

"TROUBLE SPOTS" IN THE LAW AFFECTING NONPROFIT
ORGANIZATIONS*

by

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I. INTRODUCTION

My object here is to offer a brief survey of some important current issues in the law affecting nonprofit organizations. I'll make no effort to be comprehensive. Rather, I'll simply focus on a range of different issues that I think are important from the point of view of policy and that are not yet well understood. The issues chosen naturally reflect my own interests and expertise. Since I was trained both as a lawyer and as an economist, my comments will also reflect an economist's perspective.

The analyses that I offer here will be casual and suggestive rather than thorough and formal. In general, I'll try to be stimulating rather than responsible. Moreover, since Harvey Dale promised me that I needn't provide footnotes or other documentation, I'm going to indulge myself by citing nothing beyond my own work.

II. THE UNRELATED BUSINESS INCOME TAX

In recent years, "unfair competition" has been a major subject of public controversy concerning the nonprofit sector. One reason for this is that the Small Business Administration has chosen to lead a campaign to eliminate what they see as the unwarranted privileges that nonprofit organizations have in competing with small businesses. Much of this agitation has focused on the unrelated business income tax (UBIT). As a consequence, there were hearings on the UBIT two years ago before the Subcommittee on Oversight of the House Ways and Means Committee, and that Subcommittee has since proposed legislation that would strengthen the UBIT somewhat. At the same time, a number of academic commentators has suggested that the UBIT unfairly burdens nonprofit organizations and should in fact be repealed.

My own feeling is that this debate about the UBIT is largely a tempest in a teapot. Given the corporate income tax as it's presently structured, the UBIT serves an essential purpose in preserving the tax base and avoiding incentives for highly inefficient investment behavior on the part of nonprofits. Moreover, the current rules for applying the UBIT are reasonably sensible, and the proposed revisions (which are modest) will make them even better. The difficult cases in applying the UBIT typically involve activities that exhibit economies of scope. These are activities, such as operating a cafeteria, that would not normally qualify for exemption in themselves but

that can often be produced at a substantial savings when provided by an exempt nonprofit, such as a university or a museum, in conjunction with the nonprofit's principal exempt (or "related") activities. But even here there probably remains relatively little room for improvement, and also little reason to believe that there will be much effect upon competition between nonprofit and for-profit organizations as a consequence of the application or the nonapplication of the tax.

I've expounded these views at length in an article in last April's issue of the Virginia Law Review,² and shall not pursue them at further length here. There is, however, one issue on which I believe that my article is mistaken, and it may be important. This concerns the exclusion from the UBIT of interest income on corporate bonds. In my article, I suggest briefly that this exclusion is consistent with good tax principles and that its elimination would skew the investment incentives of nonprofit organizations. Professor Daniel Halperin at Georgetown, however, has questioned this view in private correspondence, and I suspect he may be right. In my article, I defend the exclusion of dividends from the UBIT on the grounds that, if they were taxed, nonprofits would have an excessive incentive to invest in wholly-owned businesses rather than to hold a diversified portfolio of stocks. And I suggest in passing that the same argument applies to exclusion of interest income from the UBIT. But it does not. The return on capital "lent" by an exempt nonprofit to an unrelated business operated within the nonprofit corporate shell would be taxable at corporate rates under the UBIT. If that same business were operated as an independent corporation which borrowed money from the exempt nonprofit by selling bonds to the latter, the return on the capital lent to the nonprofit would not be taxed at all under current law. Consequently, taxing such income would not create undesirable investment incentives for an exempt nonprofit.

It does not necessarily follow from this that interest income should be taxable to an exempt nonprofit under the UBIT. One might still defend that exemption as

2. Hansmann, Unfair Competition and the Unrelated Business Income Tax, 75 Va. L. Rev. 605 (1989).

maintaining the (admittedly illogical) differential in taxation between interest and dividend income that is created by the corporate tax in general. But the issue probably deserves more thought. Moreover, it is an important issue. High-interest corporate junk bonds are very commonly placed with nonprofit organizations precisely to take advantage of the latter's exemption from tax on interest income. Taxing corporate bond income under the UBIT might therefore raise appreciably the cost of corporate takeovers.

III. TAX EXEMPTION

Although I believe that the appropriate scope of application for the UBIT is not in general an important or difficult issue in the law of nonprofits, I believe that the appropriate scope of the federal corporate income tax exemption for nonprofits -- that is, the definition of what is and is not an exempt purpose -- is an important and difficult issue. The same is true for the exemption of nonprofit organizations from local property taxation. Since both corporate income taxes and property taxes can be seen as taxes on the return from invested capital, the issues raised by both are analogous, though not entirely identical.

A central question here is whether there is any case to be made for granting exemption to a nonprofit organization that receives no donative income but rather is financed entirely by private fees charged for the services it renders. Such organizations probably comprise the overwhelming bulk of the nonprofit sector today, including most nonprofit hospitals, day care centers, and nursing homes, as well as virtually all health maintenance organizations. My own view is that case for exempting such organizations is weak. Presumably all would agree that we should not exempt a service-providing organization from taxation simply because it's incorporated as a nonprofit if it doesn't provide services of a kind or quality that are not available from a for-profit organization. One could, of course, take the other view and simply exempt all nonprofit corporations from the corporate income tax. But this would undoubtedly be poor policy. The problem is not so much that it would permit nonprofit organizations to underprice their for-profit competitors but that it would encourage an excessively rapid buildup of capital in nonprofit firms where that capital

might be used inefficiently and where it might remain embedded for a very long time without being subject to any pressures (such as the capital markets) that would turn it to more productive uses.

In order to merit tax exemption, therefore, a nonprofit organization must be responding to some form of market failure that prevents for-profit firms from offering services of the kind or quality that are socially efficient.

But what kind of market failure are the nonprofit organizations mentioned above – hospitals, HMOs, etc. – responding to? One possibility is that they're responding to problems of asymmetric information, or "contract failure," with respect to their customers. That is, the nonprofits in question might serve as fiduciaries for their customers in situations where the latter are in a poor position to look out for themselves. But, as has been much debated in the literature on nonprofits, it is not at all clear that the types of nonprofit organizations in question here in fact play this role in any important way. Moreover, even if they did this would not in itself provide grounds for tax exemption. For consumers who feel the need to deal with a fiduciary organization can presumably be left to themselves, without benefit of subsidy, to patronize such organizations. Something more is needed to justify tax exemption.

I have argued, in the Yale Law Journal in 1981, that the best candidate for this "something else" is that nonprofit organizations may be inefficiently constrained in their ability to raise capital, and that tax exemption can help compensate for (or at least avoid aggravating) this problem.³ In short, tax exemption can help nonprofit organizations to accumulate the capital that they need to meet the demand for their services that arises when for-profit firms are inadequate because of problems of contract failure. But, as I noted in my 1981 article, while this may be the best argument for exempting "commercial" nonprofits from corporate income taxation, it is nevertheless a very tenuous argument. Indeed, not only is it arguable that most exempt commercial nonprofits do not serve an important function as a response to

3. Hansmann, The Rational for Exempting Nonprofit Organizations from the Corporate Income Tax, 91 Yale L. J. 54 (1981).

contract failure, but what is more they are often arguably overcapitalized as well. Thus they fail to satisfy either of the elements of the justification for exemption just described.

We must ask, then, whether there is any other rationale for exempting these organizations from taxation. Or are they simply anachronistic holdovers from an earlier day when philanthropy played a larger role in the industries in question? Or, worse, are they simply opportunistic responses to the presence of tax exemption?

If in fact we can find no better justification for exemption for these organizations than those that have previously been offered, then we must be prepared to withdraw exemption from them. I suspect, for reasons I explore at slighter greater length in a recent article in the Case Western Reserve Law Review,⁴ that the appropriate way to proceed here is to withdraw exemption through legislation on an industry-by-industry basis, as was done in 1986 when exemption was withdrawn from nonprofit insurance companies, including health insurers. A tentative and partial ranking of industries according to the desirability of withdrawing their tax exemption (or, alternatively, the difficulty of justifying their exemption) might go as follows: HMOs, hospitals, nursing homes, day care centers. Note, however, that even within these industries there will probably remain particular institutions that continue to merit tax exemption because, for example, they are heavily donatively financed and provide extensive research or aid to the poor. Some way will therefore need to be found to draw a line between the exempt and non-exempt firms within each industry. For example, in the hospital industry one might seek to continue exemption for the university-affiliated research and teaching hospitals while withdrawing exemption from the typical nonprofit community general hospital. Or, if nonprofit nursing homes in general are denied exemption, one might nevertheless wish to continue exemption for church-affiliated homes that receive a substantial fraction of their revenue from the church or from donations rather than from fees to patients and their families. And

4. Hansmann, The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?, 39 Case Western Reserve L. Rev. 807 (1989).

even here, what constitutes a "significant fraction" could be a difficult question.

IV. THE LEGAL DEFINITION OF "CHARITY"

Most of the types of nonprofit organizations whose status as exempt organizations I've just been questioning have received their exemption under the theory that they are "charitable" organizations. This serves to emphasize the fact that the legal definition of "charity" is today quite confused. And this is the next issue that I would like to turn to.

Two related questions arise in this connection. First, for what purposes should we use the legal concept of charity? That is, for what legal purposes should it make a difference whether an organization is or is not categorized as a charity under the law? Second, what criteria should we apply to determine whether a particular organization is or is not a charity? These two questions are, obviously, closely interrelated. Indeed, they are so interrelated that I will approach them here iteratively.

The legal concept of charity was originally employed, in the 16th century or perhaps earlier, to determine the purposes for which a charitable trust could be formed. I'll return to this use of the concept below. For the moment, however, I'd like to suggest that the prototypical modern use of the concept of charity is not in defining valid purposes for charitable trusts but rather in defining the scope of charitable deduction from the personal income tax. That is, as a first cut we should designate as charities those organizations to which donations should be tax deductible.

With the charitable deduction, the government effectively provides matching grants to organizations that receive private donations. When, then, should the government provide such matching grants? The most obvious answer is: When the organization in question is providing services of benefit to the public that would otherwise be undersupplied. This suggests that it would be appropriate to define as charitable those organizations that provide public goods in the economist's sense of the term – that is, goods that exhibit both non-rivalry and nonexcludability. (Non-rivalry means that it costs no more to provide the good or service to many persons than to one; nonexcludability means that once the good is provided to one person, it

is impossible to exclude others from enjoying its benefits as well whether or not they pay for them.) But this leaves us with several further questions.

First, how broad a segment of the public must be served by the class of organizations in question? There's an economic efficiency argument for providing government subsidies even to organizations that provide services that are public goods for only a very limited segment of the public. But, when this is done, there may be a problem of distribution involved. The Metropolitan Opera is a case in point. As I have argued elsewhere (in the Yale Law Journal in 1980⁵), that organization provides a service that is, in important part, a public good. But it is a public good only to individuals who actually attend performances – that is, who buy tickets. These individuals, who are also the source of virtually all of the Met's substantial donative income, are a small and exceptionally wealthy subset of the general population. Should working people in Peoria pay higher taxes to subsidize the consumption of such conspicuously expensive entertainment by the rich in New York? Perhaps it's because of doubts on this score that the Metropolitan Opera has been classified for tax purposes not as a charitable organization but rather as an "educational" one – though the tax consequences are the same either way.

Second, what about donations to political organizations? Political activity would seem to be the quintessential public good. When I donate to a political cause or candidate, I benefit all who would benefit from its victory. If charitable organizations are those donatively supported organizations that provide services that are public goods for a broad segment of the public, why aren't political organizations charitable, and why do we exclude them from the charitable deduction? Perhaps we are worried that political power is a different kind of good, and that federal matching grants for political contributions made at the donor's marginal tax rate would even further skew political power in favor of the prosperous than is now the case.

In any case, if, as I believe, we should understand that public goods are at the core of the legal concept of charity, then we need no longer be in thrall, as the courts

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

have too often been, to the ancient lists of charitable purposes that are found in the Statute of Elizabeth and elsewhere. In particular, we should understand that promotion of health and education are charitable only when they involve public goods. Thus, among health-related activities, finding a cure for cancer is a charitable activity but performing an appendectomy for an individual of reasonable means is not. Providing aid to the poor is presumably a charitable activity only because a broad segment of the (non-poor) public feels it benefits, whether for selfish or altruistic reasons, when poverty is reduced.

With these thoughts in mind, we can inquire further into the purposes for which we use the concept of charity. As I mentioned, it was originally used for determining the purposes for which charitable trusts could be formed. Charitable trusts are entitled to two benefits that private trusts are not: infinite life and enforcement by public authorities. Does our notion of charities as providers of public goods square with these benefits? Surely one can understand why the costs of public enforcement should be incurred if and only if the trust provides public goods. Also, it seems reasonable that trusts for the production of private goods should not be permitted infinite life. But why should even those trusts providing public goods be permitted infinite life? Perhaps we can only say that there's a greater chance that they won't become quickly obsolete than is the case with trusts providing only private goods.

The legal concept of charity is today used to demarcate those organizations that are entitled to a wide range of benefits. Conspicuous among these is tax exemption. For many organizations that provide public goods and receive substantial donations – that is, those that qualify for the charitable deduction – tax exemption can be justified on much the same grounds that serve to justify the deduction. But with tax exemption, as opposed to deduction, we are led to the question of whether an organization can be charitable even if it receives no donations. Or, going even further, can an organization be charitable even if it provides only private goods, in the sense that there's rivalry in consumption and individuals can easily be excluded from having the benefits of consumption if they don't pay? In short, can purely commercial nonprofits

be charitable?

This brings us, of course, back to our previous discussion of tax exemption. My own view is that, whether or not we decide that commercial nonprofits such as hospitals and health maintenance organizations should be provided tax exemption, we should not stretch the concept of charity to cover them. Rather, we should consider as charities only those organizations that truly produce public goods. If we wish to grant tax exemption to organizations that do not fit this narrow definition of charity, then such organizations should be granted their exemption under one of the many other categories of exempt organizations that fall under section 501(c) of the tax code -- for example, as social service organizations under section 501(c)(4).

We also use the concept of charity to designate organizations for many non-tax purposes. For example, charitable organizations are exempt from federal securities regulation. Perhaps this reflects a judgment that nonprofit organizations that produce public goods are less likely to issue fraudulent securities than are those that produce private goods. Or perhaps it simply reflects a judgment that if nonprofits producing public goods issue fraudulent securities, the proceeds from the fraud will go to a good cause. Neither theory is obviously persuasive, any more than the logic supporting the now-abandoned doctrine of charitable immunity from torts was persuasive. It would probably be best if we stopped using the concept of charity to exempt organizations from any such forms of regulation or liability.

Recently, the concept of charity has also begun to be used to demarcate a special class of organizations for purposes of nonprofit corporation law. I believe this is also very unfortunate, as the following discussion suggests.

V. CORPORATION LAW

A Revised Model Nonprofit Corporation Act has recently been promulgated under the aegis of the ABA. Although there is a great deal to admire in this model act, I believe its fundamental structure is deeply flawed. In particular, I think it is a great mistake to divide up nonprofit organizations, as the revised model act does, into three different types that are subject to different degrees of fiduciary accountability. Since I

have explored this issue at length elsewhere,⁶ I won't go into detail about it here. Following up the preceding discussion of charity, however, I should say that I believe the most fundamental mistake that's made in the act is to classify nonprofit corporations according to whether they are charitable or non-charitable, and to impose stronger fiduciary duties upon the former. If, as suggested above, we understand the concept of charity to designate those organizations that provide public goods, then the legal concept of charity can usefully be used to designate those nonprofit organizations that are deserving of public subsidy. But corporation law has nothing to do with subsidies. To introduce the concept of charity into nonprofit corporation law is to confuse the purposes for which nonprofit corporations are formed. In general, nonprofit corporations perform an important fiduciary role whether or not the services they provide are public goods worthy of special governmental support. Thus, all nonprofit corporations should be subject to the same relatively strict fiduciary obligations.

We need, then, yet another Revised Model Nonprofit Corporation Act. It shouldn't be hard to draft. In effect, one can get what is needed by simply taking the provisions of the current Revised Model Nonprofit Corporation Act that governs so-called public benefit corporations, making them applicable to all nonprofit corporations, and discarding the sections of the Act that apply to mutual benefit nonprofits or religious nonprofits. The state of Georgia is currently redrafting its nonprofit corporation act along roughly these lines, and it would be well if other states were to seek to follow suit.

VI. ANTITRUST

The federal government has recently begun stepping up its efforts to apply antitrust law to nonprofit organizations. The interesting question that this enforcement activity raises is: Should we apply different antitrust rules to nonprofit organizations than to for-profit organizations? In particular, should conspiracies among

6. Hansmann, Reforming Nonprofit Corporation Law, 129 U. Pa. L. Rev. 497 (1981).

nonprofit organizations not to compete with each other be treated differently from similar reached by for-profit firms?

In this connection, we should presumably draw a distinction between the unrelated and related activities of the nonprofits involved. Suppose, for example, that each of the Ivy League colleges owned a macaroni factory. And suppose that the presidents of these colleges got together to fix the price of macaroni in order to increase the amount of unrelated business income each college receives. We should have no difficulty deciding that this is an antitrust violation. Presumably it was on something like this theory that the NCAA was successfully prosecuted for antitrust violations.

The harder question is whether a conspiracy among nonprofit organizations to eliminate competition concerning their principle activities should be treated more leniently than a similar conspiracy among for-profit firms. For example, what if the nation's leading law schools conspired to raise tuition (or, equivalently, keep down scholarships), collectively set the wages offered to law professors, and mutually cut back expenditures on recruiting applicants to a bare minimum? (There is in fact strong evidence that the first and third of these practices were pursued in the past, and perhaps the second as well.) The best justification for permitting such conspiracies is that any funds saved will be used to provide more of the services for which the organization was formed – e.g., legal education – and that this will benefit the very groups (students and faculty) whom these practices might otherwise hurt. The best argument against these practices, on the other hand, is that they may often be used to cross-subsidize one group at the expense of another. Because the objectives pursued by nonprofit organizations are less clear than those pursued by business organizations, the best policy here is rather ambiguous. My own first reaction to these issues is to treat nonprofit organizations much the same as for-profit organizations for antitrust purposes. But the issue could clearly use further thought.

VII. REGULATION OF CHARITABLE SOLICITATION

A number of states have tried various devices to regulate the amount that nonprofits spend on fund-raising. The first statutes sought to limit the percent of

expected revenue that a nonprofit could spend on the costs of fund raising. These statutes were struck down by the Supreme Court on First Amendment grounds in the Schaumburg and Munson cases. Subsequently, states sought simply to require disclosure of the expected percentage to be consumed by costs of fund-raising. In the Riley case, the Supreme Court recently struck down these statutes too as abridgements of First Amendment rights.

These cases may be the end of the matter. On the other hand, they may still leave some possibilities for following the disclosure route. For example, it may be possible to force charities to make disclosure to a state agency. The state agency, in turn, might then be able to publish the percentage spent on fund-raising by each nonprofit. Or, as a refinement of this approach, perhaps tax exemption could be conditioned upon a nonprofit's willingness to reveal the percentage spent on fund raising to a state agency, which then in turn could publish the figure. Organizations that choose not to disclose need then simply forego tax exemption. If some such disclosure device can be made to pass constitutional muster, we then still have the question of whether it would be good policy. And that question, I think, raises some interesting questions.

I don't want to address the First Amendment question here. Rather, I want to ask a prior question: Even if there were no First Amendment issues involved, how would we want to regulate charitable solicitation? More particularly, is disclosure of the fund-raising percentage a good idea even in the absence of First Amendment problems?

I suspect that the answer is yes. But I think that the subject could nevertheless use some further thought by serious policy analysts. First of all, there's the question of what it is that a nonprofit should disclose. Is it just the percentage of expected receipts that will go to the costs of solicitation itself? Is that a well defined figure? Is there a clear demarcation between the costs of solicitation and the administrative costs of the nonprofit agency?

More to the point, what do we think consumers might do with such percentages when they are disclosed? How should consumers react? How will nonprofits

alter their fund-raising strategies in the face of such disclosure? Can they "game" the disclosure rules? Will solicitation strategies and donor responses settle down to a stable equilibrium that makes sense from an efficiency standpoint? All of this, I believe, could use further thinking through.

VIII. ENDOWMENT REGULATION AND TAXATION

Well-established operating nonprofits, such as the major private universities, tend to accumulate very large financial reserves in the form of endowments. A substantial fraction of these funds is typically in the form of so-called quasi endowment that is not restricted to endowment purposes by the terms of the gift but rather is accumulated at the institution's discretion. In a forthcoming article in the Journal of Legal Studies, I suggest that currently prevailing endowment policies may not always be sensible and that there may be a tendency among nonprofits in general toward excessive endowment accumulation.⁷ If this is so, then various policy measures might be contemplated.

One such measure would be to follow the suggestion first made by the Filer Commission to the effect that the rules that discourage accumulation by private foundations be extended to operating nonprofits as well. Or we could go even further and adopt rules of the type currently in force in Germany and Canada that strongly discourage the accumulation of any endowment funds by operating nonprofits beyond those gifts that are explicitly restricted to endowment by the terms of the gift. Beyond this, we might also give further consideration to the proposal made by Simes 35 years ago to the effect that restrictions on gifts to charity, including restrictions that funds be devoted to endowment, not be enforceable beyond 30 years from the date of the gift. Or we might accept the Treasury's recent proposal to impose a 5% tax upon all investment income received by nonprofits.

I don't mean to suggest that any of these measures are necessarily good policy. But it would probably be appropriate to give them at least a little further thought.

7. Hansmann, Why Do Universities Have Endowments?, J. Leg. Stud. (forthcoming, Jan. 1990).

IX. CONCLUSION

There are surely many more important topics that deserve attention in the law of nonprofits. The disparate group that I've mentioned here offer just a sampling. But I hope they're enough to indicate that there's still plenty of work left for students of the law of nonprofits.