

# Using Donations to Set the Boundaries of Charitable Tax Exemption

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## I. Introduction

Between 20-25 years ago, Mark Hall and I wrote two articles and a book proposing that charitable tax exemption under Section 501(c)(3) be limited to organizations that relied on donations for a substantial portion of their annual operating expenses.<sup>1</sup> We believed at the time that relying on donations to set the boundaries of charitable tax exemption was not only supported by theory (mostly economic theory, although as I will outline below, I now believe broader sociological and political theory also supports this approach) but that doing so would provide far better normative guidance for what organizations should be given the tax benefits of charitable status than current law.

I suppose I should be very grateful that my status as an academic is not measured by the number of ideas I have proposed that became law. Certainly, the “donative theory” as Mark and I referred to it at the time, has pretty much been a complete bust in the marketplace of ideas, at least from the standpoint of legislative adoption. However, I continue to believe that our approach of using donations to solve the problems of identifying organizations entitled to charitable exemption under 501(c)(3) is the best theoretical and normative solution to a whole set of what I will call “boundary” issues – principally the problem of identifying what organizations should be viewed as having a *prima facie* case for exemption under 501(c)(3), and which should not, as well as commercial activity, permissible lobbying, and questions regarding fundraising expenses. On the other hand, my quarter-century-later revisit of our theory also has convinced me that the donative approach probably does not offer any particular succor for how to deal with the public policy doctrine or

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<sup>1</sup> John D. Colombo and Mark A. Hall, *The Charitable Tax Exemption* (Westview Press 1995); Mark A. Hall and John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 Wash. L. Rev. 301 (1991); Mark A. Hall and John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 Ohio St. L.J. 1379 (1992).

private inurement. But it at least does no worse at solving these problems than other approaches.

Moreover, I now have evidence that while no legislature, administrative agency or court has officially adopted “the donative theory” of tax exemption, the IRS and state courts, in particular, have unabashedly used donations as a major marker of charitable status. “The Donative Theory” might not officially be “law,” but donations clearly play a very important part in determining eligibility for charitable status under both 501(c)(3) and state tax exemption (particularly property tax exemption) laws.

In the rest of this paper, I return to some of the elements of the donative theory proposed by Mark and me so many years ago, to illustrate that the theoretical underpinnings remain sound, and that tying exemption to donations can solve at least some of the intractable boundary issues listed above in a relatively straightforward manner. I also examine other approaches to the boundary issues that may be useful, and I end with an observation about IRS rulings and court cases that have, I think, *de facto* adopted a donative approach to boundary questions.

## II. The Theoretical Background

### A. *Economic Theory*

The theoretical case for using donations as the boundary for charitable tax exemption begins with a somewhat-controversial conclusion that the suite of tax benefits granted to “charitable” organizations as defined in Section 501(c)(3) constitutes a form a government subsidy. While one could certainly argue that tax exemption itself is not, in fact, a government subsidy given that many 501(c)(3) organizations have no net income that would be subject to tax, the conclusion that the overall suite of tax benefits flowing to these organizations, which include the deduction for charitable contributions and the ability to issue tax-exempt bonds is a form of government subsidy is less controversial. Still, if you disagree with the subsidy characterization, then the economic case for using donations as the normative test for charitable tax-exemption is weak (although as I note below, political and sociological theory would still support this approach).

If, however, you are willing to accept that tax exemption and its associated tax benefits are a form of subsidy, then the economic case for using donations to dole out the subsidy is fairly straightforward. In general, government uses subsidies to expand production of some good or service that is perceived to be undersupplied. We have tax incentives for energy-efficient cars to increase the sales of such vehicles; we provide home mortgage interest deductions to make home ownership “cheaper” and thereby stimulate consumption of housing.<sup>2</sup>

So how does this impact charitable tax exemption? If one assumes that 501(c)(3) status confers a certain level of government subsidization, then the next question concerns whether this subsidization makes any sense economically. Mark and I observed that it does make some sense with respect to organizations that rely on donations to produce goods or services. In the private market, individuals purchase goods and services for their own personal benefit. Organizations providing these services then can adjust pricing and output as necessary to meet market demand. There is no need for government subsidization as a general matter, though as noted above, government sometimes provides subsidies (either directly or through the tax system) to increase demand for specific policy goals (e.g., to stimulate the purchase of alternative energy vehicles).

Donative entities, on the other hand, operate in an area of private market failure. They provide goods and services that either are not or cannot be directly “matched” to individual consumers.<sup>3</sup> Thus these organizations cannot rely on normal market forces to adjust pricing and output. Instead, the organizations rely on donations (at least in part) to provide the funding for the output of their goods and services.

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<sup>2</sup> Whether subsidization is good policy or not is a wholly different question – many policy analysts, for example, would argue that the home mortgage interest deduction has simply resulted in wasteful overconsumption of housing.

<sup>3</sup> Market failure may have many causes. Henry Hansmann described a specific kind of market failure that he termed “contract failure” in which the purchaser of a particular good or service is not the consumer (e.g., disaster relief, where donors essentially fund relief for third parties) or where the consumer is particularly unable to judge the quality of (or their need for) a particular good or service. Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 Yale L.J. 837 (1980).

Donations, however, are voluntary. This means that an organization that relies on donations to produce services almost certainly will suffer chronic underfunding because of the free-rider phenomenon that economic theory (as well as common observation) predicts will accompany voluntary payments. Think of public radio. The annual (is it now quarterly? Weekly?) fundraising appeals indicate that not everyone who avails themselves of the benefits of public radio pay their fair share – indeed, if they did so, presumably we would not see the irritating fundraising appeals at all. Providing some sort of government financial help to organizations suffering this chronic underfunding makes some sense.

Of course, subsidization is not the only response government could make to these underfunding situations. Another response would be direct government funding via grants. Indeed, government routinely “purchases” services from non-governmental social service agencies by providing direct grants to those organizations. However, Mark and I observed that in many cases, government may not provide any direct funding as a result of the vagaries of majoritarian politics; or even if some grants occur, these grants are insufficient to meet the full demand for the services in question, and that organizations then turn to donations to fill the funding gap. We referred to this lack of direct government response to the undersupply of the goods and services in question as “government failure.” But turning to donations to solve government failure in turn means the organization in question will suffer from the chronic underfunding that accompanies voluntary payments and the free-rider effect.

Accordingly, Mark and I hypothesized that organizations that function at the intersection of private market failure and government failure turn to donations to survive. But relying on donations almost guarantees a funding gap due to the free-riding effect. The suite of tax benefits accompanying 501(c)(3) status helps to fill this gap.<sup>4</sup> Thus donations

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<sup>4</sup> There remains the question why, if majoritarian politics interferes with direct government provision of needed public services, the majority seems to be happy with tax exemption for those same services. Mark and I hypothesized that the explanation is that tax exemption is a giant “back scratching” (or if you prefer, “log-rolling”) scheme, which each member of the majority agrees to tax-exemption so that some of their preferences get this benefit, at the expense of paying a little bit (the lost tax revenue – or 35-40 cents on the dollar, instead of the entire dollar a government grant would require) for funding someone else’s preferences. The fact that tax exemption costs the public fisc less than direct grants (e.g., tax exemption costs only the lost revenue from the corporate tax on net earnings or the individual tax on deductible donations)

provide both a signal that an organization is doing something valued by the public and deserving of public support, and at the same time initiates an economic situation that indicates a need for such support.

### *B. Political and Social Theory*

What neither Mark nor I appreciated twenty-five years ago, however, is that using donations to identify organizations in need of government help (or benign government non-interference) through tax exemption is also supported by political and social theory. Political scientists and sociologists explain the emergence of nonprofit organizations not in economic terms, but in terms of pluralism. The nonprofit sector provides an outlet for expression of ideas and activities not provided by the majority. Our society is stronger as a result of this pluralistic expression, and “forgiving” taxation for these organizations both helps them survive economically and signals their importance to the functioning of civilized society. Indeed, this conception of pluralism as the core of charitable tax exemption is what lay at the center of Justice Powell’s concerns in his concurrence in the famous *Bob Jones* opinion.

Once again, donations provide the key evidence that there is a pluralistic activity that is important enough to confer exemption. Professor Saul Levmore, in fact, addressed the propriety of using donations as a signal to direct government financial help for pluralistic activity in his article *Taxes as Ballots*.<sup>5</sup> Accordingly, while Mark and I justified the donative approach mostly on economic grounds, these days I view the sociological explanation of encouraging pluralistic activity as equally (if not more) compelling a rationale to focus on donations as the marker of charitable exemption.

### **III. Donations and Boundaries**

When teaching my class on tax-exempt organizations, I present the steps for

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means that this agreement is cheaper than direct government funding, and of course classic economics predicts that as an item gets cheaper, people will consume more of it – that is, the majority is willing to support an expansive definition of “charitable” precisely because everyone gets something out of the arrangement, and the arrangement overall is relatively cheap compared to direct government funding for the same level of output.

<sup>5</sup> Saul Levmore, *Taxes as Ballots*, 65 U. Chi. L. Rev. 387 (1998).

qualifying for 501(c)(3) status as follows. First, an organization must meet the technical organizational requirements (organized as a nonprofit, with the correct “magic language” in the organizational documents dedicating assets to a charitable purpose). Second, the organization must establish that it pursues what I call a “prima facie charitable purpose” – that is, the organization must show that at least as an initial matter, it can claim to pursue some kind of recognized charitable purpose: religious, educational, poor relief, etc. But having a prima facie charitable purpose is not sufficient to establish entitlement to exemption. There remain six “limitations” on exempt status, as follows:

- (1) Illegality/Public Policy,
- (2) Private Inurement,
- (3) Private Benefit,
- (4) Lobbying,
- (5) Political Campaign Activity, and
- (6) Commercial Activity.

One can think of the initial decision that a *prima facie* charitable purpose exists and the six limitations as the boundaries on exempt status. For example, an organization that runs a school clearly has a prima facie charitable purpose identified in I.R.C. Section 501(c)(3) (an educational purpose). But if that organization endorses a candidate for public office, it will not qualify for exemption – a boundary. This part of the paper, therefore, examines each of these boundary questions with specific examples, setting forth the current state of the law, followed by how the boundary issue would be resolved using donations as the boundary-setting tool, followed by other possible solutions to the boundary problem. The order in which I present this discussion deviates from the order above (which is the order I teach this material in my class on tax-exempt organizations) and instead proceeds from the areas in which I think the donative approach helps the most, to those which the donative approach helps the least.

## A. *The Prima Facie Charitable Purpose*

### 1. *Current Law*

Current law is both straightforward and nearly useless in defining the concept of charitable for tax-exemption purposes. Straightforward, because the tax definition of “charitable” is quite clear: it is tied to the common-law definition of charity for purposes of charitable trust law.<sup>6</sup> “Useless,” because of two reasons: (1) that body of law (the common law of charitable trusts) has everything to do with the ancient property-law Rule Against Perpetuities, and nothing to do with tax policy, and (2) because of (1), the definition of charity at common law is essentially limitless – all you need to qualify is to be doing something that provides a benefit to a “charitable class,” a large-enough group of people (it does not have to be an indefinite or limitless group<sup>7</sup>) to be considered a general benefit to the public.

This approach certainly makes sense for the Rule Against Perpetuities – society really shouldn’t care if a person dedicates their wealth in perpetuity for some arguably-public cause: it’s their money, after all; let them do with it as they please, at least as long as they are not violating the law. But applying this open-ended definition to tax policy is problematic. We collect taxes to supply the public with goods and services not otherwise supplied by the private market; permitting large caches of wealth to “opt out” of the tax system creates problems for funding these government-supplied services. Or put more simply, tax policy must be concerned with the integrity of the tax base, or the entire system will fall apart.

This definitional problem has become manifest in the modern world. The Treasury Regulations that attempt to provide some examples of “charitable” for 501(c)(3) purposes are hopelessly outdated, drafted in 1959 when *Leave It To Beaver* and *The Adventures of Ozzie & Harriet* ruled that new-fangled device called “television.” Aside from

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<sup>6</sup> Treas. Reg. 1.501(c)(3)-1(d)(1).

<sup>7</sup> See Restatement of Trusts 3d, Section 28, General Comment (f) (“The class of potential beneficiaries, however, may not be so narrowly defined as to benefit only named individuals or a class of friends, descendants, or other relatives of the settlor.”).

restating certain obvious principles (e.g., “relief of the poor” as a charitable purpose), they have little to offer in the way of guidance for a multitude of modern entities.

The area in which the lack of a theoretical limiting principle creates the most difficulty deals with organizations that claim that a commercial business (or something that looks an awful lot like a commercial business) is in fact a charitable purpose. Below, I discuss the current law (and its deficiencies) with respect to specific examples in this particular genre.

*a. Nonprofit Hospitals*

Under Revenue Ruling 69-545, we continue to classify modern nonprofit hospitals as “charities” based upon the notion that hospitals provide a “community benefit” in the form of health care for the general community. But there is no agreement regarding exactly what “counts” as a community benefit, nor how much (in any kind of quantifiable term – dollars spent, revenue forgone, employee time used, etc.) such benefits are required in order to support tax exemption. The result is that we routinely provide tax exemption to very large and very profitable business enterprises. For example, Ascension Health Care, the largest Catholic health system in the country, earned net revenues of \$1.8 billion in FY2014<sup>8</sup> and has undertaken a \$2 billion construction of a health facility in ... the Cayman Islands.<sup>9</sup> If this is a charity, then I’m a trained nuclear physicist.

So why, exactly, do we still classify these hospitals for tax purposes as “charities”? Do we honestly believe that Ascension would cease to exist and the health care system would fall apart if tax exemption were no longer available? That conclusion would be insane, particularly for the wealthy health service providers.<sup>10</sup> If Ascension had to pay taxes on its net earnings from FY2014, it would still be left with over \$1 billion; that’s probably

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<sup>8</sup> <http://www.bizjournals.com/stlouis/news/2015/02/20/ascension-posts-115-million-profit-in-q2.html>

<sup>9</sup> [http://www.stltoday.com/business/local/how-a-st-louis-based-health-care-system-became-one/article\\_c07ada87-ab74-5175-a0b0-5219dd7b95f1.html](http://www.stltoday.com/business/local/how-a-st-louis-based-health-care-system-became-one/article_c07ada87-ab74-5175-a0b0-5219dd7b95f1.html)

<sup>10</sup> I do understand that there are a number of nonprofit hospitals (those in rural areas and critical access hospitals in urban areas providing services largely to the Medicaid and uninsured poor populations) that live on a financial edge. But this is a health care policy problem, not a tax problem, and we should not be trying to fix it with tax exemption.

enough to eat on. Moreover, the health care system already is largely a taxable system: doctors are not exempt on their income; neither are nurses, pharmacies, pharmaceutical companies, medical equipment suppliers, or health insurers. In fact, nonprofit hospitals are the only part of the health care system that is tax-exempt. So do we classify nonprofit hospitals as charities because we are buying some sort of public service (e.g., health care for the uninsured poor) that would otherwise be unavailable? Perhaps in part, but this purchase is very strange, since we never tell the seller (the hospitals) how much it is of what we want that they have to do - current law does not in fact require any particular level of charity care (or anything else, for that matter) to qualify for exempt status.<sup>11</sup>

If one views tax exemption as an economic tool, designed to encourage providing goods and services not otherwise provided by the private sector, exemption for nonprofit hospitals (at least, exemption as a class) makes no sense. Nor does it make much sense as a tool to advance pluralism – perhaps in the early 1900’s, when hospitals were an extension of religious and social communities, that proposition would have been viable, but not today, when community hospitals are gobbled up by nation-wide systems like Ascension Health and have as much to do with pluralistic association as the local Ford dealer (in fact, the local Ford dealer might have a better case).

#### *b. Pharmacies*

In *Federated Pharmacy Services*,<sup>12</sup> the 8<sup>th</sup> Circuit Court of appeals held that a nonprofit pharmacy selling drugs and medical supplies to the elderly and poor at cost did not qualify for tax exemption because a pharmacy was inherently a commercial enterprise.

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<sup>11</sup> Imagine, for example, that we replaced the Supplemental Nutrition Assistance Program (also known as “food stamps”) that permit the poor to buy food with a policy that told grocery stores “you’ll get tax exemption if you provide some free food to the poor.” “How much?” “Well, we’re not going to tell you that; just make sure it’s enough to argue that it’s a significant community benefit.” Surely every human being with a brain (OK, maybe not Donald Trump) would think such a system for feeding the poor was crazy. But that is exactly the system we have in place to deal with healthcare for the uninsured poor that don’t qualify for Medicaid. There is some preliminary evidence that the Affordable Care Act is making headway on the issue of the uninsured, see <http://www.cnbc.com/2015/01/07/obamacare-effect-uninsured-rate-hits-record-low.html>, which indicates that if we are interested in buying health care for the uninsured, doing so with a direct government program is better than doing so through a vague connection with tax-exemption.

<sup>12</sup> *Federated Pharmacy Services v. Comm’r*, 625 F.2d 804 (8th Cir. 1980).

Selling drugs at cost was not charitable because the pharmacy could still recover costs and pay salaries (although the court opined that selling these items below cost to the same population would present a different case).

The contrast between *Federated Pharmacy Services* and our treatment of nonprofit hospitals is striking. Each operates a business, providing goods and/or services for a fee. Most nonprofit hospitals, in fact, strive to be profitable, and as noted above, at least some are extremely successful in that regard. These organizations are considered charities, but an organization that strives to serve an underserved population without making a profit is not a charity. This comparison alone should make one question the usefulness of our current definition of a *prima facie* charitable purpose. If “community benefit” is the test of exemption, someone should explain exactly why Federated Pharmacy Services was not providing such a benefit. I cannot do so.

*c. Banking, Real Estate Development, and Law Firms*

When is a bank or a real estate developer charitable? If you said “never,” exit stage left. The correct answer is “when they are targeted toward poor relief or combatting discrimination.” The IRS concluded in Rev. Rul. 74-587<sup>13</sup> that an organization providing loans and start-up capital to businesses owned by minorities or other disadvantaged groups in a depressed urban area was charitable, because the organization because the organization’s activities helped combat racial prejudice and poverty. In Rev. Rul. 70-585,<sup>14</sup> the Service ruled that an organization that builds housing for the poor is exempt; an organization that builds housing for minority families in order to integrate a neighborhood is exempt, even if the housing is not strictly aimed at the poor. But an organization that builds modestly-priced housing for the middle class to promote economic integration of a wealthy neighborhood not exempt.

With respect to law firms, organizations that provide legal services to the poor have

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<sup>13</sup> 1974-2 C.B. 162

<sup>14</sup> 1970-2 C.B. 115

long been exempt under the long-standing “poor relief” thread of charity.<sup>15</sup> But in the 1970’s the IRS decided that “public interest” law firms also could be exempt. These are organizations that do not dedicate services to the poor, but (in theory, at least) litigate issues that involve important public policy and likely would otherwise not be litigated because of the lack of sufficient economic stake by potential litigants.<sup>16</sup> The Service later augmented this ruling with a Revenue Procedure<sup>17</sup> that placed some strict procedural limits on organizations applying for exempt status. For example, a qualifying organization cannot use attorneys’ fees (either from clients or court-ordered) to pay for more than 50% of its costs; in effect, this means that the other 50% must come from non-fee sources, such as government grants or private donations.

Like the somewhat jarring dichotomy between nonprofit hospitals and nonprofit pharmacies, the rulings recounted in this section also perfectly illustrate the ad-hoc decisions that result from a lack of limiting principle in charitable tax exemption. On the one hand, one could argue that both Rev. Rul. 74-587 and 70-585 correctly implement the principle that charity involves helping the poor, and not helping the middle class. But if that is true, the “public interest law firm” rulings violate that principle by telling us that a nonprofit law firm need not help the poor to be exempt – it just has to be litigating “something important.” On the other hand, if a broader principle of community benefit is at work, it would explain exemption for public-interest law firms, but not the denial of exemption for affordable middle-class housing in the Hamptons.

*d. Thoughts on the Edge: Community Farms and Tesla Motors*

One of the problems with the current approach to charitable purpose is that it provides no ready answers regarding the “charitableness” of many activities that some may consider highly beneficial to the community, if not the world, but which have decidedly commercial overtones. Take, for example, the idea of a community farm, using organic

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<sup>15</sup> Rev. Rul. 69-161, 1969-1 C.B. 149.

<sup>16</sup> Rev. Rul. 75-74, 1975-1 C.B. 152.

<sup>17</sup> Rev. Proc. 92-59, 1992-2 C.B. 411.

farming techniques and often donated labor to preserve agricultural land in its natural state, but selling the farm output at cost (or at a modest profit for future reinvestment). Is such an organization a “charity”? Conventional wisdom says “no” – according to the IRS, farming is not itself a charitable activity, even to preserve agricultural land and if one believes the precedent of *Federated Pharmacy Services*, the courts would agree: farming is inherently a business.<sup>18</sup> But why should this be so? Is there any real doubt that a community farm provides a community benefit, particularly if it is sustained by donated labor? Moreover, it appears that if the farm can claim to be preserving ecologically significant land or educating the public (or farmers) about particular farming techniques, land management, etc., then the farm has an excellent chance of exemption.<sup>19</sup>

Environmental protection is another area in which the concept of charitable developed in 1601 has difficulty with the modern world. The IRS certainly has recognized that environmental protection can be a charitable purpose.<sup>20</sup> But would this extend to a business designed to commercialize environmentally-friendly technology? A few years ago as a commentator on another paper at NCPL, I asked whether Tesla Motors, dedicated to commercializing electric vehicles, could be considered a charity if it were properly organized as a nonprofit. One can certainly argue that electric vehicles provide a broad community benefit – in fact, this benefit is recognized by both federal and state laws regarding tax benefits for low-emission vehicles and edicts (*e.g.*, from California) requiring a certain percentage of auto sales to be “zero-emission” vehicles. If one adheres to a notion of public or community benefit as the standard for defining charity, why shouldn’t my hypothet-

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<sup>18</sup> Rev. Rul. 78-384, 1978-2 C.B. 174.

<sup>19</sup> *E.g.* Rev. Rul. 76-204, 1976-1 C.B. 152. *See also* *Dumaine Farms v. Comm’r*, 73 T.C. 650 (1980) upholding exemption for an experimental working farm that tested various conservation techniques and educated local farmers about the results.

<sup>20</sup> *E.g.*, Rev. Rul. 76-204, 1976-1 C.B. 152; Rev. Rul. 78-384, 1978-2 C.B. 174. In addition, conservation easements have become a whole area of law unto themselves. *See generally*, Stephen J. Small, *FEDERAL TAX LAW OF CONSERVATION EASEMENTS* (1997 & current supp.).

ical Tesla be tax-exempt, even if it makes a profit? After all, profits don't seem to faze the IRS with respect to charitable exemption for nonprofit hospitals or Harvard University.<sup>21</sup>

## 2. *The Donative Approach*

### *a. In General*

This lack of limiting principle in current law, the resulting uncertainty, and the almost limitless discretion of the IRS (and courts) to define “charitable” would be eliminated by using the donative approach. Mark and I proposed that an organization would achieve prima-facie charitable status if it could show that one-third of its operating revenue for the year came from donations from the general public. While we certainly could argue about the one-third threshold and other technical aspects of implementing this system,<sup>22</sup> the con-

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<sup>21</sup> The IRS has denied exemption to organizations it finds are “just operating businesses” in a variety of other situations, including the recent Tax Court case *Asmark Institute, Inc. v. Commissioner*, T-C Memo 2011-20. An exhaustive list of these rulings can be found in the current supplement to Douglas M. Mancino and Francis Hill, *TAXATION OF EXEMPT ORGANIZATIONS*, 2015 Cum. Supp. No. 1 at S3-51 through S3-58. Their conclusion echoes my own: “[T]he apparent contradiction in the treatment of universities and hospitals, on the one hand, and the fee-for-service structures found inconsistent with Section 501(c)(3) status in these rulings will have to be explored more fully. . . . References to competition with taxable entities appear in some of the rulings, but their persuasive power is uncertain in light of the presence of taxable hospitals and colleges, as well as for-profit arts organizations.” *Id.* at S3-58.

<sup>22</sup> We covered a lot of technical background to the donative approach in our articles and book. For example, we recognized that donated labor should count for this purpose and came up with a standardized measurement to do so. We also proposed allowing capital gifts to count by amortizing them into the donative stream under a depreciation-like construct. And in order to keep organizations from “bouncing” in and out of exempt status, the calculations would be made on a four-year rolling average, similar to what is already done under Section 170(b)(1)(A)(vi) and 509(a)(2) to separate a public charity from a private foundation. New organizations would get four years to meet the test initially, sort of like the advance ruling process for public charity status currently in effect. In order to avoid situations in which organizations spent huge sums of money for fund-raising just to get to the donative threshold, we proposed that fundraising costs would be subtracted from donations for purposes of calculating the donative fraction, as discussed further in the text *infra*. And finally, we recognized that one-third was not set in stone – it could be more or less. Again, we used one-third because that was the number already in place in the public charity/private foundation definitional sections, but all we really said was that the donations had to be a “substantial” part of operating income, leaving the exact definition of “substantial” to the political process.

One item relating to the definition of the donative base that I no longer agree with was our treatment of government grants. In our work laying out the technical implementation of the donative approach, we argued that government grants should not count in the donative base – specifically, that government grants should be “neutral” items, neither counting in the numerator (donations) or the denominator (revenue) of the donation fraction. I now believe that approach is wrong. Government grants that are truly grants, as opposed to payments for services rendered, should count as donations from the general public, just as they do for purposes of our definitions of public charities vs. private foundations. *See, e.g.*, Treas. Reg. 1.509(a)-3(g).

cept is pretty simple: the public determines whether an organization is charitable, not the IRS, based upon the public's donative activity. This approach coincides with a sensible tax policy rationale for providing exemption and the other associated tax benefits (e.g., deductibility of donations): the predicted free-rider problem means that donative entities are chronically underfunded; the tax benefits accruing to such entities under our proposed system would help correct for this underfunding. As I outlined immediately above, I now also believe that this system is in harmony with the notion that nonprofit charities provide critical support for our pluralistic society. People signal the importance of specific organizations via their donations; we respond with tax exemption and the associated tax benefits to provide financing for these pluralistic endeavors. This system empowers a pluralistic approach to solving problems by giving small groups government subsidies to do their work (at least in part).

*b. Practical Result*

This system would resolve the issues identified above. Most nonprofit hospitals would no longer be tax exempt, because they receive little, if any, donative funding for operations. The same is likely true of organizations like Federated Pharmacy Services – there was no indication from the opinion in that case that Federated had much donative support (although if they did, or could drum it up, then a court wouldn't be able to deny exemption because, hey, pharmacies are just businesses, right?). Community redevelopment organizations, however, might well pass the test – the IRS noted in both Rev. Rul. 70-585 and 74-587 that the organizations qualifying for exemption were largely funded by government grants and private donations.<sup>23</sup> At the same time, this system opens exemption to organizations such as the one providing affordable middle class housing (which the IRS ruling noted was funded in part by private donations). Similarly, organizations like

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<sup>23</sup> See, e.g., Rev. Rul. 74-587 (“The organization is financed by grants from private foundations and by public contributions.”); Rev. Rul. 70-585 (Situation 1: “The organization derives its operating funds through Federal loans and contributions from the general public. Where possible, renovations are made with volunteer help.” Situation 2: “It is financed by contributions from the general public and by funds obtained under Federal and State housing programs.” Etc.)

community farms could conceivably be tax exempt, if they were sufficiently supported by donations.

Most beneficial of all, this approach gets the IRS and the courts out of the business of declaring what is or is not “charitable” for tax purposes. The population makes that decision, based upon their donative behavior, subject to certain limitations discussed below.

### 3. *Other Approaches*

The basic problem with the prima-facie definition of charitable is that it has no inherent limiting principle because there is no inherent theory that defines charity for tax-exemption purposes. Accordingly, as I have said many times at NCPL gatherings, adopting a theory, any theory, of why we provide tax exemption and its associated benefits (deductible contributions, tax-exempt bonds) would be a normative improvement. For example, if you like Rob Atkinson’s view that exemption rewards the act of altruism and any such act should be rewarded – fine and dandy.<sup>24</sup> That theory lets us know that an entity formed as a nonprofit and therefore embodying an initial altruistic decision is exempt forever. Nonprofit hospitals would be exempt under this theory (subject to compliance with other limitations discussed below) no matter their current operations, because the initial decision to form them was altruistic. Fine. That approach makes the analysis of whether an organization has a prima facie charitable purpose very easy. If instead your view is that charity extends only to helping the poor,<sup>25</sup> that also is a fine limiting principle, and Harvard, the Lincoln Center, the Mayo Clinic and similar organizations can pay up.

I have nagging doubt, however, that adopting a coherent theory of tax exemption is very high on the IRS’s to-do list. In absence of that, I strongly agree with Richard Schmalbeck that the 1959 regulations have far outlived their usefulness, and a thorough update is in order. If we have no theory, then perhaps we can at least have ad-hoc examples of prima-facie charitable purposes that track the modern world, rather than the world

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<sup>24</sup> Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C.L. Rev. 501 (1990).

<sup>25</sup> E.g., Rob Reich, A Failure of Philanthropy, *Stanford Social Innovation Review*, Winter 2005, available at [http://web.stanford.edu/group/scspi/media/pdf/key\\_issues/policy\\_journalism.pdf](http://web.stanford.edu/group/scspi/media/pdf/key_issues/policy_journalism.pdf).

of 65 years ago. In particular, the IRS needs to think through and then explain why certain commercial activities (e.g., nonprofit hospitals, universities) are tax-exempt but others are not. Saying that an organization is not exempt because it is primarily a business hardly cuts it in an era in which I can send postcards from Ascension Health’s Cayman Islands heart facility funded by their \$1-billion-plus annual profit.

## *B. Commercial Activity*

### *1. Current law*

Over time, I have decided that the best way to think about commercial activity by charities is to break organizations into two types. The first type is one that claims their commercial activity is also their charitable activity; I have discussed these organizations immediately above. The second type involves organizations that have some other charitable program (it may consist of making grants to other charities), and (at least in theory) use commercial activities to fund that other charitable program. Current law with respect to these latter organizations, however, may be in even worse shape (if that is possible) than the law surrounding prima facie charitable purpose. We start with a simple question: how much commercial activity may one of these second types of organizations engage in and still retain exempt status? We find there is no answer.

The regulations are inscrutable. Regulations §1.501(c)(3)-1(b)(1)(i) states that an exempt charity’s organizational document (e.g., articles of incorporation or trust agreement) may not empower it to “engage, other than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.”<sup>26</sup> A couple of paragraphs later, the regulations warn that an organization will fail to qualify for exemption “if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.”<sup>27</sup> But an even later part of the regulations (1.501(c)(3)-1(e)) states that an organization may qualify for exemption even if “it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in fur-

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<sup>26</sup> Treas. Reg. §1.501(c)(3)-1(b)(1)(i).

<sup>27</sup> Treas. Reg. §1.501(c)(3)-1(c)(1).

therance of the organization's exempt purpose and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business ... ."<sup>28</sup> It appears from these regulations, therefore, that the key concept in determining the effect of commercial activity on exempt status (as opposed to whether the commercial activity is taxable under the UBIT) is the concept of "in furtherance of." The regulations, particularly Regulations §1.501(c)(3)-1(e), seem to say that unrelated business activities that are "in furtherance of" can be substantial without endangering exempt status; activities that are not "in furtherance of," however, must be insubstantial in order to retain exemption.

The problem is that the regulations under 501(c)(3) do not tell us anything about when a commercial activity is or is not considered "in furtherance of" an exempt purpose. Thus one possible interpretation of the regulations is that "in furtherance of" is equivalent to "substantially related" under the UBIT. Or put the opposite way, one might conclude that any "unrelated" activity under the UBIT is *not* "in furtherance of," and any "substantial" amount of unrelated commercial activity therefore creates exemption problems.<sup>29</sup> Certainly, one cannot see "related" activity as creating exemption problems; if an activity is related for UBIT purposes, then by definition it must functionally advance the organization's exempt purpose, and hence must be viewed as being "in furtherance of" that purpose. But the contrary proposition (that "unrelated" activity automatically is *not* "in furtherance of") is not necessarily true. In fact, if this proposition were correct, then the statement in Regulations § 1.501(c)(3)-1(e) quoted above that an organization may operate a business as long as the "primary purpose" is not carrying on an unrelated business makes no sense. If *any* "unrelated" business were viewed as *not* being "in furtherance of," then any unrelated business that was "substantial" would cause an organization to lose exempt status. A "substantial" business is presumably well short of one that is a "primary purpose"; therefore, the reference in Regulations § 1.501(c)(3)-1(e) to an organization losing exemption when an unrelated business becomes its primary purpose would be completely

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<sup>28</sup> Treas. Reg. §1.501(c)(3)-1(e).

<sup>29</sup> See Jessica Pena & Alexander L.T. Reid, *A Call for Reform of the Operational Test for Unrelated Commercial Activity in Charities*, 76 N.Y.U. L. REV. 1855, 1864 (2001).

meaningless, because any “substantial” unrelated business would cause loss of exemption even if that business was not the “primary purpose.”

The only sensible harmonization of these regulations, therefore, is that in enacting the UBIT, Congress did not intend to alter the “destination of income” test for the purpose of granting exemption to an entity in the first instance.<sup>30</sup> That is, unrelated business activity is taxed, but if the proceeds are used to support charitable activities, the organization in question is still entitled to an exemption (for its other income). It is only when the operation of the unrelated business becomes the entity’s “primary purpose” that it loses exempt status, because at that point (obviously) the entity’s “primary purpose” is no longer charitable. Put another way, “in furtherance of” has two meanings: commercial activity may be “in furtherance of” an exempt purpose by being functionally related to that purpose (for example, the music school of an exempt university puts on concerts for which it charges admission fees) *or* by being a source of revenue to expand charitable outputs.

Early interpretations of the regulations by the IRS seemed to support the notion that even substantial unrelated business activity would not endanger exempt status as long as the revenues from that activity (which, of course, would be taxable under the UBIT) were used for charitable purposes. In Rev. Rul. 64-182,<sup>31</sup> the IRS considered a case in which an exempt organization derived its revenues largely from renting space in a commercial office building; the revenues were used to make grants to other charitable entities. Concluding that the rental activity was “unrelated” for purposes of the UBIT, the Service nevertheless ruled that the organization was entitled to retain its exempt status as an organization described under section 501(c)(3) because it was carrying on a charitable program “commensurate in scope” with its financial resources.<sup>32</sup>

The background to the 1964 revenue ruling, however, is more revealing than the ruling itself in interpreting the “commensurate-in-scope” language. Prior to approving the 1964 revenue ruling, the General Counsel’s office referred the issue in the proposed ruling

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<sup>30</sup> See Ellen P. Aprill, *Lessons from the UBIT Debate*, 45 TAX NOTES 1105, 1107 (1989).

<sup>31</sup> Rev. Rul. 64-182, 1964-2 C.B. 186.

<sup>32</sup> *Id.*

to the Exempt Organizations Council for analysis. The Council's analysis, attached to General Counsel's Memorandum 32689,<sup>33</sup> contained two primary conclusions. First, "the amount of expenditures of an organization for charitable purposes must be taken into consideration in equating business activities with charitable activities" under the primary purpose test of reg. section 1.501(c)(3)-1(c). Second, if after considering such expenditures, "an organization is shown in fact to be carrying on a real and substantial charitable program reasonably commensurate in financial scope with its financial resources and its income from its business activities and other sources," then the organization would be considered as having a charitable primary purpose.<sup>34</sup> According to the Council's analysis, the primary purpose test "becomes a test of whether there is a real, bona fide or genuine charitable purpose ... and not a mathematical measuring of business purpose as opposed to charitable purpose."<sup>35</sup> Or in other words, (1) "primary purpose" cannot be determined by a mathematical comparison of size based upon number of employees, space utilized, or similar factors – there is no specific mathematical limit on unrelated business activities and (2) the dedication of net revenues from an unrelated business to charitable purposes is a necessary part of the analysis of the effects of unrelated business activity on tax exemption, and such dedication itself is evidence that an organization's "primary purpose" is charitable. On the other hand, the Council indicated that when the operation of a substantial unrelated business did not result in cross-subsidization, the organization was no longer being operated primarily for charitable purposes.<sup>36</sup> By implication, the Council's analysis seemed to be that dedication of revenues from commercial activity to charitable activities was "in furtherance of" a charitable purpose.

A later General Counsel's Memorandum further illuminated the "commensurate in scope" idea. This memo provides perhaps the best analysis of the doctrine and related is-

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<sup>33</sup> Gen. Couns. Mem. 39862, 1963 WL 62497 (IRS GCM) (Oct. 9, 1963).

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> As summarized by the Counsel's office in GCM 34682, 1971 IRS GCM LEXIS 38 (Nov. 17, 1971) "the Council's supporting Appendix also indicated that, aside from the 'primary purpose' requirement of the regulations, the better logic in cases in which the business activity does not in fact provide any significant funds for charitable use is that the organization is not being operated exclusively for charitable purposes."

sues of any IRS document. Reaffirming the original view of the Exempt Organizations Council that there were no “bright line” tests in determining whether unrelated business activity was consistent with exempt status, the memo stated,

[A]side from express statutory limitations on business activity, such as section 502 and the newly enacted provisions relating to private foundations, there is no quantitative limitation on the “amount” of unrelated business an organization may engage in under section 501(c)(3), other than that implicit in the fundamental requirement of charity law that charity properties must be administered exclusively in the beneficial interest of the charitable purpose to which the property is dedicated.

...

[F]or some time now it has been increasingly apparent that our earlier approach to the problem of permissibility or nonpermissibility of business activities of charities has been based on a misconception that somehow in the enactment of the provisions for exemptions of charities from income tax, Congress intended an implied restriction on the extent of their engagement in business activities. In the years past, the Service sought by ruling and by litigation to deny the right of charities to engage in business, insisting that somewhere, somehow in the enactment of the exemption provisions Congress must have intended to limit the classification of exempt charities to those charities not engaging to any substantial extent in commercial endeavors.

Exhaustive research of legislative history from the earliest enactment of the charitable provisions of our income tax laws fails to provide support for such proposition. To the contrary, the evidence is clear that the first provision for exemption of charities from imposition of tax under the Corporation Excise Tax of 1909, from which the present income tax exemption provisions derive, was accompanied not by any intention to limit exemption to charities not engaged in business, but an intention to assure exemption of certain charities that were engaged in business.<sup>37</sup>

The memo also addressed the issue regarding what should happen in cases in which the operation of an unrelated business either produced no profit to subsidize charitable activities or in which the profit was purposely reinvested to grow the unrelated business, as opposed to dedicated to expanding charitable outputs. As to the former case, the memo agreed with the original position of the Council that “the better logic in cases in which the business activity does not in fact provide any significant funds for charitable use is that the

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<sup>37</sup> Gen. Couns. Mem. 34682, 1971 IRS GCM LEXIS 38, \*26-\*29 (Nov. 17, 1971).

organization is not being operated exclusively for charitable purposes.”<sup>38</sup> With respect to the latter case, the memo observed,

We think that if an organization devotes its resources to business use which produces a reasonable return on the investment, but refuses to apply any significant part of its profits or resources to any charitable program and the condition prevailed for an unwarranted long time, a prima facie case could be made out that the organization is not administering its properties exclusively in the beneficial interest of charity since it is neither accomplishing any short range or any long range charitable purpose in respect to the beneficial use of its properties.<sup>39</sup>

The memo cautioned, however, that each such case would need to be resolved on its particular facts and circumstances.

The IRS of the past two or three decades, however, seems to have forgotten that this sensible analysis exists, and instead has used the commensurate-in-scope doctrine only sporadically, sometimes in harmony with the 1964 analysis, and sometimes not.<sup>40</sup> Case law, moreover, is even worse, almost never mentioning the “in furtherance of” aspect of the regulations nor the commensurate in scope doctrine. As a result, no one actually knows how much commercial activity (and what types of commercial activity) will result in tax exemption difficulty.

## 2. *The Donative Approach*

The donative approach would solve the commercial activity problem as follows. First, because exemption would require a certain percentage of donations to operating revenues every year (let’s say 1/3 for now, though I will reiterate that this fraction is not set in stone), the donative approach is self-limiting with respect to commercial activity. The more revenue that comes from commercial activity, the lower the donative percentage; accordingly, charities would need to limit their business activity to keep it in line with donations. In fact, the donative approach provides a handy mathematical solution to the

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<sup>38</sup> Id. at \*18.

<sup>39</sup> Id. at \*23-24.

<sup>40</sup> See, e.g., James J. Fishman, Stephen Schwarz and Lloyd Mayer, *TAXATION OF NONPROFIT ORGANIZATIONS: CASES AND MATERIALS* 328-29 (4<sup>th</sup> ed., 2015); John D. Colombo, *Reforming the Internal Revenue Code Provisions on Commercial Activity by Charities*, 76 *FORDHAM L. REV.* 667 (2007).

problem: commercial revenues together with any other non-donative revenue could not exceed two-thirds of the total revenue.

A second limitation on commercial activity from the donative approach comes from donors themselves. Mark and I hypothesized that there is a “market in altruism” – that is, individual donors have many choices in directing their donations. We opined that a donor’s choices would be influenced at least in part by the perception of need – that is, a donor would be less likely to give money to a charity that the donor perceived did not need the financial help. Commercial activities (particularly successful ones) would impact this perception of need, and hence cause a decline in donations, placing a further constraint on the charity’s commercial activity. I believe one sees evidence of this “market in altruism” in nonprofit hospitals, which were at one time mostly supported by donations and volunteer labor, but today get very little of either (the occasional “build a new cancer wing” gift notwithstanding).

The combination of the market in altruism effect and the mathematical limits would tend to restrict charities in expanding their commercial endeavors. Charities would have to be careful both about the absolute size of commercial activity in relation to donations and the perception that such activity made them a less desirable target of philanthropy. Of course, whether placing such limits on commercial activity is a good thing can be debated; here, I only note that the donative approach would provide a very bright line answer to the “how much commercial activity is too much” question.

### *3. Other Approaches*

The lack of any even modestly-clear guidance on the commercial activity issue could be remedied by an updated revenue ruling from the IRS setting forth current guidelines for commercial activity by charities. My own view is that such a ruling should reinforce the conclusions the IRS reached in 1964: there is no particular limit on commercial activity by charities; rather, the question is whether the commercial activity is helping to appropriately expand charitable outputs. Several years ago, I suggested that such a new ruling could include a safe harbor provision that tied revenues from commercial activity to

some baseline rate of return on low-risk securities.<sup>41</sup> As long as the commercial activity produced net revenues at least equal to this baseline and the charity spent those revenues on charitable outputs, no issue would arise regarding tax exemption. However it may be done, it is crucial for the IRS to make clear the point that there is no artificial limit on commercial activity as long as that activity is subordinate to charitable output.

#### 4. *And What About the UBIT?*

I have written more words about the UBIT than any one individual should, so this will be brief. I have argued in the past that the best rationales for the UBIT are to protect the corporate tax base from erosion by exempt organizations acquiring corporate businesses, and Henry Hansmann's observation that the UBIT likely promotes economic efficiency by keeping charitable organizations from acquiring business activities that they have no expertise in managing.<sup>42</sup> Hansmann's observation can be expanded to the notion that the UBIT discourages "empire building" by charitable managers, or what some have referred to as "managerial diversion" from the core charitable enterprise.

The donative approach, however, has a built-in mechanism to control commercial activity. As noted above, charities would need to balance commercial revenues against donative revenues in order to maintain exemption. Accordingly, Mark and I believed that the UBIT would no longer be necessary to protect the corporate tax base and avoid managerial diversion under this system. The system is inherently self-regulating: too much commercial revenue in comparison to donations and exemption is lost, and too much commercial activity (we hypothesized) would lead donors to give their money to other charities that appeared more deserving in the market for philanthropy.

Without the donative approach, the UBIT probably needs to stay, despite my musings of two years ago that perhaps it was time to just repeal it. Henry was almost certain-

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<sup>41</sup> John D. Colombo, *Regulating Commercial Activity by Exempt Charities: Resurrecting the Commensurate-in-Scope Doctrine*, 39 EXEMPT ORG. TAX REV. 341 (2003).

<sup>42</sup> See John D. Colombo, *Reforming the Internal Revenue Code Provisions on Commercial Activity by Charities*, 76 Fordham L. Rev. 667 (2007); Henry Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 Virginia Law Review 605-35 (1989).

ly correct that there needs to be some mechanism to discourage willy-nilly acquisitions of taxable businesses by charities, and the UBIT performs some of that function, however imperfectly.

### *C. Lobbying*

#### *1. Current Law*

Section 501(c)(3) states quite sternly that “no substantial part” of the activities of an exempt charity can be lobbying. This statutory limitation raises two main issues: (1) what is lobbying and (2) how does one measure when lobbying is “substantial.” We have fairly good answers to question (1) in the form of extensive regulations on lobbying under Section 4911 (these regulations technically only define lobbying for purposes of the 509(h) election, discussed below, but are at least an inferential source of detail on the definition of lobbying for the 501(c)(3) limitation). The one criticism that could be levied here is that the regulations pre-date the internet era, and hence do not specifically cover issues relating to mass e-mails; click-throughs and the like.

With respect to question (2), however, there is no better guidance for “how much lobbying is too much” than there is for “how much commercial activity is too much” – or put more succinctly, just as the IRS has failed to provide answers in the commercial activity sphere, so too have they failed in the lobbying sphere.

The best source of “guidance” (if you can call it that) on the issue comes from the *Christian Echoes* case decided by the 10<sup>th</sup> Circuit in 1972.<sup>43</sup> The court in this case rejected any kind of mathematical approach to defining “no substantial part” and instead adopted what the court called a “balancing” test (what I refer to as a “centrality” test) in which it found that the lobbying activities of *Christian Echoes* were “essential” to its mission and both “substantial and continuous.”<sup>44</sup>

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<sup>43</sup> *Christian Echoes National Ministry, Inc. v. United States*, 470 F.2d 849 (10<sup>th</sup> Cir. 1972).

<sup>44</sup> *Id.* at 851, 855-56.

Perhaps as a result of the fact that the “no substantial part” test has no useful boundaries, Congress adopted an alternative mathematical system for determining allowable lobbying expenditures in Section 501(h) and 4911. This system, which must be elected by a charity (and is applicable only to public charities that are not churches), sets up a sliding scale of permitted lobbying expenditures based upon the organization’s charitable purpose expenditures (“exempt purpose expenditures” or EPE); the maximum allowable is \$1 million, reached when an organization has \$17 million of EPE. A lower limit applies to “grass roots” lobbying (generally 25% of the overall lobbying limit), and violations generally are punished by payment of an excise tax of 25% of the excess lobbying expenditures (an organization can lose exemption for repeated gross violations of the limits – four years of overspending by 150% - but no organization should ever face this sanction since expenditure amounts are knowable and can be planned ahead). Extensive regulations under 4911 define lobbying, although as noted above, they are somewhat dated in our current internet-connected world.

The biggest problems with the elective test are (1) almost no one uses it<sup>45</sup> (why should they, when the vagueness of the “no substantial part” test provides far more operating leeway) and the overall limits are very seriously out-of-date, having never been increased since the original passage of the statute in 1976. A million dollars simply doesn’t go very far anymore. The result is that there really aren’t any limits on legislative lobbying for well-established charities, as the Catholic and Mormon churches established during their blitz on Proposition 8 in California a few years ago.<sup>46</sup> The famous tax-lawyer advice to clients of “don’t be a pig” (e.g., in this context, don’t be Christian Echoes) is all that really rules this limitation.

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<sup>45</sup> I have only anecdotal evidence from practitioners for this statement; as far as I know, the IRS has never published statistics on the number of 501(h) elections made.

<sup>46</sup> See John D. Colombo, LDS Church, Proposition 8, and the Lobbying Limitation, Nonprofit Law Prof Blog, Nov. 18, 2008, available at <http://lawprofessors.typepad.com/nonprofit/2008/11/lds-church-prop.html>; Compare Brian Galle, *The LDS Church, Proposition 8, and the Federal Law of Charities*, Nw. U. L. Rev. Colloquy (2009), available at [http://scholarlycommons.law.northwestern.edu/nulr\\_online/159/](http://scholarlycommons.law.northwestern.edu/nulr_online/159/).

## 2. *The Donative Approach*

The solution proposed by Mark and me to the twin issues of lobbying and political campaign activity (see below) was to repeal the current limitations on both and deduct the costs of political activity (in whatever form – campaign or lobbying) from the donations received (e.g., the numerator of the donative fraction) before testing for the minimum donation percentage. In other words, only the net donations would count toward the donative threshold.

In effect, this system imposes a 33% (or whatever the donative threshold may be) “tax” on political expenditures, by forcing a putative charity to reserve at least one-third of its revenues for nonpolitical purposes. Assume, for example, that a putative charity receives \$1000 in donations, all of which it spends on lobbying. Under a “net donations” approach, this entity fails the exemption test, because it has \$1000 in revenue and zero in net donations (after deducting the expenses on political activity). In order to meet a one-third donative threshold, the entity in question could spend only \$666.66 on political activities; the rest would need to be spent on some kind of active charitable program.<sup>47</sup>

This approach overcomes the main problems with current law identified above. The uncertainty of the “no substantial part” test is removed, as is the artificial \$1 million cap on lobbying expenditures. An organization could engage in a very extensive lobbying (or political campaign) program, but also would be required to maintain a minimum (one third) of other charitable outputs. We recognized, of course, that we would still need a

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<sup>47</sup> Technically, the donative approach proposed by me and Mark did not require the entity in question actually to spend the \$333.33 on any charitable activity, because the mathematical donations test would replace the “charitable purpose” test of current law. However, it is hard for me to believe that donors would be happy with an organization that simply “banked” one-third of their donations for no purpose; again, relying on the market in altruism, I would expect that such a strategy would eventually cause donations to dry up. Of course, one could imagine that the one-third portion would be spent on the peculiar priorities of the donors, but that is essentially already true of charities generally – they spend money on things designed to attract donative support. My view is that not much would change on that front; the NRA would have different spending priorities than the Sierra Club, but that is part of the celebration of pluralism that this area is all about.

Note also that the “tax” becomes greater if the organization in question has other non-donative revenue. If the organization hypothesized in the text also had \$500 of sales revenue, for example, then the total revenue is \$1500. In order to pass the 1/3 threshold, the organization would need \$500 in net donations, and thus could spend only \$500 on political campaign activity.

system of classifying expenditures as “lobbying” (or political campaign activity), but the regulations under Section 4911 (and Rev. Rul. 2007-41, discussed below) already largely accomplish that goal.

### 3. *Other Approaches*

The main difficulty with any approach to political activity is determining the appropriate relationship between these activities and other nonpolitical charitable outputs. One can certainly make a strong argument that there should be no restrictions on lobbying as a charitable activity at all, as long as the lobbying is for the benefit of a charitable class; after all, petitioning one’s government for redress is a constitutionally-protected action. In the context of our donative approach, Mark and I believed that we should modestly limit (but not eliminate) the amount by which government funds activities directed toward the government itself, but lobbying in general should not be seen as inconsistent with charitable purpose. Other commentators have visited this question extensively, and have reached differing compromises, but generally agree with the overall conclusion that lobbying is not inconsistent with charitable activity.<sup>48</sup> Other than that observation, I don’t have a good answer for the question of the appropriate relationship between lobbying and other charitable activity – that is, how much lobbying should be permitted. Lobbying is often the only way to fully realize underlying policy goals. Until we develop some broader consensus on this underlying question, no alternative solution seems possible, and “muddling along” with the current system is probably the best we can do.

### D. *Political Campaign Activity*

#### 1. *Current Law*

In theory, the current law with respect to political campaign activity is a bastion of clarity compared to the issues of commercial activity and lobbying: none is permitted. In

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<sup>48</sup> See Lloyd H. Mayer, *Nonprofits, Speech and Unconstitutional Conditions*, 46 Conn. L. Rev. 1045 (2014); Miriam Galston, *Lobbying and the Public Interest: Rethinking the Internal Revenue Code’s Treatment of Legislative Activities*, 71 Tex. L. Rev. 1269 (1993); Laura Brown Chisolm, *Exempt Organizations Advocacy: Matching the Rules to the Rationales*, 63 Ind. L. Rev. 201 (1987); Elias Clark, *The Limitation on Political Activities: A Discordant Note in the Law of Charities*, 46 Va. L. Rev. 439 (1960). Compare Brian Galle, *Charities in Politics: A Reappraisal*, 54 Wm. & Mary L. Rev. 1561 (2013).

practice, however, current law faces three problems: (1) the IRS has essentially abandoned enforcement of the political campaign activity limitation; (2) one must draw the line between prohibited campaign activity and permitted “issue advocacy” (which may or may not be “lobbying”) and (3) the current Supreme Court might well find the limitation unconstitutional in light of its views about corporate participation in political campaigns,<sup>49</sup> although conditioning tax-exemption on a political activity limitation is far different from a direct limitation on campaign spending, and the current court might find expansion of the doctrine of unconstitutional conditions more distasteful than the political campaign activity ban on a 501(c)(3) organization.

The first problem is a matter of politics and will. Part of me cannot fault the IRS for simply giving up on enforcing the campaign activity rules in the current political climate; the other part of me is damned angry about it. Tax law has enough trouble retaining its legitimacy without the agency in charge of enforcement making a wholesale decision that the law doesn’t matter. The second problem is solvable with regulations and other regulatory guidance; while one can certainly nitpick any regulatory effort, my own view is that Rev. Rul. 2007- 41 makes considerable progress in drawing the lines between permissible issue advocacy and prohibited campaign activity, and I hope will form the basis for a more extended regulations effort on this front down the road. The third problem will require a test case; there should be no shortage of those if the IRS decides to actually enforce the law.

## 2. *The Donative Approach*

As noted directly above, Mark and I proposed that the current “zero tolerance” rule on political campaign activity be repealed, and that campaign activity would be treated the same as lobbying (any expenditures on campaign activity would be deducted from the donative base before testing for the donative threshold). As with lobbying, we saw no necessary conflict between political campaign activity and charity – in fact, one of the

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<sup>49</sup> See Mayer, *supra* note 48; Laura Brown Chisolm, *When Statutory Regimes Collide: Will Wisconsin Right to Life and Citizens United Make Federal Tax Regulation of Campaign Activity Unconstitutional?*, 13 U. Pa. J. Const. L. 867 (2011).

more effective ways to move causes of social justice is to “throw the bums out” and elect your own slate of bums. However, as with lobbying, we believed there should be modest limits on the amount of government subsidy going to campaign activity via the tax-exemption/deduction route.

Note also that the donative approach essentially combines all political activity (campaign and lobbying) into a single “activity.” Amounts spent on campaign activity necessarily would reduce amounts spent on lobbying and vice-versa. Charities could engage in a significant amount of political activity overall, but would have to judge for themselves how best to deploy resources in meeting their objectives. Both activities, moreover, would be subject to the “one-third tax” discussed above with respect to lobbying.

### 3. *Other Approaches*

Once again, the key question to be answered is the relationship of political campaign activity to the definition of charity. As noted above, Mark and I did not find that political campaign activity necessarily was antithetical to charitable status, and would repeal the zero-tolerance rule. Other commentators have taken a range of positions, some supporting our basic conclusion,<sup>50</sup> and others disagreeing with it on grounds that vary from economic efficiency to protecting the legitimacy of charities and the democratic process.<sup>51</sup> It is true that Mark and I originally made our proposals before *Citizens United*

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<sup>50</sup> Laura Brown Chisolm, *Politics and Charity, A Proposal for Peaceful Coexistence*, 58 Geo. Wash. L. Rev. 308 (1990). Other commentators have addressed the issue specifically in the context of churches. See, e.g., Nina J. Crimm and Laurence H. Winer, *Politics, Taxes and the Pulpit: Provocative First Amendment Conflicts* (2011); Lloyd H. Mayer, *Politics at the Pulpit, Tax Benefits, Substantial Burdens, and Institutional Free Exercise*, 89 B.U. L. Rev. 1137 (2009).

<sup>51</sup> In addition to the works cited in footnote 50, see Johnny Rex Buckles, *Is the Ban on Participation in Political Campaigns by Charities Essential to Their Vitality and Democracy? A Reply to Professor Tobin*, 42 U. Rich. L. Rev. 1057 (2008); Bruce Chapman, *Between Markets and Politics: A Social Choice Theoretic Appreciation of the Charitable Sector*, 6 Geo. Mason L. Rev. 821 (1998); Roger Colinvaux, *The Political Speech of Charities in the Face of Citizens United: A Defense of Prohibition*, 61 Case W. Res. L. Rev. 685 (2012); Brian Galle, *Charities in Politics: A Reappraisal*, 54 Wm. & Mary L. Rev. 1561 (2013); Richard W. Garnett, *A Quiet Faith? Taxes, Politics, and the Privatization of Religion*, 42 B.C. L. Rev. 771 (2001); Oliver A. Houck, *On the Limits of Charity: Lobbying, Litigation, and Electoral Politics by Charitable Organizations Under the Internal Revenue Code and Related Laws*, 69 Brook. L. Rev. 1 (2003); Benjamin M. Leff, “*Sit Down and Count the Cost*”: A Framework for Constitutionally Enforcing the 501(c)(3) Campaign Intervention Ban, 28 Va. Tax Rev. 673 (2009); Donald B. Tobin, *Political Campaigning by Churches and Charities: Hazardous for 501(c)(3)s, Dangerous for Democracy*, 95 Geo. L.J. 1313 (2007).

drastically changed the campaign expenditure landscape; however, I tend to agree with sentiments that the problems are more ones of disclosure<sup>52</sup> – if donor disclosure rules were made uniform across various types of exempt entities, the “one third tax” imposed by the donative approach likely would make charities unattractive vehicles for campaign organizations. We would also need to deal with the problem of deductibility of donations to charities in light of the lack of such deductibility to political campaign organizations (or 501(c)(4) organizations), but this is doable with rules like what are currently used for deductibility of union dues that partially are used for political purposes.

At the very least, however, the current law deserves enforcement rather than administrative capitulation. It may well be that the current Supreme Court would find the ban on political activity by charities unconstitutional in a test case, given their bent in *Citizens United* regarding political “speech” by corporations. So be it; if true, it would relieve the IRS of one potential headache in the administration of charitable exemption; if not true, then we would at least know that, and could then adjust the law (or not) to some consensus belief regarding the appropriate role of campaign activity in charitable activities generally.

#### *E. Private Benefit*

##### *1. Current Law*

Like the other boundary areas discussed above, private benefit is a doctrinal mess. No one (including the IRS) can adequately define what it is or when it becomes a problem, for a simple reason: literally all the activities of a charity provide private benefit in some form, including directly to the charitable class and indirectly to a whole host of actors outside the charitable class as a result of actually serving the charitable class. Charities must pay employees, the phone bill, the electric bill, airline fares, bank fees, etc., etc. – all of which involve a private benefit to those service providers.

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<sup>52</sup> *E.g.*, Galle, *supra* note 51, at 1630-31 and sources cited therein.

What we know from discernable current law is the following. First, private benefit is a limitation separate and apart from private inurement (discussed below). Private benefit does not require an unequal exchange, nor does it require the presence of insiders: private benefit can occur in an arm's length transaction between the charity and outside parties. The IRS has described private benefit as a balancing test. In a 1987 General Counsel's memo, the IRS stated, "An organization is not described in section 501(c)(3) if it serves a private interest more than incidentally ... A private benefit is considered incidental only if it is incidental in both a qualitative and quantitative sense. In order to be incidental in a qualitative sense, the benefit must be a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by benefiting certain private individuals ... to be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity."<sup>53</sup> The problem with this "definition," of course, is that it is a quintessential balancing test with no substantive limits and no guidance on exactly what a charity is supposed to balance. Terms such as "necessary concomitant" are useless; does "necessary" in this context mean the fabled "appropriate and helpful" that Justice Cardozo cribbed from constitutional law in explaining the test for deductible business expenses in *Welch v. Helvering*?<sup>54</sup> Or does it literally mean "necessary" in the sense of "no other reasonable option"? When is a benefit not "substantial" in comparison to a public benefit? Do we measure that by monetary impact? Number of charitable beneficiaries served? Can an organization fighting for economic survival claim more leeway in private benefit transactions than one relatively well-off that may not need the transaction at issue to stay in business?

We also know that the IRS tends to raise private benefit in certain specific contexts. These contexts are (1) joint ventures (partnerships) with for-profit actors; and (2) transactions with for-profit actors that seem primarily designed to benefit the for-profit actor, instead of the charitable class. Examples of the former include the famous whole-hospital

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<sup>53</sup> Gen. Couns. Mem. 39598 (Jan. 23, 1987).

<sup>54</sup> *Welch v. Helvering*, 290 U.S. 111 (1933).

joint venture ruling,<sup>55</sup> though echoes of this go back as far as the *Plumstead Theater* case<sup>56</sup>; examples of the latter include the case that started it all (*American Campaign Academy*)<sup>57</sup>; credit-counseling organizations;<sup>58</sup> down-payment assistance organizations;<sup>59</sup> physician recruitment;<sup>60</sup> hospital/doctor joint ventures<sup>61</sup>; and a particularly favorable agreement with a private fundraiser (*United Cancer Council*).<sup>62</sup> Explaining the doctrine beyond these specific examples, however, is mostly an exercise in futility. Nevertheless, I have usually attempted to capsulize it for students by telling them that in any particular transaction between a charity and an actor outside the charitable class, they should ask themselves whether the transaction appears to be structured more toward enriching the outside actors than helping the charitable class; if the former, then alarm bells should ring loudly, although they won't really know if a problem exists without litigation.

## 2. *The Donative Approach*

Mark and I did not discuss private benefit generally in our works setting out the donative approach to tax exemption. We did specifically deal with one aspect of the issue: excessive fundraising. On this point, we suggested the same approach we used in dealing with lobbying and campaign expenditures: net fundraising costs out of donations (but not out of revenue) before applying the donative threshold test. In general, this meant that fundraising costs could not be more than two-thirds of total donations; we believed that this approach would encourage charities to be cost-efficient with fundraising, but provided considerable leeway to incur fundraising costs.

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<sup>55</sup> Rev. Rul. 98-15, 1998-1 C.B. 718.

<sup>56</sup> *Plumstead Theater Society v. Comm'r*, 74 T.C. 1324 (1980).

<sup>57</sup> *American Campaign Academy v. Comm'r*, 92 T.C. 1053 (1989)

<sup>58</sup> Office of Chief Counsel Memorandum 200431023 at 9 (July 30, 2004) available at <http://www.irs.gov/pub/irs-wd/0431023.pdf>. Credit counseling agencies are now subject to special statutory rules in Section 501(q).

<sup>59</sup> Rev. Rul. 2006-27, 2006-21 I.R.B. 915.

<sup>60</sup> Rev. Rul. 97-21, 1997-1 C.B. 121.

<sup>61</sup> Gen. Couns. Mem. 39862, 1991 IRS GCM LEXIS 39 (Nov. 22, 1991).

<sup>62</sup> *United Cancer Council, Inc. v. Comm'r*, 16 F.3d 1173 (1999).

In revisiting the donative approach for this article, I would conclude that private benefit as a general concept should simply be abandoned if the donative approach were systematically adopted. If one believes, as we did and I still do, in some kind of market in altruism, I would substitute disclosure about various financial deals by charities and let donors make up their minds about whether such deals are troubling or not. Remember that, unlike private inurement, which is essentially stealing charitable assets, private benefit does not involve such stealing. Instead, it involves a judgment call by the IRS and ultimately courts that a particular transaction is more about helping actors outside the charitable class than helping the charitable class. I am no more sanguine about the accuracy of such judgments in the private benefit context than I am in the context of charitable purpose; let individuals decide what activities they choose to support knowing the facts, and leave the rest alone, at least as long as there is no “stealing” of charitable assets going on.

### 3. *Other Approaches*

As far as I know, only two people, Darryll Jones and I, have considered how to better define the private benefit limitation.<sup>63</sup> Though our analysis differs in some details and emphasis, we both concluded that there may be legitimate concern regarding “sweetheart” deals between charities and outside actors; deals that, although not inurement, might not be the best use of charitable assets. My solution to this problem involved using presumptions: a transaction would be presumed outside of the private benefit limitation unless it involved sub-contracting core services to a non-exempt actor or involved an exclusive dealing arrangement. Transactions in these latter two categories initially would be presumed to violate the private inurement limitation, unless the charity could present a reasonable case that the transaction in question was in the best interests of serving the charitable class. Reasonableness, in this case, would not be subject to IRS second-guessing as

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<sup>63</sup> See John D. Colombo, *In Search of Private Benefit*, 58 Fla. L. Rev. 639 (2006); John D. Colombo, *Private Benefit: What Is It – and What Do We Want It To Be?* 27-29 (National Center on Philanthropy and the Law available at

<http://www1.law.nyu.edu/ncpl/resources/documents/JohnColomboFormattedNCPLPaper2011.pdf> ; Darryll Jones, *Restating the Private Benefit Doctrine for a Brave New World*, 1 NW J. of Tech. and Intellectual Property 1 (2003) available at

<http://scholarlycommons.law.northwestern.edu/cgi/viewcontent.cgi?article=1008&context=njtip>

long as the charity documented the rationale for its decision and potential alternatives – something akin to the process used under Section 4958 to establish a presumption of reasonable compensation under current law.

Or ... we could just abandon private benefit as a limitation on exempt status completely. In egregious cases, the question presented is whether a charity is actually “primarily” pursuing a charitable purpose, and could be resolved in that manner. A separate private benefit doctrine may simply not be worth the complication it brings to the regulation of the charitable sector.

#### *F. The Public Policy/Illegality Doctrine*

##### *1. Current Law*

The Public Policy/Illegality doctrine covers exactly the two items it purports to. First, an organization will not qualify for exemption if its activities violate criminal laws.<sup>64</sup> The only real difficulty here is determining when an organization has acted illegally – after all, organizations can act only through human beings. The question of “imputation” of actions of human beings to organizations is not a problem confined solely to the realm of tax-exemption; the criminal law in general has similar issues in determining when a corporation is guilty of a crime. The IRS, however, seems not to have opined on this issue in any detail, and it is probable that this imputation would occur only when one could reasonably conclude that the individual was acting within their authority as it relates to the organization.

The public policy prong, however, is another huge doctrinal swamp. The racial discrimination practices of Bob Jones University were not criminal violations; nor were they explicitly prohibited by Section 501(c)(3). In proclaiming that Bob Jones was not entitled to exemption because these practices violated “fundamental public policy,” however, the Supreme Court opened the door to a myriad of interpretations that even today

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<sup>64</sup> Rev. Rul. 75-384, 1975-2 C.B. 204. *Bob Jones University v. United States*, 461 U.S. 574 (1983).

disrupt the exempt sector with the various musings regarding whether an organization's opposition to gay marriage will result in loss of tax exemption.<sup>65</sup>

All we know for certain is that discrimination by an educational institution against a minority class on the basis of race is prohibited by the “common law” of tax exemption. We know nothing beyond that; the IRS has never expanded *Bob Jones* beyond this proposition.<sup>66</sup> I do not know of any case in which a church or single-gender school has ever lost exempt status under the public policy doctrine.<sup>67</sup> The IRS has not expanded the holding to racial discrimination in favor of the minority class (so-called “reverse discrimination”) despite Supreme Court rulings that affirmative action programs may be unconstitutional in certain circumstances.<sup>68</sup> The issue was raised briefly in an administrative ruling involving Kamehameha schools in Hawaii, a purely private school which restricted admissions to students of Hawaiian descent, but nothing ever happened on that front.<sup>69</sup> Academics who have written about *Bob Jones* uniformly agree that the scope of the opinion is unknown, and could in theory support any position from the narrowest construction (only discrimination against a minority class on the basis of race in education is prohibited) to the

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<sup>65</sup> That the conclusions of these musings span the entire range of possibilities from “The IRS will take away our exemption tomorrow” to “revocation of exemption will never happen” is a good indication of the doctrinal problems created by *Bob Jones*. See, e.g., Sarah Posner, *The Panic Over Churches' Tax-Exempt Status in a Gay-Married World*, available at <http://religiondispatches.org/the-panic-over-churches-tax-exempt-status-in-a-gay-married-world/> (quoting Richard Schmalbeck as a voice of reason among the insanity).

<sup>66</sup> In PLR 8910001 (Nov. 30, 1988) the IRS ruled that a privately-administered trust established for the “relief of worthy and deserving white persons” over age 60 was not exempt, and opined at the end that *Bob Jones* “was not limited to racial discrimination in education, but encompassed the eradication of racial discrimination in general.” No formal Revenue Ruling that I am aware of has repeated this broad statement, although one regularly sees statements in rulings that an exempt charity cannot have purposes that are illegal or violate fundamental public policy.

<sup>67</sup> A very few court cases exist in which the illegality branch of the doctrine has been applied to revoke tax exemption; see, e.g., *Church of Scientology of California v. Commissioner*, 83 T.C. 381 (1984) (Church violated public policy doctrine by engaging in criminal conspiracy under 18 U.S.C. Section 371). As noted in the text, I view the *Bob Jones* “public policy” doctrine as different from the rule that a charity cannot engage in criminal activity. I know of no IRS ruling or court decision that has applied the non-illegality portion of the public policy doctrine to strip exemption from a church, although not all IRS private rulings and position papers are available to the public (and I haven't read them all anyway!), so I cannot unequivocally say it has never, ever happened.

<sup>68</sup> See Fishman, Schwarz & Mayer, *supra* note 40, at 147-49; David A. Brennan, *Race-Conscious Affirmative Action by Tax-Exempt 501(c)(3) Corporations After Grutter and Gratz*, 77 St. John's L. Rev. 711 (2003).

<sup>69</sup> See Fishman, Schwarz & Mayer, *supra* note 40, at 148.

broadest (any discrimination of any kind in any circumstance that violates some constitutional principle or other law is prohibited).<sup>70</sup>

## 2. *The Donative Approach*

One of the easiest criticisms of the donative approach is that if taken literally, all sorts of organizations with distasteful, disgraceful or even illegal purposes would potentially qualify for exemption. The Ku Klux Klan would hardly have a problem meeting the donative support test; neither would the Ayrn Nation. I have little doubt that Sheriff Joe Arpaio could form an organization dedicated to physically removing illegal immigrants from the United States, if not burning them at the stake, and receive a groundswell of donations from across the country.

As a result, Mark and I opined that the public policy doctrine should stay in place, since there was no other mechanism to regulate “pluralism gone wild” than to withdraw exemption from activities that the majority in some way explicitly disavowed. In retrospect, however, I believe our position was too simplistic. The theory is still valid, but one of the mechanisms for executing the theory (the public policy doctrine) is very seriously flawed.

The theory harkens back to our conception of exemption as a giant back-scratching scheme: the public tolerates exemption where they would not tolerate direct government expenditures because everyone gets something for their favorite cause and are willing to tolerate everyone else getting that same something. I agree to let your church get exemption in return for your agreement to let my church get exemption, even though we both think each other’s churches are heretical and the other person is surely going to hell, out of mostly pure self-interest (economic or otherwise). If, however, there is an activity which the majority explicitly disapproves of and wishes to exclude from this back-

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<sup>70</sup> E.g., David A. Brennan, *The Power of the Treasury: Racial Discrimination, Public Policy, and “Charity” in Contemporary Society*, 33 U.C. Davis L. Rev. 389 (2000); David A. Brennan, *Charities and the Constitution: Evaluating the Role of Constitutional Principles in Determining the Scope of the Tax Law’s Public Policy Limitation for Charities*, 5 Fla. Tax Rev. 779 (2002); Nicholas A. Mirkay, *Is It “Charitable” to Discriminate?* 2007 Wisc. L. Rev. 45 (2007); Johnny Rex Buckles, *Do Law Schools Forfeit Federal Income Tax Exemption When They Deny Military Recruiters Full Access to Career Services Programs?*, 41 Ariz. St. L.J. 1 (2009); Miriam Galston, *Public Policy Constraints on Charitable Organizations*, 3 Va. Tax Rev. 291 (1984).

scratching scheme, then it should not be exempt. This theory nicely explains the illegality part of this limitation: there is no more explicit and direct way for the majority to declare disapproval of a particular action than to make it a crime; having done so, it makes perfect sense that the majority would not want this action part of the back-scratching paradigm.

The public policy doctrine, however, does not appropriately execute this theoretical underpinning. Instead of withdrawing exemption through specific public opprobrium (as expressed, for example, by the criminal law), the current approach largely eliminates things by speculation whether a public policy is “fundamental” or permits them by administrative inaction, a set of circumstances we should not tolerate in tax law, where taxpayers deserve to know what the rules are. Accordingly, I have come to believe that Justice Rehnquist was exactly correct in his dissent in *Bob Jones*: the appropriate way to deal with these cases is for Congress to explicitly limit exemption via an amendment to Section 501(c)(3) (or other governing statute). Doing so makes the limitation explicit (at least, if good drafting is involved), just as criminal statutes are explicit, and would largely end the argument regarding the scope of the public policy limitation. If we want to outlaw just discrimination against a minority class on the basis of race in education, say so explicitly in the statute; then we know that opening a single-gender school or refusing to perform gay marriages do not affect exempt status. If we want a broader prohibition, draft a broader one. From the standpoint of our back-scratching paradigm, in fact, this is the only way to be sure that the majority really does want to eliminate a given activity from the exemption log-rolling compromise.

### 3. *Other Approaches*

As noted above, writings on *Bob Jones* have uniformly noted the uncertainty in tax administration engendered by the decision, but have taken various positions on whether the doctrine should be applied expansively, narrowly or somewhere in-between. Given that Congress is unlikely to act in this area any time soon, my own view is that this is another area begging for a current Revenue Ruling that would bring clarity to the IRS’s own administrative position. Concurrent with my most recent views on this issue, this ruling should state clearly that the IRS will confine the public policy doctrine to the narrow hold-

ing of *Bob Jones* – viz., that discrimination against the minority class on the basis of race in education is not consistent with exempt status – but would also clearly state that the IRS will not expand the doctrine beyond this narrow holding in the absence of a statutory amendment. That would shift the burden of action (or inaction) to Congress, and end the wild speculation about whether the IRS will pull exemption from churches refusing to perform gay marriages, whether affirmative action violates the public policy doctrine; whether a single-gender school is OK, and so forth. And Justice Powell will perhaps rest in peace, knowing that *Bob Jones* will not have become a tool for dismembering pluralistic expression that goes against the party line.

### *G. Private Inurement*

#### *1. Current Law*

The private inurement limitation may be the only limitation on charitable tax exemption that is well-defined and clearly understood. The principle is straight-forward: private inurement is the diversion of charitable assets to an insider; in effect, it is an insider stealing from the charity. Inurement transactions follow two patterns: the charity paying too much to an insider for services rendered or property provided (e.g., unreasonable compensation, excessive rent) or the charity getting paid too little for economic value it provides to the insider (below market loans; free use of charitable assets).

The one major problem with the private inurement limitation was that prior to the 1990's, the IRS's only remedy for inurement was to revoke tax-exemption from the charitable organization involved. This was sort of like executing the victim of a crime instead of the perpetrator; in response, Congress finally passed the intermediate sanctions regime of Section 4958, which generally applies a large excise tax to the wrongdoer (the individual who initiated and benefitted from the inurement transaction) instead of punishing the exempt organization.

That is not to say that the inurement limitation is without controversy. The IRS has yet to issue regulations on how inurement applies in certain kinds of incentive-compensation transactions, and there is some debate regarding whether the safe-harbor

provision of the 4958 regulations relating to compensation have done anything other than ratchet up salaries for executives and supply an endless amount of business to “compensation consultants.” The concept of “unreasonable compensation” also remains as murky as it is under Section 162. Nevertheless, of all the limitations discussed above, the inurement limitation is the most well-defined and administered.

## *2. The Donative Approach*

The donative approach to boundary-setting has no inherent method to limit stealing from charities by insiders. Accordingly, the private inurement limitation would need to remain in place.

## *3. Other Approaches*

Aside from some debate about technical issues under 4958 such as the compensation safe-harbor (see above), no one has seriously recommended significantly altering the scope of the inurement provision. With respect to potential technical tinkering, I doubt that the inexorable climb in executive salaries will be tempered by repealing the compensation safe-harbor in the regulations; in an era in which Nick Saban makes \$7 million a year as Alabama’s football coach, I find it hard to get all that excited about the salary of Lincoln Center’s CEO or that of university presidents (and since I don’t think hospitals should be exempt anyway, I don’t get excited about hospital CEO’s either – and in any event, I’d rather go visit the \$5-million-a-year cardiologist for heart bypass surgery than the person making \$50,000). The 4958 process appears to mostly work; leave it alone – God knows there are several other things, as recounted above, that are more pressing to deal with.

## **IV. Some Evidence from the Trenches: The Donative Approach In Action**

Though the donative approach has not been adopted (or even seriously discussed) by Congress or the IRS as an overall method of determining eligibility for charitable exemption under Section 501(c)(3), state courts and the IRS itself have relied on donations as significant indicators of charity. I have noted in the past that the IRS has cited donations (or the lack thereof) as a major factor in assessing charitable status in a number of rulings, including the community redevelopment and housing rulings cited in part III.A.,

above. Note also that the IRS's procedural guidelines on exempt public interest law firms essentially mandate that 50% of their funding come from private donations or government grants.

The most direct use of donations as evidence that an organization should qualify as a tax-exempt charity, however, comes from state court decisions. In Idaho, Illinois, Iowa, Maryland and Minnesota, courts have held explicitly that support by private donations is a key factor in determining charitable status.<sup>71</sup> In *Care Institute, Inc.*, for example, the Supreme Court of Minnesota denied exemption to an assisted-living facility in part because of a lack of donative support,<sup>72</sup> and lack of donations similarly played a role in the Illinois Supreme Court's denial of exemption to Provena Covenant hospital.<sup>73</sup> While these courts

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<sup>71</sup> *Sunny Ridge Manor v. Canyon County*, 106 Idaho 98, 675 P.2d 813 (1984) ("A number of factors must be considered: (1) the stated purposes of its undertaking, (2) whether its functions are charitable (in the sense just discussed), (3) *whether it is supported by donations*, (4) whether the recipients of its services are required to pay for the assistance they receive, (5) whether there is general public benefit, (6) whether the income received produces a profit, (7) to whom the assets would go upon dissolution of the corporation, and (8) whether the "charity" provided is based on need."); *Methodist Old Peoples Home v. Korzen* (39 Ill. 2d 149 (1968) (to be charitable under Illinois law, an organization must meet five factors: (1) It has no capital, capital stock or shareholders; (2) It earns no profits or dividends but rather derives its funds mainly from private and public charity and holds them in trust for the purposes expressed in the charter; (3) It dispenses charity to all who need it and apply for it; (4) It does not provide gain or profit in a private sense to any person connected with it; and (5) It does not appear to place any obstacles in the way of those who need and would avail themselves of the charitable benefits it dispenses.); *Supervisor of Assessments v. Group Health Ass'n, Inc.*, 308 Md. 151, 517 A.2d 1076 (1986) ("A determination of whether an institution is charitable must include a careful examination of the stated purposes of the organization, the actual work performed, the extent to which the work performed benefits the community and the public welfare in general, *and the support provided by donations.*"); *North Star Research Institute v. Hennepin County*, 306 Minn. 1, 236 N.W.2d (1975) ("In these cases, assessment has been made of such factors as (1) whether the stated purpose of the undertaking is to be helpful to others without immediate expectation of material reward; (2) *whether the entity involved is supported by donations and gifts in whole or in part*; (3) whether the recipients of the 'charity' are required to pay for the assistance received in whole or in part; (4) whether the income received from gifts and donations and charges to users produces a profit to the charitable institution; (5) whether the beneficiaries of the 'charity' are restricted or unrestricted and, if restricted, whether the class of persons to whom the charity is made available is one having a reasonable relationship to the charitable objectives; (6) whether dividends, in form or substance, or assets upon dissolution are available to private interests."); *R. K. Richards v. Iowa Dept. of Revenue*, 414 N.W.2d 344 (Iowa 1987)("It is, however, important that contributions of money, goods, and services have played *some* part in the establishment and operation of a charitable institution."

<sup>72</sup> 576 N.W.2d 734, 739 (1998).

<sup>73</sup> *Provena Covenant Medical Center v. Dept. of Revenue*, 236 Ill.2d 368, 925 N.E.2d 1131, 1146 (2010) ("While Korzen factors one and four thus tilt in favor of characterizing Provena Hospitals as a charitable institution, application of the remaining factors demonstrates that the characterization will not hold. Provena Hospitals plainly fails to meet the second criterion: its funds are not derived mainly from private and public

admittedly have not used donations as the sole criteria for exemption, they do indicate that using donations as a key indicia of “charitableness” is already a part of the underlying fabric of the analysis of charitable exemption at the state level.

## V. Final Observations

The system we have for setting the boundaries of charitable tax exemption is broken. Here is a quick summary of the evidence presented above:

1. We have no idea what should be considered charitable for tax purposes, particularly when dealing with commercialized activities. The modern world has overtaken the 1959 regulations by light-years, and there is no coherent theory for deciding borderline cases. The result is wildly inconsistent decision-making at the margins, and an inability to let go of outdated views (e.g., that nonprofit hospitals are, as a class, charities).
2. We more or less know what commercial activity is, but have no idea how much of it is too much, and the IRS vacillates among positions as necessary to win litigation, to the detriment of any coherent policy.
3. We more or less know what lobbying is, but also have no idea how much is too much; the mechanism to alleviate this uncertainty (501(h)) is by most accounts rarely used and outdated in its mathematical limits.
4. We have no idea what private benefit is, although in theory we know how much is too much (any). There is no good theoretical explanation for why this limitation exists beyond the notion that a charity must primarily be a charity and not an accommodation party for actors outside the charitable class. Why the IRS finds partnerships so alarming is unknown, since they are nothing more than business ventures by charities which don’t seem to bother anyone in other contexts, and the doctrine overall is unpredictable and undefined.

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charity and held in trust for the purposes expressed in the charter. They are generated, overwhelmingly, by providing medical services for a fee.”).

5. We have no idea what a fundamental public policy (as opposed to an illegal activity) is. *Bob Jones* itself addressed only a very narrow issue, and the IRS has been unwilling to clarify its position on this doctrine, leading to exactly the problem Justice Powell identified in his concurrence: the fear that not towing the governmental party line will result in loss of exemption.

6. We have a decent idea of what prohibited political campaign activity is under Rev. Rul. 2007-41, and a clear mandate on how much of it is too much (any). But the IRS has abandoned any effort at enforcement of the law due to political pressure, and there are not-insubstantial concerns that the rules may be held unconstitutional if challenged in court.

7. The only limitation that actually seems to work pretty well is the inurement limitation, although it suffers from what are probably unavoidable technical difficulties (defining “unreasonable” compensation; the possibility that the safe-harbor compensation-setting mechanism simply ratchets-up compensation). Still, of the seven items listed here, it is the most well-defined, best understood, and probably the most administrable.

The donative approach to boundary-setting would largely fix problems 1, 2, 3, 4 and 6. To paraphrase Meat Loaf’s classic hit song, “five out of seven ain’t bad.”<sup>74</sup> That, plus the existing evidence that courts and even the IRS itself uses donations to signal what is truly charitable might suggest that the donative approach is worth another (or maybe a first) look. But to sum up where this is likely to go in a Yoda-like phrase (the newest Star Wars movie is due out soon, after all), “My life I value; my breath I won’t hold.”

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<sup>74</sup> [www.youtube.com/watch?v=k5hWWe-ts2s](http://www.youtube.com/watch?v=k5hWWe-ts2s)