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Darryll K. Jones[*]

I. INTRODUCTION

Nothing is free, not even charity. In almost every case, a tax-exempt nonprofit organization[1] must transact with profit-seekers to achieve the charitable goal for which the organization has been granted tax exemption. The organization will have to fund *somebody's* accession to wealth. It may be, for example, that a particular nonprofit organization need only hire one or two employees to deliver meals to elderly beneficiaries. Even in that circumstance, an organization must normally pay market rates for the labor necessary to achieve its charitable goal.[2] Employees will profit; the law presumes as much,[3] and we would be hard pressed to articulate an objection. In their daily pursuit of the public good, nonprofits nevertheless exist and must participate in the amoral, for-profit market just as any other consumer. They rent space, pay for transportation, and purchase labor and supplies, in most cases paying whatever the market demands and thereby conveying profit on a third party.[4] The conveyance of profit on a third party for routine

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1. Henceforth, I will use the term "nonprofit organization" or "nonprofit" to refer to entities granted tax exemption under I.R.C. § 501(c)(3) (2006). Although there are many provisions under which an entity may be granted tax exemption, this Article concerns only those organizations granted exemption under I.R.C. § 501(c)(3). *See generally* I.R.C. § 501.

2. Though it is the rare exception that a charitable organization will operate for any appreciable length of time entirely with voluntary labor and donated goods and services, I leave open the possibility that some organizations are able to do so.

3. For example, the tax law regarding the reasonableness of compensation paid to nonprofit employees explicitly states that reasonableness can be determined by comparing the "compensation levels paid by similarly situated organizations, both taxable and tax-exempt." Treas. Reg. § 53.4958-6(c)(2)(i) (2002). Hence, reasonable compensation is a function of the entire market, not just what other nonprofits pay.

4. State law sales tax exemptions granted to nonprofit organizations do not change this

goods and services is an implicit condition precedent to the accomplishment of any charitable goal. Thus, nonprofits are not immune from market forces merely because their fiduciaries must personally disdain the profit motive.[5] The point is so clearly axiomatic that it is almost unremarkable.

It is more than remarkable, though, that tax exemption jurisprudence reacts with clearly palpable suspicion when noncharitable beneficiaries actually profit conspicuously from the accomplishment of a charitable goal. This Article argues that the manifestation of that suspicion via legal barriers and tax penalties designed to punish third-party profit-taking is as counterproductive to charitable goals as the market forces that perpetuate the charitable classes with which tax exemption law is concerned. In 2006, for example, the Internal Revenue Service ("the Service") announced a summer offensive, of sorts, against charitable housing down payment assistance organizations which assist needy first-time home buyers in prohibitive markets.[6] Down payment assistance organizations

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result since those exemptions do not affect the market price nonprofits must pay for goods and services.

5. Nearly thirty years ago, Professor Henry Hansmann explained that nonprofit owners must comply with the "nondistribution constraint" as a condition to receiving tax exemption. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980). In short, the nondistribution constraint means that nonprofit organizations cannot exist for the purpose of generating profit for "owners" or those who stand in an ownership-type relationship with respect to the nonprofit organization. *See* Darryll K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 VA. TAX REV. 575, 577–78 (2000). The problem addressed in this Article, though, is slightly different. It pertains to the extent to which a nonprofit organization may engage in extraordinarily profitable transactions (though still at market rate) with particular outsiders to achieve a charitable goal.

6. The Service's efforts began in earnest with the issuance of Revenue Ruling 2006-27, 2006-1 C.B. 915. In that ruling, the Service stated that organizations that provide seller-funded down payment assistance grants did not qualify for tax-exempt status under I.R.C. 501(c)(3) because the seller who made donations to fund down payment grants ultimately benefited by selling a home to grant recipients. The Service issued a news release along with the ruling in which it stated:

> "The IRS is increasingly concerned with organizations that are taking advantage of homebuyers who need assistance for a down payment to realize the American dream of homeownership," said IRS Commissioner Mark W. Everson. "So-called charities that manipulate the system do more than mislead honest homebuyers and ultimately jack up the cost of the home. They also damage the image of honest, legitimate charities."
>
> The IRS is examining 185 organizations that operate down-payment-assistance programs. A particular organization's tax-exempt status can be verified using the on-line database at irs.gov (click on "Charities & Non-Profits" and then click on "Search for Charities"). In addition, the agency has denied applications for tax

sometimes solicit funds from housing market stakeholders, such as builders and developers, who might later profit from a charitable beneficiary's receipt of a down payment grant.[7] The funds are then used to make grants to enable low and moderate income families to make a down payment towards the purchase of a home.[8] The goal seems noble, at least enough to warrant tax exemption. In a surprising series of rulings, though, the Service has stated that if a grant-maker also happens to be the builder or developer from whom the charitable beneficiary subsequently purchases a long-sought-after home, the organization conveys an improper private benefit on a third party.[9] Such a private benefit would cause revocation of the nonprofit's tax-exempt status.[10] So far, the Service has given little heed to the objection that the ruling would prevent "hundreds of thousands" of low- or moderate-income citizens from becoming homeowners.[11]

Tax exemption jurisprudence is premised on the assumption that nonprofit organizations will enrich particular charitable beneficiaries

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> exemption from over 20 organizations that seek to provide this service and is considering applications from a number of other down-payment assistance organizations.

I.R.S. News Release IR-2006-74 (May 4, 2006), *available at* 2006 IRB LEXIS 209.

7. *See, e.g.*, Rev. Rul. 2006-27, 2006-1 C.B. 915 (Situation 2).

8. *Id.*

9. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2007-33-031 (Aug. 17, 2007). In that ruling, the Service revoked a down payment assistance organization's tax-exempt status, stating:

> Our adverse determination was made for the following reasons:
>
> A substantial part of your activities consists of providing down payment assistance to home buyers. To finance the assistance you rely on home sellers and other real-estate related businesses that stand to benefit from these down payment assistance transactions. Your receipt of a payment from the home seller corresponds to the amount of the down payment assistance provided in substantially all of your down payment assistance transactions. The manner in which you operate demonstrates you are operated primarily to further your insiders' business interests. Therefore, you are operated for a substantial nonexempt purpose. In addition, your operations further the private interests of the persons that finance your activities. Accordingly, you are not operated exclusively for exempt purposes described in section 501(c)(3).

Id.

10. *Id.*

11. Manuel Mirabal, *Helping Home Buyers with Down Payments Pays Off for Society*, CHICAGO SUN-TIMES, Dec. 30, 2006, at 12 ("Why, then, is the federal government attempting to prevent hundreds of thousands of Americans from achieving homeownership? That's what would happen if lawmakers and bureaucrats in Washington succeed in snuffing out the nonprofit programs that offer down payment assistance to low- and middle-income Americans.").

for the public good. Nonprofit organizations are necessarily dependent, however, on noncharitable third parties—for example, vendors,—for the accomplishment of charitable goals.[12] It is therefore ironic that tax exemption jurisprudence is characterized by suspicion and hostility whenever the possibility arises that a third party, even a vendor of absolutely indispensable goods and services, might explicitly profit from a formal or informal partnership with a nonprofit organization.[13] Nonprofits must pay market price for goods and services, but when they do so via certain types of market-dictated transactions—formal or informal partnerships or economically similar franchises that convey conspicuous profit on third-party vendors[14]—tax exemption jurisprudence reacts with hostility. The jurisprudence treats the explicit conveyance of nothing more than market rate through such partnerships or franchises as nearly conclusive evidence that tax exemption is inappropriate, even when the charitable goal cannot otherwise be accomplished.[15]

Generally, partnerships and similar franchises arise in more extraordinary circumstances, such as when the nonprofit's very existence is threatened—because it cannot achieve its charitable purpose otherwise—and it needs more than retail or ad hoc access to

12. Some nonprofits also rely on customers to achieve their charitable goals. Tax-exempt universities, for example, are at least in part able to achieve their charitable goal by charging tuition.

13. The hostility and suspicion is embodied in a still vaguely defined doctrine known as the prohibition against private benefit. *See* Am. Campaign Acad. v. Comm'r, 92 T.C. 1053 (1989) (holding that a nonprofit organization did not qualify for tax exemption because its activities served the private interest of a private entity); Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (1990) ("An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest.").

14. In some instances, for example, nonprofits have entered into an exclusive service or product provider relationship with a vendor, usually as a last-ditch effort to achieve the charitable goal. *See infra* note 16 and accompanyiug text. I assert, in Section II, *infra*, that these franchises are essentially informal partnerships.

15. I have argued elsewhere that a joint venture involving a nonprofit and a for-profit entity is improper, even if the terms are set at market rate, because the joint venture, in effect, conveys a franchise in the nonprofit organization's profit stream to a for-profit entity. *See* Jones, *supra* note 5, at 620–39. The impropriety in those cases, though, arose from the fact that the nonprofit and for-profit entities were controlled by the same individual(s) and therefore created an opportunity and incentive to divert charitable resources to private use. *See id.* As will be seen in Section II, *infra*, the same analysis has effectively been applied to situations when the incentive and opportunity does not exist. That is, the necessary grant of a franchise to an unrelated third party has been attacked even though there is neither opportunity nor incentive to divert charitable resources.

capital or services.[16] Since the early 1980s, for example, health care transactions have largely been motivated by a desperate search for revenues by which to provide treatment to indigent patients and fund research into new cures.[17] Nonprofit hospital operating revenues, most of which are generated from paying customers, fund both medical research and the provision of health care to the poor.[18] Paying customers—or more accurately, paying customers' insurance providers—historically paid for nonpaying customers and other non-revenue-generating activities, such as medical research through "cross-subsidization."[19] Changes in the health care marketplace made it difficult, if not impossible, for nonprofir hospitals to cross-subsidize those activities.[20] It thus became critically important that nonprofit hospitals generate higher patient volume. At the same time, for-profit hospitals seek to monopolize the same paying customer base, not necessarily to fund indigent care or pay for new research, but to stem the erosion of their profit margins caused by the same market forces affecting nonprofit hospitals.[21]

Hence, without patient referrals, free or below-cost care and nonprofit medical research became practically impossible. Physicians, who essentially serve as gatekeepers directing patients to one or another hospital, are cast in the role of "brokers" upon whom

16. *See, e.g.*, St. David's Health Care Sys. v. United States, 349 F.3d 232 (5th Cir. 2003) (nonprofit hospital entered into joint venture due to financial difficulties).

17. For a comprehensive discussion regarding the health care market changes and their effects on tax-exempt hospitals see Darryll K. Jones, *Tax Exemption Issues Facing Academic Health Centers in the Managed Care Environment*, 24 J.C. & U.L. 261 (1997).

18. Dwayne A. Banks, Stephen E. Foreman & Theodore E. Keeler, *Cross-subsidization in Hospital Care: Some Lessons From the Law and Economics of Regulation*, 9 HEALTH MATRIX 1, 9–10 (1999) ("In order for hospitals to care for nonpaying or under-paying patients, they simply overcharge paying patients to cover their uncompensated costs.").

19. *See id.*

20. Alice A. Noble, Andrew L. Hyams & Nancy M. Kane, *Charitable Hospital Accountability: A Review and Analysis of Legal and Policy Initiatives*, 26 J.L. MED. & ETHICS 116, 117 (1998) ("With the capital demands of competition and corporate transformations, hospitals claim less ability to subsidize free care or underfunded services internally. In addition, private payers are increasingly trying to limit the shifting of costs from the uninsured to the privately insured.").

21. *See, e.g.*, Melanie Evans, *Good News, Bad News; Hospitals' Net Profit Margin Up, Operating Margin Down*, MODERN HEALTHCARE, Nov. 1, 2004, *available at* www.kellogg.northwestern.edu/news/hits/041101mh.htm (noting "the drop-off in operating profits caused by the nation's tight healthcare labor market, lower payments from public insurers and the growing cost of technology and pharmaceuticals").

nonprofit hospitals rely for patient volume.[22] Nonprofit hospitals, therefore, seek partnerships and franchise-type relationships with physicians as a means of obtaining the patient referrals necessary to fund indigent care and pursue medical research.[23] Physicians necessarily benefit in a more conspicuous way than they previously had when nonprofit hospitals compensated them on an ad hoc or case by case basis. Nevertheless, present law raises an almost insurmountable bar[24] to the explicit profit-taking that occurs via "whole hospital" joint ventures even when nonprofits assert, without challenge, that charitable care is impossible in the absence of the partnership.[25]

It is also important to note that most charitable activities are worthy of tax exemption precisely because both government and for-

22. Mark A. Hall, *Institutional Control of Physician Behavior: Legal Barriers to Health Care Cost Containment*, 137 U. PA. L. REV. 431, 434 (1988). ("Physicians, not institutions, control the vast bulk of health care expenditures. Doctors determine when, how long, how intensively, and in what environment to treat patients. They order the laboratory tests, x-rays, pharmaceuticals, and surgery that determine the short-term institutional costs of treatment and that ultimately create the long-term demand for capital resources and insurance coverage. Although difficult to quantify with precision, informed estimates place 70 to 90 percent of health care expenditures within the control of individual practitioners.")

23. *See* Eileen M. Newell, *Healthcare Joint Ventures: Pushing Tax-Exempt Law to the Limits?*, 18 J. CONTEMP. HEALTH L. & POL'Y 467, 468–69 (2002) (citation omitted) ("Often, a nonprofit organization is willing to contract with a for-profit entity in order to generate the funding necessary to provide healthcare to the community. In such a relationship, for-profit organizations are attempting to decrease costs and increase revenue, which ultimately provides a greater rate of return for investors. Regardless of the entity's philosophy behind offering its services, healthcare providers try to find the most efficient and effective means to operate their facilities. As a result, new combinations of joint ventures and alliances between nonprofit and for-profit entities emerge, commonly in the form of a partnership or a limited liability company (LLC)."); *see also* Leslie Berkman, *Nonprofit Hospitals Diversify*, L. A. TIMES, Oct. 2, 1988, at C5 (describing the financial pressures and incentives for nonprofits/physician joint ventures).

24. Gerald M. Griffith, *Revenue Ruling 98-15: Dimming the Future of All Nonprofit Joint Ventures?*, 20 EXEMPT ORG. TAX REV. 405 (1998) (asserting that the Service's approach to nonprofits' participation in joint ventures places those joint ventures in "serious jeopardy"); *see* Cynthia F. Reaves and Jay E. Gerzog, *Unwind of Columbia/HCA Whole Hospital Joint Venture in Northern Virginia May Just Be the Writing on the Wall*, 23 EXEMPT ORG. TAX REV. 455 (1999) (arguing that most nonprofit hospital joint ventures with for-profit hospitals will fail to meet IRS standards).

25. In *St. David's Health Care System, Inc. v. United States*, for example, the government successfully prevented a nonprofit hospital from participating as a partner in a joint venture with a for-profit entity even though all parties conceded that the nonprofit accomplished "important" charitable goals via the partnership. 2002-1 U.S. Tax Cas. (CCH) ¶ 50,452 (2002), *rev'd*, 349 F.3d 232 (5th Cir. 2003).

profit markets fail to provide those "public goods."[26] There is insufficient political or profit motivation to do so. Hence, if charitable organizations are denied access to the market mechanisms by which those public goods can be provided, those public goods will simply not occur and classic charitable beneficiaries—i.e., the poor—will suffer.[27]

The hostility to explicit third-party profit-taking prevails, in most cases, regardless of the extent to which the nonprofit organization and its charitable goals are rescued by the more formal relationship. It seems as though the explicit conveyance of third-party profit categorically trumps all other considerations. Present law is entirely ambivalent to whether the nonprofit's survival is made possible only by the formal or informal partnership transaction.[28] As the stakes rise—that is, as the third party's wholesale participation becomes most crucial to the accomplishment of the charitable goal—the antipathy to third-party profit grows most intense. The further irony is that as charitable goals become more important, as measured by the indispensability of the goal to life itself—i.e., housing and health

26. For an informative and far ranging discussion of the market's inability to provide public goods and the charitable sector's role in filling that need, see Bruce Chapman, *Between Markets and Politics: A Social Choice Theoretic Appreciation of the Charitable Sector*, 6 GEO. MASON L. REV. 821 (1998). *See generally* Hansmann, *supra* note 5 (regarding the market and "contract" failures that give rise to nonprofit organizations).

27. I use the phrase "classic charitable beneficiaries" to draw a distinction between poor people who depend on government or charity for basic sustenance, and wealthier persons who rely on charity to provide such things as opera houses and community swimming pools, for example. It is too much to say that the intended beneficiaries in *Plumstead Theatre Society v. Comm'r* would have "suffered" had the Service's approach to explicit third-party profit-taking been upheld in that case. See *infra* notes 47–52 and accompanying text for an in-depth discussion of *Plumstead*.

28. At one point, the Treasury Department formally proposed regulations containing the notion that the benefit to the charitable goal might outweigh whatever objection existed to informal partnerships involving third-party profit-taking. *See* Failure by Certain Charitable Organizations to Meet Certain Qualification Requirements; Taxes on Excess Benefit Transactions, 63 Fed Reg. 41,486, 41,503 (Aug. 4, 1998) (A proposed Treasury Regulation § 53.4958-5(a) that would have stated, "[a] revenue-sharing transaction may constitute an excess benefit transaction regardless of whether the economic benefit provided to the disqualified person exceeds the fair market value of the consideration provided in return if, at any point, it permits a disqualified person to receive additional compensation without providing proportional benefits that contribute to the organization's accomplishment of its exempt purpose."). The proposal was later omitted from the final regulations. *See* Excise Taxes on Excess Benefit Transactions, 67 Fed. Reg. 3076, 3081–82 (Jan. 23, 2002) (explaining that the IRS and Treasury Department intend to continue monitoring such transactions and removing the proposed language from the final regulations).

care, for example—nonprofit organizations' ability to harness the market's goods and services in pursuit of those indispensable public goods becomes weaker.[29] It is in these situations that the law imposes the harshest requirements on charitable operations.

Section II proves the *status quo ante* by surveying the legal response to third-party profit-taking via partnerships and franchises (both formal and informal) in health care, housing, scientific research, and fundraising. It is only with respect to scientific research that tax exemption jurisprudence explicitly acknowledges a positive role for explicit third-party profit-taking, and even then only begrudgingly.[30] The survey will demonstrate that antipathy to explicit third-party profit-taking leaves charitable goals unfulfilled. It will relate admittedly anecdotal accounts of market and charitable failure in housing, fundraising, and health care, and then juxtapose those accounts with successes in scientific research where the antipathy to third-party profit is relatively low. Section II leads to a discussion of whether any sensible policy goal is achieved by the present law's approach to third-party profit-taking.

Section III will discuss the evolution of the "private benefit doctrine," the doctrine under which present law deals with third-party profit-taking. As noted earlier, explicit third-party profit transactions are usually relied upon only in dire circumstances, and with regard to the most important charitable goals.[31] Typically, a charitable organization desperately and unsuccessfully exhausts all other options before embarking upon a transaction that explicitly requires sharing the organization's "profit" with a third party as a means to accomplishing the goal. Just as typically, tax exemption jurisprudence responds with figurative shock that the organization would dare participate in a transaction by which a third party might explicitly become wealthier. The shock apparently results from a failure to distinguish purpose, on the one hand, and effect, on the other. Certainly, charitable fiduciaries should not operate under a

29. This point is especially evident with regard to nonprofit organizations' efforts to provide affordable housing and health care. *See infra* notes 115–16 and accompanying text.

30. *See* Treas. Reg. § 1.501(c)(3)-1(d)(5)(iv)(b) (1990) (indicating that granting exclusive rights to scientific research performed by a nonprofit organization is appropriate "if the granting of such exclusive right is the only practicable manner in which the patent, copyright, process, or formula can be utilized to benefit the public").

31. *See, e.g.*, St. David's Health Care Sys., Inc. v. United States, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,452 (2002), *rev'd*, 349 F.3d 232 (5th Cir. 2003).

subjective intent to direct tax-exempt financing to the enrichment of noncharitable third parties. To do so would mean that an organization is operating for private rather than public benefit. Nevertheless, those fiduciaries are sometimes required to engage in transactions that have that objective effect if they are to faithfully achieve the charitable purpose for which tax exemption has been granted. The private benefit doctrine allows for this necessity in some circumstances but not with respect to explicit third-party profit-taking.

Section IV analyzes the logic of the *status quo ante* from an efficiency perspective. To prohibit third-party profit-taking, Section IV argues, is to prohibit the accomplishment of valuable charitable goals, because some charitable goals can be accomplished solely by conveying explicit third-party profit. Yet many such goals, labeled charitable under I.R.C. § 501(c)(3), must be paid for in any event under the auspices of another legal régime, usually at greater cost to society.[32] Thus, the prohibition against explicit third-party profit-taking is classically inefficient because it generates more costs than it saves.[33]

Section V then looks at the problem using equity as the appropriate standard. It notes that the burden of the indignation to third-party profit falls on charitable beneficiaries who must do without certain necessities as a result of the law's adamant insistence that no one person becomes wealthier from charitable activities. Equity, or "fairness," is an illusive concept, of course, but Section V attempts to define that concept by reference to both Rawlsian and economic theories. That some beneficiaries might suffer in the absence of third-party profit does not necessarily mean the flood

32. *See* Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient Than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667, 667 (1994) (arguing that income redistribution such as might occur for the relief of the poor is less expensively accomplished via the tax system than through other legal systems).

33. The concept of economic efficiency used in this Article is one that seeks the most good for the most people. Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961, 968 (2001) ("Under a common understanding of normative economic analysis, legal rules are assessed by reference to wealth maximization or efficiency."). Thus, laws are most efficient to the extent they maximize "aggregate social utility." *See generally* Eyal Zamir, *The Efficiency of Paternalism*, 84 VA. L. REV. 229, 246–49 (1998) (explaining that standard economic analysis has, as its goal, the maximization of aggregate social utility). My argument boils down to an assertion that prohibiting explicit third-party profit-taking in tax exemption jurisprudence decreases aggregate social utility because nobody is made better off while some people are made worse off.

gates to third-party profit-taking should be opened. But, as Section VI concludes, that fact suggests the need for a more "nuanced"[34] cost benefit analysis; the selective use of third-party profit-taking as a means to achieve a greater good is necessary and inevitable. Nothing is free, not even charity.

II. THE ANTIPATHY TO THIRD-PARTY PROFIT-TAKING

Present law regarding third-party profit-taking has been almost exclusively shaped by a single administrative decision[35] and without significant input from either Congress or the judiciary. Notable exceptions exist and are discussed below, but for the most part Congress and the judiciary have been content to defer to the Service. The Service's approach has evolved from something similar to a nonprofit "business judgment rule,"[36] whereby deference is accorded

34. I first expressed the thesis of this Article in a short column I wrote for Tax Notes magazine. *See* Darryll K. Jones, *The Greedy and the Good in Nonprofit/For-Profit Partnerships*, 111 TAX NOTES 1155 (2006). Paul Streckfus, who serves as editor of The Exempt Organization Tax Review, responded in a letter to the editor. His argument is, essentially, that nonprofit organizations simply cannot serve "two masters"—good works and profit making. Paul Streckfus, *'The Greedy' and 'the Good' Shouldn't Mix*, 111 TAX NOTES 1307 (2006). To that argument, I responded, in essence, that to deny nonprofits the ability to confer profits on indispensable third parties is essentially to doom needy charitable beneficiaries to their miserable status quo. Darryll K. Jones, *Misplaced Indignation on Nonprofit/For-Profit Partnerships*, 111 TAX NOTES 1523 (2006). Professor Harvey Dale later observed in an email that both Streckfus and I were likely correct but that the law should take a more "nuanced" approach so that third-party profit-taking is tolerated when necessary to achieve a charitable purpose. E-mail from Harvey Dale, Professor of Law and Director of the Nonprofit Law Center, New York University, to Darryll K. Jones, Associate Professor of Law and Associate Dean of Academic Affairs, University of Pittsburgh School of Law (July 1, 2006, 09:21 EST) (on file with author).

35. *See infra* notes 54–59 and accompanying text (regarding the Service's 1991 General Counsel Memorandum taking the position that explicit third-party profit-taking in nonprofit hospitals invariably violates I.R.C. § 501(c)(3)).

36. Elizabeth S. Miller & Thomas E. Rutledge, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations?*, 30 DEL. J. CORP. L. 343, 345 (2005) ("The business judgment rule, which originally existed as a common law standard, but is now codified in part, is a standard of judicial review that protects the broad discretion conferred on a corporate board of directors from excessive judicial interference. If a board has exercised a minimum level of care, typically satisfied by reference to the procedures utilized in arriving at its decision, then courts will not second-guess the merits of that decision."). The modern business judgment rule is often associated with landmark cases from Delaware. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Aronson v. Lewis, 473 A.2d 805 (Del. 1984). Business judgments in the for-profit world have long benefited from a spirit of judicial deference designed to (1) acknowledge that managers know best and usually act reasonably and (2) discourage judges from substituting their own judgments for those of organization managers. *See* United Copper Sec. Co. v. Amalgamated

to fiduciaries in the good faith pursuit of the charitable goal, to one that is diametrically opposed to that approach. The present approach is characterized less by deference than by close and skeptical scrutiny. This Article advocates a return to the former approach. Simply put, tax exemption jurisprudence should afford nonprofit managers a version of the business judgment rule with regard to the transfer of the organization's profit to third-party vendors indispensable to the charitable goal. Thus, if indispensability is objectively established,[37] nonprofit managers should be allowed to go forward at arm's length without jeopardizing the organization's tax-exempt status. Moreover, if the managers bargain in good faith with third parties, the Service should not substitute its judgment for that of nonprofit managers regarding the degree to which accomplishing the charitable goal is worth explicit third-party profit-taking. By contrast, and under present law, the Service usually concedes that the goal pursued via third-party profit-taking is itself worthy of tax exemption.[38] It then revokes tax exemption essentially on the basis that the cost is too high whenever a single person or entity obtains an explicit profit in exchange for goods or services necessary, even in the strictest sense, to accomplish the charitable goal.[39] That administrative decision—that some charitable goals just cost too much and therefore do not deserve tax exemption—is, in fact, the default rule today.

Copper Co., 244 U.S. 261, 263–64 (1917) ("Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors . . . . Courts interfere seldom to control such discretion *intra vires* the corporation, except where the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment . . . .").

37. The prototypical business judgment rule does not require a showing that a transaction is indispensable in order to gain the benefit of the presumption. *See supra* note 36. Though I object to the Service's approach to third-party profit-taking, I understand the concern enough to suggest that nonprofit organizations should be required to prove extraordinary circumstances before then becoming entitled to a form of the business judgment rule.

38. In the more notable contexts—charitable housing and health care—it is obvious that the goal is "charitable" in the legal sense. Hous. Pioneers, Inc. v. Comm'r, 58 F.3d 401 (9th Cir. 1995); *see, e.g.*, Redlands Surgical Servs. v. Comm'r, 113 T.C. 47 (1999), *aff'd per curiam*, 242 F.3d 904 (9th Cir. 2001) (relating to charitable health care).

39. *See supra* note 31.

A. The Original Approach—Nonprofit Business Judgment Rule

The earliest administrative analysis of third-party profit-taking demonstrated a far different approach than is currently employed. In 1988, the Service was asked whether the transfer of third-party profit via a partnership with for-profit providers should cause the revocation of an organization's exempt status.[40] The transaction involved a nonprofit hospital that operated an outpatient facility that was financially dependent on patient referrals from individual physicians.[41] In the ruling, physicians paid a discounted fee to operate one of the nonprofit hospital's departments and, in return, received a right to a share of the department's excess revenues from future operations.[42] The nonprofit hospital agreed to share its revenue stream from the department with its physician partners in hopes of generating greater department usage from which to fund indigent care and medical research. In effect, the physicians were provided a share of the profits—profits made possible only by their active participation, and without which charitable health care would have been impossible, or greatly reduced.

The 1988 analysis employed to approve such transactions very clearly exemplified a nonprofit business judgment rule. The initial question was whether the organization was truly pursuing the goal for which tax exemption had been granted, or just trying to transfer wealth to a private party. The Service addressed this question simply by repeating the nonprofit's stated reasons for the proposed transactions.[43] There was no apparent effort to scrutinize the stated

40. I.R.S. Priv. Ltr. Rul. 88-20-093 (Feb. 26, 1988); *see also* I.R.S. Priv. Ltr. Rul. 89-42-099 (Jul. 28, 1989). Both rulings involved substantially similar facts, as set forth in the text, and are therefore consolidated for purposes of the discussion.

41. *See also* I.R.S. Gen. Couns. Mem. 39,732 (May 19, 1988) (describing the circumstances leading to the decision of nonprofit hospitals to engage in partnerships with physicians: "The organization states that physician participation was considered critical to the success of an outpatient center both to provide quality medical care and to obtain patient referrals.").

42. *See* I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991) (describing the economic circumstances causing nonprofit hospitals to seek partnerships with physicians).

43. *See, e.g.*, I.R.S. Gen. Couns. Mem. 39,732 (May 19, 1988) ("In each of these ruling requests, the exempt organization has stated that its reason for entering into the partnership is to provide better medical services to the public in the area served. The promotion of health for the benefit of the community is an established charitable purpose. We have found no reason to doubt that the exempt organization's activities in each partnership arrangement will be related to its exempt purposes.").

reasons except to note that the reasons were logically consistent with the charitable goal for which tax exemption was granted.[44] The second part of the analysis asked only whether the transaction was structured through arm's-length negotiations.[45] Thus, the Service was satisfied that the articulated reasons logically supported the accomplishment of the charitable goal and market rates applied to the transaction, as is presumptively the case whenever parties bargain at arm's length. In fact, the Service declined a specific request to apply a "but-for" test that would have required nonprofit organizations to show that without the explicit third-party profit-taking, the charitable goal would not be accomplished.[46] Hence, the 1988 analysis allowed charitable fiduciaries to exercise wide latitude so long as they acted in good faith and at arm's length.

The 1988 analysis was preceded, ironically, by a judicial controversy in which the Service sought to apply a much more restrictive rule. In *Plumstead Theatre Society v. Commissioner*,[47] a nonprofit theatre organization sold a portion of its future profits from a dramatic production to for-profit investors. Without the compensated participation of the investors, the dramatic production would not have occurred because the fiduciaries could not otherwise have raised enough operating capital.[48] The Service agreed that the organization's goal of putting on dramatic productions deserved tax exemption and that the investors' participation was necessary.[49] Nevertheless, the Service thought the manner in which the organization went about achieving the goal—joining a partnership with private individuals and then dividing the profit from the production—was categorically inconsistent with tax exemption.[50] There was, in effect, a disagreement between the nonprofit organization and the Service regarding the appropriateness of the method chosen to achieve the admittedly charitable goal. There was never a concern regarding the worthiness of the goal. Instead,

44. *Id.*

45. *Id.*

46. *Id.* ("[T]he exempt organization has made no showing that the outpatient facility could not have been established but for participation in the limited partnership. We see no basis for a 'but for' test.").

47. 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982).

48. *Id.* at 1332–34.

49. *Id.* at 1330–34.

50. *Id.* at 1333–34.

Plumstead involved a judicial test of the Service's "per se" rule, whereby any explicit third-party profit-taking, regardless of how essential to the charitable goal, was deemed absolutely inconsistent with tax exemption.[51] The Tax Court rejected the "per se" approach and reversed the Service's revocation of tax exemption.[52] In doing so, the Court seemed to acknowledge the market conditions in which the organization operated, noting the necessity of the transaction, and concluding that the transaction was conducive and indispensable to the charitable goal. As in the later 1988 ruling, the Court gave no indication that the law should look with skepticism at the reasons given by the charitable fiduciaries for their economic course of action. It appeared, then, that both *Plumstead* and the 1988 analysis put the matter to rest.

B. Present Law—Close and Skeptical Scrutiny

The 1988 analysis seemed consistent with, and perhaps mandated by, the Tax Court's decision in *Plumstead*. It is somewhat unclear why the analysis took a rather dramatic reversal less than four years later.[53] In 1991, the Service reconsidered the exact same facts as its 1988 ruling using a new analysis.[54] The new analysis not only evinced a willingness to scrutinize and disagree with the objective logic offered in support of third-party profit-taking, but showed downright incredulity, motivated entirely by the presence of explicit third-party profit. In contrast to its earlier deferential approach, the Service categorically dismissed the idea that forming a partnership with a necessary service provider furthered the goal for which tax exemption was granted.[55] Indeed, the Service concluded just the

51. Michael I. Sanders, *Health Care Joint Ventures Between Tax-Exempt Organizations and For-Profit Entities*, 15 HEALTH MATRIX 83, 88–90 (2005).

52. *Plumstead*, 72 T.C. at 1333–34.

53. I discuss one probable reason in Section III, *infra*.

54. I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991); *cf.* I.R.S. Gen. Couns. Mem. 39,732 (May 19, 1988).

55. I.R.S. Gen. Couns. Mem. 39,862. The Service specifically provided:

> The proper starting point for our analysis of the net revenue stream arrangements is to ask what the hospital gets in return for the benefit conferred on the physician-investors. Put another way, we ask whether and how engaging in the transaction furthers the hospital's exempt purpose. Here, there appears to be little accomplished that directly furthers the hospitals' charitable purposes of promoting health. No expansion of health care resources results; no new provider is created. No improvement in treatment modalities or reduction in cost is foreseeable. We have to

opposite, and that conclusion—assuming it was correct—was sufficient from the Service's standpoint to end the theoretical inquiry concerning whether nonprofits deserve tax exemption when they enter such transactions. Since the transaction was categorically unrelated to the charitable goal, in the Service's view, tax exemption should have been revoked on that basis alone. Nevertheless, the Service assumed, for the sake of argument, that the transactions furthered a charitable purpose.[56] It reasoned that the transfer of a nonprofit's profit stream to a third party, even if necessary to accomplish the charitable goal, was simply too much under any circumstance.[57] Such "revenue sharing" transactions were deemed inherently inconsistent with tax exemption.[58] That conclusion precluded any consideration whatsoever of either the extent to which the charitable goal was rendered impossible without the transaction or whether the nonprofit fiduciaries exercised good faith in the analysis leading to the transaction.[59]

> look very carefully for any reason why a hospital would want to engage in this sort of arrangement.

Id.

56. *Id.*

57. *Id.* The Service specifically stated:

> Even if the net revenue stream joint ventures somehow furthered a charitable purpose, they still would be problematic. The second step of our close scrutiny analysis casts an even more unfavorable light on them. These joint ventures benefit the private interests of the physicians to too great an extent to be considered incidental to the charitable purposes achieved.

Id.

58. General Counsel Memorandum 39,862 thus became known for articulating a "per se" violation of I.R.C. § 501(c)(3). *See* John Colombo, *Health Care Reform and Federal Tax Exemption: Rethinking the Issues*, 29 WAKE FOREST L. REV. 215, 230 (1994) (critiquing the current position of the Service regarding the tax-exempt status of today's healthcare providers). Actually, the Service first articulated a "per se" rule against revenue sharing partnerships in 1975. *See* I.R.S. Gen. Couns. Mem. 36,293 (May 30, 1975) (stating that a nonprofit organization's participation as a general partner in a limited partnership with for-profit entities was "incompatible" with I.R.C. § 501(c)(3)). That articulation appears to have vanished into a proverbial black hole by the time the 1988 rulings were issued, most likely as a result of *Plumstead*.

59. Two commentators suggest the degree of thought that informs a nonprofit organization's decision to engage in commercial-type transactions in pursuit of the charitable goal: "A decision to venture into Enterprise is a long-term management strategy. It is not a quick fix for a financially vulnerable nonprofit organization that is experiencing systematic funding problems. In contemplating enterprise strategies, social service nonprofit organizations must consider whether the risk is worth the ultimate financial reward." Gail A. Lasprogata & Marya N. Cotten, *Contemplating "Enterprise": The Business and Legal Challenges of Social Entrepreneurship*, 41 AM. BUS. L. J. 67, 69–70 (2003). If, in fact, a nonprofit devotes serious

The 1991 ruling essentially annouticed the Service's reincarnated antipathy to third-party profit-taking as a means to achieve a charitable goal, regardless of the extent to which the goal's accomplishment depended on the third party's participation. Were it not for the judicial rebuke in *Plumstead* the Service might have re-imposed a categorical prohibition on all profit-sharing transactions. *Plumstead* made it necessary to admit to at least the possibility that profit sharing and tax exemption are compatible. As a result, the Service formulated specific, and oftentimes onerous, contractual terms, demanding that they be included in any revenue-sharing partnership.[60] The antipathy has further manifested itself since the 1991 ruling in uniformly successful challenges to revenue-sharing arrangements not in compliance with those strict guidelines.[61] The judiciary has agreed with the Service even when absolute compliance has created barriers to the charitable goal,[62] despite provable charitable gains derived exclusively from the transaction.[63] Meanwhile, Congress has been content to ratify whatever approach the Service asserts is correct.[64] As a result, present law condemns explicit third-party profit-taking in a variety of circumstances.

attention and study to the decision to engage in "entrepreneurial" activity in pursuit of the charitable goal—and that decision is a weighty, arguable one—whose conclusion should prevail, the Service's or the nonprofit manager's?

60. Rev. Rul. 98-15, 1998-1 C.B. 718. The ruling holds, *inter alia*, that a revenue sharing partnership will not cause the revocation of tax exemption if (1) the majority of the partnership's governing members are appointed by the nonprofit organization, (2) the governing members have no financial interest in the hospital's operations, (3) the governing documents require the partnership to operate in a fashion that "furthers charitable purposes," and (4) management of the partnership's hospital operations is vested in individuals or an entity unrelated to the partners.

61. *See* St. David's Health Care Sys. v. United States, 349 F.3d 232, 239 (5th Cir. 2003); Redlands Surgical Servs. v. Comm'r, 113 T.C. 47, 97 (1999), *aff'd per curiam*, 242 F.3d 904 (9th Cir. 2001).

62. *See* Gary J. Young, *Federal Tax-Exemption Requirements for Joint Ventures Between Nonprofit Hospital Providers and For-Profit Entities: Form over Substance?*, 13 ANNALS HEALTH L. 327, 363–64 (2004) (discussing the decrease in charitable health care resulting from the Service's rules on joint ventures).

63. In *St. David's Health Care System*, the nonprofit hospital's assertion that it could not survive without entering into the partnership and that charitable health care increased as a result of the partnership was accepted by all parties, but was ultimately treated as irrelevant to the court's decision. *St. David's Health Care Sys.*, 349 F.3d at 236–37; *see also* Brief for City of Austin as Amicus Curiae Supporting Petitioner, St. David's Health Care Sys. v. United States, 349 F.3d 232 (5th Cir. 2003) (Nos. 02-50959, 02-51312).

64. *See* I.R.C. § 4958(c)(4) (West 2007). In I.R.C. § 4958(c)(4), Congress delegates authority to the Treasury Department (of which the IRS is a part) to determine by regulations

C. Present Law Examples and Exceptions

In *United Cancer Council, Inc. v. Commissioner*,[65] a nonprofit organization dedicated to the search for cancer treatment and prevention found itself in dire financial straits after many of its dues-paying member agencies terminated their memberships.[66] The situation became so severe that the national organization eventually declared itself bankrupt.[67] Prior to doing so, however, the organization tried to avert disaster by hiring a professional fundraiser.[68] Unfortunately, the nonprofit couldn't afford to pay the fundraiser. To address this problem, the nonprofit entered into a contract, whereby the fundraiser would be compensated from the net revenues it raised on behalf of the nonprofit.[69] In effect, the fundraiser agreed to accept a share of the nonprofit's "profit" as compensation for its efforts. The fundraiser collected nearly $29 million over six years through direct and indirect solicitations. Approximately $26.5 million, however, was paid to the fundraiser to cover expenses and compensation. Only $2.5 million went to the nonprofit organization.[70] Though the fundraiser helped stave off bankruptcy for at least six years, the Service nevertheless argued that the transaction was categorically inconsistent with tax exemption. Indeed, the Service argued that the transaction was a "per se" violation of the conditions for tax exemption;[71] that argument, had it been accepted, made any evidence regarding the economic necessity or arm's length nature of the transaction irrelevant. Judge Posner's opinion in this case is instructive because it directly states the relevanr question: whether there are any such instances when market rates are simply too much to pay to achieve a recognized charitable goal—a question Posner unfortunately fails to answer.[72]

The "per se" approach unsuccessfully asserted by the Service in *United Cancer Council* nevertheless prevails with regard to charitable

the extent to which revenue-sharing transactions will cause the revocation of tax exemption.

65. 109 T.C. 326 (1997), *rev'd*, 165 F.3d 1173 (7th Cir. 1999).

66. *Id.* at 330.

67. *Id.* at 328–29.

68. *Id.* at 330.

69. *Id.* at 331.

70. *Id.* at 331–33; *see also* United Cancer Council v. Comm'r, 165 F.3d at 1175.

71. *United Cancer Council*, 109 T.C. at 399.

72. *United Cancer Council*, 165 F.3d at 1179 (suggesting that in some circumstances it may be better for a nonprofit organization to dissolve rather than pay market rates).

organizations dedicated to providing affordable housing for poor and indigent families. The Service has been rather consistent in denying or revoking tax exemption if a private person or entity is granted an explicit profit from transactions that admittedly provide housing to poor people. In *Housing Pioneers, Inc. v. Commissioner*,[73] for example, a nonprofit organization was entitled to federal and state tax credits for its participation in providing affordable housing to low-income tenants.[74] Of course, nonrefundable tax credits are of no use to nonprofit organizations because those organizations are already exempt from tax. The only logical conclusion is that Congress and the State must have intended to grant funding to nonprofit organizations—by way of a tax credit—with which to purchase charitable housing for needy families from for-profit investors.[75] The credit, in effect, serves as the means by which an almost risk-free profit inducement is made to for-profit housing developers.[76] This was all admitted by the Ninth Circuit Court of Appeals. Still, the court agreed with both the Service and the Tax Court that the transfer of profit to a third party necessitated the revocation of tax exemption despite whatever charitable gains were obtained thereby.[77] The objection to third-party profit-taking, even in the face of demonstrable charitable success, has more recently served as the basis to deny tax exemption to organizations that provide down payment assistance to needy first-time home buyers. In those instances, down payment assistance grants to home buyers were funded by the builders who would eventually profit from the buyers' purchases.[78] The inevitable explicit profit to the third party,

73. 58 F.3d 401 (9th Cir. 1995).

74. *Id.* at 401–02.

75. *See* Lee A. Sheppard, *A Bad Mix: Do-gooders and Tax Shelters*, 19 EXEMPT ORG. TAX REV. 23, 23–24 (1998) ("By giving nonprofit organizations tax credits to sell, Congress designed a system in which the do-gooders would be compelled to look to the tax shelter market for capital.").

76. *See* Megan J. Ballard, *Profiting from Poverty: The Competition Between For-Profit and Nonprofit Developers for Low-Income Housing Tax Credits*, 55 HASTINGS L.J. 211, 218 (2003) ("If the developer is a nonprofit organization, the entity must sell its credits; credits are of no use to tax-exempt organizations.").

77. *Hous. Pioneers*, 58 F.3d at 403 (remarking that the assumption that Congress intended nonprofit organizations to compensate for-profit partners by transferring the tax credit is probably correct).

78. Rev. Rul. 2006-27, 2006-21 I.R.B. 915.

according to the Service, required revocation or denial of tax exemption.[79]

As mentioned earlier, there are rare exceptions to the prevailing hostility to third-party profit-taking. *Plumstead* represents one instance in which the judiciary saw no reason to deny tax exemption when third-party profit was necessary to the accomplishment of the charitable goal.[80] Congress, too, eventually agreed that third-party profit-taking should not be viewed as *necessarily* inconsistent with tax exemption (though not in a way that precipitated a wholesale rethinking of the Service's approach and certainly not in an authoritative manner). Instead, legislators remarked in committee reports that categorical inconsistency embodied in the "per se" rule goes too far.[81] The statute resulting from that discussion, I.R.C. § 4958(c)(4), merely delegates to the Service the authority to determine when third-party profit-taking is consistent with tax exemption.[82] Presumably, Congress also intends to condone some third-party profit-taking without limiting the Service's role in determining which transactions are permissible.

There are, in fact, two instances in which the Service has recognized the legitimacy of explicit third-party profit-taking to achieve a goal for which tax exemption has been granted. The most recent of these instances presaged a wholesale rethinking of the third-party profit-taking antipathy described above. Congress, in the legislative history of I.R.C. § 4958(c)(4), instructed the Service to issue regulations describing the circumstances under which insider third-party profit-taking would be permissible.[83] The Service responded by proposing regulations that would have allowed such transactions, but only if the terms of the transactions prohibited a

79. *Id.*

80. *See supra* notes 47–52 and accompanying text.

81. H.R. REP. NO. 104-506, at 56–57 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1143, 1179–80.

82. I.R.C. § 4958(c)(4) (West 2007), states:

> **Authority to include certain other private inurement.** To the extent provided in regulations prescribed by the Secretary, the term "excess benefit transaction" includes any transaction in which the amount of any economic benefit provided to or for the use of a disqualified person is determined in whole or in part by the revenues of 1 or more activities of the organization but only if such transaction results in inurement not permitted under paragraph (3) or (4) of section 501(c) [26 U.S.C.S. § 501(c)], as the case may be. In the case of any such transaction, the excess benefit shall be the amount of the inurement not so permitted.

83. H.R. REP. NO. 104-506, at 56–57.

person from receiving a profit share "without providing proportional benefits that contribute to the organization's accomplishment of its exempt purpose."[84] The proposed rule was quite similar, if not identical, to the private benefit rule the Service applied in the 1988 rulings. It did not require a showing that the profit-taking was necessary in the strict sense to the accomplishment of the charitable goal, but only that profit-taking contributed "proportionately" to the charitable goal. The proposal suggested the possibility of a return to the nonprofit business judgment rule analysis employed in 1988. Unfortunately, the Service withdrew the proposal, stating instead that it still adhered to the belief that some explicit third-party profit-taking is categorically inconsistent with tax exemption, regardless of any other charitable concern or result.[85]

The second instance stands in stark contrast to, and perhaps as an indictment of, the prevailing antipathy to third-party profit-taking. Some nonprofit organizations, such as universities and private research facilities, are devoted to scientific research. Tax law recognizes scientific research as a goal worthy of tax exemption.[86] Scientific research is of little use, though, unless it can be exploited for the betterment of humankind. Technology transfer is therefore just as important as technology development. Long-standing regulations pertaining to tax exemption of scientific research organizations relate a general rule that a scientific research organization will not be entitled to tax exemption unless the results of its research are extended to public rather than private benefit.[87] The regulation also admits that it is often expensive to transform scientific research into a publicly available benefit and a scientific organization may grant a franchise—an exclusive license or partnership—in scientific research to a single profit-making entity if doing so is the only "practicable" way to get new technology to the

84. Prop. Treas. Reg. § 53.4958-5, 63 Fed. Reg. 41,486, 41,503 (Aug. 4, 1998) ("[A] revenue-sharing transaction may constitute an excess benefit transaction regardless of whether the economic benefit provided to the disqualified person exceeds the fair market value of the consideration provided in return if, at any point, it permits a disqualified person to receive additional compensation without providing proportional benefits that contribute to the organization's accomplishment of its exempt purpose.").

85. "Under these standards, inurement may exist even though a disqualified person receives a reasonable amount from a revenue-sharing arrangement." Excise Taxes on Excess Benefit Transactions, 67 Fed. Reg. 3076, 3081–82 (Jan. 23, 2002).

86. I.R.C. § 501(c)(3) (2000); Treas. Reg. § 1.501(c)(3)-1 (as amended in 1990).

87. Treas. Reg. § 1.501(c)(3)-1(d)(5)(iii).

marketplace and into public use.[88] The economic result is that a private, profit-seeking entity is granted an exclusive right to exploit tax-exempt funded research.[89] The results from explicit third-party profit-taking with regard to scientific research are "spectacular" in some instances.[90] A nonexclusive right under this rule would probably not serve as the inducement necessary to get research into the marketplace, particularly when the application costs of fundamental research are significant. Thus, the rule condones explicit third-party profit-taking as an exceptional method of achieving a charitable goal.

Present law still adheres, with few exceptions, to a belief that third-party profit-taking is inconsistent with tax exemption, even under fair market standards and even though the charitable goal may be unmet in the absence of the third-party profit-taking. That the transaction may be necessary in the strictest sense to the charitable goal is of no consequence. Section III will outline the theoretical genesis of this strange result.

88. Treas. Reg. 1.501(c)(3)-1(d)(5)(iv)(b) ("For purposes of this subdivision, a patent, copyright, process, or formula shall be considered as made available to the public if such patent, copyright, process, or formula is made available to the public on a nondiscriminatory basis. In addition, although one person is granted the exclusive right to the use of a patent, copyright, process, or formula, such patent, copyright, process, or formula shall be considered as made available to the public if the granting of such exclusive right is the only practicable manner in which the patent, copyright, process, or formula can be utilized to benefit the public.").

89. Third-party profit-taking is most assuredly the vehicle by which technology is transferred to the public good:

> [T]here is very little altruism in the scientific collaboration. The [for-profit] firm fully expects to realize some tangible benefit and will negotiate as hard with the university as with any other business partner for its position. . . . Clearly, the purpose is to transfer technology exclusively to a proprietary firm who can than exploit the privileged information for personal gain and to benefit the university.

Michelle Sinclair & Joseph Galaskiewicz, *Corporate-Nonprofit Partnerships: Varieties and Covariates*, 41 N.Y.L. SCH. L. REV. 1059, 1070 (1997).

90. J. H. Reichman, *Computer Programs as Applied Scientific Know-How: Implications of Copyright Protection for Commercialized University Research*, 42 VAND. L. REV. 639, 644 n.17 (1989); *see also* Peter D. Blumberg, *From "Publish or Perish" to "Profit or Perish": Revenues From University Technology Transfer and the 501(c)(3) Tax Exemption*, 145 U. PA. L. REV. 89, 91 (1996) (citations omitted) ("One of the prevalent forms of technology transfer is patent licensing, in which a university licenses a patent or other valuable right to a corporation. In exchange for the grant of the license or right, the university receives fixed or contingent royalty payments annually or on some other negotiated basis. This marriage benefits both partners: the university develops a new revenue stream and the corporation gains access to heretofore untapped technologies that may be prohibitively expensive to develop in its own laboratories.").

III. THE PRIVATE BENEFIT DOCTRINE AND THIRD-PARTY PROFIT-TAKING

The statutory authorization for tax exemption imposes a "public benefit requirement," if at all, only by logical implication.[91] The common denominator connecting religious, charitable, scientific, and educational endeavors, for example, is that the whole society—the public—benefits from the pursuit of those endeavors, even if select individuals receive more direct benefit than others.[92] The doctrinal requirements pertaining to charitable tax exemption are actually articulated in the regulations interpreting I.R.C. § 501(c)(3).[93] One such regulatory provision states a seemingly unremarkable axiom—that a revenue-generating entity should enjoy tax exemption only if it provides a public benefit.[94] If that requirement is nor satisfied, the tax exemption subsidy is wasted.[95] The provision goes further, though, by suggesting that the occurrence of private benefit invariably precludes the occurrence of

91. Charitable organizations are granted tax exemption by I.R.C. § 501(c)(3) (2006), which provides tax exemption for:

> Corporations, and any community chest, fund, or foundation, 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 (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

92. "The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burdens which would otherwise have to be met by appropriations from other public funds, and by the benefits resulting from the promotion of the general welfare." Bob Jones Univ. v. United States, 461 U.S. 574, 590 (1983) (citing H.R. Rep. No. 1860 (1938)). There is a separate line of reasoning suggesting that the tax exemption for religious organizations is granted not so much for the public benefit derived, but because tax exemption is the best way to prevent government entanglement with religious organizations. *See* Walz v. Tax Comm'n, 397 U.S. 664 (1970).

93. Treas. Reg. § 1.501(c)(3)-1 (1989).

94. "An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest." *Id.* § 1.501(c)(3)-1(d)(1)(ii).

95. *See supra* note 92.

public benefit.[96] The suggestion expresses logic similar to that embodied in the Service's "per se" rule and may even provide regulatory support for the present approach to explicit third-party profit-taking. In any event, there can hardly be a quarrel with the regulatory admonition that an entity is not organized for an exempt purpose "unless it serves a public rather than a private interest."

For a long time, the admonition was effectively ignored because it seemed only to state the obvious. Politics, though, has a strange way of clarifying (or perhaps confusing) things,[97] and such is the case with the public benefit doctrine. ***American Campaign Academy v. Commissioner***[98] involved a tax-exempt educational organization that trained students for careers as political campaign workers. The Service revoked the organization's tax exemption because it appeared that the organization had a conservative bent. Most of the graduates worked for Republican candidates and, as a result, the Service found that the organization was unnecessarily conveying a private benefit on the Republican Party—not pursuing a public benefit.[99] The case demonstrated the Service's belief that public and private benefits are mutually exclusive in tax exemption jurisprudence. The discernable benefit (better-trained campaign workers) flowed to the Republican Party—a select, noncharitable "person"—so the organization served a private interest according to the Service; the Tax Court agreed, in effect, that the presence of private benefit precluded public benefit.[100]

96. The word "rather" suggests that private benefit categorically precludes public benefit. *See supra* note 92.

97. Consider the attitude common in today's world: "You are either for us or against us." This political oversimplification occurs both domestically (in the case of bitter partisanship) and internationally (President Bush's proclamation to the world after 9/11). *See* Hilary Charlesworth, *The Missing Voice: Women and the War in Iraq*, 7 OR. REV. INT'L L. 5, 18–19 (2005) (discussing the "use of simple dichotomies" by George Bush and Tony Blair); Russell E. Jacobus, *Don't Let Politics Subvert Effort to Provide Health Care for All Residents*, GREEN BAY PRESS GAZETTE, Mar. 6, 2007 http://www.greenbaypressgazette.com (calling for an abandonment of party loyalty in favor of taking action that would most benefit the citizens of the state).

98. 92 T.C. 1053 (1989).

99. "You have failed to establish that you are operated exclusively for exempt purposes as required by section 501(c)(3). You are operated for a substantial nonexempt private purpose. You benefit Republican Party entities and candidates more than incidentally. Also, your activities serve the private interests of Republican Party entities rather than public interests exclusively." *Id.* at 1063.

100. *Id.* at 1065–66. The analysis employed in *American Campaign Academy* has been criticized as an "indefensible" basis upon which to deny tax exemption to a partisan

American Campaign Academy was the first case to articulate a distinction between "primary" and "secondary" benefits. Primary benefits, according to the court, are those an organization actually intends to achieve.[101] A student's academic achievement is an example of a primary benefit from a tax-exempt educational organization. Secondary benefits are those that necessarily result from the pursuit or accomplishment of the primary benefit.[102] Employers of skilled or learned workers, for example, receive a secondary benefit when educational organizations achieve their primary benefit. They gain access to skilled or learned labor. The concept of secondary benefit supports the assertion made here. It is inevitable that an organization will convey a third-party benefit or profit as it pursues and accomplishes the primary goal for which tax exemption is granted.[103] The Service was rightly concerned in *American Campaign Academy*, though, because it appeared that secondary benefits were unnecessarily directed towards a single entity.[104] It is entirely logical that an organization does not serve the "public interest" if its beneficial effects unnecessarily redound to certain select individuals. To the extent an organization makes irrelevant distinctions—i.e., discriminates—between secondary beneficiaries, it cannot be viewed as serving the public interest, at least not exclusively as required by the enabling statute.[105] *American Campaign Academy* summarized these propositions by stating that an organization is not entitled to tax exemption if its secondary

organization. *See* Laura Brown Chisolm, *Politics and Charity: A Proposal for Peaceful Coexistence*, 58 GEO. WASH. L. REV. 308, 344 n.159 (1990). Professor Chisolm makes a strong case that the analysis was skewed by the obvious political nature of the case. Nevertheless, *American Campaign Academy* is often cited as the judicial source of the private benefit doctrine. *See, e.g.*, John D. Colombo, *In Search of Private Benefit*, 58 FLA. L. REV. 1063, 1073–75 (2006).

101. *See Am. Campaign Acad.*, 92 T.C. at 1074.

102. *Id.*

103. "Respondent does not quarrel with the notion that exempt educational organizations must inherently confer private benefits on participating individuals." *Id.*

104. Of course, it may have been tidier and less controversial had the Service sought revocation of tax exemption based on improper political activity. *See* I.R.C. § 501(c)(3) (2006) (regarding the prohibition against participation in political campaigns); Treas. Reg. § 1.501(c)(3)-1(c)(3)(iii) (1989). *See generally* Laura Brown Chisolm, *supra* note 100.

105. *Bob Jones University v. United States* involved a nonprofit organization that made irrelevant distinctions between those who would receive its "primary" benefit—education. 461 U.S. 574 (1983). In that case, the United States Supreme Court held that the nonprofit organization conld not possibly be considered "charitable" so long as it made those distinctions. *Id.* at 605.

beneficial effects are "earmarked for a particular organization or person."[106]

The Service concedes the inevitability of secondary benefits but then extends the private benefit analysis to the point from which present law is derived.[107] The Service refers to inevitable secondary benefits as "qualitative" incidents of charitable activity; if a private benefit does not necessarily occur as a result of the pursuit of the charitable goal, it should cause the denial or revocation of tax exemption.[108] In addition, the Service posits a "quantitative" requirement under which even inevitable secondary benefits can cause the denial or revocation of tax exemption: "To be quantitatively incidental, a benefit must be insubstantial when viewed in relation to the public benefit conferred by the activity."[109] The Service's quantitative requirement can be viewed in one of two ways. First, it can be viewed as a logical extension of the *American Campaign Academy* context. That case condemned a consistent conferral of a secondary benefit on a single entity and, at least in passing, referred to "[o]ccasional economic benefits" as not creating a prohibited private benefit.[110] The court also referred, with apparent approval, to "earmarking" benefits to a particular person as evidence of improper private benefit.[111]

The *American Campaign Academy* context might be relied upon to conclude that the court would have approved of a qualitative

106. *Am. Campaign Acad.*, 92 T.C. at 1074.

107. I.R.S. Gen. Couns. Mem. 39,862 (Nov. 22, 1991) ("In our view, some private benefit is present in all typical hospital-physician relationships. Physicians generally use hospital facilities at no cost to themselves to provide services to private patients for which they earn a fee. The private benefit accruing to the physicians generally can be considered incidental to the overwhelming public benefit resulting from having the combined resources of the hospital and its professional staff available to serve the public.").

108. *Id.*

109. The full discussion on the qualitative and quantitative requirements states:

> Any private benefit arising from a particular activity must be "incidental" in both a qualitative and quantitative sense to the overall public benefit achieved by the activity if the organization is to remain exempt. To be qualitatively incidental, a private benefit must occur as a necessary concomitant of the activity that benefits the public at large; in other words, the benefit to the public cannot be achieved without necessarily benefiting private individuals. Such benefits might also be characterized as indirect or unintentional. To be quantitatively incidental, a benefit must be insubstantial when viewed in relation to the public benefit conferred by the activity.

Id.

110. *Am. Campaign Acad.*, 92 T.C at 1066.

111. *Id.* at 1074.

requirement; the rationale in that case condoned only an occasional secondary benefit flowing to "nonselect" individuals. Perhaps a secondary benefit must always be "substantial," and thus improper, if it is consistently conferred on a single person or entity instead of being widely dispersed and conferred only occasionally.[112] Thus, although it did not say so, the court might have viewed the consistent, rather than occasional, conferral of a secondary benefit on a single noncharitable third party, even one absolutely necessary to the accomplishment of the goal for which tax exemption is statutorily authorized, as simply too much. The strongest evidence available for this conjecture is that the courts have rarher consistently approved of the Service's suspicion and its restrictive approaches to third-party profit-taking since the 1991 ruling.

A second, more economically grounded way of interpreting the Service's quantitative requirement is that it expresses a conclusion that some charitable goals deemed sufficient for tax exemption by an act of Congress are just too expensive. Though the market may demand a certain price, the Service essentially concludes that in some cases the price is too high.[113] In either case, the gist of present law is that (1) a continual benefit (2) flowing exclusively to a single noncharitable third party (3) as a consequence of achieving an organization's primary goal is, nonetheless, irreconcilable with tax exemption even if the primary goal cannot be achieved in the absence of the third-party benefit. The next section explores the logic and policy of the Service's approach. For now, though, it is helpful to recall the consequences of that approach using the contexts identified in the prior section, and to compare the consequences arising from situations that might be viewed as conferring "occasional" private benefit.

The aversion to third-party profit has spawned uncertainty, at best, and barriers, at worst, with respect to a number of transactions

112. The government appears to have used this argument in *American Campaign Academy*:

> Respondent contends that where the training of individuals is focused on furthering a particular targeted private interest, the conferred secondary benefit ceases to be incidental to the providing organization's exempt purposes. By contrast, respondent contends that when secondary benefits are broadly distributed, they become incidental to the organization's exempt purposes.

Id. The best that can be said about the opinion is that it is too muddled to know whether the Tax Court adopted this analysis.

113. *See supra* note 109 and accompanying text.

either helpful or absolutely necessary to an organization's charitable goal. The aversion explains, for example, why the Service challenges tax exemption when an organization enters into exclusive and thoroughly necessary fundraising,[114] health care,[115] or housing joint ventures.[116] Those transactions evince each of the three prongs comprising present law and have therefote been successfully blocked, even when it has been proven that the charitable goal cannot otherwise be achieved. The result, seemingly inconsequential to the Service and the courts, is that charitable goals remain unfulfilled by either the charitable or for-profit market. The aversion might also explain the suspicion applied in recent years to less explicit but economically similar types of third-party profit-taking. The grant of pouring rights—whereby Coke or Pepsi, for example, obtains the exclusive right to sell soft drinks during tax-exempt sporting events, and the like[117]—has generated challenges to tax exemption. Exclusive pouring rights are but a variation of the larger corporate sponsorship phenomenon whereby a third party obtains exclusive or nonexclusive naming rights, for example, to a university's basketball stadium or other large advertising venue.[118] The transactions boil down to partnerships through which a third party is granted continual and exclusive access, though indirect, to a revenue stream generated by the organization's accomplishment of its primary purpose.[119] These less explicit third-party profit transactions do not jeopardize an organization's entire tax exemption, but are nevertheless taxed on an

114. United Cancer Council v. Comm'r, 109 T.C. 326 (1997), *rev'd*, 165 F.3d 1173 (7th Cir. 1999) (exemplifying a challenge to third-party profit-taking in the fundraising context).

115. St. David's Health Care Sys. v. United States, 349 F.3d 232 (5th Cir. 2003) (exemplifying a challenge to third-party profit-taking in the health care context).

116. Hous. Pioneers, Inc. v. Comm'r, 58 F.3d 401 (9th Cir. 1995) (exemplifying a challenge to third-party profit-taking in the housing context).

117. *See* Frances R. Hill, *Targeting Exemption for Charitable Efficiency: Designing a Nondiversion Constraint*, 56 SMU L. REV. 675, 690 (2003) (stating that under a pouring rights contract, "an organization receives a fee for agreeing that a particular brand will be the only brand of a particular product available on the property of or at an event run by that organization").

118. *See generally* Edward L. Palmer & Lisa Sofio, *Food and Beverage Marketing to Children in School*, 39 LOY. L.A. L. REV. 33 (2006); Christian Maximilian Voigt, *"What's Really in the Package of a Naming Rights Deal?" Service Mark Rights and the Naming Rights of Professional Sports Stadiums*, 11 J. INTELL. PROP. L. 327 (2004).

119. *See, e.g.*, Voigt, *supra* note 118, at 330 (noting that pouring rights granted to PepsiCo at the Pepsi Center in Denver provided a revenue stream separate from the organization's primary purpose to house sporting events).

individual transactional basis precisely because of the exclusivity granted by the nonprofit organization.[120]

It is also helpful to compare the law's current approach to *explicit* third-party profit-taking with the consequences resulting from *implicit* third-party profit-taking. It is a settled legal principle that nonprofit organizations are entitled to pay reasonable amounts for necessary goods and services.[121] That principle precludes any challenge to tax exemption on the basis that a nonprofit health care organization hires individual physicians or even a physician practice group for a fixed, market-rate fee (paid from the organization's revenues) to provide services necessary to operate a particular hospital department. Nor could there be an objection if a nonprofit organization hired a fundraiser or housing developer on a nonexclusive basis to provide goods or services required for the accomplishment of its goal.[122] In these cases, though, there is

120. An interesting point with regard to corporate sponsorships is that although a third party reaps secondary benefits, sometimes exclusively, from an organization's pursuit of its charitable goal, the analytical focus is not concerned with whether the organization is conferring an impermissible private benefit. Instead, the analysis focuses on whether the grant of a franchise—by way of the exclusive sponsorship arrangement—generates unrelated business taxable income. Concerns about corporate sponsorships were first officially raised when the Service issued an administrative ruling stating that sponsorship revenues were subject to taxation as unrelated business income. I.R.S. Tech. Adv. Mem. 91-47-007 (Aug. 16, 1991). The ruling provoked an intense lobbying effort led primarily by representatives of NCAA bowl games. *See generally* Elizabeth M. Roberts, *Presented To You By . . . : Corporate Sponsorship and the Unrelated Business Income*, 17 VA. TAX REV. 399 (1997). In 1993, the Service issued proposed regulations intended to codify the administrative holding. Taxation of Tax-Exempt Organizations' Income from Corporate Sponsorship, 58 Fed. Reg. 5690 (proposed Jan. 22, 1993) (later withdrawn). Congress responded by enacting a statute intended to reinstate the nontaxable nature of corporate sponsorships existing prior to the administrative ruling. *See* I.R.C. § 513(i) (2006). Thereafter, the Service withdrew the first set of proposed regulations and proposed a different set of regulations. Taxation of Tax-Exempt Organizations' Income from Corporate Sponsorship, 65 Fed. Reg. 11,012 (Mar. 1, 2000) (to be codified at 26 C.F.R. pt. 1). The proposed regulations were finally enacted in 2002 more than ten years after the first expression of concern. Treas. Reg. § 1.513-4 (2002). Though they focus on unrelated business income rather than private benefit, the regulations nevertheless use the same criteria—exclusivity—to withdraw tax exemption. The sale of nonexclusive pouring rights, for example, will not generate taxable income while the sale of exclusive pouring rights will generate taxable income. *Id.* § 1.513-4(c)(2)(vi)(B). Essentially, tax exemption is withdrawn with respect to a particular transaction if the organization trades with only one party.

121. *See* Consuelo Lauda Kertz, *Executive Compensation Dilemmas in Tax-Exempt Organizations: Reasonableness, Comparability, and Disclosure*, 71 TUL. L. REV. 819, 833–34 (1997).

122. *See* United Cancer Council v. Comm'r, 165 F.3d 1173, 1178 (7th Cir. 1999) (pointing out that there would not have been an issue with regard to the private inurement prohibition if the taxpayer had hired many individuals to perform necessary fundraising rather

necessarily an implicit sharing of the organization's revenue (or "profit") to achieve a charitable purpose. The law expresses no objection in these cases, except that the amount paid must not be so unreasonable that it is tantamount to the conveyance of a dividend or profit.[123]

As previously noted, scientific research regulations allow a nonprofit organization to grant exclusive rights to a variable fee (i.e., royalties) from new technology.[124] Those regulations suggest that third-party exclusivity is condoned only when necessary to achieve a greater good; an explanation more consistent with present law's antipathy to explicit third-party profit-taking might be that exclusive rights with respecr to a *single* charitable asset is tantamount to an occasional rather than continuing third-party benefit.[125] If an organization conveyed the rights to all of its assets solely to a single third party, the law might react in the same way it does with regard to other explicit third-party profit-taking.

The Service's objection to explicit third-party profit-taking may simply be a matter of degree; admitting that would ultimately weaken the objection. Should the law distinguish between occasional and continual third-party benefit? In each of the transactions discussed above, for example, there is necessarily a sharing of the organization's revenue, whether referred to as "profit" or "cost," to achieve a goal for which tax exemption has been granted. More precisely, in each transaction, a noncharitable third party financially benefits as a consequence of the organization's pursuit of the public good. In some circumstances, then, the law treats that benefit as improper profit-sharing and thereafter condemns the transaction by

than just one fundraiser).

123. Kertz, *supra* note 121, at 835 ("The question asked is whether the compensation is reasonable because it is made for services actually rendered, or whether the payment is a prohibited dividend-like distribution to those who control the organization.").

124. *See* Sinclair & Galaskiewicz, *supra* note 89, at 1070.

125. The Service's approach to "ancillary joint ventures," as compared to joint ventures involving all the assets of a nonprofit organization, supports this notion. As noted earlier, this challenges certain joint ventures unless they meet very stringent requirements designed to guard against private benefit. Those requirements do not apply, though, if the joint ventnre involves only a small portion of an organization's assets. *See* Rev. Rul. 2004-51, 2004-1 C.B. 974. The fact that only a small portion of the assets are subject to the arrangement is apparently sufficient to alleviate any concerns regarding private benefit. The distinction is difficult to understand. That an organization can license its intellectual property to a single vendor without being taxed—an exclusive partnership, in effect, with regard to a single asset—also supports the point. I.R.C. § 512(b)(2) (2006).

revoking tax exemption. In others, the law treats the third-party benefit as nothing more than the legitimate cost of achieving the charitable goal, and thus, insufficient grounds for revocation of the tax exemption. The only difference between the two types of transactions is that in the former a third party enjoys a continual exclusive relationship with the organization while in the latter the third-party relationship is better described as *ad hoc*. All that is left, then, is to ponder why tax exemption is inconsistent with a select third party obtaining wealth from the accomplishment of a charitable goal, even when the charitable goal cannot otherwise be accomplished.

IV. AN EFFICIENCY ANALYSIS OF THIRD-PARTY PROFIT-TAKING

Present law has no quarrel with what this Article refers to as implicit profit-taking, such as when various "nonselect" individuals occasionally profit from the goods or services they sell to nonprofit organizations at market rates.[126] The law reacts viscerally, though, to what is referred to as explicit profit-taking, such as occurs when certain "select" individuals continually profit from the goods and services they sell to nonprofit organizations even at market rates.[127]

126. *See* Kertz, *supra* note 121, at 833–34.

127. I have previously argued that when an insider grants herself a franchise with respect to a nonprofit organization she runs afoul of the prohibition against private inurement. *See* Jones, *supra* note 5, at 620–39. Thus, if a nonprofit manager purchases all of the organization's supplies exclusively from the manager's separately-owned entity, even at market rates, there is an inherent and unavoidable conflict of interest that threatens the fiduciary obligations sought to be enforced by the private inurement prohibition. Recently, however, the Service has proposed a new regulation that would label this transaction a private benefit violation:

> *Example 3.* (i) O is an educational organization the purpose of which is to train individuals in a program developed by P, O's president. All of the rights to the program are owned by Company K, a for-profit corporation owned by P. Prior to the existence of O, the teaching of the program was conducted by Company K. O licenses, from Company K, the right to use a reference to the program in O's name and the right to teach the program, in exchange for specified royalty payments. Under the license agreement, Company K provides O with the services of trainers and with course materials on the program. O may develop and copyright new course materials on the program but all such materials must be assigned to Company K without consideration if the license agreement is terminated. Company K sets the tuition for the seminars and lectures on the program conducted by O. O has agreed not to become involved in any activity resembling the program or its implementation for 2 years after the termination of O's license agreement.
>
> (ii) O's sole activity is conducting seminars and lectures on the program. This arrangement causes O to be operated for the benefit of P and Company K in

The difference between implicit and explicit profit-taking, though, is only a matter of degree. The accepted premise in either case is that the nonprofit organization is purchasing the goods or services necessary to the accomplishment of the charitable goal. A nonprofit organization will inevitably have to purchase some necessary goods and services from a profit-seeker and in doing so will pay market prices. So long as market rates apply to either circumstance, the nonprofit organization will convey at least the same amount of profit to implicit profit-takers as it does to explicit profit-takers.[128] In fact, implicit profit-taking should be more expensive to the nonprofit organization than explicit profit-taking.[129] It is economically

> violation of the restriction on private benefit in §1.501(c)(3)-1(d)(1)(ii), regardless of whether the royalty payments from O to Company K for the right to teach the program are reasonable. Based on these facts and circumstances, O is not operated exclusively for exempt purposes and, therefore, is not described in section 501(c)(3).

Prop. Treas. Reg. § 1.501(c)(3)-1(d)(iii), 70 Fed. Reg. 53,601, 53,601-02 (Sept. 9, 2005). It is precisely because the transaction impairs a fiduciary obligation—regardless of whether it prevents a public benefit—that it should be labeled private inurement rather than private benefit. The difference is not insignificant because there is authority for the proposition that private benefit will not cause the revocation of tax exemption if the private benefit is "insubstantial" compared to the public good achieved. *See* Am. Campaign Acad. v. Comm'r, 92 T.C. 1053, 1066 (1989) ("Thus, should petitioner be shown to benefit private interests, it will be deemed to further a nonexempt purpose under section 1.501(c)(3)-1(d)(1)(ii), Income Tax Regs. This nonexempt purpose will prevent petitioner from operating primarily for exempt purposes absent a showing that no more than an insubstantial part of its activities further the private interests or any other nonexempt purposes. Section 1.501(c)(3)-1(c)(1), Income Tax Regs."). The above quoted example does not specifically address that authority. The example could be interpreted as excluding the possibility of insubstantial private benefit under these circumstances and, if so, that would cure my objection. In any event, there is no such de minimis exception with regard to private inurement. *See* Orange County Agric. Soc'y, Inc. v. Comm'r, 893 F.2d 529, 534 (2d Cir. 1990); Jones, *supra* note 5, at 604 ("The case law generally confirms that any overpayment in favor of the insider, no matter how small, results in private inurement.").

128. Wholesale price is simply retail price less the hypothetical costs of sale.

> Although retail prices tend to be higher than wholesale prices, this is because it costs more to sell at retail. Not only can there be, therefore, no presumption that the net gains to the seller are different at the two levels, but economic theory implies that returns at the two levels will tend toward equality, since until they are equalized dealers will have incentives to enter at the level where the higher returns are being earned and by entering will bid those returns down.

Contrail Leasing Partners, Ltd. v. Consol. Airways, Inc., 742 F.2d 1095, 1101 (7th Cir. 1984).

129. Implicit profit takers are here rendered analogous to retail sellers and, in order to achieve a profit, must pass along their additional retail costs to the buyer. The profit to the implicit profit taker will not be greater than it is to the explicit profit taker because the implicit profit taker will have more costs to offset against the higher retail price. *See id.* The cost to the purchaser, however, will be higher because the retailer must pass along her sales cost to the

inefficient to require a charitable organization to pay higher costs for the same or a lesser amount of services or goods.[130]

The only difference between implicit and explicit profit-taking, a difference with apparent significance to the Service, is that explicit third-party profit-taking conveys profit on a single individual or entity. The difference is admittedly not entirely without consequence. That a single, noncharitable third party might become very rich, or just conspicuously wealthier, through a business association with a tax-subsidized entity is sufficient to raise questions regarding the appropriateness of tax exemption. Conspicuous wealth generates resentment in those who do not have it;[131] its attainment as a result of charitable functions could also result in reputational harm to the charitable sector as a whole.[132] The chances of any single person or entity getting rich through implicit profit-taking are much smaller, as are the chances that resentment towards the charitable sector might result in lower donor patronage. There are also pragmatic reasons explaining why explicit third-party profit-taking is cause for concern. Explicit third-party profit-taking increases the mathematical possibility, though certainly not the inevitability, that the public benefit will be entirely excluded, since increased payments to noncharitable persons necessarily decreases payments to charitable beneficiaries.[133] The law would be an ass, indeed, if it did not make

consumer.

130. A law is most efficient, either under the Pareto or Kaldor-Hicks definition, when no change to that law can cause at least one person to be better off without causing at least one other person to be worse off. *See* Patrick B. Crawford, *The Utility of the Efficiency/Equity Dichotomy in Tax Policy Analysis*, 16 VA. TAX REV. 501, 516–522 (1997) (describing Pareto efficiency and Kaldor-Hicks efficiency). My argument that present law is inefficient is therefore based on the observation that the law could be changed to the advantage of charitable beneficiaries without creating a disadvantage for anyone else.

131. *See* Edward J. McCaffery, *The Tyranny of Money*, 98 MICH. L. REV. 2126, 2126 (2000) ("A human activity almost as venerable as the accumulation and opulent display of vast riches is the condemnation of the accumulation and opulent display of vast riches.").

132. *See, e.g.*, Debra Morris, *New Charity Regulation Proposals for England and Wales: Overdue or Overdone?* 80 CHI.-KENT. L. REV. 779, 780 (2005); Mark Sidel, *The Guardians Guarding Themselves: A Comparative Perspective on Nonprofit Self-Regulation*, 80 CHI.-KENT. L. REV. 803, 805–06 (2005). Both articles discuss the extent to which improper wealth-taking has a negative impact on financial support of charitable organizations. This Article, of course, is not concerned with improper behavior, but the effect should be the same to the extent the public thinks that becoming rich by selling goods to a charitable organization is always improper.

133. This is the precise policy-oriented concern raised by Judge Posner in *United Cancer Council, Inc.* when he speculated that "[m]aybe desperate charities should be encouraged to

provisions for the reasonable possibility of harm arising even from necessary transactions. The law would demonstrate just as much obstinacy, though, if it insisted on an approach that extinguished the possibility of the bad as well as the good. This is the state of the law today; the law prohibits the bad and precludes the good. The task, then, is to devise an analytical approach that would render explicit third-party profit-taking sufficiently like implicit third-party profit-taking so as to further the good while prohibiting the bad.

Condemning both the good with the bad, as does present law, constitutes a failure to make a logical distinction. There can be no argument against the proposition that tax exemption is not intended to make people wealthy, at least not in the financial sense. If that is nevertheless an unintended consequence, the law should logically be concerned. If the cause of the unintended consequence has nothing to do with the law's purpose—the accomplishment of a charitable goal—then the effect should be prohibited just as much as the intent. If, on the other hand, the cause is something related to the accomplishment of the charitable goal, there ought to be more questions asked before the effect is categorically prohibited as well.[134] Present law acknowledges that the cause of explicit third-party profit-taking is oftentimes a transaction necessary to the accomplishment of a charitable goal, but the law fails because it does not ask additional questions. Principal among the further questions is the extent to which the goal might be accomplished without explicit third-party profit-taking. In other words, how indispensable is explicit third-party profit-taking to the charitable goal? If the necessity of explicit third-party profit-taking is questionable even to a disinterested observer, the law should indeed exhibit close and skeptical scrutiny

fold rather than to embark on expensive campaigns to raise funds." United Cancer Council, Inc. v. Comm'r, 165 F.3d 1173, 1178 (7th Cir. 1999). The remark was made in the context of a finding that the charity's expenses were indeed very high but nevertheless the result of the "best bargain" the charity could get. *Id.*

134. See Treas. Reg. § 1.501(c)(3)-1(e) (1990), which invites inquiry into objective facts to determine the purpose of a presumptively noncharitable activity. ("An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes.").

upon its occurrence. This point is addressed below. For now, let us stipulate, for the sake of argument, that explicit third-party profit-taking is indispensable to some charitable goals. If the stipulation is accurate, present law antipathy can be based on one of two likely assumptions. First, present law might assume that conspicuous wealth occurring as an inevitable consequence of the accomplishment of a charitable goal is, by itself, too great a price to pay for the charitable goal, as compared to the price of implicit profit-taking.[135] Second, present law might assume that the occurrence of conspicuous wealth categorically precludes the occurrence of public benefit. The first assumption is irrational to the extent that it doesn't recognize that the aggregate third-party profit is the same whether wealth is explicit or implicit (conspicuous or inconspicuous). The second assumption is a ***non sequitur*** because of the capitalist doxology that the pursuit of individual profit is the fount of public good.[136] If the public good is derived not just incidentally, but exclusively from the pnrsuit of individual profit, it

135. *See supra* notes 109–11 and accompanying text; *cf. United Cancer Council*, 165 F.3d at 1178.

136. That the pursuit of individual gain is the source of public good was famously expressed by Adam Smith:

> But the annual revenue of every society is always precisely equal to the exchangeable value of the whole annual produce of its industry, or rather is precisely the same thing with that exchangeable value. As every individual, therefore, endeavors as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of the greatest value; every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was not part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. It is an affectation, indeed, not very common among merchants, and very few words need be employed in dissuading them from it.

Adam Smith, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776), *reprinted in* 39 GREAT BOOKS OF THE WESTERN WORLD 194 (William Benton ed., 1952); *see also* Zamir, *supra* note 33, at 246 ("The crux of standard economic theory is that, given certain assumptions, the sum (or average) of human well-being is maximized if everyone acts so as to maximize her own well-being. The rules of supply and demand lead to an optimal allocation of resources and entitlements, and thus to the maximization of total well-being (measured for each person by the sum of money she is willing to pay for any entitlement).").

must also be true that public benefit cannot be achieved in the absence of private benefit.[137]

There is a rather latent, though no less important, separation of powers concern related to the first conclusion—that conspicuous wealth is just too great a price for any charitable goal: Congress grants tax exemption for charitable health care, defined as health care for indigent patients and medical research into new cures.[138] Assume, for the moment, that the tax-exempt goal can be accomplished only through certain market mechanisms that inevitably convey conspicuous wealth, such as by gaining access to a wholesale market via a franchise or partnership. Allowing the Service to effectively preclude charitable health care organizations from the single mechanism by which the goal can be accomplished is tantamount to a repeal of the statutorily granted tax exemption with respect to the particular goal. That is, in effect, what the Service authorizes itself to do through the quantitative aspect of its private benefit analysis. Recall that under the quantitative analysis, the necessary and inevitable private benefit must be "insubstantial" in relation to the charitable goal.[139] The Service essentially assumes the role of legislator when it concludes that an inevitable and necessary cost of a congressionally authorized charitable goal is too high and shall not be paid. *Plumstead* represents the rare occasion where the usurpation is relatively undisguised, and the court rightly, if unknowingly, rejects the Service's exercise of legislative authority.[140] In most cases, however, the quantitative analysis is sufficiently obscured by sensational facts or alternative reasons that the courts are seemingly oblivious to the separation of powers issue.

137. "[E]xempt educational organizations must inherently confer private benefits on participating [i.e., noncharitable] individuals." Am. Campaign Acad. v. Comm'r, 92 T.C. 1053, 1074 (1989).

138. *See* Rev. Rul. 69-545, 1969-2 C.B. 117. For an informative overview of the tax exemption requirements pertaining to health care organizations, see John M. Quirk, *Turning Back the Clock on the Health Care Standard for Tax Exemption*, 43 WILLAMETTE L. REV. 69 (2007).

139. *See supra* note 109 and accompanying text.

140. *See, e.g.*, *United Cancer Council*, 165 F.3d at 1173 (rejecting the assertion that fundraising contracts using a profit share necessarily resulted in revocation of tax exemption); Plumstead Theatre Soc'y v. Comm'r, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982) (rejecting a categorical bar to partnerships between nonprofit and for-profit entities as necessary to accomplish a charitable goal).

The two assumptions identified above should also be analyzed using the same parameters applied throughout tax jurisprudence. Do the assumptions contribute to the efficient accomplishment of the sought-after good; do they lead to the most equitable outcome?[141] The first assumption, that conspicuous wealth is simply too great a price, considered in light of the stipulation that explicit third-party profit-taking is indispensable, leads to inefficiency because it essentially bars nonprofit organizations from the benefits of wholesale markets. The defining characteristics of wholesale markets are exclusivity and bulk sales. Exclusivity and bulk sales allow wholesalers to set prices lower than the prices that prevail in retail markets. Retail markets, on the other hand, are characterized by ad hoc sales and nonexclusivity. Prices are higher on individual sales because of the additional expenses generated at retail levels. Consumers who require a large and continuous supply of a certain good or service in any event are therefore better off purchasing on a wholesale rather than a retail basis. In fact, a purchaser of wholesale goods will pay less than the retail purchaser, all other things being equal.[142] Purchasers of goods and services on the wholesale market essentially grant a franchise to the seller with regard to the purchased good or service. The relationship is necessarily mutually beneficial; the purchaser benefits from the lower prices, while the seller benefits from the franchise.

Explicit profit-taking transactions are often nothing more than nonprofit organizations participating in an available wholesale market when it is advantageous or necessary to do so. In prototypical health care or housing transactions, a nonprofit organization may need health care providers or builders, for example, to achieve a charitable purpose. For various reasons, those necessary service providers may be unavailable on a retail basis. If the nonprofit organization can guarantee a certain sales volume, the service providers will more likely deal with the organization at a price that is affordable or reasonably desirable to the nonprofit organization. This hardly seems objectionable. The service providers will reap a benefit that would not otherwise occur and, given the stipulation that the

141. *See* Crawford, *supra* note 130, at 502 ("The standard analytical model used in tax policy eases the burden by neatly separating efficiency and equity issues, purportedly freeing tax policy analysts to settle determinate efficiency issues before tackling the more amorphous equity components.").

142. *See id.*

charitable goal would not otherwise be attained, so too will charitable beneficiaries.

The sole basis upon which this outcome should cause consternation is that if it were simply untrue. One reason this might be is that there are other means to achieve the charitable goal. The law can account for this possibility by placing the burden on charitable fiduciaries to prove the lack of alternatives other than resorting to the wholesale market. A second, more global, possibility is that the explicit (conspicuous) third-party profit-taking generates distrust with respect to the entire charitable sector and that distrust could translate into lower aggregate financial support for the entire sector. A third possible reason is that conspicuous third-party profit-taking necessarily precludes public benefit in the specific instance in which the third-party profit-taking occurs. If, in fact, any of these objections prevail—if third-party profit-taking does not accomplish otherwise unattainable charitable goals—then the objections under present law would be legitimate. None of the possible reasons for doubting the outcome could withstand close scrutiny.

Even if third-party profit-taking were merely helpful, rather than indispensable to the charitable goal, its occurrence would not preclude public benefit. The Service agreed with this proposition once when it stated that it was unnecessary that a charitable organization prove that a recognized charitable goal could not be accomplished but for the explicit third-party profit-taking.[143] The lack of a "but-for" requirement meant that the transaction need only have been helpful to the charitable goal. If it is assumed, though, that a negative effect occurs when third-party profit-taking is merely helpful, then it would still be unnecessary to completely bar the transaction. A better approach would be to impose the same requirement that exists with respect to the exclusive licensing of new technology derived from tax-exempt scientific organizations.[144] Under that approach, explicit third-party profit-taking would be permitted only if it was the only "practicable" way to achieve the charitable goal. That approach would theoretically impose a higher requirement than "merely helpful" without categorically barring the transaction.

143. *See, e.g.*, I.R.S. Gen. Couns. Mem. 39,732 (May 19, 1988).

144. *See* Treas. Reg. § 1.502(c)(3)-1(d)(5)(iii) (2002).

The second possible reason why explicit third-party profit-taking might be deleterious to charitable goals is less logical but harder to dismiss: People question tax exemption when other people become conspicuously wealthier as a result of nonprofit organizations.[145] Whether the questions arise from unfounded suspicion or irrational envy is beside the point if public support for the charitable sector nevertheless decreases as a result. So long as the wealth is derived via market rate transactions, though, there really is no logical reason for suspicion or envy. The law should not react to the public's failure to distinguish between purpose and effect, even if that failure causes some harm. Suffering the consequences of irrational envy should instead be viewed as an unavoidable cost of achieving a greater benefit. This reasoning, in fact, has been accepted by the Service with regard to the closely related private inurement prohibition. The Service has pointedly stated that there is no cause to question tax exemption when an insider is paid a salary determined by reference to for-profit markets.[146] If the market dictates conspicuous wealth, then so be it, according to recently enacted regulations.[147] Implicit in that decision is the idea that the goal cannot be achieved except under the terms imposed by the market, and that concession to irrational envy would create unreasonable barriers to the charitable goal. This same rationale should apply when the market dictates explicit third-party profit-taking.

The private inurement prohibition rightly assumes that when insiders "siphon" an exempt organization's wealth to their personal enjoyment, the charitable goal necessarily suffers.[148] That assumption makes sense because the resources unnecessarily diverted to an insider's personal enjoyment could have been used for the charitable goal. The assumption is based on the notion that the organization has essentially paid a dividend to a de facto shareholder. The

145. *See* Sidel, *supra* note 132, at 804–05.

146. Mabee Petroleum Corp. v. United States, 203 F.2d 872 (5th Cir. 1953) (explaining that charitable organizations are entitled to pay "reasonable salaries"); Treas. Reg. § 53.4958-4(b)(1)(ii) (2002) (defining "reasonable compensation" by reference to market rates paid by similar entities, whether nonprofit or for-profit); Treas. Reg. § 53.4958-6(c)(2)(i) (2002) (noting that compensation paid by similar entities, whether nonprofit or for-profit, is relevant to the determination of "reasonable compensation").

147. Treas. Reg. § 53.4958-6(c)(2)(i) (2002) (stating that compensation paid by similarly situated for-profit entities is a relevant factor in determining whether a nonprofit organization's employee compensation is reasonable).

148. *See* Jones, *supra* note 5, at 647.

payment means that the organization is no different from a for-profit organization and is therefore not entitled to tax exemption. It would be incorrect, though, to assume the same with regard to third-party profit-taking, particularly if the transaction is necessary in the strictest sense to the charitable goal.[149] Yet, if the first two possible reasons underlying present law are excluded, that assumption is all that is left. Explicit third-party profit-taking, necessary to the charitable goal, must be prohibited solely under the belief that third-party profit-taking is inherently inconsistent with public benefit. Professor Francis Hill notes that present law mistakenly assumes that the absence of private benefit assures public benefit.[150] She argues that the absence of private benefit doesn't logically assure the charitable goal is being achieved because charitable assets might nevertheless be diverted from the public good in other ways. The same mistake, in opposite terms, is made with regard to the presence of private benefit. Present law assumes, at least with regard to explicit third-party profit-taking, that the presence of private benefit assures the absence of public benefit and therefore justifies denial or revocation of tax exemption. The presence of private benefit, though, is not logically synonymous with the absence of public benefit. If anything, the presence of public benefit very nearly assures some private benefit if, as is the premise of this Article, a nonprofit organization must necessarily engage for-profit vendors to achieve the charitable goal. If private benefit precluded public benefit, then all third-party profit-taking, whether implicit or explicit, would be barred. Such a result would prevent the accomplishment of most charitable goals.

Present law is inefficient, at best, because it unnecessarily prevents the accomplishment of charitable goals at the least possible cost. In effect, present law bars nonprofit organizations from

149. The requirement that a private benefit must be "qualitatively" incidental to the charitable goal precludes the conclusion that the benefit prevents the accomplishment of the charitable goal. *See supra* note 109 and accompanying text.

150. Hill, *supra* note 117, at 683 ("The absence of a private benefit does not in itself establish the presence of a public benefit. A hospital may pay appropriate compensation based on comparable compensation arrangements in that area but still not provide a community benefit and thus would not qualify for exemption as an organization described in 501(c)(3). An organization established to study the effect of acid rain on coniferous trees may pay modest salaries and engage in no other private benefit activity but still either do no studies or never release any of its studies to the public. In these cases, there is an absence of private benefit and an absence of public benefit. The error of current law is to conflate the absence of a private benefit with the presence of a public benefit.").

wholesale markets and the corresponding ability to cheaply obtain necessary goods and services. The ultimate effect is that nonprofit organizations must either pay higher retail prices, because those prices result only in permissible ad hoc private benefit (implicit private benefit), or forego the charitable goal altogether. Evaluating present law as a matter of equity is a bit more difficult because "equity" is such an elusive concept. For example, if present law doesn't prevent the receipt of something to which people are entitled, it can logically be argued that "life just isn't fair," but not because of the law. Another way of viewing the problem is that if present law unnecessarily perpetuates social injustices, the law should logically be viewed as an actual source of social or economic inequity. We might even view the latter proposition from an efficiency standpoint because people who unnecessarily suffer social inequity create costs for society at large.

V. AN EQUITY ANALYSIS OF THIRD-PARTY PROFIT-TAKING

The apparent morality underlying the current approach to taxable/tax-exempt partnerships is that profit-seeking is synonymous with greed and greed has nothing to do with charity.[151] The argument goes further. When charity enters into a partnership with profit, the reasoning goes, charity necessarily dissolves and tax exemption should be withdrawn, except in those rare and irrational cases in which profit potential is stripped completely from the partnership.[152] The implication, one disproved in prior sections, is that profit-making necessarily precludes charity. A frequent refrain, in fact, is that charity and profit-making simply can never coexist.[153] This viewpoint implies that when a nonprofit organization concedes to profit-taking, even by those with no official connection to the organization, it will eventually be captured by the profit-seekers and charity will suffer. The argument assumes too much. Nonprofit organizations already coexist with profit-seekers in a mostly profit-seeking world. All those with whom it must transact are profit seekers, and yet it is illogical to assume that the nonprofit organization is really a for-profit wolf in nonprofit sheep's clothing. The fear can also be alleviated by simply enforcing what is already

151. *See* Streckfus, *supra* note 34, at 1307.

152. *See id.*

153. *See id.*

required of nonprofit boards. If nonprofit managers act independently, and after informing themselves of the relevant facts and circumstances, the law can safely assume that the organization will not be captured by third-party profit-seekers. The law need only impose independent and informed decision-making requirements to prevent the potential harm, indeed as it does in the for-profit world via the business judgment rule.[154]

The unfairness that prevails under present law has much to do with the observation that the burden of indignation[155] over conspicuous wealth arising from nonprofit operations is felt most by those who would benefit the most from a contrary rule and who, by definition, are the neediest. That is, present law imposes a regressive burden—the most hardship on those with the least resources.[156] If neither the for-profit market nor governments provide certain necessary public goods (such as housing and health care) in adequate quantities, it is only the poor who suffer when legal rules prevent private parties from filling the unmet need. The relatively affluent can purchase those goods; the indignation to third-party profit-taking cost them nothing directly. Nor, in fact, does the indignation profit anyone. It seems apparent, for example, that the indignation does not result in sufficient housing and health care being made available to the poor via government or the market because the crisis in housing and health care continues unabated.[157] Perhaps the equity analysis would work out differently if indeed government or the market provided universal housing and health care. So long as they do not, however, a legal rule that unnecessarily prevents private actors from providing a remedy is manifestly unfair.[158]

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154. *Cf.* Miller & Rutledge, *supra* note 36, at 345.

155. *See* McCaffery, *supra* note 131, at 2126.

156. Clark C. Havighurst & Barak D. Richman, *Distributive Injustice(s) in American Health Care*, 69 LAW & CONTEMP. PROBS. 7 (2006) (regarding the "regressive" nature of the American health care system in which the greatest burdens are placed on those with the least amount of income).

157. Jonathan Oberlander, *The Political Economy of Unfairness in U.S. Health Policy*, 69 LAW & CONTEMP. PROBS. 245, 245 (2006) ("The American health care system presents an intriguing paradox: it is perennially in crisis, yet seemingly impervious to comprehensive reform."); *see also* John J. Ammann, *Housing Out the Poor*, 19 ST. LOUIS U. PUB. L. REV. 309 (2000) (arguing that federal housing policy makes it harder for poor people to attain adequate housing).

158. I am admittedly setting forth a "natural law" assertion here to the extent I am appealing to what I believe to be a universally understood and agreed upon fact: that unnecessarily perpetuating harm is unfair.

Reasonable people may disagree about what is "fair" and what is not "fair." Reasonable people may likewise disagree about whether the failure of government and profit-seekers to provide essential goods and services to the poor and working poor is an injustice for which society is responsible. On the other hand, reasonable people are unlikely to disagree that the law's unnecessary prevention of a cure or remedy for a universally recognized harm is "unfair," however that term is defined by different individuals. Suffering harm is perhaps fair when harm is necessary, unfair when the harm is unnecessary. Thus, if tax exemption jurisprudence prevents nonprofit organizations from alleviating housing and health care shortages *unnecessarily*, that too is unfair. Any area of law that *unnecessarily* perpetuates recognizable harm must be viewed as unfair under principles of natural law. If, rather than rescuing the poor and working poor from profit-seekers, tax exemption jurisprudence leaves them as they are without a reasonable cause, it can safely be labeled unfair.

Despite its elegance, or lack thereof, nothing can definitively prove or disprove the latter assertion. A Rawlsian analysis helps, though Rawls' elegance is not a guarantee of ultimate truth.[159] Ultimately, Rawlsian analysis asserts that people view as fair only that which is in their own self-interest, assuming, *ex ante*, that they shall occupy the most disadvantageous societal position.[160] In other words, the only objective measure of fairness is that taken by those who have nothing. If citizens had to decide upon a legal structure prior to knowing their position in society, would they agree to prohibit the sorts of transactions effectively prohibited under present tax exemption jurisprudence?[161] Would they do so even accepting the premise that neither government nor the capitalist market would sufficiently provide certain necessary goods or services, some of which are indispensable to human existence? Rawlsian analysis would answer both questions in the negative. It would be against self-interest, from the perspective of the most disadvantageous socio-economic position, and therefore unfair, to tolerate present tax

159. *See generally* JOHN RAWLS, A THEORY OF JUSTICE (1971).

160. *See id.*

161. *See id.* at 136–37 (regarding the "veil of ignorance" whereby citizens must decide upon legal rules before knowing their class or social position in society).

exemption jurisprudence insofar as it prevents remediation of societal problems for those among us with nothing.

As noted earlier, Rawlsian philosophy cannot be accepted as "ultimate truth" since that is a concept that cannot be objectively verified. Utilitarian philosophy embodied in the notion of economic efficiency is a neater concept that perhaps determines fairness from the vantage of those who either want to maintain or increase what they already have.[162] Would those of us who have everything prefer to spend anything unnecessarily? Probably not, and yet it is those who have everything, relative to poor people, who ultimately pay the cost of the existence of those with nothing. Housing and health care costs, for example, do not evaporate simply because the law prevents charitable individuals from paying them. Thus, to the extent that present law makes everyone worse off, it is inequitable precisely because it is inefficient.[163]

VI. CONCLUSION: A SIMPLE "NONPROFIT BUSINESS JUDGMENT" SOLUTION

This Article began by stating what should be recognized as a truism: Charity is not free. To achieve their good works, charitable organizations must deal with for-profit markets. At some point, charities must pay market rates to one or more profit-seekers—employees or vendors—to achieve the goal for which tax exemption

162. The utilitarian ethos that a change from one state to another is efficient only if it makes at least one person better off without making any person worse off implies the maintenance or increase of *ex ante* wealth distribution even at the expense of perpetuating poverty. *See supra* note 130 (regarding Pareto and Kaldor-Hicks efficiency).

163. Louis Kaplow and Steven Shavell argue that "fairness" should not be independently relied upon to evaluate legal rules because, in essence, notions of fairness might require legal policies that result in some or all people being worse off. Kaplow & Shavell, *supra* note 33, at 1011. Their argument scrupulously avoids the words "fair or unfair" but essentially is that an analytical process that makes more people worse off is itself unfair:

> Our argument for basing the evaluation of legal rules entirely on welfare economics, giving no weight to notions of fairness, derives from the fundamental characteristic of fairness-based assessment: such assessment does not depend exclusively on the effects of legal rules on individuals' well-being. As a consequence, satisfying notions of fairness can make individuals worse off, that is, reduce social welfare. Furthermore, individuals will be made worse off overall whenever consideration of fairness leads to the choice of a regime different from that which would be adopted under welfare economics because, by definition, the two approaches conflict when a regime with greater overall well-being is rejected on grounds of fairness.

Id.

has been granted. The law assumes as much by allowing, and indeed expecting, that charities will pay market rates for necessary goods and services. It is also axiomatic that in some markets it is more efficient, if not required, that consumers achieve economies of scale that are more available from wholesale rather than retail markets. Tax exemption jurisprudence, however, disdains conspicuous wealth. As a result, it raises no objection when charitable organizations widely disperse their secondary benefits by purchasing goods and services from a diverse population. It objects, though, when a necessary and inevitable private benefit is garnered by a single individual or entity, such as might occur when a charitable organization engages in a relationship characterized by exclusivity. Thus, tax exemption jurisprudence very nearly bans explicit profit-taking via any sort of exclusive arrangement, even when explicit profit-taking is the sole means to achieve a charitable goal. In certain instances, health care and housing primarily, this ban severely limits a nonprofit's ability to achieve charitable goals.

At an earlier time, tax exemption jurisprudence took the opposite approach; rather than enacting a clear ban on explicit profit-taking, it very clearly recognized the necessity to engage market requirements to achieve charitable goals.[164] This Article's conclusion is that the law should devolve to a position similar, but not quite as lenient, as it originally held. One way of summarizing that original position is that so long as a transaction can be considered "necessary," in the sense that term is used in I.R.C. § 162,[165] nonprofit organizations should be allowed to engage in the transaction. Thus, under the earlier approach, the law allowed nonprofit organizations to engage in exclusive arrangements that allowed for explicit third-party profit-taking as long as the arrangement furthered the charitable goal.

The earlier approach, however, probably didn't sufficiently account for legitimate concerns. Though the concerns don't justify a complete ban on explicit third-party profit-taking, they are not so unreasonable that they should be ignored altogether. Conspicuous wealth arising from a transaction with a charitable organization, for

164 *See* Plumstead Theatre Soc'y v. Comm'r, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982); I.R.S. Priv. Ltr. Rul. 89-42-099 (Jul. 28, 1989); I.R.S. Priv. Ltr. Rul. 88-20-093 (Feb. 26, 1988).

165. *See* Welch v. Helvering, 290 U.S. 111, 115 (1933) (defining "necessary" as a function of a manager's subjective belief regarding a transaction's usefulness to the overall endeavor).

example, will likely engender resentment even if the transaction is necessary and consummated at market rates. Under those circumstances, the resentment and the resulting reputational harm to the charitable sector is perhaps the lesser of two evils; without the transaction and its potential negative consequence, the charitable need would be entirely unmet. Still, the reputational harm could be avoided without sacrificing the charitable goal merely by application of a better calibrated rule. Thus, explicit third-party profit-taking should be subjected to a business judgment rule hinging on a showing of necessity. The original approach to explicit third-party profit-taking did not require that fiduciaries demonstrate that certain transactions were necessary, only that it was appropriate to the accomplishment of a charitable goal.[166] Presently, the law applies a necessity standard to explicit third-party profit-taking arising from the exclusive licensing of technology developed by tax-exempt research organizations.[167] A nonprofit business judgment rule—one that requires an adequately informed board and arms-length business dealings[168]—would afford the fiduciaries a presumption of correctness with regard to that higher level of necessity. That presumption should be subject to challenge only when it has been shown that charitable fiduciaries have not acted in good faith—as, for example, when fiduciaries are operating under a conflict of interest. Tax-exempt assets could be protected from abuse for private gain by allowing the Service the opportunity to challenge the necessity finding, but without casting the initial decision in a presumptively negative or suspicious light as is done under current law.

166. *See supra* note 46 and accompanying text regarding the Service's rejection of a "but-for" requirement with regard to explicit third-party profit-taking.

167. *See supra* note 88 and accompanying text regarding the observation that explicit third-party profit-taking with respect to scientific research is tolerated only if it is the only "practicable" way to achieve technology transfer.

168. *See* Treas. Reg. § 53.4958-6 (2002) (providing for a presumption of correctness with regard to compensation arrangements if adequate process is employed in determining the compensation).