"Milking the Cash Cow"
Commercial Activities Undertaken by Nonprofit Organizations:
Analysis and Recommendations

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This paper will discuss whether the conduct of significant commercial activities by a nonprofit organization described in section 501(c)(3) of the Internal Revenue Code of 1986 (the "Code") should cause such organization to forfeit its tax exempt status or to suffer some other sanction.[1]

The paper concludes, very generally, that under current law there is no *per se* limit to the amount of related or unrelated commercial activity that may be conducted by a nonprofit organization. The paper further concludes that this result is appropriate, arguing that the intermediate sanctions, private inurement, private benefit, and "exclusively operated" limitations are sufficient enforcement tools for the IRS. These tools need to be applied in a more coherent manner by both the IRS and the courts, however, and a broad analytical framework for applying these tools is suggested. Finally, the paper emphasizes the importance of a decentralized approach to the regulation of nonprofit organizations perceived to be engaging in inappropriate or excessive commercial

[1] The issue of "commercial" nonprofits is not a new one and there has been a considerable amount of commentary during recent years. See, e.g. Colombo, *Commercial Activity and Charitable Tax-Exemption* [to be published in the William & Mary Law Review; draft copy available from Professor Colombo at the University of Illinois College of Law]; Weisbrod, ed., TO PROFIT OR NOT TO PROFIT (1998); Troyer, *Quantity of Unrelated Business Consistent with Charitable Exemption – Some Clarification, 56 Tax Notes 1075 (1992);* Eliasberg, *Charity and Commerce: Section 501(c)(3) – How Much Unrelated Business Activity,* 21 Tax L. Rev. 53 (1965); Pena & Reid, *A Call for Reform of the Operational Test for Unrelated Commercial Activity in Charities,* 76 N.Y.U.L. Rev. 1855 (2001).

activities, with the IRS, state and local governments, and the public each playing a crucial role.

I. Preliminary Matters

A. A Premise.

In order to reduce the number of moving analytical parts in this paper, I have relied upon a broad initial premise; namely, that the list of organizations described in Code section 501(c)(3), and the charitable tax deduction permitted under Code section 170, will remain basically unchanged. While both Code provisions are certainly fair game for other commentators, and have been for some time,[2] they will be accepted here with all their virtues and faults intact.

In addition, the resolution of the issues discussed in this paper would have important implications for two other areas of concern: (i) the IRS position with respect to "joint ventures" engaged in between for-profit and nonprofit entities[3] and (ii) the application of the so-called "integral part" test of Treas. Reg. § 1.502-1(b) under which an organization can in some instances be recognized as charitable because it functions as an

[2] In *Agents Without Principals: The Economic Convergence of the Non-Profit and For-Profit Organizational Forms*, 40 N. Y. L. Sch. L. Rev. 457 (1996), for example, Professor Evelyn Brody discusses the economic convergence of the for-profit and nonprofit sectors and asks whether society might prefer to subsidize charitable and social outputs produced by all organizations, rather than subsidize only the output of nonprofit organizations.

[3] See Rev. Rul. 98-15, 1998-1 C.B. 718 (1998). See also Colombo, *A Framework for Analyzing Exemption and UBIT Effects of Joint Ventures*, 34 Exempt Organization Tax Review 187 (Nov. 2001).

integral part of a related charitable organization.[4] I have not sought to discuss either of these issues in detail in the present paper.

B. A Word About Terminology.

Although I refer periodically in this paper to "commercial" activities of nonprofits -- a fairly neutral term that denotes nothing more than the selling of goods or services -- I have generally avoided the term "commerciality," a newly-minted word used exclusively by exempt organization commentators that suggests that hard-hearted capitalists have somehow captured an otherwise pristine organization for their own profit-driven purposes. This question of word choice, I submit, is more than academic. Otherwise solid analyses can get caught up in misleading anecdotal finger pointing when bemoaning the commerciality of certain nonprofits. The museum that flogs its wares in a shopping mall, a YMCA that provides luxurious amenities to attract the young professional set, and the hospital with china service for its VIP rooms, are but three examples. Not only are these activities not necessarily inappropriate (although opinions may differ), but, more importantly, these and other similar examples represent such a small portion of nonprofit activity that the emphasis placed on them may be misdirected.

C. Common Assumptions.

There are a number of policy rationales that have been suggested for tax exemption in general and a variety of recommendations for addressing what is often referred to as the

[4] See *Geisinger Health Plan v. Commissioner*, 30 F. 3d 494 (3d Cir. 1994) in which the Third Circuit held that a subsidiary entity may only receive derivative tax exemption if its association with its parent provides a "boost" to the subsidiary. Id. at 501.

"commerciality issue."[5] Given the somewhat divergent, even contradictory, nature of these analyses, it is helpful to review those points as to which there seems to be near-universal agreement. Starting with a common set of assumptions should help in reaching a consensus for appropriate next steps.

There appears to be common agreement with respect to the following points.

1. Nonprofits are important. There can be little doubt as to the important economic and social role that section 501(c)(3) organizations play in our society. Traditional relief organizations, religious organizations, schools, hospitals, grant-making organizations and the like contribute enormously to our self-image as a country and to our economy.

2. Nonprofits are varied and complex; legislative or regulatory change has a cost. Spanning the entire social and economic landscape of the United States, nonprofits are naturally quite varied in their purposes, structure, governance, and financing, as well as in their responsiveness to economic incentives or to governmental regulation. Because of this enormous variety, as well as the complexity of some very large nonprofits, any significant change in the statutory or regulatory scheme regarding commercial activity by nonprofits will have an economic cost as all existing organizations respond to these new rules and take steps to either comply with or avoid them. Any broad-based governmental action is likely to have numerous, and in many instances unpredictable, repercussions.

[5] See, e.g. Hansmann *The Role of Nonprofit Enterprise* 89 Yale L.J. 835 (1980).

3. The UBIT is imperfect. Although the unrelated business income tax ("UBIT") is the government's key tool for measuring the extent of and taxing "unrelated" commercial activity, it not a particularly rigorous tax. Not only is the initial distinction between "related" and "unrelated" activities inherently vague, the numerous statutory and court-created exceptions, modifications, special rules and the like make the tax relatively east to avoid, although often at a cost of using a structure that has been specially tailored to address the vagaries of the UBIT rules.

4. The corporate income tax is also imperfect and the corporate tax base is porous. Under our current system of taxation, there is nothing sacrosanct about operating a commercial business and paying a corporate-level tax. Any non-publicly held business that desires to avoid paying corporate level tax can easily do so, the simplest two approaches being to utilize an S corporation or a limited liability company taxed as a partnership. Other approaches include distributing profits in the form of compensation, allocating expenses advantageously among related parties and using an off-shore base of operations, although each of these alternative approaches (and others) have certain risks associated with their implementation.

II. What's the Law?

A. The Code

Section 501(c)(3) unambiguously requires that an organization described in such section must be "organized and operated *exclusively*" for certain enumerated purposes [emphasis supplied]. The statute does not read "primarily" or "principally" operated for

charitable purposes and it is difficult to see how the IRS or a court could validly require a lesser standard than "exclusively."[6] It seems self-evident that every effort should be made to interpret section 501(c)(3) in a manner that reflects the actual statutory language, although the following discussion suggests that this has hardly been the case.

Code sections 511-14 relate to the tax on unrelated business taxable income of organizations described in sections 401(a) and 501(c). Section 513(a) provides that "the term 'unrelated trade or business' means . . . any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes from the profits derived) to the exercise or performance by such organization of its charitable, educational or other purpose or function constituting the basis for its exemption under section 501 . . .".

With section 501(c)(3) and section 513(a) read together, as they must be, it seems an inescapable conclusion that an organization that is organized and operated *exclusively* for charitable purposes may also conduct a trade or business activity whose only relation to the charitable purpose of the organization is the need for funds. Or, put more directly, the conduct of an "unrelated" trade or business (as defined) can nonetheless be related to the carrying out of the tax exempt purpose or function of the organization and in fact

[6] In *Better Business Bureau of Washington D.C. v. United States,* 326 U. S. 279 (1945) the U.S. Supreme Court observed that:

"It has been urged that a liberal construction should be applied to this exemption from taxation … Even the most liberal of constructions does not mean that statutory words and phrases are to be given unusual or tortured meanings unjustified by legislative intent or that express limitations on such an exemption are to be ignored. Petitioner's contention, however, demands precisely that type of statutory treatment. Hence it cannot prevail.

"In this instance, in order to fall within the claimed exemption, an organization must be devoted to educational purposes exclusively. *This plainly means that the presence of a single noneducational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes.*" [Emphasis supplied.]

must be so related or its conduct would be in direct violation of the "organized and operated exclusively" requirement of section 501(c)(3).

B. Destination of Income Test.

The conclusion that "unrelated" trades or businesses can nonetheless serve a charitable purpose was established by the Supreme Court's 1924 decision in *Trinidad v. Sagrada Orden de Precidores*[7] and its progeny (albeit admittedly more clearly established by the progeny than by the parent). In *Sagrada Orden* the Supreme Court set forth what came to be known as the "destination of income test" with the following two observations about the predecessor to section 501(c)(3):

> "Two matters apparent on the face of the clause go far towards settling its meaning. First, it recognizes that a corporation may be organized and operated exclusively for religious, charitable, scientific or educational purposes, and yet have a net income. *Next, it says nothing about the source of the income, but makes the destination the ultimate test of exemption."* [Emphasis added.]

To be sure, the Court did not stop with this unambiguous statement, but went on to indicate that the most of the revenue-producing activities of the religious order in question did not constitute a business in any event and those few activities which did constitute a business were both negligible in size and closely related to the religious

[7] 263 U. S. 578 (1924).

functions of the order. The broader language of the decision quoted above was quickly seized upon by other courts, however, to flatly hold, as did the Second Circuit in *Roche's Beach, Inc. v. Commissioner,*[8] that "the destination of income is more significant than its source.[9]

C. The Regulations

What do the regulations make of the unambiguous "organized and operated exclusively" standard of section 501(c)(3) and the equally unambiguous acknowledgment in section 513 that a tax exempt organization may conduct a trade or business whose only utility to the organization is the production of income? They sow confusion.

Treas. Reg. § 1.501(c)(3) - 1(b)(1)(i), describing the "organizational test", gets off on the wrong foot by providing that the articles of organization of a section 501(c)(3) organization may not "expressly empower the organization to engage, other than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes." This same rule is restated, in slightly different words, two sections later in Treas. Reg. § 1.501(c)(3) - 1(b)(1)(iii).[10] Why this waffling on the meaning of "exclusively?"

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[8] 96F. 2d 776 (2d Cir. 1938).

[9] For a complete discussion of the development of the destination of income test, see Eliasberg, supra, note 1.

[10] "An organization is not organized exclusively for one or more exempt purposes if its articles expressly empower it to carry on, otherwise than as an insubstantial part of its activities, activities which are not in furtherance of one or more exempt purposes, even though such organization is, by the terms of such articles, created for a purpose that is no broader than the purpose specified in section 501(c)(3). Thus, an organization that is empowered by its articles 'to engage in a manufacturing business', or 'to engage in the operation of a social club' does not meet the organizational test regardless of the fact that its articles may

The confusion is exacerbated by Treas. Reg. § 1.501(c)(3) - 1(c)(1) where the "insubstantial part" rule of the organizational test, quoted above, becomes a rule that "an organization will be regarded as 'operated exclusively' for one or more exempt purposes only if it engages *primarily* in activities which accomplish one or more exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than a *insubstantial* part of its activities is not in furtherance of an exempt purpose." [Emphasis supplied.] So what, one might ask, is the rule? And why does it require a Talmudic process to divine?[11]

The section 501(c)(3) regulations take one more stab at the issue of commercial activity under the heading of "organizations carrying on trade or business."[12] The regulation provide that:

> "An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes. An organization which is organized and operated for

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state that such organization is created 'for charitable purposes within the meaning of section 501(c)(3) of the Code'."

[11] Referring to this as a "Talmudic" process may be giving too much credit to the regulations. "Ptolemaic" may be a more apt description.

[12] Treas. Reg. § 1.501(c)(3)-1(e)(1).

primary purpose of carrying on an unrelated trade or business is not exempt under section 501(c)(3)…"

One could stretch and pull the section 501(c)(3) regulation quoted immediately above to mean that a nonprofit organization may engage in an unrelated trade or business to the extent of 49% of its overall activities, a reasonable proxy for less than "primary," but no more. But such a rule would ignore the "organized and operated exclusively" rule of section 501(c)(3), place far too much emphasis on the definition of an "unrelated trade or business" under Code section 513, and would, by turns, be too strict and too lenient a rule.[13]

D. The Commensurate in Scope Test

Notwithstanding the somewhat confusing language of the regulations discussed above, the IRS has for many years accepted the conclusion that there is no *per se* limit to the amount of related *or* unrelated income that a nonprofit organization may generate. In Rev. Rul. 64-182, 1964-1 C.B 186, the IRS considered a charitable organization that owned and operated a large commercial office building and that made grants to other charitable organizations. The IRS held that the organization was "operated exclusively" for charitable purposes where it was shown that it carried on a "charitable program

[13] See Pena and Reid, *supra* note 1. Here the authors conclude that "…the operational test limits the amount of unrelated trade or business activity but does not limit related trade or business activity. Understood in this way, the application of the operational test should be simple: First, identify which activities are related and which are unrelated to (i.e., do not further) the charity's charitable purposes; second make sure that those activities that are related to the charitable purposes are the charity's primary activities and purposes." The authors go on to propose a rebuttable presumption of exempt primary purpose if the organization can demonstrate that over a three year rolling period the sum of its gross income and expenses derived from any unrelated trade or business does not exceed the sum of its gross income and expenses derived from related activities.

commensurate in scope with its financial resources." The IRS did not discuss whether the rental income derived from the operation of the commercial office building was "related" or "unrelated" for purposes of section 513, presumably because this was not a controlling factor. Seven years later, the IRS concluded in GCM 34682 (1971) that "there is no quantitative limitation on the 'amount' of unrelated business an organization may engage in under section 501(c)(3) …" The GCM considered the following hypothetical question:

> "A large department store creates a nonprofit corporation to take over and operate its business assets. The articles of incorporation and bylaws of the nonprofit corporation contain a statement that the purpose of the organization is to engage in charitable works by contributing to those exempt organizations exempt under section 501(c)(3) which are selected by the officers of the nonprofit corporation in their role as trustees. The articles and bylaws further provide that all proceeds derived from the business operation commensurate with its financial resources will be expended annually in its program of charitable giving. Is the corporation deemed a feeder organization? Is it, on the other hand, considered to be primarily engaged in charitable activities within the meaning of the regulations?
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> "Assuming that all the assets of the organization referred to in your first series of questions have been effectively dedicated to some charitable objective, we believe that, aside from section 502, *such organization could engage in an indeterminate amount of business and still be exempt under section 501(c)(3) so long as it can be said that there is a reasonable operation of the property for the beneficial use of charity*. In such case, we would regard it as being operated

exclusively for charitable purposes, and not for the primary purpose of carrying on unrelated trade or business within the meaning of regulations section 1. 501(c)(3) - 1(e). Thus, we would hold that, in accord with Rev. Rul. 64-182, the organization would be entitled to exemption under Code section 501(c)(3). [Emphasis supplied.][14]

The implications of GCM 34682 (if the GCM in fact correctly summarizes the law) seem far-reaching. *Any* commercial business could be operated as a section 501(c)(3) organization so long as it makes grants to other charitable organizations commensurate in scope with its financial resources. While the private foundation excess business holdings rules would put something of a brake on this conclusion, it would not be terribly difficult to avoid private foundation status either by means of obtaining sufficient contributions from the public or by having the exempt organization qualify as a supporting organization under section 509(a)(3).

Because of the implications, it is important to determine whether GCM 34682 is right or wrong. I believe, although not without some hesitancy, that GCM 34682 correctly summarizes the law and is consistent with the language of section 501(c)(3) and section 513, discussed above. The IRS has not formally backed away from these conclusions and in fact recent private letter rulings suggest that the conclusions quoted

[14] The GCM goes on to conclude that the nonprofit organization running a department store would not be a "feeder organization": "Neither would we consider such an organization to be a "feeder" within the meaning of section 502 of the Code, if under the facts, the distribution of the organization's income to other charitable organizations is discretionary in the sense that the trustees or directors are not under a legal or equitable duty to pay all the income over to other charitable organizations to the exclusion of any use or devotion of the income to charitable purposes in any other manner."

above are still accurate.[15] If I am wrong, however, and the conclusions of GCM 34682 are inaccurate as a matter of law, it seems fair to say that the IRS has some explaining to do. If 100% unrelated revenue is not okay, what amounts is?

E. The Commerciality Doctrine

Given the already complex state of affairs described above, it would hardly seem necessary to produce another "doctrine" with which nonprofits must cope. And yet the so-called "commerciality doctrine" seems to have sprung fully armed out of the heads of legal commentators, with little or no support from the Code, the regulations, IRS published guidance or case law.[16] Quite simply, I don't believe this doctrine exists. Perhaps equally importantly, I don't believe the doctrine provides a useful tool for analyzing tax exemption. As noted above, related commercial activities by nonprofits already represent a huge component of nonprofit activity. It would be folly to suggest that this activity is permissible only if carried on in a manner materially different from taxable enterprises. As for unrelated business activities, if UBIT is being paid on the profits, and the profits are being dedicated to charitable purposes, why shouldn't the activity be carried on in as commercial a manner as possible? In sum, I think the commerciality doctrine, to the extent it has any life at all, should be abandoned.

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[15] [Cite to bingo and pull-tab rulings. Observe that assets held in an S corporation produce 100% UBI. As would an interest in a partnership or an LLC operating a trade or business.] Professor Eliasberg, in *Charity and Commerce*, supra note 1, notes that when Congress enacted the UBIT in 1950, it did not limit the amount of UBIT that an exempt organization could earn and that "it was generally assumed that as long as an organization's 'primary purpose' was one described [in the predecessor to section 501(c)(3)] any amount of unrelated business activity would not endanger exempt status." *Id.* At 93.

[16] Bruce Hopkins, in THE LAW OF TAX-EXEMPT ORGANIZATIONS (Wiley, 1998), devotes an entire chapter to this doctrine. Hopkins acknowledges that the doctrine has no origin in the Code or the income tax regulations. Even the courts, while referring sporadically to "commercial" enterprises conducted by non-profits, have never identified or relied upon a "commerciality doctrine."

III. What's the Problem?

There is a perception that at least some nonprofits are too commercial – they compete (or even "converge") with the for-profit sector, they pay their executives high salaries and they have a decreasing dependence on charitable gifts. Furthermore, data suggest that nonprofits have become *increasingly* commercial during recent decades, prompting fears that the nonprofit sector may eventually become indistinguishable from the private business sector of our economy.

The "commerciality" issue has produced a considerable amount of commentary, including some sharp criticism of the courts and of Congress, impatience with the IRS, and suspicion of nonprofit managers. There has been little consensus, however, regarding solutions. Before seeking to add even modestly (measured either by wattage or by weight) to this prior analysis, it seems appropriate to ascertain the nature of the problem that has attracted so much attention. In short, what's the big deal? If the issue is simply whether some nonprofits are too "commercial," i.e. derive too much of their revenue and spend too much of their time selling goods or services to customers, I would submit that the horse is already well out of the barn and is to be found grazing in the high meadows.[17] It

[17] See Hill and Mancino, TAXATION OF EXEMPT ORGANIZATIONS, Warren Gorham & Lamont (2002), in which the authors note that the revenues of all organizations exempt under section 501(a) were estimated to account for 12.4% of the U.S. gross domestic product in 1995. The authors decry the "vigorous process of convergence between the tax-exempt and taxable sectors" and question what it means to be a tax-exempt organization in light of such convergence. Similarly, in the Supreme Court brief filed by a summer camp objecting to discriminatory property taxation in violation of the Commerce clause of the U.S. Constitution, for example, the camp asserted flatly that "To begin with, nonprofit organizations in this country are collectively, and in many cases individually, 'big business' in every sense except that they have purposes other than making a profit . . . [we] all know that in terms of every indicia – number of employees, wages and benefits, purchase of goods and services – nonprofits are major players in the U.S. economy." Brief for Petitioner at 39, *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, __ U.S. __ (1977). This and other similar statements made in *amici curiae* briefs caused Professor Brody to warn, in essence, that charitable

hardly bears repeating that certain nonprofit organizations derive somewhere between most to virtually all of their income from commercial activity, with hospitals and universities being the two principal examples. While one might debate whether such organizations ought to be tax exempt at all, or whether they should be entitled to the same level of governmental "subsidies" as so-called "donative" nonprofits, I have purposely assumed in the premise recited above that the basic list of section 501(c)(3) nonprofits, and the charitable tax deduction, will remain intact. Instead, taking the world as it is, one must recognize that some of our largest and most prestigious nonprofit organizations operate in a thoroughly commercial manner.[18]

Notwithstanding the foregoing, a number of criticisms have been voiced as to the harm of excessive "commerciality" in the nonprofit sector. These criticisms, and a brief commentary, follow.

A. "Taint" of Commerciality.

Some commentators have expressed concern that section 501(c)(3) organizations have the ability to engage in considerable amounts of commercial activity without fear of loss of tax exemption. With or without the imposition of unrelated business income tax

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organizations should be careful not to "hock their halo", lest society choose to reconsider charitable subsidies. See Brody *Hocking the Halo*, supra note 5, at 456.

[18] It is probably not fair to group educational institutions with health care organizations under the broad "commercial nonprofits" rubric. Tax exempt health care organizations are required by economic realities to operate in vigorous competition with for-profit providers and there has clearly been a considerable degree of convergence between for-profit and nonprofit healthcare organizations. By contract, there are relatively few for-profit educational institutions, and these appear to be concentrated at the trade school level, as well as certain on-line institutions (e.g., University of Phoenix) and secondary schools (e.g., the Edison Project). It may be appropriate that the nonprofit healthcare industry be singled out for separate regulation, while leaving the law intact for other nonprofits. As we have vividly seen in the joint venture area, trying to draft a general rule that applies equally to "whole hospital joint ventures", and to ancillary joint ventures engaged in by other nonprofits, is exceedingly difficult. Rev. Rul. 98-15, 1998-1 C.B. 718.

on such activities, this uncontrolled commerciality is thought to be undesirable, possibly because all nonprofits will become tarred by the commerciality brush.

As my comment above under "A word about terminology" suggests, I am not persuaded by the view that the conduct of commercial activities by nonprofits is inherently bad. In fact, for those nonprofits whose principal activity is selling educational or healthcare services, it may be desirable for them to be more like their for profit counterparts, at least in some respects. It would surely do no harm, and perhaps considerable good, if large nonprofits focused more on maximizing their output of charitable "product" through increased attention to efficient administration, cost controls, and innovative approaches to their traditional missions. Having an entrenched, inefficient management team and losing money on operations year after year should not be equated with goodness.

B. Uncertain State of the Law.

Other commentators have noted that the current state of the law under the "operational test" of Treas. Reg. §1.501(c)(3)-1(c)(1) is unpredictable and often contradictory; these commentators express concern that tax exempt organizations are hampered by the absence of clear rules and many can ill-afford lawyers to help them navigate the troubled waters of the operational test for tax exemption.[19]

I am sympathetic to the plight of the small nonprofit and concerned about hard-to-reconcile cases. Nonetheless, under current law a typical nonprofit has little to fear as a

[19] See Pena & Reid, supra note 1.

practical matter with respect to "excess" commercial activity and loss of tax exempt status. Nonprofits can engage in extensive commercial activities, whether related or unrelated, with very little concern, so long as they carefully document their charitable purposes and make reasonable (commensurate) expenditures for such purposes. While there may be no hard and fast rule regarding the definition of "commensurate," a carefully laid out plan for the application of unrelated commercial revenue would be likely to forestall an IRS challenge. In sum, the vast majority of tax exempt organizations are not adversely affected by the seemingly unreconcilable cases and with even a small amount of education and due diligence they can easily avoid any risk to their exempt status.

Nonetheless, uncertainty in the law is not a good thing and an effort should be made to rationalize IRS enforcement efforts against nonprofits that have strayed from the "exclusively operated" requirement. Such a rationalized approach is proposed below.

C. Diversion.

Yet another concern is that permitting the conduct of extensive commercial activities will divert the attention of organization managers away from the tax exempt purposes of the organization in favor of the profit-making commercial activity.

While nonprofit managers might have their attention diverted for any number of reasons, and while it would be unfortunate if a medical relief agency came to realize that there is more profit in selling first kid kits to the minivan set and hence favored the latter activity, it is almost impossible to imagine that some kind of federal income tax "rule" is going to address this problem in a constructive manner. The IRS clearly has an important

role to play in enforcing the "borders" of section 501(c)(3),[20] but the concern with diversion smacks of the kind of paternalism alluded to above in "In a Word about Attitude." A tax exempt organization that loses its way will see decreased contributions, decreased governmental grants, threatened loss of state and local tax benefits, and loss of idealistic employees. These strike me as more persuasive sanctions than a top-down federal rule about "what kind" or "how much" commercial activity is acceptable.

D. Unfair Competition.

It may also be asserted that the conduct of commercial activities by a section 501(c)(3) organization constitutes "unfair competition" with the for-profit sector.

My response to this criticism is that the UBIT was expressly designed to deal with the issue of unfair competition. If the UBIT isn't performing this task satisfactorily it ought to be fixed,[21]but the specter of unfair competition should not also be used as the basis for revocation of tax exempt status.

E. Erosion of corporate tax base.

It can be argued that the increased commercial activity of nonprofits will lead to an erosion of the corporate tax base.

[20] [Cite to Professor Simon.]

[21] Exactly how the UBIT ought to be fixed is thankfully not within the scope of this paper. Tightening up the royalty exception and perhaps overturning the result in the *Rensallaer* decision are two options, however, that may warrant further consideration. The ability to base royalties on the net income of the licensed property and the ability to allocate overhead expenses on a purely *pro rata* basis go a long way to taking the bite out of the UBIT dog. [Reference Hauser conference on this topic.]

My response to this argument, at least with respect to *unrelated* trades or businesses, is the same as that immediately above -- if the UBTI is not protecting the fisc in an appropriate manner it ought to be fixed. If the criticism instead is that *related* commercial activities are eroding the tax base, my response would be two-fold. First, these represent activities that section 501(c)(3) seeks to encourage -- we should be pleased to their expansion. Second, for the reasons alluded to above, the corporate tax base is a fairly porous enterprise to begin with and corporate-level tax can be easily avoided through the use of an LLC or an S corporation or, slightly less easily, through a variety of techniques to strip out corporate-level income.

Notwithstanding the foregoing responses to individual concerns that have been raised with respect to commercial activities undertaken by nonprofits, these concerns in the aggregate have a certain persuasive force. If in fact large for-profit and nonprofit organizations are increasingly "converging", because nonprofits are "hocking their halos" or, if you will, "milking the cash cow" of their commercial enterprises, it is a cause for concern. But I question whether this concern is best addressed by a new federal rule that would seek to explicitly limit the type or amount of permissible commercial activity.[22] Rather, I believe a better response to inappropriate commercial activity would be a combination of the multiple step enforcement approach described below at the federal level (which draws entirely on existing law), improved donor awareness, and improved state and local attentiveness to nonprofit activity.

IV. Discussion

[22] More broadly, the federal response might be to redefine "charity" or to limit tax deductible contributions.

The current state of the law with respect to commercial activity by nonprofits is unclear and at times contradictory. This lack of clarity makes if difficult for a nonprofit organization to assess whether a commercial activity that it desires to undertake will pose a threat to its tax exempt status. Also, as would typically be the case in any regulated sector of the economy where the regulations are vague or incomplete, abuse cases arise from time to time that attract considerable attention. I believe that although the current absence of a *per se* limit on commercial activity is appropriate, the IRS and the Courts might better utilize the enforcement tools at hand. In addition, state and local governments and the public need to be sufficiently involved and well-informed to perform their important regulatory duties as well.

A. Proposed Analytical Framework.

Set forth below is an analytical framework that should be equally useful to nonprofits, the IRS and the courts. I believe application of this analysis, which draws entirely from existing law, will simplify the evaluation of commercial activities engaged in a nonprofit organization in order to determine whether such activity will jeopardize its tax exempt status or produce some other sanction.

Even though I have sought to simplify and rationalize the analysis, one cannot expect formulaic black and white answers in an area of the law as fact-specific as that regarding tax-exempt organizations. Consider the process of achieving *recognition* of tax exempt status in the first place. Unlike virtually all other "qualification" rules in the Code, the rules for qualifying as a section 501(c)(3) organization are inherently vague and

subjective. How could the *revocation* of tax exempt status not retain at least some of this same subjectivity? And what if it does? We look to the IRS to be fair in its treatment of nonprofits and we look to the courts to backstop the IRS judgment with their own. Nonprofits that consciously operate close to the edge of the following analysis will necessarily face some uncertainty, which I do not view as particularly undesirable.

Inappropriate commercial activity is unlikely to occur as an isolated event. Rather, it will often be accompanied by impermissible activities such as excessive compensation, private inurement and private benefit. I suggest that the analysis proceed in precisely that order, as described below.

1. *Should intermediate sanctions be imposed?*

While still relatively new, intermediate sanctions have proven to be a well thought out, and largely effective, enforcement tool. The simple act of having the salary and fringe benefits of "disqualified persons" (as defined in Code section 4958) reviewed by a disinterested compensation committee of the Board of Trustees, as is required for an organization to avail itself of a presumption of reasonableness, is tremendously effective for self-regulation by nonprofits. Sunlight truly is the best disinfectant and the vast majority of volunteer board members, when provided with sufficient facts to make a decision, will act responsibly. The intermediate sanctions rules are also the best place for

the IRS to start if it becomes concerned with excessive commercial activity; the recent successes by the IRS in using intermediate sanctions bears out this conclusion.[23]

2. *Is there evidence of private inurement?*

If the "intermediate" sanction of section 4958 proves insufficient,[24] the IRS should proceed to an analysis of potential private inurement. Although I will not summarize the private inurement rules here,[25] this is a reasonably well established body of law, albeit one that is highly fact specific.

3. *Is there evidence of private benefit*?

The private benefit doctrine serves as a backstop to the private inurement rules and should be the next step in an IRS analysis. Although specific "insiders" of an organization may not be profiting directly, the beneficiaries or an organization may represent too narrow a group to be fairly said to represent the public.

Again, there is a reasonably well developed body of case law delineating what is, and is not, an impermissible private benefit.[26]

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[23] [Cite to Bishop Estate matter and *STA-Home Healthcare* case.]

[24] Notwithstanding some backpedaling in the final intermediate sanctions regulations issued in January 2002, the IRS is generally well advised to follow Congress' instruction in the legislative history of section 4958 that revocation of tax exempt status should generally be reserved for extreme cases, not for situations in which there is a single instance of excess compensation.

[25] [Cite to authorities.]

[26] See Colombo, supra note 2, in which the author asserts that the IRS has muddied the private benefit doctrine by expanding it from its traditional common law origin (organization must benefit a broad charitable class, not specific individuals) to a test that looks not only to primary beneficiaries of an organization but to secondary beneficiaries as well. Under this expanded test, the IRS looks askance at doctors who profit from a particular arrangement or, in *American Campaign Academy,* 92 T. C. 1053 (1989), a political party that receives a disproportionate benefit from an educational organization that otherwise serves a broad charitable class.

4. *Is the organization exclusively operated for charitable purposes?*

Finally, if specific instances of excess benefits, private inurement or private benefit cannot be found (or proven) the IRS should consider applying the broad "operated exclusively" rule of section 501(c)(3).[27] While this test is inherently somewhat subjective, the IRS should seek to apply the test in an organized and predictable manner. I suggest that the inquiry proceed along the following lines.

A. Define tax exempt purpose.

Looking to the organizational documents of the nonprofit as well as its Forms 990, the IRS should define the precise *purpose* of the nonprofit.

B. Is the tax exempt purpose directly served by the commercial activity in question?

If the commercial activity in question is the exempt purpose of the organization (i.e. education by a university, health care by a hospital) this should be the end of the inquiry with respect to the activity in question.

If the commercial activity is simply related to the exempt purpose of the organization, an inquiry should be made whether the conduct of the activity is proportionate to the principal activity to which it is related. A large chain of drug stores operated in a rural area would not, for example, be proportionate to the healthcare

[27] An initial stopping point in this analysis would be to ensure that the organizational documents of the nonprofit reflect an exclusively charitable purposes.

activities of a single nonprofit hospital, although a single hospital pharmacy serving the public might be.[28]

If the "related" commercial activities are proportionate with the exempt activities of the nonprofit, the inquiry ends there with respect to those activities. Otherwise, these activities are examined in the same context as "unrelated" business activities described below.

C. If the reason for the commercial activity is generating revenue, does the organization engage in charitable activities that are commensurate in scope with its resource?

In the case of business activities of a nonprofit that are either taxable activities or nontaxable activities that do not directly serve the purposes of the nonprofit other than the need for money,[29] the IRS should apply the "commensurate in scope" test first enunciated in Rev. Rul. 64-182. Here again, the rules to be followed are somewhat difficult to ascertain. Nonetheless a comparison of the charitable expenditures of the organization to the "5% payout" rules applicable to private foundations, leavened with common sense, would be a good place to start.

D. "Big Picture" Analysis

If an organization "passes" all of the foregoing steps, it is still appropriate and desirable for the IRS to make an overall judgment as to whether the organization is in fact operating exclusively for charitable purposes. If the nonprofit is operating in a manner

[28] See *Hi-Plains Hospital* [Cite].
[29] Most, if not all, of the section 512(b) "modifications" to the UBIT would fall in this category.

consistent with its original purposes that were previously approved by the IRS, does not engage in excess benefit transactions, is free from private inurement and private benefit, and makes charitable expenditures that are commensurate with its size and its revenues, it may in fact be very difficult for the IRS to make a case under this final step in the analysis. Nonetheless, tax exemption should not be controlled purely by mechanical rules and there should be the opportunity to simply assert that the exclusively operated test has not been satisfied. [Retain this last point? What if common law definition of "charitable" has evolved?]

B. State and Local Response.

[To be completed, but the point here is that state and local governments can and should make their own determination of charitable status. There's no preemption doctrine in the law of nonprofits, especially when state and local tax benefits, credits, exemptions and the like are on the line. Discuss role of Attorneys General.]

C. Public as regulator.

In addition to federal, state and local authorities, an equally important regulator of inappropriate or excessive commercial activity conducted by section 501(c)(3) organizations is the public. The crucial role performed by the public could be better performed, however, if Form 990 reporting is strengthened. While one donor might choose to financially support a tax exempt organization with huge commercial revenues, others might rationally choose to not support such an organization. Collective gift-making decisions serve as a check on inappropriate activity, commercial or otherwise.