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Subchapter F of Title I of the Internal Revenue Code, as well as the Division of the Internal Revenue Service which deals with non-profit corporations, is entitled Exempt Organizations. As we know this is a misnomer. While organizations "exempt" under section 501(c) are not taxable on activities related to their exempt function, they are not totally exempt from tax. All are taxed on debt financed income[2] and income from an unrelated business. [3] Private foundations pay a small excise tax on investment income.[4] Social clubs are taxed on their investment income and on profits from dealings with nonmembers.[5] The Treasury wants to extend taxation of investment income to business leagues.[6] The purpose of this paper is to consider the theory that underlies these rules--

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[2] IRC §§514, 512(a)(4). The tax does not apply if borrowing is related to the exempt function. IRC §512(b)(1)(A).

[3] IRC §511

[4] IRC §4940

[5] IRC §512(a)(3)

[6] Department of the Treasury, General Explanation of the Administration's Fiscal Year 2001 Revenue Proposals at 880.

should non-profits be taxed as they are today or should they be more-- or less-- exempt from tax?

In the early stages of the history of our income tax, not for profit entities were possibly considered by their very nature not to be subject to the tax. As Professor Bittker states, it was "suggested that an income tax could appropriately be imposed only on activities conducted for profit, and that crucial statutory notions like 'net income' and 'business expenses' do not ring true when applied to nonprofit organizations."[7] We have come to understand, however, that many nonprofit organizations do engage in activities with the intent of earning a profit.

In any event, at least since the modern income tax in 1913, the Treasury has not interpreted the Internal Revenue Code as providing income tax exemption to non-profit entities, in the absence of a specific exemption.[8] Although, the list of exempt organizations has been expanded on numerous occasions, beginning as early as 1916,[9] it clearly does not include all nonprofit organizations.

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[7] Boris I. Bittker & George K. Rahdert, The Exemption of Nonprofit Organizations from Federal Income Taxation, 85 Yale L. J. 299, 302 (1976) (hereinafter Bittker). It is also sometimes suggested that the tax cannot readily be applied because of difficulty in determining the appropriate tax rate. See id. at 314-6.

[8] See Bittker supra note 7 at 303.

[9] Ibid.

State law tends to divide non-profit organizations into two groups-- Public benefit organizations (roughly those which are exempt under sections 501(c)(3) and (4) of the IRC) and Mutual organizations.[10] As to some mutuals, members make contributions which may be deductible as business or investment expenses. (Business Mutuals). In other circumstances, member's contributions are personal. (Consumer Mutuals).

In the case of retirement savings, which is not the subject of this paper, the very essence of the special treatment seems to be the exemption of investment income from tax.[11] But in other cases, the rationale for the exemption is not clear. Exemption from

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[10] See e.g. California Corporation Code §§5130, 7111. Revised Model Nonprofit Corporation Act §17.07

[11] The Treasury offered this as a reason not to oppose a special rule which would allow pension funds to invest in debt-financed real estate without being subject to the unrelated business income tax. IRC §514(c)(9)(C)(ii). See, Suzanne Ross McDowell, Taxing Leveraged Investments of Charitable Organizations: What is the Rationale?, 705, 715 (1988-89). Much has been said, including by the present author, about the justification for the special treatment of qualified pension plans under Section 401 of the Code. See e.g. Daniel I. Halperin, Special Tax Treatment for Employer-Based Retirement Programs: Is It "Still" Viable as a Means of Increasing Retirement Income?, 49 Tax L. Rev. 1 (1993); Daniel I. Halperin and Alicia H. Munnell, Assuring Retirement Income for All Workers, (forthcoming from Brookings 2000). Little, if any, print has been devoted to the rationale for exemption for income devoted to life, health or other benefits for

income tax may, perhaps, be required to be consistent with the charitable deduction. However, charitable deductions are not available for many organizations that are exempt from income tax. For these organizations, at least, the income tax exemption must have an independent rationale.

This paper proceeds as follows. I start with an exploration of the justification for full tax exemption. Organizations which may be the recipients of charitable deductions will be considered first; followed by a brief discussion of other so-called public benefit organizations. We then turn to mutual organizations, first consumer and then business.

Finally, I consider the reasons why one might want to tax unrelated income including the income from debt financed activities. The conclusion summarizes my findings and may be usefully read at this point.

As noted above, private foundations pay a small tax on investment income, which has been justified as an audit fee.[12] Some question whether an audit fee is appropriate or,

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employees. It should be noted that prior to the Tax Reform Act of 1969, P.L. 91-172 §121(b)(5)(A), section 501(c)(9) did not apply unless 85% of the income consisted of contributions by the employer or members. This rule severely limited the amount of investment income. In any event, the treatment of these organizations will not be considered herein. See sections 501(c)(4) (as to local associations of employees) and 501(c) (9), (11), (17), (18), (20), (21), (22) and (24).

[12] S. Rep. No. 91-552, 91st Cong. 1st Sess. 27 (1969), reprinted in 1969-3 Cum. Bull. 423, 442. See Frances R. Hill and Barbara Kirshten, Federal and State Taxation of

if it is, why it should be limited to private foundations as opposed to being applied to all exempt organizations.[13] This issue will not be discussed in this paper.

Discussion of the rationale for income tax exemption will, of course, be suggestive as to the characteristics required of an organization in order to be entitled to such treatment. However, this paper will not explore, in depth, whether or not the category of exempt organizations should be expanded or contracted.

Public Benefit Organizations

Initially, we need to consider whether the purpose of the charitable deduction would be compromised by taxing the income of the organization.[14] Tax deductions for charitable expenditures are allowable only for contributions to qualifying nonprofit organizations. This is not the only way to accomplish the apparent goal. A subsidy for the provision of particular goods and services could also be provided by direct government grants or by tax benefits either to the purchaser of these goods or services or to for-profit

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Exempt Organizations 6-4 to 6-7.

[13] See Bittker supra note 7 at 327.

[14] The need to avoid compromising the charitable deduction cannot fully explain an exemption for income, which applies to many more organizations, Henry Hansmann, The Rational for Exempting Nonprofit Organizations from Corporate Income Taxation, 91 Yale L. J. 54, 72 (1981)) (Hereinafter Rationale). However, it may justify an exemption limited to (c)(3) organizations.

suppliers. For example, a deduction could be provided for the "purchase" of disaster relief by a transfer directly to the party in need or through an intermediary for-profit organization, rather than the Red Cross.

As Henry Hansmann suggests, in discussing the income tax exemption, there may be a fear that a for-profit organization will be less likely to provide the desired service[15] and may use the subsidy to increase the return to the owners. It may also be thought that requiring the gift be made to an organization, which in some sense benefits society in general, makes it easier to police such fraudulent behavior by the contributor as attempts to claim deductions for benefitting oneself or a close relative. Without deciding whether it is appropriate to take this course, once we limit charitable deductions to contributions to organizations meeting certain characteristics, does it follow that such an organization must itself be exempt from tax?

The charitable deduction [16] reduces the price of certain goods and services or allows donors to purchase more of such items for a given out of pocket cost. This can be justified as alleviating the failure of the market adequately to supply public goods, including redistribution of income, or, as it is sometimes put, as relieving the burden of, or

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[15] He notes that in some cases, for example education and research, nonprofits tend to produce a different mix of goods than for profits in the same field. Id. at 68.

[16] Contributions to organizations exempt under section 501(c)(3) are deductible for income, gift and estate taxes. IRC §§170, 2055, 2522.

substituting for, government .[17] Similar results can be achieved by lowering the costs of the organization. Thus, an exemption from sales taxes lowers the cost of purchasing otherwise taxable goods or reduces the price to purchasers from exempt organizations.[18] A real property tax exemption lowers the cost of owning real estate.[19] A postal rate reduction reduces mailing costs.[20] The ability to issue tax exempt bonds lowers borrowing costs[21] and so on.[22]

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[17] See, Evelyn Brody, Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption, 23 J. of Corp. L. 585, 590 (1998) (note 23 quoting from 1938 Committee report). See Treas. Reg. 1.501(c)(3)-1(d)(2). The charitable deduction also has been defended as consistent with a reasonable measure of income under an income tax since contributions to charity are not available for personal consumption or, at least, could not be enjoyed by the donor without also being enjoyed by others. William D. Andrews, Personal Deductions In an Ideal Income Tax, 86 Harv. L. Rev. 309 (1972).

[18] See generally Janne G. Gallagher, Sales Tax Exemptions for Charitable, Educational, and Religious Nonprofit Organizations, 7 Exempt Org. Tax Rev. 429 (1993)

[19] See generally W. Harrison Wellford and Janne G. Gallagher, Unfair Competition? The Challenge to Charitable Tax Exemption.

[20] See 39 C.F.R. 111.1

[21] IRC §145

[22] Wage costs would also likely be reduced if employees of exempt organizations were exempt from income taxes. While this was never the case, section 501(c)(3)

Since the organization must spend all of its funds for its exempt purposes and cannot remit profits, it should not have taxable income from its exempt activities unless amounts, in excess of nontaxable receipts, are set aside for future expenses or used to purchase capital items. Therefore, whether or not the income of the organization is taxed will affect the relative cost of capital expenditures and set asides for the future, as compared to ordinarily deductible current costs. The existence of the charitable deduction may, in certain circumstances, be an indicator of the appropriate treatment. For example, it suggests, as described below, that the contribution itself should not be taxable. Nevertheless, in general, the income tax exemption raises separate issues since it affects only organizations that do not currently spend their income.[23]

Further, if all funds are not currently expended for exempt purposes, the excess may be invested to produce investment income Let us turn first to the possibility of taxable income from carrying on exempt activities and then consider investment income.

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organizations were given the choice to be exempt from social security tax until 1983 and are still exempt from unemployment taxes. IRC §3306(c)(8). See P.L. 98-21, §102(b)(1) amending IRC §3121(b)(8)(B). Churches can elect out of FICA taxes, IRC §3121(b)(8), but if they do so, their employees are subject to self employment taxes. IRC §1402(c)(2)(G).

[23] Rationale supra note 14 at 72.

Income from Related Activities

If receipts are for services performed by the organization in the performance of its exempt function, the organization would certainly be able to deduct its expenses related to the supply of such goods or services. Thus, as just suggested, there would be income from exempt activities only if there is an expenditure on a capital item or a set aside for future expenses.

Boris Bittker has expressed concern that the potential income could be greater in the case of donative nonprofits, like the Red Cross. This could occur if contributions were taxable while expenditures in carrying out the charitable or exempt function were not deductible since they are not related to activities carried on for profit.[24] However, Henry Hansmann argues that the Red Cross could be deemed to be selling disaster relief (like Tiffany's sells wedding gifts).[25] From this perspective, contributions to the Red Cross would be gross income and the costs of providing relief would be deductible expenses. If the Tiffany analogy holds, characterizing these payments as income to the Red Cross does not detract from the possibility that, as far as the donor is concerned, the transfer constitutes a gift.

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[24] Bittker supra note 7 at 309-11. See Eden Hall Farm v. U.S., 389 F. Supp. 858 W.D. Pa 1975). In that case the government asserted that the organization was not exempt and denied deductions on the grounds that an activity was not carried on for profit. The issue was moot because the court found the organization to be exempt.

[25] Rationale supra note 14 at 61.

In any event, such receipts appear to be donative contributions which, under normal tax principles, should be exempt as gifts.[26] This result is consistent with the goals of the deduction for charitable contributions. Otherwise, if the contribution were taxable and expenditures not deducted, the benefit of the charitable deduction would be offset. Moreover, this seems justified even if the contribution is used for a capital expenditure. If a charitable contribution used for a capital expenditure, for example building or equipment, were taxable, subject to future deductions for depreciation, the amount that the organization could expend would be reduced by the difference between the current tax liability and the present value of the tax savings from the future tax deductions. This

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[26] See Bittker supra note 7 at 308-9; In Branch Ministries, F.2d (D.C. Cir 2000) the court noted that the IRS explicitly represented both in its brief and at oral argument that donations were nontaxable as gifts even if the organization lost its exemption for engaging in political activities.

Hansmann also suggests, that transfers, particularly those intended for capital expenditures (or presumably endowment), could be considered non-shareholder contributions to capital which would not be included in income under §362(c). Rationale supra note 14 at 62 (n. 29). Denial of basis, as occurs under §362, could be relevant if income were taxed unless there was no attempt to recover the cost of capital in the charge made for goods and services. In the case of a gift, the donor's basis would carry over to the donee.

would reduce the value of the contribution in the case of contributions for capital expenditures as compared to contributions for current purposes. There is no apparent reason for this result.[27]

The issue is, perhaps, more difficult if the profit (used for capital expenditures or set aside for future expenses) arises from the conduct of the exempt activity, as in the case of a hospital, nursing home or day care center charging patrons more than the organization's costs. Because of the non-distribution constraint, which precludes reversion to members or contributors, it may be reasonable to assume that eventually all funds will be used for related expenditures. If all expenditures, including those on dissolution, were eventually deductible, taxable income over the life of the organization would be zero. Still, the time value of tax payments would be positive unless tax refunds were made with interest.[28]

Boris Bittker, however, suggests that there is little to be served by taxing this income, stating that "Since these accumulations and capital outlays are irrevocably dedicated to the institution's non profit objectives, ... we do not regard this alternative method of computing a nonprofit's income as very appealing: nor can we say that it has

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[27] This would occur, however, if deductible contributions could be made to for profit suppliers

[28] More directly, the organization would have to borrow to pay tax and while, if no loss carryforwards expire, future refunds might be sufficient to pay loans, they would not cover the interest charge. See Rationale supra note 14 at 62.

any economic or social advantages over a regime of complete exemption" [29] This statement, although it appears to merely state the conclusion, may in fact be true as to a set aside for a future current expenditure. The present value of the future expenditure would be equal to the amount set aside, so a current deduction (the result of not taxing the set aside) would, if tax rates do not change, correctly measure the future deduction. The treatment of investment income would, as explained below, determine whether the future expenditure would be treated as favorably as a current one.[30]

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[29] Bittker supra note 7 at 312.

[30] For example, assume income of $100 is set aside for future expenses. If the excess is not taxable but investment income is taxed, the organization (assuming a 10% return and a 40% tax rate) will accumulate $106 after one year and $112.36 after two. On the other hand, if the profit of $100 is taxed, investment of the $60 of after-tax income would provide $63.60 after one year and $67.42 after two. An expenditure of $112.36 at that point would provide a tax savings of $44.94. If there were no current income and a carryback were available against the income previously taxed ($100+6+6.36), the previous tax payments of $44.94 ($40+2.40+2.54) would be refunded.

Similarly, if investment income were not taxed, the accumulation would be $121 in the first case and $72.60 in the latter. An expenditure of $121, if deductible, would save $48.40 in taxes which when added to the $72.60 would provide $121. Note, however, that in this case, the previous tax payments which could be refunded, would only be $40.

A failure to tax an amount spent or set aside for a capital item would be equivalent to immediate deduction (or expensing) for a capital expenditure which has been described as equivalent to tax exemption for investment income.[31] Thus, if investment income is generally not taxed, this treatment would not raise any special concern. If investment income is taxed, however, the question of special treatment for capital expenditures financed from the income derived from related activities must be faced.

As discussed more fully below, membership-type organizations are generally not taxed on profits from dealing with members. Taxation may be viewed as a futile exercise, since if profits were taxable, they could be eliminated by raising funds from capital contributions or by operating as a cooperative, which would allow a deduction for amounts allocated to members. It may seem anomalous to exempt the profits of a country club from providing golf to members while taxing the income from supplying day care or hospital services, particularly in circumstances where the public benefit organization seems very close to a membership or mutual organization. Nevertheless, many of these organizations are a long way from membership organizations and could not easily, if at all, adapt to the cooperative model. Moreover, if they could raise "capital contributions" they would, as such contributions would probably be deductible as charitable contributions. Thus, regardless of how social clubs may be treated, it may not be inappropriate to

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[31] See William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113, 1127 (1974).

consider whether income from the supply of goods and services should be taxed to charitable organizations.

If the goal is to reduce the price or improve the quality of goods and services, it might seem consistent to tax profits, which, alternatively could have been used to reduce prices or improve quality. Thus, as Henry Hansmann has written, it seems that the case for exemption turns on the appropriateness of facilitating expansion, that is the desirability of a subsidy to capital formation by the organization.[32] In his well known contract failure argument, Hansmann suggests that there are good and services for which nonprofits are the most efficient providers, in that customers prefer to deal with nonprofits and would value good and services from them more highly.[33] However, because they lack access to capital, nonprofits would tend not to grow fast enough to meet the demand.[34] Therefore , it could make sense[35]

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[32] Rationale supra note 14.

[33] Id at 69.

[34] Id. at 72-4

[35] Of course a case has to be made that the supply of these good and services merits government aid. For example, should we care about hospital services to the well off. Hansmann also notes that contract failure might not be a problem in some circumstances and many exempt organizations seem to be over capitalized. Id. at 89. See Daniel Shaviro, Assessing the "Contract Failure" Explanation for Nonprofit Organizations and Their Tax-Exempt Status, 41 N.Y. L. School L. R. 1001 (1997). (Noting that tax-exemption aggravates the problem of locked-in capital. Id at1006) As stated above, this

for the government to provide capital to the organization by not taxing profits used for expansion.[36]

In the long run, the income tax exemption would be consistent with the goal of lower prices for the subsidized services.[37] Thus, a nonprofit would expand until costs equal revenue but, unlike a for-profit, costs would not include a return on capital.[38] Therefore, if nonprofits eventually replace for-profit competitors, the price of the goods or services should fall as prices would no longer need to be high enough to provide a return on capital investment. Moreover, in equilibrium, there should be no net income since capital expenditures would merely replace depreciation.[39]

If the income comes from the exploitation of the assets utilized in related activities, rather than from the beneficiaries of the exempt services, the case for exemption seems stronger since there is no concern about keeping prices to a minimum. An example would be royalties earned by an art museum from allowing others to make reproductions of its

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paper will not explicitly discuss this issue.

[36] While admitting that exemption of income from related activities would be a "crude mechanism," id. at 75, he suggests that high earnings would correlate with expansion needs, in that such earnings would reflect the fact that demand for services exceeds supply. Id. at 74.

[37] Id. at 80.

[38] Id. at 71-8.

[39] Id. at 79. This would not be the case if there were no inflation adjustment since in those circumstances, replacement costs would exceed allowable depreciation.

holdings. It would also seem compatible with the charitable deduction to exempt this income from tax, since it enhances the ability of the museum to enlarge its collection.[40] A similar argument could be made for payments for allowing others access to the nonprofit's "customers" or beneficiaries, such as payments to a University for the exclusive right to sell a particular brand of beverage on campus, or advertising or corporate sponsorship payments in connection with an event or publication. However, as discussed below, some may assert that it would unfair to potential competitors if these payments were exempt.

Investment Income

Let us next consider an organization with an endowment which produces investment income. Tax treatment of investment income should depend upon the desired relationship between current and future spending. As discussed below, from the point of view of the donor, tax exemption appears to favor future spending on charity more than it does current spending. On the other hand, from the organization's perspective, tax exemption may be essential to achieve neutrality as to the timing of expenditures. However, in some circumstances, exemption could be considered inconsistent with the goals of the income tax. Moreover, there is some reason to believe that a preference for current spending may not be undesirable. In the end, whether or not investment income should be taxable depends upon a complex balancing of these competing considerations.

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[40] See Hansmann, Unfair Competition and the Unrelated Business Income Tax, 75 Va. L. Rev. 605 (1989).

If it is determined that investment income should be taxed, at least in certain circumstances, it would be necessary to consider investment income as a separate item. For example, it would not make sense to offset investment income by current expenditures for exempt purposes. On the other hand, as noted above, if investment income is not generally taxed, there would be no reason to tax income from related activities.

As previously discussed, the charitable contribution will reduce the price of good and services. For example, a donor in a 40% bracket can purchase $100 worth of charitable activities for $60 of after tax income (a price reduction of 40%). Alternatively, if the individual neither spent her money on personal consumption nor made a charitable contribution, after one year, she would, if she earned 10%, have $63.60 available.[41] This would support a charitable contribution of $106 (again a 40% discount).[42] On the other hand, if the gift is made initially and investment income of the donee is not taxed, the charity would have $110.[43]

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[41] If she invested the $60 of after-tax income to earn 10%, she would earn $6 before tax. After paying tax at 40%, she would have $63.60.

[42] The tax savings from the contribution of $106 ($42.40) when added to the accumulation of $63.60 totals $106.

[43] The example assumes a contribution in one taxable year which is not spent until a later year. There may no advantage if the expenditure occurs in the same taxable year. In that case, the donor could contribute $110 to charity at the same out of-pocket cost. Since the charitable contribution would offset the wage income, if withholding could be

Thus, if the donor is focused on alternative means of deferred consumption, $110 of charitable activities can be purchased by giving up just $63.60 of personal consumption, effectively a discount of 42%. The discount would increase as consumption is further delayed. Accordingly, the income tax exemption for charities may be said to favor contributions for an endowment over gifts for current spending. A donor who contributes to an endowment is effectively prepaying for future charitable services while avoiding the tax on investment income which would be imposed if the donor continued to hold the investment.[44] These charitable services could directly benefit the donor, as, for

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adjusted, she would be able to invest $100 and earn $10 of investment income. The charitable deduction would offset both the wage income and the $10 of investment income. See Evelyn Brody, Charitable Endowments and the Democritization of Dynasty, 39 Ariz. L. Rev. 873, 944. For a general discussion of the potential opportunities because taxation is periodic and not continuous, see Victor Thuronyi, The Concept of Income, 46 Tax L. Rev. 45, 65-8. See also, Daniel Halperin, Mutual Insurance article, **CITE**

As the text suggests, the advantage to the donor is not with respect to the charitable deduction itself. The present value of the deduction is the same whether it is allowed currently or deferred until the recipient actually uses the funds for charitable purposes. In either case it effectively makes $100 of wages or other income tax-free. The benefit from the earlier deduction is the ability to exempt the intervening investment income from tax.

[44] In the case of property which appreciates in value, rather than producing current income, if a charitable contribution of market value is allowed without including the

example, gifts to a local orchestra, or, could provide intangible benefits, in the form of long term recognition or good feelings.

If the investment income were taxed at 40%, however, the charity would have $106 available and the price reduction would not vary as between current and future purchases. In sum, since investment income is normally taxed, the price reduction for future as opposed to current consumption holds steady if income is taxed to charities and increases if the investment income is exempt.

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appreciation in income, there may be a contrary incentive to delay the gift. Since the donor would not be taxable on the appreciation, investment income is exempt even though the gift is delayed. Therefore, if the $60 in after-tax income is invested in property which doubles in value to $120, the donor can contribute $200 to charity by adding her tax-savings from the contribution to the value of the property. This matches the amount the charity would accumulate if it had invested an initial $100 contribution in similar property.

In the latter case, if the donor had invested another $40 in identical property, she would have property worth $80 but there would be $40 of deferred gain which would be taxable if the property were sold. On the other hand, if the gift is delayed and the donor invests $100 in the property which she contributes to charity when it is worth $200, the tax savings would provide $80 with no potential tax on the appreciation. Since she uses her appreciated investment to fund the charitable contribution, her investment would also increase tax-free.

On the other hand, from the charity's perspective, neutrality may require exemption for investment income.[45] A tax on investment income is said to discriminate against future as opposed to current consumption, in that the amount available for future consumption would increase by the after-tax as opposed to the pre-tax rate of return. Since the premium for deferring expenditures is reduced when investment income is taxed, some suggest that there is a bias in favor of spending for current needs.[46]

To recapitulate, an exemption for investment income may be necessary to create neutrality in the hands of a charity as between current and future spending. On the other hand, because other future consumption by the donor is affected by the income tax on funds accumulated for this purpose, the price reduction for charitable spending, as compared to other deferred consumption, is relatively greater the longer consumption is deferred. Given this conflict, the appropriate treatment of income from capital earned by

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[45] Perhaps, this is also necessary in order to be neutral between current consumption by the donor and a contribution for future charitable services.

[46] In the case of a nonprofit, this would include purchases of assets related to the exempt function which would not produce taxable income, comparable to purchase of housing in the case of individuals. For a general discussion of the impact on savings if investment income is exempt, see Eric M. Engen and William G. Gale, The Effects of Fundamental Tax Reform on Saving in Economic Effects of Fundamental Tax Reform (Henry J. Aaron and William G. Gale eds 1996). It should be noted that the impact of an increased rate of return on savings is uncertain because those individuals who have a specified target in mind would save less if the rate of return is increased.

a nonprofit may turn on the implication of the income tax--consumption tax debate and the case for building an endowment.

Because they believed it is biased against savings, some favor replacing the income tax with a consumption tax, or any form of taxation which effectively eliminates investment income from tax.[47] They believe that an exemption for investment income would increase savings or at least not discriminate against those with a taste for future as opposed to current consumption. Opponents of consumption taxation, however, have asserted that any positive impact on savings would be more than offset by the likely impact on distribution of income.[48] They argue that income (which represents the power to consume) is a better reflection of taxable capacity than consumption and while it is possible to adopt a consumption tax which has the same burden with respect to income as the current income tax, this is unlikely to occur. Hence, a consumption tax would be unfair.

Perhaps, however, this conflict is minimized if the investments are held by a charitable organization. This may be particularly true in those cases where the donor does not control the charity and there is a clear separation between donors and beneficiaries. In these circumstances, the potential unfairness of a universal consumption tax would be alleviated and taxation of investment income may not be necessary to protect the

[47] See e.g. Robert E. Hall & Alvin Rabushka, The Flat Tax (2d ed. 1995).

[48] See e.g. Alvin C. Warren Jr., Fairness and a Consumption-Type or Cash Flow Personal Income Tax, 88 Harv. L. Rev 931 (1975).

distributive goal of an income tax. Society may get additional savings with less harmful effects.[49]

Professor Bittker offers the example of two retirement homes-the first provides services at cost and would thus, have no taxable income; the second uses income from its endowment to provide shelter at no cost to the indigent. For Bittker, it would be absurd to tax the income of the latter while the former is exempt.[50] Perhaps, he views it as inappropriate to tax investment income or he believes that the appropriate rate to be that of the average beneficiary, which might be zero.[51]

Exemption of investment income will, of course, facilitate the buildup of an endowment due to both the tax savings and the increased investment flexibility that comes from not having to take taxes into account. Many would view this favorably. Thus, James

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[49] Brody supra note 43 at 929.

[50] See Bittker supra note 7 at 310-11. He may be suggesting that the investment income should be offset by the expense of operation, in addition to his concerns about the appropriate rate.

[51] See Bittker supra note 7 at 314-6. However, even in this case, if, as discussed above, we want to maintain the relationship between charitable and private expenditures, whether consumption is current or deferred, it is the donor's rate that is relevant. The incidence of the burden as between the donor and the beneficiary depends upon the donor's behavior. If the donor keeps her after tax contribution constant, the beneficiary bears the burden of any additional tax. On the other hand, if the donor has a target benefit to the organization in mind, she would bear the burden.

Tobin has described an endowment as maintaining intergenerational equity by preserving the ability of an institution to continue to support the same set of activities indefinitely, without regard to the prospects of future gifts or other sources of funds.[52] This encourages stability and, in the case of a University, is consistent with the interest of alumni and entering students in preserving the reputation of the institution which provides their degree.[53]

On the other hand, providing the donor with an incentive to give in the form of additions to an endowment, thereby tying the organization's hands, may inefficiently affect the timing and manner of expenditures for charitable needs. This could be alleviated by prohibiting restrictions that last beyond a certain period or by liberalizing the cy pres doctrine to give the trustees of the organization more discretion.[54]

However, any tendency of the trustees to favor giving for endowment or to add unrestricted gifts to the endowment would remain. Trustees may view endowment

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[52] James Tobin, What Is Permanent Endowment Income?, 64 Am. Econ. Rev. 427 (1974). Tobin states: "The trustees of an endowed institution are the guardians of the future against the claims of the present....Sustainable consumption is their conception of permanent endowment income.... [T]hey must regard as a principal criterion of endowment income the fixing of student fees and educational quality across generations. " Ibid.

[53] Henry Hansmann, Why Do Universities Have Endowments?, 19 J. Legal Stud. 3, 27 (1990).

[54] See Brody supra note 43 at 944.

growth as providing for their future security and freedom from fund-raising restraints or as an end in itself, perhaps, as an indication of their success which they can more easily measure and control than the activities of the organization.[55] From Tobin's perspective this may not be a problem.

Others, however, argue that there is a tendency to over invest in endowments.[56] For such people, while it makes sense to protect against short term financial downturns which hamper the ability to raise funds, the case for totally ignoring the potential for future giving is weak. Although, freedom from constant fund raising can positively free up managers to spend more time on their mission, perhaps, a nonprofit should not be able to continue a program in perpetuity independent of a continuing level of support. From this perspective, a bias against accumulation in the form of a tax on investment income, at least in some circumstances at a moderate rate, may not be objectionable.[57]

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[55]See Howard F. Tuckman and Cyril F. Chang, Accumulating Financial Surpluses in Nonprofit Organizations 253, 259-60, in Governing, Leading and Managing Nonprofit Organizations (Dennis R. Young, Robert M. Hollister and Virginia A. Hodgkinson eds 1992); Brody supra note 43 at 935; Hansmann supra note 53 at 37.

[56] See Robert Eisner, Discussion, 64 Am. Econ. Rev. 438-41 (1974). "We clearly do not want to squander all our capital in expenditures of this week or year. But neither do most of have any good reason to reserve our capital to provide equal expenditures forever and ever and ever." Id at 441; Brody supra note 43 at 921-2, 933, 948.

[57] Id. at 945. See George A. Break & Joseph Pechman, Relationship Between the Corporation and Individual Income Taxes 28 Nat'l Tax J. 341, 344 (1975):

Further, recall that the justification for exemption of income from related activities was the need for a subsidy for expansion. While a buildup of assets may reflect a need for expansion in the near future, for example, because of the aging of the population, high earnings on unrelated business or investments could be an indication that expansion is neither needed nor feasible. Perhaps, the demand for the services is such that if supply increases, it cannot be sold at a price that will cover costs.[58] In that case a capital subsidy may not required and taxation of investment income will mitigate the problem of excessive capital locked into a nonprofit.

In any event, the case for special treatment of the investment income of nonprofits is weaker if donors and beneficiaries of charitable organizations overlap substantially or at

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"Investment income in moderate amounts does indeed provide both independence and valuable protection against unforseen contingencies, but in large amounts it may serve mainly to protect the recipient institution from any market test of the value of its activities. A moderate tax on this investment income then, would not destroy the protected position of highly endowed philanthropies, but it would reduce their ability to finance activities that are not directly supported by the public."

In 1987, the Joint Committee on Taxation included a 5% tax on investment income of all exempt organizations in its list of revenue options. See, Suzanne Ross McDowell, Taxing Leveraged Investments of Charitable Organizations: What is the Rationale?, 705, 726 (note 119) (1988-89) (hereinafter McDowell); Hansmann, supra note 53 at 7.

[58] Hansmann supra note 40 at 621 (n.49)

least come from the same income class.[59] In Hansmann's terminology, a number of c(3) and (c)(4)'s can be considered "commercial non profits"[60] in that they principally supply goods and services to customers who pay market price. Although it may have been relevant when the endowment was created, the charitable deduction is of relatively little current benefit to these organizations. Exempting investment income, however, would privilege the set aside of funds for future consumption through the organization as compared to retention by customers. Even if one feels comfortable with this when there is a clear separation between donors and beneficiaries, is exemption for investment income justified if contributors and beneficiaries have the same marginal rate? Would it still be justified if the donor maintains control over future spending as she could with a private foundation or a donor advised fund.[61]

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[59] Henry Hansmann notes that organizations with substantial capital accumulations generally do not serve the poor. Rationale supra note 14 at 65. This seems true as to museums and symphonies but maybe less true of Universities, unless we view future status as relevant. See Bittker supra note 7 at 334.

[60] Rationale supra note 14 at 59.

[61] See Treas. Reg. §1.170A-9(e), (10), (11); Albert R. Rodriguez, William C. Choi & Ingrid P. Mittermaier, The Tax-Exempt Status of Commercially Sponsored Donor Advised Funds, 17 Exempt Org. Tax Rev. (1997). The Administration has made a proposal to revise the treatment of donor-advised funds. See Department of the Treasury, General Explanation of the Administration's Fiscal Year 2001 Revenue Proposals at 535.

In sum, the treatment of investment income may depend upon the degree to which one feels it is desirable for our tax system to channel long-term savings through charitable endowments and upon whether or not one believes that "the non-distribution constraint", which means that the donor can no longer use the funds for private consumption, justifies, at least in some circumstances, abandoning the income-tax ideal in favor of exemption for investment income. These are difficult questions whose answer may depend more on a value judgment than it does logic.

Section 501(c)(4) organizations

The income tax exemption for organizations exempt under section 501(c)(4) raises similar issues with respect to the impact on current and future spending. To the extent there is no constraint on distributions, however, the argument for exemption is weaker since funds built up on a tax-free basis can be returned to members.[62]

In any event, exempting contributions from tax seems necessary to avoid discouraging contributions. However, the exemption for gain on the sale of appreciated property transferred by a donor reduces the price of spending much like the charitable contribution and seems particularly inappropriate.[63]

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[62] There may be a prohibition under State law but the IRS has apparently been unsuccessful in attempts to require this as a condition for tax exemption. **Add CITE**

[63] The lack of a gift tax exemption beyond $10,000 annually may limit the potential for abuse.

Mutual Benefit Organizations:

Traditionally most mutual organizations, which did not have shareholders with rights to residual profits, were not subject to tax. While some of these exemptions have been repealed,[64] many similar organizations are still exempt from tax. Further, cooperatives may eliminate taxable income by allocating any residual profits back to members.

We begin first with a discussion of organizations whose members cannot deduct their contributions--what I will call consumer mutuals. It has been observed that the use of a separate entity would enable consumers to avoid tax on investment income unless there is an entity level tax on such income. In the case of business mutuals, to which deductible contributions can be made, the tax advantage has appeared to be deferral, not exemption. However, as will be demonstrated, a special tax on investment income can, in some circumstances, offset the benefit of deferral.

Consumer Mutuals

[64] Mutual savings banks and savings and loans previously were previously exempt under IRC §501(c)(14). TIAA- CREF and Blue Cross were exempt under §501(c)(3) or (4) until 1986 See §501(m). Until recently very little tax was collected from mutual insurance companies. See Robert C. Clark, The Federal Income Taxation of Financial Intermediaries, 84 Yale L.J. 1603, 1637-64 (1975).

Income may be derived from amounts paid by members, from the performance of services for members and nonmembers, and from the capital invested by the organization, either directly in assets necessary to carry out its function or in unrelated investments.

Member payments may appear to be similar to amounts paid for goods and services but they could also be akin to contributions to capital or to moving funds from one pocket to another. The underlying rationale for exemption may be as simple as the idea that dealing with yourself or pooling of resources does not in itself result in income.[65] For example, if Adam sets aside $1000 in a bank account in order to purchase a piece of play equipment for his children, the "bank account" is not taxed on the receipt of $1000 of income. Similarly if Adam's neighbor Betty also contributes $1000 to a joint bank account for the purchase of this equipment, the joint account does not have income merely because there are now two unrelated parties who are participating. The question is whether this analogy can be applied to a country club with hundreds of members.

Such a club may avoid the appearance of income by requiring a capital contribution to join and then charging annual dues which exactly cover the cost of operations. The dues may be lower than that charged by a for-profit club because the nonprofit need not cover either the cost of services performed by members, without compensation, or a return on the capital invested in the club's property. Should we

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[65] See Joint Committee Estimates of Federal Tax Expenditures quoted by Brody supra note 17 at 595 (stating that imputed income from nonbusiness activities conducted by individuals or collectively by certain nonprofit organizations is outside the normal tax base).

attempt to tax members on the discount received or is this merely "imputed" income of the kind that normally is untaxed?

For example, if the play equipment had to be assembled on site, Adam would not be taxable on the imputed income from doing so on behalf of his children alone. Perhaps, this treatment should also apply if Adam and Betty work together to assemble the equipment or even if Betty does it herself. But, it is not clear that this rationale would extend to a multi-member organization especially when members do not perform an equal amount of services.

Similarly, if Adam owned the equipment himself, he would not be taxed on the imputed return on the value of the equipment, just as he would not with his house and automobile. Is the imputed return from property owned jointly with hundreds of other a different story?[66]

In any event, we have come to realize that completely exempting social clubs from tax would extend beyond the contribution to capital and imputed income analogy to income derived from investments and from services performed for others. For example, if the bank account earns $500 in interest before it is used to purchase a $2500 play piece, the $500 of interest income should be taxed just as if Adam or Betty had earned it individually.

Similarly, suppose Adam and Betty can hire an operator of an amusement ride to come to the neighborhood for the day for $500, which they are able to raise by charging

[66] A similar concern with respect to public benefit organizations may be alleviated to the extent the beneficiaries are not identical to the donors.

neighborhood kids for rides. Since the cost allocable to the rides enjoyed by the neighbors is less than $500, Adam and Betty have earned a profit which they can apply to eliminate any cost for their own children. In this case, Adam and Betty have enjoyed some consumption for their children which normally would be paid for with after-tax income.

Since 1969 Social clubs[67] have been taxed on investment income and income from non-members less the expenses allocable to such income.[68] Their exemption applies only to exempt function income–"gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities or services in furtherance of the purposes constituting the basis for the exemption of the organization."

Under this rule, the Adam and Betty club would be taxed on any investment income and on the amusement ride charges less the expense related to the paying customers. Since the expenses allocable to their own children could not be deducted, there would be some net income. In effect, the "loss" from providing rides to their own children

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[67] IRC Section 512(a)(3). This provision also applies to certain organizations providing employee benefits (under §§ 501(c)(9), (17) and (20)) but would seem to have limited effect in these cases since it does not apply to income set aside for the payment of such benefits. See, however §512(a)(3)(E).

[68] The exemption also applies to income set aside for charitable purposes unless derived form an unrelated trade or business. A social club which does too much business with the general public may lose its exemption. Treas. Reg. §1.501(c)(7)–1(b).

would not offset their profit from dealing with the neighbors. [69] However, any imputed return on the capital invested in play equipment, or from the services involved in assembling it, would remain tax free, as would any amounts paid by members in excess of the cost of services they receive.

Thus, social clubs are taxed like cooperatives. Cooperatives are subject to the corporate tax but are allowed a deduction for patronage dividends, of which only 20% need be paid in cash.[70] Patronage dividends are limited to earnings from business with or for patrons and cannot be paid out of amounts derived from earnings from business with or for other customers to whom no amounts are paid or to whom smaller amounts are paid with respect to substantially identical transactions.[71] It would seem that the intended

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[69] One need consider how costs should be allocated to taxable income--possibly, incremental costs only but some fixed costs could be incremental to extent facility is larger because of expectation of dealing with non-members. Additional questions involve how members are distinguished from non-members if level of services differ among members. Does this matter unless the relationship between costs and charges also differs?

[70] IRC §§1382(b), 1388. Members must consent to patronage dividends which are not paid. In effect, it is as if distributions are paid and returned by members as capital contributions. IRC §1388(c). Interest need not be allocated on unpaid dividends which suggests that members expect a return on their "capital contribution" in the form of a price adjustment. See Klein, Income Taxation and Legal Entities, 20 U.C.L.A. L. Rev. 13, 34, 68 (n. 223) (1972) (hereinafter Klein)

[71] IRC §1388(a).

result of this rule would be to tax the organization on investment income and on profits derived from dealing with nonmembers--which is consistent with the rule applicable to social clubs.[72]

A similar rule applies to political parties under section 527. These organizations are taxed on all income except "exempt function income." Since exempt function income includes contributions, dues, proceeds from a political fund-raising or entertainment event, bingo games or sale of political campaign materials, the tax would generally apply only to investment income.[73] To the extent these organizations are viewed as membership organizations intended to achieve common ends (as opposed to serving the ends of the candidates or other party insiders), it would seem to make sense to track the treatment of social clubs. However, to the extent income comes from non-members-- perhaps, entertainment events and bingo-- it should, to be consistent with the treatment of social clubs, be subject to tax.[74]

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[72] See Bittker supra note 7 at 348, 352. Farmer's cooperatives "exempt" under IRC section 521 are not limited in the source of patronage dividends. These organizations are more like business mutuals discussed in the next section. See also IRC section 501(c)(16).

[73] Bittker objects to the taxation of investment income of political parties stating it does not measure any coherent concept of income. Bittker supra note 7 at 329.

[74] Under IRC section 527(f), organizations which are otherwise exempt from tax, but which engage in political activities (spend money to influence the selection, nomination or election of a candidate to any public office) are subject to tax on the lesser

Taxable organizations ordinarily can offset income from one activity against losses on another. However, membership organizations, which are not exempt, are subject to section 277. This provision does not allow losses from dealings with members to be applied against either income from dealing with nonmembers or investment income.

Essentially the difference between non-exempt membership organizations, subject to section 277, and the taxation of exempt social clubs, cooperatives and political parties would be that the former is subject to tax on income from dealing with members. This is mitigated somewhat by section 456 which allows prepaid income from members to be deferred until services are performed.[75] As suggested above, exemption of income from

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of the amount so spent or their investment income. The goal would be to approximate the treatment under section 527. In order to do this, it would also be necessary to make certain that there are no deductible contributions or the benefit of the deduction is offset. This explains IRC section 162(e)(3), denying deduction for dues, paid to an exempt organization, allocable to expenditures involving participation in a political campaign on behalf of a candidate for public office, and the special excise tax under IRC section 4955, applicable to organizations exempt under section 501(c)(3). The latter is not big enough to offset the benefit of the charitable deduction. However, such an organization, which engages in political activities, is supposed to lose its exemption.

[75] While this is the correct treatment for the organization, immediate taxation is needed to offset the advantage to members who, by prepaying, avoid tax on investment income. See Daniel I. Halperin, Interest in Disguise: Taxing the "Time Value of Money,"

members is justified only if it is appropriate to consider income from members as essentially contributions to capital (shifting of funds from one pocket to another). This may not be the case with large organizations.

On the other hand, in many cases, it would be possible to set prices so as to avoid profits from dealing with members or to operate as a cooperative, which would allow a retroactive price adjustment. This could occur if members are willing to supply capital which would not earn a specific return, either directly as a capital contribution or by accepting noncash patronage dividends.[76] Agreement to do so would depend on there being reasonable assurance that contributing members will reap the benefits of their contributions in other ways.[77] Although that suggests there is imputed income, it will be difficult to tax. Thus, the tax treatment of social clubs seems acceptable unless one believes that there are important cases where capital is being raised through profits on dealing with members and that this practice could not be modified in response to a change in the tax rules. Further to accomplish anything, it would probably be necessary to modify the treatment of cooperatives.

The question remains, however, whether the treatment of social clubs should be extended to other consumer mutual organizations, particularly those which may be in part provide recreational benefits for members.[78] In some cases, for example credit unions,[79]

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95 Yale L. J. 506, 515-18.

[76] See Klein supra note 70 at 37-8.

[77] Id. at 67.

[78] See IRC sections 501(c)(8), (10) and (19) According to the regulations, section

there may be little justification for exempt status. Given the elimination of the tax exempt status of insurance companies under sections 501(c)(3) or (4), [80] the same might be said for other exempt organizations performing an insurance function.[81] On the other hand, exemption of investment income for some of these entities might not be inconsistent with the treatment of organizations providing similar benefits to employees.[82] Thus, any change in the law should be considered in that context.

Section 501(c)(12) relating to mutual telephone and electric companies appears to recognize the inappropriateness of exempting income from investments and dealing with nonmembers. It requires, generally, that 85% of income "consists of amounts collected from members for the sole purpose of meeting income and expenses." However, income from pole rentals and telephone listings can be ignored in applying the 85% test. This could allow a substantial amount of "outside" income which it seems appropriate to tax.

Business Mutuals

501(c)(10) does not apply to organizations which would qualify as social clubs. Treas. Reg §1.501(c)(10)-1(a).

[79] IRC §501(c)(14)(A).

[80] See IRC Section 501(m).

[81] See IRC Sections 501(c)(8), (12)(as it relates to life insurance companies of purely local character), (13)(to the extent we can think of cemetery companies as providing a form of insurance),(19), (23) and (26).

[82] See note 11 supra .

If the mutual organization is one to which the members make tax deductible contributions,[83] tax exempt status is said to provide only deferral and not full exemption.[84] To illustrate, if these organizations functioned like cooperatives, any income in excess of currently deductible expenditures could be allocated back to members, eliminating taxable income at the entity level. The member would be taxable but would have an offsetting future deduction when the funds were "returned" to the organization. Hence, it is "only" a matter of timing. The deduction is allowed too early.

Thus, the current tax exemption for a trade association allows the organization's members to obtain an immediate deduction for dues or similar payments to the organization in excess of the amount needed for current operations. In addition, they avoid tax on a proportionate share of the earnings from investing such surplus amounts.

For example, if the payment was $100 in excess of current needs and this amount was invested to earn 10%, the member's taxable income would be under stated by $110. Because of the exemption, this advantage is not offset by taxing the income of the association. However, if the member could deduct payments to the association, this understatement of income would be offset by the loss of future deductions. For example, suppose the Association were to spend $110 in year 2. In the above example, the member contributes $100 in year one, taking a deduction in advance of the expenditure by the Association and avoiding investment income of $10, thus lowering year one income by

[83]See IRC Sections 501(c)(5), (6). Also some of the organizations to which §501(c)(12) applies.

[84] See Bittker supra note 7 at 354.

$110. Alternatively, if the member postpones the dues payment until year 2, the member would report $110 in additional income in year 1 but claim an equal deduction in year 2. As the Treasury put it, "assuming that dues and similar payments would be deductible by the member if made in a later year, to the extent that investment income is earned by the trade association in one year and spent in a later year, the current-law exclusion effectively provides the benefit of a deduction before the expenditures actually is made." [85]

Citing the timing advantage, the Treasury has proposed that the investment income of business leagues or trade associations be taxed unless it is set aside for charitable or educational purposes.[86] The Section of Taxation of the American Bar Association in a report to the ABA House of Delegates opposed the recommendation stating that "the time value of the tax dollars sought to be protected" was "of insufficient importance to warrant the additional complexity."[87] The report noted that the "only significant consequence of permitting these excess dues to be invested by a tax exempt entity is to defer the government's receipt of the tax on such income from the year of the initial dues payment to the year in which the excess dues are applied to carry out the trade association's exempt activities."[88] This statement could imply that "mere" deferral is not

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[85]Department of the Treasury, General Explanation of the Administration's Fiscal Year 2001 Revenue Proposals at 880.

[86] Id at 881. A similar recommendation was made a year earlier.

[87]American Bar Association Section of Taxation, Report to the House of Delegates, 25 Exempt Org. Tax Rev. 141, 142 (1999).

[88] Id. at 141-2

sufficient to warrant the change but this seems unlikely because as the ABA well knows much of the complexity in the Internal Revenue Code is intended to preclude the benefit of deferral.

Thus, it is hard to take this argument seriously unless it is assumed, as the letter claims, that "based on the ease with which many trade associations could avoid this new tax by earmarking their investment income for educational purposes, there is significant likelihood that the proposal would merely complicate the tax law without resulting in any real revenue gain." [89] However, this set aside provision, which is borrowed from section 512(a)(3), applicable to social clubs, is overly generous. As will be demonstrated below, the investment income should be taxed regardless of the purpose for which it is used.

Since it is not obvious why an extra tax on investment income compensates for the benefit of deferral, it may be that the ABA is also asserting that taxation of investment income would more than compensate for the advantage of deferral and thus, would over tax the Association and its members. Returning to the prior example, if the contribution is delayed until the second year, ten dollars of investment income is taxed to the member and there is a deduction for $110. However, if the contribution is made in year 1, under the proposal, ten dollars of investment income is taxed to the Association but the deduction for the member is only $100, even though the actual expenditure by the association is $110. The deduction may appear to be too small. However, although the deduction is smaller, it is also earlier and the value of the $100 deduction is, in fact, equal to $110, one year later. Put another way, since deferral (by acceleration of deduction) is

[89] Id. at 142.

equivalent to tax exemption for investment income, it can be offset by an extra tax on such income.[90]

This can be demonstrated by example. If the member contributes $100, the Association will earn $10, pay tax of $4 (assuming a 40% rate) and will have $106 to spend for is activities. Alternatively, if the member does not make the contribution, it will owe $40 in tax. If it invests $60, it will, if the tax rate is the same, accumulate $63.60. If it contributes $106, to the Association, this will reduce taxes by $42.40 which, when added to the accumulation of $63.60, funds the $106 contribution. Although in the first example, the deduction is limited to $100, the value of a $100 deduction in year one is, at a 6% after-tax return, exactly equivalent to a deduction of $106 one year later.

Therefore, in this example, the tax on investment income exactly compensates for the acceleration of the deduction. The rule should be the same whether the $106 is spent on association activities or some or all of it is devoted to charitable or educational activities. In the case of a consumer mutual, such as a social club, the exemption for amounts set aside for charity recognizes that if investment income were used for charitable purposes, it effectively is not taxed. Thus, if a member contributes $100 to a social club which invests it, earns $10 and contributes it to charity, excluding the income from tax reaches the same result as if the member invested on her own, earned $10, and made a deductible charitable contribution.

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[90]Daniel I. Halperin, Interest in Disguise: Taxing the " Time Value of Money," 95 Yale L.J. 506, 544 (1996)

But in the context of a trade association, the tax on investment income is in effect an indirect tax, to compensate for the acceleration of the deduction. This acceleration enables the Association to invest $100 as opposed to the $60, after tax, that would have been available to the member, if the deduction were not allowed. As shown, in the latter case, there would have been $63.60 accumulated in year 2 which would have permitted a deductible contribution –for association business or charity of only $106. The tax on investment income reduces the accumulation, in the case of the contribution in year 1, to $106 and is just as necessary to achieve parity when the money is used for educational and charitable purposes as it is when it is used for business purposes.[91] One hundred ten dollars would be accumulated for charity only if the money had been contributed to charity in year 1, which, as noted above, allows tax exemption for investment income. A mere set-aside for charity, after the income is earned, is insufficient to justify the same result.

Taxation of investment income, however, is not a complete proxy for a more direct effort to eliminate the deferral advantage. For example, to the extent funds are invested in depreciable assets, the imputed return from the investment would not ordinarily be included in investment income. If the imputed income cannot be taxed, the equivalent result could be accomplished only if, at the time a capital expenditure is made,

[91] For similar reasons, the existence of the charitable deduction, which can offset tax on investment income given to charity by an individual or corporation, does not establish that the charity itself should be exempt. As shown, exemption for the charity allows a larger accumulation than if the contributor continued to hold the funds.

an amount equal to the difference between the expenditure and the present value of deductions for depreciation could be included in income.

Moreover, the current system provides an advantage only when expenses would be allowed in a year following the payment of dues or the receipt of other income. Thus, unlike social clubs, there would be no tax advantage for an exemption for either income from nonmembers or from a short-term investment of dues, if the accumulated funds are spent in the same taxable year.[92]

In order to more clearly subject the right amount of income to tax, the association could be required to include all receipts, including dues or contributions in income, which could then be offset by the usual deductions for ordinary and necessary business expenses. However, in some circumstances, this approach may lead to deductions which are not currently usable. To avoid this problem, the excess of current income over deductions could be allocated back to the individual members. In the end, taxing the investment income to the Association, which is administratively simpler than these other approaches, may be close enough.

An additional objection to the Treasury proposal was that it singled out business leagues and did not cover other entities that were business related, most obviously labor unions. In fact, it was argued that labor unions are even more obvious candidates for a tax on investment income because, with the 2% floor on miscellaneous deductions, union dues are generally not deductible. Thus, unions are more like consumer mutuals, such as social clubs. However, it seems that the 2% floor is intended as an administrative device to

[92] See Bittker supra note 7 at 358.

help police excessive claims of small amounts rather than an affirmative statement of non-deductibility.[93] If a more accurate measurement of income would require a deduction, it may be argued that an exemption for the income of the union is justified as a partial attempt to compensate for the inappropriate measurement of income that results from the 2% floor. Members of a trade association would still be treated more favorably, than most union members, even if the association were taxable on investment income and the union was not.

Unrelated Business Income

The question of whether unrelated business income should be taxed arises, of course, only if it is decided not to generally tax investment income. Support for taxation of unrelated business income is based on grounds of equity or fairness to potential competitors, revenue and efficiency.

Unfair Competition

The Committee Report in 1950,[94] when UBIT was first enacted, referred to the potential unfair advantage nonprofits had over their for profit competitors because they

[93] Consider, for example, IRC section 132 which excludes items from income as a working conditions. This would normally require that the employee would be entitled to a deduction if she paid for it herself. However, the fact that the 2% floor may preclude a deduction does not prevent exclusion. See Treas. Reg. §1.132-5(a)(1)(vi).

[94] H. Rep. No 2319, 81st Cong. 2d Sess. 38 (1950); S. Rep No. 2375, 81st Cong. 2d Sess. 28-9 (1950).

would have pre-tax profits available for expansion.[95] Moreover, since they neither had to pay taxes nor provide a return on equity capital, nonprofits could cut prices thereby driving out competitors. UBIT was not applied to dividends, interest and other passive income on the grounds that the risk of competition was not as great and, as the normal form of investment, it was presumably intended to be nontaxable.[96]

Fear of unfair competition may make sense with respect to a related business. For example, a nonprofit hospital may want to keep its charges as low as possible. A mutual savings bank might take advantage of the absence of equity holders, who need to be compensated, to pay higher interest to depositors or charge less to borrowers. These practices would be consistent with the reasons for which the organizations were formed [97] and should be viewed favorably.

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[95] In an efficient capital market, this should not make a great deal of difference. For profits have the offsetting and larger advantage of excess to the equity markets

[96] See, McDowell supra note 57 at 709, 725.

[97] See Brody, supra note 17 at 620. In the case of mutual insurance companies, it is sometimes assumed that capital comes from current policyholders. They initilally over pay for insurance but get their money back plus a return on their capital from future policyholder dividends. See Graetz, ; Klein supra note 70 at 60. In the case of a mutual savings bank, capital appears to have been created by under compensating early depositors for the use of funds. See id. at 67-8, 70.

When the mission of the organization is not involved, however, a nonprofit would have no reason not to seek a return on capital invested in a business.[98] Since all investments must have an equal expected return, adjusted for risk, nonprofits, which cut prices, would earn a subnormal return, presumably less than it would earn, as adjusted for risk, from passive investing. It would seem unlikely that a nonprofit could often hope that a "temporary" price cut would permanently eliminate competitors so that they could achieve extraordinary returns by raising prices above normal.[99]

However, some observers have suggested that this line of reasoning fails to take account of the classical corporate tax system.[100] Because of the existence of the double tax on corporate profits, it is sometimes assumed that public corporations must earn a higher rate of return than the return on other investments.[101] If this did not occur and the corporate tax fell on investors, the double tax would produce an inadequate return. Thus,

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[98] See Bittker supra note 7 at 319.

[99] See Klein supra note 70 at 63-6.

[100] See Susan Rose-Ackerman, Unfair Competition and Corporate Income Taxation, 34 Stan. L. Rev. 1017 (1982); Henry Hansmann, Unfair Competition and the Unrelated Business Income Tax, 75 Va. L. Rev. 605 (1989) (hereinafter UBIT). For a contrary view as to the importance of ths factor, see Klein supra note 70 at 63-4 (note 212).

[101] Hansmann, UBIT supra note 100 at 610. See Harberger, The Incidence of the Corporation Income Tax, 70 J. Pol. Econ.215 (1962) (this is sometimes referred to as the "traditional view.")

the corporate base is assumed to shrink until the reduced supply of goods enables prices and, therefore profits, to increase enough so that after the corporate tax, the expected return is equivalent to the pre-tax return from other investments.[102] This may offer an organization, such as a nonprofit, which can avoid the corporate tax, an opportunity to make an extraordinary return.[103]

For example, if the normal rate of return were 10% and the corporate tax 33.3%, a corporate business could be expected to earn 15%. A nonprofit would have an incentive to operate this business directly even if it could not do so efficiently. As long as it could earn more than 10%, it would earn more than it could on other investments. Thus, a nonprofit may be willing to enter a business, where for-profits are just making 15%, even though the result of additional entrants would be to drive profits below the level necessary to provide a fair rate of return on investment.[104]

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[102] Because of the increased supply of capital outside the corporate sector, the rate of return on these investments declines so the burden of the corporate tax is shared by all investments.

[103] Individuals can avoid the corporate tax by using non-traded limited liability companies, taxed as partnerships, or Subchapter S corporations. Thus, they would have a similar incentive to operate their own business rather than investing in a diversified portfolio of stocks. Although individuals generally might not have access to enough capital to do this efficiently, small business may count on the extra tax burden imposed on large competitors to offset their cost advantage.

[104] Some observers reject the idea that corporations earn such excess returns.

However, if the UBIT applied to the directly owned business, it would reduce the return (on the efficiently operated business) from 15% to 10% and there would no reason to favor direct ownership over a portfolio of investments. Thus, nonprofits only have an incentive to engage in a related business where UBIT would not apply. Rose-Ackerman suggests this may be unfair to a for-profit company, if it could not have anticipated the entry of nonprofits and exit is costly.[105] She suggests repeal of UBIT would spread competition around and mitigate the unfairness. It would seem, however, that future instances of unanticipated competition might be relatively rare. Mitigating past harm would require exit by nonprofits, which may be unlikely if exit is costly, and may benefit the wrong party if the business has changed hands at a reduced price.

Under, the so-called new view, it is believed that, because the source of the marginal investment by corporations is retained earnings or debt, the marginal return on corporate investment need not be extraordinary. Under this view, however, to reflect the extra corporate tax, existing stock would sell at a discount from the value of the assets to the corporation. Again, this may offer an organization, which can avoid that tax, an opportunity to make an extraordinary return by buying, stock at a discount, even though it is worth full value to it. In order to achieve this result, the nonprofit would have to liquidate the corporation. Under current law, such a liquidation would trigger a tax to the extent that the value of the corporate assets exceed their basis. This would correspond to the tax paid by the seller if the nonprofit bought assets.

[105] Rose-Ackerman, note 100 at 1028.

Efficiency

Starting from the same premise as Rose-Ackerman, Hansmann expresses concern that the potential higher return from directly investing in one or a few businesses could entice a nonprofit to put all its eggs into a few baskets, buying businesses which it could not necessarily operate efficiently.[106] Noting the potential harm from the decreased diversity in the nonprofit's investments and the economic loss if a nonprofit, rather than the most efficient operator, is running the business, he, effectively, looks to the UBIT to replicate the corporate tax, thereby deterring the inefficient investment choices that would otherwise be made by nonprofits. Unlike Rose-Ackerman, Hansmann looks favorably on investment in a related business because of the potential for lower costs if the nonprofit exploits an activity in which it would engage, in any event, in connection with its mission.

For Hansmann, the exceptions for passive income are needed in order not to distort the investment choices of the nonprofits. This is most straightforward in the case of dividends. If dividends were taxed under UBIT, then there would be a double tax on portfolio investments and a single tax on direct investments, restoring the same differential that would result from repeal of UBIT.[107] He suggests that a similar analysis would lead to an exemption for portfolio interest as well.[108] But this does not seem to

[106] UBIT supra note 100 at 614-5.

[107] Id. at 625.

[108] Ibid.

follow since applying UBIT to interest would result in only a single tax, just as there would be on direct investments.

However, if we again focus on the desire to avoid an incentive to pursue the possibility of an extraordinary return on direct investments, it would follow that the goal of the UBIT is merely to replace the corporate tax. Thus, it need not apply to income in other forms, that is income not ordinarily earned by a corporation.[109] If the UBIT applied to interest, it would drive the return down below the after-tax return on the direct investment, recreating the incentive for direct investment.

While this argument seems persuasive, it would seem to apply only to those nonprofits with large capital accumulations and, thus, the ability to compete for assets normally owned by publically traded corporations.[110] Moreover, it may be that, ideally, it should not apply to the entire income from an unrelated business. Perhaps, as discussed next, income that could have been debt-financed should be tax-free.

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[109] As Hansmann suggests, the exemption for rents could be justified on the grounds that real estate is not ordinarily owned in corporate form. Id. at 626. If this were the theory, perhaps, it would not make sense to tax rentals when they are based on the income of the lessee as the statute now does. IRC §512(b)(3)(B)(ii).

[110] But see id. at 622 suggesting that even smaller nonprofits could easily finance the purchase of a business because of the excessive return they will earn. On the other hand, see McDowell supra note 57 at 733 (noting that in the case of both taxable and tax-exmpts, the advantage of borrowing is the difference between income earned and the interest rate on debt).

Controlled Business

Since corporations can avoid the double tax to the extent they are debt financed, it seems logical that even if there is an extraordinary return on corporate investment, it would be limited to the portion normally financed by equity. Thus, in the above example, if debt financing normally represents 60% of capital, the return on investment at the corporate level need only be 12% or $1200 on a $10,000 investment. If the nonprofit borrowed 60% of the capital, $600 could be paid out to the debt holders and after the corporate tax, there would be 400 left, a 10% return for equity holders who supplied $4000. If the nonprofit purchased bonds for $6000 which earned $600, it would make 10% on the entire investment. On the other hand, if an nonprofit did not borrow and invested $10,000 in the business, UBIT, applicable to the entire income, would reduce the 12% return to eight per cent (or $800), a subnormal return.

To avoid this result, the nonprofit would transfer the business to a controlled subsidiary in return for stock and $6000 of debt. The subsidiary could reduce its income by the interest payments and since, as discussed below, interest is normally exempt from UBIT, the tax burden would be reduced. However, UBIT now applies to interest (and other deductible payments) paid to the parent nonprofit, so the entire earnings from the business would be taxable.[111] This achieves parity between direct operation of a business

[111] IRC §512(b)(13). Until recently, since attribution rules did not apply, this section could be easily avoided by the use of a second tier subsidiary to own the business. Control also required 80% ownership. Now since more than 50% ownership is deemed to

by a nonprofit and the transfer to the subsidiary but may, as suggested above, produce the wrong answer in both cases.

Critics of the recent tightening of these rules have argued that interest would be excluded from tax if the subsidiary borrowed from another person and the nonprofit lent money to an unrelated party.[112] Similarly, as noted above, the nonprofit could reduce the income from a directly operated unrelated business by borrowing against the assets and using the funds to invest in unrelated passive investments. Therefore, it is argued, that as long as the arrangement is at arms length, there is no reason to tax the interest paid by the related party to the nonprofit.[113]

In terms of neutrality, however, if interest from related parties is not subject to UBIT, it would be logical to allow a business, which is being operated directly, a deduction for "interest" to the extent its level of borrowing is below normal. Since such a deduction

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be control and attribution applies, the provision has much more force. See P.L 105-34 § 1041. But it still would not affect a joint venture whereby a group of nonprofits formed a corporation, financed partly by debt, to invest in various activities. Gallagher, When is a Business Not a Business? Exploiting Business Opportunities and Enhancing Economic Returns by Capitalizing on the Income Tax Exemption of Tax-Exempt Organizations, 50 Taxes 928, 946 (1997).

[112] See, Harry L. Gutman, Taxing Transactions Between Exempt Parents and Their Affiliates, 26 Exempt Org. Tax Rev. 45 (1999).

[113] An individual can lend funds to a 100% owned corporation and reduce the corporate tax burden.

for imputed interest does not appear to be feasible, it is not possible to achieve fully consistent results in all circumstances. Moreover, applying the UBIT to the entire income might be appropriate if it is thought to be desirable to foster more diversity by encouraging nonprofits to borrow from outsiders were feasible. On the other hand, it could be more efficient in certain circumstances to self finance (or at least to own the real estate used in the business), rather than borrowing (or leasing from outsiders).[114]

Revenue

In 1950, it was suggested that if UBIT were not enacted, nonprofits would own a significant portion of business producing a revenue loss. Since nonprofits would be selling other non-taxed assets to acquire the business, this revenue loss could occur only if nonprofits acquired a taxable business previously conducted in the corporate sector, thereby eliminating the corporate tax. Such acquisitions could be facilitated by the fact that nonprofits might be willing to pay a higher price than that offered by other buyers because, as discussed above, the elimination of the corporate tax would provide an above normal return even if the before tax return on capital was reduced because of the higher price. Previous holders of the stock of the acquired company would replace nonprofit entities as shareholders of the remaining corporations or hold other investments, such as loans to nonprofits for the purpose of acquiring a business

Under this analysis, if the corporate tax were eliminated, as it would be under corporate-shareholder integration, there would be no need for UBIT to protect the

[114] See Gutman supra note 112 at 49 .

revenue. In addition, the potential efficiency concern raised by Hansmann would no longer be present. Thus if the income tax no longer applied to corporate profits, one would expect the rate of return earned by corporations to eventually decline as the corporate sector expanded.[115] In that case, a nonprofit could no longer expect to earn more on direct investments and would have every incentive to diversify and stick to what it can operate efficiently.

However, elimination of the corporate tax would require a new revenue source, perhaps, most equitably from those who bore the burden of the eliminated tax.[116] Thus, it has been suggested that the potential revenue loss from adoption of corporate integration could be mitigated by denying the benefits of integration to nonprofits who would continue to bear one level of tax on investments in stock.[117] If this were the case, the UBIT would presumably continue to be needed for directly owned businesses in order to maintain parity between the two investments.

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[115] A discussion of the potential short-term windfalls and possible mitigation thereof is beyond the scope of this paper.

[116]See George A. Break & Joseph Pechman, Relationship Between the Corporation and Individual income Taxes 28 Nat'l Tax J. 341, 344 (1975) (Proposing a tax on nonprofits in these circumstances).

[117] Report of the Department of Treasury on Integration of the Individual and Corporate Tax Systems, Taxing Business Income at 36 (1992). In the shareholder credit form of integration, the tax paid at the corporate level on their behalf would not be refunded.

One of the goals of integration would be to eliminate any incentive to disguise equity as debt. However, if dividends are effectively fully taxable to nonprofits, this goal would not be met, unless interest is also taxed. Accordingly, it has been proposed that the tax treatment of interest and dividend payments to nonprofits from corporations be identical, perhaps by applying a withholding tax to both which would be nonrefundable to exempt nonprofits.[118] Perhaps, this would cause nonprofits to favor loans to individuals or governments, which would remain tax-free.

In any event, if, as it seems, the strongest argument for UBIT relates to the protection of the corporate tax base, it may be strange to retain and even expand the tax if the corporate tax were eliminated by integration.

Related Business

Tax exemption for income from a related business was justified earlier as a source of funds for nonprofits who lack sufficient access to capital to finance needed expansion. In addition, unlike an unrelated business, it might be efficient for a nonprofit to engage in an operation which exploits an activity that would otherwise be conducted as part of the exempt function of the organization. For example, a university may utilize a field house built for its basketball team to hold rock concerts. On the other hand, as suggested above, it is in these circumstances that nonprofits would have the incentive to undercut

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[118] Break and Pechman, supra note 116. ALI, Federal Income Tax Project, Integration of the Individual and Corporate Income Taxes, Reporter's Study of Corporate Tax Integration (Alvin C. Warren Jr. reporter) at 159-67. (1993)

prices. Since the field house is needed for its basketball program, the University may not be concerned about its overall profitability and would rent it out for concerts as long as the rent exceeded marginal costs. It may be noted that small business complaints about unfair competition is with respect to what are now deemed to be related businesses.

Some have suggested that an activity should be considered related only if by itself it could be the basis for exemption.[119] It is only in these circumstances that price cutting would be viewed as conforming to the mission of the organization. If the mission is not involved and there are no economies from exploiting the exempt function, price cutting may not be a concern but there is still no reason to encourage the activity, even if it is somehow related.[120] Moreover, if an activity were truly an efficient exploitation of activities related to its exempt function, taxation of profits would not discourage it.[121] Revenue would still exceed marginal costs.

At the same time, taxation could discourage an investment, intentionally more extensive than needed to carry out its mission, initiated with expansion into unrelated activities in mind.[122]

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[119] See UBIT supra note 100 at 627.

[120] See id. at 629-31 (Suggesting that it might be reasonable to tax all profits earned by a museum gift shop).

[121] UBIT supra note 100 at 627

[122] For example, a field house built by a University large enough to hold rock concerts which drew crowds far greater than those that came to see the basketball team.

For example, the University may only be able to afford a field house, or one as large as the one needed for concerts, if it could rely on retaining 100% of the profits from unrelated activities to reduce its overall cost of operation. If the profits are taxed, reducing the return by 35%, the field house, or, at least, one that size, might not be affordable. But, perhaps, the construction of this field house should be discouraged as inefficient.

On the other hand, taxation of activities exploiting a related function would raise difficult issues of cost allocation.[123] Moreover, such taxation could be avoided where a substantial overlap among those served would permit shifting of profits to clearly related

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[123]Limiting a deduction to marginal costs would minimize the possibility of encouraging inefficient activities. However, there are competing considerations. This approach could subject the nonprofit to heavier taxation than a for profit. For example given that a magazine editorial side normally loses money, should a nonprofit, nevertheless be taxed on profits from advertising without any offset for editorial losses? Moreover, limiting deductions to marginal cost does not seem to be the correct result when a nonprofit efficiently chooses a larger facility than needed for exempt activities because of unrelated opportunities. For a detailed proposal, see Subcommittee on Oversight of House Ways and Means Committee, Draft Report Describing Recommendations on the Unrelated Business Income Tax at 56-7, 100th Cong. 2d Sess. (Comm. Print 1988).

activities.[124] This suggests that case by case line drawing may be the only way to deal with this difficult subject.

Passive Investments[125]

The unrelated business income tax is said not apply to passive income. Actually, the Code merely exempts certain types of income--dividends, interest, royalties, annuities, rents in certain circumstances--that are normally thought of as passive or as income from investments.[126] The Code also exempts income from the sale of property unless it is inventory or held for sale to customers in the ordinary course of business.[127]

Other forms of what may appear to be investment income may have been subject to tax, however, because it was not clear that there was a sale of property. In response, the statute has been amended to exclude additional forms of income, such as payments with respect to securities loans,[128] loan commitment fees[129] and income from lapse or

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[124] Thus, a university can reduce dining hall charges and increase tuition. UBIT supra note 100 at 629.

[125] For a general discussion of the line between "business" and "passive", see Thomas J. Gallagher, When is a Business Not a Business? Exploiting Business Opportunities and Enhancing Economic returns by Capitalizing on the Income tax Exemption of Tax-Exempt Organizations, 50 Taxes 928 (Dec 1997).

[126] IRC §512(b)(1),(2),(3).

[127] IRC §512(b)(5).

[128] IRC §512(b)(1), (a)(5).

[129] IRC §512(b)(1).

termination of options.[130] In addition, the regulations exempt income from notional principal contracts and go on to exclude "other substantially similar income from ordinary and routine investments, to the extent determined by the Commissioner." [131]

On the other hand, income that traditionally seems passive, such as interest, could actually amount to business income, for example, contingent interest based on business profits.[132] While the code recognizes the distinction with respect to rents,[133] interest is always exempt.

The scope of the exemption should depend upon the rationale for the unrelated business income tax. It was suggested above that one purpose might be to impose a tax, in lieu of the corporate tax, on transaction that might otherwise be carried out in corporate form and produce an extraordinary return. Does securities lending and other sophisticated financial transactions, described above, fit this description?

Alternatively, the tax is said to be intended to reduce "unfair competition." While, it has been pointed out that potential competition is not a statutory requirement for an unrelated business, it does seem to have an impact on how the law is interpreted. Although, most doubt that unfair competition is a serious concern, it was suggested earlier that it could be a problem when the organization is exploiting an exempt activity. Again, the passive investment exclusion could be evaluated with that purpose in mind.

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[130] IRC §512(b)(5).

[131] Treas. Reg. §1.512(b)-1(a)(1).

[132] See Gallagher, supra note 125 at 934.

[133] IRC §512(b)(3)

Debt Financed Income

Seller financing

The "passive" income exclusion does not apply to "debt financed property." The original purpose of these rules was to prevent the use of a tax-exempt entity to enable a "seller" of a business to convert ordinary income into capital gain. The prototype transaction involved a sale of a business for deferred payments limited to the income from the business.[134]

Under current law, payments by the buyer must provide for interest at the so-called applicable federal rate (the rate paid by the Treasury for an obligation with a comparable maturity) with only the balance amortizing the stated selling price.[135] Since given the risk retained by the seller, the true interest rate should be substantially higher than the Treasury rate, presumably, the stated selling price would be greater than fair market value to reflect the higher interest that is implicit in the transaction. If there is no down payment, the seller's risk has not changed and it would want to earn the same

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[134] See, Commissioner v. Brown, 380 U.S. 563 (1965) ("Clay Brown"); McDowell supra note 57 at 710; William H. Weigel, Unrelated Debt-Financed Income: A Retrospective (and a Modest Proposal), 50 Tax Lawyer 625, 643 (19) (hereinafter Weigel).

[135] IRC §1274. At the time the debt-financed rules were enacted, it was possible for interest to be ignored and all proceeds treated as selling price entitled to capital gain treatment. See Commissioner v. Brown, 380 U.S. 563 (1965); Weigel, supra note 135 at 650.

return on its investment as it would in the absence of a sale. While, this is achieved if the seller is entitled to the full profits from the business, the seller effectively may not be paid at all for the business transfer. In any event, the seller eventually loses the business, once the stated selling price is fully amortized.

However, much of the payment would be capital gain (or a return of capital to the extent of basis), rather than ordinary income as it would be if the business had not been "sold." Thus, the transaction is beneficial to the seller if either little is really being sold or if the capital gain treatment compensates for the eventual loss of the business.

If the same deal is made with a for-profit, however, the annual payment could not be equal to the full earnings because the buyer would have to pay tax on the payment in excess of deductible interest. This makes the deal less feasible from the seller's point of view. The debt financed rules are intended to put a tax-exempt buyer in the same position. William H. Weigel suggests, however, that these rules are no longer needed.[136] He argues that given the current difference between tax rates on ordinary income and capital gain and the rules which require imputation of interest, there can be no advantage unless the valuation is inflated and little advantage if it is.[137]

Of course, this situation could change. Therefore, it seems risky to assume that the debt financed provisions are unnecessary, unless it is possible to change the rules, as to the seller, to limit the potential for capital gain treatment, perhaps, by imputing interest at a higher rate when certain conditions apply. It should be noted, moreover, that to the

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[136] Id. at 658.

[137] Id. at 649-53.

extent the nonprofit is willing to pay a higher price or a higher annual payment than a for-profit company, it is transferring some of the benefit from exemption to the seller. The debt financed rules can be justified as an attempt to prevent this transfer.[138]

A similar transfer may occur in those transactions in which one side is over taxed and the other side is under taxed. While, if both parties are in the same marginal tax bracket, such a transaction might be taxed fairly overall, the under taxed party would have to give up part of its economic return to the over taxed party. However, if a tax exempt is on the latter side of the transaction, the under taxed party may be able to retain the full economic profit.[139] Perhaps, rules similar to the debt financed rules are needed to preclude the shifting of the benefit of exemption in these circumstances.[140]

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[138] See H.R. Rep. No.2319, 81st Cong. 2d sess. 38-9 (1950), reprinted in 1950-2 Cum. Bull. 380, 410.

[139] In the case of so-called junk bonds sold at a discount, the annual imputed interest would overstate the real expected return since it does not account for default. Thus, taxable people might insist on a higher return to reflect the excess tax burden. Perhaps, the issuer's deduction should be limited to the expected interest. In any event, the issuance of junk bonds would be more expensive if tax-exempt buyers did not exist.

[140] The Administration has recommended that tax-exempts and other so-called tax indifferent parties be taxable on income of a tax shelter which is allocated to them. Department of the Treasury, General Explanation of the Administration's Fiscal Year 2001 Revenue Proposals at 634.

Other Borrowing

Debt financed transactions are taxable without regard to whether there is seller financing. The Treasury justified this in 1969 on the premise that nonprofits should not be able to grow without being beholden to future contributors, who could offer a form of oversight.[141] Taxation of debt-financed income seems ill-suited for this purpose, however. As long as an organization can earn income in excess of inflation, it can grow as long as it keeps spending down. If this is viewed as a general problem, annual distribution rules, like those applicable to private foundations,[142] which may be designed to prevent a real increase in assets without further contributions, could be extended to so-called public charities.

It may be argued that even with such rules in place, taxation of debt-financed income could still be necessary. Thus, leveraged investments are riskier and might promise a higher return; a return that is inconsistent with the assumption behind any pay out requirement. Moreover, we might want assurance that exempt organizations do not take undue risks, given the investment of government money in the form of tax preferences. It is not clear, however, that all debt financing is risky or that undue risk

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[141] U.S. Treasury Dep't, Tax Reform Studies and Proposals, Joint Publication of House Ways & Means Comm. and Sen. Fin. Comm., 91st Cong. 1st Sess. 306-7 (Part 3) (Comm. Print Feb. 5, 1969). Weigel, supra note 134 at 646, McDowell, supra note 57 at 713. Some observers have suggested that if oversight is a concern the private foundation rules offer a model. See id. at 730.

[142] IRC Section 4942

could not exist in other forms.[143] Moreover, under current law, nonprofits may be highly leveraged without running afoul of the debt financing rules. This can be achieved by tracing borrowing to the purchase of assets related to their exempt function or through short sales or notional principal contracts, which provide the advantage of leverage but are not considered to involve the assumption of debt.[144] In addition, it may be relatively easy to push borrowing down one level so that while the actual investment is highly leveraged, the exempt organization itself has not borrowed.[145]

This suggests that we should pay attention to the risk inherent in the entire portfolio and if risk is a concern, we could prohibit risk in excess of a certain level without necessarily taxing debt financed income.[146]

Conclusion

Whether the investment income of public benefit organizations should be taxed depends upon a value judgment regarding the trade off between current and future spending. Given an income tax which taxes investment income, the preference for deferred spending for charitable purposes may be greater than the preference for current

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[143] See Weigel, supra note 134 at 656-57.

[144] See id. at 627.

[145] See for example, Catherine E. Livingston, Letter Ruling Alert, 27 Exempt Org. Tax Rev. 263 (2000) ((discussing the use of a controlled foreign subsidiary to engage in leveraged transaction). See also Weigel, note 134 at 656.

[146] Cf. IRC § 4944

spending. However, for the organization to be neutral, between current and future spending, investment income may have to be exempt. Such exemption could encourage savings without the potential harm of a universal consumption tax. Nevertheless, in some circumstances, exemption could be inconsistent with our choice of income as opposed to consumption taxation. Taxation of investment income could also restore balance, given a potential bias for accumulation of an endowment beyond the efficient level.

If investment income were to be taxed, income from related activities could still be exempt as a way of facilitating the expansion of the organization or, perhaps, by analogy to the treatment of social clubs.

As to mutual organizations, the treatment of social clubs seems correct and we should consider expanding it to other organizations. Further, the tax advantage of trade associations should be eliminated and, in this regard, the taxation of investment income seems a sensible proxy for more direct taxation of their income. However, it is not inconsistent to leave the treatment of unions unchanged. Finally, the treatment of insurance like organizations might depend on an evaluation of the justification for exemption for entities providing employee benefits, other than pensions. There is a particular need for serious evaluation of the special treatment of the latter organizations.

UBIT makes sense as precluding the loss of both efficiency and revenue which could arise from attempts by nonprofits to avoid the corporate tax which applies when they hold traded securities. Interest and other deductible payments from related parties, in theory, should not be taxed unless it is believed wise to provide a preference for outside financing of a business acquisition or operation. The line between related and unrelated business should be evaluated in the light of the potential for inefficient unfair competition from exploiting assets used in the exempt function and the inefficient incentive to avoid the corporate tax when economies of scale do not exist.

The exemption for passive income appears acceptable but further examination of the line between passive and active is needed. As to debt financing, taxation of income derived from seller financing is justified as a means of precluding transfer of the benefit of exemption. Such transfers might be a problem in other circumstances and a similar approach should be considered. The extension of the debt financed rules beyond seller financing seems unjustified but overall risk could be a legitimate concern.