

**THEORIES OF THE FEDERAL INCOME TAX**

**EXEMPTION FOR CHARITIES:**

**THESIS, ANTITHESIS, AND SYNTHESIS\***

by

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Dyadic classifications ... have less interest [than tripartite systems] while quadratic ones apparently are too complicated for most people to keep in mind, which is why there is no holy Quadrinity.

Robert Nozick, Philosophical Explanations at 557 n.\* (1981).

### I. Introduction.

The fact that the federal income tax law has a specific exemption<sup>1</sup> for a class of organizations collectively described as "charitable"<sup>2</sup> immediately suggests two related questions. First, what (if anything) about these organizations makes them worthy of special treatment, and, second, is income tax exemption a fitting form of special treatment, an appropriate means to encourage whatever it is about such organizations

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1. This is, of course, I.R.C. Section 501 (c)(3). It is important to note that this section exempts only three kinds of income -- gift, exempt purpose, and passive investment; a fourth, unrelated business income, is explicitly subject to tax. I.R.C. § 511. In this paper I will not differentiate among the kinds of income exempt under 501 (c)(3), and I will not deal with the rationale for taxing unrelated business income. For a brief description of the way these various forms of income differ, see Atkinson, Altruism in Nonprofit Organizations, 31 B.C.L.Rev. 501, 599-600 (1990). For a recent re-assessment of the rationale for the UBIT that nicely addresses earlier treatments, see Hansmann, Unfair Competition and the Unrelated Business Income Tax, 75 Va. L. Rev. 605 (1989).

2. The Internal Revenue Code's tax exemption provisions extend far beyond the borders of charity, which will be the limit of my discussion. See H. Dale, Rationales for Tax Exemption 1, 1 note 1 (Feb. 1, 1988) (unpublished manuscript) (noting wide range of other tax exempt entities). Charity's closest cousins in the revenue code are their fellow nonprofits, the mutual benefit organizations. The traditional basis for their exemption is defended in Bittker & Rahdert, The Exemption of Nonprofit Organizations from the Federal Income Taxation, 85 Yale L.J. 299, 348 (1976), criticized in Hansmann, The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation, 91 Yale L. J. 54, 96 (1981), and refurbished in Atkinson, supra note 1, at 624-25.

that we find worthy? For convenience, I will refer to these questions as the worthiness issue and the fit issue, respectively.

I want to suggest, with more than mock seriousness, that borrowing the three-staged Hegelian schema is a heuristically helpful way to approach the systematic answers that have been given to these two basic questions. In addition to meeting Nozick's criterion, noted above, Hegel's tripartite scheme rightly suggests relations among the things classified. The theories I describe are intimately related, even if my presentation is somewhat Procrustean. Flaws in one theory did give rise to alternatives, and I try to capture some of that in what follows. In broad outline, I will try to show how problems with the conventional wisdom -- the view that the tax exemption subsidizes the social benefits charities provide -- gave rise to Bittker and Rahdert's antithetical tax-base defining rationale, which in turn has spawned a set of related theories that combine the better elements of their predecessors.

Hegel's approach may not work as a theory of history, but it works surprisingly well as a history of theory, or at least charitable exemption theory. With that in mind, you will, I trust, pardon some reshuffling of chronology in order to give a more coherent account of theory. It would hardly be Hegelian to let the untidiness of history spoil the elegance of theory.

## II. Prolegomena to Any Future Exemption Theory.

Before we turn to the theories themselves, I need to make a few preliminary comments about what we want -- and what we can reasonably expect -- in an

exemption theory.<sup>3</sup> I do not want to suggest that we are at the end of the history of theories of the tax exemption, that the logical possibilities have all been tried.<sup>4</sup> But I do want to say something about what the general parameters of future debate will be. Failure to focus on these parameters has led the theorists I discuss -- myself included - - into philosophical fly-bottles.

The first point to note is implicit in the distinction between the first of today's papers and this, the second, between giving a history of the exemption and justifying the exemption. The former must be a descriptive account, the latter must be a normative account, and we must be careful to note that the requirements of the two are quite different. A descriptive account is deficient if it does not explain all the data. Einstein's physics is in that sense better than Newton's, and a physics that explains quantum mechanics too will be better still. Normative theory, by contrast, is more ambiguously related to its data.<sup>5</sup> The data include our beliefs and intuitions as

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3. Shallow bow to Kant aside, these preliminary observations are inspired in large part by Hall and Colombo's effort to identify criteria by which to judge an exemption theory. Hall & Colombo, The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption, 66 Wash. L. Rev. 328-31. As I will note at various points in this discussion, I do not accept all their criteria, but I think they have made explicit and articulate much that was previously only implicit, and often confusedly so.

4. Even if all the logical possibilities have been exhausted, the history of the exemption will certainly go on, in political debates about its proper scope. Indeed, that is a subsidiary theme of my paper: debates about both the fit and the worthiness questions are irreducibly political, despite the best efforts of theoreticians to make them something else.

5. See Callahan, Ethical Issues in Professional Life 9-10 (1988) and Rawls A Theory of Justice 20 (1971) (discussing reflective equilibrium); see also Moore, Moral Realism, 1982 Wis. L. Rev. 1061, 1106-1116 (suggesting that normative theory is more like descriptive theory, even in so central a case as physics, than I allow).

to what is good, and these can change as a result of our examination.

Exemption theories often rest, explicitly or implicitly, on descriptive accounts of the role of charity, but they themselves are normative. We start with the raw data, the exemption provisions of 501(c)(3) and what we feel its scope should be, and try to figure out why the organizations covered by it are included. At the same time, we must ask whether what they have in common, or the various different things that have given rise to their inclusion, are worthy of inclusion. We encounter something of a feedback loop: Does the theory explain why this kind of organization is exempt? Is the exemption of this kind of organization a good idea? Conflating these questions can lead to confusion about the appropriate grounds for criticizing a theory. You cannot say "this is a deficient theory, because it doesn't account for the exemption of (for example) religious organizations"<sup>6</sup> without presupposing that such organizations are entitled to the exemption. If you know that, either you already have an exemption theory or you are at risk of begging the worthiness question.

This brings us to my second point: most of us do come close to begging the worthiness question. In the case of the charitable exemption, one intuition that we want our theories to explain is deeply held and not always clearly articulated. We are accustomed to thinking of the organizations in question here as virtuous in a way associated with the words "charity" and "philanthropy," words related etymologically to the notion of selfless, other-regarding love. Moreover, we want an account of the

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6. But see Harvey Dale's criticism of the "relief of government burdens" theory. Dale, supra note 2, at 4.

charitable exemption in terms of that quality, an account that makes charity integral to the exemption, that shows the exemption to be tied to what makes the organizations charitable. A theory that does not make direct reference to this quality will disappoint us, even if it is elegant and internally consistent.<sup>7</sup> We congratulate Laplace for moving the Unmoved Mover out of physics, but we are likely to be uncomfortable with theories that explain our intuitions about "charity" out of the charitable exemption.

Third, we do not just want an explanation of the exemption in terms of its relation to "charity"; we also want a monolithic account of charity itself. This inclination, which I shall call the temptation of the one true way, has two principle sources.<sup>8</sup> The first source takes us back to the very roots of western theory, Plato's notion that when we describe various things by a common term like "good" or "charitable," they must have some feature in common, the feature that is the essence of "goodness" or "charitability." Modern philosophers have questioned the adequacy of this account of description, pointing out that things described by the same term can bear a family resemblance to one another even though all members of the class do not share a single common characteristic.<sup>9</sup> Something like this happens when an

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7. This is perhaps the most serious problem with Hansmann's theory, a problem not attributable to anything within the theory, but to exogenous standards we impose on the theory. For a discussion of that theory, see infra Part V.A.1.

8. Harvey Dale underscores the persistence of the fallacy with a quote from Mencken: "For every complex problem, there is a solution which is simple, elegant, ... and wrong." Hall & Colombo, supra note 3, at 330 note 76.

9. See J. Carney and R. Scheer, Fundamentals of Logic 71-77 (2d ed. 1974).

elderly relative peers into a bassinet and declares that the baby within has an Atkinson face.

Something like this happens, too, in our everyday dealings with putatively charitable organizations. We recognize the charitable in terms of a range of factors, a gestalt or family resemblance approach. If you will forgive a shift of sensory metaphors, this is what a partner in my old law firm meant by saying that a prospective client seeking charitable exemption did not pass "the smell test."

But we are pressed toward the one true way by something other than the shadow of Plato. To see the other source of pressure in that direction, we must distinguish between two branches of normative theory, the moral and the legal.<sup>10</sup> The moral can live comfortably enough with a family resemblance or gestalt theory of charity; it need only identify charity in the abstract. But the legal cannot; a legal definition of charity must be applicable in practice, as well as in principle, to particular cases.

The norms of a legal system can, of course, be ad hoc; that is what the traditional distinction between law and equity was all about. But the virtue of equity, its flexibility, was also the source of its greatest vice: equity varied with the chancellor's foot or, more accurately if less charitably, with those to whom the

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10. There may be others, and these two certainly cross and re-cross, but the distinction is sufficient for my purposes here. It is not, of course, original with me. See Leff, Unspeakable Ethics, Unnatural Law, 1979 Duke L.J. 1229.

chancellor's foot was applied.<sup>11</sup> Ad hoc legal definitions seriously diminish the possibility of effective oversight, inviting abuses of discretion.<sup>12</sup> They also diminish certainty and predictability in the law, values particularly treasured in matters involving the Treasury. Thus in the realm of charity we face a problem that pervades law's empire: when we see the good of charity we know it is multiform and Protean, yet we need a simple and invariant standard by which to reward it.<sup>13</sup> And we do not improve things much when we move from a "know it when I see it" standard to a multifactor balancing test, because it is hard to make the weighing of the factors principled. As Judge Easterbrook has argued, such tests are hardly law at all.<sup>14</sup>

The quest for a single invariant legal standard is exacerbated in the case of charity by a further problem. The most intuitively appealing single criterion of charitable status is the squishy one we have already identified: selfless love of others. Here again, there is no great problem for moral theory. Moral norms are applicable

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11. See Da Costa v. De Pas, 27 Eng. Rep. 150 (1754), in which an eighteenth century Jewish testator's bequest to support a synagogue and Jewish education was converted under the doctrine of *cy pres* to fund Christian education. See also Laird, Phantom Selves: The Search for a General Charitable Intent in the Application of the Cy Pres Doctrine, 40 Stanford L. Rev. 973, 974-75 (using Da Costa case to illustrate the distinction between judicial and prerogative *cy pres*).

12. This is painfully well illustrated by the fate of gay and lesbian organizations seeking charitable status for tax exemption and other purposes. See Big Mama Rag v. United States, 631 F.2d 630 (D.C.Cir. 1980); State ex rel Grant v. Brown, 39 Ohio St. 2d 112, 313 N.E.2d 847 (1974).

13. See Rose, Crystals and Mud in Property Law, 40 Stan. L. Rev. 577 (1988) (describing how property law vacillates between "crystalline" and "muddy" standards, the former bright-line but brittle, the latter murky but malleable).

14. Easterbrook, Faculty Colloquium, Florida State University, February 7, 1991.



to your own motives, which you can at least try to be honest about, and to the motives of others hypothetically. A respectable moral theory need only enable us to say, for example, "if her motive is thus, or the result of her action is so, then she is a good person, or she has acted well." Legal norms, on the other hand, must be applicable to others than the applier, at least some of whom, we can safely bet, will not be honest about their motives, especially when something is to be gained by dissembling. And legal norms must be practicably, not just hypothetically, applicable. For legal purposes we cannot simply say an organization is charitable if its collective heart, or the hearts of its supporters, are in the right place and leave it at that. We must be able to say, with a degree of assurance, that a particular organization in fact meets the test at a particular time. As I have said elsewhere, state of mind may be as provable in principle as the state of digestion, but it is a good deal more difficult to prove in practice.<sup>15</sup> Thus normative theories of charity for legal purposes will tend to look for external criteria, leaving things of the heart, if not to God, at least to moralists.

All this leaves us with a trilemma. If, as I have suggested, we want a theory that takes account of the "charity" of charities, and if charity, like the love that we assume to be at its core, is a matter primarily of the heart, then, in seeking a legal definition in objective terms, we are bound to be disappointed. At best, we will find a proxy for what we are inclined to believe is the real criterion. Alternatively, if we admit charity to be a complex phenomenon, we avoid the fallacy of the one true way, but only at

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15. Atkinson, *supra* note 1, at 529.

the price of a seriously complicated legal definition. Finally, if we justify the exemption in terms of something other than the organizations' "charitability," we do violence to our strong intuition that this is the key that should unlock the federal treasury. At the risk of beginning on a pessimistic note, we can be sure from the outset that a legal definition of charity will not be entirely satisfactory, in large part because some of the things we want in an exemption theory are at odds with others.<sup>16</sup>

### III. Exemption Theories Proper.

With these considerations in mind -- the reciprocal relationship of normative theory to its data, the fallacy of the one true way, and the tension between "legal" and "equitable" standards -- we can turn from metatheory to theory, from what we want and expect in a theory to the theories that have been proffered, and how well they measure up. Following Hegel's example (and Nozick's epigram), I will suggest that there are, if not three theories, then three phases of theorizing: the traditional subsidy theory, Bittker and Rahdert's income definition theory, and a less coherent set of syntheses of these two. Each set of theories offers a distinct take on our two central questions, the issues of worthiness and of fit.

#### A. The Thesis: Traditional Subsidy Theory.

The traditional subsidy theory of the tax exemption for charities answers the

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16. In addition, of course, any legal definition will involve compromises in the name of cost-effectiveness and administrative feasibility, topics that I will not have much to say about directly, as they involve a level of detail present constraints of time and space cannot accommodate.

first of our two questions – Why do charities warrant special treatment? – by pointing to their provision of two kinds of public benefits. The first of these I will call primary public benefits, since they are thought to inhere in the particular activities that the organization undertakes. Charities generate primary public benefits either by providing goods or services that are deemed to be inherently good for the public or by delivering ordinary goods or services to those who are recognized as being especially needy. Health care and education are examples of products deemed to be inherently good; providing them to anyone, irrespective of need, is considered to produce public benefits. Providing food and shelter for the poor or otherwise disadvantaged is an example of benefitting an especially needy class; it makes no difference that the goods provided are themselves mundane. In summary, charities provide primary public benefits in two ways: especially good goods to ordinary people, and ordinary goods to the especially deserving.

Beyond these primary public benefits, charities are said to provide a second kind of public benefit, which I will call "meta-benefits." These benefits derive not from either what product is produced or to whom it is distributed, but rather from how it is produced or distributed. Traditional theory has identified two ways charities provide such "meta-benefits." In the first place, they are said to deliver goods and services more efficiently, more innovatively, or otherwise better than other suppliers. In the second place, charities' very existence is said to promote pluralism and diversity, which are taken to be either inherently desirable or intimately related to our

liberal democratic values.<sup>17</sup> On this view, the charitable exemption is an indirect subsidy by which the government encourages organizations engaging in activities that promote the public good by providing the primary goods and metabenefits I have outlined.<sup>18</sup> This view, which is pretty much the foundation of present law, has

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17. For examples of these views, see Stone, Federal Tax Support of Charities and Other Exempt Organizations: The Need for a National Policy, 1968 U.S. Cal. Tax Inst. 27, 45 ("objectives of pluralism and diversity"); B. Hopkins, The Law of Tax-Exempt Organizations 6-7 (1987) (charities foster "voluntarism and pluralism" and decentralized, efficient decision-making and resource allocation); L. Simes, Public Policy and the Dead Hand 133-34 (1955) (commending the "pioneering element" in charitable trusts); Sacks, The Role of Philanthropy: An Institutional View, 46 Va. L. Rev. 516, 524 (1960) (citing "initiative of thought and action," "diversity of views and approaches," and "experimentation in new untried ventures"); Belknap, The Federal Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy, in 4 Commission on Private Philanthropy and Public Needs, Research Papers 2035-36 (1977) [hereinafter Filer Commission Papers] ("preference for private activity and diversity").

This view is related to the defense of private foundations as "charitable entrepreneurs," the most innovative and counter-majoritarian of charities. See, e.g. Simon, Charity and Dynasty Under the Federal Tax System, 5 Prob. Law 1 (1978); M. Fremont-Smith, Foundations and Government 49-53 (1965) ("Foundations in a Pluralistic Society").

18. This view is widely expressed by both courts and commentators. See, e.g., Bob Jones University v. United States, 461 U.S. 574, 591 (1983) ("Charitable exemptions are justified on the basis that the exempt entity confers a public benefit -- a benefit which the society or the community may not itself choose or be able to provide, or which supplements and advances the work of public institutions already supported by tax revenues."); M. Fremont-Smith, supra note 17, at 158 ("The grant of tax exemption to charitable entities and the allowance of tax deduction for charitable contributions represent an attitude of positive governmental encouragement of philanthropy which has been present in the American tax system since its inception."); B. Hopkins, supra note 17, at 5 ("Clearly then, the exemption for charitable organizations is a derivative of the concept that they perform functions which, in the organizations' absence, government would have to perform; therefore, government is willing to forego the otherwise tax revenues in return for the public services rendered."); Stone, supra note 17, at 45 ("The principal justification for tax benefits granted to these organizations (continued...)")

several things to commend it. In the first place, it promises a single standard that unifies the field. Moreover, it is a standard that seems in accord with our intuitive notion of charity, in its broader, philanthropic meaning. The notion of "public benefit" corresponds nicely to love of humanity in general. Finally, the public benefit theory grafts the rationale of the tax exemption onto the more ancient root of the

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18. (...continued)

[charities] and their donors should be that they relieve the government of what might otherwise be necessary governmental functions which are better accomplished in this fashion than they would be through direct government expenditures or grants."); Belknap, supra note 20, at 2038 ("the policy underlying the tax exemption of charitable organizations is motivated primarily by a desire on the part of government to encourage activities contributing to the general welfare"); H. Oleck, Nonprofit Corporations, Organizations, and Associations 277 (1988) ("these organizations perform functions which would fall squarely on the government if private volunteers were not willing to devote their time and energy to them."); Reiling, Federal Taxation: What is a Charitable Organization?, 44 A.B.A.J. 525, 595 (1958) (charitable exemption "differs only in method from a disbursement of government funds" and "therefore cannot be sustained at law except when the public interest is served in much the same manner as when public funds are properly expended") (footnote omitted).

As several of these sources suggest, the traditional subsidy theory is sometimes expressed as, or alongside, the narrower notion that the benefits charity provide are benefits that the government would otherwise have to provide at taxpayers' expense. See Hall & Colombo, supra note 3, at 345-46; Dale, supra note 2, at 4. This notion is easily subsumed under the broader public benefit theory I describe in the text: relieving the burdens of government is one way charities benefit the public. Standing alone, this theory cannot account for a large and historically significant segment of the charitable sector, churches and other religious organizations, without running afoul of the establishment clause of the First Amendment, as the Bob Jones case, quoted above, implicitly admits. Dale, supra note 2, at 4. Moreover, this theory does not explain why tax subsidy is better than governmental provision, id. at 5, as the broader public benefit theory does with its invocation of metabenefits. But see Weisbrod, Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy, in The Economics of Nonprofit Institutions 85 (S. Rose-Ackerman ed. 1986) (descriptive account of nonprofits as supplementing persistent governmental underprovision of some public goods).

trust law definition of charity.<sup>19</sup>

Nevertheless, the subsidy theory suffers weaknesses in respect to both the worthiness and the fit issues, weaknesses that make it unacceptable in its traditional form. To take the former first, traditional theory rests on the fairly explicit premise that either particular goods and services, or particular modes of supplying them, can be identified as especially good for the public under neutral principles. The emphasis has generally been on identifying the former, what I have called primary benefits, and the results, it is fair to say, have hardly been encouraging, either in principle or in practice.

In practice there are two related problems, one of process and the other of substance: who decides what is a public benefit, and what a public benefit really is. As a practical matter, of course, the Internal Revenue Service decides initially, subject to judicial review. Even assuming, for the sake of argument, that this is an appropriate location of the decision, by what standard should it be made? Both Treasury Regulations and recent cases refer us to the evolving common law concept of charity,<sup>20</sup> but that begs rather than answers the question. Unless we are to return to the ad hoc applications of the chancellor's foot, the evolution of the common law concept of charity must itself be guided by an identifiable and articulable standard of

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19. Commissioners for Special Purposes of the Income Tax v. Pemsel, A.C. 531, 583 (1891).

20. Treas. Reg. Section 1.501(c)(3)-1(d)(2); Bob Jones University v. United States, 461 U.S. 574 (1983).

public benefit. Both liberal economic theory, which is methodologically agnostic as to the "goodness" of particular goods, and liberal political theory, which is substantively neutral to competing conceptions of the social good, offer little help in identifying primary benefits. To cloak the exemption in the garb of "public benefit" without saying more about the cloth from which it is cut invites the suggestion that exemption is a matter of naked and unprincipled political preference.

And even if worthy primary goods could be identified, there is a problem with the traditional subsidy theory in principle – it proves too much.<sup>21</sup> If particular goods and services are worthy of subsidization through tax exemption, why shouldn't the subsidy extend to for-profit producers? None of the answers that can be offered within the confines of the traditional subsidy theory is compelling.<sup>22</sup>

One possible argument is that nonprofits produce what economists call public goods, goods the enjoyment of which cannot effectively be limited to those who pay and which thus are unlikely to be produced in optimal quantities by for-profit firms<sup>23</sup>. Charities do, in fact, frequently produce public goods: enhanced

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21. And too little, for calling the exemption a subsidy makes it difficult to account for the exemption of religious organizations, a large and historically central component of the charitable world, without running afoul of the Establishment Clause. See Dale, *supra* note 2, at 4 (criticizing the traditional theory on this ground); L. Joblove, Special Treatment of Churches Under the Internal Revenue Code, Yale Program on Nonprofit Organizations, Working Paper No. 21 (1980).

22. In setting out and rebutting these arguments, I am following Hansmann, *supra* note 2, at 67.

23. More technically, public goods are said to have two distinct characteristics. In the first place, it is no more costly to provide the good to many than to one, because each can enjoy the good simultaneously without interfering with the others'

(continued...)

environmental quality, listener-sponsored radio, improved race relations, and community development are examples. As Hansmann points out, however, the exemption now applies to many organizations such as hospitals, schools, and nursing homes that provide essentially private goods. These exceptions eat up any public goods rule on which traditional theory can claim to ground the exemption in anything like its present form.<sup>24</sup>

Another possible basis for limiting the subsidy to nonprofits is the fear that for-profit suppliers would use the subsidy to increase distributable profits rather than to increase output or lower prices. Hansmann points out, however, that, in a perfectly competitive economy without market failures, for-profit firms in the long run will tend to pass a subsidy on to consumers as well as nonprofits will.<sup>25</sup> New firms will enter the subsidized industry to get the supranormal profits attributable to the subsidy;

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23. (...continued)

enjoyment. Second, once the good has been supplied to one, it is not feasible to exclude others from enjoying it as well. Thus, in the case of radio broadcasts, it is no more costly to send transmissions to everyone in a given area than to a single person, and it is difficult to ensure that only those who pay for the broadcast receive it. These conditions lead to an underproduction of public goods by private firms, even though demand for them may be high.

24. Hansmann, supra note 2, at 68.

25. Hansmann, supra note 2, at 67. The Utah Supreme Court raised a similar possibility in Utah County v. Intermountain Health Care, Inc., 709 P.2d 265, (Utah 1985). "It may very well be, as a matter of public policy, that all hospitals, for-profit and nonprofit, should be granted a tax exemption because of the great public need they serve." Id. at 277. This should logically follow under traditional subsidy theory, the court reasoned, from the fact that "both provide the public with the same service." Id. at 279. The court did not speculate further on this possibility, however, because the Utah constitution would bar any legislative effort to offer such a generous exemption. Id. at 277.



increased output will drive prices down, thus ensuring that the subsidy is passed on to consumers.<sup>26</sup>

Bear in mind that we have looked thus far only at the kinds of good or service charities provide, ignoring any reasons for favoring charities based on the way they provide goods and services. We have, in other words, focussed on the primary benefits charities provide, ignoring the metabenefits side of traditional subsidy theory. In this we are being faithful to the subsidy theory in its classic expressions. The asserted metabenefits of efficiency, pluralism, and diversity figured in more as rhetorical flourishes than as integral components of an exemption rationale, sometimes as a broad normative defense of the nonprofit sector but never systematically as an explanation of its tax treatment<sup>27</sup>. As we shall see, this latent possibility has been realized in several permutations of the subsidy theory in the third, synthetic phase. Before turning to that, however, we need to conclude our criticism of traditional theory, which takes us next to the issue of fit.

Even if there were a reason to subsidize nonprofit but not for-profit production, there remains the question of whether tax exemption is an appropriate vehicle for the subsidy. Hansmann points out that such a subsidy is proportional to

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26. Hansmann observes that in fact many markets in which charities and other nonprofits operate are characterized by market failures that would permit a for-profit to skim off any subsidy. This observation, as we shall see, is the seed from which Hansmann's own exemption theory grows. See *infra* Part V.A.1.

27. See Dale, *supra* note 2, at 5 (noting fuzziness of claims of that charities are more efficient providers of goods and services than governments).

retained earnings, and questions whether that linkage is justified under the traditional subsidy theory. In his view, "there is no reason to expect a positive correlation between the amount of a nonprofit's retained earnings and the factors . . . that might justify a subsidy."<sup>28</sup>

Harvey Dale captures this point nicely in a parable he tells the graduate tax mavens at NYU (a pearl he generously, if not wisely, cast in my direction as well): Suppose someone in the market for legal advice came upon two equally qualified lawyers and offered to pay them based upon their respective net worths. This would strike us as odd, because net worth has little correlation with the services to be performed -- as little, the parable suggests, as a subsidy to charities through the tax system has with the social benefits charities provide. And the point of the parable is all the more penetrating when backed by the force of Surrey's arguments about the general wastefulness of tax subsidies.<sup>29</sup>

Traditional subsidy theory addresses the fit question rather indirectly, sometimes suggesting that tax exemption is the only politically feasible or practically administrable form of subsidy to charity, sometimes, perhaps making a virtue of necessity, hailing the very indirectness of the subsidy as a salutary stimulus to pluralism and decentralized decision-making.<sup>30</sup> This rather glibly discounts the

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28. Hansmann, supra note 2, at 71.

29. S. Surrey, Pathways to Tax Reform (1973); S. Surrey & P. McDaniel, Tax Expenditures (1985).

30. See Hopkins, supra note 17, at 7; Simon, The Tax Treatment of Nonprofit Organizations, in The Nonprofit Sector, supra note 61, at 67, 70.

importance of the fit issue. To say that traditional theory reached this conclusion too glibly, however, is not to say that the conclusion is wrong. I shall argue below that, after all the arguments for a tighter fit are given their due, looseness of fit may be an inevitable, if not entirely desirable, element of the exemption. But before we punt on the issue of fit, we need to examine Bittker and Rahdert's call for an end run around it.

B. Antithesis: Bittker and Rahdert's Income Definition Theory.

Problems with the traditional theory led Bittker and Rahdert to deny one of its central assumptions -- the notion that the tax exemption is a subsidy -- and to turn this negation into a positive theory of the exemption. If the tax exemption could be viewed not as a subsidy of some good -- primary or otherwise -- that the organization provides, but rather as a recognition that the revenue thus exempted is for some reason not appropriately included in the tax base, the problems of the traditional subsidy theory would be avoided. The search for a link between retained earnings and the purpose for favoring the tax-exempt organization would be less exigent, and criticisms of the general inefficiency of tax subsidies would be beside the point. Moreover, if charities' income is not measurable or not properly included in the tax base for reasons internal to the tax system, then the paradox of charities' being more favorably treated than their for-profit counterparts disappears, along with the need for a substantive standard of charitability.

After canvassing the early legislative history, Bittker and Rahdert concluded that charities and other nonprofits had been exempted primarily because the income tax

could only logically be levied on activities undertaken for profit.<sup>31</sup> Bittker and Rahdert accepted this nascent rationale as essentially sound, and elaborated it into a full-blown exemption theory. They identified two fundamental problems with taxing the income of such organizations: first, their net income cannot be made to fit under any workable tax definition of income, and second, even if it could, no appropriate tax rate could be applied to them.<sup>32</sup>

With respect to the definition of income, Bittker and Rahdert point to problems on both the revenue and the expenditure sides of the ledger. On the revenue side, the basic issue is whether to treat dues and contributions for tax purposes as the equivalent of business income or, alternatively, as gifts or capital contributions. If dues and contributions are treated as the latter, Bittker and Rahdert maintain, they are excluded from the computation of gross income under provisions of the tax code generally applicable to individuals and for-profit corporations.<sup>33</sup>

On the disbursements side, one basic issue is whether expenditures for the conduct of the organization's program should be deductible as analogous to ordinary and necessary business expenses or nondeductible as not intended to make a profit;<sup>34</sup> another is whether the current charitable deduction could be stretched or

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31. Bittker & Rahdert, supra note 2, at 302-04.

32. Id. at 305.

33. Id. at 307-09.

34. Id. at 309-12.

amended to cover such payments.<sup>35</sup> If either of these basic issues is resolved in favor of deductibility, as Bittker and Rahdert suggest they should be, the taxable income of public service organizations will essentially be reduced to zero, since all their assets are ultimately dedicated to their organizational programs.<sup>36</sup> Thus, even if a workable definition of public service organizations' income could be developed, the game would not be worth the candle.

Furthermore, Bittker and Rahdert argue that, even if a workable definition of their income could be developed, there would be insurmountable problems in finding the appropriate rate at which to tax it under either current theory of appropriate tax rates, the "benefit" or "ability to pay" theories. The primary reason for this difficulty is that the rate should ideally reflect the individual rates of the organizations' beneficiaries, many of whom are likely to be poor and thus "over-taxed" by any rate. Thus, if the game of taxing charities were to be played, the predictable losers would be their beneficiaries.<sup>37</sup>

Hansmann has taken issue with Bittker and Rahdert on both the income-defining and rate-setting difficulties they identify. Each of Hansmann's criticisms is answerable, but only in terms that press us beyond the central premise of Bittker and Rahdert's exemption theory, i.e., the idea that exemption is a matter of technical necessity or administrative convenience rather than policy choice. I want now to

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35. *Id.* at 312-13.

36. *Id.* at 311-12 (business expense deduction), 313 (charitable deduction).

37. *Id.* at 314-15.

examine those criticisms and show how they press us toward a synthesis of Bittker and Rahdert's theory with the very subsidy theory they were trying to supplant.

Hansmann offers several reasons why the problem of fixing an appropriate tax rate for charities is a bogey. In the first place, he argues that, even as applied to businesses, the corporate rate is seldom justified in terms of "ability to pay" of those on whom the tax ultimately falls. The incidence of the corporate income tax is uncertain, and sometimes corporations are viewed as having tax-paying capacities in their own right.<sup>38</sup>

Even if Hansmann is right that Bittker and Rahdert misstate the conventional theory of corporate income taxation, their theory of the exemption still suggests an intelligible basis for taxing for-profit corporations but not their non-profit counterparts. In effect, their technical definition of income, if extended to all nonprofits, would simply convert the corporate income tax into an excise tax on net earnings distributable for owners' private consumption.<sup>39</sup> Bittker and Rahdert do not suggest such an extension, and we will have to look beyond their theory for an

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38. Hansmann, supra note 2, at 65.

39. Hansmann himself notes this prospect but dismisses it with the following observation:

This argument proves too much, however, for it suggests that all nonprofit corporations should be exempt, whereas exemption has in fact always been available only to certain categories of them, and so far even the strongest supporters of the exemption have not suggested that it be extended to all organizations that are legitimately formed as nonprofits.

Id. 63-64 (emphasis in original; footnotes omitted). My own exemption theory rests on precisely this suggestion. See infra, Part V.A.2.b.

explanation of why this should be done.

In the second place, Hansmann maintains that even if the incidence of the tax were an appropriate concern, it would not present a problem: "[I]t is not obvious that the ultimate incidence of an income tax levied on nonprofits would be especially regressive."<sup>40</sup> For one thing, donors are likely to share the burden with beneficiaries; the former will probably to some extent increase their giving to offset the tax rather than simply allow less of their gifts to go to charities' beneficiaries. To the extent that the tax burden thus falls on donors, who are generally well-heeled, an income tax on nonprofits would not be regressive. And the beneficiaries of nonprofits are themselves often well-to-do, whether the organization receives its revenue from donations (as in the case of museums, schools, and performing arts groups) or from sales of goods or services (as in the case of private colleges and hospitals).

With respect to the regressivity problem, both Hansmann on the one hand and Bittker and Rahdert on the other may take too narrow a perspective. Even assuming that progressivity is an appropriate goal of the tax system as a whole, it need not be present in every part of that system. Thus one might tolerate an element of regressivity in the tax exemption of elite cultural institutions, as long as the difference is made up elsewhere in the system. But that underscores, once again, the question Bittker and Rahdert try to avoid: what is it about such organizations that would justify treating them favorably?

Finally, Hansmann argues that the exemption only benefits those charities that

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40. Hansmann, *supra* note 2, at 65.

retain revenues from year to year, as opposed to those like the Salvation Army that pass their revenues directly through to their beneficiaries. Charities of the former sort, those that retain revenues in the form of endowment funds or capital expenditures, "are generally organizations, such as private schools, colleges, and hospitals, that disproportionately serve the well-to-do."<sup>41</sup>

This criticism, however, threatens to beg two important questions raised by Bittker and Rahdert themselves. In the first place, to reach the conclusion that highly redistributive charities like the Salvation Army do not benefit by the tax exemption, one must assume that their distributions would be deemed deductible expenses. Only if these expenditures are deductible do organizations that distribute all revenues within the annual tax accounting period have no taxable income. If these expenses are not deductible, then the benefits the Salvation Army confers upon indigents would have to be purchased with after-tax dollars. Whether these expenditures would be deductible is an open question; as Bittker and Rahdert point out, these expenditures hardly fit comfortably within the current definition of ordinary and necessary business expenses, with its emphasis on profit-earning motivation.<sup>42</sup>

In the second place, to reach the conclusion that capital-intense organizations do benefit from the exemption, one must assume negative answers to the questions Bittker and Rahdert raise about the scope of the depreciation deduction. If, contrary to Hansmann's assumptions, their plant and equipment were subject to sufficient

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41. *Id.* at 66.

42. Bittker & Rahdert, *supra* note 2, at 309-10.



generous depreciation allowances, their potential taxable income might, as Bittker and Rahdert suggest, be effectively eliminated, albeit more indirectly and awkwardly than under the present system of outright exemption.<sup>43</sup>

Like his criticism of the purported rate-setting problem, Hansmann's reply to the problem of constructing a workable definition of charitable organizations' income also presses us beyond the bounds of Bittker and Rahdert's theory.<sup>44</sup> First, as he points out, many charities receive most of their revenues not from donations, as Bittker and Rahdert tend to assume, but from the sales of goods and services directly to consumers. Hospitals are an obvious example. Hansmann argues that

[f]or such organizations it would be perfectly easy and natural to carry over the tax accounting that is applied to business firms, taking receipts from sales as the measure of gross income and permitting the usual deductions for expenses incurred in producing the goods or services sold. The resulting net earnings figure could be taxed just as in the case of a business firm.<sup>45</sup>

Second, Hansmann argues that, even for charities that receive most of their revenue in the form of donations, "there is a natural correlate to the concept of taxable income developed for business entities."<sup>46</sup> To produce this correlate, Hansmann relies on an equation of purchases and donations that, we shall see, is central to his own exemption theory. To use Hansmann's own example, your paying Tiffany's to send a wedding gift to a friend is structurally "much the same as if you

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43. *Id.* at 313-14.

44. Hansmann, *supra* note 2, at 58-62.

45. *Id.*

46. *Id.* at 61.

give to the Red Cross money to spend on food for a flood victim; in each case you are paying an organization to render services to a third party."<sup>47</sup> The obvious point of identifying this structural similarity is to suggest that the Red Cross could be taxed on the excess of its donation revenue over operating expenses, just as Tiffany's is taxed on its net profits. Hansmann himself makes this point quite explicit: "Thus, it seems that without much difficulty we can extend to nonprofits the general principles of tax accounting commonly applied to profit-seeking firms."<sup>48</sup>

In invoking "general principles of tax accounting" and "the usual deductions," Hansmann may again be assuming too much, begging one of the questions Bittker and Rahdert pose: Are distributions to altruistic organizations' beneficiaries, in kind or cash, to be treated as deductible? Yet read another way, Hansmann seems to be answering that question, albeit elliptically, in the negative. If by "usual deductions" he has in mind "ordinary and necessary business expenses," then such deductions could quite consistently with current concepts be limited to those expenditures necessary to the production of income. Disposing of income earned is obviously a different matter, and could be treated less favorably.

But to say that ordinary concepts of income measurement could be carried over to the income of commercial nonprofits is not to say that they should be. Nor is it clear why applying these concepts in the nonprofit context is any easier or more natural than applying the very different approach suggested by Bittker and Rahdert.

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47. Hansmann, *supra* note 2, at 61-62.

48. Hansmann, *supra* note 2, at 62.

As a descriptive matter, Hansmann is quite right that the receipts of commercial nonprofits closely resemble those of their for-profit counterparts. At the same time, Bittker and Rahdert are equally right in pointing out that the distribution of receipts in the two cases are quite different. Identifying these characteristics of nonprofits -- similarities to for-profits on the one hand and differences from them on the other -- leaves entirely unanswered the normative question of whether their income should be treated the same. Hansmann's assimilation of the income of commercial nonprofits to that of for-profit firms shows that the taxation of the former's income is possible, not that it is appropriate.

The strength of Hansmann's critique of Bittker and Rahdert's theory is to point out that all the questions they raise about the definition of altruistic nonprofits' income are technically answerable on fairly straightforward analogies to the income of for-profit firms. This might require a degree of complexity, even convolution, but these would hardly be novelties to the tax code. Thus, if we are not to extend ordinary principles of income taxation to nonprofits, we must look for a normative, rather than merely a technical, reason. Tiffany's net income available for distribution to its stockholders is arguably different from the Red Cross's distributions of donations to flood victims, but the two could be made subject to tax with roughly equal convenience. But again, that only poses the normative question: Should we make this extension? What is it about charities that warrants according them special treatment?

The inevitability of policy choices at this point can be illustrated in another

way. Even if Bittker and Rahdert are right, and the charitable exemption is necessary as a matter of tax base definition, the issue of worthiness comes in through the back door. Their theory of its own force applies to all nonprofits, yet, with respect to charities, they somewhat arbitrarily limit its scope to the present reach of 501(c)(3).<sup>49</sup> They give us no reason, consistent with their own theory, to think that these limits are appropriate. They themselves seem content with the policy choices reflected in current law. But one of the reasons they give for seeking an alternative to current law is that the asserted virtues of charity are difficult to prove.<sup>50</sup> Unless they are prepared to extend their theory, and the scope of the charitable exemption, to cover all legitimate nonprofits, they will leave us with one of the very problems they set out to avoid: How to identify the aspects of charity that make it worthy of special treatment.

C. Syntheses: The Promotion of Metabenefits.

Hansmann's critique of Bittker and Rahdert shows that exemption is not a matter of technical necessity. It could be eliminated without doing violence to the structure of the tax system, and therefore its retention requires a substantive, not merely a formal, justification. Yet our examination of the traditional subsidy theory revealed that such a justification cannot be in terms merely of "good goods," or it will prove too much and cover for-profit providers of the same goods. These two points have shaped the next round of exemption theory, in which theorists have looked to

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49. Bittker & Rahdert, supra note 2, at 331-32.

50. Id. at 332-33, 342.

the metabenefits charities provide as the policy basis for their favorable tax status. I will examine first how these theories deal with the issue of worthiness, then turn to the issue of fit.

1. The Worthiness Issue.

a. Hansmann's Capital Formation Theory.<sup>51</sup>

The first of these syntheses was Hansmann's capital formation theory, which rests on his descriptive account of the function of nonprofit firms in a capitalist economy in which for-profits are the norm. Hansmann argues that nonprofits tend to arise as the most efficient suppliers of goods and services when the normal for-profit provision fails for a particular set of reasons. Economic theory tells us that consumers usually know what goods and services they want to buy, that they are usually able to tell whether they got what they paid for, and that competition among for-profit suppliers usually ensures that they paid the lowest possible price.

But sometimes these conditions are not met; sometimes the market fails. Hansmann suggests that "nonprofit enterprise is a reasonable response to a particular kind of 'market failure,' specifically the inability to police producers by ordinary contractual devices." His generic term for this problem is "contract failure."<sup>52</sup> Hansmann identifies three basic forms of contract failure,<sup>53</sup> all of which patrons of

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51. 51. This exemption theory is set out in Hansmann, supra note 2.

52. Hansmann, The Role of Nonprofit Enterprise, 89 Yale L. J. 835, 845 (1980).

53. Hansmann does not treat these three kinds of contract failure as exhaustive; indeed, he identifies two others, voluntary price discrimination, Hansmann, supra note 2, at 854-59, and implicit loans, id. at 859-62. He uses the former to explain

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nonprofits are able to avoid on account of the nondistribution constraint, the defining characteristic of nonprofits: nonprofit firms cannot pay out net profits to a class of owners or controllers.

The first form of contract failure, which he calls "separation between the purchaser and the recipient of the service,"<sup>54</sup> is symptomatic of "the most traditional of charities – namely those that provide relief for the needy."<sup>55</sup> Take, for example, the case of the typical donee to CARE, who is in effect "financ[ing] a relatively simple service, namely shipping and distributing foodstuffs and other supplies to needy individuals overseas."<sup>56</sup> The problem, as Hansmann sees it, is that

[i]f CARE were organized for profit, it would have a strong incentive to skimp on the services it promises, or even to neglect to perform them entirely, and, instead, to divert most or all of its revenues directly to its owners. After all, few of its customers could ever be expected to travel to India or Africa to see if the food they paid for was in fact ever delivered, much less delivered as, when, and where specified.<sup>57</sup>

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53. (...continued)

patrons' contributions to performing arts organizations and the latter to explain alumni donations to colleges and universities.

Hansmann has been criticized on the grounds that these two other forms of contract failure tend to diminish rather than enhance the contract failure theory's explanatory power. See J. Douglas, Why Charity 98 (1983) ("Hansmann decorates this basic theme with subsidiary [sic] arguments that are often insightful but occasionally over-ingenious."). Voluntary price discrimination, however, is a particular instance of the public goods problem. Implicit loans, on the other hand, do seem to lack the common characteristic of contract failure, an information asymmetry that suppliers may exploit to the disadvantage of their patrons.

54. Hansmann, supra note 52, at 846.

55. Id.

56. Id. (footnote omitted).

57. 57. Id. at 847.

In the face of this inability to monitor the performance of a for-profit, the donor is likely to turn to a nonprofit, which is legally forbidden to pay out any of its receipts as "profits" and is thus less likely to skimp on the promised service.

The second form of contract failure occurs in the case of "public goods,"<sup>58</sup> which tend to be undersupplied by for-profits because, as in the case of listener-sponsored radio, it is difficult to exclude free riders, those who tune in without paying up. Some people, of course, are willing to pay for advertisement-free radio and other public goods. But if they try to buy them from for-profit firms, they will not be readily able to ensure that what they pay goes for greater output, rather than for higher profits at the same level of output. Thus, they are inclined to "buy" from a nonprofit, which is forbidden to pay out net revenues as profits. Listener-sponsored radio stations are for this reason invariably nonprofit, and, more generally, nonprofits tend to dominate the non-governmental provision of public goods.<sup>59</sup>

The third form of contract failure occurs in connection with what Hansmann calls "complex personal services."<sup>60</sup> Some services – certain forms of health care and education are Hansmann's examples – may be so complex that the purchaser will be unable to monitor quality effectively at a reasonable cost, even though the service is being supplied directly to the purchaser. In particular, purchasers may worry that the marginal dollar they spend for the service is not being used to improve the quality of

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58. 58. *Id.* at 848-54.

59. 59. *Id.* at 850-51.

60. *Id.* at 862-72.

the service, but rather to increase distributable profits. Here again, Hansmann maintains, this risk is lessened in the case of nonprofits, where such distributions are forbidden.<sup>61</sup>

Thus, in each of the three forms of contract failure he identifies, Hansmann maintains that the nonprofit form, with the nondistribution constraint as its essential characteristic, gives consumers the assurance that their difficulty in evaluating output will not be exploited to enhance distributable profits. From this descriptive analysis it is tempting to draw the normative conclusion that nonprofits should be encouraged

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61. Id. at 862-63. Nonprofit production is not the only way of dealing with consumers' difficulty in monitoring quality of output. Krashinsky, Transaction Costs and a Theory of the Nonprofit Organization, in The Economics of Nonprofit Institutions 114, 116-17 (S. Rose-Ackerman ed. 1986) (identifying other methods both inside and outside the market). Hansmann himself is aware of such alternatives, and he discusses the multiplicity of factors that influence when nonprofit production is likely to predominate. Hansmann, supra note 52, at 868-72; Hansmann, Economic Theories of Nonprofit Organizations, in The Nonprofit Sector 30 (W. Powell ed. 1987).

Several empirical studies have been made of whether the complex goods form of contract failure does in fact account for consumers' patronage of commercial nonprofits. One concluded that the results of telephone inquiries sampling consumer recognition of, and attitudes toward, nonprofits suggest "some divergence from the Hansmann theory." Perlmutter, Consumer Perceptions of Nonprofit Enterprise: A Comment on Hansmann, 90 Yale L.J. 1623, 1626 (1981). Hansmann counters that, given his view that contract failure is less significant in commercial nonprofits than in donatives and the fact that the interviews did not select for patrons of nonprofits, the responses tend to confirm his hypothesis. Hansmann, Consumer Perceptions of Nonprofit Enterprise: Reply, 90 Yale L.J. 1633 (1981). Hansmann is similarly sanguine about two other studies, one on nursing homes, Weisbrod & Schlesinger, Public, Private, Nonprofit Ownership and the Response to Asymmetric Information: The Case of Nursing Homes, in The Economics of Nonprofit Institutions 133 (S. Rose-Ackerman ed. 1986), and the other on child care, J. Newton, Child Care Decision-Making Survey--Preliminary Report (1980) (unpublished manuscript; Yale University Institute for Social and Policy Studies Program on Nonprofit Organizations). Hansmann, supra, at 32-33.



by the indirect subsidy of a tax exemption to develop in industries that exhibit contract failure. Hansmann insists, however, that this inclination not be indulged without further analysis:

[I]t is not obvious why a subsidy is needed to encourage nonprofits even where their development seems appropriate as a response to contract failure. Why can consumers not be trusted to select nonprofit rather than proprietary producers on their own in those situations in which nonprofits are to be expected to offer more reliable service? And, if there are cases in which consumers cannot in fact be trusted to make such a decision wisely, is not a tax subsidy a remarkably indirect response to the problem? Should not proprietary producers be outlawed entirely -- or at least put under severe regulatory restraint -- where they are obviously unsuitable but are likely to attract consumers nonetheless?<sup>62</sup>

Hansmann maintains that there is a less immediately apparent, but ultimately more satisfactory, reason for exempting the net revenues of such nonprofits from income taxation. This encouragement is needed because nonprofits, by definition forbidden to distribute net profits, are barred from a primary source of capital for expansion, equity investment. Moreover, they are likely to be unable to expand to an optimal size using either borrowed capital, donated capital, or retained earnings.<sup>63</sup>

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62. Hansmann, supra note 2, at 70-71 (footnote omitted); see also Hall & Colombo, supra note 3, at 374.

63. Hansmann, supra note 2, at 72-74. In a similar vein, Powell and Friedkin suggest, on the basis of several empirical studies, that "the fundamental difference between nonprofit and for-profit organizations does not turn so much on intrinsic differences in organizational form or capability, or even on legal criteria that distinguish nonprofits from for-profits, as on differences in the availability of resources and the constraints associated with their acquisition." Powell & Friedkin, Organizational Change in Nonprofit Organizations, in The Nonprofit Sector 180, 181 (W. Powell ed. 1987). On Hansmann's view, however, the limits on availability of resources to nonprofits is not an independent factor, but rather a function of the

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The exemption of their income from taxation is an appropriate and effective form of encouragement, since it helps offset this disadvantage in access to capital by increasing nonprofits' ability to retain net earnings for expansion.<sup>64</sup> If this is how nonprofits will use their enhanced net revenues,<sup>65</sup> and if we accept the implicit normative premise that, other things being equal, efficient allocation of resources is to be encouraged, then this is an entirely appropriate conclusion.

What Hansmann has done, in effect, is to put starch into the claim of traditional subsidy theory that nonprofits sometimes are more efficient than alternative, for-profit suppliers. He has, accordingly, identified a metabenefit that warrants subsidizing nonprofits with a tax exemption while explaining the denial of that benefit to for-profits in the same industry. For-profits do not labor under the

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63. (...continued)  
nonprofit constraint, the essential legal and economic difference between for-profits and nonprofits.

Empirical research on the effect of capital constraints on the responsiveness of nonprofits to changes in demand is inconclusive. Hansmann, *supra* note 61, at 38-39; Steinberg, Nonprofit Organizations and the Market, in The Nonprofit Sector, *supra* note 61, at 133-34.

64. Hansmann, *supra* note 2, at 72-75. Cf. Utah County v. Intermountain Health Care, Inc., 709 P.2d 265 (Utah 1985). In Utah County, in response to the dissent's argument that denial of property tax exemption to two components of nonprofit hospital network would result in higher costs to patients, the majority argued that "[t]he far more logical assumption is that growth of the IHC system would possibly be slowed." *Id.* at 276 (emphasis in original).

65. Hansmann himself has provided empirical evidence in support of his capital-formation hypothesis. Analyzing state tax exemptions, he found that the market shares of nonprofit firms tend to be greater where the value of their tax exemption, i.e., the rate at which they would be taxed if not exempt, is greater. Hansmann, The Effect of Tax Exemption and Other Factors on the Market Share of Nonprofit Versus For-Profit Firms, 40 Nat'l Tax J. 71 (1987); *but see*, Part V.B.1.

same capital constraints, and, furthermore, owing to the very market failures that give rise to nonprofits in some industries, for-profits might be able to siphon off the subsidy in the form of higher profits rather than pass it on to consumers in the form of higher output or lower prices.

For all its elegance, however, there are two disquieting features of Hansmann's theory. In the first place, Hansmann concludes that the exemption should apply to only those nonprofits that arise in response to the kind of market failure he has identified. Hansmann concedes that "if nonprofit firms could be demonstrated to have important efficiency advantages over for-profit firms under identifiable conditions other than contract failure, similar reasoning could justify granting tax exemption to nonprofit firms in those circumstances as well."<sup>66</sup> Despite his concession that there may be other forms of "efficient" nonprofits than those he has recognized, the tenor of his writings suggests that he believes the canon is essentially closed. He himself is willing to concede that some traditionally exempt charities that do not fit his efficiency criteria -- in particular, those providing education, hospital care, nursing care, and day care -- should continue to be exempt because, in "a significant fraction of these industries, . . . a substantial subset of consumers feels more comfortable patronizing a nonprofit."<sup>67</sup> Hansmann would, however, continue the exemption only "[u]ntil we

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66. Hansmann, *supra* note 2, at 87, n.92.

67. Hansmann, *supra* note 2, at 88-89.

have better data suggesting that these consumers are mistaken."<sup>68</sup> In thus implying that a defense of the charitable exemption can only be made in terms of economic efficiency, Hansmann ignores the possibility that other asserted metabenefits of charity might justify the exemption subsidy on other, or broader, grounds.

The second disquieting aspect of Hansmann's theory lies deeper, in his descriptive account of the role of nonprofits. To see more concretely what Hansmann's theory omits, we need to examine his conflation of donations and purchases, a revealing peculiarity in the way he explains nonprofits as a solution to contract failure. This peculiarity is most apparent in Hansmann's discussion of relief organizations like CARE, his prototypical case of contract failure.

Somewhat counterintuitively, Hansmann speaks of those who finance CARE's overseas relief operations as "customers," rather than, as ordinary usage would suggest, as "contributors" or "donors." Hansmann's choice of terms is not accidental. As he says in discussing another relief organization, the Red Cross,

the contributor is in effect buying disaster relief. And the Red Cross is, in a sense, in the business of producing and selling that disaster relief. The transaction differs from an ordinary sale of goods or services, in essence, only in that the individual who purchases the goods and services involved is different from the individuals to whom they are delivered.<sup>69</sup>

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68. Id. More recently, Hansmann seems less inclined to give such nonprofits the benefit of the doubt. Hansmann, supra note 1, at 634; see also Hansmann, The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?, 39 Case W. Res. 807, 818, 822-24 (1988-89) (urging continued contraction of the scope of nonprofit tax exemption).

69. Hansmann, The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation, 91 Yale L.J. 54, 61 (1981); see also Hansmann, supra note 52, at 872-73.

It is both accurate and instructive to point out structural similarity between contributions and purchases, but it is something else again to dismiss the significance of who gets the goods. A physicist could, with equal accuracy, describe music as a series of vibrations. In both descriptions, however, something critical is missing, at least to the aficionado. In the case of the Red Cross, what is missing is reference to what seems, on the face of the transaction, to be its motivation, the kind of selfless regard for others that we associate with the core of charity. Moreover, the transaction offers the prospect of a proxy for, if not an external measure of, that apparently charitable motive: the conferring of a benefit on another without the expectation of a material reward. Two recent theories have tried to give these insights greater clarity and rigor.

b. Putting Charity Back into the Charitable Exemption.

Hall and Colombo offer an argument within the framework of economic analysis for subsidizing donative organizations as economically efficient; I offer an argument outside economic analysis for exempting a wider range of nonprofit organizations as the institutional embodiments of various forms of altruism. Because Hall and Colombo answer Hansmann in his own terms, I will consider their theory first.

(1) Hall and Colombo's Donative Theory.

To see how Hall and Colombo justify their donative theory in economic terms,

we must return to Hansmann's argument that the greater efficiency of nonprofits in some industries is not itself a sufficient reason to warrant treating them more favorably under the tax laws than their for-profit counterparts. His reason for requiring something more is summed up in the rhetorical question "Why can consumers not be trusted to select nonprofit rather than proprietary producers on their own in those situations in which nonprofits are to be expected to offer more reliable service?"<sup>70</sup> A critical assumption here is that, with the problems of contract failure redressed by nonprofits through the nondistribution constraint, their customers will purchase the amount of goods and services from them that maximizes their marginal utility, and hence a socially optimal level of production will occur. Patrons quite literally get what they pay for, and thus can be depended upon to buy as much as, and no more than, they want.

Hall and Columbo nicely isolate a flaw in this reasoning: while it may be true of commercial nonprofits, those financed by the sale of goods and services to those who consume them, it is probably not true of donative nonprofits, those through which patrons are buying goods or services to be consumed by strangers or by the public at large. Donative nonprofits may not produce an optimal level of output because wealth redistribution, an integral component of their output, is in some respects a public good. To the extent that donors' utility is tied to the receipt of benefits by

<sup>70</sup> Hansmann, *supra* note 2, at 70-71 (footnote omitted); see also Hall & Colombo, *supra* note 3, at 374.

gifts of other donors. Accordingly, what the donors are really interested in buying – the provision of goods or services free or below cost to others – will probably be chronically undersupplied. Thus, in the case of donative nonprofits, Hall and Columbo conclude that subsidization is economically justified.<sup>71</sup>

Hall and Columbo's analysis produces a justification for the tax exemption that is significantly narrower than Hansmann's with respect to both donative and commercial nonprofits. This is somewhat surprising with respect to donative nonprofits, since Hall and Colombo's theory covers all donative nonprofits, not just those that are undercapitalized. This greater theoretical breadth is not likely to make their theory broader in application, however, for three reasons. First, Hansmann argues that most donatively financed organizations are likely to be undercapitalized. Second, Hansmann concedes that in practice undercapitalization could not be made an administrably feasible criterion for exemption. Third, in describing the implementation of their theory, Hall and Colombo insist that even donative organizations, in order to continue to qualify for the exemption, would have to receive an average of one third of their annual support from donations.<sup>72</sup> This condition would bar the exemption of most private foundations, both operating and grant-making, and perhaps many heavily endowed and fee-supported public charities like museums and schools.

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71. Hall & Colombo, The Donative Theory of the Charitable Tax Exemption, Ohio St. L. Rev. 1, 14-25 (forthcoming).

72. Id. at 104.

With respect to commercial nonprofits, the donativity theory calls for an even greater narrowing, compared both to Hansmann and to existing law. Hansmann would extend the exemption to a potentially large class of commercial nonprofits that supply complex goods and services that a substantial number of customers feel more comfortable buying from nonprofits on account of the difficulties of directly assessing quality themselves. Hall and Colombo, on the other hand, see no evidence of donations in the case of such commercial nonprofits, and thus find no room for them in an exemption designed to overcome the free-rider problems associated with donative financing.<sup>73</sup>

(2) Atkinson's Altruism Theory.

My justification shares Hall and Colombo's focus on donations but differs in its scope and its ultimate rationale. To take the former first, I, unlike Hall and Colombo, find a donative element in commercial nonprofits, and in commercial nonprofits that supply garden variety goods,<sup>74</sup> not just those goods that Hansmann identifies as

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73. James Bennett and Gabriel Rudney propose an analogous exclusion of commercial organizations. They would tax receipts from the sale of any product unless (1) more than 50% of the cost of production is financed by gifts or grants, as opposed to sales receipts or investment income, and (2) the subsidized product is "directed at a specific recipient group or purpose deemed charitable." Bennett & Rudney, A Commerciality Test to Resolve the Commercial Nonprofit Issue, 36 Tax Notes 1095, 1097-98 (1987). The first requirement would mean that virtually all commercial nonprofits would be subject to tax on their exempt function income. Moreover, with respect to all nonprofits, "[a]ll investment earnings except exempt interest [presumably under provisions applicable to all taxpayers] are taxable revenues under the commerciality test." Id. at 1097.

74. My favorite example, Presbyterian and Reformed Publishing Co. v. Commission, 743 F.2d 148 (3d Cir. 1984), involves books.



complex and difficult for the consumer to evaluate. To find an element of donativity (or, as I prefer to call it, altruism) here, we must look on the supply side. How does capital get into such firms? If pooled by buyers, the resulting organization is a mutual benefit nonprofit or a cooperative, an organization in which the consumer-members are primarily interested in helping themselves.

But if the capital is provided by non-purchasers, that provision itself is altruistic. Whenever an organization with the potential to return profit to its founders<sup>75</sup> is set up on a nonprofit basis, the founders have necessarily forgone that potential profit. The net revenues that otherwise would have been distributable to its founders are now committed to the purposes for which the organization was created. Moreover, as long as the organization continues to abide by the nondistribution constraint, its potential profits are available for subsidizing the purchases of its patrons. Thus, the founders' initial contribution of their potential earnings has an ongoing aspect; the organization embodies their altruism. As long as it remains nonprofit, this element of altruism remains, even if all other factors of production must be purchased at market prices. This makes for an exemption that is extremely, perhaps shockingly, broad, broader not only than Hansmann and Hall and Colombo, but also than present law.

How can such breadth be defended? Here we reach the second difference between me on the one hand and Hall and Colombo on the other, the divergent

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75. This is a critical, and not always easily monitored, condition. See Atkinson, *supra* note 1, at 554; Hall & Colombo, *supra* note 71, at 55-56.

grounds on which we would favor altruistic organizations. What the exemption does, on my theory, is to grant advantageous tax status to organizations that exhibit altruism either as donative nonprofits or as the kind of altruistic commercial nonprofits that I have identified. My rationale is that altruistic supply of a good or service -- any good or service -- is a metabenefit worthy of consideration for tax preference. By contrast, Hall and Colombo try to ground subsidy of donativity on its economic efficiency.

I suspect, however, that this difference is not very deep. I would be happy to be persuaded that subsidizing altruism promoted economic efficiency. I like both altruism and efficiency, but I like the former independently of, and even if it comes at some cost in, the latter. On this point I doubt that Hall and Colombo would disagree, though they are more sanguine than I that no trade-off will be necessary.<sup>76</sup> What I said above about Hansmann's theory applies here as well: we should beware of suggesting that efficiency is the only measure of the common weal.

c. Promoting Other Metabenefits: Roads More Travelled (But Less Mapped).

The synthetic metabenefit theories I have described so far -- Hansmann's, Hall and Colombo's, and my own -- all flirt rather shamelessly with the fallacy of the one

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76. Much the same can be said of my disagreement with Hall and Colombo over whether a preference for altruism need be grounded in political theory. Cf. Atkinson, supra note 1, at 628-630 with Hall & Colombo, supra note 71, at 59. Here again, I would happily be persuaded that subsidizing altruism is consistent with, or even conducive of, prevailing liberal democratic values, as Hall and Colombo have cogently argued. But if prevailing political theory were, say, libertarian, I would be inclined to trade rugged individualism for charity at a pretty steep discount. Cf. Hall and Colombo's effort to reconcile charitable exemption with Nozickean libertarianism.

true way. To borrow a phrase from Hall and Colombo, we are looking for "bright-line mathematical tests."<sup>77</sup> In so doing, we may be guilty of murdering to dissect, of basing our exemption theories on a cadaver of our own creation rather than on the flesh-and-blood charities that populate the real world. I will not repeat the sources of that temptation here, but I do want to point to two related dangers and to suggest a more holistic approach that is, I think, essentially reconcilable with what John Simon described at the first annual Philanthropy and the Law Conference as "the High Road of Grand Theory."

The first danger is distortion. When we Grand Theorists force the body of charity into the Procrustean bed of single-variant theories, we are tempted to leave out aspects that do not readily fit. Some of these may be important aspects of our pre-analytic, ordinary language understanding of charity. And this danger of distortion carries with it a second danger: in failing to account for these aspects of charity, we may be weakening the political case for the exemption of a more or less wide array of organizations we are ready to accept, from a more synoptic perspective, as charitable. Occam's razor may cut too deeply.

For both these reasons, we need to keep the class of metabenefits open, even at the expense of theoretical untidiness. This is what John Simon, for example, is doing when he argues that private foundations, the perennial pariahs of the charitable tribe, are important sources of innovation,<sup>78</sup> and it is what some defenders of

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77. Hall & Colombo, *supra* note 71, at 131.

78. Simon, *supra* note 17.

charitable health care are doing when they assert that charities serve their clientele with more compassion or care or quality than for-profit counterparts.<sup>79</sup> In both cases they may be wrong, and neither case can be proved without treading what Simon has called the Low Road of empirical research. But without some such defense, the exemption of these and other traditional charities may be lost or curtailed -- and perhaps should be.

Identification of these additional metabenefits can complement Grand Theories in several ways. In a purely political sense, it may give vulnerable organizations a leg up that they need in the legislature even though they are comfortably covered in principle by a Grand Theory. In the case of organizations that are not so covered, the additional metabenefits may serve both a political and a theoretical function. On the political front, they may provide grounds for exemption independent of Grand Theory. On the theoretical front, they may operate like the epicycles in Ptolemy's astronomy. The more numerous they become, the more reason theorists will have to suspect that the wrong candidate is at the center of the cosmos.

There is, finally, a negative corollary to the existence of metabenefits, and that is the existence of what might, in parallel fashion, be called meta-harms. Some vices may warrant denying the exemption even to an organization that possesses the requisite virtue; the presence of that virtue need not atone for all sins. In the idiom of the traditional subsidy theory, the public benefits an organization provides, real and significant though they be, may nevertheless be negated by the public harms it inflicts.

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79. Hall & Colombo, identify and assess these claims, *supra* note 3, at 364-80.

So, for example, the Supreme Court found the admitted public good Bob Jones University provided as a nonprofit educational institution to be more than counterbalanced by its racially discriminatory policies.<sup>80</sup>

## 2. The Fit Issue.

Each of the grand metabenefit theories I have identified addresses the fit issue in the old terms, treating exemption as a subsidy and either defending the exemption's fit, as Hansmann and Hall and Colombo do, or dismissing the issue too casually, as I do. As a result, theory has not advanced as far here as it has on the worthiness issue. I am, accordingly, going to try both to account for what I take to be an impasse and to begin to move beyond it. Let's start with what the metabenefit theorists have said.

### a. Hansmann.

The asserted fit between Hansmann's capital formation theory of worthiness and tax exemption as a proper means of redress is fairly straightforward. Where demand for a good provided by a nonprofit is rising, its retained earnings will also rise,<sup>81</sup> and thus a subsidy tied to net revenues is scaled to the need for expansion.

There are, however, several problems here. In the first place, nonprofit

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80. Hall and Colombo argue that two of these meta-harms -- racial discrimination and political activities -- are covered by their donativity theory. Hall & Colombo, supra note 71, at 79-87. I'm more inclined to see them as epicycles, genuinely and irreducibly extraneous to Grand Theories. Atkinson, supra note 1, at 635. If Hall and Colombo are right, of course, their theory is the more elegant for its greater explanatory power on this point.

81. Hansmann, supra note 2, at 82-84.

managers may choose to increase present production rather than expand.<sup>82</sup> If they do, the subsidy will not work as intended.<sup>83</sup> More fundamentally, the tax exemption is not nicely calibrated to subsidize only those nonprofits that are in fact undercapitalized.<sup>84</sup> Hansmann admits that, for the tax exemption to serve as an effective capital formation subsidy, it should apply only to organizations that meet two criteria: (1) they are more efficient than producers than alternative for-profits, and (2) they are undercapitalized.<sup>85</sup> The first criterion is met by limiting the exemption to organizations in industries beset by contract failure, but the second criterion is, by Hansmann's own admission, not feasible to measure.<sup>86</sup> His response is to argue that the second factor usually correlates with the first, that nonprofits arising in response to contract failure usually experience undercapitalization.<sup>87</sup> But even if this is true as to industries, it may not be true as to particular entities within an industry.

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82. Hansmann recognizes this possibility. *Id.* at 80-81. And there's still a gloomier prospect: waste. Nonprofit managers, who are not subject to scrutiny by equity owners, may exert themselves less than their counterparts in for-profit firms to minimize costs. Nonprofits are thus preferable on efficiency grounds to for-profit alternate suppliers only when this efficiency loss is more than offset by the efficiency gains the contract failure theory predicts. *Id.* at 70 n. 57; Hansmann, *supra* note 52, at 878.

83. But note that the exemption will make expansion relatively more attractive *if* we assume that in a world without the exemption expenditures for increased current production go untaxed. *See* Hansmann, *supra* note 2, at 82.

84. Dale, *supra* note 2, at 8.

85. Hansmann, *supra* note 2, at 86.

86. *Id.*

87. *Id.* at 87 n. 93; *id.* at 88 n. 98.

As Hall and Colombo point out, a problem with using income as a proxy for capital need is that "one organization with heavy capital needs may have little income (and hence a small subsidy), while another with slight needs may have a large income."<sup>88</sup>

Finally, the need for exemption on Hansmann's theory seems fairly weak. His own models suggest that, even in the absence of tax exemption, nonprofit suppliers would probably come to dominate industries in which they are the most efficient suppliers<sup>89</sup>. At most, then, the exemption accelerates the achievement of an optimal outcome that will occur eventually, though more slowly, in its absence. And offsetting even this advantage is the fact that the exemption will allow modestly inefficient nonprofit firms to compete with more efficient for-profits, perhaps successfully enough to dominate entire industries.<sup>90</sup> Hansmann, to his credit, candidly concedes that tax exemption is, at best, "an extremely crude mechanism for dealing with the problems of capital formation in the nonprofit sector."<sup>91</sup>

b. Hall and Colombo.

Hall and Colombo offer an elaborate economic explanation of why the charitable exemption fits their proffered basis for exemption, the organization's support by donations. I cannot even begin to do justice here either to their own argument or to my reservations about it. But even if their theory is right on this

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88. Hall & Colombo, supra note 3, at 388.

89. Hansmann, supra note 2, at 83-84.

90. Id. See also Hall & Colombo, supra note 3, at 388 (criticizing Hansmann's failure to show why tax subsidy is better than grants or tax-exempt bond financing).

91. Hansmann, supra note 2, at 92.

point, its implementation produces a paradox. The more donative support an organization receives, and thus the more deserving it is of subsidy in terms of the likely undersupply of the good it produces, the greater will be its ratio of donative to other income and hence the less helpful the subsidy will be. Why less helpful? Because gifts are not ordinarily included in income anyway, and even if they were, they could be offset by an operating expense deduction if they were disbursed.<sup>92</sup>

c. Atkinson.

I, for my part, fell into the traditional subsidy theory's error of dismissing the fit issue too lightly,<sup>93</sup> an error I want to begin to rectify here. I want to suggest -- tentatively, with trepidation -- that the fit issue is in some respects an illusion, and in any event not a matter of critical importance to the theory of the charitable exemption. The indirectness of the subsidy through tax exemption is not, as I formerly thought, primarily a matter of political expediency, the result of inability to secure more direct subsidies. It is better seen as partly a matter of political preference and partly an artifact of the present tax system.

Let's take the artifact aspect first. Recall the central point of the fit issue: what does the level of an organization's income have to do with the degree to which it should be subsidized? This question can usefully be turned around: what relation does the level of an organization's (or an individual's) income have to do with the

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92. I owe the identification of this paradox to Hall and Colombo themselves. Hall & Colombo, supra note 71, at 102-03; see also Hall & Colombo, supra note 3, at 403.

93. Atkinson, supra note 1, at 609, 632.



extent to which it (or he or she) should bear the costs of government? I suggest we turn the question around this way for two related reasons. First, it points up an implicit assumption about the fit issue, namely, that there is something natural or inevitable or correct about financing government operations with an income tax geared to net revenues. If the history of this country up until this century and the current tax systems of other liberal democracies may be admitted into evidence, there is not.

Second, turning the question around suggests that if nonprofits were taxed on their net income, the fit question would not be eliminated; we would encounter it again, albeit running in the opposite direction. But, you will object, coming from that direction it is the same for charities as for other tax-payers, namely, is net income a proper basis on which to allocate the burdens of government? True enough. I would suggest, however, that even if that question is generally to be answered in the affirmative, a significant subquestion remains: Are there any potential tax-paying entities that ought to be relieved of bearing the burdens of government?<sup>94</sup>

We are back, of course, to Bittker and Rahdert's tax base defining argument, but with a twist, and a twist that I hope to show you is part of an upward spiral rather than a circle, or worse. Hansmann's critique of Bittker and Rahdert showed that the

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94. Those of you who have not tired of the metaphysics metaphors will tolerate a final parallel. My theory does to Bittker and Rahdert's theory what Marx and Feuerbach did to Hegel's: stand it on its head. Bittker and Rahdert, you will remember, argued that the charitable exemption is not a subsidy because the income tax cannot logically be levied on nonprofit organizations; I argue that charities should be granted what I admit to be a favorable tax status precisely because operation as a nonprofit involves an element of altruism worthy of favorable status.

income of charity could be taxed, as a matter of technical feasibility, but not that it should be taxed, as a matter of policy preference. If we define charity out of the tax base it is not, as Bittker and Rahdert suggest, because we have no other choice, but because, I want to suggest, we have so chosen. Either way, however, the fit issue is defused. It is a useful, but dangerous, shorthand to describe the tax exemption as a subsidy. It is, if I am right, more properly understood, and defended, as an exclusion from the tax base.<sup>95</sup>

Whatever you call it, of course, the exemption costs money, the revenues that would in its absence have been collected from the organizations within its scope. It is this fact, I think, that inclines us to look for a tighter fit than we have yet found between the revenues foregone and the activities promoted.<sup>96</sup> It would be helpful to be able to say that the charitable exemption is a wonderfully well-suited way to subsidize what we think are the virtues of charity, but it need not be disastrous to concede that it isn't. And even if it is disastrous, it may nevertheless be true.

#### IV. Conclusion: Synthesizing the Syntheses.

I want to conclude, however, not on a note of despair, but on a note of hope

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95. See Hopkins, supra note 17, at 13:

Congress is not "giving" such organizations any "benefits"; the exemption (or deduction) is not a "loophole," a "preference," or a "subsidy" – it certainly is not an "indirect appropriation." Rather, the various Internal Revenue Code provisions comprising the tax exemption system exist basically as a reflection of the affirmative policy of American government to not inhibit by taxation the beneficial activities of qualified exempt organizations acting in community and other public interests.

96. See Hall & Colombo, supra note 3, at 329.

(or at least encouragement). The political battle for the exemption is winnable, even without a shield against the fitness point, because the virtues of charity that we have canvassed are close to the core values of our culture. Whether the last decade, with its attacks on charity and much else that we cherish, is an aberration will depend on what we do in the next decade.

I hope we come back to a truly kinder and gentler America, and I think that will include the promotion of selfless regard for others. Moreover, I think the charitable exemption reflects not only a desire to promote the helping of others, but also a healthy agnosticism about how that help can best be given, a willingness on the part of the majority to promote minority conceptions of the good of others. That, ultimately, is what we are asking our fellows to promote when we defend the charitable exemption. To persuade them, we may have to show more than that we are helping others by our own lights; we may have to point to the minor metabenefits that fall outside Grand Theory, and we may have to assure them that we are mindful of meta-harms like racial discrimination. In fairness, too, we must tell them how much helping others our way will cost. On this issue, economics will have much to tell us. But whether we assume those costs will depend, ultimately, on what kind of society we want to live in. That, I'm afraid, we will have to decide for ourselves.<sup>97</sup>

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97. Cf. Posner, The Economics of Justice (1981) (arguing that economic analysis can answer both questions posed in the text).

