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CHAPTER 9

About the UBIT . . .

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§ 9.01 INTRODUCTION

This article is about the tax on unrelated business income¹ in

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¹ The tax on "unrelated business taxable income" of certain tax-exempt

the same sense in which a path may go about a lake. It is not directed at immersion in the tax provisions themselves, but rather at circumnavigating them from a wary distance in the hope of finding some useful perspectives.

The article first sets forth a brief historical background to the 1950 enactment of the UBIT provisions, and their development through the end of the '70s. This historical survey shows the lack of any coherent rationale for the UBIT.

It then considers the more current events on the UBIT legislative scene, through the end of 1989. The pace of activity here demonstrates that the lack of rationale has not deflected the energies of those who desire to reshape the UBIT legislation.

Finally, the article suggests an alternative perspective from which to consider revisions to the UBIT. It argues that the scope of the UBIT debate is too narrow when it focuses only on organizations which derive their tax-exempt status from I.R.C. Section 501(c).² It recommends that consideration should also be given to various other provisions under which many other persons³ achieve tax exemption. Because the policy considerations are complex, and the alternative perspective also leads down fairly

organizations is imposed by § 511-15 of the Internal Revenue Code of 1986, as amended. It will usually be referred to in this article as the "UBIT." All references to the Internal Revenue Code of 1989, as amended, will be cited as "I.R.C.," and all references to the Treasury Regulations under it will be cited as "Treas. Reg." or "Temp. Reg." as appropriate.

² I.R.C. § 501(c) is the principal definitional subsection in subchapter F of the Internal Revenue Code of 1986. It describes 25 types of organization which are granted some form of tax exemption. Among them are charitable entities (I.R.C. § 501(c)(3)); social welfare organizations (I.R.C. § 501(c)(4)); fraternal beneficiary societies (I.R.C. § 501(c)(8)); labor, agricultural, or horticultural groups (I.R.C. § 501(c)(5)); social and recreational clubs (I.R.C. § 501(c)(7)); and business leagues (I.R.C. § 501(c)(6)). According to the IRS's Master File of Tax-Exempt Organizations, in 1985 these six types of entities comprised more than 90% of the total number of organizations recognized by the Service as tax exempt under I.R.C. § 501(c). V. HODGKINSON & M. WEITZMAN, *DIMENSIONS OF THE INDEPENDENT SECTOR: A STATISTICAL PROFILE*, Table 1.4, at p. 17 (2d ed. 1986).

³ The word, "person," is used throughout this article in its strict tax sense, and is intended to include an individual, a trust, an estate, a corporation, and a partnership. I.R.C. § 7701(a)(1).

intricate paths, this portion of the article is suggestive rather than comprehensive.

An extensive bibliography of relevant articles and books is provided in an Appendix at the end of the article.⁴

§ 9.02 HISTORICAL BACKGROUND

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.”⁵ These words, with additions not here relevant, have been carried forward without substantial change into the current Code.⁶

In a landmark 1924 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.⁷ Thus, it has long been clear that the word, “*exclusively*,” is not to be given a rigidly literal meaning.

The Supreme Court’s opinion is interesting for two reasons:

⁴ Only a few news items are included, however; the major focus is on more analytical or scholarly writings. See also B. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* chs. 36–39 (5th ed. 1987); I R. DESIDERIO & S. TAYLOR, *PLANNING TAX-EXEMPT ORGANIZATIONS* ch. 34 (1988); P. TREUSCH, *TAX-EXEMPT CHARITABLE ORGANIZATIONS* ch. 6 (3d ed. 1988).

⁵ Corporate Excise Tax Act of 1909, § 38, 36 Stat. 112 (1909) (emphasis added). The even-earlier 1894 income tax provided a similar exemption limited to “corporations, companies, or associations organized and conducted *solely* for charitable, religious or educational purposes” Revenue Act of 1894, ch. 349, § 32, 28 Stat. 556 (1894) (emphasis added). It was, however, promptly held unconstitutional. *Pollock v. Farmer’s Loan & Trust Co.*, 158 U.S. 601 (1895). For an excellent detailed discussion of the historical background to the UBIT, see Eliasberg, *Charity and Commerce: Section 501(c)(3)—How Much Unrelated Business Activity?*, 21 TAX L. REV. 53 (1965).

⁶ I.R.C. § 501(c)(3).

⁷ *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924).

- (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 religious, charitable, etc., purposes, regardless of the source of the income. The Court observed that the Act "says nothing about the source of the income, but makes the destination the ultimate test of exemption."⁸
- (2) It may be that the "relatedness" notion (later adopted for UBIT purposes) stems from an ambiguity in the Court's discussion of the sale transactions. The Court said:

"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."⁹

It is not clear from the context which of two possible meanings to put on the emphasized words: do they mean that the sales were incidental in the sense of being trivial or unimportant? 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."¹⁰ Either interpretation would be correct on the facts of the case; neither seems compelled.

From 1924 on, the courts, applying the destination test, permitted tax-exempt organizations to engage in a growing variety of substantial business activities.¹¹ By the early '40s, Treasury had become concerned. In 1942, the "relatedness" concept—but *not*

⁸ 263 U.S. at 581. The quoted language in the opinion, however, is mere dictum.

⁹ 263 U.S. at 582 (emphasis added).

¹⁰ 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.

¹¹ 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).

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.”¹² 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.”¹³

The perceived abuses—loss of revenue and unfair competition—would have been more cleanly addressed by taxing all income from *competitive* businesses, whether such businesses were related to the exempt activities of the organization or not. The choice of the relatedness test, rather than a competitiveness test, is nowhere discussed. It is a sure sign of an inadequate rationale when a diagnosis of a tax disease is followed by a legislative prescription which aims at a quite different target.

Congress did not respond with the requested tax in 1942. 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. School’s macaroni company. There, a wholly-owned “feeder” subsidiary of the school was granted tax exemption.¹⁴ Although the appellate decision in

¹² 1 *Revenue Revision of 1942: Hearings Before the House Committee on Ways and Means*, 77th Cong., 2d Sess. 89 (1942) (emphasis added).

¹³ *Ibid.* (emphasis added).

¹⁴ *C.F. Mueller Co. v. Commissioner*, 14 T.C. 922 (1950) (reviewed, 1 dissent), *rev’d*, 190 F.2d 120 (3d Cir. 1951). The Tax Court held the corporation to be taxable; the Third Circuit unanimously reversed. In reversing, however, it took note of the intervening enactment of the UBIT, stating that “[w]hat we do here with the problem is of little importance for the future, since Congress has entered the area of dispute and declared the rule for the [future].” 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).

Mueller 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 Congressional debates. Representative Dingell, for example, referred to the risk that "all the noodles produced in this country will be produced by corporations held or created by universities" ¹⁵

Although the 1942 Hearings did not produce legislation which taxed unrelated business income, the 1942 testimony 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. ¹⁶ 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" ¹⁷ The 1950 testimony is interesting both for what it condones and what it condemns. Passive income received by exempt entities was clearly approved for tax-free status; the only reason enunciated was that such receipts are "the traditional sources of income of these institutions" ¹⁸ Active business income, however, was 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

¹⁵ *Revenue Revision of 1950: Hearings Before the House Committee on Ways and Means*, 81st Cong., 2d Sess. 579-80 (1950). The author's colleagues at the N.Y.U. Law School are still pondering important legal issues, and are still supported by a handsome endowment from the eventual sale of the *Mueller* stock. It is a case of noodles nourished by noodles, or perhaps *Mueller* for *mullers*.

¹⁶ 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).

¹⁷ *Ibid.*

¹⁸ *Ibid.* Actually, the Code does not describe the income as "passive." Rather, it enumerates specific categories of income, e.g., dividends and interest. I.R.C. § 512(b)(1).

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 spark-plug or chinaware factory run by a university.”¹⁹

The resulting legislation²⁰ adopted the relatedness test, which remains in the Code to the present date.²¹ The principal problem addressed by the Act was “that of unfair competition.”²² Less, but some, attention was paid to the UBIT’s revenue-raising potential.²³

Although Congress has tinkered with the UBIT since 1950, its most significant revisiting of the area took place in 1969.²⁴ The Tax Reform Act of 1969 enacted five major, and several other less important, changes:

- (1) It extended the reach of the UBIT to almost all exempt organizations, albeit with a deferred effective date for churches and church affiliates.²⁵
- (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).²⁶
- (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.²⁷

¹⁹ *Id.* at 166.

²⁰ Revenue Act of 1950, Pub. L. No. 814, § 301(a), defining “unrelated business net income.”

²¹ I.R.C. § 513(a).

²² 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).

²³ See, e.g., H. Rep. No. 2319, 81st Cong., 2d Sess. 1-3 (1950).

²⁴ 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).

²⁵ I.R.C. § 511(a)(2)(A).

²⁶ I.R.C. § 513(c).

²⁷ I.R.C. § 512(a)(3).

- (4) Responding to the Service's loss in *United States v. Clay Brown*,²⁸ it imposed the UBIT on debt-financed income of certain types.²⁹
- (5) It imposed the UBIT on interest, rents, and royalties received from controlled organizations.³⁰

Subsequent legislative developments, prior to the events described below, have been less significant even if not inconsequential.³¹ They are not discussed here.

§ 9.03 CURRENT EVENTS

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.³² The dialogue was heated and intense, as were the lobbying pressures generated by both sides.

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

²⁸ 380 U.S. 563 (1965).

²⁹ I.R.C. § 514.

³⁰ I.R.C. § 512(b)(13).

³¹ The subsequent legislative tinkering has, however, added to the complexity and irrationality of the UBIT pattern.

³² See, e.g., U.S. SMALL BUSINESS ADMINISTRATION, *UNFAIR COMPETITION BY NON-PROFIT 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 (Aug. 26, 1985). The use of the adjective "nonprofit" in this context, although common, is confusing. One might wonder how a "nonprofit" organization could ever engage in business for profit. Of course, the very existence of the UBIT, which *only* applies to business profits of "nonprofit" entities, demonstrates that it is well understood that such organizations may and often do carry on such activities. The term "nonprofit" should be understood to reflect the legal restrictions preventing such organizations from *distributing* any profits to their members, trustees, directors, etc. This prohibition, sometimes referred to as "the nondistribution constraint," is what distinguishes so-called nonprofit entities from their for-profit cousins. The use of the adjectives "nonprofit" or "not-for-profit"—although inept—is far too well-established, however, to be eradicated by these considerations.

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."³³ The Oversight Subcommittee held five days of hearings from June 22 through June 30, 1987.³⁴ 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 . . ."³⁵ A very considerable volume of comments was submitted, filling 960 printed pages in the 1988 Written Comments.

The Subcommittee held a further public hearing on May 9, 1988, at which Assistant Secretary for Tax Policy O. Donaldson Chapoton, among others, testified.³⁶ On May 19, 24, and 25, 1988, and again in early June 1988, the Oversight Subcommittee met in closed sessions to discuss the options.³⁷ The members were unable to agree. No firm decisions were made, no final legislative language was drafted, and no definitive committee report was issued. A draft report, however, was circulated to members of the Oversight Subcommittee on June 23, 1988.³⁸ It remains under consideration, no further formal committee action having been taken since then.

³³ 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).

³⁴ They have been reprinted in three parts. 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).

³⁵ 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"].

³⁶ See Jones, *Treasury Advocates UBIT Fine Tuning: But UBIT Overhaul Not Needed*, 39 TAX NOTES 791 (May 16, 1988).

³⁷ See Jones, *Pickle Subcommittee Appears Willing to Modify UBIT Stance*, 39 TAX NOTES 907 (May 23, 1988); Jones, *Oversight Subcommittee Makes More Progress on UBIT Package*, 39 TAX NOTES 1022 (May 30, 1988).

³⁸ The draft report is reprinted in HIGHLIGHTS & DOCUMENTS 3027-48 (June 24, 1988). For a helpful description and analysis, see Troyer, *Changing UBIT: Congress in the Workshop*, 41 TAX NOTES 1221 (Dec. 12, 1988). See also Spitzer,

The election of President Bush in the Fall of 1988, marking the end of the Reagan administration, also led to the usual substantial turnover in staff positions in Washington. For that and other reasons, progress stalled on legislative initiatives to modify the UBIT. By the summer of 1989, most of the high-ranking tax staff positions had been filled at Treasury, the IRS, and on the Hill. On September 7, 1989, the chairmen and ranking minority members of both the House Ways and Means Committee and its Oversight Subcommittee wrote to Assistant Secretary of the Treasury Kenneth Gideon about the UBIT. The letter read, in part:

"We view the final resolution for improvements in the unrelated business income tax rules to be a priority matter for this Committee. Recognizing that the pending draft report and recommendations were developed in consultation with the prior Administration, we request the official position of the current Administration on the proposed recommendations contained in the draft report as well as any other proposal or modification to a recommendation you would like for us to consider. This will enable the Subcommittee and full Committee to move forward to reform the UBIT laws."³⁹

On September 21, 1989, Assistant Secretary Gideon replied, confirming that "[t]he Treasury Department and the Internal Revenue Service share your desire to move this project forward in the near future."⁴⁰ His letter referred to the then-pending IRS "taxpayer compliance measurement program for tax-exempt organizations" due to be completed in 1990, suggesting that it "should provide important new data on compliance in this area."⁴¹

There was no further activity on UBIT reform in 1989, but the signs strongly suggest that the issue will be on the legislative agenda

Reform of the UBIT: An Open letter to Congress, 43 TAX NOTES 195 (Apr. 10, 1989).

³⁹ The letter is reprinted at 44 TAX NOTES 1427 (Sept. 18, 1989).

⁴⁰ Letter from Kenneth W. Gideon, Assistant Secretary (Tax Policy), to Hon. Dan Rostenkowski, Hon. Bill Archer, Hon. J.J. Pickle, and Hon. Richard T. Schulze (Sept. 21, 1989).

⁴¹ *Ibid.*

for 1990. Both the Chief of Staff of the Joint Committee on Taxation and the Chief Counsel for the House Ways and Means Committee have so stated.⁴²

§ 9.04 AN ALTERNATIVE PERSPECTIVE

There are compelling reasons for broadening the scope of the UBIT debate. The tendency to focus only on organizations described in I.R.C. § 501(c)⁴³ forecloses consideration of potentially illuminating alternative taxing patterns, ignores other massive sources of capital which earn income free from U.S. income tax, and cannot be justified by reliance on any clear policies or rationales for the current UBIT rules.

[1] The Current UBIT Rules Lack Clear Rationales

As the preceding historical survey shows,⁴⁴ the legislative history of the UBIT provides no coherent rationale for its pattern of taxation. To combat perceived unfair competition by tax-exempt organizations, Congress adopted a relatedness test rather than a competitiveness test.⁴⁵ There is no satisfactory explanation for this

⁴² See Hoerner, *Major Overhaul of Taxation of Tax-Exempts in the Offing*, 45 TAX NOTES 1273 (Dec. 11, 1989) (remarks of Ronald A. Pearlman, Chief of Staff of the Joint Committee on Taxation); Evans, *Congress May Try to Simplify Estate Freezes, Credit Extensions, and Foreign Provisions in 1990*, 45 TAX NOTES 1392 (Dec. 18, 1990) (remarks of Robert J. Leonard, Chief Counsel for the House Ways and Means Committee). Mr. Pearlman's remarks are reprinted in full at 2 EXEMPT ORG. TAX REV. 644-48 (1990).

⁴³ See n. 2, *supra*, for a brief description of I.R.C. § 501(c).

⁴⁴ See *supra* text accompanying notes 5-30.

⁴⁵ Congress more recently has adopted a straight-forward competitiveness test, in I.R.C. § 501(m), limited to organizations "providing commercial-type insurance." This was aimed at whittling down the tax exemption, among others, of TIAA-CREF and certain Blue Cross and Blue Shield organizations. Tax Reform Act of 1986, § 1012(a), Pub. L. No. 99-514, 100 Stat. 2085, 2390-91. Some commentators have urged the general adoption of a similar test for all tax-exempt organizations. See, e.g., Bennett & Rudney, *A Commerciality Test to Resolve the Commercial Nonprofit Issue*, 36 TAX NOTES 1095 (Sept. 14, 1987); Copeland & Rudney, *Business Income of Nonprofits and Competitive Advantage*, 33 TAX NOTES 747 (Nov. 24, 1986); Copeland & Rudney, *Business Income of Nonprofits and Competitive Advantage—II*, 33 TAX NOTES 1227 (Dec. 29, 1986). See also Hansmann, *Unfair Competition and the Unrelated Business Income Tax*,

choice in the committee reports, in testimony, or in any other legislative materials.⁴⁶

Any searching consideration of the UBIT ultimately involves analyzing the underlying reasons for granting certain organizations tax exemption in the first place. There is a modest legal literature which attempts to set forth rationales for tax exemption.⁴⁷ It is beyond the scope of this article to describe or

75 VA. LAW REV. 605, 634 (1989). This suggestion, to no one's surprise, has been strongly opposed by many persons in the nonprofit sector. The Service has also objected because it feels a competitive test would be difficult to administer.

⁴⁶ On June 22, 1987, Deputy Assistant Secretary (Tax Policy) O. Donaldson Chapoton testified on the UBIT before the Subcommittee on Oversight. His remarks included the statement that the relatedness test has "conceptual merit." Statement of O. Donaldson Chapoton, Deputy Assistant Secretary (Tax Policy), Department of the Treasury, Before the Subcommittee on Oversight of the Committee on Ways and Means, U.S. House of Representatives June 22, 1987, 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. 23, 38 (Serial 100-26 1987). The meager analysis offered in support of that claim, however, does little to justify it, and the arid legislative history of the UBIT disputes it.

⁴⁷ The following seem particularly useful: Atkinson, *Altruism in Nonprofit Organizations*, YALE PROGRAM ON NONPROFIT ORGANIZATIONS, WORKING PAPER NO. 145 (Sept. 1989); 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); Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393 (1988); 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); McGovern, *The Exemption Provisions of Subchapter F*, 29 TAX LAW 523 (1976); 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 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.

Several of the above articles are more centrally concerned with the policies affecting the deductibility of gifts to charities than with tax exemption of the

critique these writings. There is general scholarly agreement, however, that none of the suggested policy justifications is sufficient, and each is subject to significant conceptual or practical criticisms.⁴⁸

It is fair to say, then, that we lack adequate policy rationales both for underlying tax exemption and for the scope and form of the UBIT rules. It does not follow that tax exemption should be abandoned, any more than that the UBIT should be repealed. After all, "[t]he life of the law has not been logic: it has been experience."⁴⁹ It seems clear, furthermore, that these policy deficiencies will not forestall further legislative efforts to modify the existing Code patterns. Change is inevitable, and appears quite likely even in the short run.

[2] An Alternative Perspective—In General

This article does not venture any new policy justification for exempting organizations from income tax, nor any new rationale to guide the likely legislative reshaping of the UBIT provisions. Rather, it suggests a different perspective from which to view these matters. Many entities and organizations are exempt from the U.S. income tax under provisions that are quite separate from I.R.C. Section 501(c).⁵⁰ In the aggregate, these persons control assets and derive income in dimensions which dwarf the denizens of Section 501(c).⁵¹ Yet the tax rules affecting them are rarely considered or compared when UBIT issues are being analyzed. "Horizontal" and

charities themselves. Although distinct, the two questions are deeply intertwined. 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 to receive tax-deductible gifts.

⁴⁸ For an extremely terse, and therefore possibly misleading, description and critique of most of the proffered rationales, see Dale, *Rationales for Tax Exemption*, INDEPENDENT SECTOR SPRING RESEARCH FORUM 3 (1988).

⁴⁹ O. HOLMES, *THE COMMON LAW* 1 (Little, Brown, & Co. 1881).

⁵⁰ As described in n. 30, *supra*, I.R.C. § 501(c) contains the principal definitional categories for organizations deriving their tax-exempt status from subchapter F of the Internal Revenue Code of 1986, §§ 501 et seq.

⁵¹ See *infra* text accompanying notes 69-75.

“vertical” equity policies, as well as pragmatic revenue concerns, argue for including these persons and rules within the field of vision of those pondering possible modifications to the tax treatment of Section 501(c) organizations. The article’s thesis is that this perspective is important, *not* that it is sufficient. Thus, it should be added to the debate, but it should not necessarily displace other considerations.

The notion that tax writers, thinking about the UBIT, should refer to some or all of these “other” tax-exempt persons is not entirely novel. Both in the Code and in other writings, some such “other” entities occasionally have been noticed, and the rules governing them occasionally have been referenced.⁵² Such comparisons, however, have been rare. They ought to become routine.

[3] Tax Exemption Outside of I.R.C. Section 501(c)

Many persons are entitled to tax-exemption by virtue of rules entirely outside of I.R.C. Section 501(c). Before attempting to list some (if not all) of them, three statutory examples should be considered briefly. Most income of U.S. states or possessions is free from tax;⁵³ qualified pension, profit-sharing, and stock bonus plans are tax exempt;⁵⁴ and partnerships are not subject to the income tax.⁵⁵ The examples are chosen to illustrate three different “flavors” of tax exemption. The first example—U.S. states or possessions—is of persons *forever* exempt from tax: neither the entity nor any of the beneficiaries of its bounty is ever subject to tax on its income.⁵⁶ The second example—qualified deferred compensation plans—is of persons *temporarily* exempt from tax: the entity

⁵² For two quite recent examples, see Spitzer, *Reform of the UBIT: An Open Letter to Congress*, 43 TAX NOTES 195, 199 (April 10, 1989) (pension plans); Aprill, *Lessons from the UBIT Debate*, 45 TAX NOTES 1105, 1109-10 (Nov. 27, 1989), reprinted in 2 EXEMPT ORG. TAX REV. 687, 692 (1990) (pension plans).

⁵³ I.R.C. § 115.

⁵⁴ I.R.C. § 501(a), incorporating I.R.C. § 401(a) by reference.

⁵⁵ I.R.C. § 701.

⁵⁶ Of course, employees *are* taxed on salaries received from such entities, as in general are all taxpayers receiving compensation for services or payment for goods sold. Ordinary citizens benefiting from governmental expenditures, however, are *not*.

itself is not taxed on its income, but its beneficiaries typically are taxed upon their later receipt of distributions.⁵⁷ The last example—partnerships—is of *pass-through* exemption: the entity is exempt from tax, but its owners are immediately taxed on its income whether distributed or not.⁵⁸ Of these three, only the first two “flavors” are of interest to us here. They are both alike in their potential for tax-base erosion.⁵⁹

Some of the candidates for inclusion in the list of “forever” or “temporary” tax exemption are: U.S. states, municipalities, or possessions;⁶⁰ qualified deferred compensation plans;⁶¹ foreign governments, their instrumentalities, and international organizations;⁶² and Indian Tribes.⁶³ Other candidates, tax-exempt only with respect to certain types of income, include: foreign central banks of issue with respect to income on obligations of the U.S. and bank deposits;⁶⁴ and foreign individuals, trusts, and corporations with respect to foreign source income,⁶⁵ most types of interest,⁶⁶ and, in appropriate cases, certain treaty-protected income.⁶⁷ Each nominated group could easily justify extended consideration, merely to understand the scope, patterns, details, and exceptions of and to its tax-exempt status. For

⁵⁷ See, e.g., I.R.C. §§ 402, 403.

⁵⁸ I.R.C. § 702(a).

⁵⁹ Although the first “flavor,” i.e., “forever” tax exemption, obviously always erodes the tax base, the second “flavor,” i.e., “temporary” tax exemption, only defers the revenue. The fiscal impact of deferral, however, is asymptotic to tax exemption. The revenue effects of deferral are a function of the length of deferral, the discount rate used, and the respective tax rates in effect from time to time.

⁶⁰ I.R.C. § 115.

⁶¹ I.R.C. § 501(a), cross-referring to I.R.C. § 401(a).

⁶² I.R.C. § 892.

⁶³ Although no statutory or Constitutional provision explicitly provides for this exemption, it has long been held that such Tribes are nevertheless exempt under I.R.C. § 61(a), which contains the Code's general definition of “gross income.” See, e.g., LTR 8937036 (June 20, 1989).

⁶⁴ I.R.C. § 895.

⁶⁵ I.R.C. §§ 871, 872(a), 881, 882(a).

⁶⁶ I.R.C. §§ 871(h), 871(i), 881(c), 881(d).

⁶⁷ I.R.C. § 894.

purposes of this article, however, it is sufficient to mention the candidates, without further exploration.

It is not clear whether all of the above persons should be treated as analogous to Section 501(c) entities for purposes of the UBIT-analysis perspective here suggested. It is also unclear whether other possibly analogous situations should be added to the list.⁶⁸ What does seem clear is that these very questions should be asked, and then hopefully answered, during the ongoing analysis of UBIT reform.

[4] Comparison of Sizes of Tax-Exempt Persons

The force of the argument depends in part on the respective sizes of the tax-exempt groups. Data are extraordinarily difficult to obtain, for various reasons. Some of the tax-exempt persons file no reports or information returns with the U.S.; others file reports which are limited in scope. Statistical assumptions vary among agencies, and from report to report, with respect to data which are available. Compliance with filing requirements is variable. Different years are covered by different reports. Thus, despite considerable efforts to gather data,⁶⁹ there are quite significant defects in the accuracy, comparability, and comprehensiveness of what could be found. At best, then, only a general and broad impression of respective sizes can be glimpsed, dimly, from the limited statistics provided here. Much more work needs to be done on the gathering and organizing of relevant information in this area.⁷⁰

The amount of total capital controlled by foreign governments, their instrumentalities, foreign central banks of issue, foreign individuals, and foreign corporations is almost impossible to estimate. The great bulk of it is probably fairly liquid, can easily be shifted among different investments and jurisdictions, and can

⁶⁸ For example, the so-called "inside build-up" of certain life insurance policies may achieve substantial, or perhaps total, tax exemption.

⁶⁹ The author is grateful to his research assistant, Michael Frankel, for earnest and creative efforts, over several months, to locate useful statistics.

⁷⁰ Candor mandates an acknowledgment that the author is neither knowledgeable about nor adept at searching out sources for the desired data.

easily be deployed within the U.S. on a tax-exempt basis. Similar observations could be made about the capital controlled by U.S. states, municipalities, possessions, and their instrumentalities. Financial assets of qualified pension plans are approaching \$2 trillion.⁷¹

By contrast, total assets of the organizations described in I.R.C. Section 501(c) were estimated to amount to just over \$200 billion in 1975, of which less than \$50 billion constituted financial assets.⁷² In 1982, the assets of charitable tax-exempt organizations⁷³ amounted to just under \$280 billion;⁷⁴ by 1985, that figure had grown to just under \$425 billion.⁷⁵

By any reasonable estimate, the size of the persons entitled to tax exemption *outside* of I.R.C. Section 501(c) is vastly greater than the size of the persons *within* it. The magnitude of their respective sizes is almost impossible to pin down, for the reasons described above, but it seems certain to be at least 10:1, and it might be 20:1 or more. Whatever ratio is accepted, it is obvious that revenue and tax policy considerations affecting tax-exempt organizations within Section 501(c) should not be analyzed without also taking

⁷¹ As of end-1988, the financial assets of private pension funds amounted to just under \$ 1.14 trillion, and those of state and local retirement funds amounted to just over \$610 billion. The data come from the FLOW OF FUNDS ACCOUNTS, FINANCIAL ASSETS AND LIABILITIES, YEAR-END 1965-1988, at p. 28 (Z.1 release, Sept. 1989, Board of Governors, Federal Res. System).

⁷² Rudney, *The Scope and Dimensions of Nonprofit Activity*, THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 55, 61, Table 4.6 Powell, ed., 1987).

⁷³ Such entities are described in I.R.C. § 501(c)(3). Although they thus are a subset of the § 501(c) universe, they are the most populous and wealthiest such subset.

⁷⁴ V. HODGKINSON & M. WEITZMAN, DIMENSIONS OF THE INDEPENDENT SECTOR: A STATISTICAL PROFILE 43, Table 2.11 (2d ed. 1986).

⁷⁵ Hilgert & Mahler, *Nonprofit Charitable Organizations, 1985*, SOI BULLETIN, Fall 1989, at 53, Figure A. The \$425 billion figure is *exclusive* of assets of private foundations. *Ibid.* Such private foundations, in 1985, had aggregate assets of just under \$100 billion. Riley, *Private Foundation Returns, 1985*, SOI BULLETIN, Summer 1989, at 27, 40, Table 1. Interestingly, just over \$47 billion of the 1985 assets of tax-exempt charitable organizations (the \$425 billion figure in the text) was owned by College Retirement Equities Fund and Teachers Insurance and Annuity Association of America, whose tax-exempt status has been narrowed by virtue of I.R.C. § 501(m). See note 45, *supra*.

into account those persons whose tax-exemption comes from without that subsection.

[5] Recognition, in the Code, of the Extra-Section 501(c) Perspective

In some few situations, the U.S. tax regime has recognized the similarities between organizations treated as tax exempt under I.R.C. Section 501(c) and those granted tax exemption under entirely separate provisions. One of the first of these involved so-called "tax exempt entity leasing."⁷⁶ These rules, originally added to the Code in 1984,⁷⁷ now appear at I.R.C. Section 168(h). They were targeted at certain transactions in which a domestic tax-exempt organization, itself unable to use tax deductions, entered into sale-leaseback transactions with for-profit taxpayers, enabling them in turn to claim generous depreciation allowances under the so-called ACRS rules.⁷⁸

To counteract this perceived abuse, Congress denied the benefits

⁷⁶ The tax-exempt entity leasing rules in I.R.C. § 168(h) were adopted after those in I.R.C. §§ 48(a)(4) and (5), which, as later amended, deny investment tax credits for property used by certain tax-exempt organizations, governments, and foreign persons.

⁷⁷ Tax Reform Act of 1984, Pub. L. No. 98-369, 31, 98 Stat. 494.

⁷⁸ See H.R. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess. 1138 (1984); S. Rep. No. 196, 98th Cong., 2d Sess. 123 (1984). Several of the transactions involved the U.S. Navy selling and then leasing back its own ships. A discussion of the tax-exempt leasing rules is outside the scope of this article. See, generally, Odell, *Special Partners—Exempt and Foreign Entities*, 46 INST. ON FED. TAX'N ch. 29 (1988); Hopkins, *Leasing Transactions of Tax-Exempt Organizations: What Can be Done Under the New Rules?*, 15 N.Y.U. CONF. TAX PLAN. CHARIT. ch. 4 (1987); Duvall & Ash, *Caveat Lessor: Leasing to Tax-Exempt Entities*, 14 J. REAL EST. TAX'N 54 (1986); Edgar, *Is There Life After Section 168(j)? Coping with the Tax-Exempt Leasing Rules*, 64 TAXES 81 (1986); Reynolds, *Tax Exempt Entity Leasing—Temporary Regulations*, 26 TAX MGMT. MEMO. 341 (Dec. 23, 1985); Sanders, *Syndication With Tax-Exempt Organizations as Partners*, 2 J. TAX'N INDIV. 341 (1985); Warren, *Leases and Service Contracts with Tax-Exempt Entities After the DRA*, 16 TAX ADVISER 230 (1985); Yanowitz & Purcell, *An Analysis of the Just-Issued Temporary Regulations on Tax-Exempt Entity Leasing*, 63 J. TAX. 112 (1985); Granof, *Tax Exempt Leasing: A Framework for Analysis*, 44 PUB. ADMIN. REV. 232 (1984); Vallee, *Sale-Leaseback Transactions by Tax-Exempt Entities and the Need for Congressional Guidelines*, 12 FORDHAM URB. L.J. 349 (1984).

of the ACRS rules to lessors with respect to any "tax-exempt use property,"⁷⁹ and defined the quoted phrase as including certain types of property "leased to a tax-exempt entity."⁸⁰ For this purpose, a "tax-exempt entity" explicitly includes certain governments and governmental agencies, "an organization . . . which is exempt from tax imposed by this chapter," and "any foreign person or entity."⁸¹ The adoption of this definition demonstrated Congressional recognition of certain parallels in the tax treatment of governments, governmental agencies, foreign persons, and tax-exempt entities.⁸² The regulations make clear that exempt deferred compensation plans, "and similar arrangements," are also subject to these rules.⁸³

Congress again saw analogies while enacting the Revenue Reconciliation Act of 1989.⁸⁴ I.R.C. Section 163(j), as added by Section 7210(a) of that Act, denies interest deductions to domestic corporations, under certain circumstances, when the recipient of the interest is not subject to U.S. income tax.⁸⁵ Congress explicitly recognized that foreign persons and U.S. tax-exempt organizations should be viewed similarly for these purposes: the legislative history states that "[t]he committee also determined that cases involving domestic tax-exempt entities should receive similar

⁷⁹ Depreciation deductions were not wholly denied, but were substantially scaled back. Instead of the generous ACRS rules, an alternative and slower capital-cost recovery system was prescribed. I.R.C. §§ 168(g)(1)(B), 168(g)(2).

⁸⁰ I.R.C. § 168(h)(1)(A).

⁸¹ I.R.C. § 168(h)(2)(A). Of course, if any such person is in subject to tax, the rationale for the rule disappears. The statute recognizes this point, and reinstates full ACRS deductions for property leased under such circumstances. E.g., I.R.C. §§ 168(h)(1)(D) (tax-exempt entity subject to the UBIT rules), 168(h)(2)(B) (foreign person, or its U.S. shareholder(s), subject to tax).

⁸² See STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX REFORM ACT OF 1984, 98th Cong., 2d Sess. 47-49.

⁸³ Temp. Reg. § 1.168(j)-1T, Q&A 11.

⁸⁴ The President signed this into law on Dec. 19, 1989.

⁸⁵ The precise language denies deductions "if no tax is imposed by this subtitle with respect to such interest." I.R.C. § 163(j)(3)(A). No attempt is made here to describe the various other conditions which must be met before the disallowance rule of I.R.C. § 163(j) comes into play. For a discussion of this new provision, see Plutte & Pearson, *The Foreign Tax Provisions of OBRA, 1989*, 19 TAX MGMT. INT'L J. 19-23 (1990).

treatment to cases involving foreign tax-exempt persons.”⁸⁶

[6] The Extra-Section 501(c) Perspective—Two Examples

The suggested perspective may provide interesting comparisons for the UBIT dialogue. Only two comparisons (out of many) that exemplify that perspective will be mentioned here: (1) the definition of commercial activities of foreign governments, and (2) the control threshold for the new earnings-stripping rules. No conclusions are drawn; rather, these are intended merely to illustrate the sorts of issues that may emerge from such an effort. In all cases, the comparative exercise obviously would involve deciding whether the two situations are similar or disparate, and—if similar—which of the different taxing patterns should be adopted.

[a] *Commercial Activities of Foreign Governments*

Foreign governments are generally exempt from U.S. income tax on their investment income.⁸⁷ The exemption does not extend,

⁸⁶ H. Rep. No. 247, 101st Cong., 1st Sess. 1242 (1989). See also *id.* at 1244-46 for an extended discussion of the meaning of being “tax exempt.” The earnings-stripping provision, originally proposed by the House Ways and Means Committee and ultimately enacted into law, was dropped by the Senate Finance Committee at one stage of the legislative process. Even the Senate Committee, however, noted that foreign entities bore resemblances to domestic tax-exempt organizations for these purposes. In recommending only that the Treasury study the so-called debt-equity question, the Senate Finance Committee also directed it “to consider the policy and revenue implications of the current tax treatment of corporate distributions with respect to debt and equity owned by tax-exempt entities and foreign persons.” SENATE COMM. ON FINANCE, 101ST CONG., 1ST SESS., REVENUE RECONCILIATION ACT OF 1989, EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON OCTOBER 3, 1989, at 69 (Comm. Print 1989).

⁸⁷ I.R.C. § 892(a)(1). The history and complexity of I.R.C. § 892 is beyond the scope of this article, but—given the thesis of the article—should not be beyond the scrutiny of those interested in possible comparisons with the UBIT rules. Further discussions can be found in following articles: Bergquist, *U.S. Taxation of Foreign Governments and their Controlled Entities*, 39 TAX NOTES 115 (April 4, 1988); Levine & Shajnfeld, *Eligibility of Foreign Government's Pension Fund for Section 892 Exemption*, 17 TAX MGMT. INT'L J. 37 (1988); Knight, Lokey & Willoughby, *Investment in the United States by a Foreign Government: Effects of the Tax Reform Act of 1986*, 16 TAX MGMT. INT'L J. 47 (1987); Levine &

however, to income "derived from the conduct of any commercial activity."⁸⁸ Recently proposed (and temporary) regulations define the scope of "commercial activities" for this purpose.⁸⁹ The shape of that definition is quite different from the rules describing the UBIT. Foreign governments are generally subject to tax on their earnings derived from any income-producing activity, with only limited exceptions.⁹⁰ The exceptions include income from most sorts of investments⁹¹ and—fascinatingly—income derived from "nonprofit activities."⁹² The relevant portion of the regulation reads, "Activities that are not customarily attributable to or carried on by private enterprise for profit are not commercial activities."⁹³ This exception, then, appears to depend on showing

Shajnfeld, *U.S. Tax Exemption for Foreign Governments and Controlled Entities After TRA*, 66 J. TAX'N 222 (1987). For earlier articles, antedating the important statutory amendments to I.R.C. § 892 in 1986 and 1988, see Jarchow, *United States Taxation of Foreign Governments, International Organizations and Their Employees*, 20 SW. L.J. 789 (1980); Tillinghast, *Sovereign Immunity from the Tax Collector: United States Income Taxation of Foreign Governments and International Organizations*, 10 LAW & POLY INT'L BUS. 495 (1978); Taylor, *Tax Treatment of Income of Foreign Governments and International Organizations*, ESSAYS IN INTERNATIONAL TAXATION: 1976, at 154 (1976).

⁸⁸ I.R.C. § 892(a)(2)(A)(i).

⁸⁹ Temp. Reg. § 1.892-4T, added by T.D. 8211, 53 Fed. Reg. 24060 (June 27, 1988).

⁹⁰ Temp. Reg. § 1.892-4T(b).

⁹¹ Temp. Reg. § 1.892-4T(c)(1).

⁹² Temp. Reg. § 1.892-4T(c)(3). The quoted words are the caption to that paragraph of the regulations. Reference to a caption in the regulations, however, is of dubious value in interpreting the text. Cf. I.R.C. § 7806(b), making such references to captions, in the Code itself, irrelevant.

⁹³ The quoted language is substantially identical to that which appeared in the prior regulations. Those now-superseded regulations differed only by the inclusion of the phrase "in the United States" after the words "for profit." Treas. Reg. 1.892-1(c)(2)(v). The exemption for nonprofit-type activities of foreign governments dates back at least to Rev. Rul. 66-73, 1966-1 C.B. 174, which considered "an organization separate in form but wholly owned by a foreign government." The ruling said:

"[W]here the organization does not have purposes, functions, and activities of the type which are customarily attributable to and carried on by private enterprise for profit in this country, or, to the extent it has such purposes, functions, and activities, taken as a whole they are so circumscribed and limited that the organization does not in fact substantially resemble such a private

whether certain types of activity have been undertaken, customarily and historically, by the nonprofit sector rather than by business.⁹⁴ It is an explicit reference to actual practice rather than to any description of the activities as noncompetitive, related, or passive.

[b] *Control Threshold for the New Earnings-Stripping Rules*

Under limited circumstances, even "passive" interest, royalties, and rents may be treated as UBIT.⁹⁵ This may occur when the tax-exempt recipient controls the payor. Each payment subject to this regime has the distinctive character of being deductible to the for-profit payor. Thus, but for this rule, the payments would reduce taxable income of the payor, but be free from tax in the hands of the tax-exempt recipient. The provision only applies, however, when the tax-exempt payee owns 80 percent of the stock of the for-profit payor.⁹⁶ One of the Oversight Subcommittee's

enterprise, it . . . will be entitled to the benefits [of tax exemption] granted by section 892 of the Code."

⁹⁴ It is interesting to compare the definition of "non-commercial governmental functions" in Temp. Reg. § 1.936-10T(c)(5)(iv). That definition, used to determine whether certain investments qualify for special treatment under I.R.C. § 936(d)(4), reads, in part, "the term . . . refers to activities that, under U.S. standards, are not customarily attributable to or carried on by private enterprises for profit and are performed for the general public with respect to the common welfare or which relate to the administration of some phase of government.

⁹⁵ I.R.C. § 512(b)(13).

⁹⁶ I.R.C. § 368(c), incorporated by reference in I.R.C. § 512(b)(13). The base-eroding potential, of course, is not confined to situations in which the tax-exempt recipient controls the taxable payor. This point has been recognized by the Staff of the Joint Committee on Taxation, in its so-called LBO (leveraged buyout) pamphlet:

"When an exempt organization purchases bonds issued by a taxable corporation, the interest income paid to the exempt organization . . . is excluded from the UBIT, unless the bonds were 'debt-financed' by the exempt organization . . . or the payor corporation is a controlled subsidiary of the exempt organization. Consequently, corporate income that is paid to exempt organizations holding debt may escape taxation entirely by being deductible at the level of the payor corporation and excludable from taxable income at the level of the payee exempt organization." STAFF OF THE JOINT COMMITTEE ON TAXATION, FEDERAL INCOME TAX ASPECTS OF CORPORATE FINANCIAL STRUCTURES 18 JCS-1-89 Jan. 18, 1989) (footnote omitted).

UBIT-revision options would reduce the threshold of control from 80 percent (measured by voting power) down to 50 percent (measured by vote *or* value).⁹⁷

The target of this statutory arrow is tax-free base erosion. It is thus quite comparable to the earnings-stripping rules added by the 1989 tax legislation,⁹⁸ but the control threshold adopted for these purposes was not 80 percent but 50 percent.⁹⁹ The Conference Report on the 1989 legislation justified the adoption of the new rules under I.R.C. Section 163(j), in part, by reference to that older special UBIT rule:

"Some have argued that under present law, foreign persons may be treated for some purposes more favorably than similarly situated U.S. persons. For example, the unrelated business income tax rules impose a tax on earnings stripping amounts (i.e., interest, annuities, royalties, and rents) received by any tax-exempt organization that individually owns 80 percent or more of a U.S. subsidiary (sec. 512(b)(13)). No similar rule applies to foreign persons." (H. Rep. No. 386, 101st Cong., 1st Sess. 568 (1989).)

It is one of the clearest examples of the sort of reasoning by analogy urged by this article. No explanation appears for the choice of the lower control threshold adopted by the 1989 legislation, but it is of obvious interest to persons following the fate of the above-mentioned proposal to reduce the UBIT threshold.

§ 9.05 CONCLUSION

Because the current form of the UBIT cannot be explained by reference to any satisfactory rationale, policy makers should seek

Options for changing this tax pattern are discussed later in the same booklet. *Ibid.* at pp. 123-24.

⁹⁷ See n. 35, *supra*.

⁹⁸ I.R.C. § 168(j), discussed *supra*, in text accompanying notes 84-86.

⁹⁹ I.R.C. § 163(j)(4)(A), incorporating by reference the provisions of I.R.C. §§ 267(b) and 707(b)(1). The provisions are particularly intricate because (1) attribution and constructive ownership rules apply, (2) special rules are provided for certain partnerships (in I.R.C. § 163(j)(4)(B)), and (3) the measurements often refer to the value, rather than the voting rights, of corporate stock.

illumination elsewhere. Because the number and size of tax-exempt entities outside of I.R.C. Section 501 is massively greater than within it, tax administrators and other protectors of the fisc cannot afford to ignore that ocean while focusing only on the UBIT pond. Because change seems likely, organizations which are subject to the UBIT rules ought to puzzle about their future tax status from a frame of reference much broader than is now typical.

It thus seems almost self-evident that UBIT reformers and defenders alike should ponder possibly parallel provisions in other portions of the Internal Revenue Code. It is appropriate to consider whether such arguably analogous rules are indeed similar to, or instead are distinguishable from, the UBIT pattern. That question, and other insights derived from this broader perspective, will both perhaps contribute to the debate. The recommended wider view, then, is hardly startling. What is remarkable is how rarely it appears to have been taken in the past.

It is not clear what insights may come from adopting this recommended viewpoint. The similarities and disparities in the Code are themselves complex. So little have these ideas been contemplated that a current map of the paths of future reasoning would be like an ancient chart of the United States, drawn by hand before there had been any careful exploration or measurement of the continent. It follows that this article is best thought of as a work in process. It is a recommendation of one route to follow, rather than a description of any ultimate destination.

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