

A CALL FOR REFORM OF THE OPERATIONAL TEST FOR UNRELATED COMMERCIAL ACTIVITY IN CHARITIES

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This Note proposes a reform of the operational test for charitable exemption found in § 501(c)(3) of the Internal Revenue Code. Under current law, the operational test uses a facts-and-circumstances standard to distinguish activity that furthers a charitable purpose from unrelated activity and to determine how much unrelated activity to allow. Due in part to the common law's expansive interpretation of the charitable purposes enumerated in § 501(c)(3), the operational test permits charities to engage in significant amounts of commercial activity without risking loss of exemption—the broader the definition of a charitable purpose, the more commercial activities may be related to it. Yet as commercial activity by charities increases, so too does the public perception that charities compete unfairly with for-profits and thus do not merit tax-exempt status. The perceived abuse of the charitable tax exemption puts pressure on the courts and the Internal Revenue Service to distort the scope of the current operational test in an effort to reduce commercial activity by charities. The result, a subjective “smell test,” has produced an inconsistent and unprincipled jurisprudence—sometimes even punishing charities for engaging in commercial activity that is related to charitable purposes. Further complicating matters is the Internal Revenue Service's tendency to allow significant amounts of commercial activity in clear contradiction of operational test jurisprudence. This Note judges the current operational test to be unworkable and proposes a modified test to take its place.

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* This Note was sponsored by the National Center on Philanthropy and the Law. The authors wish to thank Jill S. Manny, Executive Director of the National Center on Philanthropy and the Law, for her comments and guidance; the staff of the *New York University Law Review* and, in particular, our editors, B. Rudolph Delson, Parvin Daphne Moyne, and David S. Karp for their tireless editorial support; and Laura Auwers, Deborah Schenk, Michael Klausner, and Stephen Schwarz for their helpful comments on earlier drafts. This Note represents the authors' views and not necessarily those of our editors. Copyright © 2001 National Center on Philanthropy and the Law.

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INTRODUCTION

As commercial activity by charities¹ increases, some people fear that charities and for-profit organizations are becoming indistinguishable.² In a 1993 series of articles exposing alleged abuses in the non-

¹ This Note will use the term "charities" to refer to organizations listed under § 501(c)(3) of the Internal Revenue Code (I.R.C. or the Code). Charities are exempt from tax under I.R.C. § 501(a) (1994). The organizations covered under the § 501(c)(3) rubric include those "organized and operated" to promote "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." I.R.C. § 501(c)(3) (1994); see also *infra* note 18 and accompanying text for a discussion of the term "charitable." This Note will refer to these purposes variously as "charitable purposes" or "exempt purposes." The reader should be aware that there are many other types of tax-exempt and nonprofit organizations whose characteristics differ from those listed under § 501(c)(3) and that this Note does not address the nuances that those other nonprofit organizations introduce. Furthermore, charities listed under § 501(c)(3) may be distinguished further as public charities, private foundations, or supporting organizations, depending on the nature of their financial support. See § 509 (defining private foundation). Since public charities conduct most of the commercial activity, this Note will not distinguish among these subcategories but instead will discuss the group under the rubric of "charities."

² Unlike a for-profit, a charity's funds by law may not inure to the benefit of any private party or shareholder (the "nondistribution constraint"), and a charity must be both

profit sector, reporters Gilbert M. Gaul and Neill A. Borowski argued that many charities engage in excessive commercial activity, do not deserve tax-exempt status, and, in fact, shortchange the United States of more than \$36.5 billion in tax revenue each year.³ The authors supported their conclusion with evidence that many tax-exempt organizations “make huge profits, pay handsome salaries, build office towers, invest billions of dollars in stocks and bonds, employ lobbyists and use political action committees to influence legislation. And increasingly they compete with taxpaying businesses.”⁴

One may infer from the Internal Revenue Service’s (IRS or the Service) Statistics of Income data that commercial activity indeed has been on the rise over the past several decades. Within the nonprofit sector, assets increased 312% and revenues increased 380% between 1975 and 1995 while, during the same period, charitable contributions increased by only 190%.⁵ Over the same period, 67% of financing for

organized and operated for the furtherance of a charitable mission. § 501(c)(3) (defining charity as organization “no part of the net earnings of which inures to the benefit of any private shareholder or individual”); Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 *Yale L.J.* 835, 838 (1980) (coining term “nondistribution constraint”). This Note concerns the latter requirement—the operational test of § 501(c)(3) which requires charities to engage primarily in activities that further charitable purposes in order to maintain their tax exemption. See § 501(c)(3); see also *Treas. Reg. § 1.501(c)(3)-1(c)* (as amended in 1990); *infra* Part I.A. This Note addresses the unrelated business income tax in Part I.B, but only to the extent it relates to the operational test and this Note’s proposed modifications of it.

³ Gilbert M. Gaul & Neill A. Borowski, *Nonprofits: America’s Growth Industry*, *Phila. Inquirer*, April 18, 1993, at A1 (part of exposé entitled “Warehouses of Wealth: The Tax-Free Economy”). As Professor Stephen Schwarz noted, outrage against the nonprofit sector is not a new phenomenon. As early as 1948, people were upset at the use of universities to shelter business profits from tax. Stephen Schwarz, *Federal Income Taxation of Investments by Nonprofit Organizations: Beyond a Primer 1 & n.2* (Nov. 3, 2000) (manuscript on file with the *New York University Law Review*) (citing Benjamin Fine, *University Dollars Yielding Tax-Free Business Profits*, *N.Y. Times*, Dec. 13, 1948, at A1). For example, New York University School of Law once famously owned the Mueller Macaroni company. See *infra* text accompanying note 45. Others suggest that charities do not merit tax exemption because “[e]lite American philanthropy serves the interests of the rich to a greater extent than it does the interests of the poor, disadvantaged, or disabled.” Teresa Odendahl, *Charity Begins at Home: Generosity and Self-Interest Among the Philanthropic Elite 3* (1990).

⁴ Gaul & Borowski, *supra* note 3. In particular, Gaul and Borowski cited the million-dollar salaries of some nonprofit executives, the abuses of some charitable hospitals in failing to care for the poor while running commercial businesses on the side, and the high tuition and huge research budgets at tax-exempt universities. *Id.*

⁵ See Alicia Meckstroth & Paul Arnsberger, *A 20-Year Review of the Nonprofit Sector, 1975-1995*, *SOI Bull.*, Fall 1998, at 153. Meckstroth and Arnsberger also divide the sector into small, medium, and large organizations, and find a similar trend has affected all three types of nonprofits. *Id.* at 156 fig.E. The huge increase in assets over this period is due, in part, to the gains in the stock market; however, program service revenue accounted for two-thirds of total revenue. *Id.* at 154 fig.D.

nonprofits came from program service revenues (fees collected from services that are part of a charity's exempt purposes) and only 19% from contributions.⁶ These statistics show that a substantial number of today's charities, particularly public charities,⁷ finance themselves not with donations, but rather with the sale of goods and services for a fee—that is, with commercial activity.⁸

However, the large amount of commercial activity in the charitable sector should not itself be cause for alarm because charitable activity is not antithetical to commercial activity. The primary distinction between for-profit and charitable organizations lies not in whether they engage in commercial activity, but rather in the nature of their missions. A charity's mission is to accomplish the statutorily recognized exempt purpose or purposes for which it was organized.⁹ By contrast, the mission of a for-profit simply is to generate the maximum profit for its shareholders. This distinction in missions is crucial for determining the policy for commercial activity in charities because it entails a further distinction, between commercial activity that is *related* to a charity's exempt purposes and that which is *unrelated* to such purposes. The Internal Revenue Code (I.R.C. or the Code) does not limit charities with regard to related commercial activity; it does, however, regulate unrelated commercial activity in charities via the unrelated business-income tax,¹⁰ which taxes charities on certain types of unrelated business income, and the operational test,¹¹ which denies exemption to charities that engage in too much unrelated activity. This Note concerns the latter requirement.

The Code does not proscribe a charity from charging fees for the goods and services it provides. A healthcare organization accom-

⁶ See *id.* at 154 fig.D. The remainder includes four percent from dividends and other interest, three percent from sales of assets, one percent from membership dues, and five percent from other sources. *Id.*

⁷ Public charities are § 501(c)(3) organizations that receive most of their support from a broad public base, such as government grants and many small donations from individuals. By distinction, private foundations have a much narrower base of support and control—typically a single donor, family, or corporation—and are subject to many more regulations than public charities. See § 509 (defining private foundations). Among public charities, program service revenue amounted to 54% of total revenue for educational organizations, 86% for healthcare organizations, 29% for arts, culture, and humanities organizations, and 13% for religion-related organizations. See Meckstroth & Arnsberger, *supra* note 5, at 152 fig.B.

⁸ While private foundations' assets also more than tripled during the same period, unlike charities, about two-thirds of private foundations' income was from investments and most of the remainder was from charitable contributions (depending on the size of the foundation). *Id.* at 157, 159.

⁹ See *supra* note 1.

¹⁰ *Infra* Part I.B.

¹¹ *Infra* Part I.A.

plishes the mission of healing the sick even if the sick pay for their care. Universities accomplish their educational mission even if students pay tuition. Even tithing can be seen as a commercial activity—an exchange of money for services—that is part of a church's religious mission. Thus, commercial activity may be related intimately to a charity's mission.

Furthermore, charities may finance their charitable projects with commercial activity. Charities may derive income from donations, from investments in passive income generators like certain securities, royalties, or rents, from user fees, or from the sale of goods and services. Each of these sources of financing for charities is a form of commercial activity.¹² Thus, commerce can pervade nearly every aspect of a charity's activity.

Although related commercial activity in charities should not be alarming per se, there are some legitimate reasons to police commercial activity by charities that is unrelated to their charitable purposes. The main complaint against commercial activity in charities (whether related or unrelated) is that it competes with for-profit businesses for scarce dollars. These for-profit businesses regard the competition as "unfair" since charities are tax exempt and have certain marketing advantages—the "halo" effect—that result from the goodwill inherent in their public perception.¹³ Second, unrelated commercial activity may have a negative effect on charitable donations. Joseph Cordes and Burton Weisbrod have identified an "aversion premium" in charities—a negative externality that results when charities engage in unrelated commercial activity.¹⁴ This externality includes the "disutility of

¹² Note, however, that the Code tends not to treat passive income or donations as commercial activity requiring regulation. See §§ 512(b)(1)-(13) (exempting, *inter alia*, dividends, interest, payments with respect to securities loans, royalties, and rents from unrelated business-income tax). For a discussion of the unrelated business-income tax, see *infra* Part I.B.

¹³ Unrelated Business Income Tax: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means, 100th Cong. 98-99 (1987) (testimony of Hon. Frank S. Swain, Chief Counsel for Advocacy, U.S. Small Business Administration). Of course, if unrelated commercial activity becomes too widespread, the halo could become tarnished, which would give small businesses less to complain about. A related concern is that rapid growth in the charitable sector from unrelated commercial activity will ultimately crowd out the for-profits by locking up too many assets in the charitable sector. Given the nondistributional constraint and the fact that charities may exist in perpetuity, overgrowth in the charitable sector could create economic inefficiency.

¹⁴ Joseph J. Cordes & Burton A. Weisbrod, *Differential Taxation of Nonprofits and the Commercialization of Nonprofit Revenues*, 17 *J. Pol'y Analysis & Mgmt.* 195, 198-99 (1998). The authors suggest a few ways to reduce commercial activity by charities: (1) Increase the attractiveness of charitable contributions to make charities more reliant on donations and hence more averse to commercial activity; or (2) reduce the corporate tax rate to minimize the above-normal return charities capture by virtue of their tax-exempt

the activity” and a “net loss of contributions from donors.”¹⁵ If the tax exemption for charities exists in order to facilitate the accomplishment of charitable purposes,¹⁶ the more unrelated commercial activity that charities undertake, the less energy and resources they may spend on their charitable projects. Finally, building on the aversion premium insight, too much unrelated commercial activity might demoralize would-be philanthropists, harming the charitable sector as a whole. As it becomes more common for charities to undertake unrelated commercial activities, donors might contribute less, decreasing the aversion premium and encouraging more charities to undertake unrelated commercial activities.¹⁷

Assuming that there is a need for restraining the amount of unrelated commercial activity by charities, a good place to start would be the definition of charitable purposes. As used in § 501(c)(3), “charitable” is understood to include

relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.¹⁸

status. *Id.* at 211-12 (discussing effects of corporate tax rates on nonprofit commercial activity).

¹⁵ *Id.* at 199.

¹⁶ There is disagreement on the rationale for the exemption of charities from tax. For a comprehensive analysis of theories for charitable exemption, including relief of government burden, community benefit, capital subsidy, altruism, and donative/moral theories, see John D. Colombo & Mark A. Hall, *The Charitable Tax Exemption* (1995). For further discussions of the rationale underlying the exemption, see generally Rob Atkinson, *Theories of the Federal Income Tax Exemption for Charities: Thesis, Antithesis, and Syntheses*, 27 *Stetson L. Rev.* 395 (1997); 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 Donative Theory of the Charitable Tax Exemption*, 52 *Ohio St. L.J.* 1379 (1991); Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Tax*, 91 *Yale L.J.* 54 (1981).

¹⁷ It appears that the charitable sector as a whole does suffer from the perceptions generated by the actions of individual charities. See, e.g., Harry Stainer, *Donation Drop Hits West Side Agency*, *Plain Dealer* (Cleveland), Oct. 2, 1994, at 9-B (describing impact of United Way “scandal” on local organization). In the wake of the United Way “scandal,” one former United Way executive wrote: “The public today wants . . . their organizations supported by gifts, not by commercial business ventures[.]” That is to say, the public feels “anger and revulsion” when they read about executives of charities leading the life of for-profit CEOs and call on Congress to impose greater restrictions on all charities as a result. John S. Glaser, *The United Way Scandal* 261 (1994).

¹⁸ *Treas. Reg.* § 1.501(c)(3)-1(d)(2) (as amended in 1990). In 1954, Treasury replaced the “relief of the poor and distressed” definition of charity with the above common-law

As Professor Tommy Thompson notes, this definition is "so broad, it can conceivably encompass almost any program to promote social welfare, making the exemption difficult to define and administer."¹⁹ Therefore, Thompson suggests that the Treasury Department and the IRS should use a "well-planned litigation and ruling program" to restrict the common-law definition of charitable purposes and thereby narrow the commercial activity coming through the front door of the statute.²⁰

Instead of adopting Thompson's reasonable plan, the Service has chosen to rely on the operational test of § 501(c)(3) to challenge troublesome amounts of commercial activity in charities. After an entity has established that it is organized for charitable purposes, as defined by the statute, regulations, and the common law,²¹ the operational test requires the entity to operate in such a manner that its activities are primarily in furtherance of those charitable purposes.²² However, because "charitable purposes" is defined too broadly, it is difficult to determine whether commercial activity is related or unrelated to those charitable purposes, and the operational test cannot do its job. The result of the courts' and the Service's quixotic efforts to apply the operational test so broadly has been the devolution of the current test into an unprincipled inquiry.²³

It already is difficult for many small and underadvised charities to comply with the complex regulations imposed by the Code. Uncer-

definition, thereby opening the door wide for charities to expand their commercial activities. See Tommy F. Thompson, *The Unadministrability of the Federal Charitable Tax Exemption: Causes, Effects and Remedies*, 5 *Va. Tax Rev.* 1, 12-13 & n.43 (1985) (identifying common-law definition of charity as part of cause for present incoherence in administration of charitable exemption).

¹⁹ Thompson, *supra* note 18, at 14.

²⁰ See *id.* at 35-36.

²¹ See *infra* note 27 and accompanying text.

²² See *infra* note 31 and accompanying text.

²³ See *infra* Part II. Incoherence and confusion in administration of the charitable tax exemption has not gone unnoticed. See generally Lawrence Zelenak, *Serving Two Masters: Commercial Hues and Tax Exempt Organizations*, 8 *U. Puget Sound L. Rev.* 1 (1984). Zelenak built on several prior analyses. See Robert J. Desiderio, *The Profitable Nonprofit Corporation: Business Activity and Tax Exemption Under Section 501(c)(3) of I.R.C.*, 1 *N.M. L. Rev.* 563, 588-89 (1971) (proposing amendment to § 501(c)(3) to prohibit organizations from operating trade or business regularly); Note, *Profitable Related Business Activities and Charitable Exemption Under Section 501(c)(3)*, 44 *Geo. Wash. L. Rev.* 270, 286 (1976) (recommending that courts and Service analyze organizations' purposes rather than business activities for administering charitable exemption). At the time Zelenak was writing, many of the more egregious "commercial hue" cases following *B.S.W. Group Inc. v. Commissioner*, 70 *T.C.* 352 (1978), discussed *infra* notes 54-61 and accompanying text, were being decided. Zelenak pointed out, as will this Note, that the commercial-hue test does not interpret the statute accurately because commercial activity is permitted under the statute if it is related to exempt purposes. Zelenak, *supra*, at 21-22.

tainty in the fundamental operating requirements for tax exemption only compounds these difficulties and makes compliance more expensive. Charities should not have to divert scarce resources away from accomplishing their charitable purposes and toward lawyers fees every time they engage in a commercial enterprise. The policy underpinning the regulation of commercial activity in charities must be clear enough that charities can administer the rule to themselves.

The current facts-and-circumstances standard is subjective and misguided. This Note proposes a more coherent operational test than the standard currently in use.²⁴ The proposed analysis takes two steps: The first is to categorize each activity in which a charity engages as either related or unrelated to its charitable mission; the second is to weigh the related activities against the unrelated activities to determine the organization's primary purpose. The net effect is to test the destination of the charity's income. If the related activities exceed the unrelated activities (exclusive of certain items of passive income),²⁵ then the organization is presumed to be operated primarily for charitable purposes and should pass the operational test of § 501(c)(3). This proposal discards the current facts-and-circumstances test and replaces it with a more systematic inquiry.

Part I will discuss the operational test in more detail and place it in the context of the means by which the Code regulates commercial activity by charities generally. Part II will critique the application of the operational test by the courts and the IRS and will show how the facts-and-circumstances analysis they employ has caused the operational test to devolve into incoherence and uncertainty. Part III will set forth a proposal to reform the operational test into a more coherent and more easily administered test.

I

THE REGULATION OF COMMERCIAL ACTIVITY IN CHARITIES UNDER PRESENT LAW

Two sections of the Code regulate commercial activity in charities: the operational test of § 501(c)(3) and the unrelated business-income tax (UBIT) provisions found in §§ 511 to 514.²⁶ Although both doctrines regulate commercial activity in charities (and do not entirely succeed), they were enacted at different times and have different policy motivations, goals, and impacts.

²⁴ See *infra* Part III.

²⁵ See *infra* Part III.B.2 for a discussion of how excess is measured under the proposal.

²⁶ Section references refer to the Internal Revenue Code unless otherwise indicated.

A. The Operational Test

Being operated for charitable purposes is one of the six fundamental requirements for charitable tax exemption²⁷ and was part of the original statutory language of the provision preceding § 501(c)(3).²⁸ The statute requires that charities be “operated exclusively for” charitable purposes²⁹ in order to qualify for tax-exempt status, and it penalizes organizations that engage in substantial amounts of activities that are unrelated to their charitable purpose with the loss of tax exemption.³⁰ This sanction, loss of exemption, is extreme.

The ordinary reading of “operated exclusively for” exempt purposes would be that any charity that engaged in activities unrelated to the charity’s charitable purpose would fail the operational test. However, the Service, the Treasury Regulations, and the courts have interpreted “exclusively” to mean that the charity must be operated “primarily” for a charitable purpose.³¹ That is, a charity may engage

²⁷ Paraphrased, the six requirements for exemption under § 501(c)(3) are that an organization must (1) be organized and (2) be operated exclusively for charitable purposes; (3) have no part of its earnings inure to any private party; (4) not engage in substantial amounts of lobbying; and (5) not participate in any political campaigns for or against candidates for public office. I.R.C. § 501(c)(3) (1994). The common law has added the requirement (6) that no part of the organization’s purposes or activities may be illegal or violate fundamental public policy. *Bob Jones Univ. v. United States*, 461 U.S. 574, 591-92 (1983).

²⁸ The first federal income tax, passed in 1894, exempted “corporations, companies, or associations organized and conducted solely for charitable, religious, or educational purposes.” Revenue Act of 1894, ch. 349, § 32, 28 Stat. 509, 556 (1894). For additional history of the regulation of commerce in charity, see Kenneth C. Eliasberg, *Charity and Commerce: Section 501(c)(3)—How Much Unrelated Business Activity?* 21 Tax L. Rev. 53 (1965). Eliasberg’s article chronicles the progression of the tax law through (1) Corporate Excise Tax Act of 1909, to (2) 1924 Supreme Court case of *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924), to (3) Revenue Act of 1950, to (4) amendments to Treasury Regulations in 1959, and recommends a return to the pre-1950 state of the law.

²⁹ § 501(c)(3). See *supra* note 1 for the Code’s list of charitable purposes; see also *supra* note 18 and accompanying text for a discussion of “charitable.”

³⁰ Treas. Reg. § 1.501(c)(3)-1(a)(1) (as amended in 1990) (“If an organization fails to meet either the organizational test or the operational test, it is not exempt.”).

³¹ Treasury Regulation section 1.501(c)(3)-1(c)(1) (as amended in 1990) states:

An organization will be regarded as “operated exclusively” for one or more exempt purposes only if it *engages primarily* in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

(emphasis added). The Regulations follow the Supreme Court’s decision in *Better Business Bureau of Washington, D.C., Inc. v. United States*, 326 U.S. 279, 283 (1945) (holding that, in context of charitable and educational exemption from Social Security tax, exclusively “means that the presence of a single noneducational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes”); see also *St. Louis Union Trust Co. v. United States*, 374 F.2d 427, 431 (8th Cir. 1967) (“[A]ctivity which is not religious, charitable, scientific, literary or educational will

in some amount of activity that is unrelated to its charitable purpose but will lose its exemption if the unrelated activity becomes excessive. Thus the operational test tolerates a certain amount of commercial activity.³²

The Treasury Regulations address the operational test's application to commercial activity specifically in subsection 1.501(c)(3)-1(e), which concerns "[o]rganizations carrying on trade or business."³³ This trade-or-business subsection makes it absolutely clear that a charity does not lose its exemption even if it operates a trade or business as a substantial part of its activities. However, it carries the caveat that "the operation of such trade or business [must be] *in furtherance*³⁴ of the organization's exempt [i.e., charitable] purpose or purposes," and it requires that "the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in § 513 [a UBIT provision]."³⁵

The trade-or-business subsection provides that a charity may operate a trade or business that is in furtherance of—and related to—its charitable purpose to whatever extent it pleases without violating the operational test. However, it must not engage in so much unrelated trade or business as to become operated for the primary purpose of conducting trade or business unrelated to an exempt purpose. As such, the operational test limits the amount of unrelated trade or business activity but does not limit related trade or business activity. Understood in this way, the application of the operational test should be simple: First, identify which activities are related and which are unrelated to (i.e., do not further) the charity's charitable purposes; second,

not result in loss of deductibility or of exemption if that activity is only incidental and less than substantial."); accord *Dulles v. Johnson*, 273 F.2d 362, 368 (2d Cir. 1959); *Seasongood v. Comm'r*, 227 F.2d 907, 912 (6th Cir. 1955); *Estate of Philip R. Thayer*, 24 T.C. 384, 391 (1955); Rev. Rul. 77-366, 1977-2 C.B. 192, 193.

³² It hardly could be otherwise. UBIT, discussed *infra* Part I.B., would be pointless if the existence of income from unrelated activities automatically disqualified the organization for tax exemption.

³³ Treas. Reg. § 1.501(c)(3)-1(e) (as amended in 1990).

³⁴ It is unclear whether the Treasury meant to distinguish the phrase "in furtherance" from the term "related" appearing in the statute and as used in the other part of the regulation. Arguably, "furthering" an exempt purpose might include conducting unrelated commercial activity and using the profits to further charitable activity. However, the reference in the trade or business subsection to § 513 and the corresponding Treasury Regulations clarifies the matter: As stated in Treasury Regulation section 1.513-2(a)(4) (as amended in 1983), "[o]rdinarily, a trade or business is substantially related to the activities for which an organization is granted exemption if the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption." This Note will use the terms "related" and "in furtherance" interchangeably.

³⁵ Treas. Reg. § 1.501(c)(3)-1(e)(1) (as amended in 1990) (emphasis added).

make sure that those activities that are related to the charitable purposes are the charity's primary activities and purposes.

Rather than set forth a rule that utilizes the logical two-part inquiry above, the Treasury Regulations establish a subjective facts-and-circumstances standard: "In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes."³⁶ By encouraging a broad, facts-and-circumstances inquiry, the Regulations permit the analysis to devolve into a "[d]oes this organization smell like a charity to me?" standard—which is just what has happened. As Part II will show, the facts-and-circumstances approach ultimately has encouraged the conflation of two discrete questions: (1) Is the activity related to and in furtherance of the charitable purpose, and (2) if not, is the activity substantial?

B. UBIT

In contrast with the operational test of § 501(c)(3), UBIT imposes a more moderate sanction on unrelated commercial activity—namely a tax on a charity's unrelated-business income at the corporate tax rate.³⁷ UBIT taxes charities on trade or business that regularly is carried on and unrelated to the charity's exempt purposes. Section 511 imposes the tax. Section 512 defines unrelated business taxable income as "the gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it, less the deductions allowed by this chapter . . .";³⁸ and § 513 defines "unrelated trade or business" as "any trade or business the conduct of which is not substantially related . . . 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 . . .".³⁹ Finally, § 513(c) defines the term "trade or business" as "any activity which is carried on for the production of income from the sale of goods or the performance of services."⁴⁰

Congress created UBIT in 1954 to curb competition between charities and for-profit companies.⁴¹ Treasury explicitly wrote this ra-

³⁶ *Id.*

³⁷ Section 511 imposes a tax on unrelated-business taxable income, defined in § 512, at the rates for corporate taxable income provided in § 11. I.R.C. § 511 (1994).

³⁸ § 512(a)(1).

³⁹ § 513(a).

⁴⁰ § 513(c).

⁴¹ See H.R. Rep. No. 81-2319, at 36 (1950); S. Rep. No. 2375, at 28-29 (1950); Internal Revenue Code of 1954, Pub. L. No. 83-591, 68 Stat. 730.

tionale into the UBIT Regulations: "The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete."⁴² To effect the same end (curbing competition with for-profits), § 502 denies exemption to "feeder organizations."⁴³ A feeder organization is one whose primary purpose is to carry on a trade or business for profit, but which gives all of its profits to a charity.⁴⁴ Before § 502, a charity like the New York University (N.Y.U.) School of Law could operate a for-profit subsidiary like the Mueller Macaroni Corporation, the nation's largest pasta manufacturing company, free of tax.⁴⁵

UBIT has many exemptions⁴⁶ and is relatively easy to avoid through careful tax planning.⁴⁷ Indeed, some call UBIT a "voluntary

⁴² Treas. Reg. § 1.513-1(b) (as amended in 1983).

⁴³ See § 502(a) (defining "feeder organizations" as organizations that primarily conduct trade or business but donate all profits to charity).

⁴⁴ Section 502 overrules the destination-of-income test, a common-law test for charitable tax exemption created by *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924), and explicitly forbids tax exemption for feeder organizations. The destination-of-income test specified that the place to test for the charitable exemption is the destination, not the origin, of the income. Thus, any organization that donated substantially all of its profits to charity was exempt from tax, including purely for-profit, commercial enterprises, known as "feeder organizations." Were they tax exempt, feeder organizations would have a competitive advantage over their for-profit counterparts: Feeder organizations would be able to reinvest a greater amount of income in their businesses than for-profits, thus enabling them to grow faster than taxed corporations, potentially even to monopolize the market. See Donald L. Sharpe, *Unfair Business Competition and the Tax on Income Destined for Charity: Forty-Six Years Later*, 3 Fla. Tax Rev. 367, 386-87 (1996). Sharpe proposes a novel destination of income test inspired by § 512(b)(15). For a history of the enactment of § 502 and an analysis of the policy for that section, see Eliasberg, *supra* note 28, at 80-93.

⁴⁵ See *C.F. Mueller Co. v. Comm'r*, 190 F.2d 120 (3d Cir. 1951) (upholding exemption of N.Y.U.'s macaroni corporation). At that time, N.Y.U. also held *Howes Leather Company*, *American Limoges China*, and the *Ramsey Corporation*. See Schwarz *supra* note 3, at 1-2; John Brooks, *The Marts of Trade: The Law School and the Noodle Factory*, *New Yorker*, Dec. 26, 1977, at 48-53 (explaining how N.Y.U. Law School made tremendous profits as exclusive beneficiary of Mueller Company).

⁴⁶ The exceptions to § 512(b) include seventeen subsections modifying UBIT to exclude various commercial activities including passive investment income (e.g., dividends and royalties), rents from real property, and research income. §§ 512(b)(1)-(17) (1994 & Supp. IV 1999). Section 513 excludes many other activities, such as trade or business performed by unpaid volunteers, trade or business performed for the convenience of the organization's members (e.g., university cafeterias), sales of donated merchandise, bingo, some types of corporate sponsorships, public entertainment at state fairs, and the rental of telephone poles. §§ 513(a)-(i) (1994 & Supp. IV 1999).

⁴⁷ A classic way of avoiding UBIT is to create a taxable subsidiary of the charity, which conducts all the unrelated trade or business. The parent charity pays no UBIT as long as it does not "control" the subsidiary, which § 512(b)(13)(D) defines as owning more than fifty percent of the vote or value of a corporation or fifty percent of the profits in a partnership or other entity. However, charities may avoid the control issue by adding another exempt

tax”—which is to say, not a tax at all.⁴⁸ Many others have written about the ways in which UBIT has failed not only to regulate commercial activity in charities generally, but even to accomplish the purposes for which it was enacted.⁴⁹ This Note focuses instead on the fundamental requirements for receiving a charitable tax exemption: that is, on the operational test and its failings.

II

DEVELOPMENT AND APPLICATION OF THE OPERATIONAL TEST

The Treasury Regulations establish that the operational test is meant to indicate when an organization is operating exclusively for charitable purposes.⁵⁰ Under the test, all the relevant “facts and circumstances” should be considered.⁵¹ However, the regulations fail to articulate a clear framework for identifying what amounts to “more than an insubstantial” nonexempt purpose.⁵² This failure has left the Service with the responsibility of interpreting and enforcing the opera-

organization between it and the UBIT-paying subsidiary. A parent is not deemed to control a subsidiary two tiers below it. See Tech. Adv. Mem. 93-38-003 (June 16, 1993) (noting that UBIT does not tax parent on rental income from second-tier subsidiary). Note that in order to avoid the constructive ownership rules that would apply to the parent organization, the first-tier organization must own less than 50% of the second-tier organization. § 512(b)(13)(D)(ii) (Supp. IV 1999). A large parent charity holding many types of assets—some generating profits and others losses—can then drop some of the loss assets into its profitmaking, taxpaying subsidiary organization to soak up the subsidiary’s taxable income with the income tax deductions generated by the loss-making assets. A taxable subsidiary can still be a good solution even if the charity does not have the right kind of assets to net out the unrelated-business taxable income, since donors do not like to see their charities engaged in unrelated trade or business. Charities also may use controlled subsidiaries to limit liability. See generally Michael I. Sanders, *Joint Ventures Involving Tax-Exempt Organizations* 163-68 (2000) (describing use of subsidiaries to avoid UBIT); James J. McGovern, *The Use of Taxable Subsidiary Corporations by Public Charities—A Tax Policy Issue for 1988*, 38 *Tax Notes* 1125 (1988) (discussing taxable subsidiaries and competition between taxable and exempt entities).

⁴⁸ Schwarz, *supra* note 3, at 34. At the November 2-3, 2000 conference of the National Center on Philanthropy and the Law, entitled “Taxing Charitable Investments,” the assembled members of the nonprofit tax bar reviled UBIT variously as “a picture of a tax, with nearly zero compliance”; “merely a barrier to entry” to commercial markets rather than a bar or intermediate sanction, and “a dog that doesn’t bite.” Nat’l Ctr. on Philanthropy and the Law, N.Y.U. Sch. of Law, Conference, *Taxing Charitable Instruments*, Nov. 2-3, 2000 (notes on file with author).

⁴⁹ For general discussion of UBIT issues, see *To Profit or Not to Profit: The Commercial Transformation of the Nonprofit Sector* (Burton A. Weisbrod ed., 1998); see also Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 *Va. L. Rev.* 605 (1989) (surveying arguments for repeal of UBIT, but ultimately defending it).

⁵⁰ See *supra* notes 29-31 and accompanying text.

⁵¹ Treas. Reg. § 1.501(c)(3)-1(c)(1) (as amended in 1990).

⁵² The full text of subsection 1.501(c)(3)-1(c)(1) reads as follows: “Primary activities. An organization will be regarded as ‘operated exclusively’ for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such ex-

tional test, and the courts with the task of developing jurisprudence based primarily on subjective notions of how much commercial conduct is acceptable for charitable organizations. The result has been the development of a facts-and-circumstances test that is unpredictable and difficult to administer.

Part II.A will discuss *B.S.W. Group Inc. v. Commissioner*,⁵³ the case most often credited with formulating the operational test's facts-and-circumstances approach. Part II.B will review and critique the factors most often utilized in the facts-and-circumstances test and illustrate why this approach, as it has been employed, is an inadequate tool for identifying unrelated commercial activity. Part II.C addresses two alternatives to the facts-and-circumstances approach: the integral-part test and the commensurate-in-scope test. The creation of these tests reflects the inadequacy of the facts-and-circumstances approach and highlights some of its problems. Finally, Part II.D will conclude with a critique of the Service's position on how much commercial activity is allowable and how these determinations are made at the administrative level.

A. *B.S.W. Group Inc. v. Commissioner* and the Birth of the Facts-and-Circumstances Test

*B.S.W. Group Inc. v. Commissioner*⁵⁴ was the first case to engage in a full facts-and-circumstances analysis in an attempt to enforce the operational test. B.S.W. was an organization with the stated purpose of providing consulting services in the area of rural policy and program development. B.S.W. assisted organizations in dealing with problems involving their operating environment, internal management, and planning. B.S.W.'s only activity was the provision of these services exclusively to other exempt organizations via a third-party consultant.⁵⁵

In upholding the Service's decision not to extend 501(c)(3) status to B.S.W., the tax court identified the following factors as evidence of a "forbidden predominant purpose": fees set at or close to cost rather than below cost; the provision of services to any nonprofit organization rather than only to tax-exempt 501(c)(3)s; no proof that B.S.W. would not compete with for-profit entities engaged in similar activities; the existence of profits;⁵⁶ the fact that B.S.W.'s only source of

empt purposes specified in § 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose." *Id.*

⁵³ 70 T.C. 352 (1978).

⁵⁴ *Id.*

⁵⁵ *Id.* at 353-55.

⁵⁶ *Id.* at 354-57, 360.

revenue was from its consulting activities; and the lack of any assurance that officers serving without pay would not eventually be paid.⁵⁷ The court determined that these factors illustrated a commercial hue that amounted to "the conduct of a consulting business of the sort which is ordinarily carried on by commercial ventures organized for profit"⁵⁸ The fact that profits were fairly low, that B.S.W. did not advertise, and that officers worked on a volunteer basis were not enough to qualify B.S.W. for § 501(c)(3) exemption.

B.S.W. made clear that all relevant factors should be considered when a court engages in an operational test analysis.⁵⁹ Yet, the court provided no guidance for how to identify the relevant factors, how to conduct the operational test, or how to make a substantiality determination.⁶⁰ Aside from identifying some factors as weighing more heavily in the equation than others, the court made no specific suggestions and provided no standardized method for determining whether there exists a substantial unrelated purpose.⁶¹ Without clear guidance, the test can be applied ad hoc, with determinations based on whatever facts of the case at hand appear relevant.⁶² The problem with this

⁵⁷ Id. at 358-60. The court notes that the "financing does not resemble that of the typical section 501(c)(3) organization. Petitioner has not solicited, nor has it received voluntary contributions" Interestingly, there is no statutory requirement that a 501(c)(3) receive contributions as part of its revenue stream.

⁵⁸ Id. at 358.

⁵⁹ Id. at 356-58. The reality is that courts consider whatever number and combination of factors they deem relevant. It was not until 1994 that a court clearly indicated there might be limits on this discretion. See *Nonprofits Ins. Alliance of Cal. v. United States*, 32 Fed. Cl. 277, 284 (1994) (noting that no one factor is dispositive of primary commercial purpose and that all relevant factors must be considered).

⁶⁰ Some courts engage in a comparison of the exempt and nonexempt activities in an attempt to determine when a purpose is substantial, but there is no established requirement this approach be taken. See *Christian Manner Int'l v. Comm'r*, 71 T.C. 661, 665-66 (1979) (confirming that "weighing of the importance of the exempt purpose against the substantial nonexempt purpose is not the test," but noting that whether exempt purpose is incident to nonexempt purpose is relevant); Lit. Guideline Mem. (Jan. 22, 1988) (clarifying manner in which operational test should be conducted and citing *Christian Manner* for proposition that "'substantial' has a qualitative . . . meaning"). However, some courts do perform a comparative analysis. See, e.g., *Columbia Park & Recreation Ass'n v. Comm'r*, 88 T.C. 1, 25 (1987) (comparing revenues and expenditures of commercial recreational activities against exempt community service activities); *Greater United Navajo Dev. Enters. v. Comm'r*, 74 T.C. 69, 78 (1980) (noting that to determine if nonexempt purpose is substantial, comparison between organization's activities serving exempt purpose must be made).

⁶¹ B.S.W., 70 T.C. at 358. The court noted that competition in particular was strong evidence of the predominance of a nonexempt purpose. Interestingly, the court did engage in some limited quantitative analysis. In examining B.S.W.'s profit, it determined that the net profit from consulting services was not insubstantial, at 10.8%, when compared to the projected income. Id. at 359.

⁶² The lack of guidance has resulted in some courts considering as few as only one or two factors. See *Wayne Baseball, Inc. v. Comm'r*, 78 T.C.M. (CCH) 437, 439 (1999) (deter-

individualized approach is that the decisionmaker can manipulate factors or only consider those factors that support an outcome reflective of his or her subjective notions about what amount of commercial activity is acceptable.

The facts-and-circumstances test also is fraught with administrative problems. One common problem is a misunderstanding of the facts-and-circumstances test's focus. In the words of the *B.S.W.* court, it is "the purpose towards which an organization's activities are directed, and not the nature of the activities themselves, [that are] ultimately dispositive of the organization's right to be classified as a section 501(c)(3) organization . . ."⁶³ The test's goal is to identify the charity's primary purposes. Activities should be relevant only to the extent that they assist in making that determination.⁶⁴ The courts, however, often confuse the analysis and focus on the nature of the activities themselves rather than exploring what purpose the activities further.⁶⁵ Since an activity can further both an exempt and a nonexempt purpose, focusing solely on the nature of the activity without asking how that activity is related to the charity's purpose can lead erroneously to the revocation of exemption.⁶⁶

Furthermore, in applying the facts-and-circumstances test, courts often scrutinize all commercial activities, when only unrelated activities should be at issue. Both the Treasury Regulations and *B.S.W.* make it clear that the facts-and-circumstances test should be focused only on those activities that do not further the charity's exempt pur-

mining without referring to any factors that "on balance [the] nonexempt purpose was substantial in comparison to [the] petitioner's promotion of the game of baseball to the surrounding community").

⁶³ *B.S.W.*, 70 T.C. at 356; see also *Aid to Artisans, Inc. v. Comm'r*, 71 T.C. 202, 211 (1978) (noting that activities themselves and manner in which they are conducted are relevant, but only insofar as they offer insight into underlying purpose).

⁶⁴ The Service recognized the pervasiveness of this confusion when in 1988 the Director of the IRS's Tax Litigation Division circulated a Litigation Guideline Memorandum in an attempt to resolve the problem. Lit. Guideline Mem. (Jan. 22, 1988). The Memorandum blames "arguably ambiguous regulatory language, seemingly inconsistent judicial development and insufficient administrative clarification" for the confusion. *Id.* However, the Memorandum does little to resolve the problem. Rather than propose a solution, the Memorandum reiterates how activities versus purposes are to be treated and encourages administrative decisionmakers to stop making the mistake. *Id.*

⁶⁵ *Bethel Conservative Mennonite Church v. Comm'r*, 80 T.C. 352, 361 (1983) (upholding denial of exemption because Church offered medical plan to congregation members only), *rev'd*, 746 F.2d 388, 391-92 (1984) (noting that Tax Court had misapplied test and should have asked whether medical plan furthered Church's exempt purposes; fact that medical plan was only available to congregation members was irrelevant); *Copyright Clearance Ctr. v. Comm'r*, 79 T.C. 793, 803 (1982) (noting manner in which fundraising efforts were conducted indicated nonexempt purpose, but only briefly inquiring into what charitable purpose was behind organization's other activities).

⁶⁶ *B.S.W.*, 70 T.C. at 357.

poses. There is no limit to the amount of related commercial activities in which an organization may engage; hence, those activities are irrelevant under the facts-and-circumstances test.⁶⁷ The decision in *Nonprofits' Insurance Alliance of California v. United States*⁶⁸ illustrates the error that courts often make on this point. The activity in question was the administration of a group self-insurance risk pool. The stated purpose of Nonprofits' Insurance Alliance was to provide reasonably stably priced liability coverage to its nonprofit members.⁶⁹ The court engaged in a thorough review of all the relevant case law, and explicitly recognized that the sole fact that an organization is engaged in a trade or business does not, in and of itself, bar the organization from exemption. Despite this, the court never bothered to ask whether or not the activities of Nonprofits' Insurance Alliance were in furtherance of its exempt purposes.⁷⁰ Rather, the court simply applied the facts-and-circumstances analysis and determined that the organization's activities amounted to a substantial, nonexempt purpose.⁷¹

While the Treasury Regulations make clear that only unrelated commercial activities jeopardize exemption, neither the regulations nor the courts attempt to identify questionable activities as related or unrelated before engaging in the facts-and-circumstances test analysis.⁷² As a result, the standard is to launch into a facts-and-circumstances test whenever an organization engages in commercial activity of any kind. Furthermore, as the next Section will show, the factors that are considered under the facts-and-circumstances test are inadequate tools for determining whether a nonexempt purpose exists and whether that purpose is substantial.

⁶⁷ This principle has been recognized for some time. In *A.A. Allen Revivals, Inc. v. Commissioner*, 22 T.C.M. (CCH) 1435, 1443 (1963), the court stated that "profitable or even competitive activities in furtherance of [the charity's] religious purpose do not affect its right to exemption."

⁶⁸ 32 Fed. Cl. 277 (1994).

⁶⁹ *Id.* at 279.

⁷⁰ *Id.* at 287 (referring only to organization's nonexempt purpose); see also *Bethel Conservative Mennonite Church v. Comm'r*, 746 F.2d 388, 391 (1984) (overruling lower court, which failed to consider whether medical plan in question was in furtherance of Church's exempt purposes).

⁷¹ *Nonprofits' Ins. Alliance*, 32 Fed. Cl. at 283-87.

⁷² Although Treasury Regulation section 1.501(c)(3)-1(e)(1) refers to I.R.C. § 513 (1994), which outlines more precisely the meaning of relatedness, it may be that the reader never looks to § 513 for the meaning of "relatedness" because she is confused as to how "relatedness" is important in the analysis. Part of this confusion might stem from the inconsistent language used in the Treasury Regulations. Section 1.501(c)(3)-1(c)(1) talks about activities that "accomplish," while section 1.501(c)(3)-1(e)(1) uses both "relatedness" and "in furtherance." These terms presumably refer to the same concept. See *supra* note 34.

B. *Factors of the Facts-and-Circumstances Test*

This Section reviews and critiques some of the more common factors considered in the facts-and-circumstances test. These ill-focused and ill-used factors often result in subjective analyses and inconsistent case law, both of which make it impossible for a charity to anticipate how much commercial conduct it can engage in before jeopardizing its exempt status. Some factors are qualitative in nature, and are inherently flawed because they only establish whether the conduct in question is commercial, which says nothing about how much of the conduct is unrelated to the organization's exempt purposes. The quantitative factors are potentially helpful, but the absence of standards for factors such as profit or level of sales allows courts to continue making inconsistent decisions.

1. *Profits*

The case law has not set a precise limit on the amount of profit a charity may earn from commercial conduct before it will be found to have a substantial nonexempt purpose in violation of the operational test. Nor is there a consensus on how heavily profits should weigh in the analysis. Some courts cite the proposition that the existence of profits is only "some" evidence of a commercial purpose,⁷³ while others have noted that "consistent non-profitability" can suggest the absence of a commercial purpose.⁷⁴ One court has gone so far as to distinguish the lack of profits in the early stages of an activity from the lack of profits later on, arguing that later nonprofitability is stronger evidence of lack of commercial purpose.⁷⁵

High profits from commercial activities often have resulted in adverse determinations, even if other factors weigh against revocation. For example, in *Fides Publishing v. United States*,⁷⁶ the sale and publication of religious materials returned a significant profit.⁷⁷ The court, clearly disturbed by the level of profits generated, held that *Fides* was not operated for exempt purposes. In downplaying its overreliance on the profit factor, the court stressed the fact that a commercial activ-

⁷³ *Scripture Press Found. v. United States*, 152 Ct. Cl. 463, 468 (1961) (rejecting IRS's argument that where there are large profits, commercial purpose will follow).

⁷⁴ *Golden Rule Church Ass'n v. Comm'r*, 41 T.C. 719, 731 (1964); but see *Peoples Translation Serv./Newsfront Int'l v. Comm'r*, 72 T.C. 42, 49 (1979) (holding that two consistent years of nonprofitability is insufficient to contradict evidence of commercial purpose).

⁷⁵ *Living Faith, Inc. v. Comm'r*, 950 F.2d 365, 374 (7th Cir. 1991).

⁷⁶ 263 F. Supp. 924 (N.D. Ind. 1967).

⁷⁷ *Id.* at 931; see also *Inc. Trustees of the Gospel Worker v. United States*, 510 F. Supp. 374 (1981) (upholding revocation of religious organization's exemption because five million dollars generated from publishing activities indicated highly efficient business venture as commercial purpose).

ity—publishing—was Fides’s only activity.⁷⁸ The court never asked if this activity furthered the organization’s exempt purpose.⁷⁹

Not surprisingly, in cases where profits are minimal, the courts do not seem to be bothered. For example, in *Cleveland Creative Arts Guild v. Commissioner*⁸⁰ the profits generated from arts and crafts festivals never exceeded \$3500.⁸¹ There, the court noted that the financial results of the various arts and craft festivals did not suggest that the motivation for these events was to make a profit since they furthered the organization’s exempt purpose of promoting the arts.⁸² In neither *Cleveland Creative Arts* nor *Fides Publishing* did the courts admit that the level of profits was the determining factor.

Including profits as a factor to consider raises several concerns. In most cases, the decision to engage in a trade or business, whether made by an exempt or nonexempt organization, is by definition driven by a desire to generate revenues and, eventually, profits. Thus, any charity engaging in commercial conduct is intending to generate revenue. Allowing courts to decide on a case-by-case basis how much profit may be earned puts charities in the position of guessing how much profit they are allowed to generate before jeopardizing their tax-exempt status.⁸³

⁷⁸ *Fides Publishing*, 263 F. Supp. at 934.

⁷⁹ See *Scripture Press Found. v. United States*, 285 F.2d 800, 804-05 (Ct. Cl. 1961) (revoking exemption of organization engaged in sole activity of publishing religious materials). But see *Presbyterian & Reformed Publ’g Co. v. Comm’r*, 743 F.2d 148, 157-58 (3d Cir. 1984) (agreeing that profit is relevant factor to consider, but reversing Tax Court’s determination that large amounts of profits indicated petitioner, religious publishing house, did not qualify for § 501(c)(3) status).

⁸⁰ 50 T.C.M. (CCH) 272 (1985).

⁸¹ *Id.* at 278.

⁸² *Id.* at 278-79; see also *Passaic United Hebrew Burial Ass’n v. United States*, 216 F. Supp. 500 (D.N.J. 1963), in which the Service asserted that profits, ranging from \$6500 one year to \$298 three years later, from the sale of caskets and burial charges meant that Passaic United was indistinguishable from a commercial funeral parlor and in violation of the operational test. In rejecting this argument, the court noted that the Service had not given “adequate consideration to plaintiff’s charitable purposes as expressed in its certificate of incorporation, [which was] to provide for the burial of ‘the indigent and poor of the Hebrew faith’ and the devotion of any ‘profit’ to ‘the care of the aged and the chronic ill.’” *Id.* at 505-06. Since *Passaic United Hebrew Burial Ass’n*, the Service appears to have loosened its position on burial activities for profit. In Private Letter Ruling 2000-33-049 (May 24, 2000), the Service determined that the sale of caskets by a monastic church will not result in revocation, and only sales to the general public will result in UBIT. It should be noted, however, that the Ruling does not state the amount of expected or actual profit generated.

⁸³ Interestingly, some types of conduct raise concern while others do not. For example, many large hospitals, healthcare systems, and traditional university-type educational institutions make significant amounts of profit but are rarely in danger of losing their charitable exemption. Their commercial activity is mostly policed by UBIT. On the other hand, the Service clearly is disturbed by some commercial activities more than others, such as pub-

The use of profits in the analysis is relevant and should be preserved, but in order to prevent inconsistent revocations, which occur when profits are afforded too much weight, a standard must be established. In addition, in conducting the analysis, courts must be sure to consider as a negative factor only profit generated from unrelated commercial activity.

2. *Competition and Fees or Cost of Services*

The inclusion of both competition and cost of services among the factors is inconsistent. On the one hand, under the facts-and-circumstances test, courts consider competition to be "strong evidence of the predominance of nonexempt commercial purposes."⁸⁴ On the other hand, charging fees that are below cost is considered evidence of activities that are conducted in furtherance of a charitable purpose.⁸⁵ In the context of the facts-and-circumstances test, where competition is frowned upon and low-cost services are encouraged, this puts service-providing organizations seeking exemption in a lose-lose situation. If a charity does not charge a below-cost price for its goods or services, this fact will weigh against it in the facts-and-circumstances analysis. However, if it sets prices that are below cost or discounted, not only is its trade or business activity likely to be unsuccessful, but also the charity likely will be accused of competing with its for-profit counterparts in violation of the operational test. For example, in *Federation Pharmacy Services, Inc. v. Commissioner*,⁸⁶ the court found that the sale of prescription drugs at a discount to the elderly "smack[ed] more of commercialism than of charity."⁸⁷ In addition, the court concluded that Federation Pharmacy Services was competing directly with profitmaking drug stores.⁸⁸ The opinion made clear that evidence of

lishing by religious institutions. The traditional importance of religious institutions and education, and the expansive definition of "charitable," are two possible reasons for this discrepancy in treatment. See generally Nina J. Crimm, *Evolutionary Forces: Changes in For-Profit and Not-For-Profit Health Care Delivery Structures; A Regeneration of Tax Exemption Standards*, 37 B.C. L. Rev. 1 (1995); Thompson, *supra* note 18, at 10-14.

⁸⁴ B.S.W. Group Inc. v. Comm'r, 70 T.C. 352, 358 (1978).

⁸⁵ Peoples Transl. Serv./Newsfront Int'l v. Comm'r, 72 T.C. 42, 49 (1979) (arguing that setting rates below cost distinguished organization from organizations denied exempt status); see also Rev. Rul. 68-306, 1968-1 C.B. 257 (granting exemption to newspaper publisher whose subscription was not enough to cover costs of operation).

⁸⁶ 72 T.C. 687 (1979).

⁸⁷ *Id.* at 692.

⁸⁸ *Id.* at 691-92. The court did note briefly that had prices been set below cost or at no cost, the situation would be different, but it did not elaborate on how. *Id.* at 692; see also Wash. Research Found. v. Comm'r, 50 T.C.M. (CCH) 1457, 1462-63 (1985) (upholding revocation of educational organization's exemption that failed to show it would not compete with commercial firms); Pulpit Resource v. Comm'r, 70 T.C. 594, 611 (1978) (noting

competition, even if prices are low and sales are made to the elderly and disabled, is evidence of a nonexempt purpose.⁸⁹

The competition factor, irrespective of cost of services, also raises an evidentiary problem. A charity has the burden of demonstrating it qualifies for exemption.⁹⁰ Thus, in the facts-and-circumstances test context, it must provide information about the relevant factors so that the decisionmaker can engage in the facts-and-circumstances analysis. With regard to the competition factor, if the charity is engaged in commercial conduct, it could be difficult to show that there is no competition with for-profit entities. For example, in *Living Faith, Inc. v. Commissioner*,⁹¹ the court upheld revocation of exemption when Living Faith failed to illustrate that it was not in competition with its commercial counterparts.⁹² Living Faith was engaged in the promotion of the healthy-living doctrines of the Seventh Day Adventist Church and operated a vegetarian restaurant and health-food store located in a mall.⁹³

With regard to Living Faith's failure to prove lack of competition, the court suggested that Living Faith might have met its burden by illustrating how "dining or shopping at Living Faith's restaurant and health food stores differs, if it does, from the same experience one might have while dining or shopping at other vegetarian restaurants and health food stores."⁹⁴ Exactly how Living Faith could have shown to the Tax Court's satisfaction that a different dining experience was provided at its restaurant is not clear.⁹⁵

This example highlights an evidentiary problem that plagues all of the qualitative factors. Unless charities know in advance what factors will disturb the adjudicator and what type of evidence satisfies that concern, they will always be engaged in a guessing game.⁹⁶ Fur-

that profit from sale of religious publication suggests commercial purpose, but does not "negate that petitioner was operated exclusively for charitable purposes").

⁸⁹ See *Fed'n Pharmacy Servs.*, 72 T.C. at 690.

⁹⁰ See *Am. Campaign Acad. v. Comm'r*, 92 T.C. 1053, 1065 (1989); *Hancock Acad. of Savannah, Inc. v. Comm'r*, 69 T.C. 488, 492 (1977).

⁹¹ 950 F.2d 365 (7th Cir. 1991).

⁹² *Id.* at 373.

⁹³ *Id.* at 367-68.

⁹⁴ *Id.* at 375.

⁹⁵ Courts concerned that § 501(c)(3) organizations are competing with for-profit firms seem to be forgetting that UBIT was instituted for that very reason. See *supra* Part I.B. Including competition in the operational test is redundant.

⁹⁶ Competition seems to be a factor that the courts, not the Service, are concerned with. For example, in a 1997 Private Letter Ruling, the IRS upheld the § 501(c)(3) status of a health center in direct competition with for-profit health clubs in the area. See *Priv. Ltr. Rul.* 89-35-061 (June 12, 1989) (granting exemption to health club because it furthered charity's exempt purpose, without addressing competition issue). For a discussion of the Service's more lenient approach to commercial activity by charities, see *infra* Part II.D.

thermore, considering competition adds little to the facts-and-circumstances analysis. It does not identify an activity as related or unrelated to an exempt purpose, nor does it measure the substantiality of the activity in question. Considering competition confuses the analysis and should not be part of the facts-and-circumstances test.

3. *Commercial Hue or Manner of Operations*

Perhaps the most troubling factor of all is the commercial hue factor. It poses the tautological question: Does the commercial activity in question have a commercial hue? Given that the analysis begins with the identification of commercial conduct, it is difficult to comprehend how confirmation that the activity is, in fact, commercial assists in making a determination of the substantiality of that activity.

There is no precise definition of "commercial hue." Generally, any activity or element of an activity conducted by a charity in a manner similar to how a for-profit might conduct that activity could suggest a commercial hue.⁹⁷ In *Plumstead Theater Society, Inc. v. Commissioner*,⁹⁸ the Service argued that Plumstead Theater had a commercial hue because the only play it had produced was an original literary work in which professional actors were used and for which tickets were sold to the public.⁹⁹ In another case, *Better Business Bureau of Washington D.C., Inc. v. United States*,¹⁰⁰ the Court found that the organization's corporate sounding title indicated a "permeating" commercial hue.¹⁰¹ There is no established method for identifying a commercial hue; hence, such a finding is completely discretionary.

In some cases, the presence of the commercial hue is more apparent and its use less troubling. For example, in *Incorporated Trustees of the Gospel Worker Society v. United States*,¹⁰² the court rightly revoked the exemption of an organization that had 5.3 million dollars in

⁹⁷ See *Paratransit Ins. Corp. v. Comm'r*, 102 T.C. 745, 754 (1994) (noting that manner in which petitioner insures its members "clearly bespeaks" commercial nature).

⁹⁸ 74 T.C. 1324 (1980).

⁹⁹ *Id.* at 1331. The court disagreed with the Service and granted exemption in this case, but it never challenged the use of the commercial hue factor. See *Living Faith, Inc. v. Comm'r*, 950 F.2d 365, 373 (7th Cir. 1991) (considering mailings distributed by religious organization that stated: "We want to serve you better with expanded hours and services[,] as strong evidence of commercial hue).

¹⁰⁰ 326 U.S. 279 (1945).

¹⁰¹ *Id.* at 283-84 (describing organization's "corporate title" as indication of permeating commercial hue); see also *Am. Ass'n of Christian Sch. Voluntary Employees Beneficiary Ass'n Welfare Plan Trust v. United States*, 850 F.2d 1510, 1513-15 (11th Cir. 1988) (holding plaintiff was not exempt because it operated like commercial mutual-insurance company, collecting premiums and engaging in underwriting practices consistent with those of industry).

¹⁰² 510 F. Supp. 374 (D.D.C. 1981).

accumulated profits. The organization's main activities were publishing religious materials and providing living arrangements for twenty-three elderly women at the cost of \$500,000 a year.¹⁰³ In another case, the Tax Court revoked the exemption of a church operating a debt-collecting agency and magazine subscription service, both of which were found to be "imbued with . . . a commercial hue."¹⁰⁴ Not every case, however, will be this clear.

More than any other factor, commercial hue allows adjudicators to replace crucial steps in the analysis with their own intuitive sense of what is right and wrong. The factor is both theoretically unsound and practically inadministrable. Commercial hue should be left out of the facts-and-circumstances test entirely.¹⁰⁵

4. Other Factors

The factors reviewed above are among those most commonly utilized. This list, however, is by no means exhaustive. Any fact or circumstance deemed relevant to the operational test analysis may be considered. Additional factors include the type of clients receiving services,¹⁰⁶ funding sources,¹⁰⁷ expenditures,¹⁰⁸ advertising,¹⁰⁹ source

¹⁰³ Id. at 374-76, 380-81; see also *N. Am. Sequential Sweepstakes v. Comm'r*, 77 T.C. 1087, 1094-96 (1981) (holding that organization conducting team skydiving competition in which only its creators participated, and financially supporting participation in international competition was not operated for exempt purposes).

¹⁰⁴ *Universal Church of Jesus Christ, Inc. v. Comm'r*, 55 T.C.M. (CCH) 144, 153 (1988).

¹⁰⁵ See, e.g., *Zelenak*, supra note 23, at 3 (proposing test for granting exempt status, "whether or not the organization's activities are imbued with a 'commercial hue'").

¹⁰⁶ See *Quality Auditing, Inc. v. Comm'r*, 114 T.C. 498, 508-09 (2000) (arguing that steel auditor services were provided to private entities); *United Cancer Council, Inc. v. Comm'r*, 109 T.C. 326, 339-42 (1997) (challenging appropriateness of multimillion-dollar fundraising contract with third party that primarily worked with nonprofits), rev'd, 165 F.3d 1173 (7th Cir. 1999); *B.S.W. Group, Inc. v. Comm'r*, 70 T.C. 352, 360 (1978) (considering fact that only some of B.S.W.'s clients were exempt organizations).

¹⁰⁷ See *Copyright Clearance Ctr., Inc. v. Comm'r*, 79 T.C. 793, 801-02 (1982) (considering amount of revenues from contributions as relevant factor); *Greater United Navajo Dev. Enters., Inc. v. Comm'r*, 74 T.C. 69, 75-76 (1980) (meticulously examining all of petitioner's financial reports to review expenditures and sources of funding); *B.S.W.*, 70 T.C. at 359 (noting that petitioner had not received any public contributions).

¹⁰⁸ See *Church by Mail, Inc. v. Comm'r*, 765 F.2d 1387, 1392 (9th Cir. 1985) ("[T]he purpose and objective to which the income of the Church is devoted is the ultimate test in determining whether it is operated exclusively for an exempt purpose."); *Easter House v. United States*, 12 Cl. Ct. 476, 479 (1987) (noting what petitioner, adoption agency, spent on advertising and that agency had voluntarily paid for birth mothers' medical care); *Columbia Park & Recreation Ass'n, Inc. v. Comm'r*, 88 T.C. 1, 25 (1987) (comparing expenditures for commercial activities and community service activities).

¹⁰⁹ See *Plumstead Theatre Soc'y, Inc. v. Comm'r*, 74 T.C. 1324, 1331-32 (1980) (overruling Service and noting that advertising plays in newspaper is acceptable); *Peoples Translation Serv./Newsfront Int'l v. Comm'r*, 72 T.C. 42, 50 (1979) (noting favorably that bi-weekly published bulletin sells no advertising space).

of revenues, and the charity's corporate structure.¹¹⁰

From the perspective of a charity litigating loss of exemption, allowing the consideration of factors outside the usual list means courts may consider mitigating circumstances that indicate a charitable exemption is appropriate. Of course, flexibility also presents a danger because it never can be known in advance what factors will be weighed negatively.¹¹¹ The "dining experience" factor in *Living Faith* illustrates this danger.¹¹² Nevertheless, so long as standards are introduced into the equation, some flexibility should remain an element of the operational test.

As we have seen, purely qualitative factors, such as commercial hue and the existence of profits or competition, add little to the analysis. These factors do nothing more than provide a descriptive critique of the activity in question. In order for a facts-and-circumstances test to be effective in determining whether a charity is engaged in substantial amounts of unrelated commercial activity, the factors considered must be quantitative in nature and be weighed in a predictable manner.

C. *The Commensurate-in-Scope and Integral-Part Tests*

This Section will review two outgrowths of the facts-and-circumstances test: the commensurate-in-scope test and the integral-part test. In certain circumstances, courts have occasionally used these tests in place of the facts-and-circumstances test. The integral-part test is still alive, but is only used in limited circumstances when two charities are engaged in a partner-subsidiary relationship. The commensurate-in-scope test, rarely used today, injects a comparative element into the facts-and-circumstances analysis by comparing the commercial activity in question to the charitable purpose in an effort to identify the charity's primary purpose. Both tests were born in an attempt to improve the analysis, but as this Section will show, neither

¹¹⁰ In *Housing Pioneers, Inc. v. Commissioner*, 65 T.C.M. (CCH) 2191 (1993), the court revoked the charitable exemption of an organization with the stated purpose of providing affordable housing to low-income and handicapped people because of the complicated nature of a limited-partnership agreement with a for-profit real estate company. In determining that *Housing Pioneers* was operated for a substantially nonexempt purpose, the court did not weigh any of the *B.S.W.* factors. Instead it noted that the tax benefits to the for-profit partner and the exempt purposes of *Housing Pioneers* were "inextricably interwoven." *Id.* at 2196.

¹¹¹ Another less commonly considered factor that might be useful in the analysis is the amount of time spent on activities. See, e.g., Rev. Rul. 77-366, 1977-2 C.B. 192, 193 (referring to amount of time spent organizing lectures, discussions, and workshops).

¹¹² See *Living Faith, Inc. v. Comm'r*, 950 F.2d 365, 375 (7th Cir. 1991); see also *supra* note 91-95.

the commensurate-in-scope test nor the integral-part test solves the problems associated with the facts-and-circumstances test. However, each test highlights the ineptness of the operational test as it exists today.

1. Commensurate-in-Scope Test

The commensurate-in-scope test attempted to inject the operational test with a measuring tool for deciding when commercial conduct rises to the level of an inappropriate primary purpose in violation of the operational test. Specifically, the test requires the adjudicator to compare the amount of commercial and charitable activities. Unfortunately, the test achieved only limited success and died before it fully developed. Still, a look at the commensurate-in-scope test's comparison approach illustrates the utility of, and need for, a more concrete method of identifying a substantial commercial purpose. The commensurate-in-scope test first was introduced in a 1964 Revenue Ruling.¹¹³ The test requires that charities engaged in commercial activities conduct charitable activities that are in scope with their revenues.¹¹⁴ When employed, it was used in place of, rather than as a supplement to, the facts-and-circumstances test.¹¹⁵

In a 1969 General Counsel Memorandum, the General Counsel applied the commensurate-in-scope test and advised denying exemption to a farming operation formed to assist charitable programs through contributions.¹¹⁶ In this Memorandum, the General Counsel also set forth two principles for evaluation under the operational test via the commensurate-in-scope analysis: (1) "That the amount of expenditures of an organization for charitable purposes must be taken into consideration in equating business activities with charitable activities" and (2) that the primary purpose of an organization is charitable if the charitable activities are "commensurate in financial scope with its financial resources and its income from its business activities and other sources."¹¹⁷

The 1969 Memorandum makes it clear that the amount of charitable work required under the commensurate-in-scope test is contin-

¹¹³ Rev. Rul. 64-182, 1964-1 C.B. 186 (granting exemption to organization that derived its revenue principally from renting large commercial space because charitable activities were commensurate in scope with financial resources).

¹¹⁴ *Id.*; see also Rev. Rul. 67-5, 1967-1 C.B. 123 ("Foundation [was not] carrying on a charitable program commensurate in scope with its financial resources.")

¹¹⁵ In Revenue Ruling 64-182, 1964-1 C.B. 186, and Revenue Ruling 67-5, 1967-1 C.B. 123, the Service made a commensurate-in-scope determination, but did not engage in the traditional *B.S.W.* facts-and-circumstances analysis.

¹¹⁶ Gen. Couns. Mem. 34,176 (July 30, 1969).

¹¹⁷ *Id.*

gent upon the amount of commercial revenue generated. It did not, however, set forth specific levels of allowable commercial activity or required charitable activity.¹¹⁸ While the commensurate-in-scope test still leaves the decisionmaker with the final say, it does provide some guidance for how to make that determination.

In a 1981 General Counsel Memorandum, the test took a step backwards. In this Memorandum, the General Counsel refused to publish a Revenue Ruling that applied the commensurate-in-scope test to a fundraising golf tournament because he did not want taxpayers to believe that the commensurate test was a sufficient analysis.¹¹⁹ The Memorandum cited the proposition that there is no "categorical rule" or "quantitative limitation" to determine the correct proportion of charitable and commercial activity.¹²⁰ The General Counsel wrote that the "answer to each case is a complex, difficult, many-sided factual and legal problem, the solution to which cannot be arrived at by any simply formulated rule."¹²¹ Thus, the Service reverted to a facts-and-circumstances analysis, nullifying the utility of the commensurate-in-scope test's comparison approach.

It is not clear why the Service suddenly abandoned the commensurate-in-scope test in favor of the facts-and-circumstances approach.¹²² There is, however, a lesson in the short-lived success of the commensurate-in-scope test: Guidance in the analysis need not replace the facts-and-circumstances approach wholesale. The operational test can include a quantitative or standardized element without defeating the facts-and-circumstances approach, which would assist the adjudicator in making consistent primary-purpose findings and improve the consistency of such determinations.

2. *The Integral-Part Test*

The integral-part test addresses a unique set of operational test cases and thus has only limited applicability. For that subset of cases, however, the integral-part test has improved the operational-test anal-

¹¹⁸ See *id.*

¹¹⁹ Gen. Couns. Mem. 38,742 (June 3, 1981) ("[T]he commensurate-in-scope test must be applied carefully and specifically to the individual facts and circumstances of a particular case.").

¹²⁰ *Id.*

¹²¹ *Id.*

¹²² See Evelyn Brody, *A Taxing Time for the Bishop Estate: What Is the I.R.S. Role in Charity Governance?*, 21 U. Haw. L. Rev. 537, 573-78 (1999) (suggesting that commensurate-in-scope test was introduced exclusively for purpose of providing charitable exemptions to organizations that exist solely for purpose of distributing income to other 501(c)(3) organizations).

ysis. The integral-part test is not codified.¹²³ It is a judicial creation used in limited circumstances in place of the facts-and-circumstances test, and it focuses not on the purposes or activities of a charitable organization, but rather on the relationship between a service-providing organization seeking exemption and the tax-exempt charity purchasing the services.¹²⁴ Under this doctrine, a corporation providing services, which may not be eligible for a § 501(c)(3) exemption on a stand-alone basis, may qualify derivatively for an exemption if it provides services to a charity that are integral to the operation of the tax-exempt corporation.

The weak statutory foundation of this test resulted in some initial confusion regarding how to make an integral-part finding. One line of cases required a "necessary and indispensable" relationship between the service provider and the charity.¹²⁵ Meanwhile, the Service sometimes required that the services provided by the subsidiary be "essential" to the charity before the Service could make an integral-part finding.¹²⁶ These definitions, however, only replaced one set of words with another without clarifying how to administer the test or identifying its boundaries.

¹²³ Treas. Reg. § 1.502-1(b) (as amended in 1990) is statutory support for the doctrine. See *Geisinger Health Plan v. Comm'r*, 100 T.C. 394, 401 (1993) (noting that integral-part test is noncodified, but recognized, basis for exemption); *IHC Health Plans, Inc. v. Comm'r*, T.C. Memo 2001-246, 43 (Sept. 19, 2001) (noting that genesis of integral-part test may be found in Treasury Regulation section 1.502-1(b)), available at 2001 WL 1103284. Subsection 1.502-1(b) outlines an exception to the prohibition on tax exemptions for feeder organizations, stating in relevant part that "[i]f a subsidiary organization of a tax-exempt organization would itself be exempt on the ground that its activities are an integral part of the exempt activities of the parent organization, its exemption will not be lost because . . . the subsidiary derives a profit from its dealings with its parent organization" Treas. Reg. § 1.502-1(b) (as amended in 1970) (emphasis added); see also Rev. Rul. 80-106, 1980-1 C.B. 113 (granting exemption to organization that operated thrift shop); Rev. Rul. 68-26, 1968-1 C.B. 272 (granting § 501(c)(3) status to organization run by church that published educational and religious materials for parochial schools).

¹²⁴ The seminal integral-part doctrine case is *Squire v. Students Book Corp.*, 191 F.2d 1018 (9th Cir. 1951), in which the court held that a bookstore located on a college campus was exempt because it bore "a close and intimate relationship to the functioning of the College." *Id.* at 1020.

¹²⁵ See *Hosp. Bureau of Standards & Supplies, Inc. v. United States*, 158 F. Supp. 560, 563 (Ct. Cl. 1958); see also *HCSC-Laundry v. United States*, 450 U.S. 1, 6-7 (1981) (discussing *Hospital Bureau*); *Council for Bibliographic & Info. Techs. v. Comm'r*, 63 T.C.M. (CCH) 3186 (1992) (applying *Hospital Bureau* standard).

¹²⁶ See Gen. Couns. Mem. 39,830 (Aug. 30, 1990) (analyzing whether HMO provides essential services to hospital before making integral-part finding). But see Rev. Rul. 81-19, 1981-1 C.B. 353 (reasoning simply that organization operating vending machines is "integral part" of exempt university because it exclusively benefits members of student body and faculty).

In 1994, a Third Circuit case, *Geisinger Health Plan v. Commissioner*, finally provided a framework for the analysis.¹²⁷ The *Geisinger* court proposed a two-pronged analysis for the integral-part test. The first prong requires that the subsidiary not carry on a trade or business that would amount to a substantial unrelated trade or business were it regularly carried on by the parent. Second, the relationship of the subsidiary to its parent must "somehow enhance[] the subsidiary's own exempt character to the point that . . . the subsidiary would be entitled to § 501(c)(3) status."¹²⁸ For the most part, the Service has adopted this framework.¹²⁹

The exact relationship between the integral-part test and the facts-and-circumstances test is unclear. The integral-part test has taken the place of the traditional facts-and-circumstances approach when the exempt status of two organizations in parent-subsidiary or common-control relationship is at issue. On occasion, however, the integral-part test is combined or used in conjunction with the facts-and-circumstances test. For example, in *Council for Bibliographic and Information Technologies v. Commissioner*, the Service argued that an organization that operated to provide a local library with an electronic cataloging system, software, and technological support was operated for a substantial nonexempt purpose.¹³⁰ The Service did not find that the corporation's activities advanced any educational or other charitable purpose. Relying heavily on integral-part doctrine cases, the court overruled the Service and held that the existing "close and intimate relationship" between the corporation and the library was sufficient to meet the "operated exclusively for" requirement.¹³¹ The court also noted that the services were provided at costs substantially below fair

¹²⁷ 30 F.3d 494, 502 (3d Cir. 1994). For a discussion of the *Geisinger* case, see John D. Colombo, Health Care Reform and Federal Tax Exemption: Rethinking the Issues, 29 Wake Forest L. Rev. 215, 231-35 (1994), which discusses the importance of *Geisinger* in establishing "important principles in exemption for health care providers"; Seth Dewees, Healthcare Organizations and 501(c)(3): Uncertainty in the Post-Geisinger World, 7 Health Matrix 351 (1997).

¹²⁸ *Geisinger*, 30 F.3d at 502. It should be noted that the integral-part doctrine does not require a strict subsidiary relationship. Rather, a control and close supervisory relationship must exist between the entities. See Gen. Couns. Mem. 39,830 (Aug. 30, 1990) ("A strict parent-subsidiary relationship is not required."); see also Gen. Couns. Mem. 39,003 (June 24, 1983) (referring to this as "structural relatedness" requirement).

¹²⁹ See, e.g., Priv. Ltr. Rul. 2001-32-039 (May 15, 2001); Priv. Ltr. Rul. 1999-18-066 (Feb. 11, 1999); Priv. Ltr. Rul. 98-35-031 (July 30, 1998); Priv. Ltr. Rul. 97-21-031 (Feb. 26, 1997). But see Priv. Ltr. Rul. 97-20-035 (Feb. 19, 1997), in which the Service accepted the assertion that an educational institution created to build and operate three facilities: a continuing-education center, a golf course, and a hotel, functions as an integral part of the university without ever inquiring into whether or not the *Geisinger* requirements were met.

¹³⁰ 63 T.C.M. (CCH) 3186, 3187-2, 3187-3 (1992).

¹³¹ *Id.* at 3187-3.

market value and that the organization's profits would be used to reduce future costs.¹³²

The integral-part test is a direct response to the facts-and-circumstances test's inability to deal with complex multiple-entity cases. Unlike the facts-and-circumstances test, which purports to be analyzing purposes, but often involves a confused analysis of activities as well, the integral-part test identifies the focus of the analysis with more clarity. Furthermore, the "but for" determination required by the test is less vague and inconsistent than the weighing of factors that takes place under the facts-and-circumstances test. Lastly, the integral-part test may allow exemptions for some organizations that are certain to fail the facts-and-circumstances test, but are deserving of exemption nonetheless.

In the end, however, the benefits of the integral-part test are overshadowed by the fact that the doctrine only serves to muddle the commercial-activity doctrine further. Because the integral-part doctrine was created and functions solely to deal with service-providing organizations, it can only be supplemental. Furthermore, measuring what is "necessary" or "indispensable" may be just as difficult as determining "substantiality" under the facts-and-circumstances test.

D. The Service's Position on the Commercial Activity of Charities

The Service formally asserts that it adheres to the judicially created facts-and-circumstances test¹³³ to determine whether or not a charity is engaging in substantial amounts of unrelated commercial activity in violation of the operational test of § 501(c)(3). Despite this formal assertion, over the last decade the Service's administrative rulings have rarely involved a facts-and-circumstances analysis. As this Section will show, the Service's unofficial position is to allow considerable amounts of commercial activity before questioning a charity's qualification for exemption.¹³⁴ This is in direct conflict with the case law, which, as we have seen, favors revocation whenever a charity

¹³² Id. at 3187, 3188.

¹³³ The 1988 Litigation Guideline Memorandum clarifying the focus of the operational test confirmed that the facts-and-circumstances approach was the law. Lit. Guideline Mem. (Jan. 22, 1988).

¹³⁴ This liberal stance is a fairly recent phenomenon. After all, most of the cases reviewed in Part II are from the 1960s through the 1980s and are cases that were initiated by a Service decision to revoke an organization's charitable exemption. The fact that there have been fewer operational test cases in recent years, aside from the complex joint venture variety, supports this argument. It could be that the Service made an affirmative decision to scale back the policing of commercial activity, but the exact reason for the shift is not clear.

"looks" too much like a for-profit entity.¹³⁵ The Service takes a different approach, making determinations in a conclusory manner, engaging in no, or minimal, reasoning, or simply ignoring the inquiry altogether. This lax approach seems to benefit charities at first glance, but in fact, the Service's failure to develop a coherent test for what amounts to a substantial nonexempt purpose only adds additional uncertainty to the turmoil surrounding the operational test.¹³⁶

The Service most often encounters commercial activity by charities in the context of determining whether or not that organization should be paying UBIT on income generated by a particular unrelated commercial activity. In a 1994 Private Letter Ruling, the Service described the relationship between UBIT and the operational test as follows: "[I]f [an activity] is found to be unrelated to [the charity's] exempt purpose, [the charity] would at the very least be subject to the tax on unrelated business income. If the [unrelated] activity is found to be substantial, then [the charity's] exempt status would be jeopardized."¹³⁷

Although the Service recognizes that there is a relationship between the operational test and UBIT, it does not always treat UBIT and the operational test as a continuum of inquiries. In fact, it is commonplace for the Service to make a UBIT determination without ever questioning whether or not the charity continues to qualify for exemption.¹³⁸ In some cases, the decision not to delve into a facts-and-circumstances test inquiry is somewhat surprising and suggests the Service's reluctance to disturb a charity's exempt status.

¹³⁵ See *supra* Part II.B.1.

¹³⁶ This analysis will be based on private administrative rulings issued by the Service to charities over the last decade. Under I.R.C. § 6110(j)(3) (1994), these private rulings cannot be cited as legal precedent. Despite their limited legal weight, they are a valuable resource when examining the IRS's treatment of a particular issue. However, a few practical concerns should be noted. First, because private rulings are initiated by the taxpayer, it is unlikely that the most troubling cases will be confronted. Also, unsophisticated or unadvised charities probably often do not request private rulings. Thus, the private letter rulings may represent an incomplete picture of the issues.

¹³⁷ Priv. Ltr. Rul. 94-36-002 (Jan. 26, 1994).

¹³⁸ See Priv. Ltr. Rul. 97-20-035 (Feb. 19, 1997) (holding that educational institution must pay UBIT on certain golf course income when charity's only other activity was operating continuing education center; Service never questioned organization's qualification for exemption); Priv. Ltr. Rul. 97-02-004 (Aug. 28, 1996) (finding tours with purpose of fostering survival and unity of certain group are subject to UBIT when tour amounts to luxury vacation, without inquiring into whether operational test had been violated); Priv. Ltr. Rul. 96-45-004 (July 17, 1996) (holding that certain income earned by university from its golf course is subject to UBIT; no operational test inquiry); Priv. Ltr. Rul. 89-47-002 (July 31, 1989) (holding that charity engaged in sale of court directory to general public is subject to UBIT, while sales to members is not; does not mention operational test requirement).

For example, in a 1996 Private Letter Ruling, the Service did not question the exempt status of a consortium of charitable and educational institutions organized for the purpose of providing noncommercial instructional television, even though they were renting more than half of those stations to for-profit organizations.¹³⁹ In another, more recent example, the Service was asked to determine whether or not a charity with the sole purpose of running a five-day summer agricultural festival should pay UBIT on income generated from the leasing of storage space during the winter months. The Service determined that the charity would have to pay UBIT on income generated from the winter-storage-rental activity, but never questioned the organization's exempt status.¹⁴⁰

This liberal approach also can be seen in several cases where the Service has made affirmative determinations that considerable amounts of unrelated commercial activity do not violate the facts-and-circumstances test. For example, in a 1994 Private Letter Ruling, the Service did not revoke the tax exemption of a charity that was engaged in the sale of herbs and that planned to enter into an agreement with a for-profit distributor.¹⁴¹ The organization's purpose was to provide instruction and promote the practice of traditional medicinal systems. The sale of herbs was initially expected to generate thirty percent of the revenues, but actually had generated eighty to eighty-one percent of the organization's revenue. Even more surprising, because the sale of herbs was found to be a related activity, the charity was not required to pay UBIT.¹⁴² A few years later, the Service again made a determination that suggests that generating over three-quarters of one's income from an unrelated commercial activity is acceptable; in 1995 it upheld the charitable exemption of an educational institution engaged in publishing activities that generated seventy-five percent of the charity's income. In that case, however, the publishing activities were deemed unrelated, and the Service did require the organization to pay UBIT on any generated income.¹⁴³

Although the trend has been for the Service to allow liberal amounts of unrelated commercial activity, the Service makes these decisions without engaging in any rational or coherent analysis. Despite

¹³⁹ Priv. Ltr. Rul. 97-03-025 (Oct. 21, 1996). The Service determined that the income from the leasing of radio stations was not subject to UBIT because the income could be classified as income from real property rent, an exception to UBIT. For a discussion of the problems the exceptions to UBIT create for the operational test, see *infra* Part III.A.

¹⁴⁰ Priv. Ltr. Rul. 98-22-006 (Jan. 29, 1998).

¹⁴¹ Priv. Ltr. Rul. 94-36-002 (Jan. 26, 1994).

¹⁴² *Id.*

¹⁴³ Priv. Ltr. Rul. 96-36-001 (Jan. 4, 1995).

the fact that § 501(c)(3) and the Treasury Regulations promulgated thereunder require an analysis, the Service typically engages in no inquiry at all.¹⁴⁴ This approach is not only unprincipled, it leads to uncertainty.¹⁴⁵ At any moment, the Service could change its position and begin limiting the amount of unrelated commercial activity allowed. In the interest of predictable and consistent results, a reliable and sensible standard is needed—one that can guide charities, the Service and the courts in determining whether or not charities are engaging in too much unrelated commercial activity. More certainty and guidance will protect charities from jeopardizing their exempt status.

III

A PROPOSAL TO REFORM THE OPERATIONAL TEST

As Part II has shown, the current incarnation of the operational test as a facts-and-circumstances standard suffers from subjectivity and from a lack of consideration for the fact that charities are entitled to conduct as much commercial activity as they wish, so long as it is related to charitable purposes. However, as Part III.A will show, it would be inappropriate to rely solely on UBIT to police unrelated commercial activity in charities. Rather, the operational test should be enhanced, as Part III.B advocates, by modifying the “primary purposes test” in Treasury Regulation section 1.501(c)(3)-1(e) so as to allow charities to create a rebuttable presumption of compliance with the operational test, provided that the charity’s amount of unrelated business income and expenses does not exceed the related- business income and expenses, exclusive of certain items of passive income.

A. The Unification of UBIT and the Operational Test: A False Hope for Reform

Given the many problems with the operational test described above, a natural approach would be to avoid it by relying solely on UBIT to police the amount of unrelated commercial activity in charities or, alternatively, to apply the operational test only when an organ-

¹⁴⁴ For example, in the case involving the sale of herbs, the Service did not engage in any analysis or weighing of factors. Instead, it simply cited some of the related activities, such as research and training, as proof that the primary purpose was not disturbed by the herb sales. Priv. Ltr. Rul. 94-36-002 (Jan. 26, 1994).

¹⁴⁵ For example, a 1987 General Counsel Memorandum concluded that the provision of day care referrals and information was not an unrelated activity subject to UBIT where the charity’s principal activity was operating day care centers. Gen. Couns. Mem. 39,622 (Apr. 10, 1987). Only five years later, in a 1992 Memorandum, the Service made the opposite determination and revoked the charitable exemption of an organization engaged in the same activity. This time, the Service deemed the activity an unrelated commercial activity. Gen. Couns. Mem. 39,872 (Apr. 19, 1992).

ization's unrelated-business taxable income becomes excessive, thereby making UBIT an intermediate sanction. However, UBIT was not designed for such a task, and, as discussed below, it cannot take the place of a well-defined operational test.

Such an integration of UBIT and the operational test might function as follows: UBIT would tax unrelated-business income that is less than substantial while the operational test would revoke the charity's exemption only when the unrelated business becomes substantial. A charity would pass the operational test without triggering UBIT for any activity that is related to its charitable purposes, regardless of how substantial such activity was. Insubstantial amounts of unrelated commercial activity might or might not trigger UBIT, but they would not cause the charity to fail the operational test.¹⁴⁶ However, if the amount of unrelated activity were substantial, then the charity would fail the operational test and lose its exemption.¹⁴⁷

Thus, administration of the operational test could be as simple as fixing the limit on the permissible amount of unrelated-business taxable income for charitable organizations: If an organization had too much unrelated-business taxable income, then it would no longer be operating primarily for exempt purposes and would lose its exemption. There could be a safe-harbor rule, just as there is for the regulation of lobbying in charities,¹⁴⁸ that would define precisely how much unrelated-business income charities of different sizes could take in without risking loss of exemption.

¹⁴⁶ The activity would trigger UBIT if it is regularly carried out and does not fall into one of the many exceptions to UBIT discussed below, and the organization has not structured itself such as to avoid UBIT.

¹⁴⁷ This integrated approach has its supporters. Consistent with its goal of collecting taxes, the Service already tends to use UBIT as an intermediate sanction, thereby avoiding the application of the facts-and-circumstances test entirely while raising modest amounts of revenue. See *supra* Part II.D. Going beyond integration, Kenneth Eliasberg has argued that there would be no need to limit unrelated commercial activity at all, and therefore no need to identify an organization's primary purpose, provided that unrelated activities in charities were taxed. See Eliasberg, *supra* note 28, at 100-01. Although Eliasberg's idea has the virtue of simplicity, it is not practical because UBIT, in its present incarnation, is a long way from taxing all unrelated activity, and even if it were expanded to cover all unrelated activity, it is not clear that the IRS would be up to the task of enforcing such a rule.

¹⁴⁸ I.R.C. § 501(c)(3) (1994) says "no substantial part of the activities [of a charity may be] carrying on propaganda, or otherwise attempting, to influence legislation . . ." The Code and Treasury Regulations leave the definition of substantiality ambiguous for purposes of § 501(c)(3), which creates many of the same problems as the operational test. I.R.C. § 501(h) (1994) permits charities to opt out of the vague substantial lobbying standard of § 501(c)(3) by electing an "expenditure test" that requires separate accounting of a charity's grassroots and other lobbying expenses. Although complex to apply, § 501(h) provides a precise definition of substantiality, and it gives charities a safe harbor within which they can be certain their activities do not jeopardize their tax exemption.

Although that approach would have the advantage of precision and would avoid a facts-and-circumstances analysis for purposes of the operational test, it would suffer from the imperfections of UBIT. As discussed above,¹⁴⁹ UBIT was not designed to police the border between exempt and nonexempt entities, and it is an inadequate replacement for the operational test because of UBIT's limitations, exceptions, and ease of avoidance.¹⁵⁰ For example, UBIT's "regularly carried on" requirement¹⁵¹ is inappropriate for the operational test because it limits the focus of UBIT to ongoing commercially competitive activities, whereas the operational test should encompass all forms of unrelated commercial activities by charities.¹⁵² If a charity with a small operating budget and very few activities occasionally provides investment banking services to high net worth individuals, with resulting income of millions of dollars, its status as a charity should at least be questioned, even though it is not subject to UBIT because the activity is "irregular." An unrelated but highly profitable commercial venture that eclipses an organization's other charitable activities ought to undermine the charity's exempt status even if that venture happens only once in a while.

Perhaps the most serious of the UBIT exemptions is the exception of royalty income under § 512(b)(2), which allows charities (e.g., the Sierra Club) to sell or rent their extremely valuable subscriber lists to for-profit companies (e.g., Visa) to create hugely profitable products (e.g., affinity credit cards).¹⁵³ Other exceptions include certain

¹⁴⁹ Supra notes 37-49 and accompanying text.

¹⁵⁰ See supra note 46-47 and accompanying text.

¹⁵¹ § 512(a)(1).

¹⁵² The "regularly carried on" requirement serves to limit UBIT's focus to competition with for-profit firms, a goal which is not of primary importance for the operational test, since it is a qualification for tax exemption, while UBIT corrects the conduct of recognized charities without threatening their tax exemption.

¹⁵³ In *Sierra Club, Inc. v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996), the 9th Circuit held that "'royalties' in § 512(b) are defined as payments received for the right to use intangible property rights and that such definition does not include payments for services." *Id.* at 1535. Schwarz identifies several other, similar fact patterns, including the National Geographic Society's recent acquisition of a stake in an Internet-based adventure-travel tour company, iExplore, Inc.; Columbia University's joint ventures with NutritionU.com, UNext.com, and Fathom.com to provide information and online education programs; the College Board's SAT tutoring for-profit subsidiary; and the Museum of Modern Art in New York's for-profit joint venture with the Tate Gallery to sell products on the Internet. Schwarz, supra note 3 at 32-33 (citing Karen W. Arenson, *Columbia Sets Pace in Profiting Off Research*, N.Y. Times, Aug. 2, 2000, at B1; Daniel Costello, *Museum of Modern Art's Ambitious Expansion Plan Faces Trouble*, Wall St. J., June 7, 2000, at B1; Jane Levere, *National Geographic Buys Stake in iExplore*, N.Y. Times, Aug. 21, 2000, at C7; Jodi Wilgoren, *Aged Upstart, College Board, Is Joining Gold Rush on Web*, N.Y. Times, Sept. 25, 1999, at A1).

real property rents;¹⁵⁴ activity performed by unpaid volunteers;¹⁵⁵ activity performed for the convenience of a charity's members, students, patients, officers, or employees;¹⁵⁶ sales of merchandise that has been given to the organization (e.g., the clothes and other items sold by the Salvation Army);¹⁵⁷ certain activities of trade shows, state fairs, and so on;¹⁵⁸ certain hospital services;¹⁵⁹ certain bingo games;¹⁶⁰ certain pole rentals;¹⁶¹ distributions of low cost articles and exchanges or rentals of member lists among charities;¹⁶² and finally, the activity of soliciting and receiving corporate sponsorship payments.¹⁶³

Another troubling exception to UBIT is the exemption of commercial activity conducted by unpaid volunteer labor.¹⁶⁴ Charities whose commercial activity is conducted exclusively by volunteers can escape UBIT entirely. The exception also gives organizations with both paid and volunteer laborers a planning opportunity to avoid UBIT by allocating the volunteer labor to the unrelated activity, and paying only those who conduct the related activity. Finally, since organizations can structure themselves to avoid UBIT by using subsidiary organizations,¹⁶⁵ tying the operational test to the amount of UBIT charities pay would make the operational test similarly avoidable.

Due to the many problems with UBIT, it would be a mistake to tie the operational test to the amount of UBIT a charity pays. However, incorporating some of the concepts of UBIT—without all of its exceptions and limitations—into the operational test, as the following Section proposes, could convert the facts-and-circumstances standard

¹⁵⁴ § 512(b)(3).

¹⁵⁵ § 513(a)(1).

¹⁵⁶ § 513(a)(2).

¹⁵⁷ § 513(a)(3).

¹⁵⁸ § 513(d).

¹⁵⁹ § 513(e).

¹⁶⁰ § 513(f).

¹⁶¹ § 513(g).

¹⁶² § 513(h).

¹⁶³ § 513(i) (West 2000). This boondoggle allows charities to devote as much activity as they wish to soliciting corporate sponsorships as long as "there is no arrangement or expectation that such person will receive any substantial return benefit other than the use or acknowledgement of the name or logo (or product lines) of such person's trade or business in connection with the activities of the organization that receives such payment." § 513(i)(2)(A) (West 2000). Football fans know one example of a qualified sponsorship payment: The FedEx Orange Bowl. To those who have seen the program, it strains credulity to believe that FedEx is receiving nothing more than a "mere acknowledgment" in return for its sponsorship of the College Bowl given the number of times the company's name is mentioned and the amount of time the camera spends focusing on its logo. Rather, it appears to be nothing more than an advertising agreement between FedEx and the Orange Bowl, and a substantial one at that. See, e.g., <http://www.orangebowl.org>.

¹⁶⁴ § 513(a)(1).

¹⁶⁵ See *supra* note 47.

into a more objective and coherent analysis that better serves the policy behind the operational test.

*B. The Exempt-Primary-Purposes Presumption:
A Proposal to Modify the Operational Test*

The current state of the operational test often leads to a subjective investigation of the degree to which a charity resembles a for-profit company. At the same time, the Service's current practice is to ignore the unadministrable facts-and-circumstances approach and simply allow considerable amounts of unrelated commercial activity to pass unregulated.¹⁶⁶

Treasury Regulation section 1.501(c)(3)-1(e) should be modified to interpret the operational test of § 501(c)(3) better.¹⁶⁷ Charities should be allowed to create the rebuttable presumption of the existence of an exempt primary purpose (and hence of compliance with the operational test), provided that the charity's unrelated-business income and expenses do not exceed the charity's related-business income and expenses, exclusive of certain items of passive income. Under this proposal, section 1.501(c)(3)-1(e) might read as follows (blacklined to show added text in italics and deleted text struck through):

§ 1.501(c)(3)-1 Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.

...

(e) Organizations carrying on trade or business—

(1) In general.

An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business[.], as defined in section 513 *The term "unrelated trade or business" means, for purposes of this subsection, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or*

¹⁶⁶ See *supra* Part II.D.

¹⁶⁷ Of course, it would be hubris to pretend that such a difficult problem could be dispensed with a simple amendment to the Treasury Regulations. As such, the following proposal is offered in the spirit of generating discussion of the appropriate limitations on unrelated commercial activity in charities.

other purpose or function constituting the basis for its exemption under section 501.

(i) Presumption of Exempt Primary Purpose.

An organization may create the rebuttable presumption that it is operated for an exempt primary purpose if it demonstrates with credible evidence that during an average, three-year period, the sum (rather than net) of its gross income and expenses derived from any unrelated trade or business (including amounts that would be treated as gross income derived from an unrelated trade or business for purposes of section 512(b)(13)) does not exceed the sum of its gross income and expenses (including those deductions directly connected with the carrying on of such trade or business) derived from any related activities, exclusive of income and expenses attributable to those items listed in sections 512(b)(1)-(17). The Internal Revenue Service may rebut this presumption only if it develops sufficient contrary evidence that such unrelated amounts exceed related amounts.

(ii) Facts-and-Circumstances Test.

If the organization cannot create such a presumption, then [i]n determining the existence or nonexistence of such nature of its primary purpose, all the circumstances must be considered, including the size and extent of the unrelated trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes. . . .

(2) Taxation of unrelated business income. . . .

(3) Examples.

The provisions of this section may be illustrated by the following examples:

Example (1). Over the last three years, X, an educational organization that otherwise satisfies the conditions of section 501(c)(3) had the following cash flows (averaged to even out abnormal amounts). X received \$90,000 of unrelated business income each year and spent \$10,000 in conducting such unrelated business. X received \$30,000 of tuition payments which were related to its charitable purpose. In addition, X received \$70,000 of charitable contributions and \$100,000 of investment income. X spent \$60,000 on the operation of its educational activities over the same period. X cannot create the presumption of an exempt primary purpose, and may lose its tax-exempt status under a facts-and-circumstances analysis because the total unrelated business income and expenses of \$100,000 exceeds the total related income and expenses of \$90,000, which sum is composed of \$30,000 of tuition payments and \$60,000 of educational expenses. The charitable contributions and investment income are excluded from the calculus because they fall under sections 512(b)(10) and 512(b)(1), respectively.

Example (2). The facts are the same as in Example (1) except X now receives \$50,000 of tuition payments. X may create the rebuttable presumption of an exempt primary purpose because related income and expenses total \$110,000, which exceeds the total unrelated business income and expenses of \$100,000. The Service may rebut such presumption, however, if it develops sufficient contrary evidence that X's unrelated amounts exceed its related amounts.

Example (3). The facts are the same as in Example (1) except X has no unrelated income or expenses other than a payment of \$100,000 from a wholly owned C corporation, a shoe store, that would be treated as gross income derived from an unrelated trade or business for purposes of section 512(b)(13). In addition, X now has no related income and \$110,000 of related expenses in the form of grants to other charitable educational organizations. X may create the rebuttable presumption of an exempt primary purpose for purposes of section 501(c)(3) because the related income and expenses total \$110,000, which exceeds the sum of unrelated business income and expenses of \$100,000.

1. The Identification of Unrelated Trade or Business

The first step for creating the rebuttable presumption of an exempt primary purpose is to distinguish related from unrelated trade or business activities. Ultimately this relatedness analysis must be an inquiry into the connection between an organization's activities and its exempt purposes. However, by incorporating the same definition of unrelated trade or business as that in § 513(a) (governing UBIT), but absent its exceptions and those in §§ 513(b)-(i), the modified operational test would not risk penalizing organizations for engaging in related commercial activity.¹⁶⁸ As discussed above,¹⁶⁹ the exceptions to § 513 serve to limit UBIT to commercial activity by charities that are in direct competition with for-profit entities, and contribute greatly to UBIT's impotence as a device for distinguishing between exempt and nonexempt organizations. As such, there is no policy rationale for incorporating those exceptions into the operational test.

Without its exceptions, the definition of unrelated trade or business in § 513 is very helpful for purposes of administering the operational test. The Treasury Regulations explain that a trade or business includes "any activity carried on for the production of income from the sale of goods or performance of services."¹⁷⁰ This definition of

¹⁶⁸ Note that the § 501(c)(3) regulations already contain a reference to § 513, but the reader quickly loses sight of it in the confusion of the facts-and-circumstances test. See Treas. Reg. § 1.501(c)(3)-1(e)(1) (as amended in 1990).

¹⁶⁹ Supra Part III.A.

¹⁷⁰ Treas. Reg. § 1.513-1(b) (as amended in 1983).

commercial activity is broad enough to pick up much of the commercial activity that has given charities trouble under the operational test.

Another advantage of using the definition of "unrelated trade or business" from § 513(a) is that the Regulations and Service rulings have developed a highly articulated standard for relatedness.¹⁷¹ Although this has led to a sometimes absurd level of detail—for example, the Service has determined that a museum gift shop's sales of soap and perfumes are not related to an educational purpose, while home furnishings resembling those on display at the museum are related¹⁷²—the clear focus of the § 513(a) inquiry on the degree to which the commercial activity is related to exempt purposes is a welcome relief from the jumbled and incoherent concepts employed in the current operational test.

2. *The Limitation of Unrelated Trade or Business*

Under the proposal, in order to create the rebuttable presumption of an exempt primary purpose, an organization must limit its unrelated trade or business income and expenses to amounts less than the related income and expenses, exclusive of certain items of passive income (those listed in §§ 512(b)(1)-(17)).

It is significant that the proposal compares both the revenues and the expenses associated with a charity's activities rather than net amounts. This approach compares *activities*, related versus unrelated, rather than sources of income. If the test were to consider only the revenues an unrelated commercial activity generates, then it would not catch organizations that spend a substantial amount of resources engaged in unprofitable yet still unrelated activity. The operational test must be able to catch unrelated activity even if it is not commercially successful because the test is meant to limit organizations to a charitable primary purpose. Some activities generate income while others expend it, and they should all count under the operational test.

¹⁷¹ § 1.513-1(d)(2). An income-producing trade or business activity is "related" to an exempt purpose if it has a "substantial" "causal relationship" to it; that is, the income must "contribute importantly to the accomplishment of the exempt purposes" See *supra* note 34 for a discussion of the terminology "in furtherance" versus "related."

¹⁷² Priv. Ltr. Rul. 86-05-002 (Sept. 4, 1985); see also Rev. Rul. 78-98, 1978-1 C.B. 167 (finding recreational use of school's ski facility by students is related, but income from use by public is unrelated trade or business); Rev. Rul. 73-105, 1973-1 C.B. 264 (holding sale of scientific books and city souvenirs by museum of folk art to be unrelated while other items sold in museum shop were related to museum's exempt function); Priv. Ltr. Rul. 95-50-003 (Sept. 18, 1995) (analyzing historical museum gift shop items in detail and finding, for example, that reproductions and adaptations of prototypes in museum's collections are related to museum's exempt purpose while designs that merely interpret items in museum collection—such as Christmas tree gift wrap set and ornaments depicting vase with flowers, flower basket, and flying goose—are unrelated).

On the other hand, if the test only considered the costs associated with an activity, it would not catch highly profitable commercial activity that is cheap to produce—for example, an organization that exploits a valuable piece of intellectual property over a low-maintenance web site. By considering the sum of costs and revenues associated with a charity's activities rather than net amounts, the test appropriately penalizes a charity for engaging in high-cost, high-revenue, unrelated activities most heavily and low-cost, low-revenue, unrelated activities least heavily. Most importantly, it does not penalize charities for engaging in related commercial activity, unlike the current incarnation of the operational test.

Charitable contributions (listed in § 512(b)(10)) are not considered related income for purposes of this proposal because if they were allowed, then an organization could flout the rule by using a controlled private foundation or other friendly third party to make contributions in an amount sufficient to offset any excess unrelated income. Similarly, the expense of collecting charitable contributions is not included in the calculation since an organization should not be able to improve its balance sheet for purposes of satisfying the presumption merely by spending great amounts of resources soliciting charitable contributions. The proposal simply excludes charitable contributions and the expense of soliciting them from the calculation.

Other items of passive income, such as investment income, royalties, and rents, are neither related nor unrelated to charitable purposes. Apart from the public-support test in § 509 relating to private-foundation status, charities presently have no limits on the amount of passive income they may collect. It would indeed be a radical departure from current practice suddenly to treat the income from a university's endowment as something that might jeopardize its tax-exempt status. On the other hand, large amounts of passive income should not help a charity pass the operational test either, since by definition passive income does not further charitable purposes. That said, the passive income provisions in § 512(b) might be in need of reform.¹⁷³

The proposed reform of the operational test is intended to work with the other Code provisions already in place, and, in particular, § 512(b)(13), an antiabuse provision that polices charities' use of subsidiaries to avoid the appearance of conducting unrelated business activities.¹⁷⁴ The problem is that charities may collect amounts of passive income such as rent or royalties from a subsidiary that derives

¹⁷³ See *supra* note 153 and accompanying text.

¹⁷⁴ See I.R.C. § 512(b)(13) (1994 & Supp. IV 1999) (specifying that "controlling organization" must include as unrelated-business income any payment from entity it controls, to extent such payment reduces net unrelated income of controlled entity).

the funds to pay such fees from unrelated trade or business. Therefore, the proposal includes in unrelated income any amounts received from controlled organizations¹⁷⁵ that would be treated as gross income derived from an unrelated trade or business for purposes of § 512(b)(13). Just as it is important for the administration of UBIT that charities not be able to conduct unrelated trade or business activities in subsidiary organizations and collect the income derived therefrom tax free in the guise of passive rent or investment income, so too is it important for the operational test to include such unrelated income in the analysis of an organization's primary purpose. Thus, if a charity has a for-profit subsidiary, the subsidiary's income may be included in the calculation if that subsidiary meets the requirements of § 512(b)(13).¹⁷⁶

The facts described in Example (3) are meant to draw the reader's attention to the status of grantmaking organizations. In the example, X is an education-based, grantmaking organization that receives income from a taxable subsidiary as well as from several passive income sources. Apart from illustrating the operation of § 512(b)(13), this example shows that since making grants to charity is considered related activity, the charitable destination of an organization's income is one way of establishing an exempt primary purpose. X is not, however, a feeder organization of the kind that existed prior to the enactment of § 502¹⁷⁷ because its wholly owned subsidiary, a shoe store, pays tax on its income. Charitable grantmaking is just one form of related activity recognized by the proposed test. However, to the extent readers find this example troublesome, the test could treat grantmaking as a sort of passive expense, excluded from the comparison of unrelated and related activities just as the test excludes passive income.

3. *The Facts-and-Circumstances Analysis for Failure to Create a Presumption of Exempt Primary Purposes*

Under the proposal offered here, if an organization fails to create the rebuttable presumption of an exempt primary purpose, that organization would be subject to a facts-and-circumstances analysis, just as it would be under the current operational test. However, the pro-

¹⁷⁵ I.R.C. § 512(b)(13)(D) (1994 & Supp. IV 1999) (defining "control" for such purposes as ownership of more than fifty percent of subsidiary organization by vote or stock value and incorporating § 318 constructive-ownership rules).

¹⁷⁶ The proposal does not include a solution to the problem of double drop down and other end-runs around § 512(b)(13). See *supra* note 47. That subject deserves its own article.

¹⁷⁷ See *supra* notes 43-45 and accompanying text.

positional attempts to make it absolutely clear that the factfinder should examine the degree to which *unrelated* commercial activity is excessive. Related commercial activity should not be penalized. Any effort to rebut the presumption of the existence of exempt purposes necessarily would entail an inquiry that first distinguishes unrelated from related activities and then compares them to determine which is greater. That is, the presumption would generate a well-conducted analysis, quite different from the garbled approach now employed.¹⁷⁸

The vestigial facts-and-circumstances analysis would be reserved only for those situations in which an organization cannot create the presumption of an exempt primary purpose. Although even a circumscribed facts-and-circumstances analysis inherently generates some uncertainty, it should not be abolished entirely from the operational test because a facts-and-circumstances test is more difficult to evade than are the formal requirements of the rebuttable presumption described above. For example, complex joint ventures and unusually convoluted corporate structures designed to evade UBIT might be more easily dealt with by a facts-and-circumstances approach. More importantly, however, is the fact that the presence of the rebuttable presumption in the Treasury Regulation would establish the terms of a facts-and-circumstances inquiry on a comparison of related and unrelated activities.

Given the dependence of charities on the public perception of rectitude within the charitable sector as a whole, it is important for the Service to have broad powers to look through abusive structures to maintain philanthropic morale.¹⁷⁹ Since in the postreform world, most disagreements between charities and the Service would focus on the objective concepts of relatedness and substantiality involved in the presumption rather than subjective concepts concerning substantiality in an open-ended facts-and-circumstances analysis, the proposed modifications to Treasury Regulation section 1.501(c)(3)-1(e) would improve the operational-test jurisprudence.

CONCLUSION

The purpose of this Note has been to evaluate the status of the law regulating commercial activity in charities and to stimulate discussion by proposing a modification to Treasury Regulation section 1.501(c)(3)-1(e) that would allow charities to create a rebuttable presumption of an exempt primary purpose, and hence of compliance

¹⁷⁸ See *supra* Part II for a critique of the current approach.

¹⁷⁹ See *supra* note 17 for a discussion of decreased giving after the United Way "scandal."

with the operational test. The proposal would reserve the current facts-and-circumstances test only for those situations in which an organization fails to create the presumption of an exempt primary purpose. As Judge Posner observed, a facts-and-circumstances test "is no standard at all, and makes the tax status of charitable organizations and their donors a matter of the whim of the IRS."¹⁸⁰ Adoption of this Note's proposal would simplify the application of the operational test, thus conserving scarce judicial and IRS resources.

At the same time, the modifications would increase the test's fairness. Section 501(c)(3) demands that organizations be operated exclusively for exempt purposes, so it is wrong to permit factfinders to penalize an organization for commercially successful activity when that activity is related to an organization's exempt purposes. By targeting only commercial activity that is unrelated to an organization's exempt purposes rather than any activity that is commercially successful, this Note's proposal would interpret § 501(c)(3) better than does the current facts-and-circumstances test.

Finally, the proposed modifications clarify a murky area of the law. Clarity in tax law is of paramount importance for taxpayers in general, but it has particular urgency for charities because the law regulating the charitable sector is very complex, and many charities are underadvised due to a chronic insufficiency of funds. The penalty for violating the operational test—loss of exemption—is so extreme, that charities need to be absolutely certain when and if they are in danger of failing that test. Adopting the proposal described above would improve the administration of the charitable tax exemption with little cost. In addition, it would transmit better the policy underpinning the charitable tax exemption, while at the same time reducing the role of subjectivity. Perhaps most importantly of all, it would help concerned managers of charities—not to mention their attorneys—sleep soundly at night.

¹⁸⁰ *United Cancer Council, Inc. v. Comm'r*, 165 F.3d 1173, 1179 (7th Cir. 1999) (overruling Tax Court's holding that nonprofit no longer was operated for exempt purposes when it hired very expensive for-profit company to help raise funds).

