

# Devolution's Discord: Resolving Operational Dissonance with the UBIT Exemption

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## I. INTRODUCTION

In 1997, the regional unemployment rate in Newport News, Virginia, was 4.2%, a strong sign of economic stability. Nevertheless, the region reported a second stunning figure during the same period: a 69% increase in requests for food assistance during one twelve-month period.<sup>1</sup> In Macon, Georgia, the reported increase hovered at a little under 40%; in Greeley, Colorado, 50%.<sup>2</sup> Publicly distributed food from the government fell from 22.2% to 13.4% between 1991 and 1997, leaving the private sector and hungry families to fill a shortfall of 24.5 billion pounds of food in the next six years.<sup>3</sup> The burgeoning food insecurity of the working poor can be linked directly to recent changes in social welfare policies.<sup>4</sup> The conservative parsimony in funding social welfare in the 1990s has fed the growing hunger for charitable services;<sup>5</sup> the trend, however, is not new.<sup>6</sup> Beginning in the early 1980s, the federal government began to retreat from directly funding anti-poverty programs.<sup>7</sup> Instead, government policies called for an aggressive combination of state, local, and charitable deliveries. New policies minimized federal involvement in social

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1. Elaine Rivera, *Hungry at the Feast: In Spite of Prosperity and Job Growth, a New Study Warns of a Festering Crisis Among the Working Poor*, TIME, July 21, 1997, at 38.

2. *See id.*

3. *See id.*

4. *See id.*; *see also infra* Part II.

5. For the purposes of this Note, charities are only those organizations primarily dedicated to providing subsistence, housing, and related services to the poor.

6. *See generally* THE REAGAN PRESIDENCY AND THE GOVERNING OF AMERICA (Lester M. Salamon & Michael S. Lund eds., 1984) (discussing the effect of Reagan's budget policies on social services and nonprofit organizations); Constance Casey, *Who Will Help the Helpers? Charity May Begin at Home but Not in the House Under Newt Gingrich*, S.F. EXAMINER, Jan. 22, 1995, at A4 (referring to a Gingrich statement calling on nonprofits to aid those hurt by welfare reform and the lack of federal funding for charitable organizations); Milt Freudheim, *Charities Aiding Poor Fear Loss of Government Subsidies*, N.Y. TIMES, Feb. 2, 1996, at B8 (discussing various state and local charities that have lost grants and subsidies).

7. *See* ALAN J. ABRAMSON & LESTER M. SALAMON, THE NONPROFIT SECTOR AND THE NEW FEDERAL BUDGET 23-53 (1986).

services and devolved poverty assistance to state and local governments.<sup>8</sup> Devolution, traditionally a shift of services and resources to state and local governments, has an added dimension. Rather than a shift from government to government, the movement includes a transfer of responsibility from the federal government to private charities. This transfer of responsibility must be scrutinized. With devolution at its height, the greatest fear for charities is the impact of the crowning achievement of post-Reaganomics, the Personal Responsibilities Act of 1996 ("Welfare Reform Act").<sup>9</sup> The Welfare Reform Act<sup>10</sup> slashes \$504 billion from the national welfare budget through 2002.<sup>11</sup> When individuals lose government benefits, charities are the only institutional recourse for dislocated families and individuals.<sup>12</sup> Unlike social welfare programs of the past, the safety net no longer exists.<sup>13</sup>

For example, twenty-one million Americans requested emergency food help in 1997.<sup>14</sup> Thirty-one percent of the hungry reported a recent loss or reduction of Food Stamps, a federal food subsidy program.<sup>15</sup> For the homeless, the numbers show that an average of 20% of overall requests for shelter and 24% of requests by homeless families were denied

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8. See *id.* Although state and local governments will play a fundamental role in the new regime of funding poverty services, this Note will focus solely on the role of the federal government. The data on state responses are incomplete, but some states have begun to feel the impact of decreased funding. For example, Ohio chipped in \$1.5 million for food pantries in 1997, a first for the state. See Alice Thomas, *Pantries No Longer a Stop Gap*, COLUMBUS DISPATCH, Dec. 7, 1997, at B1.

9. Personal Responsibility and Work Opportunity Reconciliation Act of 1996, 42 U.S.C.A. §§ 601-609 (West Supp. 1999).

10. Although this Note refers to the Welfare Reform Act specifically, charities receive funding from several government sources. This Note focuses, however, on results of the Welfare Reform Act.

11. See *Increased Private Support for Public Assistance Programs: Hearings Regarding the Mutual Roles of Government and Churches in Providing Basic Human Services for Poor and Vulnerable Groups Before the Subcomm. on Children and Families of the Senate Labor Comm.*, 104th Cong. (1996) (statement of Rev. Fred Kammer, President of Catholic Charities) [hereinafter *Kammer Testimony*]. This figure includes Food Stamps, AFDC, EITC, Medicaid and across-the-board cuts in nondefense discretionary programs; it does not include cuts in housing programs or in Medicare.

12. See Personal Responsibility and Work Opportunity Reconciliation Act of 1996 §§ 601-609.

13. Under the Temporary Aid to Needy Families program, the living subsistence grant in the Welfare Reform Act, one member of each family on welfare is required to find employment within two years or lose benefits and lifetime benefits are limited to five years. See 42 U.S.C. § 608.

14. See Second Harvest, *Hunger 1997: The Faces and Facts, Executive Summary* (visited June 21, 1999) <<http://www.secondharvest.org/research/faces/section2.htm>>.

15. For a more thorough discussion of the anti-poverty programs of the 20th century, see JUDITH M. GUERON, *REFORMING WELFARE WITH WORK* (1987); H.P. MILLER, *POVERTY AMERICAN STYLE* (1966); J.T. PATTERSON, *AMERICA'S STRUGGLE AGAINST POVERTY, 1900-1980* (1981); R.D. PLOTNICK & F. SKIDMORE, *PROGRESS AGAINST POVERTY: A REVIEW OF THE 1964-1975 DECADE* (1975).

due to lack of resources.<sup>16</sup> To place those numbers in context, one must realize that an estimated 750,000 people are homeless on any given night.<sup>17</sup> For the agencies trying to service this population, it is impossible to miss the direct correlation between the increased demand for poverty relief services and the decline in federal welfare programs. When Congress cut \$23 billion from the Food Stamp program over five years, it allocated only \$100 million for food banks to take up the burden.<sup>18</sup> Charities also face an expanding need to provide emergency shelter and low-income housing.<sup>19</sup> Medical care to the poor, in light of the funding recisions in Medicaid, is a third area of grave concern.<sup>20</sup>

The WeFeed Food Bank is just one of the organizations charged with meeting these newest increases in the poor community.<sup>21</sup> Last year, its operating costs were \$89,000; its income from donations and grants totaled \$62,000, leaving a deficit of \$17,000. In addition, WeFeed turned away a number of families, recognizing that to provide services to them would cost an addition \$28,000. Organizations like WeFeed are tacitly and sometimes explicitly told to absorb these costs and serve the newest members of the poor community. Even more, they are exhorted to do so with decreases in funding—essentially, to find alternate sources of income.

These dueling commands effectively give birth to a peculiar relative of cognitive dissonance, one that this Note terms *operational dissonance*.<sup>22</sup> Cognitive dissonance is the “condition of conflict or anxiety resulting

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16. See UNITED STATES CONFERENCE OF MAYORS, A STATUS REPORT ON HUNGER AND HOMELESSNESS IN AMERICA'S CITIES: 1998 (1998).

17. National Law Center on Homelessness and Poverty, *Homelessness and Poverty in America* (visited Mar. 28, 1999) <<http://www.nlchp.org/htpusa.htm>>.

18. See David Sarasohn, *A Problem Eating at America*, NEWARK STAR LEDGER, Mar. 24, 1998, at A3.

19. The Department of Housing and Urban Development's budget lost \$11 billion between 1980 and 1995 and an additional \$5.2 billion in 1996. Between 1978 and 1991, housing needs for the poor increased by 1.1 million. See *Kammer Testimony*, *supra* note 11.

20. Medicaid, the federal medical assistance program for the indigent, faces sharp cuts. Because medical care for the poor is now the province of the states, estimated cuts in the number of qualified aid recipients range from twenty to thirty-five percent. Nonprofit hospitals, despite their tax status, tend to shun offering care to the poor, relegating care to charity clinics or mobile hospital units. See *id.*

21. WeFeed is a hypothetical food bank program designed to offer a cogent example of the crisis faced by charities. I will use WeFeed to demonstrate various economic principles of my argument.

22. As I define operational dissonance, the tension exists between the federal government's expectations of charities and its actions in promulgating tax policy. Cf. Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433, 467 (1996) (describing a form of institutional dissonance wherein a nonprofit “must accommodate the institutional expectations of its industry, its donors, its volunteers, its members, its beneficiaries, its clientele, its corporate sponsors, its government granting agencies and the taxpaying public. Inevitably, expectations conflict.”).

from inconsistency between one's beliefs and one's actions."<sup>23</sup> Operational dissonance describes the crisis arising from a tension between the federal government's expectations of charities and federal funding policies. We expect nonprofits to provide costly services to a rapidly expanding population and to pay for those services. Concomitantly, we establish policies that cut funding and preclude the generation of the tax-exempt income that would allow these organizations to meet our service expectations.<sup>24</sup>

To resolve operational dissonance, we must adjust either our expectations of charities or our actions towards them. One way of adjusting our actions would be through an exemption from the unrelated business income tax ("UBIT"). Although additional steps are needed to maximize charities' utility to society, such as an expansion of the tax incentives for lending to charities,<sup>25</sup> the passage of the charity tax credit,<sup>26</sup> and an increase in direct government subsidization,<sup>27</sup> this Note will focus solely on the effects of operational dissonance in our social services and the role of the UBIT exemption in resolving this dissonance.

Part II of this Note establishes the motive for targeting charities for exemption, rather than a broad-based exemption for all nonprofits. Section A explains operational dissonance in greater depth, detailing the mismatch of expectations and resources with regard to charities. Section B examines the distinct funding problems endemic to charitable organizations, and describes the inadequacy of the current tax breaks for charities: charitable deductions and the income exemption. Section C responds to these phenomena by redefining charity and proposing a qualification test.

Part III is devoted to a presentation of the UBIT exemption as a response to operational dissonance. Through the prism of the WeFeed hypothetical, this Part explores an alternative funding scheme for poverty-servicing charities. Section A outlines the UBIT exemption proposal as it relates to the current crisis. Section B describes the history of UBIT. Section C lays out the current context for the UBIT exemption and how it could strengthen poverty-servicing charities.

Part IV responds to probable critiques of UBIT exemptions. Section A anticipates potential objections from policymakers. Section B addresses the underlying principle for the UBIT, the unfair competition ar-

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23. AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE 368 (3d ed. 1992).

24. See *infra* Section III.B.

25. See generally Seth M. Hendon, Note, *The Possibility of Tax Incentives for Lending to Charitable Organizations*, 8 YALE L. & POL'Y REV. 414 (1990).

26. See *infra* Section III.C.

27. See generally ABRAMSON & SALAMON, *supra* note 7, at 83-86.

gument. Section C engages the economic efficiency arguments posed by critics of UBIT exemptions. Section D focuses on the most recent critique, which alleges that UBIT exemptions result in limited accountability of nonprofits.

Ultimately, this Note concludes that the UBIT exemption for charitable nonprofits is the proper vehicle for beginning to resolve operational dissonance in our construction of social welfare services.

## II. CHARITIES AND THE RESOURCE CRUNCH

This Part explains operational dissonance, which derives from the contrary policy directives government gives private charities. To frame the presentation, Section A describes the first policy directives—ones that embody the expectations government has of charities. As the federal government rethinks its responsibility to provide social welfare services to the poor, it concurrently calls upon private charities to fill the resulting void. Section B addresses the second conflicting directive. It reveals how the tax code’s assumptions about “income exemption” prevent charities from engaging in activities that would allow them to finance their role of providing social welfare services. Section C recommends a change in the definition of public charities in the tax code and, relatedly, in public consciousness, to draw greater attention to the need to create special initiatives to address operational dissonance.

### *A. Federal Policies and Operational Dissonance*

This Section explains operational dissonance in the context of the evolving charity-government relationship. The first branch of operational dissonance is the result of government’s devolution-era expectations of charities. The basis of these expectations lies in the advent of charities, which was the result of government and market failures.<sup>28</sup> With charities as a tool for service delivery, the federal government systematized its expectations in several policies promulgated over the last two decades.

#### *1. A Response to Government and Market Failure*

The engagement of charitable services in social welfare policy finds its roots in companion theories—government failure and market failure. Nonprofit status exists for the promotion of organizations that can serve to “lesse[n] the burdens of Government.”<sup>29</sup>

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28. The American economy is divided into three sectors, public, private and nonprofit. I discuss the separate expectations of each in Subsection II.A.1.

29. Treas. Reg. § 1.501(c)(3) (1998).

We historically look to the private sector to provide opportunities for employment, income generation, and competitive services, and we depend on the market to regulate revenue and to promote efficiency.<sup>30</sup> From the government and its attendant agencies, we expect social welfare services and management of the marketplace.<sup>31</sup> In the nonprofit sector, we see a bridge between the failure of the private sector to substantively employ<sup>32</sup> or to employ at all and the government's failure to satisfy subsistence and housing needs that fall in the gap.<sup>33</sup> Because of extensive government and market failures, certain nonprofits have had to fill in the gap by providing services. As redefined, the charity category is now consciously limited to recognize the peculiar role charities play in assisting government and the market with relief for the poor.

## 2. *The Codification of Federal Expectations of Charities*

Over time, the federal government radically changed its philosophy regarding its role in providing services to the poor.<sup>34</sup> Where once the government's role was to provide extensive and exhaustive social welfare services, government devolution policies mandate that the federal government step back from its traditional role as primary provider for the poor and pass the mantle of responsibility to private charities.<sup>35</sup>

The government's shift in its social welfare policy approach has led to immediate material and public-relations crises for charities.<sup>36</sup> Charities in

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30. See Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 504 (1990).

31. See *id.*

32. Substantial employment refers to jobs that provide a living wage, that is, the ability to meet the needs of subsistence.

For a more thorough discussion of the need for full employment, see WILLIAM JULIUS WILSON, *THE TRULY DISADVANTAGED: THE INNER CITY, THE UNDERCLASS AND PUBLIC POLICY* (1987). Wilson explores the impact of wage and price stability, economic dislocation, and the need for full employment. His chapter with Robert Aponte and Kathryn Neckerman describes the impact of the minimum wage on the ability to answer subsistence needs and the eventual reliance on governmental aid. Although the chapter focuses on a rebuttal of Charles Murray's *Losing Ground*, the implications for social welfare are evident, particularly vis-à-vis the need for a better wage system. Wilson posits that a minimum wage, or a lack of a living wage, encourages dependence on social welfare services. See WILSON, *Joblessness Versus Welfare Effects: A Further Reexamination*, in WILSON, *supra*, at 93.

33. See Avner Ben-Ner, *Who Benefits from the Nonprofit Sector? Reforming Law and Public Policy Towards Nonprofit Organizations*, 104 YALE L.J. 731, 744 (1994) (reviewing CHARLES T. CLOTFELTER, *WHO BENEFITS FROM THE NONPROFIT SECTOR?* (1992)).

34. Some will argue that the government's decision to divest itself of responsibility to the poor is simply an expected pendulum shift in social policy. Compare, for instance, the Elizabethan Poor Laws, which left the responsibility of caring for the poor to private charities.

35. See Hendon, *supra* note 25, at 415. Devolution also required that state and local governments take on a greater role in providing social services.

36. See CHARLES WOLPERT, *CHARITY FINANCING* 11-15 (1989) (discussing the current difficulties facing charities); see also Lester M. Salamon, *Rethinking Public Management: Third*

both eras were seen as vehicles for providing services to the poor.<sup>37</sup> The meaning of “helping the poor” had significantly changed, however, under different government regimes. Under the Great Society regime, private charities assisted government, focusing on contracted service delivery.<sup>38</sup> In the current era of devolution, the safety net has disappeared, and the trickle of poor clients requesting help from private charities has increased to a flood.<sup>39</sup> Charities are left with their old directive to assist the needy. They find, however, that it is not enough for them to provide the supplemental food bank or an emergency shelter. Instead they are being asked to provide basic food and medical assistance and to build low-income housing.<sup>40</sup> The material effects of the government’s change in roles have become increasingly clear. Charities know that, when people lose government benefits,<sup>41</sup> charities themselves are now the only recourse.<sup>42</sup>

### *B. Lack of Resources as the Second Branch of Operational Dissonance*

Although government has been quick to call on charities to address the needs of poor persons, it has failed to fund charities adequately and to realize that federal tax policy treats charities in ways that prohibits them from taking on their enhanced role altogether. This Section discusses the lack of resources available to charities, thus laying the groundwork for the UBIT exemption proposal.

#### *1. Lack of Resources*

Government studies show the high cost of providing social welfare services to the poor.<sup>43</sup> This news comes as no shock to private charities. Although charities are supposed to provide expensive services to an ever-increasing number of people, falling contributions and dwindling government support constrain their ability to do so effectively.<sup>44</sup> Charities,

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*Party Government and the Changing Forms of Government Action*, 29 Pub. Pol’y 255, 255-273 (1981) (critiquing devolution in its early stages).

37. See ABRAMSON & SALAMON, *supra* note 7, at 53 (“Underlying many of the cuts in federal domestic spending in recent years is a body of conservative social theory that views government and voluntary organizations as natural antagonists and that supports government budget cuts as a way to strengthen the voluntary sector by getting government out of its way.”).

38. See RUTH HOOGLAND DEHOOG, *CONTRACTING OUT FOR HUMAN SERVICES: ECONOMIC, POLITICAL, AND ORGANIZATIONAL PERSPECTIVES* 1-33 (1984) (discussing the history of contracting out services).

39. See SUSAN R. BERNSTEIN, *MANAGING CONTRACTED SERVICES IN THE NONPROFIT AGENCY* 177-200 (1991).

40. See *Second Harvest*, *supra* note 14.

41. For an example of legislation under which this will take place, see 42 U.S.C.A. § 608 (West Supp. 1999).

42. See *supra* Part I.

43. See *Kammer Testimony*, *supra* note 11.

44. See *id.*

like any other organization, "ultimately must cover the full economic costs of all resources they consume. There is no magic by which a non-profit can produce a service at a lower cost than can a for-profit firm."<sup>45</sup> The federal retreat on funding to social programs parallels a similar retreat from subsidizing nonprofits, including charities.<sup>46</sup> The onus has fallen on individual donors to ante up. It is unlikely, however, that philanthropy alone can replenish the depleted coffers. Charities face two problems. The first is a general decline in charitable giving by individual donors to qualified charities.<sup>47</sup> The second is a decrease in government subsidies to nonprofits.<sup>48</sup>

The devolution of poverty services to charities places a heavy burden on them that many will be unable to meet. Charities are largely dependent on government funding with minimal assistance from private donations.<sup>49</sup> Only about ten percent of contributions to human services organizations have originated with private donations.<sup>50</sup> Less than half of those monies are spent on services to low-income families.<sup>51</sup> When coupled with dollars spent by religious organizations, some estimate that during the 1990s only around \$12 billion in private charitable donations assisted low-income families. At this stage charitable giving cannot offset the estimated impact of federal cuts in social welfare programs.<sup>52</sup> Some projections suggest that only an increase of 50% or more in giving to human services organizations could offset government cuts. Indeed, present rates of private contributions could only compensate for as much as five percent of governmental reductions, although more conservative estimates place the figure at one to two percent.<sup>53</sup> To meet the needs of the poor through charity, contributions would have to increase by more than four times the current projected growth rate.<sup>54</sup>

Given the overwhelming evidence that charities rely on government funds almost exclusively, funds for poverty-servicing charities, therefore,

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45. Atkinson, *supra* note 30, at 504.

46. *See supra* note 7 and accompanying text.

47. *See WOLPERT, supra* note 36, at 41.

48. *See supra* note 4 and accompanying text.

49. *See WOLPERT, supra* note 36, at 27.

50. *See* AMERICAN ASS'N OF FUNDRAISING COUNSEL TRUST FOR PHILANTHROPY, *GIVING USA* 1995, at 30 (1996) [hereinafter *GIVING USA*]; *see also* Alice Gresham Bullock, *Taxes, Social Policy and Philanthropy: The Untapped Potential of Middle- and Low-Income Generosity*, 6 CORNELL J.L. & PUB. POL'Y 325, 327 (1997).

51. *See* REBECCA BLANK, *IT TAKES A NATION* 202 (1997).

52. *See id.* *See generally* WOLPERT, *supra* note 36.

53. *See* BLANK, *supra* note 51, at 202.

54. *See Kammer Testimony, supra* note 11.



must come from government sources.<sup>55</sup> In contrast to private donations, government spending during the same time equaled roughly \$200 billion.<sup>56</sup> This figure represents almost thirty percent of the total budget of all nonprofits.<sup>57</sup> For instance, in 1993, Catholic Charities received more than seventy-five percent of its total income from government funding, almost \$1.2 billion.<sup>58</sup> The cutbacks in federal spending “will result in significant reductions in federal funds flowing to nonprofit organizations.”<sup>59</sup> Between 1996 and 2002, nonprofits will lose an estimated \$253.6 billion in federal revenues.<sup>60</sup> The gap in funding has only grown wider in recent years and is expected to increase. Unless the decreases in funding and charitable donations are countered with other forms of funding, charities will be unable to meet the needs of the poor.

## 2. *The Dissonance in Tax Policy*

As demonstrated, the current subsidy regime unfairly burdens charities that provide social services by cutting back federal funds and relying too heavily on waning donations. Certainly the standard provisions that apply to nonprofits—for example, the charitable deduction and the income exemption—act as subsidies. However, these exemptions are less effective for organizations that serve the poor. Charities, like other organizations, are encouraged to generate income through donations, government grants, and the implicit tax subsidy of the “income exemption.”<sup>61</sup> The exemption of nonprofit income was designed to allow nonprofits to raise funds through solicitation and, if necessary, the sale of goods and services. Historically, however, charities have hesitated to seek revenue through commercial ventures because they, unlike other nonprofits, can rarely justify their commercial activities as “substantially related,”<sup>62</sup> a fundamental requirement of the unrelated business income tax.<sup>63</sup> Gov-

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55. See Lester M. Salamon, *The Charitable Behavior of the Charitable Sector: The Case of Social Services*, in *WHO BENEFITS FROM THE NONPROFIT SECTOR?* (Charles T. Clotfelter ed., 1992); WOLPERT, *supra* note 36, at 27.

56. See *Kammer Testimony*, *supra* note 11.

57. See *id.*

58. See *id.*

59. See *id.*

60. See *id.*

61. See Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 *YALE L.J.* 835, 836-37 (1980).

62. Treas. Reg. § 1.513-1(d)(1) (1998). “Substantially related” requires that a nonprofit demonstrate a substantial relationship between the service sold and the tax-exempt purpose of the organization. For further discussion, see Part III.

63. When a museum opens a gift shop or a university sells research, although they are subject to UBIT review, a host of exceptions often preclude the imposition of income tax on the resulting revenue. Charities, however, suffer from a lack of related services. For example, a food bank is unlikely to open a gift shop, and, were it to open a restaurant, it would be subject

ernment has thus reengineered policies to prod charities to serve a major and costly social role, but it persists in treating charities under the federal tax laws as though they are supplementary providers of social services.

*C. The Need for a New Category of Tax-Exempt Organizations: The Charities*

The hypothetical WeFeed shelter, like other shelters, food pantries, and free medical clinics, operates to serve the poorest among us. They offer services to those who have been ignored by the economic boom, those who have limited resources and limited options. WeFeed depends on the rest of society to assist it in its endeavors. In order to allow charitable organizations to address the needs of the poor, we must first revise our popular and legislative perceptions of charitable organizations. Traditionally, tax laws have grouped all nonprofits together. The tax code has defined a charitable organization as any organization that provides services without regard to profit.<sup>64</sup> According to Treasury regulations, a charitable organization created under § 501(c)(3) of the Internal Revenue Code can provide a range of several services, including service to the poor, the advancement of religion, education or science, and the promotion of social welfare.<sup>65</sup> Notably, only a subset of these organizations, those that serve the poor, have stepped into the void left by the federal government and provided the needy with emergency food and shelter, low-income housing, medical care, and other staples of subsistence.

Our current grouping of nonprofits substantially burdens poverty-servicing charities.<sup>66</sup> The regulations mask their need for special treatment and hide their unique problems. For example, charities are the only group of nonprofits whose fiscal health has been damaged by welfare reform laws.<sup>67</sup> They bear the high cost of supporting the poor, and they face additional operating costs as they expand their administrative structures to coordinate social services. Additionally, these charities are worthy of special respect; they have agreed to fulfill the covenant to help the poor

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to the UBIT and revocation of its nonprofit status. I explore this distinction in greater detail in Section III.A.

64. See Treas. Reg. § 1.501(c)(3) (1998).

65. "[C]haritable is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of 'charity' as developed by judicial decisions. Such terms include: Relief of the poor and distressed or of the underprivileged. . ." Treas. Reg. § 1.501(c)(3)-(d)(2).

66. I will use the term "nonprofit" throughout the Note to refer to all tax-exempt entities governed by § 501(c)(3). "Poverty-servicing charity" and "charity" refer only to the organizations delivering relief and services to the poor and satisfying the definition I propose here.

67. See ABRAMSON & SALAMON, *supra* note 7, at 86-90; see also Hendon, *supra* note 25, at 415-17.

now that it has been broken by the public sector. Given their generosity, they have earned the right to demand concessions from both the private and public sector.

These concessions must be codified to have real impact on charities and their ability to generate revenue. The modified definition would go beyond the antiseptic description included in the current regulations. In addition to the standard qualifications, the new definition would include specific requirements for operation and organization.<sup>68</sup> Qualified charities would satisfy one of two criteria. Either they would be organized and operated primarily to assist the poor with not less than seventy-five percent of annual expenses directed to that effort, or they would be organized to solicit and collect gifts and grants to be distributed to charities that satisfy the first criterion.<sup>69</sup>

Setting the threshold for annual expenses at seventy-five percent disqualifies organizations that would organize simply to capitalize on the proffered exemptions and subsidies.<sup>70</sup> The threshold also encourages organizations, such as faith-based entities, to increase their proportion of poor-relief efforts without fundamentally altering the nature of the organization. Restricting the definition of charity allows for targeted proposals designed to address the impact of devolution and its service-slashing policies.

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68. When organizing a nonprofit under § 501(c)(3), the Treasury Regulations require that two independent tests be met: organizational and operational. The primary purpose of the tests is to insure that organizations utilizing the § 501(c)(3) status adhere to the exempt purposes set forth. Specifically, § 501(c)(3)-seeking entities must prove that they are organized and operated exclusively for the charitable purposes recognized. Failure to meet either test automatically disqualifies an organization from tax exemption. The organizational test is designed to ensure that the stated purpose of the nonprofit, particularly its articles of incorporation, meets the requirements set by § 501(c)(3). The operational test addresses the actual activities sponsored by or participated in by the nonprofit.

69. The proposed definition reflects the character ascribed to charities by the Revenue Acts of 1918 and 1921, with substantial modifications.

[T]he Service stated that the term “charitable” in § 231(6) of the Revenue Acts of 1918 and 1921 (predecessor provisions of Section 501(c)(3)) was limited to the relief of the poor: “[C]haritable” in its popular and ordinary sense pertains to the relief of the poor. In Section 231(6) of the Revenue Acts of 1918 and 1921 the organizations enumerated are religious, charitable, scientific, literary or educational. . . . It seems obvious that the intent must have been to use the word “charitable” in Section 231(6) in its more restricted and common meaning and not to include either religious, scientific, literary, educational, civil or other social welfare organizations. Otherwise, the word “charitable” would have been used by itself as an all-inclusive term, for in its broadest sense, it includes all of the specific purposes enumerated. That the word “charitable” was used in a restricted sense is also shown from its position in the Section. The language is “religious, charitable, scientific, literary or educational.”

FRANCES R. HILL & BARBARA L. KIRSCHTEN, *FEDERAL AND STATE TAXATION OF EXEMPT ORGANIZATIONS* §§ 2, 5 (1994) (quoting I.T. 1800, II-2 C.B. 152 (1923)).

70. The threshold nevertheless allows charities to invest in administrative costs, additional staff not covered directly, and adjunct programs such as education, job training, or child care.

## III. WEFEED AND A NEW SOURCE OF INCOME

The resolution of WeFeed's resource woes requires society to solve the conflict between its beliefs and actions by either altering the devolution of poverty services to charities or increasing their access to capital. Looking back at two decades of devolution and the congressional testimony raising these issues, it is unlikely that government will so radically shift its expectations. Solving operational dissonance through adjustment of our tax-expenditure policies<sup>71</sup> for charities is simpler.<sup>72</sup> The existing tax-expenditure policies of charitable donations and government subsidies do not meet the expanding need for charities' unique services.

Where then can charities like WeFeed turn for funds? The obvious answer is that WeFeed, like museums and colleges and other nonprofits, should find a profitable venture and generate revenue to support its poverty services. Indeed, the charitable exemption exists, in part, to facilitate just this solution. Nonprofits are not precluded from generating a profit, only from distributing the profit to individuals who have a stake in the organization.<sup>73</sup> Thus, the exemption of income subsidy does hold promise if there is actual income to exempt—which there is not for most poverty-servicing charities.

Unfortunately for organizations like WeFeed, commercial enterprise is a risky venture. Because of their limited size and cash-strapped status, charity-run businesses would be responsible for producing at least a third of a charity's revenue to justify their existence. Yet, the regulatory construction of the unrelated business income tax and accompanying case law indicate that the types of businesses envisioned would endanger the charity.

A fundamental policy concern with the UBIT is the capital lost to the charity's mission because of the heavy taxation of business-generated income. Taxed at corporate rates on any money produced by the operation, the significant social cost of thousands of dollars absorbed despite the destination of the income must be considered. The first principles that buttress tax-exemption for charities do not disappear simply because of the more commercial source of funds. WeFeed and its companion charities need funds—and in unprecedented amounts. UBIT serves only to siphon those funds away from the nonprofits that need them most.

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71. Tax expenditure policies are the primary source of funding for charities after direct subsidization. See *infra* Section III.C.

72. The government's unwillingness to increase direct spending is apparent in the cuts through welfare reform, the primary source of funding for charities. In short, we cannot force greater amounts of private giving and are unwilling to increase government spending.

73. The preclusion against private inurement does not, however, include just compensation to employees of a nonprofit. See Treas. Reg. § 1.501(c)(3) (1990).

The solution lies then in exemption from the UBIT. Such an exemption would free charities to enter the commercial market with other non-profits, fully utilizing their exemption-of-income subsidy and wholly re-dedicating profits to the furtherance of their exempt purpose.

This Part presents the proposed UBIT exemption, its rationale, and expected impact. Section A presents the UBIT exemption proposal and defines the parameters of the alternate “poverty services” test. Section B illustrates why UBIT poses such a danger to charities. Section C distinguishes between current exceptions and the effects of the proposed exemption. Section C also reintroduces the WeFeed example to demonstrate the effects of the UBIT exemption, asserting that the impact of the UBIT exemption would provide three important benefits to charities. Section D concludes with the feasibility of the UBIT exemption and an explanation of its benefits. The exemption would encourage the charities to seek out new sources of income, endowing charities with the same autonomy enjoyed by other members of the independent sector. The UBIT exemption would also allow charitable organizations to retain critical income.

#### *A. The UBIT Exemption Proposal*

The solution to the crisis prompted by operational dissonance lies in exempting charities from the UBIT by waiving the “substantially related” test.<sup>74</sup> Charities would thus be free to engage in unrelated commercial activities and, for the first time, surrender none of their profits to the Treasury. Charities would enjoy this second benefit only when they allocate substantial portions of the money to fund their exempt purposes.

##### *1. The Importance of Unrelated Business Income*

UBIT, while ostensibly only a tax on unrelated business income, functions as a barrier to charities’ entry into commercial markets. When most nonprofits seek to increase their revenue base, they rely on several sources of funds, including public support, government grants, the sale of program-related services, and unrelated business income. The last of these sources, unrelated business income, offers a controllable and substantial source of income—a source not tied to public whims about giving,<sup>75</sup> the vagaries of tax cuts and government grants,<sup>76</sup> or the ability to

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74. See Treas. Reg. § 1.501(c)(3)-(1)(c)(1) (1990).

75. See Bullock, *supra* note 50, at 327.

76. See *supra* notes 11-15 and accompanying text.

produce program-related services.<sup>77</sup> Indeed, recent literature exhorts nonprofits to enter the for-profit arena through such enterprises as joint ventures, for-profit subsidiaries, and spin-offs.<sup>78</sup>

Nevertheless, unrelated business income comes with its own set of pitfalls, hidden within the UBIT policies. Besides the looming risk of losing tax-exempt status, charities would also lose a hefty portion of their business income to the UBIT.<sup>79</sup> The potential costs of these pitfalls should not be underestimated. The value of tax-exempt status lies in the ability to seek charitable donations and foundation and government grants. Charities, with few independent resources,<sup>80</sup> need the additional income to fund expanding programs and to lessen their dependence on government funds.<sup>81</sup> Other nonprofits avoid the UBIT, taking advantage of numerous exceptions and carving out new areas of "substantially related" activities. Indeed, for many nonprofits, "[w]e have just about reached the day when any tax attorney who has a tax-exempt client paying unrelated business income tax is probably guilty of malpractice."<sup>82</sup>

Unfortunately, the character and mission of charities sharply limit their ability to circumvent the "substantially related test."<sup>83</sup> As explained more fully in later sections, poverty-servicing charities have a narrowly defined mission and are characteristically small or medium-sized organizations. Other nonprofits, on the other hand, primarily fall into two categories for the "substantially related" test: proprietary charities like hospitals or large endowment organizations such as art museums, or a hybridization of both—the private or public university. Unlike these typically larger entities, which can diversify their goals to reach a broader target population, charities are necessarily limited in scope to serve a poor population with food, shelter, or subsistence needs. These distinctions can sustain a comfortable delineation of organization type and the application of the "poverty services" test to regulate exempted organizations.

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77. See James R. Hasselback & Angela Y. Robbins, *UBIT Exceptions Let Non-Profits Run Tax-Free Businesses*, 25 TAX'NFOR L. 36, 36-38 (1996); Hendon, *supra* note 25, at 417-18.

78. See Bruce R. Hopkins, *Partnerships or Joint Ventures as Vehicles To Achieve Charitable Objectives*, 31 CATH. LAW. 123 (1987); Michael Schill, *The Participation of Charities in Limited Partnerships*, 93 YALE L.J. 1355 (1984).

79. The UBIT is levied at corporate rates: "(A) 15 percent of so much of the taxable income as does not exceed \$50,000; (B) 25 percent . . . as exceeds \$50,000 but does not exceed \$75,000; (C) 34 percent . . . as exceeds \$75,000 but does not exceed \$10,000,000; (D) 35 percent . . . as exceeds \$10,000,000." 26 U.S.C.A. § 11(b)(1)(A)-(D) (West Supp. 1999).

80. See GIVING USA, *supra* note 50, at 125; WOLPERT, *supra* note 36, at 27.

81. See *supra* Part I.

82. Jennifer Anne Spiegel, Note, *Sierra Club: Rationalizing the Royalty Exception to the Unrelated Business Income Tax*, 63 FORDHAM L. REV. 1697, 1700 (1995).

83. See *supra* note 73 and accompanying text. This section provides a more concrete comparison between poverty-servicing charities and other nonprofits.

## 2. *Regulating the UBIT Exemption*

The regulation of the UBIT exemption, like the UBIT itself, demands criteria for application. Charitable organizations seeking exemption should be subject to a test of accountability. The dedication-of-resources prong would specify what is required of qualified charities. The augmented IRS filing of the 990-T would supply the information necessary for enforcement.

### *a. Dedication of Resources*

The tests should require that exempt organizations be qualified charities, requiring the dedication of seventy-five percent of annual expenses to poor relief.<sup>84</sup> In addition, organizations seeking the UBIT exemption would be required to commit seventy-five percent of the income exempted from the final UBIT calculation to direct tax-exempt purposes.<sup>85</sup>

### *b. Required Filing of a Comprehensive 990-T*

Using the 990 tax forms and the other filings currently required by IRS regulation, the revised dedication-of-resources test provides a means of tracking and assessment. Currently, only charities with incomes of over \$1000 must file. The proposed exemption policy would adapt the 990-T to monitor compliance with the dedication-of-resources test.

### *c. Penalty for Violation*

In keeping with the spirit of the regulations, a violation of (a) or (b) would result in immediate suspension of tax-exempt status.

## *B. Why Use UBIT To Aid Charities*

Before 1950 and *C.F. Mueller Co. v. Commissioner*,<sup>86</sup> nonprofits enjoyed virtually unfettered funding in the for-profit world. Nonprofits like New York University, which owned Mueller Macaroni Company, purchased or operated businesses not related to their charitable charter and used them as feeder organizations to pour profits into their nonprofit endeavors.<sup>87</sup> Business enterprises allowed nonprofits a unique opportunity

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84. See *infra* Section III.A.

85. Seventy-five percent serves as an example only. Without empirical analysis of the costs of charities to operate business ventures, setting this second limit is premature.

86. 190 F.2d 120 (3d Cir. 1951).

87. See Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 316-18 (1975).

to generate revenue that was especially valuable to those nonprofits that lacked the ability to charge substantial fees for their services.<sup>88</sup>

The first corporate income tax law, passed in 1894, expressly exempted unrelated business income if that income was dedicated to charitable purposes.<sup>89</sup> Congress and the courts rationalized that the profit realized from unrelated business should be treated as investment income—as income collected to support the organization's charitable purposes.<sup>90</sup> Subsequent cases expanded the reading of the 1894 exemption, allowing feeder corporations to remain tax-exempt so long as their profits fed back into their parent nonprofit.<sup>91</sup> Opponents feared the ability of individuals to form nonprofits to attain tax-exempt status for their businesses. As one court noted, however, if a nonprofit did not carry out its nonprofit ends, the reason for its tax exemption would disappear.<sup>92</sup> Otherwise, as Boris Bittker and George Rahdert explained, "like dividends, interest, membership dues, and contributions, business profits are sought as a way of financing the organization's ultimate (and exempt) purposes."<sup>93</sup>

Congress passed the Revenue Act of 1950<sup>94</sup> in response to New York University's ownership of Mueller, then one of the largest pasta makers in the country. Competing business owners called for a tax on Mueller's income and prompted lawmakers to argue that to allow Mueller to operate untaxed was akin to a government subsidy—inherently unfair and economically inefficient.<sup>95</sup>

### 1. *Understanding the UBIT*

The result of the Revenue Act of 1950, the UBIT, taxed income from enterprises that met three requirements.<sup>96</sup> First, the enterprise had to be a trade or business.<sup>97</sup> Second, the enterprise had to be "regularly carried

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88. See JAMES T. BENNETT & THOMAS J. DiLORENZO, *UNFAIR COMPETITION: THE PROFITS OF NONPROFITS* 19 (1989).

89. See Act of Aug. 27, 1894, ch. 589, § 32, 28 Stat. 509, 556.

90. See *Trinidad v. Sagrada Orden De Predicadores De La Porvicia Del Santismo Rosario De Filipinas*, 263 U.S. 578 (1924) (holding that the federal government could not tax a religious organization's income from the sale of wine and chocolate).

91. See *id.* at 618; *Roche's Beach, Inc. v. Commissioner*, 96 F.2d 776, 779 (2d Cir. 1938) ("No reason is apparent to us why Congress should wish to deny exemption to a corporation organized and operated exclusively to feed a charitable purpose when it undoubtedly grants it if the corporation itself administers the charity.").

92. See *Unity Sch. of Christianity*, 4 B.T.A. 61, 69 (1926).

93. Bittker & Rahdert, *supra* note 87, at 317.

94. Revenue Act of 1950, Pub. L. No. 81-814, §§ 421-422, 64 Stat. 906, 947.

95. See Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 *STAN. L. REV.* 1017, 1017-20 (1982).

96. See Treas. Reg. § 1.511(a)(1) (1998).

97. Revenue Act of 1950 § 301(a), 64 Stat. at 948.



on.”<sup>98</sup> Finally, the business had to be “substantially unrelated” to the activities of the exempt organization.<sup>99</sup> For the purposes of the IRS, all three elements must be met to trigger application of the UBIT.<sup>100</sup>

*a. “Trade or Business” Test*

According to § 513 of the Internal Revenue Code, a trade or business includes “any activity which is carried on for the production of income from the sale of goods or the performance of services.”<sup>101</sup> The regulations do not specify the parameters of commercial ventures, thus the IRS generally treats most commercial activities as businesses for tax purposes.<sup>102</sup> For the purposes of the UBIT exemption, the trade or business test is wholly applicable, as the intent is to encourage charities to engage in business enterprises.<sup>103</sup>

*b. “Regularly Carried On” Test*

As with the “trade or business” test, ambiguity surrounds what constitutes a “regularly carried on” activity. In general, the guidelines specify that the performance and duration of a commercial enterprise should be compared to analogous commercial activities conducted by for-profit firms. Several cases,<sup>104</sup> revenue rulings,<sup>105</sup> and academic articles<sup>106</sup> have addressed the parameters of “regularly carried on.” The test would certainly apply to the qualified charities because the prospective business ventures would have to be “regularly carried on” to generate sufficient revenue.<sup>107</sup>

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98. *See id.*

99. *See id.*

100. *See* Deidre Dessingue Halloran, *UBIT Update*, 36 CATH. LAW. 39 (1995).

101. Treas. Reg. § 1.513(c).

102. Treas. Reg. § 1.513(b).

103. The parameters of trade or business will not be addressed in great detail. The subject does not capture much attention, because it is not a widely contested prong of the UBIT test.

104. *See, e.g.,* NCAA v. Commissioner, 914 F.2d 1417 (10th Cir. 1990); Mobile Arts & Sports Ass’n v. United States, 148 F. Supp. 311 (S.D. Ala. 1957); Suffolk County Patrolmen’s Benevolent Ass’n v. Commissioner, 77 T.C. 1314 (1981), *acq.* 1984-1 C.B. 2.

105. *See, e.g.,* Rev. Rul. 73-424, 1973-2 C.B. 190; Rev. Rul. 75-201, 1975-1 C.B. 164; Tech. Adv. Mem. 89-47-002 (July 31, 1989).

106. *See* Erik M. Jensen, *Taxation, the Student Athlete, and the Professionalization of College Athletics*, 1987 UTAH L. REV. 35, 46-47; Mary E. Monahan, Note, *Unfair Competition or Fundraising? A Proposal To Modify the Regularly Carried On Test of the Unrelated Business Income Tax*, 10 AM. J. TAX POL. 73 (1992).

107. Although the question of “regularly carried on” is an issue of grave concern to many nonprofit organizations, it seems reasonable to predict that charities will concede the application of the test.

c. “*Substantially Related*” Test

The third and most relevant prong of the UBIT test mandates that commercial activities conducted by tax-exempt entities be “substantially related” to the exempt purposes of the organization.<sup>108</sup> To qualify as a related activity, the “IRS requires a substantial causal relationship between an activity and an organization’s exempt purposes.”<sup>109</sup> A causal relationship exists only if the activity can be directly traced to the exempt purposes. A standard example is that of a nonprofit experimental dairy farm that produces milk.<sup>110</sup> If the farm chose to sell its milk to local stores on a regular basis, the profits would not be subject to the UBIT because the production of the milk is substantially related to the purpose of the farm. However, the sale of ice cream or butter would incur a UBIT penalty on profits. The sale of derivative products constitutes an unrelated activity not tied to the purposes of the farm. Between the milk and the ice cream, however, are a host of exceptions, ones that nonprofits regularly invoke when facing adverse UBIT rulings.

The “substantially related” exceptions allowed for nonprofits span volunteer labor,<sup>111</sup> royalties,<sup>112</sup> gambling activities,<sup>113</sup> and others.<sup>114</sup> The current debate on the UBIT challenges the necessity of repeal by parading these exceptions, casting doubt on the need for any exemption at all.<sup>115</sup> The literature fails to distinguish, as this Note does, between exceptions for related businesses and an exemption for unrelated activities.<sup>116</sup>

2. *WeFeed and the UBIT Exemption*

The unrelated activity exemption proposed would allow the WeFeed Food Bank, our fictitious example, to invest in a McDonald’s franchise as

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108. See Treas. Reg. § 1.513-1(d)(3) (1998).

109. Halloran, *supra* note 100, at 43.

110. See *id.*

111. See Treas. Reg. § 1.513(a)(1) (1994).

112. See Treas. Reg. § 1.512(b)(2) (1994).

113. See Treas. Reg. § 1.513(h)(1)(B) (1994).

114. See Treas. Reg. § 1.513(a)(2)-(f)(1) (1994).

115. See Rose-Ackerman, *supra* note 95 (criticizing the economic analysis used to justify UBIT). See generally Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605 (1989) (criticizing the unfair competition rationale and posing economic efficiency arguments); Donald L. Sharpe, *Unfair Business Competition and the Tax on Income Destined for Charity: Forty-Six Years Later*, 3 FLA. TAX REV. 367 (1996) (surveying developments in the UBIT and the promulgation of additional bases for the tax); John M. Strefeler & Leslie T. Miller, *Exempt Organizations: A Study of Their Nature and the Applicability of the Unrelated Business Income Tax*, 12 AKRON TAX J. 223 (1996) (examining the current state of the UBIT and its justifications in relation to recent changes in exempt organizations).

116. See sources listed *supra* note 115.

an untaxed source of income.<sup>117</sup> Under the current UBIT regime, if the franchise were to realize \$350,000<sup>118</sup> in profits for the fiscal year, thirty-four percent would be taken in taxes. Because the franchise, although a food service, is not substantially related to the exempt purpose of providing low-cost meals to the poor, the food bank would be subject to the UBIT on the first dollar of profit. With the proposed UBIT exemption, however, the food bank could reinvest the bulk of the income in its exempt purposes, using the part of the amount saved from the UBIT to pay workers and meet other business-related costs.<sup>119</sup> A second example would be that of a commercial parking lot operated by a collective of homeless shelters. If the lot averaged \$75,000 in profits each year, the shelters could lose more than 25% in UBIT. Again, the exceptions to the UBIT do not apply to the lot, and the charity loses important revenue. With the current exceptions, neither the food bank nor similar charities are relieved of the UBIT. The relevant exceptions, convenience, donated merchandise, and the royalty modification, are discussed below.<sup>120</sup>

*a. Convenience Exception*

If a nonprofit's commercial activity is conducted for the convenience of its members, students, patients, or employees, the profits from the business are not subject to the UBIT.<sup>121</sup> To illustrate, if the WeFeed Food Bank sold its sandwiches only to those who ran the food bank, the UBIT would not apply to revenues from sales of the sandwiches. Similarly, if the food bank ran a cooperative food store instead and charged patrons a membership fee, the profits from the cooperative would likely be exempt from taxation and would meet the substantiality test.<sup>122</sup> The sale of food

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117. The hypothetical is based on fiscal considerations including ease of market entry, start-up costs, and the ability to utilize existing connections, such as links to communities in need of low-skill employment.

118. *Business Abstract Reports*, DUNN & BRADSTREET, Apr. 8, 1998, available in Westlaw, DUNBR File. I compiled the average income for 95 random urban and suburban McDonald's sites nationwide.

119. See Eric W. Sokol, Comment, *Making Tax-Exempts Pay: The Unrelated Business Income Tax and the Need for Reform*, 4 ADMIN. L.J. 527, 532 (1990) (observing that tax-exempt organizations have, in the past, "us[ed] their tax-free income to finance [d]ebt" and arguing that, although this practice was often used to leverage funds for the acquisition of property, the same principle applies).

120. "While an exception means that an activity is not an unrelated trade or business, a modification means that the IRS will not tax the exempt organization on income from a particular, unrelated activity. Major modifications categories include dividends, interest, annuities, rents and royalties." Halloran, *supra* note 100, at 47-48.

121. See Treas. Reg. § 1.513(a)(2) (1994).

122. Other examples include the sale of books to students or of medical supplies to patients. Defining membership constitutes the critical audit issue for other nonprofits. See Halloran, *supra* note 100, at 45.

to non-employees or non-members, however, renders the income subject to the UBIT.

Why not have the food bank run a cooperative instead of the franchise? Despite the number of charitable organizations qualified for the convenience exception, the majority of the proposed patrons lack the resources to purchase the food without assistance, and they would be unlikely to do so from a cooperative, no matter how low the prices.<sup>123</sup> Moreover, charging for a service designed to assist the poor would run contrary to the mission of the charity and could conflict with the ability of the charity to qualify for essential government funding.

*b. Donated Merchandise and Low-Cost Items Exception*

A second UBIT exception, one particularly relevant for charities, exempts profits from the sale of items given to nonprofits.<sup>124</sup> Thrift stores run by charitable organizations fall within the ambit of this exception and would also qualify under this Note's revised charity definitions.<sup>125</sup> The homeless shelter that sells thrift clothing to middle- and upper-income patrons as well as the poor violates the UBIT exception. Under the proposed exemption, however, the charity could generate revenue to provide the poor with clothing at a low cost and also fund its shelter program.

*c. Royalty Modifications to UBIT*

Royalty-payments exceptions also attract fierce criticism from UBIT proponents.<sup>126</sup> Under the modification rules currently in place, the UBIT does not apply if the nonprofit organization receives "passive income"—that is payment for "activities not tending to incite competition between for-profit and nonprofit organizations."<sup>127</sup> The IRS exempts royalty income from the proceeds of a patent license, the rental of mailing lists, or the sale of a logo for a credit card.<sup>128</sup> In general, however, the passive income rule leaves little room for charities to qualify. Where a major university can lease its logo to a major credit card company, few charities generate the recognition required to attract a buyer. The same holds true for the sale of the logo for advertising purposes in catalogs or calendars. Charities will rarely have an opportunity to take advantage of the royalty exception.

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123. See *supra* Section III.A.

124. See Treas. Reg. § 1.513(a)(3) (1994).

125. See Halloran, *supra* note 100, at 46.

126. See, e.g., *id.*; Spiegel, *supra* note 82.

127. Spiegel, *supra* note 82, at 1699.

128. See Halloran, *supra* note 100, at 48; Spiegel, *supra* note 82, at 1699.

As demonstrated, the existing exceptions do not extend to the commercial ventures envisioned for charities. Unlike other nonprofits, charities cannot engage in substantially related activities and are, therefore, almost automatically subject to the tax and the potential loss of their tax-exempt status. Employing the “poverty services” test opens the world of commercial endeavors to a new generation of charities.

#### IV. RESPONSES TO THE UBIT EXEMPTION PROPOSAL

Beginning with its inception in 1950, lawmakers, courts, nonprofits, and academics have debated the UBIT’s necessity and considered ways to extend or contract its reach.<sup>129</sup> This Part responds to the prevailing critiques of UBIT exemption. Section A anticipates objections to the poverty-services test. Section B reacts to the unfair competition rationale, the initial justification for UBIT. Section C turns to questions of economic efficiency. Section D engages the most recent criticism of UBIT repeal, that UBIT is a tool for accountability and monitoring compliance with the regulations of nonprofits.

##### A. *Preempting Objections to the UBIT Exemption*

Charities, organizations dedicated to poor relief and trying to meet the burgeoning consumption of subsistence services, desperately need alternative sources of revenue. The most obvious source is the commercial enterprise, because an “exemption of income” provision already exists for the business ventures of nonprofits.

Congress, while set in its devolutionary ways, is receptive to solutions for operational dissonance. In the past few years, Congress has considered two proposals designed to address the fall-out from devolution. The first proposal, the Charity Tax Credit (“CTC”), is the brainchild of former Republican Senator Dan Coats. The proposal would offer a \$500 tax credit to individual donors who give to qualified charities.<sup>130</sup> A second piece of legislation making its way through Congress is Democratic Representative Tony Hall’s Good Samaritan Act,<sup>131</sup> proposed in response to the Second Harvest report on hunger in America. The proposal would allow deductions for farmers and small businesses donating food to nutrition programs and food banks.<sup>132</sup>

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129. See generally Sharpe, *supra* note 115.

130. See S. 1079, 104th Cong. (1995); S. 1994, 105th Cong. (1998). Although Sen. Coats’s bills never made it out of committee, his idea has been revived in the current Congress. See S. 997, 106th Cong. (1999); H.R. 1607, 106th Cong. (1999).

131. See H.R. 1325, 106th Cong. (1999).

132. See Sarasohn, *supra* note 18.

The UBIT exemption, like the CTC and the Good Samaritan Act, would not require direct subsidies. Rather, the UBIT exemption is a tax expenditure policy, one that permits legislators to resolve dissonance without creating additional government programs or directly funding existing ones.<sup>133</sup> The continued survival of nonprofit organizations serves as a testament to the Congressional support of tax expenditure policies.<sup>134</sup> For example, the Taxpayer Relief Act of 1997 extended the UBIT exception for royalties to include corporate sponsorship.<sup>135</sup> The UBIT exemption would follow the current trends toward replacing direct subsidies with implicit subsidies, making it a politically feasible solution.<sup>136</sup>

With the UBIT exemption, government would pave the way for numerous mutual benefits. Auxiliary funds would offer charities an opportunity to end their dependence on government funding and gain greater autonomy in service provision. With autonomy in funding would come the chance to innovate in service delivery and even the level of service itself—opportunities not currently available to organizations reliant on government funds.

### B. *Unfair Competition*

When for-profit corporations compete with nonprofit, tax-exempt organizations, for-profit corporations often fear the ability of the nonprofits to undercut prices and to drive their unsubsidized counterparts out of the market.<sup>137</sup> Several law-and-economics scholars and some courts reject these contentions, maintaining that the unfair competition rationale is, at best, dubious and possibly a screen for alternative concerns.<sup>138</sup> In any

133. See generally HARVEY ROSEN, PUBLIC FINANCE 378 (1995).

134. See ABRAMSON & SALAMON, *supra* note 7, at 54.

135. See Taxpayer Relief Act of 1997, Pub. L. 105-34, § 965, 111 Stat. 788, 893-94.

136. See Charles Clotfelter, Economics of Giving (Mar. 1997) (unpublished manuscript, on file with author).

137. See Rose-Ackerman, *supra* note 95, at 1023 (citing Richard L. Kaplan, *Intercollegiate Athletics and the Unrelated Business Income Tax*, 80 COLUM. L. REV. 1430, 1432 (1980)); see also Atkinson, *supra* note 30.

Advocates for for-profits maintain that current federal policies give nonprofits unfair competitive advantages in the same revenue generating activities in which for-profits engage. The most frequently stated objective of the unfair competition crusade is to restore and police the traditional boundary between for-profits and nonprofits, a boundary defined with greatest particularity in federal tax law but evident in other areas as well.

*Id.* at 507.

138. See, e.g., Clarence LaBelle Post No. 217, Etc. v. United States, 580 F.2d 270 (8th Cir. 1978). In *Clarence LaBelle*, the court considered the application of UBIT to proceeds from a bingo game operated by a nonprofit. The appellant questioned the proper application of the tax if the game did not directly compete with for-profit competitors. The court acknowledged the question but refused to establish a standard that would make income taxable only under the unfair competition rationale. Because the charities would compete directly with for-profit actors

event, provisions in the dedication-of-resources test address the economic objections to the UBIT exemption for charities, particularly those premised on unfair competition.

### 1. *Predatory Pricing*

The underlying rationale for the UBIT asserts that, without it, charities would engage in predatory pricing, charging below-market-value in an attempt to eliminate competition. At the outset, however, a line must be drawn between “aggressive competition” and predatory pricing.<sup>139</sup> The fear of predation as a consequence of exemption can be abated through both a prohibition of such activity through the poverty-services test and a careful consideration of such an outcome.

Taking the latter first, critics must bear in mind the implausibility of predatory pricing from the small group of organizations eligible for UBIT exemption. Poverty-servicing charities may enter the market at a comparative advantage, given the socially conscious destination of profits. They will, however, just as likely face the necessary disadvantage of entering a market with fewer resources than their competitors. This disadvantage leaves scant room for aggressive competition—let alone a concerted effort of predatory pricing.

Some academics also respond to worries of predation with the rationale that if price-cutting were profitable, for-profit competitors would do it as well.<sup>140</sup> Others, such as Rose-Ackerman, suggest that the fear of competition is based on the large after-tax profit margin enjoyed by exempt organizations.<sup>141</sup> Economists note, however, that charities would not engage in traditional predatory pricing when their profits can be better spent to defray costs and invest in charitable missions.<sup>142</sup> Even the seminal case of *C.F. Mueller Co. v. Commissioner* held that no evidence existed

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in their markets, however, a discussion of alternative rationales lies beyond the scope of this Note.

139. See Jonathan Moore Peterson, *Taming the Sprawlmart: Using an Antitrust Arsenal To Further Historic Preservation Goals*, 27 URB. LAW. 333, 345 (1995); see also *Northeastern Tel. Co. v. American Tel. & Tel. Co.*, 651 F.2d 76, 86 (2d Cir. 1981).

140. See, e.g., Peterson, *supra* note 139.

141. See, e.g., Rose-Ackerman, *supra* note 95, at 1020.

142. See Julie A. Roin, *Unmasking the “Matching Principle” in Tax Law*, 79 VA. L. REV. 813, 851 (1993); see also John Copeland, *Some Suggestions for Revision of Tax-Exempt Organization Rules*, 51 TAX NOTES 911, 915 (1991).

[A]lthough tax exemption may provide an organization with the ability to underprice taxable competitors, the actual effect of the tax exemption on an organization’s commercial behavior is not clear. While some exempt organizations may price their goods and services at less than what the market will bear, others may seek to maximize financial returns because of concerns such as funding or expansion.

*Id.*

to support the competitor's claims of predatory pricing.<sup>143</sup> UBIT was born after NYU won its case, when Congress realized that the litigants were anticipating a possible problem and not reacting to an existing situation.

An affirmative step in the poverty-services test could allay concerns as well. As generally small- to medium-sized organizations with a prescribed limit on the use of funds, UBIT-exempt charities would find predatory pricing to be an economically unsound venture. The additional provision in the proposed poverty-services test would require charities to operate at or near fair market value or jeopardize their tax status.<sup>144</sup> If charities are compelled to allocate the bulk of their commercial profits to exempt purposes, the margin available for predatory pricing, if intended, shrinks and the potential loss of tax-exempt status reduces motivation.<sup>145</sup>

## 2. *Excessive Entry*

UBIT proponents are also concerned about the expansion of UBIT-exempt organizations into unrelated markets. The proposed UBIT exemption necessarily triggers this criticism. The benefits of charities in unrelated markets, however, outweigh the possible costs.<sup>146</sup> The dispersion of UBIT-exempt businesses throughout the markets diffuses the impact of indirect subsidies to nonprofits.<sup>147</sup> Without the ability to move into unrelated markets, charities would be forced to sell program-related services. Unless they sell their subsistence services in a manner similar to the Salvation Army, they are taxed for any income generated. Significant profit-making from services to the poor is questionable at best. With a guarantee of fair market value and a reinvestment of revenue into exempt purposes, the threat to unrelated markets further diminishes.

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143. See *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120, 127 (3d Cir. 1951).

144. I do not propose a fair-market-value test in the poverty-services test, however, because of the debate surrounding the unfair competition rationale.

145. See *supra* Section II.C.

146. Whereas a museum can sell art-related items and hospitals can rent out laboratory space, charities cannot market related items. See *supra* note 83 and accompanying text.

147. See *Rose-Ackerman*, *supra* note 95, at 1037-38.

The nonprofit sector is, after all, rather small relative to the economy as a whole. If the sector's productive business investments were spread across the economy, they would be unlikely to have much competitive impact. But the tax on unrelated business income prevents such dispersion. Tax-exempt firms must now concentrate their profitable endeavors in those few lines of business judged to be "related." For example, the growth of gift shops and vacation tours operated or sponsored by nonprofit organizations may be, in part, a response to the conditions of the tax law. Such concentration in a few areas makes it much more likely that the business activities of nonprofits will impose losses on competitive for-profit firms. . . .

It appears, then, that the tax on unrelated business activity creates more unfairness than it can possibly prevent.

*Id.* (footnotes omitted).



### 3. *Unfair Subsidy*

Opponents of the UBIT exemption disagree about the fairness of a subsidy for charities in the for-profit market, the by-product of exempting taxable income.<sup>148</sup> As with all subsidies, the UBIT exemption derives its justification in large part from two theories of subsidization: public good and altruism. The public good theory justifies subsidies for charities in the form of tax exemption by imputing to government an obligation to support the production of social welfare services.<sup>149</sup> The more applicable theory for charities, however, is the theory of altruism.<sup>150</sup> Altruism claims that if charities confer benefits on a community without regard to compensation, they warrant special tax treatment.

#### *a. Public Goods Theory*

The theory of public goods, or traditional subsidy theory, assumes organizations merit tax exemption when they produce goods or services valued by consumers. Charitable services are construed as a public good when consumers “reveal their true preferences and [c]ontribute to public revenues accordingly.”<sup>151</sup> The history of social welfare services bears out this societal preference for aid to the poor. Even in the context of devolution, the continuation of aid to the poor through TANF and similar programs evinces a sustained belief that poor-relief is a public good. While Congress cuts back on the provision of services, the bitter contest surrounding those cuts supports the theory. Further, federal funds remain a mainstay of poverty-relief services, with state and local governments contributing as well.<sup>152</sup> The public goods theory justifies a subsidy for charities as an extension of a well-documented public preference for government-sponsored poor relief. Both citizens and government rely on charities as partners in social-service provision and as the safety net for those whom government does not aid.

#### *b. Altruistic Theory*

Rob Atkinson’s altruism theory responds to the following question: “Should nonprofits be encouraged to arise and operate in areas other than those in which the orthodox theory predicts they will be the most

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148. Bittker and Rahdert, while not opposed to UBIT specifically, do question the validity of an additional subsidy to nonprofits. See Bittker & Rahdert, *supra* note 87, at 36; see also Sokol, *supra* note 119.

149. See FRED FOLDVARY, PUBLIC GOODS AND PRIVATE COMMUNITIES 7 (1994); Atkinson, *supra* note 30, at 517. See generally STEPHEN SHMANSKE, PUBLIC GOODS, MIXED GOODS, AND MONOPOLISTIC COMPETITION (1991).

150. See Atkinson, *supra* note 30.

151. Hendon, *supra* note 25, at 417.

152. See *supra* text accompanying notes 10-18.

efficient suppliers?"<sup>153</sup> Altruistic theory accepts the positive construct of the public good theory and maintains that "favorable tax treatment of altruistic nonprofits is an affirmative preference for something they provide."<sup>154</sup> By extension, the UBIT exemption for charities acknowledges our historical obligation to the poor and offers charities an opportunity to further dedicate their activities. The altruism theory requires the existence of need and the uncompensated benefactor. Charities provide both and deserve the reward of the UBIT exemption.

The unfair competition critique suffers from scant empirical support, questionable analysis, and an inappropriate application to the charities in question. As one commentator has noted, "both courts and academics have contributed to the demise of the unfair competition rationale, leaving no guiding principle for the application of the UBIT and its exceptions."<sup>155</sup>

### C. *Economic Efficiency*

Critics, notably Henry Hansmann, also argue that repeal of the UBIT could result in economic inefficiencies for both the market and the exempt organization.<sup>156</sup> First, the market would suffer by the entrance of nonprofit, tax-exempt participants unless the organization has no for-profit parallel or provides a better service.<sup>157</sup> Second, UBIT-exempt charities would fail to diversify their investments, overcrowding in one portfolio.<sup>158</sup> Third, the UBIT exemption would cause charities to hoard monies and not expend resources on present programs.<sup>159</sup> Each inefficiency critique, however, assumes that all nonprofits would reap the benefits of exemption. Because the exemption applies only to charities, the effects are markedly different and generally refutable.

Hansmann believes that tax exemptions should be allowed only where the income derives from an activity more efficiently performed by the nonprofit.<sup>160</sup> This criticism, while valid, ignores the present situation of charities. Without the ability to enter related markets, the only venue open to charities exists in competitive markets.<sup>161</sup> In addition, the proposed UBIT exemption only applies to a limited number of organiza-

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153. See Atkinson, *supra* note 30, at 510.

154. Atkinson, *supra* note 30, at 618.

155. Spiegel, *supra* note 82, at 1720.

156. See Hansmann, *supra* note 115, at 626-33.

157. See *id.* at 613-17.

158. See *id.*

159. See *id.*

160. See *id.*

161. See *supra* text accompanying notes 75-78.

tions, some of whom will elect not to participate, mitigating the competitive effect. The competitive-effect critique also lacks empirical support.

Hansmann posits that, without the UBIT, nonprofits would receive a higher rate of return on investment and on savings.<sup>162</sup> The increased ability to save would inhibit spending and encourage nonprofits to underfund current projects in favor of future possibilities.<sup>163</sup> There are two responses to Hansmann's argument. First, as noted in Part I, many of the organizations affected by the change in charitable status do not have large endowments or massive savings. Indeed, they tend to operate from subsidy to subsidy, donation to donation.<sup>164</sup> Inhibiting their ability to save, the inevitable consequence of a tax on income, encourages this dependence on other forms of income.<sup>165</sup> Instead, the repeal of the UBIT for charities would encourage savings and investment, a necessary step to financial stability. Financial stability would relieve the stress on government to serve as the primary donor to charity. Likewise, it would compensate for the low level of private donations to charities.

Hansmann's third concern theorizes that organizations would cease to be "present-oriented" and would cut spending on current projects in order to save for future expenditures.<sup>166</sup> Hansmann fears that, for example, universities would cut spending to research and teaching to invest in unrelated businesses.<sup>167</sup> Again, the very nature of the charities and their role contradicts this possibility. Charities are uniquely "present-oriented." Unlike universities or research foundations, future production of goods does not have the same value to a charity. The rise in the number of homeless and jobless will result in more charities offering emergency services like food and shelter.<sup>168</sup> Cuts in medical funding and the acceleration of diseases like AIDS through the poor community mandate medical care for the indigent.<sup>169</sup> Charities do not have the luxury of conservation of resources. The mandate of society, especially now, requires that charities remain active in the anti-poverty arena. Rather than retreating to count their coins, the history of charities unequivocally suggests that the resources not dedicated to stability will go directly to funding services.

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162. See Hansmann, *supra* note 115, at 613-17.

163. See *id.* at 619.

164. See *Kammer Testimony*, *supra* note 11.

165. See generally DAVID HYMAN, *ECONOMICS* 744 (1991).

166. See Hansmann, *supra* note 115, at 618.

167. See *id.* at 619.

168. See *supra* notes 12, 14 and accompanying text.

169. See WOLPERT, *supra* note 36, at 27.

*D. Accountability*

This Note's proposed UBIT exemption would open the way for charities to enter the commercial market and would allow those organizations to reap indirectly subsidized profits. Nonetheless, the UBIT, in addition to gathering revenue for the federal government, acts as a means of holding charities accountable. Perhaps the most salient attack on the proposed UBIT exemption, the accountability argument does not rely on economic analysis or defunct competitive rationales.<sup>170</sup> Rather, the accountability rationale requires that the public and government have the ability to monitor the actions of these new entrants to the competitive market.<sup>171</sup> To this end, the UBIT acts as an "intermediate monitor" of charitable activities.<sup>172</sup>

The proposed poverty-services test,<sup>173</sup> however, provides an alternative source for fostering accountability in those charities that choose to participate. First, the test compels charities to file comprehensive 990-T forms, something not currently required of most charities. The new form would not only replace the UBIT as an intermediate check but would also give the public a better sense of what exists in the nonprofit world.<sup>174</sup> The penalty component of the test acts as a further check against abuse, rendering the UBIT unnecessary. Charities would be unwilling to jeopardize their tax-status, particularly when there is little hope of private benefit.<sup>175</sup>

## V. CONCLUSION

Charitable organizations occupy a unique position in the nonprofit sector. Charities are the answer to the twin failures of market and government to allocate resources and to supply services for the poor. The advent of operational dissonance, the tension between our expectations

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170. See Spiegel, *supra* note 82, at 1738.

171. Spiegel notes that nonprofits especially require monitoring.

Accountability is particularly important because, generally, exempt organizations are less accountable than for-profits. With respect to for-profit organizations, "[c]ompetitive pressures in product markets, labor markets, and markets for managerial control assure consumers that businesses will be reasonably responsive." Exempt organizations, because of the accumulation of tax privileges, are more isolated from these competitive pressures, and therefore, exempt organizations are less accountable to the public.

*Id.* (footnotes omitted) (quoting James T. Bennett, *Unfair Competition and the UBIT*, 41 TAX NOTES 759, 763 (1988)).

172. See *id.* at 1739.

173. See *supra* Subsection III.A.2.

174. A ubiquitous critique is that there is a lack of information about the nonprofit sector, despite its tax privileges.

175. See Treas. Reg. § 1.501(c)(3) (1998).

of service and failure to provide resources for it, requires a dramatic change.

When charities agree to fulfill the covenant broken by the public sector, they earn the right and the ability to demand concessions from both the private and public sectors. As currently applied, the UBIT diminishes the ability of charities to generate income, save, and invest. Although the UBIT exemption for charities is a small first step, it is critical to resolving operational dissonance and carving out a fairer place for charities.

