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The Nonprofit Sector and the Federal Tax System

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Exemption is the term most often used by scholars, practitioners, and policy makers to describe the relationship between nonprofit organizations and the federal tax system in the United States. But although the term is useful as shorthand to characterize the complicated connections between the nonprofit sector and federal tax law, it also should be recognized as the misnomer that it largely is. The nonprofit sector is subject to a wide range of federal taxes—some of which apply broadly to nonprofit and for-profit entities alike, others of which fall almost exclusively on organizations that are ostensibly "exempt." Insofar as nonprofit entities are excused from payment of federal income tax, exemption comes with a heavy load of compliance burdens, disclosure obligations, and other behavioral restrictions that dictate the day-to-day lives of these organizations. Rather than existing at several steps' remove from the federal tax system, nonprofit entities are, in fact, tangled up in tax.

Indeed, if the relationship between the nonprofit sector and the federal tax system were to be summarized in a single word, *entanglement* rather than *exemption* would be the more appropriate term. Nonprofit organizations in the United States are caught in a complex web of nonprofit-specific code provisions, the most significant of which are summarized and evaluated in previous editions of this book upon which this chapter builds (Simon 1987; Simon, Dale and Chisholm 2006). Even seemingly unrelated tax statutes often tie back to the nonprofit sector in winding ways. There is, moreover, no non-entangling option; even total exemption would result in interactions between tax authorities and nonprofit organizations at exemption's boundaries.

Some interactions between the federal tax system and the nonprofit sector are probably desirable. Insofar as the federal tax system seeks to support nonprofit organizations, such support almost inevitably involves a considerable degree of contact. The dominant dilemma in the design of the federal tax rules for nonprofit organizations is how to manage entanglement without releasing all strings.

Before proceeding further, it may help to clarify what exactly "entanglement" entails. The dictionary definition of *entanglement* is straightforward—"the condition of being deeply involved"—but that single definition elides entanglement's many manifestations (Merriam-Webster n.d.). Courts and commentators have drawn a helpful distinction between *administrative entanglement* and *political entanglement* (e.g., *Meek v. Pittenger* 1975; Underwood 1976). Administrative entanglement refers to the involvement of tax authorities in the lives of nonprofit organizations; political entanglement refers to the involvement of nonprofit organizations in the political sphere. Each category can be subdivided further. The clearest form of administrative entanglement is *enforcement entanglement*, which occurs when tax authorities audit the returns of nonprofit organizations or seek to collect taxes from them (e.g., through liens, levies, and foreclosures). Enforcement entanglement can be avoided if nonprofit organizations are exempt from tax, but exemption leads to a second form of administrative entanglement: *borderline entanglement* (i.e., interactions between nonprofit organizations and tax authorities policing exemption's boundaries) (Zelinsky 2012). Meanwhile, political entanglement can occur when nonprofit organizations are *subjects* of political controversy or when they are *participants* in political conflict. The two categories sometimes overlap, as when issues of taxation tug nonprofit organizations into the political sphere. Likewise, the efforts of tax authorities to prevent nonprofit organizations from becoming involved in political conflicts may themselves be a source of administrative entanglement.

Administrative entanglement and political entanglement both refer to the entanglement of the nonprofit sector and the organs of government; a different type of entanglement occurs when nonprofit organizations become involved in the market—for example, by operating profit-seeking enterprises. *Market entanglement* raises several potential concerns. One is a worry about unfair competition between nonprofit organizations that enjoy the benefits of tax exemption and for-profit firms that pay full freight (Rose-Ackerman 1982). A second concern is that excessive entanglement between the nonprofit sector and the market will divert nonprofit organizations from their core missions (Dees 1998). A third is that nonprofit managers will prove ill-equipped to succeed in commercial ventures and that they will squander their organizations' resources when they try (Hansmann 1989). The weight of these concerns is discussed at greater length in other chapters of this book (Mosley, Chapter 10, "Social Service Nonprofits"; Brest, Chapter 16, "The Outcomes Movement in Philanthropy and the Nonprofit Sector"). The key point for purposes of this chapter is that market entanglement is an additional dimension of entanglement between the nonprofit sector and other sectors of society that the tax system seeks to control.

This chapter approaches the phenomenon of entanglement in four sections. The first section sets out the central dilemma in the tax treatment of nonprofit organizations: how to support the nonprofit sector through the tax system while managing administrative, political, and market entanglement. The second section explores the key provisions of the Internal Revenue Code affecting the nonprofit sector and explains how these provisions balance a set of seemingly irreconcilable policy objectives with varying degrees of success. The third section considers recent legislative changes that significantly reduce the tax system's support for the nonprofit sector while generating greater entanglement along several dimensions, and also raising the possibility that some nonprofit entities will opt out of tax-exempt status altogether. A final section offers tentative thoughts on entanglement's future and reflections on possible reforms.

Entanglement in Theory

The notion of entanglement is familiar to lawyers from the First Amendment context, where one element of the Supreme Court's test for whether a provision violates the Establishment Clause is whether it produces "an excessive government entanglement with religion" (*Lemon v. Kurtzman* 1971, quoting *Walz v. Tax Commission of the City of New York* 1970). Not coincidentally, this oft-cited phrase originates in a case addressing the tax treatment of nonprofit organizations. In that case, Bronx attorney Frederick Walz argued that a New York state statute exempting churches and other nonprofit organizations from property taxes violated the First Amendment's prohibition on any "law respecting an establishment of religion" (Graham 1970). The Supreme Court rejected Walz's argument in a 1970 decision that introduced the concept of entanglement into First Amendment jurisprudence.

The justices' opinions in *Walz* reveal four perspectives on the relationship between exemption and entanglement. Chief Justice Warren Burger, who wrote the majority opinion, posited that exemption minimizes entanglement rather than supporting exempted entities. "Either course, taxation of churches or exemption, occasions some degree of involvement with religion," the chief justice acknowledged, but "elimination of exemption would tend to expand the involvement of government by giving rise to tax valuation of church property, tax liens, tax foreclosures, and the direct confrontations and conflicts that follow in the train of those legal processes" (*Walz v. Tax Commission of the City of New York* 1970:674–675). Justice William

Brennan, in a concurring opinion, argued that exemption serves to support "the diversity of association, viewpoint, and enterprise essential to a vigorous, pluralistic society." Although Brennan did not go as far as Burger in arguing that taxation would lead to *greater* government entanglement in church affairs, he said that termination of exemptions would not "quantitatively lessen the extent of state involvement." Exemption, moreover, is "fundamentally different" from—and less entangling than—direct subsidies (i.e., cash grants), according to Brennan, because exemption involves "passive" rather than "affirmative" state involvement (*Walz v. Tax Commission of the City of New York* 1970:690–691). The "symbolism of exemption," he wrote, quoting Harvard Law School professor Paul Freund, is "that organized religion is not expected to support the state" and that "the state is not expected to support the church" (*Walz v. Tax Commission of the City of New York* 1970:691, quoting Freund 1969).

Two members of the court—Justice John Marshall Harlan and Justice William Douglas—both acknowledged the economic equivalence between exemption and subsidy but nonetheless fell on opposite sides of the ultimate 7–1 split.[2] Justice Harlan, in a solo concurrence, said that "sweeping" exemptions like New York's property tax reprieve "need not entangle the government in difficult classifications of what is or is not religious" because the statute covered a broad range of sectarian and secular eleemosynary organizations. He added that exemption is generally less entangling than a direct subsidy because "subsidies, unlike exemptions, must be passed on periodically and thus invite more political controversy" (*Walz v. Tax Commission of the City of New York* 1970:699). The lone dissenter, Justice Douglas, was unmoved by his colleagues' efforts to distinguish exemption from other forms of support. "A tax exemption is a subsidy," plain and simple, he wrote, and he saw little reason to believe that either was less entangling than the other (*Walz v. Tax Commission of the City of New York* 1970:704).

The question presented in *Walz*—whether property tax exemptions for houses of worship result in "excessive government entanglement with religion" or otherwise violate the Establishment Clause—is just one among a constellation of issues surrounding exemption and entanglement. Nonetheless, the justices' opinions in that case illuminate important aspects of the relationship between nonprofit institutions and the tax system. First and foremost, the opinions acknowledge that both taxation and exemption result in some amount of entanglement. As Edward Zelinsky would later write, "In the tax context, there are no disentangling alternatives" (Zelinsky 2017:xv). To use the terminology introduced earlier, exemption trades away enforcement entanglement for greater borderline entanglement. Even if we allow organizations to self-certify that they satisfy the exemption criteria, the process of establishing those criteria still requires lawmakers to decide which organizations do and do not merit the implicit support that exemption provides.

Second, the opinions of Justices Brennan, Harlan, and Douglas highlight some of the most salient similarities and differences between exemptions and subsidies. Exemption is indeed the economic equivalent of taxation coupled with a subsidy equal to the tax liability that the exempt organization otherwise would have to pay. And yet exemptions and subsidies often differ symbolically and programmatically. Exemptions, on the whole, may be less controversial and subject to less frequent reauthorization than subsidies and in this respect may reduce political entanglement. Whether that constitutes an argument in favor of exemptions is contestable. What Justice Harlan refers to negatively as "political controversy" might be cast in a more positive light as "democratic debate."

The comparison between support via exemption and support via subsidy skips over the question of why the tax system should support nonprofit organizations in the first place. One potential answer is that nonprofit organizations produce goods that are quasi-public (i.e., nonrivalrous) or public (i.e., nonrivalrous and nonexcludable), and that market mechanisms tend to underproduce goods of that character. But the public goods account runs into the reality that, for many nonprofit organizations, the production of public goods is not a primary activity. Hospital beds, for example, are both rivalrous and excludable; the same is arguably true for seats in a classroom and in a symphony hall.

A related justification for government support of the nonprofit sector posits that nonprofit institutions tend to redistribute to the poor. This explanation overlaps with the first. We might think of redistribution as a public good because it (possibly) leads to lower crime rates, because it generates greater political and social stability, and because individuals have a moral or aesthetic taste for living in more equal societies (Thurow 1971). In any event, the redistribution rationale—like the public goods account—applies to a relatively small segment of the nonprofit space. While some nonprofit organizations (e.g., soup kitchens and homeless shelters) redistribute, others (e.g., many art museums, operas, K–12 private schools, and business leagues) do not. In some cases, nonprofit organizations that enjoy tax-exempt status actively oppose redistributive efforts (Hendrie 2015; Americans for Tax Reform 2018).[3] Moreover, if the goal is to redistribute wealth from rich to poor, then we might ask why policy makers have chosen to do so indirectly via tax-favored treatment for nonprofit organizations rather than directly through cash assistance, food stamps, housing vouchers, and so on. If the government supports nonprofit institutions through tax exemption in order to advance redistributive objectives, then it is pursuing a far from first-best strategy to achieve that goal.

Three other rationales fare somewhat better in justifying the federal tax system's support for the nonprofit sector. One—which we might call the *Tocquevillian account*—emphasizes the importance of nonprofit organizations as checks on governmental power. A second—which can be characterized as the *Hayekian account*—highlights the ability of the nonprofit sector to aggregate information and preferences without succumbing to the pathologies of the political process and central planning. A third—which I call the *Pigouvian account*—posits that gifts to nonprofit organizations generate positive externalities (i.e., social benefits that the giver of the gift does not fully capture), and that government subsidies are necessary to ensure that the optimal amount of gift-giving occurs.[4]

Start with the Tocquevillian account. Tocqueville feared that governments in democratic societies would acquire excessive power unless citizens formed and fostered nonprofit associations that organized joint undertakings, generated social capital, and thereby checked governmental growth (Tocqueville [1840] 1899). The implications of Tocqueville's theories for the nonprofit sector have been well rehearsed elsewhere (Clemens 2006; Smith and Grønbjerg 2006); the key point here is that the Tocquevillian account assumes a separation between the nonprofit sector and the state. Government support for the nonprofit sector thus must be designed to avoid excessive administrative entanglement; otherwise the Tocquevillian virtues of nonprofit associations are lost. The implications for political entanglement are more subtle. Separation between the nonprofit sector and the state is a Tocquevillian value, but in order to perform their checking function, nonprofit organizations must interject themselves into political life under certain circumstances.

What I call the Hayekian account differs from the Tocquevillian narrative, but the policy implications are similar. Friedrich Hayek argued that "the peculiar character of the problem of a rational economic order is determined precisely by the fact that the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form, but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess" (Hayek 1945:519). Centralized planning is doomed to fail, according to Hayek, because central planners lack the information they need to allocate resources optimally (or even intelligently). Majoritarian electoral processes are unlikely to solve the information problem either. As Saul Levmore puts the point, "Voters across the country are unlikely to be well informed about my local hospital or your university, so a conventional exercise in direct democracy would not delegate decision-making to better informed parties" (Levmore 1998:427). The exemption for nonprofit organizations and its cousin, the deduction for charitable contributions, deliver support based on the resource allocation decisions of individuals who enjoy greater access to information than do legislators and bureaucrats. These individual decisions can be thought of as "ballots" through which individuals cast votes regarding the distribution of public funds.

The Hayekian account, like the Tocquevillian account, counsels against too active a government role in determining the destination and degree of support. After all, the premise underlying the Hayekian account is that individuals know more than the government about which organizations will use funds in the most socially productive ways. The Hayekian account also helps explain why we might opt for exemption and deduction over, say, a several-hundred-dollar voucher that each citizen could allocate to nonprofit organizations of his or her choosing. With exemption and deduction, the size of the subsidy scales with the amount that an organization raises from donors and other constituents. In this respect, as Levmore notes, such subsidies "permit[] intensity of preferences (or knowledge) to be recorded" (Levmore 1998:428).

A purely passive approach to government support for the nonprofit sector would pose obvious problems, however. If any organization could self-certify as tax exempt, then much of the income tax base would wither rapidly. To paraphrase James Madison, if men were angels, no entanglement would be necessary, but given the non-angelic nature of many men and women, the government must establish and enforce some rules to prevent us from transferring all of our assets to exempt entities that exist purely to support our own lifestyles. The Tocquevillian and Hayekian accounts require that nonprofit organizations enjoy a significant degree of freedom from administrative entanglement with government, and yet some strings must remain attached or else the tax base will fall out from under us.

The Pigouvian account (the name being derived from the early- to mid-twentieth century English economist Arthur Cecil Pigou) proceeds quite differently than the Tocquevillian and Hayekian accounts, though some of its implications are similar. It builds on the observation that individuals are imperfect altruists: they derive a personal benefit from giving to others (what might be called "warm glow"), but they do not fully account for the interests of others when allocating resources themselves. The Pigouvian account posits that in some cases, a subsidy for charitable contributions will be needed in order to induce individuals to make gifts that leave society on the whole better off.

Arithmetic may illustrate the point. Imagine that *A* derives a "warm glow" benefit of 99 from giving 100 to *B*. *A*, in other words, is an imperfect altruist: she cares about *B*, but she still would prefer that resources be allocated to her rather than to *B*. Thus, absent any intervention, *A* will fail to make the gift to *B* even though the total benefit from the gift (*A*'s 99 plus *B*'s 100) is greater than the benefit that *A* gets from consuming the 100 herself.

Under these circumstances, as Louis Kaplow has explained, total welfare can be enhanced by offering a small subsidy to *A* for giving to *B*. Consider, for example, a policy that offers a subsidy of 2 to *A* for every 100 that she gives to *B* (Kaplow 1995). The subsidy leads the imperfectly altruistic *A* to give 100 to *B*, even though she would not have done so before the subsidy. The reason why is that the benefit of 99 that *A* derives from giving to *B* plus the subsidy (worth 2 to her) for doing so exceeds the opportunity cost to *A* of sacrificing 100. The total benefit in the gift-giving case is 199 as compared to 100 when *A* declines to give and consumes herself.[5]

Interestingly, nothing in the Pigouvian account is specific to *charitable* giving. The donee (*B* in the example above) could just as easily be another individual rather than an organization. The Pigouvian justification for subsidizing gifts does depend, though, on the premise that transfers from *A* to *B* are bona fide transfers from which *A* derives utility. If, by contrast, *A* and *B* did not care about each other but simply exchanged "gifts" with each other (e.g., *A* gives 100 to *B* and *B* gives 100 to *A*), then society would have no interest in subsidizing the transfers. Indeed, the back-and-forth transfers would likely reduce social welfare because they entail transaction costs with no benefits. The Pigouvian account thus suggests a need for rules to ensure that subsidized gifts from *A* to *B* do not flow back to *A*.

One important implication of the Pigouvian account is that it suggests that subsidies for charitable giving may enhance social welfare even if charities allocate resources less efficiently than the government. Imagine that *C* derives a benefit of 60 from giving 100 to a nonprofit organization. Imagine also that the nonprofit organization uses its resources less efficiently than the government would. Assume that the government would generate a benefit of 100 from spending 100, while the nonprofit organization would generate a benefit of only 50 from spending the same amount.

Even though the nonprofit organization will spend its resources less efficiently than the government, there is still a strong welfarist argument in this scenario for offering a subsidy to *C* to induce her to give to the organization. Say that the government offers *C* a tax benefit of 40 if she gives 100 to the organization. *C* is now indifferent between giving 100 to charity (warm glow benefits of 60; tax benefit of 40) and consuming the 100 herself. Thus, by offering a charitable subsidy of 40, the government can induce *C* to make a charitable gift that leaves *C* no worse off and society 50 better off, even though the charity is less efficient than the government.

Exactly how large this Pigouvian subsidy for charitable contributions should be is the subject of a robust economics literature.[6] The key point for present purposes is that the Pigouvian account can offer an additional justification for government subsidies to the nonprofit sector that mirrors the Tocquevillian and Hayekian accounts in several important respects and differs in several others. Like the Tocquevillian and Hayekian accounts, the Pigouvian account provides a rationale for a laissez-faire approach to the regulation of the nonprofit sector. Underlying the Pigouvian account is the premise that individuals derive satisfaction from donating to charities that they have chosen; presumably this satisfaction would be squandered if the government commandeered the nonprofit sector and transformed charitable giving into a form of paying taxes.[7] But unlike the Tocquevillian account, the Pigouvian account does not depend on the democratic benefits of nongovernmental organizations and, unlike the Hayekian account, it does not depend on the assumption that the allocation of resources by nongovernmental actors will be more efficient than the allocation of resources by legislators and bureaucrats. To the contrary, the Pigouvian account suggests that legislators and bureaucrats can tolerate a certain amount of inefficiency among nonprofit organizations without sacrificing the welfare benefits of charitable giving.

Finally, note that the decision to support nonprofit organizations through exemption and its cousin, deduction, may reduce administrative and political entanglement relative to direct subsidies, but that decision also raises concerns regarding market entanglement. One concern (discussed at greater length shortly) is that tax-exempt organizations will enjoy an unfair competitive advantage vis-à-vis taxpaying firms that offer similar services. Perhaps a more serious concern is that individuals will seek to claim charitable contribution deductions for transfers to nonprofit organizations that effectively amount to purchases of goods and services—purchases that, in many cases, would not be tax-deductible if they occurred in a more transparent market context. Policy makers may succeed in managing market entanglement through well-designed rules and standards, but the concerns will nonetheless linger. In short, exemption and deduction do not eliminate entanglement altogether but simply trade different types of entanglement for forms that appear to be more tolerable.

Entanglement in Practice

The two main ways in which the federal tax system supports the nonprofit sector are exemption and deduction. Exemption allows nonprofit organizations to earn income without paying entity-level tax; deduction allows donors to a subset of nonprofit organizations to reduce their taxable income by the amount of the gift. But such support comes with strings attached. The federal tax system employs six specific strategies of control over nonprofit organizations that enjoy the benefit of exemption and the subset of those that are also aided through deduction. The six strategies are (1) purpose restrictions, (2) limits on specific activities, (3) nondistribution constraints, (4) transparency requirements, (5) public support conditions, and (6) payout mandates. Not all such strategies are employed with respect to all entities, but all six seek to strike a balance (successfully or not) between support and the various varieties of entanglement.

Purpose Restrictions

Section 501(c) of the Internal Revenue Code provides an exemption from federal income tax for organizations organized and operated for specific purposes. Its sprawling twenty-nine-paragraph list of exempt organizations ranges from congressionally chartered corporations (section 501(c)(1)) to cooperative health insurance issuers (section 501(c)(29)). Most familiarly, section 501(c)(3) allows an exemption for entities organized and operated exclusively for one of nine ends: religious, charitable, scientific, testing for public safety, literary, educational, fostering national or international amateur sports competition, prevention of cruelty to children, and prevention of cruelty to animals. These "(c)(3)" entities include most of the largest nonprofit organizations by assets and revenue. They occupy a privileged position within the nonprofit sector because donors to (c)(3) entities—unlike donors to most other exempt organizations—are eligible to claim charitable contribution deductions for their gifts.[8]

Section 501(c)(3) organizations account for about three quarters of all entities exempt from taxation under section 501, but several other paragraphs are worthy of note. Section 501(c)(4) extends the benefit of exemption (but not deduction) to "organizations not organized for profit but operated exclusively for the promotion of social welfare," including AARP, the American Civil Liberties Union (ACLU), the National Rifle Association (NRA), the Sierra Club, and a number of nonprofit health plans. Section 501(c)(5) reaches labor, agricultural, and horticultural organizations, including the AFL-CIO, the American Farm Bureau Federation, and many of their affiliates.[9] Section 501(c)(6) applies to business leagues, chambers of commerce, real estate boards, boards of trade, and "professional football leagues" (a category that has been extended to include nonfootball athletic associations such as the PGA Tour and the U.S. Tennis Association). Section 501(c)(7) covers "clubs organized for pleasure, recreation, and other nonprofitable purposes." Two separate paragraphs grant exemptions to fraternal societies operating under the lodge system: section 501(c)(8), which applies to societies providing for the payment of life, sick, accident, or other benefits to members or their dependents, and section 501(c)(10), which applies to societies whose net earnings are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes. Section 501(c)(10) societies are—like section (c)(3)s but unlike most other exempt entities—eligible to receive tax-deductible contributions as long as those gifts are used exclusively for religious, charitable, scientific, literary, and educational (but not fraternal) purposes.

Although the scope of section 501(c)(3) is broad, and the rest of section 501(c) reaches further still, some limits merit mention. First, organizations that engage in illegal activities may be disqualified from exempt status. Thus, in a 1975 ruling, the IRS denied exemption under 501(c)(3) and 501(c)(4) to a nonprofit organization formed to promote world peace that primarily sponsored protests at which it urged demonstrators to engage in civil disobedience.[10] More recently, the IRS in 2013 denied exemption to a nonprofit cooperative association of cannabis producers based on the "well established" principle that "tax deductions and exemptions are not applicable to activities that are illegal."[11] The IRS also has long held that educational institutions seeking exemption under section 501(c)(3) must adopt a "racially nondiscriminatory policy as to students"—a conclusion that it (loosely) derived from section 501(c)(3)'s language regarding permissible purposes.[12] The Supreme Court upheld that position in a controversial 1983 case involving Bob Jones University, which at the time banned interracial dating among its students. "To warrant exemption under § 501(c)(3)," Chief Justice Burger wrote for the court's majority, "an institution . . . must demonstrably serve and be in harmony with the public interest," and its "purpose must not be so at odds with the common community conscience as to undermine any public benefit that might otherwise be conferred" (*Bob Jones University v. United States* 1983:591–592).

Chief Justice Burger's opinion in the *Bob Jones* case drew a sharp rebuke from his colleague Justice Lewis Powell, who found the "element of conformity" in the chief justice's analysis to be "troubling." "Far from representing an effort to reinforce any perceived 'common community conscience,'" Powell wrote, "the provision of tax exemptions to nonprofit groups is one indispensable means of limiting the influence of governmental orthodoxy on important areas of community life" (*Bob Jones University v. United States* 1983:609). The back-and-forth between Burger and Powell illustrates a central challenge for the tax system. On the one hand, the tax system seeks to support the nonprofit sector while avoiding excessive entanglement; on the other hand, few are willing to say that every nonprofit organization is entitled to such support regardless of its purpose. Indeed, even Justice Powell ultimately agreed with the majority's result in *Bob Jones*, though he arrived at that result through different reasoning.

The compromises struck by the IRS, Congress, and the courts are uneasy. The IRS still denies section 501(c)(3) status to educational institutions with racially discriminatory policies toward students, but it grants such status to educational institutions that prohibit students from marrying across religious lines and that bar same-sex relationships.[13] It has denied section 501(c)(3) status to an organization whose primary purpose was to decriminalize sexual activity between "consenting" children and adults—a decision that the Tax Court later upheld—but a number of white supremacist organizations have gained exemption under section 501(c)(3) (*Mysteryboy Inc. v. Commissioner* 2010; Stiffman 2016). Congress, for its part, enacted legislation in 1976 that denied exemption under section 501(c)(7) to social clubs whose written policies discriminate on the basis of race, color, or religion, though it amended that language four years later to reauthorize exemption for clubs that "in good faith" limit their membership to followers of a particular religion "in order to further the teachings or principles of that religion, and not to exclude individuals of a particular race or color."[14] These decisions may or may not be defensible; more importantly for the present discussion, these sorts of legislative and regulatory judgment calls are inevitable whenever the tax system restricts eligibility for exemption and deduction on the basis of purpose.

Limits on Specific Activities

A second way in which the federal tax system regulates nonprofit entities is to limit exemption on the basis of the activities in which organizations engage. These restrictions potentially reduce political entanglement and market entanglement, though at the cost of additional administrative entanglement.

<u>Limits on Political Entanglement:</u> Section 501(c)(3) flatly prohibits organizations that enjoy exemption under that paragraph from engaging in certain political activities. Specifically, it says that a (c)(3) cannot "participate in, or intervene in, . . . any political campaign on behalf of (or in opposition to) any candidate for public office." This restriction is known as the Johnson Amendment, so named for then senator Lyndon B. Johnson, who added it to the code in 1954 after two (c)(3) organizations backed his opponent in the Democratic Party primary for U.S. Senate in Texas (O'Daniel 2001). It has proven to be one of the most controversial features of section 501(c)(3) in the decades since.

Several justifications for the Johnson Amendment are plausible, beyond what was likely the original rationale (i.e., ensuring that Lyndon Johnson retained his Senate seat in 1954). One argument, building on the Pigouvian account, is that political campaigns are zero-sum and so campaign expenditures do not in general lead to positive externalities (or, more precisely, the benefit to the supported candidate is offset by the detriment to her rival). The counterargument is that our democracy functions better with an electorate that is well informed; thus, interventions in political campaigns, insofar as they convey valuable information to voters, do indeed generate positive externalities. Other potential justifications for the Johnson Amendment emphasize its role in reducing political entanglement. The Johnson Amendment arguably shields (c)(3)s from political pressure exerted by elected officials seeking endorsements and other campaign-related support. Partly for this reason, thousands of clergy members and dozens of other (c)(3) leaders spoke out against legislation in 2017 that would have carved out a de minimis exception to the Johnson Amendment (Banks 2017; Taeb 2017). (The proposal passed the House as part of the late 2017 tax reform package but was eliminated from the Senate version and the final legislation for procedural reasons (Aprill and Hemel 2018).) The Johnson Amendment also might be said to preserve a politics- and partisanship-free zone of American life. The argument would be that our polity and our society are stronger and more stable when bonds of friendship and social capital cut across party lines, and that by limiting the benefits of (c)(3) status to organizations that stay out of politics, the Johnson Amendment encourages the sorts of institutions that promote these cross-cutting ties.

Significantly, the Johnson Amendment does not prohibit all political activity on the part of (c)(3) entities. Those organizations still may seek to “influence legislation,” as long as those efforts do not become a “substantial part” of the organization’s activities. Some (c)(3) entities are eligible to opt out of the substantiality standard and into a quantitative test that allows lobbying expenditures up to a specific dollar limit ($1 million a year for the largest (c)(3) organizations).[15]

Educational institutions, hospitals and medical research organizations, and most other public charities can opt into section 501(h); private foundations cannot. Interestingly, Congress in 1976 also excluded churches from eligibility for the section 501(h) quantitative test at the request of religious leaders, who expressed concern that the IRS might be influenced by the test even with respect to churches that did not opt in.[16]

The Johnson Amendment applies only to organizations that are exempt under section 501(c)(3) and section 501(c)(29) (the paragraph for cooperative health insurers). Organizations covered by other code provisions can endorse candidates without losing their exempt status and can engage in lobbying activities without abiding by section 501(c)(3)'s substantiality standard or section 501(h)'s quantitative test. Most controversially, the IRS's interpretation of section 501(c)(4) has allowed organizations exempt under that paragraph to engage in substantial campaign-related activities. Although the statute limits exempt status to organizations that are "operated exclusively for the promotion of social welfare," regulations dating back to 1960 allow organizations to qualify under section 501(c)(4) if they are "primarily engaged" in social welfare promotion. Interventions in political campaigns on behalf of or in opposition to candidates for public office do not qualify as "promotion of social welfare" under those regulations,[17] but the slip from "exclusively" to "primarily" has prompted practitioners to argue and advise clients that section 501(c)(4) organizations can engage in substantial campaign-related efforts—perhaps up to 50 percent of total activity—without running afoul of the primary activity standard (Colvin 2010). The IRS also has said that organizations covered by section 501(c)(5) (labor unions, etc.) and section 501(c)(6) (business leagues, etc.) can engage in political action as long as their primary purpose and activities remain consistent with the code paragraph under which they claim exemption.[18]

The tax treatment of political activity by nonprofit organizations poses challenging normative questions. The key point for present purposes is that whatever approach the tax system takes toward political activity by nonprofit organizations, entanglement of some form is inevitable. The Johnson Amendment's bright-line prohibition on politicking potentially leads to enforcement entanglement, both when the IRS takes away an entity's exempt status and subsequently when the IRS seeks to collect taxes from the now-nonexempt organization. But even that "bright line" is not so bright, as the definition of campaign activity turns out to be fuzzy at the edges.[19] A more permissive regime still requires the tax authority to decide how much is too much and what activities count toward that quantitative or qualitative threshold. The one way to avoid these line-drawing questions would be to give all nonprofit organizations carte blanche to engage in as much political activity as they want without endangering their exempt status, but while that would minimize administrative entanglement over political activity questions, it would only further entangle the nonprofit sector in the political process.

<u>Limits on Market Entanglement:</u> In addition to the limits on political entanglement discussed earlier, the federal tax system seeks to limit market entanglement through the unrelated business income tax, or UBIT. The tax is set at the same rate as the corporate income tax and thus has the effect of treating the "unrelated business income" of an exempt organization as if it were nonexempt income earned by a for-profit firm. It applies both to (c)(3)s and noncharitable exempt organizations. And although total UBIT collections are quite modest (in 2013, less than $500 million for all organizations exempt under section 501(c), or about 0.02 percent of all federal tax collections that year[20]), the UBIT looms large over planning and operations for many nonprofit organizations.

UBIT generally applies to trades and businesses "regularly carried on" by exempt organizations that are "not substantially related" to the organization's exempt purpose,[21] with a number of important exceptions—including for dividends, interest, annuities, royalties, and most rental income.[22] Thus, a university that earns income from an executive master's in business administration program will not pay UBIT on that income stream, because the activity is substantially related to the university's educational purpose, but if the university owns a macaroni factory, then it almost certainly will pay UBIT on its income from that enterprise. The macaroni factory example is not fanciful: the acquisition of a macaroni factory by New York University School of Law in 1947 was one event triggering the passage of the first UBIT statute three years later.[23] Other factual scenarios present more difficult line-drawing challenges. For example, the IRS has ruled that an art museum gift shop's sales of greeting cards that display artwork from the museum's own collection and from other art collections do not constitute "unrelated business income" because those sales "contribute[] importantly to the achievement of the museum's exempt educational purposes by stimulating and enhancing public awareness, interest, and appreciation of art,"[24] but sales of scientific books and city souvenirs by an art museum gift shop are subject to UBIT because those items "have no causal relationship to art or to artistic endeavor."[25]

It is questionable whether the UBIT rules actually protect for-profit firms against competition from nonprofit entities. In the absence of the UBIT rules, nonprofit entities presumably would allocate capital to whatever investments they thought would yield the highest returns. Those investments likely would be spread across sectors, affecting the overall supply of capital and thus the rate of return on capital investment but not necessarily impacting any specific sector disproportionately. To illustrate: imagine that in a world without UBIT, University X enters into book publishing, macaroni manufacturing, and sausage making. Under the UBIT rules, however, University X has the ability to earn tax-exempt income from book publishing but not from macaroni manufacturing or sausage making, and so it may choose to invest in book publishing even when the expected pretax return there is lower than the expected pretax return from macaroni manufacturing and sausage making.[26] The likely result is that with UBIT, for-profit book publishers bear the brunt of competition from universities, whereas without UBIT, the effects of competition would be more evenly distributed. More generally, the UBIT provisions systematically disfavor for-profit firms in sectors such as education and medical care that nonprofit organizations can enter without facing tax (Rose-Ackerman 1982).

The current UBIT regime still can be defended on other grounds. In the absence of the UBIT provisions, nonprofit enterprises would have an incentive to form or acquire active business enterprises in order to take advantage of exemption. Imagine, for example, that the pretax rate of return on capital investment in the corporate sector is 10 percent and the corporate income tax rate is 20 percent. Thus, if a university buys \$100 of stock in a for-profit macaroni manufacturing corporation, it can expect to earn after-tax returns of \$8 per year. If the university instead buys the macaroni factory and integrates the enterprise into its nonprofit structure, then—absent UBIT—the university's return on the \$100 investment would rise from \$8 to \$10. Indeed, even if the university could not manage the macaroni factory as efficiently as a for-profit corporation could, the university still would be better off buying the factory rather than buying stock in the for-profit macaroni corporation so long as the university could generate greater than an 8 percent return when operating the factory itself. The UBIT rules mitigate this potential distortion by equalizing the tax treatment of the university-owned macaroni factory and the factory owned by a for-profit corporation. This arguably reduces market entanglement, because passive investments in for-profit enterprises are less likely than active investments to divert nonprofit managers from their organizational missions.

The UBIT rules also might be justified on the basis of the Hayekian account outlined earlier.[27] Recall that the argument there was that individuals know more than legislators and bureaucrats about which nonprofit entities ought to receive additional resources. Charitable contributions arguably reflect these individual judgments. So, at least potentially, do decisions to purchase goods and services related to a nonprofit organization's exempt purpose. For example, a student's decision to pay tuition at a particular university, or a patient's decision to pay for treatment at a particular hospital, may reflect the student's or patient's judgment that the university or hospital is effective at achieving its educational or medical mission. Choices by individuals to contribute to charities or to patronize the related businesses of nonprofit organizations can thus be thought of as "ballots" that convey information about which institutions merit the support that deduction and exemption supply. By contrast, a grocery shopper's decision to buy a box of macaroni produced by a university-owned factory potentially tells us less about whether the university is effective at achieving its educational goals, and so—the argument goes—income derived from that sale should not lead to the university receiving any more support from the tax system.[28]

This cursory discussion does not exhaust all of the arguments in favor of UBIT and against. What it does seek to illustrate is that the decision to support the nonprofit sector through income tax exemption—a choice that arguably reduces administrative and political entanglement—potentially leads to greater market entanglement as nonprofit organizations have an incentive to operate unrelated businesses in order to leverage their tax-exempt status. The federal tax system has responded to this outcome through a set of complicated rules that seek to manage market entanglement, but at the cost of additional administrative entanglement.

Nondistribution Constraints

A defining feature of nonprofit organizations—and a central concern of the federal tax regime for nonprofit entities—is the nondistribution constraint: the rule that nonprofit organizations cannot distribute their assets to directors, officers, or others who control the organization. Several provisions embody or reflect this rule. Sections 501(c)(3), 501(c)(4), 501(c)(6), and 501(c)(7) all state that in order for an organization to qualify for exemption under those paragraphs, "no part of the net earnings" of the organization may "inure[] to the benefit of any private shareholder."[29] Section 501(c)(10) arrives at a similar result through slightly different language.[30] Regulations impose equivalent restrictions with respect to labor unions and agricultural and horticultural organizations exempt under sections 501(c)(5).[31] In addition, section 4958, enacted in 1996, imposes a tax on "excess benefit" transactions between exempt organizations and various "disqualified persons," a category that includes anyone who has been "in a position to exercise substantial influence" over the organization in the previous five years. The tax applies to any transaction between a disqualified person and an exempt organization in which the disqualified person receives an economic benefit that exceeds the value of the consideration that she has provided to the organization. The tax begins at 25 percent of the excess benefit and rises to 200 percent if the transaction is not reversed within the year.[32] Additional penalties for self-dealing apply to private foundations and their contributors and managers.[33]

The relationship between the nondistribution constraint and entanglement is nuanced. Enforcement of the nondistribution constraint and related rules inevitably results in administrative entanglement. For example, section 4958's tax on "excess benefit" transactions requires the IRS to determine whether a nonprofit manager has been paid more than her work is worth—an inquiry that is anything but straightforward (Jones 2000). At the same time, the nondistribution constraint also serves an entanglement management function. To see why, imagine a regime that allowed a deduction for charitable contributions and an income tax exemption for nonprofit organizations but imposed no constraint on distribution. Individuals would have an incentive to hold their assets in nonprofit organizations that they control; whenever an individual desired liquidity, she could direct her organization to distribute its assets back to her. She would, in effect, have an individual retirement account (IRA) with no limits. The tax authority might try to stop this by enforcing purpose restrictions more rigorously and scrutinizing exemption applications more aggressively; otherwise, the consequences for the fisc could be dire. By relying on the nondistribution constraint and similar self-dealing rules, the IRS can reduce the risk of tax arbitrage through exempt organizations without placing too much emphasis on the purpose provisions. These rules related to nondistribution rules are, concededly, crude proxies for whether an organization is pursuing objectives worthy of exemption, but they likely entail fewer difficult value judgments than purpose-focused inquiries might.

The nondistribution constraint has been a topic of considerable scholarly debate over the last several decades.[34] Of particular note, Anup Malani and Eric Posner have proposed that the nondistribution constraint be relaxed so that section 501(c)(3) organizations can raise equity capital and incentivize managers with a share of profits. They acknowledge that this might lead individuals and firms to try to use (c)(3)s as tax shelters, but they respond that nondistribution is a clumsy measure for a (c)(3)'s social value. Instead, they suggest that the IRS could exercise greater judgment in granting (c)(3) status and that Congress could further flesh out the criteria for exemption (Malani and Posner 2007; for a competing view, see Galle 2010). What one thinks of such a reform depends in part on how one weighs entanglement's costs. For Tocquevillians and Hayekians (and possibly to a lesser extent for Pigouvians too), important values are compromised when the tax system's support for the nonprofit sector comes to depend on legislators' and bureaucrats' fine-grained judgments as to which organizational purposes are worthy of public backing. The nondistribution constraint is one way to avoid such fine-grained judgments while also ensuring that nonprofit organizations are not used to extract subsidies from the government for self-benefiting transfers or reciprocal gifts. Advocates of the nondistribution constraint would argue that even if the rule makes it harder for nonprofit organizations to raise capital or incentivize managers, those downsides are preferable to the alternative in which purpose restrictions must be more specifically detailed and policed.

Transparency Requirements

A fourth strategy of control that the federal tax system employs with respect to nonprofit organizations is transparency. Most exempt organizations (other than churches) with gross receipts of $50,000 a year or more—and all private foundations—are required to file annual information returns.[35] Exempt organizations generally must make their information returns available for public inspection.[36] The most familiar of these returns, Form 990, provides a trove of data on the filing organization, including information on its governance structure, principal activities, financial performance, and compensation of directors, officers, and key employees.

Whether or not sunshine is the best disinfectant, it is likely one of the least entangling regulatory strategies. For example, disclosure of officer compensation on Form 990 arguably relieves some of the pressure on the IRS when it comes to enforcement of excess benefit rules. Rather than having to determine whether an organization paid its executive director too much, the IRS can focus on ensuring that the organization accurately disclosed the executive director's compensation and then can rely on donors, the media, and others to judge whether compensation was excessive. Organizations that solicit charitable contributions may have an incentive to disclose some of this information to potential donors regardless of any statutory requirement, but the public inspection mandate facilitates scrutiny by other stakeholders, including beneficiaries, employees, partner organizations, and peer institutions.[37]

Transparency requirements do not, of course, allow policy makers to delegate all difficult value judgments to nongovernmental actors. First, transparency requirements themselves lead to some amount of administrative entanglement, as tax authorities still must enforce those requirements against nonprofit organizations that fail to comply. Second, the design of transparency requirements is not value neutral. For example, deciding whether to require nonprofit organizations to disclose their donors pits transparency values against the associational freedom interests that anonymity protects (*NAACP v. Alabama ex rel. Patterson* 1958). Third, transparency may intensify popular demand for governmental intervention to halt perceived excesses by nonprofit organizations that reporting reveals. For example, Form 990 disclosures that revealed growing university endowments and generous compensation packages for athletic coaches likely added fuel to demands from both sides of the ideological spectrum for regulatory action with respect to the wealthiest educational institutions (Kim 2017; USA Today Editorial 2015). In those cases, transparency led to an increase in political entanglement and—as explored later—an increase in administrative entanglement when Congress enacted taxes aimed at those universities and their highest-paid employees in December 2017.

Public Support Conditions

A fifth way in which the federal tax system regulates exempt organizations—and, in particular, charitable nonprofits—is by tying the most generous tax benefits to some showing of public support. The Internal Revenue Code and accompanying regulations draw a distinction between "public charities" and "private foundations," with public charities receiving the most generous tax treatment. Contributions to public charities now are deductible up to 60 percent of adjusted gross income (versus 30 percent for private foundations);[38] public charities are exempt from 2 percent tax on investment income that applies to private foundations;[39] and—as discussed momentarily—public charities are exempt from payout mandates to which private foundations are subject. Churches, schools, hospitals, and medical research institutions qualify as "per se" public charities, but for other 501(c)(3) organizations, public charity status depends on public support.

The code sets forth three ways for organizations to show that they receive sufficient public support to qualify for public charity status. The first path—the *one third support test*—requires that the organization receive at least one third of its financial support from government grants and contributions from the "general public."[40] (Donors are not considered members of the general public to the extent that they provide more than 2 percent of an organization's support.) A second path—the *facts and circumstances test*—requires that the organization receive at least 10 percent of its support from government and the general public, in which case the test looks to factors such as whether the organization's governing body "represents the broad interests of the public." A third path requires that the organization receive at least one third of its support from contributions from the general public, government grants, and gross receipts from activities related to its exempt purpose, and no more than one third of its support from investments and unrelated business income. A charitable organization that satisfies none of these requirements becomes a private foundation.

The rules regulating the public charity/private foundation distinction are substantially more complicated than the preceding paragraph lets on. The key point is that public charity status depends on some showing that the organization attracts support from beyond a small coterie of donors. The test is not majoritarian. An organization with a few dozen contributors or modest gross receipts can, depending on its other income, qualify as a public charity. Yet an organization that relies exclusively on one individual or one family will generally flunk the public charity test.

The public support conditions broadly conform to the Tocquevillian account of exemption and deduction. Consistent with the Tocquevillian view, the public support conditions ensure that the most generous benefits go toward organizations that build social capital beyond a single family or a small number of families. The public support conditions potentially also incentivize insular organizations to reach out more broadly for members. Thus, the public support conditions subsidize the associational bonds that, in the Tocquevillian view, are democracy's glue. The public support conditions also might be justified on information-aggregation grounds (i.e., the Hayekian view). Only when a number of individuals, each with their distinctive epistemic advantages, come together to support an organization does the organization earn the most robust governmental backing.

The importance of the public support conditions should not be overemphasized. The benefits of being a public charity rather than a private foundation are significant, but the difference between public charity and private foundation status still is slight relative to the difference between section 501(c)(3) status and exemption under the noncharitable paragraphs of section 501(c). Moreover, the remarkable recent rise of donor-advised funds allows philanthropists to obtain the benefits of public charity status while still largely retaining control over the allocation of funds themselves. In short, while conditioning tax-preferred status on public support is one strategy that the federal tax system uses to regulate charitable nonprofits, it is a strategy of which the system makes relatively modest use.

Payout Mandates

One more way in which the federal government sometimes regulates nonprofit organizations is to mandate that they distribute a certain percentage of their assets each year. This strategy is employed sparingly. Only private foundations are subject to payout mandates, and the mandate is modest (5 percent of net assets annually).[41] Private foundations can obtain an exemption from this mandate if they qualify as "operating foundations," which generally means that they must spend at least 85 percent of their net income on the active conduct of charitable activities.[42] By far the largest organization in this latter category is the J. Paul Getty Trust, which runs the eponymously named art museum in Los Angeles (Foundation Center 2014). Congress has at various times considered proposals to apply a payout mandate to the largest university endowments, but it has never enacted such a mandate.[43]

The private foundation payout mandate arguably addresses the concern that foundation managers will seek to stockpile wealth for reasons of self-interest. Managers of wealthier foundations are likely to earn higher compensation (in the form of financial benefits and prestige) than managers of foundations with fewer assets, and a manager who spends down all of the foundation's assets is out of a job (Galle 2016). The 5 percent payout mandate may be understood as a relatively unobtrusive (though arguably insufficient) policy response to these sorts of agency costs. The payout mandate also may reflect a policy judgment that the social value of philanthropic spending is higher today than in the future, though if part of the rationale for exemption and deduction is that dispersed individuals are better able to assess the value of various philanthropic projects than a central government is, one might wonder why that same Hayekian argument would not apply to the *timing* of spending as well (see Klausner 2003 for further discussion).

An alternative justification for the payout mandate builds on Tocquevillian premises. The primary incentive for most 501(c)(3) organizations to retain public charity status is to avoid becoming subject to the private foundation payout mandate. The mandate thus nudges charitable nonprofits toward seeking public support. And when such organizations engender associational bonds, they deliver the greatest benefits to society. In this view, the payout mandate for private foundations is the "stick" half of a carrot-and-stick approach toward encouraging charitable nonprofits to play the role that the Tocquevillian account envisions for them.

Less Support, More Strings

This brief tour through the Internal Revenue Code provisions affecting nonprofit organizations has so far focused on provisions that predate the December 2017 tax law. That law—colloquially (though not formally) known as the Tax Cuts and Jobs Act[44]—altered the tax treatment of the nonprofit sector in several significant ways. The result is that the federal tax system now does less to support and more to constrain nonprofit organizations overall. Beyond the actual provisions of the December 2017 law, the politics surrounding the law's passage suggest potential changes in the relationship between Congress and the nonprofit sector.

The most meaningful change affecting the nonprofit sector in the December 2017 law is one that, on its face, has nothing to do with nonprofits at all: the near-doubling of the standard deduction to $12,000 for single taxpayers ($24,000 for married couples filing jointly). The change is offset by a repeal of the deduction for personal exemptions (and for families with three or more members, the net effect of these two changes is an increase in taxable income). For our purposes, the key consequence is that taxpayers will be much more likely to claim the standard deduction under the new law, and taxpayers who claim the standard deduction cannot claim itemized deductions for charitable contributions.

The impact on 501(c)(3) entities and other organizations eligible to receive deductible contributions is likely to be profound. The Joint Committee on Taxation estimates that the percentage of tax units claiming a charitable contribution deduction will fall from around 21 percent under the old law to roughly 9 percent under the new.[45] The total tax expenditure associated with the charitable contribution deduction will decline by approximately 29 percent, according to the Joint Committee's projections. Notably, this anticipated drop is not the result of any change to the charitable contribution deduction itself. Indeed, the most significant change to section 170—the provision governing charitable contributions—was an increase in the cap on deductions for cash contributions to public charities from 50 percent of an individual's adjusted gross income to 60 percent.[46] The nonprofit sector is so tangled up in tax that changes to altogether separate sections of the code can have multibillion-dollar ramifications for nonprofit organizations.

Other changes in the December 2017 law that will affect nonprofit organizations include the doubling of the estate tax exemption and the dramatic cut in the corporate income tax rate. As for the first, the new law raised the amount that taxpayers can transfer to their heirs at death from approximately $5.5 million ($11 million for a married couple) to $11 million ($22 million for a couple). Since the specter of the estate tax had motivated many high-net-worth individuals to make charitable contributions, this change is likely to lead to less giving. Estimates range from a $4 billion to a $7 billion drop attributable to the estate tax change (National Council of Nonprofits 2018; Rooney 2018). As for the corporate tax cut, the reduction in the top statutory rate from 35 percent to 21 percent is likely to have a negative effect on corporate philanthropy, but perhaps more importantly, it reduces the income tax advantage of exempt status by two fifths. In many cases, because of generous expensing provisions, the effective tax rate on corporate investment is zero or less. As discussed shortly, the lower corporate tax rate may cause some nonprofit organizations to shed exempt status altogether.

At the same time as it (indirectly) reduced the tax system's support for the nonprofit sector, Congress also tied on additional strings. The most significant in dollar terms is a rule that prevents exempt organizations from using losses incurred in one unrelated trade or business to offset taxable income from another. For example, if an art museum loses money on gift shop sales of area maps but earns income subject to UBIT by renting an event space, the organization now cannot deduct its gift shop losses against its event rental gains. Lawmakers articulated no rationale for this new rule, which does not apply to for-profit corporate taxpayers (who can indeed use losses from one trade or business to offset income from another). The most plausible explanation for its inclusion in the law is that it raises a modest amount of revenue ($3.5 billion over the next decade, according to the Joint Committee on Taxation[47]), and sponsors of the

December 2017 law knew that they needed revenue from somewhere to finance the law's steep cut in corporate rates.

Two other elements of the December 2017 law appear to be designed to align the tax treatment of nonprofits with that of other employers. The first—and much more significant of the two—imposes a 21 percent excise tax on annual compensation in excess of $1 million paid by an exempt organization to any of its five highest-compensated employees.[48] The measure tracks an existing provision that denies a deduction for amounts in excess of $1 million paid by publicly held corporations to their highest compensated officers.[49] Since the corporate income tax rate is now 21 percent, the excise tax on exempt organizations is economically equivalent to the denial of a deduction for taxable publicly held corporations. The new excise tax on exempt organizations can be thought of as a supplement to the nondistribution constraint, insofar as it deters exempt organizations from distributing earnings to executives in the form of salary rather than dividends. A second, more minor measure applies the UBIT (again, a 21 percent tax) to transportation fringe benefits that an exempt organization grants to its employees.[50] This provision is likewise intended to track the treatment of for-profit employers, who now are denied a deduction for transportation fringes.

Last but not least, the new law imposes a 1.4 percent tax on the net investment income of private colleges and universities whose endowment assets exceed $500,000 per student.[51] The financial impact of the new tax—for universities and for the federal fisc—is limited. For Harvard University, with an endowment exceeding $37 billion, the cost would have been a modest $43 million if the provision had been in effect in 2017 (Guillaume 2018). More disconcerting is what the provision may augur about the relationship between the nonprofit sector and the federal tax system. The new tax specifically targets private colleges and universities while sparing other public charities with vast endowments.[52] As N. Gregory Mankiw, a Harvard economist and former advisor to President George W. Bush, noted in the *New York Times*, the tax has never been justified as anything other than "tribal politics" on the part of conservative lawmakers who view elite universities to be too liberal (Mankiw 2017). An unsympathetic interpretation of the change would be that Congress chose to penalize institutions that were doing too much to provide a Tocquevillian counterweight to the dominant political coalition.

The implications of the new law for the relationship between the federal tax system and the nonprofit sector are likely to be far-reaching. The reduction in support and the addition of new strings raise the question of whether some nonprofit organizations will relinquish the benefits of deduction and/or exemption altogether. For example, a church whose pastor seeks to deliver political endorsements from the pulpit might decide to forgo 501(c)(3) status—and thus free itself from the Johnson Amendment—now that nearly nine tenths of taxpayers claim the standard deduction and thus are indifferent between donating to 501(c)(3)s versus 501(c)(4)s. Likewise, an organization such as the PGA Tour—which has several employees whose compensation exceeds $1 million—might decide that the benefits of exemption no longer outweigh the regulatory costs, especially now that the corporate tax rate is so much lower and the new excise tax on excess compensation applies to the entity.[53]

Indeed, similarly motivated exits from exempt status predate December 2017. Fresh off its initial public offering, Google in 2005 announced the creation of Google.org, a corporate philanthropy that has eschewed exempt status altogether and instead operates as a taxable subsidiary (Vise 2005). Insofar as the parent company can claim business expense deductions for Google.org's costs (as it likely can), the company can more or less match the tax benefits that it would derive from exemption under section 501(c)(3) (Hines, Horwitz and Nichols 2010). In a similar vein, Facebook founder Mark Zuckerberg and his spouse, Priscilla Chan, chose in 2015 to establish a limited liability company (LLC) rather than a tax-exempt private foundation in order to pursue their philanthropic ambitions (Singer and Isaac 2015). Because the LLC's primary asset is non-dividend-paying Facebook stock, the tax advantage of private foundation status would have been marginal, while the use of the LLC form allows the couple to avoid the transparency requirements, payout mandates, and restrictions on political activity that would have accompanied private foundation status. The same year that Zuckerberg and Chan established their philanthropic LLC, the National Football League (NFL)—previously a 501(c)(6) organization—chose to give up that status in part so that it could escape from the transparency requirements that exemption entailed (Belson 2015).

The existence—and increasing attractiveness—of "exit options" such as these limit the potential efficacy of tax law as a tool for regulating the nonprofit sector. Efforts to impose additional activity limits, transparency requirements, and other constraints on exempt organizations run the risk of causing those organizations to opt out of exempt status altogether. To be sure, charitable nonprofits that continue to derive significant revenue from high-income itemizers will almost certainly decide to retain their 501(c)(3) status. And still other organizations may conclude that the reputational benefits of tax-exempt status exceed the regulatory costs. The point remains, though, that as the tax system provides less and less support to the nonprofit sector through exemption and deduction, the ability of policy makers to attach additional strings to exemption and deduction will wane.

Entanglement's Future

The scenario sketched out in the previous paragraph may seem tolerable on first glance. A viable exit option would protect nonprofit organizations from overly intrusive regulatory interventions. But the exit option is viable only insofar as exemption and—especially—deduction cease to deliver the support that they once did. For those who believe that a vibrant democracy requires a robust third sector and that a robust third sector depends in part on the tax system's assistance, a scenario in which nonprofit organizations are nearly indifferent between exempt and nonexempt status is a rather gloomy outcome.

To be clear, such a grim scenario has not yet come to pass. Millions of taxpayers—mostly those with six- and seven-figure incomes—will continue to claim itemized deductions for charitable contributions. Moreover, the changes in the December 2017 tax law most likely to drive a decline in charitable giving—the increase in the standard deduction and the doubling of the estate tax exemption—are set to expire at the end of 2025. Yet even if we revert to the status quo ex ante, the tax incentive for charitable contributions will continue to apply only to the minority of taxpayers who itemize their deductions. The tax incentive for charitable giving has not been broadly participatory for quite some time (Colinvaux 2017).

For precisely this reason, many members of the academic and think-tank communities have long supported replacing the charitable contribution deduction with a credit. All taxpayers who donate to 501(c)(3) organizations (or who donate above a certain percentage of their income to such entities) would claim a credit of somewhere between 12 cents and 25 cents—depending on the particulars of the proposal—for each dollar that they give.[54] Concededly, such a change might distort the decisions of some high-bracket taxpayers as to whether to donate money or volunteer their time. Imagine a lawyer in the 37 percent income tax bracket who can earn $400 an hour but whose time as a volunteer is worth only $300 to a charity. Setting tax considerations aside, the economically efficient decision—if the lawyer wants to donate an hour's worth of work to a charity—would be for the lawyer to work an additional hour and to donate the $400 that she earns. But if she is taxed on that $400 at a 37 percent rate and she receives a credit of only 12 cents on the dollar for contributions, an extra hour of work will finance a cash contribution of less than $300.[55] She may therefore choose to volunteer the extra hour rather than to bill an additional hour as a lawyer and contribute the proceeds. Note, though, that while from a strictly economic perspective this is an inefficient outcome, from a Tocquevillian perspective it may be a feature rather than a bug. Encouraging individuals to engage with nonprofit organizations beyond the simple act of writing a check is consonant with the view that the nonprofit sector strengthens democratic society by building thick and lasting associational bonds.

Perhaps a graver risk is that a charitable contribution credit—by making the fact of government support more transparent—will also break the long-lasting ideological détente among lawmakers with respect to the federal tax system's treatment of the nonprofit sector. Prior to December 2017, politicians had for the most part exhibited remarkable self-restraint in this regard. Neither conservatives nor liberals had sought to use the rules governing exemption and deduction to systematically favor their side or disadvantage the other. The *Bob Jones* case, despite Justice Powell's worries, did not lead the IRS, Congress, or the courts down a slippery slope of deciding which viewpoints would and would not render an organization ineligible for exempt status. Successive Republican administrations cut off federal funding for NGOs that provided abortion counseling, but no administration sought to tear away the tax-exempt status of such groups. A controversy arose in 2013 with respect to allegations that the IRS under the Obama administration had singled out conservative political groups seeking tax-exempt status for special scrutiny, but a subsequent investigation by the Treasury Department's inspector general revealed that the alleged targeting was in fact part of an IRS effort to police the limits on political activities by exempt organizations that affected conservative and liberal groups alike.[56]

In this limited respect, "exemption" may indeed be a reasonably accurate description of the relationship between the nonprofit sector and the federal tax system. This area of law has, for much of our history, remained apart from the ideological wars waged in other tax and nontax fields. The 2013 uproar marked a notable deviation from that norm, and the imposition of the endowment tax in the December 2017 law arguably did as well. The health of the nonprofit sector will depend in no small part on whether these two developments mark the beginning of a broader trend.

In sum, support of the nonprofit sector through exemption and (in some cases) deduction inevitably leads to entanglement of the administrative, political, and market varieties. Yet the Hayekian, Tocquevillian, and Pigouvian rationales for government subsidies to the nonprofit sector require a degree of separation between the nonprofit sector and the state. The six strategies outlined in this chapter seek to strike a balance between excessive entanglement and releasing all strings. Few would defend the existing balance as optimal in all respects, but if and as it is recalibrated, the fundamental trade-off between support and entanglement will remain.

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[1] For helpful comments, I thank Ellen Aprill, Joseph Bankman, Paul Brest, Patricia Bromley, Jacob Goldin, Walter Powell, and participants in the Nonprofit Handbook Author Workshop at the Stanford Center on Philanthropy and Civil Society.

[2] The ninth seat was vacant at the time of the decision. It would be filled days later when the Senate voted to confirm Harry Blackmun to the court (Weaver 1970).

[3] See, for example, Alexander Hendrie, "Van Hollen's Liberal 'Action Plan' Is Nothing But Old Ideas and Failed Politics, Americans for Tax Reform" (January 12, 2015, 5:27 p.m.), https://www.atr.org/van-hollens-liberal-action-plan-nothing-old-ideas-and-failed-policies ("Income redistribution and higher taxes . . . have failed in the past and they will not help hardworking Americans reach their potential"); "Contribute to ATR," Americans for Tax Reform, https://www.atr.org/donate (accessed May 11, 2018) (noting that Americans for Tax Reform is exempt from tax under section 501(c)(4) of the Internal Revenue Code).

[4] Neither Tocqueville nor Hayek had much to say about the federal tax system's treatment of the nonprofit sector. Tocqueville died three years before the first federal income tax took effect. Hayek's treatment of the "independent sector" is limited to three pages of the third volume of *Law, Legislation, and Liberty* (Hayek 1982:49–51). Nonetheless, ideas immanent in the writing of Tocqueville and Hayek can be (and to some extent already have been) developed into reasonably robust justifications for the federal tax system's general attitude toward the nonprofit sector. Pigou, for his part, *did* write (at some length) about charitable giving and related issues (Pigou 1907). The Pigouvian account here, however, is derived from later authors writing in the welfare economics tradition, whose work is influenced by Pigou but does not follow directly from Pigou's prescriptions (Andreoni 1990).

[5] *A*'s benefit is 99 of warm glow plus 2 from the subsidy, but the benefit of 2 from the subsidy should not be counted because it comes at a cost of 2 to taxpayers.

[6] For one important contribution, see Saez (2004). For an impressively clear overview that is accessible to non–economically trained audiences, see Bakija (2013).

[7] On the disutility that individuals associate with paying taxes, see Sussman and Olivola (2011).

[8] Organizations whose purpose is testing for public safety are—curiously, unlike other section 501(c)(3) entities—ineligible to receive tax-deductible contributions.

[9] The American Horticultural Society and state-level horticultural groups tend to seek and obtain exemption under section 501(c)(3), thus enabling them to receive deductible contributions.

[10] Internal Revenue Service, Revenue Ruling 75-384, 1975-2 C.B. 204.

[11] Internal Revenue Service, Private Letter Ruling 201333014 (May 20, 2013).

[12] Internal Revenue Service, Revenue Ruling 71-447, 1971-2 C.B. 230.

[13] See, for example, HUC-JIR Rabbinical, Cantorial and Educational Programs: Policies and Expectations, Hebrew Union College–Jewish Institute of Religion, http://huc.edu/admissions/policies-and-expectations (accessed May 10, 2018) ("At this time applicants who are married to or in committed relationships with non-Jews will not be considered for acceptance to the Rabbinical, Cantorial or Masters in Education programs. . . ."); Sarah Pulliam Bailey, "IRS Commissioner Promises Not to Revoke Tax-Exempt Status of Colleges That Oppose Gay Marriage," *Washington Post* (August 3, 2015), https://www.washingtonpost.com/news/acts-of-faith/wp/2015/08/03/irs-commissioner-promises-not-to-revoke-tax-exempt-status-of-colleges-that-oppose-gay-marriage.

[14] See Act of Oct. 20, 1976, Pub. L. No. 94-568, 90 Stat. 2697; Act of Dec. 24, 1980, Pub. L. No. 96-601, § 3, 94 Stat. 3495, 3496 (codified as amended at § 501(i)).

[15] See I.R.C. § 501(h); Staff of the Joint Committee on Taxation, JSC-5-87, Lobbying and Political Activities of Tax-Exempt Organizations 5 (1987).

[16] Staff of the Joint Committee on Taxation, JCS-33-76, General Explanation of the Tax Reform Act of 1976, at 415 (Dec. 29, 1976).

[17] See 25 Fed. Reg. 11,741 (1960) (codified as amended at Treas. Reg. § 1.501(c)(4)-1(a)(2)).

[18] See General Counsel Memorandum 34233 (December 30, 1969). For a comprehensive treatment of these issues, see Aprill (2011).

[19] The IRS sought to address this fuzziness in 2007 with a revenue ruling that addresses twenty-one different factual situations involving varying degrees of political involvement. See Rev. Rul. 2007-41, 2007-25 I.R.B. The judgment calls embodied in the revenue ruling are themselves a form of borderline entanglement.

[20] See Internal Revenue Service, Statistics of Income Division, Unrelated Business Income Tax Returns, Tax Year 2013, tbl. 1 (October 2016), https://www.irs.gov/pub/irs-soi/13eo01ub.xls; Internal Revenue Service, 2013 Internal Revenue Service Data Book 3 (2014).

[21] I.R.C. §§ 512(a)(1), 513(a).

[22] I.R.C. § 512(b).

[23] See *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120, 120-21 (2d Cir. 1951); Note, "The Macaroni Monopoly: The Developing Concept of Unrelated Business Income of Exempt Organizations," *Harvard Law Review* 81(6): 1280-1294 (1968); see also Hearings of the Revenue Revision of 1950 Before the House Committee on Ways and Means, 81st Cong., 2d Sess. 579–580 (1950) (statement of Rep. Dingell) ("From the purely competitive standpoint . . . the advantage of a tax-exempt organization . . . is so great that, if something is not done to level it off, the macaroni monopoly will be in the hands of the universities.").

[24] Revenue Ruling 73-104, 1973-1 C.B. 263.

[25] Revenue Ruling 73-105, 1973-1 C.B. 264.

[26] On the treatment of university presses under the UBIT rules, see Harding (2008:112–114).

[27] Hayek himself said that "it is most important for a healthy society that we preserve between the commercial and the governmental a third, *independent sector*." Hayek (1982:391). While his

reasons for wanting to preserve the nonprofit sector's independence from the government are clear, his reasons for wanting to preserve its independence from the market are less so.

[28] To be sure, consumers might make macaroni-buying decisions based on their assessment of the macaroni maker's charitable good works. For example, charitable activities are an integral element of the branding of Newman's Own, a maker of pasta sauces, salad dressings, and other food items.

[29] See I.R.C. §§ 501(c)(3), (4), (6).

[30] See I.R.C. § 501(c)(10) (allowing exemption only if "the net earnings of [the organization] are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes").

[31] See Treas. Reg. § 1.501(c)(5)-1(a)(1).

[32] See I.R.C. § 4958.

[33] See I.R.C. § 4941.

[34] For the seminal article on the subject, see Hansmann (1980).

[35] I.R.C. § 6033.

[36] I.R.C. § 6104.

[37] Regarding "outrage constraints" on executive compensation at nonprofit institutions, see Brian Galle and David I. Walker, "Nonprofit Executive Pay as an Agency Problem: Evidence from U.S. Colleges and Universities," *Boston University Law Review* 94(6):1881-1934 (2014).

[38] See I.R.C. § 170(b)(1)(B), (G). The 60-percent-of-AGI cap for contributions to public charities applies from 2018 to 2025, after which the cap falls back to 50 percent.

[39] See I.R.C. § 4940.

[40] See Treas. Reg. § 1.509(a)-3.

[41] I.R.C. § 4942.

[42] Treas. Reg. § 53.4942(b)-1(c).

[43] For a summary of such proposals, see Wolf (2011).

[44] The legislation lost its name after the Senate parliamentarian ruled that the section setting forth the bill's short title violated a procedural restriction on provisions in budget reconciliation bills that do not affect revenues or outlays. See Aprill and Hemel (2018:125).

[45] Staff of the Joint Committee on Taxation, JCX-34-18, Estimates of Federal Tax Expenditures for Fiscal Years 2017–2021, at 49 tbl. 4 (May 25, 2018); Staff of the Joint Committee on Taxation, JCX-3-17, Estimates of Federal Tax Expenditures for Fiscal Years 2016–2020, at 45 tbl. 3 (January 30, 2017).

[46] The new law also repealed the charitable contribution deduction for amounts paid in exchange for college athletic event seating rights and strengthened the substantiation requirement for certain contributions.

[47] Staff of the Joint Committee on Taxation, JCX-67-17, Estimated Budget Effects of the Conference Agreement for H.R. 1, the "Tax Cuts and Jobs Act"—Fiscal Years 2018–2027 (December 18, 2017), https://www.jct.gov/publications.html?func=startdown&id=5053.

[48] I.R.C. § 4960.

[49] I.R.C. § 162(m).

[50] I.R.C. § 512(a)(7).

[51] I.R.C. § 4960.

[52] See, for example, Kaiser Foundation Hospitals, Form 990, at 11 (2016) (reporting securities holdings of more than $22 billion).

[53] See PGA Tour, Inc., Form 990 (2016).

[54] For a summary of such proposals, see Roger Colinvaux, Brian Galle and Eugene Steuerle, "Evaluating the Charitable Contribution Deduction and Proposed Reforms" 12 tbl. 5 (Urban Institute, June 2012).

[55] After earning \$400 and paying the 37 percent tax, the lawyer would be left with \$252. If she contributed the \$252 to charity, she would receive a credit of \$30.24 (i.e., 12 percent of \$252). If she contributed the \$30.24, she would receive an additional credit of \$3.63 (i.e., 12 percent of \$30.24). If she continued to contribute her credits and to claim credits on those contributions ad infinitum, the resulting amount would be \$252/(1 – 0.12), or \$286.36.

[56] See Treasury Inspector General for Tax Administration, "Review of Selected Criteria Used to Identify Tax-Exempt Applications for Review" (September 28, 2017).

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