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# TARGETING EXEMPTION FOR CHARITABLE EFFICIENCY: DESIGNING A NONDIVERSION CONSTRAINT

Frances R. Hill\*

## I. INTRODUCTION

EXEMPTION from taxation has become a policy without a rationale and a tax regime without conceptual coherence at the very time that exempt organizations are being used for everything from operating business enterprises to financing political campaigns. The malleability of the exempt organization form means that it is commonly co-opted for commercial and political purposes.<sup>1</sup> This convergence of activities erodes the distinctiveness of exempt organizations.<sup>2</sup> It is no longer possible to refer to exempt organizations with any confidence that a taxable entity or a political organization is not engaged in the same kinds of activities.<sup>3</sup> In this era of convergence between the taxable and

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1. Since September 11, 2001, the use of the charitable form as a device for financing terrorist activities has been featured in press reports on efforts to trace the flow of terrorist funds around the world. Some organizations appear to be engaged simultaneously in charitable activities and terrorism or the funding of terrorism. *U.S. Representative Michael Oxley (R-OH) Holds Hearing on Disputing Terrorist Network Case Flow: Hearing Before the House Financial Servs. Comm.*, 107th Cong. (2001) (statement of Rep. Oxley, Chairman, House Financial Servs. Comm.).

2. Pioneering work on convergence marks the three books written by Burton A. Weisbrod and his collaborators in which convergence issues have become an increasingly prominent theme. See BURTON A. WEISBROD, *THE VOLUNTARY NONPROFIT SECTOR: AN ECONOMIC ANALYSIS* (1978); BURTON A. WEISBROD, *THE NONPROFIT ECONOMY* (1988); BURTON A. WEISBROD, *TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NONPROFIT SECTOR* (1998).

3. The cases of commercial convergence and campaign convergence differ in one important respect even though both may divert resources from exempt activities. Commercial activities raise questions of internal diversion but seem to have no adverse impact on markets. Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 *STAN. L. REV.* 1017 (1982). The efforts to show that exempt organizations were subsidized producers that lowered prices in markets have been inconclusive. For a recent article summarizing and rejecting these efforts, see John D. Colombo, *A Proposal for an Exit Tax on Nonprofit Conversion Transactions*, 23 *J. CORP. L.* 779 (1998). Political activities differ because they provide an avenue around the reporting and disclosure provisions of the Federal Election Campaign Act, 2 U.S.C. §§ 431-455 (2002) ("FECA"). For a discussion of

exempt sectors and between political organizations and charities, what does it mean to describe an organization as exempt?

Current tax law provides no satisfactory answer to this question. Indeed, the question itself is rarely asked. Most efforts to develop a rationale for exemption are simply rationalizations of the current tax rules. The rules are isolated requirements that are easily manipulated to encompass activities related tenuously, at best, to the statutory purposes that purportedly provide the rationales for exemption.

Current tax law provides exemption from taxation for a broad range of organizations.<sup>4</sup> By any available measure, tax exempt nonprofit organizations are growing rapidly.<sup>5</sup> The number of exempt organizations and the revenues they control continue to increase.<sup>6</sup> Such increases are especially marked with respect to § 501(c)(3) charitable organizations.<sup>7</sup> Americans continue to support exempt organizations with their financial contributions and with the donation of their time and talents.<sup>8</sup>

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these issues, see Frances R. Hill, *Softer Money: Exempt Organizations and Campaign Finance*, 91 TAX NOTES 477 (2001) and 32 EXEMPT ORG. TAX REV. 27 (2001).

4. Section 501(c) enumerates the types of organizations that may qualify for exemption under § 501(a). In addition, § 529 (qualified tuition payments) and § 527 (political organizations) are exempt from taxation. All statutory references are to the Internal Revenue Code of 1986, as amended (the "code"). For analysis of the various types of exempt organizations, see FRANCES R. HILL & DOUGLAS M. MANCINO, *TAXATION OF EXEMPT ORGANIZATIONS* (2002) [hereinafter *TAXATION OF EXEMPT ORGANIZATIONS*].

5. One of the more intensive efforts to document the growth of the exempt sectors is available in J. COMM. ON TAX'N, 106TH CONGRESS, *STUDY OF PRESENT LAW TAXPAYER CONFIDENTIALITY AND DISCLOSURE PROVISIONS AS REQUIRED BY SECTION 3802 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998, VOLUME II: STUDY OF DISCLOSURE PROVISIONS RELATING TO TAX-EXEMPT ORGANIZATIONS*, JCS-1-00 (Comm. Print 2000) [hereinafter *JCT DISCLOSURE STUDY*]. The JCT based its computations on data from the IRS Exempt Organizations/Business Master File, Table 3. *Id.* at 18 n.31. The JCT included the following helpful caveat with respect to this data source:

The data regarding tax-exempt organizations provided in this section and elsewhere in this volume of the study were assembled by the IRS for a variety of purposes. Different data were subject to different level of quality review by the IRS; consequently, the accuracy of the numbers provided may vary. Unless otherwise noted, the data provided includes only those organizations that have received recognition of their tax-exempt status from the IRS. Thus, the data does not include organizations, such as churches, that are not required to seek recognition of tax-exempt status from the IRS.

*Id.*

6. According to one recent estimate, exempt organizations account for twelve percent of gross domestic product. Cecelia Hilgert, *Charities and Other Tax-Exempt Organizations, 1994*, 17 STAT. OF INCOME BULL. 89 (1998) [hereinafter *SOI BULLETIN*].

7. *JCT DISCLOSURE STUDY*, *supra* note 5, at 18, 20 finds that there are over 776,000 such organizations.

8. It was not surprising that Americans turned to § 501(c)(3) organizations when they wanted to assist families of the victims of the September 11 attacks. The ensuing controversies over organizations' use of these contributions has raised long-neglected questions relating to the role of contributors and beneficiaries and the appropriate discretion afforded to organization managers. These controversies were the subject of two Congressional hearings in late 2001. *Charitable Contributions for September 11: Protection Against Fraud, Waste, and Abuse: Hearing Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce*, 107th Cong. (2001); *Charitable Organizations Response to Terrorist Attacks: Hearing Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 107th Cong. (2001).

This article asks whether increases in the number and revenue of § 501(c)(3) organizations mean that charitable activity has increased or has increased to a commensurate extent. The only response is that no one can say with any certainty. The reasons that this fundamental question cannot be answered are found not simply in data insufficiency but also, and more importantly, in conceptual insufficiency. The exempt sector is incompletely described and only partially theorized.<sup>9</sup> This article explores the proposition that a significant proportion of the growth in the exempt sector has been growth in non-exempt activities, and that much of the growth reflects diversion of resources from exempt activities to commercial or political activities. Convergence of activities and the malleability of the exempt organization form are features of the contemporary economy.<sup>10</sup>

The issue is not whether particular activities should be limited to particular forms. This is neither possible nor desirable. There is no reason to seek to prohibit taxable universities or exempt universities or to require that all health care be provided by nonprofit tax-exempt hospitals or by taxable hospitals. There is no reason to ban gift shops or restaurants in museums or T-shirt sales at zoos. Efforts to halt convergence by restrictive clauses in the organization's articles are unlikely to prevail and are inconsistent with the modern trend in corporate law against the ultra vires doctrine.<sup>11</sup>

The question explored here is not what activities an exempt organization should be permitted to undertake, but how various activities should be taxed. The tax issue posed by convergence is not whether the activities themselves are ultra vires, but whether they are consistent with the tax efficiency of the exemption provisions. Are the benefits provided by exemption from taxation and the deduction of charitable contributions efficient in the sense that they are targeted to exempt activity? Or, are these tax provisions inefficient in the sense that they subsidize all of the activities in which exempt organizations now engage? To the extent that exemption is a benefit for the conduct of activities that are consistent with § 501(c)(3) purposes, the exemption provisions are efficient. To the extent that exemption subsidizes activities that are not related to exempt purposes, they are tax inefficient. This article proposes a tax mechanism

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9. These two propositions are closely related. Incomplete empirical data undermines theoretical development, and partial theories limit the data analyses that can be conducted even with present data.

10. Convergence in operations activities may well result in institutional isomorphism in terms of organizational structures and operations. See Paul J. DiMaggio & Walter W. Powell, *The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields*, in *THE NEW INSTITUTIONALISM IN ORGANIZATIONAL ANALYSIS* (Walter W. Powell & Paul J. DiMaggio eds., 1991). For an insightful discussion of the role of such philanthropists as Margaret Slocum Sage, Andrew Carnegie, John D. Rockefeller, and Henry Ford in structuring the large private foundations along the line of a business enterprise, see Peter Dobkin Hall, *A Historical Overview of the Private Nonprofit Sector*, in *THE NONPROFIT SECTOR: A RESEARCH HANDBOOK* 3-26 (Walter W. Powell ed., 1987).

11. See, e.g., Michael A. Schaeftler, *Ultra Vires-Ultra Useless: The Myth of State Interest in Ultra Vires Acts of Business Corporations*, 9 J. CORP. L. 81 (1983).

for targeting exemption to exempt activities and preventing diversion of the benefits of tax exemption to activities that are not related to exempt purposes.

This article focuses on the question of whether the diversification of the activities to exempt organizations to encompass commercial and political activities is consistent with charitable efficiency. Exemption from taxation is the operative question. There is no barrier in tax law to conducting charitable activity with after-tax money. An individual who does not want a charitable contribution deduction is free to give away money, wisely or foolishly, as that person determines. A corporation may do the same thing, limited only by its duty to its shareholders. Both patterns of activity are tax inefficient.

The § 170 charitable contribution deduction and the § 501(c)(3) exemption are together a means of solving the tax inefficiency of using after-tax money for charity. This structure is efficient to the extent that it is targeted to the kind of activities that are consistent with achieving the organization's exempt purposes. However, to the extent that it would be possible to operate a department store or a manufacturing plant by capitalizing the enterprise with deductible contributions and paying no tax on the income, legitimate questions arise.<sup>12</sup> The same is true to the extent that one can offer political contributors a tax deduction for a political contribution.<sup>13</sup> The question explored here is a question of charitable efficiency and the internal diversion of resources to activities that neither support exemption from taxation nor bear any meaningful relation to an organization's articulated exempt purpose. The lack of targeting of exemption to activities consistent with exempt purposes undermines the charitable efficiency of exemption and the § 170 deduction.

The absence of appropriate targeting of exemption for charitable efficiency arises in substantial part from the unarticulated "organizational presumption" that pervades current law and its interpretation. Activities conducted by exempt organizations are generally presumed to be consistent with the organization's exempt status. This reasoning becomes increasingly circular over time. An organization is initially treated as exempt on the basis of one or more exempt purposes stated in its organiz-

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12. There is little doubt that any of these activities could be conducted on a tax-exempt basis by a university through the simple expedient of integrating them into the curriculum, thereby satisfying the substantially related exception to the definition of an unrelated trade or business. See I.R.C. § 513(a) (2002); Treas. Reg. § 1.513-1(d) (2002). For a detailed analysis of the substantially related requirement, see *TAXATION OF EXEMPT ORGANIZATIONS*, *supra* note 4, ¶ 22.05.

13. The use of § 501(c)(3) organizations to offer political contributors a tax deduction may well become more common now that the Federal Election Commission ("FEC") has promulgated final regulations that exempt § 501(c)(3) organizations from the "electioneering communication" requirements of the Bipartisan Campaign Reform Act of 2002 ("BCRA"), Pub. L. No. 155, 116 Stat. 81 (2002). See 11 C.F.R. § 100.29(c)(6). By basing this position solely on the prohibition on participation or intervention in a political campaign that applies to § 501(c)(3) organizations, the FEC avoided an inquiry into whether issue ads consistent with § 501(c)(3) status might constitute electioneering communication within the meaning of the BCRA.

ing documents.<sup>14</sup> Because the determination is made at the beginning of an organization's existence, before it has developed the full range of activities that it will pursue, the initial exempt purpose may become unrelated to its activities. While a § 501(c)(3) organization is required to be both organized and operated for an exempt purpose, the operational test is less rigorous than the organizational test in the sense that the initial grant of recognition of exemption shapes the perception of the organization's activities.<sup>15</sup> In practice, the definition of exempt activities becomes the activities conducted by an exempt organization. The result is charitable inefficiency. As exempt entities engage in more and more activities that are indistinguishable from those of taxable entities and political committees, defining activities as exempt based on the exempt status of the organization is incoherent and inefficient. The organizational presumption is the basis of this charitable inefficiency.

The organizational presumption is also the basis for the lack of transparency and the absence of accountability that is characteristic of so many exempt organizations. Exempt organizations have resisted disclosing information relating to most of their operations and the sources of their funds.<sup>16</sup> In effect, the organizational presumption results in information asymmetry between organization insiders and anyone else, including contributors, beneficiaries, the public, and government regulators.<sup>17</sup> The absence of monitoring and the lack of governance mechanisms that would achieve monitoring from within the organization mean that organization managers can diversify the organization's activities under the cover of the organizational presumption while still claiming to be operating an exempt organization. The managers may well be technically correct under current law, no matter how diverse the organization's activities become.

Exempt organizations that engage in these activities do not take the position that they are operating commercial or political enterprises as ends in themselves. Rather, they assert that the commercial or political activities are inextricably related to their exempt activities or that such activities, particularly commercial activities, provide revenue used to fund exempt activities. The first assertion, that activities are related to exempt purposes, is simply a matter of advocacy. One example is college football. If the Service had not issued a series of revenue rulings providing that both intramural and intercollegiate athletics were exempt activities, universities would simply have begun offering a degree in athletic

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14. The organizational test is set forth in Treas. Reg. § 1.501(c)(3)-1(b) (2002).

15. The operational test is set forth in Treas. Reg. § 1.501(c)(3)-1(c) (2002).

16. For a discussion of the disclosure requirements, see *infra* Part II.A. at notes 39-42. For a detailed discussion of these requirements, see TAXATION OF EXEMPT ORGANIZATIONS, *supra* note 4, ¶ 33.05.

17. For an economic analysis of the market distortions introduced by information asymmetry, see George A. Akerlof, *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970) (analyzing the effects of information asymmetry in used car market).

activities.<sup>18</sup>

The second assertion, that exempt organizations use revenue from all sources for their exempt activities, raises empirical and conceptual questions. Virtually no data exist on how exempt organizations use their resources. The conceptual issue is why an exempt organization should be able to operate a pasta factory, a profitable football program, or an oligopolistic blood bank on a tax-favored basis even if it uses the revenue for charitable activity. Asking this question focuses on the nexus between sources and uses of revenue. This article considers the nexus between sources and uses not as a matter of the unrelated business income tax but as a question of the reasons for exemption.<sup>19</sup>

The leading rationale for tax exemption is Henry Hansmann's effort to address contract failure arising from information asymmetry.<sup>20</sup> The information asymmetry Hansmann addresses arises in the case of a "purchaser" who wants to provide a benefit to a third party, which is the paradigmatic case of a charitable contribution. The problem of information asymmetry for Hansmann is that the purchaser cannot be certain that the money committed to the organization will be used as he or she intends, because the purchaser lacks access to information needed to monitor the organization's use of the money. Instead of providing the purchaser additional information about the uses of the money or a role in the governance of the organization as a way of imposing accountability, Hansmann's response is to offer the purchaser more information about the organization itself. The information that Hansmann proposes to provide is the information that the organization will not use the purchaser's money for the benefit of the organization's insiders. Hansmann calls this information the "nondistribution constraint." In tax law, this kind of in-

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18. Rev. Rul. 67-291, 1967-2 C.B. 184 and Rev. Rul. 64-275, 1964-2 C.B. 142 treat activities related to intercollegiate athletics as tax exempt. Rev. Rul. 80-295, 1980-2 C.B. 194 and Rev. Rul. 80-296, 1980-2 C.B. 195 treat the sale of broadcast rights to amateur athletic contests and intercollegiate games as education of the public, an exempt activity.

19. In effect, this article brings the destination of income doctrine of prior law back into active consideration, but for the purpose of determining what is going on inside a purportedly exempt organization, not for the purpose of determining whether an activity produces unrelated business income. The destination of income doctrine is based on *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924) (holding that revenue from the sale of wine and chocolate was not taxable because the revenue was used for the religious order's exempt religious activities). For a discussion of the destination of income doctrine for determining unrelated business income tax issues, see TAXATION OF EXEMPT ORGANIZATIONS, *supra* note 4, ¶ 21.01[1].

20. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980); Henry B. Hansmann, *The Rationale for Exempting Nonprofit Organizations from the Corporate Income Tax*, 91 YALE L.J. 54 (1981); Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497 (1981); *The Effect of Tax Exemption and Other Factors on the Market Share of Nonprofit versus For-Profit Firms*, 40 NAT'L TAX J. 71 (1987) [hereinafter *The Effect of Tax Exemption on Market Share*]; Henry B. Hansmann, *The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?*, 39 CASE W. RES. L. REV. 807 (1989) [hereinafter *The Evolving Law of Nonprofit Organizations*]; Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605 (1989).

formation is provided by the private benefit doctrines.<sup>21</sup>

This article suggests that diversion of resources from exempt to nonexempt activities inside exempt organizations is an equally important issue and proposes enactment of a “nondiversion constraint” applicable to particular activities funded by particular sources of revenue. This article contrasts the concept of an organization as an entity with the concept of an organization as an aggregate. It suggests that entity treatment has adverse consequences for the efficiency of exemption and the § 170 deduction because the benefits of these two provisions are not targeted to exempt activities. This article identifies characterization issues that are made more difficult by the organizational presumption arising from the entity approach and discusses the difficulties of determining under what circumstances an entity should be exempt based on a limited amount of exempt activity. This article suggests that viewing an organization as an aggregate of transactions enhances charitable efficiency by targeting tax benefits to exempt activities. This article analyzes organizations as aggregates of transactions through which revenue from particular sources is allocated to particular uses. It then maps patterns of either charitable activity or patterns of diversion arising through matching sources of revenue to particular uses inside organizations. Based on this map of diversion, which is a map of specific patterns of charitable inefficiency, this article sets forth a legislative proposal for targeting exemption through a nondiversion constraint based on transfer taxes on diversion transactions within the organization. This nondiversion constraint is seen as operating in conjunction with, not replacing, Hansmann’s nondistribution constraint.

## II. EXEMPT ORGANIZATIONS AS ORGANIZATIONS

Exempt organizations are only partially described and incompletely theorized largely because analysis has focused on the adjective and ignored the noun.<sup>22</sup> Focusing on exemption without also focusing on what it means to be an organization can never be more than partially successful as an approach to analyzing exempt organizations. Focusing on the adjective while ignoring the noun has come to mean that a peppercorn of exempt activity is treated as the defining characteristic of an entire organization. This approach results in reliance on an unarticulated organizational presumption that all activities of an exempt organization are exempt activities (or at least closely related to exempt activities) because the organization conducting the activities is an exempt organization. The

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21. Hansmann located his nondistribution constraint primarily in state nonprofit corporation law and devoted relatively little attention to tax law. *See supra* note 20.

22. Partial descriptions and incomplete theories reinforce each other. Now that more data are becoming more readily available through Guidestar (<http://www.guidestar.com>) and the National Center on Nonprofits & Philanthropy and the National Center for Charitable Statistics at the Urban Institute (<http://www.nccs.urban.org>), issues of partial theories are becoming more important. Data do not explain themselves, and theories are required, if only to be rejected or refined.



label initially affixed to the organization becomes an independent factor in characterizing the organization's activities. As a result, activities which would be taxable or would be subject to regulation under federal election law if conducted outside of a § 501(c) organization become exempt activities or are treated as substantially related to exempt purposes.<sup>23</sup> The organizational presumption thus facilitates convergence between the taxable sector and the exempt sector and increases the difficulty of articulating reasons for the favorable tax treatment accorded § 501(c) organizations.

This section of the article examines two approaches to the analysis of exempt organizations as organizations—the entity approach and the aggregate approach. It suggests that treating organizations as entities obscures analysis of the internal structures and operations of organizations and thereby facilitates diversion of funds from exempt to nonexempt uses within the organization. The entity approach creates three fundamental problems: It equates an organization with its managers, it exacerbates the information asymmetry that precludes meaningful transparency and accountability, and it facilitates diversion of revenue from exempt to non-exempt activities.

This section then suggests that an aggregate approach that treats an organization as a nexus of transactions through which revenue from particular sources is allocated to particular uses offers a more heuristic conceptual framework for addressing these issues. The aggregate approach directs attention to the multiple sources of funds, the multiple activities conducted by exempt organizations, and the possibility of diversion of funds from exempt to nonexempt uses. In light of the patterns of diversion that this approach suggests, the central analytical question becomes the descriptive and analytical utility of treating organizations as entities. It also leads to questions about the decision-making processes that result in diversion and the informational predicate required for monitoring and accountability. These questions suggest that an exempt organization is more than its managers, but encompasses contributors and beneficiaries as well.<sup>24</sup> Thus, the aggregate approach raises fundamental questions about the organizational presumption arising from the entity approach.

#### A. ORGANIZATIONS AS ENTITIES

For federal income tax purposes, exempt organizations are generally treated as entities. Section 501(a) refers to organizations' being treated as exempt. While § 501(c)(3) enumerates exempt purposes and then refers to several activities that are either limited or prohibited, there is no meaningful concept of what proportion of an exempt organization's revenue or staff time or any other factor must be devoted to exempt activities in order to sustain exemption for the organization.<sup>25</sup>

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23. See *infra* Part III.A.

24. This article does not address the role of the public as stakeholders.

25. See *infra* Part III.B. for a discussion of the commensurate in scope concept.

Exemption for § 501(c)(3) organizations now rests largely on compliance with the three private benefit doctrines: private benefit,<sup>26</sup> inurement,<sup>27</sup> and excess benefit transactions.<sup>28</sup> These three doctrines are the expression in the tax law of Hansmann's nondistribution constraint.<sup>29</sup> Much of the past two decades of policy effort in the exempt organization field has been devoted to developing the three private benefit doctrines, but much remains to be done. The limitations and prohibitions on various forms of private benefit are important for charitable efficiency in their own right.<sup>30</sup>

At the same time, using the private benefit doctrines as the touchstone for exempt status has had the paradoxical and counterintuitive result of reinforcing the organizational presumption arising from treating exempt organizations as entities. Misuse of the private benefit doctrines in this way conflates the absence of a private benefit with the presence of a public benefit. While the regulations provide that "[a]n organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or part to the benefit of private shareholders or interests,"<sup>31</sup> they also provide that "[a]n organization is not organized or operated for one or more [exempt] purposes . . . unless it serves a public rather than a private interest."<sup>32</sup> Each of these requirements must be satisfied. The absence of a private benefit does not in itself establish the presence of a public benefit. A hospital may pay appropriate compensation based on comparable compensation arrangements in that area but still not provide a community benefit and thus would not qualify for exemption as an organization described in § 501(c)(3). An organization established to study the effect of acid rain on coniferous trees may pay modest salaries and engage in no other private benefit activity but still either do no studies or never release any of its studies to the public. In these cases, there is an absence of private benefit and an absence of public benefit. The error of current law is to conflate the absence of a private benefit with the presence of a public benefit.

The private benefit doctrines are concerned to varying degrees with conflicts of interest involving organization managers. Provided that organization managers do not violate these conflict of interest prescriptions of varying degrees of specificity, the organization will remain exempt. Indeed, the innovative element of § 4958 is to insulate the organization

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26. See I.R.C. § 501(c)(3) (2002); Treas. Reg. § 1.501(c)(3)-1(c)(2) (2002).

27. Section 501(c)(3) is a private benefit to insiders who have substantial influence over the operation of the organization. Any amount of inurement in theory supports revocation of exemption, but the Service has been reluctant to take this step. In the case of dormant organizations or organizations with no remaining resources, revocation of exemption imposes no meaningful sanction.

28. Section 4958 imposes sanctions on organization managers and disqualified persons, but not on the exempt organization, in the case of excess benefit transaction.

29. See *supra* note 20.

30. For a detailed discussion of the three private benefit doctrines, see TAXATION OF EXEMPT ORGANIZATIONS, *supra* note 4, at ch. 4.

31. Treas. Reg. § 1.501(c)(3)-1(c)(2) (1959).

32. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (1959).

from any consequences whatsoever in the event of an excess benefit transaction. In effect, exemption now depends on a formulation of the private benefit doctrines that imposes no sanctions at all on the organization.<sup>33</sup> Thus, it is now in practice virtually impossible for an organization to lose its exempt status.<sup>34</sup> This may well be a rational approach to private benefit. What is not rational is to use the private benefit doctrines as the primary or even sole criterion of exemption.

The paradox of the private benefit doctrines' misuse as the primary criteria of exempt status is that it exacerbates information asymmetry, and thereby limits the opportunity for meaningful accountability of organization managers. As long as organization managers avoid private benefit issues, they are able to use the private benefit doctrines as an important reason for limiting the role of contributors and beneficiaries in organizational governance. Section 501(c)(3) organizations are distinctively opaque. Few have members with the right to elect directors or to participate in organizational governance.<sup>35</sup>

The governance structures of most § 501(c)(3) organizations would be familiar to Berle and Means.<sup>36</sup> In fact, the centralization of managerial control is even more complete in the absence of shareholders with the dual rights of owners—the right to receive distributions and the right to participate in corporate governance.<sup>37</sup> Reliance on the nondistribution constraint to prevent distributions unrelated to the organization's exempt purposes has been misused as a rationale for limiting the right of contributors or beneficiaries to participate in governance of exempt organizations. This position is based on the erroneous assertion that such involvement by contributors or beneficiaries would mean that distributions to beneficiaries would become private benefits that would jeopardize the organization's exempt status.

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33. The excess benefit transaction provision of I.R.C. § 4958 is likely to displace both the inurement and the private benefit provisions of I.R.C. § 501(c)(3) because it is more fully articulated, thereby providing greater guidance to both audit agents and exempt organizations.

34. Revocation has always been highly unlikely due to the reluctance of the Service to take such a step, but there has not previously been a statutory provision that provides protection from revocation.

35. I.R.C. § 501(c)(5) labor organizations and § 501(c)(6) business leagues, as well as social and fraternal organizations, have members with some role in the election of directors and in organizational governance.

36. ADOLPH BERLE, JR. & GARDNER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1933) (discussing separation of ownership and control in business corporations). For an analysis of the process of consolidating hierarchical control in participatory structures like political parties, see ROBERT MICHELS, *POLITICAL PARTIES: A SOCIOLOGICAL STUDY OF THE OLIGARCHIAL TENDENCIES OF MODERN DEMOCRACY* (Eden & Cedar Paul trans., 1968) (1915).

37. This article does not deal primarily with these governance issues, but instead suggests that governance issues of participation and accountability are related to the information asymmetry that arises from treating an organization as an unexamined entity rather than as an aggregate of activities. The proposal developed in this article for a nondistribution constraint gives the concept of transparency operational meaning. In so doing, it provides a basis for increased accountability through participation by directors, members, contributors, and even beneficiaries and the public.

Transparency is much discussed in the wake of the controversies over the use of funds by the September 11 charities and the scandals in the corporate world relating to the use of off-balance sheet special purpose entities.<sup>38</sup> Exempt organizations, like taxable entities, are already subject to disclosure requirements.<sup>39</sup> The application for recognition of exemption, the organization's articles, and the annual information return for the past three years are all subject to disclosure.<sup>40</sup> The names of contributors are not currently subject to disclosure to the public, although the five largest contributors are disclosed to the Service. The UBIT return is not disclosable because it is a tax return that is subject to the confidentiality provision of the Code.<sup>41</sup> The kind of information that defines the nondiversion constraint is not disclosed because it does not exist in any form that can be conveyed to the public. Current discussions relating to changes in the annual information return do not contemplate the kind of information that defines the nondiversion constraint.<sup>42</sup>

Disclosure provides the basis for but is distinguishable from accountability. Mere disclosure of raw data does not necessarily assist those persons who cannot analyze the data in terms meaningful to their concerns. Indeed, some forms of disclosure may enhance organizational opacity. Even forms of disclosure that permit directors, members and others to use the data do not in themselves provide for accountability in the absence of governance structures that give directors and members a voice in the organization's operations.

## B. ORGANIZATIONS AS AGGREGATES

An exempt organization is not devoted solely to exempt activities. Organizations, including exempt organizations, are aggregates of multiple activities. A § 501(c)(3) organization is an aggregate of exempt activities and other activities that are either inconsistent with exempt status or permissible only in some limited amount. Convergence of the activities of exempt organizations with the activities of taxable entities or political organizations means that exempt organizations, including § 501(c)(3) organizations, tend to engage in a broad range of activities.

Exempt organization theorists have attempted to deal with this issue by developing typologies of organizations.<sup>43</sup> The most common such type is

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38. *Charitable Contributions for September 11: Protecting Against Fraud, Waste, and Abuse: Hearing Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce*, 107th Cong. (2001); *Charitable Organizations Response to Terrorist Attacks: Hearing Before the Subcomm. on Oversight and Investigations of the House Comm. on Ways and Means*, 107th Cong. (2001).

39. For a detailed discussion of disclosure requirements, see TAXATION OF EXEMPT ORGANIZATIONS, *supra* note 4, at ch. 33. See also JCT DISCLOSURE STUDY, *supra* note 5.

40. I.R.C. § 6104(d) (2002).

41. I.R.C. § 6104(d)(3) (2002); Treas. Reg. § 301.6104(d)-1(b)(3)(iii) (1999).

42. GENERAL ACCOUNTING OFFICE, TAX-EXEMPT ORGANIZATIONS: IMPROVEMENTS POSSIBLE IN PUBLIC, IRS, AND STATE OVERSIGHT OF CHARITIES, GAO-02-526 (2002).

43. Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Exemption*, 52 OHIO ST. L.J. 1379 (1991); Mark A. Hall & John D. Colombo, *The Charitable*

the concept of a "commercial nonprofit" which refers to exempt organizations that earn program service revenue from engaging in an exempt activity, and not to organizations that earn returns on their investments or engage in profitable business activities. The paradigmatic commercial nonprofit under this approach is a hospital.<sup>44</sup> These typologies, however constructed, tend to exacerbate the analytical problems in the entity approach in so far as they use the presence or absence of one element to characterize an entire organization. To the extent that such typologies bespeak recognition of the multiple activities in which exempt organizations engage, they might be considered useful modifications of the entity construct. Conceptualizing an exempt organization as an aggregate of activities, only some of which support exemption, presents a more analytically useful and empirically descriptive view than do prior efforts to develop typologies of exempt organizations.<sup>45</sup>

Tax law identifies at least three types of activities, each with a different relation to exempt status. First are the activities that provide the basis for exemption. Section 501(c)(3) lists eight exempt purposes: religious, charitable, scientific, literary, educational, fostering national or international amateur sports competition, preventing cruelty to children and animals, and testing for public safety.<sup>46</sup> Second are activities that do not themselves support exemption, but are consistent with exempt status provided that the extent of the activities is limited. Examples are legislative lobbying for § 501(c)(3) organizations,<sup>47</sup> an insubstantial amount of private benefit transactions, a broad range of commercial activities that have been excepted from the unrelated business income tax,<sup>48</sup> and an undetermined amount of unrelated business income. These activities jeopardize

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*Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307 (1991); Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 520-62 (1990).

44. Academics who write on exemption appear reluctant to treat universities as commercial nonprofits. For a notable exception, see John D. Columbo, *Why Is Harvard Tax-Exempt? (And Other Mysteries of Tax Exemption for Private Educational Institutions)*, 35 ARIZ. L. REV. 841, 843 (1993).

45. This approach is based on theories of the firm as a nexus of contracts. See R.H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937). For a contemporary perspective on the implications of Coase, see Jason Scott Johnson, *The Influence of The Nature of the Firm on the Theory of Corporate Law*, 18 J. CORP. L. 213 (1993). For an analysis of the nexus of contracts theory in non-traditional markets, see Herbert J. Hovenkamp, *Market Efficiency and the Domain of the Firm*, 18 J. CORP. L. 173 (1993).

46. The last purpose, testing for public safety, was added to § 501(c)(3) in 1954 to reverse a judicial decision denying exempt status to Underwriters' Laboratories. See *Underwriters' Labs. v. United States*, 135 F. 2d 371, 374 (7th Cir. 1943). The legislative history emphasizes the restriction of this provision to the testing of consumer products. See S. REP. NO. 1662-83 at 310 (1954), reprinted in 1954 U.S.C.C.A.N. 4621, 4950. This is the only exempt purpose that supports exemption but does not support an I.R.C. § 170 charitable contribution deduction.

47. Legislative lobbying is an exempt activity for I.R.C. § 501(c)(4) social welfare organizations.

48. Investment activities, rents, royalties, dividends, interest, annuity payments, income from the leasing of mailing lists, trade show revenues, corporate sponsorship payments, and proceeds of bingo games are all exempt from the unrelated business income tax under I.R.C. §§ 512(b), 513(d)-(i). For a detailed analysis of exceptions and modifications

exempt status only if the extent of the activities exceeds certain limits.<sup>49</sup> Third are prohibited activities. Included in this third category are inurement<sup>50</sup> and, in the case of § 501(c)(3) organizations, participation or intervention in a political campaign.<sup>51</sup> In theory, any amount of the prohibited activities supports revocation of exemption. In practice, such substantial controversy surrounds characterization of particular activities as either inurement, or participation or intervention in political campaigns that they rarely result in revocation of exemption.

The relative lack of inquiry into the uses of resources is consistent with a similar absence of analytical curiosity about exempt organizations' sources of financial support.<sup>52</sup> Exempt organizations' capital structures are only partially described and incompletely theorized. While the reasons for this neglect are unclear, part of the problem is a pervasive assumption that revenue from all sources is used for exempt activities. Another part of this analytical lapse results from the assumption that the sources of exempt organizations' resources are less important than the uses of resources. This article suggests that analysis of exempt organizations begin with the assumptions that organizations have multiple sources of financial support and that they use their resources for all of the activities in which they are known to engage. It is then possible to analyze the implication of each source and each use and then map the patterns of using revenues from particular sources for particular uses. In this way, the assumptions and rationalizations that remain unexplored when one conceptualizes exempt organizations as entities can be examined more systematically.

Public charities are commonly assumed to derive their support from contributions from the public.<sup>53</sup> Voluntary contributions from the public are consistent with the idea of exempt organizations as expressions of the voluntary associative activity of individuals with common interests who

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to the unrelated business income tax, see *TAXATION OF EXEMPT ORGANIZATIONS*, *supra* note 4, at ch. 23.

49. The limitations are not precisely defined. Both the determination of the amount of the activity and the specification of the limitation are not based on precedential guidance but are matters of facts and circumstances based as much on lore as on law.

50. Inurement is providing a private benefit to a person in a position to exert influence over the operation of the organization.

51. These campaign activities are prohibited in the case of I.R.C. § 501(c)(3) organizations, but I.R.C. § 501(c)(4) organizations may engage in some amount of campaign activities.

52. The data currently available come from the information returns, Form 990, filed by exempt organizations with annual revenue of at least \$25,000, and the annual return reporting unrelated business income, Form 990-T. Churches are not required to file annual information returns without regard to their annual revenues, but they are required to file returns reporting their unrelated business income. In addition to the data limitations arising from the filing requirements, data limitations arise from the design of the tax forms, which are intended for tax administration and not primarily for research on exempt organizations. The forms' design results in underreporting of the amount of commercial activity that falls in categories exempted from the unrelated business income tax.

53. The distinction between public charities and private foundations rests on the presence or absence of support from the public. See I.R.C. § 509 (2002) (defining public support for this purpose).

are not dependent on government. In fact, direct contributions from the public constitute approximately 10 percent of the support received by public charities.<sup>54</sup> Because most public charities are not membership organizations, they collect very limited amounts of revenue in the form of dues. Small organizations received approximately half of their support in the form of direct contributions.<sup>55</sup>

Contributions from corporate contributors are not separately stated in government data but they are both important and controversial.<sup>56</sup> The initial controversy arose with respect to the corporate contributors and centered on whether contributions to exempt organizations were a breach of the board's fiduciary duty to the shareholders as a waste of corporate assets. This issue was addressed in the social responsibility movement among corporations, which linked the profitability of the corporation with the social betterment of the communities where the corporations were located. Controversy also arose with respect to the effect of corporate contributions on the exempt organization recipient. The increasing use of corporate sponsorship transactions has blurred the distinction between a contribution to the organization and the sale of advertising by the exempt organization.<sup>57</sup>

Grants from private foundations are not reported separately by the Service, though the data would prove analytically useful in addressing issues of accountability and of the contributors role as actors in exempt organizations. Grants from private foundations are negotiated by the managers of public charities, and the private foundation managers may become invested in the public charity managers. Private foundation support can thus reinforce managerial control.

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54. SOI BULLETIN, *supra* note 6, at 90, 92.

55. *Id.* at 91 (urging caution in relying on these data due to the small sample size).

56. There is a voluminous literature on this broad topic. The following references do not claim completeness but do give a reasonable idea of the diverse approaches and viewpoints. Melvin A. Eisenberg, *Corporate Conduct That Does Not Maximize Shareholder Gain: Legal Conduct, Ethical Conduct, the Penumbra Effect, Reciprocity, the Prisoner's Dilemma, Sheep's Clothing, Social Conduct, and Disclosure*, 28 STETSON L. REV. 1 (1998); Faith S. Kahn, *Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy*, 44 UCLA L. REV. 579 (1997); Henry N. Butler & Fred McChesney, *Why They Give at the Office: Shareholder Welfare and Corporate Philanthropy in the Contractual Theory of the Corporation*, 84 CORNELL L. REV. 1195 (1999); Nancy J. Knauer, *The Paradox of Corporate Giving: Tax Expenditures, the Nature of the Corporation, and the Social Construction of Charity*, 44 DEPAUL L. REV. 1 (1994).

57. The tax controversy issue involves only the exempt organization. The corporation will properly deduct the amount either as an I.R.C. § 162(a) ordinary and necessary business expense or as an I.R.C. § 170 charitable contribution deduction. The exempt organization will not be subject to unrelated business income tax if the amount is a contribution received through a corporate sponsorship transaction because the organization is treated as merely acknowledging the generosity of the corporate sponsor but it will be taxed if the amount is treated as revenue from the sale of advertising. The distinction between advertising and corporate sponsorship is elusive. For a history of the controversy over the Service's initial treatment of most corporate sponsorship transactions as sales of advertising by an exempt organization, see Frances R. Hill, *Corporate Sponsorship in Transactional Perspective: General Principles and Special Cases in the Law of Tax Exempt Organizations*, 13 U. MIAMI ENT. & SPORTS L. REV. 5 (1996).

It is entirely possible for exempt organizations to operate almost entirely on funding from private foundations. Private foundations will require information on the use of the grants, but they are not in a position to impose general accountability of the recipient organization to its contributors and beneficiaries. With private foundation support, a public charity may serve a cause without becoming accountable to any constituency, body of contributors, or groups of beneficiaries. At the same time, private foundations monitor their grant recipients, and this monitoring focuses on both private benefit and diversion of grant funds to other uses.

The single largest source of revenue for the exempt sector in the aggregate was program service revenue, which accounted for over 70 percent of exempt organizations' total revenue in 1994.<sup>58</sup> Program service income is revenue from conducting activities that support exempt status, such as tuition for providing education or fees for providing health care.<sup>59</sup> Universities and hospitals receive the bulk of these program service payments, but museums, nonprofit theaters, zoos, and community arts organizations charge admissions fees, and many types of educational organizations, including those providing continuing legal education for members of state bar associations, charge the equivalent of tuition.<sup>60</sup> Program service fees also include Medicare and Medicaid payments to health care providers. Health care organizations accounted for 58 percent of the total revenue of the entire exempt sector, and 90 percent of the revenues of health care organizations came from program services payments.<sup>61</sup> Private tax-exempt educational institutions accounted for over 25 percent of the total revenue of all exempt organizations, and program service revenue accounted for 66 percent of this amount.<sup>62</sup>

The analysis here refers to commercial activities, not to unrelated business income. Unrelated business income data are generally thought to under report the extent of unrelated business income earned by exempt organizations. In addition, these data do not report the amount of revenue earned from commercial activities that are not subject to the unrelated business income tax. Corporate sponsorship arrangements are one of the most visible such arrangement. Affinity marketing arrangements—including credit cards, and income from the licensing of mailing lists based on currently enrolled students and alumni—are lucrative sources of revenue. More recently, some organizations have entered into

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58. SOI BULLETIN, *supra* note 6, at 90.

59. Education is one of the exempt purposes set forth in I.R.C. § 501(c)(3), but health care is not. Health care was initially an exempt purpose only to the extent it qualified as charity, which is an enumerated exempt purpose. Over time, the charity care and community benefit requirements have eroded and health care has become an independent, but non-statutory, exempt purpose.

60. State bar associations are I.R.C. § 501(c)(6) organizations, but there are quite a number of I.R.C. § 501(c)(3) organizations that provide continuing legal education. At least one for-profit company also provides continuing legal education with content equivalent to that provided by exempt providers and at a price equivalent to exempt providers.

61. SOI BULLETIN, *supra* note 6, at 93.

62. *Id.*



exclusive marketing arrangements, commonly known as “pouring rights contracts” in recognition of the early development of these arrangements with respect to soft drinks. Under such an arrangement an organization receives a fee for agreeing that a particular brand will be the only brand of a particular product available on the property of or at an event run by that organization. Universities with their large numbers of consumers living in a defined space controlled by the exempt organization have found soft drink and fast food companies willing to pay fees for exclusivity.<sup>63</sup> These activities were not initially treated as unrelated business activities, but the regulations now treat payments under “exclusive provider” contracts as unrelated business income.<sup>64</sup>

Investment earnings are also important sources of support for exempt organizations. Exempt organizations are not simply passive investors with low-risk investment strategies. The larger organizations, at least, are active managers of their portfolios and engage in a wide range of securities lending activities to enhance their investment yields.

Exempt organizations also fund operations through issuing debt instruments to investors. While exempt organizations cannot issue equities, they do issue debt. Universities are among the most active issuers of bonds, which are secured by the projected tuition revenues. At least some organizations, including some universities, make operational decisions with debt service and the implications on their bond ratings as important considerations.

Government grants are an increasingly important source of revenue for exempt organizations.<sup>65</sup> Health care organizations and universities have long received government grants in addition to program service support. Smaller exempt organizations are now receiving a wide range of government grants to provide social services.<sup>66</sup>

Since the 1996 changes in welfare, churches are one of the more important participants in these government programs.<sup>67</sup> But it would be fair to say that government grants and government contracts pervade the exempt sector. This has been a phenomenon long in the making.

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63. Public schools have also found these exclusivity arrangements lucrative sources of increasing revenue. Soft drink and fast food contracts have become controversial on grounds that young children should not be given the impression that their school endorses these foods as a significant portion of their daily diet. The controversies become particularly acute when the exempt organization or public school is compensated as a percentage of the sales revenue.

64. Treas. Reg. §1.513-4(c)(2)(vi)(B).

65. SOI BULLETIN, *supra* note 6, at 90-91.

66. The 1996 welfare reform legislation contained the charitable choice provision that enabled faith-based charities to become government funded service providers on condition that they did not require the recipients of the government funded services to participate in any religious activities as a condition of participation.

67. The current administration has promulgated three Executive Orders: Establishment of the White House Office of Faith-Based and Community Initiatives (Jan. 29, 2001); Agency Responsibilities with Respect to Faith-Based and Community Initiatives (Jan. 29, 2001); and Equal Protection of the Laws for Faith-Based and Community Organizations (Dec. 12, 2002), available at <http://www.whitehouse.gov/news/orders> (last visited Feb. 15, 2003).

The Filer Commission devoted more attention to the relations of the exempt organizations to government than it devoted to exempt organizations' relations with taxable entities.<sup>68</sup> The Commission found that by 1974 the government was taking direct responsibility for many activities that had previously been the province of exempt organizations and that the government was also becoming a major source of funds for exempt organizations. These trends were particularly pronounced in health care, education, and social services.<sup>69</sup> While acknowledging that government funding was "a matter of life and death for many organizations," the Filer Commission identified a "dilemma over control and finances" as one of the central issues facing exempt organizations.<sup>70</sup> The Commission noted that the government had provided significant support to exempt organizations in earlier periods in American history but also noted that this practice was subject to frequent criticism.<sup>71</sup>

The Filer Commission emphasized the importance of having sources of support other than the government, observing that "memories of loyalty oaths as a condition of government funding still are fresh, as are recollections that the institutions that resisted such pressures had private as well as governmental resources to draw on."<sup>72</sup> The Commission made the perceptive observation that staff members in organizations that are heavily dependent on the government may regard themselves more as civil servants than as managers of independent organizations.<sup>73</sup>

The relationship between sources of revenue and the nature of an organization's operations has never been systematically addressed. The question of what exempt organizations do and the related question of whether an increase in resources held by exempt organizations means an increase in exempt activity, still cannot be answered. The reasons have

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68. COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, *GIVING IN AMERICA: TOWARD A STRONGER VOLUNTARY SECTOR* 89-105 (1975) [hereinafter *FILER COMMISSION*]. A survey conducted for the Filer Commission found that a sample of exempt organization leaders identified government relations as their "foremost concern." *Id.* at 97.

69. *Id.* at 89-95.

70. This ever increasing amount of involvement by government in the finances of nonprofit organizations presents a dilemma for the nonprofit sector. On the one hand, government money is needed—it is a matter of life or death for many organizations—as the number and size of nonprofit groups has grown and the amount of private funding has, in recent years, moved relatively slowly and even fallen off as measured in deflated dollars. On the other hand, government money obviously comes with strings attached, however invisible and unintentional they may be. The more a private nonprofit organization depends on government money for survival, the less "private" it is going to be, the less immune to the influence of public political processes and priorities.

*Id.* at 96.

71. *Id.* at 96-97.

72. *Id.* at 98.

73. *Id.* at 99. The Commission found that "[t]he presence of a firm core of private support, however small, in a private organization that gets major public funding can be of crucial importance in determining whether the managers of the organization regard themselves and behave as independent operators or as civil servants."

less to do with data than with concepts and the absence of an analytical framework that facilitates consideration of these issues. Mapping patterns describing the use of particular types of resources for particular uses helps identify the analytical issues.<sup>74</sup> The following section of the article identifies the tax issues that cannot be resolved under the current law with its entity characterization and organizational presumption.

### III. TAX IMPLICATIONS OF TREATING ORGANIZATIONS AS ENTITIES

Treating exempt organizations as entities results in an unarticulated organizational presumption that raises two fundamental tax problems under current law. The first problem involves the characterization of activities as exempt or not exempt and the assumption that all of the activities conducted by an exempt organization are exempt activities. Treating organizations as entities not only obscures diversion of revenue from exempt to non-exempt activities, but also makes it more difficult to characterize particular activities as exempt or not due to the organizational presumption that arises from the entity concept. The second problem involves the relative scope of exempt and non-exempt activities. Entity characterization requires the articulation of the basis for determining that an entire organization should be exempt. Current law permits an exempt organization to engage in certain activities that are not exempt activities but has failed to develop criteria for determining the permissible scope of nonexempt activities.

#### A. CHARACTERIZATION AND THE ORGANIZATIONAL PRESUMPTION

Characterization of the activities of exempt organizations has no coherent conceptual basis related to exemption. The problem derives, at least in part, from treating exempt organizations as entities. Once an organization receives a determination letter recognizing that it has been organized for one or more exempt purposes it is presumed to operate in a manner consistent with its purposes. The tax status of the entity becomes a factor in characterizing its activities.<sup>75</sup>

College football is educational because it takes place in or under the auspices of an entity that is exempt from federal income tax.<sup>76</sup> Professional football is a trade or business because it is conducted by for-profit

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74. See *infra* Part IV.

75. The tautological elements of this statement are deliberate, but they are not unprecedented in tax law. The basic definition of gross income is stated as follows: "Gross income means all income from whatever source derived." I.R.C. § 61(a) (2002).

76. Rev. Rul. 67-291, 1967-2 C.B. 184 and Rev. Rul. 64-275, 1964-2 C.B. 142 treat both intramural athletics and intercollegiate athletics as educational within the meaning of I.R.C. § 501(c)(3). Rev. Rul. 80-296, 1980-2 C.B. 195 treats the sale of broadcast rights to an intercollegiate game as education of the public, an exempt activity.

entities that are subject to tax.<sup>77</sup> Sales of greeting cards by museums are exempt because the seller is a public charity engaged in educational activities. However, sales of the same cards by a card shop are taxable because the card shop is not qualified as an organization that serves educational purposes within the meaning of § 501(c)(3).<sup>78</sup> Computer sales by university bookstores are, if not educational themselves, sufficiently related to education to claim exemption from taxation, while computer sales by taxable vendors to students at the same university to be used for the same course work will be taxable.<sup>79</sup> Even certain churches that have become increasingly involved in multiple activities only tenuously related to churches' sacerdotal functions are exempt.<sup>80</sup> In each case, the organizational presumption is a significant factor in characterizing the activity and thereby determining its tax treatment.

Problems of characterization have been particularly acute in two areas where the tax law of exemption intersects other bodies of tax law. These are (1) the intersection with federal election law around the prohibition on participation or intervention in election campaigns, and (2) the intersection with the normal rules of taxation relating to commercial transactions from which exempt organizations are excepted under the broad modifications and exceptions to the unrelated business income rules.

The difficulty of distinguishing much political activity from the exempt activity of education has been documented but not resolved because the activities in question are conducted by exempt organizations.<sup>81</sup> If the same activities were conducted by political parties, they would be treated

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77. The teams that comprise the National Football League ("NFL") are taxable business entities, but the NFL is an I.R.C. § 501(c)(6) trade association. As such, the NFL is not subject to entity-level tax. I.R.C. § 501(c)(6) (2002).

78. Rev. Rul. 73-104, 1973-1 C.B. 263 treats such sales as educational because they list the artist on the back of the card. The museum sold the cards through catalogues and also sold the cards to commercial retail card shops at a volume discount. The ruling also suggests that the sale will build public awareness of and support for the museum selling the card and for museums in general. The Service subsequently voiced its misgivings about the ruling, stating that "[a]lthough we were not entirely comfortable with the frankly commercial scope of the methods of distribution in Rev. Rul. 73-104, we were unable to develop a satisfactory legal rationale for a more restrictive rule." Gen. Couns. Mem. 37902 (Mar. 28, 1979). See also, Gen. Couns. Mem. 39346 (Mar. 15, 1985). The Service also ruled that sale of art books and reproductions of items not included in the museum's own collection was not unrelated business income because such sales enhanced appreciation of art in general. Rev. Rul. 73-105, 1973-1 C.B. 264. Despite its articulated misgivings, the Service extended this reasoning to income from shops and museums that are open off their premises. See Tech. Adv. Mem. 95-500-03 (Sept. 8, 1995).

79. Sales of consumer goods at college bookstores are excluded from unrelated business income under the "convenience exception" based on the premise that students cannot readily leave campus to shop. I.R.C. § 513(a)(2) (2002). The empirical basis for this position seems tenuous when so many students have automobiles and when so many retailers are eager to locate near campuses.

80. Patricia Leigh Brown, *Megachurches as Minitowns*, N.Y. TIMES, May 9, 2002, at F1 (describing a church with multiple commercial activities that describes itself as a "destination center"). The article also describes a church with a McDonalds franchise (complete with drive-through window) at the church, for which the church paid \$100,000.

81. For a detailed analysis of the characterization issues in this area, see TAXATION OF EXEMPT ORGANIZATIONS, *supra* note 4, at ch. 6.

as campaign activities subject to federal election law. Before § 527 was amended to require disclosure of contributors, some organizations were using so-called “new § 527 organizations” and § 501(c)(3) or § 501(c)(4) organizations to pay for the same televised issue ads and were successfully characterizing the § 527 ads as political activity and the § 501(c)(3) or § 501(c)(4) ads as educational activity.<sup>82</sup>

The unrelated business income tax provisions rely on the organizational presumption to ensure that few commercial activities are subject to the unrelated business income tax.<sup>83</sup> The organizational presumption is expressed through the concept that an activity is “substantially related” to the organization’s exempt purpose.<sup>84</sup> The same activity conducted by a taxable entity is subject to tax.

The organizational presumption permits § 501(c)(3) organizations to receive tax deductible contributions and use them to capitalize taxable subsidiaries. Any dividends paid to the exempt parent are not taxed, even if the taxable subsidiary is controlled by the exempt organization. Interest and royalty payments from a controlled taxable subsidiary are subject to tax under § 512(b)(13).

The organizational presumption also serves to recharacterize income earned by joint ventures depending on the tax status of the partner receiving the income.<sup>85</sup> The general treatment of income from a partnership in which an exempt entity is a partner is to treat the partnership as a flow-through entity in which the partners receive the same type of income. At least in the case of so-called whole hospital joint ventures, the Service taxes the revenue according to the tax status of the partner.<sup>86</sup> Under this approach, control by the exempt entity creates a variant of the destination of income test. The income destined for the taxable entity is taxed and the income destined for the exempt entity is not taxed.

These characterization issues have arisen as a result of the empirical phenomenon of convergence and are exacerbated by the conceptual limitations of the entity concept of organizations. These characterization issues are themselves the basis of the second major problem arising from the entity approach, which is the difficulty of determining under what circumstances an entire organization is exempt.

#### B. THE SCOPE OF EXEMPT ACTIVITIES: THE COMMENSURATE IN SCOPE STANDARD

If an organization is treated as an entity, how should tax law determine whether the entire organization is exempt? This question is important because the organizational presumption based on the entity concept of an

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82. *Id.* at ¶ 18.10.

83. See *id.* at ch. 21-26 for a detailed analysis of the unrelated business income tax.

84. See *id.* at ¶ 22.05 for a discussion of the “substantially related” concept.

85. MICHAEL I. SANDERS, *PARTNERSHIPS AND JOINT VENTURES INVOLVING TAX-EXEMPT ORGANIZATIONS* (2d ed. Supp. 2002).

86. Rev. Rul. 98-15, 1998-1 C. B. 718.

organization permits an exempt organization to lobby with deductible funds, engage in a broad political range of election campaign activity with deductible funds, and capitalize its commercial enterprises (including those conducted in taxable subsidiaries and joint ventures with taxable entities) with deductible funds. All of these activities depend on the entity concept and the organizational presumption. Taxable entities that engage in the same commercial activities are subject to tax on their income and political organizations engaging in the same campaign activities are subject to federal election law limitations and disclosure requirements. Exempt organizations escape tax on their commercial activities and avoid the limitations and disclosure requirements of federal election law.

It is far from clear how this happened. Section 501(c)(3) provides that an organization is described in that section only if it is “organized and operated exclusively” for one or more of the exempt purposes enumerated in that section.<sup>87</sup> In addition, the regulations provide that “[a]n organization is not organized or operated exclusively for one or more of the purpose specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest.”<sup>88</sup> But what does “exclusively” mean in this context? In *Better Business Bureau v. United States*, the Supreme Court held that even one nonexempt purpose, insubstantial in nature, was inconsistent with § 501(c)(3) status.<sup>89</sup> The applicable regulations provide that an organization is “organized exclusively for one or more exempt purposes” only if its organizing articles expressly limit its purposes to exempt purposes and, in addition, “[d]o not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.”<sup>90</sup> There is no guidance on what constitutes an “insubstantial part” of an organization’s activities for the organizational test. In practice, most organizations do not expressly permit any level of activities that are not exempt apart from activities that are “in furtherance of one or more exempt purposes.” This means that there are clauses permitting the organization to conduct administrative functions that are necessary to operating as an organization.

The uncertainty surrounding the meaning of “exclusively” for purposes of the operational test has been more pronounced. The regulations provide that “[a]n organization will be regarded as ‘operated exclusively’ for one or more exempt purposes only if it engages primarily in activities which accomplish one more such exempt purposes specified in § 501(c)(3).”<sup>91</sup> The only additional guidance regarding the meaning of “primarily” for this purpose is that “[a]n organization will not be so regarded if more than an insubstantial part of its activities is not in further-

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87. Treas. Reg. § 1.501(c)(3)-1(d)(1)(i) (as amended in 1990).

88. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (as amended in 1990).

89. *Better Bus. Bureau v. United States*, 326 U.S. 279 (1945).

90. Treas. Reg. § 1.501(c)(3)-1(b)(1)(i) (as amended in 1990).

91. Treas. Reg. § 1.501(c)(3)-1(c)(3) (as amended in 1990).

ance of an exempt purpose.”<sup>92</sup> These two sentences read together suggest that “primarily” is to be read as requiring that other activities are not substantial. The UBIT regulations seem, at least to some observers, to provide a different interpretation in the case of the conduct of a trade or business:

An organization may meet the requirements of § 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization’s exempt purpose or exempt purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in § 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes. An organization which is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt under § 501(c)(3) even though it has certain religious purposes, its property is held in common, and its profits do not inure to the benefit of individual members of the organization.<sup>93</sup>

This regulation has generally been interpreted as liberalizing the interpretation of what constitutes, primarily, an exempt purpose. The most expansive reading of this regulation is that it permits an exempt organization to conduct commercial activities without a practical limit.<sup>94</sup> This view does not represent a consensus that the Service and the courts may be relied upon to apply. It is a reading consistent with the organizational presumption and nicely illustrates the usefulness for large organizations operating large commercial enterprises of failing to treat organizations as aggregates of activities. The result has been that the statutory requirement of exclusive operation for one or more exempt purposes has become a theory requiring only a peppercorn of exempt activity embedded in an organization that has succeeded in obtaining a determination letter from the Service based on statements of intended exempt activities. The conceptual nihilism reached its most complete expression in a private ruling from the Internal Revenue Service National Office that takes the position that an organization that conducted bingo games and then used approximately one percent of its gross revenues for its articulated charitable purposes was operating exclusively for an exempt purpose.<sup>95</sup> How did the Service manage to get to this position from the language of § 501(c)(3)?

The confusion began with the Congressional deliberations that resulted

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92. Treas. Reg. § 1.501(c)(3)-1(c)(3) (as amended in 1990).

93. Treas. Reg. § 1.501(c)(3)-1(e) (as amended in 1990).

94. Thomas A. Troyer, *Quantity of Unrelated Business Consistent with Charitable Exemption—Some Clarification*, 6 EXEMPT ORG. TAX REV. 409 (1992).

95. Tech. Adv. Mem. 9711003 (Nov. 8, 1995).

in the enactment of the unrelated business income tax.<sup>96</sup> Congress was responding to the relationship between the several universities and taxable companies that claimed to have no taxable income because they contributed all of their net income to the university. The most famous of these arrangements was between the New York University Law School and C.F. Mueller Company, the pasta products company.<sup>97</sup> Congress was concerned about unfair competition between businesses that paid no taxes and those that were subject to tax, a concern which led Congressman Dingell, then a junior member of the Ways and Means Committee, to express the concern that “[e]ventually all the noodles in this country will be produced by corporations held or created by universities, by educational institutions, and there will be no revenue to the Federal Treasury from this industry.”<sup>98</sup> In the most common pattern addressed by Congress, the exempt organization conducting the exempt activities did not also conduct the commercial activity, but instead received a contribution or a dividend distribution from the taxable entity that claimed exemption based on its distributions to an exempt entity. The issue of the extent of the exempt entity’s commercial activity does not arise in this pattern. The issue was whether the commercial entity could qualify for exemption because its net earnings were used to finance exempt activities.

Congress addressed the problem of the commercial entity by denying either an exemption or a complete charitable contribution deduction. In so doing, Congress could be regarded as having addressed, albeit indirectly, questions relating to the extent of permissible commercial activity. If the view that there are no limits does represent Congress’ intent, then there is little reason to argue that Mueller’s should not be exempt. Distinguishing a fully controlled taxable subsidiary of an exempt parent from a commercial enterprise conducted within the exempt organization and accounting for 98 percent of the organization’s revenue would seem to be matters of form that should not be treated differently in substance. The difference arose because Congress regarded the problem of the commercial enterprise’s taxable income (or exempt status) as having arisen from the destination of income test. The commercial enterprises argued that they were exempt based on the destination of their income, namely, a

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96. *Hearings on the Revenue Revision of 1942 Before the House Comm. on Ways and Means*, 77th Cong. (1942); *Report on the Revenue Bill of 1943 Before the House Comm. on Ways and Means*, Rpt. No. 871, 78th Cong. (1943); *Report on the Revenue Bill of 1943 Before the Senate Finance Comm.*, Rpt. No. 627, 78th Cong. (1943); *Revenue Revisions, 1947-48, Hearings Before the House Comm. on Ways and Means*, 80th Cong. (1947); *Revenue Revisions of 1950, Hearings Before the House Comm. on Ways and Means*, 81st Cong. (1950); *Revenue Revisions of 1950, Hearings Before the Senate Comm. on Finance*, 81st Cong. (1950).

97. *C.F. Mueller Co. v. Comm’r*, 190 F.2d 120 (3d Cir. 1951), *rev’g* 14 T.C. 922 (1950). The Second Circuit had applied the destination of income test to a taxable entity that contributed its net income to a § 501(c)(3) organization. *Roche’s Beach, Inc. v. Comm’r*, 96 F.2d 776 (2d Cir. 1938), *rev’g* 35 B.T.A. 1087 (1937). It is worth emphasizing that the Tax Court never followed the appeals courts in this matter.

98. *Hearings on Revenue Revision of 1950 Before the Comm. on Ways and Means of the House of Representatives*, 81st Cong. 579-80 (1950).



university or other exempt entity. In drafting the unrelated business income tax provisions, Congress took pains to distinguish UBIT from the destination of income test. The legislative override of the Supreme Court case that created the destination of income test has been interpreted, erroneously, to argue that the use of an exempt organization's resources is irrelevant to its exempt status. This is a logical leap that is inconsistent with the Congressional action. Congress thought it was addressing the issue of characterization of various income as unrelated business income, not addressing the question of the scope of the exempt activities conducted by an organization claiming to operate "exclusively" for an exempt purpose. One could argue that Congress should have addressed the question of the scope of permissible UBIT, but it might be excused for thinking that the "exclusively" standard in § 501(c)(3) was sufficient.

The Service, undoubtedly responding to insightful advocacy, intensified the confusion in its first public ruling on a case in which the exempt entity conducted its own commercial activities. In the Field Foundation ruling, Revenue Ruling 64-182, the service ruled that a § 501(c)(3) organization that derived its revenue from the rental of a large commercial building that it owned, and that used its revenue to make grants to other § 501(c)(3) organizations, was itself exempt because "it is shown to be carrying on through such contributions and grants a charitable program commensurate in scope with its financial resources."<sup>99</sup> The Service based this determination on the regulation permitting an exempt organization to conduct a substantial trade or business,<sup>100</sup> but made no reference to either that section's reference to the primacy of exempt activities or to the regulations defining the statutory concept "exclusively" as "primary."<sup>101</sup> It is difficult to determine how this pattern differs from the relationship between Mueller's and the New York University Law School. In each case, one entity earned revenue from commercial activities and directed its net revenue to one or more entities conducting exempt activities. The Service took the position that making contributions and grants constituted exempt activities. Accepting this argument should mean that Mueller's would qualify for exemption since it, in substance, made an annual contribution to the New York University Law School. One difference was that Mueller's did not characterize its payment as a contribution but as a dividend. The Service has never addressed the implications of this distinction.

The "commensurate in scope" standard could be reconciled with the concept that an organization is exempt only if it operates primarily for an exempt purpose. Doing so would require that the Service develop guidance regarding what criteria should be used. This, in turn, would require that the Service look directly at the activities conducted by the exempt organizations, and that it pay attention to the noun in determining

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99. Rev. Rul. 64-182, 1964-1 C.B. 186.

100. Treas. Reg. § 1.501(c)(3)-1(e) (as amended in 1990).

101. Treas. Reg. § 1.501(c)(3)-1(c) (as amended in 1990).

whether the adjective is appropriate. But, instead of offering this guidance, the Service has generally ignored the issue. By 1997 the Service ruled that an exempt organization that transformed itself into a bingo operator was exempt even though only one percent of its revenue was used for exempt activities.<sup>102</sup> The ruling states that the organization claimed that it devoted 50 percent of its time to conducting bingo operations and 41 percent of its time to conducting exempt activities.<sup>103</sup> There is no information in the ruling relating to the basis for these percentages or the implications of the admission that less than half of its time was devoted to exempt activities. Such issues would seem to be important in light of the minimal amount of its revenue devoted to exempt purposes. By 1998 the Service had reached the point of stating that cases about the extent of unrelated business activity should not be litigated because of the hazards of litigation.<sup>104</sup> This ruling did not rely directly on the commensurate in scope test, stating that this test had been used primarily in the case of organizations that did not conduct exempt activities directly but made contributions to other organizations conducting exempt activities. The basis for this distinction remains unexplored.

The difficulties presented by the “commensurate in scope” test for determining the exempt status of an entire organization become more acute when one tries to conceptualize the process of determining whether an organization that lobbies and engages in commercial activities should be exempt. Does one simply add the amount of money devoted to each? The amount of staff time (or staff and volunteer time) devoted to each? Are commercial activities that are “substantially related” to the organization’s exempt purpose for UBIT purposes properly treated as exempt or rather as commercial activities for purposes of the commensurate in scope test? Or does one simply ignore the entire issue so that the bingo operator model becomes the common model throughout the exempt sector? If one pursues this course, why should taxable entities that fund their own company foundations or make contributions to other exempt entities face the deduction limits currently imposed under § 170? The allowance for an insubstantial amount of private benefits adds yet another layer of complexity. How does one account for any such private benefit that does not in itself jeopardize exempt status? Is it aggregated with other activities that do not in themselves support exemption? Under this approach, an insubstantial amount of private benefit would not jeopardize exempt status unless the organization also engaged in enough UBIT, together with enough lobbying, to produce a different result.

These puzzles have no resolution in current law. Indeed, these questions are never asked. Once they are asked, there is no coherent basis for determining whether an exempt organization is operating exclusively for

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102. Tech. Adv. Mem. 97-11-003 (Nov. 8, 1995).

103. The organization did not conduct exempt activities directly, but, like the Field Foundation, made contributions to other § 501(c)(3) organizations.

104. Field Serv. Adv. 19991007 (Nov. 24, 1998).

an exempt purpose. In short, the statutory requirement has become a nullity. This is the basis of charitable inefficiency under current law. The difficulty of suggesting that the concept of an exempt organization has any meaning under current law can be illustrated by the following hypothetical. An organization uses 40 percent of its revenue to increase its unrelated business activity, 20 percent for lobbying, and 15 percent for issue ads during a presidential campaign. Such an organization would in all likelihood be exempt under current law.

Even if these issues of characterization and scope were resolved, diversion would continue (albeit on a reduced scale), and the exemption would continue to be inefficient. The response proposed here is to apply a nondiversion constraint at the level of particular activities funded from particular sources of revenue and forego any attempt to determine how to define an exempt organization as an entity.

#### IV. MAPPING PATTERNS OF DIVERSION

If an exempt organization is understood as an aggregate of transactions through which various sources of revenue are used to fund particular activities, each with a distinctive relationship to exemption, the next step is to map the intersections of sources and uses of revenue inside § 501(c)(3) public charities. Figure 1 presents such a map. The patterns of diversion noted in Figure 1 highlight transactions that define charitable inefficiency and, in certain cases, abuse of the nonprofit, tax-exempt form.

Figure 1: Patterns of Diversion

		Uses of Revenue			
		Exempt Activities	Commercial Activities	Lobbying	Electoral Politics
Sources of Revenue	§ 170 Contributions	<i>Charity</i>	<i>Diversion</i>	<i>Diversion</i>	<i>Diversion</i>
	Program Revenue	<i>Market Charity</i>	<i>Diversion</i>	<i>Diversion</i>	<i>Diversion</i>
	Private Foundation Grants	<i>Charity</i>	<i>Diversion</i>	<i>Diversion</i>	<i>Diversion</i>
	Commercial Activities	<i>Internal Contribution</i>	<i>Reinvestment</i>	<i>§ 162(e)</i>	<i>§ 162(e) and FECA Prohibition</i>
	Government Funding	<i>State Charity</i>	<i>State Capitalism</i>	<i>Prohibited as Government Subsidy</i>	<i>Prohibited as Government Subsidy</i>

Characterizing certain intersections of sources and uses as diversions leads to the question: diversion from what? In the case of § 501(c)(3) organizations, the answer is more complex than simply a diversion from the purposes enumerated in § 501(c)(3). The broader concept based on the structure of exemption is that the diversion in question is a diversion from the provision of a public benefit to a class of charitable benefi-

ciaries. This is the purpose of structuring § 501(c)(3) organizations as recipients of deductible charitable contributions under § 170.

Mapping diversion from the provision of a public benefit to a charitable class of beneficiaries provides the empirical basis for examination of the claim that all sources of income are used for exempt activities. The claim that charitable use of the revenues justifies engaging in a broad range of commercial activities becomes more difficult to sustain when it becomes clear that the commercial activities may be funded with deductible charitable contributions, or private foundation grants, or program service revenue. There is no barrier to any of these patterns of diversion under current law. The question addressed here is whether such uses are consistent with charitable efficiency or whether exemption should be more carefully targeted to activities that are more directly related to the exempt purposes that provide the basis for exemption and the charitable contribution deduction.

The approach to mapping taken here is to examine the patterns that emerge from devoting each of the five sources of income to each of the four uses. This exercise begins with charitable contributions, then considers, in order, program service revenue, private foundation grants, commercial activities, and government grants. Other categories might be used, but these sources of revenue capture the primary sources of revenue for § 501(c)(3) organizations.

#### *Uses of Charitable Contributions*

The category of deductible contributions encompasses contributions from all types of contributors, including taxable corporations and foreign persons, both natural and corporate. Distinctions among contributors create no technical or policy issues when the contributions are used to support exempt activities. Distinctions among contributors do create technical and policy issues when they are used for legislative lobbying or for electoral campaign activities.

The use of contributions for commercial activities is a clear case of diversion. Current law imposes virtually no tax on commercial activities and there is no guidance on the issue of how much unrelated business income is consistent with exempt status apart from the general requirement that activities that further the organization's exempt purposes must be the organization's primary activity.<sup>105</sup>

Under current law, § 501(c)(3) organizations may engage in some amount of lobbying. Again, the scope is uncertain, especially under the "no substantial part" test.<sup>106</sup> Whatever amount of lobbying is permissible, lobbying is not an exempt activity that itself supports exemption as

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105. For a discussion of the commensurate in scope standard, see *supra* Part III.B.

106. Two tests are the "substantial part" test of Treas. Reg. § 1.501(c)(3)-1(c)(3) and the "expenditure" test of § 501(h) and § 4911. See Treas. Reg. § 1.501(c)(3) (as amended in 1990); I.R.C. § 501(h) (2002); I.R.C. § 4911 (2002). See TAXATION OF EXEMPT ORGANIZATIONS, *supra* note 4, at ch. 5.

an organization described in § 501(c)(3).<sup>107</sup> There is no requirement that lobbying be on legislation related to the organization's exempt purposes.

Because lobbying is not an exempt activity and there is no requirement that lobbying be limited to issues related to the organization's exempt purpose, one might treat any amount of lobbying using deductible charitable contributions as a diversion. On the other hand, one might treat a level of lobbying consistent with exempt status as a quasi-exempt use but not a diversion. One might wish to refine the concept by treating lobbying on issues related to the organization's exempt purpose as an exempt activity for purposes of mapping patterns of diversion. Because excess lobbying is inconsistent with exempt status, any amount of deductible charitable contributions used to fund excess lobbying should be treated as a diversion. Conceptualizing exempt organizations as aggregates of transactions and mapping patterns of diversion permits a more nuanced analysis of lobbying than simply treating it as either entirely consistent with exemption or entirely inconsistent with exemption.

Electoral campaign activities present a characterization dilemma.<sup>108</sup> Much of the electoral activity of § 501(c)(3) organizations takes the form of print or mass media "issue ads" that have elements of public education as well as participation or intervention in a political campaign and perhaps even legislative lobbying.<sup>109</sup> The Service has issued no precedential guidance in this area for more than twenty years, during which time the entire manner of financing and conducting electoral campaigns has been transformed by the increased importance of soft money and the efforts to limit it.<sup>110</sup> Some activities that shape electoral outcomes qualify as exempt activities. The result is that what are in substance campaign contributions qualify for the § 170 charitable contribution deduction and evade the limitations and disclosure requirements of federal election law.<sup>111</sup>

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107. Lobbying is an exempt activity for § 501(c)(4) organizations, but § 504 provides that a § 501(c)(3) organization that loses its exempt status due to excessive lobbying cannot restructure itself as a § 501(c)(4) organization. I.R.C. § 501(c)(4) (2002); I.R.C. § 504 (2002).

108. For a detailed discussion of these characterization issues, see TAXATION OF EXEMPT ORGANIZATIONS, *supra* note 4, at ch. 6.

109. For an analysis of these overlapping characterizations and the issues that arise with respect to these intersections, see Hill, *Softer Money*, *supra* note 3.

110. Rev. Rul. 78-284, 1978-1 C.B. 154; Rev. Rul. 80-282, 1980-2 C.B. 178. The Service has issued two nonprecedential articles in its Continuing Professional Education Text. See Judith Kindell & Jack Reilly, *Election Year Issues*, in *Internal Revenue Service Exempt Organizations Continuing Professional Education Technical Instruction Program*, reprinted in 94 TAX NOTES TODAY 70-28 (1994); Judith Kindell & John Francis Reilly, *Election Year Issues*, in *Internal Revenue Service Exempt Organizations Continuing Professional Education Technical Instruction Program*, reprinted in 2001 TAX NOTES TODAY 193-50 (2001).

111. There is nothing particular new in these issues. They date to at least the 1988 general election, when several candidates had used § 501(c)(3) organizations to raise deductible contributions from core contributors. This technique became quite controversial after the House of Representative imposed a sanction on then-Speaker Newt Gingrich. See generally *House Comm. on Ethics, In the Matter of Representative Newt Gingrich*, H.R. REP. NO. 105-1 (1997). In perhaps the most inexplicable ruling position it has ever taken in this area, the Service ruled that an organization which served as the funding structure for the activities that led to Gingrich's difficulties did not engage in prohibited political cam-

This means that foreign persons, corporations, unions, and otherwise qualifying contributors who have reached the contribution limitation imposed by federal election law may turn to a § 501(c)(3) organization as a vehicle for so-called issue ads and a broad range of other forms of support for candidates for public office.

In this case, diversion within the organization becomes a means of using one statute to avoid and evade the requirements of another. Any intersection of two or more statutes creates opportunities for “statutory arbitrage” of this kind. This issue is perhaps the most difficult issue facing § 501(c)(3) organizations. To the extent that § 501(c)(3) organizations become the favored structure for electoral abuse, it will be difficult for § 501(c)(3) organizations to claim that their favored tax status is based on the public good that they uniquely provide.

Even without the opportunities for statutory arbitrage, electoral activity is a diversion. As in the case of legislative lobbying, there is no requirement that even permissible types of electoral activity be substantially related to an organization’s exempt purpose or purposes. Any effort to craft such a requirement would fail because candidates take so many shifting positions on so many issues. Therefore, there would be no reliable basis for determining whether any candidate’s actual positions at the time of a particular vote or even legislative debate would be consistent with any one organization’s exempt purposes.<sup>112</sup>

Certain forms of electoral activity are prohibited and, in theory, engaging in such activities results in revocation of exemption. The Service has been reluctant to revoke exemption on these grounds. Congress responded to this reluctance by imposing an excise tax on the organization and its managers in cases of excess political activity.<sup>113</sup> The § 4955 excise tax presents the logical conundrum of allowing an organization to engage in prohibited activity if it pays a toll charge in the form of an excise tax.<sup>114</sup>

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paigned activity. See Tech. Adv. Mem. (unreleased), *reprinted in* 1999 TAX NOTES TODAY 24-25. This ruling has never been released as a published private letter ruling because it resulted in no change in the status of the organization. The Service’s position was crafted by the National Office after the Baltimore District Office had recommended that the Progress and Freedom Foundation be found to have engaged in prohibited political activity. See Memorandum from Paul G. Accettura, Chief Counsel’s Office, Employee Benefits and Exempt Organizations, to Diane Crosby, District Counsel’s Office, Delaware-Maryland District (May 3, 1997) (responding to a draft adverse letter ruling), *reprinted in* 2000 TAX NOTES TODAY 51-16 (2000); see also Memorandum from Sarah Hall Ingram, Associate General Counsel, Employee Benefits and Exempt Organizations, to the District Counsel, Delaware-Maryland District (December 30, 1997) (disagreeing with a proposed adverse position), *reprinted in* 2000 TAX NOTES TODAY 51-17 (2000).

112. There are good reasons apart from purely tactical considerations for candidates to take such positions. Legislatures work through accommodation and the formation of shifting coalitions.

113. Section 4955, which was added to the Code in the Revenue Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 (1987).

114. Section 4958 raises the same issues with respect to inurement and excessive amounts of private benefit, both of which in theory not only support but require denial or revocation of exemption.

At the same time, it is an example of taxing an activity rather than revoking the exemption of the entire organization.

### *Uses of Program Service Revenue*

Program service revenue is revenue earned by performing the exempt activity that forms the basis for the organization's exemption. Patient fees charged by hospitals and tuition charged by educational institutions are the leading examples of program revenue. Like charitable contributions, program service revenue can be used for any of the activities that an exempt organization performs. Use of program service revenue for the exempt activity that produces the revenue is a form of market charity, but it is not a diversion.

Mapping the sources and uses of money helps clarify the confusion that has arisen from describing organizations that generate program service revenue as "commercial nonprofits." This term conflates the idea of diversion with the concept of convergence. If program service revenue is used to fund the exempt activity producing such revenue, then there is no diversion, but instead a reinvestment in exempt activity. If program service revenue is used for commercial activities there is diversion. Diversion depends on the use of the revenue, not on the commercial form of a sale of services that defines the transactions through which program service revenue is earned. This paradigmatic diversion is obscured by the term "commercial nonprofit," which is based on the form of the transaction through which the revenue is earned, not on the use of the revenue. This distinction is never considered if organizations are treated as entities and there is no analysis of the uses of revenue inside the entity.

The analysis of diversion of program service revenue for legislative lobbying parallels the analysis of the use of charitable contributions for legislative lobbying. Similarly, analysis of the funding of electoral campaign activities with program service revenue parallels the analysis of the diversion involved in funding such activities with charitable contributions. In both cases, however, there is one difference that relates to issues of monitoring and accountability. Program service revenue is not a voluntary contribution, but rather a purchase of a benefit. Patients at a hospital or students at a university are not contributors who can withdraw their contributions at no cost to themselves. In this sense, contributors have greater discretion to take action in the event of diversion, if they learn of or even suspect diversion, than do patients or students. Tuition-paying students or fee-paying patients are more like members of a business league who join for economic reasons and then find that the organization is using their dues to support candidates whom they themselves may not support. The students or patients have few, if any, options to acquire the services they are purchasing from another provider. In this situation, the Supreme Court has held that the use of the organization's treasury funds for political campaign activity is an impermissible diversion of funds from

the organization's exempt purpose.<sup>115</sup> If an organization's sole purpose is to take positions on a well-defined issue, then the Court has not found the same diversion from the organization's exempt purpose. In effect, the Court found that the political activity was related to the organization's exempt purpose, although it did not base its decision on this reasoning, but rather found that members could leave the organization with no cost to any other interest related to the organization's exempt purpose.<sup>116</sup>

#### *Uses of Private Foundation Grants*

Private foundation grants differ from § 170 contributions in the sanctions imposed on the contributing private foundation in cases where uses of the grant by the recipient organization are inconsistent with the requirements of § 501(c)(3) and the private foundation requirements. This pattern of sanctions is a limited indirect form of a nondiversion constraint. The sanctions fall on the private foundation, however, and not on the § 501(c)(3) recipient organization that actually engaged in the diversion.

Private foundations may fund the exempt activities of § 501(c)(3) public charities. The consequences to the private foundation for funding commercial activities are less clear. Private foundations themselves are subject to limitations on their investment strategies and their commercial investments that do not apply to public charities.<sup>117</sup> Private foundations may invest in program-related investments that are commercial in both form and substance and still achieve an exempt purpose.<sup>118</sup>

Clearer limitations apply in the case of lobbying and political activity.<sup>119</sup> Section 4945(d)(1) provides that a private foundation may not, directly or indirectly, engage in legislative lobbying. The lobbying regulations applicable to public charities that receive grants from private foundations contain rules aimed at ensuring that private foundations that fund public charities that lobby are not treated as having made taxable expenditures based on the lobbying activities of the public charities.<sup>120</sup> Section 4945(d)(1) contains quite broad exceptions that have the effect of confining the definition of lobbying for this purpose to activities centering on actual contact with legislators and their staffs.<sup>121</sup> The sanctions applicable under § 4945(d)(1) apply only to the private foundation providing the funding, and not to the public charity using the funds for activities triggering the sanctions. In this sense, the sanctions are misplaced and

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115. See *Austin v. Mich. State Chamber of Commerce*, 494 U.S. 652 (1990); *Communications Workers v. Beck*, 487 U.S. 735 (1987).

116. *FEC v. Mass. Citizens for Life*, 479 U.S. 238 (1986).

117. These requirements are the jeopardizing investments provisions of § 4944 and the excess business holdings provisions of § 4943.

118. I.R.C. § 4944(c); Treas. Reg. § 53.4944-3.

119. Because public charities have become so dependent on private foundation grants, certain public charities argue that limitations on advocacy using private foundation funding either do not exist or should be eliminated.

120. Section 4945 imposes an excise tax on such taxable expenditures.

121. Treas. Reg. § 53.4945-2(d) (as amended in 1990).



inefficient because the private foundation faces considerable barriers to monitoring.<sup>122</sup>

Section 4945(d)(2) contains parallel rules relating to electoral campaign activities. If a private foundation funds a public charity that engages in electoral campaign activities that a private foundation could not engage in directly, the private foundation will be treated as having made a taxable expenditure.<sup>123</sup> Here, too, there are quite broad exceptions for nonpartisan voter registration and nonpartisan assistance to voters in reaching the polls.<sup>124</sup> Under § 4945(d)(2) the sanctions fall on the private foundation that funded the taxable expenditure, not on the public charity that used the funds for the activity triggering the sanction. Responsibility for preventing impermissible uses by grant recipients is placed on the private foundation making the grant. This prevents collusion between the private foundation and the recipient organizations, but it does not address diversion by the public charity.

### *Uses of Revenue from Commercial Activities*

Revenue from commercial activities can also be used for any of the activities undertaken by the exempt organization earning the commercial revenue. Commercial activities are both sources and uses of revenue. It may seem incongruous to refer to diversion in the case of commercial revenues. The diversion framework applies, however, due to the rationale commonly advanced for not limiting the amount of commercial activity that is consistent with exempt status. The rationale is based on the assertion that revenue from commercial activities is used for the organization's exempt activities. This claim would treat both commercial activities and program service revenue as forms of self-funding. It is generally not possible to prove or disprove this assertion. Mapping the sources and uses of money and crafting a nondiversion constraint that addresses patterns of diversion will provide information on the empirical basis for such a claim and apply sanctions in cases in which it is not correct. The rationale is described by the shorthand of an internal contribution here.<sup>125</sup> If, however, the commercial activities lose money or simply break even, there is no revenue to distribute to exempt activities.<sup>126</sup>

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122. See Part II for a discussion on organizational opacity and limits on disclosure. Also see Part V for a discussion of whether the nondiversion constraint should be directed at the organization or its officers and directors or both.

123. See TAXATION OF EXEMPT ORGANIZATIONS, *supra* note 4, ¶ 11.03 (discussing taxable expenditures that do not satisfy the minimum distribution requirements of § 4942).

124. *Id.* at ¶ 11.03[3].

125. One might also describe it as an internal destination of income concept. It parallels the claim pursued successfully in *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924). Current law, however, provides a § 170 deduction and not an exemption from tax.

126. The Business Venture Division of the Smithsonian Institution experienced substantial losses during the past fiscal year, and such losses resulted in staff cuts and adverse effects on exempt activities. See Jacqueline Trescott, *Smithsonian Hurt by Drop in Tourism*, WASH. POST, Sept. 28, 2002, at C1.

Reinvestment of profits in the commercial enterprise is treated here as a diversion. In this sense, it contrasts with the reinvestment of program service revenue in the exempt activity that produced it. One response to this analysis is to say that reinvestment may only defer the internal contribution. In this sense, the case of commercial revenue raises the same deferral issue raised by endowments or by set-asides. At the same time, reinvestment in the exempt organization's commercial activities introduces an element of indirectness that distinguishes such reinvestment in commercial activities from a set-aside by a private foundation for a particular identified exempt activity.<sup>127</sup>

The use of commercial revenue for lobbying in some aspects parallels the prior analysis of lobbying. It also, however, raises the issue of comparison with the treatment of lobbying expenses incurred by taxable enterprises. This is an appropriate comparison because both organizations have engaged in the same kind of market transactions to produce the income. Conceptualizing an exempt organization as an aggregate of transactions—as a nexus of the multiple sources and uses of revenue rather than as undifferentiated entities—facilitates this comparison. Taxable entities may not deduct their lobbying expenses as ordinary and necessary business expenses, even if the legislation in question relates directly to the corporation's business.<sup>128</sup> Dues paid to a trade association are not deductible to the extent that the trade association incurs lobbying expenses.<sup>129</sup> In the case of a § 501(c)(3) organization, in contrast, commercial revenue is not subject to any tax because it falls outside the narrow definition of the unrelated business income tax that can be used to fund lobbying with respect to legislation, whether or not such legislation is related to the exempt organization's exempt purpose. Based on the preceding analysis, this is diversion.

The use of revenue from commercial activities for electoral campaign activities is also a diversion and presents a contrast with the treatment of commercial revenue generated by taxable entities, including those engaged in the same kind of commercial activities. The use of commercial revenue for election activity should be subject to the same FECA prohibitions that apply to taxable entities.

#### *Uses of Revenue from Government Grants and Contracts*

Government grants and contracts generally require accounting that matches the government funding with approved uses and separate accounting for the funds.<sup>130</sup> The use of government funds for exempt activities is labeled here state charity, and the use of government funds for

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127. Section 501(c)(3) public charities have no such provision because they are not subject to the minimum distribution requirement applicable to private foundations under § 4942.

128. I.R.C. § 162(e) (2002).

129. I.R.C. § 162(e)(3); Treas. Reg. § 1.162-28.

130. OFFICE OF MGMT. & BUDGET, CIRCULAR A-110 (as amended in 1999), available at <http://www.whitehouse.gov/omb/circulars/a110/a110.html>.

commercial activities is labeled state capitalism. Use of government funds for lobbying is prohibited.<sup>131</sup> The FECA prohibits contributions or independent expenditures from corporations that are government contractors, although it is far from clear that this prohibition encompasses all forms of issue advocacy that has the result and the intention of influencing electoral outcomes.

## V. TARGETING EXEMPTION THROUGH A NONDIVERSION CONSTRAINT

Tax expenditure analysis treats tax benefits as the equivalent of direct expenditures in terms of their impact on government budgets.<sup>132</sup> The § 170 charitable contribution deduction is treated as a tax expenditure in the annual tax expenditure budgets, but the § 501(a) exemption has never been treated as a tax expenditure for this purpose. Nevertheless, the Supreme Court has brought both the § 170 charitable contribution deduction and the § 501(a) exemption within the analytical framework of tax expenditure analysis by treating both as government subsidies.<sup>133</sup>

Much of the discussion of tax expenditures focuses on whether tax-based programs operate as efficiently as direct expenditure programs. In her thoughtful consideration of the earned income tax credit, Anne Alstott pointed out that using tax-based programs rather than direct government expenditures raises issues of accuracy, responsiveness, and compliance.<sup>134</sup> She concluded that a tax-based system resulted in "less accurate targeting" than did direct payments.<sup>135</sup> The issue raised here is which tax regime targets the benefits of exemption to exempt activities by differentiating among the various types of activities conducted by contemporary exempt organizations.

The nondistribution constraint as expressed for tax purposes in the three private benefit doctrines represents a general anti-abuse provision that provides little basis for monitoring the most relevant aspects of the organization. The nondiversion constraint proposed here represents an effort to target the tax benefit rather than simply to rely on the more general organization-level anti-abuse approach.<sup>136</sup> The purpose of targeting is not to deny exemption to entire organizations but to create tax-based incentives to use the charitable contribution deduction and the ex-

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131. The sponsor of this legislation had originally tried to prohibit any lobbying by an organization that received government funds.

132. Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970); Stanley S. Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Government Assistance*, 84 HARV. L. REV. 352 (1970).

133. *Regan v. Taxation with Representation*, 461 U.S. 540 (1983).

134. Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of a Tax-Based Welfare Reform*, 108 HARV. L. REV. 593 (1995).

135. *Id.* at 589.

136. For an earlier consideration of targeting that focused on the § 170 charitable contribution deduction, see Paul R. McDaniel, *Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction*, 27 TAX L. REV. 377 (1972).

emption to direct resources to exempt activities. This is the essence of charitable efficiency.

The technical tax mechanism for a nondiversion constraint depends on looking inside an exempt organization to take account of the internal transactions by which revenue from particular sources is committed to particular uses.<sup>137</sup> Targeting exemption depends on providing more favorable tax treatment for revenues used for exempt activities than for revenues used for activities that are merely consistent with exempt status or for activities that are inconsistent with exempt status.

The initial issue is whether the sanctions should fall on the sources of revenue or on the organization or on the organization managers.<sup>138</sup> This article defines the problem as information asymmetry arising from the opacity and hierarchy of exempt organizations. Hansmann also defined the problem as information asymmetry, but did not link it as directly to organization managers as this article does. As Hansmann noted, the purpose of a nondistribution constraint is to give contributors confidence that their contributions will be used as warranted by the organization. That is also one of the purposes of a nondiversion constraint. Contributors who give money to an organization for its exempt activities may not want the organization to use the money to support its taxable subsidiary, legislative lobbying, or election campaign activities. Under current law, contributors have no right to monitor the use of their contributions absent a specific agreement with the organization. Agreements regarding particular uses are negotiated with respect to large contributions, but not with respect to average contributions. The controversies that erupted around the use of funds that contributors thought had been solicited on behalf of the September 11th victims offers the clearest case of contributor disaffection that we have seen. Many of these controversies continue without any resolution satisfactory to the contributors or the intended beneficiaries.

In addition to Hansmann's expressed concern with contributors' confidence in exempt organizations, there is an issue virtually unexplored in the academic literature relating to exempt organizations or in policy discussions relating to exemption, namely, the confidence that beneficiaries have in exempt organizations. These issues are most evident in cases of clearly identified beneficiaries. The September 11th victims and their families are one such charitable class, and it is not surprising that they have demanded a role in the administration of funds collected for their benefit. It is also not surprising that a storm of controversy erupted over Congressional testimony given by the Service suggesting that benefi-

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137. The model developed above identified twenty such transactions. As noted in that discussion, it would be possible to divide certain categories, which would increase the number of transactions, or to combine some or all of the categories of non-exempt uses, which would reduce the number of transactions.

138. The organization itself becomes a source of revenue when it engages in revenue-producing commercial activities.

ciaries have no legitimate role in monitoring exempt organizations.<sup>139</sup>

The opacity and lack of accountability of most exempt organizations support placing sanctions on the organization and its managers, not on contributors. By imposing the tax on the organization and its managers, innocent contributors are protected from the loss of a charitable contribution deduction where they are powerless to prevent the diversion of their contribution. Except in cases of collusion, which may occur most commonly in cases involving political activities, the diversion occurs at the level of the organization and at the behest of organization managers. In the case of any diversion of charitable contributions that qualify for the § 170 charitable contribution deduction, an excise tax will apply to organization managers on the model of § 4955 or § 4958 as well as a transfer tax payable by the organization.

Once it has been decided to place sanctions on the user of the revenue, the next question becomes whether the organization itself, the organization managers, or both should be subject to sanctions. This article, having identified information asymmetry as the fundamental problem, opts for placing sanctions on both the organization and its managers. Section 4958 sanctions only managers and disqualified persons, the two parties to an excess benefit transaction. Section 4955, in contrast, sanctions both the organization and its managers, apparently on grounds that the organization's resources have been diverted to prohibited uses, in this case, prohibited electoral campaign activity. The nondiversion constraint follows the reasoning of § 4955 in this respect.

Crafting the elements of a nondiversion constraint applicable to the organization and its managers begins with the accounting requirement that revenue from each of these five sources be placed in separate accounts and that the four distinct types of activities also be funded from separate accounts. An organization could then have up to nine accounts—five source accounts and four use accounts. The degree of accounting complexity reflects and is determined by the organization's operational complexity. Small organizations are less likely to have multiple sources of revenue used for multiple activities than are large organizations, thus the administrative burden on small organizations should not be a barrier to considering a nondiversion constraint. At the same time, it should be possible to define a small organization exception at some reasonable level of average annual resources.

The purpose of these two accounting requirements is to permit tracking of transfers from a source account to a use account. This is the accounting basis of operational transparency and the informational predicate of organizational accountability. This kind of accounting permits an organi-

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139. *Response by Charitable Organizations to the Recent Terrorist Attacks: Hearing Before the House Comm. on Ways and Means*, 107th Cong. (2001) (statement of Steven Miller, Tax Exempt Government Entities Division, Internal Revenue Service). The Service almost immediately moderated its position. I.R.S. Notice 2001-78, 2001-50 I.R.B. 1 (accompanied by a Statement of Commissioner Charles O. Rossotti (Nov. 16, 2001), reprinted in 2001 TAX NOTES TODAY 223-71 (2001)).

zation to provide evidence that revenue from its commercial activities is in fact used to fund exempt activities. It also permits the organization managers to document the economic performance of their commercial ventures as well as the organization's ability to sustain them without diverting resources from the organization's charitable mission. In this sense, a nondiversion constraint is a management tool that well-managed exempt organizations should already be using.<sup>140</sup>

The operational transparency resulting from this kind of accounting would enable board members of large and small organizations to perform their roles more effectively. It would be clear to all the board members, most of whom will not be accountants or lawyers, how the charitable contributions are being used, how the revenue from commercial activity is being used, how private foundation grants are being used, and how government contract or grant funds are being used. None of this information is available in comprehensible form if accounts are commingled. Tracking transfers permits a test of the common justification of commercial activities in terms of the use of the funds for exempt purposes. If, and to the extent, that this proves to be the case, that transaction can be identified and the appropriate tax treatment applied to it.

If the first step in crafting a nondiversion constraint is to identify specific transactions between source accounts and use accounts within the organization, the next step is to design a series of tax sanctions for diverting revenue to nonexempt uses. Targeting tax exemption means that exempt uses should be tax-favored and all other uses should be, to some degree, disfavored in their tax treatment. This regime of targeting can be achieved with a series of transfer taxes imposed on transfers from source accounts to use accounts within the organization. The transfers that arise under the analytical framework developed here are listed in Figure 2. The following discussion parallels the prior discussion of mapping diversion by discussing transfers from each source of revenue to each of the four uses identified here.

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140. In the wake of the financial scandals involving the United Way of the National Capital Area, the president and chief executive officer of the United Way of America announced that the organization has adopted new accounting procedures "making it easier for donors and the public to understand our financial practices." He also noted that donors now want detailed accounting information before they will entrust their funds to an organization. See Peter Woriskey, *National United Way Sets Fiscal Changes: Local Group Told to Alter Accounting*, WASH. POST, Oct. 15, 2001, at B01.

Figure 2: Transactions Identifying Exempt Activities and Diversions

1. Charitable contributions used for exempt activities;
2. Charitable contributions used for commercial activities;
3. Charitable contributions used for legislative lobbying;
4. Charitable contributions used for political campaign activities;
5. Program service revenue used for exempt activities;
6. Program service revenue used for commercial activities;
7. Program service revenue used for legislative lobbying;
8. Program service revenue used for political campaign activities;
9. Commercial revenue used for exempt activities;
10. Commercial revenue used to support commercial activities;
11. Commercial revenue used for legislative lobbying;
12. Commercial revenue used for political campaign activities;
13. Foundation grants used for exempt activities;
14. Foundation grants used for commercial activities;
15. Foundation grants used for legislative lobbying;
16. Foundation grants used for political campaign activities;
17. Government grants used for exempt activities;
18. Government grants used for commercial activities;
19. Government grants used for legislative lobbying;
20. Government grants used for political campaign activities.

*Transfer Taxes on Uses of Charitable Contributions*

This system operates most clearly in the case of charitable contributions. Any charitable contributions used for exempt activities will not be subject to an internal transfer tax. An organization that receives contributions and uses them for its exempt activities will have one source account and one use account. Any amounts in the source account not used currently will be held as an endowment.<sup>141</sup>

Charitable contributions used for commercial activities will be subject to transfer taxes at the point that revenue is transferred from the contributions source account to the commercial use account. This is the essence of the nondiversion constraint. The current tax regime imposes no tax on the non-exempt use but does impose a tax on revenue earned from commercial ventures. The tax is imposed only in the increasingly rare event that the commercial activity cannot be characterized in a way that eludes characterization as unrelated business income or falls within one of the numerous modifications and exceptions to the definition of unrelated taxable income.

Even if the revenue is characterized as unrelated business income, the unrelated business income tax is a perverse incentive to using funds for exempt activities because it provides the greatest subsidy to poorly run

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141. Endowments raise questions of deferred use for future exempt activities. But endowments represent the same issue of diversion as do current accounts. This issue is addressed in the private foundation provisions that require that set asides be designated for identified exempt activities. The endowments of public charities might be subject to this requirement. Taxable entities are also subject to some limitation on accumulation through the § 531 accumulated earnings tax.

commercial enterprises. If the commercial activities generate no revenue, there is no tax. Taxing revenue does not address the original diversion transaction.

This article focuses on the proposition that even if the internal problem of the unrelated business income tax were addressed, the diversion issue would remain. While more revenue resulting from commercial activities would be taxed, the diversion transfer, which is the core of charitable inefficiency, would remain unaddressed and the exemption would remain untargeted and inefficient. If a § 501(c)(3) organization transferred its revenue from charitable contributions to an unrelated taxable entity, that transfer would be inconsistent with continued exempt status, unless the § 501(c)(3) transferor could establish that the taxable entity was achieving the same exempt purpose that the charitable entity was achieving.

The limits of this reasoning are posed by two hypotheticals involving transfers by Harvard University of its alumnae/i contributions to taxable entities.<sup>142</sup> In the first case, Harvard transfers its alumnae/i contributions to the John Deere Company, a taxable manufacturer of farm machinery and lawn mowers. In the second case, Harvard transfers its alumnae/i contributions to the University of Phoenix, a taxable university. Apart from the likely uproar from the Harvard alumnae/i, the Service would have a problem identifying what is wrong under current law. There is no private benefit from the transfer itself in either case, even though the additional revenue received from Harvard might be used by the taxable recipients to distribute dividends or increase staff salaries. In the second case, assuming that the University of Phoenix invested the capital contribution in its educational activities, would the use of the funds for an activity that is one of the enumerated § 501(c)(3) purposes mean that Harvard was engaging in an exempt activity through the University of Phoenix? Why does this transaction seem inconsistent with Harvard's continued exemption?

Charitable contributions used for legislative lobbying, which under current law includes initiative and referendum campaigns, also represent a form of diversion, but the diversion is less clear than it is in the case of commercial activities. Legislative lobbying is a permissible activity, within limits, but not an exempt activity for a § 501(c)(3) organization. This means that a § 501(c)(3) organization cannot be organized solely or primarily for legislative lobbying. At the same time, because § 170 is written in terms of contributions to particular types of organizations, there is no limitation on the use of deductible charitable contributions for legislative lobbying. Arguably, legislative lobbying implicates issues of democratic participation that transcend tax issues. But, at the same time, as the Supreme Court held in *Taxation with Representation*, exemption

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142. Such a transfer would be treated as a capital contribution to the taxable entity by a non-shareholder, assuming Harvard held no stock in either corporation, within the meaning of § 118 and Treas. Reg. § 1.118-1. If Harvard held stock in the taxable entity, the capital contribution would increase its basis in its existing shares.



represents a subsidy, and conditions on the terms under which that subsidy is granted are not an impermissible burden on the First Amendment rights of speech and association.<sup>143</sup>

Two approaches to the transfer tax in the event of lobbying would help achieve the appropriate balance between democratic participation and subsidy concerns. One would be to determine a meaningful limit on lobbying expenditures. Section 501(h) takes such an approach, but few organizations make the § 501(h) election. Some organizations fear that making the election might increase the possibility of audit, although the Service has said repeatedly that this is not the case. Large organizations find the \$1 million cap restrictive and prefer to rely on the indeterminacy of the "no substantial part" test. One approach might be to make the § 501(h) expenditure test mandatory while permitting large organizations to exceed the \$ 1million cap by some percentage of the amount used for exempt activities subject to a transfer tax on that excess amount. The second approach might be to consider a substantially related test for lobbying activities. Some might object that this would constrain logrolling in legislative lobbying, but a rejoinder is that § 501(c)(3) organizations should be pressing their information and point of view, not hiring staff to push a broad political agenda of a particular political party or faction of a political party unrelated to the organization's exempt purpose.

Election campaign activities are prohibited under current law as inconsistent with the exempt status of § 501(c)(3) organizations. At the same time, the possibility of offering core supporters the tax benefit of deductible contributions while avoiding the limitations and disclosure requirements of federal election law remains a tantalizing prospect for incumbents and challengers alike.<sup>144</sup> In this case, the Code already contains a confiscatory excise tax on such activity. Section 4955 was enacted because Congress understood that § 501(c)(3) organizations were being used to give contributors a charitable contribution deduction while avoiding the limits and requirements of the FECA. Section 4955 applies to revenue from any source, not simply revenue from charitable contributions. In cases of collusion, the Service can deny contributions their § 170 deductions. However, many contributors will be innocent victims of diversion for whom penalties are inappropriate. Section 4955 could be amended to increase the rate of sanctions in the case of the diversion of charitable contributions revenue.

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143. *Regan v. Taxation with Representation*, 461 U.S. 540 (1983). For a discussion of subsidy theory, see *TAXATION OF EXEMPT ORGANIZATIONS*, *supra* note 4, at ¶ 5.02. For a discussion of the concept of unconstitutional conditions, see Kathleen Sullivan, *Unconstitutional Conditions*, 102 HARV. L. REV. 1415 (1989).

144. The controversy surrounding Newt Gingrich's use of § 501(c)(3) organizations to fund electoral activity made use of these structures too controversial for many politicians. See *supra* note 110. Pressures of the new Bipartisan Campaign Reform Act may lead politicians to take another look. They are already forming § 501(c)(4) organizations to avoid disclosure under the FECA or § 527(i).

*Transfer Taxes on Uses of Program Service Revenues*

Program service revenues should be subject to the same transfer taxes as those applied in the case of charitable contributions. The only rationale for charging a fee for providing the services that provide the basis of the organization's exemption is to enable the organization to continue to provide such services. The organization is not diverting financial resources or staff time from its exempt activities, which distinguishes program revenue from revenue earned from commercial activities.

*Transfer Taxes on Uses of Private Foundation Grants*

Private foundation grants are already subject to substantial limitations on use imposed as a condition of receipt by a public charity.<sup>145</sup> Private foundations that give grants used for purposes other than exempt activities are subject to a series of excise taxes, but the recipient organizations that in fact divert the grant from the promised use for exempt activities face no sanctions apart from jeopardizing their prospects for funding from a particular foundation in the future. Consistent with targeting within the recipient organization, the nondiversion constraint would apply transfer taxes on any use of a foundation grant for purposes other than exempt purposes. The transfer taxes imposed would mirror those imposed on revenue from charitable contributions. The accounting model based on source and use accounts would facilitate monitoring by the private foundation that made the grant and thereby ease the burden of compliance with the private foundation's expenditure responsibility. It would also facilitate monitoring by the board of the public charity recipient.

*Transfer Taxes on Revenue from Commercial Activities*

The current treatment of commercial activities ignores the source of the funding of the commercial activities or the uses of the revenues produced by the commercial activities. Targeting requires that both the source and uses be considered. Revenue from commercial activities used for exempt activities might seem a likely case for favorable tax treatment. This would revive the destination of income test of prior law by applying it inside the organization. The issue that Congress never directly addressed, and that the Service has avoided, is that of the permissible scope of commercial activities.

The issue is whether that transfer should be tax-favored on grounds that it provides funding for exempt activities or whether the use of the organization's resources (including staff time and other administrative overhead) for commercial activities, should be discouraged. If the internal transfer is tax-favored, commercial revenue generated inside exempt organizations and used for exempt activities is treated more favorably

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145. Many public charities have grown so dependent on private foundation grants that they have made loosening those limitations a priority. This is especially marked with respect to legislative lobbying and particularly political activities.

than commercial revenue generated by taxable entities and contributed to exempt organizations, presumably for exempt activities.<sup>146</sup> There might be some basis for this difference if the unrelated business income tax rules taxed all commercial income of an exempt organization, but the structure of UBIT and its many modifications and exceptions mean that very little of the commercial income of exempt organizations is taxed. The result is that any tax incentive for a transfer to commercial activities is also an incentive for the expansion of commercial activities. The commensurate in scope issue then becomes more acute, not simply as a matter of proportionality but also, and more importantly, as question of business efficiency and as a question of the relation to exempt activities.

Any commercial revenues reinvested in a commercial enterprise will be subject to a transfer tax. This transfer tax will make reinvestment, and thus the operation of commercial enterprises inside exempt organizations, inefficient and thereby enhance the incentive to focus the organization managers' time and attention on exempt activities.

Any commercial revenues used for legislative lobbying should become subject to § 162(e), which provides that lobbying is not an ordinary and necessary business expense. In addition, this transfer of commercial revenue to legislative lobbying uses would be subject to a transfer tax.

Any commercial revenues used for political activities should be prohibited based on the prohibition of the use of corporate funds for either contributions or independent expenditures under the FECA. In this instance, concern with the terms of engagement outside the organization are as important as concerns with diversion within the organization. The transfer tax should thus be confiscatory, capped only by the amount of commercial revenue the organization generated during the taxable year.

#### *Transfer Taxes on Revenue from Government Grants and Contracts*

Government contracts or grants are subject to government accounting requirements that may carry stiffer sanctions than those imposed by a nondiversion constraint. At the same time, the increasing reliance of exempt organizations on government funding means that targeting for charitable efficiency should encompass government grants as well as the other sources of funds. Exempt organizations are already subject to record-keeping requirements with respect to the use of government funds.

#### *Excise Tax on Organization Managers*

Organization managers control the internal diversion transfers discussed here. The tax on managers should be based on the total diversion within the organization during the taxable year. Sections 4955 and 4958 both contain manager-level taxes that could serve as the templates for the manager-level tax anticipated here. The purpose of taxing managers is to provide an incentive to avoid the internal diversion that define charitable

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146. The § 170 charitable contribution deduction is limited, and the limit is lower in the case of corporate contributors than in the case of individual contributors.

inefficiency. Taxing managers also provides an element of accountability that is not available under current law.

## VI. TARGETING, CHARITABLE EFFICIENCY AND COMPLEXITY

Targeting tax exemption through the nondiversion constraint proposed here raises issues of appropriate levels of complexity in tax reform. The complexity of the nondiversion constraint is appropriate to the complexity of the operations of the various organizations subject to it. Small organizations that receive § 170 contributions and engage solely in exempt activities will have one source account and one use account. Organizations that receive revenue from multiple sources and direct these revenue to multiple types of activities will need to trace amounts only to those activities in which they have chosen to engage. The amount of the transfer tax on the organization and on the organization managers will be proportional to the diversions that the organization managers have authorized.

The nondiversion constraint is less complex than the alternatives available in this era of convergence. One approach is to do nothing and thereby accept continued diversions. The alternative is to develop a workable commensurate in scope concept to limit the permissible level of diversion. Opting for the nondiversion constraint suggested here makes the problem of crafting a commensurate in scope concept less pressing and eases the problems of characterization discussed here.

The nondiversion constraint offers the additional benefit of providing the basis for operational transparency. In so doing, it establishes a workable framework for meaningful participation and accountability within exempt organizations.