WORKING DRAFT

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RATIONALES FOR TAX EXEMPTION

by
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Introduction

This paper has three aims. First, it contains a brief description of various rationales which purport to justify or explain the granting of tax exempt status to certain organizations.[1] The aim is not to set forth a thorough exegesis, but rather merely a precis, of these rationales. The risk of distortion through oversimplification is real.

Second, it will venture a few select observations or criticisms of some of the theories. Here, again, the goal is to be brief rather than comprehensive. For the sake of clarity, any observations or criticisms follow directly after the description of each particular rationale.

Third, it suggests that no single rationale can or should be expected to explain or justify tax-exempt status. The not-for-profit sector of our society is complex and varied; its lineage is ancient. It would be unreasonably simplistic to expect to capture its essence or justification within the compass of any theory.

It does not follow that exploring such rationales is a waste of time. The exploration may help prevent uncritical acceptance of any particular theory. By pondering the limits of these justifications, by seeking out their weaknesses, we may better understand their proper force; we may become better-balanced advocates of our positions; we may better perceive the strengths of the positions of our opponents.

Rationales for Tax Exemption

The legal literature discussing tax-exemption rationales is not voluminous.[2] A number of different justifications for exempting nonprofit organizations from the income tax may be gleaned from a perusal of the principal writings. Five such theories are discussed briefly, in no particular order, below.[3]

First, tax-exempt status may be justified because the activities of the nonprofit sector are direct replacements for governmental obligations. The notion is that government should not tax organizations, thus reducing their ability to deliver goods and services by the amount of the tax, when that reduction merely creates a vacuum which must be filled by the government itself.[4] Stated another way, a deal has been struck: tax exemption in exchange for the private fulfillment of governmental duties.

This theory may be criticized on several grounds: (1) it fails to explain why tax exemption is not granted to for-profit providers of the same goods and services;[5] (2) it cannot explain the tax exemption of churches and religious organizations, since the First Amendment forbids government from intruding into those areas;[6] and (3) the amount of the tax-exemption benefit is not related to the value of goods or services provided, but rather to

the amount of capital or retained earnings of the organization;[7] (4) the theory does not support tax exemption, but merely argues that tax exemption is one of tow routes for the provision of the desired goods and services.[8] Despite these criticisms, this first rationale remains the most "popular" and oft-repeated justification for tax exemption.

Second, tax-exemption may be justified because of the way nonprofit organizations contribute to pluralism. The notion is that such organizations provide goods and services for the public, but perhaps more efficiently and in any event with more diversity than the government.[9]

Possible criticisms include: (1) it is not clear how to measure efficiency; some would dispute the claim that not-for-profit entities are more efficient than government, at least in all instances; lacking an agreed gauge, it is impossible to rely on that criterion;[10] (2) the argument from pluralism proves too much, because for-profit firms could also claim it;[11] (3) the justification does not provide useful guidelines for decision-makers trying to draw lines between various forms of and limits on tax exemption.[12]

Third, tax exemption may be explained by the inappropriateness of applying customary measures of "income" to not-for-profit entities.[13] Critics could counter: (1) the difficulty of defining an appropriate tax base argues for better or specially-crafted definitions, not exemption; (2) the problems may be overstated; at least a good portion of the receipts of non-profits respond fairly well to ordinary notions of "income."[14]

Fourth, the exemption may be justified on the grounds that taxing the not-for-profit indirectly would impose the tax burden on its customers and beneficiaries, but without taking into account their ability to pay.[15] Critics could respond: (1) tax rates imposed on entities, even in the business world, are not selected on the basis of the ability of the entities' customers to pay;[16] (2) in many cases, the ability-to-pay criterion would be met: in the case of "donative" nonprofits by the joint "contributions" of donors and customers, and in the case of "commercial" nonprofits by their typically-affluent customers;[17] (3) in any case, the true incidence of an entity-level income tax is a much-debated and uncertain question;[18] (4) the tax-exemption benefit itself fails to take into account the ability to pay of the entity's customers; the benefit is closely related to the retained "capital" of the entity rather than the nature of its clientele.[19]

Fifth, the exemption may be based on the joint presence of "contract failure" and insufficiency of capital. This rationale,

espoused somewhat gingerly by Prof. Hansmann,[20] is by far the most difficult to encapsulate; it is also perhaps the most satisfactory current contender among these theories. It deserves a slightly enlarged description. It proceeds from two notions. First, Prof. Hansmann postulates that many "commercial" nonprofits operate in industries characterized by "contract failure," i.e., in which customers are unable to "make accurate judgments about the quality, quantity, or price of services provided by alternative producers."[21] Second, Prof. Hansmann argues that certain nonprofit organizations have severe restraints on their ability to raise capital, unlike for-profit organizations which can readily borrow or issue stock.[22] When both criteria are met, i.e., when an industry is characterized by contract failure and nonprofits in that industry have substantial needs for capital, tax exemption may be justified as "a crude mechanism for subsidizing capital formation . . . ."[23]

Several criticisms may be made: (1) the rationale is, admittedly, "crude," since the value of the tax exemption is not well related to the goals sought; (2) it is not clear that it is wise to facilitate the aggregation of capital in the nonprofit sector, where it may be retained, free from tax and other means of diffusion;[24] (3) if the rationale were accepted, implementing legislation would almost certainly involve quite considerable complexity;[25] (4) granting tax exemption to a industry because it has trouble raising capital seems likely to promote economic inefficiency; (5) Prof. Hansmann's argument accepts as a given that an entity-level tax on income is appropriate (or at least inevitable) for business corporations; that premise gives away so much theoretical ground that there is not enough footing left to provide adequate support for a justification for sector-specific entity-level tax exemption.

Conclusion

At the outset, I promised a brief description and criticism of various rationales for tax exemption. I further proposed a thesis: that none of them is adequate to explain the rich variety of the not-for-profit sector. Instead, we must acknowledge that we are where we are not because of any prior rationale, but simply because that is the way we grew. Nor will any rationale adequately explain the growth pattern, since the tree has responded over time to all of the vagaries of human passions and conflicts.

In fairness, proponents of these rationales might agree that none is completely satisfactory. They might say that theories for tax exemption do not have as their primary goal an accurate description of the way things are. Rather, such theories are more helpful in providing guidelines for decisions about how things

should be in the future. The various rationales can help legislators, regulators, and others to weigh alternatives for and evaluate possible changes in the tax treatment of not-for-profit entities. The failure of a theory to answer all questions does not prevent it from being useful in answering some questions.

These points have some force; various rationales have been, will be, and should be invoked as aids to reasoning, even if they do not resolve all conundrums. The logical gap is this -- if we concede that a given rationale is helpful in some, but not all, cases, how do we decide which cases fall in the former and which in the latter category? Either we need a still further theory to apply for that purpose, or we must resort to an appeal to "common sense" or "good judgment." I believe that no theory, and no theory of theories, will ever suffice to answer all of our current questions, much less future questions still unknown. We will always, finally, need to decide them without having any clearly-controlling formula to determine our course.

Oliver Wendell Holmes once said, "a page of history is worth a volume of logic."[26] Clearly we cannot understand or explain the scope of the tax-exemption privilege without studying history. History, however, is no more sufficient a guide than rationales; the future is not fully foretold by the past. It may be true, as Santayana said, that "[t]hose who cannot remember the past are condemned to repeat it."[27] But it is also true that, as Heraclitus is reputed to have opined nearly 500 years before the birth of Christ, "One cannot step twice into the same river."[28] And thus, again, looms the abyss -- although we may not rely on history alone as a guide, we lack comprehensive rules to instruct us when to deviate from prior experience in light of new conditions.

There is no solution to this inevitable dilemma. Indeed, in some sense we ought to embrace the uncertainty. If we are careful and thoughtful, our judgments will be both informed by history and influenced by at least some of the imperfect rationales scholars have advanced. Nevertheless, at the end of the day, our own minds and hearts will have to choose, and the choices will not always be clear. There will be room for vigorous disagreements. That too may be cause for celebration rather than consternation. If we truly believe in pluralism, we should embrace these opportunities with open minds and with intellectual honesty and rigor.

Thus, we must continue to study history. We must seek better rationales for our privileged status. We should not expect to find the Holy Grail; we should, rather, expect a quest without end. We cannot wait for final enlightenment, but must continue to make decisions as we go. As Learned Hand has told us, "life

is made up of a series of judgments on insufficient data, and if we waited to run down all our doubts, it would flow past us."[29]

The ultimate goal is the exercise of thoughtful and informed judgments, rather than the elaboration of a comprehensive rationale. Theories are valuable not because they offer any realistic hope of all-inclusive solutions but because they provide grist for the mill of judgment. We should not expect total solutions; unrealistic expectations, unsatisfied, might be disheartening. We should instead stand fast on the uncertain ground of human judgment, informed by, but never totally constrained or determined by, even our best rationales and our most trenchant histories.

FOOTNOTES

1. An organization may be wholly or partially exempt from a wide variety of taxes, e.g., federal income or excise taxes, state or local income or property taxes. This paper addresses only exemption from federal income taxes, although qualification for such exemption often also results in exemption from other taxes.

The principal focus here is on entities described in Section 501(c)(3) of the Internal Revenue Code of 1986 [hereinafter I.R.C.], i.e., "main stream" charities. Many other sorts of organizations are wholly or partially exempt from federal income taxation, either by virtue of being described in other paragraphs of I.R.C. Section 501(c) or under a myriad of other provisions. For example, tax-exempt status is afforded to certain pension and profit-sharing trusts, farmers' and some other cooperative organizations, and foreign governments and their instrumentalities. Still other entities are generally free from income tax liability because their shareholders, beneficiaries, or partners are instead directly taxable on the entities' income, e.g., so-called S corporations, most partnerships, simple trusts, real estate investment trusts, and registered investment companies. The examples, in all cases above, are illustrative, not exhaustive. See B. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 28-29 (5th ed. 1987), for others.

Because this paper generally does not discuss membership and mutual-benefit organizations, it also does not set out the quite-separate rationale for exempting their receipts from income taxation. That rationale is: the income tax should not be asserted against the entity, since the entity is merely a combination, pooling, or conduit for the activities of the various members. Payments by a group of neighbors to build and maintain a swimming pool for their common use would not have been taxed (nor would they have been deductible to those making the payments). Thus, their payments to a pool association should not attract an income tax. One court put it this way:

> "[W]here individuals have banded together to provide recreational facilities on a mutual basis, it would be conceptually erroneous to impose a tax on the organization as a separate entity. . . . No income of the sort usually taxed has been generated; the money has simply been shifted from one pocket to another, both within the same pair of pants. . . . [A]s to these funds the organization does not operate as a separate entity." McGlotten v. Connally, 338 F. Supp. 448, 458 (D.D.C. 1972).

See Bittker & Rahdert, infra note 2, at 348-58; R. DESIDERIO & S. TAYLOR, infra note 2, at 4-16 - 4-18. This rationale is not free from problems. Indeed, it raises deep issues of why any entity which has members (i.e., shareholders, partners, beneficiaries) is subject to income tax. That line of inquiry would entail a discussion of so-called integration or imputation issues, and tax-incidence questions, which have been long debated with respect to the corporate income tax generally. Fortunately, it is outside the scope of this paper.

2. Among various sources consulted, the following seem particularly useful: Belknap, The Federal Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy (1954), reprinted in IV RESEARCH PAPERS SPONSORED BY THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS: TAXES 2025 (1977); Bittker & Rahdert, The Exemption of Nonprofit Organizations from Federal Income Taxation, 85 YALE L.J. 299 (1976); 1 R. DESIDERIO & S. TAYLOR, PLANNING TAX-EXEMPT ORGANIZATIONS section 4.03 (1987); Ellman, Another Theory of Nonprofit Corporations, 80 MICH. L. REV. 999 (1982); Hansmann, The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation, 91 YALE L.J. 54 (1981); B. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS ch. 1 (5th ed. 1987); McDaniel, Federal Matching Grants for Charitable Contributions: A Substitute for the Income Tax Deduction, 27 TAX L. REV. 377 (1972); McNulty, Public Policy and Private Charity: A Tax Policy Perspective, 3 VA. TAX REV. 229 (1984); Stone, Federal Tax Support of Charities and Other Exempt Organizations: The Need for a National Policy, 1968 U. SO. CAL. TAX INST. 27.

Several of the above articles are more centrally concerned with the policies affecting the deductibility of gifts to charities than with tax exemption of the charities themselves. The two questions are deeply intertwined. For example: "[T]he deduction allowed the donor is the counterpart of the exemption from income tax enjoyed by the charity itself [so that] the same policy decisions that justify the exemption for the charitable organization support the charitable contribution deduction." McNulty, supra, 3 VA. TAX REV. at 233; but see Hansmann, supra, at 72. Nevertheless, little effort has been made to plumb the depths of the relatively voluminous literature on the deduction. Furthermore, the scope of tax-exemption is not coterminous with the scope of the charitable deduction: many tax-exempt organizations are not eligible for tax-deductible gifts. The focus on legal literature reflects the background and training of the author, and should not be taken to suggest that other disciplines should be ignored; indeed, one of the main themes of this paper is that historical, economic, and other literature are often quite important.

3. The author's enumeration is not free from question: not only might the various theories mentioned be organized or subdivided differently, but other possible justifications could be added to the list.

4. This is the rationale mentioned in the final report of the prestigious Filer Commission:

> "A frequently cited justification for tax immunities that affect nonprofit organizations is that government, in fact, would itself have to supply many of the services, fill many of the functions, of such organizations if they did not exist." REPORT OF THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, GIVING IN AMERICA: TOWARD A STRONGER VOLUNTARY SECTION 103 (1975).

Compare the following formulation:

> "Clearly then, the exemption for charitable organizations is a derivative of the concept that they perform functions which, in the organizations' absence, government would have to perform; therefore, government is willing to forego the otherwise tax revenues in return for the public services rendered." B. HOPKINS, supra note 2, at 5.

The same notion finds voice in Congressional reports, e.g., H. Rep. No. 1860, 75th Cong., 3d Sess. 19 (1939), and in court decisions, e.g., McGlotten v. Connally, 338 F.2d 448, 456 (D.D.C. 1972).

5. See, e.g., Hansmann, supra note 2, at 67-71.

6. The size of the church/religious sector is considerable. It accounts for almost half of the entire nonprofit universe, measured by amounts donated annually. See, e.g., AAFRC TRUST FOR PHILANTHROPY, GIVING USA: ESTIMATES OF PHILANTHROPIC GIVING IN 1986 AND THE TRENDS THEY SHOW 61-62 (1987) (over $40 billion donated to religious organizations and agencies in 1986). Other possible measures of its size are problematical due to the inaccuracy of available statistics and the difficulty of obtaining data from many of the organizations in question. See, e.g., V. HODGKINSON & M. WEITZMAN, DIMENSIONS OF THE INDEPENDENT SECTOR: A STATISTICAL PROFILE 106 (Independent Sector, 2d ed. 1986) ("The religion subsector presents a major problem for our estimates.") The zone proscribed by the First Amendment does not exhaust the areas in which the state would not act; there are many other sorts of entities whose functions would not be taken over by government should they cease to exist, yet to which tax exemption has always been afforded. See Belknap, supra note 2, at 2032-33:

"[T]he quid pro quo explanation of tax exemptions . . . is not adequate as a justification of the privilege in some of the most important segments of the general area under discussion. . . . [T]he tax exemption privilege has much deeper roots than the quid pro quo theory would admit."

7. See, e.g., Hansmann, supra note 2, at 71. A quite similar criticism, directed at the mismatch resulting from the use of property tax exemption as a means of encouraging educational activities, is put forth in Note, Alternatives to the University Property Tax Exemption, 83 YALE L.J. 181, 183 (1973).

8. See Bittker & Rahdert, supra note 2, at 332.

9. Belknap puts it as follows:

"[G]overnment has granted the charitable tax exemptions in order to encourage voluntary private organizations to carry out certain activities which by common understanding are agreed to rate among the highest in the scale of social values. The preference that these activities be carried out by voluntary private organizations is based upon two advantages that private action in these fields enjoys over government action.

"The first advantage is that voluntary private enterprise can often do the job better. . . .

"The second advantage of private control . . . lies in the effect of such control upon the overall pattern of our society. . . . [T]he broad ramifications of freedom require a preference for private activity and diversity." Belknap, supra note 2, at 2035-36.

See also Stone, supra note 2, at 39-40.

10. See Bittker & Rahdert, supra note 2, at 332-33:

"Lacking a method for measuring these appealing but elusive virtues, one must perforce rely on intuition in comparing the achievements of private charities with those of government, when they are performing similar functions."

11. We could require a conjunction of charitably-aimed public benefit and diversity, thus excluding, e.g., General Electric Corp. from the justification. Even so, the theory would not explain why for-profit hospitals, health clubs, and schools are not exempt from the income tax.

12. The rationale may be fairly close to the mark in explaining why, over time, various entities in the not-for-profit sector have been made tax exempt. To the extent that its very "fuzziness" encompasses the variety of our history, it correspondingly fails to be useful as a predictor of any particular issue's outcome in the future.

13. See Bittker & Rahdert, supra note 2, at 307-16. For example:

> "[A]ll exempt organizations engaged in public service activities share one common feature: if they were deprived of their exempt status and treated as taxable entities, computing their 'net income' would be a conceptually difficult, if not self-contradictory task." Id. at 307 (footnote omitted).

The authors also argue that, even if an appropriate tax base could be defined, it would be difficult to fix an appropriate tax rate to apply to it. Id. at 314-16.

14. See, e.g., Hansmann, supra note 2, at 59-62. In particular, Hansmann finds no problem in using traditional tax-base and tax-rate notions in the case of "commercial" nonprofit organizations:

> "But Bittker and Rahdert overstate the difficulties. To begin with, many nonprofits receive little or no income from donations, but rather derive all or nearly all of their income from sales of goods or services . . . For such organizations it would be perfectly easy and natural to carry over the tax accounting that is applied to business firms . . . ." Id. at 59.

Hansmann goes on to argue that Bittker and Rahdert exaggerate the definitional difficulties even in the case of "donative," as opposed to "commercial," nonprofits. Id. at 61-62.

15. See Bittker & Rahdert, supra note 2, at 314-16. This fourth theory, although listed separately from the third, is closely linked to the latter. Indeed, the authors viewed it as really part of the appropriate-tax-rate issue.

16. See Hansmann, supra note 2, at 65.

17. Hansmann, supra note 2, at 65, arguing that in such cases the tax burden would not be "especially regressive."

18. See, e.g., Hansmann, supra note 2, at 65 n. 41. These issues are outside the scope of this paper, as remarked in note 1, supra.

19. Hansmann, supra note 2, at 66.

20. Hansmann, supra note 2. The adverb derives from personal conversations between the author and Prof. Hansmann.

21. Hansmann, supra note 2, at 68. The notion is further explicated, and examples are provided, id. at pp. 69-70.

22. Id. at 72-75.

23. Id. at 75.

24. Consider, for example, the policies behind the adoption of I.R.C. section 4942, captioned "Taxes on failure to distribute income." See generally B. HOPKINS, supra note 2, at 526-43.

25. It is not possible to explore all of the reasons in this paper. However: (a) since not all industries would be characterized by contract failure, some workable definition of each "industry" would have to be provided; (b) mechanisms would be needed to prevent entities from flowing their excess capital out of intended industries directly or indirectly into other uses and industries; (c) some method would be required for periodic reviews to measure whether the desired capital build-up had been achieved, so that tax exemption could be withdrawn.

26. New York Trust Co. v. Eisner, 256 U.S. 345, 349 (1921) (Holmes, J.). Compare his earlier apothegm, "The life of the law has not been logic: it has been experience." O. HOLMES, THE COMMON LAW 1 (Little Brown 1881).

27. G. SANTAYANA, I THE LIFE OF REASON (1905).

28. Plutarch ascribes these words to Heraclitus in CONCERNING THE E AT DELPHI 18, 392B. See also Plato, Cratylus 402A.

29. L. HAND, On Receiving an Honorary Degree (1939), THE SPIRIT OF LIBERTY 104 (Vintage Books 1959).