowable to Feeder, Inc. under Limitation C is \$21x.

Rationale: The purpose of Limitation C is to restrict the ability of the 501(c)(3) owner to use equalizing distributions of amounts equal to tax and return on investment distributed from feeders or unrelated businesses to fund related activities where the organization does not receive at least 75% of its financial support during the taxable year from (i) gifts, grants, contributions, and membership fees; (ii) investments, other than feeders and unrelated businesses; and (iii) related businesses. Otherwise, the danger exists that any given 501(c)(3) organization could use tax equivalent dollars and equalizing distributions of return on investment to fund activities unresponsive to social needs as reflected by the excessive ratio of gross receipts received from feeders and unrelated businesses to financial support received from the public.

6. As a condition to electing the credit, officers, directors, and employees of the 501(c)(3) owner shall be prohibited from receiving compensation from a feeder or unrelated business.

Rationale: The purpose is to discourage the 501(c)(3) owner from diverting energy and attention away from its charitable purposes.