

# **The IRS University Compliance Project Report on UBIT Issues: Roadmap for Enforcement . . . Reform . . . or Repeal?**

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On April 25, 2013, the Internal Revenue Service released its long-awaited final report on its college and university compliance project.<sup>1</sup> One of the major emphases of this project was investigating compliance with unrelated business income tax (UBIT) rules. The final report indicated significant compliance problems, but frankly nothing that students of the UBIT would not have expected. Ultimately, the report raises a series of existential questions for the UBIT, including whether proper enforcement of the current rules is even possible, and if not, whether major reform or repeal are better solutions. Though I have been a consistent advocate of major reform of the UBIT over the past many years, my own view is that the report provides a strong case for simply repealing the UBIT.

This paper addresses these questions in three main parts. First, I review and summarize existing UBIT law, particularly as it applies to colleges and universities. While this body of law is familiar to those who work with exempt organizations, it provides a useful framework for the discussion to follow. I next give a very short summary of the compliance project's particular findings with regard to the UBIT. The final part then turns to the existential questions raised above: is the UBIT even capable of enforcement in the modern university context? If not, would major reform help, or has the UBIT outlived its usefulness?

## **I. A (Brief) Summary of Existing Law (with special attention to colleges and universities)**

### *A. Basic Rules*

Sections 511-513 of the Internal Revenue Code ("Code") together impose tax at standard corporate tax rates on the "unrelated business income" of an otherwise-exempt

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<sup>1</sup> Internal Revenue Service, *College and Universities Compliance Project Final Report*, available at [http://www.irs.gov/pub/irs-tege/CUCP\\_FinalRpt\\_042513.pdf](http://www.irs.gov/pub/irs-tege/CUCP_FinalRpt_042513.pdf) (hereafter "*Final Report*").

organization under Section 501.<sup>2</sup> The basic statutory requirements for the application of the UBIT are (1) a "trade or business" as that term is used in Section 162 of the Code,<sup>3</sup> (2) that is "regularly carried on,"<sup>4</sup> and (3) is not "substantially related" to the accomplishment of the organization's exempt purpose.<sup>5</sup> The first two of these requirements are relatively clear. A "trade or business" is a profit-making activity that involves the sale of goods or services.<sup>6</sup> One quirk of the "trade or business" requirement, however, is that in order to be a trade or business, an activity must be carried on for profit.<sup>7</sup> The IRS has in recent years become far more aggressive in using the "profit motive" factor to disqualify money-losing ventures from UBIT analysis, thereby limiting situations in which losses from one activity offset profits from another,<sup>8</sup> and indeed appears to be using criteria under Section 183 (known colloquially as the "hobby loss" rules) to determine whether a profit motive exists.<sup>9</sup>

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<sup>2</sup> The one aspect of the UBIT that I do not consider in this paper is debt-financed income under Section 514; while many colleges and universities certainly use bond financing and other debt to acquire assets, the IRS final report did not focus on 514 issues as being of significant importance in UBIT compliance. Moreover, the overall structure of section 514 has been critiqued many times in the past, and there is little to add to that discussion. For a sampling of these critiques, see Samuel D. Brunson, *Repatriating Tax-Exempt Investments: Tax Havens, Blocker Corporations, and Unrelated Debt-Financed Income*, 106 Nw. U. L. Rev. 225 (2012); Emily Cauble, *Harvard, Hedge Funds, and Tax Havens: Reforming the Tax Treatment of Investment Income Earned by Tax Exempt Entities*, 29 Va. Tax Rev. 695 (2010); Milton Cerny et al., *New Scrutiny of College and University Executive Compensation and Unrelated Business Activity*, 37 J.C. & U.L. 93 (2010); Robert J. Jackson & William B. Weatherford, *Do Tax-Exempt Entities Have an "Ace" Up Their Sleeves? (Section 514 -- Debt-Financed Income)*, 65 Exempt Org. Tax Rev. 583 (2010); Suzanne Ross McDowell, *Taxation of Unrelated Debt-Financed Income*, 12 N.Y.U. Nat'l Center on Philanthropy & L. Conf. § C (2000). This article also avoids as much as possible discussions of the UBIT implications of research arrangements and athletic programs, which are the subject of other papers at this conference.

<sup>3</sup> I.R.C. Section 513(a); Treas. Reg. 1.513-1(b).

<sup>4</sup> I.R.C. Section 512(a); Treas. Reg. 1.513-1(c).

<sup>5</sup> I.R.C. Section 513(a); Treas. Reg. 1.513-1(d).

<sup>6</sup> Treas. Reg. 1.513-1(b).

<sup>7</sup> See, e.g., *U.S. v. American Bar Endowment*, 477 U.S. 105, 110 n.1 (1986) ("taxpayer's primary purpose for engaging in the activity must be for income or profit."); *Professional Insurance Agents v. Comm'r*, 726 F.2d 1097, 1102 (6<sup>th</sup> Cir. 1984) ("existence of a genuine profit motive is the most important criterion for . . . a trade or business.").

<sup>8</sup> See FRANCES R. HILL AND DOUGLAS M. MANCINO, *TAXATION OF EXEMPT ORGANIZATIONS* ¶22.03 at 22-8 (2002, supp. 2013); BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 638-640 (10<sup>th</sup> ed. 2011).

<sup>9</sup> In its original questionnaire to colleges and universities sent at the beginning of its compliance project, the agency asked respondents to indicate "whether your organization incurred a loss from the activity in at least three out of the five previous years (2001 – 2005)." IRS Form 14018, *Compliance Questionnaire Colleges and Universities* 7-8, available at [http://www.irs.gov/pub/irs-tege/sample\\_cucp\\_questionnaire.pdf](http://www.irs.gov/pub/irs-tege/sample_cucp_questionnaire.pdf). The "three out of five year" standard is an inversion of the safe harbor provided under Section 183, which states that an activity will be presumed to be "for-profit" if the taxpayer has reported a profit in three of the previous five

“Regularly carried on” means that the business is conducted with the same “frequency and continuity” as a for-profit analog. For example, for-profit restaurants operate year-round. Therefore, a restaurant operated by a charity year-round would be “regularly carried on,” but a food booth operated for two weeks of the year at the local state fair would not.<sup>10</sup> On the other hand, if a charity operated a Christmas-tree lot in November and December, that business likely would be “regularly carried on” because commercial Christmas-tree lots operate seasonally during that same period.

By far the most difficult of the UBIT criteria to apply is the last. The regulations state that in order for a trade or business to be substantially related, it must bear a “causal relationship” to the accomplishment of the organization’s exempt purpose and “contribute importantly” to that purpose.<sup>11</sup> Both IRS rulings and cases suggest that this means that the business must be tied directly to the way in which the charity *specifically executes* its exempt purpose, rather than simply related to that purpose in some diffuse way. For example, art museums are exempt as “educational” organizations. IRS rulings indicate sales of postcards with art reproductions, books about art and art-related materials by an art museum are “related” but sales of science books are not,<sup>12</sup> even though sales of science books would ordinarily be considered an educational activity in its broadest sense. In other words, sales of art-related items further the museum’s charitable purpose because they are related to the specific method the museum uses to advance its overall educational mission: displaying art. Similarly, in *Carle Foundation v. U.S.*,<sup>13</sup> the 7<sup>th</sup> Circuit Court of Appeals held that pharmacy sales by an exempt hospital were “related” when the sales were to patients, but not when the sales were to the general public. Sales to patients are

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years (two out of the previous seven years if the activity is breeding, training or racing horses). I.R.C. Section 183(d). Section 183, however, does not by its terms apply to the UBIT activities of an exempt organization, since the statute applies only to individuals and S corporations. I.R.C. Section 183(a). Moreover, failing the presumption under Section 183(d) does not make an activity “not-for-profit” – rather, it simply invokes a complex facts and circumstances test, which makes clear that activities can show losses for many years and still be “for-profit” (for example, a real estate development which has legitimate expectations of profit upon sale of the land and buildings years down the road). See Treas. Reg. 1.183-2.

<sup>10</sup> Treas. Reg. 1.513-1(c)(2). See *NCAA v. Comm’r*, 914 F.2d 1417, 1421-22 (10<sup>th</sup> Cir. 1990).

<sup>11</sup> Treas. Reg. 1.513-1(d)(2).

<sup>12</sup> Rev. Rul. 73-105, 1973-1 Cum. Bull. 264.

<sup>13</sup> *Carle Found. v. United States.*, 611 F.2d 1192 (7<sup>th</sup> Cir. 1979).

directly connected to the execution of a hospital's exempt purpose: providing medical care *to patients*; sales to the general public are not.

Finally, a major overlay to these three main requirements is the "fragmentation" rule. Codified in Section 513(c), this rule permits the IRS to "fragment" an overall business activity into its income producing "parts" and test each of those parts against the UBIT requirements set forth above. The regulations describe the fragmentation rule as follows:

Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.<sup>14</sup>

While sale of advertising in otherwise-exempt publications was the original source of the fragmentation rule and led to one of the more famous UBIT cases in *U.S. v. American College of Physicians*,<sup>15</sup> the regulations offer two other specific examples (although the Service has used the fragmentation rule in a number of other contexts<sup>16</sup>): hospital pharmaceutical sales to the general public can be fragmented from sales to patients and advertising activities can be fragmented from publication of an underlying magazine or journal.<sup>17</sup> Note that the fragmentation can be by product (e.g., fragmenting the sale of science books by an art museum from sales of art books<sup>18</sup>) or by the class of persons served (e.g., patients vs. non-patients, or in the university context, students/faculty/staff vs. the general public<sup>19</sup>).

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<sup>14</sup> Treas. Reg. 1.513-1(b). *See generally*, HILL AND MANCINO, *supra* note 8, at ¶22.02; HOPKINS, *supra* note 8, at 643.

<sup>15</sup> *United States v. American College of Physicians*, 475 U.S. 834 (1986) (sales of advertising in medical journal not substantially related; advertising could be separately tested under UBIT because of fragmentation rule). For additional discussion of advertising in the university setting, see the discussion regarding corporate sponsorship payments at notes 37-48, *infra*.

<sup>16</sup> For example, the IRS has fragmented sales of specific items by museum gift shops, holding that in the case of an art museum, sales of art reproductions, art postcards, books about art and so forth are "related" while sales of science books are "unrelated." Rev. Rul. 73-104, 1973-1 C.B. 263; Rev. Rul. 73-105, 1973-1 C.B. 264.

<sup>17</sup> Treas. Reg. 1.513-1(b).

<sup>18</sup> Rev. Rul. 73-105, 1973-1 C.B. 264.

<sup>19</sup> Tech. Adv. Mem. 9645004 (use of university golf course by students and staff is related; use by alumni and guests not related).

Thus as detailed below, the fragmentation rule provides the IRS with a very powerful tool to “slice and dice” revenue streams in various ways for UBIT testing purposes.

A number of court precedents, IRS rulings and other IRS guidance on these basic rules directly involve universities. In one of the more famous pronouncements on whether a trade or business is “regularly carried on,” the 10<sup>th</sup> Circuit in *NCAA v. Commissioner*<sup>20</sup> held that income from sales of advertising in the NCAA men’s basketball tournament souvenir program was not subject to the UBIT because the tournament (and hence the sale of advertising for the program) was conducted over a short period of time once a year and thus not “regularly carried on.”

Several other precedents involve the “substantially related” criterion. The IRS regulations, in fact, use a performing arts example in illustrating when an activity is substantially related, noting that sales of tickets to the general public would be related activity in this case because part of the training for performing arts students is teaching performance in front of a general audience.<sup>21</sup> Under a similar theory, the income from tickets sold to the public for athletic events also is considered “related.”<sup>22</sup> Travel tour programs by university alumni associations, on the other hand, generally fail the substantially related test without a substantial formal educational program,<sup>23</sup> and regulations on travel tour activities finalized in 2000 indicate that the Service will use the fragmentation rule to test individual tours for compliance with the “educational content” standard.<sup>24</sup>

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<sup>20</sup> *NCAA v. Comm’r*, 914 F.2d 1417 (10<sup>th</sup> Cir. 1990). My own view is that this case was wrongly decided. The key question in “regularly carried on” analysis is whether the activity is carried on with the same timing and frequency as a commercial analogue. In the case, the court seemed to adopt sports magazines (e.g., *Sports Illustrated*) as the commercial comparison. On that standard, of course, the NCAA’s souvenir program was not “regularly carried on” because sports magazines are published monthly (or more often) throughout the year, rather than for a short time once a year. But the correct analogue isn’t *Sports Illustrated* – it is advertising sold by the NBA, NFL, NHL, or MLB for its championship tournaments, all of which are similarly held for a short period (well, OK, some of them do seem to go on forever . . .) once a year. All the professional leagues have souvenir programs for their championships, just like the NCAA.

<sup>21</sup> Treas. Reg. 1.513-1(b).

<sup>22</sup> See, e.g., Rev. Rul. 80-296, 1980-2 C.B. 195.

<sup>23</sup> Rev. Rul. 78-43, 1978-1 C.B. 164.

<sup>24</sup> Treas. Reg. 1.513-7(a).

Facility use also has been the subject of IRS guidance. In general, the IRS has held that use of university facilities, such as recreational facilities, by students, faculty and staff is related, but use by the general public (including alumni) is not.<sup>25</sup> When it comes to events held in university facilities, income from commercial acts (as opposed to student productions) generally is unrelated, unless there is a strong connection between the commercial act and the university's execution of its educational mission. Having the Chicago Symphony play in a performing arts center might well be related to the university's fine arts educational mission; the same argument is harder to make for general entertainment acts such as rock concerts, professional sports games, and so forth.<sup>26</sup>

The IRS also has considered the UBIT with respect to programmatic efforts that do not directly involve university students, such as summer music or athletic camps. Revenue from such camps run by the university generally is considered "related" because the camps involve direct instruction to improve the abilities of the participants – a classic educational activity.<sup>27</sup>

*B. Key Exceptions (again with special emphasis on university operations)*

"Riddled with exceptions" is something of an understatement in characterizing the UBIT. While cataloging all of the exceptions likely would triple the length of this article (and in any event, such cataloging already has been done meticulously by the leading treatises on exempt organizations<sup>28</sup>), a few have particular weight in university operations and as noted in Part II. below, were specifically mentioned by the IRS in its final compliance project report.

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<sup>25</sup> See, e.g., Treas. Reg. 1.513-1(d)(4)(iii) (dual-use facilities in general); Rev. Rul. 79-98, 1978-1 C.B. 167 (income from general public's use of ski facilities owned by exempt school and otherwise used for physical education classes was UBIT); TAM 9645004 (use of university golf course by students and staff is related; use by alumni and guests not related).

<sup>26</sup> See, e.g., GCM 39863 (revenue from using multipurpose facility for rock concerts, professional basketball games and similar events aimed at general public audience not related); see also TAM 9147008

<sup>27</sup> Rev. Rul. 77-365,

<sup>28</sup> E.g., HILL AND MANCINO, *supra* note 8; HOPKINS, *supra* note 8.

## 1. The “Convenience” Exception

I.R.C. Section 513(a)(2) provides an exception from the UBIT for an activity carried on “primarily for the convenience of members, students, patients, officers or employees.”<sup>29</sup> Whether a particular activity meets the convenience exception is, of course, a facts-and-circumstances inquiry, and virtually no guidance exists regarding the line between “convenience” and not – making this area an especially ripe one for an expansive interpretation by affected taxpayers.<sup>30</sup> The convenience exception looms especially large in the university context, helping to shield from taxation everything from sales of toothpaste to students by a university bookstore to income from parking garages. Income from the general public (or alumni) from these sources, however, generally would be fragmented and subject to the UBIT.

The university bookstore is a prime example of the interaction between the fragmentation rule, the “substantially related” rule and the convenience exception. IRS examination guidelines for universities published in 1994 state:

The sale to students, officers and employees of books, supplies, and other items that are necessary for courses at the institution is an activity substantially related to the institution's educational purposes. Thus, the sale of books that are required or recommended for courses at the institution and general school supplies such as notebooks, paper, pencils, typewriters, and athletic wear necessary for participation in the institution's athletic and physical education programs, does not constitute unrelated trade or business. Similarly, educational purposes are served by the availability of other materials that further the intellectual life of the campus community. In general, the sale to students, officers, and employees of an institution of books, tapes, records, compact discs, and computer hardware and software (whether or not required for courses) is considered an activity substantially related to educational purposes.<sup>31</sup>

Thus the guidelines first fragment “related activity” sales (books and educational supplies) from sales of other items. The guidelines, however, then list items that may qualify for the

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<sup>29</sup> I.R.C. Section 513(a)(2). The exception is limited to 501(c)(3) organizations and public universities which are subject to the UBIT by virtue of Section 511.

<sup>30</sup> See HILL AND MANCINO, *supra* note 8, at ¶22.03[2] (“little guidance exists as to what constitutes a convenience-type activity.”); HOPKINS, *supra* note 8, at 707.

<sup>31</sup> INTERNAL REVENUE SERVICE, I.R.S. COLLEGE AND UNIVERSITY EXAMINATION GUIDELINES, 1994-27 I.R.B. 36 at 342.(13) (1994) available at <http://www.federaltaxissues.com/docs/IRS-announce-94-112.pdf> (hereafter, “GUIDELINES”).

“convenience” exception when sold to students or employees: “Excepted merchandise may include toilet articles (such as toothpaste), wearing apparel or novelty items bearing the institution's insignia, and other items such as candy, cigarettes, newspapers and magazines, greeting cards, photographic film, cameras, radios, and television sets or other appliances.”<sup>32</sup> In a subsequent sentence, however, the guidelines invoke the fragmentation rule again to declare that sales to alumni do not qualify for the convenience exception and “the sale of multiple computers, in a single year, to a single student or the sale of a computer to someone who is not a student, officer or employee of the institution may result in unrelated business income.”<sup>33</sup>

The convenience exception and fragmentation rules also play prominent roles in other university operations. Revenue from vending machines on campus generally would be excluded per the convenience exception,<sup>34</sup> as would revenue generated by on-campus parking for students, faculty and staff.<sup>35</sup> Concession sales at university athletic events should also be exempt, analogous to a museum operating a cafeteria for the convenience of staff and visitors.<sup>36</sup>

## 2. Advertising and the Corporate Sponsorship Exception

As noted above, advertising played a key role in shaping the modern UBIT. In 1967, the IRS promulgated Treasury Regulation Section 1.513-1(b),<sup>37</sup> for the first time taking the position that an overall “trade or business” – such as publishing - could be broken into its component revenue streams – such as the sale of advertising. Though the regulation was

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<sup>32</sup> *Id.* (my only reaction: “television sets or other appliances” – really? Visions of the university Best Buy store dance in my head . . .). Compare, however, Rev. Rul. 81-62, 1981-1 C.B. 355, where the IRS ruled that sales of heavy appliances by exempt senior citizens center was unrelated.

<sup>33</sup> GUIDELINES, *supra* note 31, at 342.(13)(5).

<sup>34</sup> See Rev. Rul. 81-19, 1981-1 C.B. 353 (“The goods and services dispensed by the vending machines are necessary for the day-to-day living on the campus of students, faculty, and staff. If the university operated the vending facilities, the income would not be subject to the tax on unrelated business income because the activity would be carried on for the convenience of its students and employees within the meaning of section 513(a)(2) of the Code.”).

<sup>35</sup> See Rev. Rul. 69-269, 1969-1 C.B. 160 (parking revenue generated by patients and visitors “substantially related” to mission of exempt hospital).

<sup>36</sup> See, e.g., PLR 8623081, 1986 PLR LEXIS 3919 (March 17, 1986) (concession sales at related event not subject to UBIT); Rev. Rul. 74-399, 1974-2 C.B. 172 (museum cafeteria).

<sup>37</sup> For an excellent recitation of the history of the fragmentation rule, see *United States v. American College of Physicians*, 475 U.S. 834 (1986).

heavily criticized, Congress codified its substance in the 1969 Tax Reform Act as new Section 513(c).<sup>38</sup> In 1986, however, the U.S. Supreme Court in the *American College of Physicians* case ruled that while the fragmentation approach was valid, it did not create a *per se* rule that advertising income was subject to the UBIT; rather, as with any other revenue source, such income would be tested according to the “substantially related” rule.<sup>39</sup> While the Court held that under the particular facts of the case before it the advertising was not substantially related, the general validation of the fragmentation approach and the seemingly high bar set in the case for “relatedness”<sup>40</sup> resulted in the IRS subjecting nearly all advertising income to the UBIT – until the IRS touched the “third rail” of university exempt activities: college football.

In Technical Advice Memorandum 9147007,<sup>41</sup> the IRS ruled that income received from corporations paying to “sponsor” two college football bowl games would be subject to the UBIT. According to the IRS, the “sponsorship” arrangement provided return benefits to the sponsoring corporation (prominent display of the corporate name and logo on the venue’s field, scoreboard, player uniforms, and related print materials) that went well beyond simple “donor recognition” that the Service traditionally ignored as a “quid pro quo” and was more akin to payments for advertising – which payments, when fragmented from the overall trade or business of conducting the football game, would be subject to the UBIT.

The reaction was predictably crazy, and even though the IRS voluntarily backed away from the broad implications of its position, in 1997 Congress enacted Section 513(i),

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<sup>38</sup> Pub. L. No. 91-172, 83 Stat. 487 (1969).

<sup>39</sup> *United States v. American College of Physicians*, 475 U.S. 834 (1986). The Court held in this particular case that the advertising in question was not substantially related.

<sup>40</sup> *Id.* at 848-49 (“Yet the statutory and regulatory scheme, even if not creating a *per se* rule against tax exemption, is clearly antagonistic to the concept of a *per se* rule for exemption of advertising revenue.”). The Court went on to suggest that in order for advertising to meet the “substantially related” test, it would have to systematically present information specifically related to the editorial content of the publication. This suggests that, for example, if an issue of ACP’s magazine focused on treatment of hypertension limited all advertising to hypertension treatments, such advertising conceivably could meet the “comprehensive or systematic presentation” required to connect the advertising to the execution of ACP’s exempt purpose.

<sup>41</sup> Tech. Adv. Mem. 9147007, 1991 PLR LEXIS 1778 (August 16, 1991). A good succinct summary of the “Cotton Bowl” ruling, as it became known, is in JAMES J. FISHMAN AND STEVEN SCHWARZ, *TAXATION OF NONPROFIT ORGANIZATIONS* 397 (3d ed. 2010). See also Richard L. Kaplan, *Intercollegiate Athletics and the Unrelated Business Income Tax*, 80 Colum. L. Rev. 1430 (1980).

specifically exempting “corporate sponsorship” payments from the UBIT. The IRS finalized regulations for the new statute in 2002 as Treasury Regulation 1.513-4.

While the details of the operation of the corporate sponsorship exception could fill a book,<sup>42</sup> the key for purposes of this paper is that the provision attempts to draw a line between payments that are “advertising” and payments that are merely “sponsorship.” The latter are exempt from the UBIT, but recall that the former are not automatically taxable. In general, if a particular arrangement involves a corporation making payments and receiving only the right to display the corporate name, logo or product lines, the payments will qualify as “sponsorship” payments and not advertising.<sup>43</sup> Hence the combination of the regular UBIT rules, the fragmentation rule and the corporate sponsorship exception creates a matrix of four possible outcomes: a particular payment may be (1) advertising that is not regularly carried on (e.g., the NCAA case discussed above) and hence not subject to the UBIT; (2) advertising that is regularly carried on, but meets the requirements of the American College of Physicians case for “substantially related” and thus is not subject to the UBIT; (3) advertising that is regularly carried on but is not substantially related and hence subject to the UBIT and (4) payments that are classified as corporate sponsorship payments, which also are not subject to the UBIT per the express statutory language in Section 513(i).

Universities appear to have all four of these outcomes. The IRS has long held that revenue from sales of advertising in a student newspaper is “substantially related” to training students in the various different aspects of running a newspaper and hence not subject to the UBIT.<sup>44</sup> On the other hand, a 1955 ruling found that advertising income from a radio station owned by a university and operated in part to train students in radio was not substantially related, because the bulk of the station’s operations were commercial in nature and not for student-training purposes.<sup>45</sup> The tax treatment of sales of advertising in programs for student arts productions and athletic events probably hinges on whether

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<sup>42</sup> For additional detail on the workings of Section 513(i), see HILL AND MANCINO, *supra* note 8, at ¶22.11[7]; HOPKINS, *supra* note 8, at 714-718.

<sup>43</sup> Treas. Reg. 1.513-4(c)(2)(iv).

<sup>44</sup> 1.513-1(d)(iv) Example 5.

<sup>45</sup> Rev. Rul. 55-656, 1955-2 C.B. 266.

these sales are “regularly carried on” under the rationale of the NCAA case discussed above, although guidance is lacking and universities seem to take differing viewpoints on the matter.<sup>46</sup> Universities seem to agree, however, that advertising revenue from unrelated events for the general public is not related and subject to the UBIT.<sup>47</sup> Corporate sponsorship payments, of course, abound, ranging from payments for naming a stadium or other university building to corporate logos on scoreboards to named scholarships, faculty chairs and other academic support.<sup>48</sup>

### 3. The Investment Income Exception

Section 512(b)(1) exempts from the calculation of unrelated business taxable income all “dividends, interest . . . and annuities . . . .” This exception is interpretively relatively straightforward,<sup>49</sup> and of special interest to universities only because some university

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<sup>46</sup> I have not uncovered any specific IRS ruling about this. Several universities have on-line “manuals” addressing UBIT issues; these seem to take different approaches to the UBIT aspects of program advertising for university events. The University of Tennessee’s guidelines, for example, suggest that such advertising is not subject to the UBIT. See The University of Tennessee, Office of the Controller, *Unrelated Business Income Tax: A Determination and Reporting Guide 1* (2012) (hereafter *Tennessee UBIT Guide*) available at [http://controller.tennessee.edu/tax/UUbitdetguide%20web%207-12-2012\(justin\).doc](http://controller.tennessee.edu/tax/UUbitdetguide%20web%207-12-2012(justin).doc). A similar guide from the University of Illinois, however, suggests that program advertising will be considered unrelated income unless the advertising meets the definition of “sponsorship” payments. University of Illinois, *Business and Financial Policies and Procedures*, Section 18.13 “Advertising Activities” available at <http://www.obfs.uillinois.edu/cms/one.aspx?portalId=909965&pageId=913985>

<sup>47</sup> *Tennessee UBIT Guide* at *id.*

<sup>48</sup> Corporate sponsorships appear to have become big business at nearly every university. A quick perusal of the web will bring up any number of slick “corporate sponsorship opportunity” pages at nearly all universities, from the small, private Catholic Miscordia University, [http://www.misericordia.edu/misericordia\\_pg.cfm?page\\_id=1078&subcat\\_id=114](http://www.misericordia.edu/misericordia_pg.cfm?page_id=1078&subcat_id=114) to (of course) the large state University of Texas, <http://www.texassports.com/sponsorship/tex-corporate-sponsors.html>.

A problem in the Fischman and Swarz casebook raises the intriguing question whether exclusive “pouring rights” arrangements with soft drink companies would constitute qualified sponsorship payments. See FISHMAN AND SCHWARZ, *supra* note 41, at 410, problem 1(c). The answer would appear to be “no” – see Treas. Reg. 1.513-4(f), Example 6 (exclusive pouring rights is a “substantial return benefit” and value is taxable).

<sup>49</sup> There may be some lingering interpretive issues with respect to highly advanced financial instruments, the design of which often outstrips the IRS’s ability to respond to market innovation. The regulations under Section 512(b)(1), however, are fairly expansive, including in the passive income exception “income from notional principal contracts” and “other substantially similar income from ordinary and routine investments.” Treas. Reg. 1.512(b)-1(a)(1). For those seeking additional detail on the application of the 512(b)(1) exception to advanced financial instruments such as swaps, derivatives and so forth, see HILL AND MANCINO, *supra* note 8, at ¶23.02[5].

endowments exceed the GDP of many countries<sup>50</sup> – and hence we should not overlook its importance to the overall university UBIT picture.

#### 4. Real Estate Rents

The fourth major UBIT exception with a major impact on universities is the exclusion of real estate rental income in Section 512(b)(3). This section excludes from the calculation of unrelated business income “all rents from real property” unless the rent is based on a percentage of the net income or profit of the lessee.<sup>51</sup> If the lease arrangement includes personal property along with the real property, the personal property rents generally are not excluded unless the amounts attributable to the personal property are “incidental” – which the regulations define as 10% of the total rent.<sup>52</sup>

The definition of “real property” for purposes of this exclusion is quite broad and includes anything defined as real property under Section 1245(a)(3)(C) and Section 1250(C).<sup>53</sup> Accordingly, in addition to land, the definition includes structures and other “fixtures” typically defined as real property under state law. The IRS has held, for example, that a lease of a pipeline system that included right-of-way interests in land and associated buildings and fixtures is “real property,”<sup>54</sup> as are interests in rooftop sites for telecommunications antennas<sup>55</sup> and a microwave transmission tower system.<sup>56</sup>

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<sup>50</sup> I hate continually to pick on Harvard, but in this case, the shoe fits. *See, e.g.,* Katy Hopkins, *10 Colleges with Largest Financial Endowments*, U.S. News and World Report (Nov. 27, 2012) available at <http://www.usnews.com/education/best-colleges/the-short-list-college/articles/2012/11/27/10-colleges-with-largest-financial-endowments>.

<sup>51</sup> I.R.C. Section 512(b)(3)(A) and (B)(ii).

<sup>52</sup> Treas. Reg. 1.512(b)-1(c)(2). If the amount of rent attributable to personal property is more than 10%, the rent attributable to personal property is not excluded; if the rent attributable to personal property is more than 50% of the total rent, then none of the rental is excluded under 512(b)(3). Of course, loss of the exclusion under 512(b)(3) does not automatically mean that the rental income will be taxable; one would apply the rest of the normal UBIT tests to such income (trade or business, regularly carried on, substantially related) to determine taxability.

<sup>53</sup> Treas. Reg. 1.512(b)-1(c)(3)(i).

<sup>54</sup> Rev. Rul. 67-218, 1967-2 C.B. 213.

<sup>55</sup> PLR 200041024, 2000 PLR LEXIS 1336 (July 18, 2000) (rooftop site, air rights, and permanent platform considered real estate for REIT purposes).

<sup>56</sup> Rev. Rul. 75-424, 1975-2 C.B. 270 (the building housing transmitting equipment, the heating and air conditioning system, the transmitting and receiving towers, and the fence are real estate assets for purposes of the REIT rules, but the antennae, waveguides, transmitting, receiving, and multiplex equipment, and the prewired modular racks are not).

The rental period does not have to be long-term in order for payments to be considered rent from real estate. In fact, the IRS has held that revenue received by an organization for renting a meeting hall for a single afternoon or evening would qualify.<sup>57</sup>

There is one key limitation to the real estate rental exception, however. The IRS has steadfastly held that revenue from renting space for occupancy where the landlord provides services for the convenience of the renter is not “rent from real estate” under Section 512(b)(3).<sup>58</sup> Thus renting parking spaces in a garage or lot or hotel rooms does not constitute rent from real property, but rather a “service” for the convenience of the customer.<sup>59</sup> Services “customarily rendered in connection with the rental of rooms or other space for occupancy only” are permitted, however.<sup>60</sup> Hence, “the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, the collection of trash, etc., are not considered as services rendered to the occupant.”<sup>61</sup> In the university context, the IRS has held that the “services for the convenience of the renter” limitation means that, for example, a lease of a football stadium to a pro team for practices or games would not be exempt rental income (and also not “substantially related”) where the university in question provided “extensive grounds and playing field maintenance, dressing

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<sup>57</sup> Rev. Rul. 69-178, 1969-1 C.B. 178. *See also* PLR 200222030 (March 3, 2002) (rental of classroom space for meetings exempt real estate rental).

<sup>58</sup> Treas. Reg. 1.512(b)-1(c)(5).

<sup>59</sup> *Id.* (“For purposes of this paragraph, payments for the use or occupancy of rooms and other space where services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist camps or tourist homes, motor courts or motels, or for the use or occupancy of space in parking lots, warehouses, or storage garages, does not constitute rent from real property.”). One might argue that at least in some cases, parking spaces might not involve any associated services and therefore be excludable rent. Prior to 1990, the IRS apparently had similar thoughts and had waffled some on whether parking revenue could ever be considered rent from real estate, but in 1990 the IRS issued Gen. Couns. Mem. 39825 (Aug. 17, 1990) concluding that parking revenue was never excludable as rent. *See also*, *Ocean Pines Assoc., Inc., v. Comm’r.*, 135 T.C. 276 (2010) (income from parking fees not excludable rent from real estate). *See generally*, KPMG, *Can I Park Here? The Tax Court Weighs in on the UBTI Controversy* (Nov. 1, 2010) available at <http://www.kpmginstitutes.com/taxwatch/insights/2010/pdf/wnit-110110-ubti-controversy.pdf>.

Note that simply because certain income does not automatically qualify for exclusion as rent from real property does not necessarily mean the income will be taxed under the UBIT. If a particular revenue stream were “substantially related” or qualified for some other exclusion, the income would still be exempt from taxation. For example, parking fees for parking by students, faculty and staff should be excluded from the UBIT as either “substantially related” or under the “convenience” exception. *See text at notes 34-36, supra.*

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

room linens, and stadium and dressing rooms, pursuant to the lease.”<sup>62</sup> There is a potential workaround for the “services for the convenience of the renter” limitation, however. If such services are provided by an independent third party, and not the exempt organization/landlord, then payments for “space alone” should qualify as exempt rental income.<sup>63</sup>

Universities appear very conscious of both the real estate rental exception and the “customary services” limitation (and their workarounds). Internal university UBIT guides invariably note that space rentals accompanied by “convenience” services result in UBTI.<sup>64</sup> University of Tennessee UBIT guide notes in its section on facilities rental section that “to shield University’s income from UBI, renter should contract with outside vendor to supply service.”<sup>65</sup> In any event, the real estate rent exception will, with proper planning, shield the largest percentage of any lease payments for facilities from the UBIT.

## 5. Royalties

The final major exception affecting universities is the exception for royalties. The major issue with royalty payments in some ways mirrors the issue with space rental payments: the question of associated services. In general, “royalties” are defined as payments for the use of property, usually an intangible such as a trademark, logo, copyright or patent, or for the exploitation of minerals or natural resources like oil, gas, or minerals.<sup>66</sup> Payments for services, however, are not royalties, and much of the tension in this area has been over the dividing line between payments for services and payments for royalties.

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<sup>62</sup> Rev. Rul. 80-298, 1980-2 C.B. 197. *See also*, Rev. Rul. 76-402, 1976-2 C.B. 177 (lease of tennis courts along with furnished dormitory rooms, linens, maid service, meals, and dining facilities to an individual for use by the individual in conducting a summer tennis camp not exempt real estate rental).

<sup>63</sup> *See, e.g.*, Internal Revenue Service, *Tax Guide for Churches and Religious Organizations* 17, available at <http://www.irs.gov/pub/irs-pdf/p1828.pdf> (“If the church enters into a lease with a third party who operates the church’s parking lot and pays rent to the church, such payments would not be subject to tax, as they would constitute rent from real property”).

<sup>64</sup> *E.g.*, University of California, *Unrelated Business Income Tax Status and Determination Guide* 9, available at <http://tax.ucmerced.edu/Data/Sites/5/media/taxtraining/ubit-taxdeterminationguide.pdf>; University of Texas, *Unrelated Business Income Review Guidelines* 4, available at [http://www.utexas.edu/business/accounting/pubs/ubit\\_guidelines.pdf](http://www.utexas.edu/business/accounting/pubs/ubit_guidelines.pdf).

<sup>65</sup> *Tennessee UBIT Guide*, *supra* note 46, at 5.

<sup>66</sup> *See generally*, HILL AND MANCINO, *supra* note 8, at ¶23.03; HOPKINS, *supra* note 8, at 697-98; *Sierra Club, Inc. v. Comm’r.*, 86 F.3d 1526, 1531 (9<sup>th</sup> Cir. 1996).

Perhaps the most famous case illustrating these issues is *Sierra Club v. Commissioner*, decided by the 9<sup>th</sup> Circuit in the 1990s.<sup>67</sup> The case involved the question whether payments received by the Club for use of its mailing list and for an “affinity card” arrangement with a bank credit card issuer constituted royalties. The IRS argued that the payments were not royalties because each arrangement involved “active” participation by the Club, in contrast to the usual “passive” nature of royalty income. The court, however, rejected the “passivity” argument and restated the rule that the key issue is whether the payments were for the use of property or (at least partly) for the services provided by the Club as part of the underlying arrangement (e.g., updating the mailing list; “advertising” the affinity card arrangement to members). In the case of the mailing lists, all the administration of the list and marketing was done by third parties under a commission arrangement with the Club; the Club itself performed no services with respect to maintaining or marketing the lists. Accordingly, the court found that the payments the Club received for use of the lists were royalties – payments solely for exploitation of the Club’s property rights in the lists.<sup>68</sup>

With respect to the affinity card arrangement, the court remanded on the grounds that the agreements between the Club and the bank were unclear, and the Tax Court should not have granted summary judgment in favor of the Club.<sup>69</sup> On remand, however, the Tax Court found in favor of the Club, noting that it was the bank, not the Club, that performed the marketing and solicitation services.<sup>70</sup>

The result of *Sierra Club* and subsequent similar cases is that the “royalty” exception has been enlarged beyond the traditional payments (e.g., copyrights, patents, mineral exploitation) to virtually any payment that can be cast as one for exploitation of an underlying property right, at least as long as the recipient is smart enough to pawn off any related services to some third-party servicing entity. In the university context, this means that revenue from mailing lists, affinity card arrangements, and income from licensing marks for sports-related souvenirs should all be exempt.

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<sup>67</sup> *Sierra Club, Inc. v. Comm’r.*, 86 F.3d 1526 (9<sup>th</sup> Cir. 1996).

<sup>68</sup> *Id.* at 1536.

<sup>69</sup> *Id.* at 1537.

<sup>70</sup> *Sierra Club, Inc. v. Comm’r.*, T.C. Memo 1999-86 (March 23, 1999).

### *C. Allocating Expenses*

The final piece of the UBIT sieve consists of the rules for allocating expenses between charitable, related and unrelated activities for “dual use” facilities or employees. Again, while these rules are not specific to universities, they play an important role in university UBIT reporting if for no other reason than the fact that universities are large, complex organizations with significant overhead.

The allocation rule itself is simple: in addition to expenses attributable solely to the conduct of the unrelated business, an exempt organization may also deduct an allocable share of the costs (including depreciation and overhead) of “dual use” facilities or personnel, which costs must be allocated between the exempt and non-exempt activities on a “reasonable basis.”<sup>71</sup> The regulations suggest that allocation on the basis of relative time spent on the exempt and non-exempt activities would be reasonable,<sup>72</sup> but case law reveals that what is “reasonable” is often in the eye of the beholder. The vagaries of the “reasonable” standard are well-illustrated by a case that appropriately involves a university: *Rensselaer Polytechnic Institute v. Commissioner*.<sup>73</sup>

The facts of the case are straightforward and replicated across nearly every college and university. Rensselaer owned an arena used for both student athletics and other educational programs and for public shows (e.g., commercial ice shows) subject to the UBIT. In allocating “dual use” expenses (expenses solely attributable to the UBIT uses were not an issue), Rensselaer divided its costs into two main categories: variable costs (those that are incurred as a result of actually using the facility, such as heating for an event, but cannot be precisely allocated to any specific event) and “fixed expenses” such as depreciation and overhead. Rensselaer allocated both the variable costs and fixed costs in proportion to the actual use of the fieldhouse for exempt and unrelated functions. That is, it took the total number of hours of use for both exempt and unrelated activities, and divided the total number of hours by the unrelated-use hours to get the allocation

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<sup>71</sup> I.R.C. Section 512(a)(1); Treas. Reg. 1.512(a)-1(c).

<sup>72</sup> *Id.*

<sup>73</sup> 732 F.2d 1058 (2d Cir. 1984).

fraction.<sup>74</sup> While the IRS ultimately agreed with the allocation of the “variable” costs, it objected to the allocation of the fixed costs in this manner, arguing that this system in effect allocated a portion of the costs for “unused” time to unrelated activities;<sup>75</sup> costs of “unused” time, according to the Service, could never be “directly connected” to unrelated uses. The court, however, disagreed, finding that this allocation was “reasonable.”<sup>76</sup>

The result of cases such as *Rensselaer* is that universities enjoy favorable expense allocation rules for dual-use facilities and personnel, which are likely to be the vast majority of cases. Universities typically do not build facilities solely for unrelated commercial use; accordingly, nearly any activity that produces unrelated income will have associated “dual use” depreciation and personnel overhead.

## **II. The IRS Final Compliance Project Report UBIT Findings**

The college and university compliance project resulted in audits of 34 institutions (two thirds of which were large institutions with over 15,000 students), reviewing UBIT returns mostly for the years 2006-2008.<sup>77</sup> In its final report on the compliance project, the IRS detailed the major UBIT compliance issues it found. The major adjustments resulted from three areas. First, the IRS disallowed losses from certain activities that it found were not conducted with a profit motive, and therefore did not meet the “trade or business” requirement for UBIT.<sup>78</sup> Because these losses had been used to offset income from other unrelated activities, such disallowances “could amount to more than \$60 million in assessed taxes.”<sup>79</sup> Second, the IRS reclassified expenses that had been allocated to unrelated activities under the expense allocation rules discussed above.<sup>80</sup> Third, the IRS

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<sup>74</sup> For example, if the field house were used a total of 100 hours, 75 for exempt activities and 25 for unrelated activities, 25% of the variable and fixed costs would be allocated to the unrelated use.

<sup>75</sup> This kind of allocation has the effect of allocating expenses of unused time in the same proportion as “used” time. In the example in the footnote above, costs of unused time get allocated in the same proportion (75/25) as “used” time. The alternative method would be to construct a fraction in which total available time is the denominator, and time used for unrelated activities is the numerator, resulting in a much smaller expense allocation to the unrelated activity.

<sup>76</sup> *Id.*

<sup>77</sup> *Final Report, supra* note 1, at 9-10.

<sup>78</sup> *See* text at notes 7-9, *supra*.

<sup>79</sup> *Final report supra* note 1, at 2, 12-13.

<sup>80</sup> *Id.*

reclassified certain activities as “unrelated.”<sup>81</sup> Most of the adjustments involved discrete areas of university operations, including advertising, facility rentals, and use of fitness and recreation centers, arenas and golf courses.<sup>82</sup> The net effects of these adjustments were to increase unrelated income (note, income, not tax revenue) by some \$90 million.<sup>83</sup>

### III. Where Do We Go From Here: Enforcement, Reform or Repeal?

The UBIT section of the final compliance project report raises some interesting questions regarding the future of the UBIT. There is little question the IRS found significant compliance issues: the agency disallowed losses on activities in 70% of the examined returns, reallocated expenses in 60%, and reclassified activities as “unrelated” in 40%.<sup>84</sup> Given that two-thirds of the audits were of large institutions with what we can assume are sophisticated legal and tax accounting staffs,<sup>85</sup> one wonders whether these findings are the result of intentional exploitation of ambiguities in the law, ignorance, or both. A larger question, however, is what to do about it. Should the IRS commit more resources to UBIT enforcement? Or does the report support a more radical approach to the future of the UBIT?

#### A. *The Futility of Enforcement*

The UBIT section of the final report is written in a manner that almost seems to be a billboard advertisement for increasing enforcement efforts. “\$90 Million increases in UBTI!” “\$60 million in potential taxes recovered!” bullet points headline the executive summary.<sup>86</sup> Anyone with even a passing knowledge of the UBIT (or the ability to do simple math), however, would quickly conclude that the notion of investing more resources in enforcement is insane.

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<sup>81</sup> *Id.*

<sup>82</sup> *Id.* at 14.

<sup>83</sup> *Id.* at 2.

<sup>84</sup> *Id.* at 12-13. Of course, these were audit adjustments; one assumes these adjustments would be subject to administrative appeal within the IRS and ultimately litigation if the amounts involved were significant. Accordingly, we do not really know whether all these adjustments will hold up; perhaps when all is said and done we will find more accurate compliance than the report would indicate.

<sup>85</sup> In fact, the IRS found that 57% of 990Ts were reviewed by outside accountants, and about 20% of the audited institutions sought outside advice on the classification of activities under the UBIT (the IRS disagreed with outside opinions some 40% of the time). *Id.* at 14.

<sup>86</sup> *Id.* at 2.

First, there is the “simple math” part. The Service conducted 34 in-depth audits, utilizing untold person-hours of enforcement time, in order to get . . . what? Even if all \$90 million of the UBTI increase ended up in taxes at the maximum corporate rate and all \$60 million of the “potential taxes” were recovered (both highly unlikely events<sup>87</sup>), the net revenue resulting from the effort would be \$96 million, or about \$32 million per audit year. That’s not even a rounding error in the federal budget; \$32 million, in fact, is ***less than three ten-thousandths of one percent of tax collections*** for the 2011 year.<sup>88</sup> In other words, the massive audit of colleges and universities produced at most the same revenue as raising tax rates by .0003%. From a pure revenue perspective, therefore, investing significant additional resources in UBIT enforcement is unlikely to be cost-effective.

Of course, enforcement has benefits other than simply revenue collection. Regular, high-profile enforcement actions serve as warnings to other taxpayers to up their own compliance levels. The UBIT, however, suffers from almost unique statutory ambiguity that almost no level of enforcement is likely to resolve. First, there is the inherent inability of anyone to define the core concept of “substantially related.” The IRS’s own regulations on this are nearly inscrutable, telling us only that

Trade or business is *related* to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is *substantially related*, for purposes of section 513, only if the causal relationship is a substantial one.<sup>89</sup>

The university setting, moreover, illustrates perfectly the inherent problems. “Advertising” (leaving alone for the moment the definitional divide between advertising and “corporate sponsorship”) is one activity that the IRS has relentlessly pursued as almost *per se* unrelated, except if the advertising is in a university student newspaper, when it is

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<sup>87</sup> At least part of the potential tax revenue from the IRS audit adjustments might be offset by accumulated losses from other UBIT activities, as the IRS recognizes in its report. Moreover, as note 84, *supra*, indicates, these audit adjustments might not stand up in administrative appeal or court scrutiny. The notion that the IRS adjustments might produce \$90 million in tax revenue is very highly optimistic, if not downright fanciful.

<sup>88</sup> The total of personal and business income tax collections in 2011 was approximately \$1.6 trillion dollars (\$1,600,000,000,000). Internal Revenue Service, *Internal Revenue Service Data Book 2011* at 3 (2011) available at <http://www.irs.gov/pub/irs-soi/11databk.pdf>.

<sup>89</sup> Treas. Reg. 1.513-1(d)(2).

considered related.<sup>90</sup> Selling tickets to the general public for events conducted on university grounds is unrelated if the event is The Ice Capades or Cirque de Soleil, but not if the event is the Chicago Symphony Orchestra, Itzhak Perlman or a University of Michigan football game attended by 100,000 of your closest friends.<sup>91</sup> No wonder the IRS disagreed with outside opinions on “relatedness” 40% of the time: what if the University offers ice skating courses? Does that make The Ice Capades related?<sup>92</sup>

Overlay the impossibility of defining “related” with the major exceptions and expense allocation rules discussed in Part I of this article, and the problems compound. The “convenience” exception is essentially open-ended – as Frances Hill and Doug Mancino note, there is very little interpretive material concerning when an item is “for the convenience” of students/employees.<sup>93</sup> What we do know is that in the right circumstances, selling TV sets and other appliances is protected by the “convenience” exception;<sup>94</sup> what if a university were to lease motor scooters for student transportation? Cars? We also know that universities can turn clearly unrelated advertising into non-taxable revenue through the alchemy of the corporate sponsorship exclusion; and if the institution carefully avoids related personal services, renting a stadium for a rock concert becomes exempt real estate rental. Other commentators have eloquently stated the futility of “enforcement” with respect to expense allocation as long as the standard is allocation in any “reasonable manner.”<sup>95</sup>

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<sup>90</sup> 1.513-1(d)(iv) Example 5.

<sup>91</sup> See text at notes 21-24, *supra* (general public tickets for football and performing arts concerts “substantially related” to educational mission of university, but not “commercial ice shows”).

<sup>92</sup> At the 2008 National Center on Philanthropy and the Law annual conference at NYU, I offered what I hoped was a somewhat amusing commentary on the difficulties of defining “relatedness” with the example of NYU buying and operating General Motors as a training activity for its business and law students (this was pre-GM bankruptcy; maybe NYU should have bought GM – its students might well have done a better job running GM than its own management). Though at the time I intended this example to be “out there,” looking back on it I wonder if my commentary might have been more accurate than I thought.

<sup>93</sup> HILL AND MANCINO, *supra* note 8, at ¶22.03[2].

<sup>94</sup> See text at notes 32-33, *supra*.

<sup>95</sup> See, e.g., Joseph J. Cordes and Burton A. Weisbrod, *Differential Taxation of Nonprofits and the Commercialization of Nonprofit Revenues in TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NONPROFIT SECTOR* (Burton Weisbrod, ed. 1998) (hereafter TO PROFIT OR NOT TO PROFIT) at 83, 97-100 (commenting on how current expense allocation rules permit “strategic” expense allocations by exempt organizations to reduce any tax due under the UBIT; Robert J. Yetman, *Tax-Motivated Expense Allocations by*

Even the IRS's most successful attack of using profit motive to disallow losses from perennial loss activities may be a hollow victory. The strategy relies in large part on a combination of the profit motive requirement of a trade or business and the special UBIT provision permitting fragmenting of revenue streams for separate UBIT analysis. If these loss activities are strategically paired with revenue-producers in a separate for-profit subsidiary (which, if the pairing is really good, will produce exactly \$1 of overall profit every year), the disallowance strategy may disappear: there is no "fragmentation" analog to the trade or business definition for regular for-profit corporate enterprises,<sup>96</sup> and long-standing exemption doctrine tells us that a for-profit subsidiary will be analyzed for tax purposes as an insulated stand-alone entity.<sup>97</sup>

For all these reasons, committing additional resources to enforcement of existing UBIT rules would seem pretty much useless. This observation, in turn, raises the ultimate question: should we leave "well enough alone" with respect to the UBIT, or should we embark on some more radical reformation or even complete repeal?

*B. Reform or Repeal: Identifying Policy Concerns with Business Activity by Charities*

Reforming the UBIT is an almost perennial subject. Congress has held multiple hearings on the topic over the past 25 years,<sup>98</sup> and yet mostly nothing happens, with reforms limited

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*Nonprofit Organizations*, 76 Acct. Rev. 297 (suggesting that nonprofit hospitals and educational institutions, in particular, engage in "creative" expense allocation to reduced unrelated business taxable income).

<sup>96</sup> The general rule that a trade or business must be a "for-profit" activity certainly applies to C corporations, but there is no authority for the IRS to "fragment" the operations of an overall business in a regular corporation in order to apply a loss-disallowance strategy. There are myriad examples of C corporations that show tax losses for many, many years, racking up huge net operating loss carryforwards, without IRS interference (General Motors, General Electric are two that come immediately to mind).

<sup>97</sup> The "corporate separate-identity" rule resulted from *Moline Properties v. Comm'r*, 319 U.S. 436 (1943) where the Supreme Court held that the tax system must respect the separate identity of a corporate entity formed for a valid business reason. The IRS then applied the corporate separate-identity doctrine in the tax exemption sphere in GCM 39326 (Jan. 17, 1985) and PLR 8706012 (Oct. 31, 1986) holding that activities of a for-profit subsidiary would not be imputed to an exempt parent, even where the entire board of the subsidiary was made up of directors and employees of the exempt parent. *See generally*, John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 William & Mary L. Rev. 489, 514-516 (2002).

My thanks to Bonnie Brier, NYU's General Counsel, for pointing out that the separate corporation strategy may be limited by exempt bond financing requirements, which in turn limit the ability to conduct unrelated business activities in bond-financed facilities. Still, one suspects that some creative reorganization could be employed to minimize the effect of the IRS's "hobby loss" strategy.

<sup>98</sup> The most extensive of the recent hearings were the "Pickle" hearings conducted by the Oversight Subcommittee of the House Ways and Means Committee in 1987 and 1988. For commentary on the proposals discussed at the time, see Ellen P. Aprill, *Lessons from the UBIT Debate*, 43 Tax Notes 1105 (1989);

to a handful of “around the edges” changes.<sup>99</sup> Aside from political inertia, which certainly plays a major role in maintaining the status quo, another major stumbling block to considering reform of the UBIT is that, like exemption itself, we have no clearly-agreed upon rationale for why the UBIT exists. Without such a rationale, the discussion of systematic reform is useless. This section of the paper, therefore, discusses what might be plausible policy concerns for the UBIT, and then suggests how those rationales might underlay reform efforts.<sup>100</sup>

### 1. “Unfair Competition”

Unfair competition, in particular, was a major theme that led to the enactment of the UBIT in 1950.<sup>101</sup> But we should recognize a difference between “unwanted” competition and “unfair” competition. Any time a charity competes in the marketplace with a for-profit provider, such competition might be unwanted; small businesses, in particular, often are the most vocal adherents to the notion that any competition by an exempt organization is necessarily bad.<sup>102</sup> The issue is not competition *per se*, however; rather, “unfair” competition presupposes that the exempt organization is somehow unfairly using the economic benefits of exemption to subsidize its commercial activities. An example would be a sort of “predatory pricing” in which an exempt organization prices its product below

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A.L. Spitzer, *Reform of the UBIT: An Open Letter to Congress*, 40 *Tax Notes* 195 (1989). The Oversight Subcommittee had its eyes on the UBIT again as recently as July 25, 2012 (testimony and transcript available at <http://waysandmeans.house.gov/calendar/eventsingle.aspx?EventID=303617>)

<sup>99</sup> For example, in the Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780, Congress amended Section 512(b)(13) (which required certain payments from controlled subsidiaries to be included in UBIT even if they were payments otherwise exempt, such as interest) to permit such payments to be excluded if they were at fair market value. For an explanation of Section 512(b)(13), see HILL AND MANCINO, *supra* note 8, at 23.09.

<sup>100</sup> Much of the material that follows in this section is adapted or copied from John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 *WM. & MARY L. REV.* 487 (2002) and John D. Colombo, *Reforming Internal Revenue Code Provisions on Commercial Activity by Charities*, 76 *FORDHAM L. REV.* 667 (2007).

<sup>101</sup> See, e.g., H. Rep. No. 2319, 81<sup>st</sup> Cong., 2d Sess. 36 (1950); S. Rep. No. 2375, 81<sup>st</sup> Cong., 2d Sess., 28 (1950); Harvey P. Dale, “About the UBIT . . .” *NYU EIGHTEENTH CONFERENCE ON TAX PLANNING FOR 501(C)(3) ORGANIZATIONS*, Chapter 9 at page 9-7 (1990); Henry Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 *VA. L. REV.* 605, 613 (1989); Donald L. Sharpe, *Unfair Business Competition and the Tax on Income Destined for Charity: Forty-Six Years Later*, 3 *FLA. TAX REV.* 367, 385-86 (1996); Ethan G. Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 *EMORY L.J.* 1475, 1488-90 (2005).

<sup>102</sup> See Hansmann, *supra* note 101, at 605; Sharpe, *supra* note 101, at 450-51.

its competitors because it does not have to recoup the costs of taxation.<sup>103</sup> Less evil-sounding, but still of significant concern, is the possibility that an exempt organization will unfairly expand market share by using its tax savings to re-invest in its commercial activity, thus expanding the activity with a source of money (tax exemption) unavailable to for-profit competitors (who must pay taxes).<sup>104</sup>

If “unfair” competition is defined in these traditional terms (e.g., predatory pricing or subsidized market expansion), then there is a significant question whether unfair competition is a valid policy concern at all. In fact, legal academics and economists who have examined the issue have reached an almost remarkable consensus that “unfair” competition in the form of predatory pricing or predatory market expansion simply is not a serious policy concern.<sup>105</sup> As these commentators have observed, if one assumes that exempt organizations engage in direct commercial activities in order to capture the financial premium discussed above to cross-subsidize charitable activities, then there is no incentive for exempt organizations to cut prices in order to maximize market share - in fact, just the opposite is true.<sup>106</sup> Similarly, there is little incentive for these organizations to subsidize the expansion of commercial activities with the tax savings incurred by exemption; presumably, these funds also would be earmarked for expenditure on charitable activities.<sup>107</sup> Thus even though “unfair competition” has been cited as a primary rationale for enacting the UBIT, it in fact may not be a very serious policy concern in practice.<sup>108</sup>

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<sup>103</sup> See Hansmann, *supra* note 101, at 610.

<sup>104</sup> See Sharpe, *supra* note 101, at 385-89.

<sup>105</sup> See Boris I. Bittker & George W. Radhert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 316-26 (1976); Hansmann, *supra* note 101, at 613; William A. Klein, *Income Taxation and Legal Entities*, 20 UCLA L. REV. 13, 61-68 (1972); Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017 (1982); Richard Steinberg, “Unfair” Competition by Nonprofits and Tax Policy, 44 NAT’L TAX J. 351, (1991).

<sup>106</sup> See Hansmann, *supra* note 101, at 610-12; Klein, *supra* note 105 at 62; Rose-Ackerman, *supra* note 105, at 1024 (“Nonprofit firms engage in tax-exempt business activity to provide funds to subsidize their primary activities. Therefore they want to maximize expected profits.”); Steinberg, *supra* note 105, at n.7.

<sup>107</sup> See the sources cited in note 105, *supra*.

<sup>108</sup> Note that there may be economic distortions resulting from having exempt charities enter a market previously populated only by for-profit firms, and that because such exempt charities do not pay income taxes, they might find entry into a particular market cost-effective even if for-profit firms do not. This market entry could result in depressed prices as a result of oversupply and could result in bankruptcies of for-profit

That “unfair competition” is not, in fact, a serious justification for the UBIT also is evidence by the legislative history and the statute itself. The statute taxes “unrelated” business activities, not “unfairly competing” ones. In fact, whether a business activity competes *at all* with a for-profit is irrelevant to a determination of taxability.<sup>109</sup> Moreover, the related/unrelated test leaves a very large swath of “related” activities exempt from tax, even if they do compete (fairly or not) with for-profit providers.<sup>110</sup> Hospitals, for example, can sell pharmaceuticals and medical equipment to outpatients fully capable of patronizing a for-profit pharmacy without running afoul of the UBIT.<sup>111</sup> A bit of tax planning, moreover, can go a long way in converting what might look like an unrelated activity into a related one. To take a fanciful hypothetical, one suspects that if New York University’s law school implemented clinical legal education offerings relating to being corporate legal counsel and directly operated Mueller Macaroni as a clinical or externship placement vehicle for students, such a business would no longer be “unrelated” under the UBIT.<sup>112</sup>

An exhaustive review of the legislative history by Ethan Stone, moreover, confirms that “unfair competition” was not, in fact, an animating rationale for the passage of the UBIT in 1950.<sup>113</sup> Stone notes that the history leading to the passage of the UBIT was notable for the fact that complaints of unfair competition by for-profit businesses were essentially absent

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firms that would not occur in the absence of such entry. *See generally*, Rose-Ackerman, *supra* note 105, at 1026-30; Steinberg, *supra* note 105, at 356. I view this issue as an economic efficiency argument, however, and not a traditional “unfair competition” complaint since there is no predatory pricing or market expansion involved in these cases.

<sup>109</sup> Dale, *supra* note 105, at pp. 9-11 to 9-12.

<sup>110</sup> Hansmann, *supra* note 101, at 628-29; Sharpe, *supra* note 101, at 427-450.

<sup>111</sup> *See* Rev. Rul. 78-435, 1978-2 C.B. 181 (sales of hearing aids to outpatients not unrelated business); *see generally*, DOUGLAS M. MANCINO, TAXATION OF HOSPITALS AND HEALTH CARE ORGANIZATIONS, at pages 15-37 to 15-38 (2013); THOMAS K. HYATT & BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT HEALTHCARE ORGANIZATIONS 447-49 (2d ed. 2001).

<sup>112</sup> *Compare* Treas. Reg. Section 1.513-1(d)(4) (admission charges for performances by students of performing arts school not unrelated business income); Priv. Ltr. Rul. 7840072, 1978 PRL LEXIS 2452 (July 1978) (operation by college of professional repertory theater open to general public not unrelated income). As noted earlier in this paper, a few years ago I used the example of NYU buying and operating General Motors as a vehicle for training lawyers and MBAs. My suggestion came before GM’s bankruptcy; it may well have been the case that NYU’s students would have done better at running GM than its own board-elected management. The regulations do indicate that a factor in determining relatedness will be whether the activity is larger than it needs to be to accomplish its related purpose. Treas. Reg. 1.513-1(d)(3). If the purpose of a university MBA and/or law program is to train students in the operation of a large international business enterprise, then how large is too large?

<sup>113</sup> Stone, *supra* note 101.

(Stone’s “dog that didn’t bark”) and that Congress and Treasury both ignored the salient point that if unfair competition is the key concern, it is a concern of at least some passive income (dividends, interest, real estate rents and royalties) as well.<sup>114</sup>

In short, the legislative history provides little or no support for the notion that “unfair competition” was a motivating factor in the passage of the UBIT. More importantly for the purposes of this paper, there is little evidence to suggest that “unfair competition” in its classic sense *should* be an appropriate regulatory concern.

## 2. Protecting the Corporate Tax Base

Like “unfair competition,” protecting the corporate tax base was certainly an uttered rationale at the time of enacting the UBIT.<sup>115</sup> The tax base protection rationale has (at least) two strands. The first strand is the observation that without something like the UBIT, charities could earn premium rates of return on invested capital by purchasing and running a business directly, rather than purchasing stock as a passive investor. The existence of the corporate tax means that in corporate commercial enterprises, taxes are paid twice on an equity investment: once at the entity level at the corporate tax rate (currently a maximum of 35%) and then again as income from the corporate business is distributed to shareholders (at a current maximum rate of 20%). On the other hand, income from proprietorships or “pass-through” entities such as partnerships is taxed only once - at the individual tax rate. Similarly, because interest payments are deductible business expenses under Code Section 163, there is no corporate-level tax on the earnings a corporation uses to pay interest; thus an investor’s return on corporate debt effectively is taxed only once, at the individual level. The double-taxation on equity investment inherent in the corporate form means that the maximum tax rate on a dollar invested as equity in a corporate enterprise is roughly 48%, as opposed to the roughly 40% rate applicable to single-taxed investments. In order for corporate equity to be an attractive investment, therefore, a dollar invested in corporate equity must earn a higher rate of return pre-tax

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<sup>114</sup> *Id.* at 1495-1512.

<sup>115</sup> H.R. Rep. No. 2319, 81<sup>st</sup> Cong., 2d Sess. 39 (1950). *See* Stone, *supra* note 101 at 1491, n.55 and sources cited therein (suffice it to say that nearly every article written about the UBIT has noted this rationale); Dale, *supra* note 101, at page 9-5; Sharpe, *supra* note 101, at 393.

than a dollar invested in a similar-risk single-tax enterprise or in corporate bonds, so that after-tax returns are similar.<sup>116</sup>

If there were no corporate-level tax, then a charitable enterprise would have no financial incentive to engage in direct commercial activities over passive investments (other than in a case, discussed further below, where the charity has excess capacity from capital already expended to pursue their charitable mission – for example, an empty football stadium, or excess supercomputer time), because capital markets presumably would equalize investment returns on all capital.<sup>117</sup> But the existence of the corporate-level tax means that a nonprofit organization can “capture” a premium financial return (essentially the amount the capital markets require to equalize returns on capital in corporate and unincorporated businesses or between corporate equity and debt) if it can conduct a business directly and avoid the corporate tax that otherwise would be paid.<sup>118</sup> Exempt charities presumably would seek such premium returns in order to enhance the revenue available to spend on their charitable mission. As a result, our system currently can provide a substantial incentive for an exempt organization to operate a commercial

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<sup>116</sup> Assume, for example, that one can earn \$10 on a \$100 investment (10%) pre-tax on either an equity investment in a corporation (e.g., stock) or in a proprietorship. At the maximum tax rates currently in effect, the \$10 pre-tax return on the proprietorship results in approximately a \$6 (6%) return after-tax on that investment (the \$10 pre-tax return less the \$4 personal income tax due at our approximately-40% rate). But in the corporate investment, the \$10 pre-tax return is first reduced to \$6.50 by the corporate level tax; the shareholder then owes another 20% personal income tax on this \$6.50 (the current maximum rate on dividends), reducing the pre-tax return to \$5.20. Thus the 10% pre-tax return in the double-tax corporate world ends up as a 5.2% return (and this example illustrates that the effective tax rate on earnings relating to corporate equity is roughly 48%). Corporate businesses, therefore, presumably must earn a premium return on equity to attract investors - in my example, the corporate investment would need to return roughly \$11.54 (11.54%) in order to produce the same after-tax return as the proprietorship.

Because interest payments are deductions from taxable income under I.R.C. §163, no entity-level tax is paid on the income earned to make an interest payment to a corporate bond-holder. That is, a corporation that earns \$10 and pays it to an investor as interest has a \$10 deduction under §163, and therefore has zero taxable income and no tax liability. Thus a corporate bond, like an equity investment in a proprietorship or partnership, is a single-taxed investment and does not suffer from the double tax applied to corporate equity investments.

<sup>117</sup> See Cordes and Weisbrod, *supra* note 95, at 88-90.

<sup>118</sup> *Id.* See also Hansmann, *supra* note 101, at 610 (“The more compelling view . . . is that the corporate income tax does affect the cost of capital at the margin and that, everything else being equal, tax-exempt corporations have higher rates of return on investment than those of taxable firms.”). As noted below, Professor Michael Knoll opined in a 2007 article that the premium return to exempt charities is the result of corporate equity investors “devaluing” assets purchased with equity in C-corporation form because of the investor-level tax on dividends, not because of the corporate-level tax. Michael S. Knoll, *The UBIT: Leveling an Uneven Playing Field or Tilting a Level One?* 76 *FORDHAM L. REV.* 857 (2007).

enterprise directly, as opposed to simply being a passive investor, if the direct commercial activity would escape the corporate-level tax in the exempt organization's hands.

There is some evidence that this kind of activity was occurring prior to the enactment of the UBIT. Although Mueller Macaroni is the famous example of a charity (NYU) directly operating a corporate business,<sup>119</sup> commentators often fail to note that NYU was not just in the macaroni business: it “also owned a leather company, a piston ring factory, and a chinaware manufacturing operation. Other colleges and universities owned enterprises manufacturing automobile parts, cotton gins, and food products, and operated an airport, a street railway, a hydroelectric plant, and a radio station.”<sup>120</sup>

The second tax-base protection rationale was to avoid charities being used as accommodation partners in tax-shelter transactions, especially leasebacks and bootstrap acquisitions.<sup>121</sup> Again, anecdotal evidence of charities being used in these transactions abounded at the time of the enactment of the UBIT, but as Harvey Dale and others have observed, there was nothing special about charities' participation *per se* – the promoters of these transactions were simply looking for tax-indifferent accommodation parties to help convert nondeductible capital expenditures into deductible lease payments or ordinary income into capital gains.<sup>122</sup>

Unlike the unfair competition rationale, therefore, there is some reason to at least consider tax base protection as a viable regulatory rationale. Only one of the tax-base protection prongs, however (that dealing with avoidance of corporate income tax to create premium returns), is specifically applicable to charities; the tax-shelter issues are more universal concerns, and as Ethan Stone has noted, the UBIT arguably did little to specifically address these problems.<sup>123</sup>

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<sup>119</sup> Mueller Macaroni presumably led Rep. John Dingell to utter his famous comment during the UBIT floor debates that if something wasn't done about the issue “all the noodles produced in this country will be produced by corporations held or created by universities.” Hearings Before the House Committee On Ways and Means, 81<sup>st</sup> Cong., 2d Sess., 579-80 (1950). See FISHMAN & SCHWARZ, *supra* note 41, at 362.

<sup>120</sup> Rose-Ackermann, *supra* note 105, at 1017 n.2 (1982).

<sup>121</sup> Stone, *supra* note 101, at 513-518.

<sup>122</sup> Stone, *supra* note 101, at 519. See Dale, *supra* note 101, at 9-13 to 9-22 (calling for consideration of how organizations that are “exempt” from tax for reasons other than Section 501 fit into the UBIT rationales).

<sup>123</sup> *Id.*

### 3. Managerial Diversion

“Managerial diversion” refers to the concern that certain business activity by nonprofits is inherently bad because it diverts the attention of managers and resources away from the core charitable mission and core charitable outputs. The National Geographic Society’s restructuring in the early 2000’s may have resulted in greater emphasis on profitable activities such as cable television partnerships and documentary films at the expense of field research, for example.<sup>124</sup> A school that makes a decision to sell its services in the form of tuition charges runs the risk of pricing its target audience out of the market; museums and zoos with admission fees may do the same.<sup>125</sup> Another similar concern is that commercial activity will displace core values of “altruism, pluralism and community,”<sup>126</sup> and that charities will turn to a new set of managers who “may be equally likely as for-profit managers to cheat the consumer or donor with respect to output characteristics that are not readily observable. In effect, true nonprofits may be turned into ‘for-profits in disguise’ as a result of the managerial selection process . . . .”<sup>127</sup> Brian Galle nicely summarized the various issues surrounding managerial diversion in a somewhat different context (political activity by charities), and refers to problems of combining charitable activities with non-charitable ones in economic terms as “diseconomies of scope” – such combinations can dramatically increase agency costs and reduce the “warm glow” associated with charity, among other things.<sup>128</sup>

Another variation on the managerial diversion theme is the argument made by Ethan Stone that the UBIT was enacted largely to restrict charities to activities that historically had been considered “charitable” – that is, the UBIT was largely a political reaction to charities undertaking activities outside their traditional sphere.<sup>129</sup> In this account, the

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<sup>124</sup> Burton A. Weisbrod, *Conclusions and public-policy issues: Commercialism and the road ahead*, in TO PROFIT OR NOT TO PROFIT, *supra* note 95, at 294.

<sup>125</sup> *Id.* at 294-295.

<sup>126</sup> Janne Gallagher, *Peddling Products: The Need to Limit Commercial Behavior by Nonprofit Organizations*, 12 EXEMPT ORG. TAX REV. 1007, 1014 (1995).

<sup>127</sup> Estelle James, *Commercialism Among Nonprofits: Objectives, Opportunities and Constraints*, in TO PROFIT OR NOT TO PROFIT, *supra* note 95, at 271, 281.

<sup>128</sup> Brian Galle, *Charities in Politics: A Reappraisal*, 54 WM. & MARY L. REV. 1561, 1591-1607 (2013).

<sup>129</sup> Stone, *supra* note 101.

UBIT plays largely a “border patrol” role to insure that charities do not stray too far from traditional charitable activities, which could result in loss of political legitimacy for the charitable sector.

Whatever the underlying explanation, under the diversion rationale commercial activity should be minimized in order to keep charitable managers’ “eyes on the ball” of providing services corresponding to the core charitable mission. The further activities stray from the core charitable mission, the more likely that some set of “bad things” (economic inefficiency; a change in the core values of the organizations) will happen.

#### 4. Economic Efficiency

The final policy concern I will discuss in this iteration of my thoughts on the UBIT<sup>130</sup> is economic efficiency. Some aspects of economic efficiency overlap the managerial diversion concern noted above – that is, when nonprofit managers undertake activities outside their core charitable mission, efficiency suffers (Brian Galle’s “diseconomies of scope” observation noted above). But another set of efficiency issues center around whether an exempt charity’s operation of a commercial activity creates inefficiencies in the capital markets or in the distribution of goods and services that would result via competition by for-profits only or that would result by exempt nonprofits if they concentrated their resources solely on production of charitable outputs.

As explained above, the basic source of economic inefficiency in exempt charity/for-profit competition is the potential for an exempt charity to escape the corporate tax that otherwise would be levied on commercial activities in corporate form. It follows, therefore, that economists agree that the most economically efficient solution for dealing with commercial activity by nonprofits is simply to repeal the corporate income tax (thus ending the distortion in economic production resulting from the possibility of premium financial returns by nonprofits through exemption while at the same time eliminating all economic

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<sup>130</sup> I have in the past also discussed two additional concerns: (1) what I call “self-subsidization” – the ability of charities to fund themselves entirely through commercial businesses without relying on donations – and (2) the dangers posed to charitable assets from business activities conducted in the same business container. The former concern I have discussed extensively in my “donative” approach to tax exemption; because I think this self-subsidization issue really is more one of defining the scope of exemption than of business activity by charities, I leave this issue to that sphere. *See generally*, JOHN D. COLOMBO AND MARK A. HALL, *THE CHARITABLE TAX EXEMPTION* (Westview Press 1995); *see also*, Colombo, *Commercial Activity*, *supra* note 100 at 541-44. As for the second issue, we have insurance.

distortions resulting from the corporate income tax).<sup>131</sup> Faced with the reality of the corporate tax and the likelihood that it will be with us for quite some time, however, these same commentators are divided on how current rules (in particular, the UBIT) affect economic efficiency in the context of the existence of the tax and the existence of exemption for certain charities.

Writing in 1982, Susan Rose-Ackerman opined that economic efficiency supported repealing the UBIT.<sup>132</sup> She reasoned that in markets where costs of exit were high, for-profit firms could be harmed by unexpected competition from exempt firms entering the for-profit market and driving prices down as a result of increased supply.<sup>133</sup> In these cases, the high costs of exit would prohibit for-profit firms from liquidating their investment and moving to more profitable businesses, thus resulting in a certain level of economic harm to the for-profit investors.<sup>134</sup> Entry by exempt charities into commercial businesses was most likely where premium financial returns were available as a result of the charity escaping the corporate tax.<sup>135</sup> Because of the “related/unrelated” distinction in the UBIT, these premium financial returns were available to exempt charities only when commercial activities would pass the “related” test under the UBIT (and thus would be exempt from the corporate tax). As a result, the existence of the UBIT pressured charities to confine commercial activities to particular segments of the economy, rather than to spread those activities over the entire economy, with the result that specific for-profit firms that competed in “related” areas would suffer disproportionate financial harm under the current system.<sup>136</sup> Repealing the UBIT would permit charities to enter any commercial enterprise, thus “spreading” the potential harm across the entire economy and permitting the economy to operate more efficiently.

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<sup>131</sup> Steinberg, *supra* note 105, at 356. See Hansmann, *supra* note 101, at 618 (noting that “partial integration” of the corporate tax – essentially, a partial repeal of the tax – for corporations whose stock is held by exempt charities would eliminate some economic inefficiencies); Cordes & Weisbrod, *supra* note 95, at 88 (noting that a *neutral* tax on commercial profits would render an exempt charity indifferent to investing in direct commercial enterprises vs. passive investments).

<sup>132</sup> Rose-Ackerman, *supra* note 105.

<sup>133</sup> *Id.* at 1026-30.

<sup>134</sup> *Id.*

<sup>135</sup> *Id.* at 1027-28 n.32.

<sup>136</sup> *Id.* at 1038.

Henry Hansmann, however, argued that some tax on commercial activities was necessary to promote economic efficiency.<sup>137</sup> Hansmann noted that without such a tax, all corporate enterprises would be worth more in the hands of an exempt charity (which could avoid the corporate tax) than in the hands of private investors.<sup>138</sup> In order to capture these premium financial returns, therefore, charities would be tempted to invest their excess capital in a few directly-operated commercial enterprises rather than to spread their capital over the financial markets through passive investments.<sup>139</sup> This trend would lead to poor diversification of investments, managerial inefficiency (the diseconomies of scope argument noted above) and would pressure charities to save capital to invest in businesses rather than to spend capital on charitable outputs. In contrast, the existence of the UBIT helps channel charitable investments into those areas in which the charity is likely to enjoy economies of scope, thus enhancing efficiency.<sup>140</sup> Economist Richard Steinberg agreed that “exempting commercial activities from taxation when they are undertaken by the nonprofit but not the for-profit sector is clearly distortionary”<sup>141</sup> but as of 1991, at least, believed that the state of economic and empirical research on capital markets and entry/exit issues made any conclusions about the efficiency effects of the UBIT premature. More recently, Michael Knoll agreed that without the UBIT, nonprofits would enjoy a tax-induced financial advantage in acquiring assets held by high-bracket taxpayers in a corporate enterprise, though his analysis differs substantially from that of Hansmann.<sup>142</sup> Despite these disagreements, it appears that, like the issues of protecting the corporate tax base and avoiding managerial diversion, economic efficiency is a significant concern as a rationale underlying the UBIT, and the bulk of commentary seems to agree that some mechanism is

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<sup>137</sup> Hansmann, *supra* note 101.

<sup>138</sup> *Id.* at 682.

<sup>139</sup> *Id.* at 614-15.

<sup>140</sup> *Id.* at 626-33.

<sup>141</sup> Steinberg, *supra* note 105, at 356.

<sup>142</sup> Michael S. Knoll, *The UBIT: Leveling an Uneven Playing Field or Tilting a Level One?*, 76 *FORDHAM L. REV.* 857 (2007). Knoll’s analysis is that the tax advantage “arises because investors are overtaxed on such investments [e.g., assets financed by equity capital in C corporation form] and therefore devalue them.” *Id.* at 878. Knoll’s conclusion is that an equalizing tax is necessary but not the corporate-level tax assessed by the UBIT – rather, he concludes that the tax rate “should be set as the product of the individual tax on corporate income . . . and the share of such assets financed by equity . . .” *Id.* at 878-879. In other words, the distortion is caused by the investor-level tax on equity, not the corporate-level tax on corporate profits.

needed to avoid charities investing in business activities simply because tax rules can offer a premium rate of return in the appropriate circumstances.

### *C. Relating Policy Concerns to Types of Business Activity*

If one discards “unfair competition” as a viable rationale for the UBIT, then the question remaining is what to do about the three remaining policy concerns. At this juncture, therefore, it may be helpful to examine the various kinds of commercial activity undertaken by charities and connect those to the policy concerns of protecting the corporate tax base, avoiding excessive managerial diversion, and promoting economic efficiency.

In a prior article, I developed what I called a “taxonomy of commercial activity,” classifying such activity into one of five categories: (1) commercial activity that is also the primary exempt activity; (2) commercial activity that is functionally related to the organization’s exempt purpose (e.g., “substantially related” activity under the UBIT); (3) “unrelated” commercial activity that exploits excess capacity; (4) “unrelated” commercial activity that does not exploit excess capacity but the revenues from the activity are directed to charitable outputs, and (5) “unrelated” commercial activity that becomes “empire building” for its own sake.<sup>143</sup> The Type 1 and 5 commercial activities more properly implicate the definition of exemption itself, rather than the taxability (or not) of commercial activities. The classic example of Type 1 activity is a nonprofit hospital, engaged in the activity of selling health care services for a fee, at prices virtually identical to for-profit hospitals in similar markets. There is little doubt that nonprofit hospitals are engaged in commercial activity; in this case, however, the specific commercial activity in which they are engaged has been approved (under the correct ancillary conditions)<sup>144</sup> as a primary charitable activity. Low-income housing partnerships are another example of a charitable organization engaging in a commercial enterprise (building and renting housing) as its primary charitable activity.

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<sup>143</sup> Colombo, *Reforming Internal Revenue Code Provisions*, *supra* note 100, at 682-87. The “empire building” concern is what led Treasury to propose an aggregation rule for determining whether a particular nonprofit had a “primary” charitable purpose in the Pickle hearings in the late 1980’s. See Evelyn Brody, *Business Activities of Nonprofit Organizations: Legal Boundary Problems*, in *NONPROFIT AND BUSINESS: A NEW WORLD OF INNOVATION AND ADAPTATION* 32-33 (Joseph J. Cordes and C. Eugene Steuele, eds. 2008).

<sup>144</sup> See, e.g., *IHC Health Plans, Inc. v. Comm’r*, 325 F.3d 1188 (2003); John D. Colombo, *The Failure of Community Benefit*, 15 *HEALTH MATRIX* 29, 30-37 (2005).

The only regulatory decision facing Type 1 activity is whether it should be exempt or not. We have chosen in some circumstances to provide exemption even when an organization is engaged in a primary activity that is commercial, and that policy decision is outside the scope of the UBIT. With respect to Type 5 activity, again the question is largely whether the organization in question is “primarily” pursuing a charitable purpose or has instead evolved primarily into a commercial organization. This question is within the domain of the “commerciality” limitation on exemption, which though related to the UBIT, performs a different function: denying exemption (or not) rather than taxing revenues from activities.<sup>145</sup>

Type 2, 3 and 4 activities, however, do not necessarily implicate underlying tax-exempt status. The question with these activities is how they interact with the policy concerns of protecting the corporate tax base, avoiding managerial diversion and promoting economic efficiency and whether there is a better path for dealing with these policy concerns than the current UBIT.

In general, Type 2 activity (a commercial activity that would be “substantially related” under current UBIT standards) might be a concern for tax-base erosion, but little else. Since the activities are functionally related to the exempt purpose they bear little risk of managerial diversion (after all, management is engaging in these activities as an integral part of their exempt activities). Moreover, as Hansmann has noted, these activities raise few, if any, economic efficiency problems since one would assume these activities involve some kind of economies of scope (e.g., the capital asset has already been purchased or employees are already trained to do these activities).<sup>146</sup> For example, one would expect that the music school that puts on concerts by for-profit groups already has personnel experienced in concert planning and execution.

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<sup>145</sup> For an example of a Type 5 situation, see Tech. Adv. Mem. 200437040, 2004 P.L.R. LEXIS 612, \*25-\*26 (June 7, 2004). This memorandum dealt with an exempt church that owned a for-profit subsidiary engaged in extensive and growing commercial activities. The IRS cautioned the exempt parent that it “cannot be allowed to focus its energies on expanding its subsidiary’s commercial business and assets, and neglect to translate that financial success into specific, definite and feasible plans for the expansion of its charitable religious activities.”

<sup>146</sup> Hansmann, *supra* note 101 at 626-28.

A similar conclusion surrounds Type 3 activities. The classic examples here are a university renting its stadium facilities to a professional football team for the summer or leasing unused supercomputer time to for-profit research groups.<sup>147</sup> In this kind of case, we seemingly should not penalize charities for attempting to get a financial return on temporarily “fallow” assets. There may be some concern that we not encourage charities to consciously “over-invest” in capital facilities or in employees simply to use them in commercial businesses, but to the extent that investments are made at a level necessary to conduct charitable activities, earning a profit through maximum utilization of that investment would seem to be a desirable and efficient outcome. Moreover, if the capital investment is made in the first instance to pursue charitable activities, there is little reason to think that there is much risk to the corporate tax base (since the activities for which the investment was made likely would not have been undertaken by the private market). Managerial diversion also would be limited, because if the capital assets used in the commercial activity were primarily meant for charitable purposes, any commercial activity by definition will be subordinate to charitable use. For example, the empty athletic stadium is only available to rent when the university’s teams are not using it – generally, this means the summer only. Ditto for the unused supercomputer time – commercial use will by necessity be subordinate to academic use.

Type 4 activity would appear to be the major concern. On the one hand, it seems that we should not unduly impede the ability of charities to develop alternative resources to expand charitable outputs. Other commentators have noted the modern pressures on funding sources for charities;<sup>148</sup> if investing wisely in certain commercial activities produces revenue to expand charitable outputs, that seems as though it would be a generally good thing. Yet there are some countervailing concerns. Unlike category 2 or 3 activities, those in category 4 are far more likely to result in managerial diversion, since the commercial activity is not subordinate to any charitable use of the underlying assets. The church that runs a Starbucks to supplement the collection plate will almost certainly need to invest significant managerial time in running the Starbucks, and running a Starbucks

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<sup>147</sup> See *id.* at 627, 628.

<sup>148</sup> See Burton A. Weisbrod, *The Nonprofit Mission and Its Financing: Growing Links Between Nonprofits and the Rest of the Economy*, in *TO PROFIT OR NOT TO PROFIT*, *supra* note 95, at 1-7.

would (one hopes) have very little in common with running a church. Category 4 activities also raise the largest questions of protecting the corporate tax base and economic efficiency. These activities are, in fact, at the core of Hansmann's concern that without the UBIT, nonprofit managers would be engaged in activities for which they have little expertise.

*D. Potential Responses to Policy Concerns*

1. Do Nothing

The above discussion indicates that there are three reasonable policy concerns with charities engaging in business activities (protecting the corporate tax base, managerial diversion and economic efficiency) and that these policy concerns are most acute in Type 4 business activity: activities that would be "unrelated" in the current statutory scheme and do not involve exploitation of excess capacity or already-developed expertise. The next question is whether we should "do" anything with the UBIT in light of the above discussion.

One perfectly reasonable response is to do nothing. The UBIT itself already addresses each of the policy concerns to some degree. Indeed, as noted above, Henry Hansmann argued in favor of the UBIT in something like its present form as promoting economic efficiency. By granting tax-favored status only to "related" activities, the UBIT also encourages management not to stray too far from core charitable activities, thereby addressing the managerial diversion concern. Finally, history supports the notion that the UBIT has had at least some effect in protecting the corporate tax base: NYU no longer owns a piston-ring manufacturing company alongside Mueller Macaroni, and indeed appears to have abandoned its business acquisition binge upon the enactment of the UBIT. There certainly are advantages to leaving things alone, not the least of which would be predictability and certainty: tax-exempt charities have had some sixty years to more or less unravel the UBIT rules, and significant (if imperfect) compliance regimes have been built on this sixty years' worth of knowledge.

Nevertheless, the IRS compliance project does indicate significant compliance problems, particularly with the dividing line between related/unrelated in areas where universities appear to be engaged in Type 3 activities: "unrelated" uses of already invested capital, such as golf course revenue, alumni travel programs, athletic facility memberships for faculty, staff and community members, and rock concerts, ice shows and similar events

at stadiums. In addition, allocation of overhead expenses and offsetting losses from activities that had never produced a profit were other areas of concern. Clearly, the rules are complex and compliance is difficult, so perhaps one could imagine improvement.

## 2. A “Commerciality” Tax

For the past several years, I have favored dealing with the underlying policy issues by expanding the UBIT to cover all commercial activities, related or not. My rationale for this has been as follows. Taxing all commercial activities obviously would more completely protect the corporate tax base than the current system, since no commercial activity (even if it is “related”) would escape taxation. Second, taxing all commercial activity would promote economic efficiency, because charities could not earn a premium rate of return on a particular activity simply by classifying it as “related” and thereby avoiding the income tax that would otherwise be due. Under this proposed system, a charity presumably would choose to invest in a direct commercial activity only if the after-tax rate of return it could earn would be greater than the market rate on a diversified portfolio of investment assets – that is, the charity would have to make a decision that it could earn a premium rate of return by efficient operation of the commercial enterprise, and not just by avoiding taxes.<sup>149</sup> It is likely, therefore, that if all commercial activity were taxed, charities would concentrate on commercial activities for which they enjoy significant economies of scope with respect to either capital investments or employees or which had some other kind of synergy with their charitable programs, which in turn would also help curb empire-building tendencies and avoid managerial diversion issues.<sup>150</sup> At the same time, if these synergies exist, there is little reason to believe that a commercial activity tax would deter charities from undertaking activities for which they have clear economies of scope and can

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<sup>149</sup> See Hansmann, *supra* note 101, at 627. Taxing all commercial activity also should satisfy Susan Rose-Ackerman’s concern that the current system distorts economic activity by encouraging nonprofits to invest more in related than unrelated activity. Rose-Ackerman, *supra* note 105. As noted above, Rose-Ackerman suggested getting rid of the UBIT because of this distortion, but subjecting all commercial activity to tax should also eliminate this problem.

<sup>150</sup> See, e.g., Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 TENN. L. REV. 687, 733 (1999). Cordes and Weisbrod, however, theorized that differential taxation might help efficiency by giving charities “an excuse” to engage in activities that would take advantage of economies of scope but might otherwise be forgone “because of nonprofits’ aversion to profit-making activities.” Cordes and Weisbrod, *supra* note 95, at 100.

earn premium returns as a result of exploiting their expertise or excess capacity. As a former professor once told me, “until tax rates get to 100%, take the money.”

A “commercial activity tax” also would be simpler. I am fully cognizant that at some level, a commercial activity test replaces one definitional problem (what is “substantially related”) with another (what is “commercial”), but I continue to believe that defining when an activity is commercial is inherently easier and somewhat more precise than defining “substantially related.”<sup>151</sup> This, in turn, would curb the possibility that charities exploit the “substantially related” test to acquire commercial activities that they place in the related category to avoid taxation. In fact, the IRS report indicated that some of this behavior exists, given that one of its major audit adjustments was reclassifying activities from “related” to “unrelated.” The simplification would extend to a repeal of many of the exceptions to the current UBIT; since I would tax all commercial activities, I also would jettison the “convenience” exception, the corporate sponsorship exception, the exception for real estate rents (traditionally regarded as a “trade or business” under Section 162, rather than an investment activity under Section 212) and the exception for royalty income (which involves commercial exploitation of property rights). I also believe that an expanded commercial activity tax would reduce the opportunities for creative expense allocations, though again I freely admit that some amount of this would continue as long as “charitable” overhead is allocable in part to noncharitable activities.<sup>152</sup> On the other side of the coin, however, I would also repeal the fragmentation rule; taxation would be on the basis of integrated trade or business activities, just as it is in the for-profit corporate world, though I would leave in place the IRS’s ability to use the current doctrine of requiring a business to be “for-profit” in order to get applicable business expense deductions.

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<sup>151</sup> See, e.g., Colombo, *Commercial Activity*, supra note 100, at 559-562. See also, Brody, supra note 150, at 733 (“[E]xtending the definition of “business” to nonprofit activities related to an organization’s exempt purpose would simplify the law, but not necessarily increase tax revenues.”).

<sup>152</sup> See, e.g., Brody, supra note 150, at 703; Cordes and Weisbrod, supra note 95, at 97-100; Yetman, supra note 95. The reason that a broader commerciality tax would be simpler on this front is that it would eliminate the game of classifying money-losing activities as “unrelated” and money-making ones as “related” and thus require spreading overhead costs evenly across all commercial activities. Nevertheless, “aggressive” allocations of overhead undoubtedly would continue as long as such allocations are permitted at all. We could, of course, ban overhead allocation; the UBIT hearings in the late 1980’s did consider restricting allocation of expenses for “dual use” assets. See Brody, supra, at 703 n.58. Professor Rich Schmalbeck noted in his own conference presentation that the IRS could adopt a “marginal cost” rule for expense allocations via new regulations, which also would seriously restrict creative overhead allocations.

In the university context, this proposal would not mean taxing tuition revenue, at least not at this time.<sup>153</sup> It would mean taxing revenue from football/basketball ticket sales and TV/radio contracts, from public concerts scheduled by the performing arts center, from sales of memberships in athletic facilities and fees to use golf courses (regardless whether the use is by faculty, staff or students), revenue from joint venture exploitation of intellectual property with for-profit partners and so forth. Whether this system would actually result additional tax revenues (or, viewed from the opposite perspective, a decrease in revenues to the university after taxes) depends on facts I do not have, particularly the profitability of these activities to individual universities. My gut reaction is that revenues would largely be unaffected by a commercial activity tax; athletic programs, for example, are notorious money-losers,<sup>154</sup> and it is unlikely that subjecting ticket sales to a commercial activity tax would actually result in additional tax revenue or from the opposite perspective, any decline in revenues available after-tax to the university.<sup>155</sup> Revenue, however, is not the goal, and is probably a futile proposition with any form of UBIT; rather, it is furthering the other public policy concerns outlined above.

### 3. Or How About Outright Repeal?

The third possible reaction would be the outright repeal of the UBIT. The case for repeal is straightforward and given the findings of the IRS compliance project, surprisingly strong. The case starts with the observation above that the only commercial activity we should be very concerned about controlling through some UBIT-like vehicle (as opposed to

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<sup>153</sup> I have previously explained that I would define “commercial” by determining whether the activity was one that competes with for-profit firms providing essentially the same good or service. Colombo, *Commercial Activity*, *supra* note 100 at 560-61. While there are certainly a few for-profit universities out there, I do not believe that one can reasonably conclude (yet) that education services of the kind provided by exempt colleges and universities are widely available from for-profit firms. *Id.* That day may come – for example, I would conclude just the opposite with respect to nonprofit hospitals’ revenues from patient services. On the other hand, ticket revenue from athletic events does not differ substantially from ticket revenue earned by pro teams; indeed, in many markets college football/basketball competes directly with pro teams for customers, and fans often debate whether the college or pro “product” is more entertaining. *See, e.g.,* Gregg Doyel, *College football is better than NFL, and it’s not even close*, CBS Sports.com, available at <http://www.cbssports.com/collegefootball/story/15274851/college-football-is-better-than-nfl-and-its-not-even-close>.

<sup>154</sup> *See* John D. Colombo, *The NCAA, Tax Exemption and College Athletics*, 2010 U. Ill. L. Rev. 109, 143-145.

<sup>155</sup> *See also*, Brody, *supra* note 150 at 733 (“ . . . extending the definition of “business” to nonprofit activities related to an organization’s exempt purpose would simplify the law, but not necessarily increase tax revenues.”)

controlling through revocation of exemption for, e.g., Type 5 activity) is the Type 4 activity: an “unrelated” activity *that also does not involve exploitation of excess capacity or other economies of scope*. That observation alone indicates that the UBIT is unnecessarily broad, capturing both Type 3 and Type 4 activity in its bounds. That overbreadth could be justified in the same way I have previously justified an even broader commerciality tax – as further supporting the corporate tax base – but there is little other justification in the UBIT as it exists (as opposed to the additional simplification justification of a broader commerciality tax). The case for repeal, therefore, boils down to this: is there any reason to assume that absent the UBIT, Type 4 commercial activity would suddenly explode? Or put another way, can we imagine that mechanisms other than tax law might be serve as a significant deterrent to increases in Type 4 activity without the UBIT?

I start the answer to these questions with the observation that universities do not seem to be engaged in many Type 4 activities today. The interim compliance project report<sup>156</sup> contains data on the various kinds of UBIT activities universities engage in; virtually all of these activities involved exploitation of existing capital. Perhaps the closest thing to a Type 4 activity reported was the operation of a hotel (25% of large institutions reported operating a hotel, as opposed to 3% of small institutions),<sup>157</sup> although even here one could argue that universities are exploiting economies of scope since many already have extensive food-service and “room-rental” experience from campus student dormitories. Travel tours also seemed popular, with 35% of large institutions reporting such activities.<sup>158</sup> Twenty-two percent of large institutions also reported “partnership allocations” which could include Type 4 activities, but the report lacked detail on the kinds of activities occurring in these partnerships.<sup>159</sup> The nearly-universal activities reported seemed to fall more in the Type 2 or Type 3 categories: food service (likely for faculty, staff and students); facility and arena rentals; advertising and parking lots, for example.<sup>160</sup>

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<sup>156</sup> Internal Revenue Service, *IRS Exempt Organizations College and Universities Compliance Project Interim Report* (May 7, 2010), available at [http://www.irs.gov/pub/irs-tege/cucp\\_interimrpt\\_052010.pdf](http://www.irs.gov/pub/irs-tege/cucp_interimrpt_052010.pdf)

<sup>157</sup> *Id.* at 30.

<sup>158</sup> *Id.*

<sup>159</sup> *Id.*

<sup>160</sup> *Id.*

Of course, one might conclude that the absence of Type 4 activity is a testament to the effectiveness of the UBIT in channeling activities into the Type 2 and Type 3 categories. The UBIT, however, has not kept churches from exploiting Type 4 activities (the church-owned Starbucks or athletic facility),<sup>161</sup> nor has it kept charities from involvement in abusive tax shelter transactions that caught the eye of the Congress in 2005.<sup>162</sup> Instead, there are reasons to believe that particularly in today's internet-connected world with public disclosure of Forms 990T, charities would not rush to Type 4 activities if the UBIT were repealed. First, there are many practical limits to exempt charities taking over corporate America. The largest, of course, is the nondistribution constraint<sup>163</sup> that effectively bars nonprofits from access to public equity markets. Without that access, the notion that charities will begin a wholesale takeover of for-profit businesses seems far-fetched. Beyond capital access, entrepreneurs will continue to adopt for-profit business forms that can easily and legally accommodate cashing in on the entrepreneurial profit; if there is serious money to be made, it likely will not be made in nonprofit form. If nothing else, we can surely count on good old greed to limit nonprofit excursions into the for-profit world.

Second, there is the possibility that enhanced disclosure of commercial activity, coupled with the modern world of internet-based communications that can keep donors apprised of every financial move made by a charity, will help control any tendencies of nonprofit managers to go on a corporate-business buying binge. Over twenty years ago, Mark Hall and I theorized that a "market in altruism" would work to control excessive unrelated business activity in a system where exemption was based on donation levels because donors would adjust donations in light of other revenue sources and perceived need.<sup>164</sup>

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<sup>161</sup> See, e.g., Elizabeth Bernstein, *Holy Frappuccino!*, Wall St. J., Aug. 31, 2001 at W1.

<sup>162</sup> See, e.g., Stephanie Strom, *Official Cites Tax Abuses with Charities*, New York Times, April 6, 2005, available at [http://www.nytimes.com/2005/04/06/national/06charity.html?\\_r=0](http://www.nytimes.com/2005/04/06/national/06charity.html?_r=0). The Tax Increase Prevention and Reconciliation Act of 2005 increased penalties on tax-exempt organizations involved in tax shelters as accommodation parties.

<sup>163</sup> The "nondistribution constraint" is a phrase coined by Henry Hansmann to describe the fact that charitable organizations cannot have equity owners that receive a distribution of net surplus from the charitable entity. See, e.g., Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835. This in turn means that charities cannot sell stock (equity ownership interests) or otherwise solicit equity investments. Capital formation in a charitable enterprise is limited to retained earnings and donations.

<sup>164</sup> John D. Colombo and Mark A. Hall, *THE CHARITABLE TAX EXEMPTION* 128-129, 175-179 (1995).

Empirical and anecdotal evidence suggests that nonprofit managers do, in fact, worry about how commercial activity impacts both the “halo effect” and their own donor base.<sup>165</sup> While there is legitimate reason to believe that “disclosure overload” may desensitize donors or other important constituencies to commercial behavior by charities, there is also at least anecdotal evidence that charities care very much about such disclosures and their potential impact. A good recent example is the pushback from charities regarding disclosures of fundraising expenses and “overhead” as a percentage of charitable expenditures, reported in the Tampa Bay Times “America’s Worst Charities” investigation.<sup>166</sup> Far from shrugging their shoulders, the charitable world responded immediately and vociferously, no doubt extremely worried about the effects of the story on charitable giving overall (and to specific charities with high fundraising costs).<sup>167</sup> One certainly could conceive of a “commercial activity disclosure” form attached to the Form 990 (if the UBIT is repealed, of course, Form 990T goes away) that would be part of the internet disclosure sites such as Guidestar and Charity Navigator.

Accordingly, it is possible to believe that mechanisms external to the existence of the UBIT would be at least as effective at controlling Type 4 commercial activity as the UBIT. Of course, we will never really know until we try it, but repeal is the ultimate simplification.<sup>168</sup>

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<sup>165</sup> See generally, Burton A. Weisbrod, *Modeling the Nonprofit Organization as a Multiproduct Firm: A Framework for Choice*, in *TO PROFIT OR NOT TO PROFIT*, *supra* note 95, at 47, 55-59.

<sup>166</sup> Kris Hundley and Kendall Taggart, *America’s Worst Charities*, Tampa Bay Times, June 6, 2013, available at <http://www.tampabay.com/topics/specials/worst-charities1.page>.

<sup>167</sup> Not even two weeks after the Tampa Bay Times story ran, the chief executives of BBB Wise Giving Alliance, Charity Navigator and GuideStar authored an open letter criticizing what they called “The Overhead Myth” and launched a web site called “The Overhead Myth” to counter the story. See <http://overheadmyth.com>; *BBB Wise Giving Alliance, Charity Navigator and GuideStar Join Forces to Dispel the Charity “Overhead Myth,”* available at <http://www.guidestar.org/rxa/news/news-releases/2013/2013-06-17-overhead-myth.aspx>. See also, Nader Salass, “America’s Worst Charities” List Criticized by The Association Of Fundraising Professionals, The Huffington Post, June 17, 2013, available at [http://www.huffingtonpost.com/2013/06/17/americas-worst-charities-list\\_n\\_3454652.html](http://www.huffingtonpost.com/2013/06/17/americas-worst-charities-list_n_3454652.html).

<sup>168</sup> It would be possible to do what Congress did in 1986 with the capital gains provisions: leave the statutory provisions intact despite a technical “repeal,” ready to be reinstated if the world truly does come crashing down. Such a strategy, of course, may signal that the “repeal” is not really a repeal, and therefore itself serve as a deterrent to additional investment in commercial enterprises by charities, which presumably would be all for the better anyway.

#### **IV. Summary**

The IRS college and university compliance project in my view offered few surprises with respect to the UBIT in its current form. Given the inherent lack of definition in nearly all the operational concepts underlying the UBIT, one would expect controversies in categorization of activities as related vs. unrelated and expense allocation strategies. The real surprise is that the compliance project presents (for me, at least) a significantly strong case for repealing the UBIT entirely, or at least suspending it for a time. Despite its obvious pride in the adjustments uncovered by the audits, the report actually shows almost conclusively that emphasizing enforcement is not cost-effective. The existence of the UBIT, moreover, has not deterred universities from “commercializing” their operations over the past few decades; yet according to the IRS report data, that commercialization remains largely confined to areas where universities have economies of scope. One might argue that the UBIT has prevented more egregious commercialization (e.g., what I identify above at “Type 4” activity), but some evidence exists to believe that external publicity and managerial concern about “image” have restrained commercial activity as much as or more than the UBIT, and that a disclosure regime could be used as an effective deterrent to excessive commercialization in the future. Though I continue to believe that an expanded commerciality tax is the better theoretical route when discussing significant reform of the UBIT, ultimately the question of how much commercial activity we should tolerate in the tax-exemption regime is one that should be dealt with in the context of underlying exempt status. Meanwhile, if an expanded commerciality tax is untenable politically and if the policy concerns that might directly implicate a UBIT-like mechanism might also be resolved through external constraints such as disclosure and publicity through the Internet, then the UBIT may well be something whose time has gone.