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by Ellen P. Aprill and Lloyd Hi toshi Mayer

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In this report, Aprill and Mayer argue that there is no uniform answer to the question whether a tax exemption is a subsidy, and they urge policymakers and exempt organizations to note the distinctions when changes to laws or other guidance regarding exemption are under consideration.

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Does the exemption from federal income tax enjoyed by almost all nonprofit organizations — including but not limited to section 501(c)(3) charities — constitute a subsidy? Or does it instead reflect the appropriate application of general income tax principles? With over 100 years of history behind the issue, we would expect the answer to be well settled. But limited attention and inconsistent statements from government sources have left its resolution confused.

The answers to these questions are increasingly relevant to policy debates concerning tax-exempt nonprofits. For example, whether a tax exemption constitutes a tax subsidy is a key issue in evaluating the growing criticism of private foundations and large college and university endowments.¹ And while concerns about donor-advised funds have tended to focus on the deductibility of charitable contributions,² the exemption issue also merits scrutiny.³ Also, with the current high level of the standard

¹ See, e.g., Accelerating Charitable Efforts Act (S. 1981) (ACE Act) (addressing in part private foundations); Brian Galle, "Pay It Forward? Law and the Problem of Restricted-Spending Philanthropy," 93 *Wash. U. L. Rev.* 1143 (2016) (private foundations); Mae C. Quinn, "Wealth Accumulation at Elite Colleges, Endowment Taxation, and the Unlikely Story of How Donald Trump Got One Thing Right," 54 *Wake Forest L. Rev.* 451 (2019) (college and university endowments); and sources cited *infra* note 84 (same).

² See, e.g., ACE Act; Samuel D. Brunson, "'I'd Gladly Pay You Tuesday for a [Tax Deduction] Today': Donor-Advised Funds and the Deferral of Charity," 55 *Wake Forest L. Rev.* 245 (2020); Kate Harris and Daniel J. Hemel, "Don't Delay Deductions for Gifts to Donor-Advised Funds," *Chronicle of Philanthropy*, Oct. 7, 2019; and Roger Colinvaux and Ray D. Madoff, "A Donor-Advised Fund Proposal That Would Work for Everyone," *Chronicle of Philanthropy*, Sept. 23, 2019.

³ Whether tax exemption operates as a subsidy is also relevant to whether exemption for religious organizations violates the Establishment Clause, but what constitutes a prohibited subsidy in that constitutional context is beyond the scope of this report. See Boris I. Bittker, "Churches, Taxes and the Constitution," 78 *Yale L.J.* 1285 (1969); and Edward A. Zelinsky, "Are Tax Benefits Constitutionally Equivalent to Direct Expenditures?" 112 *Harv. L. Rev.* 379 (1998).

deduction, only some 10 percent of taxpayers take the charitable contribution deduction⁴ — but all section 501(c)(3) charities can benefit from exemption.⁵ Moreover, section 501(c) includes an additional 28 categories of exempt organizations, only a few of which can receive deductible contributions.⁶ Whether a tax exemption operates as a subsidy must be considered on its own, independent of issues regarding the charitable contribution deduction.⁷

This report sets forth the complexity of the exemption-as-subsidy question. Section I reviews statements regarding tax exemptions and subsidies by our three branches of government and highlights inconsistencies among various government statements, particularly the inaccuracy of Supreme Court assertions. Section II reviews professor Daniel Halperin's important work regarding the tax exemption as a subsidy. In several articles, he has identified particular circumstances in which exemption does function as a subsidy and others in which it does not. Section III discusses some possible justifications for those aspects of exemption that do constitute a subsidy. Section IV concludes the argument.

⁴ The status of the charitable contribution deduction as a subsidy is a separate issue, although it is generally considered to constitute a subsidy. *See, e.g.*, Joint Committee on Taxation, “Estimates of Federal Tax Expenditures for Fiscal Years 2020-2024,” JCX-23-20, at 9 (Nov. 5, 2020) (“the ability of donors . . . to claim a charitable contribution deduction is a tax expenditure”). *But see* Johnny Rex Buckles, “The Community Income Theory of the Charitable Contributions Deduction,” 80 *Ind. L.J.* 947 (2005) (arguing against this position).

⁵ See Urban-Brookings Tax Policy Center Briefing Book, “How Did the TCJA Affect Incentives for Charitable Giving?” (2021). It is unclear if the temporary addition of a \$300 non-itemizer charitable contribution deduction for 2020 (under section 62(a)(22)) and 2021 (under section 170(p)) will have much, if any, effect on charitable giving. See Penn Wharton Budget Model, “New Charitable Deduction in the CARES Act: Budgetary and Distributional Analysis” (Mar. 27, 2020).

⁶ According to the 2020 IRS Data Book, section 501(c)(3) organizations that have applied for and received tax exemptions or are recognized as exempt under a tax treaty number 1,404,170. (This number excludes many churches, some church-affiliated organizations, and small section 501(c)(3) organizations, which are not required to apply for exemption.) Organizations exempt under all other categories of section 501(c) number 349,654. IRS, “2020 Data Book,” Table 14. To get some idea of relative size, in tax year 2018, Form 990, “Return of Organization Exempt From Income Tax,” data showed total assets of section 501(c)(3) organizations to be \$4.23 trillion and total assets of section 501(c)(4) through (9) organizations to be \$756.5 billion. IRS Statistics of Income division, “Charities and Other Tax-Exempt Organizations Statistics” (updated Aug. 31, 2021).

⁷ As professor Jennifer Bird-Pollan recently wrote, “Much of the scholarship around the non-profit tax benefits does not attempt to distinguish between the deduction for contributions and the exemption for income at the theoretical level.” Bird-Pollan, “Taxing the Ivory Tower: Evaluating the Excise Tax on University Endowments,” *Pepp. L. Rev.* 101, 108 (coming 2021).

We undertake these tasks because we believe that Halperin's work deserves further attention from policymakers, particularly in light of recent developments regarding EOs, including the enactment of the section 4968 excise tax on the investment income of large college and university endowments as well as the ongoing debate regarding donor-advised funds and private foundations.⁸ Further, we find that his analysis benefits from being placed in the context of what our three branches of government have said about the issue.

Like Halperin, this report finds no easy, one-size-fits-all answer to the question of whether a tax exemption is a subsidy. Any glib assertion that a tax exemption constitutes a subsidy misunderstands and mischaracterizes the tax-exempt sector. We urge policymakers and EOs themselves to pay attention to the distinctions discussed here when changes to laws or other guidance regarding exemption are under consideration.

I. The Inconsistency of Government Statements

A. The Judicial Branch

Courts serve as the most significant source of misinformation on whether the exemption from income tax provided to most nonprofits is a subsidy. As early as 1930, Judge Learned Hand suggested exemption was generally a subsidy. In a case involving political activities by a charitable nonprofit, tax exempt under what is today section 501(c)(3), he wrote, “Controversies of that sort must be conducted without public subvention; the Treasury stands aside from them.”⁹ More recently, the Supreme Court in *Taxation With Representation* flatly stated that “both tax exemptions and tax-deductibility are a form of subsidy that is administered through the tax system. A tax exemption has much the same effect as a cash grant to the organization of the amount

⁸ See *supra* notes 1 and 2 and accompanying text.

⁹*Slee v. Commissioner*, 42 F.2d 184, 185 (2d Cir. 1930); see also Frances R. Hill and Douglas M. Mancino, *Taxation of Exempt Organizations*, para. 5.02 (2021) (characterizing *Slee* as applying a subsidy analysis).

of tax it would have to pay on its income.”¹⁰ Similarly, in *Bob Jones* the Supreme Court declared, “When the Government grants exemptions or allows deductions all taxpayers are affected; the very fact of the exemption or deduction for the donor means that other taxpayers can be said to be indirect and vicarious ‘donors.’”¹¹ The Court then went on to conclude that charities must therefore justify receiving tax exemptions: “Charitable exemptions are justified on the basis that the exempt entity confers a public benefit.”¹² Many other courts have since repeated the holdings from both of these cases,¹³ and many commentators have looked to them.¹⁴

But courts have on occasion been more nuanced, at least concerning noncharitable nonprofits that are tax exempt under section 501 but not section 501(c)(3). The most sophisticated analysis is in *McGlotten*.¹⁵ There the federal district court had to evaluate whether discrimination by a noncharitable nonprofit constituted state action. It held that exempting member-generated funds received by section 501(c)(7) social clubs from income tax was not a subsidy. The judge concluded that “Congress has determined that in a situation where individuals have banded together to provide recreational facilities on a mutual basis, it would be conceptually erroneous to impose a tax on the organization as a separate

entity.”¹⁶ The court reasoned that “the funds exempted are received only from the members and any ‘profit’ which results from overcharging for the use of the facilities still belongs to the same members.”¹⁷ As a result, “no income of the sort usually taxed has been generated; the money has simply been shifted from one pocket to another, both within the same pair of pants.”¹⁸ In contrast, the court also concluded that tax exemption for passive investment income of section 501(c)(8) fraternal orders did constitute a subsidy provided by the government: “Here individuals are providing funds which are then invested for the purposes of benefiting the contributing members, and the exemption of this income is a ‘benefit’ provided by the Government.”¹⁹ Based on these distinctions, the court held that section 501(c)(8) fraternal orders but not section 501(c)(7) social clubs fell within the coverage of the Civil Rights Act.²⁰

B. The Executive Branch

Treasury and the IRS have also recognized a distinction between charitable and noncharitable nonprofits on the subsidy issue, although often without breadth or depth of analysis. For example, GCM 33495 (Apr. 27, 1967), which concluded that some tax-exempt noncharitable nonprofits can engage in unlimited lobbying for their exempt purposes, reasoned that the subsidy argument justifying the limitation on lobbying by tax-exempt charities “seems substantially diluted . . . in situations where payments to the exempt organization in question are not deductible.” Similarly, in 2004 then-IRS Commissioner Mark W. Emerson said, “For many tax-exempt entities, *most notably charities*, tax-

¹⁰ *Regan v. Taxation With Representation*, 461 U.S. 540, 544, (1983); see also *Leathers v. Medlock*, 499 U.S. 439, 450 n.3 (1991) (refusing to distinguish tax deductions and tax exemptions, citing *Taxation With Representation*); and *Texas Monthly Inc. v. Bullock*, 489 U.S. 1, 14 (1989) (“every tax exemption constitutes a subsidy that affects nonqualifying taxpayers”).

¹¹ *Bob Jones University v. United States*, 461 U.S. 574, 591 (1983).

¹² *Id.* at 591.

¹³ For decisions repeating the holding in *Taxation With Representation*, see, e.g., *Parks v. Commissioner*, 145 T.C. 278, 337 (2015); *Redwood Empire Publishing Co. v. State Board of Equalization*, 207 Cal. App. 3d 1334, 1342 (1989); *Gallacher v. Commissioner*, 602 A.2d 996, 1004 n.10 (Conn. 1992); *Pooh-Bah Enterprises Inc. v. The County of Cook*, 905 N.E.2d 781, 790 (Ill. 2009); and *Hearst Corp. v. Iowa Department of Revenue and Finance*, 461 N.W.2d 295, 304 (Iowa 1990). For decisions repeating the holdings in *Bob Jones*, see, e.g., *IHC Health Plans Inc. v. Commissioner*, 325 F.3d 1188, 1195 (10th Cir. 2003); *Universal Life Church Inc. v. United States*, 128 F.3d 1294, 1297 (9th Cir. 1997); *Geisinger Health Plan v. Commissioner*, 985 F.2d 1210, 1215 (3d Cir. 1993); and *Free Fertility Foundation v. Commissioner*, 135 T.C. 21, 26 (2010).

¹⁴ See *infra* note 45 and accompanying text.

¹⁵ *McGlotten v. Connolly*, 338 F. Supp. 448 (D.D.C. 1972).

¹⁶ *Id.* at 458 (footnote omitted); see also *id.* at 462 (“the exemption of nonprofit clubs, limited as it is to member-generated funds and available regardless of the nature of the activity of the particular club, does not operate as a ‘grant’ of Federal funds”).

¹⁷ *Id.* at 458.

¹⁸ *Id.*

¹⁹ *Id.* at 459; see also *id.* at 462 (“The exemption provided fraternal orders by section 501(c)(8) is of wider scope, shielding from taxation not only member-generated funds but passive investment income as well. Unlike the exemption for nonprofit clubs, it cannot be explained simply as a matter of pure tax policy. Because it is available only to particular groups, it operates in fact as a subsidy in favor of the particular activities these groups are pursuing” (footnote omitted)); and Hill and Mancino, *supra* note 9, at para. 7.02 (discussing *McGlotten*).

²⁰ *Id.* at 462.

exemption, the charitable contribution deduction, and other tax benefits constitute an indirect subsidy of activities Congress has determined are beneficiary to society.”²¹

Treasury has on occasion questioned the exemption provided to some noncharitable nonprofits. For example, after Congress directed it to study section 501(c)(8) fraternal beneficiary societies, Treasury published a report in 1993 concluding that the societies’ exemption was a subsidy for their insurance and charitable activities that favored members. The report suggested that Congress should consider modifying tax exemptions for those activities.²²

Insurance activities of fraternal benefit societies are also treated as a subsidy in Treasury’s tax expenditure budget. Treasury Assistant Secretary Stanley S. Surrey is credited with inventing the tax expenditure concept in 1967.²³ According to Surrey and his coauthor Paul R. McDaniel, an income tax has two distinct elements: “The first element consists of structural provisions necessary to implement a normal income tax . . . The second element consists of special preferences found in every income tax.”²⁴ Subsidies fall into the second element. Based on Surrey’s work, the Congressional Budget and Impoundment Control Act of 1974 requires both Treasury and Congress to prepare lists of tax expenditures as part of the budget process.²⁵ Treasury’s most recent expenditure budget lists the exemptions for credit unions, some small insurance companies, and some mutual and cooperative telephone and electric companies as tax expenditures.²⁶ It does not, however, list the exemptions of other categories of section 501(c) tax-exempt organizations as tax expenditures.

Like the courts, Treasury and the IRS distinguish between charitable and noncharitable tax-exempt organizations. These tax administrators, however, do so in ways different from courts. In particular, they do not treat exemption under section 501(c)(3) as a tax expenditure and therefore a subsidy.

C. The Legislative Branch

Compared with the judicial branch, the legislative branch more consistently distinguishes the extent to which charitable and noncharitable section 501(c)s receive a tax subsidy. Like the court in *McGlotten*, Congress has distinguished member and investment income. In 1969 it expanded the reach of the unrelated business income tax to include passive investment income received by section 501(c)(7) social clubs, section 501(c)(9) voluntary employees beneficiary associations, and section 501(c)(17) supplemental unemployment benefits trusts.²⁷ It justified this change on the grounds that the tax-free receipt of passive investment income “bestowed a substantial additional advantage to the members.”²⁸ At the same time, it left member-related income exempt from tax.

But the most important and influential ongoing government statement regarding exemption as a subsidy comes from “Estimates of Federal Tax Expenditures,” published by the Joint Committee on Taxation.²⁹ As noted, tax expenditures are defined as departures from a normal income tax. Of course, what constitutes the normal, or normative, tax structure is a constant matter of dispute. The JCT has explained that its staff “uses its judgment in distinguishing between those income tax provisions (and regulations) that can be viewed as part of normal

²¹ IR-2004-81, at 9 (emphasis added).

²² Treasury, “Report to the Congress on Fraternal Benefit Societies,” at 11-12 (1993); see also David S. Miller, “Reforming the Taxation of Exempt Organizations and Their Patrons,” 67 *Tax Law.* 451, 464-465 (2014) (discussing the report).

²³ Leonard E. Burman and Joel Slemrod, *Taxes in America: What Everyone Needs to Know* 171 (2020).

²⁴ Surrey and McDaniel, *Tax Expenditures* 3 (1985).

²⁵ See Congressional Budget Act of 1974, sections 3(3), 101(c), 601. The Treasury Department’s most recent tax expenditure budget is for fiscal 2022 (dated June 3, 2021). The JCT now fulfills the congressional obligation to publish a tax expenditure budget. See *infra* note 29 and accompanying text.

²⁶ Treasury, *supra* note 25, at 9, 13.

²⁷ See Tax Reform Act of 1969, section 121(b)(1) (codified at section 512(a)(3)).

²⁸ H.R. Rep. No. 413, 91st Cong., 1st Sess. 48 (1969); and S. Rep. No. 552, 91st Cong., 1st Sess. 71 (1969).

²⁹ The Congressional Budget Office relies on JCT staff estimates for the revenue effects of proposed legislation, a long-standing arrangement that was made a statutory requirement in the Balanced Budget and Emergency Deficit Control Act of 1985, section 273. Because the JCT provides the official revenue estimates for all proposed legislation and has published reasoning behind its decisions, most rely on its list rather than Treasury’s.

income tax law and those special provisions that result in tax expenditures.”³⁰ The JCT defines tax expenditures as “any reductions in income tax liabilities that result from special tax provisions or regulations that provide tax benefits to particular taxpayers.”³¹

For the JCT, tax exemption under section 501 is sometimes a tax expenditure and sometimes not. In its most recent tax expenditures report, it explained, “Nonprofit corporations that satisfy the requirements of section 501 also generally are not subject to the corporate income tax.”³² While true, this observation fails to acknowledge how many section 501(c)(3) organizations (particularly private foundations) are organized as trusts rather than corporations and have been subject to an excise tax on investment income since 1969.³³

The tax expenditure publication continues, “The tax exemption for noncharitable organizations that have a direct business analogue or compete with for-profit organizations organized for similar purposes is a tax expenditure.”³⁴ The JCT does not explain how close the analogue or competition must be. Moreover, the JCT qualifies its own statement by not considering the exemption of some mutual benefit nonprofits with for-profit business members a tax expenditure: “The tax exemption for certain nonprofit cooperative business organizations, such as trade associations, is not treated as a tax expenditure just as the treatment of for-profit pass-through business entities is not treated as a tax expenditure.”³⁵ Mutual benefit nonprofits, however, are not passthroughs. Indeed, state law generally forbids distributions of assets to members of mutual benefit nonprofits during the life of the entity. Members of mutual benefit organizations can receive assets only upon

dissolution of the entity. At the least, how the analogy justifies the characterization of mutual benefit nonprofits for tax expenditure purposes is unclear.

The JCT, however, relies on the degree of business activities to conclude the exemption for charitable organizations is not a tax expenditure: “With respect to other nonprofit organizations, such as charities, tax-exempt status is not classified as a tax expenditure because the nonbusiness activities of such organizations generally must predominate and their unrelated business activities are subject to tax.”³⁶ Whether business and nonbusiness characterization maps well onto the distinction between for-profit and nonprofit is uncertain, as the mixed for-profit and nonprofit healthcare and education sectors demonstrate. Further, the JCT recognizes that “there are numerous exceptions that allow for otherwise unrelated business income to escape taxation, and these exceptions are treated as tax expenditures.”³⁷ To categorize activities of mutual benefit EOs, the JCT relies on the notion of imputed income: “In general, the imputed income derived from nonbusiness activities conducted by individuals or collectively by certain nonprofit organizations is outside the normal income tax base.”³⁸

As a result of this approach, the JCT considers only the following exemptions for nonprofits to be tax expenditures: voluntary employees’ beneficiary associations under section 501(c)(9);³⁹ mutual or cooperative electric companies under section 501(c)(12);⁴⁰ cemetery companies under section 501(c)(13);⁴¹ credit unions under section 501(c)(14)(A);⁴² some small property and casualty insurance companies under section 501(c)(15);⁴³ and some exceptions to the UBTI rules under sections 512 to 514.⁴⁴

³⁰ JCT, “Background Information on Tax Expenditure Analysis and Historical Survey of Tax Expenditure Estimates,” JCX-18-15 (Feb. 6, 2015).

³¹ JCT, *supra* note 4, at 2.

³² *Id.* at 9.

³³ Private foundations, which, for the most part, are grant-making entities controlled by an individual, family, or corporation, are a special category of organizations exempt under section 501(c)(3). See section 509(a). They have long been subject to a modest excise tax on investment income. Section 4940.

³⁴ JCT, *supra* note 4, at 9.

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.* at 32. Consideration of employee-benefit-related exemptions is beyond the scope of this report.

⁴⁰ *Id.* at 9 n.21.

⁴¹ *Id.* at 21.

⁴² *Id.* at 9 n.21, 29.

⁴³ *Id.*

⁴⁴ *Id.* at 9 n.21, 22, 29.

Summary: Courts are more likely than other government actors to make broad assertions about an exemption as a subsidy. While other government statements reflect greater nuance, they also expose inconsistencies. Initially taking their lead from the courts, many commentators have assumed a tax exemption for nonprofits is a subsidy across the board.⁴⁵ Halperin's work, discussed in the next section, underscores the need for narrow rather than broad assertions regarding this issue.

II. Increased Clarity From Recent Commentary

In recent years several commentators have thoughtfully reconsidered the subsidy issue.⁴⁶ Their analyses reveal a more complicated reality. On one hand, under these analyses a tax exemption for nonprofits is often not a subsidy but rather a logical application of the general principles underlying the federal income tax system. On the other hand, these reconsiderations identify important exceptions to this conclusion. These exceptions stem from untaxed benefits to members of noncharitable nonprofits, the value of tax deferral, and similarities to taxed business activities.

A. Exemption Is Not a Subsidy . . .

Halperin in particular has provided the most comprehensive analysis of this issue. In a series of articles, he has carefully considered whether and to what extent income tax exemption is a subsidy for charitable and noncharitable nonprofits.⁴⁷ In one article in this series, Halperin rejected the

argument of Boris I. Bittker and George K. Rahdert in their classic and influential 1976 article, which took the position that the administrative impracticality of measuring the net income of most nonprofits justified exemption.⁴⁸ Halperin bluntly called this position "wrong" because "there is nothing about the nature of the charitable organization that precludes income taxation."⁴⁹

Still, Halperin concluded that the exemption was not in general a subsidy for tax-exempt charities. He gave two reasons: First, to the extent a charity receives donations, those are nontaxable gifts under long-standing section 102, as the IRS has acknowledged;⁵⁰ second, for fees received by a charity for activities concerning its exempt purpose, "such receipts would be offset, in part at least, by immediate expenditures for the performance of these services, which should be deductible as ordinary and necessary expenses for the production of this income."⁵¹ He also explained that a "for-profit organization will clearly have taxable income if it sets aside profits for current or future distribution to shareholders or owners. A charitable organization, however, is distinguished from a for-profit entity by what has been referred to as the non-distribution constraint, which precludes remittance of profits to shareholders or members."⁵² For similar reasons, he determined that exemption of donations and fees received by section 501(c)(4) social welfare organizations also generally did not represent a subsidy.⁵³

⁴⁵ See Evelyn Brody, "Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption," 23 *J. Corp. L.* 585, 592 and n.30 (1998) (citing John D. Colombo, "Why Is Harvard Tax-Exempt (and Other Mysteries of Tax Exemption for Private Educational Institutions)," 35 *Ariz. L. Rev.* 841, 861 and n.125 (1993) (listing sources)); Buckles, *supra* note 4, at 975; Lloyd Hitoshi Mayer, "Nonprofits, Speech, and Unconstitutional Conditions," 46 *Conn. L. Rev.* 1045, 1064 (2014); and Kathleen M. Sullivan, "Unconstitutional Conditions," 102 *Harv. L. Rev.* 1413, 1424-1425 and n.34 (1989).

⁴⁶ In particular, Miller has examined the exempt sector as a whole and made several recommendations for reform. Miller, *supra* note 22.

⁴⁷ Halperin, "The Tax Exemption Under I.R.C. Section 501(c)(4)," 21 *N.Y.U. J. Legis. & Pub. Pol'y* 519 (2018); Halperin, "Is Income Tax Exemption for Charities a Subsidy?" 64 *Tax L. Rev.* 283 (2011); Halperin, "Income Taxation of Mutual Nonprofits," 59 *Tax L. Rev.* 133 (2006); Halperin, "Tax Policy and Endowments — Is Excessive Accumulation Subsidized?: Part I," *The Exempt Organization Tax Review*, Jan. 2011, p. 17; and Halperin, "Tax Policy and Endowments — Is Excessive Accumulation Subsidized?: Part II," *The Exempt Organization Tax Review*, Feb. 2011, p. 125.

⁴⁸ Halperin, "Charities," *supra* note 47, at 284 (citing Bittker and Rahdert, "The Exemption of Nonprofit Organizations From Federal Income Taxation," 85 *Yale L.J.* 299 (1976)). Halperin agrees with and cites Henry Hansmann, "The Rationale for Exempting Nonprofit Organizations From Corporate Income Taxation," 91 *Yale L.J.* 54 (1981), on this point.

⁴⁹ Halperin, "Charities," *supra* note 47, at 284.

⁵⁰ *Id.* at 290; see also section 102; and *Branch Ministries v. Commissioner*, 211 F.3d 137, 143 (2000).

⁵¹ Halperin, "Charities," *supra* note 47, at 287.

⁵² *Id.* at 292 (footnotes omitted); see also *id.* at 293-294 (supporting this reasoning with a mathematical example); and Philip T. Hackney, "What We Talk About When We Talk About Tax Exemption," 33 *Va. Tax Rev.* 115, 151 (2013) (agreeing with this result on the grounds that charities lack owners who benefit from any profits).

⁵³ Halperin, "501(c)(4)," *supra* note 47, at 528-529. He says, "Further, since a charitable organization, unlike a business corporation, will not have shareholders or owners who demand a return on their investment, it need not operate at a profit over the long term." *Id.*

But Halperin took a different approach with noncharitable nonprofits other than social welfare organizations. In particular, he asserted that the exemption of member-related income is generally not a subsidy.⁵⁴ Using a social club as a typical noncommercial, mutual benefit organization, he explained, “If a social club expends its income for the current benefit of its members, it should not have taxable income as conventionally measured” because “we do ordinarily allow expenses even for activities not carried out for profit to the extent of income from that activity” so that “at most, only net receipts would be subject to tax.”⁵⁵

Through a series of mathematical examples, he further demonstrated that exempting income used for future expenses does not constitute a subsidy because “it is the equivalent to allowing a deduction for the present value of the future expenditures.”⁵⁶ He extended these conclusions to other noncommercial, mutual benefit nonprofits, including cooperatives, homeowners associations, and political parties,⁵⁷ and also to business, mutual benefit nonprofits such as trade associations to the extent income is used for current expenses.⁵⁸

In sum, Halperin finds that the income of many nonprofits (both charitable and noncharitable) used for current or future expenses should not be considered a subsidy but instead a reflection of the normal income tax.

B. . . Except When It Is

But as Halperin and others have noted,⁵⁹ some benefits enjoyed by EOs are properly characterized as subsidies.⁶⁰ These exceptions arise from benefits to members (for noncharitable, mutual benefit nonprofits), the value of deferring taxes otherwise owed, and similarities to taxable business activities.

In particular, Halperin sees some member benefits as subsidies. Those subsidies occur when members benefit from income from nonmember sources — whether payments for the provision of goods or services to nonmembers or investment income — because, in Halperin’s words, the members “enjoy personal consumption from untaxed income.”⁶¹ Congress has recognized this principle to some extent by applying UBIT to the nonmember and investment income of some, but not all, noncharitable nonprofits that provide mutual benefits to their members.⁶²

Halperin also demonstrated that members can benefit from the value of deferral. They do so if they are permitted to immediately deduct dues that the receiving nonprofit sets aside for future expenses or uses for capital expenditures. Those expenditures would not be immediately deductible if paid by the member directly.⁶³ Halperin therefore concluded that the exemption of deductible dues used for these purposes also

⁵⁴ Halperin, “Mutual Nonprofits,” *supra* note 47, at 140.

⁵⁵ *Id.* (footnotes omitted).

⁵⁶ *Id.* at 141; *see id.* at 140-148 (providing further explanation and mathematical examples), and 164 (summarizing his reasoning and conclusions).

⁵⁷ *Id.* at 151, 160.

⁵⁸ *Id.* at 155-156; *see also* Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts*, para. 102.3.1 (agreeing regarding trade associations and other nonprofit business organizations), para. 102.4 (agreeing regarding social clubs) (2021); Colinvaux, “Political Activity Limits and Tax Exemption: A Gordian’s Knot,” 34 *Va. Tax Rev.* 1, 8-9 (2014) (agreeing regarding political organizations); Mayer, “A (Partial) Defense of Section 501(c)(4)’s ‘Catchall’ Nature,” 21 *N.Y.U. J. Legis. & Pub. Pol’y* 439, 469-470 (2018) (agreeing generally); and Linda Sugin, “Politics, Disclosure, and State Law Solutions for 501(c)(4) Organizations,” 91 *Chi. Kent L. Rev.* 895, 903 (2016) (agreeing and noting the resulting inaccuracy of the Supreme Court’s statement in *Taxation With Representation*, *supra* note 10 and accompanying text). *But see infra* note 91 (contrary views).

⁵⁹ *See* Hackney, “Political Justice and Tax Policy: The Social Welfare Organization Case,” 8 *Tex. A&M L. Rev.* 271, 313 (2021) (same conclusion regarding section 501(c)(4) organizations); Hackney, “Prop Up the Heavenly Chorus? Labor Unions, Tax Policy, and Political Equality,” 91 *St. John’s L. Rev.* 315, 325 (2017) (same conclusion regarding section 501(c)(5) organizations); Hackney, “Taxing the Unheavenly Chorus: Why Section 501(c)(6) Trade Associations Are Undeserving of Tax Exemption,” 92 *Denv. U.L. Rev.* 265, 293, 294-295 (2015) (same conclusion regarding section 501(c)(6) organizations); and Miller, *supra* note 22, at 468-469 (same conclusion).

⁶⁰ Commentators have especially focused on the exemption for investment income received by noncharitable nonprofits. *See* Ellen P. Aprill, “Examining the Landscape of section 501(c)(4) Social Welfare Organizations,” 21 *N.Y.U. J. Legis. & Pub. Pol’y* 345, 397 (2018) (agreeing regarding investment income for section 501(c)(4) organizations that provide more than incidental benefits to their members); Bittker and Lokken, *supra* note 58, at para. 102.4 (agreeing regarding investment income received by social clubs); Colinvaux, *supra* note 58, at 9 (agreeing regarding investment income received by political organizations); and Mayer, *supra* note 58, at 470-471 (agreeing regarding investment income received by section 501(c)(4) organizations that provide more than incidental benefits to their members).

⁶¹ Halperin, “Mutual Nonprofits,” *supra* note 47, at 136 (quoted language), 136-137 (explaining further).

⁶² *Supra* notes 27 and 28 and accompanying text.

⁶³ Halperin, “Mutual Nonprofits,” *supra* note 47, at 155-156.

constitutes a subsidy.⁶⁴ Given deduction limitations, this conclusion applies primarily, if not exclusively, to section 501(c)(6) trade associations.⁶⁵

Halperin did not neglect the value of deferral to charities. Charities benefit from deferral when exempt income from related income is used for specified capital expenditures. That deferral constitutes a subsidy.⁶⁶ Halperin writes, “Exemption for income from related activities used for capital expenditures amounts to an immediate deduction for such expenditures” and thus “is undoubtedly special treatment.”⁶⁷ The special treatment becomes clear when contrasted with the way for-profit businesses treat capital expenditures: “Taxable businesses, in contrast, must capitalize such expenditures and deduct depreciation over time. Obviously, such an immediate deduction is greater than the present value of the depreciation deductions.”⁶⁸

Investment income also benefits from deferral. For-profit entities generally owe income tax on investment returns; thus, the exemption of those returns from tax for charities is a departure from normal income tax principles.⁶⁹ Even though the investment returns will presumably be spent to further exempt purposes in the future that would offset those returns (like future business expenses for a for-profit entity), exemption effectively accelerates that offset, and so provides a tax deferral benefit.⁷⁰ Halperin draws the same

conclusions for section 501(c)(4) social welfare organizations, even if they provide only community, not private, benefit.⁷¹

Further, Halperin concludes that some commercial, mutual benefit nonprofits, particularly credit unions and organizations providing insurance, strongly resemble for-profit counterparts that are taxable.⁷² He focuses on the tendencies of such entities to accumulate reserves benefiting their members, use net income for capital expenditures, make distributions of net assets on dissolution to their members, and often have only tenuous connections among their members (rendering the members similar to owners).⁷³ Halperin’s argument is that some current exempt purposes — for example, operating a credit union that complies with section 501(c)(14)(A) — do not merit exemption from federal income tax because of these characteristics. This conclusion is consistent with the JCT position that the exemptions for credit unions and some small insurance companies constitute tax expenditures.⁷⁴ Halperin also notes that some other mutual benefit nonprofits, such as cemetery companies exempt under section 501(c)(13), may display enough of these characteristics to be considered as having received a subsidy.⁷⁵

While not a focus of Halperin’s arguments, his conclusions regarding mutual benefit nonprofits are consistent with Congress’s decision through enactment of the UBIT to tax regularly carried-on business activity that is not substantially related to an otherwise tax-exempt nonprofit’s exempt purposes.⁷⁶ In theory, the rationale for UBIT is similar to the rationale put forward by Halperin (and the JCT) for considering exemption of some commercial, mutual benefit nonprofits a subsidy,

⁶⁴ *Id.* at 156; see also Bittker and Lokken, *supra* note 58, at para. 102.3.1.

⁶⁵ The limitations that prevent individuals who pay dues to other types of mutual benefit nonprofits from deducting those dues include the suspension of miscellaneous itemized deductions under section 67(g) and the 2 percent floor on those deductions that applies under section 67(a) outside the suspension period.

⁶⁶ Halperin, “Charities,” *supra* note 47, at 295.

⁶⁷ *Id.* at 295; see also *id.* at 295 n.48 (providing a mathematical example), 295-296 (distinguishing capital expenditures for some exempt-purpose-related assets).

⁶⁸ *Id.* at 295; see also *id.* at 295 n.48 (providing a mathematical example), 295-296 (distinguishing capital expenditures for some exempt-purpose-related assets).

⁶⁹ *Id.* at 300-302.

⁷⁰ *Id.* at 300-301; see also Bird-Pollan, *supra* note 7, at 110 (agreeing regarding investment income received by charities); and Brian Galle, “The Quick (Spending) and the Dead: The Agency Costs of Forever Philanthropy,” 74 *Vand. L. Rev.* 757, 768 (2021) (same).

⁷¹ Halperin, “Charities,” *supra* note 47, at 312; and Halperin, “501(c)(4),” *supra* note 47, at 532.

⁷² Halperin, “Mutual Nonprofits,” *supra* note 47, at 149.

⁷³ *Id.*, at 149-150, 165; see also Miller, *supra* note 22, at 470-471 (agreeing with Halperin’s reasoning).

⁷⁴ See *supra* notes 42-43 and accompanying text.

⁷⁵ Halperin, “Mutual Nonprofits,” *supra* note 47, at 151 n.58; and Miller, *supra* note 22, at 460, 465-466.

⁷⁶ Sections 512-514.

although UBIT as implemented may not completely fit this rationale.⁷⁷ And as the JCT has noted, there are some gaps in the coverage of UBIT.⁷⁸

III. Justifying Subsidies

Even when some aspect of exemption is a subsidy, a sufficient justification for it may well exist. For example, Halperin looks to Henry Hansmann's capital subsidy theory to justify the exemption of revenues used for capital expenditures.⁷⁹ Hansmann's capital subsidy theory emphasizes the burden nonprofits face from their inability to raise capital through equity investors. Because of this limit, Hansmann posits that a subsidy in the form of exemption from taxation for investment income is appropriate if nonprofits are more efficient in providing some services than for-profit counterparts.⁸⁰

But because not all aspects of exemptions are subsidies, and because a sufficient justification may exist to support some of the aspects that are subsidies, any reduction or elimination of exemption needs to be carefully tailored. They need to target only aspects of exemption that are subsidies and lack sufficient justification. Recently enacted section 4968 illustrates the problems that can arise when that care is not taken. The Tax Cuts and Jobs Act enacted this section, imposing an excise tax on the investment income of some exempt universities with, among other requirements, assets exceeding \$500,000 per student.⁸¹ Long before the enactment of section 4968, Halperin expressed his belief that "an unlimited subsidy for charitable accumulation is not an efficient and equitable use of limited government resources."⁸² He recommended "a tailored tax on investment income."⁸³ Section 4968, however, applies only to large college and

university endowments. According to professor Edward A. Zelinsky, it is therefore "best defended in political terms as an incremental step towards the kind of comprehensive tax on all charitable endowments suggested by conventional tax policy criteria."⁸⁴

Another kind of justification would have been possible but would have required a differently structured excise tax. Congress could have imposed a tax targeted at large university endowments because the endowments fail to advance the universities' exempt educational purpose. Senate Minority Leader Mitch McConnell, R-Ky., has defended the provision in those terms, particularly in connection with his ultimately successful efforts for tuition-free Berea College to be exempt from section 4968.⁸⁵ McConnell contrasted Berea's tuition-free mission with Harvard's failure to use its endowment "to make tuition more affordable."⁸⁶ As Zelinsky has observed, "Congress could have designed section 4968 as a tax regulating tuition practices but it did not."⁸⁷ Suggestions that have been advanced for provisions more closely tied to student need include permitting a school to offset the tax through increased financial aid or recruiting from underrepresented communities.⁸⁸ As enacted, however, section 4968 fails to meet Halperin's criteria for deciding whether to retain or remove exemption.

In his work, Halperin has not only narrowed the aspects of tax exemption to be characterized as subsidies but also acknowledged possible justifications for at least some of those aspects. For

⁷⁷ See Ethan G. Stone, "Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax," 54 *Emory L.J.* 1475, 1495-1498 (2005).

⁷⁸ *Supra* notes 37 and 44, and accompanying text.

⁷⁹ Halperin, "Charities," *supra* note 47, at 297.

⁸⁰ Hansmann, *supra* note 48, at 72-75.

⁸¹ TCJA section 13701.

⁸² Halperin, "Tax Policy and Endowments: Part I," *supra* note 47, at 25.

⁸³ Halperin, "Tax Policy and Endowments: Part II," *supra* note 47, at 133.

⁸⁴ Zelinsky, "Section 4968 and Taxing All Charitable Endowments: A Critique and a Proposal," 38 *Va. Tax Rev.* 141, 143 (2018). See also Congressional Research Service, "College and University Endowments: Overview and Tax Policy Options" (May 4, 2018); James J. Fishman, "How Big Is Too Small: Should Certain Higher Educational Endowments' Net Investment Income Be Subject to Tax?" 28 *Cornell J.L. & Pub. Pol'y* 159, 178-180, 199 (2018). Galle, *supra* note 70; and Bird-Pollan, *supra* note 7.

⁸⁵ The provision was eliminated from the TCJA under a procedural requirement known as the Byrd rule. Aprill and Hemel, "The Tax Legislative Process: A Byrd's Eye View," 81 *Law & Contemp. Prob.* 99, 124 (2018). It was included in the Bipartisan Budget Act of 2018 section 41109.

⁸⁶ Zelinsky, *supra* note 84, at 165 ("McConnell says *Herald-Leader* editorial was wrong to criticize him for tax on Berea College," *Lexington Herald-Leader*, Dec. 28, 2017).

⁸⁷ Zelinsky, *supra* note 84, at 165. JCT, "General Explanation of Public Law 115-97," JCS-1-18 (Dec. 2018), makes no mention of a relationship between the excise tax and use of endowments to reduce tuition.

⁸⁸ Fishman, *supra* note 84, at 42; and CRS, *supra* note 84, at 19.

Halperin, benefits to members (for noncharitable, mutual benefit nonprofits), the value of deferring taxes otherwise owed, and similarities to taxable business activities are likely subsidies. But even then, other considerations, such as access to capital, may mean that exemption is an appropriate choice. That said, Halperin remains skeptical of a sufficient justification for the exemption for investment income for noncharitable nonprofits,⁸⁹ and, importantly, at least for significant accumulations of investments, even for charities, although he is open to arguments otherwise.⁹⁰ Overall his work reduces the extent to which a tax exemption requires justification as a subsidy relying on government resources.

IV. Conclusion

As Halperin's work demonstrates, broad assertions that a tax exemption provides a subsidy are inaccurate.⁹¹ Contrary to the oft-quoted language from Supreme Court opinions, whether the exemption from federal income tax enjoyed by most nonprofits operates as a subsidy is not amenable to a single answer. Instead, the answer depends on a variety of factors, including whether the nonprofit has members who benefit from its activities; whether the nonprofit has income other than contributions from its members to which the exemption extends;

whether tax is effectively deferred by the exemption and, if so, whether that deferral is financially valuable to the nonprofit or its members; and whether the nonprofit's activities closely resemble the activities of taxable, for-profit businesses.

Often, references to the subsidy afforded nonprofit or tax-exempt organizations are in fact referring primarily to nonprofit organizations exempt under section 501(c)(3) and rely at least implicitly on the charitable contribution deduction, which has been consistently treated as a subsidy. That is, tax exemption is included as an additional subsidy without much thought. However, focusing only on section 501(c)(3) organizations, which permits this elision, is too narrow an approach.

As this report describes, some aspects of exemption further subsidize both section 501(c)(3) and other EOs. But the extent to which they do so will vary from organization to organization. Some organizations have considerable investment income, others none. Some organizations benefit from deferral; others do not. Any glib assertion that a tax exemption constitutes a subsidy misunderstands and mischaracterizes the tax-exempt sector. Making these distinctions should not be a purely academic exercise. Policymakers — and EOs themselves — should acknowledge and take into account these distinctions when changes to statutes, regulations, or other guidance involving tax exemptions are under consideration. ■

⁸⁹ Others are even more skeptical. Hackney questions the strength of the pooling argument except regarding relatively small (financially) noncharitable, mutual benefit nonprofits. Hackney, "Social Welfare Organization," *supra* note 59, at 311-315; Hackney, "Labor Union," *supra* note 59, at 324; and Hackney, "Trade Associations," *supra* note 59, at 294. Bittker and Lokken acknowledge that some members of a mutual benefit nonprofit may disproportionately benefit from their membership, effectively deriving an economic advantage from their fellow members. Still, they ultimately conclude that the pooling rationale still applies in that member payments are best viewed as payment for the availability of member benefits (not just use of those benefits). Bittker and Lokken, *supra* note 58, at para. 102.4.

⁹⁰ Halperin, "Charities," *supra* note 47, at 302; and Halperin, "Excessive Accumulation I," *supra* note 47, at 25.

⁹¹ Of course, not all scholars agree. See Buckles, *supra* note 4, at 975-979; and David J. Herzig and Samuel D. Brunson, "Let Prophets Be (Non) Prophets," 52 *Wake Forest L. Rev.* 1111, 1134-1135 (2017). In effect, these scholars adopt the long-standing but generally disfavored tax-base theories that justify exemption (and sometimes deductibility of contributions) on the grounds that charities (and sometimes other types of nonprofits) are not within the income tax base because they lack owners or members who benefit from any untaxed income. See John Simon, Harvey Dale, and Laura Chisolm, "The Federal Tax Treatment of Charitable Organizations" in *The Nonprofit Sector: A Research Handbook* 267, 273-274 (2006) (summarizing these theories). Those arguments, however, do not address the value of deferral when it comes to spending on capital expenditures and investment income.