

## LET PROPHETS BE (NON) PROFITS

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### INTRODUCTION

Even organizations that support such odious values as racism and homophobia are entitled, under the First Amendment to the Constitution, to espouse their values without threat of punishment by the government.<sup>1</sup> Free speech is central to U.S. democratic norms.

At the same time, the government has no obligation to subsidize bad speech. In *Bob Jones University v. United States*,<sup>2</sup> the Supreme Court announced that the Internal Revenue Service (“IRS”) could constitutionally revoke the tax-exempt status of a religiously affiliated university because of its racist policy.<sup>3</sup> The revocation was

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1. *Hustler Magazine, Inc. v. Falwell*, 485 U.S. 46, 50–51 (1988) (noting that protection of communication is deemed necessary for the processes of democracy); Steven H. Shiffrin, *Racist Speech, Outsider Jurisprudence, and the Meaning of America*, 80 CORNELL L. REV. 43, 48–50 (1994). *See generally* Jeannine Bell, *Restraining the Heartless: Racist Speech and Minority Rights*, 84 IND. L.J. 963 (2009) (dissecting “racist speech” and arguing for improvements in the regulation of racist speech); Robert C. Post, *The Constitutional Concept of Public Discourse: Outrageous Opinion, Democratic Deliberation, and Hustler Magazine v. Falwell*, 103 HARV. L. REV. 601 (1990) (examining the use of the First Amendment to immunize from regulation the concept of “public discourse”); Robert C. Post, *The Social Foundations of Defamation Law: Reputation and the Constitution*, 74 CALIF. L. REV. 691 (1986) (exploring the competing interests of the state and the First Amendment in protecting reputation and freedom of expression); Cass R. Sunstein, *Free Speech Now*, 59 U. CHI. L. REV. 255 (1992) (providing an examination of the current system of free expression as an elaboration on the American understanding of sovereignty). *But see* Mari J. Matsuda, *Public Response to Racist Speech: Considering the Victim’s Story*, 87 MICH. L. REV. 2320, 2321–22 (1989) (arguing against First Amendment protection of racist speech).

2. 461 U.S. 574 (1983).

3. *Id.* at 574–75.

constitutional even though the racism derived from the university's religious beliefs.<sup>4</sup>

Although the conclusion makes sense—and may even be right—we argue that *Bob Jones* embraces the fundamental public policy rule for tax-exempt organizations that misunderstood the relationship between subsidy, tax exemption, and tax deductibility. As a result of the Supreme Court's misunderstanding, it took the right route to arrive at the wrong place.<sup>5</sup> By applying fundamental public policy to an entity's qualification for exemption, we argue, the Supreme Court inappropriately imposes on minority speech and does so without preventing the subsidy of bad speech.

How did the Supreme Court err? It misunderstood tax exemption as reflecting a subsidy to public charities. Tax exemption does not represent a subsidy. As we will demonstrate, public charities do not belong in the corporate income tax base. Because they do not belong in the base, exempting them from paying taxes represents an accurate application of the government's taxing power.<sup>6</sup> Concomitantly, taxing public charities, far from fixing the misapplication of a subsidy, gets the tax base wrong. And when the tax base is wrong, taxes are both unfair and inefficient.<sup>7</sup>

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4. Samuel D. Brunson & David J. Herzig, *A Diachronic Approach to Bob Jones: Religious Tax Exemptions After Obergefell*, 92 IND. L.J. 1175, 1189 (2017).

5. William N. Eskridge, Jr., *Dynamic Statutory Interpretation*, 135 U. PA. L. REV. 1479, 1546–49 (1987); William N. Eskridge, Jr. & Philip P. Frickey, *Statutory Interpretation as Practical Reasoning*, 42 STAN. L. REV. 321, 343–45 (1990).

6. See generally William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972) (arguing that charities are properly exempted from the tax base because the intended effect of an income tax is to curtail private, rather than public, consumption); Ilan Benshalom, *The Dual Subsidy Theory of Charitable Deductions*, 84 IND. L.J. 1047 (2009) (discussing the role of income tax as a method of providing incentives for certain behaviors, including spending for the public good); Boris I. Bittker, *Charitable Contributions: Tax Deductions or Matching Grants?*, 28 TAX L. REV. 37 (1972) (discussing the definition of “exempt organizations” under § 501(c)(3), and the unbiased enforcement of that definition pre-*Bob Jones*); John D. Colombo, *The Marketing of Philanthropy and the Charitable Contributions Deduction: Integrating Theories for the Deduction and Tax Exemption*, 36 WAKE FOREST L. REV. 657 (2001) (exploring the major economic theories justifying tax exemption for charitable organizations); Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393 (1988) (applying the subsidy and equity theories to charitable organizations to examine justifications of deductions for charitable giving); Saul Levmore, *Taxes as Ballots*, 65 U. CHI. L. REV. 387 (1998) (noting the ability of taxpayers to subsidize “worthy” causes through § 170 contributions to § 501(c) organizations).

7. See, e.g., Beverly I. Moran, *Stargazing: The Alternative Minimum Tax for Individuals and Future Tax Reform*, 69 OR. L. REV. 223, 241 (1990) (“The comprehensive income tax base is an attempt to achieve fairness by forcing taxable income to match economic income.”).

This is not to say that tax-exempt organizations receive no federal subsidy.<sup>8</sup> But we take the position that in the nonprofit sector, enforcement of the public policy doctrine should be executed elsewhere. We derive this position from historic precedent examining the role played by tax-exempt organizations as the guardians of minority views.<sup>9</sup> We believe that a legitimate space in society should exist and be populated by nonprofits to both espouse popular and unpopular minority views. Under the specter of *Bob Jones*, some unpopular minority views could be seen as violating public policy. With those voices silenced, the nonprofit space they previously occupied would become homogenous. This type of homogeneity is normatively detrimental to a robust society. Therefore, in order to allow nonconforming views, we propose that the proper sector to house those views is in an expansionist version of the nonprofit sector.

The problem thus is not the tax-exempt status of entities under 26 U.S.C. § 501(c)(3). Rather, the problem is the interaction between §§ 501(c)(3) and 170, because § 170 represents a government subsidy of tax-exempt organizations.<sup>10</sup> Collapsing these sections together conflates the exemption from the deductible contributions. Decades of tax scholarship have been dedicated to the question of whether or not exemption of the entity represents a subsidy or not.<sup>11</sup> Despite

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8. Lloyd Hitoshi Mayer, *The “Independent” Sector: Fee-for-Service Charity and the Limits of Autonomy*, 65 VAND. L. REV. 51, 82–85 (2012) (discussing the beneficial role of the government in influencing nonprofits through government funding of charitable causes).

9. *Bob Jones Univ. v. United States*, 461 U.S. 574, 609 (1983) (Powell, J., concurring); *Walz v. Tax Comm’r of N.Y.*, 397 U.S. 664, 672–73 (1970); *Jackson v. Statler Found.*, 496 F.2d 623, 638–39 (2d Cir. 1974) (Friendly, J., dissenting from denial of reconsideration en banc); Martha Minow, *Should Religious Groups Be Exempt from Civil Rights Laws?*, 48 B.C. L. REV. 781, 783 (2007) (arguing for alternatives to the “all exemptions or no exemptions” application of civil rights laws to various religious groups). *But see* Douglas NeJaime, *Marriage Inequality: Same-Sex Relationships, Religious Exemptions, and the Production of Sexual Orientation Discrimination*, 100 CALIF. L. REV. 1169, 1170 (2012) (“By permitting religious organizations, as well as some employers, property owners, and small businesses, to discriminate against same-sex couples in situations far removed from marriage itself, the ‘marriage conscience protection’ would threaten substantial progress made in antidiscrimination law.”).

10. JOHN D. COLOMBO & MARK A. HALL, *THE CHARITABLE TAX EXEMPTION* 11, 193–94 (1995); Gergen, *supra* note 6, at 1397–98; Levmore, *supra* note 6, at 405; David M. Schizer, *Subsidizing Charitable Contributions: Incentives, Information and the Private Pursuit of Public Goals*, 62 TAX L. REV. 221, 223 (2009).

11. STANLEY S. SURREY, *PATHWAYS TO TAX REFORM* 20–21 (1973); Andrews, *supra* note 6, at 369–70; Boris I. Bittker & Kenneth M. Kaufman, *Taxes and Civil Rights: “Constitutionalizing” the Internal Revenue Code*, 82 YALE L.J. 51, 63 (1972); Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 357–58 (1976); Henry Hansmann, *Why Are Nonprofit Organizations Exempted from Corporate Income Taxation?*, in *NONPROFIT FIRMS IN A THREE SECTOR ECONOMY* 115, 121–22 (Michelle J. White ed., 1981); Harold M. Hochman & James D. Rodgers, *The Optimal Tax Treatment of Charitable Contributions*, 30 NAT’L TAX J. 1, 2 (1977);

decades of alternative theories, the original thesis by Professor Boris Bittker still makes the most sense<sup>12</sup>: charitable entities should be tax-exempt because there are no individual owners.<sup>13</sup> Without individual owners, there is no proxy for taxation of the charity.<sup>14</sup>

Although there is robust debate about whether the exemption to the entity is a subsidy, there is little debate that the deduction for charitable donations is a subsidy.<sup>15</sup> Admittedly, some have argued that since there is no consumption, the § 170 deduction is not a subsidy under Haig-Simons.<sup>16</sup> For example, Professor Bittker believed that it was inequitable to include charitable donations in the base.<sup>17</sup> In contrast, Professor William Andrews's seminal article proposed that for the charitable contributions deduction in the Haig-Simons definition of income, there would have to be personal consumption.<sup>18</sup> Professor Andrews's position is that if you create public or common goods they cannot be personal consumption, which is not income.<sup>19</sup> Despite attempts in 1917 and 1986 to advance the position that the deduction for charitable donations is not a subsidy, those arguments were never able to carry the day.

Rather than regulate charitable behavior through the threat of revoking an organization's tax exemption, which would prevent heterogeneity at the organizational levels, we propose a solution that better matches the reality of the corporate tax base and will be more effective at discouraging bad behavior. Specifically, we propose that the IRS should enforce the fundamental public policy doctrine at the deduction level. Doing so allows a pluralistic charitable world but prevents the subsidization of the negative externality.<sup>20</sup>

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John K. McNulty, *Public Policy and Private Charity: A Tax Policy Perspective*, 3 VA. TAX REV. 229, 232 (1984); Donald B. Tobin, *Political Campaigning by Churches and Charities: Hazardous for 501(c)(3)s, Dangerous for Democracy*, 95 GEO. L.J. 1313, 1317 (2007).

12. Bittker, *supra* note 6, at 42; Bittker & Rahdert, *supra* note 11, at 315–16, 357–58.

13. Bittker & Rahdert, *supra* note 11, at 315–16, 357–58.

14. *Id.*

15. Andrews, *supra* note 6, at 344; Tobin, *supra* note 11.

16. Andrews, *supra* note 6, at 344; Boris I. Bittker, *Comprehensive Income Taxation: A Response*, 81 HARV. L. REV. 1032, 1034–35 (1968); Jeff Strnad, *Taxation of Income from Capital: A Theoretical Reappraisal*, 37 STAN. L. REV. 1023, 1026 n.7 (1985).

17. Bittker, *supra* note 6, at 56–62 (explaining why donations to charitable organizations should not be taxable).

18. Andrews, *supra* note 6, at 346.

19. *Id.* at 356; see also Paul Valentine, *A Lay Word for a Legal Term: How the Popular Definition of Charity Has Muddled the Perception of the Charitable Deduction*, 89 NEB. L. REV. 997, 1007 (2011) (explaining Professor Andrew's argument that charitable gifts do not constitute consumption but rather the creation of common goods).

20. Shannon Weeks McCormack, *Taking the Good with the Bad: Recognizing the Negative Externalities Created by Charities and Their Implications for the Charitable Deduction*, 52 ARIZ. L. REV. 977, 977–78 (2010).

This argument proceeds in four parts. Part I reviews the history of the fundamental public policy doctrine. It explains how law developed and the rationales for the *Bob Jones* decision. Part II reviews the scholarly debate over whether tax exemption represents a subsidy, a natural result of the tax base, or something else altogether. Part III then brings to bear a sophisticated analysis of the purposes behind the corporate income tax and how those purposes relate to the function of public charities. Part IV then reviews the history and purposes of the deduction for charitable donations. By reviewing the history of the deduction, the rationales for the retention or modification of the deduction can be properly situated. Finally, Part V explains why the fundamental public policy rule is a poor fit in determining whether an organization should qualify as tax-exempt. We will demonstrate in Part V why fundamental public policy is a better fit with tax deductions, and why applying it to disallow deductions rather than exemptions is better tax policy and better for society at large.

#### I. *BOB JONES UNIVERSITY* AND THE PUBLIC POLICY DOCTRINE

In a series of prior articles we have discussed the Supreme Court's decision in *Bob Jones University v. United States*.<sup>21</sup> In *Bob Jones*, the Supreme Court held that the IRS could revoke the tax exemption of a tax-exempt organization for violations of "fundamental public policy."<sup>22</sup> We explored how and whether the IRS could apply the fundamental public policy doctrines to racist fraternities and organizations that discriminate based on sexual orientation.<sup>23</sup> The lesson we learned from analyzing the fundamental public policy doctrine is how clumsy and inadequate it is as a solution to the problem of regulating the behavior of charities. This is why many scholars view *Bob Jones* as an outlier.<sup>24</sup> But there is nothing in the decision to indicate it is *sui generis*.<sup>25</sup>

None of this is to say that the direct consequences of *Bob Jones* were wrong: it may have represented the best way to prevent white parents from thwarting school integration, as we discussed in an

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21. See generally Brunson & Herzig, *supra* note 4 (suggesting safe harbor regimes to aid tax-exempt organizations in complying with requirements for tax-exemption post *Bob Jones*); David J. Herzig & Samuel D. Brunson, *Tax Exemption, Public Policy, and Discriminatory Fraternities*, 35 VA. TAX REV. 116 (2015) (discussing the Court's recognition of § 501(i) as adopting Revenue Ruling 71-447 in *Bob Jones*).

22. Brunson & Herzig, *supra* note 4, at 1175.

23. *Id.* at 1215–16.

24. David A. Brennan, *The Power of the Treasury: Racial Discrimination, Public Policy, and "Charity" in Contemporary Society*, 33 U.C. DAVIS L. REV. 389, 410 (2000); Eskridge, Jr., *supra* note 5, at 1547–48.

25. Anthony C. Infanti, *A Tax Crit Identity Crisis? Or Tax Expenditure Analysis, Deconstruction, and the Rethinking of a Collective Identity*, 26 WHITTIER L. REV. 707, 791–92 (2005).

earlier article.<sup>26</sup> The Supreme Court may have seen this as the only, or the best, avenue for solving the problem, and the justice of the result is undeniable. But the cliché that hard cases make bad law exists for a reason. It is not clear that the case is properly decided from a tax or a constitutional law perspective.<sup>27</sup> A key part of the problem we have regarding *Bob Jones* is the mapping of the public policy doctrine onto § 501(c)(3) entities through the individual tax deduction statute of § 170.<sup>28</sup>

These same problems were presented in the concurrence and dissent of the case.<sup>29</sup> Justice Powell, in concurrence, was hesitant to believe that the sole function of a § 501(c)(3) charity was to “act on behalf of the Government in carrying out governmentally approved policies.”<sup>30</sup> Justice Powell instead pointed to the historic role § 501(c)(3) charities have played “in encouraging diverse, indeed often sharply conflicting, activities and viewpoints.”<sup>31</sup>

Perhaps a better view of *Bob Jones* is to recognize the case as the final chapter in a long and systematic process of terminating racial discrimination in the education system of the United States starting with *Brown v. Board of Education*.<sup>32</sup> Briefly, after *Brown* declared the “separate but equal” doctrine unconstitutional in 1954, parents tried to accomplish school segregation via private schools.<sup>33</sup> By using private schools the parents could avoid the constitutional problem posited in *Brown*.<sup>34</sup>

The IRS was not granted clarity as to whether this new class of private segregated school violated the tax exemption and continued to grant tax-exempt status to these institutions.<sup>35</sup> In 1965, after the Civil Rights Act of 1964, the IRS stopped processing applications for tax exemption from segregated private schools until 1967.<sup>36</sup> If the school was private, though, and did “not have such degree of involvement with the political subdivision as has been determined by

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26. Brunson & Herzig, *supra* note 4, at 1188–90.

27. Richard A. Epstein, *Foreword: Unconstitutional Conditions, State Power, and the Limits of Consent*, 102 HARV. L. REV. 4, 95 (1988) (“The decision in *Bob Jones* has generally received a warm response, but is nonetheless clearly incorrect, once the problem of unconstitutional conditions is forthrightly considered. The initial inquiry is whether the state could decide that its ‘compelling interest’ in eradicating racial segregation in education is sufficiently strong to allow the state to impose a direct fine or criminal punishment on the school for imposing those conditions on its students. The answer, I take it, is no.”).

28. *Bob Jones Univ. v. United States*, 461 U.S. 574, 598–99 (1983).

29. *Id.* at 606 (Powell, J., concurring); *id.* at 612–14 (Rehnquist, J., dissenting).

30. *Id.* at 609 (Powell, J., concurring).

31. *Id.*

32. 347 U.S. 483 (1954).

33. Brunson & Herzig, *supra* note 4, at 1188.

34. *Id.*

35. *Id.*

36. Herzig & Brunson, *supra* note 21, at 126.

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the courts to constitute State action for constitutional purposes,”<sup>37</sup> the IRS determined that it did not have authority to reject the school’s exemption application.<sup>38</sup>

In response to the IRS ruling, a group of African-American parents in Mississippi sued the IRS to enjoin it from granting tax-exempt status to discriminatory schools.<sup>39</sup> The IRS not only followed the district court order but also expanded the order by applying the decision retroactively.<sup>40</sup> The IRS also began to look at private schools that had already obtained exemptions and, if they discriminated on the basis of race, would revoke their exemptions.<sup>41</sup> One such school was Bob Jones University.<sup>42</sup>

In *Bob Jones*, the Court answered the question that the IRS assumed in application, whether a state law corporation doing business as a university could qualify as tax-exempt under § 501(c)(3) of the Internal Revenue Code (“Code”).<sup>43</sup> In the university’s articles of incorporation, the university stated that its purpose was “to conduct an institution of learning . . . , giving special emphasis to the Christian religion and the ethics revealed in the Holy Scriptures.”<sup>44</sup> Although the university was not affiliated with any religious denomination, the Court recognized it as “both a religious and educational institution. Its teachers are required to be devout Christians, and all courses at the university are taught according to the Bible.”<sup>45</sup>

The university’s board of directors and officers held the belief that the “Bible forbids interracial dating and marriage.”<sup>46</sup> Thus, the university excluded all nonwhites until 1971.<sup>47</sup> From 1971 until 1975, the university accepted applications from “Negroes married within their race.”<sup>48</sup> After the 1975 *McCrary v. Runyon*<sup>49</sup> decision, the university modified its policy to permit nonwhites to apply but continued to prohibit interracial dating and marriage.<sup>50</sup>

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37. *Green v. Kennedy*, 309 F. Supp. 1127, 1130 (D.D.C. 1970).

38. *Id.* at 1130–31.

39. *Id.* at 1129.

40. *Brunson & Herzig*, *supra* note 4, at 1188.

41. *Id.*

42. *Id.* at 1186.

43. *Bob Jones Univ. v. United States*, 461 U.S. 574, 577 (1983).

44. *Id.* at 579–80.

45. *Id.* at 580.

46. *Id.*

47. *Id.*

48. *Id.*

49. 515 F.2d 1082 (4th Cir. 1975) (prohibiting racial exclusion from private schools).

50. *Bob Jones*, 461 U.S. at 580–81 (“That rule read[]: *There is to be no interracial dating.* 1. Students who are partners in an interracial marriage will be expelled. 2. Students who are members of or affiliated with any group or organization which holds as one of its goals or advocates interracial marriage will be expelled. 3. Students who date outside their own race will be expelled. 4.

In November of 1970, the IRS notified the university that the IRS policy had changed following the *Green v. Kennedy*<sup>51</sup> decision “and announced its intention to challenge the tax-exempt status of private schools practicing racial discrimination in their admissions policies.”<sup>52</sup> By April of 1975, the IRS formally notified the university that the agency was revoking its exempt status and on “January 19, 1976, the IRS officially revoked the university’s tax-exempt status, effective as of December 1, 1970, the day after the university was formally notified of the change in IRS policy.”<sup>53</sup>

Bob Jones University challenged the revocation of its tax-exempt status by the IRS.<sup>54</sup> The university relied on the statutory language of § 501(c)(3) for the proposition that it was organized “exclusively for . . . educational purposes” and under the plain meaning of the statute was required to be granted tax-exempt status.<sup>55</sup> After all, the university was organized exclusively for educational purposes.<sup>56</sup> In an eight-to-one decision, the Supreme Court held that Bob Jones University did not qualify as a tax-exempt entity because the activities of the entity were “contrary to public policy.”<sup>57</sup> In prior articles, we explored how the *Bob Jones* decision is better viewed through the continuum of both congressional and executive actions and judicial decisions.<sup>58</sup>

For the purposes of this Article, it is important to look at the methodology the Supreme Court used in deciding to take an expansive “contextualist approach to the statute.”<sup>59</sup> The Supreme Court looked at the justification for tying a charitable organization’s income-tax exemption to a performance of public services to society.<sup>60</sup> “To reach this result, the Court employed the classic Hart and Sacks purpose-of-the-statute approach.”<sup>61</sup>

In order to find the common law “fundamental public policy” in § 501(c)(3), the Supreme Court also considered § 170, which permits a deduction by individual taxpayers for payments made to qualifying § 501(c)(3) organizations.<sup>62</sup> By tying together §§ 170 and 501(c)(3), the IRS and then the Supreme Court were able to create a public policy exception without considering whether the grant of § 501(c)(3)

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Students who espouse, promote, or encourage others to violate the University’s dating rules and regulations will be expelled.”).

51. 309 F. Supp. 1127 (D.D.C. 1970).

52. *Bob Jones*, 461 U.S. at 581.

53. *Id.*

54. *Id.*

55. Eskridge & Frickey, *supra* note 5, at 343–44.

56. *Id.* at 344.

57. *Bob Jones*, 461 U.S. at 582.

58. Brunson & Herzig, *supra* note 4, at 1187, 1207–08.

59. Eskridge & Frickey, *supra* note 5.

60. *See* Eskridge, Jr., *supra* note 5, at 1546–47.

61. *Id.* at 1546.

62. *See id.* at 1546–47.



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status alone was a subsidy or not.<sup>63</sup> From the Supreme Court's perspective, §§ 501(c)(3) and 170 together created an exemption that was a subsidy. Thus, in order to grant an exemption, the Court could read into either or both statutes a requirement to not violate the purposes of the statute(s). The "Court concluded that the statutory purpose would be thwarted by extending the tax exemption to organizations such as Bob Jones University."<sup>64</sup>

Because the Supreme Court combined the provisions to try to glean original intent, the opinion is oft criticized by constitutional law scholars.<sup>65</sup> When examined alone, the purpose of § 501(c)(3) is not so simplistic.<sup>66</sup> Justice Powell, in concurrence, challenged the majority position that the sole purpose of a tax-exempt entity is to act as a substitute for the government in providing goods or services.<sup>67</sup> Rather, Justice Powell pointed to the number of other Supreme Court decisions that treated § 501(c)(3) as providing that "private, nonprofit groups receive tax exemptions because 'each group contributes to the diversity of association, viewpoint, and enterprise essential to a vigorous, pluralistic society.'"<sup>68</sup>

Justice Powell continues:

I find it impossible to believe that all or even most of those organizations could prove that they 'demonstrably serve and [are] in harmony with the public interest' or that they are 'beneficial and stabilizing influences in community life.' Nor I am prepared to say that petitioners, because of their racially discriminatory policies, necessarily contribute nothing of benefit to the community.<sup>69</sup>

We believe that, had the Supreme Court considered the statutes independently, perhaps, Justice Powell's views would have held the line.

The only dissent in the case came from Justice Rehnquist.<sup>70</sup> Unlike the majority, Rehnquist viewed the exemption of § 501 separate and apart from § 170.<sup>71</sup> He asserted that "[t]he Court first seeks refuge from the obvious reading of § 501(c)(3) by turning to § 170 of the Code which provides a tax deduction for contributions made to § 501(c)(3) organizations."<sup>72</sup> This promising disentanglement approach quickly falls apart. Unfortunately, Justice Rehnquist falls short in the same way the majority does by trying to glean legislative

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63. See *Bob Jones Univ. v. United States*, 461 U.S. 574, 585, 595–98 (1983).

64. Eskridge, Jr., *supra* note 5, at 1547.

65. See, e.g., *id.*

66. See I.R.C. § 501(c)(3) (2012); Eskridge, Jr., *supra* note 5, at 1547.

67. *Bob Jones*, 461 U.S. at 608–09 (Powell, J., concurring).

68. *Id.* at 609.

69. *Id.*

70. *Id.* at 612–23 (Rehnquist, J., dissenting).

71. *Id.* at 614.

72. *Id.* at 613.

intent of § 501 from § 170. Had Justice Rehnquist continued on the path towards understanding the relationship between the statutes, he might have won the day. Under § 170 there is no requirement that the receipt qualify for tax exemption under § 501(c)(3).<sup>73</sup>

In establishing a new policy, the Supreme Court did not apply consistent scrutiny to the various authorities. For example, the Supreme Court pointed to the civil rights legislation as authority for a clear public policy preference against discrimination in educational settings but failed to address that Congress did not codify that preference.<sup>74</sup> According to Professor Eskridge, “*Bob Jones* is a classic case in which the Hart and Sacks approach is invoked by the Court as a substitute for careful analysis. The Court obviously created new law in this case, going well beyond what Congress had done.”<sup>75</sup>

It is not to say that the Court was incorrect in adding the fundamental public policy doctrine to the charitable sector. As we have stated in prior articles, the *Bob Jones* decision was a culmination of decades of clear signals by all three branches of government against preferences for discriminatory behavior.<sup>76</sup> Even the lone dissent does not disagree with the result, just the method.<sup>77</sup> Perhaps the Court should have been clearer in stating this policy shift instead of applying the Hart and Sacks approach.<sup>78</sup> Professor Eskridge argues that this approach obfuscates the rationales for the opinion and an express statement by the Court should be required. “At least it is honest: the Court’s commitment to the public value of a nondiscriminatory society is important enough to influence its interpretation of an ambiguous statute.”<sup>79</sup> When viewed through this lens, the *Bob Jones* decision might be understood as “an effort to ensure that the IRS takes account of the widespread social antagonism toward racial discrimination, as part of the general thrust of contemporary ‘public policy.’”<sup>80</sup>

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73. See I.R.C. § 170 (2012).

74. See Eskridge, Jr., *supra* note 5, at 1547.

75. *Id.*

76. Brunson & Herzig, *supra* note 4,.

77. *Bob Jones*, 461 U.S. at 622 (Rehnquist, J., dissenting) (“I have no disagreement with the Court’s finding that there is a strong national policy in this country opposed to racial discrimination. I agree with the Court that Congress has the power to further this policy by denying § 501(c)(3) status to organizations that practice racial discrimination. But as of yet Congress has failed to do so. Whatever the reasons for the failure, this Court should not legislate for Congress.”).

78. Eskridge, Jr., *supra* note 5, at 1548 (stating “that the Supreme Court often purports to rely on original legislative purposes in interpreting statutes, while in fact using the Hart and Sacks purpose analysis to bend statutory language to satisfy current policy goals”).

79. *Id.*

80. Cass R. Sunstein, *Interpreting Statutes in the Regulatory State*, 103 HARV. L. REV. 405, 480 (1989).

*Bob Jones* does not mandate that the IRS revoke the tax exemptions of entities that violate a fundamental public policy.<sup>81</sup> In fact, outside of the context of racially discriminatory schools, the IRS has rarely (if ever) revoked an exemption for violation of public policy and has only denied exemptions on public policy grounds in rare instances, as discussed above.<sup>82</sup> The rare instances where the IRS has revoked or denied exemptions on public policy grounds certainly do not represent a complete list of behaviors that violate public policy.<sup>83</sup> And yet the IRS has not revoked the tax exemptions of organizations that violate other fundamental public policies.<sup>84</sup> How can that be?

There are a handful of reasons that the IRS can ignore tax-exempt organizations' bad behavior. The first is the Supreme Court's decision in *Bob Jones* did not mandate the loss of exemption.<sup>85</sup> Rather, it confirmed that revocations for the violation of fundamental public policies were constitutionally permissible.<sup>86</sup> Though the IRS *can* revoke exemptions, the Supreme Court did not create a constitutional obligation for it to do so, and Congress has never explicitly required the IRS to enforce the public policy rule either.<sup>87</sup> This lack of constitutional or statutory obligation matters. It buttresses the fact that, both as a legal and a practical matter, the IRS has complete discretion to not enforce the fundamental public policy rule. How does the IRS have such unconstrained discretion when it comes to not enforcing the public policy rule?

While the Supreme Court held that the IRS could constitutionally revoke a tax-exempt organization's exemption if that organization violated a "fundamental public policy," it did not provide any guidance on what constituted a fundamental public policy, the violation of which would warrant loss of exemption.<sup>88</sup>

Under the Supreme Court's analysis, then, the question of whether racial discrimination violated a fundamental public policy was easy. Three decades of concerted effort by all three branches of the federal government demonstrated that the government wanted to end racial discrimination and segregation. The Supreme Court did not, however, say that three decades of concerted effort was *necessary* to establish a fundamental public policy, only that it was sufficient.<sup>89</sup> Outside of clarifying that racial discrimination did violate

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81. See *Bob Jones*, 461 U.S. at 597–98.

82. See Brunson & Herzig, *supra* note 4, at 1195; Nicholas A. Mirkay, *Globalism, Public Policy, and Tax-Exempt Status: Are U.S. Charities Adrift at Sea?*, 91 N.C. L. REV. 851, 870–74 (2013).

83. See Brunson & Herzig, *supra* note 4, at 1195.

84. *Id.*

85. *Id.*

86. *Id.*

87. *Id.*

88. See *Bob Jones Univ. v. United States*, 461 U.S. 574, 592 (1983).

89. See *id.* at 592–93.

fundamental public policy, the Supreme Court provided the IRS with no guidance in determining what else violated fundamental public policy.<sup>90</sup>

Also, as we discussed,<sup>91</sup> the *Bob Jones* decision did not provide any contours for determining the breadth of fundamental public policy.<sup>92</sup> The IRS started applying fundamental public policy to discriminatory schools in 1970 or so, sixteen years after *Brown* and six years after the Civil Rights Act of 1964. *Bob Jones* was decided more than a decade later than that<sup>93</sup>—fundamental public policy is a lagging enforcement mechanism. If this ad hoc approach is how enforcement takes place, then we have a problem.

In part, the problem arose because the Supreme Court conflated the exemption of § 501 with the deduction for charitable contributions of § 170. Revoking an organization's exemption is so punitive that it makes sense that the IRS would avoid doing so.<sup>94</sup> To understand the conflation of § 170 and § 501, we explore the independent evolution of § 501 and § 170. Through the following sections it becomes clear that § 501 developed not only independently from § 170 but for different reasons. By examining these sections separately, the confused state of affairs left after *Bob Jones* becomes clearer.

## II. IS TAX EXEMPTION A SUBSIDY?

The idea that certain types of nonprofit organizations, including, but not limited to, religious and charitable organizations, should be exempt from paying taxes has deep roots in British and American law.<sup>95</sup> The current tax exemption finds precedent both in the 1601 British Statute of Charitable Uses and in the constitutions of the early states.<sup>96</sup> The Code's current exemption regime is derived directly from the Revenue Act of 1894, and, after the 1894 Act was ruled unconstitutional, the regime was reenacted in 1909 and 1913, when Congress enacted the modern corporate and personal income taxes.<sup>97</sup> The idea that nonprofit organizations should be exempt from taxation appeared so intuitive and correct to Congress that it failed, at the time and for years afterward, to explain *why* it had exempted certain nonprofits from taxation.<sup>98</sup>

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90. Brunson & Herzig, *supra* note 4, at 1189.

91. *Id.*

92. *Id.* at 1191–92.

93. *See Bob Jones*, 461 U.S. at 574.

94. *See* Samuel D. Brunson, *Reigning in Charities: Using an Intermediate Penalty to Enforce the Campaigning Prohibition*, 8 PITT. TAX REV. 125, 154 (2011) (“In addition, as has been discussed, because of the devastating effect of [revoking the tax exemption], there may be strong political and practical reasons not to enforce the prohibition except in truly egregious cases.”).

95. Bittker & Rahdert, *supra* note 11, at 301.

96. *Id.*

97. *Id.*

98. *Id.*

Even today, after more than a century of tax exemption for qualifying public charities, scholars and policymakers have failed to agree on any consistent rationale for the tax exemption.<sup>99</sup> In spite of the lack of an explicit justification for exempting certain nonprofit entities from tax, the exemption remained uncontroversial for the first several decades of the modern income tax. As recently as 1970, the Supreme Court held that exempting religious organizations from tax did not constitute state support for religion.<sup>100</sup> According to the Court, exemption could not have been “sponsorship since the government does not transfer part of its revenue to churches but simply abstains from demanding that the church support the state.”<sup>101</sup>

A. *Bittker: Section 501(c)(3) Is Not a Subsidy*

Even before the Supreme Court’s decision, though, the idea that the tax exemption represented a subsidy was already gaining ground

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99. Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L.J. 1379, 1381 (1991) [hereinafter Hall & Colombo, *Donative Theory*] (“It is extraordinary that no generally accepted rationale exists for the multi-billion dollar exemption from income and property taxes that is universally conferred on ‘charitable’ institutions.”). Though there is no consensus on the reason for tax exemption, when people think about it, they generally come to one of a handful of conclusions. The two most common are that tax exemption is meant to subsidize charitable activities and that charitable organizations do not belong in the tax base. Mark A. Hall & John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307, 328 (1991) [hereinafter Hall & Colombo, *Hospitals*]. Although these are the primary justifications scholars have cited to explain the reasons for tax exemption, scholars have proposed other justifications as well, including the proposal that nonprofit charities should not be taxed in recognition that they enjoy a limited degree of sovereignty. Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585, 586 (1998). Even the sovereignty argument can ultimately be categorized as a base definition one, though: if the state lacks jurisdiction to tax a sovereign charity, that charity’s income does not belong in the tax base. This idea of tax-exempt organizations enjoying parallel sovereignty is undercut, though, by two realities. First, as Professor Brody points out, in certain circumstances, tax-exempt organizations do pay taxes. *Id.* at 586–87, 606. Moreover, even when they do not pay taxes, the tax law requires most tax-exempt organizations to prepare and file information returns that lay out specific financial information related to tax-exempt organizations. I.R.C. § 6033(a)(1) (2012). Among the central definitional requirements of the concept of sovereignty is that the sovereign have some type of independence from external control. Diane M. Ring, *What’s at Stake in the Sovereignty Debate?: International Tax and the Nation-State*, 49 VA. J. INT’L L. 155, 160 (2008). To be sovereign, a tax-exempt organization need not be entirely free of outside control; after all, even nation-states face some limitations on their independence. *Id.* at 161 (“Even the most powerful states must take into account the desires, needs, and views of other states in pursuing their own agendas.”). But ultimately, tax-exempt organizations are still subject to the tax law and, whether or not they pay taxes, must generally perform acts required by that law.

100. *Walz v. Tax Comm’n of N.Y.*, 397 U.S. 664, 675 (1970).

101. *Id.*

among both judges and scholars.<sup>102</sup> By the end of the 1960s, Professor Borris Bittker felt compelled to defend the nonprofit tax exemption from charges of subsidy.<sup>103</sup> He recognized that, in the language of tax, nonprofits are “exempted” from having to pay. He then argued that “[o]nce this characterization is accepted, it is only a short step to such pejoratives as ‘loophole,’ ‘preference,’ and ‘subsidy.’”<sup>104</sup>

Professor Bittker argues that the tax exemption provided to nonprofit organizations is not an exception to the generally applicable tax law because tax law is fundamentally incompatible with nonprofit organizations. To apply tax accounting concepts to nonprofit organization, he asserts, would stretch the accounting “to, or beyond, the breaking point.”<sup>105</sup>

Why would tax accounting be incompatible with nonprofit organizations? Professor Bittker highlights several ways. The first mismatch, he says, lies in determining what counts as gross income.<sup>106</sup> How should the tax law treat dues, donations, and other nonprofit revenue sources, he asks.<sup>107</sup> Or, given its obligation to use its money for charitable purposes, should the nonprofit be treated merely as a conduit for that money?<sup>108</sup>

Moreover, even if tax law answered the question of what counted as gross income, taxpayers do not pay taxes on their gross income.<sup>109</sup> Reaching taxable income, though, proves a difficult task for nonprofit organizations. In general, taxpayers arrive at taxable income by taking certain deductions.<sup>110</sup> The majority of deductible expenses are those expenses associated either with the taxpayer’s trade or business<sup>111</sup> or with other profit-making endeavors.<sup>112</sup>

The concepts of *trade or business* and *profit-making endeavors* fit uncomfortably at best on the framework of nonprofits. Professor Bittker asks whether salaries to employees qualify as ordinary and necessary trade or business expenses (a prerequisite for deductibility).<sup>113</sup> If they qualify, perhaps the money a nonprofit gives to the indigent should also qualify as deductible.<sup>114</sup>

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102. Erika King, *Tax Exemptions and the Establishment Clause*, 49 SYRACUSE L. REV. 971, 993 (1999).

103. See Boris I. Bittker, *Churches, Taxes and the Constitution*, 78 YALE L.J. 1285, 1290 (1969).

104. *Id.*

105. Bittker & Rahdert, *supra* note 11, at 307–08.

106. *Id.* at 308–09.

107. *Id.*

108. *Id.* at 309.

109. See I.R.C. §§ 1(a), 63(a) (2012). In fact, for a foreign tax to qualify as an income tax for U.S. foreign tax credit purposes, it must reach the taxpayers’ net, rather than gross, income. See Treas. Reg. § 1.901-2(b)(1) (as amended in 2013).

110. See I.R.C. §§ 62, 63.

111. See *id.* § 162(a).

112. See *id.* § 212.

113. Bittker & Rahdert, *supra* note 11, at 309.

114. *Id.* at 310.

Professor Bittker also lays out a third reason that the income tax law as presently constituted is a poor match for nonprofit firms.<sup>115</sup> Even if tax law could figure out what to include in a nonprofit's gross income, and even if it could determine what expenses the nonprofit should be permitted to deduct, it would further have to determine the appropriate tax rate for the nonprofit.<sup>116</sup> The current corporate rates may not fit. The tax rate a taxpayer pays should have some relation to the benefit she receives or to her ability to pay.<sup>117</sup> And for various reasons (including who actually bears the incidence of the tax, which economists still debate), it is difficult to figure out ability to pay or benefits received.<sup>118</sup>

*B. In Response to Bittker*

In spite of Professor Bittker's best efforts over the last half-century, viewing tax exemption as a subsidy to nonprofits has taken firm hold.<sup>119</sup> Activists commonly argue that organizations at odds with their activism should lose their tax-exempt status, implicitly viewing exempt status as a subsidy that should not be granted to organizations that endorse bad views.<sup>120</sup> And even today, scholars assert that exemption represents a subsidy, albeit often without any analysis.<sup>121</sup>

It is not absurd to assert that tax exemption represents a subsidy, of course. Such a view makes intuitive sense. A tax-exempt nonprofit that earns \$100 gets to keep that full \$100.<sup>122</sup> Alternatively, we can imagine a tax system where the government collects taxes at a 35% rate<sup>123</sup> from all corporations, including nonprofits. In that world, a nonprofit would pay \$35 of taxes when it earned \$100. Imagine in that world that the government then provides a \$35 grant to nonprofits for every \$100 they earn.

There is no doubt that in the hypothetical world, the government subsidizes nonprofits. Economically, though, the tax exemption functions exactly the same way: in both the real and hypothetical worlds, the nonprofit has \$100 after taxes.

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115. *See id.* at 314.

116. *See id.*

117. *See id.* at 315.

118. *See id.*

119. *See King, supra* note 102.

120. For example, LGBTQ+ rights activists argue that churches that have opposed same-sex marriage should lose their exemption. *See, e.g.,* Nate Carlisle, *TV Campaign Targeting Mormon Church's Tax-Exemption Kicks Off in Utah*, SALT LAKE TRIB. (Jan. 26, 2017), <http://archive.sltrib.com/article.php?id=4803801&itype=CMSID>.

121. *See, e.g.,* Linda Sugin, *Invisible Taxpayers*, 69 TAX L. REV. 617, 621 (2016) (“[T]he purpose of tax exemption is to subsidize private organizations that produce third-party benefits . . .”).

122. *See* I.R.C. § 501(a), (c) (2012).

123. Under the current corporate income tax, corporations owe taxes at a marginal rate of up to 35%. *Id.* § 11(b)(1).

Of course, just because the two are identical economically does not mean that both represent subsidies. The question of whether tax exemptions function as subsidies ultimately depends on whether “the income tax exemption for charities is consistent with normal income tax principles or is a departure that must be justified as a subsidy.”<sup>124</sup> In other words, if we assume that all corporations should naturally pay taxes, then allowing certain organizations to avoid paying taxes represents a special legislative gift to those organizations.

Professor Daniel Halperin argues that exempting nonprofits represents a departure from normal tax principles. According to Professor Halperin, “There is nothing about the nature of the charitable organization that precludes income taxation.”<sup>125</sup> In fact, according to Professor Henry Hansmann, taxing nonprofit organizations would be easy: most are “commercial” nonprofits, with analogues in the for-profit sector.<sup>126</sup> These kinds of nonprofit organizations could carry over their tax accounting from their for-profit counterparts.<sup>127</sup>

To Professor Hansmann’s point, allowing a subsidy for nonprofit organizations that engage in the same businesses as for-profit organizations seems unwarranted and, perhaps, unfair, especially when some of those tax-exempt organizations are wealthy.<sup>128</sup> If the point of the corporate income tax were to tax wealth, or even to tax revenue, then exempting nonprofit organizations with significant revenue streams certainly feels like a subsidy of their activities.

In the end, Professor Bittker’s assertion that nonprofits “are not suitable targets for an income tax”<sup>129</sup> is not fully supported by his reasoning. Certainly, he makes the case that taxing nonprofits appropriately is both complicated and administratively difficult. As a practical matter, the costs of getting it right may weigh in favor of leaving nonprofits alone for tax purposes.

On the other hand, it may not be so administratively difficult.<sup>130</sup> Many nonprofits derive a significant portion of their revenue not from donations but from providing goods and services.<sup>131</sup> Some types of traditional nonprofit organizations can also be operated as for-profit

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124. Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 *TAX L. REV.* 283, 283–84 (2011).

125. *Id.* at 284.

126. See Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 *YALE L.J.* 54, 59 (1981).

127. *Id.*

128. In 2014, for example, more than 24,000 tax-exempt organizations reported holding assets worth \$10 million or more. Table 1. Form 990 Returns of 501(c)(3) Organizations: Balance Sheet and Income Statement Items, by Asset Size, Tax Year 2014, IRS (July 2017), <https://www.irs.gov/pub/irs-soi/14eo01.xls>.

129. Bittker & Rahdert, *supra* note 11, at 304.

130. Hansmann, *supra* note 126 (“But Bittker and Rahdert overstate the difficulties [of nonprofits calculating taxable income].”).

131. *Id.*



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organizations.<sup>132</sup> For instance, the operation of for-profit and nonprofit hospitals is nearly identical.<sup>133</sup> If the only reason to exempt the nonprofit hospital is that it is difficult to figure out its income and deductions, it would appear that tax law could treat it similarly to the for-profit hospital. There would be differences of course—the for-profit hospital seems less likely to receive donations from the public—but those questions can ultimately be answered.

If the only reason for exempting nonprofits from generally applicable taxes is the administrative difficulties of taxing them, then the tax exemption would probably constitute a subsidy to the exempt nonprofit, even if Congress did not intend to provide a subsidy.

### III. SECTION 501(C)(3) TAX-EXEMPT STATUS DOES NOT REPRESENT A SUBSIDY

We agree with Professor Hansmann that taxing nonprofits does not raise insuperable problems. Certainly, as Professor Bittker argues, it may prove *difficult* to accurately tax some nonprofits.<sup>134</sup> But it is also administratively difficult to accurately tax partners in a partnership, and yet the federal income tax subjects partners to tax on their partnership income.<sup>135</sup> Difficulty is different than impossibility, and, if exemption is only the result of administrative difficulty, it effectively represents a subsidy, even if it is not meant as such.

Notwithstanding these (and other) compelling arguments that exemption represents a subsidy, we agree with Professor Bittker that exempting nonprofits from taxation is consistent with normal income tax principles and, as such, does not represent a subsidy to such organizations. We come to this conclusion on different grounds than he does, however. We argue that the tax law does not apply to nonprofit organizations *by their very nature*. Nonprofits are excluded from paying taxes—not because society likes them or because it wants to subsidize the good things they do but rather because qualifying nonprofits do not belong in the tax base.

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132. *See id.*

133. David A. Hyman, *Hospital Conversions: Fact, Fantasy, and Regulatory Follies*, 23 J. CORP. L. 741, 760 n.69 (1998).

134. *See* Bittker & Rahdert, *supra* note 11, at 314.

135. *See* Darryll K. Jones, *Towards Equity and Efficiency in Partnership Allocations*, 25 VA. TAX REV. 1047, 1076 (2006) (“At what point does the administrative difficulty of accurately measuring income earned via partnerships and then collecting the tax from the proper person create too much inefficiency? This article asserts that the present bar is set way too low.”).

A. *The Historical (and Current) Justification for the Corporate Income Tax*

The United States first experimented with taxing income during the Civil War.<sup>136</sup> During that first decade-long income tax, however, Congress gave no thought to the proper manner in which to tax corporations.<sup>137</sup> Rather, like partnerships, the income tax treated corporations as pass-through entities, and shareholders had to pay taxes on their pro rata share of corporate income, whether or not the corporation paid out a dividend.<sup>138</sup> The exclusion of corporations from the tax base during the Civil War was not absolute: the federal government did tax companies in certain industries (such as banking, transportation, and insurance) on their dividends and undistributed profits.<sup>139</sup> Because many companies in these industries were incorporated, these taxes may have seemed like corporate income taxes, but they were not aimed at corporate income or borne by the corporation. Rather, they functioned like a withholding tax on shareholder income.<sup>140</sup> Still, the industries targeted by this tax largely used the corporate form, and the Civil War tax on the income of particular entities functioned as a precursor to the modern corporate income tax.<sup>141</sup>

The original federal income tax expired, unrenewed, in 1872.<sup>142</sup> Although members of Congress proposed dozens of income tax bills following the expiration of the Civil War income tax, for more than two decades none even made it to the floor for a vote.<sup>143</sup> In 1894, though, Congress enacted a new progressive income tax.<sup>144</sup> In a break from the Civil War tax, the Revenue Act of 1894 did not treat corporations and partnerships the same; under the new law,

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136. Sheldon D. Pollack, *The First National Income Tax, 1861–1872*, 67 TAX LAW. 311, 311 (2014).

137. See Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L.J. 889, 915 (2006) (“During the Civil War and Reconstruction, there was literally no distinction between corporations and partnerships under the income tax laws enacted to meet the heavy demands of war finances.”).

138. *Id.*

139. *Id.*

140. *Id.* at 916. That these taxes were not meant to tax corporate income is underlined by the fact that shareholders who received dividends from businesses in these industries that had been taxed could exclude the dividends from their taxable income. *Id.*

141. STEVEN A. BANK, *FROM SWORD TO SHIELD: THE TRANSFORMATION OF THE CORPORATE INCOME TAX, 1861 TO PRESENT* 1–2 (2010).

142. Calvin H. Johnson, *Fixing the Constitutional Absurdity of the Apportionment of Direct Tax*, 21 CONST. COMMENT. 295, 342 (2004).

143. Sheldon D. Pollack, *Origins of the Modern Income Tax, 1894–1913*, 66 TAX LAW. 295, 299 (2013).

144. *Id.* at 305–06.

corporations became taxpayers and, like individuals, owed taxes of 2% on their income.<sup>145</sup>

Even in 1894, Congress debated whether the income tax could, much less should, reach corporations.<sup>146</sup> The proponents of the corporate income tax justified taxing corporations as entities largely because, unlike partnerships, corporations provided limited liability to shareholders.<sup>147</sup> Limited liability protects a shareholder's personal assets from creditors of the corporation the shareholder owns.<sup>148</sup> In fact, the original House version of the tax applied to for-profit corporations "by means of which the liability of the individual stockholders is in anywise limited."<sup>149</sup> While the Senate ultimately eliminated the explicit requirement that corporations provide limited liability to be subject to income taxation,<sup>150</sup> the debate on the Senate floor indicates that Senators, too, felt that limited liability justified the different tax treatment of corporations and partnerships.<sup>151</sup>

Although Congress had decided to tax all corporations,<sup>152</sup> not just those in certain industries, even this corporate income tax did not demonstrate that Congress viewed corporations as part of the natural tax base. Again, the corporate income tax was aimed at taxing something of value *to shareholders*.<sup>153</sup> That is, limited liability—the basis for imposing the corporate income tax—is primarily beneficial to those who own shares of a corporation, not to the corporation itself. True, limited liability makes it easier for a corporation to raise capital from small investors, who would not be willing to invest their money into an endeavor they do not control if they could potentially be found liable for the corporation's debts.<sup>154</sup> But the primary benefit of limited liability is to shareholders themselves, who are able to capture the upsides of corporate transactions while not fully internalizing losses.<sup>155</sup> And the corporate income tax was justified as an

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145. Jeffrey A. Maine, *Linking Limited Liability and Entity Taxation: A Critique of the ALI Reporters' Study on the Taxation of Private Business Enterprises*, 62 U. PITT. L. REV. 223, 227–28 (2000).

146. Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 87 (1990).

147. Maine, *supra* note 145, at 228.

148. Andrew Price, *Tort Creditor Superpriority and Other Proposed Solutions to Corporate Limited Liability and the Problem of Externalities*, 2 GEO. MASON U. L. REV. 439, 439 (1995).

149. 26 CONG. REC. 6831 (1894).

150. Kornhauser, *supra* note 146.

151. Maine, *supra* note 145, at 228.

152. *See id.* at 227–28.

153. *See id.* at 228.

154. *See, e.g.*, David Millon, *Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability*, 56 EMORY L.J. 1305, 1312 (2007).

155. Limited liability presents a specific type of negative externality. It allows shareholders to "externalize part of the costs of their investment onto other corporate constituencies and, in a sense, to society at large." Stephen M. Bainbridge, *Abolishing Veil Piercing*, 26 J. CORP. L. 479, 488 (2001).

appropriate payment for that benefit received by shareholders.<sup>156</sup> In short, like the Civil War tax imposed on corporations in some industries, the 1894 corporate income tax essentially provided a convenient way to collect taxes on a benefit received by shareholders.

The 1894 federal income tax ultimately proved short-lived. In 1895, a divided Supreme Court held that significant portions of the Revenue Act of 1894 were constitutionally impermissible direct taxes.<sup>157</sup> Moreover, the Court held that the impermissible direct taxes would raise such a large portion of the revenue that they could not be separated from the indirect taxes.<sup>158</sup> As a result, the Court struck down the entire 1894 federal income tax.<sup>159</sup>

The Supreme Court's *Pollock v. Farmers' Loan & Trust Co.*<sup>160</sup> decision led, inexorably, to the Sixteenth Amendment, ratified in 1913, which permitted income taxation without apportionment.<sup>161</sup> In 1909, the same year Congress proposed the Sixteenth Amendment,<sup>162</sup> it also moved ahead with a second attempt at taxing corporations.<sup>163</sup> To ensure its constitutionality, Congress styled its 1909 tax as a corporate *excise* tax; that excise tax was imposed on corporate income, though, making it effectively a corporate income tax.<sup>164</sup> Two years later, the Supreme Court upheld the constitutionality of that tax.<sup>165</sup> And two years after that, when the Sixteenth Amendment was ratified, Congress replaced the corporate excise tax (on income) with a corporate income tax.<sup>166</sup>

The early twentieth-century Congress had two motives in imposing a tax on corporations: it wanted both to raise revenue and regulate corporate power.<sup>167</sup> In justifying the corporate excise (and then income) tax, proponents focused on the benefits incorporation provided and on how the corporate income tax would serve as a type of withholding tax on shareholder income.<sup>168</sup> In addition to its role in raising revenue, the corporate income tax was a cautious stab at the federal regulation of corporations.<sup>169</sup>

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156. Maine, *supra* note 145, at 224 n.6.

157. *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601, 636–37 (1895).

158. *Id.* at 637.

159. *Id.*

160. 158 U.S. 601 (1895).

161. Bruce Ackerman, *Taxation and the Constitution*, 99 COLUM. L. REV. 1, 5 (1999).

162. *Id.* at 33.

163. See Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1215–17 (2004).

164. See *id.* at 1216.

165. Patrick E. Hobbs, *Entity Classification: The One Hundred-Year Debate*, 44 CATH. U. L. REV. 437, 456 (1995).

166. Pollack, *supra* note 143, at 327 n.219.

167. AJAY K. MEHROTRA, MAKING THE MODERN AMERICAN FISCAL STATE: LAW, POLITICS, AND THE RISE OF PROGRESSIVE TAXATION, 1877–1929, at 254 (2013).

168. Avi-Yonah, *supra* note 163, at 1217–18.

169. Kornhauser, *supra* note 146, at 53.

The tax's regulatory role comprised two parts: first, corporate tax returns would be public, and second, that publicity would allow both the government and the public at large to see what corporations did.<sup>170</sup> In addition to the publicity side of the corporate income tax's regulatory purposes, some legislators saw the corporate income tax as a "preliminary measure to control and limit managerial power directly."<sup>171</sup>

The idea of using the corporate income tax to tax shareholders seems at odds with the idea of using the corporate income tax to regulate (directly or indirectly) corporations. The first appears largely to ignore the separate existence of the corporation, while the latter appears to accept the corporation as its own entity. It is worth noting that neither justification for a corporate income tax sees the tax's incidence as falling on the entity itself. Either the tax is a way to tax shareholder income, or it is a way to ensure that the government can regulate what management does. The origins of the modern corporate income tax do not point to the corporation as an appropriate target of taxation.<sup>172</sup>

That view of the corporate income tax as doing something other than taxing corporations has continued until the present day. Professors Richard and Peggy Musgrave explain that even today, the corporate income tax can best be viewed "as a mere device for integrating corporate income into the individual income tax," not as a tax on corporate income itself.<sup>173</sup> They further argue that any claim that the corporation itself bears the incidence of corporate taxation "is hardly tenable."<sup>174</sup> Professor Reuven Avi-Yonah broadly agrees, arguing that the corporate income tax is necessary but that its purpose is "to limit excessive accumulations of power in the hands of corporate management, which is inconsistent with both democratic and egalitarian ideals."<sup>175</sup>

Just because the corporate income tax has been conceived of, both historically and currently, as a tax on shareholder income and as a limitation on the power of corporate boards does not mean that those are the only possible justifications for the tax. The consistency and longevity of these justifications strongly supports their validity, though, as does the general lack of other principled justifications. The corporate income tax could, for example, exist solely as a revenue-raising mechanism.<sup>176</sup> But if its sole reason for existing were to raise

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170. Avi-Yonah, *supra* note 163, at 1218.

171. *Id.* at 1221.

172. See RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 386 (4th ed. 1984).

173. *Id.*

174. *Id.* at 387.

175. Avi-Yonah, *supra* note 163, at 1249.

176. Although the percentage of federal revenue raised by the corporate income tax has declined sharply over the last half-century, it still accounts for about 11% of federal revenue. *Policy Basics: Where Do Federal Tax Revenues*

revenue, the corporate income tax would face at least one significant theoretical problem. If all the government wants is revenue, there is no particular reason why the Congress should impose the corporate income tax. Congress could just as easily raise individual income tax rates, create a new tax, or even impose a head tax.<sup>177</sup> An alternative explanation of the corporate income tax must explain why the tax focuses on corporate income rather than some other source.

*B. The Foundations of Tax Exemption*

The idea that tax regimes should exempt certain charitable organizations from their scope predates the income tax and may be as old as taxes themselves.<sup>178</sup> And the history of exempting certain types of charitable institutions from taxation in the United States predates not only the income tax but the United States itself.<sup>179</sup> Early colonists brought the idea of tax exemption with them from their European places of origin.<sup>180</sup> Even in colonial years, religious and educational institutions often found themselves exempt from local taxes.<sup>181</sup> Although the common law did not *require* colonial governments to exempt religious property from taxation, the necessary legislative acts were readily enacted, provided the property met a handful of requirements.<sup>182</sup>

Colonial America did not have an income tax, but in Connecticut, for example, “[c]hurch lands were exempt from property taxation.”<sup>183</sup> Throughout New England, religious and educational institutions were exempt from tax, not only because they were considered public institutions but because New England tax regimes tended to be “levied on polls, on the estimated productivity of land, and on the profitability of certain occupations.”<sup>184</sup> Because these public charities

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*Come From?*, CTR. ON BUDGET POL’Y PRIORITIES, <http://www.cbpp.org/research/policy-basics-where-do-federal-tax-revenues-come-from> (last updated Sept. 5, 2017).

177. In fact, where revenue is the sole concern, a head tax might be preferable to a corporate income tax, given that there is no way for a taxpayer to avoid a head tax liability by changing her behavior. Nancy C. Staudt, *The Hidden Costs of the Progressivity Debate*, 50 VAND. L. REV. 919, 929–30 n.26 (1997).

178. Hall & Colombo, *Donative Theory*, *supra* note 99, at 1381 n.1.

179. See Christine R. Moore, Comment, *Religious Tax Exemption and the “Charitable Scrutiny” Test*, 15 REGENT U. L. REV. 295, 298 (2003).

180. Stephen Diamond, *Efficiency and Benevolence: Philanthropic tax Exemptions in 19th-Century America*, in PROPERTY-TAX EXEMPTION FOR CHARITIES: MAPPING THE BATTLEFIELD 115, 116 (Evelyn Brody ed., 2002).

181. John D. Colombo, *Why Is Harvard Tax-Exempt? (And Other Mysteries of Tax Exemption for Private Educational Institutions)*, 35 ARIZ. L. REV. 841, 844 (1993).

182. John Witte, Jr., *Tax Exemption of Church Property: Historical Anomaly or Valid Constitutional Practice?*, 64 S. CAL. L. REV. 363, 371–74 (1991).

183. ALVIN RABUSHKA, TAXATION IN COLONIAL AMERICA 184 (2008).

184. Peter Dobkin Hall, *Is Tax Exemption Intrinsic or Contingent? Tax Treatment of Voluntary Associations, Nonprofit Organizations, and Religious*

did not match up with the bases on which colonial New England taxes were imposed, they were appropriately excluded from the tax base.

Early Americans did not refer to the “tax base” to justify their exemptions, though.<sup>185</sup> Even through the nineteenth century, the policy arguments eventually came to characterize the discussion of tax exemption (especially the argument that the benefit derived from these organizations must outweigh the lost revenue from the exemptions).<sup>186</sup> Rather, churches and educational institutions were exempt from taxation through some combination of inertia and a sense that their “continued existence was desirable.”<sup>187</sup> Moreover, the idea of exemption would have been less salient at the time. The colonies and the early Republic lacked an income tax: annual taxation did not become a regular part of American life until nearly halfway through the nineteenth century.<sup>188</sup> Because states only imposed taxes during emergencies, there was no clear way to calculate the value of tax exemptions *ex ante*.<sup>189</sup>

Out of financial necessity, the Civil War brought the United States its first federal income tax.<sup>190</sup> Although the Civil War income tax technically did not include a corporate income tax,<sup>191</sup> the Treasury Department ruled explicitly that the “income of literary, scientific, or other charitable organizations, in the hands of trustees or others, is not subject to income tax.”<sup>192</sup> After the federal income tax expired,<sup>193</sup> the administrative exemption for income of charitable organizations became irrelevant. As a result, any questions around tax exemption lay dormant until 1894.

The Revenue Act of 1894 included a 2% tax on the “net profits or income” of an enumerated list of businesses, which included all “corporations, companies, or associations doing business for profit in the United States.”<sup>194</sup> The 1894 Act explicitly exempted “corporations, companies, or associations organized and conducted

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*Bodies in New Haven, Connecticut, 1750-2000*, in PROPERTY-TAX EXEMPTION FOR CHARITIES: MAPPING THE BATTLEFIELD, *supra* note 180, at 253, 254.

185. See Moore, *supra* note 179, at 296–97.

186. Diamond, *supra* note 180.

187. *Id.* at 117.

188. *Id.* at 119.

189. *Id.*

190. STEVEN A. BANK ET AL., WAR AND TAXES 36–37 (2008). Though new in the United States, the idea of an income tax was not entirely novel by the Civil War. The modern income tax was originally conceived and enacted by Great Britain in 1799. 1 PETER HARRIS, INCOME TAX IN COMMON LAW JURISDICTIONS: FROM THE ORIGINS TO 1820, at 1 (2006).

191. See *supra* notes 136–41 and accompanying text.

192. GEORGE S. BOUTWELL, A MANUAL OF THE DIRECT AND EXCISE TAX SYSTEM IN THE UNITED STATES 275 (1863) (Treas. Dec. 110 (1863)).

193. See *supra* note 142 and accompanying text.

194. Revenue Act of 1894, ch. 349, § 32, 28 Stat. 509, 556. Although the tax was imposed on most for-profit businesses, it explicitly exempted partnerships. *Id.*

solely for charitable, religious, or educational purposes.”<sup>195</sup> And, although the Supreme Court struck the 1894 Act down as unconstitutional a year later,<sup>196</sup> effectively, the 1894 exemption became the basis for the modern tax exemption for public charities.

C. *Tax-Exempt Organizations Do Not Belong in the Tax Base*

The corporate income tax was conceived of broadly to indirectly tax shareholders’ income and to regulate corporations by preventing corporate managers from accumulating too much money.<sup>197</sup> How do those purposes map on to tax-exempt organizations? Not well, it turns out.

1. *“No Private Inurement” Prevents Economic Ownership*

To qualify for tax exemption, an organization must meet several requirements. For our purposes, a central qualification requirement is that “no part of the net earnings of [the tax-exempt organization] inures to the benefit of any private shareholder or individual.”<sup>198</sup> For purposes of the prohibition on private inurement, “private shareholder or individual” means any person with a “personal and private interest in the activities of the organization.”<sup>199</sup>

In addition to the federal tax prohibition on private inurement, state law governs the distributions nonprofit organizations can make.<sup>200</sup> Nonprofit status does not mean, of course, that an organization cannot earn a profit; rather, it means that the organization cannot *distribute* its profits to individuals.<sup>201</sup> It must use its profits in pursuing its charitable purpose.<sup>202</sup>

The tax and state law prohibitions on distributing profits do not mean that tax-exempt organizations cannot make payments that privately enrich individuals.<sup>203</sup> A tax-exempt organization can—must, in fact—compensate its employees.<sup>204</sup> Although excessive compensation would constitute impermissible private inurement, as long as the tax-exempt organization pays a reasonable salary, that salary does not inure to the benefit of an insider.<sup>205</sup> Similarly, the

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195. *Id.*

196. Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLA. L. REV. 419, 422 n.4 (1998).

197. *See supra* Subpart III.A.

198. I.R.C. § 501(c)(3) (2012).

199. Treas. Reg. § 1.501(a)-1(c) (as amended in 2014).

200. Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 501–02 (1981).

201. *Id.* at 501.

202. *Id.* at 501–02.

203. *See id.* at 505.

204. *See id.*

205. *Founding Church of Scientology v. United States*, 412 F.2d 1197, 1200 (Ct. Cl. 1969).



prohibition on private inurement does not prevent insiders from selling goods or services to a tax-exempt organization, provided the insider receives “no more than fair market value” in exchange.<sup>206</sup>

Moreover, the nondistribution constraints do not die with the tax-exempt organization. Upon termination, a tax-exempt organization’s assets must go to its exempt purpose, to the state or federal government, or to another tax-exempt organization.<sup>207</sup> If a would-be tax-exempt organization provides that, upon termination, it will distribute its assets to an insider, the organization does not qualify as exempt.<sup>208</sup>

The state law and tax prohibitions on private inurement effectively eliminate any individual’s ability to participate in the profits of a tax-exempt organization. A tax-exempt organization cannot currently distribute its profits nor can it hold those profits and distribute them upon its termination.<sup>209</sup> As a result, the first justification for the corporate income tax—to act as a backstop to the individual income tax—does not apply in the tax-exempt context. Taxing a tax-exempt organization does not effectively represent withholding of shareholders’ taxable income, because the tax-exempt organizations generally do not have shareholders. Even if a tax-exempt organization had shareholders, those shareholders could not participate in the entity’s profits.

The regulatory role of the corporate income tax is similarly inapposite in the case of tax-exempt organizations. That is not to say that the federal income tax does not serve *any* regulatory purpose with respect to tax-exempt organizations. Tax law joins state law and self-regulation in constraining what tax-exempt organizations do.<sup>210</sup> But the regulatory role of the tax law functions in an entirely different manner.<sup>211</sup>

Congress intended that the corporate income tax regulate corporations through publicity and through limiting the managerial power of directors.<sup>212</sup> Although tax-exempt organizations do not pay taxes, the tax law nonetheless requires them to file information returns.<sup>213</sup> Unlike corporations, the tax returns of which are no longer public,<sup>214</sup> the Code generally requires tax-exempt

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206. Darryll K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 VA. TAX REV. 575, 603 (2000).

207. Treas. Reg. § 1.501(c)(3)-1(b)(4) (as amended in 2014).

208. See, e.g., Rev. Rul. 66-259, 1966-2 C.B. 214.

209. *Id.*

210. Benjamin Moses Leff, *Federal Regulation of Nonprofit Board Independence: Focus on Independent Stakeholders as a “Middle Way”*, 99 KY. L.J. 731, 731 (2011).

211. See *id.* at 731–32.

212. See *supra* notes 167–71 and accompanying text.

213. I.R.C. § 6033(a)(1) (2012).

214. *Id.* § 6103(a); see also Joshua D. Blank, *Reconsidering Corporate Tax Privacy*, 11 N.Y.U. J.L. & BUS. 31, 44 (2014) (“Under current law, all tax return information *and* tax returns of individuals *and* corporations are confidential.”).

organizations' returns to be available to the public.<sup>215</sup> Ironically, it is exempt organizations' status as nontaxpayers that allows the public to see their returns. Were they taxable entities, the publicity function of taxpaying would no longer provide any regulation.

At the same time, the government has managed to find ways to limit managerial power without taxing tax-exempt organizations. Tax law does not constrain their ability to accumulate capital.<sup>216</sup> But once they have accumulated capital, tax-exempt organizations face significant limitations on how they can use that money.<sup>217</sup> Their earnings cannot inure to the benefit of a shareholder or other individual.<sup>218</sup> But that is not the only limitation tax-exempt organizations face on the use of their money. To maintain its qualification as tax-exempt, an organization must primarily pursue its qualifying exempt purpose.<sup>219</sup> To the extent more than an insubstantial part of its activities do not further its exempt purpose, the tax-exempt organization no longer qualifies for exemption.<sup>220</sup> While the law does not define at what point an activity passes from insubstantial to substantial,<sup>221</sup> if a tax-exempt organization spends too large a percentage of its total expenditures on activities unrelated to its exempt purpose, courts view it as crossing that line.<sup>222</sup> While the regulatory role of the tax law is different for tax-exempt organizations than it is for for-profit corporations, the tax regime is just as capable of preventing tax-exempt organizations from overly enriching stakeholders or spending money to consolidate power.

In addition to these explicit constraints on the way tax-exempt organizations can use their money, the IRS has attempted to overlay

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215. I.R.C. § 6104(d)(1). Not all tax-exempt organizations are subject to this disclosure requirement, though: the tax law exempts churches and their "integrated auxiliaries" from the obligation to file information returns and also provides a de minimis exemption for organizations with annual gross receipts of not more than \$5,000. *Id.* § 6033(a)(3)(A).

216. Donald L. Sharpe, *Unfair Business Competition and the Tax on Income Destined for Charity: Forty-Six Years Later*, 3 FLA. TAX REV. 367, 386 (1996).

217. *See id.*

218. Treas. Reg. § 1.501(c)(3)-1(c)(2) (as amended in 2014).

219. *Id.* § 1.501(c)(3)-1(c)(1).

220. *Id.* ("An organization will not [qualify as tax-exempt] if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.").

221. *See* Samuel D. Brunson, *Reigning In Charities: Using an Intermediate Penalty to Enforce the Campaigning Prohibition*, 8 PITT. TAX REV. 125, 144 (2011) (stating that although it appears that the line from when an activity passes from insubstantial to substantial may be within a certain threshold, its exact location is unclear).

222. *See, e.g.,* *Haswell v. United States*, 500 F.2d 1133, 1146-47 (Ct. Cl. 1974) ("For an organization that operates on as small a total budget as NARP to devote so much of its total resources to legislative activities, it fairly can be concluded that its purposes no longer accord with conceptions traditionally associated with a common-law charity.").

soft regulation<sup>223</sup> on top of the formal constraints tax-exempt organizations face. Informally, the IRS has endorsed a series of best practices for nonprofit boards.<sup>224</sup> These best practices include “conflict of interest policies, compensation policies, governing board review of agents’ actions, independent review of financial statements, investment policies, governing board minutes, . . . records retention policies,” and board composition.<sup>225</sup> Encouraging—or even mandating<sup>226</sup>—these kinds of best-governance practices may, in fact, represent better regulation than merely limiting the amount of assets over which a board has power. That limitation does not tell boards what they should or should not do. It merely limits their ability to act, whether their actions would have been beneficial or detrimental to society.

If the purpose of the corporate income tax is to reach shareholder income and to regulate corporations, tax-exempt organizations do not belong in the tax base. They have no shareholders, and they are subject to state and federal regulation that does not rely on their paying taxes. Importantly, if they do not belong in the tax base in the first place, exempting them does not represent a subsidy. Rather, it recognizes that there is no economic or regulatory case to be made for taxing tax-exempt organizations. Although the route we use to conclude that tax exemption does not represent a subsidy differs from the route Professor Bittker took, we find it inarguable that he was correct: the tax exemption is not a subsidy.

## 2. *But What About UBIT?*

Although taxing tax-exempt organizations does not comport with the policy goals that underlie corporate taxation, tax-exempt organizations are not always free from paying income tax. Specifically, tax-exempt organizations are subject to the unrelated business income tax (“UBIT”), which functions in many ways as a shadow corporate income tax.<sup>227</sup>

Prior to 1950, when Congress enacted the UBIT, a for-profit business could entirely escape taxation if it met two criteria.<sup>228</sup> First,

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223. See Thomas O. McGarity, *Some Thoughts on “Deossifying” the Rulemaking Process*, 41 DUKE L.J. 1385, 1441 (1992) (stating that informal rule making (soft regulation) allows regulators to sidestep the formal regulatory process, and includes things like “policy statements, interpretive rules, and guidance documents”).

224. Leff, *supra* note 210, at 736.

225. *Id.*

226. *Id.* at 781 (posing the question of whether mandating an organization to conform to a best practice is within the IRS’s authority under current law).

227. Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 605 (1989).

228. Samuel D. Brunson, *Repatriating Tax-Exempt Investments: Tax Havens, Blocker Corporations, and Unrelated Debt-Financed Income*, 106 NW. U. L. REV. 225, 230 (2012).

a tax-exempt organization had to own the for-profit business.<sup>229</sup> Second, the tax-exempt organization had to use revenue from the for-profit business exclusively to support its exempt purposes.<sup>230</sup> In 1940, for example, several individuals donated the stock of C.F. Mueller Company, the largest macaroni manufacturer in the United States at the time, to New York University (“NYU”).<sup>231</sup> C.F. Mueller was clearly a for-profit entity, but it claimed that it was operated for a charitable purpose because all of its income went to benefit the NYU School of Law.<sup>232</sup> Thus, the company claimed it qualified for exemption from tax.<sup>233</sup> The court agreed that, under pre-1950 law, because its purpose was not “to benefit, directly or indirectly, private interest,” C.F. Mueller met the requirements for tax exemption.<sup>234</sup>

Not only was this conclusion correct under the law at the time but it was probably also correct from a policy perspective. Because the sole shareholder of the company was exempt from taxation, taxing the C.F. Mueller Company did not reach the otherwise-taxable income of shareholders.<sup>235</sup> Given the limitations the board faced on what to do with the company’s money, taxing C.F. Mueller would have done little to regulate the board. Although the court did not refer to these fundamental policies of the corporate income tax, it did hold that, from a policy perspective, “the benefit from revenue is outweighed by the benefit to the general public welfare gained through the encouragement of charity.”<sup>236</sup>

The UBIT essentially reverses the assumption that if an entity’s revenue exclusively benefits a tax-exempt organization, the entity’s income should also be exempt from taxation.<sup>237</sup> Under the UBIT, tax-exempt organizations pay taxes at their corporate income tax rate on any unrelated business taxable income they earn.<sup>238</sup> “Unrelated business taxable income,” in turn, is the net income earned by a tax-exempt organization from any trade or business in which it engages that is not substantially related to its exempt purpose.<sup>239</sup> In other words, had the UBIT been existed in 1940, NYU would have paid income tax on macaroni that it sold.

The existence of the UBIT would seem to counter our argument that tax-exempt organizations do not meet the criteria for inclusion

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229. *Id.*

230. *Id.*

231. *Id.*

232. C.F. Mueller Co. v. Comm’r, 190 F.2d 120, 120–21 (3d Cir. 1951).

233. *Id.* at 121.

234. *Id.* at 122.

235. *See id.* at 121–22.

236. *Id.* at 122.

237. *See* Brunson, *supra* note 228.

238. I.R.C. § 511(a) (2012). The one exception is exempt trusts, which pay taxes on their unrelated business taxable income at *trust*, not corporate, rates. *Id.* § 511(b).

239. *Id.* §§ 512(a), 513(a).

in the tax base. After all, with the UBIT, Congress intentionally targeted certain income of tax-exempt organizations in spite of the lack of shareholders or regulatory aims.<sup>240</sup> However, the history of the UBIT does not bear out claims that it establishes or represents an alternative policy basis for imposing the corporate income tax.<sup>241</sup> Upon enacting the UBIT, Congress explained that “[t]he problem at which the tax on unrelated business income is directed here is primarily that of unfair competition.”<sup>242</sup> Essentially, Congress saw tax-exempt organizations (such as NYU) entering into direct competition with for-profit endeavors.<sup>243</sup> But tax-exempt organizations, it believed, had a distinct advantage in that competition: they could reinvest all of their income into expansion, while their for-profit (and taxable) competitors could only expand using their after-tax profits.<sup>244</sup> The issue Congress had was not subsidy but concern that tax-exempt organizations would eventually use their competitive advantage to “purchase a large portion of their competitors or drive them into bankruptcy.”<sup>245</sup>

The UBIT, then, was not intended to tax tax-exempt organizations more accurately. Rather, it was meant to ensure that for-profit businesses had a level field on which they could compete with tax-exempt organizations’ for-profit endeavors. Because Congress intended the UBIT to serve as a defense, its existence does not speak to the purpose of the corporate income tax and does not weigh against our analysis that tax-exempt organizations do not belong in the tax base.

If § 501(c)(3) does not lead to the logical conclusion that the entities should be part of the tax base, then the conclusions of the *Bob Jones* decision do not necessarily follow. For the fundamental public policy doctrine to apply as the Supreme Court intended, § 501(c)(3) needs to be a subsidy, which it is not. Therefore, in order for the *Bob Jones* fundamental public policy doctrine to apply, § 170 needs to be a subsidy and mapped onto § 501(c)(3).

#### IV. THE DEDUCTIBILITY OF CHARITABLE DONATIONS

The modern personal income tax was enacted in 1913. The initial draft of the income tax proposed a charitable deduction.<sup>246</sup> During

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240. See Sharpe, *supra* note 216, at 383–84.

241. See *id.* at 385–98 (stating that Congress was motivated to pass the UBIT to decrease unfair competition and was unconcerned about tax-exempt organizations competing unfairly in aspects of real estate and investments).

242. H.R. REP. NO. 81-2319, at 36 (1950).

243. *Id.*; see, e.g., *C.F. Mueller Co. v. Comm’r.*, 190 F.2d 120 (3d Cir. 1951) (finding that a for-profit company qualified as a tax-exempt organization because profits went to NYU, a tax-exempt organization).

244. H.R. REP. NO. 81-2319, at 36.

245. Brunson, *supra* note 228, at 232.

246. Ellen P. Aprill, *Churches, Politics and the Charitable Contribution Deduction*, 42 B.C. L. REV. 843, 848 (2000) (“Although an attempt to enact a

the debate over the definition of the base of net income, Congressman John Jacobs Rogers, a Massachusetts Republican, presented an amendment for a “deduction for gifts made by individuals to charitable, benevolent and religious societies.”<sup>247</sup> Representative Rogers advocated for the exemption because without it, charitable contributions would lessen: “[I]t is desirable that there should be no curtailment imposed by this act upon the benevolent members of the community.”<sup>248</sup> The amendment was not adopted, albeit without debate.<sup>249</sup>

The failure to adopt a charitable deduction in the Revenue Act of 1913 was not accidental. In the 1894 Act, there was a deduction for charitable contributions made by corporations.<sup>250</sup> Although there was an affirmative choice made to not include the deduction,<sup>251</sup> it is hard to make any definite conclusion about whether the failure to include a charitable deduction in 1913 was a rejection of Representative Rogers’s exclusion-based theory of the deduction or a rejection of the impact on charity. For example, a small pool of taxpayers with a top rate of 7% would not have necessarily had an impact on charitable giving.

To the extent that either or neither rationale was accurate, the charitable deduction was put into the Code a scant four years later in 1917.<sup>252</sup> After the First World War, Congress increased tax rates (with a top rate of 52%) through the War Revenue Act of 1917.<sup>253</sup> Charities feared that the increase in tax burden would lessen discretionary dollars, causing a second-order problem of funding charities.<sup>254</sup> Without private funding of charities, people worried that the government would either have to provide those services or

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deduction for gifts to ‘religious, charitable, scientific, or educational’ institutions in 1913 was unsuccessful.”). On the 1913 effort, see J. S. SEIDMAN, SEIDMAN’S LEGISLATIVE HISTORY OF THE FEDERAL INCOME TAX LAWS, 1938–1861, at 944–45 (1938).

247. 50 CONG. REC. 1259 (1913) (statement of Rep. Rogers); see also Carol A. Jones, *Tax Law—Hernandez v. Commissioner: The Supreme Court Forces A Square Peg into A Round Hole*, 25 WAKE FOREST L. REV. 917, 924 (1990).

248. 50 CONG. REC. 1259 (statement of Rep. Rogers).

249. See *id.*

250. Revenue Act of 1894, ch. 349, § 32, 28 Stat. 509, 556. This tax was declared unconstitutional in *Pollock v. Farmers’ Loan & Trust Co.*, 157 U.S. 429, 583 (1895).

251. 50 CONG. REC. 1259.

252. War Revenue Act of 1917, ch. 63, § 1201(2), 40 Stat. 300, 330.

253. See *id.* at 300–01 (explaining that “in addition to the normal tax,” which is capped at 50% percent for individuals, there would be an additional 2% tax on all income).

254. STAFF OF THE JOINT COMM. ON TAXATION, PRESENT LAW AND BACKGROUND RELATING TO THE FEDERAL TAX TREATMENT OF CHARITABLE CONTRIBUTIONS 6 (Feb. 2013); Stanley S. Surrey, *The Federal Income Tax Base for Individuals*, 58 COLUM. L. REV. 815, 825 (1958).

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subsidize the organizations.<sup>255</sup> To do so would have required further increasing taxes. This rather pragmatic and unromantic view of charity through the war lens enabled legislation to pass that failed in 1913.<sup>256</sup>

To avoid the impact on charities, proposals were made to permit a deduction for contributions to charities by individuals. Senator Harry F. Hollis proposed an amendment to the 1917 Act providing for an initial 20% deduction for charitable contributions.<sup>257</sup> Senator Hollis focused, rightly, on the potential impact of an income tax on the charitable sector.

Once again, although inartfully framed, there was a question of whether the deduction was an exclusion from income or a subsidy. On one hand, the advocate for the amendment, Senator Hollis, justified the amendment by saying, “Look at it in this way: For every dollar that a man contributes to these public charities, educational, scientific, or otherwise, the public gets 100 per cent: it is all devoted to that purpose.”<sup>258</sup> Senator Hollis seems to be making an argument about the appropriate base argument here.

On the other hand, the majority of the discussion surrounding the adoption on the deduction was a subsidy question. For example, former President Taft in written testimony questioned the viability of the Hampton Institute without a deduction for charitable contributions.<sup>259</sup> At the time, Senators recognized that they created a welfare state through prior governance.<sup>260</sup> Senator Hollis stated, “Now, when war comes, . . . that will be the first place where wealthy men will be tempted to economize, namely, in donations to charity.”<sup>261</sup>

It was not just the concern of Senator Hollis to sway the Senate. There was much public pressure in newspaper editorials.<sup>262</sup> The editorial staff of the *Washington Post* wrote,

If the Government takes all, or nearly all, of one’s disposable or surplus income, it must undertake the responsibility for spending it and it must then support those works of charity and mercy and all the educational and religious works in this

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255. 90 CONG. REC. 4029 (1944) (statement of Rep. Curtis) (questioning if the drafters of the tax code “want to cripple all . . . worthwhile institutions so that they must come to the Federal Government for a subsidy”).

256. JOSEPH J. THORNDIKE, MAKING THE WORLD SAFE FOR PHILANTHROPY: THE WARTIME ORIGINS AND PEACETIME DEVELOPMENT OF THE TAX DEDUCTION FOR CHARITABLE GIVING 6–9 (Apr. 2013) <http://www.urban.org/sites/default/files/thorndike-making-the-world-safe-for-philanthropy.pdf>.

257. 55 CONG. REC. 6728 (1917).

258. *Id.*

259. *Id.*; see also April, *supra* note 246, at 849 (noting that institutes of higher learning were most at risk from the rate increases).

260. See Thorndike, *supra* note 256, at 9.

261. 55 CONG. REC. 6728.

262. See *infra* notes 263–64 and accompanying text.

country have heretofore been supported by private benevolence.<sup>263</sup>

The *New York Times* stated, “There is a necessary social effect to the taxation of great income. It diminishes or dries up the springs of philanthropic eleemosynary and educational life.”<sup>264</sup>

That is not to say that the Hollis view was universal. Frank Anderson, an economist from Columbia, published a paper in the *Journal of Political Economy* discussing how charitable deductions are overrated.<sup>265</sup> In other words, the decline of charity *would*, in fact, provide a boost to government. From Anderson’s perspective, the social value of private charity was highly overrated.<sup>266</sup> He believed that the only loss is to the ego of the donor. “If [heavy taxation without a deduction] also cuts down luxurious consumption and nonessential charities, that is just what furthers the supreme end in war time.”<sup>267</sup>

Neither the exclusion from the base nor the antisubsidy views really gained traction.<sup>268</sup> Rather, a compromise reached at the time was the enactment of the first charitable exemption.<sup>269</sup> To ensure that individuals would still be subject to the income tax, the exemption was capped at 15%. The statute read in part,

Contributions or gifts actually made within the year to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals, no part of the net income of which inures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayer’s taxable net income as computed without the benefit of this paragraph.<sup>270</sup>

Since this compromise in 1917, the frame of the charitable deduction under § 170 has for the most part remained the same.<sup>271</sup>

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263. Opinion, *Exempting Charity*, WASH. POST, Aug. 25, 1917, at 6.

264. Opinion, *The Conscription of Wealth*, N.Y. TIMES, Aug. 24, 1917, at 6.

265. See Frank F. Anderson, *Fundamental Factors in War Finance*, 25 J. POL. ECON. 857, 873 (1917).

266. See *id.*

267. *Id.*; see also BANK ET AL., *supra* note 190, at 8.

268. 55 CONG. REC. 6728 (1917) (statement of Rep. Hollis) (explaining that under the subsidy view, if the federal government were to undertake to “support such institutions . . . and the taxes were imposed for the amount, they would only get [a] percentage . . . [i]nstead of getting the full amount”); *id.* at 6732 (announcing that Senator Hollis’s exclusion from the base proposal failed to pass in the Senate).

269. Vada Walters Lindsey, *The Charitable Deduction: A Historical Review and a Look to the Future*, 81 NEB. L. REV. 1056, 1057 (2003).

270. See War Revenue Act of 1917, ch. 63, § 1201(2), 40 Stat. 300, 330.

271. See Lindsey, *supra* note 269 (observing that “[a]lthough the basic premise remains the same, the current statutory scheme has been transformed from a short statutory provision into a complex set of rules”).



The argument during the 1917 debate framed how the charitable deduction would be discussed in future modifications.<sup>272</sup> First, there would be limits on the charitable deduction.<sup>273</sup> Second, “healthy charities were a desirable alternative to big government: if people didn’t want the state to absorb full responsibility for social welfare, then the tax system must find a way to encourage (or at least not penalize) charitable giving.”<sup>274</sup>

In 1924, there was a proposal to create an unlimited deduction for taxpayers that donated for the prior ten years more than 90% of their income.<sup>275</sup> This proposal is aligned with the base exclusion theory of Senator Hollis.<sup>276</sup> A taxpayer could eliminate all taxable income through giving.<sup>277</sup> “[T]he Senate Finance Committee perceived less tax abuse where a taxpayer consistently contributed large percentages of the taxpayer’s taxable income over a long period of time.”<sup>278</sup> Taxing the same dollar twice in this situation seemed superfluous. “The history provides that [t]his provision is designed substantially to free from income taxation one who is habitually contributing to benevolent organizations amounts equalling [sic] virtually his entire income.”<sup>279</sup> Clearly, by 1924 the § 170 deduction was viewed as a subsidy and not as an exemption from income.

A potential shift loomed in 1944 with the end of World War II and the need to expand revenues. The rules were modified to introduce the standard deduction and to limit the deduction to a percent of adjusted gross income instead of taxable income.<sup>280</sup>

During World War II, the government needed to raise tremendous amounts of revenue, which it did in part by adding the middle class to the tax rolls.<sup>281</sup> The expansion of the tax system to the middle class<sup>282</sup> caused compliance concerns. In order to add the middle class to the taxpaying world, accommodations had to be made including withholding and a standard deduction.

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272. See *id.* at 1079 (explaining that “[w]hile many changes [to the 1917 Act] were modest, the totality of constant modification during the past seventy years has, in fact, culminated in the complexity of the rules in existence today”).

273. Edward A. Zelinsky, *Why the Buffett-Gates Giving Pledge Requires Limitation of the Estate Tax Charitable Deduction*, 16 FLA. TAX REV. 393, 399 (2014).

274. BANK ET AL., *supra* note 190, at 399.

275. Revenue Act of 1924, Pub. L. No. 68-176, 43 Stat. 253.; see also Lindsey, *supra* note 269, at 1061.

276. 55 CONG. REC. 6728 (1917).

277. Miranda Perry Fleischer, *Generous to a Fault? Fair Shares and Charitable Giving*, 93 MINN. L. REV. 165, 171 n.24 (2008).

278. Lindsey, *supra* note 269, at 1061.

279. Fleischer, *supra* note 277.

280. John R. Brooks II, *Doing Too Much: The Standard Deduction and the Conflict Between Progressivity and Simplification*, 2 COLUM. J. TAX L. 203, 211 (2011).

281. *Id.* at 210.

282. Aprill, *supra* note 246, at 850 (“Between 1939 and 1945, the coverage of the tax system grew from about 5% to 74% of the population.”).

The standard deduction impact of the charitable deduction was unknown. Similar to Senator Hollis's discussion in 1917, charities were concerned that the new standard deduction and withholding would impact the disposable income of taxpayers.<sup>283</sup> "Lobbyists for the nonprofit sector insisted that withholding was hurting donations, as Americans struggled to make gifts from shrunken paychecks."<sup>284</sup> From the charities' point of view, the standard deduction was an existential threat.<sup>285</sup> "Can it be possible that the master minds behind the scenes who determine the policy for the Treasury Department and all other branches of government want to cripple all of these worth-while institutions so that they must come to the Federal Government for a subsidy?"<sup>286</sup>

Using the same normative frame from 1917, charities challenged the withholding aspect of the new income tax.<sup>287</sup> In order to ease administration and aid unsophisticated taxpayers' budgeting process, part of the new tax regime was withholding for taxation.<sup>288</sup> Because of withholding, paychecks would shrink. The result of the smaller paycheck would, like in 1917, reduce charitable donations.

It was reported at the time that the withholding regime caused a drop in donations.<sup>289</sup> The response of a number of charities was a formation of the Council of Taxes and Philanthropy lobby.<sup>290</sup> Charities advocated for a modification of the withholding rules to allow taxpayers to obtain a credit for charitable contributions against withholding.<sup>291</sup> "Under their plan, taxpayers would be allowed to adjust their withholding to account for expected charitable contributions over the course of the year."<sup>292</sup>

Representative Carl Curtis, a Republican from Nebraska, "worried that the bill, when carried into effect, meant that the individual who gives a portion of his hard-earned money in contributions would have the same amount of his taxes 'withheld from his wages as if he had given nothing.'"<sup>293</sup> The newly formed lobby group took a slightly more aggressive tactic, stating that

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283. 55 CONG. REC. at 6728 (1917) (statement of Sen. Hollis); see Aprill, *supra* note 246, at 850.

284. Thorndike, *supra* note 256, at 10.

285. Aprill, *supra* note 246, at 850; see also Thorndike, *supra* note 256, at 10.

286. 90 CONG. REC. 4029 (1944) (statement of Sen. Curtis).

287. See Aprill, *supra* note 246, at 851.

288. See, e.g., Thorndike, *supra* note 256, at 10.

289. *Id.*

290. According to the Congressional Record, "The United Stewardship Council, representing 21 denominations and 24,000,000 Protestant Church members, countless individual churches and clergymen, the Council on Taxes and Philanthropy, a number of Catholic churches and organizations, the American Association of Colleges, and innumerable people have protested this bill." 90 CONG. REC. 1429.

291. Thorndike, *supra* note 256, at 10.

292. *Id.*

293. Aprill, *supra* note 246, at 850–51.

[i]t is utterly unfair to give a profligate spendthrift who seldom gives a penny to charity the same credit and tax deduction as the devout widow or the conscientious contributor who gives a tithe or sacrificially gives 15 percent or more, in order to share with those who are less fortunate.<sup>294</sup>

Withholding was thought to lessen the absolute dollars available to charities.<sup>295</sup> In addition to the absolute dollar problem, Senator Curtis made a double-tax argument, stating that “[t]hey want to withhold a tax on exempt income that is given to the churches, the colleges, the hospitals, the orphanages, the Red Cross organizations, and every other institution that makes life better.”<sup>296</sup> This argument failed to win the day.<sup>297</sup> The ease for reporting proved a greater good than the marginal impact on potential charitable giving.<sup>298</sup>

Adding to the concern about absolute dollars available, the new standard deduction provided a second challenge regarding incentive for giving. This second challenge to the standard deduction from the charitable sector was a horizontal equity argument.<sup>299</sup> Taxpayer *A* who contributed \$*X* to charity would reduce their income by \$*X*, and taxpayer *B* who did not contribute to charity and kept the \$*X* would still obtain a deduction for \$*X* via the standard deduction.

Both the Congressional Record and contemporaneous newspaper accounts supported a moral justification for separating the charitable deduction from the standard deduction.<sup>300</sup> “Just think of it. Under this proposal, this presumptive deduction, atheists who hate the church, who do not believe in God, who despise everything the church is doing, are going to be given credit for having donated to churches to the extent of 2 1/2 percent of their total income.”<sup>301</sup>

The horizontal equity argument once again failed.<sup>302</sup> Despite the lack of economic theories presented at the time, an elasticity of giving argument carried the day.<sup>303</sup> The adoptive majority of the Revenue Act of 1944 believed that contributions were made because the cause

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294. Thorndike, *supra* note 256, at 10 (citing Rev. John Evans, *Churches Seek Amendment to Income Tax Act*, CHI. DAILY TRIB., July 31, 1944, at 18).

295. *See id.*

296. 90 CONG. REC. 4030 (1944) (statement of Sen. Curtis).

297. Aprill, *supra* note 246, at 851.

298. *Id.* (“Representative Robertson, for example, responded that although the members of the committee considered Representative Curtis’ viewpoint, they ‘found it absolutely impossible to work out this simplification plan on any basis other than what we [have] used.’”).

299. Brooks, *supra* note 280, at 206 n.10.

300. 90 CONG. REC. 4024; Rev. John Evans, *Churches Seek Amendment to Income Tax Act*, CHI. DAILY TRIB., July 31, 1944, at 18.

301. 90 CONG. REC. 4024.

302. *See* Aprill, *supra* note 246, at 867 (“The argument is one of horizontal equity—that itemizers and nonitemizers are similarly situated and should be treated similarly.”).

303. *See id.* at 857–58.

was worthy, not for the income tax deduction.<sup>304</sup> Senator Walter F. George, a Democrat from Georgia, stated that the “standard deduction will not remove the tax incentive for persons in the higher brackets, upon whom the charities depend for contributions in substantial amounts.”<sup>305</sup>

The Revenue Act of 1944 was enacted by Congress and signed into law by President Roosevelt.<sup>306</sup> The result of the 1944 revision was an entrenchment of the 1917 positions. Charities were a part of the fabric of society; and a threat to the charitable deduction or the amount of dollars available for charitable giving would prove a threat to the existence of charities.<sup>307</sup> “Charities may have lost this new legislative battle, but they had not abandoned their tried-and-true arguments on behalf of the deduction.”<sup>308</sup>

Until 1986, absent minor changes in the deduction, the charitable deduction remained essentially the same.<sup>309</sup> Leading up to the 1986 reform, in 1981 Congress experimented with the charitable deduction by opening it up to nonitemizers.<sup>310</sup> At the time, the Joint Committee on Taxation believed that opening up the deduction to nonitemizers would increase charitable giving, “thereby providing more funds for worthwhile nonprofit organizations, many of which provide services that otherwise might have to be provided by the Federal Government.”<sup>311</sup>

Polls at the time showed that the deduction was not having very much effect on giving, but voters liked the deduction.<sup>312</sup> Leading up to the major reform effort of 1986, with the only clear public consensus being that the deduction does not affect giving, the Treasury released a major overhaul of the Code in 1984, commonly known as Treasury I.<sup>313</sup> This plan would have a significant impact on

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304. *Id.* at 851 (citing Rep. Robert Doughton); Thorndike, *supra* note 256, at 11.

305. 90 CONG. REC. 4704.

306. Thorndike, *supra* note 256, at 12.

307. *See id.* at 10.

308. *Id.* at 12.

309. Zelinsky, *supra* note 273 (“Thus, almost four decades after the Revenue Act of 1917 inaugurated the income tax charitable deduction, the 1954 Code both increased the limits of that deduction and embraced the principle that individuals’ contributions to some donees—initially defined as churches, schools and hospitals—are subject to higher deduction limits than are contributions to all other charitable donees.”).

310. Economic Recovery Act of 1981, Pub. L. No. 97-34, § 121, 95 Stat. 172, 196; *see also* Aprill, *supra* note 246, at 852.

311. STAFF OF THE J. COMM. ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 49 (Joint Comm. Print 1981); *see also* Aprill, *supra* note 246, at 873; Thorndike, *supra* note 256, at 13.

312. Thorndike, *supra* note 256, at 13 (finding that 66% of individuals would not trade the deduction for lower rates and 74% of individuals would not change their giving if the deduction was abolished, although other polls had less clear results).

313. *Id.* at 14.

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charities through: (1) significant rate decreases; (2) a repeal of the 1981 nonitemizer provisions, (3) a limit on the charitable deduction; and (4) a limitation on the value of contribution appreciated property.<sup>314</sup>

Ironically, the primary concern of charities was the reduction of rates. As you will recall, in 1917 and 1944, the argument was the implementation of tax would impact charitable giving because there would be less absolute dollars available.<sup>315</sup> By 1984, charities argued that they did not “want to be against lower rates, so we’re looking for alternatives to replace the money we would lose.”<sup>316</sup> By 1984, charities believed that the above-the-line deduction for charitable giving had a positive correlation to the amount given.<sup>317</sup>

Moreover, by limiting or bringing the deduction below-the-line, there would be a crowding out of the nonitemizers:

The message that we as a nation will be sending to ourselves and to successor generations will be that private giving and volunteering are not, as we have hitherto argued, central to the kind of society we want to be, but merely a peripheral exercise in which only a privileged minority of the public participates or has an interest.<sup>318</sup>

Although the message regarding the expendable dollars had changed, the public subsidy argument remained. “Eventually, [Lee Cobb, vice president of the U.S. UNICEF Committee] warned, the social services provided by these nonprofit organizations would suffer and ‘government is going to have to pick up the slack.’”<sup>319</sup> Others made similar arguments that existed in 1917, stating that “[c]ontributions to charities should not be the tax base to begin with.”<sup>320</sup>

The Tax Reform Act of 1986, much like the 1944 Act, relied on simplicity. The 1986 Act increased the standard deduction (which, like in 1944, was intended to assume a baseline amount of charitable contributions), lowered rates, and eliminated the deduction for nonitemizers.<sup>321</sup> “Simplification and base-broadening were far more important than incentives for charitable giving.”<sup>322</sup> The 1986 Act continued the longstanding position that the standard deduction was

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314. *Id.*

315. *See id.* at 6–7.

316. Anne Swardson, *Charities Over Tax Reform Barrel*, WASH. POST, Jan. 30, 1985, at A4.

317. *See* Thorndike, *supra* note 256, at 14.

318. Richard Lyman, *Charity—A Matter of Deduction*, N.Y. TIMES, June 22, 1985, at 27.

319. Thorndike, *supra* note 256, at 15.

320. Peter Swords, *Charity Should Not Begin in Washington*, N.Y. TIMES, Mar. 22, 1985, at A30.

321. Thorndike, *supra* note 256, at 16–17.

322. Aprill, *supra* note 246, at 853.

a substitute for charitable giving at the lower boundary, and the lowering of rates should increase the amount of disposable income.<sup>323</sup>

Since 1986, the charitable deduction under § 170 has continued to be examined.<sup>324</sup> In 2010, the National Commission on Fiscal Responsibility and Reform was formed by the President and the leaders of both parties.<sup>325</sup> The result of the Commission was the *Bowles-Simpson Report*. The report proposed replacing the charitable deduction for itemizers with a “12% non-refundable tax credit available to all taxpayers; available above 2% of Adjusted Gross Income (AGI) floor.”<sup>326</sup> The purpose of the change was a long-term call “to lower tax rates, broaden the base, simplify the tax code, and bring down the deficit.”<sup>327</sup> These were the same guiding principles of the 1986 revisions.<sup>328</sup>

The Nobel Prize-winning economist Robert J. Shiller wrote an op-ed at the time advocating for the charitable deduction.<sup>329</sup> He framed the deduction not as a “loophole.”<sup>330</sup> The fact that the wealthy disproportionately benefit from the deduction does not matter since society as a whole benefits. Rather, he believed that income given to charity should be exempt from the definition of income.<sup>331</sup> Moreover, there is a spillover effect that the tax break “encourages a habit and a culture of giving.”<sup>332</sup> In order to achieve this norm, Professor Shiller advocated for greater signals for charitable giving.<sup>333</sup> “Instead of curtailing the charitable deduction, we should be aiming to make it an even bigger part of our culture.”<sup>334</sup> He advocated similar historic

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323. Lilian V. Faulhaber, *The Hidden Limits of the Charitable Deduction: An Introduction to Hypersalience*, 92 B.U. L. REV. 1307, 1321–22, 1321–22 n.70 (2012) (“The deduction’s current structure raises questions about the effectiveness of the standard deduction at achieving this purpose. Such concerns arise because, in reality, a taxpayer’s choice to itemize is largely attributable to other deductions—such as the home mortgage interest deduction and the state and local tax deduction—than to the number of donations a taxpayer makes.” (citing David M. Schizer, *Subsidizing Charitable Contributions: Incentives, Information, and the Private Pursuit of Public Goals*, 62 TAX L. REV. 221, 238 (2009))).

324. See, e.g., Thorndike, *supra* note 256, at 17–18.

325. NAT’L COMM’N ON FISCAL RESPONSIBILITY & REFORM, THE MOMENT OF TRUTH 6 (2010), [https://permanent.access.gpo.gov/gpo1606/TheMomentofTruth12\\_1\\_2010.pdf](https://permanent.access.gpo.gov/gpo1606/TheMomentofTruth12_1_2010.pdf).

326. *Id.* at 31.

327. *Id.* at 12.

328. Aprill, *supra* note 246, at 853.

329. Robert J. Shiller, *Please Don’t Mess with the Charitable Deduction*, N.Y. TIMES (Dec. 15, 2012), <http://www.nytimes.com/2012/12/16/business/the-charitable-deduction-and-why-it-needs-to-stay.html>.

330. *Id.*

331. *Id.*

332. *Id.*

333. *Id.*

334. *Id.* (“Using data from Giving USA, we see that total individual giving in the United States—including giving by those who don’t declare it on their tax returns—was only 1.9 percent of disposable personal income in 2011. Compare

proposals, such as making the deduction available for nonitemizers as in 1981 or, as in 1944, allowing a credit on the withholding tax calculation for the charitable deduction “so we don’t have to go through the nuisance of collecting information and detailing it at tax time.”<sup>335</sup>

These themes were then picked up in hearings held in 2011 by the Senate Committee on Finance.<sup>336</sup> In the hearings, a redux of the 1913, 1917, 1944, and 1986 hearings happened. The disposable-income and the standard-deduction-as-a-subsidy arguments were once again made. Senator Hatch explained that “from my perspective the tax reform options being discussed today are options that target charitable giving concocted by those who, hungry for more taxpayer dollars to finance reckless government spending, are now casting their sights on the already depleted resources of charities and churches.”<sup>337</sup>

By 2011, robust economic literature existed discussing the elasticity of the charitable deduction.<sup>338</sup> Economists argued that the large loss of federal revenue compared to a small increase of charitable giving.<sup>339</sup> Senator Hatch disagreed, stating, “Taxpayers who receive little or no additional tax benefit for giving to their church or charity give faithfully anyway.”<sup>340</sup> Although Senator Hatch dismissed the economists, his rhetoric was closer to Professor Shiller, who believes that the income donated to charity was not really part of the taxable income calculation.<sup>341</sup>

Currently, tax simplification and rate reduction is back on the table. In order to simplify tax returns, there are proposals to raise the standard deduction and cap itemized deductions.<sup>342</sup> Both

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that with the traditional Christian, Jewish and Islamic standards of 10 percent!”).

335. *Id.*

336. *Tax Reform Options: Incentives for Charitable Giving: Hearing Before the S. Comm. on Fin.*, 112th Cong. (2011).

337. *Id.* at 3 (statement of Sen. Orrin Hatch, Ranking Member, S. Comm. on Fin.).

338. *See, e.g.*, Miranda Perry Fleischer, *Equality of Opportunity and the Charitable Tax Subsidies*, 91 B.U. L. REV. 601, 662 (2011).

339. William A. Drennan, *Where Generosity and Pride Abide: Charitable Naming Rights*, 80 U. CIN. L. REV. 45, 86–87 (2011) (explaining that a decline in charitable giving can lead to an increase in federal revenue because taxpayers cannot deduct the charitable donation).

340. *Tax Reform Options: Incentives for Charitable Giving: Hearing Before the S. Comm. on Fin.*, *supra* note 336, at 4 (statement of Sen. Orrin Hatch, Ranking Member, S. Comm. on Fin.).

341. *Compare id.* (“Every charitable gift has one thing in common: the donor is always left worse off financially. But society is made better.”), *with* Shiller, *supra* note 329 (“Income that is freely given away should not even be considered as taxable income.”).

342. Charles Delafuente, *How a Tax Code Overhaul May Affect You*, N.Y. TIMES (Feb. 16, 2017), <https://www.nytimes.com/2017/02/16/business/yourtaxes/how-a-tax-code-overhaul-may-affect-you.html?mcubz=0>.

President Trump and the Republican Party's "A Better Way" tax plan include these constant modification techniques.<sup>343</sup> Much like the historic arguments, the concern of charities on the impact of either the substitution problem—e.g., the standard deduction—impacts charitable giving. "Of course, many advisers will say that tax incentives are not the only reason people give to charity. But tax incentives factor in at some level, and are generally credited with making Americans the most philanthropic people in the world."<sup>344</sup>

#### V. A BETTER WAY TO DEAL WITH VIOLATIONS OF FUNDAMENTAL PUBLIC POLICY

As we discussed earlier, the Supreme Court's decision in *Bob Jones* was almost certainly wrong, as a matter of both law and tax policy. That said, it was also almost certainly necessary. It was important that schools not undercut the civil rights first granted by *Brown* then augmented through decades of civil rights legislation. Wrong or not, while the Code does not even hint at the idea of a fundamental public policy requirement for tax exemption,<sup>345</sup> the idea that there is a common law of tax, which overlays the Code, is well accepted. And the fundamental public policy rule, in spite of its lack of clarity and underenforcement, has become a central part of the law of tax-exempt organizations.

As a result of its centrality and the intuitive sense that the government should not subsidize certain bad behavior, we do not argue that the fundamental public policy rule should be jettisoned. It serves a valuable purpose, both as a signal of what is acceptable and as an incentive for tax-exempt organizations to do the right thing.

At the same time, we believe that the fundamental public policy requirement is currently implemented poorly. As we have demonstrated, tax exemption is not a subsidy for public charities. Rather, it recognizes the fact that, both historically and as a matter of policy, they do not belong in the tax base. Rather than use the fundamental public policy rule to disqualify entities that would otherwise qualify as tax exempt, we believe that the fundamental public policy test should be applied to disqualify the deduction of donations to tax-exempt organizations that violate fundamental public policy.<sup>346</sup> Disqualifying deductions, rather than exemptions,

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343. *Id.*; BETTER.GOP, A BETTER WAY OUR VISION FOR A CONFIDENT AMERICA: TAX 18, 20 (2016), [http://abetterway.speaker.gov/\\_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf](http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf).

344. Paul Sullivan, *Trump's Changes to the Tax Codes May Encourage Dynastic Wealth*, N.Y. TIMES (Nov. 11, 2016), [https://www.nytimes.com/2016/11/12/your-money/trump-changes-tax-codes-may-encourage-dynastic-wealth.html?\\_r=0](https://www.nytimes.com/2016/11/12/your-money/trump-changes-tax-codes-may-encourage-dynastic-wealth.html?_r=0).

345. *Bob Jones Univ. v. United States*, 461 U.S. 574, 613 (1983).

346. We considered recommending the elimination of the deduction for charitable donations and replacing it with a matching grant at the government level. Under a matching grant program, donors would not get a deduction for



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will make it easier for the IRS to enforce fundamental public policy, will provide better leverage for encouraging tax-exempt organizations to act in socially-acceptable ways, corresponds better with tax policy, and will allow tax-exempt organizations to give voice to unpopular minority opinions.

*A. On Underenforcement*

As we have demonstrated in a previous article, since the IRS adopted the fundamental public policy rule, it has used the rule almost exclusively to disqualify racially discriminatory private schools.<sup>347</sup> Courts have similarly been hesitant to apply the fundamental public policy rule.<sup>348</sup> Even where an organization would clearly violate a fundamental public policy, courts and the IRS tend to use that only as an ancillary reason for denying or revoking an organization's exemption, not as the primary reason.<sup>349</sup>

There may be practical reasons for their not using the fundamental public policy rule, of course. The precise contours of the rule are far from clear. While a private school discriminating on the basis of race clearly violates fundamental public policy,<sup>350</sup> the Supreme Court has not defined what else qualifies as a fundamental public policy.<sup>351</sup> Rather, it instructed the IRS to be cautious and only apply the fundamental public policy rule to disqualify an organization where "there can be no doubt that the activity involved is contrary to a fundamental public policy."<sup>352</sup>

With the mandate that the fundamental public policy rule only be invoked when an activity clearly violates a fundamental public policy, combined with uncertainty over what constitutes a fundamental public policy, it makes sense that the IRS and other courts would avoid using the rule when possible. But there is an additional possibility for why they would avoid using the fundamental

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their charitable donations. Rather, a charity would send the government a list of donations it had received, and the government would provide it with an additional amount based on the amount of donations. Great Britain has implemented this kind of matching grant system. Adam Chodorow, *Charity with Chinese Characteristics*, 30 UCLA PAC. BASIN L.J. 1, 24 n.142 (2012). Ultimately, we decided that the question of how to structure a charitable subsidy was beyond the scope of this article, so for purposes of discussion, we assume the current charitable deduction. We do not mean to assert that deductibility is the only, or even the best, way to subsidize charity, and certainly our proposal could be applied to a matching grant system or other style of charitable subsidy.

347. Brunson & Herzig, *supra* note 4, at 1187.

348. *Id.* at 1192.

349. *Id.* at 1191.

350. *See Bob Jones*, 461 U.S. at 595.

351. Brunson & Herzig, *supra* note 4.

352. *Bob Jones*, 461 U.S. at 592.

public policy rule: as a practical matter, disqualification would end the existence of the tax-exempt organization.<sup>353</sup>

That kind of penalty—an effective organizational death penalty—may be steeper than is warranted. Even an organization that has policies that society finds opprobrious may also produce positive externalities. As a society, we may prefer to nudge the organization into giving up its bad behavior rather than shoving it to its end.<sup>354</sup>

Disallowing a deduction for donations to the organization, by contrast, has less lethal consequences. Because charitable donations are economically elastic,<sup>355</sup> loss of deductibility will reduce the donations that the organization will receive. And the reduced donations will negatively impact the organization's ability to both pursue its exempt purpose and continue violating public policy. But the organization will be able to continue operating and will have the ability to align its actions with public policy. This, counterintuitively, may provide incentive for the IRS to actually use the fundamental public policy rule more often and more effectively.

*B. It Is Not Clear That the Fundamental Public Policy Is Efficient in Encouraging Good Behavior*

Even if the IRS underenforces the fundamental public policy rule, the public may justifiably view the rule as a way to encourage tax-exempt organizations to give up bad behavior. There is no evidence, however, that it does so, much less that the threat of loss of exemption is the most effective way to effect that change. In fact, there is significant anecdotal evidence that the fundamental public policy rule is ineffective.

The *Bob Jones* case clarified that the fundamental public policy rule could constitutionally apply even to religious universities, making Bob Jones University an important example of the power of the fundamental public policy rule. But the Supreme Court's decision in *Bob Jones* did not effect change in the university's policies. Even after the Supreme Court ruled in 1983 that Bob Jones University's ban on interracial relationships violated fundamental public policy, and even after the university definitively lost its tax exemption, it did not change its policy.<sup>356</sup>

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353. Cf. Brunson, *supra* note 94 (explaining that the IRS does not strictly enforce prohibition on campaigning by public charities because public charities may cease to operate to avoid tax liability).

354. *Id.* at 155 (explaining that the IRS needs tools to nudge public charities toward compliance with campaigning rules rather than the current severe penalties for noncompliance that may end public charities).

355. See Fleischer, *supra* note 338.

356. *Bob Jones*, 461 U.S. at 595; see Jim Davenport, *University Surprised by Lifting of Ban*, WASH. POST (Mar. 5, 2000), <http://www.washingtonpost.com/wp-srv/WPcap/2000-03/05/096r-030500-idx.html>.

In fact, the university's ban on interracial relationships outlived the Supreme Court's decision by almost two decades.<sup>357</sup> In March of 2000, Bob Jones III, the then-president of Bob Jones University, went on *Larry King Live* and announced that he was lifting the half-century-old ban.<sup>358</sup> The university's decision to lift the ban does not appear to have any relation to its lack of tax-exempt status. Rather, the university president said that he eliminated the ban as a result of the national outcry and scrutiny the university faced when presidential candidate George W. Bush made a campaign stop there.<sup>359</sup> There is no reason to believe that President Jones III was disingenuous in explaining why he ended the ban: even today, more than fifteen years after it dropped its racial ban (and thus no longer violates a fundamental public policy), Bob Jones University is still not tax exempt.<sup>360</sup>

On the margins, at least, the threat of losing—or even the loss of—tax-exempt status does not necessarily cause a tax-exempt organization to change its bad behavior. But, as Bob Jones University demonstrates, public pressure can change behavior that violates fundamental public policy. The power of public pressure can also be demonstrated by the experience of the Mormon church. Though its origins are not entirely clear, at some point, the Mormon church prohibited anybody of African descent from holding the church's priesthood or participating in temple ceremonies.<sup>361</sup> In 1978, the Mormon church reversed its stance, eliminating any religious racial bans.<sup>362</sup>

A popular narrative says that the church changed its position out of fear of losing its tax-exempt status.<sup>363</sup> That is unlikely for a number of reasons. True, the IRS had introduced the fundamental

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357. *Bob Jones*, 461 U.S. at 595.

358. Davenport, *supra* note 356.

359. *Id.*

360. See, e.g., *President's Society*, BOB JONES U., <https://bjualumni.com/presidents-society/> (last visited Dec. 14, 2017) ("Member-qualifying gifts can be made at one time or throughout BJU's fiscal year—June 1 through May 31—to any of the following three tax-deductible funds as wells [sic] as any non-tax-deductible donations to Bob Jones University."). Moreover, a search on Guidestar.org for "Bob Jones University" does not bring up the university itself. Bob Jones University does have some affiliated tax-exempt scholarship and other funds, but the university itself does not seem to have ever renewed its pursuit for tax exemption.

361. See John G. Turner, *Why Race Is Still a Problem for Mormons*, N.Y. TIMES (Aug. 18, 2012), <http://www.nytimes.com/2012/08/19/opinion/sunday/racism-and-the-mormon-church.html?mcubz=0>.

362. *Id.*

363. See, e.g., Lance Gurwell, *Critics Still Question 'Revelation' on Blacks*, CHI. TRIB. (Jun. 2, 1988), [http://articles.chicagotribune.com/1988-06-02/news/8801040230\\_1\\_president-spencer-w-kimball-church-spokesman-jerry-cahill-mormon-church](http://articles.chicagotribune.com/1988-06-02/news/8801040230_1_president-spencer-w-kimball-church-spokesman-jerry-cahill-mormon-church) ("[C]ritics say . . . that the Mormon church, the fastest growing mainstream church in the U.S., stood to lose its tax-exempt status for discriminating against blacks.").

public policy rule in 1971, and that rule clearly disallowed racial discrimination.<sup>364</sup> But it was not until five years *after* the Mormon church's change that the Supreme Court held that a school's religious beliefs did not shield it from the necessity of complying with the fundamental public policy rule.<sup>365</sup>

In addition, even when it happened, the Supreme Court's ruling applied specifically to religious educational institutions.<sup>366</sup> In the nearly fifty years since the IRS introduced the fundamental public policy rule, it has almost exclusively used the rule to disallow the exemptions of racially discriminatory educational institutions.<sup>367</sup> In fact, the Free Exercise Clause of the Constitution probably would present a significant obstacle to the IRS from revoking a church's tax exemption.<sup>368</sup>

Why, then, would the Mormon church change its position on its racial restrictions? For much the same reason as Bob Jones University eventually did: immense public pressure. As the civil rights movement gained traction in the 1960s, the Mormon church faced immense criticism for its racist policy from liberal Christianity, the Utah branch of the NAACP, journalists, and even some prominent Mormons.<sup>369</sup> Opponents of the ban also targeted Brigham Young University ("BYU"), the Mormon church's flagship school.<sup>370</sup> When BYU athletes played other schools, opposing players often refused to play or wore black armbands in protest.<sup>371</sup> Stanford and the University of Washington severed their athletic relations with BYU entirely.<sup>372</sup> Still, in spite of the pressure, the racial ban survived the decade.<sup>373</sup>

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364. Brunson & Herzig, *supra* note 4, at 1190.

365. *Bob Jones Univ. v. United States*, 461 U.S. 574, 604 (1983). ("That governmental interest [in eradicating racial discrimination in education] substantially outweighs whatever burden denial of tax benefits places on petitioners' exercise of their religious beliefs.").

366. *Id.*

367. *See* Brunson & Herzig, *supra* note 4, at 1201–02.

368. *See id.*; Ira C. Lupu & Robert W. Tuttle, *The Mystery of Unanimity*, in *Hosanna-Tabor Evangelical Lutheran Church & School v. EEOC*, 20 LEWIS & CLARK L. REV. 1265, 1306 n.204 (2017) ("We are by no means recommending a revocation of tax-exempt status for entities that impose gender-based restrictions on ordination, and we think that such a move would indeed raise serious constitutional questions.").

369. Arman L. Mauss, *The Fading of the Pharaoh's Curse: The Decline and Fall of the Priesthood Ban Against Blacks in the Mormon Church*, 14 DIALOGUE: J. MORMON THOUGHT 10, 14–15 (1981).

370. Edward L. Kimball, *Spencer W. Kimball and the Revelation on Priesthood*, 47 BYU STUD. 5, 26 (2008).

371. *Id.*

372. *Id.*; Mauss, *supra* note 369, at 18.

373. Mauss, *supra* note 369, at 18 ("As the end of the decade approached, the Church was beginning to appear unassailable and impervious to all forms of outside pressure.").

Though the policy survived into the 1970s, the Mormon church continued to feel outside pressure to do away with it. When it built a church building in Manhattan, it faced scrutiny by African American community members and members of the city planning commission.<sup>374</sup> The Mormon Tabernacle Choir had to cancel a New England tour because of protests by black clergy in the area.<sup>375</sup> Even its relationship with the Boy Scouts of America put pressure on the church to change its policy.<sup>376</sup>

In addition, the church began to face significant internal and international pressure. Year after year, Mormon leaders received letters from would-be converts in Nigeria and Ghana asking for missionaries and asking how to respond to charges of institutional racism.<sup>377</sup> An attorney in Costa Rica sued, trying to disenfranchise the Mormon church for violating Costa Rican laws that prohibited racial discrimination.<sup>378</sup> And the ban began to create administrative problems for the Mormon church's expansion in Brazil, which had become a growth center for Mormons.<sup>379</sup>

In response to these internal and external, domestic and foreign, pressures, in 1978, the Mormon church relented.<sup>380</sup> It abandoned a policy that almost certainly violated a fundamental public policy, but it did so as a result of non-tax pressure. In fact, there is no reason to believe that the threat of losing its tax exemption would have been possible, much less important, to causing the Mormon church to change its policies.

That is not to say that the fundamental public policy doctrine has no persuasive power. But it is not clear that threatening to revoke an organization's tax-exempt status is the best way to put pressure on bad tax-exempt actors.

### C. *Subsidies for Governance*

Subsidies to tax-exempt organizations provide an important governance function: they encourage tax-exempt organizations to produce positive externalities.<sup>381</sup> They can also serve to discourage tax-exempt organizations from engaging in harmful behavior,

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374. *Id.* at 20.

375. *Id.*

376. *See id.*

377. Kimball, *supra* note 370, at 32.

378. *Id.* at 42.

379. *See* Mauss, *supra* note 369, at 24–25.

380. *See* Kimball, *supra* note 370, at 5.

381. David M. Schizer, *Subsidies and Nonprofit Governance: Comparing the Charitable Deduction with the Exemption for Endowment Income* 3 (Ctr. for Law & Econ. Studies, Columbia Univ. Sch. of Law, Working Paper No. 558, 2017), [https://papers.ssrn.com/sol3/papers2.cfm?abstract\\_id=2916882](https://papers.ssrn.com/sol3/papers2.cfm?abstract_id=2916882). A positive externality results when an actor cannot fully internalize the positive returns of her actions, and a third party also benefits from those actions.

including the violation of fundamental public policy.<sup>382</sup> Thus, the threat of losing a subsidy should prevent tax-exempt organizations from violating fundamental public policy.

In analyzing the role of subsidies, though, it is essential to keep clear what constitutes a subsidy and what does not. As we have demonstrated, the exemption of certain public charities is not a subsidy to those charities. Rather, they are exempt from the corporate income tax because they do not belong in the tax base.<sup>383</sup> The justifications for the corporate income tax do not apply, because taxing them does not represent a substitute for taxing individual income, and there are other, better ways that tax law can prevent managers from accumulating money and power.<sup>384</sup>

This does not mean that any and all organizations can be exempt from taxation provided that their assets and income do not inure to the benefit of any individual. Section 501(c)(3) includes other requirements, specifically that tax-exempt organizations must fulfill one or more of an enumerated set of charitable purposes.<sup>385</sup> This exempt-purpose requirement, combined with the unrelated business income tax, works to prevent organizations that belong in the corporate income tax base from avoiding tax.

The exempt-purpose requirement does not always work flawlessly, though. The IRS is famously underfunded<sup>386</sup> and cannot possibly do an in-depth review of each of the 101,962 applications for exemption that it processed in 2015,<sup>387</sup> much less closely monitor the more than one million tax-exempt organizations that file returns every year.<sup>388</sup> Sometimes, it may mistakenly grant a tax exemption to an organization that should not qualify.<sup>389</sup>

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382. Violating a fundamental public policy is not the only behavior that regulators can use the tax law to prevent. The same justification for regulating fundamental public policy through the tax law could also justify, for example, the prohibition on supporting or opposing candidates for office. I.R.C. § 501(c)(3) (2012). The same analysis we perform with respect to the fundamental public policy doctrine may also apply to other regulatory requirements imposed on tax-exempt organizations.

383. *Supra* Subpart III.C.1.

384. *Id.*

385. Nikki Usher & Michelle D. Layser, *The Quest to Save Journalism: A Legal Analysis of New Models for Newspapers from Nonprofit Tax-Exempt Organizations to L3Cs*, 2010 UTAH L. REV. 1315, 1332 (2010).

386. Francine J. Lipman, *Access to Tax InJustice*, 40 PEPP. L. REV. 1173, 1208 (2013).

387. IRS, 2015 DATA BOOK 57 (2016), <https://www.irs.gov/pub/irs-soi/15databk.pdf>.

388. Paul Arnsberger, *Nonprofit Charitable Organizations and Donor-Advised Funds, 2012*, 35 SOI BULLETIN 173, 173 (Winter 2016), <https://www.irs.gov/pub/irs-soi/16winbul.pdf>.

389. That may explain why the IRS has granted tax-exempt status to at least four white nationalist groups over the last decade. Michael Kunzelman, *White Nationalists Raise Millions with Tax-Exempt Charities*, ASSOCIATED PRESS (Dec.

Organizations can erroneously qualify as tax exempt. And where they do, the IRS should revoke their exemptions. It should not do so, though, because they violate a fundamental public policy but because, unlike qualifying charities, they belong in the tax base. As we have demonstrated earlier, if an organization does not belong in the tax base, it is not being subsidized by the government or by taxpayers. Thus, revoking its exemption *because it violates the fundamental public policy rule* misclassifies an organization.

Just because an organization does not fit in the tax base does not mean that it merits governmental subsidy, though. In fact, in its *Bob Jones University v. United States*<sup>390</sup> decision, the Fourth Circuit explicitly stated that the government had a policy “against subsidizing racial discrimination in education, public or private.”<sup>391</sup> And the Supreme Court has, in a nontax context, pointed out that, while the Constitution may require the state to tolerate certain violations of public policy, it is not required to provide support for such violations.<sup>392</sup>

Similarly, the government should continue to recognize the exempt nature of public charities that violate fundamental public policy. After all, their violation does not change the fact that they operate primarily for an exempt purpose<sup>393</sup> and that their profits do not inure to the benefit of individuals.

But the government should not subsidize bad behavior. And because deductible donations represent a subsidy,<sup>394</sup> eliminating the deductibility of donations to tax-exempt organizations fits precisely within the goals of the fundamental public policy rule. To avoid subsidizing tax-exempt entities that violate fundamental public policy, then, the IRS should begin disallowing those donors from deducting their donations.<sup>395</sup>

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22, 2016), <https://www.apnews.com/ae1c8163ac574bb3bd1f3facfa5fb83/White-nationalists-raise-millions-with-tax-exempt-charities>.

390. 639 F.2d 147 (4th Cir. 1980).

391. *Id.* at 151.

392. *Norwood v. Harrison*, 413 U.S. 455, 463 (1973) (“That the Constitution may compel toleration of private discrimination in some circumstances does not mean that it requires state support for such discrimination.”).

393. Again, we want to emphasize that not every organization qualifies as tax exempt, even if there is no private inurement. Section 501(c)(3) requires that tax-exempt entities pursue an enumerated exempt purpose. And that exempt purpose requirement is central to qualification, with or without the fundamental public policy rule applying at the qualification level. I.R.C. § 501(c)(3) (2012).

394. *See supra* Part IV.

395. The mechanics of such a disallowance are beyond the scope of this article, but there are many ways the IRS could implement the disallowance. It could keep a blacklist of tax-exempt organizations that are not eligible to receive deductible donations. It could require those organizations to inform donors and potential donors that their donations are not currently deductible. It could use a software solution to determine what taxpayers tried to deduct from their donations.

One advantage to focusing on the deductibility of donations is that disallowing the deductibility would not represent a death sentence to the tax-exempt entity. The entity, in other words, would have the ability, should it so desire, to come into compliance with fundamental public policy. Once the tax-exempt entity quits violating fundamental public policy, it should again receive the subsidies that other public charities receive. In other words, focusing the fundamental public policy rule on the deductibility of donations allows the fundamental public policy rule to function both as a stick and as a carrot. It not only punishes bad behavior but it rewards shedding that bad behavior.

*D. Tax Exemption Provides a Marketplace of Ideas*

Tax-exempt organizations play a unique role in American society. Because they do not distribute profits to shareholders or other individuals, they can operate outside of the normal market boundaries that constrain for-profit entities. This frees tax-exempt organizations to pursue unpopular ideas.

In fact, the IRS recognizes that, if an organization would otherwise qualify as tax-exempt, the unpopularity of the viewpoints it espouses should not disqualify it.<sup>396</sup> To prevent its agents' biases from interfering with an otherwise-qualifying organization, the IRS issued a procedure to ensure that it demonstrated "disinterested neutrality with respect to the beliefs advocated by an organization."<sup>397</sup>

Why is it important that tax-exempt organizations be permitted to pursue unpopular ideas? The Supreme Court recognized that "[t]he [tax-exempt] classroom is peculiarly the 'marketplace of ideas.'"<sup>398</sup> Moving forward, American society "depends upon leaders trained through wide exposure to that robust exchange of ideas which discovers truth 'out of a multitude of tongues, (rather) than through any kind of authoritative selection.'"<sup>399</sup>

Similarly, museums, dance companies, and even churches expose individuals to ideas that the market may be unwilling to support.<sup>400</sup> Yet nonprofit organizations have been central in a number of

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396. Beth A. Sabbath, *Tax Exempt Political Educational Organizations: Is the Exemption Being Abused?*, 41 TAX LAW. 847, 850 (1988).

397. Rev. Proc. 86-43 § 2.02, 1986-2 C.B. 729.

398. *Keyishian v. Bd. of Regents of the Univ. of the State of N.Y.*, 385 U.S. 589, 603 (1967).

399. *Id.*

400. Traditionally, the story of government support of the arts has been a story of market failure. The market failure story depends on a robust theory of the welfare state, though, a theory the grip of which has become more tenuous in recent years. Even without market failure, though, there is a degree of path dependency that means the market is unlikely to fully support nonprofit organization. Annette Zimmer & Stefan Toepler, *The Subsidized Muse: Government and the Arts in Western Europe and the United States*, 23 J. CULTURAL ECON. 33, 34-36 (1999).



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important cultural shifts because they were able to espouse opinions that were unpopular at the time.<sup>401</sup> The “comeouter” movement of the nineteenth century, for example, saw abolitionists create new churches that would “attempt to reform public opinion in areas neglected by institutional Protestantism.”<sup>402</sup>

Abolitionist churches were not exempt from the federal income tax, of course, because there was no antebellum federal income tax.<sup>403</sup> But these types of public charities have continued to advocate for unpopular positions into the twentieth century and beyond.<sup>404</sup> African American churches, for example, were central in the fight for civil rights.<sup>405</sup> And even today, tax-exempt organizations like the Gay & Lesbian Alliance Against Defamation (“GLAAD”) fight for LGBTQ+ rights.<sup>406</sup>

Charitable organizations that advocate social change have a sword hanging over their heads; as they advocate positions that may be at odds with society, they risk losing their tax exemptions. And that risk has a real chilling effect on their activities.<sup>407</sup> The ability of tax-exempt organizations to espouse opinions that are unsupported in the normal market economy provides them with the unique ability and duty to function as a marketplace of ideas. Where they risk losing their tax exemption for espousing such ideas, society risks losing new and potentially valuable ideas.

## CONCLUSION

Ultimately, if we allow tax-exempt organizations to explore ideas, some will advocate things that society opposes. The National Policy Institute, for example, is a think tank based in Arlington, Virginia.<sup>408</sup> The think tank is “dedicated to the heritage, identity, and future of

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401. For example, in *In re Strittmater*, 53 A.2d 205 (N.J. 1947), the New Jersey Supreme Court disqualified a bequest of an estate to the National Women’s Party on the grounds of insane delusion. The National Woman’s Party was founded in 1917 by Alice Paul to advocate for woman’s suffrage. After the ratification of the Nineteenth Amendment, the organization turned to the Equal Rights Amendment. *National Woman’s Party*, NAT’L WOMAN’S PARTY, <http://nationalwomansparty.org/learn/national-womans-party/> (last visited Dec. 14, 2017). Despite the tangible successes of the National Woman’s Party, giving to the organization was part of a psyche of an insane person according to the New Jersey Supreme Court. *In re Strittmater*, 53 A.2d at 205–06.

402. Ryan Jordan, *Quakers, “Comeouters,” and the Meaning of Abolitionism in the Antebellum Free States*, 24 J. EARLY REPUBLIC 587, 588 (2004).

403. Vaughn E. James, *The African-American Church, Political Activity, and Tax Exemption*, 37 SETON HALL L. REV. 371, 375–76 (2007).

404. *Id.* at 393.

405. *Id.* at 393–94.

406. GLAAD has been tax-exempt since 1989. *GLAAD Inc.*, GUIDESTAR, <https://www.guidestar.org/profile/13-3384027> (last visited Dec. 14, 2017).

407. See James, *supra* note 403, at 402–03.

408. NAT’L POL’Y INST., <https://nationalpolicy.institute> (last visited Dec. 14, 2017).

people of European descent in the United States, and around the world.”<sup>409</sup> The National Policy Institute is exempt from taxation under § 501(c)(3).<sup>410</sup>

On the opposite side of the moral spectrum lies the Council on American-Islamic Relations. It was founded in 1994 as a civil rights and advocacy group.<sup>411</sup> It qualifies as a § 501(c)(3) tax-exempt organization.<sup>412</sup> According to its web site, the Council on American-Islamic Relations “seeks to empower the American Muslim community and encourage their participation in political and social activism.”<sup>413</sup>

There is a qualitative difference between these two organizations. According to the Southern Poverty Law Center, the National Policy Institute is a white supremacist organization run by Richard Spencer, a well-known white supremacist.<sup>414</sup> It does nothing to conceal the fact that it has this specific mission. On the other hand, the Council on American-Islamic Relations is perceived as a progressive organization intended to benefit society.

We argue that, provided it otherwise qualifies for exemption, allowing the National Policy Institute tax-exempt status is not per se problematic.<sup>415</sup> While its purpose and mission may be despicable, as part of a pluralist society allowing minority viewpoints is important. Among other things, there is no assurance that society’s norms will always move in a progressive direction. President Trump ran and won the election partially on a platform of anti-Islam and anti-immigration from Islamic countries. Since the election, one of the first executive orders that President Trump executed was an

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409. *See id.*

410. Kunzelman, *supra* note 389. Note that just because the National Policy Institute has a tax exemption does not mean that exemption is warranted. If the organization does not have a qualifying charitable mission, it should not be exempt, even under our proposal.

411. *CAIR at a Glance*, CAIR, <https://www.cair.com/about-us/cair-at-a-glance.html> (last updated May 13, 2015).

412. *Id.*

413. *Id.*

414. *Richard Bertrand Spencer*, SOUTHERN POVERTY L. CTR., <https://www.splcenter.org/fighting-hate/extremist-files/individual/richard-bertrand-spencer-0> (last visited Dec. 14, 2017) (“[T]o elevate the consciousness of whites, ensure our biological and cultural continuity, and protect our civil rights. The institute . . . will study the consequences of the ongoing influx that non-Western populations pose to our national identity.”).

415. As a matter of fact, the National Policy Institute lost its tax-exempt status in February 2017, effective as of May 15, 2016. Matt Pearce, *IRS Strips Tax-Exempt Status from Richard Spencer’s White Nationalist Nonprofit*, L.A. TIMES (Mar. 13, 2017), <http://www.latimes.com/nation/la-na-richard-spencer-taxes-20170223-story.html>. It did not lose its exemption as a result of violating fundamental public policy, though. *Id.* Rather, it lost it for the mundane reason that it failed to file a Form 990 with the IRS for three years in a row. *Id.* Failure to file for three years automatically results in a tax-exempt organization’s losing its exemption. I.R.C. § 6033(j)(1) (2012).

immigration ban from a series of Islamic countries.<sup>416</sup> To the extent that tax exemption relies on the shifting sands of fundamental public policy, it is possible that the Council on American-Islamic Relations could fall out of societal favor and lose its exemption.<sup>417</sup> Although this would be a bad result, it nevertheless represents a possible future.

Additionally, neither the 1950s' formation of the NAACP nor the 1970s' formation of the Lambda Legal Defense Fund were considered "popular" or majority positions. In 1977, Gallup started polling whether same-sex marriage should be allowed.<sup>418</sup> Between 1977 and 1997, the poll numbers started at 43% and fell to as low as 32% with a high of 47%.<sup>419</sup>

Not only does applying the fundamental public policy rule risk punishing valuable minority voices but, as we have demonstrated, it does not comport with tax policy. The corporate income tax was designed to reach shareholder money and to regulate corporate behavior. For tax-exempt organizations, there is no shareholder money to reach, and the current exemption regime, combined with state nonprofit laws, appropriately regulates tax-exempt organizations' behavior.

That is not to say, of course, that society needs to subsidize tax-exempt organizations that violate fundamental public policy. But exemption is not a subsidy. Rather, it accurately reflects the corporate income tax base. Subsidization occurs when donors are permitted to deduct their donations. To the extent we want to allow a space for minority viewpoints while, at the same time, we do not want to subsidize speech that is opprobrious to society, the IRS should apply the fundamental public policy rule to § 170 of the Code. By disallowing deductible donations to bad organizations, Americans do not have to worry about subsidizing their bad speech.

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416. Ariane de Vogue et al., *US President Donald Trump Signs New Travel Ban, Exempts Iraq*, CNN (Mar. 7, 2017), <http://www.cnn.com/2017/03/06/politics/trump-travel-ban-iraq/index.html>.

417. Ben Carson has come out demanding the IRS take action against the group to remove CAIR's tax-exempt status. Bradford Richardson, *Carson: Pro-Islam Nonprofit Broke the Law with Political Attack*, HILL (Oct. 3, 2015), <http://thehill.com/blogs/ballot-box/gop-primaries/255857-carson-pro-islam-nonprofit-broke-the-law-with-political-attack>.

418. Lydia Saad, *Americans Evenly Divided on Morality of Homosexuality*, GALLUP (June 18, 2008), <http://www.gallup.com/poll/108115/americans-evenly-divided-morality-homosexuality.aspx>.

419. *Id.* The percentage of Americans who favored same-sex marriage was equally low—at about 35%—when Pew started polling in 2001. *Changing Attitudes on Gay Marriage*, PEW RES. CTR. (June 26, 2015), <http://www.pewforum.org/2016/05/12/changing-attitudes-on-gay-marriage/>.