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UNRELATED BUSINESS INCOME

by
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Unrelated Business Income[1]

I. Introduction and Scope:

A. This outline briefly discusses selected historical background to, and current developments affecting, federal income taxation of the unrelated business income of certain tax-exempt organizations. [The so-called "unrelated business income tax" (hereinafter, "UBIT") provisions of the Internal Revenue Code of 1986, as amended, appear as part III of subchapter F of Chapter 1 of Subtitle A of the Code, at I.R.C. §§ 511 et seq.] The outline then raises a few policy issues about the UBIT, and some of the proposed changes to it. Because the UBIT may be viewed as an exception to general tax-exemption of the organizations in question, the outline also briefly sets forth -- and analyzes -- the underlying rationales supporting tax exemption. A selected bibliography appears at the end of the outline (see page 21 below). Thus, the outline will cover:

1. Some of the older historical background to the UBIT, at ¶ II below.

2. Some of the more recent developments affecting the UBIT, at ¶ III below.

3. A few policy questions about the UBIT, at ¶ IV below.

4. A brief discussion of various suggested rationales for tax-exemption, at ¶ V below.

B. Although many sorts of tax-exempt organizations are subject to the UBIT, the main focus in this outline is on I.R.C. § 501(c)(3) organizations. In 1987, they represented more than 45% of the total number of tax-exempt organizations described in I.R.C. § 501(c). INTERNAL REVENUE SERVICE ANNUAL REPORT 1987 at p. 61 (Pub. 55, 1988). Even that percentage understates their number, since many churches and church-related organizations, even if described in I.R.C. § 501(c)(3), are exempt from filing with the Service. If such churches and related entities were included, the percentage might be closer to 58% (a number derived from the above data plus extrapolations from estimates for earlier years contained in V. HODGKINSON & M. WEITZMAN, DIMENSIONS OF THE INDEPENDENT SECTOR -- A

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1 Much of this outline is taken from an earlier outline by the author, prepared for the N.Y.U. Law School's Graduate Tax Workshop held on June 14, 1988.

STATISTICAL PROFILE 20 (Independent Sector, 2d ed. 1986).

C. The outline is not intended to contain a comprehensive discussion of any of the areas it addresses. Its descriptions are quite brief, and it focusses only on a limited number of issues. It does not include any extended discussion of the details of the pending options for revising the UBIT (see ¶ III.D, and Appendix A at p. 28, below). It should not be relied on to provide a balanced overview of the UBIT. Furthermore, it is not intended to cover legal issues, outside of the UBIT, affecting the conduct of business activities by nonprofit organizations. Such legal issues are nevertheless important, and include considerations of corporate structuring, conflict of interest and self-dealing, possible application of the antitrust laws, and others.

II. **The Early History -- The Rise and Fall of the "Destination Test," and the Emergence of "Relatedness":**

A. From the earliest days of this century -- even prior to the adoption of a general income tax in 1913 -- the tax law has provided an exemption for certain entities "organized and operated exclusively for religious, charitable, or educational purposes, no part of the profit of which inures to the benefit of any private stockholder or individual." Corporate Excise Tax Act of 1909, § 38, 36 Stat. 112 (1909) (emphasis added). These words, with additions not here relevant, have been carried forward without substantial change into the current Code. I.R.C. § 501(c)(3).

B. In a landmark opinion, the Supreme Court interpreted virtually identical language, from the Act of October 3, 1913, as affording tax exemption to a religious organization, even though it earned just less than three percent of its income from the sale, to its own members, of chocolate, wine, and other articles. Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578 (1924). Thus, it has long been clear that the word, "exclusively," is not to be given a rigidly literal meaning. The Trinidad opinion is interesting for two reasons:

1. It is often cited as the genesis of the so-called "destination" test for tax exemption. That test held that an organization could qualify for tax exemption so long as the ultimate destination, or use, of its income was for the prescribed reli-

gious, charitable, etc., purposes, regardless of the source of the income. The relevant language in the opinion, however, is mere dictum. The Court said the Act "says nothing about the source of the income, but makes the destination the ultimate test of exemption." 263 U.S. at 581.

2. It may be that the "relatedness" notion stems from an ambiguity in the Court's discussion of the sale transactions:

> "The articles are merely bought and supplied for use within the plaintiff's own organization and agencies -- some of them for strictly religious use, and the others for uses which are purely incidental to the work which the plaintiff is carrying on." 263 U.S. at 582 (emphasis added).

It is not clear from the context which of two possible meanings to put on the emphasized words:

a. Do they mean that the sales were incidental in the sense of being trivial or unimportant?

b. Or do they mean that the sales were incidental in the sense of being related to the exempt activities of the taxpayer?

Both meanings are proper dictionary understandings of the word, "incidental." Thus, Webster's Third New International Dictionary (G. & C. Merriam 1981) defines "incidental" either as (1) "unimportant" or "nonessential" or "minor," or as (2) "appertaining to" or "associated or naturally related" to. The 1901 edition of the Oxford English Dictionary defines it either as (1) "accessory or subordinate" but of "no essential part," or as (2) "relating or pertinent." (It treats the latter, however, as obsolete.) Either interpretation would be correct on the facts of the case; neither seems compelled.

C. From 1924 on, the courts, applying the destination test, permitted tax-exempt organizations to engage in a growing variety of substantial business activities. See, e.g., Sand Springs Home v. Commissioner, 6 B.T.A. 198 (1927) (operation of cotton gin, greenhouse, oil and gas, electricity generating, and other businesses);

Roche's Beach Inc. v. Commissioner, 96 F.2d 776 (2d Cir. 1938) (bathing beach business).

D. In 1942, the "relatedness" concept -- but not that word for it -- emerged in the legislative process for the first time. Randolph Paul, then Tax Adviser to the Secretary of the Treasury, testified about the problem of tax-exempt entities engaging in businesses. He identified two concerns: loss of tax revenue and unfair competition with for-profit enterprises. He continued:

> "It is therefore suggested that such corporations be taxed on income derived from a trade or business not necessarily incident to their exempt activities." 1 Revenue Revision of 1942: Hearings Before the House Committee on Ways and Means, 77th Cong., 2d Sess. 89 (1942) (emphasis added).

It is clear that Mr. Paul was using the emphasized phrase in the second sense, i.e., as connoting relatedness, not triviality: immediately above the quoted language, he had referred to exempt corporations which "engage in trades and business completely unrelated to their exempt activities." (emphasis added). Note that the perceived abuses -- loss of revenue and unfair competition -- would have been more cleanly addressed by taxing all income from competitive businesses, whether or not such businesses were related to the exempt activities of the organization. The choice of the relatedness test, rather than a competitiveness test, is nowhere discussed.

E. The courts continued to broaden the scope of permitted business activities. Perhaps the most celebrated case involved the famous -- and still locally revered -- N.Y.U. Law School's macaroni factory. There, a wholly-owned "feeder" subsidiary of the school was granted tax exemption. C.F. Mueller Co. v. Commissioner, 14 T.C. 922 (1950), rev'd, 190 F.2d 120 (3d Cir. 1951). See also the testimony of John Gerdes, Esq., on behalf of New York University, in 5 Revenue Revisions, 1947-48: Hearings Before the House Committee on Ways and Means, 80th Cong., 1st Sess. 3525 et seq. (1948). Although the 3d Circuit decision was handed down in 1951, the litigation involved the 1947 taxable year, and the facts of the litigation were well known to members of Congress during the 1950 debates. See, e.g., Representative Dingell's reference to the risk that "all the noodles produced in this country will be produced by corporations held or created by universities . . . ."

Revenue Revision of 1950: Hearings Before the House Committee on Ways and Means, 81st Cong., 2d Sess. 579-80 (1950).

F. Although the 1942 Hearings (¶ II.D above) did not produce legislation which taxed unrelated business income, they formed the basis for the Treasury's 1950 recommendation of a similar tax. Secretary John W. Snyder and Tax Legislative Counsel Vance Kirby both suggested a tax on "unrelated" business activities of exempt organizations. 1 Revenue Revision of 1950: Hearings Before the House Committee on Ways and Means, 81st Cong., 2d Sess. 19 (statement of Secretary Snyder); Id. at 165 (testimony of Tax Legislative Counsel Vance Kirby). Mr. Kirby, acknowledging that the genesis of the 1950 proposal was the earlier testimony of Randolph Paul, said, "A similar proposal was presented to the committee in 1942 . . . ." Ibid. The testimony is interesting both for what it condones and what it condemns:

1. Passive income received by exempt entities is clearly approved for tax-free status; the only reason enunciated is that such receipts are "the traditional sources of income of these institutions . . . ." Ibid.

2. Active business income is clearly targeted for taxation, but only if unrelated to the institution's exempt activities. Mr. Kirby made this explicit, when he testified:

> "Moreover, only business income which is not incident or related to the exempt purpose would be taxed. For example, a university bookstore may continue to sell textbooks to students, an agricultural college may run a wheat farm in connection with its educational program, a social club may sell food to its members, without affecting its tax exempt status. All of these activities would continue to be exempt from tax. Only the unrelated business would be taxed -- the sparkplug or chinaware factory run by a university." Id. at 166.

The resulting legislation adopted the relatedness test, which continues in I.R.C. § 513(a) to the present date. Revenue Act of 1950, Pub. L. No. 814, § 301(a), defining "unrelated business net income." The principal problem addressed by the Act was "that of unfair com-

petition." H. Rep. No. 2319, 81st Cong., 2d Sess. 36 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 28 (1950). Accord, Treas. Reg. § 1.513-1(b); S. Rep. No. 94-938, 94th Cong., 2d Sess. 601 (1976). Less, but some, attention was paid to the UBIT's revenue-raising potential. See, e.g., H. Rep. No. 2319, 81st Cong., 2d Sess. 1-3 (1950).

G. Although Congress has tinkered with the UBIT since 1950, its most significant revisiting of the area took place in 1969. The Tax Reform Act of 1969 enacted five major, and several other less important, changes to the reach of the UBIT:

1. It extended the reach of the UBIT to almost all exempt organizations, albeit with a deferred effective date for churches and church affiliates. I.R.C. § 511(a)(2)(A).

2. It adopted the so-called fragmentation rule, under which parts of an activity could be subject to the UBIT, even if the overall business was not (as in the case of advertising income of an otherwise exempt magazine). I.R.C. § 513(c).

3. It imposed tax on the passive investment income of, and otherwise modified the definition of UBIT for, certain social clubs, voluntary employees' beneficiary associations, and selected other entities. I.R.C. § 512(a)(3).

4. Responding to the Service's loss in United States v. Clay Brown, 380 U.S. 563 (1965), it imposed the UBIT on debt-financed income of certain types. I.R.C. § 514.

5. It imposed the UBIT on interest, rents, and royalties received from controlled organizations. I.R.C. § 512(b)(13). (See further discussion at ¶ IV.C.1 below.)

For a useful survey of the 1969 changes, see Cooper, Trends in the Taxation of Unrelated Business Activity, 29 INST. ON FED. TAX'N 1999 (1971).

H. Subsequent legislative developments, prior to the 1987 hearings described in ¶ III.C below, have been less significant even if not inconsequential. They are not discussed here.

III. **Recent Developments:**

A. Beginning in the early '80s, and spearheaded by the Office of the Chief Counsel for Advocacy of the Small Business Administration, concerns began to be expressed about growing competition between nonprofit and for-profit enterprises. See, e.g., U.S. SMALL BUSINESS ADMINISTRATION, UNFAIR COMPETITION BY NONPROFIT ORGANIZATIONS WITH SMALL BUSINESS: AN ISSUE FOR THE 1980s (3d ed. 1984); Harris, SBA Study on Tax-Exempts Causes a Stir, 28 TAX NOTES 941 (1985). See also the extensive and useful bibliography appended to the article by Lifset, ¶ IV.B.3 below, at 183-86. The dialogue was heated and intense, as were the lobbying pressures generated by both sides.

B. On September 12, 1986, Chairman Rostenkowski of the House Ways and Means Committee issued a press release calling for the Oversight Subcommittee

> "to conduct a comprehensive review of the Federal tax treatment of commercial and other income-producing activities of organizations that have tax-exempt status under section 501 of the Internal Revenue Code." Press Release #25, reprinted in 1 HEARINGS BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE COMMITTEE ON WAYS AND MEANS, HOUSE OF REPRESENTATIVES, UNRELATED BUSINESS INCOME TAX, 100th Cong., 1st Sess. 2-4 (Serial 100-26 1987).

C. The Oversight Subcommittee of the House Ways and Means Committee held five days of hearings from June 22 through June 30, 1987. They have been reprinted in three parts. (See ¶ III.B above for the full citation.)

D. In late March 1988, Chairman J.J. Pickle of the Oversight Subcommittee issued a press release containing a number of "discussion options regarding the unrelated business income tax . . . ." Press Release #16, reprinted in SUBCOMMITTEE ON OVERSIGHT OF THE COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, WRITTEN COMMENTS ON DISCUSSION OPTIONS RELATING TO THE UNRELATED BUSINESS INCOME TAX, 100th Cong., 2d Sess. III-VI (Comm. Print, WMCP:100-30 1988) [hereinafter cited as "1988 Written Comments"].

E. A very considerable volume of comments was submitted, filling 960 printed pages in the 1988 Written Comments,

¶ III.D above. The Subcommittee held a further public hearing on May 9, 1988, at which Assistant Secretary for Tax Policy O. Donaldson Chapoton, among others, testified. See Jones, Treasury Advocates UBIT Fine Tuning; But UBIT Overhaul Not Needed, 39 TAX NOTES 791 (No. 7, May 16, 1988).

F. On May 19, 24, and 25, 1988, and again in early June 1988, the Oversight Subcommittee met in closed sessions to discuss the options referred to at ¶ III.D above. (For press reports, see Jones, Pickle Subcommittee Appears Willing to Modify UBIT Stance, 39 TAX NOTES 907 (No. 8, May 23, 1988); Jones, Oversight Subcommittee Makes More Progress on UBIT Package, 39 TAX NOTES 1022 (No. 9, May 30, 1988).) The media have reported various subcommittee "actions" as notations on a spreadsheet form, but it is not clear how accurate the reports are, or whether the reported "actions" are firm decisions. The TAX NOTES version of the spread sheet appears at the end of this outline as Appendix A, p. 28 below.

G. As of the date of this outline, nothing further has emerged from the Subcommittee. It appears that a report -- containing a discussion of the various options for revising the UBIT and the subcommittee's view on each -- has been drafted by the staff of the Subcommittee. It seems unlikely that actual legislative language will be agreed to, as none has yet been drafted. Subcommittee staff members have stated that the draft report may still be considered and voted on by the Subcommittee, and forwarded to the full House Ways and Means Committee, before the end of the current Congressional session. Observers are much less sanguine about this. Whether or not the report is forwarded, it seems virtually certain that no further legislative action will be taken during 1988. The UBIT issue, however, is not dead, and most believe that it will emerge again in the next Congress.

IV. Selected Policy Issues Affecting the UBIT:

A. Indirect effects:

1. An entity's tax-exempt status for Federal tax purposes, particularly as to I.R.C. § 501(c)(3) organizations, is often relied on by other governmental entities for their own uses. Thus, for example, lower postage privileges, state and local real estate and other tax exemptions, and many

other benefits flow from the federal classification.

2. Federal tax exemption is not available to an organization which derives too substantial a portion of its income from unrelated business activities. Rev. Rul. 69-220, 1969-1 C.B. 154; Indiana Retail Hardware Ass'n v. United States, 366 F.2d 998 (Ct. Cl. 1966).

3. The UBIT operates to broaden the class of organizations which qualify for federal tax exemption. It obviously contemplates that an exempt entity may derive at least some unrelated business income, and -- by providing for a response other than complete revocation of tax exemption -- gives the Service and courts a "half-way house" remedy. In close cases, this may be a more palatable result, and thus tends to permit a broader spectrum of business activities to be carried on without loss of exempt status. Cf. United States v. Fort Worth Club, 345 F.2d 52 (5th Cir.), modified and aff'd, 348 F.2d 891 (5th Cir. 1965) (tax exemption denied to social club with substantial business income because, prior to Tax Reform Act of 1969, the UBIT did not apply to I.R.C. § 501(c)(7) organizations).

4. Few if any of the benefits referred to in ¶ IV.A.1 above have intermediate (or "half-way house") sanctions. Thus, to the extent that the existence of the UBIT tends to broaden the class of tax-exempt entities, it carries in its wake a correspondingly broader class of other benefits, which in turn are largely free of UBIT-type mediation or cost.

Are these observations important for tax policy? Should the Code's exemption provisions be "de-coupled" from the definitions used for other purposes? If so, how should this be accomplished?

B. Relatedness v. Destination or Competitiveness Tests:

1. As shown above (see ¶ II.D), the genesis of the relatedness test is shrouded in some mystery. Although it clearly derives from the 1942 testimony of Randolph Paul, that testimony does not explain why the test was chosen -- and the test is not particularly well crafted to deal with the twin

problems of unfair competition and revenue. Should a straight-forward competitiveness test be used instead? Compare I.R.C. § 501(m), added by the Tax Reform Act of 1986, § 1012(a), denying tax exemption to certain providers of "commercial-type insurance." See also Bennett & Rudney, A Commerciality Test to Resolve the Commercial Nonprofit Issue, 36 TAX NOTES 1095 (No. 14, Sept. 14, 1987). Or should an active/passive test be used instead? If so, how should it be phrased and interpreted?

2. The destination test was criticized for permitting too much business activity by nonprofit entities. Aside from unfair competition and revenue concerns, at least one other theme is sometimes dimly discernable in the UBIT debate: it is perhaps undesirable to divert the attention of managers of tax-exempt entities away from the charitable mission of the organization towards its business operations. Is this view correct? Should it be implemented through the Code?

3. A frequent theme in the UBIT debate is that profitable activities help support the provision of benefits to those less able to pay. Thus, for example, YMCAs have urged that dues-paying members at their health clubs help subsidize the use of those facilities by less-wealthy members. See, e.g., April 15, 1988, letter from Robert A. Boisture, Associate General Counsel, YMCA of the USA, to Representative J.J. Pickle, reprinted in 1988 Written Comments, ¶ III.D above, at 953-54 (supporting the "community affordability" option, set out at p. 29 below). For a thoughtful analysis of this view, see Lifset, Cash Cows and Sacred Cows: Commercial Activities in the Nonprofit Sector, 1988 SPRING RESEARCH FORUM WORKING PAPERS 160 (Independent Sector 1988), arguing that such cross-subsidization may be an important feature of most justifiable profit-making ventures of tax-exempt entities. How does this cross-subsidization notion square with the discrediting of the destination test?

4. To what extent is the destination test implicit in the charitable deduction under I.R.C. § 170? Consider two models:

   a. A tax-exempt entity conducts a macaroni business, using the profits in its charitable ac-

tivities. Given the UBIT, the profits of the business are taxed.

b. A tax-paying person (individual or otherwise) conducts a macaroni business, and donates the profits to an I.R.C. § 501(c)(3) organization. Because of the charitable deduction (and subject, of course, to its various limits), the taxpayer does not pay tax on the business profits. Neither does the charitable donee.

Is the charitable deduction a disguised version of the destination test? Could the destination test thus be viewed as a charitable deduction allowed to the business-side of the entity itself? What implications does this have for tax policy? See generally Steuerle, The Issue of Unfair Competition, Working Paper, Center for the Study of Philanthropy and Voluntarism, Institute of Policy Sciences and Public Affairs, Duke University (February 1988).

C. The Controlled Subsidiary:

1. The Tax Reform Act of 1969, § 121(b)(2)(C), added I.R.C. § 512(b)(13). Under certain circumstances, it transforms what would otherwise be tax-exempt non-UBIT income into tainted income subject to the UBIT, if the income is received from a "controlled organization." See Treas. Reg. § 1.512(b)-1(l). The evil at which this provision was aimed is described in the legislative history as follows:

> "In certain cases exempt organizations do not engage in business directly but do so through nominally taxable subsidiary corporations. In many such instances the subsidiary corporations pay interest, rents or royalties to the exempt parent in sufficient amount to eliminate their entire income, which interest, rents, and royalties are not taxed to the parent even though they may be derived from an active business." H. Rep. No. 91-413 (Part 1), 91st Cong., 1st Sess. 49 (1969).

If the problem is erosion of the tax base, why is the remedy limited to controlled organizations? Consider the perhaps analogous cases in which taxable entities deduct payments made to recipi-

ents which, in turn, do not pay tax: foreign persons, unrelated tax-exempt lenders (pension funds, etc.), creditors with net operating losses, etc. Consider also the overall real effective tax rate on taxable recipients of interest, royalties, and rents generally.

2. Is the underlying problem the possible absence of arm's length pricing? Consider the policies behind, e.g., I.R.C. §§ 1239, 267(a)(1), and 871(h)(3). If so, are the rules in I.R.C. § 482 relevant here? Treas. Reg. § 1.482-1(a)(3) says that, for purposes of I.R.C. § 482:

> "The term 'controlled' includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted."

The spread-sheet options, at p. 28 below, would extend the definition of "control" to 50%-or-more owned entities (instead of the 80% line now in the Code). See p. 31 below. Is this an improvement? Does it matter whether the stock of the taxable entity is owned by the tax-exempt organization or, for example, the particular employees whose efforts are directed to the activities in question? What would be the impact of adopting, for purposes of I.R.C. § 512(b)(13), a control test like the one quoted above?

D. The UBIT as Playing Field Leveler:

1. As shown in ¶ II.F.2 above, the principal purpose of the UBIT is to eliminate unfair competition, i.e., to level the playing field. A simple image is suggested: taxes are a cost of doing business; avoiding taxes may be viewed as a subsidy; tax exemption thus presents a tilted playing field, in which subsidy-like benefits flow to the nonprofit community to the detriment of for-profit enterprises. Is this accurate? Consider, e.g., the following:

   a. For the years 1981 through 1986, the combination of the investment tax credit and the

accelerated cost recovery system often produced a negative tax rate for the purchase of qualifying equipment. Those benefits, unavailable to exempt organizations, amounted to a conscious subsidy to for-profits. The tax system actually provided capital for their use. The benefit was directly proportionate to the amount of eligible tangible personal property acquired, which may account, in part, for the rapid growth of for-profit hospitals during those years.

b. The tax benefits of ownership of equipment -- including deductions for depreciation, interest, and other costs -- may be transferred to capital-poor for-profit enterprises through lease transactions. This, in general, should reduce the cost of such property to those businesses. Nonprofit organizations are forbidden to obtain these benefits, per I.R.C. § 168(h), which should comparatively increase their costs for such property.

c. Start-up losses, which are readily available to for-profit enterprises to set off against later profits, are often administratively denied to nonprofit enterprises. (Although the law does permit net operating loss carryforwards to nonprofit organizations operating an unrelated business, under I.R.C. § 512(b)(6), the Service frequently takes the position that start-up losses of a nonprofit do not become part of a net operating loss, since the activity, at inception, is not carried on for profit. Cf. Treas. Reg. § 1.512(b)-1(e)(3); Rev. Rul. 81-69, 1981-1 C.B. 351; The Brook, Inc. v. Comm'r, 86-2 U.S.T.C. ¶ 9646 (2d Cir. 1986), reversing 51 T.C.M. 133 (1985); Iowa State University of Science and Technology v. United States, 500 F.2d 508 (Ct. Cl. 1974).)

2. Following the downfall of Jim and Tammy Bakker, the PTL filed for bankruptcy. The bankruptcy judge enjoined the Service from revoking the tax exemption of the PTL. The Service appealed, and filed the Revenue Agent's Report [hereinafter, "RAR"] as part of the appeal papers, thus making them available to the public. (On appeal, the injunction was dissolved; the dissolution in turn

was affirmed by the Fourth Circuit on April 20, 1988; and the PTL's tax exempt status has been revoked by the Service. Ann. 88-79, 1988-19 I.R.B. 48.) The RAR alleges, in the alternative, (1) that the PTL should not have been tax exempt at all, given its extensive business activities, or (2) that the PTL should pay UBIT on such business activities. The tax deficiency asserted for the first allegation is over $60 million; the tax deficiency asserted for the second alternative allegation is over $80 million! How can this be? What implications does it have for the level-playing-field notion of the UBIT? What light does it shed on the allocation-of-expenses rules used for UBIT purposes?

V. Rationales for Tax Exemption:[2]

A. The UBIT may be viewed as an exception to the general tax-exempt status of the entities to which it applies. Thus, consideration of the shape of the UBIT inevitably calls into question the deeper question of the underlying rationale for tax exemption. Somewhat surprisingly, although there are many writings about the UBIT (see, e.g., the selected bibliography at p. 21 below), the legal literature discussing tax-exemption rationales is not voluminous. Among the most helpful items are: Belknap, The Federal Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy (1954), reprinted in IV RESEARCH PAPERS SPONSORED BY THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS: TAXES 2025 (1977); Bittker & Rahdert, The Exemption of Nonprofit Organizations from Federal Income Taxation, 85 YALE L.J. 299 (1976); 1 R. DESIDERIO & S. TAYLOR, PLANNING TAX-EXEMPT ORGANIZATIONS § 4.03 (1987); Ellman, Another Theory of Nonprofit Corporations, 80 MICH. L. REV. 999 (1982); Hansmann, The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation, 91 YALE L.J. 54 (1981); B. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS ch. 1 (5th ed. 1987); McDaniel, Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction, 27 TAX L. REV. 377 (1972); McNulty, Public Policy and Private Charity: A Tax Policy Perspective, 3 VA. TAX REV. 229 (1984); Simon, The Tax Treatment of Nonprofit Organizations: A Review of Federal and State

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2 Much of this portion of the outline is taken from an earlier paper by the author, cited at ¶ V.A below.

Policies, in W. POWELL, ed., THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 67 (1987); Stone, Federal Tax Support of Charities and Other Exempt Organizations: The Need for a National Policy, 1968 U. SO. CAL. TAX INST. 27. See also Dale, Rationales for Tax Exemption, 1988 SPRING RESEARCH FORUM WORKING PAPERS 3-14 (Independent Sector 1988).

B. Several of the above writings are more centrally concerned with the policies affecting the deductibility of gifts to charities than with tax exemption of the charities themselves. The two questions are closely intertwined. For example:

> "[T]he deduction allowed the donor is the counterpart of the exemption from income tax enjoyed by the charity itself [so that] the same policy decisions that justify the exemption for the charitable organization support the charitable contribution deduction." McNulty, supra ¶ V.A, at 233; but see Hansmann, supra ¶ V.A, at 72.

Nevertheless, little effort has been made to plumb the depths of the relatively voluminous literature on the deduction. Furthermore, the scope of tax-exemption is not coterminous with the scope of the charitable deduction: many tax-exempt organizations are not eligible for tax-deductible gifts. The focus on legal literature reflects the background and training of the author, and should not be taken to suggest that other disciplines should be ignored; indeed, historical, economic, religious, and other writings are probably at least as important.

C. A number of different justifications for exempting nonprofit organizations from the income tax may be gleaned from a perusal of the principal writings. Five such theories are discussed briefly, in no particular order, below. The enumeration is not free from question: not only might the various theories mentioned be organized or subdivided differently, but other possible justifications could be added to the list. In each case, a brief statement of the rationale is followed by an equally brief listing of possible criticisms. Caveat: the brevity itself may be misleading -- the risk of distortion through oversimplification is real.

1. Tax-exempt status may be justified because the activities of the nonprofit sector are direct replacements for governmental obligations. The

notion is that government should not tax organizations, thus reducing their ability to deliver goods and services by the amount of the tax, when that reduction merely creates a vacuum which must be filled by the government itself. This is the rationale mentioned in the final report of the prestigious Filer Commission:

> "A frequently cited justification for tax immunities that affect nonprofit organizations is that government, in fact, would itself have to supply many of the services, fill many of the functions, of such organizations if they did not exist." REPORT OF THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, GIVING IN AMERICA: TOWARD A STRONGER VOLUNTARY SECTOR 103 (1975).

Stated another way, a deal has been struck: tax exemption in exchange for the private fulfillment of governmental duties. This theory may be criticized on several grounds:

a. It fails to explain why tax exemption is not granted to <u>for</u>-profit providers of the same goods and services.

b. It cannot explain the tax exemption of churches and religious organizations, since the First Amendment forbids government from intruding into those areas.

c. The amount of the tax-exemption benefit is not related to the value of goods or services provided, but rather to the amount of capital or retained earnings of the organization.

d. The theory does not support tax exemption, but merely argues that tax exemption is one of two routes for the provision of the desired goods and services.

2. Tax-exemption may be justified because of the way nonprofit organizations contribute to pluralism. The notion is that such organizations provide goods and services for the public, but perhaps more efficiently and in any event with more diversity than the government. Belknap puts it as follows:

> "[G]overnment has granted the charitable tax exemptions in order to encourage voluntary private organizations to carry out certain activities which by common understanding are agreed to rate among the highest in the scale of social values. The preference that these activities be carried out by voluntary private organizations is based upon two advantages that private action in these fields enjoys over government action.
>
> "The first advantage is that voluntary private enterprise can often do the job better. . . .
>
> "The second advantage of private control . . . lies in the effect of such control upon the overall pattern of our society. . . . [T]he broad ramifications of freedom require a preference for private activity and diversity." Belknap, supra ¶ V.A, at 2035-36.

Possible criticisms include:

a. It is not clear how to measure efficiency; some would dispute the claim that not-for-profit entities are more efficient than government, at least in all instances; lacking an agreed gauge, it is difficult to rely on that criterion. See, e.g., Bittker & Rahdert, supra ¶ V.A, at 332-33:

> "Lacking a method for measuring these appealing but elusive virtues, one must perforce rely on intuition in comparing the achievements of private charities with those of government, when they are performing similar functions."

b. The argument from pluralism proves too much, because for-profit firms could also claim it. Even if the rationale required a conjunction of charitably-aimed public benefit and diversity, thus excluding, e.g., General Electric Corp., from the justification, the theory would not explain why for-profit hospitals, health clubs, and schools are not exempt from the income tax.

c. The justification does not provide useful guidelines for decision-makers trying to draw lines between various forms of and limits on tax exemption.

3. Tax exemption may be explained by the inappropriateness of applying customary measures of "income" to not-for-profit entities. This is the theory espoused by Bittker & Rahdert, supra ¶ V.A, at 307-16:

> "[A]ll exempt organizations engaged in public service activities share one common feature: if they were deprived of their exempt status and treated as taxable entities, computing their 'net income' would be a conceptually difficult, if not self-contradictory task." Id. at 307 (footnote omitted).

The authors also argue that, even if an appropriate tax base could be defined, it would be difficult to fix an appropriate tax rate to apply to it. Id. at 314-16. Critics could counter:

a. The difficulty of defining an appropriate tax base argues for better or specially-crafted definitions, not exemption.

b. The problems may be overstated; at least a good portion of the receipts of nonprofits respond fairly well to ordinary notions of "income." See, e.g., Hansmann, supra ¶ V.A, at 59-62.

4. The exemption may be justified on the grounds that taxing the not-for-profit indirectly would impose the tax burden on its customers and beneficiaries, but without taking into account their ability to pay. This notion is also put forth by Bittker & Rahdert, supra ¶ V.A, at 314-16. (This theory, although listed separately from the rationale immediately above, is closely linked to the latter. Indeed, the authors viewed it as really part of the appropriate-tax-rate issue.) Critics could respond:

a. Tax rates imposed on entities, even in the business world, are not selected on the basis of the ability of the entities' customers to pay.

b. In many cases, the ability-to-pay criterion would be met: in the case of "donative" nonprofits by the joint "contributions" of donors and customers, and in the case of "commercial" nonprofits by their typically-affluent customers. See Hansmann, supra ¶ V.A, at 65, arguing that in such cases the tax burden would not be "especially regressive."

c. In any case, the true incidence of an entity-level income tax is a much-debated and uncertain question.

d. The tax-exemption benefit itself fails to take into account the ability to pay of the entity's customers; the benefit is closely related to the retained "capital" of the entity rather than the nature of its clientele.

5. The exemption may be based on the joint presence of "contract failure" and insufficiency of capital. This rationale, espoused somewhat gingerly by Prof. Hansmann in the article cited supra, at ¶ V.A, is by far the most difficult to encapsulate. It proceeds from two notions. First, Prof. Hansmann postulates that many "commercial" nonprofits operate in industries characterized by "contract failure," i.e., in which customers are unable to "make accurate judgments about the quality, quantity, or price of services provided by alternative producers." Second, Prof. Hansmann argues that certain nonprofit organizations have severe restraints on their ability to raise capital, unlike for-profit organizations which can readily borrow or issue stock. When both criteria are met, i.e., when an industry is characterized by contract failure and nonprofits in that industry have substantial needs for capital, tax exemption may be justified as "a crude mechanism for subsidizing capital formation . . . ." Id. at 75. Several criticisms may be made:

a. The rationale is, admittedly, "crude," since the value of the tax exemption is not well related to the goals sought.

b. It is not clear that it is wise to facilitate the aggregation of capital in the nonprofit sector, where it may be retained, free from tax and other means of diffusion. Consider, for example, the policies behind the adoption of I.R.C. § 4942, captioned "Taxes on failure to distribute income."

c. If the rationale were accepted, implementing legislation would almost certainly involve quite considerable complexity. For example: (a) since not all industries would be characterized by contract failure, some workable definition of each "industry" would have to be provided; (b) mechanisms would be needed to prevent entities from flowing their excess capital out of intended industries directly or indirectly into other uses and industries; (c) some method would be required for periodic reviews to measure whether the desired capital build-up had been achieved, so that tax exemption could be withdrawn.

d. Granting tax exemption to a industry because it has trouble raising capital seems likely to promote economic inefficiency.

e. The argument accepts as a given that an entity-level tax on income is appropriate (or at least inevitable) for business corporations. That premise gives away so much theoretical ground that there is not enough footing left to provide adequate support for a justification for sector-specific entity-level tax exemption.

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3 See also the extensive and useful bibliography appended to the article by Lifset, ¶ IV.B.3 above, at 183-86. Further items can be found in the chapters of the books by R. DESIDERIO & S. TAYLOR, and B. HOPKINS, cited below in this bibliography.

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Appendix A

TAX NOTES TODAY[4]
MAY 23, 1988
Washington Roundup
UBIT OPTION PAPER IN THIS ISSUE
(19 MAY 88)
FULL TEXT

The full text of the original press release, announcing the Ways and Means Oversight Subcommittee's discussion options relating to UBIT, appeared in the April 1, 1988, issue of Tax Notes Today at 88 TNT 73-10. Set forth below are the discussion options; the Subcommittee's actions are listed in capital letters to the right of each option.

Option	Action
I. 'SUBSTANTIALLY RELATED' TEST:	
Repeal 'substantially related' test and replace it with a 'directly related' test.	DROP
Determine whether each income-producing activity standing alone is tax-exempt.	DROP
Retain 'substantially related' test; however, impose UBIT on specified activities (as listed in A-L below) whose nature and scope are inherently commercial, rather than charitable.	OK, BUT RE-VISIT IN 4 TO 5 YEARS
A. Apply UBIT to gift shop/bookstore income with exceptions for (1) on-premise sales of low-cost mementos, (2) on-premise sales of an educational nature which relate to the organization visited, (3) in the case of a hospital, articles generally used by or for inpatients, (4) in the case of a university, articles in furtherance of educational programs, or low-cost items (dollar cap), and computer sales not in excess of one sale per student/faculty per year. In addition, apply UBIT to income from all catalog and mail/phone order or other 'off-premise' sales (with exception for de minimis sales, in relation to amount of 'on-premise' sales).	APPLY SAME NEW RULE TO BOTH ON AND OFF PREMISES SALES

B. Apply UBIT to all sales or rental income of medical equipment and devices (including hearing aids, portable x-ray units, oxygen tanks), laboratory testing, and pharmaceutical drugs and goods (with exceptions for (1) in-patients, continuous-care outpatients, or emergency treatment outpatients or (2) items not available in immediate geographic area.)	SALES AND RENTAL TO PATIENTS -- OK
C. Apply UBIT to income from certain health, fitness, exercise and similar activities unless program is available to a reasonable cross-section of the general public such as by scholarship or fees based on community affordability.	SEPARATE TEST FOR EACH FACILITY
D. Apply UBIT to travel and tour services (with exception for services provided by colleges/universities to students/faculty as part of a degree program curriculum, and de minimis sales to non-students/faculty.)	OK
E. Apply UBIT to adjunct food sales (with exception for on-premise services and/or sales provided primarily for students, faculty, employees, members, or organization visitors).	OK
F. Apply UBIT to income from certain veterinary services such as grooming, boarding, and elective surgery (with exceptions for spaying and neutering, measures to protect the public health, and measures recommended by a veterinarian for the health of the animal).	OK, BUT [sic]
G. Apply UBIT to hotel facility income which is patronized by the public (with exception for facilities operated, but only to the extent necessary, in furtherance of the organization's exempt purpose). In addition, apply UBIT to certain sales of condominiums and time-sharing units.	OK, BUT COLLEGES ARE VULNERABLE
H. Apply UBIT to routine testing income (with exceptions for Federal or State mandated activity, pre-surgical medical testing, and laboratory testing which is part of a student educational training program).	RETAIN CURRENT LAW

I. Apply UBIT to income from affinity credit card/catalog endorsements.	OK
J. Apply UBIT to advertising income and allow deductions from UBIT only for direct advertising costs.	OK
K. Apply UBIT to theme/amusement parks.	OK
L. Apply UBIT to additional specified activities determined to be inherently commercial.	DROP
II. CONVENIENCE EXCEPTION:	
Repeal 'convenience' exception (income from activities carried on primarily for the convenience of a Section 501(c)(3) organization's members, students, patients, offices, or employees). Income from activities that are substantially related to the organization's exempt purpose would remain tax free, subject to the specific rules listed in Section I. above.	OK
III. 'REGULARLY CARRIED ON' TEST:	
Repeal 'regularly carried on' test. Income from an activity that is not a trade or business would remain tax-free.	NO, RETAIN
IV. TAX TREATMENT OF ROYALTIES INCOME:	
Apply UBIT to royalties measured by net or taxable income derived from the property; or royalties received by an organization for use of property if such organization, or closely related organization, either: (1) created such property, or (2) performed substantial services or incurred substantial costs with respect to the development or marketing of such property. Retain present law for certain non-working property interests, and exception for products that are part of the organization's exempt function.	OK, BUT CLARIFY

V. DEDUCTION FROM TAXABLE UBIT:

Increase $1,000 UBIT deduction for certain Section 501(c) organizations to $5,000 or $10,000, with phase-out beyond $50,000 income level. Limit the increased deduction to 501(c)(3) activities directly carried on by the exempt organization.	1) WITH $10,000 PHASE OUT 2) 501(c)(3)s ONLY

VI. UNRELATED DEBT-FINANCED INCOME.

Limit the current law UBIT exception for unrelated debt-financed property to only those pension funds, educational institutions and title holding companies that make at least a 20 percent equity investment of their interest in the property. Retain character of debt-financed income received from all pass-through entities.	OK, BUT 2 YEAR DELAY IN EFFECTIVE DATE

VII. SUBSIDIARIES AND JOINT VENTURES:

Modify the definition of 'control' in the case of exempt organizations having taxable subsidiaries. Define 'control' as ownership directly, indirectly, or by attribution of at least 50 percent of stock, by vote or value (rather than 80 percent of combined voting stock, under present law).	OK
Extend 'control' rules where exempt organizations in the aggregate own more than 50 percent of the subsidiary's stock.	OK
Provide that a controlled taxable subsidiary's income can be no less than its UBIT would have been if the income-producing activity had been carried on directly by the exempt parent organization.	OK
Aggregate income and activities of controlled subsidiaries for purposes of determining if primary purpose of parent is a tax-exempt purpose.	OK

VIII. ALLOCATION RULES:

With respect to facilities used for exempt purposes as well as unrelated business purposes, allow a deduction against UBI for a proportionate share of the direct operating cost of the facility (e.g., maintenance, insurance, and utilities), but not allow a deduction for a share of the general overhead of the organization or for depreciation.	RETREAT SLIGHTLY: PRO-RATE INDIRECT COSTS BASED ON TOTAL TIME AVAILABLE

IX. TAX INFORMATION REPORTING/INTERNAL REVENUE SERVICE (IRS) ADMINISTRATION:

Expand Form 990-T reporting requirement to include more reporting on: (1) activities and income which the organization claims to be exempt or excluded from UBIT, and (2) revenue sources such as contributions, grants or other funding sources.	OK
Provide more detailed reporting of revenue producing activities and income on Form 990.	OK
Consider 'short form' reporting for small organizations, based on revenues.	OK
Require affiliated group that includes an exempt organization to file a consolidated information return.	OK
Recommend that IRS have an integrated examination program for exempt organizations and subsidiaries (taxable and exempt).	OK
Recommend that IRS conduct the following studies and report on: (1) nonprofit exempt hospital reorganizations (examining the extent, purpose, effect of the use of subsidiaries); (2) exempt organizations that file Form 990s but do not file Form 990-T's (examining activities of a sample group to determine compliance with UBIT); (3) the feasibility of requiring State and Federal land-grant universities to file an information return; (4) the use, purpose and effect of joint ventures; and, (5) study, after five years, on effect of UBIT changes.	OK, WITH ADDITIONS: RESEARCH EXEMPTION

X. MISCELLANEOUS:

Codify IRS position (upheld by some courts) that a social club (or other organization whose investment income is subject to UBIT) may not, in determining UBIT, reduce its net investment income by losses on sales to non-members.	OK
Exempt from UBIT an organization's contingent rental income received through a prime tenant, where the prime tenant leases real estate from a tax-exempt organization, the prime tenant's net profits are based on fixed rents derived from subtenants, and the prime tenant does not provide services to subtenants except through an independent contractor.	DROP
Exempt from UBIT investment income earned from non-refundable loan commitment fees.	DROP
Modify rules applicable to organizations 'testing for the public safety.'	UL
Consider modification of various piecemeal UBIT exclusions enacted since 1969.	ADD TO STUDY