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ARTICLES

ADHERING TO THE OLD LINE: UNCOVERING THE HISTORY AND POLITICAL FUNCTION OF THE UNRELATED BUSINESS INCOME TAX

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ABSTRACT

This Article examines the history of the building pressure during the 1940s to tax charities' business income and finds that the traditional explanations hide an underlying political function. As the charitable exemption became more important with the expansion of the income tax in the 1940s, it attracted new attention from both policymakers and a growing tax-shelter industry. Charities and sympathetic policymakers tried to justify a suddenly important blanket subsidy to charity on the basis of the charities' exclusive dedication to good works. Tax-shelter promoters made the effort more difficult by featuring charities in roles, such as buying and leasing commercial real estate and operating businesses, distinctly incompatible with traditional perceptions of charitable activities. The "unrelated business income tax" (UBIT) prevents this cognitive dissonance. It discourages activities that make charities look uncomfortably uncharitable by taxing them, while simultaneously leaving exempt the "old line" of passive investment and business activities related to an exempt purpose.

"The action taken is so extraordinary and so revolutionary . . . that it occurs to me probably the whole system of tax exemption for educational and charitable organizations might seriously be threatened if this precedent is allowed to spread. I think that the trustees of your alumni fund ought to look over the situation very carefully to see whether . . . it is not better for you to adhere to the old line rather than to go out into the competitive business field the way you have done." Congressman Walter A. Lynch, 1947.¹

"Noncompliance involving tax-exempt entities is especially disturbing because it involves organizations that are supposed to be carrying out some special or beneficial public purpose." Mark Everson, Commissioner of Internal Revenue, 2004.²

¹ *Proposed Revisions of the Internal Revenue Code: Hearings Before the H. Comm. on Ways and Means*, 80th Cong. 3535 (1947) [hereinafter *1947 Hearings*].

² *Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities: Hearings Before the S. Comm. on Finance*, 108th Cong. 5 (2004) [hereinafter *2004 House Hearings*].

INTRODUCTION

As the above quotes illustrate, policymakers can get emotional when they find tax-exempt charities³ acting in ways that do not fit their perceptions of what charities do. Policymakers and the public alike have a perception that “charity” means selfless dedication to the public good. When that perception is shaken, a political reaction to stop the unseemly behavior and resolve the cognitive dissonance is likely. Such sentiment has been running high again lately. In June 2004, the Senate Finance Committee held hearings on self-dealing and tax shelter facilitation at nonprofits and the staff released a white paper, which proposed a broad-based crackdown on charities.⁴ In April 2005, the Senate Finance Committee and the House Ways and Means Committee both held hearings on problems with charities.⁵ The following month, the House Ways and Means Committee held further hearings on nonprofit hospitals.⁶ The American Jobs Creation Act of 2004 included provisions aimed at certain well-publicized tax shelters involving the purported sale-leasebacks of government infrastructure,⁷ as well as abuses involving non-cash charitable donations.⁸ The broader proposals regarding the regulation of charities and their governance are under consideration, and it appears that further legislation may be in the offing.⁹

³ I will generally refer to organizations exempt from taxation under section 501(c)(3) of the Internal Revenue Code as “charities,” and to the exemption under section 501(c)(3) as “the charitable exemption” or the “exemption.” Except as specifically indicated, references to “the Code,” “I.R.C.” and section references without further explanation refer to sections of the 2000 volume of United States Code title 26. References to “Treas. Reg.” refer to sections of the 2005 volume of Code of Federal Regulations title 26.

⁴ See *2004 House Hearings*, *supra* note 2; U.S. Senate Comm. on Finance, *Staff Discussion Draft*, June 21, 2004, *witness statements available at* <http://finance.senate.gov/hearings/testimony/2004test/062204stfdi.pdf> [hereinafter Finance Committee, *Staff Discussion Draft*].

⁵ See *Overview of the Tax-Exempt Sector: Hearing Before the H. Comm. on Ways and Means*, 109th Cong. (2005), *witness statements available at* <http://waysandmeans.house.gov/hearings.asp?formmode=detail&hearing=400>; *Charities and Charitable Giving: Proposals for Reform: Hearing Before the S. Comm. on Finance*, 109th Cong. (2005), *available at* <http://finance.senate.gov/sitepages/hearing030505.htm>.

⁶ See *The Tax-Exempt Hospital Sector: Hearing Before the H. Comm. on Ways and Means*, 109th Cong. (May 26, 2005), *witness statements available at* <http://waysandmeans.house.gov/hearings.asp?formmode=detail&hearing=415>.

⁷ See American Jobs Creation Act of 2004, Pub. L. No. 108-357 §§ 847–49, 118 Stat. 1418, 1601–07.

⁸ *Id.* §§ 882–84, 118 Stat. 1418, 1627–34.

⁹ See Remarks of Sen. Chuck Grassley, News Conference on the Panel on the Nonprofit Sector’s Final Report (June 22, 2005), *available at* <http://finance.senate.gov/press/Gpress/2005/prg062205.pdf> (“This report today will be of great use as the Finance Committee—in a bipartisan basis with Senator Baucus—now begins drafting legislation.”).

As the above quotes also indicate, this dynamic is not new. In this Article, however, I argue that that it was new in the 1940s. Before World War II, those who bothered to explain the charitable exemption from the federal income tax described it as a subsidy to charity, but very few bothered to explain it. It was a traditional exception to a relatively minor tax, and no one gave it much thought. This changed with the vast expansion of the income tax during World War II. As the tax expanded, tax exemptions became newly valuable and attracted new attention.

In particular, the charitable tax exemption attracted the attention of tax shelter promoters, who realized for the first time that a person who does not pay taxes is handy for facilitating tax avoidance by persons who do. The first two waves of this perennial form of tax shelter—the sale-leaseback and the bootstrap purchase—arose in the mid-1940s. In each case, an exempt party “bought” income-producing property from a taxable seller and then “leased” it back to the seller (or close affiliate), leaving the seller with a tax-advantaged income stream and the charity with a small fee for the use of its exemption.

With new importance came new attention. The attention, however, did not result from a technical analysis of the new tax shelters, nor did it cause a fundamental rethinking of the policy of subsidizing charities with an income-tax exemption. To the contrary, it arose from nonanalytical discomfort with charities’ strange new activities—buying commercial real estate and businesses—that challenged public perceptions of the kind of activity the exemption subsidized. In focusing on these uncharity-like activities, policymakers and the press largely ignored the tax shelters. Instead of aiming their anger and legislative efforts at taxable people avoiding taxes, they became incensed at the inappropriate activities of charities and looked for ways to stop those activities.

The denouement of this confrontation between perceptions of the charitable exemption and its reality was the passage of the “unrelated business income tax” (UBIT) in 1950. The original UBIT taxed the income of certain tax-exempt charities to the extent the income derived from the active conduct of a business unrelated to the charity’s exempt purpose. The UBIT was justified then and has been justified since as a measure to protect taxable businesses from unfair tax-exempt competition and to protect against erosion of the tax base by rapacious charities buying or crushing taxable businesses. Below the surface, however, its primary function has been political symbolism. It deters

charities from engaging in activities that do not comport with policymakers' perceptions of the type of activity subsidized by the charitable exemption.

Understanding this explains one of the longstanding puzzles of the charitable income tax exemption: the UBIT's inconsistency with its stated goals. Prior commentators, from the 1940s until today, have generally approached this puzzle from an ahistorical perspective. They have analyzed the exemption and the UBIT, looking for underlying economically rational policies. They have then proposed reforms to resolve inconsistencies between the statute and its presumed policy rationales. In this Article, I propose a very different role for the UBIT as a political expedient for avoiding an instrumental policy analysis of the charitable exemption, rather than the considered result of such an analysis. In other words, the UBIT protects the symbolic meaning of the exemption, rather than an instrumental policy goal.

The importance of this historical context is that the political dynamics of the 1940s continue to characterize exemption policy today. First, understanding the history and political function of the exemption and the UBIT has important implications for proposals to reform them. Reform proposals misconceive the problem when they suggest ways of conforming the exemption or the UBIT to presumed efficient economic policy objectives. As a consequence, they propose reforms that do not resonate with policymakers. Different arguments are necessary to reform a law sustained, not by economic analysis, but by strong inherited perceptions about charities. Legal change, for better or worse, is likely to come from events or arguments that shake perceptions about the kind of activities subsidized by the exemption. Second, the cautionary lesson of the 1940s for today's policymakers is clear. When charities' perceived misbehavior mixes with tax avoidance, it is tempting for policymakers to focus so closely on bringing the charities' behavior back to "the old line" that they fail to address the underlying mechanisms of tax avoidance.

The argument will proceed as follows: Part I introduces the charitable exemption and the UBIT. This Part also reviews the existing theories explaining the charitable exemption and the UBIT and discusses the standard, but largely unexamined, understanding of their history. Part II reviews the standard critiques of the UBIT's traditional justifications—preventing unfair competition and protecting the corporate income tax base. I then look at the detailed historical record to show that these traditional justifications are more problematic than prior commentators have realized. Importantly, there were

no taxpayers complaining about unfair competition from charities in the 1940s, although the parallel debate over the tax advantages of cooperatives drew massive organized protest. Likewise, policymakers in the 1940s were fully aware of the standard critiques and consistently ignored them. Part III builds on the expanded critique of the UBIT's traditional justifications in Part II to propose an alternative explanation for the UBIT. I show that the UBIT was a political reaction to end activities by charities that did not comport with the public perceptions supporting the exemption.

I. BACKGROUND

A. *The Charitable Tax Exemption*

Section 501(c)(3) of the Internal Revenue Code exempts certain “charitable” organizations from the federal income tax.¹⁰ The Code imposes two principal requirements for exemption—nonprofit form and exempt purpose.¹¹ The first constraint is that the exempt organization must be organized in nonprofit form, such that its earnings cannot inure to private benefit.¹² Henry Hansmann has dubbed this the “nondistribution constraint.”¹³ The second requirement for exemption is that the organization must be organized and operated exclusively for a statutorily-defined exempt purpose.¹⁴ The list of exempt purposes was typical of state nonprofit corporation statutes at the time the exemption was enacted.¹⁵ The key word is “charitable.” Courts interpreting the law of charitable trusts have generally interpreted the term broadly, looking for purposes “designed to accomplish objects that are beneficial to the community—i.e., to the public or indefinite members

¹⁰ The statute lists several other specific types of organizations and other subsections of section 501 exempt a variety of other organizations. I.R.C. § 501. I concentrate on the charitable exemption, although much of what is true of this exemption is equally true of other subsections.

¹¹ A third constraint prohibits certain political activities. *See* I.R.C. § 501(c)(3). The extent and purpose of this prohibition is very murky and controversial and beyond the scope of this Article, which does not purport to explain every provision of 501(c)(3), but rather to explain the new significance several of its provisions took on as the tax background changed during World War II and the resulting need for the UBIT.

¹² Section 501(c)(3) exempts only organizations “no part of the net earnings of which inures to the benefit of any private shareholder or individual.”

¹³ Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 *YALE L.J.* 835, 838 (1980) [hereinafter Hansmann, *Role of Nonprofit Enterprise*].

¹⁴ Section 501(c)(3) exempts only organizations “organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals.”

¹⁵ *See* Note, *Permissible Purposes for Nonprofit Corporations*, 51 *COLUM. L. REV.* 889, 890–94 (1951).

thereof—without also serving what amount to private trust purposes.”¹⁶ The Treasury has long adopted this interpretation in construing the exempt purposes requirement.¹⁷ Both of these constraints derive from traditional common law constraints on charitable trusts and corporations.¹⁸

To the extent charities use their business and investment income to provide levels of charitable activities (whether revenue-generating or not) that are not justified from a pure profit-loss perspective, the charitable exemption subsidizes the provision of such activities by organizations that have such income. The charitable exemption can also be, in practical effect, a subsidy to the cost of capital of exempt organizations in carrying out their business and investment activities. A taxable corporation has profitably invested capital in its business only if its after-tax return from that investment equals its “cost of capital.” If the capital is provided by a third party as debt or equity, the cost of capital is the return it must pay to the person providing the capital. If the capital comes from the corporation’s own retained earnings, the cost of capital is the opportunity cost—the return a third party would have paid for use of that capital. The charitable exemption does not subsidize debt capital, because taxable corporations can deduct interest paid from their taxable income. It does, however, subsidize capital from donations (equity)¹⁹ and retained earnings. For these sources of capital, the charity’s cost of capital is lower than that of a taxable person because its after-tax return on internal investment is higher than the return a taxable person could pay for using the same capital in the same investment. By lowering the cost of capital, the charitable exemption subsidizes charities, transferring economic value to charities, relative to taxpayers and at taxpayers’ collective expense.²⁰

¹⁶ RESTATEMENT (THIRD) OF TRUSTS § 28 cmt. a (2003) (citation omitted).

¹⁷ See Treas. Reg. § 1.501(c)(3)–1(d)(1). This regulation was first adopted in 1959. See T.D. 6391, 1959-2 C.B. 139, 144.

¹⁸ See RESTATEMENT (THIRD) OF TRUSTS § 28 (2003) (charitable purposes). The prohibition on private inurement of profits is not an explicit part of the law of charitable trusts, but is implicit because the laws governing charitable trusts (such as perpetual existence) do not apply to trusts with individual beneficiaries. See *id.* §§ 1 cmt. c, 28 cmt. e.

¹⁹ Rob Atkinson has demonstrated that an important function of nonprofit organizations is to facilitate altruistic investment of capital. See Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 567 (1990). Such altruistic investments are effectively the equity capital of donative nonprofit organizations such as charities.

²⁰ Boris Bittker and George Rahdert argued that the exemption was not a subsidy but a recognition that charities simply did not have “income” within the meaning of the federal income tax. Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299 (1976). This argument does not withstand much scrutiny and has not been taken seriously since Henry Hansmann effectively rebutted it in 1981. See Henry B. Hansmann, *The Rationale for Exempting Nonprofit*

B. *The Unrelated Business Income Tax (UBIT)*

Exempt organizations owe a tax on their “unrelated business taxable income.”²¹ UBIT is levied at either the corporate or trust rates, depending on the nature of the exempt organization.²² The UBIT applies only if three conditions are met. First, the exempt organization must have income from the conduct of a business. Second, the business must be regularly carried on by the exempt organization. Finally, the business must not be substantially related (except as a source of funds) to the exempt organization’s performance of its exempt functions.²³ In addition to these restrictions, dividends, interest, loan proceeds, annuity payments, royalties, rents, capital gains, and certain other categories of “passive” income are specifically excluded from the tax.²⁴

Accordingly, for UBIT purposes, income is first divided into tax-free “passive” income (income from sources fitting into the passive income exceptions) and potentially taxable “active” income (income from all other sources). Active income is further divided into tax-free “related” income (from the active conduct of a business related to an exempt purpose) and taxable “unrelated” income (from all other active business endeavors).

The classic example, whose importance in passing the UBIT will be discussed below, is New York University’s (NYU) acquisition of the Mueller noodle company in 1947.²⁵ The Mueller acquisition provides an easy framework to illustrate these distinctions. If NYU earns income by operating the C.F. Mueller pasta factory, that business is regularly carried on and bears no relationship to the educational purpose of NYU. The income is taxable under the UBIT. By contrast, if NYU’s student dining hall makes its own pasta and sells it to students on the meal plan, NYU is regularly carrying on a business, but the business is also related to NYU’s exempt purpose. The UBIT does not apply. Similarly, if NYU receives dividends on the publicly-traded

Organizations from Corporate Income Taxation, 91 YALE L.J. 54, 58–62 (1981) [hereinafter Hansmann, *Rationale for Exempting*].

²¹ See I.R.C. § 511. Generally speaking, “unrelated business taxable income” (UBTI) is adjusted gross income less deductible expenses directly related to an unrelated business. See *id.* §§ 512(a), 513(a).

²² See I.R.C. § 511(a)(1) (referencing I.R.C. § 11 for exempt organizations formed as corporations); *id.* § 511(b)(1) (referencing I.R.C. § 1(e) for exempt organizations formed as trusts).

²³ See *id.* §§ 512(a), 513(a); Treas. Reg. § 1.513-1(a).

²⁴ See I.R.C. § 512(b)(1); Treas. Reg. § 1.512(b)1. A significant exception to these rules can arise if the exempt organization is deemed to have financed the acquisition of income-producing property with debt. See I.R.C. § 514.

²⁵ See *Law School to Get Company’s Profits*, N.Y. TIMES, Oct. 3, 1947, at 27. For further discussion of the role of the Mueller acquisition, see *infra* notes 242–253 and accompanying text.

common stock of the American Italian Pasta Company or interest from that company's bonds, that income is once again earned from an unrelated business regularly carried on (assuming NYU continuously maintains a portfolio of securities), but it fits into the passive income exceptions to the UBIT. The UBIT does not apply. Finally, if the C.F. Mueller Company donates money to NYU to create an endowed tax chair, the income does not derive from the conduct of a business. The UBIT does not apply.

There are a number of other specific exceptions to the UBIT. For instance, student cafeterias, university bookstores, and other businesses "primarily for the convenience of [the exempt organization's] members, students, patients, officers, or employees" are exempt.²⁶

The UBIT also taxes income from debt-financed investment property to the extent of the acquisition indebtedness relative to basis in the property.²⁷ For instance, if NYU purchases an industrial building for cash and leases it out to the C.F. Mueller Co. for use as a spaghetti factory, NYU's rental income fits into the passive income exceptions to the UBIT. The UBIT does not apply. If NYU finances eighty percent of the purchase price with a bank loan, however, the property is debt-financed. The UBIT applies to eighty percent of its rental income initially and a lower percentage over time, as NYU pays down the mortgage and builds equity. The current debt-financed income rules date from the 1969 tax reform. The predecessor provision to section 514, passed with the original UBIT in 1950, operated in a similar fashion. The 1950 version, however, applied only to rental income from leases of real property longer than five years.²⁸

C. *Standard History of the UBIT*

Commentators have given very little thought to explaining the origin of the UBIT, although considerable effort has been devoted to criticizing it. The standard story of the UBIT has been told often, but rarely in any detail.²⁹ In

²⁶ See I.R.C. § 513(a)(2).

²⁷ See I.R.C. §§ 512(b)(4), 514.

²⁸ See Revenue Act of 1950, Pub. L. No. 81-814, §§ 422(a)(4), 423, 64 Stat. 906, 949, 950-52.

²⁹ See BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 744 (8th ed. 2003); Bittker & Rahdert, *supra* note 20, at 316-20; Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. CORP. L. 585, 605-06 (1998); John Copeland & Gabriel Rudney, *Business Income of Nonprofits and Competitive Advantage*, 33 TAX NOTES 747, 749-50 (1986); Harvey P. Dale, *About the UBIT...*, 18 N.Y.U. CONF. ON TAX PLANNING FOR 501(C)(3) ORG. 9-1, 9-3 to 9-8 (1990); Kenneth C. Eliasberg, *Charity and Commerce: Section 510(c)(3)—How Much Unrelated Business Activity?*, 21 TAX. L. REV. 53, 74-76 (1965); Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax*

this section, I will summarize this standard account as background for more detailed historical explorations to follow.

The standard story of the UBIT begins with the Supreme Court's decision in *Trinidad v. Sagrada Orden de Predicadores*³⁰ and the "destination of income" test.³¹ As discussed above,³² an organization is only exempt if it is organized and operated "exclusively" for an exempt purpose. This requirement implies that an organization that engaged in any kind of non-exempt activity (such as running a business or investing in real estate or securities) might not be exempt, even if it dedicated the proceeds exclusively to exempt purposes. This issue reached the Supreme Court in *Sagrada Orden de Predicadores*, in which the colonial government of the Philippines attempted to deny exemption to the Dominican Order, citing its extensive land holdings and investments, as well as some minor retail activities. Although the exact meaning of the Court's decision has never been clear, it spawned a line of cases holding that the exclusivity requirement applied to the manner in which an organization used its funds (the "destination" of its income), rather than the activities it engaged in to raise funds (the "source" of the income).

Accordingly, a tax-exempt organization could raise money for its exempt activities by engaging in business activities unrelated to those exempt activities.³³ The high-water mark (so to speak) for this doctrine was the

Exemption, 52 OHIO ST. L.J. 1379, 1442–43 (1991); Richard L. Kaplan, *Intercollegiate Athletics and the Unrelated Business Income Tax*, 80 COLUM. L. REV. 1430, 1432–34 (1980); Donald L. Sharpe, *Unfair Business Competition and the Tax on Income Destined for Charity: Forty-Six Years Later*, 3 FLA. TAX REV. 367, 370–71, 380–85 (1996); Note, *The Macaroni Monopoly: The Developing Concept of Unrelated Business Income of Exempt Organizations*, 81 HARV. L. REV. 1280, 1280–82 (1968); Comment, *Colleges, Charities and the Revenue Act of 1950*, 60 YALE L.J. 851, 853 (1951). Of these, Eliasberg's is the only serious historical study.

³⁰ 263 U.S. 578 (1924).

³¹ See Dale, *supra* note 29, at 9-3 to 9-5; Eliasberg, *supra* note 29, at 60–74; Sharpe, *supra* note 29, at 380–81.

³² See *supra* notes 14–17 and accompanying text.

³³ See *Sand Springs Home v. Comm'r*, 6 B.T.A. 198, 214 (1927) (upholding exemption of income from various active enterprises); *Appeal of Unity Sch. of Christianity*, 4 B.T.A. 61, 68 (1926) (upholding exemption of earnings from publications and an inn). This was probably a misreading of the Court's holding in *Sagrada Orden de Predicadores*. The Court unequivocally rejected the government's arguments that passive investment income was taxable. *Sagrada Orden de Predicadores*, 263 U.S. at 582. With regard to the active sale of goods, the Court held that the order's activities did not "amount to engaging in trade in any proper sense of the term." *Id.* Second, all of the items were either "for strictly religious use [or] for uses which are purely incidental to the work which the [order] is carrying on." *Id.* Third, the transactions apparently were not carried out for the purpose of financial gain. *Id.* The implication of the Court's holding was that a charity that had a significant active business for profit with the general public would not be exempt from income tax. Contemporary observers were not nearly as certain as modern observers that there ever was a secure

Second Circuit's 1939 *Roche's Beach* decision, in which the Second Circuit upheld the exemption of a corporation whose only activity was to hold and operate a commercial beach because its charter required all profits to be used for charity.³⁴

In 1942, the Bureau of Internal Revenue withdrew its acquiescence to the *Roche's Beach* decision. The same year, Randolph Paul, then Tax Advisor to the Secretary of the Treasury, complained to the House Ways and Means Committee that charities, in particular universities, were abusing their exemptions and competing with taxable businesses. Paul then proposed a tax on income from businesses unrelated to an exempt purpose.³⁵

Nothing resulted from the 1942 suggestion.³⁶ After NYU announced the Mueller acquisition in 1947, however, the House Ways and Means Committee

"destination of income" test. See, e.g., George R. Blodgett, *Charities in Business*, 8 N.Y.U. ANN. INST. ON FED. TAX'N 1133, 1136 (1950); Comment, *supra* note 29, at 862-63.

³⁴ See *Roche's Beach, Inc. v. Comm'r*, 96 F.2d 776 (2d Cir. 1938).

³⁵ *Revenue Revision of 1942: Hearings Before the H. Comm. on Ways and Means*, 77th Cong. 89 (1942).

³⁶ During the UBIT hearings in 1950, Vance Kirby, the Treasury's Tax Legislative Counsel, mentioned that Paul had made a "similar proposal" in 1942. *Revenue Revision of 1950: Hearing Before the H. Comm. on Ways and Means*, 81st Cong. 165 (1950) [hereinafter *1950 House Hearings*]. He was undoubtedly right that the 1950 proposal owed its form in part to Paul's enigmatic 1942 statement. Paul's suggestion got a frosty reception at the time, however. There was a complete disconnect between it and the real push for the UBIT, which did not start until after the 1947 hearings. See Randolph Paul, *The Justifiability of the Policy of Exempting Farmers' Marketing and Purchasing Cooperative Organizations from Federal Income Taxes*, 29 MINN. L. REV. 343, 361 (1945) ("A proposal by the Treasury Department, in connection with the Revenue Act of 1942, that the business income of educational and other organizations be subjected to income tax was summarily rejected by Congress."). Kenneth Eliasberg surmised that Paul's testimony prompted Congress to seek more information by requiring exempt organizations to file information returns for the first time in the Tax Revenue Act of 1943. See Eliasberg, *supra* note 29, at 75. Eliasberg was probably confused by the title of that Act. The 1943 Act actually passed in early 1944 and Paul gave his testimony (with respect to the 1942 Act) almost two years earlier, leaving any causal connection very tenuous. The committee reports on the 1943 Act did, as Eliasberg noted, refer to concerns about exempt organizations and explain the new information return requirement as an attempt to obtain better information on which to act. See H.R. REP. NO. 78-871, at 24-25 (1943); S. REP. NO. 78-627, at 21 (1943). This language was probably aimed at cooperatives, which the 1943 Act required to file returns, rather than at organizations cited by Paul (universities and churches), which did not have to file returns under the 1943 Act. See Revenue Act of 1943, Pub. L. No. 78-235, § 117(a), 58 Stat. 21, 36-37 (1944). The NTEA, discussed further *infra* notes 98-110, had already begun its agitation against cooperatives in late 1943 and publicly claimed credit for the information return provision. See *Roberts Dairy Co. v. Comm'r*, 195 F.2d 948, 950 (8th Cir. 1952); *Co-op Unlimited*, BUS. WK., Mar. 18, 1944, at 102, 107. It is also worth noting that Paul's remarks before the House Ways and Means Committee do not seem to have reflected settled policy even within the Treasury. In the immediate aftermath of his testimony, the Treasury's Division of Tax Research produced two internal reports on the proposal, both arguing against it. William J. Shultz, Exemptions Under I.R.C. Sec. 101 (June 27, 1942) [hereinafter Shultz Report] (on file with the National Archives at College Park, MD (NACP), Record Group 56, Dep't of the Treas., Entry 682); Office of Tax Policy, Subject Files, 1913-72, HA8 Exempt Organizations, [hereinafter OTA Archives], Box 18, Folder 3 - Section 101 Exemptions (study by Mr. Shultz, April 30, 1942); Dep't of the Treas., Div. of Tax

held hearings, concerned over perceived evidence that charities were acquiring businesses in competition with taxpaying businesses.³⁷ Those hearings failed to produce legislation largely because the Treasury was not prepared to take a position.³⁸ By 1950, however, concern was mounting that charities were abusing their tax exemption by acquiring and running businesses in unfair competition with taxpaying competitors and to the detriment of federal tax revenues. President Truman proposed the UBIT and Congress passed it to deal with the problem.³⁹ The original UBIT applied to most charities, but left out churches and many other categories of tax-exempt organizations.

Nineteen years later, charitable abuses were mounting again. Certain charities, most prominently the University Hill Foundation, began to purchase businesses in so-called “bootstrap” transactions, designed to evade the UBIT.⁴⁰ The Treasury fought these transactions in a protracted litigation campaign, but ultimately lost before the Supreme Court in the 1965 *Clay Brown* decision.⁴¹ Charities (and other exempt organizations) also began to sell advertising pages in their “exempt purpose” magazines in an increasingly commercial manner. Taxable publishers soon began to complain about unfair competition.⁴² Finally, there were reports that churches, which were left out of the original UBIT, were buying and operating businesses.⁴³

In the 1969 tax reform, Congress addressed each of these issues. Section 514 of the Code addressed bootstraps, replacing the original debt-financed lease provisions with the current provision taxing income from all debt-

Research (initials L.S.H., probably Ludwig S. Hellborn), Proposal to tax income from “unrelated” business conducted by religious, charitable, scientific, and educational organizations exempted from income taxation under Section 101(6), I.R.C. (May 20, 1942) [hereinafter May 1942 Memorandum] (on file with the OTA Archives, *supra*, Box 18, Folder 27—Unrelated Business Income of Tax Exempt Organizations (1942) to (1985)).

³⁷ See 1947 Hearings, *supra* note 1, at 3395–403.

³⁸ See 1947 Hearings, *supra* note 1, at 1895–96, 1901–04 (statement of Lee M. Wiggins, Under Sec’y of the Treasury). The Treasury, along with the charities and probably most congressmen, was not expecting the 1947 Hearings to examine seriously topics other than cooperative taxation. Accordingly, Under Secretary Wiggins appeared with a detailed report on cooperatives, but nothing on other exempt organizations. See 1947 Hearings, *supra* note 1, at 1872–87. The news of NYU’s Mueller acquisition, which broke approximately one month before Wiggins’ testimony, had apparently changed the focus of a number of the committee members.

³⁹ See Revenue Act of 1950, Pub. L. No. 81-814, §§ 301, 331, 64 Stat. 906, 947–53, 957–59.

⁴⁰ See Note, *Bootstrap Acquisitions: The Next Battle*, 51 IOWA L. REV. 992, 992–93 n.4 (1966) (listing cases).

⁴¹ See *Comm’r v. Brown*, 380 U.S. 563 (1965).

⁴² *Tax Reform, 1969: Hearings Before the H. Comm. on Ways and Means*, 91st Cong. 967 (1969) [hereinafter 1969 Hearings] (statement of Mortimer M. Caplin, Nat’l Tax Equality Ass’n).

⁴³ *Id.*

financed property.⁴⁴ To address the complaints of taxable magazine publishers, section 513(c) was added to the Code. Section 513(c) codified the Treasury's "fragmentation rule," applying the UBIT not only to stand-alone businesses, but also to unrelated business activities (such as the sale of advertising) conducted in the context of a larger related activity (such as publishing an educational magazine).⁴⁵ Finally, section 511 was amended to apply the UBIT to all organizations exempt under sections 401(a) and 501(a) of the Code (including all charities).⁴⁶

D. Explanations of the UBIT

Courts, commentators, and the Treasury have long been nearly unanimous in explaining why Congress added the UBIT to the Code, although they have been divided in assessing its wisdom. The reason for this unanimity is not hard to discern. Congress gave a fairly clear and intuitively compelling explanation for its action. The primary reason given was protecting taxable businesses against unfair tax-exempt competition. The secondary reason was to protect the tax base against a wholesale transfer of taxable businesses and real estate to exempt purchasers. Recently, two scholars have suggested justifications for the UBIT beyond the stated aims of Congress in passing it. Each of these justifications faces serious problems. I will sketch out each of these explanations and the main problems with them below.

1. Unfair Competition

The main stated purpose of the UBIT was undoubtedly to prevent unfair competition between taxable and tax-exempt persons. The President's message to Congress proposing the UBIT cited unfair competition as the justification.⁴⁷ Similarly, the House and Senate reports each began the discussion of the new provision by noting that the problem addressed "is primarily that of unfair competition,"⁴⁸ and the idea was repeated many times in the 1947 and 1950 congressional hearings that led to the UBIT.⁴⁹ The

⁴⁴ See Tax Reform Act of 1969, Pub. L. No. 91-172 §§ 121(d)(1),(3)(A)–(B), 83 Stat. 487, 543, 548.

⁴⁵ See *id.* § 121(c).

⁴⁶ See *id.* § 121(a)(1)–(3).

⁴⁷ H.R. DOC. NO. 81-451, at 5 (1950) ("[A]n exemption intended to protect educational activities has been misused in a few instances to gain competitive advantage over private enterprise through the conduct of business and industrial operations entirely unrelated to educational activities.").

⁴⁸ See H.R. REP. NO. 81-2319, at 409 (1950); S. REP. NO. 81-2375, at 504 (1950).

⁴⁹ See, e.g., 1950 House Hearings, *supra* note 36, at 114 (statement of Chairman Doughton); 1947 Hearings, *supra* note 1, at 3439 (statement of Chairman Knutson).

Treasury regulations implementing the UBIT also stated clearly that “[t]he primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete.”⁵⁰

The basic idea behind the unfair competition explanation is simple: When exempt organizations conduct business activities that are unrelated to their exempt purposes, they enter into direct competition with taxable businesses engaged in the same endeavors. A business that pays no taxes has a cost advantage over a business that does: its cost of capital is reduced.⁵¹ There is an unresolved (and perhaps irresolvable) debate over the exact mechanisms and magnitudes of this advantage. Some have complained that exempt competitors could use (or were using) their cost advantage to lower prices and pursue market share. Others have complained that exempt competitors were able to expand their operations rapidly or buy out their competitors, using their retained earnings. Over the years, most of the arguments for unfair competition have been polemical and thus not entirely rational or well thought out. A grain of rationality exists in all of these fears and complaints, however. They essentially boil down to the plausible argument that the exemption has the potential to give exempt firms a competitive advantage and, thus, to create economic distortion, given imperfectly competitive product and capital markets (including imperfect interchangeability of different forms of capital investment) and different taxation of the return on different forms of capital.⁵²

⁵⁰ Treas. Reg. § 1.513-1(b).

⁵¹ The House Ways and Means Committee expressed this idea in 1950 by noting that “tax-free status . . . enables [exempt organizations] to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes.” H.R. REP. NO. 81-2319, at 409 (1950). Proponents and opponents of the unfair competition theory have debated whether exempt organizations would be likely to use their tax advantage to reduce prices below their taxable competitors’ cost. See, e.g., Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017, 1023 n.21 (1982) (citing sources). The effect on prices is subsidiary to the larger question of the economic advantage conferred by tax exemption and I will not discuss it separately here.

⁵² See Rose-Ackerman, *supra* note 51, at 1021 (“For-profit investors’ claims of injury are neither obviously correct nor patently false.”); Richard Steinberg, “*Unfair*” *Competition by Nonprofits and Tax Policy*, 44 NAT’L TAX J. 351 (1991) (reviewing arguments and evidence). Various commentators have argued that the apparent advantage of tax-exempt firms is illusory. See, e.g., Bittker & Rahdert, *supra* note 20, at 319 (arguing that unfair competition does not make sense in the short run and is hard to predict in the long run); Brody, *supra* note 29, at 620; Copeland & Rudney, *supra* note 29, at 751; William Klein, *Income Taxation and Legal Entities*, 20 UCLA L. REV. 12, 61–68 (1972). Many seem to assume that long-term market prices are determined exogenously in perfectly competitive markets. As Steinberg points out, higher profits might not induce an exempt competitor in a perfectly competitive market (i.e., facing a short-term perfectly inelastic demand curve) to reduce prices, but would invite new exempt entrants into the market, shifting the supply

Whether that distortion is “unfair” is a tougher question.⁵³ Those who complain about unfair competition seem to mean that taxing some corporations while exempting others creates an economic distortion between similarly situated competitors. The argument assumes that the distortion is not warranted by some other overriding public policy. To determine if they are right, one must answer two imponderable questions. First, which participants in the corporate enterprise really pay the corporate income tax? Second, is there any fundamental policy reason to treat those participants equally with the beneficiaries of exempt organizations?⁵⁴ Because there do not seem to be definitive answers to either of those questions, the fear of unfair competition is at least as plausible as its denial. In other words, politicians in 1950 were speaking coherently when they criticized the charitable exemption on the basis

curve and reducing prices over the long term. See Steinberg, *supra*, at 358. Some also ignore the cost of capital as a cost of doing business. If they do discuss the cost of capital, they often assume that all forms of capital are economically interchangeable and uniformly taxed, which has never been a reasonable assumption. It is beyond the scope of this Article to resolve whether unfair competition is a real problem and, if it is, the exact magnitude of the problem and whether the UBIT helps or hurts. It is sufficient for these purposes to note that a rational policymaker pondering the effects of tax exemption on the real economy in 1950 could rationally worry about its potential to introduce economic distortions by favoring certain competitors over others.

⁵³ Hansmann has noted that this kind of equity argument, taken to its logical conclusion, could only apply, if at all, during a period of transition from taxation to tax-exemption. Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 613 (1989) [hereinafter Hansmann, *Unfair Competition*]. Assuming that such a narrow explanation is an implausible basis for tax policy, Hansmann criticizes Rose-Ackerman for taking “the term ‘unfair’ too literally” and reinterprets the concept of unfair competition to mean inefficient economic distortion. *Id.* at 613–14. The problem with this argument is that Rose-Ackerman’s literal understanding seems to match better with the intuitive fears of protesting taxpayers and policymakers. They often used the unfair competition argument in conjunction with arguments about defending the tax base and sometimes conflated the two, but they clearly meant something different by the two arguments. As will be discussed below, the concern with unfair competition arose from the complaints against tax-favored cooperatives at a time when the tax exemption had just undergone such a huge economic transformation that taxable businessmen could and did plausibly argue that they were facing something new. See *infra* notes 184–197 and accompanying text. As Hansmann surmises, when these businessmen gave concrete examples of unfair competition, they talked much more about the pressure to sell their businesses to cooperatives than about pressure to shutter their businesses. See Hansmann, *supra* at 611–12. As he failed to understand, however, proud independent businessmen were not emotionally sanguine about the forces they felt were compelling them to sell out to socialist firms with whom they could not compete because of government favoritism. See *infra* notes 93–115 and accompanying text.

⁵⁴ See Atkinson, *supra* note 19, at 626–28. For a discussion of “horizontal equity” interpretations of the unfair competition claim, see Rose-Ackerman, *supra* note 51, at 1020–21. Rose-Ackerman notes that if exempt organizations can only compete in certain industries, as has been the case since 1950, the equity question becomes more complicated. She assumes that any claim of unfairness collapses when rephrased as whether, as a matter of horizontal equity, we wish to treat similarly the beneficiaries of exempt organizations and the participants in the corporate enterprise (she assumes these are shareholders, but that is not clear). This assumption seems unwarranted as an empirical matter, and shaky as a normative proposition.

of unfair competition. Their concern was not definitively justified, but it was certainly “good enough for government work.”

2. Revenue Protection

As most commentators recognize, the UBIT had a second stated objective: protecting the tax base from erosion.⁵⁵ The principal focus of the Treasury and Congress in this regard was “leaseback” purchases, in which an exempt organization purchased commercial real estate with borrowed funds and simultaneously leased it back to the buyer.⁵⁶

Again, the basic idea was straightforward. If charities enjoyed a significant tax advantage over taxable persons in operating businesses, they would gradually acquire or bankrupt many of those businesses, particularly those organized in corporate form. As this process proceeded, more and more business income would accrue to tax-exempt owners, and the federal government would collect less and less in corporate income tax. Policymakers also worried that charities were using their tax advantage to acquire businesses and commercial real estate with borrowed funds, using their tax savings to amortize the debt. This raised the possibility that the tax-base erosion could accelerate by leverage alone, unlimited by the size of the charities’ endowments. It also suggested that the taxpayers selling properties to charities were in some way appropriating some of the benefit of the tax exemption.⁵⁷

⁵⁵ See *Am. Med. Ass’n v. United States*, 887 F.2d 760, 772 (7th Cir. 1989); *La. Credit Union League v. United States*, 693 F.2d 525, 540 (5th Cir. 1982); Bittker & Rahtert, *supra* note 20, at 320; Brody, *supra* note 29, at 608; Copeland & Rudney, *supra* note 29, at 750; Dale, *supra* note 29, at 9-5, 9-7; Hansmann, *Unfair Competition*, *supra* note 53, at 621–22; Kaplan, *supra* note 29, at 1433; Sharpe, *supra* note 29, at 393–94. It should be noted that Bruce Hopkins considers explanations of the UBIT beyond unfair competition as “revisionist theories.” HOPKINS, *supra* note 29, at 744. These theories were, however, cited in the committee reports at the time.

⁵⁶ See *1950 House Hearings*, *supra* note 36, at 19 (statement of John W. Snyder, Sec’y of the Treasury); H.R. REP. NO. 81-2319, at 38–40 (1950); S. REP. NO. 81-2375, at 31 (1950).

⁵⁷ There are obvious limits to the fear that charities might take over all American businesses and commercial real estate, to the extent it can be assumed that the exempt organizations involved would genuinely adhere to the nondistribution constraint and use their income for purely exempt purposes. These limits have often eluded those who get caught up imagining legal entities to be real people. Focusing on the real people—natural individuals—involved, anyone who sells a business or commercial property to charity ends up with liquid private capital. It has always been unrealistic to think that the ambitious and avaricious capitalist masses would stow in their mattresses the cash they made from selling their businesses and commercial real estate to charities. Capital seeks out investment and investment implies private inurement. Businesses owned and run by real charities for real charitable purposes do not fit the bill. Of course, to the extent one assumes that taxable individuals would use nominally nonprofit vehicles for purposes of tax evasion, the threat to the public fisc is real. See *infra* notes 124–147 and accompanying text (discussing the real nature of charities’ acquisitions of businesses and real estate in the 1940s).

3. *New Explanations*

In addition to Congress' stated explanations for the UBIT, scholars have proposed two new explanations in recent years. Evelyn Brody has recently developed a competing theory to explain the UBIT as part of her effort to reconceptualize the charitable tax exemption. Brody's theory focuses on the received view, unconsciously continued from archaic attitudes toward the church, that it is inappropriate to tax charitable organizations because they are similar to independent sovereigns.⁵⁸ She recognizes, of course, that modern charitable organizations do not have the actual attributes of sovereignty. Rather, she uses the term to refer to the view that charities are not perceived purely as creatures of the state, but rather as having legitimacy independent of the state. This perception puts boundaries on the state's willingness to regulate them.⁵⁹ She uses this insight to explain why both state and federal governments exempt charities from paying taxes, rather than granting them direct subsidies.

Brody also uses the sovereignty insight to explain why the UBIT limits the exemption in ways that cannot readily be explained on the stated grounds of preventing unfair competition or protecting tax revenue. She explains the UBIT as the naturally jealous reaction of one sovereign to the undue strengthening of another.⁶⁰ This theme certainly featured in the discussions of the UBIT, especially in the 1947 Hearings. Harold Knutson, Chairman of the House Ways and Means Committee, was troubled by premonitions that the medieval struggles between the sovereign and the church could return if charities used their exemption to seize a significant portion of the nation's property.⁶¹

Henry Hansmann has also proposed a new explanation for the UBIT based on economic efficiency.⁶² Hansmann gives a variety of reasons why it might

⁵⁸ Brody, *supra* note 29.

⁵⁹ *Id.*

⁶⁰ *Id.* at 606–07.

⁶¹ See 1950 House Hearings, *supra* note 36, at 579–80 (statement of John Dingell) (worrying about takeover by nonprofits); 1947 Hearings, *supra* note 1, at 3456–57, 3530 (statement of Harold Knutson) (worrying about return to church domination of the middle ages).

⁶² Hansmann himself couches his explanation as a less literal interpretation of “unfair competition.” Hansmann, *Unfair Competition*, *supra* note 53, at 613–14. However, he makes no effort to explain how his various efficiency arguments for the UBIT could be described as “unfair competition” (as opposed to tax incentives that do not efficiently promote an efficient nonprofit sector). Accordingly, his arguments appear to propose a completely different explanation. Hansmann also accepts the tax-base protection rationale for the UBIT. *Id.* at 621–23.

be inefficient to give nonprofit organizations a tax incentive to invest in active business endeavors: It might tempt nonprofits into imprudent failure to diversify in investing their endowments, tend toward managerial inefficiency, tempt nonprofits to save too much and spend too little on operations related to their nonprofit purposes, and skew tax incentives against the very activities the tax subsidy aims to promote.⁶³ He concludes that the UBIT itself is desirable because it promotes efficiency. Hansmann suggests some modifications of the rules regarding “related” business activities to target and administer the exemption subsidy more efficiently.

Without questioning Hansmann’s various arguments individually, it is questionable whether this hodgepodge of efficiency speculations really amounts to an explanation for the UBIT. Without any definite idea of how much diversification, managerial inefficiency, nonprofit savings, and nonprofit activities is desirable, Hansmann’s theories seem more like after-the-fact rationalizations of the status quo. They find no direct support (and Hansmann claims none) in the stated reasoning of the policymakers involved in passing the UBIT and in modifying it over time. In other words, in a world in which political policy choices (including the exemption itself) were actually driven by detailed efficiency analyses, Hansmann would raise some plausible arguments for the UBIT or something like it. However, as a description of the kind of gut-felt and unanalyzed intuitions of efficiency that might plausibly drive policy choices without discussion, Hansmann’s arguments seem to suffer from the cut of Ockham’s Razor.

The remainder of this Article will examine the full historical and political background of the UBIT and propose a new explanation for its passage, grounded in symbolic politics. Part II will ask this basic question: What changed in the 1940s to focus the attention of the press, the public, and policymakers on the business activities of charities? The answer to this question is very different from what one would expect. The increase in tax rates and broadening of the tax base during World War II spawned three separate reactions that combined to place political emphasis on the business activities of charities. The first was the increased value of the exemption, which threatened new scrutiny of the largely unexamined policy of subsidizing charity by tax exemption. The second was the rise of an active and vociferous business lobby against unfair competition by tax-favored cooperatives. This lobby, the National Tax Equality Association (NTEA), added business

⁶³ See Hansmann, *Unfair Competition*, *supra* note 53, at 614–21.

conducted by charities to its complaints in the late 1940s after noticing its publicity potential. The third reaction was the development of the first wave of tax shelters that used contrived transactions with charities to produce tax savings for the taxable participants and a small facilitation fee to the charity. This reaction was the direct source of the activities (most famously, NYU's Mueller acquisition) that riveted political attention in the late 1940s. Part III discusses how these three elements came together in the 1940s to produce the UBIT, whose chief virtue is to steer charities away from activities that do not mesh with the perceptions of charity that support the exemption itself.

II. LIMITATIONS OF PRIOR EXPLANATIONS

Scholars have pointed out for more than fifty years that the UBIT is logically inconsistent with the reasons Congress gave for passing it. As noted above, a few scholars have proposed alternative explanations. For the most part, however, scholars have assumed that Congress either missed the inconsistencies between its explanations and actions, or that it acted based on "paranoid rather than rational" motivations.⁶⁴ This analysis has led to proposals to reform the UBIT to conform with its purported ends, as well as calls to abolish it as irrational.

This section will discuss the problems both with these prior analyses and with the prior explanations for the UBIT itself, concluding that simple ignorance cannot explain what happened and a diagnosis of paranoia glosses over the question of what, if not the stated purposes, motivated the UBIT. Section A discusses the logical inconsistencies between the UBIT and the "unfair competition" explanation pointed out by previous scholars. It then shows that ignorance or mistake cannot explain these inconsistencies, because policymakers were aware of them while the UBIT was under consideration. Apparently, however, policymakers saw these inconsistencies as irrelevant to what they were doing. They knew about them but ignored them. Section B goes beyond prior criticisms to point out inconsistencies between the unfair competition argument and the facts surrounding the UBIT's passage. From the rhetoric of unfair competition and the circumstances of other similar issues, at the time of the UBIT and since, one would expect to find evidence of numerous complaining taxpayers. In fact, there were no complaining

⁶⁴ Klein, *supra* note 52, at 68.

taxpayers. This makes Congress' irrational actions to defend uncomplaining taxpayers against hypothetical competition all the harder to explain.

Section C goes further beyond traditional criticisms of the UBIT to question the revenue protection explanation. It will demonstrate that the UBIT was also an oddly incongruous response to the real tax avoidance schemes that prompted it. The business transactions by charities that attracted policymakers' attention did threaten tax revenues. The reason they did so, however, was that they were schemes created by taxable persons to avoid tax otherwise due. The charitable participants were merely "accommodation parties," lending their exemption to the scheme for a small fee. Despite this, policymakers were only able to see abuse by the charities in these transactions. Policymakers knew that legislation against charities alone could not prevent the taxable participants from pursuing the same or similar schemes with other tax-indifferent counterparties. Nonetheless, they repeatedly and stubbornly fixated on the hypothetical danger that charities would remove too much income from the tax base, rather than on the real problem that taxable persons were using transactions with tax-indifferent persons to avoid paying taxes.

Section D will discuss why Brody's and Hansman's alternative explanations do not solve these problems, leaving open the question of why Congress passed the UBIT despite, rather than because of, its stated explanations. Part III will address this question.

A. *Logical Inconsistencies with the Unfair Competition Argument*

1. *The Arguments*

Commentators from 1940s to the present have attacked the UBIT as logically inconsistent with the unfair competition concerns that it purports to address. Most have pointed out that the distinctions between active and passive income, on the one hand, and related and unrelated income, on the other, make no sense if one is worried about unfair competition.⁶⁵ In each

⁶⁵ See, e.g., Bittker & Rahdert, *supra* note 20, at 319–26; John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487, 500 (2002); Copeland & Rudney, *supra* note 29, at 750; Dale, *supra* note 29, at 9–5; A.B.A., Comm. on Taxation, *Report of the Committee on Organizations Exempt Under Section 101, Internal Revenue Code*, in SECTION OF TAXATION PROGRAM AND COMMITTEE REPORTS TO BE PRESENTED AT THE TENTH ANNUAL MEETING OF THE SECTION 82, 86 (1949). Some commentators note that the UBIT does not require a finding that the business actually has taxable competitors. See, e.g., Dale, *supra* note 29, at 9–5; Hall & Colombo, *supra* note 29, at 1443. To the extent this argument is different from the argument that the UBIT makes incoherent distinctions between different kinds of income, it

case, the exemption seems to confer the same competitive advantage that the UBIT was purportedly designed to address.

This is obviously true with respect to an active business related to an exempt purpose. An exempt hospital across the street from a taxable hospital competes with its neighbor directly.⁶⁶ This point was made at great length in 1987 by persons complaining of such competition before a subcommittee of the House Ways and Means Committee.⁶⁷ Although competition between

is easily answered on grounds of administrative efficiency. It is reasonable to expect most profitable business activities to have or attract competition, but it is notoriously difficult to prove competition. See, e.g., IIA PHILLIP E. AREEDA, JOHN L. SOLOW & HERBERT HOVENKAMP, *ANTITRUST LAW* 87–365 (2d ed. 2002) (discussing proof of market power).

⁶⁶ It is possible that nonprofit hospitals provide an inherently different service than for-profit hospitals. See Jill R. Horwitz, *Why We Need the Independent Sector: The Behavior, Law, and Ethics of Not-for-Profit Hospitals*, 50 *UCLA L. REV.* 1345 (2003). Nonprofit hospitals and similar nonprofit businesses present problems for Hansmann and those who follow him in explaining nonprofit organizations as mechanisms to help altruistic donors overcome the agency problems that bedevil attempts to confer benefits on strangers, separated from the donors by geographic, social, or temporal gaps. Hansmann tries to fit these organizations into his theory by arguing that nonprofits also arise to deal with complex services that are hard for consumers to evaluate. Hansmann, *Role of Nonprofit Enterprise*, *supra* note 13, at 868–72. This portion of Hansmann’s theory seems forced. Hansmann himself has conceded that the existence of nonprofit hospitals, and the tax exemptions they enjoy, may be more of a historical holdover than a special conceptual category, reflecting an earlier period less specialized and less capital-intensive medicine, in which hospitals provided mainly indigent care and wealthy people saw private doctors. *Id.* at 867. The fact that nonprofit hospitals are not now inherently different from for-profit hospitals does not mean that they cannot be. In the last twenty years, some states have taken action in this regard, conditioning hospitals’ property tax exemptions on evidence that they provide indigent care. See Janne Gallagher, *The Legal Structure of Property Tax Exemption for Charities*, 40 *EXEMPT ORG. TAX REV.* 285, 289 (2003); T.J. Sullivan & Bradley E. Karlin, *State Community Benefit Needs Assessment, Planning, and Reporting Laws*, 23 *EXEMPT ORG. TAX REV.* 285, 286 (1999). Recently, there has been similar talk in Congress. See *supra* note 6 and accompanying text. Historical chance also seems likely to be the better explanation for several other of Hansmann’s anomalous cases. For a more detailed discussion of Hansmann’s theory, see *infra* notes 212–214 and accompanying text.

⁶⁷ *Unrelated Business Income Tax: Hearings Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 100th Cong. (1987). I take no position on whether the businesses that complained in 1987 were justified in doing so. It is enough for the purposes of this Article to note that the unfair competition argument itself is coherent. See *supra* notes 47–54 and accompanying text. It is no less coherent when made by taxable corporations in competition with a “related” business. Hansmann argues that the distinction is justified because the exemption is premised on the notion that nonprofit corporations are more efficient providers of types of goods and services related to an “exempt purpose.” Hansmann, *Unfair Competition*, *supra* note 53, at 617. There is an internal logic to this position if one first accepts Hansmann’s thesis that the exemption itself is a capital subsidy carefully calibrated to the disadvantage faced by nonprofit firms in raising equity capital. Hansmann, *Rationale for Exempting*, *supra* note 20, at 72–75. This Article pursues a very different positive explanation for the post-World War II exemption. See *infra* notes 184–229 and accompanying text. Hansmann’s theory is also not without problems as a normative position. See *infra* note 201.

investors in the real estate or capital markets is sometimes less obvious, it is no less real, and unfair competition presumably poses the same problems.⁶⁸

Hansmann is the only commentator who has attempted to refute this argument as to passive income. His reasoning is worth considering, both for what he says and the underlying attitudes it reveals.⁶⁹ Hansmann specifically addresses only three of the passive investment income exceptions: dividends, interest, and rentals. With respect to dividends, he argues that no distortion is possible because dividends reflect corporate income that has already been subjected to the corporate income tax. With respect to interest income (which is deductible from the income of the payor), he claims that whatever policy underlies the distinction between the treatment of interest and dividends in general should justify the distinction in the UBIT. With respect to rentals on real estate, he says that such property is usually held in pass-through entities, so that leaving it untaxed does not unduly distort the positions of taxable and tax-exempt investors. Hansmann makes no attempt to explain the UBIT exception for royalties, another crucial category of passive income. This omission, in itself, casts doubt on his piecemeal explanation.

More tellingly, however, none of Hansmann's arguments address the logic of unfair competition. In the absence of integration between the corporate and personal income taxes, exempting the income of one corporation while taxing similar income of another similarly situated corporate competitor gives a relative subsidy to the cost of capital of the first corporation. This is true no matter how many times the corporate (or personal) income tax has already been levied against other persons in the process of generating that income. In fact, the logic of unfair competition extends beyond corporate competitors to competition against any taxable person. The magnitude of the distortion is different, depending on how many levels of taxation are imposed between the income-generating activity and the ultimate beneficiaries of the income. The nature of the distortion is the same.

Rather than explaining the passive income exceptions to the UBIT, Hansmann's arguments point out the very problem with the passive income exceptions that he is trying to resolve. Hansmann unconsciously refuses to take the logic of unfair competition seriously because it is impossible to defend

⁶⁸ Investors in commercial real estate and securities, for instance, bid against each other competitively for investments. If one group of investors has a lower cost of capital than another group, that will presumably distort the competition between them (and the market for commercial real estate and securities) over time.

⁶⁹ See Hansmann, *Unfair Competition*, *supra* note 53, at 625–26.

the UBIT as a coherent response to it. Instead, he slips from an unfair competition argument to a tax-base protection argument. It is consoling to know that the corporate income tax has been applied at least once to the income stream if one is trying to protect the corporate tax base.⁷⁰ Our tax system, however, has never granted a complete exemption for intercorporate dividends. Nor are the passive income exemptions confined to income from corporate payors. The core UBIT (ignoring, for the moment, the debt-financed income provisions) thus makes no more sense as a measure to protect the corporate tax base than it does as a deterrent to unfair competition.

One possible response to these logical problems is that life is messy and legislation is rarely logically coherent. This is undoubtedly true. Where a statute is logically inconsistent with its stated and accepted explanation, however, that inconsistency is a symptom of some underlying phenomenon. Identifying that underlying phenomenon is crucial to determining the importance of the inconsistency.

Inconsistency may reflect a simple unintended mistake by the drafters. It may reflect a political bargain made in the rough and tumble of the legislative process. But it may also reveal that the statute is serving unacknowledged purposes. To date, commentators on the logical inconsistency of the income covered and exempted by the UBIT have considered only the first possibility. As will be discussed further below, the explanation in this case seems to lie in the third.⁷¹

⁷⁰ Hansmann is not the only commentator to make this move. *See, e.g.*, Colombo, *supra* note 65, at 528 (equating “direct commercial activities” with active business endeavors, subject to the UBIT if unrelated to exempt purpose).

⁷¹ The anomalous coverage of the UBIT does not appear to reflect the second possibility—a deliberate political compromise. Even in the 1947 Hearings, Noah Mason, the strongest proponent of taxing charities in the House, had no objection to passive and related active business income. It seems clear that there had been no haggling over the content of legislation prior to the 1947 Hearings. Lee M. Wiggins, the Under Secretary of the Treasury, did not propose legislation because he and his staff simply had not decided what they thought. *See* Papers of A.L.M. Wiggins, Daily Logs, Oct. 27, 1947, Oct. 28, 1947, Nov. 3, 1947 (on file with the Truman Library). Wiggins regarded the attempts of Republican congressman to force him to take a position as pure political theater. *Id.* at Nov. 4, 1947. He likewise resented Colin Stam’s attempts to pressure him behind the scenes as an inappropriate attempt to shift the pressure the Joint Committee staff was feeling from the same congressman. *Id.* at Nov. 7, 1947. The 1947 hearings were about grandstanding, not logrolling. By the 1950 House Hearings, by contrast, several political compromises had already been concluded behind the scenes. Most importantly, the President had rejected the Treasury’s proposal to tax cooperatives on undistributed patronage dividends. The Treasury’s draft of the President’s January 1950 message to Congress contained the proposal. *See* Message of the President on Tax Revision, at 4 (undated, hand annotated as “Treasury Draft”) (on file with the Truman Library in Truman Papers, Files of Charles S. Murphy, Presidential Speech File, Tax Message, January 23, 1950 [hereinafter Murphy Speech File]) (including refutation of NTEA claims and proposal to tax undistributed patronage dividends). Charles Brannan, Secretary of Agriculture, quickly sent a

2. Evidence Policymakers Were Aware of the Arguments

A careful review of the historical record shows that the incongruous coverage of the UBIT was not a mere oversight. The problem was squarely presented to Congress in the 1947 Hearings by the NTEA, a lobby for cooperative tax reform about which more will be said in later sections.⁷² The NTEA's representative told the House Ways and Means Committee that the logic of unfair competition applied equally to all investment income and recommended abolishing the exemption.⁷³ In the same hearings, NYU's representative made the same logical point, arguing that buying the entire C.F. Mueller company was no different than buying Mueller's stocks or bonds, and should therefore be exempt.⁷⁴ The same arguments were repeated at the 1950 Senate Hearings.⁷⁵ One witness testified directly (as an observation of the market, not as a complaint) that increased competition among tax-exempt parties for "leaseback" deals was having a noticeable effect on prices.⁷⁶

letter to Charles Murphy, one of Truman's aides, opposing the proposal. Appended to the typed letter, which repeated the cooperatives' legal and technical arguments, was a handwritten annotation: "Of course, the real argument is that such a move would be almost political suicide for the Democrats. It is a terrific handicap to the Republicans now." Letter from Charles F. Brannan, Sec'y of Agric., to Charles Murphy, Admin. Assistant to the President (Jan. 17, 1950) (on file with the Truman Library in Murphy Speech File, *supra*). The next day, Murphy deleted the proposal. See Message from the President of the United States Transmitting Request for a Revision of the Tax Laws, at 8–10 (draft dated Jan. 18, 1950) (on file with the Truman Library in the Murphy Speech File, *supra*) (deleting references to the NTEA's attacks on cooperatives and cooperative tax proposal). Likewise, the absence of churches and cooperatives from the President's proposal reflected earlier political calculations and compromises. See Memorandum for the Secretary, at 11 (Jan. 17, 1950) [hereinafter 1950 Briefing Book] (on file with the OTA Archives, *supra* note 36, Box 34.2, Binder—1950 Revenue Program (September 2, 1949)) (attributing exclusion of churches partially to absence of cases of abuse and partially to danger that taxing "religious institutions might be considered an attack on the church"); Sources of Additional Revenue for 1950 Tax Program Agreed to by Treasury Staff and Mr. Stam, at 2 (Jan. 11, 1950) (on file with the Truman Library, Papers of L. Laszlo Ecker-Racz, File: 1950 Tax Program v. 1) (agreeing to exclude churches due to absence of cases of abuse). A table of contents to the Ecker-Racz collection lists Vance Kirby, the Tax Legislative Counsel, as author of this report. At the 1950 House Hearings, Mason and several other members of the Ways and Means Committee protested loudly to Secretary Snyder about these omissions and received the nonresponsive responses one would expect in such circumstances. See *1950 House Hearings*, *supra* note 36, at 39–40, 114–16, 120–21 (statement of John Snyder, Sec'y of the Treasury). Once again, however, no one questioned the propriety of leaving out passive income or related business income.

⁷² See *infra* notes 98–122 and accompanying text.

⁷³ See *1947 Hearings*, *supra* note 1, at 3407–09 (statement of Leonard J. Calhoun, Nat'l Tax Equality Ass'n).

⁷⁴ See *1947 Hearings*, *supra* note 1, at 3530 (statement of John Gerdes, NYU).

⁷⁵ See *1950 Senate Hearings*, *supra* note 140, at 657 (statement of Richard B. Barker, Sand Springs Home and Widows Colony).

⁷⁶ See *1950 House Hearings*, *supra* note 36, at 566 (statement of King E. Fauver, Oberlin Coll.) (commenting that "rentals have been coming down since insurance companies went into [leasebacks]"); *id.* at 578 (statement of Philip C. Pendleton, Am. Council on Educ.) (noting that "[t]he life insurance companies are putting far more in [to leasebacks] than we are"); *cf.* Mark Levy, *The Trend of Corporations to Sell Their Real*

Treasury officials also understood the incongruity of taxing only active business income. After Randolph Paul first proposed the UBIT in 1942, the Treasury commissioned two studies of the proposal. One of these studies noted that the unfair competition argument logically applied to all income-producing activities other than soliciting donations.⁷⁷ As to “[t]he saving grace of philanthropy which Mr. Paul finds absent from ‘unrelated’ enterprise profits,” the author notes that it “is likewise absent from these other [unrelated and passive] elements of income; indeed, it is present only as to contribution receipts.”⁷⁸ When the Joint Committee on Taxation repropoed the UBIT in early 1949, a Treasury memorandum noted critically that “[t]he proposal would treat business income less favorably than certain types of investment income (chiefly interest and rents) which are essentially similar in character to business income.”⁷⁹ Another 1949 Treasury report, outlining the preliminary plan for what would become the UBIT, also noted that “[t]he same [competitive] advantage accrues with respect to investments.”⁸⁰

Although those arguments were presented, no one took them seriously. Rather, policymakers ignored them and took it as given that active business revenues were a problem, that passive revenues were not, and that the problem of unfair competition resided only in active business pursuits. In the 1950

Estate to Institutional Investors, MORTGAGE BANKER, Dec. 1947, at 7 (quoting a Connecticut Mutual Life Insurance Co. officer as saying “[t]here have been so many diversions from what we formerly considered to be sound leasing procedure it is difficult for me to see just what long range effect the entrance of the insurance companies into the purchase of real estate will have on real estate in general. It does seem that these lease and purchase deals permitting cancellation clauses, re-purchase agreements and renewal options at greatly reduced rentals have already caused a considerable influence upon lease terms not only to the tenants of the highest standing but all along down the line.”); Harry T. Rohs, *Life Insurance Men Are Buying More Factories, Stores, Offices, Labs*, WALL ST. J., Aug. 2, 1948, at 1 (“[I]n the first rush of insurance companies to get into this new investment field, there was much competition and some transactions were made at rates of return barely above 3%. ‘Much lower than we think justified,’ says one insurance executive.”).

⁷⁷ William J. Shultz, Div. of Tax Research, U.S. Dep’t of the Treasury, *Exemptions Under I.R.C. Sec. 101*, at 40–41 (June 27, 1942) (on file with the OTA Archives, *supra* note 36, Box 18, Folder 3, Section 101 Exemptions (study by Mr. Shultz, Apr. 30, 1942)). A note attached to the report indicates that it was sent to Randolph Paul on June 11, 1943, with the caveat that “It cannot be considered a completely finished job and has not been finally checked but it is believed to be substantially accurate. It may, therefore, serve your present purposes of getting a summary view of the situation.”

⁷⁸ *Id.* at 40.

⁷⁹ Div. of Tax Research, U.S. Dep’t of the Treasury (initials R.E.S.), *Suggestions for Taxation of Business Income of Section 101 Organizations*, at 2 (Feb. 3, 1949) (on file with the OTA Archives, *supra* note 36, Box 18, Folder 1, Tax Exempt Orgs. (other than Coops.) 1942–72, Tab 6).

⁸⁰ Div. of Tax Research, U.S. Dep’t of the Treasury (initials J.C., probably John Copeland), *Preliminary Plan for Taxation of Certain Types of Income of Section 101 Organizations*, at 2 (Apr. 12, 1949) [hereinafter *Treasury Report*] (on file with the OTA Archives, *supra* note 36, Box 18, Folder 1, Tax Exempt Orgs. (other than Coops.) 1942–72, Tab 6).

House Hearings, a worried congressman asked a Treasury official whether taxing passive income would be the logical extension of the Treasury's proposal. The confused official had no coherent answer. Disaster was averted only when Congressman Lynch interrupted to remind everyone to focus on the matter at hand—active businesses run by universities.⁸¹ Richard Barker, a tax lawyer representing the Sand Springs Home and Widows Colony, made the argument in the 1950 Senate Hearings and suggested requiring charities to expend a high level of their funds currently on exempt activities.⁸² The senators simply ignored him, asking no questions. Everyone recognized that whatever the point of the UBIT was, passive income was not it.

Likewise, the 1949 Treasury Report, while acknowledging that the unfair competition argument applied equally to passive income, nonetheless noted the “long-standing historical policy of permitting the tax-free passive receipt of income from endowments (interest, dividends, rents and some types of royalties)” and lamely concluded, without further explanation, that taxing passive investment income would contravene a “very basic social policy.”⁸³ The report made no attempt to specify what that policy might be.

The House Ways and Means Committee Report in 1950 ignored the issue of competitiveness, justifying the exclusion of passive income by noting that “investments producing incomes of these types have long been recognized as proper for educational and charitable organizations.”⁸⁴ The Senate Finance Committee report did acknowledge the question, but answered it only by stating conclusively that passive income sources “are not likely to result in serious competition for taxable businesses having similar income.”⁸⁵ There was, of course, no evidence before the Committee to support this, and it is doubtful that the technical staff believed it.

Apparently, like the Supreme Court a quarter century before,⁸⁶ everyone simply viewed passive investment and “related” business activities as a natural

⁸¹ 1950 House Hearings, *supra* note 36, at 176 (statement of Congressman Lynch) (noting that the question before Congress was “whether [businesses operated by educational institutions] should in their competitive business have a 38 percent advantage over other people in the same line of business”).

⁸² See *Revenue Revisions of 1950: Hearings on H.R. 8920 Before the S. Comm. on Finance*, 81st Cong. 657 (1950) [hereinafter *1950 Senate Hearings*].

⁸³ Treasury Report, *supra* note 80, at 1–2.

⁸⁴ H.R. REP. NO. 81-2319, at 38 (1950).

⁸⁵ S. REP. NO. 81-2375, at 30–31 (1950).

⁸⁶ See *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924). The Supreme Court's decision in *Sagrada Orden de Predicadores*, properly read, made this distinction and strongly indicated that an organization with unrelated business activities could be denied exemption for that reason. *Id.* at 581. The

and traditional activity of exempt organizations. Policymakers understood that the main point of the exemption was to subsidize such unexceptional income sources. Clearly, then, they could not be the glaring abuse of the exemption that everyone had in mind and wanted the UBIT to address.⁸⁷

The bifurcation described above between attitudes toward active unrelated income, on the one hand, and related and passive income, on the other, presents serious problems for the unfair competition explanation. Why did policymakers who purported to be acting to prevent unfair competition feel so differently about these economically comparable sources of income? Why did they consider strong arguments against such a distinction simply irrelevant? An obvious answer would be that active unrelated competition was more salient, producing taxpayer pressure, and Congress only responded where it felt pressure. This answer is contradicted by the facts, however, as the following section will demonstrate.

B. The Historical Incongruity of the Unfair Competition Explanation: The Absence of Complaining Taxpayers

Courts and commentators have largely ignored the factual background of the UBIT. Several scholars have criticized Congress for legislating without adequate evidence of a problem.⁸⁸ Most have merely noted NYU's Mueller acquisition and a few other prominent examples and concluded that a surge of activity must have prompted Congress to react.⁸⁹ A few have assumed there were complaints about unfair competition from the fact that Congress passed a law to deal with the problem.⁹⁰ None has given careful attention to the actual record.⁹¹

Court's opinion was not properly read by subsequent courts which affected the state of the law in 1950. *See supra* notes 30–33 and accompanying text. However, that does not change the reasoning of the opinion as a reflection of the Court's thoughts at the time.

⁸⁷ This appears to be a historically inaccurate perception of the exemption. *See* Eliasberg, *supra* note 29, at 55–58 (discussing congressional debates over original exemption in Corporate Excise Tax Act of 1909 and showing that exemption originally included to clarify that religious publishers with related active business income were excluded).

⁸⁸ *See* Bittker & Rahdert, *supra* note 20, at 319; Comment, *supra* note 29, at 851–52.

⁸⁹ *See, e.g.,* Brody, *supra* note 29, at 606.

⁹⁰ *See, e.g.,* Kaplan, *supra* note 29, at 1433; Sharpe, *supra* note 29, at 370–71.

⁹¹ Eliasberg thought that the numerous witnesses who appeared before the House Ways and Means Committee in November 1947 were evidence of widespread complaints. Eliasberg, *supra* note 29, at 76. As will be discussed below, the witnesses Eliasberg references were actually protesting tax-favored cooperatives.

In Arthur Conan Doyle's short story, *Silver Blaze*, Sherlock Holmes solves a mystery, in part, by noticing a watchdog that did not bark when the perpetrator approached in the middle of the night. Holmes deduces from the dog's silence that the crime must have been an inside job.⁹² The unfair competition explanation for the UBIT faces a similarly telling clue: the taxpayers who did not bark. Although the UBIT was passed in the name of protecting taxable businesses from unfair competition, it was not passed at the behest of taxable businesses. The few taxpayers' representatives who did appear to complain about specific kinds of unfair competition all left empty handed. As in *Silver Blaze*, however, the proof must begin with the observation that the dog in question was inclined to bark loudly when it felt threatened. Subsection 1 will examine the dog barking—the fights against tax-favored cooperatives, tax-exempt magazine advertising, and “related” business income. Subsection 2 will consider the dog's anomalous silence in the controversy over charities' business activities.

1. *The Dog Barks: The Fight Against Cooperatives and Beyond*

Starting in the summer of 1943, the NTEA conducted an intense lobbying effort to eliminate the tax advantages of cooperatives, and, to a lesser extent, government-owned businesses. The 1947 House Hearings and the passage of the UBIT in 1950 were contemporaneous with this campaign, were at least partially attributable to it, and drew from it the rhetoric of unfair competition. In this parallel and related case, the taxable businesses barked to high heaven.

a. *An Introduction to Cooperative Taxation in the 1940s*

The rhetoric of unfair competition did not achieve political prominence by chance.⁹³ It resulted from an intense lobbying campaign during the 1940s to

⁹² See ARTHUR C. DOYLE, *Silver Blaze*, in 2 THE ANNOTATED SHERLOCK HOLMES 261, 280 (William S. Baring-Gould ed., 1967).

⁹³ The NTEA was not the only or the first source of the idea that tax advantages, and tax exemptions in particular, could produce unfair competition. The NTEA, however, gave the idea a very large megaphone from 1943 to 1950. The idea itself is intuitive and seems to have occurred independently to various persons thinking about the exemption at the time. Randolph Paul mentioned it when he proposed the UBIT in a 1942 House Ways and Means Committee hearing. See *supra* note 35 and accompanying text. Within the Treasury technical staff, it came up as early as a May 1940 memorandum by the Division of Tax Research, noting that, “products or services [produced by charities] compete directly with those of ordinary business and place the exempt institutions at a competitive advantage. The Government, by making an indirect subsidy to these groups, encourages them to undercut less favored businesses which are liable for income taxes.” Irene Till, Div. of Tax Research, U.S. Dep't of the Treasury, Corporations Exempt from Income Tax, at 4 (undated, with attached transmittal slip dated May 17, 1940) (on file with the Franklin D. Roosevelt Library, Oscar Cox

eliminate the tax advantages of cooperative corporations. In the 1940s, the Internal Revenue Code included a tax exemption for corporations formed as farmers' cooperatives to buy supplies or to sell farm products on a collective basis, provided they met certain limits on business with nonmembers and return on capital stock and that they dealt with their members at cost.⁹⁴ Cooperatives typically met the latter requirement by paying annual "patronage dividends" to their members after they closed their books and determined their actual costs and reserves. The idea of these dividends was to operate the cooperative at cost. The dividend traced up the price actually paid by the member (in the case of purchasing cooperatives) or to the member (in the case of marketing cooperatives) with, respectively, the cooperative's actual cost or actual revenue net of cost.

At the same time, the Bureau of Internal Revenue took the position that cooperative corporations that did not meet the requirements for exemption could nonetheless deduct patronage dividends, including dividends to nonmembers who did business with the cooperative. Theoretically, this allowed a cooperative that was operating at cost to "zero out" its income and pay no tax at the corporate level, passing on its income to its patrons.⁹⁵

The only obstacle to zeroing out income in this way was that capital expenditures (e.g., for grain elevators) were not deductible. The most obvious solution to this problem was to borrow any needed capital from third-party lenders. A more subtle and popular solution was to force patrons to lend the capital by distributing patronage dividends in the form of IOUs, rather than cash, and then to deduct the full face amount of the IOUs as a patronage

Collection, File: Tax Exemption). It is not clear what prompted this memorandum, but apparently there was some discussion between the Division of Tax Research and the Bureau of Internal Revenue about asking exempt organizations to file information returns. See Roy Blough, Memorandum for the Files, Re: Luncheon Conference at 12:30 P.M. (May 3, 1940) (on file with the Truman Library, Papers of Roy Blough, File: Dep't of the Treasury Copies of Letters & Memos July 1939–August 1940 [hereinafter Blough papers]); Roy Blough, Memorandum for the Files, Re: Conference with Mr. F. Howell Campbell at 10:00 A.M. (May 3, 1940) (on file with the Truman Library, Blough papers, *supra*).

⁹⁴ See 26 U.S.C. § 101(12) (1946).

⁹⁵ I.T. 3208, 1938-2 C.B. 127. The same decision ruled that deferred patronage dividends were taxable income to the patrons (as opposed to price adjustments). The cooperatives and their patrons do not seem to have been very concerned about this, presumably because many patrons were not paying much, if any, federal income tax or because in the absence of information returns and matching, it was simply unlikely that many patrons would actually pay the tax due. See 1950 Senate Hearings, *supra* note 82, at 711 (statement of Garner M. Lester, Nat'l Tax Equality Ass'n) (supporting withholding of tax on patronage dividends because "recipients of patronage dividends frequently forget to report them in spite of the Treasury's recent efforts to jog their memory").

dividend.⁹⁶ As the tax advantages of this method increased, large cooperatives steadily attenuated their patrons' rights to retrieve retained patronage dividends until patron's rights began to resemble the rights of common stockholders (i.e., the right to participate in any distribution of retained earnings, but not to force a distribution).⁹⁷ This meant that large cooperative corporations began to look very much like large noncooperative corporations with one difference: they generally paid no income tax.

b. The Rise of the NTEA and the Fight Against Cooperatives

In 1943, with wartime tax rates exceeding eighty percent, a group of midwestern businessmen formed the NTEA to fight against what they perceived to be the threat of tax-free competition.⁹⁸ The NTEA quickly began to lobby Congress and the Treasury.⁹⁹ It also began to orchestrate press coverage and mass mailings to Congress by businessmen who competed with cooperatives, such as grain merchants, oil jobbers, and hardware dealers. The NTEA was formed to address the taxation of cooperatives.¹⁰⁰ Until late 1947,

⁹⁶ See *Midland Coop. Wholesale v. Comm'r*, 44 B.T.A. 824, 833–34 (1941).

⁹⁷ See, e.g., W.C. Bryant, *Tax-Exempt Co-ops, Other Privileged Firms About to Be "Probed,"* WALL ST. J., Oct. 23, 1947, at 1 (discussing patronage dividends of Midland Cooperative Wholesale); Letter from Perry E. Parks, Parks Feed Store, to Walter F. George, Chairman, U.S. Senate Comm. on Fin. (Aug. 20, 1949) (on file with the Nat'l Archives, Washington, D.C., Record Group 46, Records of the U.S. Senate, Committee on Finance, 81A-F7, Revenue: Tax Exempt Organizations [hereinafter Finance Committee Archives], Box 32, Folder: Tax Exempt Organizations 1949 (Folder 1 of 2)) (enclosing a patronage dividend certificate "from the local co-op," and complaining that "I have not been able to get any money on it and if it will be of any use to you, keep it").

⁹⁸ See NAT'L TAX EQUAL. ASS'N, THE FIGHT FOR TAX EQUALITY 1–2 (undated pamphlet) (on file with the Nat'l Archives, Record Group 128, Records of the Joint Committee on Taxation [hereinafter JCT Archives], Box 146, File: Cooperatives); *Girding for Co-ops*, BUS. WK., Sept. 25, 1943, at 98. The NTEA initially incorporated as the "Central Coordinating Group, Inc." See *Co-Op Birthday*, BUS. WK., Dec. 30, 1944, at 17.

⁹⁹ Within months of formation, the NTEA apparently succeeded in lobbying Congress to require tax-exempt cooperatives to file information returns. See *supra* note 36. Ironically, the NTEA tried to position itself as purely involved in research and education, so as to achieve the status of a tax-exempt organization to which tax-deductible contributions could be made. See *Roberts Dairy Co. v. Comm'r*, 195 F.2d 948, 950 (8th Cir. 1952); Leslie J. Oester, Vice President, Nat'l Tax Equality Ass'n, Small Business Imperiled by Co-op Tax Freedom, Statement to the House Comm. on Small Business 3 (Apr. 27, 1945) (transcript available at the Truman Library, Papers of Cooperative League of the U.S.A., Washington, D.C. Office, Box 154, Tax and Coops Folder 2) [hereinafter Oester 1945 Statement] ("The National Tax Equality Association is a coordinating organization engaged solely in research and educational activities."). Apparently out of concern that it would be labeled a lobby rather than an educational association, the NTEA made early efforts to downplay its role in pressing for or orchestrating congressional hearings. See Alfred D. Stedman, *NTEA Asks Showdown on Co-Op Tax*, ST. PAUL DISPATCH-PIONEER PRESS, Aug. 26, 1945, at 1.

¹⁰⁰ See, e.g., Dorothea Kahn, *Campaign to Check Co-ops Begun by Tax Association*, CHRISTIAN SCI. MONITOR, May 22, 1944, at 1 ("The Association states that it is studying tax inequalities of many kinds, but is

it focused almost exclusively on cooperatives, although it also consistently criticized tax exemptions for government-operated businesses, such as municipal utilities and the Tennessee Valley Authority.¹⁰¹

Before the 1947 hearings, however, NTEA materials and spokespeople never mentioned charitable and educational organizations.¹⁰² In fact, the NTEA's December 1, 1947 bulletin declared "HEARINGS END ON HIGH NOTE," even though the hearings on charitable and educational organizations had yet to begin.¹⁰³ After the 1947 Hearings, however, the NTEA's propaganda added charities to its list of secondary issues, apparently impressed by the reaction of congressmen and the press to news of NYU's spaghetti factory.¹⁰⁴

The NTEA orchestrated taxable businesses in a massive, nationwide, highly organized lobbying campaign against unfair competition from cooperatives throughout the 1940s and well beyond.¹⁰⁵ In May 1947, months

chiefly concerned with what it regards as tax favoritism toward co-operative business.").

¹⁰¹ See, e.g., *1947 Hearings*, *supra* note 1, at 3407–10, 3428 (statement of Leonard J. Calhoun, Nat'l Tax Equality Ass'n); Research Dep't, Nat'l Tax Equal. Ass'n, *Legal Tax Dodging and Its Effects on Growth and Competition*, at 29–30 (1947) (on file with University of Iowa Libraries, Iowa City, Social Documents Collection, File: National Tax Equality Association); Oester 1945 Statement, *supra* note 99, at 17–18 (discussing "Competition from Government Owned Business"); LORING SCHULER, *NAT'L TAX EQUALITY ASS'N, TAX EXEMPT PRIVILEGES OF COOPERATIVES AND GOVERNMENTAL BUSINESS* (1944) (on file with the Truman Library, Papers of the Cooperative League of the U.S.A., Washington, D.C. Office, Box 154, Tax and Coops Folder 2). This position followed naturally from the strong element of anticommunist polemic in its rhetoric. Utility companies also seem to have been important supporters of the NTEA. See H.R. REP. NO. 81-1675, at 11 (1950).

¹⁰² When the NTEA's representative testified during the portion of the 1947 Hearings that dealt with charities (as opposed to cooperatives, mutuals, and government-owned businesses), he admitted that while the NTEA had prepared extensive reports on cooperatives, mutuals, and government-owned businesses, its statement on charities was "based on preliminary studies and accordingly does not afford a basis for answering detailed questions." *1947 Hearings*, *supra* note 1, at 3407 (statement of Leonard J. Calhoun). In a radio debate broadcast over the Mutual network in May 1947, Senator George Aiken, arguing for the cooperatives, mocked the NTEA for not being "concerned over the fact that the same law that exempts farm cooperatives that make no profits from paying tax also exempts chambers of commerce, advertising clubs, manufacturers' associations, and many other organizations." *Should All Co-Ops Pay Federal Income Tax?*, *The American Forum of the Air* 6 (Mutual Broadcasting System radio broadcast May 6, 1947) (transcript on file with University of Iowa Libraries, Iowa City, Manuscript Collection, Facts for Farmers, Record, File: National Association of Cooperatives, 1947). Aiken clearly did not think he was up against an organization that was actively opposing all exempt organizations. Nor did the NTEA's representative in the debate respond by saying that the NTEA's agenda included other exempt organizations. Rather, he pulled out a telegram from the National Retail Hardware Association, stating that hardware retailers would gladly accept taxation of their purchasing cooperatives. *Id.*

¹⁰³ *Hearings End on High Note*, *NAT'L TAX EQUALITY ASS'N BULL.*, Dec. 1, 1947, at 1.

¹⁰⁴ See *NAT'L TAX EQUAL. ASS'N*, *supra* note 98, at 8.

¹⁰⁵ Contemporary observers were impressed with the scope and pervasiveness of the campaign. As early

before the Mueller transaction, NTEA pressure caused the House Ways and Means Committee to announce hearings on cooperative taxation, which were eventually held, after several postponements, in November of 1947.¹⁰⁶ The Committee also added a few days to consider exempt organizations other than cooperatives, apparently at the behest of the Treasury and Joint Committee staff.¹⁰⁷ Aside from the hearings in 1947, the cooperative issue generated

as August 1947, a local newspaper editor in Hokah, Minnesota, wrote:

For a long time my mail has been flooded with propaganda coming from people who for one reason or another are bent upon killing the co-operative movement. . . .

. . . EVERYBODY has been receiving this same kind of mail and is being fed this same kind of doctrine. The upshot of the whole matter is that a country-wide attack is being made against “co-ops” and that the entire population is being told if the co-operative movement is not crushed it will put an end to all individual business—and soon.

H.E. Wheaton, *The Straw That Broke the Camel's Back*, HOKAH (MINN.) CHIEF, Aug. 23, 1945, at 1. Not only did Mr. Wheaton perceive the campaign as pervasive, he also assumed that readers would understand his oblique reference to the NTEA without further elaboration. The size of the campaign is also evident from the sheer volume of NTEA postcards and NTEA-inspired constituent communications to Congress. NAT'L TAX EQUALITY ASS'N, BE IT HEREBY RESOLVED—237 RESOLUTIONS FAVORING FEDERAL INCOME TAX EQUALITY ADOPTED BY ORGANIZATIONS REPRESENTING 710,440 BUSINESSMEN (undated pamphlet purportedly submitted to House Ways and Means Committee at 1947 Hearings) (on file with University of Iowa Libraries, Iowa City, Special Collections, Social Documents Collection, File: National Tax Equality Association); *see infra* note 116 (discussing archives of constituent communications).

¹⁰⁶ *See 1947 Hearings*, *supra* note 1, at 1867–3161. The hearings were initially announced in May 1947 and expected to occur in June. *See Progress Toward Tax Equality*, NAT'L TAX EQUALITY ASS'N BULL., May 15, 1947, at 1 (apparently quoting Ways and Means Committee press release, stating that hearings “on various phases of Federal taxation . . . [including] the taxation of earnings made by labor unions, trade associations, educational institutions, municipal utilities and cooperatives” would begin on May 19 and that “[i]t is expected that the co-op tax liability will be reached about mid-June”). On June 20, 1947 the Ways and Means Committee announced that it would hold five days of hearings from July 21 to 25. *See Hearings Set! . . . July 21–25*, NAT'L TAX EQUALITY ASS'N BULL., July 1, 1947, at 1 (quoting press release in full, stating that “[a]n exemption from Federal income taxes is provided for under Section 101 of the Internal Revenue Code in the case of many types of charitable and other organizations. The forthcoming hearings will be confined solely to problems arising under that Section of the Code”). Subsequent press from both sides persuaded the committee to postpone the hearings to November and give them more time. *See Knutson Re-Sets Hearings for November 4*, NAT'L TAX EQUALITY ASS'N BULL., July 15, 1947, at 1.

¹⁰⁷ *See Should They Pay Taxes on Profits from Stores, Factories, Rail Yards?*, WALL ST. J., Apr. 12, 1947, at 1 (attributing push for hearings on business activities of charities, as opposed to cooperatives, to joint committee staff). This conclusion seems accurate. Colin Stam, chief of staff of the Joint Committee on Internal Revenue Taxation, pressed for hearings in both 1946 and 1947 and prepared draft press releases emphasizing noncooperative exempt organizations. *See* Letter from Colin F. Stam, Chief of Staff, Joint Comm. on Internal Rev. Taxation, to Harold Knutson, Chairman, House Comm. on Ways and Means (May 13, 1947) (on file with the JCT Archives, *supra* note 98, Box 150, Folder: Tax Exempt Organizations 1947) (attaching draft press release); Tentative Draft 4/1/46, Press Release: Notification of Hearings on Tax Exempt Orgs. (on file with the JCT Archives, *supra* note 98, Box 150, Folder: Tax Exempt Orgs. 1946). It seems clear that the House Ways and Means Committee did not use this draft in 1947. The quotes from the NTEA's bulletins do not match the draft. *See supra* note 106. Likewise, the National Association of Cooperatives' press release reporting the Committee's June 1947 press release was titled “Ways and Means Hearings for

weeks of congressional hearings at various times from 1945 to 1960¹⁰⁸ and mountains of constituent and lobbying communications.¹⁰⁹

This unrelenting pressure on the cooperative issue kept exemption issues on the agendas of Treasury and the Congress through 1950. In fact, when Treasury Secretary Synder presented the President's UBIT proposal to the House Ways and Means Committee in 1950, Chairman Doughton was concerned that it did not include cooperatives. He noted that "[y]ou had a good deal of complaint about competitive positions, about certain organizations that are taxed and certain organizations that are not taxed; and where they claim that it creates an unfair and difficult competitive situation."¹¹⁰ As everyone in the room understood, he meant cooperatives.

c. Taxpayer Campaigns Against Unfair Competition After the UBIT

In the years after the UBIT passed, another taxpayer fight began, this time over the treatment of advertisements in magazines published by charities and other exempt organizations. Taxable publishers lobbied the Treasury for years until, in 1967, the Treasury finally published regulations adopting the

'Exempts' Begin July 21! But What About the 'Non-Exempts'?' Stam's draft left no doubt that the hearings would address both cooperatives exempt under section 101(12) and "non-exempt" cooperatives. References to noncooperatives were sufficiently oblique prior to November 1947 that no charities signed up to testify and Chairman Knutson was forced to make an additional press statement, questioning whether charities minded being taxed. *See To Weigh Tax Exemptions*, N.Y. TIMES, Nov. 16, 1947, at 39.

¹⁰⁸ *Tax Treatment of Earnings Cooperatives: Hearings on the Subject of Tax Treatment of Earnings of Cooperatives, Before the H. Comm. on Ways and Means*, 86th Cong. 1-439 (1960); *General Revenue Revision: Hearings on Topics Pertaining to the General Revenue Revision of the Internal Revenue Code Before the H. Comm. on Ways and Means*, 85th Cong. 1955-2226 (1958); *1950 Senate Hearings*, *supra* note 80, at 706-54; *1950 House Hearings*, *supra* note 36, at 2015-304; *Government Competition With and Assistance to Business: Hearings Before Subcomm. No. 2 of the H. Select Comm. on Small Business*, 80th Cong. 1-648 (1947). A witness in the 1960 hearings claimed that Congressional hearings on the topic between 1947 and 1958 lasted thirty-one days and filled 2956 pages of testimony. *Tax Treatment of Earnings Cooperatives: Hearings on the Subject of Tax Treatment of Earnings of Cooperatives, Before the H. Comm. on Ways and Means*, 86th Cong. 117 (1960) (statement of George B. Blair, Pres. of the Nat'l Council of Farmer Coops.).

¹⁰⁹ For some of the constituent correspondence, see sources cited *infra* note 121. The files of the Treasury Department, the congressional tax committees, and the White House reflect professional lobbying by both sides. *See, e.g.*, Letter from Wallace J. Campbell, Coop. League of the U.S., to David D. Lloyd, Assistant to Charles S. Murphy, Admin. Assistant to the President (Jan. 10, 1950) (on file with the Truman Library in Murphy Speech File, *supra* note 71).

¹¹⁰ *1950 House Hearings*, *supra* note 36, at 115. Snyder's response was that co-op taxation could not be detached from farm policy. *Id.* He had recently discovered this the hard way. *See supra* note 1. Legislators with rural constituencies also found it a difficult issue, requiring them to deal, on the one hand, with large numbers of local businessmen participating in the NTEA's campaign and, on the other hand, with co-op members. *See, e.g.*, Jay Walz, 'Coops' in Center of Political Fight, N.Y. TIMES, Aug. 31, 1947, at E4.

“fragmentation rule.”¹¹¹ Incensed exempt organizations forced hearings on the matter in conjunction with the 1969 tax reform, hoping to convince Congress to reverse the Treasury’s rule. The House Ways and Means Committee spent three days listening to impassioned exempt organizations and their taxable competitors.¹¹² Lobbying materials and constituent letters piled up.¹¹³

Similarly, in 1987, the Small Business Administration rallied outraged taxpayers to force hearings on unfair competition by the related business activities of exempt organizations. A House Ways and Means subcommittee held a week of hearings and compiled several volumes of written comments, much of which were taken up with crowds of angry small business people, eager to tell Congress their tales of unfair competition.¹¹⁴

These controversies are not only notable for the large volume of letters, comments, and live testimony they produced. It is also important to notice the nature of the taxpayer protests. Although professional lobbying organizations were marshalling and egging on the protests in each case, they were able to orchestrate very specific and personal complaints. Taxpayers named exempt organizations they felt were harming them personally and detailed the harm they had personally suffered, as they perceived it.¹¹⁵ Without judging whether the taxpayers were justified in their complaints in any of these instances, one can nonetheless conclude that taxable businesses bark loudly when they

¹¹¹ See *supra* note 45 and accompanying text for a discussion of the fragmentation rule.

¹¹² See *1969 Hearings*, *supra* note 42, at 965–89, 1071–77, 1104–42.

¹¹³ Table of letters from constituents, lobbyists and legislators (on file with the JCT Archives, *supra* note 98, Box 684, Tax Reform Act of 1969 (HR 13270) Tax on Unrelated Business—Advertising, Folder: Advertising Sec 512). Other written comments were included in the transcript of the 1969 Hearings. See *1969 Hearings*, *supra* note 42, at 1349–425.

¹¹⁴ See *Hearings Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 100th Cong. (1987); SUBCOMM. ON OVERSIGHT OF THE HOUSE COMM. ON WAYS AND MEANS, 100TH CONG., WRITTEN COMMENTS ON DISCUSSION OPTIONS RELATING TO THE UNRELATED BUSINESS INCOME TAX (Comm. Print 1988).

¹¹⁵ See, e.g., *Unrelated Business Income Tax: Hearings Before the Subcomm. on Oversight of the H. Comm. on Ways and Means*, 100th Cong. 1219–21 (1987) (statement of Frank Eisenzimmer, Cascade Athletic Club) (detailing YMCA competition); *1969 Hearings*, *supra* note 42, at 1245 (statement of Henry Zwirner, Fairchild Publ’ns) (detailing exempt competitors); *1950 House Hearings*, *supra* note 36, at 2075–77 (statement of Ernest Peter, Iowa Indep. Oil Jobbers Ass’n) (describing competitive pressure on his business and other oil jobbers); Letter from Arthur G. Weigold, Torrington Creamery, Inc., in *1947 Hearings*, *supra* note 1, at 1983 (detailing dairy competition in Torrington, Conn.). In 1950, a rural merchant wrote Chairman George to complain that his fertilizer sales disappeared when “co-ops opened up just 55 feet from my back door . . . we are only handling dry goods and a small amount of groceries. In other words the co-op are [sic] making me close. My tax too high [sic] while they do not pay tax.” Letter from B.S. Chandler to Walter F. George, Chairman, U.S. Senate Comm. on Fin. (June 26, 1950) (on file with the Finance Committee Archives, *supra* note 97, Box 32, Folder: Tax Exempt Organizations June 1950).

perceive unfair competition. They were doing it throughout the 1940s and long afterward. What they were not doing, however, was complaining about the threat Congress was eager to defend them against: unfair competition from charities.

2. *The Absence of Taxpayer Protest over the Charitable Exemption*

If the desire to prevent unfair competition was the actual motivating force behind the UBIT, one would expect to find that it was passed in response to pressure from taxpayers complaining about unfair competition. If the concept of unfair competition is theoretically shaky, as critics have long claimed, this only heightens the expectation that Congress and the Treasury adopted it in direct response to hordes of self-interested taxpayer lobbyists.

The actual history of the UBIT belies these expectations in almost every respect.¹¹⁶ First, there is almost no evidence of taxpaying businesses complaining to Congress or the Treasury. The transcripts of the congressional hearings in 1947 and 1950, for instance, contain only five witnesses who arguably fit this description.¹¹⁷ Ironically, the Revenue Act of 1950 did not address the principal concerns of any of these witnesses, nor did any congressman or Treasury representative ever use the specific industries represented by these witnesses (commercial research and hospitality) as an example when they listed litanies of unfair competition.¹¹⁸

¹¹⁶ Commentators have not noticed this and often assumed there were complaints. See, e.g., Kaplan, *supra* note 29, at 1433. Eliasberg conflated the long November 1947 cooperative hearings with the short December hearings about charities. See Eliasberg, *supra* note 29, at 76.

¹¹⁷ In 1947, a representative of the NTEA complained about competition by exempt organizations as part of a broad argument for the elimination of almost all tax exemptions (including for passive investment income of charitable endowments and the activities of governmental organizations). *1947 Hearings, supra* note 1, at 3407–31 (statement of Leonard J. Calhoun). For the NTEA, however, the broader argument was merely a sideline to the objective of applying the corporate income tax to cooperatives. In 1950, the NTEA concentrated its testimony exclusively on cooperatives. See *1950 Senate Hearings, supra* note 82, at 710–18. Harold M. Dudley, representing the American Council of Commercial Laboratories also made a statement in the 1947 Hearings, objecting to competition from university laboratories. *1947 Hearings, supra* note 1, at 2755–59. In 1950, the United States Chamber of Commerce testified against unfair competition, but ultimately did not favor a UBIT, arguing instead that the Treasury should deny exemption to charities engaged in “improper activities.” *1950 House Hearings, supra* note 36, at 2530–33 (statement of Ellsworth C. Alvord). Finally, in 1950, representatives of the American Hotel Association complained about competition for convention and banquet business from fraternal lodges and country clubs. *1950 Senate Hearings, supra* note 82, at 48–88 (statement of Daniel J. O’Brien); *id.* at 589–95 (statement of Ray Smith).

¹¹⁸ Seven years later, Mr. Dudley, of the American Council of Commercial Laboratories, was still making the same arguments he had made in 1947 without success. See Letter from Norman A. Sugarman, Baker, Hostetler & Patterson, to Dan Throop Smith, Deputy Sec’y, U.S. Dep’t of the Treasury (Dec. 13, 1957) (attaching statement from Dudley). Thirty-seven years later, his successors were still hoping to get lucky. See

Congressman Noah Mason did claim, in the 1950 House Hearings, that a spaghetti factory in his district had recently been “forced to the wall” by competition from expansion into the Midwest by the C.F. Mueller Company, implying that Mueller’s competitive success must be due to its tax exemption.¹¹⁹ No representative of this spaghetti company appeared in person, however, or even asked Mason to include a letter or statement in the record. There is reason to doubt the authenticity of his claim.¹²⁰ In fact, the only letter from a spaghetti company I could find in the archived correspondence files of the House Ways and Means Committee, the Senate Finance Committee, and the Joint Committee on Internal Revenue Taxation complained exclusively about competition from tax-advantaged cooperatives.¹²¹

Unrelated Business Income Tax: Hearings Before the Subcomm. on Oversight of the H. Comm. on Ways and Means, 100th Cong. 551–80 (1987) (statement of Grover C. Williams, Am. Council of Indep. Labs.).

¹¹⁹ See *1950 House Hearings*, *supra* note 36, at 580 (“We have a macaroni factory in my district that has been in operation over 35 years. It is now being forced to the wall by the competition from this macaroni factory of the New York University that is gradually getting out into the Middle West with their product.”).

¹²⁰ The claim itself is doubtful because Mason’s version of it in his 1950 article contained facts that can be charitably described as exaggerated. See Noah M. Mason, *Uncle Sam’s Untapped Millions*, AM. MAG., Feb. 1950, at 30. In that article, Mason purported to have discovered Mueller’s tax-free status only after “a little macaroni factory” in his district “complained bitterly to me that his business was being hurt by unfair competition from an enormous nontaxpaying macaroni manufacturer in New Jersey.” *Id.* Mason was clearly aware of the Mueller transaction at the 1947 House hearings, which began only a few months after NYU announced the transaction and long before anyone could have noticed unfair competition. Moreover, Mason said nothing about the little macaroni manufacturer in those hearings.

¹²¹ Letter from E.F. Lexow, General Manager, Quality Macaroni Company, to Sen. Walter F. George, Chairman, U.S. Senate Comm. on Finance (June 30, 1950) (on file with the Finance Committee Archives, *supra* note 97, Box 32, Folder: Tax Exempt Orgs. June 1950). I reviewed some but not all of the committee correspondence files in detail because, at times, letter-writing campaigns organized by the NTEA swelled the files with vast amounts of duplicative correspondence. From the file labels and some random sampling, these constituent communications appeared to be exclusively dedicated to the cooperative issue. In addition, it should be noted that the correspondence in the files of these committees does not include all of the correspondence received by individual senators and representatives, although a certain amount of such correspondence is in the files of the Joint Committee because it was forwarded to the Joint Committee staff for a reply or advice on how to reply. The correspondence I looked at can be found as follows:

House Ways and Means Committee: National Archives, Washington, D.C., Record Group 233, Records of the U.S. House of Representatives, 81st Cong., Comm. on Ways & Means, HR 81A–F17.1 [hereafter Ways & Means Archives], Box 168, Revision: C, Folders: Tax Exempt Organizations (Cooperatives), Cooperatives 1950; *id.* at Box 169, Revision: L–T, Folders: Tax-Exempt Organizations 1950; *id.* at HR 80A-F18.6, Boxes 696-716, Tax Exempt Cooperatives—Chronologically Arranged Correspondence Feb. 1948–May 1948; *id.* at Boxes 716–718, Tax Exempt Cooperatives—Subject Arranged Correspondence Feb. 1948–May 1948.

Senate Finance Committee: Finance Committee Archives, *supra* note 97, Box 32, Folders: Tax Exempt Organizations 1949 (two folders), Tax Exempt Organizations Jan. Feb. March Apr. 1950, Tax Exempt Organizations May 1950, Tax Exempt Organizations June 1950, Tax Exempt Organizations July 1–9, 1950; *id.* at Box 33, Folders: July 10–20, 1950 (two folders); July 24–27,

Likewise, the correspondence archives of the Treasury Department, the House Ways and Means Committee, the Senate Finance Committee, and the Joint Committee on Taxation contain only a handful of constituent communications protesting unrelated business activities by charities.¹²² These scattered protests all came from citizens outraged in the abstract about the idea of charities competing with taxable businesses. None of them came from persons claiming that they were personally suffering from unfair competition. A 1948 Treasury report attempted to list in detail all known cases in which an exempt charity operated a business. The report mentions only one case (a group of dentists complaining about the clinic at a dental college), which came to the government's attention because a taxable competitor complained about unfair competition.¹²³ Ironically, this one example of an actual complaint concerned "related" business activities, which the UBIT ultimately allowed to continue untaxed.

Passing the UBIT required a significant effort by Congress and the Treasury. It is therefore reasonable to expect to find a strong motivating force driving the effort. In the absence of taxpayer protest, concern for unfair competition in the abstract seems an unlikely source of this impetus.

1950; July 28, 1950; July 29, 1950; August 1–2, 1950; August 3–4, 1950; *id.* at Box 34, Folders: August 5–8, 1950; August 9–10, 1950 (two folders); August 11–31, 1950; September, 1950; October & November, 1950.

Joint Committee on Internal Revenue Taxation: JCT Archives, *supra* note 98, Box 155, Exemptions, Folder: Income Tax: Corporations; *id.* at Box 146, Cooperatives 1949–1954; Cooperatives—Farmers 1943–47, Folders: Cooperative Associations 1943, Cooperative Associations 1944, Cooperative Associations 1945, Cooperative Associations 1946, Cooperatives—Farmers' 1943, Cooperatives—Farmers' 1945, Cooperatives 1949; *id.* at Box 289, Sec. 501 Exemptions from Tax on Corporations, Certain Trusts, etc. 1946, 1954, 1955, 1956, and 1957, Folder: Section 501 Exemptions from Tax on Corps., Certain Trusts, Etc. 1946, 1954, 1955.

¹²² Charities were never an objective of the NTEA as it pushed for hearings at the House Ways and Means Committee. See *supra* note 102. After the 1947 Hearings, however, the NTEA broadened its literature beyond questions of cooperative taxation. Most of the constituent letters complaining about universities and other charities were written after the 1947 Hearings and seem to be NTEA inspired. They generally mention exempt organizations other than cooperatives only in the context of protests over unfair competition from cooperatives and mutuals. See, e.g., Letter from William H. Ellsworth, Merchs. & Mfrs. Bank, to Robert L. Doughton, Chairman, House Comm. on Ways and Means (May. 14, 1949) (on file with the Ways & Means Archives, Box 168, Folder: Tax Exempt Organizations (Cooperatives)) ("[T]here is a great deal of tax dodging on gifts, so called, to universities and colleges. We think the law should be changed so they will be taxed . . . the most flagrant violation in our laws is to permit the cooperatives to go into business and compete with all the rest of the people . . .").

¹²³ See Tax Exempt Organizations Other than Cooperatives, at 14 (c. 1948) [hereinafter Copeland Report] (on file with the OTA Archives, *supra* note 36, Box 18, Folder 4: Subcommittee on Section 101 corporations other than coops (Treas. and Joint Com. on Int. Rev. Taxation–1946)).

C. Problems with the Revenue Explanation

Sections A and B above questioned the mismatch between the UBIT and its primary traditional purpose—avoiding unfair competition. This section considers problems with the UBIT’s secondary purpose—protecting federal tax revenues. These problems are actually closely related. If Congress’ response to nonexistent taxpayer concerns is odd, the reason the taxpaying businesses were not pressuring Washington is fairly simple: businesses come to Congress to complain when they face competition (especially if they can argue that it is unfair). They do not come to complain when they discover an effective method of tax avoidance.

The transactions that attracted the attention of the policymakers and the press in the late 1940s were actually manifestations of tax-shelter schemes used by taxable persons to avoid tax. Charities participated in these transactions only as “accommodation parties,” effectively lending their exemption for a small fee. The tax cheats were the taxable participants.

The problem with the revenue protection argument is not that there was no threat. There was a serious threat to tax revenue in these transactions—the threat that taxable persons would escape tax through sham transactions with charities. Congress faced the same threat again in the late 1960s when it expanded the debt-financed income rules. The problem is, rather, that neither Congress nor the Treasury ever clearly identified or reacted to the real threat of taxable persons sheltering their income with sham transactions. Rather, policymakers consistently focused their attention, anger, and reform efforts at the “abuses” of the charitable accommodation parties and ignored the probability that the promoters would find other accommodation parties and would continue to market similar schemes.

Subsection 1 below explains the actual threats to federal revenues reflected in charities’ “business investments.” Although a few contemporary commentators properly analyzed them, the two distinct schemes involved have generally been misunderstood and confused together.

1. The Threat to Revenue: Why the Dog Did Not Bark

The reason businessmen did not object to unfair competition by charities is that no such unfair competition was occurring. Rather, taxable businessmen were eagerly entering into tax-avoidance transactions with charities. The exempt organizations conducting these transactions were not competing with

taxable business. Rather, they were providing a valuable tax-avoidance service to taxable business: renting out their tax exemptions for a fee.

Congressman Mason's local spaghetti manufacturer may have responded with fear at the news of NYU's Mueller acquisition. Most business owners, however, simply began looking for a charity to help them cash out or finance their businesses on tax-advantaged terms. Many business people, in fact, seem to have reacted by going into the brokerage business, matching taxable businesses with willing charities.¹²⁴ The Chamber of Commerce of the United States made this dynamic clear in its testimony before the House Ways and Means Committee in 1950. While the Chamber did not "quarrel with the principle and purpose" of the Treasury's proposals on leasebacks, it was concerned that it would be difficult to draft a law which would not "close or impede an important new avenue of financing," noting that "[i]t is well known fact that insurance companies [which were effectively tax-exempt at the time] have made substantial investments in the purchase of industrial and business real estate and the execution of long-term leases thereof."¹²⁵

By contrast, the controversies over tax-exempt cooperatives, advertising sales by exempt publications, and the "related" business activities of exempt organizations were not tax avoidance schemes for taxable businesses. In these cases, exempt organizations were actually operating independent businesses for their own profit, not as a paid service to taxable owners.¹²⁶ It was the competition from these businesses (and the perceived tax advantage behind it)

¹²⁴ See, e.g., *1950 House Hearings*, *supra* note 36, at 541 (statement of Royall Little, Textron Inc.) (noting that "within the last 2 years hardly anyone wishing to sell a business will deal with me because I will not be party to [the bootstrap or leaseback] device of avoiding the corporate tax"); *1947 Hearings*, *supra* note 1, at 3455 (statement of Robert Stewart, Purdue Univ.) (describing a "cold call" from a businessman who, inspired by press reports of the Mueller purchase, was looking for a university to buy his company).

¹²⁵ *1950 House Hearings*, *supra* note 36, at 2531 (statement of Ellsworth C. Alvord). Mr. Alvord went on to acknowledge the danger that a leaseback involving an exempt party would be manipulated to give tax advantages to the taxable party, but cautioned against per se rules, favoring, instead, a case-by-case analysis of whether "the facts establish that these vital terms have been determined by objective arm's-length methods and procedures." *Id.* at 2531-32. For a modern-day heir to Mr. Alvord's arguments, see Dean Thomas Riskas, *Are SILOs Abusive? A Primer on How They Work*, DAILY TAX REP. (BNA), Apr. 12, 2004, at J1.

¹²⁶ A constant theme of the NTEA complaints about unfair competition from cooperatives was that business owners were selling out to cooperatives at prices no taxpayer could afford. The difference is that these sales were real—the owners were exiting a business in which they felt they could no longer compete (or, to put it differently, for which they were made an offer they could not refuse). By contrast, leasebacks never involved owner exit and bootstraps could, but did not require it. They generally were played as pure tax scam. The emotional attitude of an owner forced to sell her business because her competitor has a lower cost structure is very different, no matter what the price, from that of an owner who has just discovered a tax-efficient way to take capital out of the business.

that prompted taxpayer concern and the clamorous protest that brought these issues to the attention of policymakers.

Two tax shelter schemes were reflected in charities' business transactions in the late 1940s: leasebacks and bootstraps.

a. Leasebacks

The main charity-facilitated tax shelter of the 1940s was the leaseback.¹²⁷ These transactions were heavily marketed by promoters touting them both as tax shelters and as a form of off-balance-sheet financing.¹²⁸ In this transaction, taxpayers purported to sell real property to exempt organizations or to insurance companies (which, at the time, were effectively tax exempt).¹²⁹ The exempt buyer then leased the property back under a long-term net lease, usually renewable for one or more similar terms.

This arrangement amounted to a long-term loan secured by real property. By characterizing it as a lease, however, the taxpayer could convert nondeductible repayments of loan principal into deductible payments of rent and effectively depreciate nondepreciable real property.¹³⁰ The seller/lessee could also set the nominal purchase price above or below basis, as convenient, to recognize an immediate capital gain or loss.¹³¹

In some cases, these transactions were blatantly designed to have no economic reality: the buyer borrowed the entire purchase price. The parties

¹²⁷ For contemporary descriptions of the tax aspects of the leaseback transaction, see William L. Cary, *Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax and Policy Considerations*, 62 HARV. L. REV. 1, 16–27 (1948); Note, *Some Economic and Legal Aspects of Leaseback Transactions*, 34 VA. L. REV. 686, 694–96 (1948). For a long list of major leaseback deals and their terms through 1947, see Levy, *supra* note 76, at 2.

¹²⁸ See John Kobler, *Real Estate's Mighty Atom*, SAT. EVENING POST, Feb. 12, 1949, at 39 (profiling David Gadlow, a successful promoter); Letter from Robert R. Coker, President, J.L. Coker & Co., to A.L.M. Wiggins, Under Sec'y, U.S. Dep't of the Treasury (Mar. 31, 1948) (on file with the OTA Archives, *supra* note 36, Box 19, Folder 40: HA 8/1 Unrelated Business Income of Tax Exempt Organizations—Lease-Back Operations (enclosing marketing letter from Louis Schlesinger Co.)).

¹²⁹ At the beginning of the 1940s, state insurance regulation generally prohibited insurance companies from investing in real estate. By 1950, however, the insurance companies had eliminated or loosened many of these regulations and dominated the leaseback market. See, e.g., *1950 House Hearings*, *supra* note 36, at 566 (statement of King E. Fauver, Oberlin Coll.) (commenting that “rentals have been coming down since insurance companies went into [leasebacks]”); *id.* at 578 (statement of Philip C. Pendleton, Am. Council on Educ.) (noting that “[t]he life insurance companies are putting far more in[to leasebacks] than we are”); Cary, *supra* note 127, at 30–31 (discussing regulatory changes).

¹³⁰ See Cary, *supra* note 127, at 17–21.

¹³¹ See *id.* at 21–23.

carefully designed the features of the transaction—such as purchase price, rental payments, and lease duration—to amortize the “buyer’s” loan and leave it with a small amount of additional profit. To make sure that the “seller” did not actually give up the property, the lease included an option to repurchase for a token price or an option to renew the lease for token rent. The net effect was to leave the exempt organization with a small premium for the use of its exemption. More artful transactions did not include token repurchase or renewal options, to avoid making the transfer of title obviously illusory. Instead, these transactions played with the various lease features (rental schedule, duration, nonbargain renewal provisions) to achieve the same economic result in a more subtle fashion.

Frenzied leaseback promoters also touted various nontax benefits to the seller’s balance sheet. A good number of credulous clients (or the clients’ more credulous creditors) were undoubtedly attracted by the benefits of off-balance-sheet debt.¹³² However, the main motivating force behind such transactions was tax savings.¹³³ The tax savings depended on finding a buyer/lessor with a significantly lower marginal tax rate than the seller/lessee, because the buyer/lessor recognized income equal to the deductions enjoyed by the seller/lessee. Tax-exempt buyer/lessors seem to have been a universal feature of leasebacks in the 1940s, although insurance companies largely supplanted charities toward the end of the decade, as state limitations on their ability to make real estate investments were repealed.¹³⁴

¹³² One of the primary economic advantages claimed by leaseback promoters was that leasebacks increased a lessee’s total borrowing power. *See id.* at 5–16; Note, *supra* note 127, at 687. To the extent this resulted from the semi-nonrecourse character of a lease obligation in bankruptcy, leasebacks commanded a higher rate of return to the lender, which should, in theory, have decreased the lessee’s borrowing potential. Cary, *supra* note 127, at 9. To the extent a leaseback allowed a lessee to evade the language of existing debt covenants, however, there may have been something (albeit something that would go away in the long term) to the arguments. *Id.* at 15–16. A 1948 Virginia Law Review note, which was much quoted by politicians and journalists over the next few years for describing the leaseback as “[t]he most noteworthy financial device of the present century,” described its economic benefits as “fundamentally the offspring of an idiosyncrasy in accounting practice, a method by which a large long-term obligation can be effectively concealed on the books of a corporation.” Note, *supra* note 127, at 691. Even if the borrowing advantage was purely illusory, however, it probably had real significance in the marketing of leasebacks. As William Cary delicately put it, “[t]he question of borrowing versus selling and leasing back throws an interesting light upon the psychology of some businessmen.” Cary, *supra* note 127, at 12.

¹³³ *See id.* at 16 (“[T]here can be no question that the tax aspect has been an important, and in many cases controlling factor.”).

¹³⁴ *See* Note, *supra* note 127, at 694 (“It has been previously noted that leaseback investors are limited almost exclusively to three classes: charitable foundations, universities, and insurance companies. The most striking element of similarity among these three types of organization is their complete or almost complete exemption from federal income taxes.”).

b. Bootstraps

The other significant abuse relevant to the UBIT was the so-called “bootstrap” transaction. Bootstraps began in the 1940s, although they rose to greater prominence in the 1950s. They accelerated even more after the Supreme Court rejected one of the government’s main lines of attack against them in the 1965 *Clay Brown* decision.¹³⁵ Congress and the Treasury were dimly aware of bootstraps before 1950, but did not differentiate them from leasebacks. This confusion is understandable. Bootstraps were different from leasebacks, but worked on the same basic principle: an exempt counterparty absorbed income generated as a byproduct of a transaction that favorably transformed the taxable party’s tax attributes. Whereas leasebacks aimed to convert payments from nondeductible to deductible, bootstraps were mainly aimed at creating favorably-taxed capital gains out of unfavorably-taxed ordinary income and corporate surpluses potentially taxable as “unreasonable” accumulations.¹³⁶

In the typical transaction,¹³⁷ the owner of a closely-held corporation generating significant taxable cash income sold the stock to an exempt organization in exchange for a note plus some nominal amount of cash (usually the corporation’s cash balance at closing). Simultaneously, the exempt organization liquidated the corporation and leased its business assets to a new taxable corporation owned by persons affiliated with the seller. The lessee, to no one’s surprise, kept former management in place at their former salaries. The lease required the lessee to pay eighty percent of its net profits to the exempt organization as rent. The note, in turn, required the exempt organization to pay ninety percent of the rent to the seller to pay down principal. The lessee paid little tax, after deducting “salaries” and “rent.” The exempt organization paid no tax, effectively transferring most of the ordinary income of the business to the owner in the form of low-taxed capital gains.

¹³⁵ See *Comm’r v. Brown*, 380 U.S. 563 (1965).

¹³⁶ High personal rates on corporate distributions, coupled with the threat of “Section 102” taxes excess profit accumulation, were important in driving early bootstrap transactions. See, e.g., *Sale of Business to Charitable Organizations*, 5 RIA TAX’N REP. 201, 201–02 (1948) [hereinafter *RIA Report*]; Abraham Tannenbaum, *Sale of a Business to a Charity*, 28 TAXES 723, 728 (1950). In 1950, Royall Little, founder of Textron, admitted the importance of section 102 in his earlier acquisitions, but complained that he had been unable to compete for such acquisitions recently because he was not willing to engage in bootstrap transactions (probably because the Senate and IRS were investigating him for abuse of charitable trusts). See *1950 House Hearings*, *supra* note 36, at 540–41.

¹³⁷ See James A. Moore & David H.W. Dohan, *Sales, Churches, and Monkeyshines*, 11 TAX L. REV. 87, 89–90 (1955) (describing a “hypothetical case” resembling standard University Hill transaction); Note, *supra* note 40, at 992–93 (describing the “standard agreement first used by the University Hill Foundation”).

The UBIT's antileaseback provisions restricted these leases to five years. The spread between a single level of capital gains tax and the corporate and/or individual taxes that would otherwise have attached to the business earnings seems to have been sufficiently large, in the right case, to fully fund a premium price for the business in five years or less.

NYU's acquisitions in 1946 and 1947 were essentially bootstraps.¹³⁸ Although there are strong indications that bootstrap promoters were in full swing before 1950,¹³⁹ the only other public example before 1950 using a charity as counterparty was an oil distribution company, named "SICO," whose owner essentially recapitalized it as a tax-exempt foundation. The foundation used the business proceeds to pay the former owner "purchase price installments" over a long period and distributed the remainder to local public schools.¹⁴⁰ After 1950, however, certain promoters, most notably the University Hill Foundation, generated large numbers of transactions.¹⁴¹

¹³⁸ See *C. F. Mueller Co. v. Comm'r*, 14 T.C. 922, 923 (1950) (reciting that sale was motivated by death and estate tax liability of president and majority shareholder); Tannenbaum, *supra* note 136, at 729 n.27 (equating Mueller acquisition with bootstraps); *Into the Tax-Exemption Fold*, BUS. WK., Jan. 26, 1946, at 67 (describing leveraged sale of The Ramsey Corp. by NYU alumni as motivated by owners' concerns over estate tax liability). The Mueller transaction may have involved significant charitable intent. In the 1947 House Ways and Means Committee hearings, John Gerdes, representing NYU, claimed that the university was able to finance one hundred percent of the purchase price of the businesses it acquired (including, most famously, the Mueller noodle business) because the purchase price was below market, reflecting the sellers' genuine charitable intent. See *1947 Hearings*, *supra* note 1, at 3539.

¹³⁹ See *RIA Report*, *supra* note 136 (noting that "[m]any taxpayers have found the answer to [tax cost of selling a business] in a sale of the business to a charitable religious or educational organization, or foundation" and describing bootstrap sale); Note, *supra* note 40, at 992 n.3 (noting that University Hill Foundation received exempt status in 1946 as Loyola University Foundation); *Boren's Tax Issue: Tax Favoritism*, BUS. WK., July 28, 1945, at 76 (describing apparent bootstrap sale of Nebraska Power Co. to a nonprofit corporation formed for the purpose); Tannenbaum, *supra* note 136, at 727-28 (tax practitioner describing "typical fact patterns" in 1950); Memorandum from R.C. Dunlap, Chief, Bureau of Internal Revenue, Practice and Procedure Div., Exempt Orgs.' Rulings Section, to George E. Adams, Head, Bureau of Internal Revenue, Legislation and Regulations Div. (Jan. 4, 1949) (on file with the OTA Archives, *supra* note 36, Box 18, Folder 27: Unrelated Business Income of Tax Exempt Organizations (1942) to (1985)) (attaching schedule of exempt organizations "Engaged in Business Activities," listing \$790,000 of rental income reported by Loyola University Foundation). Royall Little, president of Textron, also testified at the 1950 House Hearings that he had been unable to buy businesses "within the last 2 years . . . because I will not be party to that device of avoiding the corporate tax." *1950 House Hearings*, *supra* note 36, at 541. Little seems to be referring to bootstraps.

¹⁴⁰ See *1950 Senate Hearings*, *supra* note 82, at 534-42 (statement of Clarence Shock); Div. of Tax Research, U.S. Dep't of the Treasury (initials TAM), Investigation of Nineteen Tax Exempt Organizations (Other Than Cooperatives) by the Bureau of Internal Revenue 3-7 (Apr. 15, 1946) (on file with the at OTA Archives, *supra* note 366, Box 18, Folder 1, Tax Exempt Organizations (other than Cooperatives) 1942-72, Tab 4).

¹⁴¹ See Note, *supra* note 40, at 992 n.4 (listing cases).

c. *Charities Were Incidental and Interchangeable Participants*

It is important to emphasize, as Harvey Dale pointed out years ago, that there was no special connection between leasebacks, bootstraps, and charities. The promoters were looking for tax-indifferent counterparties and the comprehensive and permanent nature of the charitable tax exemption served that purpose.¹⁴² These early transactions were simply the forerunners of a long line of similar tax shelters that continue today. Each successive scheme is designed to concentrate the tax benefits of a transaction (such as losses or capital gains treatment) on a taxable party and the tax detriments (usually taxable ordinary income equal to the tax benefit) on a tax-indifferent “accommodation party.” The accommodation party’s tax indifference may result from accumulated losses, exempt status, or different principles of income recognition under a foreign tax system.¹⁴³

Indeed, by the time Congress passed the UBIT in 1950, life insurance companies were dominating the leaseback business.¹⁴⁴ Even though Congress eliminated the insurance companies’ effective tax exemption in 1950, other counterparties seem to have taken their place. Five years after the UBIT, the IRS needed to issue a revenue ruling on the subject, recharacterizing such leases as loans.¹⁴⁵ Apparently, the IRS felt taxpayers were attempting the same maneuver using noncharitable accommodation parties.

Moreover, even if a taxpayer wanted to deal with a charity, any exempt organization would do. A particularly bold businessman could dispense with the trouble of locating and negotiating with an existing charity, and simply incorporate a brand new charity, tailored to the task at hand.¹⁴⁶ These points

¹⁴² See Dale, *supra* note 29.

¹⁴³ For a current variation, see *Tax Shelters: Who’s Buying, Who’s Selling, and What’s the Government Doing About It?: Hearings Before the S. Comm. on Finance*, 108th Cong. 18–20 (2003) (discussing sale-in lease-out transactions in which taxpayers seeking depreciation deductions purport to buy municipal infrastructure from domestic and foreign municipalities). See also *ACM P’ship v. Comm’r*, 157 F.3d 231, 247–48 (3d Cir. 1998) (invalidating a variation using partnership allocation rules for lack of economic substance).

¹⁴⁴ See *supra* note 129.

¹⁴⁵ See Rev. Rul. 55-540, 1955-2 C.B. 39. Since 1950, the schemes have generally run in the other direction, with a buyer/lessor seeking nominal title to assets in order to take depreciation deductions. See *Frank Lyon Co. v. United States*, 435 U.S. 561, (1978); *TOBY COZART, EQUIPMENT LEASE CHARACTERIZATION*, 545 TAX MGMT. PORT. (BNA), A-18 to A-53 (1996).

¹⁴⁶ See *supra* note 55 and accompanying text (SICO). A much-repeated claim in the late 1940s was that an Omaha lawyer had organized several such transactions. See Mason, *supra* note 120, at 128.

were not lost on the large numbers of businessmen and brokers who were eagerly seeking out charitable counterparties for such transactions.¹⁴⁷

2. *UBIT's Incongruous Response to the Threat*

Given the very real threat to federal tax revenues represented by leasebacks and bootstraps, it is tempting to dismiss the anomalies of Congress' unfair competition rhetoric and conclude that Congress and the Treasury acted against "unfair competition" in 1950 without taxpayer prompting because they were really trying to shut down tax avoidance schemes. As noted above, Hansmann's explanation of the UBIT essentially takes this approach (although on logical, rather than historical, grounds).¹⁴⁸ Certainly, some of those involved in passing the UBIT felt that there was significant revenue at stake.¹⁴⁹

If concern over tax avoidance was an obvious motivation for Congress to act without taxpayer prompting, however, it raises other questions. The questions here are the reverse of those in the previous subsection: If the government was trying to shut down form-over-substance tax shelters

¹⁴⁷ See, e.g., H.R. REP. NO. 81-2319, at 39 (1950) (remarking that "in the case of the leaseback arrangements the sellers seem to take the position that they will not sell at all unless they receive better terms than a taxable business can offer"); *1950 House Hearings*, *supra* note 36, at 541 (statement of Royall Little, Textron) (noting that his refusal to participate in bootstraps had precluded any acquisitions of companies for two years); *id.* at 576 (statement of Philip C. Pendleton, Am. Council on Educ.) ("I get a [leaseback] proposition about once a month or so They are trying to sell something to us. I am agreeing with Mr. Mason that they get advantages, many advantages, out of leasebacks, not the least of which is that they get free capital and also tax money."); *1947 Hearings*, *supra* note 1, at 3455 (statement of Robert Stewart, Purdue Univ.) (describing a "cold call" from a businessman who, inspired by press reports of the Mueller purchase, was looking for a university to buy his company); *id.* at 3538 (statement of John Gerdes, NYU) (acknowledging that "[p]eople are still offering us things"); *New Financing Trend*, BUS. WK, Apr. 17, 1948, at 98-100 (discussing realtor David Gadlow, who had then completed more than \$50 million of leaseback transactions with universities and insurance companies); Rohs, *supra* note 76 (noting with respect to leasebacks to tax-exempt insurance companies, "[w]hile big and little business doesn't exactly stand in line to convert its real estate into life insurance cash, there's no lack of daily inquiries from would-be sellers"); *Schools' Tax-Free Business*, U.S. NEWS & WORLD REP., Jan. 9, 1948, at 40 (describing the origin of a typical transaction as "[a] university is approached by a businessman, who offers his business for sale"). Some flavor for the heated atmosphere may be gleaned from a September 1949 letter from a concerned citizen of Boston to Chairman Doughton, noting with alarm that he "was told yesterday by a man whose word I would never question, of some 41 conferences going on at this moment, all relating to the subject of good solid paying Corporations being sold to Tax Exempt Institutions." Letter from C. C. Bennett to Robert F. Doughton, Chairman, H. Comm. on Ways and Means (Sep. 27, 1949) (on file in Ways & Means Archives, Box 168 (Revision, C), Folder: Tax Exempt Organizations (Cooperatives)). It is not clear if this letter refers to leasebacks, bootstraps, or both.

¹⁴⁸ See *supra* notes 62-63 and accompanying text.

¹⁴⁹ See, e.g., *1950 Senate Hearings*, *supra* note 82, at 7 (statement of John W. Snyder, Sec'y, U.S. Dep't of the Treasury) (noting "[i]ncreased extension" of exemption threatens \$100 million in annual lost revenues).

promoted by taxable businessmen to other taxable businessmen why did it do so in the name of unfair competition? And why was all the attention on the exempt organizations, which, at best, were facilitating tax cheating by others, rather than on the taxable persons using these schemes to avoid tax?

One problem with explaining the UBIT as a response to leaseback and bootstrap tax avoidance schemes is that the policymakers never focused on the taxable persons avoiding tax and how they were doing it. The originators and chief beneficiaries of leaseback and bootstrap transactions were the taxpayers using them to avoid tax, not the exempt organizations. The exempt organizations were completely interchangeable facilitators in these transactions, taking only a small fee for their participation. Any legal or natural person with the proper tax attributes would serve. Both Congress and the Treasury were aware, for instance, that insurance companies had begun to facilitate most of the leasebacks well before the UBIT became law.¹⁵⁰

Predictably, the UBIT did not stop the abuses. The type of form-over-substance shelter at the core of the leaseback and bootstrap transactions continued. The new schemes simply did not involve charities. Eventually, Congress and the Treasury had to address the underlying abuses by recharacterizing the transaction to accord with economic reality, taxing the taxable party. As noted, the Treasury issued a revenue ruling a few years later discussing situations in which it would treat a purported sale-leaseback as a contingent sale and deny rent deductions to the seller/lessee only five years after the UBIT.¹⁵¹ In later years, as successive waves of accelerated depreciation and investment tax credits gave attractive tax attributes to nominal ownership, the Treasury applied the same principles to deny those attributes to buyer/lessors.¹⁵² In 1986, this position was partially codified in section 469 of the Internal Revenue Code, denying the taxable party the improper tax benefit by disallowing most passive activity loss deductions and credits.¹⁵³ This

¹⁵⁰ See Office of Tax Policy, U.S. Dep't of the Treasury (initials JC, probably John Copeland), Preliminary Suggestions for Taxation of Business and Investment Income of Section 101 Corporations and Revision of Section 162(a) Applicable to Trusts and Estates, at 6 (undated, probably c. 1948 or 1949) (on file with the OTA Archives, *supra* note 36, Box 18, Folder 1, Tax Exempt Orgs. (other than Co-ops.) 1942-72, Tab 6) (advocating continued exemption for rental income despite leaseback problem because "life insurance companies are doing most of this business now"). The IRS did carry out a long and ultimately unsuccessful litigation campaign against the tax avoiders in post-UBIT bootstrap transactions. See Note, *supra* note 40, at 992-93 (1965). Having lost against the tax avoiders in court, however, the Treasury's reflexive legislative solution, codified in 1969 as section 514 of the Code, was to expand the UBIT to cover debt-financed income.

¹⁵¹ See *supra* note 145 and accompanying text.

¹⁵² See COZART, *supra* note 145, at A-18 to A-53.

¹⁵³ Ironically, the same tax act that added the debt-financed property rules to the UBIT in 1969 also

emphasis on denying depreciation deductions to nominal owners, however, generated a new set of tax avoidance schemes in the early 1980s, as tax-exempt entities of all sorts (including, notoriously, the U.S. Navy) leased their property to taxable persons who immediately leased it back, keeping only the benefits of accelerated depreciation.¹⁵⁴ Congress attempted to stop these transactions in 1984 by amending section 168 of the Code to deny accelerated depreciation to the taxpayer.¹⁵⁵ Recently, Congress realized that the scams had reversed again, this time taking the form of “sales” of municipal infrastructure (e.g., subway cars) to taxable persons who immediately leased them back, again keeping only accelerated depreciation.¹⁵⁶ In response, new legislation attempts to deny the benefits of such transactions to the taxable party.¹⁵⁷

Bootstrap sales also involved two key techniques that, predictably, had much wider applications. Eventually, Congress and the Treasury had to address these techniques directly. Code sections 453 and 453A were added to recharacterize abusive installment sales and prevent gain deferral.¹⁵⁸ Section 1274 was added to require the seller to pay tax on imputed interest.¹⁵⁹

Again, policymakers did not simply overlook the fact that leasebacks and bootstraps were tax avoidance schemes of taxable persons, not charitable organizations. In 1947 and 1950, exempt organizations argued strenuously that the tax should fall on the persons trying to avoid it, rather than on the exempt organizations facilitating the scheme.¹⁶⁰ In 1966, the House Ways and Means Committee held hearings to address the continuing bootstrap problem. The Treasury’s proposal at that time eventually became the debt-financed income rules added to the UBIT in 1969. At those hearings, the Treasury admitted that the measure would not prevent the bootstrap transactions it was

addressed a problem very similar to that posed by the 1940s leasebacks by adding § 636 to the Code. In that case, the House Report methodically considers the abuse of so-called “production payments” on mineral properties (that is to say contracts to deliver a portion of mineral production from a given property) and concludes that they were being used to disguise secured loans. The legislative solution was to recharacterize the transactions for what they were. See H.R. REP. NO. 91-413, at 138–44 (1969).

¹⁵⁴ See Dale, *supra* note 29, at 9-18 to 9-19.

¹⁵⁵ See I.R.C. § 168 (g), (h).

¹⁵⁶ S. REP. NO. 108-192, at 197–98 (2003).

¹⁵⁷ See American Jobs Creation Act of 2004, Pub. L. No. 108-357, §§ 847–49, 118 Stat. 1418, 1601–07 (sale-leasebacks); *id.* §§ 882–884, 118 Stat. at 1627–34 (noncash donations).

¹⁵⁸ See Installment Sales Revision Act of 1980, Pub. L. No. 96-471, § 2(a), 94 Stat. 2247, 2247–53.

¹⁵⁹ See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 41(a), 98 Stat. 494, 538.

¹⁶⁰ See, e.g., *1950 Senate Hearings*, *supra* note 82, at 525–34 (statement of Carter Davidson, Am. Council on Educ.); *id.* at 587 (statement of L.G. Tighe, Yale Univ.); *1950 House Hearings*, *supra* note 36, at 494–500 (statement of Paul Cabot, Harvard Univ.); *id.* at 558–59 (statement of King E. Fauver, Oberlin Coll.); *id.* at 573–79 (statement of Philip C. Pendleton, Am. Council on Educ.).

supposed to address, but would merely prevent certain tax-exempt organizations from participating in them.¹⁶¹

Nonetheless, in formulating a legislative response, neither the Treasury nor Congress ever considered any approach that would tax the person trying to avoid tax. Instead, they reflexively focused on eliminating charities' special ability and incentive to facilitate the avoidance. In theory, administrative efficiency might favor concentrating on the exempt facilitator, rather than the actual tax avoider. In practice, however, no one made or considered such arguments. All concerned simply assumed that charities were the persons abusing the tax laws and targeted legislation accordingly.

A 1946 Treasury memorandum is a striking illustration of this seemingly contradictory attitude toward tax avoidance. In discussing the potential for revenue loss in purchases of operating businesses and leaseback transactions, the author assumes that the question is whether the transaction represents "a method of tax avoidance which could be used by other [exempt] institutions" but evaluates the likelihood that exempt organizations will pursue this "avoidance" based on the prevalence of taxable persons with the right attributes to participate.¹⁶² This is only semantically different from asking how many taxable persons might be able to avoid taxes by seeking out (or simply creating) an exempt organization to facilitate a tax-shelter transaction. The semantics are telling, however. The author was so focused on the impropriety of exempt organizations participating in such transactions that he lost track of who was avoiding a tax and who was merely assisting.

Three years later, as Congress and the Treasury were beginning serious consideration of the UBIT, Laurence Woodworth, then an economist on the staff of the Joint Committee on Internal Revenue Taxation, wrote a report on the subject that reveals the same strange mental process. Woodworth was well aware that the real revenue problem involved leasebacks and bootstraps, even though most of the public attention had focused on the Mueller case.¹⁶³

¹⁶¹ See *infra* notes 170–175 and accompanying text.

¹⁶² Div. of Tax Research, U.S. Dep't of the Treasury (initials EGK, probably E. Gordon Keith), Acquisitions of Business Properties by Tax-Exempt Organizations, at 5–7 (Apr. 16, 1946) (on file with the OTA Archives, *supra* note 36, Box 18, Folder 27—Unrelated Business Income of Tax Exempt Organizations (1942) to (1985)).

¹⁶³ See Laurence N. Woodworth, Recommended Changes in the Tax Treatment of Educational and Charitable Organizations 1 (c. Apr. 1949). The report exists in the archives only in two incomplete parts. An unsigned and undated (but hand-dated Apr. 25, 1949) copy, including only the introduction and Part A, is on file with the OTA Archives, *supra* note 36, Box 34.2, File EA-1/49.01—Treasury-Joint Committee Staff: Revenue Program for 1949–50 [hereinafter Woodworth Report Part A]. A draft of Part B is attached to an

Nonetheless, Woodworth saw the problem to be addressed as whether exempt organizations were improperly using leasebacks and bootstraps to augment their tax subsidy beyond the intentions of Congress, compounding their income-generating capital on a tax-free basis. Accordingly, his report bundled the analysis of leasebacks and bootstraps with a general discussion of whether exempt organizations should be allowed to retain capital surpluses at all. Tellingly, Woodworth recognized, as had the 1946 Treasury report, that none of his proposals would stop taxpayers from engaging in leasebacks with insurance companies that would be every bit as dangerous to the public fisc, but concluded that “[t]his problem . . . is beyond the scope of this paper.”¹⁶⁴

The same thinking was evident in Congress. In the 1950 House Hearings, Philip C. Pendleton, representing the American Council on Education, argued doggedly for taxing the taxable party to leasebacks. Pendleton noted that it was the taxable person, not the charity, that was obtaining the tax advantages.¹⁶⁵ He further noted that insurance companies were engaging in more leasebacks than charities, so that taxing charities would not end the abuse.¹⁶⁶ The congressmen completely ignored these arguments. Immediately after Pendleton pointed out that the problem could not be addressed by focusing on charities because life insurance companies would take their place, Representative Noah Mason interrupted him to state that “we have to change the law to make it illegal so the Treasury can catch up with these fellows who are avoiding payment of taxes deliberately.”¹⁶⁷ In the next breath, however, he made it clear that by “these fellows who are avoiding payment of taxes,” he meant NYU.¹⁶⁸

Likewise in 1966, Stanley Surrey, then Assistant Secretary of the Treasury, testified in support of a bill to tax debt-financed income of exempt

internal JCT memorandum, dated May 27, 1949, on file with the JCT Archives, *supra* note 98, Box 150, File: Tax-Exempt Charitable Organizations [hereafter Woodworth Report Part B].

¹⁶⁴ Woodworth Report Part B, *supra* note 163, at 9.

¹⁶⁵ *1950 House Hearings*, *supra* note 36, at 575.

¹⁶⁶ *Id.* at 578. Pendleton does not seem to have been aware that the Treasury had already recommended eliminating insurance companies' effective tax exemption.

¹⁶⁷ *1950 House Hearings*, *supra* note 36, at 578. It should be noted that Congress also addressed the problem of the effective tax exemption of life insurance companies in 1950. *See* Revenue Act of 1950, Pub. L. No. 81-814, § 401, 64 Stat. 906, 961. Mason's response, however, was not meant to assure Pendleton that Congress would be taxing the insurance companies, as well. *See infra* note 166 and accompanying text.

¹⁶⁸ *See 1950 House Hearings*, *supra* note 36, at 579 (“The NYU, the Treasury is now suing them. There is a case in court now on the profits made by the macaroni factory which they bought to avoid taxes . . . [a]nd there is a question whether under the present law they can collect on that.”).

organizations that was eventually incorporated into the 1969 tax reform.¹⁶⁹ The bill was designed to respond to the resounding defeat of the government's litigation campaign against bootstraps in the *Clay Brown* decision.¹⁷⁰ Surrey admitted that the proposed legislation would not prevent a taxable seller from paying capital gain rates on income that was effectively either dividends or interest—the tax avoidance technique at the heart of bootstraps. He acknowledged that the Treasury's bill would merely discourage exempt organizations from participating in such transactions.¹⁷¹

Surrey was aware of this lapse and explained it in two ways. First, he argued that the transactions had thus far always involved exempt organizations, giving rise to the hope that “adoption of the present bills would obviate the necessity of dealing with the capital gains issue.”¹⁷² At a time when the spread between the top ordinary income and capital gains brackets was forty-five percent,¹⁷³ however, this argument was not credible. Promoters had chosen exempt organizations as accommodation parties because they were easy to find (or make) and maximized the take, but other counterparties could be found. Second, Surrey argued that the transaction “has sufficient elements in common with some kinds of ordinary commercial transactions to make it important that care be taken in any legislative withdrawal of capital gains treatment.”¹⁷⁴ On the face of it, this was also an odd argument for someone principally concerned about revenue. At that point, the government had been litigating bootstrap cases for years against the taxable “sellers” (i.e., the people avoiding tax) for the same reason Willie Sutton robbed banks: that was where the money was. Moreover, it is ironic that, in the name of taking care not to affect legitimate transactions, Surrey backed a proposal that has greatly complicated, and sometimes prevented, the participation of exempt organizations in legitimate transactions ever since.¹⁷⁵ Again, distaste at the spectacle of exempt organizations taking part in tax avoidance schemes appears to have distracted Surrey from the persons actually evading tax, as well as any serious

¹⁶⁹ *Unrelated Debt Financed Income of Tax-Exempt Organizations: Hearings on H.R. 15942 and H.R. 15943 Before the H. Comm. on Ways and Means*, 89th Cong. 24–25 (1966) [hereinafter *1966 Hearings*].

¹⁷⁰ *See* *Comm'r v. Brown*, 380 U.S. 563 (1965).

¹⁷¹ *1966 Hearings*, *supra* note 169, at 24–25.

¹⁷² *Id.* at 25.

¹⁷³ *Compare* I.R.C. § 1(a)(2) (1964) (setting seventy percent top ordinary income rate), *with id.* § 1201(b) (setting twenty-five percent top capital gains rate).

¹⁷⁴ *1966 Hearings*, *supra* note 169, at 24.

¹⁷⁵ *See* William K.S. Wang, *Apply UBIT to De Facto Leverage, But Not to 'Spurious Leverage,'* 95 TAX NOTES 925 (2002); William H. Weigel, *Unrelated Debt-Financed Income: A Retrospective and a Modest Proposal*, 50 TAX LAW. 625, 626–42 (1997).

consideration of possible negative effects on exempt organizations' legitimate commercial transactions.¹⁷⁶

As these examples demonstrate, arguments for the UBIT show a puzzling failure to grapple with the real revenue problems at hand. This stubborn focus on charitable participants does not make sense if revenue alone was driving the process. Instead, one would have expected serious consideration of the methods taxpayers were using to avoid tax they owed and some attempt to address those methods head-on. It might have been that, after such a consideration, the government would have decided to pursue the exempt participants, in lieu of or in addition to the actual tax avoiders or promoters, for reasons of administrative efficiency. But no policymaker appears to have considered, let alone studied and rejected, such an approach in the years leading up to the UBIT. Given the actual and blatant tax avoidance that undergirded both leaseback and bootstrap transactions, this consistent failure by talented and honest revenue officials is surprising and the revenue theory of the UBIT seems highly suspect.

D. The Paranoid Delusion Theory

The above sections have demonstrated that the traditional explanations for the UBIT simply do not match up with what Congress did or the historical environment in which it acted. As discussed above, previous commentators have pointed out the logical flaws with the traditional explanations. Unfortunately, previous commentators have concluded their analysis after laying out the logical problem. They have not considered why the very arguments they were making had no effect on Congress or the Treasury in passing the UBIT in 1950 or expanding it in 1969. They have merely ascribed the passage of these laws to fantasy or paranoia on the part of policymakers,¹⁷⁷

¹⁷⁶ Apparently the Treasury conducted an internal study at the time, considering the feasibility of legislation that would impose the appropriate tax treatment on the seller and concluding that it was technically or politically infeasible to do so. Telephone Interview with Daniel Halperin, Stanley S. Surrey Professor of Law, Harvard Law Sch. (Feb. 8, 2005). I did not locate that study in the OTA Archives, but Surrey's defensive comments may have been informed by it. Without seeing the study, it is difficult to tell what conclusions to draw, but it is worth remembering that Congress eventually addressed the larger questions raised by bootstraps with general legislation aimed at the seller. *See supra* notes 158–159 and accompanying text.

¹⁷⁷ Klein, *supra* note 52, at 68; *see also* Bittker & Rahdert, *supra* note 20, at 320 (“Whether the fear of ‘unfair competition’ was rooted in reality or in fantasy, it carried the day.”). To be fair, Klein recognized that by concluding that unfair competition arguments reflected “fears [that were] paranoid rather than rational,” he had not exhausted possible avenues of analysis. He understood that “[a] proper study of the effects of historical remnants and political ideology” was the next step, but concluded that such a study was beyond the

and moved on to discuss proposals that might rationally implement either the government's stated objectives or the commentator's preferred alternatives.¹⁷⁸

No serious attempt has been made to explain why Congress passed the particular muddled rule it did in the particular muddled fashion it chose. Simply noting that Congress did something silly or illogical is only the beginning of the analysis. The interesting question is what motivated members of Congress and Treasury officials to say one thing and do another, apparently without noticing the contradiction and certainly without bothering to explain it. As noted, this question is not merely dead history. The staff of the Joint Committee on Taxation recently proposed a raft of punitive sanctions on tax-exempt entities that participate in tax-avoidance transactions, as well as the entities' managers.¹⁷⁹ Notably, these sanctions far exceed those levied on shelter promoters.¹⁸⁰ The report seems unaware of the contrast, but does

scope of his project. Klein, *supra* note 52, at 68.

¹⁷⁸ See, e.g., James Bennett & Gabriel Rudney, *A Commerciality Test to Resolve the Commercial Nonprofit Issue*, 36 TAX NOTES 1095 (1987); Bittker & Rahdert, *supra* note 20, at 330 (suggesting abolition of UBIT as an "unjustified venture," in preference to expanding it to close "loopholes"); Brody, *supra* note 29, at 587, 629 (arguing that the exemption and UBIT result from anachronistic views of charities as sharing some attributes of sovereignty and that policymakers should dispel such views in formulating policy); Colombo, *supra* note 65, at 556-65 (proposing imposition of corporate tax on all active business income); Dale, *supra* note 29, at 9-14 (suggesting rationalizing treatment of all persons "forever" or "temporarily" exempt from federal income tax); Hall & Colombo, *supra* note 29, at 1450-74 (proposing exemption based on maintaining minimum level of donative support); Klein, *supra* note 52, at 73-74 (tentatively favoring abolition of entity-level income taxation); Rose-Ackerman, *supra* note 51, at 1022 (proposing abolition of UBIT). Henry Hansmann is the odd man out. He argues that the UBIT is not contradictory and is efficient in its current form. See Hansmann, *Unfair Competition*, *supra* note 53, at 607 (arguing that economic efficiency rationales support the UBIT in its current form so that a more important analysis should concentrate on the scope of the underlying nonprofit organization exemptions). Brody is a partial exception to the rule, in that she does not take the unfair competition explanation at face value and argues, instead, that deeper historical forces have animated both the exemption and the UBIT. Brody, *supra* note 29, at 607-29. As will be discussed below, this Article builds on Brody's central historical insight. Brody's ultimate project, however, was to point out the contradiction between the exemption/UBIT regime and a preferred normative framework and then to advocate for eliminating the contradictions in favor of her preferred normative framework.

¹⁷⁹ See STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 247-53 (Comm. Print 2005), available at <http://www.house.gov/jct/s-2-05.pdf> [hereinafter JOINT COMMITTEE REPORT]. The staff proposes to impose an entity-level tax equal to one hundred percent of the proceeds (after other penalties) if the entity knew or had reason to know the transaction was listed. The staff also proposes to tax as unrelated business income any revenues from a transaction that is later listed and to impose penalties for failure to disclose participation in "reportable" transactions. *Id.* at 250-51. In addition, the staff proposes a \$20,000 penalty (up to an aggregate of \$200,000 per transaction) on each "entity manager that [sic] approves a tax-exempt entity's participation in a prohibited tax shelter transaction, knowing or with reason to know that the transaction is a prohibited tax shelter transaction." *Id.* at 251.

¹⁸⁰ See I.R.C. §§ 6111, 6707 (imposing on "material advisors" penalties of \$50,000 for failure to report "reportable transactions" and penalties of \$200,000 or, if greater, fifty percent of gross proceeds to the advisors for failure to report "listed transactions"). The penalties imposed under I.R.C §§ 6111 and 6707 are similar to

tellingly attempt to justify the new sanctions by arguing that “[r]egardless of the policy rationale for providing exempt status to an organization, the exemption from tax generally is limited to income derived from those activities that substantially further the basis for exemption.”¹⁸¹ Likewise, distaste for charities’ participation in tax shelters may well add new and onerous “governance” requirements to the Code.¹⁸²

The final Part will try to answer this question by exposing the elephant in the middle of the room: Unrelated business activities posed a threat to the political perceptions that were supporting the charitable exemption at the early stages of its development as a significant subsidy to charity. The UBIT arose to neutralize that threat by steering exempt organizations away from politically problematic activities.

III. THE POLITICAL FUNCTION OF THE UBIT

As discussed above, the UBIT does not fit well with its traditional explanations. Unfair competition does not logically explain the distinctions between active and passive or related and unrelated income. Moreover, the complete absence of complaining taxpayers seems to undermine the idea that Congress was galvanized into action to defend them against the depredations of charities. The revenue explanation also falls flat, not because leaseback and bootstrap transactions did not pose a significant threat to revenue, but because policymakers consistently missed the taxable persons avoiding taxes through these transactions and focused their ire on “abuses” by the charitable facilitators. Finally, the theory that Congress simply went crazy and began chasing after tax chimeras is an unsatisfying abdication of analysis. Clearly, Congress was chasing after something other than its stated quarry, but the specific kind of madness that was driving it bears analysis and diagnosis. This Part will attempt that analysis and diagnosis. The point is not to reconstruct a rational policy analysis that never happened, but to figure out how and why

those imposed on exempt entity managers under the staff’s proposals. The additional taxes imposed on the entity itself are over and above these penalties.

¹⁸¹ JOINT COMMITTEE REPORT, *supra* note 179, at 249; *see also id.* at 253 (justifying imposition of UBIT on revenue to exempt accommodation party from transactions later “listed” as abusive by the Treasury because “once such a determination is made, the income should not be considered as related to the organization’s exempt purposes and should be taxed as unrelated business income, regardless of whether the organization regularly engages in such types of transactions”).

¹⁸² Finance Committee, *Staff Discussion Draft*, *supra* note 4, at 11.

Congress avoided that analysis. The key lies in perceptions of the charitable exemption's nature and purpose.¹⁸³

A. *The Increased Importance of the Exemption*

1. *Prior to World War II: The Unexamined Subsidy*

No one talked much about the federal income tax exemption for charities during the first thirty years of its existence. The reason for this is simply that it was not very important to anyone. Before World War II, the federal income taxes were generally low and always narrowly targeted at business corporations and high-income individuals. The few courts and commentators to take up the purpose of the exemption before 1940 described it as a subsidy or “encouragement” for worthy organizations.¹⁸⁴ No political thought was given to this theory, however, because it was a very inconsequential subsidy. As late as 1939, a thorough scholarly consideration of policy arguments about

¹⁸³ On a technical level, the assumption underlying this analysis is that symbolism is often more important than instrumental calculation in motivating and guiding the legislative process. See MURRAY EDELMAN, *THE SYMBOLIC USES OF POLITICS* 23–29 (1964). In this case, as will be discussed, the exemption itself is a symbolic, rather than instrumental, piece of legislation in the first place. When events of the 1940s (and later crises) shook the symbolic role of the exemption, policymakers' first (and last) instinct was to restore the symbolism to its prior condition, not to reevaluate a fundamentally noninstrumental policy on instrumental grounds. None of this is meant to accuse policymakers of irrational behavior, in the sense of failing to pursue their interests efficiently, given constraints on information and other bounds on human rationality. My focus, however, is on what those interests were and my assumption is that all players' interests were constrained, and perhaps even generated directly, by shared “public ideas” concerning the character and social desirability of charity. Steven Kelman, *Why Public Ideas Matter*, in *THE POWER OF PUBLIC IDEAS* 31, 31–53 (Robert B. Reich ed., 1988) (emphasizing the importance of shared ideas and persuasion, in addition to narrow self-interest, in explaining the motivations of political actors); see also Michael E. DeBow & Dwight R. Lee, *Understanding (and Misunderstanding) Public Choice: A Response to Farber and Frickey*, 66 *TEX. L. REV.* 993, 998–1002 (1988) (discussing interaction of self-interest and forces of ideology in producing and implementing legislation).

¹⁸⁴ See, e.g., *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578, 581 (1924) (“Evidently the exemption is made in recognition of the benefit which the public derives from corporate activities of the class named, and is intended to aid them when not conducted for private gain.”); *Appeal of Unity Sch. of Christianity*, 4 B.T.A. 61, 69 (1926) (“If these purposes or any of them are the controlling reasons for the corporation's existence and all things are devoted by it to that end, the congressional purpose of exemption, ‘made in recognition of the benefit which the public derives,’ should not be defeated because its incidental features are to some extent profitable.”); Lawrence R. Bloomenthal, *Tax Exemptions, Part I—General Principles*, 15 *TAX MAG.* 269, 269 (1937) (“A tax exemption invariably acts as a subsidy to the individuals or classes of individuals benefited thereby.”); M.H. Hunter, *Tax Exemption—A Subsidy*, 8 *NAT'L TAX MAG.* 332, 351–52 (1930) (describing all property and income tax exemptions equally as subsidies to the exempt persons unless motivated by administrative convenience); Edwin S. Todd, *Tax Exemption and Tax Delinquency*, 12 *TAX MAG.* 159, 161 (1934) (“[E]very legislative grant of tax exemption is a species of state subsidy.”) (emphasis omitted).

charitable tax exemptions devoted slightly over a page to the federal income-tax exemption and then moved on to devote the rest of the article to “[t]he most frequently discussed type of [charitable] tax exemption”—state property tax exemptions.¹⁸⁵ The Treasury lost the few “destination of income” cases it pursued and never suggested a legislative change.¹⁸⁶ In this context, exemption of charities and other organizations simply did not merit any substantive or rhetorical attention. It was not poorly explained; it was simply unexamined.

2. *The Transformation of the Income Tax and Charitable Exemption During World War II*

World War II transformed the federal income tax and, with it, the charitable income tax exemption. To finance the war, the federal government sharply expanded the federal income tax, adding stunningly high rates on corporations and individuals alike, including for businesses, taxes on excess profits, and excess accumulations.¹⁸⁷ These changes transformed the federal income tax from a narrow tax on the superfluous wealth of “economic royalists” to a broad tax, paid by the majority of citizens and of high economic importance to most of them.¹⁸⁸ This transformation of the role and importance of the income tax transformed the charitable exemption in three distinct, though interrelated, ways.

The first change, resulting from the increase in rates, was that the income tax exemption simply became more economically significant to exempt organizations and their competitors. In 1938, corporate tax rates topped out at nineteen percent. By the end of the war, the top bracket exceeded fifty percent

¹⁸⁵ Lucy Winsor Killough, *Exemptions to Educational, Philanthropic and Religious Organizations*, in TAX EXEMPTIONS 23, 23–25 (Tax Policy League 1939).

¹⁸⁶ See, e.g., *Sagrada Orden de Predicadores*, 263 U.S. at 581; *Roche’s Beach, Inc. v. Comm’r*, 96 F.2d 776, 778 (2d Cir. 1938); *Sand Springs Home v. Comm’r*, 6 B.T.A. 198, 217 (1927); see also *Unity School*, 4 B.T.A. at 69.

¹⁸⁷ The Second Revenue Act of 1940 added the excess profits tax. See Pub. L. No. 76-801, § 201, 54 Stat. 974, 975–98 (1940). During the 1940s, section 102 of the Internal Revenue Code imposed high surtaxes on a corporation that accumulated surpluses “for the purpose of preventing the imposition of the surtax upon its shareholders.” I.R.C. § 102(a) (1947). This provision preceded World War II but took on new urgency as corporations accumulated war profits and shareholders faced high personal rates on distributions.

¹⁸⁸ See LAWRENCE H. SELTZER, *THE PERSONAL EXEMPTIONS IN THE INCOME TAX* 58–71 (1968); see also SIDNEY RATNER, *TAXATION AND DEMOCRACY IN AMERICA* 505–06, 516–19 (1967) (describing tax measures from 1941 to 1944). Franklin Roosevelt used the Revenue Acts of 1935 and 1936 as the basis for one of the major themes of his 1936 election campaign—the attack on “economic royalists.” See MARK. H. LEFF, *THE LIMITS OF SYMBOLIC REFORM: THE NEW DEAL AND TAXATION, 1933–1939*, at 185–93 (1984).

and corporate distributions were subject to vastly higher personal rates.¹⁸⁹ As one unhappy milk distributor put it in 1944, protesting competition from cooperatives:

We didn't do so badly in former years when our tax rate was 13%. I didn't mind starting each day with a 13% handicap. I was sure I could do a 13% better job than my largest competitor. However, after our tax rate was increased to 30%, 40% and 50%, I found that I just couldn't run fast enough any more to keep ahead of the procession.¹⁹⁰

Contemporary observers were well aware of this change and commented on it directly and often.¹⁹¹

A second change that came with the increased economic importance of the income tax was the inception of tax shelter schemes using exempt organizations to absorb adverse tax items. Tax avoidance schemes were prevalent before the 1940s. World War II, however, brought much higher tax rates (including, for corporations, the excess profits tax) to a much broader swath of corporations and individuals. The higher rates and broader tax base of the 1940s seem to have inspired much more concentrated, professional, and

¹⁸⁹ See RATNER, *supra* note 188, at 491–524, tbls.C-2 & C-3; JOHN F. WITTE, *THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 110–30* (1985). During the war, corporate incomes were also subject to an excess profits tax that by the end of the war was levied at a flat ninety-five percent. See *id.* at 495–98, 506–07, 517, 518.

¹⁹⁰ See Letter from Benjamin F. Castle, President, Milk Indus. Found., to Walter F. George, Chairman, U.S. Senate Comm. on Fin. (June 14, 1944) (quoting “from a letter recently received”) (on file in the JCT Archives, *supra* note 98, Box 146, File: Cooperative Associations 1945).

¹⁹¹ See, e.g., E. Gordon Keith, *New Data on Tax-Exempt Organizations*, in NAT'L TAX ASS'N, 1945 PROCEEDINGS OF THE THIRTY-EIGHTH ANNUAL CONFERENCE ON TAXATION 257–58 (Raymond E. Manning ed., 1946) (contrasting prewar period of low taxes and no concern over abuse of exemption with post war period in which complaints of unfair competition and tax avoidance arose); Letter from Colin F. Stam, Chief of Staff, Joint Comm. on Internal Rev. Taxation, to Harold Knutson, Chairman, H. Comm. on Ways and Means (May 13, 1947) (on file with the JCT Archives, *supra* note 98, Box 150, Folder: Tax Exempt Organizations 1947) (“With the present corporate rates, tax exemptions are more important than in the prewar period.”); Memorandum from Mr. Shere and Mr. Surrey, Office of Tax Policy, U.S. Dep't of the Treasury, to Sec'y, U.S. Dep't of the Treasury, regarding Tax-Exempt Organizations 2 (June 23, 1947) (on file with the OTA Archives, *supra* note 36, Box 18 Folder 1–Tax Exempt Organizations (other than Cooperatives) 1942–72, Tab 5) (recommending renewed study of exemption, among other reasons, because increases in tax rates make exemption more significant); Statement by Loring A. Schuler, Nat'l Tax Equal. Ass'n (Oct. 25, 1944) (on file with the JCT Archives, *supra* note 98, Box 146, File: Cooperative Associations 1945) (“For many years the situation was not serious, from a competitive point of view. The tax rate was low. The differential enjoyed by the non-taxpayers was small.”).

sophisticated efforts at tax avoidance.¹⁹² The charitable exemption was quickly incorporated into leaseback schemes and early bootstraps.¹⁹³

A final and crucial change accompanied the broadening of the income tax. As “the personal income tax ceased to be an indicator of affluence and became a mere token of citizenship,”¹⁹⁴ the popular conception of the tax changed radically. As Carolyn Jones has documented, the federal government actively promoted this change with a concerted popular propaganda effort.¹⁹⁵ The gist was to convince the populace that paying income tax was a patriotic duty, shared by all in the spirit of united national purpose. A corollary of this transformed perception of the tax, however, was a heightened popular sensitivity to income tax exemptions. No one really thought about excluding exempt organizations from a tax on “economic royalists” and “fat cats.” It looked anomalous and disturbing, however, to exclude them from a patriotic duty owed equally by every American from Rockefeller to the stalwart factory worker.

3. *Sensing the Change Without Seeing It*

On this background, it is not surprising that the NTEA¹⁹⁶ began agitating against the tax privileges of cooperatives in 1943, or that the press, the Treasury, and Congress started to take note of leasebacks and bootstraps in 1946 and became increasingly uncomfortable with them.¹⁹⁷ Everyone sensed that something was different and felt vaguely wrong. The real change was the

¹⁹² While the publication of sophisticated tax research is not an exact proxy for the prevalence of sophisticated tax avoidance, it is surely not without significance that NYU began its annual institute on federal taxation in 1943 and the University of Southern California followed in 1949. Likewise, NYU began to publish *The Tax Law Review* in 1945 and the American Bar Association began to publish *The Section of Taxation Bulletin* (predecessor to *The Tax Lawyer*) in 1947. The country was not without tax publications or meetings before 1943, but the sudden burgeoning of sophisticated publications in the 1940s seems related to the level of activity in the profession.

¹⁹³ For a discussion of these methods of tax avoidance, see *supra* notes 130–147 and accompanying text.

¹⁹⁴ LEFF, *supra* note 188, at 287.

¹⁹⁵ See Carolyn C. Jones, *Class Tax to Mass Tax: The Role of Propaganda in the Expansion of the Income Tax During World War II*, 37 *BUFF. L. REV.* 685, 700–28 (1989).

¹⁹⁶ For a discussion of the origins and activities of the NTEA, see *supra* notes 98–110 and accompanying text.

¹⁹⁷ It should be noted that the claim here is not that the NTEA’s campaign was fueled by the demands of the broad public or that the public (and especially press) reaction was rational. To the contrary, a new perception of the income tax made small businesses, the press, and the public receptive to arguments of tax equality. It was for this reason that the NTEA expanded its efforts to cover charities’ business endeavors, which were clearly not an actual competitive concern of its members, after the 1947 House Hearings revealed the issue’s emotive power.

subtle transformation of a nominal subsidy to a significant subsidy. The charitable exemption had been a legislative afterthought. Now it was a highly valuable subsidy, a tempting tool for newly lucrative tax avoidance maneuvers, and an odd departure from the ideal of broad-based patriotic tax liability. It was very difficult to see this change, however, because on paper the exemption had not changed at all. The words were the same, only their economic and symbolic meanings were transformed.

If the change in the nature of the exemption was subtle, the changes in charities' behavior were not. Policymakers and the press naturally riveted their attention on the suddenly scandalous behavior of formerly staid pillars of civic virtue. This focus on obvious symptoms and shift away from the deeper malady set off a chain of political pressures that led to the UBIT and has sustained it politically ever since. To understand the problem Congress faced and the solution it chose, it is important to first understand the problems with the charitable exemption as a subsidy and the popular perceptions that supported it in the face of these perceptions when it came under heavy scrutiny in the 1940s. Section B will discuss the oddities of the charitable income tax exemption as a subsidy. Section C will discuss the perceptions about charitable organizations that supported the exemption and threats to these perceptions that arose during the 1940s. Section D will propose a new theory of the UBIT as a mechanism for protecting the perceptions that support the exemption.

B. Problems with the Charitable Exemption as Subsidy

As the exemption changed, policymakers and commentators began, for the first time, to examine it critically, looking to explain or attack its existence. Received wisdom described it as a subsidy or “encouragement” to charitable activities.¹⁹⁸ This description, however, raised serious problems. Viewed as a traditional subsidy, the charitable exemption is very odd in several important respects.

The first problem is that the selection of recipients is largely independent of political control.¹⁹⁹ The exemption is a blanket subsidy for a wide array of

¹⁹⁸ See *supra* note 184 and accompanying text.

¹⁹⁹ There are exceptions to this. See *Bob Jones Univ. v. United States*, 461 U.S. 574 (1982) (holding organizations practicing racial discrimination cannot be “charitable” under I.R.C. § 501(c)(3) because racial discrimination is against public policy). It should be noted that proponents of the exemption have long cited independence from political control as a virtue of the exemption. To give one of the most famous examples, President Charles Eliot of Harvard took this position in a controversy over state property tax in 1874. He

private activities, most of which are valuable to only narrow portions of society. Yet it is largely free from direct political control or supervision. Many of the subsidized organizations (probably the vast majority) cannot individually command well-organized masses of voters or other sources of concentrated political power. Similarly, individual charities' arguments (if any) that their activities are desirable from a public interest perspective have widely varying force and cogency. Some have strong political support and receive direct government grants and subsidies in addition to the exemption.²⁰⁰ But many, if not most, of the subsidized interests do not have the political support to build a consensus for a direct subsidy equal to the indirect subsidy they receive through the exemption, and many would be unable to obtain any direct subsidy at all.

The second problem is that the amount of the subsidy to each recipient is independent of either political popularity or any standard of the public interest. Rather, the size of the subsidy depends solely on the recipient's ability to generate taxable income, whether in the form of a return on passive investment capital or income from profitable business activities.

Both of these features began to puzzle theorists in the 1940s and have done so ever since.²⁰¹ To see the depth of the problem, it is enough to look at how

argued eloquently that forcing charities to lobby the government for support would undermine their independence and public support, as well as fomenting disputes between religious and other social groups. *See* Brody, *supra* note 29, at 593 (quoting statements). The fact that there may be some virtues to separating government support from political control does not make it any less odd that politicians should lend stable support to such a separation.

²⁰⁰ *See, e.g., Sen. Carper's Sussex County Schedule for Tuesday, November 23, 2004*, STS. NEWS SERV., Nov. 22, 2004 (LEXIS, NEWS Library, SNS File) (reporting state senator's announcement of federal grant to Parent Information Center for outreach to Hispanic parents of children with disabilities living in Kent and Sussex Counties).

²⁰¹ *See, e.g., Hansmann, Rationale for Exempting, supra* note 20, at 71 ("[T]here is no reason to expect a positive correlation between the amount of a nonprofit's retained earnings and the factors just described that might justify a subsidy."); Woodworth Report Part A, *supra* note 163, at 2 ("The exemption method of providing a subsidy is especially erratic in its application."). Hansmann attempts to explain tax exemption on efficiency grounds, as a means of making up for nonprofits' inability to use equity financing. Hansmann, *Rationale for Exempting, supra* note 20, at 72–74. This theory is unpersuasive. First, Hansmann assumes that inability to raise equity capital will result in inefficient capitalization and that retained earnings will crudely make up the difference, while having a salutary correlation to the popularity of the organization's activities (supposedly measured by the amount of earnings). *Id.* As Colombo and Hall have pointed out, the assumption that income corresponds to donative support is not justified. *See* Hall & Colombo, *supra* note 29, at 1416–19. In addition, it does not appear that equity is a significant source of capital, relative to debt and retained earnings, for most for-profit firms. In 2002, for instance, net issuance of corporate debt exceeded net issuance of corporate equity by a factor of more than ten to one. *See* SEC. INDUS. ASS'N, 2003 SECURITIES INDUSTRY FACT BOOK 16 (2003). The pattern is reversed when retained earnings are taken into consideration. Total

the government goes about making direct, politically selected grants to subsidize particular activities, such as research, education, or social relief.²⁰² These grants are often made to nonprofit organizations, but mere demonstration of nonprofit status is never enough to qualify for a direct subsidy and the amount of potentially taxable income is never the basis for determining the size of an award. Rather, direct government subsidies are almost always subject to notoriously cumbersome and detailed budgeting, monitoring, and reporting requirements to assure that the amount of the subsidy matches the exact activities to be subsidized, that the subsidy is spent on those activities, and that those activities are, in fact, accomplished.²⁰³

At first glance, these problems should have been very serious, if not fatal, from a political point of view. The blanket nature of the subsidy seems so politically complex as to be inherently unstable. From a public choice perspective, a blanket subsidy should be quickly and violently dismembered in a struggle between political forces opposing the activities of individual recipients, seeking additional subsidies for the activities of individual recipients, or simply coveting the budget lines of politically defenseless recipients. From a public interest point of view, legislators should be

corporate equity outstanding in 2002 was almost double the outstanding corporate debt. *Id.* at 17. The availability of equity capital is probably much more important to early-stage enterprises, with no established stream of earnings to retain or to use to reassure lenders. Ironically, this is precisely the stage at which Hansmann's equity subsidy does not help. More importantly, perhaps, Hansmann's explanation simply seems incompatible with the actual history of the exemption. As he admits, his explanation "seems never to have been expressly offered before." Hansmann, *Rationale for Exempting*, *supra* note 20, at 72.

²⁰² The subsidies discussed are broad-based subsidies that tend to be distributed according to general rules based on ideology and attempts to achieve broad policy outcomes. A very different dynamic applies when Congress is appropriating for specific public works that largely impact one or only a few congressional districts. In those cases, the appropriations seem to be controlled much more by the direct electoral considerations of representatives and their parties. See Frances E. Lee, *Geographic Politics in the U.S. House of Representatives: Coalition Building and Distribution of Benefits*, 47 AM. J. POL. SCI. 714, 715 (2003).

²⁰³ For instance, recipients of grants from the National Institutes of Health (NIH) must comply with a set of rules governing the administration of grants, summarized in a 142 page manual. See NAT'L INST. OF HEALTH, NIH GRANTS POLICY STATEMENT (2003), available at http://grants1.nih.gov/grants/policy/nihgps_2003/nihgps_2003.pdf. It is hard to overemphasize the detailed and intensely intrusive nature of the rules, which range from "encourage[ment]" to use seat belts and to maintain a smoke-free workplace, *id.* at 54, to requirements that grantees submit periodic financial and other reports to the government, detailing their performance of the subsidized program and use of public funds. *Id.* at 129. Exempt organizations (other than churches) are required to file annual information returns on Form 990. See I.R.C. § 6033; Treas. Reg. § 1.6033-2(a)(2)(i). Organizations claiming exemption under subsections (3), (9), (17), and (20) of section 501(c) of the Internal Revenue Code are also required to file an initial application for recognition of exemption and to receive an IRS determination of exemption as a condition of exemption. I.R.C. §§ 505(c), 508(a). While these requirements allow the Treasury to determine that the organization is operating within the general parameters of the exemption, they do not compare to the detailed reporting on finances, results, and efficacy that usually accompany government grants.

dissatisfied with a subsidy that predictably funds nonoptimal (or even undesirable) activities at more or less random levels.²⁰⁴

The 1947 House Hearings present a graphic illustration of this vulnerability. In a protracted colloquy with NYU's John Gerdes, Harold Knutson, the chairman of the Ways and Means Committee, began to question whether the government should subsidize any charitable activities in the absence of substantive government controls over their activities. Knutson was specifically concerned about the possibility that exempt educational institutions might use their subsidies to teach communism.²⁰⁵ Recognizing that Knutson's line of thinking was an uncomfortably direct challenge to the assumptions behind the exemption, Manhattan congressman Walter Lynch warned Gerdes that NYU's action had the potential to undermine the entire exemption. Lynch urged Gerdes to persuade "the trustees of your alumni fund . . . to look over the situation very carefully to see whether or not the best interests of the educational organizations, charitable organizations throughout the country are being served."²⁰⁶

Despite this apparent political vulnerability, the blanket charitable exemption subsidy survived its transformation in the 1940s and has remained remarkably stable ever since.²⁰⁷ The most surprising moment in this history of stability was the beginning—the period between 1940 and 1950 when the exemption changed, in practical effect, from legislative grace to blanket subsidy. How did such a politically problematic program survive such a fundamental transformation?

C. *Justifying the Transformed Exemption*

Scholars have debated why Congress should or should not want to grant a subsidy of this sort. Most attempts to formulate a normative defense or assault on the exemption-as-subsidy share two common features. First, they approach

²⁰⁴ It should be noted that there have been recent signs of discomfort. The Joint Committee staff's reform recommendations include proposals to require exempt organizations to file reports every five years, in essence justifying their continued exemption. JOINT COMMITTEE REPORT, *supra* note 179, at 220–29. Even this proposal, however, merely requires charities to demonstrate that they are still organized and operated for exempt purposes, not that they are accomplishing any desirable goal, let alone doing so efficiently (or in a seat-belted and smoke-free environment). *Id.* at 224.

²⁰⁵ See 1947 Hearings, *supra* note 1, at 3530–33.

²⁰⁶ *Id.* at 3535.

²⁰⁷ Section 501(c)(3) was not amended at all in the 1940s and has been amended only twice since, both times in 1954. James J. McGovern, *The Exemption Provisions of Subchapter F*, 29 TAX LAW. 523, 529 (1975).

the exemption from an ahistorical perspective, assuming that there is a single explanation for its original enactment and subsequent persistence. Second, almost all include a program to reform the existing exemption to conform it to the normative justification that supposedly brought it about. In other words, they do not explain the exemption as it actually exists, much less the remarkable stability of its flawed form over time.²⁰⁸

The key to understanding what happened in the 1940s is to understand that there was no fundamental rethinking of the exemption when the transformation of the income tax radically changed the nature of a blanket exemption from that tax. Even though changed circumstances eventually forced policymakers to pay attention to the exemption in a way they never had before, no one in government ever opened a serious discussion of the merits of subsidizing charities through a federal income tax exemption.

This did not have to be the case. As policymakers noticed the exemption and identified it as a subsidy, they could have reacted in two possible ways. They could have noticed that the practical effect of the exemption was now radically different than it had been before 1940 and undertaken a ground up consideration of whether and how to subsidize charity. In the alternative, they could have looked for a justification for the law already on the books. Although the NTEA took the former route, policymakers in the Treasury and Congress chose the latter without exception.²⁰⁹ This began a process of justification that culminated in the UBIT. The subject of this section is the process by which policymakers in 1940s justified the transformed exemption without ever rethinking the policy behind it.

²⁰⁸ The exceptions to this rule are Lawrence Stone, Rob Atkinson, and Donald Sharpe, who describe the blanket nature of the subsidy as promoting a larger societal goal (Stone and Sharpe describe it as pluralism and Atkinson as altruism) served by nonprofit organizations in general, rather than any individually valuable activity of its recipients. See Atkinson, *supra* note 19, at 616–38; Sharpe, *supra* note 29, at 371; Lawrence M. Stone, *Federal Tax Support of Charities and Other Exempt Organizations: The Need for a National Policy*, 20 U.S. CAL. SCH. L. TAX. INST. 27, 39 (1968). For this reason, they are not particularly perturbed at its lack of precision. It should be emphasized that the purpose of this article is not to support or oppose any normative argument for continuing, amending, or abolishing the charitable exemption or the UBIT. It is, rather, to examine and explain their development in historical context.

²⁰⁹ A memorandum apparently prepared around 1948 by the joint efforts of Treasury and Joint Committee staff opened by noting “[t]hat tax exempt organizations have been subject to but little analysis for many years is suggested by the fact that eight of the nineteen subsections in section 101 remain in present law substantially as they appeared in the 1913 act Over so long a period it is only natural that conceptions as to what constitutes proper purposes for exemptions should change.” Copeland Report, *supra* note 123, at 6. The rest of the memorandum, however, fails to follow up on this initial suggestion.

1. *Perceptions of Continuity*

The first and most important reason that policymakers immediately began to look for justifications for the exemption, rather than rethinking it, was inertia. Although they sensed that the exemption had taken on new importance, the text of the law had not changed. Not only did the exemption appear unchanged on the statute books, it appeared to have the status of ancient wisdom.²¹⁰ In the 1947 and 1950 congressional hearings, the charities were well aware of this and used words such as “ancient” and “traditional” to describe their subsidy at every chance.²¹¹ This patina of continuity and respectability was important. Though *stare decisis* is not often recognized as a principle of legislation, it undoubtedly has a significant effect on the legislative process. The unchanged text of an ancient and traditional law comes with a presumption that some public policy supported it when passed and probably continues to do so. Rethinking an old statute is like tearing up an old orchard and replacing it with new trees. It can be done and sometimes it needs to be done, but it is expensive and risky and will rarely be considered before all other alternatives. Thus, for policymakers noticing the exemption’s increased importance, the obvious question was not whether the exemption could be justified at all, but rather what policy already justified it.

As should already be clear, the “justification” that sustained the exemption was not a logical and instrumental theory of tax, economic, or political policy. It was a set of symbolic perceptions that made policymakers comfortable continuing what they perceived as the honorable path of their forebears. Subsections 2 and 3 explain the additional elements that helped build a new justification for the exemption and the problems that threatened to erode it, precipitating the UBIT.

²¹⁰ See, e.g., Thomas J. Lynch, Gen. Counsel, U.S. Dep’t of the Treasury, Address before the Section on Taxation of the New York State Bar Association, at the House of the Association of the Bar of the City of New York 5 (Jan. 28, 1950) (on file with the JCT Archives, *supra* note 98, Box 31, File: 1950) [hereinafter Lynch Speech] (“It should be emphasized that there is no intent . . . to reverse the longstanding Federal policy of encouraging altruistic organizations taxwise.”); 1950 Briefing Book, *supra* note 71, at 9 (citing “long-standing Congressional policy to accord special recognition to organizations presumed to be carrying on socially desirable activities, some of which might otherwise require the expenditure of public funds”); see also *supra* notes 58–61 and accompanying text (discussing Evelyn Brody’s work on the importance of tradition and received wisdom in justifying charitable tax exemptions).

²¹¹ See, e.g., 1950 House Hearings, *supra* note 36, at 494 (statement of Paul C. Cabot, Harvard Univ.) (describing “ancient exemption from taxation”).

2. *The Role of the Nondistribution and Exempt Purpose Requirements*

As policymakers looked for reassurance that the exemption was justified, two constraints already imposed on exempt organizations were of immediate assistance to them: the nondistribution constraint and the exempt purpose requirement. This subsection will discuss the role of the nondistribution constraint. Subsection 3 will consider the exempt purpose requirement.

Hansmann and many subsequent commentators have pointed out the function of the nondistribution constraint as part of the nonprofit organizational form, as opposed to the income tax exemption. The theory concludes that the government promises to enforce the nondistribution constraint on nonprofit corporations and trusts to cure a certain kind of market failure—the difficulty of paying for the provision of gratuitous benefits to persons who are either diffuse or distant (socially, geographically, or temporally) from the payor.²¹² For instance, a U.S. donor who wants to pay a small amount of the cost of feeding starving children in Africa or of endowing a permanent, high-quality academic institution for centuries to come will find it very difficult to contract with an individual or a for-profit legal entity to perform the service. The for-profit payee's incentives are to use as little of the money as possible on the donor's project and pocket the rest. The payor will often balk at the expense of effective contract negotiation, monitoring, and enforcement. The difficulties compound if the donation is an "altruistic supply of capital"—as Atkinson put it in expanding Hansmann's theory—intended to be used independent of the donor and often long after the donor's death.²¹³ The nondistribution constraint allows promoters and managers of donee organizations to tie themselves to the mast credibly, alleviating the concerns of potential donors about the misappropriation of their donations.

²¹² See Hansmann, *Role of Nonprofit Enterprise*, *supra* note 13, at 845; see also Atkinson, *supra* note 19, at 512–13, 590–92 (proposing significant modification to Hansmann's theory and discussing the special case of temporal separation between donors and posthumous beneficiaries). Hansmann describes the role of some nonprofits, such as symphony orchestras and universities, as managing price discrimination between patrons and/or arranging implicit loans to customer who are later expected to become donors. See Hansmann, *Role of Nonprofit Enterprise*, *supra* note 13, at 854–62. Both of these functions are hard to distinguish from Atkinson's altruistic capital. For a discussion of the problems with Hansmann's attempts to extend his theories further to organizations that supposedly render services too complex for consumers to evaluate, see *supra* note 66. It should be noted that Hansmann tries to explain universities on this basis. Atkinson's altruistic capital seems a better explanation, at least as to research universities that have functions other than selling educational services to students. In any case, this Article will focus on Hansmann's main "contract-failure" explanation.

²¹³ See Atkinson, *supra* note 19, at 567.

The importance of the nondistribution constraint in justifying a blanket subsidy is fairly easy to see if looked at through Hansmann's lens. The federal government donates tax subsidies to a wide variety of organizations. It makes sense to impose and police a nondistribution constraint as a minimum assurance that the subsidy will go exclusively to the intended organizations and will not be siphoned off for the personal profit of people associated with them. The difference from the state law constraints is that the federal constraint is better described as a covenant imposed and enforced by the donor, rather than a guarantee promised to the donor by another body.²¹⁴

The courts that created the destination of income test understood the importance of the constraint and used it as the basis of their doctrine.²¹⁵ Likewise, nonprofit officials appearing before Congress as the UBIT was under consideration understood the power of this constraint and used it heavily to reassure Congress that all was well with the subsidy.²¹⁶

²¹⁴ See Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 605 (1981) [hereinafter, Hansmann, *Reforming Nonprofit Corporation Law*] (“[F]ederal tax law does effectively make the government a patron of many nonprofits, and to this extent the government has an interest in policing the behavior of nonprofits that is much like that of any other patron.”).

²¹⁵ See *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578, 582 (1924) (noting legal constraints on Dominican Order and members' vows of poverty and concluding that “[i]n using the properties to produce the income, it therefore is adhering to and advancing those purposes, and not stepping aside from them or engaging in a business pursuit”); *Appeal of Unity Sch. of Christianity*, 4 B.T.A. 61, 69 (1926) (“If these purposes or any of them are the controlling reasons for the corporation's existence and all things are devoted by it to that end, the congressional purpose of exemption, ‘made in recognition of the benefit which the public derives,’ should not be defeated because its incidental features are to some extent profitable. It is only when such profits or net income are used for private rather than public benefit that Congress has taxed them.”).

²¹⁶ See, e.g., *1950 Senate Hearings*, *supra* note 82, at 526 (statement of Carter Davidson, Am. Council on Educ.) (“[E]very cent of income merely increases our public service.”); *id.* at 537 (statement of Clarence Shock, SICO Co.) (“[SICO] taxes itself 100 percent and even in case of liquidation must give all of its net assets to public schools.”); *1950 House Hearings*, *supra* note 36, at 572 (statement of Philip C. Pendleton, Am. Council of Educ.) (“[N]o part of college income is ever expended for any purpose other than improved facilities and services.”); *1947 Hearings*, *supra* note 1, at 3401 (statement of Samuel McCrea Cavert, Fed. Council of the Churches of Christ in Am.) (emphasizing nondistribution and exempt purpose constraints and stating that the Council supports “appropriate methods” of dealing with “abuses of these conditions”); *id.* at 3442, 3444, 3447 (statement of Lloyd Morey, Univ. of Ill.) (emphasizing nondistribution and exempt purpose requirements); *id.* at 3463 (statement of A.W. Peterson, Univ. of Wis.) (“The income [of universities] is used for education, not for private gain.”); *id.* at 3512 (statement of Graham L. Davis, Am. Hosp. Found.) (“[Any hospital net income in one year] would be used in the next or succeeding years to make up deficits. It cannot be used for any other purpose legally.”); *id.* at 3529–30 (statement of John Gerdes, NYU) (“[The government and public gained on New York University's acquisition of Mueller because] [i]f the Mueller Co. were continued as a private enterprise only 38 ½ percent of its income [paid in federal income taxes], instead of 100 percent, would be devoted to public purposes.”).

The nondistribution constraint alone was not enough to maintain the exemption as a blanket subsidy. In searching for a public policy justification for the exemption, policymakers needed to convince themselves not only that the subsidy would reach the intended activities, but also that those activities were worth subsidizing. The exempt purpose requirement helped in this regard.

The basic intuition behind the traditional requirement that a charitable trust have a charitable purpose and indefinite benefit is fairly clear: These activities benefit society and might not be adequately supported by markets. Much productive work has been done attempting to explicate this intuition in more economically or politically precise terms.²¹⁷ For purposes of this Article, however, the important fact is the traditional and persistent intuition that charitable purposes define “good works”—broad categories of endeavor that are socially useful, politically popular, and unlikely to be adequately supplied by markets alone.

Again, the symbolic importance of this constraint to justifying a blanket tax subsidy for charities is straightforward. It reassures policymakers, in conjunction with the nondistribution constraint, that the subsidy will be expended for the public good. Because of the exempt purpose requirement, the exemption started with an air of good public policy. For the most part, this image diverted policymakers’ thoughts away from questioning the exemption at an instrumental level and towards finding a way to restore the patina of respectability to the exemption by ending the charities’ disturbing new activities. In the words of a Treasury report from the early 1940s:

Our guide here cannot be logic—for logic is useless when the issue is one of axiomatic first premises—but recognition of the popular mores. And on this matter, though there are as yet no Gallup polls to support a generalization, it would appear that Congress was correctly

²¹⁷ See, e.g., Atkinson, *supra* note 19 (analyzing nonprofits as providing “metabenefit” of altruistic activity in society, in addition to the benefits of specific goods and services); Hansmann, *Reforming Nonprofit Corporation Law*, *supra* note 214, at 509–53 (criticizing positive and negative restrictions on purposes of nonprofit corporations); Hansmann, *Role of Nonprofit Enterprise*, *supra* note 13, at 848 (analyzing role of nonprofit organizations as solving market failures, such as the provision of public goods and the bridging of “contract failure” in the provision of various types of goods and services); Stone, *supra* note 208, at 39 (arguing that nonprofit sector allows for private nongovernmental social organization that is “not only desirable but may very well be a prerequisite to the continuation of a democratic society”); Burton A. Weisbrod, *Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy*, in *THE ECONOMICS OF NONPROFIT INSTITUTIONS: STUDIES IN STRUCTURE AND POLICY* 21 (Susan Rose-Ackerman ed., 1986) (analyzing nonprofits as a mechanism to supply demand for public goods in excess of level provided by government).

interpreting the public heart, if not the public mind, in placing the altruistic expenditure of funds for ‘religious,’ ‘charitable,’ ‘educational,’ and ‘civic’ purposes ahead of the expenditure of a part of these funds for the ordinary functions of the federal government.²¹⁸

This assessment of congressional attitudes was accurate. Charities appearing before Congress have always made sure to emphasize the good works they perform.²¹⁹ In 1947 and 1950, however, the charities’ efforts at self-promotion were almost overshadowed by the eagerness of Congressmen to pat them on the back. Even Representative Mason, the NTEA’s²²⁰ strongest ally in the House, commented at the 1947 Hearings that “we are not interested in any activities by any educational or religious organizations that do not compete directly . . . with taxpaying organizations.”²²¹ Likewise, Congressman John Dingell of Michigan, a fierce proponent of the UBIT in 1950, began an attack on Philip C. Pendleton, Treasurer of the University of Pennsylvania, by emphasizing that he was in favor of exempting educational activities.²²² Congressmen less dedicated to that position spent most of the 1947 and 1950 Hearings expressing their high regard for and desire to support the fine charities the witnesses represented.²²³ Likewise, no congressman was willing even to discuss the NTEA’s plea to abolish the charitable exemption altogether in the name of economic rationality and tax equality.²²⁴

3. *Nontraditional Activities as Threats to Perceptions of the Exemption*

If these two traditional constraints help to explain why the charitable exemption did not immediately implode under the pressures of the transformed

²¹⁸ Shultz Report, *supra* note 36, at 35.

²¹⁹ *See, e.g., 1950 House Hearings, supra* note 36, at 494 (statement of Paul C. Cabot, Harvard Univ.) (“Many of these institutions—Harvard is a conspicuous example—are engaged . . . in research projects of incalculable importance to the national defense and ultimately to the scientific advancement and welfare of mankind.”); *1947 Hearings, supra* note 1, at 3396 (statement of Willard E. Nelson, Treasurer of the Gen. Conference of Seventh-Day Adventists) (“The primary objectives of Seventh-Day Adventists . . . are . . . to alleviate human suffering and to prepare the children and youth for this work . . .”).

²²⁰ For a discussion of the origins and activities of the NTEA, see *supra* notes 98–110 and accompanying text.

²²¹ *1947 Hearings, supra* note 1, at 3406.

²²² *1950 House Hearings, supra* note 36, at 582.

²²³ *See, e.g., id.* at 498 (statement of Rep. Robert W. Kean) (“I certainly did not want to propose any legislation which would in any way injure my alma mater.”); *1947 Hearings, supra* note 1, at 3400 (statement of Chairman Knutson) (expressing reluctance to examine religious organizations).

²²⁴ *See 1947 Hearings, supra* note 1, at 3408–09 (statement of Leonard J. Calhoun) (advocating restricting exemption to cover donations only).

income tax, however, they were ultimately not sufficiently strong to preserve it. The weakness of these two constraints was the same as the source of their strength: Because they based the subsidy on symbolic perceptions that charity serves the public good, rather than on direct political control or careful economic calibration to defined social goals, they left the exemption vulnerable to any disturbance to the symbolic role of charity.

The perception that the exemption subsidized “good works” could be disturbed by pointing out that the broad categories of the exemption included some highly unpopular activities. For instance, as discussed, in 1947, House Ways and Means Committee Chairman Knutson openly began to consider whether it made sense for the federal government to subsidize schools that were fomenting communism, much to the consternation of his fellow congressmen.²²⁵ Such anecdotes, however, were not particularly dangerous if they appeared to be isolated exceptions to a general rule of political acceptability. For instance, if a given member of Congress was violently opposed to subsidizing a school that taught communism, he would nonetheless be unwilling to repeal the exemption if he perceived that education was, in general, a “good work.”

Mueller and the leasebacks posed a more serious danger to the perceptions underlying the exemption. They were evidence that, despite the nondistribution constraint and the exempt purpose requirement, the exemption was supporting organizations engaged systematically in commercial activities that did not fall within any recognizable category of “good works.” This evidence did not call into question the very resilient perception that traditional charitable activity was worthwhile. Rather, it undermined confidence that the exempt purpose requirement was actually limiting the exemption to charitable organizations in the first place. As Congressman Lynch pointed out in 1947, this had the potential to call the entire exemption into question.²²⁶

In the 1947 and 1950 House Hearings, no major charity (except for NYU in 1947) was willing to argue that the conduct of active unrelated business by charities was in accord with public policy.²²⁷ The perception problem was too

²²⁵ See *supra* notes 205–206 and accompanying text.

²²⁶ See *supra* note 206 and accompanying text.

²²⁷ See *1947 Hearings, supra* note 1, at 3525–42 (statement of John Gerdes, NYU). Richard Barker, a tax lawyer representing the Sand Springs Home and Widow Colony and clearly outside of the universities’ unified policy program at the 1950 hearings, also spoke in apparent defense of unrelated activities, suggesting a tax on income from any source if not largely spent on exempt activities during the year earned. *1950 Senate Hearings, supra* note 82, at 656 (“What difference does it make if you are trying to block this loophole what

obvious for that. Many of the nonprofit officials professed to be just as upset as the congressmen and they probably were.²²⁸ Rather, the discussion was only about what, if anything, to do about the problem. By the 1950 Hearings, in fact, the discussion was entirely about exactly who and what should be taxed.²²⁹

D. Political Function of the UBIT

The remainder of this Article will propose a new explanation for the UBIT. This proposal is that the UBIT deters charities from engaging in activities that look bad. The UBIT created a tax gradient, taxing the income from certain types of investment activities, but exempting others. Take, for instance, an officer of NYU trying to decide whether to use the university's endowment to buy the C.F. Mueller business from the American Italian Pasta Company, or simply to buy publicly traded stock of the American Italian Pasta Company. From a tax standpoint, NYU is probably indifferent because the business will pay either corporate income tax or UBIT. Given the trouble, illiquidity, and undiversified risks of direct ownership, NYU chooses the stock in most cases.²³⁰

the source of the income is as long as it is expended?").

²²⁸ See, e.g., *1950 Senate Hearings*, *supra* note 82, at 376 (statement of James R. Killian, Jr., Mass. Inst. of Tech.) ("[The American Association of Universities] has taken a firm stand that it is improper for a college or university to undertake to own or operate an unrelated business enterprise."); *id.* at 509 (statement of Harold E. Stassen, Univ. of Pa.) ("[Unrelated business] should not be engaged in by the university or college."); *id.* at 571 (statement of Stuart Hedden, Wesleyan Univ.) ("The problem of unfair competition . . . is involved directly in the 'macaroni case' and similar cases."); *1950 House Hearings*, *supra* note 36, at 495 (statement of Paul C. Cabot, Harvard Univ.) ("I cannot believe that it is sound public policy to exempt from Federal taxation the income of manufacturing and commercial enterprises merely because they are owned by charitable institutions."); *1947 Hearings*, *supra* note 1, at 3398 (statement of Willard E. Nelson, Seventh-Day Adventists) (stating "sympathy with your objectives" of taxing nonprofit business in competition with taxable business); *id.* at 3441 (statement of Lloyd Morey, Univ. of Ill.) ("[I]f such types of tax avoidance are legally possible we would like to be helpful to you gentlemen in finding them and eliminating them."); *id.* at 3456 (statement of Robert B. Stewart, Purdue Univ.) ("I recognize the problem the committee is dealing with, and I am so much concerned with it myself because this is extremely important."); *id.* at 3461 (statement of Lawrence Lunden, Univ. of Minn.) ("I would find myself hard pressed to justify [Mueller]"); *id.* at 3462 (statement of A.W. Peterson, Univ. of Wis.) ("if there are abuses . . . they should be required to pay").

²²⁹ See, e.g., *1950 House Hearings*, *supra* note 36, at 495–96 (statement of Paul C. Cabot, Harvard Univ.) (advocating tax on substantial unrelated active business, but an exemption of real estate, including leasebacks); *id.* at 501–02 (statement of J.R. Killian, Jr., Mass. Inst. of Tech.) (advocating tax on unrelated active business if separately incorporated); *id.* at 583–84 (Memorandum of the Disabled Am. Veterans) (advocating definition of taxable unrelated business income excluding DAV's fundraising methods).

²³⁰ Note that NYU made the opposite choice after the UBIT passed in 1950, holding the C.F. Mueller Company until 1976. Alexander R. Hammer, *Foremost-McKesson to Purchase Mueller Stock*, N.Y. TIMES, Sept. 29, 1976, at 71. Whatever the reason for this choice, NYU's shopping spree for new unrelated businesses seems to have ended in 1947.

The expressly intended result was that charities by and large would avoid taxable activities and concentrate their investment activities in the exempt activities. The categories were not determined by considerations of horizontal equity between taxpayers or revenue protection. Rather, they were selected for the symbolic meaning of engaging in them. In their struggle to justify the new subsidy to charities, policymakers simply acted to eliminate the cognitive dissonance. Operating spaghetti factories did not fit their perception of the type of organization they were subsidizing by the exemption. Prudently husbanding passive investment portfolios did. The solution was to give charities a strong tax incentive to choose traditional over nontraditional investments. The three subsections below will consider each of the three problems with the UBIT posed above in light of this new explanation.

1. Inconsistent Coverage of the UBIT

As discussed above, one of the fundamental problems with the unfair competition explanation for the UBIT is that it does not explain why the UBIT covers income from active unrelated business, but excepts income from active related business and passive investments. This distinction looks very different when viewed from the perspective of policymakers trying to justify a suddenly anomalous, but presumptively worthwhile, subsidy.

Active business endeavors present symbolic problems that passive investments do not. Active business endeavors appear to be what the organization “is doing.” Passive business endeavors appear to be merely what the organization “is doing with its money.” If the perception of what exempt organizations are doing with their exemption is crucial to the political stability of the exemption, active business endeavors are much more important politically than passive ones. Active business endeavors call into question the assumption that the exemption is only subsidizing categories of activity that can be classified as “good works.” Congressmen do not like to think that the charitable exemption is really subsidizing spaghetti factories, because spaghetti factories do not look charitable, no matter where their proceeds go. Passive investment is less visible as a business activity and subsidizing it does not prompt the same discomfort.²³¹

²³¹ See, e.g., *1947 Hearings, supra* note 1, at 3518 (statement of Congressman Robert W. Kean) (“I do not think there is any possible disposition upon the committee to tax revenue from endowment funds or anything which could possibly affect endowment funds.”).

Policymakers and charities alike were sure from the start that active unrelated business was a problem. No major charity, other than NYU, was willing to speak out in favor of it in the 1947 or 1950 Hearings and most spoke against it.²³² The same perception issues drove the taxation of debt-financed income and advertising income in 1969. Bootstrap purchases of businesses and highly commercial advertising sale operations looked very inconsistent with Congress' conception of what it was subsidizing. No exempt organization appeared in Congress to defend bootstraps. Exempt organizations with such tin ears that they did not appreciate the symbolic problems created by advertising activities were rewarded not only with the passage of section 513(c), but also with public ridicule in congressional hearings.²³³

It is interesting in this regard that, although policymakers explained the UBIT as a measure to prevent exempt organizations from competing unfairly, rather than to forbid competition altogether, the rhetoric of its proponents made it clear that they did not want charities to engage in business activities at all. Vance Kirby, the Treasury's Tax Legislative Counsel, described the UBIT proposal as a "proposed ban on the operation of business activities" in an internal memorandum, setting out the 1950 tax legislative agenda.²³⁴ Congressman Dingell stated in the 1950 House Hearings:

You are in the educational business. That is your business, that is your purpose. I am not going to contend that you must let your money remain in the Treasury in original currency form and ferment or become moth eaten, but why do you not go out and buy bonds of these operating companies; why do you not buy real-estate bonds from trust companies and others? You can invest that money. You can have your investment in the property without going into competitive business with the businessmen of this country.²³⁵

²³² See *supra* notes 227–229 and accompanying text.

²³³ See 1969 Hearings, *supra* note 42, at 1259–340 (statement of Bernard Hirsh, Am. Med. Ass'n).

²³⁴ Sources of Additional Revenue for 1950 Tax Program Agreed to by Treasury Staff and Mr. Stam, *supra* note 71, at 2. "Mr. Stam" refers to Colin Stam who was the chief of staff of the Joint Committee on Internal Revenue Taxation (as it was then called). See Part VII—Joint Committee History & Background, <http://www.house.gov/jct/stafhist.htm> (last visited Sept. 18, 2005). The quote certainly does not reflect the considered evaluation of Mr. Kirby. The Treasury staff was well aware that the UBIT did not literally ban business activities. See, e.g., Tax-exempt Organizations 3 (on file with the Truman Library, Papers of L. Laszlo Ecker-Racz, Folder: 1950 Tax Program v. 1) (hand annotation on document notes "statements prepared for House Floor Debate") ("The Bill does not propose to prevent an exempt organization from getting a better return by carrying on a business If they wish to take the risks involved in running a business, I see no good reason why they should not do so, so long as they operate on an equal tax basis with their competitors."). The point is Kirby's unthinking characterization of the proposal, not his intellectual understanding of it.

²³⁵ 1950 House Hearings, *supra* note 36, at 580–81.

Likewise, Congressman Lynch noted with annoyance in the 1950 House Hearings that colleges had not heeded his strong suggestion in the 1947 Hearings that they should yield to political pressure and voluntarily avoid active business. Lynch commended the Treasury for proposing legislation “with the idea that there is no intention of hurting the nonprofit institutions, but they must *confine universities to the fields for which they were established*.”²³⁶

Policymakers understood that they were not merely “taxing the untaxed” (the slogan of the NTEA).²³⁷ To the contrary, they were leaving open numerous exempt investment options in the hope and expectation that charities would take the hint and redirect their investments. They were establishing a steep tax gradient to steer exempt organizations away from politically embarrassing active investments and into passive investments more consonant with the symbolic meaning that sustains the charitable exemption. Policymakers were not intuitively uncomfortable with the inconsistency of the UBIT on economic and revenue policy grounds because those grounds were not the only (and perhaps not even the primary) motivation for the legislation. The purpose, as Treasury Secretary Snyder stated in introducing the bill at the 1950 Senate Finance Committee Hearings, was that “[o]ur tax laws have long recognized the principle that organizations operated *for worthy public purposes* should be encouraged by tax exemption. I am thoroughly in sympathy with this policy and fear that it is in danger of being *discredited* because a minority has abused it.”²³⁸

2. *Absence of Complaining Taxpayers*

The second problem with the unfair competition explanation discussed above is the total absence of complaining taxpayers. This absence is especially striking when compared with the overwhelming taxpayer participation in the simultaneous debate over cooperative taxation and later debates over unfair competition. Congress’s action in 1950 does not seem to match its stated purpose. Something else was impelling action in the name of unfair competition.

Once the inquiry is freed from the unfair competition explanation, however, the problem of the impetus to congressional action disappears. No taxpayers

²³⁶ *Id.* at 177 (emphasis added).

²³⁷ For a discussion of the origins and activities of the NTEA, see *supra* notes 98–110 and accompanying text.

²³⁸ *1950 Senate Hearings*, *supra* note 82, at 6 (emphasis added).

were complaining about unfair competition by charities. The business activities of charities, however, created symbolic problems that pressured policymakers to react.

Chief among these sources was taxpayer pressure on cooperative taxation. As discussed above, pressure by the NTEA forced the 1947 Hearings as the highpoint in its decades-long fight against tax-advantaged cooperatives.²³⁹ With the NTEA forcing hearings, however, it was a simple thing to add a few days to discuss the disquieting new leaseback and bootstrap transactions that the press and the Treasury and Joint Committee officials had started to notice in 1946. After the 1947 Hearings, the NTEA added the charitable exemption to the targets of its propaganda.²⁴⁰ The NTEA apparently noticed during the 1947 Hearings that the story of industrialist charities played better with the press and congressmen than the story of hardware middlemen who were finding it hard to give the public as low a price as the cooperative next door.²⁴¹

Another source of pressure was the press. The Treasury does not appear to have noticed leaseback and bootstrap transactions until the beginning of 1946, after early press reports caught the staff's attention.²⁴² After the 1947 Hearings, press coverage of incongruous charitable businesses mounted.²⁴³

²³⁹ For a discussion of the background to the 1947 Hearings, see *supra* notes 98–107 and accompanying text.

²⁴⁰ See NAT'L TAX EQUAL. ASS'N, *supra* note 98, at 1.

²⁴¹ See *supra* note 122.

²⁴² The first clear indication in the files of the Office of Tax Policy is a write-up by Gordon Keith of an article published in *Business Week* about NYU's acquisition of Ramsey Accessories Manufacturing Corporation. See Gordon Keith, Div. of Tax Research, U.S. Dep't of the Treasury, Files (Jan. 30, 1946) (on file with the OTA Archives, *supra* note 36, Box 18, Folder 27 (46.1)—Unrelated Business Income of Tax Exempt Organizations (1942) to (1985)); see also *Into the Tax-Exemption Fold*, BUS. WK., Jan. 26, 1946, at 67. The *Business Week* article connects the Ramsey acquisition to earlier leasebacks, in particular the 1945 deal between Allied Stores and Union College. *Into the Tax-Exemption Fold*, *supra*, at 67. Tellingly, however, *Business Week* reported the Allied Stores leaseback in an article focusing on post-war expansion of the retail sector, with no discussion of the tax aspect. See *Stores Expand*, BUS. WK., June 9, 1945, at 70, 76. Rather, the *Business Week* article describes congressional agitation over the Ramsey acquisition as an outgrowth of earlier concern over municipal acquisitions (or purported acquisitions) of private utilities. *Into the Tax-Exemption Fold*, *supra*, at 67. Immediately after Paul made his proposal to Congress, the Division of Tax Research generated a critical evaluation that acknowledged bootstrap transactions as a theoretical possibility, but dismissed that possibility as inconsequential. See May 1942 Memorandum, *supra* note 36, at 14. Clearly, the author was not aware of any actual bootstrap transactions. None of the reports and other documents in the OTA or JCT Archives before January 1946 shows any awareness of bootstraps or leasebacks.

²⁴³ See, e.g., *The Abuse of Tax Exemption*, FORTUNE, May 1950, at 74; *Colleges in Business*, WALL ST. J., Apr. 12, 1947, at 1; Kenneth Fiester, *Taxes, Dynasties, and Charity*, NATION, Sept. 30, 1949, at 41; Benjamin Fine, *More Colleges in Business, Imperiling Tax-Free Status*, N.Y. TIMES, Jan. 12, 1950, at 1; Benjamin Fine, *University Dollars Yielding Tax-Free Business Profits*, N.Y. TIMES, Dec. 13, 1948, at 1; *Looks Like a Gold Mine, Harry*, N.Y. DAILY NEWS, Nov. 24, 1949; Mason, *supra* note 120, at 30; A.G. Mezerik, *The Foundation*

What makes a compelling news story is different from what makes a compelling policy argument. The press stories did not reflect a mass of injured and complaining taxpayers. They did, however, reflect the fact that a charitable spaghetti factory made good copy because it was incongruous and disquieting.²⁴⁴ It was for this very reason that policymakers were influenced by the press coverage, although there were no complaining taxpayers to back it up.

The happenstance manner in which Congress ended up holding hearings about the exemption of charities two months after NYU announced the Mueller acquisition explains the dynamic of the hearings.²⁴⁵ Two years of scattered press reports and low-level scrutiny by the Treasury and Joint Committee staffs were enough to get a few days of hearings added on to the cooperative hearings. They were not, however, enough to warn charities that trouble was brewing. The charities seem to have been unaware that the charitable tax exemption would also be considered. They had no real reason for concern. Press reports of strange charitable activities had been sparse and generated no real public attention. The Treasury's investigations into them had been low profile. Everyone knew that the political impetus and purpose of the hearings was cooperatives and the Committee had referred to noncooperatives only obliquely in announcing the hearings.²⁴⁶

Accordingly, in the middle of November, with the cooperative hearings in full swing, Chairman Knutson publicly complained that no witnesses had signed up for the rapidly approaching portion of the hearings that would address exempt organizations other than cooperatives.²⁴⁷ When those hearings began two weeks later, a hastily gathered group of university, hospital, and church representatives took turns sitting in the witness chair. They were obviously ill-prepared and bewildered, as the congressmen asked them to justify practices in which, with one exception, none had engaged.

Racket, NEW REPUBLIC, Jan. 30, 1950, at 11; *Moola for Boola*, TIME, Nov. 14, 1949, at 96; *Schools' Tax-Free Business*, *supra* note 147, at 40; *Tax Reckoning is Coming!*, 66 CHRISTIAN CENTURY 1415 (1949). Noah Mason's article was reputed to be the most read (or, at least, circulated) magazine article of 1950, reaching the twelve million regular circulation of *American Magazine* and the *Reader's Digest*, along with two million "private reprints" (presumably distributed by the NTEA). See *Mason Given Top Honors*, DEKALB CHRON., Aug. 31, 1950, at 8.

²⁴⁴ See, e.g., *Schools' Tax-Free Business*, *supra* note 147, at 40 (juxtaposing pictures of the entrance to NYU and a smiling man serving himself from a large bowl of spaghetti).

²⁴⁵ NYU announced the Mueller acquisition on October 2, 1947. See *supra* note 25.

²⁴⁶ See *supra* note 107 and accompanying text.

²⁴⁷ *To Weigh Tax Exemptions*, *supra* note 107, at 39.

The exception was John Gerdes, the representative of NYU, whose alumni had just purchased Mueller for the benefit of its law school in a bootstrap transaction. Mueller was the latest in a string of similar transactions by NYU. The congressmen delighted in the incongruity of a spaghetti-making university. The Mueller transaction and spaghetti references were the leitmotif of the hearings. The congressmen were eager to castigate Mr. Gerdes for NYU's outlandish behavior.²⁴⁸ Mr. Gerdes seems to have come into the 1947 Hearings with no real understanding of the political symbolism of NYU's action. Accordingly, his performance in the hearings did not disappoint. His unabashed defense of NYU's acquisitions provided a perfect foil, allowing the congressmen to scold him in the sternest of terms.

The dynamic of the 1950 Hearings was completely different. Charities were, by this time, well aware of the danger facing them. A much better prepared group of charities appeared again before the Ways and Means Committee to stave off taxation. Crucially, however, they were unwilling to defend the propriety of the by-then-familiar litany of scandalous cases.²⁴⁹ Instead, they argued, by turns, that the dimensions of the abuses were not serious, that the charities should be allowed to police the abuses themselves, or

²⁴⁸ See *1947 Hearings*, *supra* note 1, at 3445 (statement of Rep. Mason) (asking Lloyd Morey, Univ. of Ill., whether he would “want to defend the New York University’s operation and ownership of the largest spaghetti factory in the country? In competition with other spaghetti factories?”); *id.* at 3451–52 (statement of Robert B. Stewart, Purdue Univ.) (noting, in reaction to Mason’s question to Morey, that “[t]he institution involving the macaroni factory, if I may make an aside, the instance is so startling, that all officers in educational institutions are sitting up and taking notice . . . that particular case is an exception to my knowledge in American educational finance and is contrary certainly to the practice at my institution”); *id.* at 3461 (Lawrence Lunden, Univ. of Minn.) (commenting that “[he] would [be] hard pressed to justify [the Mueller] situation,” but emphasizing its exceptional nature); *id.*, at 3465 (statement of Chairman Harold Knutson) (commenting on an alumni-formed royalty trust at the University of Wisconsin, “Well, I think that is somewhat along the same line as they are operating on over in New York, which resulted in a group of alumni being able to buy this much talked of macaroni or spaghetti plant. Of course, there are more instances like that than are generally believed, but we have not gone into it far enough to determine to what extent.”); *id.* at 3469 (statement of Rep. Roy O. Woodruff) (“[W]e will not touch anything that will do much damage to [universities], you may be sure of that, because I think there are not enough of these propositions such as exist up in New York with our macaroni outfit.”).

²⁴⁹ See *supra* notes 227–229. By 1950, the litany was well worn. In a January 1950 speech, for instance, the Treasury’s General Counsel, Thomas Lynch, noted that “[a] considerable amount of publicity has attended the entrance of altruistic organizations into large scale commercial activities. By now we are all familiar with these types of cases. Exempt operations of ceramic works, public utilities, and automotive accessories works—not to mention macaroni factories—have produced a vigorous reaction in the public mind. Entrance into the business field clearly was not contemplated in granting the exemption to these organizations.” Lynch Speech, *supra* note 210, at 4.

that only businesses carried out through separate subsidiary corporations should be taxed.²⁵⁰

The fact is that in 1947 and 1950 the Treasury, Congress, and the press alike were obsessed with Mueller, not unfair competition. Mueller's prominence was not due to vociferous complaints, evidence of predatory competitive activity, or even much evidence of similar cases.²⁵¹ As discussed, there is simply no evidence that competitors ever complained. It was also not because NYU had "traded on its exemption" to buy a business with one hundred percent leverage. Although this aspect of the deal bothered some policymakers, the Treasury's proposal, the Congressional reports, and the law passed in 1950 treated leasebacks as a separate problem, and most Congressmen recognized the difference in the 1947 and 1950 Hearings.²⁵² Rather, Mueller bothered people because a spaghetti factory was operating under the charitable exemption and spaghetti factories do not fit into any category of "good works." When Treasury officials and congressmen became upset about unfair competition in the noodle business or predicted that "if something is not done to level it off, the macaroni monopoly will be in the hands of the universities or their subsidiary corporations,"²⁵³ they were not primarily worried about the plight of purely hypothetical taxable noodle makers or the abstract noodle consumer. They were exercised about the dissonance between the symbolic perception of an exempt charity and the activities actually conducted by exempt organizations.

This attitude is evident in the pronouncements of Treasury officials and congressmen on the subject. New York Congressman Lynch stated in the 1947 Hearings "I know New York University pretty well and there is nothing that they teach in New York University that is incidental to spaghetti."²⁵⁴ Introducing the Treasury's proposals in 1950, Vance Kirby, the Tax Legislative Counsel, explained that Congress had granted tax exemption to charitable organizations "because Congress desired to encourage their particular altruistic or group-interest activities, which generally were not conducted for profit. However, nowhere does it appear that Congress

²⁵⁰ See *1950 Senate Hearings*, *supra* note 82, at 374–86; *1950 House Hearings*, *supra* note 36, at 493–588.

²⁵¹ For a discussion of the paucity of clear cases other than Mueller, see *supra* note 25.

²⁵² See, e.g., H.R. DOC. NO. 81-451 (1950); H.R. REP. NO. 81-2319, at 408–10 (1950); S. REP. NO. 81-2375, at 503–08 (1950).

²⁵³ *1950 House Hearings*, *supra* note 36, at 579–80 (statement of Rep. Dingell).

²⁵⁴ *1947 Hearings*, *supra* note 1, at 3536.

contemplated that such organizations would engage in the active conduct of a business.”²⁵⁵ Likewise, an exasperated Congressman John Dingell of Michigan told Philip C. Pendleton, Treasurer of the University of Pennsylvania, in the 1950 House Ways and Means Committee Hearings:

You are not going to be taxed for producing fine students. That is a very fine product that is never taxed. Always it is tax exempt. When you go into the noodle business or when you go into the real estate business, so far as I am concerned, you are going to pay a tax. That is exactly the way I am going to vote. That is my view.²⁵⁶

The UBIT was a reaction to a compelling public relations problem, not to taxpayers complaining about unfair competition. The NTEA²⁵⁷ and the press amplified the story to the point that policymakers became uncomfortable. Nor did charities ever seriously try to deny the obvious public relations problem leasebacks and bootstraps were posing for the charitable exemption. The result was political pressure to get embarrassing activities out of the press, not the end of unfair competition.

3. *Anomalous Legislative Focus on Facilitator Rather than Tax Evader*

The last problem with the traditional explanations for the UBIT discussed above concerned the revenue protection argument. The problem here is that policymakers reacted to tax shelters involving charities in a consistent and puzzling manner. Rather than consider these transactions as abuses by the taxpayers who were avoiding tax, they immediately concentrated on the charitable counterparty that facilitated the transactions. They never seriously considered addressing the problem directly by going after the tax avoider, even though this was the only approach that would have any hope of stopping the abuses. This attitude presents serious problems for a revenue-based explanation of the UBIT.

Again, the problem resolves if the UBIT is viewed instead as a reaction to problems of perception created by charities engaging in politically embarrassing activities. As noted, the incongruity of charitable spaghetti factories was a compelling story. The compelling stories attracted the attention of policymakers to the abuses. They also concentrated attention on the juicy

²⁵⁵ 1950 House Hearings, *supra* note 36, at 165.

²⁵⁶ *Id.* at 582.

²⁵⁷ For a discussion of the origins and activities of the NTEA, see *supra* notes 98–110 and accompanying text.

story—misbehaving charities—rather than on the dry, technical schemes to exploit the difference between the deductibility of rent and loan repayments or to characterize ordinary business income as capital gains.

As noted above, press reports alerted the Treasury to leasebacks and early bootstraps around 1946. None of Treasury's early evaluations of the transactions succeeded in laying out the exact nature of the scam. Early on, however, one disturbing fact came to the fore: organizations that purported to be formed and operated exclusively for charitable purposes were buying commercial real estate and industrial businesses. This departure from traditional practice seemed to warrant investigation and action against the most incongruous parties to the transactions—the charities.

This explains why charities received no response to their proposals to tax the taxable participants or to force charities to make current charitable-purpose expenditures commensurate with the tax that a taxable person would pay.²⁵⁸ Simply shutting down the tax avoidance would not have addressed Secretary Snyder's concern that a perception that exempt organizations were engaged in facilitating tax avoidance schemes, rather than in "good works," could discredit the exemption itself.

CONCLUSION

In theory, Congress should periodically and rationally question and rethink the policy objectives for all federal statutes, testing whether those objectives still make sense and whether the statutes are adapted to implement those rationales efficiently. In theory, someone (starting with the author) should have followed through on a 1948 internal Treasury report's opening suggestion:

[t]hat tax exempt organizations have been subject to but little analysis for many years is suggested by the fact that eight of the nineteen subsections in section 101 remain in present law substantially as they appeared in the 1913 act Over so long a

²⁵⁸ NYU's John Gerdes proposed this solution in the 1947 Hearings. Stuart Hedden, of Wesleyan University, made the same proposal in written comments submitted to the Senate Finance Committee, as did Richard B. Barker, a tax lawyer representing the Sand Springs Home and Widows Colony. See *1950 Senate Hearings*, *supra* note 82, at 568–71, 656–62. Donald Sharpe repeated the proposal years later. See Sharpe, *supra* note 29.

period it is only natural that conceptions as to what constitutes proper purposes for exemptions should change.²⁵⁹

In practice, even thinking about fundamental reform, let alone doing it, is difficult. It entails too much thought, energy, and uncertainty to be a day-to-day event. Moreover, when a statute is grounded in politically potent symbolism, it is hard (psychologically, let alone politically) for policymakers to debunk its symbolic meaning in the name of instrumental efficiency. Congress usually lets sleeping legislation lie. Even when problems arise with the symbolic meaning, however, the path of least resistance is usually to look for a plausible justification for the status quo and, at best, legislate against the most obvious symptoms of the underlying problem. In practice, that is what happened in the 1940s when the transformation of the income tax changed the charitable income tax exemption from a minor afterthought to a significant blanket subsidy to charity.

When the newly important exemption made itself known with a flowering of new organizations and exotic tax-shelter transactions, policymakers did not want to rethink the exemption. They wanted to justify the exemption as a time-honored subsidy for organizations perceived to be dedicated wholly to good works and leave it alone. Charities that were facilitating tax shelters made this effort at justification more difficult by publicly engaging in commercial business activities that clashed with perceptions of charitable activities.

The UBIT was designed to channel charities away from problematic activities by setting up a tax gradient that favored income-generating activities compatible with perceptions of charitable activity. At the taxable end were highly visible activities that challenged perceptions of charitable activities—active business endeavors unrelated to any charitable purpose. Law schools that wanted to make Congress uncomfortable by running spaghetti and piston-ringing factories would have to pay for the privilege. At the exempt end were activities more compatible with perceptions of charitable activity—traditional, passive investment and active business endeavors related to accomplishing a charitable objective. Charities willing to “adhere to the old line” of good works and passive investment were rewarded.

This political theory of the UBIT explains aspects of the tax that do not make sense under the traditional justifications of preventing unfair competition

²⁵⁹ Copeland Report, *supra* note 123, at 6.

and revenue erosion. It explains why the UBIT distinguishes between active and passive investments and between related and unrelated activities, even though all of them raise roughly the same problems of unfair competition and revenue erosion. It explains why Congress acted against unfair competition in the absence of taxpayers complaining about it. Finally, it explains why Congress has so often ignored the most culpable beneficiaries of charity-accommodated tax shelters—the promoters and taxable participants—and aimed remedial legislation at “abuses” by charities serving as accommodation parties.

The importance of these observations is not that the exemption or the UBIT are institutionally illegitimate or have no public policy rationale. Rather it is to point out the reason that apparently weak, spotty, and contradictory explanations have been so effective in maintaining the exemption and the UBIT over time, in the face of vociferous and well-reasoned criticisms. The modern exemption, a significant blanket subsidy to charities, is an entrenched piece of legislation in a very special sense. It was perceived as a traditional and accepted part of the statutory landscape from the moment it became important with the expansion of the income tax in World War II. This meant that all but the most radical attacks on it, from its inception, were couched as attempts to rationalize it with assumed justifications, rather than to consider its merits from scratch.

Reformers have struggled from the 1940s to this day to find rational policies underlying the exemption and have advocated reforms to rationalize the actual law with those policies. It is not surprising that fairly weak arguments have managed to protect the exemption, for all its theoretical frailty, against critics who were generally unwilling to question its fundamental legitimacy. Nor is it surprising that the reforms that have succeeded—the UBIT in 1950 and the tax reform of 1969—were not attempts to rationalize the apparently inconsistent aspects of the exemption, but rather attacks on “abuses” that called into question the exemption’s symbolic meaning.

Although these observations themselves say nothing about the normative arguments for and against the charitable tax exemption, they do hold important messages for anyone engaging in such arguments and for those who perceive abuses. In considering the efficiency and desirability of the charitable exemption or the UBIT, it is important to understand the political symbolism of the modern exemption and the UBIT. Whatever can be said for and against them in retrospect, they did not originate in the rational policy arguments

commentators have used to analyze their normative merits. This means that the structure of political symbolism that supports their surprising stability over time is also largely independent of such arguments.

Reform proposals that misunderstand, and therefore underestimate, the strength of this political structure are likely to repeat the very criticisms it has withstood all these years. On the other hand, reformers who approve of the charitable exemption from a normative point of view (and charities pushing the edges of charitable activities) need to be aware that the structural supports of the current regime are not instrumental. Changes in the legal regime or in charitable behavior that might seem marginal from an instrumental point of view have the potential to undermine the symbolic meaning from which the exemption draws its political support.

Reform proposals aimed at abuses of the exemption would likewise benefit from the lessons of 1950 and 1969. It is easy to become emotional about charities that seem to be undermining the perceptions of moral purity that sustain the exemption by accommodating tax shelters. It is dangerous, however, to get carried away with such emotions. Such emotion has often blinded policymakers to the real beneficiaries of tax shelters and tempted them into attacking the latest accommodation party in ways that do far more harm to unobjectionable charities than they do to tax-shelter participants.