

TESTIMONY
of
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Before the
Subcommittee on Oversight
House Ways and Means Committee

June 30, 1987

My name is Harvey P. Dale. I am a Professor of Law at the New York University School of Law, and the Director of that Law School's Study on Law and Philanthropy. I have recently been appointed a member of the new Advisory Group to the Commissioner of Internal Revenue on Exempt Organizations. I am also a member of the Committee on Non-Profit Organizations of the Association of the Bar of the City of New York, whose testimony was presented earlier in these hearings.

As a member of the N.Y.U. Law School faculty, I have long been aware of, and quite grateful for, the profits that a tax-exempt organization may sometimes earn from the operation of the unrelated business of selling macaroni.¹

My comments today are in three parts: first, a discussion of the history of the "relatedness" notion in the Internal Revenue Code's UBIT provisions; second, some observations about the impact of the Federal income tax on non-profit and for-profit organizations; and third, a few recommendations for action by this subcommittee and the Congress.

"RELATEDNESS"

From the earliest days of this century -- even prior to the adoption of a general income tax in 1913 -- our taxing provisions 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."² The Supreme Court, in Trinidad v. Sagrada Orden de Predicadores,³ interpreted virtually identical language⁴ 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.

The opinion is interesting for two reasons. First, 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 relevant language in the opinion, however, is mere dictum.⁵ Second, 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."⁶

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?⁷ Either interpretation would be correct on the facts of the case; neither seems compelled.⁸

In 1942, the "relatedness" concept 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 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."⁹ It is clear that Mr. Paul was using the emphasized phrase in the second sense, i.e., as connoting relatedness, not triviality.¹⁰ It is interesting, however, that 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 or unrelated to the exempt activities of the organization. The choice of the relatedness test, rather than a competitiveness test, is nowhere discussed.¹¹

Although the 1942 Hearings did not directly result in taxation of such 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.¹² The testimony is interesting both for what it condones and what it condemns. 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"¹³ Active business income is clearly targeted for taxation, but only if unrelated to the institution's exempt activities.¹⁴ The resulting legislation adopted the relatedness test, which continues in the Code to the present date.¹⁵

Curiously, the chosen line is, in part, unexplained. If the evil is competition, one might expect a line to be drawn based upon the existence or absence of competition. If the evil is the conduct of an active business, one might expect a line to be drawn based upon active-versus-passive income. Instead, the distinction depends upon neither, but rather upon relatedness. I submit that this is a confession of both ignorance and wisdom. It is ignorant, because we simply have no completely-acceptable rationale which would explain why particular exempt organizations may avoid income taxation while they actively compete with for-profit entities -- yet it is clear that they may, so long as the business in question is "related" to their exempt activities. It is wise, because, in the absence of widely-agreed theories, and lacking (as we do)

comprehensive data about the impact of competition, the relatedness notion accepts the system as it exists, and allows it, in general, to go forward without undue change but without permitting aggravated abuses.

Yet there may be abuses. Prior testimony, news stories, and other writings suggest that some do exist. They should be corrected and prevented. The only question is: how? Before making a few comments on that question, let me turn to a brief analysis of a few aspects of the income tax pattern affecting non-profit and for-profit businesses.

FOR-PROFIT AND NON-PROFIT BUSINESSES

A simple image is suggested by complaints about unfair competition between for-profit and nonprofit entities: 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.

The simple image is misleading and wrong. The actual situation is, sadly, significantly more complex. As is often and frustratingly the case with the Internal Revenue Code, an accurate picture cannot be painted without devoting tedious attention to a myriad of apparent details -- but details which may become overwhelming in cumulative effect.

For example, there are situations in which for-profit entities pay a lesser tax than nonprofits. 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. Even now, 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. Non-profit organizations are forbidden to obtain these benefits, which should comparatively increase their costs for such property.¹⁶ Furthermore, start-up losses, which are readily available to for-profit enterprises to set off against later profits, are often administratively denied to nonprofit enterprises.¹⁷

Although these could be multiplied, it is not my purpose to produce a catalog of such examples. Nor would I argue that such examples, separately or together, suggest that for-profit enterprise is always unfairly tax favored over nonprofits. It may be, however, that in particular situations such a result may occur. Of course, the opposite is often true, i.e., that for-profit businesses pay a higher tax than nonprofits. What is not clear, at least to me, is how properly to describe the resulting pattern. It seems clear that a simple image of an inclined plane surface is woefully inadequate and deceptive. Instead, the surface seems bumpy and uneven, so that a marble placed at random on it might roll either toward or away from the nonprofit edge.¹⁸

On the other hand, the current UBIT does not always work to level out bumps or realign a tilted taxing surface. Consider, for example, a for-profit enterprise which produces items pursuant to its own patent.¹⁹ The net profits, of course, are subject to income taxation. If a nonprofit organization conducts the same activities as an "unrelated" business, the same or a similar income tax liability will result. If, however, the nonprofit, rather than conducting the business, purchases the patent and licenses it, the resulting royalties will entirely escape tax.²⁰ They will not be taxed to the nonprofit entity, because they are explicitly excepted from the scope of the UBIT.²¹ They will not be taxed to licensee, because royalties are deductible against the licensee's tax base.²² A similar point could be made about any of the various types of income which, while exempt from UBIT in the hands of a nonprofit entity, are deductible from the tax base of a for-profit payor.

Two final comments may be made about the UBIT. First, the presence or absence of the UBIT does not explain even all of the anecdotes of "unfair" competition presented to this committee. For example, I understand that one hearing-aid retailer complained that a local nonprofit hospital took away much of his business by selling hearing aids to the community in which he had long been established. Not only did the hospital take away business, it did so by selling (allegedly) inferior merchandise and at higher prices! Whatever this anecdote illustrates, even if we take it at face value, it does not illustrate a situation which the UBIT could efficiently address. There is no way in which a simple tax "subsidy" could account for the success of the nonprofit. The story is about marketing, not pricing.

Second, in considering what sort of competition may be viewed as "unfair," some thought must be given to the interest of the consumers. Normally, our capitalist system does not protect competitors from one another. Their economic losses from competition are thought to be acceptable, viewed from the standpoint of

a society of users of their services and goods.²³ I do not urge that the interests of consumers should justify any and all tax "subsidy" to nonprofits. I do urge, however, that thought be given to the question of how properly to weigh such interests in analyzing pricing, and other aspects of economic behavior, of nonprofits, as affected by the UBIT.

RECOMMENDATIONS

I urge caution and humility in addressing the problems which have been discussed in these hearings. The charitable sector of this nation includes many frail entities. The impact of legislation can be very great, because its effects are both direct -- in the Internal Revenue Code itself -- and indirect -- through other regulatory schemes which borrow, often uncritically, from the Code's definitions. Furthermore, we do not know enough about what we are doing. The "relatedness" notion in the UBIT does not respond perfectly to the concerns which motivated its inventors. The current taxing pattern is strangely complex, presenting a surface which is gnarled rather than simply tilted. Thus, the problem is: even if the system is broken, our current understandings are so impoverished that we must doubt the accuracy of any diagnosis, much less the beneficial effect of any prescribed cure. To quote H.L. Mencken: "For every complex problem, there is a solution which is simple, elegant, . . . and wrong." For the present, we should follow the ancient oath of Hippocrates, and at least abstain from doing harm.

Our society is vastly complex. The roles of government, private industry, and the nonprofit sector are deeply intertwined. Indeed, that is one of the essential, and cherished, aspects of this United States, remarked upon with admiration by observers ever since de Tocqueville. Tax legislation may easily change the balance and dynamic of the system, but in our current ignorance we cannot be sure of just how. Our forefathers embraced the common law to regulate this country. It has often been remarked that the genius of the common law is its case-by-case approach, never deciding more than is required to deal with the situation at hand, allowing the overall pattern to build up by accretion, like a coral reef. We are now largely no longer a common-law society, but rather one of codes. Yet the care and caution of the common-law approach may still be valid, even for legislation.

Today, we are faced with four factors which, taken together, argue for restraint. First, the history of our nation is reflected in the current intertwining among the three sectors. As Justice Holmes remarked, "The life of the law has not been logic: it has been experience."²⁴ Second, we do not have any careful and comprehensive rationale for the scope and operation of the tax exemp-

tion. We do not have any satisfactory theory, legal or economic, to apply in making judgments about it. Third, although we have heard many anecdotes, we lack sufficient data to form a balanced picture of the true scope or impact of competition between for-profit and non-profit organizations. Fourth, and perhaps most important, we have reason to believe that much more useful data will be forthcoming in the next few months and years. Current signals include the TCMP study and the formation of a new Exempt Organization Advisory Group by the Service, the growth of better statistics on and a new taxonomy of the independent sector, and a recent explosion of academic and other studies. This committee can assist by proceeding with caution, and by supporting or mandating further studies of the issues. It is precisely because better information and improved understandings seem close at hand that wisdom may suggest pausing rather than rushing forward.

With better insights, we will better understand the scope of the problems, and then better responses can be fashioned. But for now, before legislating a general "solution," I join Cromwell in saying, "I beseech you, in the bowels of Christ, think it possible you may be mistaken." Judge Learned Hand quoted that sentence in testimony before the Senate Subcommittee on Labor and Public Welfare on June 28, 1951. He continued:

"I should like to have that written over the portal of every church, every school and every courthouse. May I say I should even add over the portal of every legislative room in the United States?"²⁵

FOOTNOTES

1. See C.F. Mueller Co. v. Comm'r, 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).
2. Corporate Excise Tax Act of 1909, Section 38, 36 Stat. 112 (1909). I am grateful to the author of the following extremely useful article for this insight, as well as several others in my testimony: Eliasberg, Charity and Commerce: Section 501(c)(3) -- How Much Unrelated Business Activity?, 21 TAX L. REV. 53, 55 (1965) (hereinafter cited as "Eliasberg").
3. 263 U.S. 578 (1924).
4. The only differences were (1) the addition of the word "scientific" to the listing of purposes for which tax exemption was available, and (2) the use of "net income" instead of "profit." The relevant statute was the Act of October 3, 1913. Ibid.
5. The Court said the Act "says nothing about the source of the income, but makes the destination the ultimate test of exemption." Ibid.
6. Ibid. (emphasis supplied).
7. 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. And 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.
8. Accord, Eliasberg at 64.
9. 1 Revenue Revision of 1942: Hearings Before the House Committee on Ways and Means, 77th Cong., 2d Sess. 89 (1942) (emphasis supplied).
10. Immediately above the language quoted in the text, supra, Mr. Paul had referred to exempt corporations which "engage in trades and business completely unrelated to their exempt activities." Ibid. (emphasis supplied).

11. Not only the relevant legislative history, but also several of Mr. Paul's other writings in the income tax area were examined but contained no illumination.

12. 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.

13. Ibid.

14. 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 spark-plug or chinaware factory run by a university." Id. at 166.

15. Internal Revenue Code of 1986, Section 513(a).

16. Internal Revenue Code of 1986, Section 168(h).

17. The law does permit net operating loss carry-forwards to nonprofit organizations operating an unrelated business. Internal Revenue Code of 1986, Section 512(b)(6). The Service, however, typically 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. Section 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. para. 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).

18. A mathematical topologist might describe it, not as a standard embedding of a plane, but as a surface wildly embedded in 3-space.

19. The for-profit may have been able to deduct the cost of research and development attributable to the patent, or may be able to depreciate the patent's cost (if purchased) over its useful life.

20. A different result might follow if the patent had been purchased subject to an indebtedness, and the royalties thus became "unrelated debt-financed income." Internal Revenue Code of 1986, Sections 512(b)(4) and 514.
21. Internal Revenue Code of 1986, Section 512(b)(2).
22. Whether this pattern produces a lower overall tax primarily depends upon the amount of the royalty income as compared to the amount of depreciation of the purchase price of the patent.
23. The Internal Revenue Service sometimes has urged that such competition is good, and to be encouraged, even between for-profit and nonprofit entities, albeit in a different context than the UBIT. E.g., Rev. Rul. 83-175, 1983-2 C.B. 109 (tax status of "deposits" analyzed; competition between tax-exempt credit unions and taxable banks is to be encouraged).
24. O. HOLMES, THE COMMON LAW 1 (Little, Brown, & Co. 1881).
25. Establishment of a Commission on Ethics in Government: Hearings Before a Subcommittee to Study Senate Concurrent Resolution 21 of the Senate Committee on Labor and Public Welfare, 82d Cong., 1st Sess. 218 (1951) (Statement of Judge Learned Hand). The same sentiments, in slightly different words but attributed to the same source and occasion, appear as L. HAND, Morals in Public Life (1951), reprinted in THE SPIRIT OF LIBERTY 170, at 174 (Vintage Books 1959).