St. John's Law Review

Volume 89, Winter 2015, Number 4 Article 3

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INTRODUCTION

Imagine that "the big one" finally strikes Southern California—a major earthquake destroys buildings and leaves thousands homeless and without power, water, and other basic necessities. Immediately, Hollywood springs into action and marshals every A-list entertainer available to perform for a concert benefiting earthquake relief. As George Clooney, Kanye West, and Taylor Swift plead with television viewers to help the people of Los Angeles, they reassure the public that one-hundred percent of all their donations will go directly to the American Red Cross for relief of those affected by the disaster. Swayed by this guarantee, the American people step up and provide millions of dollars to help their west coast neighbors recover.

Now, consider what might have happened had the celebrities instead informed the viewers that the Red Cross already had plenty of money in its coffers to handle the crisis, but that it would appreciate more donations so the Red Cross would not have to dip into its savings. Not quite as compelling of a marketing pitch, is it?

As a society, we have come to expect certain things. Politicians will say anything to get your vote; the Chicago Cubs will always be a group of lovable losers; and when we donate money to a nonprofit[1] organization, that money will, in some way, aid in making our society better. But with regard to the latter, what we do not expect is for the nonprofit organization to accept our donation and then fail to use it to further its charitable purposes,[2] or worse, to never use the money for anything at all.

Yet, as the nonprofit segment of the marketplace continues to grow,[3] a nonprofit's failure to use donations for charitable purposes occurs more and more frequently. Most of us have an ingrained image of nonprofit organizations as perpetually scraping the bottom of the barrel for pennies to cover its operating expenses, while its staff happily lives below the poverty level because they believe in "the cause." Then we write that year-end check to take advantage of tax deductions and imagine balloons falling from the sky at whatever ramshackle hut that passes for the organization's headquarters. Our generosity has enabled the organization to fight the good fight for yet another day!

Romanticism aside, many exempt organizations defy these traditional notions of the nonprofit world. While the food pantry in town probably does use every spare penny to feed the homeless, there are quite a few organizations that would happily

[1] The terms "nonprofit," "not-for-profit," and "non-profit" are each bandied about with varying degrees of frequency in both academic and popular literature and are synonymous. This Article uses "nonprofit" to encompass all three.

[2] The Internal Revenue Code exempts organizations from taxation for a number of reasons beyond just charitable purposes—for example, educational and scientific. *See* I.R.C. § 501(c)(3) (West 2014). For the purposes of this Article, the term "charitable purposes" is used to encompass all valid exempt purposes.

[3] In 2009, the Internal Revenue Service ("IRS") received 320,791 Form 990 or 990-EZ returns, which are required of all mid- to large-sized nonprofit organizations, which have combined total assets of almost $2.7 trillion. Paul Arnsberger, *Nonprofit Charitable Organizations, 2009*, STAT. INCOME BULL., 2012, at 169, *available at* http://www.irs.gov/PUP/taxstats/productsandpubs/12eofallbulteorg.pdf [hereinafter Arnsberger, *2009 Nonprofit Charitable Organizations*]. Contrast this with a decade prior when the IRS received 211,615 Forms 990 from nonprofits in 1999, with aggregate assets holdings of $1.45 trillion. Paul Arnsberger, *Nonprofit Charitable Organizations, 2005*, STAT. INCOME BULL., 2008, at 270, *available at* http://www.irs.gov/pub/irs-soi/99eochar.pdf.

accept your donation, but to be perfectly honest, are doing just fine without it. If you donated to one of these nonprofits, there is a pretty good chance your money would be added to the pot,[4] where it would sit indefinitely, unused, but earning interest.

Who cares, you say? As long as an organization is engaged in benevolently helping society, then why should we concern ourselves with inquiries into its strategy choices? After all, for-profit companies stockpile cash all the time for various purposes[5] and their shareholders, to whom that cash belongs, are perfectly fine with it. Why should we not trust the management of a nonprofit organization in the same way?

That question can be answered in two parts. The first goes back to our expectations as a society. We have the expectation that nonprofit organizations will use the funds given to them for their tax-exempt purposes in a timely manner. A common framework for understanding donations to nonprofits is to imagine the donor as purchasing services to be provided by the nonprofit to some third-party beneficiary.[6] If we purchase some services by donating money, should we not expect those services to actually be performed reasonably promptly?

The second part of the answer involves the nature of what it means to be tax exempt. In economic terms, a tax exemption is equivalent to a government subsidy.[7] When an individual donates to charity, that individual is only donating a part of the money given.[8] The Internal Revenue Code allows the individual to deduct the amount donated from his or her taxable income.[9] While a nonprofit organization enjoys the benefits of receiving

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[4] The nonprofit industry calls this an endowment, which is essentially the equivalent of the investments section of a for-profit company's balance sheet.

[5] Perhaps the most common reason a for-profit firm would seek to stockpile cash is for planning a significant capital project in the near future, which is also a common reason for nonprofits to beef up their endowments, an issue considered in Part V, *infra*.

[6] *See, e.g.*, Henry B. Hansmann, *The Role of the Nonprofit Enterprise*, 89 YALE L.J. 835, 860 (1980) (showing that donations made to colleges and universities are a way for alumni to help finance the education of current and future students).

[7] Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from the Corporate Income Taxation*, 91 YALE L.J. 54, 66–67 (1981).

[8] *Id.* at 71–72.

[9] *Id.*

unlimited amounts of tax-free income, the government is still subsidizing the operations of that nonprofit in the amount that the organization would have paid in taxes, had it been a for-profit company.[10]

Thus, society and government both have a vested interest in ensuring that nonprofit entities abide by our expectations. Unfortunately, some do not, and the problem of nonprofits hoarding cash seems to be getting worse.[11]

This tendency toward hoarding cash by some of the nation's largest nonprofits signals the need to rethink the way we treat nonprofits from a tax perspective. It is undisputed that society desires nongovernmental organizations that work to alleviate poverty, educate people, and advance human knowledge. If the government—and by extension, individual taxpayers—is subsidizing these organizations, should we not think critically about the best methods and policies for achieving our desired results?

To this end, it seems that the time has come to end income tax exemption for nonprofit organizations. The arguments for exempting nonprofits are—and have always been—shaky, at best,[12] and there are better methods for achieving our societal goals. Expanding the definition of a business expense and eliminating the income tax exemption for nonprofits would incentivize charitable organizations to use their funds currently instead of propping up their endowments at the expense of their programs.

In order to discuss the current state of affairs in the nonprofit world, Part I of this Article addresses how nonprofits are treated under the law and the various income tax exemption defenses that have been proffered over the years. Then, Part II investigates the problems raised by organizations that take

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[10] *Id.* at 66–67.

[11] The outcry has been especially strong against colleges that diligently build up their endowments at the same time that they increase costs, therefore increasing student debt. *See, e.g.*, Goldie Blumenstyk, *Pressure Builds on Wealthy Colleges To Spend More of Their Assets*, CHRON. HIGHER EDUC., Oct. 26, 2007, *available at* http://chronicle.com/daily/2007/10/508n.htm; Charles E. Grassley, *Wealthy Colleges Must Make Themselves More Affordable*, CHRON. HIGHER EDUC., May 30, 2008, *available at* http://www.grassley.senate.gov/news/news-releases/wealthy-colleges-must-make-themselves-more-affordable.

[12] *See infra* Part I.C.

advantage of their tax exemption, but decline to use their revenue for their exempt purposes. This problem has been addressed infrequently in academic literature, but Part III reviews other proposed reforms that might affect this issue. Part IV lays out the proposed solution, and Part V examines the challenges and potential objections to these reforms.

I. BACKGROUND

The taxation of nonprofit organizations currently seems to be in a place of relative stasis, although changing economic and social factors can upend a seemingly stable paradigm very quickly. This Part starts by discussing how nonprofits are currently treated by the Internal Revenue Code ("tax code"). Then, it delves into some of the history of the exemption in an attempt to glean Congress's intent in enacting it. Finally, this Part concludes by considering some of the many scholarly justifications given for exempting nonprofits from income taxation and why they all seem somewhat unsatisfactory.

A. *How the Tax Code Treats Nonprofit Organizations*

Section 501 of the Internal Revenue Code[13] is quite possibly the single most well-known statute in the United States. In subsections (c) and (d) of § 501, Congress sets forth a lengthy list of organizations that may receive an exemption from the requirement to pay tax on their income.[14] While there are dozens of purposes for which an organization may be organized and receive an income tax exemption, much of the action in § 501 happens in paragraph (c)(3), which exempts organizations "operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals."[15] The reason that these types of nonprofits—often called "501(c)(3) organizations"—receive so much attention is because money donated to them is generally deductible from the donor's taxable income under § 170 of the tax code.[16] Thus, much of the revenue

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[13] I.R.C. § 501 (West 2014).
[14] *Id.* § 501(c)–(d).
[15] *Id.* § 501(c).
[16] *Id.* § 170.

flowing into such organizations escapes taxation at two levels: once for the donor and once for the recipient. The vast majority of non-501(c)(3) nonprofits might still enjoy exemption from income tax, but their donors do not receive any special tax benefits for making a donation.[17] For this reason, almost all organizations whose purposes are even close to the purposes outlined in § 501(c)(3) will fight tooth-and-nail to be classified under § 501(c)(3).

The tax code imposes several more restrictions on organizations hoping to receive the benefits of § 501(c)(3), the most important of which is that any profits made by the organization[18] must not "inure[] to the benefit of any private shareholder or individual."[19] Professor Hansmann coined the term "nondistribution constraint" to describe this requirement because it prohibits a nonprofit from distributing its profits in the same manner as a for-profit corporation.[20] Along with the organization's purpose, the nondistribution constraint is the key characteristic that defines a nonprofit.[21]

Thus, any organization that is formed for a valid exempt purpose under § 501(c)(3) and agrees not to distribute any of its profits to any private person is eligible to be exempt from federal income tax, and donors to such organizations may deduct their donations from their taxable income. These two very powerful characteristics have driven strong growth in the nonprofit sector

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[17] This is not to say that the exemption itself is not a significant and desirable benefit, even for those nonprofits that do not qualify to receive deductible donations. Indeed, this Article's analysis generally applies equally to all entities currently exempt from federal income taxation, regardless of whether they can receive deductible donations under § 170.

[18] In a sense, the term "nonprofit" is a bit of a misnomer. Nonprofits are not barred from earning a profit; they are simply limited as to how they may use their profits. In recent years, the term "not-for-profit" has been introduced to imply that the organization is not operated for the purpose of generating a profit, but rather to fulfill its charitable purpose. "Nonprofit" still seems to be the most widely used term, however, and there is an argument to be made, albeit well outside the scope of this Article, that "not-for-profit" has its own faults, considering the behavior of many tax exempt organizations.

[19] I.R.C. § 501(c)(3).

[20] Hansmann, *supra* note 6, at 838.

[21] *See id.* Section 501(c)(3) also imposes the requirements that the organization must not, as a significant part of its operation, carry on propaganda, attempt to influence legislation, or campaign directly for or against any political candidate. I.R.C. § 501(c)(3). However, for the purposes of this Article, these additional constraints are less relevant than the nondistribution constraint.

in recent years. Between 1998 and 2010, the total number of 501(c)(3) nonprofits registered with the Interal Revenue Service ("IRS") grew from 733,790 to 1,280,739, a whopping increase of 74.5%.[22] Excluding churches, public charities received nearly $1.5 trillion in revenue in 2009 and held $2.7 trillion in total assets,[23] meaning the nonprofit sector accounted for more than ten percent of the U.S. gross domestic product ("GDP") in 2009.

Another important provision of the tax code applies to nonprofits that generate profits from activities outside their stated exempt purpose. The tax code imposes an income tax on these profits called the unrelated business income tax[24] ("UBIT"). The UBIT can be complicated, as the difference between revenue generated from an organization's exempt purposes and revenue generated from unrelated activities is seldom a bright-line difference.[25]

The tax code provides that the UBIT will be charged on income derived from the following:

> [A]ny trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.[26]

From this definition alone, a host of questions arises regarding exactly what types of revenues are subject to the UBIT.[27]

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[22] *Table 25. Tax-Exempt Organizations and Other Entities, Fiscal Years 1991–2010 (Expanded) [1]*, INTERNAL REVENUE SERV., http://www.irs.gov/file_source/pub/irs-soi/10db25eoe.xls (last visited Feb. 28, 2016).

[23] Arnsberger, *2009 Nonprofit Charitable Organizations*, *supra* note 3, at 172, 174.

[24] I.R.C. §§ 511–13.

[25] Jessica Peña & Alexander L.T. Reid, *A Call for Reform of the Operational Test for Unrelated Commercial Activity in Charities*, 76 N.Y.U. L. REV. 1855, 1858 (2001).

[26] I.R.C. § 513(a) (2012).

[27] The line between what is "substantially related" to a nonprofit's charitable purpose and what is not is rather hazy. Does the selling of cookies have anything to do with teaching young Girl Scouts about leadership and responsibility? Perhaps; but if a museum sold cookies in its cafeteria, the connection to its charitable purpose would be far more tenuous—same activity, different results depending on the nonprofit.

While the specifics of the application of the UBIT are complicated, for this Article's purposes, its importance derives from the fact that Congress enacted the UBIT to combat a specific problem that had arisen in the nonprofit sector. The legislative history of the UBIT states, "The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of [exempt] organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes."[28] Essentially, the UBIT was enacted as a means to protect the for-profit sector from the unchecked growth of competition from the nonprofit sector.[29]

One final provision of the tax code worth mentioning at this point is § 162, which pertains to deductions for business expenses.[30] Since nonprofits are exempt from income taxation, § 162 does not currently apply to nonprofits, but it will become important later in our discussion[31] so it merits some brief attention at this point. In general, businesses that are not exempt from income taxation are permitted to deduct from their taxable income "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[32] Donations by a business to a charitable organization are deductible from the business's taxable income, but not as a business expense under § 162;[33] such donations are deductible under § 170.[34] As a general rule, activities engaged in by a for-profit firm are only deductible if such activities contribute to the profit-seeking goals of the firm.[35] Thus, while a nonprofit generally may receive unlimited revenue tax-free as long as it is obtained in the pursuit of the organization's charitable purposes,[36] a for-profit firm can likewise deduct an unlimited amount of expenses from its taxable income as long as such

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[28] S. REP. No. 81-2375, at 28 (1950), *reprinted in* 1950 U.S.C.C.A.N. 3053, 3081.

[29] 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, 247 (1996).

[30] I.R.C. § 162 (West 2014).

[31] *See infra* Part IV.C.

[32] I.R.C. § 162(a).

[33] *Id.* § 162(b).

[34] *Id.* § 170(a)(1).

[35] *Id.* § 183(a).

[36] *Id.* § 501(a).

expenses were paid in the pursuit of the organization's profit-making purposes.[37] Note, however, that a for-profit firm may only deduct a maximum of ten percent of its taxable income for donations made to charitable organizations.[38] This concept is discussed further when broadening the § 162 deduction is discussed in Part V, below.[39]

B. *Historical Development of the Income Tax Exemption*

From the very beginning of broad taxation in the United States, charitable organizations have been exempt. The Tariff Act of 1894 provided that "nothing herein contained shall apply to . . . corporations, companies, or associations organized and conducted solely for charitable, religious, or educational purposes."[40] The condition that such charitable organizations not distribute their profits to any private person was added in the Payne Aldrich Tariff Act of 1909[41] and in the Corporation Excise Tax Act of 1909.[42] Four years later, the Revenue Act of 1913 added scientific purposes as a valid reason for exemption,[43] and various other expansions and limitations took place over the next several decades.[44] The passing of the Tax Reform Act of 1969, which created the distinction between private foundations and public charities and imposed several forms of tax on private

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[37] *Id.* § 162(a).

[38] *Id.* § 170(b)(2)(A).

[39] *See infra* Part V.

[40] Tariff Act of 1894, ch. 349, 28 Stat. 509, 556, *invalidated by* Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 583 (1895).

[41] Payne Aldrich Tariff Act of 1909, ch. 6, 36 Stat. 11, 113 ("[A]ny corporation or association organized and operated exclusively for religious, charitable, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual.").

[42] Corporation Excise Tax Act of 1909, ch. 6, 36 Stat. 11, 112–13 (current version at 26 U.S.C. subchapter C).

[43] Revenue Act of 1913, ch. 16, 38 Stat. 114, 172, *amended by* Revenue Act of 1916, ch. 463, 39 Stat. 756, 766, 801 (1916).

[44] *See, e.g.*, Internal Revenue Code of 1954, ch. 736, 68 Stat. 3, 163 (restricting charitable organizations from participating in political activities); Revenue Act of 1934, ch. 277, 48 Stat. 680, 700 (restricting charitable organizations from certain lobbying efforts); Revenue Act of 1921, ch. 136, 42 Stat. 227, 253 (including community chests, funds, or foundations and literary purposes as exempt purposes); Revenue Act of 1918, ch. 18, 40 Stat. 1057, 1076 (1919), *amended by* Revenue Act of 1921, ch. 136, 42 Stat. 227, 253 (including prevention of cruelty to children or animals as exempt purposes).

foundations,[45] was the last time Congress acted in any significant way that affects the tax status of nonprofit organizations. For the past forty-six years, the tax code as it pertains to nonprofits has been remarkably static.

Even though the income tax exemption for nonprofits is firmly established in the tax code, there is relatively little guidance as to Congress's justification for adopting such measures. The sponsor of the Corporation Excise Tax Act of 1909 noted that the exemption was meant for organizations "devoted exclusively to the relief of suffering, to the alleviation of our people, and to all things which commend themselves to every charitable and just impulse."[46] Similarly, a 1939 House Committee Report states that the exemption is meant for those organizations that provide "benefits resulting from the promotion of the general welfare."[47] While these and similar citations provide insight into Congress's view of the nonprofit sector, there are very few sources detailing the theoretical basis for justifying the exemption. Indeed, it seems, for the most part, like Congress simply took for granted the fact that charitable organizations should be exempt from taxation, as can be inferred from the following quote from Cordell Hull, author of the Revenue Act of 1913:

> Of course any kind of society or corporation that is not doing business for profit and not acquiring profit would not come within the meaning of the taxing clause . . . . So I see no occasion whatever for undertaking to particularize . . . . I think the better way is to follow the exemption clause that has been well defined and understood heretofore without any particular objection.[48]

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[45] Tax Reform Act of 1969, Pub. L. No. 91–172, 83 Stat. 487, 496–98. These taxes on private foundations are discussed in more detail in Part V.A.

[46] STAFF OF THE JOINT COMM. ON TAXATION, JCX-29-05, HISTORICAL DEVELOPMENT AND PRESENT LAW OF THE FEDERAL TAX EXEMPTION FOR CHARITIES AND OTHER TAX-EXEMPT ORGANIZATIONS SCHEDULED FOR A PUBLIC HEARING BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS ON APRIL 20, 2005 66 (2005); *see also* 44 CONG. REC. 4147, 4150 (1909).

[47] H.R. REP. NO. 75-1860, at 19 (1938).

[48] 50 CONG. REC. 1266, 1306 (1913). It could be argued that Representative Hull's quote reflects a similar logic as that used by Bittker and Rahdert in their article defending the income tax exemption on the basis that the terminology used to describe income and expenses by definition does not apply to nonprofits, and thus, even if we desired to tax them, there would be no mechanism for determining what to tax or how much to tax. *See infra* Part II.C.2. Representative Hull's statement

Since Congress has provided us with minimal guidance as to its justification for exempting nonprofits from income tax, it has been left to legal scholars to determine an appropriate theory for defending the exemption.

C. *Theories Justifying Income Tax Exemption for Nonprofits*

Beginning in the 1970s and running through today, a line of scholarly articles have proffered many theories as to why nonprofit organizations should be exempt from income taxation.[49] One would imagine that, with so many attempts at a satisfactory theory over the last forty years, matters would be settled; but, on the contrary, each theory seems to leave the reader unsatisfied. While each has its own merits, perhaps the very fact that so many legal scholars have felt the need to justify exempting nonprofits is itself an indication that such exemption is unwarranted in its current form.

1. The Public Good Theory

The theory of exemption with which most readers will be familiar is called the Public Good Theory ("PGT"). Indeed, even the United States Supreme Court has endorsed the PGT as one reason for exempting nonprofit organizations.[50] In *Walz v. Tax Commission of New York*,[51] Chief Justice Berger's majority opinion stated that private, nonprofit organizations "bear burdens that would otherwise either have to be met by general taxation, or be left undone, to the detriment of the community."[52]

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seems to diverge from Bittker and Rahdert's line of thinking in that Hull assumes that nonprofits are actually not acquiring profits, as compared to the current view whereby nonprofits are free to acquire profits but not to use them for the benefit of any private person.

[49] *See, e.g.*, Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299 (1976); Mark A. Hall & John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307 (1991); Hansmann, *supra* note 7.

[50] *See* Bob Jones Univ. v. United States, 461 U.S. 574, 591–92 (1983); Walz v. Tax Comm'n of N.Y.C., 397 U.S. 664, 687 (1970).

[51] 397 U.S. 664.

[52] *Id.* at 687.

Thus, the gist of the PGT is that the government is unable, or ill equipped, to fulfill all of the services that society might desire. When a nonprofit steps in and provides these services—be they, for example, education, research, or poverty relief—the government subsidizes such operations by providing a tax exemption. In the absence of the nonprofit, the government itself would be forced to provide the service or society would have to go without. As an incentive for the private sector to fill in the gap, the government in essence agrees to split the cost with the nonprofit—although Uncle Sam still gets the better end of that deal, financially.

At first glance, the PGT is fairly attractive, especially when considering nonprofits that fulfill traditional roles, such as poverty relief. As a general rule, American society provides safety nets to prevent those in poverty from living on the streets or going hungry. Welfare programs cost the federal government—depending on how you define "welfare"—up to a trillion dollars annually;[53] so whenever a private organization offers to alleviate some of the government's burden in this area, it behooves the government to subsidize that organization. Additionally, the PGT provides cover for Congress for exempting certain classes of nonprofits and not others.[54] Only those nonprofits that actually provide a public good should be exempted, with all others being taxed.[55]

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[53] Jeff Sessions, *CRS Report: Welfare Spending the Largest Item in the Federal Budget*, (Oct. 18, 2012) http://www.budget.senate.gov/republican/public/index.cfm/files/serve/?File_id=34919307-6286-47ab-b114-2fd5bcedfeb5. The Congressional Research Service report cited by Senator Sessions lists approximately eighty federal programs, not all of which are always identified as "welfare." Thus, Senator Sessions's figure of $1.04 trillion is likely on the extreme high end. *See* Glenn Kessler, *Does the Federal Government Spend More on 'Welfare' than Anything Else?*, WASH. POST (Feb. 20, 2013), http://www.washingtonpost.com/blogs/fact-checker/post/does-the-federal-government-spend-more-on-welfare-than-anything-else/2013/02/19/fa0042a2-7b0c-11e2-9a75-dab0201670da_blog.html.

[54] *See* Hansmann, *supra* note 7, at 66. When we think of nonprofits, we typically associate tax exemption with them, but the two do not always go hand-in-hand. Various forms of nonprofit organizations that might not fit into the categories set forth in 26 U.S.C. § 501(c) or (d) do not enjoy the full extent of tax benefits that most nonprofits do.

[55] *Id.*

However, the PGT is not without flaws. First, and most obvious, if the government is concerned about subsidizing public goods, why only make the subsidy available to firms that agree not to distribute their profits?[56] There seems to be no logical reason for why a for-profit firm could not build a park or a homeless shelter and receive a tax break from doing so without having to funnel the funds first through a nonprofit. True, it could be argued that limiting the exemption to nonprofit firms might ensure higher quality services for the end user of the public good or serve to reduce fraud, but in a competitive market, this problem would likely be minimal.[57]

Similarly, a number of enumerated exempt organizations in § 501(c) do not seem to produce what could be classified as a public good, again raising the question of the reasoning behind the PGT.[58] For example, a handful of organizations exempt under § 501 serve only their own members and not the public in any way, such as fraternal organizations,[59] labor organizations,[60] and credit unions.[61] What merits an income tax exemption for such entities? Sure, the members of a fraternal organization might benefit from its existence, but how does the public at large? And yet, such organizations remain free from income taxation under § 501 of the tax code.

While the Public Good Theory remains popular and is attractive at the outset, when applied to the manner in which nonprofit organizations actually operate in the context of society, its weaknesses become apparent. While it might apply to some nonprofits, the PGT cannot simply be used as a universal theory supporting tax exemption.

2. The Income Measurement Theory

In 1976, Boris Bittker and George Rahdert took a swipe at justifying nonprofit tax exemption by examining the technical meaning of the words used by the tax code in reference to income

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[56] *Id.* at 67.

[57] *Id.* Consumers—even consumers of public goods—can recognize low quality products and will thus shift demand to firms that produce higher quality goods.

[58] *See, e.g.*, I.R.C. § 501(c)(10) (West 2014) (exempting fraternal beneficiary societies, orders, or associations). There is no corresponding requirement that these organizations produce any good to be made available to the public.

[59] *Id.*

[60] *Id.* § 501(c)(5).

[61] *Id.* § 501(c)(14).

and taxation.[62] They began with the dominant exemption theory of the day, Public Good Theory, and decided it was unnecessary to even worry about defending the exemption on policy grounds because "neither the 'net income' concept nor the 'ability to pay' rationale for income taxation can be satisfactorily applied to charitable organizations."[63]

In essence, Bittker and Rahdert were arguing that, while nonprofits may very well take in more money than they spend, the difference is not "net income" in the way that term is used in the tax code.[64] From the very early days of the Revenue Act of 1894, Congress imposed a tax on the net income "of all . . . corporations, companies, or associations doing business *for profit* . . . ."[65] According to Bittker and Rahdert, since nonprofits are by definition not doing business for profit, the concept of net income, as used in federal tax statutes, cannot be applied to them.[66] These authors further argue that even if we were to attempt to tax a nonprofit's net income, calculating such a figure would simply be too difficult.[67] Are charitable donations to be included in net income?[68] Should the nonprofit be treated merely as a conduit whereby donors transfer funds to the ultimate recipients of the charity, thereby causing the nonprofit to look more like a bank than an operating entity?[69] How do you determine "ordinary and necessary business expenses" for a firm that is not motivated by profit?[70] Bittker and Rahdert raise all of these questions, and many more, in their effort to show that calculating the net income of a nonprofit organization is difficult, at best.

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62 *See* Bittker & Rahdert, *supra* note 49, at 301.

63 *Id.* at 333.

64 *Id.* at 302.

65 *Id.* (alteration in original) (quoting Revenue Act of Aug. 27, 1894, ch. 349, 28 Stat. 556) (internal quotation marks omitted).

66 *Id.* at 302–03.

67 *Id.* at 307–14.

68 *Id.* at 308.

69 *Id.* at 309.

70 *Id.* (internal quotation marks omitted).

Their solution, then, is to exempt nonprofits, not because of the type of service they provide to society, as was the case under the Public Good Theory, but because the very nature of a nonprofit firm defies the application of the principles of the tax code.[71]

In critiquing Bittker and Rahdert's argument, one obvious objection can be raised. While it might be difficult to classify all of a nonprofit's revenues and expenses using the terminology of the for-profit world, at the end of the day, the organization will bring in and spend a certain amount of money during the course of a year. If the total amount of money it brings in exceeds the amount of money it spent, could we not label that as "net income" or "profit"? It certainly seems to be the case that Bittker and Rahdert "overstate the difficulties" of determining the net income of nonprofit organizations.[72]

Indeed, the current tax code provides that "[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived."[73] However, the code does also provide that income from gifts is specifically excluded from gross income,[74] so perhaps there is a discussion to be had as to whether a donation to a nonprofit is a gift or the purchase of services to be provided to a third-party beneficiary. With these minor complications aside, it would not be particularly onerous to construct a functional definition for the net income of a nonprofit if Congress chose to do so.

Thus, the justification offered by Bittker and Rahdert, while unique and fairly clever, nonetheless fails to satisfy our need for a comprehensive defense of the tax exemption for nonprofit firms. Perhaps Professor Hansmann, writing just a few short years after Bittker and Rahdert—published in the very same journal, no less—can help in this search.[75]

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[71] *Id.* at 302.
[72] Hansmann, *supra* note 7, at 58–59.
[73] I.R.C. § 61 (2012).
[74] *See id.* § 102.
[75] *See* Hansmann, *supra* note 7, at 54.

3. The Capital Formation Theory

Having examined both the Public Good Theory[76] and Bittker and Rahdert's arguments pertaining to the problems surrounding the definition of a nonprofit's income,[77] Professor Hansmann proceeds to develop his own justification for exempting nonprofits grounded in economics.[78] According to Hansmann, nonprofits are at a disadvantage when it comes to raising funds because they are unable to issue stock and raise capital.[79] As a result, the only means by which a nonprofit may raise capital are "debt, donations, and retained earnings."[80] Donations are an "uncertain" source of funds, and many nonprofits do not even rely on a model whereby they are supported by donations at all.[81] The availability of debt, too, is likely inadequate, according to Hansmann, as lenders are seldom willing to provide enough capital for all of a firm's needs.[82]

Thus, the sole remaining, semireliable source of capital for a nonprofit is retained earnings.[83] By allowing nonprofits to accumulate retained earnings tax-free, the tax code essentially gives these firms a lifeline for their need to raise capital. Not only can tax-exempt organizations use the money they are not paying in taxes on capital expenditures, but also their increased cash flow as a result of not having to pay taxes will encourage lenders to extend them more debt financing, creating a double benefit.[84] In Hansmann's words, "the exemption can be understood as a subsidy to capital formation."[85]

While the Capital Formation Theory does seem to provide a unique alternative justification for the exemption, it too is not without its faults. Hansmann himself recognizes the most prominent of these issues, which is that "an exemption from income taxation is a crude mechanism for subsidizing capital formation in the nonprofit sector."[86] In industries where growth

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[76] *Id.* at 66–67.
[77] *Id.* at 58–62.
[78] *Id.* at 72.
[79] *Id.*
[80] *Id.*
[81] *Id.* at 72–73.
[82] *Id.* at 73.
[83] *Id.*
[84] *Id.* at 73–74.
[85] *Id.* at 74.
[86] *Id.* at 75.

is particularly strong, the benefits provided by the exemption are not enough to provide sufficient capital for expansion.[87] Conversely, there exist industries where nonprofit firms are significantly overcapitalized and the exemption is essentially handing free money to firms that do not need it.[88] If subsidization of nonprofit sectors in need of capital was the goal of Congress, enacting a blanket exemption for all nonprofits—that fall within § 501(c) and (d)—is a horribly inefficient solution.

The United States government is no stranger to directly subsidizing individual industries—look no further than the renewable energy industry.[89] Therefore, if the concern is that nonprofits in certain sectors will be unable to raise sufficient capital to survive and compete with their for-profit counterparts, Congress certainly has the tools at its disposal to directly subsidize those industries without also handing over tax dollars to nonprofits in industries without capital constraints.

Further, it is not clear that nonprofit firms will be systematically undercapitalized rather than overcapitalized.[90] Hansmann assumes that the norm for a nonprofit in an industry will be for it to be undercapitalized, but what if that is the exception and the far more common occurrence is the overcapitalization of nonprofits, in which case, tax money is being wasted on firms that do not need it? Hansmann acknowledges that there may be instances in which the exemption should be withdrawn for industries that find themselves to be overcapitalized.[91] But is this cherry picking approach not the same as simply directly subsidizing those

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[87] *Id.*

[88] *Id.*

[89] *See Federal Financial Support for Energy Technologies—Assessing Costs and Benefits: Hearing Before the Subcomm. on Energy of the H. Comm. on Sci., Space, and Tech.*, 113th Cong. 17–18 (2013) (statement of Terry Dinan, CBO Senior Advisor), *available* at https://www.gpo.gov/fdsys/pkg/CHRG-113hhrg79931/pdf/CHRG-113hhrg79931.pdf.

[90] Daniel Shaviro, *Assessing the "Contract Failure" Explanation for Nonprofit Organizations and Their Tax-Exempt Status*, 41 N.Y.L. SCH. L. REV. 1001, 1006 (1997).

[91] *See* Henry Hansmann, *The Changing Roles of Public, Private, and Nonprofit Enterprise in Education, Health Care, and Other Human Services*, *in* INDIVIDUAL AND SOCIAL RESPONSIBILITY: CHILD CARE, EDUCATION, MEDICAL CARE, AND LONG-TERM CARE IN AMERICA 245, 255 (Victor R. Fuchs ed., 1996).

industries where undercapitalization is problematic, which is also a much more efficient solution to the issue?

All told, Hansmann's Capital Formation Theory goes a long way toward justifying the income tax exemption for some nonprofits.[92] However, it is hardly a comprehensive justification that can be applied to all nonprofits that receive the exemption. Perhaps Professors Hall and Colombo can offer a more universal justification with their Donative Theory of Tax Exemption.[93]

4. The Donative Theory

Beginning in 1991, Professors Mark Hall and John Colombo published a series of articles, examining the commonly discussed justifications for income tax exemption at the time,[94] finding them all lacking—do you notice a trend developing here?—and offering their own rationale for exempting nonprofits from income taxation.[95] Hall and Colombo name their concept the Donative Theory, largely because its key aspect is the evaluation of nonprofits to determine whether they are worthy of being supported by the public through donations.[96]

In order to evaluate different justifications for income tax exemption, Hall and Colombo create a framework of four criteria against which to judge possible theories.[97] Their view of a successful theory is as follows:

> Such a theory should: (1) identify activities deserving social subsidy . . . (2) distribute the subsidy in rough proportion to the degree of deservedness; (3) explain both the income tax and the property tax exemption, and, ideally, explain the related charitable deduction as well as the various operational constraints that attach to charitable status and (4) align generally with an intuitive concept of what constitutes a charity and the major historical categories of exempt entities.[98]

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[92] The nonprofits the Capital Formation Theory aids are namely those in need of capital.

[93] *See* Hall & Colombo, *supra* note 49, at 307.

[94] These commonly discussed justifications include, namely, the Public Good Theory, Bittker and Rahdert's Income Measurement Argument, and Hansmann's Capital Formation Theory.

[95] *See* Hall & Colombo, *supra* note 49, at 307; Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L.J. 1379, 1382–84 (1991) [hereinafter Hall & Colombo, *The Donative Theory*].

[96] Hall & Colombo, *supra* note 49, at 316.

[97] *Id.* at 328.

[98] *Id.*

Generally, these criteria seem helpful. However, it is unclear that the income tax exemption, property tax exemption, and deductibility of donations must necessarily go hand-in-hand with one another. For purposes of this Article, the income tax exemption alone is considered—with more discussion on the deductibility of donations to come—and setting aside the property tax exemption for the time being.[99] The fourth criterion exists as an acknowledgment that the "charitable exemption has evolved throughout centuries of experience to take on an almost universal presence and shape."[100] It also shows that a "complete reformulation or abandonment is impossible to contemplate for both political and pragmatic reasons."[101] However, it seems to be a bit of a cop out. If we already hold an "intuitive" idea of what charities are and why they deserve special treatment, then why go through the trouble of justifying the exemption in the first place? Is it not possible that a truly satisfactory theory of exemption might indeed turn some of our traditional notions about nonprofits on their heads?[102]

Regardless, Hall and Colombo have given us a useful tool for judging a theory of exemption, which they proceed to apply to Bittker and Rahdert's Income Measurement Theory[103] as well as to Hansmann's Capital Formation Theory.[104] Not surprisingly, they find that neither theory measures up particularly well,[105] which leads them to introduce their Donative Theory of Exemption.[106]

Under the Donative Theory of Exemption, "the primary rationale for the charitable exemption is to subsidize those organizations capable of attracting a substantial level of donative support from the public."[107] When a public good is not provided to the optimally desired level by the government and such good is

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[99] See the discussion of the importance of the property tax exemption *infra* note 195.

[100] Hall & Colombo, *supra* note 49, at 331.

[101] *Id.*

[102] Indeed, Hall and Colombo proceed to make a case for eliminating the exemption for nonprofit hospitals, a class of charitable organization that has certainly traditionally been exempt from income tax. *See* Hall and Colombo, *supra* note 49, at 405–08.

[103] *Id.* at 385–86.

[104] *Id.* at 387.

[105] *Id.* at 385–89.

[106] *Id.* at 389.

[107] *Id.* at 390.

also not available in the private market largely due to free-rider problems, a confluence of both government failure and market failure emerges.[108] For these types of public goods, the only mechanism by which those who desire the good can realize its production is to make a donation toward the creation of that good.[109]

So how does the Donative Theory measure up? Under Hall and Colombo's own analysis, the results are mixed. It certainly succeeds in identifying activities deserving social subsidy; after all, if private citizens are voluntarily contributing their hard-earned dollars toward a public good, there is a good chance such good is worthy of subsidy. However, the authors admit that the results of the proportionality test "seem[] unsatisfactory."[110] They attempt to resolve this unsatisfactory result by using some circular logic, though. Essentially, their argument recognizes that the income tax exemption under the Donative Theory is probably not the best way to ensure tax support in proportion to deservedness and that a much better mechanism would be direct government support of deserving firms.[111] However, if a firm is the recipient of direct government support to produce its public good, then it must necessarily not require donations, removing it from analysis under the Donative Theory.[112] Is it not possible to identify those firms producing public goods that are receiving donations and then inject direct subsidies? It is not clear that donative support and direct government subsidization are mutually exclusive.

Hall and Colombo give lip service to the historical consistency criterion,[113] but it is not obvious that it is as easily satisfied as they claim. True, donative charities—for example, churches, schools, or homeless shelters—are certainly historically what people think of when they consider tax exempt organizations, but what of organizations that have long been exempt and derive a significant portion of their revenue from commercial activities and not just donations? Indeed, the authors themselves make a case for eliminating the exemption

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[108] *Id.* at 394.
[109] *Id.*
[110] *Id.* at 403.
[111] *Id.*
[112] *Id.* at 404.
[113] *Id.* at 405.

for nonprofit hospitals,[114] which seems likely to violate the criterion that the theory must comport with our intuitive concepts of the nature of charities and respect the historical categories of such organizations. Hall and Colombo acknowledge that their Donative Theory is a "significant retraction of the existing scope of the charitable exemption,"[115] which seems to be at odds with their stated desire to remain aligned with the "major historical categories of exempt entities."[116] And what about organizations that receive both donations and revenue from commercial activity? Or, to add a layer of complication, what if an organization receives direct government subsidies, donations, and revenue from commercial activities? Does the Donative Theory apply to such an organization?

Again, like the Capital Formation Theory, the Donative Theory seems to work quite nicely for a certain subset of nonprofit organizations, namely those that are supported through donations. But for nonprofits that receive revenue from sources other than just donations, the theory leads to inconsistent results. Take, for instance, the Susan G. Komen Breast Cancer Foundation. In fiscal year 2014, the organization recorded revenues of nearly $130 million.[117] However, less than thirty-six million of that amount was attributable to direct donations,[118] with the remaining revenue coming from merchandise sales, fundraising events—primarily the series of road races put on throughout the country—and other commercial activities.[119] Would the Donative Theory remove the exemption from the Komen Foundation because only about a quarter of its revenue comes from donations? It is unclear, which is an unsatisfying result.

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114 *Id.* at 405–08.

115 Hall & Colombo, *The Donative Theory*, *supra* note 95, at 1416.

116 Hall & Colombo, *supra* note 49, at 328.

117 Susan G. Komen, *2013–2014 Form 990 Parent Return*, SUSAN G. KOMEN, http://ww5.komen.org/uploadedFiles/_Komen/Content/About_Us/Financial_Reports/SGK%20Parent_990_PIC_Final_EY%20signed_to%20client.pdf (last visited Feb. 28, 2016).

118 *Id.*

119 *Id.*

5. Other Theories

As mentioned, there is no shortage of scholarly attempts to justify the income tax exemption for nonprofits. The theories discussed above are perhaps the most notable examples from the legal academia, but several others deserve mention.

In his 1990 article, Rob Atkinson finds Hansmann's theory useful yet unsatisfying, so he adds another layer to it and suggests that those nonprofits worthy of tax exemption are the organizations that operate out of altruism, or "the conferring of uncompensated benefits."[120] The lovely thing about Professor Atkinson's model is that virtually all organizations we traditionally think of when we think of nonprofits fit nicely into his framework justifying tax exemption. The aspect of the altruism theory that is perhaps troubling to some is that it would likely confer the tax exemption on any number of firms engaged in businesses we do not typically associate with tax exemption, a fact that Professor Atkinson acknowledges.[121]

Nina Crimm provides an analysis of Atkinson's altruism theory, as well as all of the other theories described thus far in her 1998 article. She not surprisingly concludes that "no proffered explanation has yet extended a full and satisfactory explanation that can be universally applied and has been widely accepted."[122] She then proceeds to offer her own theory, which is that tax subsidies for nonprofits compensate them for engaging in the provision of public goods, an inherently risky endeavor.[123] The tax benefits serve to offset some measure of the risk and thereby create a market for public goods where one would not have otherwise existed.[124] In a sense, Professor Crimm's rationale resembles the Public Good Theory, but couched in the terminology of economics.

To solve the inefficiency problems associated with the Public Good Theory, Crimm separates the theory justifying the exemption from the analysis of the deservedness of any

[120] Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 565 (1990).

[121] *Id.* at 510.

[122] Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLA. L. REV. 419, 438–39 (1998).

[123] *Id.* at 462.

[124] *Id.*

particular organization to receive the exemption.[125] By doing so, only those nonprofits that operate for worthy charitable purposes can claim the subsidy.[126] Professor Crimm's proposal is certainly thoughtful and insightful, but it is not immediately clear that the provision of public goods and services is as inherently risky as she claims, nor is it clear that the risk of providing public goods would deter entrepreneurs in the absence of the tax exemption.

Finally, the most compelling justification for the income tax exemption comes from Evelyn Brody's 1998 article, in which she maintains that charitable organizations have a certain amount of sovereignty into which the government refuses to intrude.[127] In Professor Brody's words, "[c]harities go untaxed because Caesar should not tax God (or the modern secular equivalent)."[128] Brody probably gives the government more credit than most of us would, as it certainly seems that the government rarely has a problem inserting itself into practically any facet of life. Brody's theory is thoughtful, but seems difficult to apply to individual organizations. For example, what makes a nonprofit hospital any more sovereign than its for-profit counterpart?

6. Conclusions from Current Theories of Income Tax Exemption

Clearly, a bevy of legal scholars have come up with some very creative and thought-provoking justifications for exempting nonprofit organizations from income taxation. Whether they approached the issue from the perspective of an economist, philosopher, or legal theorist, each contribution put a new twist on the answer to the question of why we exempt certain nonprofit firms from income taxation.

Unfortunately, while some theories seemed to work quite well for a subset of nonprofits, none of the theories left us feeling satisfied when applied across all of the categories of nonprofit organizations out there. There was never that moment when the light bulb flicked on and we said, "Aha! That is the reason why we do not tax the profits of charitable organizations." Instead, we could make statements such as "that could be a good reason

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[125] *Id.*

[126] *Id.*

[127] Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585, 586 (1998).

[128] *Id.*

for not taxing undercapitalized nonprofits," or "this could be a good reason for not taxing organizations that provide public goods and are supported substantially by donations from the public."

Absent a comprehensive theory that fits all exempt entities equally well, the average person, when attempting to justify the exemption, is likely to fall back on the well-worn rationale that most nonprofits are engaged in the kinds of activities that we want to support as a society, so we give them an income tax exemption for it. It is not scientific, and it is definitely not easy to test, but that seems to be the best justification we have at this point that fits equally well for all exempt nonprofits.

So if our best theory is unsatisfactory and unscientific, and our best scientific theories are also unsatisfactory—and fail to include broad swaths of exempt entities—where do we go from here? Should we even care? The nonprofit sector seems to have functioned fairly well for the last 100-plus years, so why rock a stable boat?

As mentioned in the Introduction, nonprofits do not exist in a vacuum;[129] they are subsidized by tax dollars and society has certain expectations of them. If we cannot provide a satisfactory, universal rationale for exempting nonprofits from income taxation, perhaps it is time to revisit the fundamentals of how the tax code treats nonprofits.

II. THE PROBLEM

In 2013, Harvard University made a profit of $1.25 billion.[130] The same year, the Howard Hughes Medical Institute in Maryland made a profit of almost $299 million,[131] the New York Metropolitan Museum of Art made a profit of $169 million,[132] Yale University profited to the tune of $370 million,[133] and the

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[129] *See supra* Part I.

[130] Harvard University, *Form 990*, FOUND. CENTER (2012), http://990s.foundationcenter.org/990_pdf_archive/042/042103580/042103580_201306_990.pdf.

[131] Howard Hughes Medical Center, *Form 990*, FOUND. CENTER (2012), http://990s.foundationcenter.org/990_pdf_archive/590/590735717/590735717_201308_990.pdf.

[132] Metropolitan Museum of Art, *Form 990*, FOUND. CENTER (2012) http://990s.foundationcenter.org/990_pdf_archive/131/131624086/131624086_201306_990.pdf.

[133] Yale University, *Form 990*, FOUND. CENTER (2012) http://990s.foundationcenter.org/990_pdf_archive/060/060646973/060646973_201306_990.pdf.

Kaiser Foundation Hospitals racked up profits of $1.76 billion.[134] As nonprofits, each of these organizations is prohibited from distributing its profits to private persons and must do one of three things with its revenue: spend it, give it to another nonprofit, or save it.

If you are wondering which of the three options these organizations chose, consider that in 2013, Harvard's net assets—of which its endowment is the largest component—increased by $2.26 billion,[135] Howard Hughes's by $1.12 billion,[136] the Metropolitan Museum of Art's by $280 million,[137] Yale's by $1.87 billion,[138] and Kaiser's by $2.26 billion.[139]

These five nonprofits are nothing more than a random sampling of some of the largest tax exempt organizations in the United States. When nine and ten-figure profits roll in, by and large the excess is simply put into the bank.[140] And 2013 was hardly a banner year for nonprofit profits. In the past ten years, Kaiser Foundation Hospital's worst year, 2004, still saw a net profit of $706 million.[141] Lest you think the above examples were cherry-picked due to their atypically large profits, the following tables show the total profits and contributions to the endowment[142] for the most recent year[143] for the ten largest nonprofits, by total assets, in the following fields: education in Table 1, health care in Table 2, and arts in Table 3.

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[134] Kaiser Foundation Hospitals, *Form 990*, FOUND. CENTER (2012) http://990s.foundationcenter.org/990_pdf_archive/941/941105628/941105628_201212_990.pdf.

[135] Harvard University, *supra* note 130.

[136] Howard Hughes Medical Center, *supra* note 131.

[137] Metropolitan Museum of Art, *supra* note 132.

[138] Yale University, *supra* note 133.

[139] Kaiser Foundation Hospitals, *supra* note 134.

[140] *See* Harvard University, *supra* note 130; Howard Hughes Medical Center, *supra* note 131; Kaiser Foundation Hospitals, *supra* note 134; Metropolitan Museum of Art, *supra* note 132; Yale University, *supra* note 133.

[141] Kaiser Foundation Hospitals, *Form 990*, FOUND. CENTER (2003), http://990s.foundationcenter.org/990_pdf_archive/941/941105628/941105628_200312_990.pdf.

[142] For the most part, the healthcare nonprofits listed in Table 2 do not list endowments, so this column is replaced by the change in net assets for this table. This figure is admittedly an inferior tool for determining contributions to endowments, as it includes investment gains and losses, with which we are not presently concerned.

[143] The year is typically 2013, but 2012 for those entries noted with an asterisk.

Table 1: Ten Largest Educational Nonprofits by Total Assets[144]

Name	2013 Net Profit (Loss)	2013 Contribution to Endowment
Harvard University	$1,258,436,182	$320,079,000
Stanford University	$635,720,686	$588,438,000
Yale University	$370,048,914	$147,031,000
Princeton University	($1,383,273,000) [145]	$153,855,000
Massachusetts Institute of Technology	($29,168,000)*	$180,985,000*
University of Pennsylvania	$783,502,000	$327,276,900
Columbia University	$683,454,335	$165,932,000
Harvard Management Private Equity Corporation	$1,148,851,664	N/A
Cornell University	$160,497,600	$142,698,495
Emory University	$308,040,859	$90,867,213
Total:	**$3,936,111,240**	**$2,117,162,608**
*2012 figures		

[144] *Display Largest Public Charities*, NAT'L CENTER FOR CHARITABLE STAT., http://nccsweb.urban.org/PubApps/showTopOrgs.php?cat=B&amt=ass_eoy (last visited Feb. 28, 2016) (deriving figures from annual IRS form 990 filings); Cornell University, *Form 990,* FOUND. CENTER (2012), http://990s.foundationcenter.org/990_pdf_archive/150/150532082/150532082_201306_990.pdf; Emory University, *Form 990*, FOUND. CENTER (2011), http://990s.foundationcenter.org/990_pdf_archive/580/580566256/580566256_201308_990.pdf?_ga=1.54794667.1899948767.1457700995; University of Pennsylvania, *Form 990*, FOUND. CENTER (2012), http://990s.foundationcenter.org/990_pdf_archive/231/231352685/231352685_201306_990.pdf?_ga=1.59314989.1899948767.1457700995.

[145] Princeton University, *Form 990*, FOUND. CENTER 1, 9 (2012), http://990s.foundationcenter.org/990_pdf_archive/210/210634501/210634501_201306_990.pdf?_ga=1.75079058.1051194472.1438123364 (finding that Princeton took a $952 million loss on the sale of assets during 2013).

Table 2: Ten Largest Health Care Nonprofits by Total Assets[146]

Name	2013 Net Profit (Loss)	2013 Gain (Loss) in Net Assets
Kaiser Foundation Hospitals	$1,765,755,591*	$2,260,324,417*
Howard Hughes Medical Institute	$298,960,625	$1,119,897,181
Kaiser Foundation Health Plan	$565,728,568*	($254,772,349)*
Partners Health Care System	$451,573,093*	$238,907,656*
Dignity Health	$401,154,604	$1,154,450,512
Cleveland Clinic	$451,637,135*	$643,241,094*
Trinity Health	$233,862,773*	($264,416,814)*
Mayo Clinic	$245,898,463*	($335,916,168)*
Shriners Hospitals for Children	$5,364,512*	$372,326,228*
Memorial Sloan Kettering Cancer Center	$96,441,000*	$291,890,000*
Total:	**$4,516,376,364**	**$5,225,931,757**
*2012 figures		

[146] *Display Largest Public Charities*, *supra* note 144; Trinity Health Corporation, *Form 990*, FOUND. CENTER (2011), http://990s.foundationcenter.org/990_pdf_archive/351/351443425/351443425_201206_990.pdf?_ga=1.213956887.1899948767.1457700995.

Table 3: Ten Largest Arts Nonprofits by Total Assets[147]

Name	2013 Net Profit (Loss)	2013 Contribution to Endowment
Cambridge University Press	$136,242,148	$1,415,683,500
Smithsonian Institution	$168,546,753	$34,861,990
New York Metropolitan Museum of Art	$168,988,217	$28,031,302
National Trust	$23,964,000	$19,346,000
Colonial Williamsburg Foundation	($20,886,575)*	$9,617,265*
New York Museum of Modern Art	($6,720,774)	$37,247,000
Boston Museum of Fine Arts	($8,856,309)	$8,719,819
American Museum of Natural History	$7,978,832	$7,844,856
Museum of Fine Arts Houston	$141,253,961	$1,462,414
National Gallery of Art	$52,169,003*	$6,515,424*
Total:	**$662,679,256**	**$1,569,329,570**
*2012 figures		

Clearly, for the largest nonprofits, business is good. Even counting Princeton's unusual $1.38 billion loss, the top ten educational nonprofits still netted an average of almost $400 million each in 2013.[148] Likewise, the top hospitals profited more than $450 million each, on average.[149] While the arts nonprofits earned a mere sixty-six million each, on average,[150] one must remember that museums do not enjoy the steady flow of revenue from tuition or health insurance reimbursement that colleges and hospitals do.

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[147] *Display Largest Public Charities*, *supra* note 144.
[148] *See supra* Table 1 (taking the average from the 2013 Net Profit column).
[149] *See supra* Table 2 (taking the average from the 2013 Net Profit column).
[150] *See supra* Table 3 (taking the average from the 2013 Net Profit column).

The fact that tax-exempt entities earn large profits is not, in and of itself, particularly troubling. Budgeting expenditures against anticipated revenues is an inexact science, and ending a year with a surplus typically means either that revenues were unexpectedly greater than anticipated or that the firm's managers were diligent in keeping expenses down. In a for-profit business, this is great news. However, in the tax-exempt world, when firms post significant profits year after year, closer scrutiny is mandated. As previously stated, society has certain expectations of nonprofits, and the fact that they are subsidized by tax dollars necessitates a higher standard of accountability.

If these profits were consistently being used to further the tax-exempt organization's charitable purposes, then it stands to reason that society would be satisfied. However, most of the wealthiest nonprofits in this country not only earn significant profits annually, but they also have a tendency to stock those profits away, building endowments seemingly simply for the sake of having a large endowment. Indeed, it has been argued that the nation's elite universities work so hard to build up their endowments, not because they have grand designs for the future of education, but because a large endowment is itself an indicator of prestige.[151]

The purpose of an endowment for a college should be to protect the school's education and research programs in the event of an economic downturn.[152] Similarly, a hospital's endowment should exist to sustain a level of patient care and medical research when revenues are less than expected,[153] and museum endowments should enable the institution to advance cultural education and preserve cultural heritage even when donations and admissions receipts decline.[154] These seem to be legitimate reasons to have an endowment. But what happens when the organization begins to serve the endowment instead of the other way around?

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[151] Peter Conti-Brown, Note, *Scarcity Amidst Wealth: The Law, Finance, and Culture of Elite University Endowments in Financial Crisis*, 63 STAN. L. REV. 699, 699 (2011).

[152] Burton A. Weisbrod & Evelyn D. Asch, *Endowment for a Rainy Day*, 2010 STAN. SOC. INNOVATION REV. 42, 44, *available at* http://www.ssireview.org/articles/entry/endowment_for_a_rainy_day.

[153] *Id.*

[154] *Id.*

When Hurricane Katrina shut down Tulane University in 2005, the school's total revenue dropped ten percent between fiscal years 2005 and 2006.[155] Being temporarily closed by a hurricane and spending many months cleaning up the aftermath would likely qualify as one of the more extreme examples of a "downturn" imaginable, and even then, Tulane's revenues were only off by ten percent.[156] Using this ten percent drop as an example of an extreme decline in revenues, Burton Weisbrod and Evelyn Asch calculated the length of time certain nonprofits could continue operating without making a single spending cut, simply by dipping into their endowments.[157] The results are surprising.

Weisbrod and Asch determined that the average hospital could function for five years at full steam even with a ten percent drop in revenue, simply by using its endowment.[158] The average college could maintain all of its programs in their entirety for twenty-one years, and the average museum could operate for thirty-seven years under the same conditions.[159] Getting more specific, they found that Princeton University's endowment was sufficient to keep the school humming along for 141 years, Harvard for ninety-six years, the Metropolitan Museum of Art for ninety years, the Boston Symphony Orchestra for fifty-three years, and small Grinnell College for a whopping 191 years.[160]

Taken alone, these numbers are not necessarily good or bad. Who cares if a nonprofit has a large endowment? Is that not simply evidence of its management's wise decision making? Perhaps; but American taxpayers subsidized a sizable chunk of each of those endowments. Even nonprofits that get almost no revenue from donations—like many hospitals—enjoy the benefit of taxpayer subsidy through the income tax exemption. If taxpayers are subsidizing these nonprofits, should they not also have some oversight concerning the use, or nonuse, of their funds?

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[155] *Id.* at 45.

[156] *Id.* at 46.

[157] *Id.* at 46–47. Weisbrod and Asch's figures are from 2010, so the specific figures may have changed, but the general trajectory remains the same. If anything, the continuing recovery of the U.S. economy is likely to have inflated endowments even more in the intervening years.

[158] *Id.* at 46.

[159] *Id.*

[160] *Id.* at 47.

As another example, consider hospital endowments. While Professor Hansmann may argue that nonprofits can have a difficult time securing debt financing,[161] health insurers are a very reliable revenue stream that has made many nonprofit hospitals exceptionally creditworthy.[162] Most nonprofit hospitals are able to issue tax-exempt debt—the interest payments are not taxable income to the lender—which carries a much lower interest rate than taxable debt, since the lender is realizing significant savings by receiving the interest tax-free.[163] William Gentry's 2002 study determined that almost sixty percent of all hospital debt was issued for the purpose of engaging in tax arbitrage.[164] That is, the hospital has an endowment sufficient to supply the organization's capital needs, but the endowment earns a greater return on investment than the hospital would have to pay on the tax-exempt debt. For example, the endowment might be earning a ten percent annual return whereas the hospital might have to pay seven percent interest on its debt. So, the hospital finances its operations through debt instead of using its savings because it is cheaper that way.[165]

What enables hospitals to take advantage of such a profitable scheme? The benefits of the tax code for nonprofits, of course. In this example, taxpayers are subsidizing the hospital in two separate ways. First, the hospital received the revenues that created its endowment tax-free, as are almost all revenues for exempt entities. Second, the only reason the hospital is able to sell debt at such a low interest rate is because the government is forgoing the opportunity to receive any tax revenue on the interest payments made to the lenders. Thus, the tax coffers miss out on two opportunities for revenue while the hospital's endowment balloons. With such a sweet deal why would a nonprofit hospital spend one penny of its endowment, ever?

Indeed, evidence shows that even during the severe financial crisis beginning around 2008, endowment-holding institutions were so loath to dip into their savings that they cut programs and expenditures rather than siphon funds from their

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[161] Hansmann, *supra* note 7, at 73.

[162] William M. Gentry, *Debt, Investment and Endowment Accumulation: The Case of Not-for-profit Hospitals*, 21 J. HEALTH ECON. 845, 848 (2002).

[163] *Id.*

[164] *Id.* at 846.

[165] *Id.* at 851, 855.

endowments.[166] If a serious recession—the worst since the Great Depression, we were told ad nauseum—was not enough to cause a nonprofit to use its endowment funds, what on earth possibly could be?

The purpose of this Article is not to criticize organizations that accumulate massive endowments.[167] If an organization determines that the best course of action is to amass a large reserve, it should be able to do just that. The problem arises, however, when taxpayers provide a substantial portion of that money and it ends up parked in an investment somewhere, never to be used for the organization's charitable purposes.[168]

This seems wrong for two reasons: It is immoral, and it is wasteful. First, implicit in the exemption for nonprofits is the expectation that such firms will use their public subsidy to actually benefit the public. When a firm receives taxpayer dollars, does it not have a moral duty to use those dollars in the agreed-upon manner? The federal government directly subsidizes all sorts of things; if the recipients of those direct subsidies took the money, put it in the bank, and never used it for anything, how long do you think the government would continue providing such subsidies?

The second objection to the current practice of using tax dollars to build impenetrable endowments is that it is wasteful. A nonprofit hospital engaged in tax arbitrage does not need an income tax exemption. But, since it has one, it does what any rational actor would do and uses it to its full advantage. The federal budget is still pretty severely in the red, and to be granting blanket tax exemptions to organizations that clearly do not need it seems like a poor policy.

[166] Weisbrod & Asch, *supra* note 152, at 45; *see also Tuition and Fees and Room and Board over Time, 2005–06 to 2015–16*, COLLEGE BOARD, http://trends.collegeboard.org/college-pricing/figures-tables/tuition-fees-room-board-time-2004-05-2014-15 (last visited Feb. 28, 2016). Further, from 2008 to 2014, tuition at private colleges rose an average of sixteen percent and tuition of public universities an average of twenty-eight percent.

[167] Indeed, this author believes it to be the mark of a well-run organization doing what any rationale manager would do.

[168] There is, of course, the argument that some portions of most endowments—especially those of colleges and universities—are restricted and therefore cannot be used by the institution, even if it wanted to. Given the fungible nature of money and the manner in which donations are typically made, that argument has been soundly discredited. *See* Conti-Brown, *supra* note 151; Weisbrod & Asch, *supra* note 152, at 46.

There does, however, seem to be a relatively simple solution to this problem. It will surely be a tough sell, politically, but it has the potential to reign in the out-of-control accumulation of wealth by the largest nonprofits yet keep in place all of the benefits enjoyed by those nonprofits that use their funds diligently for the betterment of society. Before we arrive at this Article's proposed solution, let us take a moment to discuss other recent proposals for reforming the nonprofit sector.

III. OTHER PROPOSED REFORMS

Several scholars have suggested changes to the tax code as it pertains to nonprofits in recent years. While none has gone quite so far as an outright elimination of the income tax exemption, some have gotten close, and still others have come up with some rather creative proposals for reforming nonprofit tax laws.

A. *Mandatory Distributions for University Endowments*

A number of articles has addressed the potential of extending the mandatory distribution requirements for private foundation endowments to reach the endowments of public charities, especially universities. While Congress has never voted on such measures, it has certainly been the subject of legislative inquiry,[169] and at least one short-lived amendment, which would have required mandatory payouts for university endowments in excess of $500 million, was introduced.[170]

In general, however, legal scholars have tended to resist any suggestion to impose mandatory endowment payouts for public charities. In his thoughtful discussion of university endowments, Mark Cowan examines the rationales both in favor of and opposed to mandating minimum payments or imposing tax on endowment income and concludes that both are generally ill-

[169] *See* Alexander M. Wolf, Note, *The Problems with Payouts: Assessing the Proposal for a Mandatory Distribution Requirement for University Endowments*, 48 HARV. J. ON LEGIS. 591, 597–98 (2011).

[170] *Id.* at 598.

advised.[171] Similarly, in his 2010 article, Johnny Rex Buckles advised Congress to use caution in considering whether to tax endowments of universities and other donative nonprofits.[172]

At this time, scholarly sentiment certainly seems to tilt in favor of permitting nonprofits to make their own determinations as to the best use of their endowment funds. The proposal set forth in Part V of this Article is consistent with this line of reasoning.

B. The Addition of a "Nondiversion" Constraint for Nonprofits

In her 2003 article, Frances Hill seeks to answer a very similar problem that is raised in this Article when she inquires, "[W]hether the diversification of the activities to exempt organizations to encompass commercial and political activities is consistent with charitable efficiency."[173] Put differently, she addresses the issue of nonprofit organizations that receive tax benefits but do not use their revenues in furtherance of their charitable purposes.

Instead of a solution that seeks to recover taxpayer subsidies from firms that earn significant profits without ever using them—as this Article does—Professor Hill suggests implementation of what she terms a "nondiversion constraint,"[174] which would penalize nonprofits for using funds to finance activities inconsistent with their core charitable purpose.[175] Professor Hill's nondiversion constraint is generally consistent with the proposal set forth in this Article. Whereas the nondiversion constraint seeks to ensure that money spent by

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[171] Mark J. Cowan, *Taxing and Regulating College and University Endowment Income: The Literature's Perspective*, 34 J.C. & U.L. 507, 510–11 (2008). Professor Cowan bases his conclusions "on our current understanding of how colleges and universities should be taxed," which arguably is less settled than Professor Cowan's article suggests. *Id.* at 511.

[172] Johnny Rex Buckles, *Should the Private Foundation Excise Tax on Failure To Distribute Income Generally Apply to "Private Foundation Substitutes"? Evaluating the Taxation of Various Models of Charitable Entities*, 44 NEW ENG. L. REV. 493, 539 (2010).

[173] Frances R. Hill, *Targeting Exemption for Charitable Efficiency: Designing a Nondiversion Constraint*, 56 SMU L. REV. 675, 678 (2003).

[174] *Id.* at 708–09.

[175] *Id.*

nonprofits actually goes to fund charitable activities,[176] this Article's suggestions seek to address the problem of nonprofits hoarding profits without ever spending them at all.[177]

C. *Elimination of Barriers Between Nonprofit and For-Profit Enterprises*

In recent years, several commentators have highlighted the distinction between nonprofit and for-profit organizations, with the conclusion being that perhaps the two are not as different as previously believed. "It is always startling when a distinction long believed to be a difference of kind turns out to be a difference of degree," notes Evelyn Brody, going on to argue that the similarities between nonprofits and for-profits seem to greatly outnumber the differences.[178] While the purpose of Professor Brody's article is to analyze the nonprofit and for-profit distinction from an economic perspective, she does briefly note:

> Should the public cease to view enterprises in terms of their organizational form, we would likely see subsidies tailored more towards worthy outputs by all enterprises, owned and unowned. Society might conclude, for example, that transforming monolithic tax exemption into targeted output subsidies makes more efficient and fair use of collective resources.[179]

Although she does not expand upon the concept of targeted output subsidies, except to say that it would likely be appropriate to offer such subsidies to all firms regardless of nonprofit status,[180] such a notion fits nicely with the proposal made in this Article. Part V, below, suggests a shift in the treatment of nonprofits such that, instead of granting tax breaks based on organizational form, we should provide subsidies corresponding to the actual use of funds in furtherance of a nonprofit purpose.[181]

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176 *Id.* at 709.

177 *See infra* Part V.B–C.

178 Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 457–58 (1996). Indeed, the average consumer would be hard-pressed to be able to recognize the difference between a for-profit hospital and a nonprofit hospital simply by the service provided by each. The same seems generally true for for-profit and nonprofit colleges, thrift shops, and the like.

179 *Id.* at 536.

180 *Id.* at 461.

181 *See infra* Part V.

Along similar lines, Susannah Camic Tahk noted, in her 2014 article, that both nonprofits and for-profits tend to cross the boundaries of their sectors in certain instances, even though the tax code is specifically structured to keep those boundaries clear.[182] Because of this border-crossing activity, Professor Tahk recommends various changes to the tax code, which will not only permit such activity, but also harness it to create incentives for both nonprofit and proprietary firms to create more social good through border-crossing behavior.[183]

Taking the idea of a merger of the nonprofit and proprietary form yet another step further, Anup Malani and Eric Posner, in their 2007 article, recommended decoupling tax subsidies from the nonprofit form, and making tax breaks available to all organizations engaged in charitable activities, even proprietary firms.[184] Malani and Posner characterize their issue as "the flip side of the UBIT debate: should *for-profit* firms be taxed like nonprofit firms (or more precisely, be exempt from taxes like nonprofit firms) when they engage in *charitable* activities?"[185] They conclude that there is no rational reason to grant tax breaks solely based upon organizational form, and therefore say "yes" to the question in the previous sentence.[186]

While Professors Malani and Posner focus primarily on the deductibility of donations when they discuss tax breaks for charitable purposes,[187] and this Article is concerned more with the exemption from income taxation, it remains relevant that they affirm the convergence of the nonprofit and for-profit forms and agree that tax benefits solely based upon a firm's consent not to distribute its profits are irrational.[188] Whereas their

[182] *See* Susannah Camic Tahk, *Crossing the Tax Code's For-Profit/Nonprofit Border*, 118 PENN ST. L. REV. 489, 489 (2014).

[183] *Id.* at 490.

[184] Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2022–23 (2007).

[185] *Id.* at 2023.

[186] *Id.*

[187] *Id.* at 2025–27.

[188] It should be noted that Malani and Posner's suggestion has—perhaps not surprisingly, given its somewhat radical nature—been criticized by several commentators who argue that the coupling of tax breaks with the nonprofit form serve important, and defensible, functions and can be justified under various theories, including the theory of agency. *See, e.g.*, Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1213, 1213 (2010); Benjamin Moses Leff, *The Case Against For-Profit Charity*, 42 SETON HALL L. REV. 819, 839 (2012).

suggestion is to provide more tax breaks to for-profit entities,[189] this Article takes the opposite tack and suggests fewer subsidies for nonprofits.

IV. THE PROPOSED SOLUTION

A. *A Framework for Evaluating Any Proposed Change to the Tax Code*

In order to craft an effective solution to the problem outlined in Part III, several criteria must be met. First, the solution must be narrowly tailored to address the issue. Implementing a change in the tax code that negatively affects those nonprofits that do not accumulate massive endowments or regular large annual profits is unacceptable.

Second, the solution should respect the autonomy of all organizations. Legislating strategy decisions best made by managers and directors are typically a bad idea. If an organization feels it is necessary to build a large endowment—whether it is to save for a rainy day or simply to gain prestige—the government should not intrude upon such decisions. True, Congress should have a say in how tax dollars are spent, but to the extent possible, it should also steer clear of involving itself in the operational matters of private organizations.

Third, any proposal must be inexpensive to implement and maintain. If the IRS spends more administering new rules pertaining to exempt organizations than it might receive in revenue from those same rules, the effort is pointless. Finally, and most importantly, any solution to the problem of tax-exempt money not being used for tax-exempt purposes must actually address the problem. If the end result is not that tax dollars are being used in the manner expected by society, any such solution is unsatisfactory.

To these ends, the following recommendation seems like it would be the most effective means by which nonprofits could be held accountable for the subsidies they receive.

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[189] Malani & Posner, *supra* note 184, at 2065.

B. A Proposal for Reforming Nonprofit Income Taxation

This proposal is to remove the income tax exemption for nonprofits but to allow them an unlimited deduction for expenses directly related to their charitable purposes,[190] coupled with a reasonable standard deduction,[191] allowances for carrying losses forward, and a five-year capital savings exemption.[192] The following paragraphs explain this suggestion in detail.

First, by removing the income tax exemption but permitting nonprofits to deduct all expenses actually related to their charitable purposes, those nonprofits that actually spend virtually all of their revenue[193] on fulfilling their nonprofit mission will be largely unaffected. Only those nonprofits that generate significant profits will incur a measure of income tax liability. Recognizing that it is impossible for a firm to operate

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[190] It seems reasonable that this deduction would match the business expense deduction provided to for-profit corporations in § 162, which provides a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." I.R.C § 162(a) (West 2014). All that would be required is the removal of "trade or business" and the insertion of appropriate language pertaining to nonprofit operations. Section 162 and the various cases and regulations interpreting it have already developed a very thorough framework for determining what expenses qualify for the deduction, and the very same analysis could be applied to deductions for nonprofit business expenses.

[191] It seems reasonable that this standard deduction would be somewhere around ten million dollars, but more in-depth economic analysis would be required to pinpoint an optimal figure.

[192] The question could be raised as to why this recommendation is not instead structured as an excise tax on retained earnings above a certain amount. Such a structure would indeed function identically to the suggestion put forth herein and would avoid the political pitfalls associated with news headlines touting taking away the tax exemption for charities. However, for two reasons, the recommended structure is preferred. First, it treats nonprofits more like the business entities that they are. Modern, sophisticated nonprofits function just like their for-profit counterparts, and changing the tax code to reflect the way they actually treat revenue and expenses will bring it more in line with actual current practices. Second, this author believes that for-profit organizations should also be granted a deduction for expenditures made for charitable purposes—not just a § 170 deduction for donations, but actual § 162 business expense deductions for charitable activities. This is the topic for a follow-up article, but by implementing this Article's recommendations in the structure presented here, it would be a much smaller step to permit for-profit institutions to be able to deduct expenses related to their charitable activities.

[193] Here, revenue is generally defined as all incoming cash flows. For taxpaying entities, revenue is categorized into income, capital gains, and more. For purposes of this Article, all incoming funds will simply be lumped into one category. It may be beneficial at a later date to make distinctions between, say, revenue from donations and revenue from interest on endowment assets, but it is unnecessary at this point.

with expenses precisely matched to revenues, a properly determined standard deduction, which is added to the top of an organization's total business expense deductions, will permit most nonprofits to book a small amount of profit without the fear of incurring income tax liability and to offset losses in one year against profits in future years. However, when profits reach into the eight-, nine-, or ten-figure range, the organization would be forced to pay tax on its profits.

The theory behind this part of the proposal is that, when a nonprofit earns some small amount of profit that is reasonable and to be expected for an entity that wishes to maintain financial viability into the future, it is not exploiting the exemption. However, when an exempt organization books many millions, or even billions, of dollars in profit, it would seem that such a firm is potentially exploiting the exemption. As Hansmann would put it, such a firm is overcapitalized and not in need of an exemption,[194] so why give it one?

The other prong of this proposal is to allow nonprofits to raise capital for a specific purpose over a five-year period without incurring income tax liability. In times of growth, organizations frequently raise funds over a period of time longer than one year for a major capital project, such as a new building or major equipment purchase. It would be unfair to preclude nonprofits from continuing to raise funds for such purposes, so by permitting them to designate a specific capital project for which they may set apart profits into a separate account—for a maximum period of five years—firms will be able to continue to make large capital investments as always. If the funds are spent on the capital project as designated, then there is no tax liability. If the capital project gets scrapped or there are excess funds in the account upon completion, then those funds would be subject to income taxation, although the loss carryforward deductions would still be available.

Allow us to consider two examples of how this proposal would play out in real-world situations. First, consider a small poverty relief charity with a budget of one million dollars annually. When the economy is booming, this nonprofit might receive a flood of donations, giving it a net profit in such years. On the contrary, during difficult economic times, when the need

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[194] *See* Hansmann, *supra* note 7, at 75.

is greater, its expenses might exceed its revenues and the organization will book a loss in those years. On average, however, while this nonprofit has some money in the bank for a rainy day, it does not have a large endowment earning interest from which it can draw.

For small organizations such as this one, nothing will change. Because the profits it makes in good years are small, they will fall within the standard deduction and no tax will be due. If the organization wishes to raise funds for a new building—say, for instance, a homeless shelter—it need only designate the specific capital project on its annual filing with the Interal Revenue Service ("IRS") and place the funds into a separate account. As long as they are used for that purpose within five years, those funds are also tax-free, even if they exceed the standard deduction. This organization was already filing a Form 990 each year with the IRS, which listed various key components of its charitable activities and financial performance.[195] It will continue to file the same information with the IRS—although perhaps on a different form—and nothing else will really change for this small charity. If the firm is ever audited, it must be able to justify that the expenses it has deducted are indeed in furtherance of its charitable mission, so receipts must be kept and careful records maintained. Any nonprofit of similar size is almost certainly already following such practices.

Now consider a large nonprofit metropolitan hospital. This hospital receives revenues in excess of one billion dollars each year and maintains a sizable endowment. Annual profits typically range between $50 million and $100 million,[196] most of which gets added to the endowment. To maintain its nonprofit status, the hospital does use a small percentage of its annual

[195] Nonprofits with annual receipts in excess of $500,000 are required to file Forms 990 annually. Smaller firms may file Forms 990-EZ or 990-N, but all firms, except those with less than $50,000 in gross receipts, are required to submit documentation of their financial status each year. *See Which Forms Do Exempt Organizations File?*, INTERNAL REVENUE SERV., https://www.irs.gov/Charities-&-Non-Profits/Form-990-Series-Which-Forms-Do-Exempt-Organizations-File-Filing-Phase-In (last updated Feb. 8, 2016).

[196] This translates into a five- to ten-percent profit margin, which is fairly typical for a hospital. *See Aggregate Total Hospital Margins, Operating Margins, and Patient Margins, 1992–2012*, AM. HOSP. ASS'N, http://www.aha.org/research/reports/tw/chartbook/2014/chart4-2.pdf (last visited Feb. 28, 2016).

profits on charity assistance for patients who are unable to pay their bills. Because the hospital is not using its profits for any charitable purpose in a timely manner, those profits in excess of the standard deduction will be subject to income taxation.[197] The hospital is free to add to its endowment as it sees fit, but those funds that will simply sit unused for many years will be taxed prior to being added to the endowment. If it decided to use more money on patient care instead of endowment padding, those expenses would all be 100% deductible and would reduce the organization's tax liability.

If the hospital were to book a loss in a given year, it could apply that loss to reduce its tax liability in future years. Also, if it decided to undertake a large capital expansion—such as a new wing or research center—it could do so in the exact same manner as the small charity previously described. Likewise, the hospital would continue to file all of its relevant financial information with the IRS in the same manner as before.

For nonprofits large and small, this proposal would incentivize them to spend their revenues advancing their nonprofit mission, instead of building their savings accounts without limit, although it would still permit endowment buildup—albeit with a cut going back to the taxpayers subsidizing the gains—if that is the desired strategy of the firm's managers. Likewise, it would also allow for annual fluctuations between small profits and losses without penalty.

This proposal seems to have certain benefits, but how does it stack up against the criteria previously set forth for any proposed changes to the tax code affecting nonprofits?

C. *Evaluating the Proposal Against the Framework*

So how does this proposal stack up against the framework set forth in Part V.A? The first criterion is that any changes must be narrowly tailored to specifically address the problem of nonprofits that abuse the exemption without negatively affecting those nonprofits that typically spend substantially all of their

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[197] The issue of the proper rate for the tax on such profits is beyond the scope of the discussion here. Reasonable arguments can be made for matching the rate to the rate paid by corporations on their income since nonprofits are typically organized and operated as corporations, albeit under the separate not-for-profit corporation act of each state. Arguments could also be made in favor of a lesser tax rate to serve as some measure of recognition of the history of preferred tax treatment of nonprofits.

revenues on their charitable missions. As the two examples in the previous Subsection demonstrate, the small nonprofit that uses all, or almost all, of its revenue for its purpose of poverty relief will notice virtually no change whatsoever. This is true even if the small charity earns a profit or engages in a capital campaign. It is not until a nonprofit grows large enough, and realizes significant enough profits, that it will be affected by this proposal at all, and then it is only affected only to the extent that it fails to use those profits to advance its charitable purposes. Thus, the first criterion seems to be satisfied.

The second metric is that any change should respect the autonomy of organizations. It has of course been suggested that certain charities be forced to pay out a set percentage of their endowments each year,[198] as is the case for private foundations,[199] but this seems excessively intrusive. If an organization receives revenue, it should have discretion to use the revenue as it sees fit and to the greatest extent possible. Thus, under the proposal at issue, nonprofit organizations are free to build sizable endowments; they just cannot do so with tax-free money. If they just want to save some money, they can do so to their hearts' content, but taxpayers should not be subsidizing billion-dollar endowments that are untouchable; such firms must simply pay tax on the profits that go into the endowment. Once there, the firm is free to manage the investments as it sees fit.

As a third condition, any proposed change must be inexpensive to implement and administer. Under the proposal outlined in this Article, the amount of work required by both the IRS and nonprofit organizations will change minimally. The IRS already has mechanisms in place for evaluating revenue and expenses, thanks to those statutes pertaining to corporate taxation,[200] which could very easily be adapted for the nonprofit sector. For instance, § 162 provides a thorough system for determining what expenditures are deductible as business expenses for for-profit firms, and the same system could be easily adapted to expenses allowed as deductions for nonprofits.[201] Therefore, this condition is easily satisfied.

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[198] *See, e.g.*, Cowan, *supra* note 171 (assessing arguments for mandatory minimum payouts for college endowments, but ultimately arguing against them).

[199] I.R.C. § 4942 (West 2014).

[200] *See, e.g.*, I.R.C. § 61 (2012); I.R.C. § 162 (West 2014).

[201] *See* I.R.C. § 162.

Finally, does this solution solve the problem? We are concerned about tax-exempt organizations failing to use their publicly subsidized funds for charitable purposes, so does this proposal rectify those concerns? In a narrow sense, it does. You either spend your revenues on your charitable purpose or you pay a tax. Nonprofits certainly seem like they would be incentivized to devote more of their profits to expanding their benefit to society. If they choose instead to save those profits, then they can pay a tax on the money they put into savings—which is essentially the equivalent of returning the subsidy given to them by the government. However, there is also the possibility that organizations will seek to curb their potential tax liability not by advancing their charitable purposes, but by other means. Part VI, below, addresses some of the challenges to this proposal.

D. *So What Value Remains in Nonprofit Status?*

Without an exemption from income taxation, one may wonder why an organization would choose the nonprofit form anymore. There are multiple reasons, the most important of which is the § 170 deduction for donations.[202] The recommendation to eliminate the income tax exemption does not carry over to the deduction for donations to nonprofits. The deductibility of donations is a powerful incentive for individuals to support charitable programs, and without it, nonprofits of all types would see massive declines in their revenues.

When private people give money to a nonprofit, they reasonably expect that those funds will be used in furtherance of the organization's charitable purposes, so we allow the donors to deduct the amount of their donation from their taxable income. If the nonprofit chooses not to use the funds for that purpose and instead simply adds to its endowment, the donors should not be punished. The nonprofit should pay a tax on such funds, but the donors' deductions will remain in place.

Even without the deduction for donations, the nonprofit form is an indicator that an organization is committed to its charitable purposes and worthy of public support.[203] Without the nondistribution constraint, the theory is that the public will view

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[202] *Id.* § 170.

[203] Henry Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 504–09 (1981).

the organization's management as less likely to be committed to societal benefit and more likely to be seeking a return for its shareholders and will therefore provide less financial support.[204]

Additionally, as previously mentioned, for the vast majority of charities that do not sock away megaprofits each year, virtually nothing would change.[205] Obtaining recognition by the IRS as a 501(c)(3)[206] corporation would still grant the corporation essentially the same benefits it already enjoys under the current law.

Finally, this Article does not address several additional benefits of the nonprofit form, but they are also key factors when choosing an entity type. The most prominent of these are the various forms of tax exemption beyond the income tax exemption that nonprofits enjoy. For example, most charitable organizations receive a property tax exemption and sales tax exemptions.[207] As this Article's purpose is to address reforms needed at the federal level, and property and sales taxes are state-level matters, such issues are beyond the scope of this discussion.[208] Nevertheless, such benefits are incredibly powerful motivators for those choosing the nonprofit form.

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[204] *Id.*

[205] *See supra* Part IV.B.

[206] *See* I.R.C. § 501(c)(3).

[207] *See* N.Y. REAL PROP. TAX LAW § 420-a (McKinney 2013); N.Y. TAX LAW § 1116 (McKinney 2008).

[208] An argument can be made that the state-level tax exemptions are actually more valuable to the average nonprofit than the federal exemption. The property tax exemption appears to be especially important. Consider, for example, a church that owns a large building, where it holds services. The building may have an assessed value well into the millions, which would result in significant tax liability for the church regardless of how much revenue it brought in. However, with the property tax exemption, the church need only worry about bringing in enough revenue to cover its operating expenses, which are generally proportional to the size of its congregation. While the value of the income tax exemption is proportional to the profits of the organization, the property tax exemption is proportional to its assets, thereby allowing a nonprofit to enjoy small revenues but hold large assets.

E. Convergence with Other Theories of Exemption

Even though this Article's recommendation is to eliminate the blanket income tax exemption for nonprofits, such a proposal is not necessarily at odds with the various theories justifying the exemption discussed previously.[209] In fact, the thrust of each of these theories converges nicely with this Article's proposals.

The key concept in the Public Good Theory is that society wants to create an incentive for private organizations to provide goods and services so that the government will not have to do so.[210] Under the scheme suggested herein, the same goals would be satisfied and likely to an even greater extent than under the current system. Today, nonprofits are subsidized by tax dollars merely for existing, even if they never spend their revenues on charitable activities. By removing the exemption and allowing deductions for money actually spent in furtherance of a firm's nonprofit purposes, the incentive to actually create public good will be magnified. Likewise, by taxing money received by a nonprofit and not put to good use, the public will be reimbursed for unused subsidies. Thus, the goal of the Public Good Theory will be more fully realized.

Likewise, the underlying goals of Hansmann's Capital Formation Theory[211] will be better served by this Article's recommendations than by the current system. If the reason for granting the exemption was to give nonprofits a means of acquiring sufficient capital—since they are unable to avail themselves of equity capital like for-profit firms[212]—then any changes to the current system must still allow undercapitalized nonprofits to receive, and even accumulate, revenue without being subject to income taxation. Under the proposal at hand, nonprofits may retain a certain amount of profits—up to the standard deduction limit—tax-free and may also set aside funds for a specific capital expense for a period of up to five years, also tax-free.[213] However, whereas the current tax code provides an income tax exemption to all qualifying nonprofits, regardless of need, this Article's proposal would limit the public subsidy to only those firms that are truly undercapitalized. Overcapitalized

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[209] *See supra* Part I.C.
[210] *Id.*
[211] *See* Hansmann, *supra* note 7, at 55.
[212] *Id.* at 63.
[213] *See supra* Part IV.B.

firms, like many nonprofit hospitals, which realize many millions of dollars in annual profits, would not be given public subsidies to pad their bank accounts. Hansmann himself acknowledged the risk of subsidizing overcapitalized firms but did not see it as being as much of a problem as it has become in the thirty years since he addressed the issue.[214]

When discussing the Donative Theory of exemption for nonprofits, this Article noted that it seems to work very well for those organizations that are supported largely by public donations, but perhaps not as well for more commercial nonprofits, like many hospitals, or for nonprofits that have a mix of revenues from donations and commercial activities.[215] Under the Donative Theory, charities supported by private donations should be tax exempt because they provide goods or services not adequately provided by either the government or the marketplace.[216] Under the proposal at hand, such entities would continue to be free from income taxation to the extent they actually provide such goods or services. To the extent they keep the money donated to them without putting it to charitable use, they would incur income tax liability.

The same rationale applies to a discussion of this Article's proposal in the context of Atkinson's altruism theory.[217] If we truly desire to provide tax incentives for organizations that act altruistically, should we not provide those tax breaks only when they are actually acting out of a spirit of altruism? Limitless accumulation of endowment wealth does not seem to be particularly altruistic.

Likewise, Crimm's theory of compensating nonprofits for assuming the risk of producing public goods[218] should only apply to organizations to the extent that they are producing public goods. Firms that accumulate large retained earnings would not seem to be in need of compensation for assuming risk.

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[214] *See* Hansmann, *supra* note 7, at 75.

[215] *See supra* Part I.C.4. In fact, the Donative Theory would likely argue against exempting most commercial nonprofits that are not supported by donations. *See* Hall & Colombo, *supra* note 49, at 409–10.

[216] *See supra* Part I.C.4.

[217] *See supra* Part I.C.5.

[218] *See supra* Part I.C.5.

F. *What of the UBIT?*

With the income tax exemption repealed, will the unrelated business income tax ("UBIT") automatically be done away with as well? Not necessarily. The UBIT was originally created in an effort to keep commercial nonprofits from using the advantage of taxpayer subsidies to drive for-profit firms out of business.[219] If this purpose is still a valid concern, then the UBIT could easily remain in place, and nonprofits would pay tax on the income derived from activities unrelated to their charitable mission in the same manner they currently do. However, it may be the case that the risk of nonprofits dominating the private sector is perhaps not as severe as Congress thought it was in 1950, mainly due to some of the disadvantages such organizations face, which could negate the advantage of tax exemption.[220]

Whether the UBIT lives or dies is inconsequential to the proposal made in this Article. The future of the UBIT is, however, a ripe topic for further study especially given the fact that recent scholarship has tended to blur the lines between the nonprofit and for-profit sectors.[221]

V. CHALLENGES TO THE PROPOSED SOLUTION

To be sure, any suggestion that involves ending a system that has been in place for well over a century is not without its challenges. This Part discusses some of the possible objections to this Article's proposal, beginning with perhaps the most obvious issue of the difficulty in gaining political traction for such an idea.

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[219] *See* Strefeler & Miller, *supra* note 29.

[220] The prime example of one such disadvantage is the lack of ability to attract equity capital. Thus, while nonprofits have the advantage of not having to pay taxes, they lose the ability to attract investors since they are unable to provide them with a return on their investment. Then the question becomes, which is more valuable: the tax exemption or the ability to attract equity capital? It is difficult to say, but it seems that these two factors likely balance each other out, leaving nonprofits and for-profits on a relatively even playing field. *See, e.g.*, Hansmann, *supra* note 7, at 72.

[221] *See, e.g.*, Brody, *supra* note 178 (analyzing whether there is a difference between for-profit and nonprofit sectors); Malani & Posner, *supra* note 184, at 2023 (finding that for-profits should be exempt from taxes like nonprofit firms).

A. Is the Proposal Even Possible, Given the Entrenched Nature of the Income Tax Exemption for Nonprofits?

Undoubtedly, constituents of a group that has enjoyed a benefit for over 100 years will be highly resistant to any change in that benefit that could be construed as a lessening of the subsidy provided to them. While it is true that the plan proposed herein will not affect the amount of subsidy provided to the vast majority of nonprofits, those organizations that will be most affected are also the firms with the deepest pockets, and deep pockets mean more lobbying power and ability to resist change.

While the giant nonprofits hospitals and Ivy League universities of the world will surely oppose such changes to the taxation of nonprofits, there is in fact precedent for narrowing the scope of the income tax exemption, which can serve as a model for implementation of the current plan.

To begin with, this Subsection considers the unrelated business income tax. The UBIT was not enacted until 1950, in response to a perceived problem of nonprofits utilizing their tax-exempt status in order to compete unfairly with their for-profit counterparts.[222] By 1950, the permanent income tax had been in place for thirty-seven years,[223] and charitable organizations had never paid taxes on any of their income, regardless of its source,[224] dating as far back as the Tariff Act of 1894, fifty-six years prior to the enactment of the UBIT.[225] Thus, the enactment of the UBIT in 1950 was not without some measure of controversy. Shortly after its passage, Professor Maurice Finkelstein noted:

> [T]he Revenue Act of 1950 has put obstacles—some of which are insurmountable—in the path of the taking over of industry by tax exempt associations. . . . But it is saddening to note that both the creation of the tax exemptions and their partial repeal have been accomplished without consideration of the basic elements of public policy involved.[226]

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[222] *See* Strefeler & Miller, *supra* note 29.

[223] *See* Revenue Act of 1913, ch. 16, 38 Stat. 114, 172, *amended by* Revenue Act of 1916, ch. 463, 39 Stat. 756, 777.

[224] JOINT COMM. ON TAXATION, *supra* note 46, at 100.

[225] Revenue Act of 1894, ch. 349, 28 Stat. 509, 570, *invalidated by* Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601, 637 (1895).

[226] Maurice Finkelstein, *Tax Exempt Charitable Corporations: Revenue Act of 1950*, 50 MICH. L. REV. 427, 428 (1952).

This Article's proposal is analogous to the passage of the UBIT. The percentage of the total number of exempt entities drastically affected by the passage of the UBIT was small, as will be the percentage of nonprofit firms materially affected by the proposal set forth herein.[227] Today, the UBIT's "partial repeal"[228] of the income tax exemption is viewed as fairly noncontroversial, and it has stood the test of time for more than sixty years. Who is to say that a further modification of the treatment of nonprofits cannot be similarly successful, especially when it does in fact take into account "the basic elements of public policy involved," as Professor Finkelstein put it?[229]

In addition to the UBIT, one can look to the statutes affecting private foundations for an example of a tax imposed on nonprofit organizations. A private foundation is a 501(c)(3) nonprofit organization that does not itself carry on any charitable activities but rather receives funds from a limited number of donors—frequently a single wealthy individual—and then invests or distributes those funds to other 501(c)(3) organizations.[230] Section 4942 of the tax code requires private foundations to distribute at least five percent of their total assets each year.[231] If the foundation fails to distribute at least five percent of its assets every year, the difference between the amount it actually distributes and five percent must be paid as a tax.[232] Thus, if a private foundation only distributed two percent of its total assets in a given year, it would be required to pay a tax in the amount of three percent of its total assets.

Further, private foundations are subject to a two percent tax on their net investment income each year, regardless of the manner in which they use such income.[233] Private foundations are by definition nonprofits that fall under § 501(c)(3), and yet they are subject to multiple taxes on their income.[234] Much like the UBIT, the taxes imposed on private foundations were enacted by Congress for specific reasons, even though at least one

[227] Strefeler & Miller, *supra* note 29, at n.191.
[228] Finkelstein, *supra* note 226.
[229] *Id.*
[230] I.R.C. § 509 (2012).
[231] I.R.C. § 4942 (West 2014).
[232] *Id.*
[233] I.R.C. § 4940 (2012).
[234] *Id.*

legislator decried such moves as "a beginning in the removal of income tax exemption" for all nonprofits.[235] In fact, the concept of a private foundation did not even exist prior to 1969.[236]

The excise tax on the net investment income for private foundations[237] was originally intended to defray the IRS's expenses in conducting audits of nonprofit organizations—never mind the fact that the IRS had not been thusly compensated prior to 1969 even though nonprofits had been exempt from income taxation since the income tax was made permanent in 1913.[238] However, the revenue from the excise tax has not traditionally been specifically allocated to IRS audit functions and in fact far exceeds the costs of such audits.[239]

Likewise, the tax on undistributed assets arose because wealthy individuals were creating private nonprofits into which they were transferring significant assets—and thereby taking tax deductions on their personal income taxes—but never using the money in the foundations for charitable purposes.[240] The concept of a nonprofit receiving large amounts of revenue and not putting the money towards its charitable purposes should sound familiar, as it is essentially the same problem addressed throughout this Article. If Congress could act to combat a similar problem in the context of private foundations, why should it be unable to do the same when faced with an analogous situation? Today, more than fifty years after their enactment, neither the excise tax on investment income nor the tax on undistributed income are particularly controversial.

If the UBIT and the taxes on private foundations can succeed, despite the long history of complete tax exemption for nonprofits, then it stands to reason that an additional modification, which only affects those large nonprofits that use their profits primarily to grow their endowments, would not be outside the realm of possibility.

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[235] S. REP. NO. 91-552, at 27 (1969), *reprinted in* 1969 U.S.C.C.A.N. 2027, 2054.

[236] I.R.C. § 509 (2012).

[237] *Id*. § 4940.

[238] S. REP. NO. 91-552, at 6.

[239] Bittker & Rahdert, *supra* note 49, at 326 n.68.

[240] Trevor Findley, Comment, *Tax Treatment of Private Charitable Foundations: A Call To Simplify the Excise Tax*, 49 WILLAMETTE L. REV. 477, 479–81 (2012).

B. *Would the Proposal Encourage Wasteful Spending To Avoid Taxation?*

Twenty-five years ago, Professor Hansmann considered the issue of endowment accumulation by universities and concluded that "efforts to limit endowment accumulation might in part have the effect of diverting universities toward other, less efficient forms of accumulation (for example, useless facilities or excessive esoteric research by faculty) or toward unproductive current spending."[241] This risk seems to apply equally to all categories of nonprofits should measures be enacted that entail negative consequences for the unchecked accumulation of endowments, as the proposal described in this Article does.

No one enjoys paying taxes; that much is clear. Most businesses and individuals go to great lengths to reduce their tax liability to the maximum extent allowed under the law. Thus, it stands to reason that a nonprofit, when facing a choice between paying some tax or spending money on a capital improvement, as an example—even if it does not need the improvement at that time—would quite likely choose to spend the money rather than pay the tax. One can envision a world filled with empty hospital wings, rooms full of brand new, unused scientific equipment, and universities with more professors than they know what to do with—which might not be such a bad thing!

It is conceded that the threat of an income tax on unused profits is likely to cause at least some measure of wasteful spending among some nonprofit organizations. The question then arises, which is worse: taxpayer subsidies for unnecessary expenditures or taxpayer subsidies for endowment accumulation? In an ideal world, all nonprofits would find useful, needed means of spending substantially all of their revenues, but for those that do not, this is essentially the choice.

Of course, the most useful option might be to just pay the tax and return the funds to the public, since they clearly are not needed. While that might be a consideration for a slice of particularly socially conscious nonprofits, it seems like it would be the exception, rather than the norm.

[241] Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. LEGAL STUD. 3, 40 (1990).

It does seem, however, that nonprofit organizations would still perhaps shy away from making unnecessary expenditures simply to avoid tax liability for two reasons. First, there is not a dollar-for-dollar equivalency when measuring paying the tax versus unproductive spending. Even using a high tax rate of thirty-five percent,[242] if a nonprofit earned $100 million in taxable income during a given year, it would still be able to add sixty-five million dollars of that income to its endowment, if it so chose. However, to avoid all tax liability, the organization would have to spend the entire $100 million. Thus, the unnecessary spending would need to add at least sixty-five million dollars in value to the organization or the nonprofit would be better off simply paying the tax.

The second reason is that nonprofit organizations do not exist in a vacuum. They are accountable to a host of different constituencies and must make decisions based on a variety of factors. If a university gained a reputation for wasteful spending in order to avoid tax liability, that school would likely face a backlash from its donor base. While a certain measure of increased spending would likely happen without repercussion—which would likely be a good thing, as we have already established that nonprofits can be overly stingy about protecting endowments instead of spending them—such extreme tax avoidance schemes would likely be kept in check by the need of an organization to keep its core stakeholders happy.

Thus, while it is certainly possible that highly profitable nonprofits will adjust their budgets to minimize their tax liability, and perhaps even engage in wasteful spending, there are several powerful controls to keep such spending in check. An increase in total spending is desirable, as some large nonprofits have likely underspent under the current tax system, so the risk of wasteful spending, while present, does not appear to be overly significant.

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[242] Thirty-five percent is the federal rate paid by corporations on income above ten million dollars. I.R.C. § 11 (2012). This Article is not advocating that nonprofit incomes be subject to the corporate rate, but rather uses it as an example of one of the highest rates paid by any entity in the United States as of this writing. In reality, this author believes a rate more in line with the capital gains rate—generally fifteen percent or twenty percent, depending on various factors—would be more suitable for the proposal in this Article.

C. Other Objections

Several other objections to this Article's proposal are discussed in this Subsection, beginning with the risk that large nonprofits could attempt to beat the system by breaking into multiple, smaller organizations to shield large amounts of total profit by making it appear to be smaller profits divided across many entities. For example, a hospital might attempt to spin off each of its individual departments into standalone entities for the purpose of allowing each department to max out the standard deduction, thereby permitting the departments in aggregate to accumulate profits far above what the hospital could have as a single operating entity.

This risk, and other similar attempts to "game the system," are inherent in any tax system and can be combatted through regulatory action. For example, in the scenario described above, the Treasury Department could very easily propose regulations that require affiliated entities to file a group income tax return or require separate charitable funds that support the same operating organization to disclose such support and thereby tax the conglomerate instead of each individual entity. For as long as tax liability exists, taxpayers will find creative ways to minimize their payments, and the IRS will continue to pass regulations in an attempt to curtail such action. It is the way of the world, and no different should nonprofits find themselves the subject of taxation.

Another challenge might come from organizations that rely upon endowed gifts to support specific programs, such as an endowed chair at a university. Would this Article's plan hinder the future of endowed programs by limiting the buildup of an organization's endowment? Undoubtedly, major donors might think twice if they knew that the beneficiary institution might have to use a portion of an endowed gift to pay income taxes.[243] However, due to the fungible nature of money, this would likely seldom, if ever, become an issue. A dollar is a dollar, regardless of the source, so nonprofit firms could honestly pledge to their donors that 100% of an endowed gift would be used for charitable

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[243] However, note that under this Article's proposal, the donors would still receive the full deduction. Thus, the analysis likely hinges on the degree of altruism of each donor. A cynic might argue that the donors would likely still make the full donation since the donors continue to receive the full benefit.

purposes—and not to pay income taxes—because any tax liability the organization might incur could always be paid out of other revenue streams.

The only instance in which this seems like it could become an issue would be in the event of a major donation in the range of $100 million or more. To add such an amount to an organization's endowment would surely give rise to some tax liability, and depending on the size of the firm, revenues from other sources might not be sufficient to pay the entire amount of the tax. In such case, it is possible that the nonprofit would be forced to use part of the endowed gift to pay income taxes. However, depending on the nature of the donation, the nonprofit could also take advantage of the five-year capital investment benefit and save the funds for a specific purpose.

Finally, there is the question of whether an organization will be able to undertake a long-term capital expansion project. While unlikely, it is possible that a nonprofit could engage in a capital campaign, the results of which would not be realized for more than five years. In such a case, the Treasury Department could always propose regulations permitting a nonprofit to petition for an extension of the five-year period, upon good cause shown.

Like any system of taxation that pertains to a broad scope of organizations, there will always be challenges that arise and certain groups that may feel like they are being disadvantaged. Although no tax plan is perfect, the one outlined in this Article treats organizations fairly and respects the rights of the taxpayer—and the subsidies provided by taxpayers—to a greater extent than the framework under which we currently operate.

CONCLUSION

Income tax exemption for nonprofit organizations is something that we all take for granted. Many of us have visions of nonprofits out there improving society, and while that may be quite true for most nonprofits, the income tax exemption is the equivalent of giving tax money directly to such organizations, simply because they are formed for a certain purpose, regardless of whether the funds are used for such purpose in a timely manner. While many nonprofits do struggle with lack of funds and dire needs, there exists a group of tax-exempt entities for which profits regularly flow quite freely, often to the tune of more than $100 million, or even $1 billion or more. And yet, the public subsidizes each nonprofit in exactly the same manner.

This Article outlined a potential change in the tax code regarding nonprofits that would enable undercapitalized firms to continue receiving the exact same subsidy as before, but would create a tax liability for those large nonprofits that generate substantial—ten million dollars or more—profits and fail to spend those profits in pursuit of their charitable mission. By removing the blanket income tax exemption and allowing an unlimited deduction for expenditures made in furtherance of charitable purposes, those nonprofits that use their revenues to benefit society would continue to avoid all taxation, but those that simply build their endowments without ever using such funds would not be able to benefit from a taxpayer subsidy for those funds.