

## An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation

Nina J. Crimm

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## AN EXPLANATION OF THE FEDERAL INCOME TAX EXEMPTION FOR CHARITABLE ORGANIZATIONS: A THEORY OF RISK COMPENSATION

*Nina J. Crimm\**

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\* Professor of Law, St. John's University School of Law; A.B., Washington University (1972); J.D. and M.B.A., Tulane University (1979); LL.M. in Taxation, Georgetown University (1982).

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#### ABSTRACT

*There currently is no universally-accepted theory that explains the fundamental reason underlying the deliberate and continued conferral of the federal income tax exemption on qualifying charitable organizations. This Article suggests that the rationale for the tax exemption is a separate issue from the question of whether a charitable organization deserves tax exempt treatment. As to the rationale, this Article proposes that the tax exemption is a non-volatile expected return to compensate rational charitable organizations for undertaking the provision of “inherently risky” public goods and services. With respect to the issue of deservedness, this Article looks at social and moral justifications and suggests broad guidelines based on the types of projects undertaken as an organization evolves, and the degree to which those activities comport with the organization’s initial purpose constraint.*

*The Rosetta Stone, . . . whose text in hieroglyphics, demotics [sic], and Greek was the key to revealing the stories*

*of ancient Egypt, was in fact a grant of tax immunity. Which is why, of course, it was engraved in stone and not written on papyrus.<sup>1</sup>*

—Alvin Rabushka

## INTRODUCTION

Governmental favoritism was conferred in America on non-proprietary hospitals—a category of charitable organizations—even before the Revolutionary War.<sup>2</sup> Since the Civil War, general non-tax benefits<sup>3</sup> and tax

1. *See As Certain As Death—Quotations About Taxes*, 77 TAX NOTES 1485, 1500 (Dec. 29, 1997).

2. The tax exemption for hospitals in the United States was conferred prior to the Revolutionary War. *See* W. HARRISON WELLFORD & JANNE G. GALLAGHER, *UNFAIR COMPETITION: THE CHALLENGE TO CHARITABLE TAX EXEMPTION* 119-20 (1988); David A. Hyman, *The Conundrum of Charitability: Reassessing Tax Exemption for Hospitals*, 16 AM. J. L. & MED. 327, 334 (1990).

3. After the Civil War, nonprofit organizations received certain benefits unavailable to for-profit organizations. For example, the Bankruptcy Act of 1867 exempted nonprofit organizations from voluntary and involuntary bankruptcy, and as late as 1947, nonprofit institutions were exempt from involuntary bankruptcy. *See* Nina J. Crimm, *Evolutionary Forces: Changes in the For-Profit and Not-For-Profit Health Care Delivery Structures; a Regeneration of Tax Exemption Standards*, 37 B.C.L. REV. 1, 7-8 n.19 (1995); *see also* Bankruptcy Act of March 2, 1867, ch. 176, 337, 14 Stat. 517, 535 (1867), *amended by* Act of June 25, 1910, ch. 412, § 4, 36 Stat. 838, 839 (1910), [*repealed by* Bankruptcy Act of 1947, ch. 391, 61 Stat. 652 (1947)]. Favored treatment also extended to exemption from: Social Security taxes, *see* Social Security Act of 1935, ch. 531, 49 Stat. 620, 625, § 201(b)(7) (1935), *repealed by* Social Security Amendments of 1983, Pub. L. No. 98-21, § 102, 97 Stat. 65, 70-71 (1983); collective bargaining (created and later repudiated by the National Labor Relations Board); federal unemployment insurance, *see* (Federal Unemployment Tax Act of 1939, ch. 2, 53 Stat. 183, 187, § 1607(c)(7) (1939); the minimum wage, *see* (29 C.F.R. § 779.214 (1970); [judicial interpretations] of the Fair Labor Standards Act of 1938, ch. 676, §§ 5-8, 12, 52 Stat. 1062-4 & 1067, (1938), *amended by* Fair Labor Standards Amendments of 1961, Pub. L. No. 87-30, § 2(r), 75 Stat. 65, 65 (1961); securities registration, *see* Securities Act of 1933, ch. 38, § 3(a)(4), 48 Stat. 74, 76 (1933); and unfair trade practice rules, *see* Federal Trade Commission Act, ch. 311, § 4, 38 Stat. 717, 719 (1914) (codified as amended at 15 U.S.C. § 45 (1986)). Moreover, nonprofits obtained favoritism under the copyright statutes, *see* Copyright Act of 1947, ch. 391, § 1(c) & (e), 61 Stat. 652, 653 (1947), Copyright Act of 1976, Pub. L. No. 94-553, §§ 110-112 & 118(d)(3), 90 Stat. 2541, 2549, 2551, 2559 & 2567 and *by* Act of Oct. 25, 1982, Pub. L. No. 97-366, § 3, 96 Stat. 1759, 1759 (1986), and pursuant to antitrust laws, *see* *Marjorie Webster Junior College, Inc. v. Middle States Ass'n. of Colleges & Secondary Schs.*, 432 F.2d 650, 654-55 (D.C. Cir. 1970). Nonprofit organizations were even protected from tort liability under the judicially created doctrine of charitable immunity. *See* W. PROSSER & W. KEETON, *PROSSER AND KEETON ON THE LAW OF TORTS* 1069 (5th ed. 1984); Note, *The Quality of Mercy: 'Charitable Torts' and Their Continuing Immunity*, 100 HARV. L. REV. 1382, 1982-86 (1987). For further discussion of the favored treatment of nonprofit organizations during the period of 1850-1950, *see* Henry Hansmann, *The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?*, 39 CASE W. RES. L. REV. 807, 810-12 (1988-89).

The list of favored treatment for nonprofit organizations described in I.R.C. § 501(c)(3) has declined over the past thirty years. For example, the charitable immunity doctrine is largely

## advantages<sup>4</sup> available to charitable organizations have not been bestowed

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unavailable. *See Note, supra*, at 1382, 1385. The antitrust laws now are applied with vigor to nonprofit organizations. *See Hansmann, supra*, at 817. Enforcement of the antitrust laws to mergers, acquisitions, and joint ventures of hospitals and other health care institutions has been increased, and has received much attention lately. *See Kevin J. Arquit, Developments and Trends in FTC Antitrust Enforcement*, 847 PRACTISING LAW INST. CORP. LAW AND PRAC. COURSE HANDBOOK SERIES 653,653-67 (June-July 1994); Fredric J. Entin et al., *Hospital Collaboration: The Need for an Appropriate Antitrust Policy*, 29 WAKE FOREST L. REV. 107 (1994); William G. Kopit & Robert W. McCann, *Toward a Definitive Antitrust Standard for Nonprofit Hospital Mergers*, 13 J. HEALTH POL., POL'Y & LAW 635 (1988); William T. Lifland, *Monopolies and Joint Ventures*, 846 PRACTISING LAW INST. CORP. LAW AND PRAC. COURSE HANDBOOK SERIES 141, 255-61 (June-July 1994); Dayna B. Matthew, *Doing What Comes Naturally: Antitrust Law and Hospital Mergers*, 31 HOUS. L. REV. 813 (1994); David L. Meyer & Charles F. (Rick) Rule, *Health Care Collaboration Does Not Require Substantive Antitrust Reform*, 29 WAKE FOREST L. REV. 169 (1994); Owen S. Mudge, Jr. & Allan Gibofsky, *The Developing Application of Antitrust Laws to Hospital Mergers*, 15 J. LEGAL MED. 355 (1994) Judy L. Whalley, *Mergers and Acquisitions Update*, 846 PRACTISING LAW INST. CORP. LAW AND PRAC. COURSE HANDBOOK SERIES 317 (June-July 1994).

However, § 501(c)(3) organizations do retain favored treatment in certain areas of the law. For example, the copyright laws, see 17 U.S.C. § 110(10) (1988), and the minimum wage laws, see 29 U.S.C. § 203(r) (1988 & Supp. V 1993), interpreted by 29 C.F.R. § 779.214 (1994) continue to favor these nonprofit organizations. Preferential postal rates are available (39 C.F.R. pt. 3001, subpt. C., app. A, § 3000.0212 (1988)), as are volume discounts on commodities purchased for use by the nonprofit organization, see 15 U.S.C. § 13 (1988).

4. The earliest history of the income tax exemption dates to an administrative ruling issued during the Civil War, the only period prior to 1894 that an income tax was imposed by the United States government. Pursuant to Treasury Decision 110, "the income of literary, scientific or other charitable institutions, in the hands of trustees or others, is not subject to income tax." Treas. Dec. 110 (May 1863), cited in, Tax Reform of 1969: Hearings on H.R. 13270 Before the Committee on Ways and Means, House of Representatives, 91st Cong., 1st Sess. 1425, 1428 n.1 (1969) (statement by Julius M. Greisman, Attorney, American Hospital Association). As part of The Tariff Act of 1894, Congress enacted the first federal income tax exemption for charitable organizations. *See Act of August 27, 1894, ch. 349, 28 Stat. 509, 556 (1894)*. One year later, the Supreme Court declared the Tariff Act unconstitutional. *See Pollack v. Farmers' Loan & Trust Co.*, 158 U.S. 601, 635-37 (1895). In 1909, The Payne Aldrich Tariff Act, which generally imposed an excise tax on "every corporation, joint stock company or association, organized for profit and having a capital stock represented by shares," exempted from the excise tax, among other organizations, "any corporation or association organized and operated exclusively for religious, charitable, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual." Tariff Act of 1909, ch. 6, § 38, 36 Stat. 11, 112-13 (1909). In 1913, Congress expanded the excise tax exemption to include "any corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes." Revenue Act of 1913, ch. 16, § II(G), 38 Stat. 114, 172 (1913). As part of the Internal Revenue Code of 1939, organizations exempt from income taxation included "[c]orporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary or educational purposes or for the prevention of cruelty to children or animals." Internal Revenue Code § 101(6), ch. 2, § 10, 53 Stat. 1, 33 (1939) (recodified as amended at I.R.C. § 501(c)(3) (1954), Pub. L. No. 591, 68A Stat. 3). Numerous legislative provisions expanded the reach of the tax exemption, to include such organizations as those that provide public safety testing [(Pub. L. No. 471, 62 Stat. 110 (1948)]; and amateur sports organizations, *see Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, 1730 (1976)*. Prohibitions against legislative activities and lobbying has long been a part of the

on for-profit entities. Perhaps the most famous financial benefits are the federal income tax exemption granted to charitable organizations approximately one hundred years ago pursuant to a predecessor provision of current Internal Revenue Code (I.R.C.) § 501(c)(3),<sup>5</sup> and the federal charitable income tax deduction given to donors eighty years ago under a precursor to current I.R.C. § 170.<sup>6</sup> State and local governments also provide valuable exemptions from income, sales, and property taxes to charitable organizations.<sup>7</sup> Today, these exemptions amount to over \$36.5

statutory requirements for tax exemption of charitable organizations. (Added first as part of the Revenue Act of 1934, Pub. L. No. 216, 48 Stat. 680 (1934), and expanded greatly in subsequent years, most recently in 1987 under the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330 (1987).) For further detailed histories, see Kenneth Liles & Cynthia Blum, *Development of the Federal Tax Treatment of Charities*, 39 LAW & CONTEMP. PROBS. 6 (1975); John P. Persons et al., *Criteria for Exemption Under Section 501(c)(3)*, Research Paper Sponsored by Commission on Private Philanthropy and Public Needs (U.S. Dept. of Treas. 1977).

5. Among the special benefits currently applicable to I.R.C. § 501(c)(3) charitable organizations are the following: exemption from income taxation, *see* I.R.C. § 501(a)(1998); eligibility for the receipt of charitable contributions that are deductible by donors in calculating income tax liability, *see id.* § 170, gift tax liability, *see id.* § 2522, and to reduce estate tax liability by the value of a charitable bequest, *see id.* § 2055(a)(2); eligibility to raise capital through the issuance of tax-exempt "qualified § 501(c)(3) bonds," *see id.* § 145; flexibility to structure certain employee compensation plans, such as tax sheltered annuities, *see id.* § 403(b); exemption from the federal unemployment payroll tax, *see id.* §§ 3301 and 3306(c)(8); and exemption from the communications services excise tax, *see id.* § 4253(h). Although many jurisdictions continue to exempt § 501(c)(3) organizations from state and local sales, income, and property taxes, some jurisdictions have curtailed or begun programs scrutinizing this favoritism, especially with respect to "charitable" nonprofit institutions. *See, e.g.*, TEX. TAX CODE ANN. § 11.18(d) (West 1995); *West Allegheny Hosp. v. Board of Prop. Assessment*, 455 A.2d 1170, 1172-73 (Pa. 1982); *School Dist. v. Hamot Med. Ctr.*, 602 A.2d 407, 413-15 (Pa. Commw. Ct. 1992); *Hospital Utilization Project v. Commonwealth*, 461 A.2d 894, 896-97 (Pa. Commw. Ct. 1983); *Utah County v. Intermountain Health Care, Inc.*, 709 P.2d 265, 276-78 (Utah 1985); *see also* Mark F. Baldwin, *Legislatures, Agencies Debating Whether Non-For-Profit Hospitals Deserve Their Tax-Exempt Status*, 17 MOD. HEALTHCARE, May 22, 1987, at 34 (noting that nonprofit hospitals are at risk of losing tax exemptions); David A. Hyman & T.J. McCarthy, *Property Tax Exemptions: Headed for Extinction?*, HEALTH PROGRESS, Dec. 1988, at 32 (noting that hospitals may lose property tax exemption); Daniel P. Moskowitz, *Strapped Governments Eye Nonprofit Hospitals*, 47 MED. & HEALTH, Aug. 1, 1993, available in WESTLAW, MEDHLTH data base, 1993 WL 2824098 (discussing heightened government scrutiny of nonprofit hospitals).

6. Congress first adopted a charitable contribution deduction in 1917. *See* War Revenue Act, ch. 63, § 1201(2), 40 Stat. 300, 330 (1917). Entities to which deductible contributions could be made were "corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals." *Id.*

7. Government is the most valuable source of income for most types of nonprofit organizations today, providing far more resources than private contributions. *See* Note, Lester M. Salamon, *Partners in Public Service: The Scope and Theory of Government-Nonprofit Relations*, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 99 (Walter W. Powell ed., 1987); Joseph C. Branch, Recent Decisions, *Taxation: The Property Tax Exemption and Non-Profit Homes for the*

billion per year in foregone tax revenues.<sup>8</sup>

The magnitude of the pecuniary benefit enjoyed by charitable organizations because of various tax exemptions is enormous.<sup>9</sup> With this fact in mind, if we were to focus exclusively on the federal income tax exemption, one of the largest exemptions, it may appear remarkable that there is no universally-accepted theory to explain the fundamental reason underlying the deliberate and continued conferral of that exemption on all qualifying charitable organizations. Numerous scholars have offered theories in attempts to provide the elusive explanation. As many or more commentators have criticized those offerings. Because I too am so bold as to think that I just might have a defensible theory, I am joining the ranks of those who have dared to provide a cogent explanation. However, this is not to think that my theory will not be critically examined.

As background, this Article begins in Part I with a brief explanation of the definitional concept of “charitable” for purposes of the federal income tax exemption. As will be made clear, the vagueness of its meaning is central to scholarly attempts to rationalize the exemption. Part II presents various major conventional and academic theories posed as explanations for the federal income tax exemption. Commentary on these theories also will be mentioned. Finally, in Part III, I present my own hypothesis, the theory of risk compensation. This theory suggests that the tax exemption

*Aged*, 53 MARQ. L. REV. 140, 140-41 (1970); Rebecca S. Rudnick, *State and Local Taxes on Nonprofit Organizations*, 22 CAP. U. L. REV. 321, 323 (1993); Note, *Exemption of Educational, Philanthropic and Religious Institutions From State Real Property Taxes*, 64 HARV. L. REV. 288, 288 (1950).

8. JAMES J. FISHMAN & STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS: CASES AND MATERIALS* 10 (1995). Revenue losses caused by a “special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability” are considered tax expenditures and have been explicitly adopted by Congress and the President in budget analysis as a result of the Congressional Budget Act of 1974. Congressional Budget Act of 1974, Pub. L. No. 93-344, 88 Stat. 297, 299 (codified as amended at 31 U.S.C. § 1101(a)(16) (1988); 2 U.S.C. § 622(3) (1988)). It has been predicted that for 1998 there will be \$3.2 billion in lost revenues from the I.R.C. § 170 charitable deduction; however, no projections are made regarding the value of “lost revenues” attributable to the I.R.C. § 501 income tax exemption. CONGRESSIONAL BUDGET OFFICE REPORT TO THE SENATE AND HOUSE COMMITTEE ON THE BUDGET, *REDUCING THE DEFICIT: SPENDING AND REVENUE OPTIONS* 243 (Mar. 1997) (relying on information provided by Staff of the Joint Committee on Taxation, 105th Cong., *Estimates of Federal Tax Expenditures For Fiscal Years 1998-2002*). For 1998 through 2002, it has been projected that \$95.9 billion in lost revenues would result if the I.R.C. § 170 charitable deduction were eliminated. *Id.* The Staff of the Joint Committee on Taxation has provided the explanation that § 501 organizations “are not treated as tax expenditures because the tax benefits are available to any corporation that chooses to organize itself and operate in the required manner.” Staff of the Joint Committee on Taxation, 102d Cong., 2d Sess., *Estimates of Federal Tax Expenditures For Fiscal Years 1993-1997*, at 5 (Comm. Print 1992) (without entry for the § 501 organizations).

9. Put into context, the exemptions provided to charitable organizations that are “the equivalent of the income taxes paid by 25 million taxpayers.”

is a non-volatile expected return to compensate rational charitable organizations for undertaking the provision of “inherently risky” public goods and services. Part III also suggests that the issue of an organization’s deservedness of the tax exemption must be separately addressed. It proposes that the appropriate means for determining whether an organization deserves the tax exemption requires taking into account an organization’s evolution, the need to maximize inter-generational utility, and the application of dynamic gamesmanship theory.

## I. MEANING OF “CHARITABLE” ORGANIZATION FOR I.R.C. § 501(C)(3) PURPOSES

### A. *English Antecedents of American Law*

The seeds of the tax exemption notion for American “charitable” organizations can be traced to fourteenth century England.<sup>10</sup> It was not until the seventeenth century that the first formal comprehensive list of worthy charitable uses for money and property was enumerated. In the preamble to the English Statute of Charitable Uses which was enacted in 1601,<sup>11</sup> among the uses cited as appropriate for a charitable trust were

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10. In approximately 1362, William Langland wrote a poem, *The Vision of Piers the Plowman*, which chronicles in one portion a means for wealthy merchants to save their souls by dedicating their fortunes to:

repair hospitals  
 help sick people  
 mend bad roads  
 build up bridges that had been broken down  
 help maidens to marry or to make them nuns  
 find food for prisoners and poor people  
 put scholars to school or to some other craft  
 help religious orders, and  
 ameliorate rents or taxes.

Persons et al., *supra* note 4, at 1912 (quoting the modern English version of the “B” text of the poem which was edited from numerous manuscripts by the Rev. Walter W. Skeat, 1:228, Oxford, 1886).

11. The Statute of Charitable Uses, 43 Eliz., ch. 4 (1601) (Eng.) was enacted as a supplement to the comprehensive system of the Elizabethan Poor Laws adopted by Parliament in 1597 and restated in 1601. Act for the Relief of the Poor, 43 Eliz., ch 2 (1601), *reprinted in* 7 Stat. at Large 30 (Eng. 1763). Under the 1597 laws, which addressed problems faced by destitute populations in urban England, responsibility for relief of poverty was primarily imposed on local communities. The communities had the power to tax for purposes of relieving poverty. *See* Persons et al., *supra* note 4, at 1913. The Statute of Charitable Uses addressed “whether a trust which had no specific beneficiary” should be recognized at common law when its intention was “to serve the poor, or to maintain a local roadway” rather than a specific beneficiary. Oliver A. Houck, *With Charity for All*,

“relief of aged, impotent and poor people . . . maintenance of sick and maimed soldiers and mariners . . . aid and help of . . . persons decayed.”<sup>12</sup> Relying on this enumeration of appropriate charitable uses, a confused body of judicial precedent developed in England concerning the parameters of the legal concept of charity for trust law purposes.<sup>13</sup> At the end of the nineteenth century, a decision written by Lord McNaughten in the now famous *Commissioners of Income Tax v. Pemsel*,<sup>14</sup> presented a unifying theme for conceptualizing appropriate charitable uses under the laws of trusts:

“Charity” in its legal sense comprises four principal divisions: trusts for the relief of poverty; trusts for the advancement of education; trusts for the advancement of religion; and trusts for other purposes beneficial to the community, not falling under any of the preceding heads. . . . The trusts last referred to are not the less charitable in the eye of the law, because incidentally they benefit the rich as well as the poor, as indeed, every charity that deserves the name must do either directly or indirectly.<sup>15</sup>

As a result of the decision in the *Pemsel* case, the English courts uniformly adopted this concept of charity for determining whether an organization was entitled to income tax exemption as a charitable organization.<sup>16</sup> Initially, charitable trusts were the principal form of organization for charitable activities.<sup>17</sup> By the second half of the nineteenth century,

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93 YALE L.J. 1415, 1422 n.4 (1984). The “statute deemed that such a trust should be permitted.” *Id.* For a more detailed look at the statute of charitable uses, see generally MICHAEL CHESTERMAN, CHARITIES, TRUSTS AND SOCIAL WELFARE 54-58 (1979); GARETH JONES, HISTORY OF THE LAW OF CHARITY 1532-1827, at 22-25 (1969); L. SHERIDAN & G. KEETON, THE MODERN LAW OF CHARITIES 8-9 (3d. ed. 1983).

12. Persons et al., *supra* note 4, at 1912-13 (citing GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 321, at 638 n.2 (1965)). This enumeration of charitable uses in the preamble to the English Statute of Charitable Uses also included such activities as maintaining schools of learning, repairing bridges, educating and aiding orphans, and aiding the poor pay taxes. *See id.* at 1912-13. The preamble was not intended to be an exclusive list of charitable purposes. *See id.* at 1913. Moreover, it has been determined that the list should be viewed in the disjunctive, so that relief of the distress of the aged is an appropriate charitable purpose *per se*. *See* Robert S. Bromberg, *The Charitable Hospital*, 20 CATH. U. L. REV. 237, 240-41 (1970).

13. *See* Bromberg, *supra* note 12, at 240-41; Persons et al., *supra* note 4, at 1914-15.

14. 1891 App. Cas. 531.

15. *Id.* at 583.

16. Charitable organizations have been entitled to income tax exemption in England since enactment of the first Income Tax Act of 1842. *See* Persons et al., *supra* note 4, at 1919.

17. *See id.* at 1917. The reason cited for primary use of the trust form was the flexibility available to individuals to create trusts, whereas power to form corporations was concentrated in

corporations were used increasingly in England for charitable activities.<sup>18</sup>

### B. American Law

Until the end of the Revolutionary War, the American colonies were bound by English law. However, after the Revolutionary War, many American states repealed English statutes and rejected traditional English structures.<sup>19</sup> As a result, the accepted legal form in many states in early America for charitable activities became the corporation. Most states encouraged the incorporation of private associations that engaged in essential public services.<sup>20</sup> Therefore, when the first federal income tax on corporations was adopted in America in 1894, it exempted from income taxation those

corporations, companies, or associations organized and conducted solely for charitable, religious or educational purposes, . . . nor to the stocks, shares, funds, or securities held by any fiduciary or trustee for charitable, religious, or educational purposes.<sup>21</sup>

Because American public charitable entities continued to be formed primarily as corporations rather than as trusts, subsequent income tax acts, such as the Revenue Act of 1913, contained similar provisions.<sup>22</sup> However, early legislative history gave scant information on what legislators considered to be “charitable.”<sup>23</sup>

the State.

18. *See id.*

19. Some of the American states rejected English laws *en masse*, among them the Statute of Charitable Uses. *See id.* at 1919. Some of the states also rejected the charitable trust as the legal form for operating charitable activities. *See id.*

However, corporations had been formed to conduct charitable activities in the American colonies as early as the seventeenth century. *See* James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L. J. 617, 630 (1985).

20. RONALD SEAVOY, *THE ORIGINS OF THE AMERICAN BUSINESS CORPORATION 1784-1855*, at 255 (1982); Fishman, *supra* note 19, at 631-37.

21. Act of August 27, 1894, ch. 349, § 32, 28 Stat. 509, 556 (1894).

22. *See supra* note 4 (discussing statutory history of income tax exemption); *see also infra* notes 24-30 and accompanying text (discussing whether I.R.C. § 501(c)(3) term “charitable” was intended to be synonymous with term “charity” for trust law purposes).

23. The first lengthy consideration of the term “charitable” by legislators occurred in 1924 in the Senate, when, during debate, Senator Willis of Ohio informed his fellow Senators that the Bureau of Internal Revenue (“Bureau”), predecessor to the IRS, used the term to include only organizations with activities limited to aiding the poor. *See* 65 CONG. REC. 8171(1924). Senator Willis considered the Bureau’s definition too narrow and sought to expand the statute (which for all intents and purposes was identical to the current statute) to parenthetically define “charitable” to include organizations that provide “preventive and constructive service for relief, rehabilitation,

Today, I.R.C. § 501(c)(3), the federal statute that grants exemption from income taxation to charitable organizations, reads much like its predecessor provisions. It specifically inflicts a “purpose constraint”—that is, the organization must be “organized and operated exclusively for religious, charitable, scientific . . . or educational purposes,”<sup>24</sup> but utilizes the term “charitable” without presenting a formal definition. Although the past thirty-five years have resulted in much effort to clarify the meaning of “charitable” by legislators,<sup>25</sup> the I.R.S.,<sup>26</sup> the judiciary,<sup>27</sup> commentators,<sup>28</sup>

health, character building and citizenship.” *Id.* Some senators objected to the addition of the parenthetical phrase because of its potential expansiveness and its effect of making such organizations *per se* “charitable” and thus automatically tax-exempt regardless of services provided to the poor. *See id.* at 8171-72. Senator Smoot, in particular, argued against Senator Willis’ proposal because of its use of vague terms like “health” and “character building.” *Id.* at 8172. The debate resulted in Senator Willis withdrawing his proposed statutory amendment. For further discussion of this legislative endeavor, see Marilyn G. Rose, *The Internal Revenue Service’s “Contribution” to the Health Problems of the Poor*, 21 CATH. U. L. REV. 35, 46-51 (1971).

24. I.R.C. § 501(c)(3)(1998). This section applies only to

[c]orporations, . . . or foundation[s], 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, . . . and which does not participate in, or intervene in . . . any political campaign on behalf of . . . any candidate for public office.

*Id.* Along with the term “charitable,” this provision lists religious, scientific and educational purposes which are considered to be acceptable charitable activities for exemption. *See id.* § 501(c)(4)-(27).

25. A recent example of legislators’ involvement in addressing the meaning of “charitable” was in the context of whether hospitals are *per se* charitable organizations for purposes of § 501(c)(3). In 1969, the American Hospital Association (AHA) suggested in hearings before the House Ways and Means Committee that nonprofit hospitals should be *per se* tax-exempt organizations. *See Hearings on Tax Reform Act of 1969, H.R. 13270, Before the House Comm. on Ways and Means*, 91st Cong., 1425, 1432-33 (1969) (statement by AHA attorney Julius M. Greisman). The House granted the AHA request in its report. *See H.R. CONF. REP. No. 91-413*, at 43 (1969). The Senate Finance Committee deleted the House provision granting *per se* exemption to hospitals, which the joint committee accepted. *See S. REP. No. 91-552*, at 61 (1969); *H.R. CONF. REP. No. 91-782*, at 289-90 (1969). However, as the Senate Finance Committee promised, the matter was again considered in connection with Medicare and Medicaid legislation. *See Medicare and Medicaid: Hearings Before the Subcomm. on Medicare-Medicaid of the Senate Comm. on Finance*, 91st Cong., 374-76 (1970); STAFF OF SENATE COMM. ON FINANCE, 91ST CONG., MEDICARE AND MEDICAID—PROBLEMS, ISSUES AND ALTERNATIVES 55-58 (Comm. Print 1970).

The issue has surfaced more recently. *See Tax Reform Act of 1986, Part III: Hearings Before the Senate Comm. on Finance*, 99th Cong., 29-30 (1986) (statement of Bernard R. Tresnowski, President, Blue Cross and Blue Shield Organization, Chicago, Ill., in which Mr. Tresnowski voiced objections to repeal of the Federal tax exemption for Blue Cross and Blue Shield plans). Most recently, in hearings involving the proposed Health Security Act, S. 1757, 103d Cong., (1993), the Joint Committee on Taxation examined the tax treatment of nonprofit hospitals in the context of their role in furthering charitable purposes. *See STAFF OF JOINT COMM. ON TAXATION*, 103d CONG.,

and the Department of Treasury,<sup>29</sup> there has resulted no fixed definition of the word “charitable.” Rather, as set forth in Treasury regulations, the term is to be broadly applied in “its generally accepted legal sense.”<sup>30</sup>

DESCRIPTION AND ANALYSIS OF TITLE VII OF H.R. 3600, S. 1757, AND S. 1775 (“HEALTH SECURITY ACT”) 82-84 (Comm. Print 1993). The committee recognized that a nonprofit medical care organization, in order to qualify for tax exemption, “must demonstrate that its activities are targeted to a charitable class.” *Id.* at 82. The Committee further noted that “[t]he precise nature of that charitable class has been and continues to be a source of controversy.” *Id.*

26. See, e.g., Rev. Rul. 56-185, 1956-1 C.B. 202; Rev. Rul. 69-545, 1969-2 C.B. 117.

27. See, e.g., *Bob Jones Univ. v. United States*, 461 U.S. 574, 585-89 (1983); *Girard Trust Co. v. Commissioner*, 122 F.2d 108, 109-10 (3d Cir. 1941); *Green v. Connally*, 330 F. Supp. 1150, 1157-59 (D.D.C. 1971), *aff’d mem. sub. nom.*, *Coit v. Green*, 404 U.S. 997 (1971); *Sound Health Ass’n v. Commissioner*, 71 T.C. 158, 177-78 (1978).

28. See, e.g., MARION R. FREMONT-SMITH, *FOUNDATIONS AND GOVERNMENT* 41-43 (1965); BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 123-76 (6th ed. 1992); Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 *YALE L.J.* 299, 330-33 (1976); Houck, *supra* note 11, at 1424-25; Persons et al., *supra* note 4, at 1932-50.

29. Assistant Secretary of the Treasury for Tax Policy, Edwin S. Cohen, stated in hearings before the House Ways and Means Committee: “We have tried to avoid interpreting the word ‘charitable’ in a fixed, immutable fashion. As the courts have done in many nontax settings, we have tried to give it meaning that changes and expands as the needs of society change and expand.” HOUSE COMMITTEE ON WAYS AND MEANS, 92ND CONG., 2D SESS., *LEGISLATIVE ACTIVITY BY CERTAIN TYPES OF EXEMPT ORGANIZATIONS* 5 (Comm. Print 1972).

30. Treas. Reg. § 1.503-(d)(2) (as amended, 1990). Early Treasury pronouncements consistently had interpreted the term “charitable” in its “popular and ordinary” sense, see HOPKINS, *supra* note 28, at 75 n.31-32; I.T. 1800, II-2 C.B. 152, 153 (1923); Treas. Reg. 65, art. 517 (interpreting provision under Revenue Act of 1924); Treas. Reg. 69, art. 517 (interpreting provision under Revenue Act of 1926); Treas. Reg. 74, art. 527 (interpreting provision under Revenue Act of 1928); Treas. Reg. 77, art. 527 (interpreting provision under Revenue Act of 1932); Treas. Reg. 86, art. 101(6)-1 (interpreting provision under Revenue Act of 1934); Treas. Reg. 94, art. 101(6)-1 (interpreting provision under Revenue Act of 1936); Treas. Reg. 101, art. 101(6)-1 (interpreting provision under Revenue Act of 1938); Laura B. Chisolm, *Exempt Organization Advocacy: Matching the Rules to the Rationales*, 63 *IND. L.J.* 201, 257 & n.240 (1987); see also *Eastern Ky. Welfare Rights Org. v. Shultz*, 370 F. Supp. 325, 336-37 (D.D.C. 1973) (stating that Congress intended the term “charitable” to be interpreted in its narrow sense). However, by 1959, Treasury had changed its approach to reflect a broader interpretation. See Treas. Reg. § 1.501(c)(3)-1(d)(2) (1959), which in relevant part provided:

The term “charitable” is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of “charity” as developed by judicial decisions. Such term includes: relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to

## II. SCHOLARS' THEORIES OF TAX EXEMPTION FOR CHARITABLE ORGANIZATIONS

### A. *Basic Notions*

Putting aside the weight and potency of history, scholars have stressed explanatory theories based on economic, social and public policy reasoning. Several authors have relied on considerations of the importance of nonprofit organizations in promoting pluralism in American society.<sup>31</sup> Another explanation is that the nonprofit sector provides a means by which collaborative actions of persons in our individualistic democratic society can freely express a solidarity of values and goals.<sup>32</sup> Some commentators explain that the exemption resides in the concept that charitable organizations serve important moral and social functions deserving of support.<sup>33</sup>

### B. *Subsidy Theory*

A conventional combined market and social theory, the "subsidy theory," is based upon the notion that charitable organizations relieve the government of burdens by providing essential goods and services that the government otherwise would be responsible for delivering.<sup>34</sup> The theory is

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combat community deterioration and juvenile delinquency.

Although the regulations were amended in 1990, they employ the same descriptive language of using the term "charitable" in its "generally accepted legal sense." See Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended in 1990).

The Supreme Court has infused the concept of "charitable" with an obligation to comport with public policy. See *Bob Jones Univ. v. United States*, 461 U.S. 574, 584-85 (1983) (holding that a university is not charitable if it is racially discriminatory).

31. See, e.g., HOPKINS, *supra* note 28, at 10; Norman S. Fink, *Taxation and Philanthropy—A 1976 Perspective*, 3 J.C. & U.L., Fall 1975, at 1. Courts also have cited pluralism as a rationale for the tax exemption. See, e.g., *Green v. Connally*, 330 F. Supp. 1150, 1162 (D.D.C.), *aff'd sub nom.*, *Coit v. Green*, 404 U.S. 997 (1971).

32. See HOPKINS, *supra* note 28, at 11-16.

33. See, e.g., James J. McGovern, *The Exemption Provisions of Subchapter F*, 29 TAX LAW. 523, 526 (1976). This moralistic policy also has been cited as underlying the I.R.C. § 170 charitable contribution deduction. See William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 346 (1972).

34. See H.R. REP. NO. 75-1860, at 19 (3d Sess. 1938), which indicated that

[t]he 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 burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from

premised on the notion that charitable purposes and organizations are worthy of promotion, and it is the government that should promote them through an indirect subsidy—the tax exemption.<sup>35</sup>

Critics have perceived the subsidy theory to be an incomplete explanation for the exemption.<sup>36</sup> The tax exemption has been equated to an indirect government subsidy that amounts to a tax expenditure, the efficiency of which is questionable in comparison with efficiencies perceived to attach to direct subsidies.<sup>37</sup> Finally, the subsidy theory has not been regarded as universally applicable to all nonprofit organizations.<sup>38</sup>

### C. *Alternatives to Subsidy Theory*

Scholars have proposed a number of alternative theories in response to criticisms of the subsidy theory. There are basically four alternative theories posited by academicians: (1) the income measurement theory; (2) the capital formation theory; (3) the “altruism theory;” and (4) the donative

the promotion of the general welfare.

*See also* *McGlotten v. Connally*, 338 F. Supp. 448, 456 (D.D.C. 1972) (“[T]he Government relieves itself of the burden of meeting public needs which in the absence of charitable activity would fall on the shoulders of the Government.”).

35. For example, the theory provides that charitable organizations deliver “charity,” which includes health care services to the poor free of charge because, in part, the provision of such services is recognized as a community benefit under traditional trust law, and it relieves the government of the burden of providing such services. *See* Bromberg, *supra* note 12, at 248-51; Mark A. Hall & John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307, 332-38 (1991). These are the same factors used by the IRS and courts in determining whether an organization deserves tax-exempt status as a “charitable” organization. *See, e.g.*, Treas. Reg. § 1.501-(c)(3) and cases cited *supra* note 27.

36. *See, e.g.*, Bittker & Rahdert, *supra* note 28, at 305-06; *Developments in the Law—Nonprofit Corporations*, 105 HARV. L. REV. 1578, 1620-21 (1992) [hereinafter *Developments in the Law*] (explaining subsidy theory, scrutinizing its shortcomings, and suggesting a tax expenditure analysis revealing its weaknesses).

37. *See* *Developments in the Law*, *supra* note 36, at 1620. A critic of the subsidy theory suggests that:

[E]mbedding substantive policy programs in the tax system forces ill-equipped tax administrators and legislative tax committees to make substantive policy decisions. Congressional spending eludes proper scrutiny by substantive policy committees whenever Congress includes such spending programs in tax legislation. Similarly, this practice forces the IRS to make substantive policy decisions when formulating regulations that interpret legislation.

*Id.* at 1621 (footnotes omitted); *see also* STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* 95-96, 106 (1985) (discussing administrative burdens of implementing substantive income tax policies).

38. *See supra* note 37.

theory.

## 1. Income Measurement Theory

The “income measurement theory,” proposed in 1976 by two tax scholars, Professors Boris I. Bittker and George K. Rahdert, suggests that nonprofit organizations are exempt from income taxation because there is no practical and traditional tax accounting method to measure the net income of the entities.<sup>39</sup> In other words, it is difficult for a nonprofit entity to classify certain income, such as donations, and to categorize certain expenses that could be typed as either nondeductible, or deductible as ordinary and necessary business expenses to a for-profit enterprise.<sup>40</sup> Further, even if the net income of the charities were definable and thus determinable, there is no means of setting the proper tax rates under current tax theory.<sup>41</sup> However, the income measurement theory has not been favored by other academicians on the grounds that it is inapplicable to many nonprofit organizations because donations comprise only a portion of their financial resources, while measurable income often is derived from sales of goods or services.<sup>42</sup>

## 2. Capital Formation Theory and the Nondistribution Constraint

The “capital formation theory” was constructed by economist and law professor Henry Hansmann in response to perceived inadequacies of the income measurement theory.<sup>43</sup> In his theory, Professor Hansmann suggests that the income tax exemption is appropriate for nonprofit organizations because it compensates them for inadequate access to the traditional form of capital—equity investment.<sup>44</sup> He explains that lacking borrowed capital, donated capital, or retained earnings, nonprofit organizations are unable to expand and are unlikely to reach their optimal size.<sup>45</sup> Therefore, Professor Hansman asserts that the tax exemption is an effective way to offset this disadvantage because it permits nonprofits to retain more net earnings for expansion and innovation.<sup>46</sup>

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39. See Bittker & Rahdert, *supra* note 28, at 301-07.

40. See *id.* at 307-14.

41. See *id.* at 314-16.

42. See Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501, 610-16 (1990); Hall & Colombo, *supra* note 35, at 385-87; Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 58-62 (1981).

43. See Hansmann, *supra* note 42, at 55.

44. See *id.* at 72-75 (arguing that the tax exemption levels the playing field of for-profit enterprises and nonprofit organizations with regard to capital acquisition).

45. See *id.* at 72-74.

46. See *id.* at 72-75 (stating that loss of the tax exemption would result in a lessened ability of nonprofit organizations to be technologically current).

Professor Hansmann premised his capital formation theory on the “nondistribution constraint.”<sup>47</sup> The nondistribution constraint is based on the historical rule that forbids a charity from distributing surplus funds to persons other than the intended class of charitable beneficiaries.<sup>48</sup> There is a prohibition against distributing surplusage to persons having control over the charitable organization, such as owners, donors, managers, or trustees of a charitable organization.<sup>49</sup> Consequently, Professor Hansmann argues that nonprofit organizations are the most efficient providers of goods and services as a result of “contract failures”—that is, information asymmetries and monitoring problems—that occur within the framework of for-profit enterprises because, in the private marketplace, consumers of for-profit businesses either may not have ready access to information or may have difficulty evaluating for-profit goods and service providers.<sup>50</sup> In other

47. *See id.* at 56-57.

48. *See* Statute of Charitable Uses, 43 Eliz., ch. 4 (1601) (Eng.), which was the first attempt to enforce this common law rule.

49. Professor Hansmann describes the nondistribution constraint by stating:

A nonprofit organization is, in essence, an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees. By “net earnings” I mean here pure profits—that is, earnings in excess of the amount needed to pay for services rendered to the organization; in general, a nonprofit is free to pay reasonable compensation to any person for labor or capital that he provides, whether or not that person exercises some control over the organization. It should be noted that a nonprofit organization is not barred from earning a profit. . . . It is only the distribution of the profits that is prohibited.

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

50. *See* Hansmann, *supra* note 42, at 86-91; Hansmann, *supra* note 49, at 843-45. The contract failures to which Professor Hansmann refers are types of transaction costs to which economist R. H. Coase wrote of in 1937. *See* Ronald Coase, *The Nature of the Firm*, *ECONOMICA*, (Nov. 1937), at 4, *reprinted in* THE FIRM THE MARKET AND THE LAW 33, 38-40 (1988).

Professor Hansmann describes three situations in which public consumers or patrons of an organization would prefer a nonprofit form over a for-profit form because of information asymmetries: (1) third-party payors, like persons making donations to the American Red Cross for disaster relief; (2) public goods, like public monuments or scientific research; and (3) complex personal services, like hospital care or education. *See* Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 504-6 (1981). The information asymmetry in the first category, due to such factors as physical distance from the disaster and lack of tracing of funds, means the third-party payor cannot judge whether donated funds are actually spent on disaster relief. *See id.* at 505. In the second situation, a potential patron may consider not making a donation to a for-profit provider of the public good because of both the ability to be a free-rider, and the lack of ability to monitor whether donations actually are spent on the provision of the public good. *See id.* at 505-06. In the final category, the consumer of complex personal services, such as health care or education, may lack expertise to determine the quality and appropriateness of the type of health care or education. *See id.* at 506. Professor Hansmann suggests that the nondistribution constraint solves these information asymmetries. *See id.* He asserts that because nonprofits are prohibited from

words, he suggests that the income tax exemption may encourage the development and growth of nonprofit organizations in industries characterized by information asymmetries and monitoring problems. This is so because consumers trust nonprofit organizations (due to the nondistribution constraint) more than they trust for-profit entities that are in business to make and distribute their profits to shareholders.<sup>51</sup>

For years, academicians have criticized Professor Hansmann's theories for numerous reasons, among which are its restricted application to economically efficient nonprofits, a lack of historical consistency, a deficiency in strong supportive evidence, the absence of consideration of concepts like philanthropy and charity, and the treatment of all consumers—patrons, customers, and donors—as alike.<sup>52</sup> Recently, one scholar, Professor Evelyn Brody, argued that the nondistribution constraint theory is circular.<sup>53</sup> Under the nondistribution constraint theory, as a result of the public's lack of information, it cannot judge the quality of goods and services in the marketplace by for-profit enterprises; in response, the public forms nonprofit organizations which are deemed trustworthy, regardless of merit or public accountability.<sup>54</sup> Relying on the nondistribution constraint theory as her focal point, she questioned whether the public can discern the trustworthiness of nonprofits, where there is little public accountability, any better than it can determine the trustworthiness of for-profit organizations.<sup>55</sup> She argued that if trustworthiness cannot be better discerned with respect to nonprofits, the nondistribution constraint cannot be the reason for having nonprofit providers of goods and services in the marketplace.<sup>56</sup> Moreover, if one cannot distinguish nonprofit and for-profit organizations by their trustworthiness, then the nondistribution constraint cannot explain nonprofits' entitlement to the tax exemption.<sup>57</sup>

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distributing funds to persons for personal gain and must use funds to support intended beneficiaries, patrons link a sense of security or trustworthiness to nonprofit providers and prefer them in these situations to for-profit providers. *See id.*

51. *See* Hansmann, *supra* note 50, at 506-07. However, Professor Hansmann admits that such contract failure assumptions do not apply in the case of most hospital services because physicians assist patient-consumers in making health care service decisions. *See* Hansmann, *supra* note 49, at 866-68; Hansmann, *supra* note 42, at 89.

52. *See* Ira Mark Ellman, *Another Theory of Nonprofit Corporations*, 80 MICH. L. REV. 999, 1000, 1013-18 (1982); Hall & Colombo, *supra* note 35, at 387-89.

53. *See* Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 459 (1996).

54. *See id.* at 459-60.

55. *See id.* at 460, 462-65.

56. *See id.* at 460.

57. *See id.* at 535-36. Professor Brody reminds us that the economic account is only one aspect of considering whether nonprofit organizations warrant tax exemption. *See id.* at 536.

### 3. Altruism Theory

Despite their shortcomings, Professor Hansmann's theories, as well as the subsidy theory, have served as a foundation on which others have built. Professor Rob Atkinson developed an "altruism theory,"<sup>58</sup> which takes a social policy approach that "rests on the premise that the favorable tax treatment of altruistic nonprofit organizations demonstrates an affirmative preference for something" that those entities provide, including both direct primary benefits to consumers and "metabenefits."<sup>59</sup>

He posits that public charities generate collective goods and services that benefit the public and are deemed inherently good—for example, social services to the needy, education, and health care.<sup>60</sup> Beyond these specific and direct benefits, charitable organizations generate other benefits: "metabenefits."<sup>61</sup> Metabenefits are "benefits that derive not from what product is produced or to whom it is distributed, but rather from how it is produced or distributed."<sup>62</sup> Metabenefits, which are considered intrinsically good, include such intangibles as the fostering of volunteerism and pluralism, "initiative of thought and action," experimentation, and the like.<sup>63</sup> Professor Atkinson suggests that altruism is an inherently valuable metabenefit produced by nonprofits and that it deserves tax subsidization.<sup>64</sup> He indicates that alternatives to tax subsidization may not be less costly, and that by virtue of its duration and structure, the established tax subsidization system enjoys considerable legitimacy.<sup>65</sup>

### 4. Donative Theory

Criticizing the traditional theories and refining and expanding other theories, Professors Mark A. Hall and John D. Colombo developed the "donative theory," which posits that only those charitable organizations funded substantially by philanthropic donations deserve and should be

58. Atkinson, *supra* note 42, at 618.

59. *Id.*

60. *See id.* at 605.

61. *Id.* (describing traditional subsidy theory as encompassing the provision of conventional goods and services beneficial to the public by altruistic nonprofit organizations, which also produce "metabenefits," meaning they have the capacity to deliver such goods or services "more efficiently, more innovatively, or otherwise better than other suppliers").

62. *Id.*

63. *See id.* at 605 & n.291

64. *See id.* at 628-29.

65. *See id.* at 632; *see also* James Andreoni, *Giving with Impure Altruism: Applications to Charity and Ricardian Equivalence*, 97 J. POL. ECON. 1447, at 1448-49 (1989) (concluding that people derive some utility and "warm glow" from the act of contributing, which makes government subsidies imperfect substitutes for gifts).

entitled to the tax exemption.<sup>66</sup> Their arguments draw on economics “strongly buttressed by the leading theories of distributive justice and by the pluralistic values that characterize the third [nonprofit] sector.”<sup>67</sup> The donative theory suggests “that the primary rationale for the charitable exemption is to subsidize those organizations capable of attracting a substantial level of donative support from the public”—that is, donative nonprofits.<sup>68</sup>

Specifically, Professors Hall and Colombo assert as direct corollaries the following: (1) the fact that an entity can attract a substantial level of donations demonstrates its worthiness of and need for donations—hence, deservedness,<sup>69</sup> and, (2) the entity’s deservedness is demonstrated by the “willingness of the public to contribute” to it.<sup>70</sup> They maintain that

neither the particular market defect that leads to a donation nor the subjective motivation for a donation is relevant to whether the object of a donation qualifies for subsidy (at most, only to the *level* of subsidy); all that matters is whether a payment is in fact a donation, which is revealed by a *quid pro quo* test.<sup>71</sup>

They also reason that because the donative theory is not based on classic economics, it answers the question of why the exemption is a response to the market failure that results in free-rider problems and the government’s inability to provide all necessary services or goods at their optimal levels.<sup>72</sup>

66. Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L.J. 1379, 1383-84 (1991); Hall & Colombo, *supra* note 35, at 389-90.

67. Hall & Colombo, *supra* note 66, at 1389.

68. Hall & Colombo, *supra* note 35, at 390. The theory fits donative nonprofits better than commercial nonprofits, which, because they generate income from other sources, do not rely on contributions to the same extent as donative nonprofits. See Hall & Colombo, *supra* note 66, at 1389-90. Professors Hall and Colombo assert that the donative theory has a “unique ability to tie together all of the major components of the taxation of charities. It explains the deduction for charitable contributions, the income tax exemption, and the property tax exemption.” *Id.* at 1433. They also state that it “nicely explains” the sales tax exemption. *Id.* at 1433 n.152.

69. See Hall & Colombo, *supra* note 66, at 1384-85.

70. *Id.* at 1385.

71. *Id.* at 1389.

72. See *id.* at 1391-92; Hall & Colombo, *supra* note 35, at 391-94. Hall and Colombo suggest that “classic economic theory”

postulates that the government is in the best position to provide public goods (either directly, or by subsidizing private production) since government can coerce purchase by everyone via the power of taxation.

Sometimes, however, the government fails . . . to supply the optimal level of a public good. The consequence of this twin failure of markets and government is that people resort to volunteerism to provide unmet public needs. . . . [F]ree-

Moreover, Professors Hall and Colombo suggest that where market defects give rise to significant donations, “the existence of substantial donative support from the public at large signals the need for an additional . . . subsidy.”<sup>73</sup> The tax exemption is appropriate “to take up the donative slack”<sup>74</sup> because the free-rider phenomenon intrudes, causing charitable donations alone to systematically fall short of supplying sufficient funds to make an organization financially able to optimally deliver all public needs.<sup>75</sup> In other words, all charitable organizations will be underfunded by donations alone, and the tax exemption fills the funding gap with a shadow subsidy. However, in applying their theory, Professors Hall and Colombo suggest that because only those nonprofit entities that attract “substantial” donations should receive the tax exemption, the entities should attain a threshold donation level of approximately thirty-three percent of gross revenue before qualifying.<sup>76</sup> Thus, Professors Hall and Colombo indicate the undeservedness of commercial nonprofits that supply complex goods and services to a substantial number of consumers for a fee.

To date, I have located two published criticisms of the donative theory.<sup>77</sup> While labeled “promising” because the theory seeks to explain both the income tax and property tax exemption, it is criticized for its “inherent arbitrariness in setting the threshold level of donations necessary

riding behavior is severely dampened by a set of motives loosely described as altruism—a willingness to take a collective view of social benefit and set aside narrow, individual self-interest. Donative nonprofits exist as the preferred organizational form when an institutional setting is required for altruism.

The observed willingness to donate conflicts with classic economics only in its most absolute form, though, by disproving the strong free rider hypothesis. That is, the willingness to donate conflicts with the classic economic theory that rational people will always choose to free ride. . . .

The persistence of the free rider disinclination to support societal or group causes supplies the most rigorous justification for subsidizing the objects of altruism. . . . The free riding incentive tells us, however, that these donations systematically fall short of supplying the objects of philanthropy at an optimally desired level, that is, the level that would be supplied if the products or services were capable of being purchased (or did not suffer from government failure). A tax exemption for donative institutions helps to take up this donative slack by using the tax system as a form of shadow subsidy.

Hall & Colombo, *supra* note 66, at 1391-93 (footnotes omitted).

73. Hall & Colombo, *supra* note 66, at 1385.

74. *Id.*

75. *See id.* at 1398.

76. *See id.* at 1450-58 (with respect to nonprofit hospitals).

77. *See* Rob Atkinson, *Theories of the Federal Income Tax Exemption for Charities: Thesis, Antithesis, and Syntheses*, 27 STETSON L. REV. 395, 428 (1997); *Developments in the Law, supra* note 36, at 1623-25.

to qualify for tax-exempt status” and its view that intensity of true public support for an institution is not necessarily reflected by the amount of donations.<sup>78</sup> Professor Rob Atkinson points out that the donative theory produces a paradox, and this point is admitted by Professors Hall and Colombo:

The more donative support an organization receives, and thus the more deserving it is of subsidy in terms of the likely undersupply of the good it produces, the greater will be its ratio of donative to other income and hence the less helpful the subsidy will be. Why less helpful? Because gifts are not ordinarily included in income anyway, and even if they were, they could be offset by an operating expense deduction if they were disbursed.<sup>79</sup>

I would suggest that the donative theory is in its own way circular. The theory is based upon worthiness or deservedness. Pursuant to the theory, the tax exemption is conferred on charitable organizations that receive donations; donations are received by “deserving” organizations. Therefore, conferral of the tax exemption is appropriate for those organizations supported by substantial donations. The theory fails to consider a number of issues. What is the connection, if any, between deservedness of the tax exemption and the level of donations an organization is able to attract? What if an existing nonprofit does not attract “substantial” donations? Are its activities necessarily not worthy of governmental support in the form of a tax exemption? Is it really not supported in a nonfinancial sense by the public? Does the failure to attract substantial donations truly mean that donors are capable of monitoring charitable organizations and that their levels of donations directly correlate with and are true indicators of the trustworthiness of nonprofits to provide quality goods and services otherwise unavailable at optimal levels due to market failure and contract failure? What about a “start-up” nonprofit organization that has yet to attract large amounts of donations because it is new to the marketplace? Does a system of permitting exemption on a trial basis for a two or five year period, as suggested by Professors Hall and Colombo, inhibit rather than encourage new entrants to the nonprofit marketplace, and hence potentially restrict the availability of certain public goods and services? Because charitable nonprofits are said to provide a valued means of expanding volunteerism, of promoting pluralism, of fostering innovation, and of supporting other “metabenefits,” does the theory devalue the importance that society has placed on them? In sum, does the donative

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78. *Developments in the Law, supra* note 36, at 1624-25.

79. Atkinson, *supra* note 64, at 428.

theory merely indicate which charitable organizations its proponents think deserve to receive a tax subsidy?

#### D. Summary

In summary, a number of scholars have valiantly attempted to explain the rationale behind the federal income tax exemption for charitable organizations. Many of the theories discussed herein have provided building blocks or foundations for more recent rationales. However, no proffered explanation has yet extended a full and satisfactory explanation that can be universally applied and has been widely accepted.

### III. PROPOSAL: RISK COMPENSATION THEORY

A basic assumption of any theory proposed to explain why charitable organizations deserve an income tax exemption is the notion that the nonprofit sector is an alternative to both the private sector and government. In other words, charitable organizations exist as an alternative to proprietary firms and to entities that are wholly supported by government ("public entities"). For example, in the health care industry, we find not only proprietary hospitals and public hospitals entirely supported by local, state or federal funds, but also nonprofit hospitals, such as academic hospitals, that are supported directly and indirectly by the government and receive private donations.<sup>80</sup> Thus, there are two questions to be asked: First, why do charitable organizations arise in addition to for-profit firms and public entities? And second, what makes the nonprofit organizations sufficiently different from proprietary entities to warrant the income tax exemption, both initially and over time?

As with some of the more recently expressed rationales for the income tax exemption for charitable organizations, my risk compensation theory utilizes as a foundation the combined theory of market and government failure: nonprofit organizations arise where the private and government sectors of society fail to adequately supply desired goods and services. The question is, "why are public and private supply inadequate?"

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80. For a general discussion of these institutions, see CHARLES E. ROSENBERG, *THE CARE OF STRANGERS: THE RISE OF AMERICA'S HOSPITAL SYSTEM* (1987) (presenting a historical overview of American hospitals); PAUL STARR, *THE SOCIAL TRANSFORMATION OF AMERICAN MEDICINE* 145-232 (1982) (examining the emergence of the modern hospital). See Crimm, *supra* note 3, at 11-15 (discussing the growth of non-profit hospitals); Nina J. Crimm, *Tax Plans for the Twenty-First Century: Medical Incentive Vouchers Address the Needs of Academic Health Centers and the Elderly*, 71 TUL. L. REV. 653, 656 n.8 (1997) (discussing proprietary and nonprofit institutions).

## A. Background

### 1. Market Failure and Government Failure

A basic microeconomic explanation for the existence of charitable organizations is their ability to facilitate the production and availability of public goods and services at a level not otherwise provided in the marketplace.

As a starting point, public or collective goods and services can be divided into two categories: pure public goods and services and impure, or mixed, public goods and services. Both categories are characterized by features of availability to an indefinite class of beneficiaries, and of the inability to force the public to directly pay a sufficient price to induce the production in the private marketplace.<sup>81</sup> Pure public goods and services are characterized by nonrivalry—that is, “one person’s consumption of the good does not interfere with its availability to others”<sup>82</sup>—and by nonexcludability—that is, no person can be excluded from consumption of the good or service even if unwilling to pay for it (a “free-rider”).<sup>83</sup> However, if the definition of public goods and services were stretched to include some goods and services that do not encompass both characteristics of total nonrivalry and nonexclusivity, then it is “sufficient that the cost of excluding an individual is greater than the marginal cost of supplying the good [or service] to her as an additional user. It is cheaper to supply the good freely than to charge each user for it.”<sup>84</sup> Thus, a for-profit firm would not have an incentive to undertake the production of a

81. See EDWIN MANSFIELD, *MICROECONOMICS: THEORY AND APPLICATIONS* 457-58 (4th ed. 1982).

82. Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1397 (1988).

83. See JOHN M. LEVY, *ESSENTIAL MICROECONOMICS FOR PUBLIC POLICY ANALYSIS* 83 (1995); MANSFIELD, *supra* note 81, at 467; RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 53-54 (1973); MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION* 16 (1965); Gergen, *supra* note 82. Nonexcludability indicates that if a nonpayer, or “free-rider,” cannot be excluded from consumption, the private market for its provision cannot be created. The concept of nonrivalry, MUSGRAVE & MUSGRAVE, *supra* at 53-54, is based on efficiency. See *id.* at 53. If the good or service is absolutely nonrival in character, then efficiency would require that every consumer having any utility for the good or service would be allowed use of it. In other words, the marginal cost of allowing another person to use the good or service is zero, and because price equals marginal cost, then the efficient price for a truly nonrival good or service is zero. However, in the rational private marketplace, a provider would not provide a good for the price of zero. For an in-depth discussion, see LEVY, *supra*, at 81.

84. Gergen, *supra* note 82, at 1397. In other words, optimal output for a pure public good is achieved when “marginal social benefit equals marginal social cost.” MANSFIELD, *supra* note 81, at 468. Nonrivalry is a weaker requirement than nonexclusivity. See LEVY, *supra* note 83, at 83; see also *supra* note 83.

pure public good or service. For example, a for-profit firm may not financially be able to undertake basic scientific research. If it were to enter into a research project, it could not hope to secure the full value of the output of its research because many persons and organizations could benefit from the research in a variety of ways and for a variety of reasons, and it would be difficult, if not impossible, to charge all such gainers.<sup>85</sup>

The second type of public goods and services can be labeled mixed or impure public goods and services. Mixed public goods and services indirectly benefit the public, but provide direct benefits to special groups of people.<sup>86</sup> For example, the existence of a museum in a community should make the community a more appealing and exciting place for all persons to live and will directly benefit those persons who utilize the facility by providing them with access to art they otherwise would not have. An urban renewal program in which slum housing is replaced with attractive low-cost housing directly benefits the residents and indirectly benefits the public by providing more aesthetically pleasing and potentially safer neighborhoods. Thus, any mixed public good or service theoretically

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85. See MANSFIELD, *supra* note 81, at 454. Mansfield explains that because of such external economies as the fact that some fundamental discoveries are not patentable and can be utilized by other producers—

there is likely to be a divergence between the private and social benefits from basic research, with the result that a perfectly competitive economy would be expected to devote fewer resources to basic research than is socially optimal. Consequently, there seems to be a good case on purely economic grounds for the government (or some other agency not motivated by profit) to support basic research. As stated in the [National Academy of Sciences'] report, [sic]

There is good theoretical reason for expecting that, left to itself, the market would not only tend to allocate too few resources to research in general, but would also tend to bias the allocation against basic scientific research. . . . These defects of the market mechanism with respect to the allocation of resources toward and among investments in research imply that the market needs to be supplemented, and perhaps, with respect to basic scientific research, entirely replaced by social provision and allocation of resources for the support of scientific research.

*Id.* at 454 (quoting NATIONAL ACADEMY OF SCIENCES, BASIC RESEARCH AND NATIONAL GOALS, REPORT TO THE COMMITTEE ON SCIENCE AND ASTRONAUTICS OF THE UNITED STATES HOUSE OF REPRESENTATIVES 136 (WASHINGTON, D.C.: U.S. GOVERNMENT PRINTING OFFICE, 1965)). Professor Mansfield estimated that the private annual rate of return on investment in corporate research was only 50% of the "social" rate of return (including benefits to others). See Peter Passell, *The Tax Credit for Research and Development: Free Lunch*, N.Y. TIMES, Feb. 5, 1998, at D2. Therefore, "[l]eft on their own, then, corporations have an incentive to invest less on research and development than is desirable from the perspective of the economy as a whole." *Id.*

86. See GARY FROMM & PAUL TAUBMAN, PUBLIC ECONOMIC THEORY AND POLICY 25 (1973); see also Gergen, *supra* note 82.

can be bifurcated into a private portion and a public portion.<sup>87</sup> The bifurcation of a mixed public good or service may be fairly simple on an abstract level, but difficult when it comes to measuring the value of each portion.

## 2. Market and Governmental Mechanisms

The market mechanism for public goods and services does not work properly because external economies make it worthwhile for rational consumers to be free-riders.<sup>88</sup> To correct for the free-rider problem, a nonmarket mechanism is needed.<sup>89</sup> One such mechanism is the government. However, the government is also inherently limited in its ability to correct for market failure, even when the majority of citizens support the governmental endeavor.<sup>90</sup> The government is limited by such problems as its own cumbersome and inefficient bureaucratic structure, resistance of the populace to governmental intrusions, and the like. Hence, it has been posited that the nonprofit sector arises to fill the gap.<sup>91</sup>

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87. Economists formulate that under pure competition, the marginal cost of a mixed good or service is equal to the sum all persons will pay for it in private and in public use. *See* FROMM & TAUBMAN, *supra* note 86.

88. The concept of external economies has been described by economists as elusive. Yet, as a general idea,

[i]t is agreed that they mean services (and disservices) rendered free (without compensation) by one producer to another; but there is no agreement on the nature and form of these services or on the reasons for their being free. It is also agreed that external economies are a cause for divergence between private profit and social benefit and thus for the failure of perfect competition to lead to an optimum situation; but for this there are many reasons, and it is nowhere made clear how many and which of these reasons are subsumed under the heading of "external economies."

Tibor Scitovsky, *Two Concepts of External Economies*, in EXTERNALITIES: THEORETICAL DIMENSIONS OF POLITICAL ECONOMY 77, 77 (Robert Staff & Francis Tannian eds., 1973). With respect to the provision of public goods, externalities (nonappropriable benefits or noncollectible costs) cause market inefficiencies. Market failure occurs with respect to the provision of public goods and they are not produced at the optimum socially efficient level. With respect to pure public goods, rational consumers (free-riders) are unwilling to pay for consumption of the goods because such goods are available even to those who refuse payment. *See* MANSFIELD, *supra* note 81, at 458, 467; LESTER M. SALAMON, AMERICA'S NONPROFIT SECTOR: A PRIMER 7-9 (1992); *see also supra* note 83 and accompanying text (discussing pure public goods and the free rider effect); *see generally* Scitovsky, *supra* (examining external economies).

89. *See* MANSFIELD, *supra* note 81, at 467.

90. *See id.* *See generally* MUSGRAVE & MUSGRAVE, *supra* note 83, at 83-105 (considering the effect of politics on budget decisions).

91. For good discussions of this public goods theory of the existence of nonprofit organizations, *see* BURTON A. WEISBROD, THE NONPROFIT ECONOMY 59-60 (1988); BURTON A.

Although this economic analysis is straightforward, the economic literature indicates more is needed.<sup>92</sup>

### 3. The Concept of Risk

The concept of risk is somewhat abstract. Dictionaries define risk as the “chance of”<sup>93</sup> or “exposure to the chance”<sup>94</sup> of injury or loss; secondarily each definition reflects that the concept of insurance covers the “degree of probability of loss.”<sup>95</sup> Not all economists agree on the definition of risk, but a common thread involves the uncertainty or variation in possible outcomes that results from a particular course of action.<sup>96</sup>

#### a. Pure, Speculative, Systematic and Diversifiable Risks

##### (1) Definitions

Scholars have refined this broad definition of risk by distinguishing among pure, speculative, systematic and diversifiable risks.<sup>97</sup> Pure risk is risk for which there is only a downside, that is, a potential for loss.<sup>98</sup> Speculative risk is that risk which involves the possibility of some degree of either gain or loss.<sup>99</sup> Systematic risk is risk that cannot be eliminated by diversification within a specific market or industry by a particular provider of goods or services; all providers in the specific market or industry face the same volatilities or variabilities.<sup>100</sup> Comparatively, diversifiable risk is

WEISBROD, NOT-FOR-PROFIT ORGANIZATIONS AS PROVIDERS OF COLLECTIVE GOODS IN THE VOLUNTARY NONPROFIT SECTOR 1-10 (1977); Gergen, *supra* note 82, at 1397-99; Hansmann, *supra* note 49, at 848-49.

92. See, e.g., FROMM & TAUBMAN, *supra* note 86, at 28-52 (discussing cost-benefit analysis); MANSFIELD, *supra* note 81, at 468-72 (suggesting a cost-benefit analysis); Roland N. McKean, *The Nature of Cost-Benefit Analysis*, reprinted in EDWIN MANSFIELD, MICROECONOMICS: SELECTED READINGS 344 (1975).

93. Webster's New World Dictionary of the American Language (Second College ed., 1980).

94. RANDOM HOUSE AMERICAN COLLEGE DICTIONARY (1962).

95. See WEBSTER'S, *supra* note 93; RANDOM HOUSE, *supra* note 94.

96. See, e.g., FROMM & TAUBMAN, *supra* note 86, at 304-17.

97. Scholars also have distinguished between risk about which probability estimates can be made and those about which probability estimates are disputed or unknown and hence cannot be made. See A. KOUTSOYIANNIS, NON-PRICE DECISIONS: THE FIRM IN A MODERN CONTEXT 501-02 (1982); FRANK H. KNIGHT, RISK UNCERTAINTY AND PROFIT (1964).

98. Theft and fire are examples of pure risks.

99. A typical example of speculative risk, also known by the Greek letter beta, which numerically describes risk in the stock market, for which investors encompass the risk of realizing gains or losses associated with investment in any particular equity. Modern portfolio theory and the capital asset pricing model account for and explain such risk in the pricing of and returns on equities. See BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 227-50 (1996).

100. See *id.* at 241.

risk that results from factors peculiar to a particular provider of goods or services in a market or industry; diversifiable risk can be reduced or limited by actions taken by the specific provider.<sup>101</sup>

The perfect market includes the provision of all goods and services, including pure and mixed public goods and services.<sup>102</sup> In that perfect marketplace, total risk—that is, pure risk plus speculative risk—would necessarily include societal needs and desires for public goods and services.

## (2) The Capital Asset Pricing Model

The capital asset pricing model (CAPM),<sup>103</sup> utilized in portfolio theory, breaks down total risk associated with investments in stocks into its two components, systematic risk (also known as beta) and diversifiable risk, in an attempt to explain stock and portfolio valuations for a perfect capital market model.<sup>104</sup> Its thesis is that because stocks can be combined in portfolios to eliminate or diversify the risk associated with a particular stock, it is the systematic risk for which an investor demands and is paid a risk premium (or return from the market).<sup>105</sup>

101. *See id.* at 242.

102. *See supra* notes 81-85 and accompanying text (discussing pure and impure public goods and services).

103. William Sharpe, John Lintner and Fisher Black created the capital asset pricing model (CAPM). For a more detailed look at the CAPM, see DAVID B. HERTZ & HOWARD THOMAS, *RISK ANALYSIS AND ITS APPLICATIONS* 194-206 (1983); KOUTSOYIANNIS, *supra* note 97, at 499-500; PETER G. MOORE, *THE BUSINESS OF RISK* 85-86, 116-29 (1983); WILLIAM F. SHARPE, *PORTFOLIO THEORY AND CAPITAL MARKETS* (1970); John Lintner, *The Valuation of Risk Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets*, 47 *REV. EC. & STAT.* 13 (1965); Jan Mossin, *Equilibrium in a Capital Asset Market*, 34 *ECONOMETRICA* 768 (1966); William F. Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk*, 19 *J. FIN.* 425 (1964); William F. Sharpe, *Risk, Market Sensitivity and Diversification*, 28 *FIN. ANALYSTS J.* 74 (1972).

104. CAPM has been criticized as having limitations. For example, contrary to the real world, it assumes perfectly efficient markets. Systematic risk for a riskless security should give a return exactly equal to the risk-free rate (e.g., the rate of investing in certificates of deposit guaranteed by the United States government), but, in the real world, this theory does not hold true. Economists have found that some stocks are more sensitive to market trends than others and that high risk stocks earn lower returns than predicted under CAPM and that low risk stocks earn higher returns than predicted by CAPM. *See* Fischer, Black et al., *The Capital Asset Pricing Model: Some Empirical Tests*, in *STUDIES IN THE THEORY OF CAPITAL MARKETS* 79-81 (Michael C. Jensen ed., 1972). Moreover, beta is not a good predictor of the future market because betas are estimates based on historical information and therefore cannot be determined for the future with any precision. Additionally, beta appears to be a poor short-term performer. Finally, beta does not account for a number of important systematic elements of risk; thus, it is not an effective quantitative measure of risk. For a fuller discussion of the various criticisms, see MALKIEL, *supra* note 99, at 256-74.

105. The return from the market is different from the rate of return. *See* MALKIEL, *supra* note 99, at 256. The rate of return equals the risk-free rate plus beta, which is the return from the market

Systematic risk arises from the variability of stock values in general; the risk of each stock in the market is correlated with the performance of the market,<sup>106</sup> although the sensitivity of particular stocks to market movement may vary. So, a stock's tendency to increase or decrease in value has a positive correlation to the stock market's up and down movements.<sup>107</sup> Systematic risk of a particular stock thus cannot be eliminated by diversification.<sup>108</sup>

On the other hand, diversifiable risk of stock value is not correlated with the stock market as a whole.<sup>109</sup> Rather, the return on a particular stock may fluctuate because of a variety of factors not associated with changes in the stock market's direction.<sup>110</sup> For example, the company may lose a lucrative client, or it may obtain a profitable new contract.

Applying the CAPM to a portfolio of investments in stocks, variations in the return from any one stock will be offset to some extent by variations in the return of another stock.<sup>111</sup> It follows that holding a number of stocks will permit diversification, or an overall smoothing of diversifiable risks.<sup>112</sup> Finally, because risk and return are related, the CAPM suggests that in a perfect market, because the portfolio compensates for diversifiable risks, returns on investments in a stock represent a risk premium for systematic risk alone.<sup>113</sup> Thus, as the systematic risk of an individual stock or portfolio increases, so too will the risk premium or return.<sup>114</sup> In other words, in order to induce an investor to purchase and hold a stock or a portfolio of stock investments that are perceived as highly risky, the investor must be compensated with high returns for the systematic risk accepted.

The CAPM has been criticized by some economists on a number of grounds.<sup>115</sup> Criticisms are based in large part on the perception that beta fails as an accurate measure of systematic risk because it is underinclusive of all systematic elements of risk, and that the CAPM is a perfect market model that is deficient in application to the real market.<sup>116</sup> However, despite the fact that other theories of pricing in the capital markets have been developed,<sup>117</sup> CAPM continues to be favored by many economists

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minus the risk-free rate. *See id.*

106. *See id.* at 251-74.

107. *See id.*

108. *See id.*

109. *See id.*

110. *See id.* at 142.

111. *See id.* at 142-43.

112. *See id.*

113. *See id.* at 244; *see also* KOUTSOYIANNIS, *supra* note 97, at 500.

114. *See* MALKIEL, *supra* note 99, at 247.

115. *See supra* note 104.

116. *See id.*

117. *See id.* (briefly outlining some criticisms of the CAPM).

and remains a vital analytical tool.

## b. Application of Risk Concepts and Capital Asset Pricing Model

### (1) Risk Aversion and Venture Capitalists

Applying these concepts to a new start-up venture, suppose that the venture is attempting to attract investment by venture capitalists. The venture is not the only one in which a particular venture capitalist can invest. It is, therefore, competing for the venture capitalist's funds. Because people are risk averse, under traditional CAPM theory, the venture capitalist will not select the risky venture unless a correspondingly higher return is expected.<sup>118</sup> In other words, the venture capitalist willing to invest in the risky venture will demand a higher premium for bearing the risk. The amount of the risk premium, by definition, cannot be quantified with certainty prior to investment.<sup>119</sup> According to the CAPM, the higher risk premium is received by the venture capitalist as compensation for assuming systematic risk.<sup>120</sup>

### (2) Risk Aversion and Firm Behavior

The prevailing opinion among economists is that, like individuals, firms are risk averse.<sup>121</sup> Decisions in for-profit firms are made by the corporate board and management, who are agents of, and accountable to, their principals, the shareholders. In the for-profit setting, the shareholders' primary concern is to maximize their profits and, because the board and management are accountable to the shareholders, a major objective is to

An arbitrage pricing theory approach was developed as an alternative to the CAPM, but it too has been criticized. See Franco Modigliani & M.H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 655 (1958); Franco Modigliani & M.H. Miller, *Reply to Heins and Sprengle*, 59 AM. ECON. REV. 592 (1969); Joseph E. Stiglitz, *A Re-examination of the Modigliani-Miller Theorem*, 59 AM. ECON. REV. 784 (1969).

118. A decision-maker's knowledge of the probability distribution of alternatives' outcomes is inadequate where risk exists. See KOUTSOYIANNIS, *supra* note 97, at 524. Risk preferences must be known and can be inferred from the decision maker's utility of wealth function. See *id.*; see also generally JOHN VON NEUMANN & OSKAR MORGENSTERN, *THEORY OF GAMES AND ECONOMIC BEHAVIOR* (3d ed. 1953) (outlining the utility of wealth function).

119. See FROMM & TAUBMAN, *supra* note 86; E. MALINVAUD, *LECTURES ON MICROECONOMIC THEORY* 290-94 (1972).

120. See *supra* notes 112-14 and accompanying text.

121. See FROMM & TAUBMAN, *supra* note 86, at 7; KOUTSOYIANNIS, *supra* note 97, at 499-529; MALINVAUD, *supra* note 119, at 296-97 (indicating that "firms behave in the face of risk as consumers do" and aversion to risk is cause for positive profits). Like under the CAPM, risk preferences are inferred from a decision maker's expected utility of wealth function, which can be determined along lines suggested by J. Von Neumann and Oskar Morgenstern. See KOUTSOYIANNIS, *supra* note 97, at 524 (citing VON NEUMANN & MORGENSTERN, *supra* note 118).

satisfy the shareholders' goal. This pressure will theoretically cause decision-makers of for-profit entities to attempt to maximize profits,<sup>122</sup> and economists explain that apart from competitive imperfections and disequilibria related to innovations, the risk aversion of firms' decision-makers accounts for the production of positive profits.<sup>123</sup>

According to traditional economic theory addressing the investment decisions of firms, the evaluation of a project is based on the project's total risk and expected return, without considering either its effects on the total risk of the firm or on that part of the total risk of the project that can be diversified away by shareholders through their portfolios.<sup>124</sup> Within this approach, a number of models exist for evaluating risky projects. One model widely used by firms is the weighted average cost of capital model (WACC), which establishes a risk-adjusted discount rate, or the risk premium, that a decision-maker will require as a return over time for investment in a project.<sup>125</sup> Basically, traditional economic theory provides that a firm's choice between projects in which to invest funds and labor are based upon the expected returns, taking into account the risk premium and probability of risks associated with each project.<sup>126</sup>

The traditional economic theory approaches each project investment decision as independent, rather than dependent on other ongoing firm projects, and as not requiring appraisal of its impact on the firm's expected total risk and return.<sup>127</sup> By comparison, modern economic theory uses the broader framework of portfolio theory to account for the firm's expected

122. Professor Evelyn Brody has asserted that business firms are less profit-maximizing than shareholders might desire because of control powers, both at policy formulation and operational levels, delegated to corporate management. *See* Brody, *supra* note 53, at 467-71. For illustrative purposes, one might consider a for-profit firm that utilizes some of its revenues to donate to a charitable organization rather than to distribute as dividends to shareholders. Certainly in the short-term, the decision to make the charitable donation does not maximize profits for shareholders. Moreover, some economists suggest that for-profit firms maximize a utility, such as sales, a budget, "satisfactory" profits or long-term survival rather than maximizing profits. *See id.* at 479 (citing Henry Hansmann, *Economic Theories of Nonprofit Organization*, in *THE NONPROFIT SECTOR: A RESEARCH HANDBOOK*, 27, 37 (Walter W. Powell ed., 1987)); WILLIAM J. BAUMOL, *BUSINESS BEHAVIOR, VALUE AND GROWTH* 45-52 (rev. ed. 1967); RICHARD M. CYERT & JAMES G. MARCH, *A BEHAVIORAL THEORY OF THE FIRM* (1963); Saul Levmore, *Irreversibility and the Law: The Size of Firms and Other Organizations*, 18 *J. CORP. L.* 333, 336 (1993); Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 *Q. J. ECON.* 99, 108 (1955).

123. *See* MALINVAUD, *supra* note 119, at 297 (stating that "the caution of firms in the face of the risk of loss explains why pure profits are on average positive").

124. *See, e.g.*, KOUTSOYIANNIS, *supra* note 97, at 529.

125. *See id.* at 542-55 (discussing the weighted average cost of capital model (WACC) and briefly outlining several shortcomings of it); *see also* Jan P. Clement & James D. Suver, *The WACC Method of Estimating the Discount Rate*, 3 *HEALTHCARE FIN. MGMT.* 87, 87-88 (1984).

126. *See generally* KOUTSOYIANNIS, *supra* note 97, at 504-29 (examining investment decisions involving risk).

127. *See, e.g., id.* at 529.

total risk and return.<sup>128</sup> This “modern” approach is similar to the CAPM. It suggests that a firm’s determination of whether to invest in a particular project should be viewed in light of the portfolio of existing firm projects.<sup>129</sup> It explicitly considers the potential risk and effect of prospective investments on the risk of the firm as a whole, and it attempts to maximize total expected returns.<sup>130</sup> Although each possible project is evaluated for its potential risk and expected return, often employing the WACC model to assist in the determination of the latter, a project also is placed into the context of the entire portfolio of existing firm projects.<sup>131</sup> This fact suggests that possible variations in the expected return on investment in a particular project will be offset to some extent by variations in the return on other projects.<sup>132</sup> As with the CAPM, investment in a number of projects should result in the diversification or overall smoothing of risks.<sup>133</sup> It then follows that because risk and return are related, where a particular project or portfolio of projects are perceived as highly risky, a risk averse firm will demand to be compensated with high returns.<sup>134</sup> Because it is understood that diversification compensates for risk that is not systematic, in the perfect market the high returns demanded with respect to a high risk project or a portfolio of projects should be attributable to systematic risk alone.

### (3) Connecting the Provision of Public Goods and Services with Risk

#### (a) The For-Profit Start-Up Firm

##### i. Pure Public Goods

As previously discussed, the provision of pure public goods and services, whether as strictly or more leniently defined, is clearly associated with pure risk—that is, the potential for production of loss, but not gain, realization.<sup>135</sup> Suppose a start-up firm is faced with the opportunity to

128. *See id.* at 576-77, 600-09.

129. *See id.* at 600.

130. *See id.* By explicitly considering the effect of an investment project on the total risk of the firm, the portfolio approach provides a link between the investment of funds in a particular project and its impact on the firm’s stock price. *See id.* at 607.

The selection of the most desirable combination of investments in projects can be stated in another way: choice of investment depends on the firm’s utility preferences with respect to net present value and variance (or standard deviation).

131. *See id.* at 600-09.

132. *See id.* at 617-30.

133. *See id.*

134. *See id.* at 609.

135. *See supra* notes 97-102, 105-08 and accompanying text.

undertake one of two alternative projects as its sole venture—the provision of a pure public good or service or of a private good or service for which there is some potential of either gain or loss realization. Because the firm is risk averse,<sup>136</sup> applying either a single project analysis or a portfolio approach, it will choose the latter project. The former choice could only result in loss; it could not be diversified and the firm would quickly be forced to dissolve.<sup>137</sup> The latter choice presents the possibility that the firm might realize gain by its provision of the private portion of the mixed public good or service. In effect, this gain from the private portion of the mixed good or service could theoretically cross-subsidize the loss realized on the provision of the public portion of the good or service.

On the other hand, assume that a start-up firm has the opportunity to enter into multiple projects, one of which is the provision of a pure public good or service while the other alternatives include choices to provide a variety of private goods or services for which there are varying degrees of speculative risk. Applying modern economic theory incorporating the portfolio approach, the firm may choose to provide not only one or more private goods, but also the pure public good or service, depending on its level of risk aversion and the expected return with respect to offering the private goods or services. Again, the firm would be cross-subsidizing the provision of the public good or service by the private goods or services for which high returns are expected.<sup>138</sup> So, for example, a start-up firm formed

136. See *supra* notes 121-22 and accompanying text.

137. This would be true of any firm in the industry even if the risk could be considered speculative, as the risk of loss would be systematic and could not be diversified. See *supra* notes 108, 134 and accompanying text.

138. In addition to the potential for gain from the provision of private goods and services, the firm might realize an intangible gain from offering the public good or service. This intangible gain would be in the form of enhanced reputation. On a practical level, measurement of the amount of gain derived from enhanced reputation might be elusive. Under generally accepted accounting standards, with respect to a for-profit firm, it might be measured from the accounting perspective of goodwill or going concern value. However, these measurements often do not truly reflect gain directly attributable to enhanced reputation. See LAWRENCE N. BLOOMBERG, *THE INVESTMENT VALUE OF GOODWILL* 9-16 (1938); HUGH P. HUGHES, *GOODWILL IN ACCOUNTING: A HISTORY OF THE ISSUES AND PROBLEMS* 175-207 (1982). In the late 19th century, one author described goodwill as follows:

It differs from other property, inasmuch as, while other property is palpable, goodwill is impalpable. Other property can be handled, weighed, or measured, its nature ascertained by inspection, its quality tested by sight, smell, feeling or analysis, or the annual income receivable from it identified. But goodwill—how can its quality be ascertained? The difference between the two kinds of property is like that between matter and life, or between a man's estate and a man's character—one is ponderable, the other imponderable.

E. Guthrie, *Goodwill*, *THE ACCOUNTANT* 425 (Apr. 23, 1898). A more modern definition reflects

under state law as a for-profit entity would likely decline to undertake as its sole project basic scientific research, a broadly defined pure public good or service, because it would have no possibility of realizing gain.<sup>139</sup> However, if the basic research were part of a package of projects, and the other projects involved the provision of private goods for which there are varying degrees of speculative risk, a start-up or established for-profit firm might decide to conduct the basic research depending on how its loss would impact expected firm gains from projects involving private goods and services.

## ii. Mixed Public Goods and Services

A mixed public good or service has characteristics of private and pure public goods or services.<sup>140</sup> A start-up firm initially considering whether to provide a mixed public good or service when no other options are available would proceed through the same analysis as the start-up firm having multiple opportunities. Because a mixed public good or service can be bifurcated into a private portion and a public portion,<sup>141</sup> the evaluation process must include this task, albeit difficult (if not impossible) on a practical level.<sup>142</sup> If it is perceived that the public portion of the mixed public good or service exceeds the private portion, then the for-profit start-up firm will not undertake the project.<sup>143</sup> On the other hand, if the firm

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some of the same sentiments:

Goodwill may be defined as a differential advantage accruing to a corporation in terms of its dominant goals—the ability to generate superior profits by whatever means to finance the technostucture’s growth, usually by selling goods through purposeful manipulation of the consumer’s customs and habits.

HUGHES, *supra*, at 194. Other concepts for determining and measuring the reputation of a for-profit firm have been suggested to include measurements of social performance, organizational effectiveness, and their relationship to economic performance data. *See generally* AHMED RIAHI-BELKAOUI, ACCOUNTING FOR CORPORATE REPUTATION (1992). With respect to nonprofit organizations, the accounting concept of goodwill does not arise because the notion of profits is taboo (at least to the extent of the nondistribution constraint). *See generally* ROBERT N. ANTHONY & REGINA E. HERZLINGER, MANAGEMENT CONTROL IN NONPROFIT ORGANIZATIONS 34-43 (1980); MALVERN J. GROSS, JR. ET AL., FINANCIAL AND ACCOUNTING GUIDE FOR NOT-FOR-PROFIT ORGANIZATIONS (5th ed. 1995); EMERSON O. HENKE, ACCOUNTING FOR NONPROFIT ORGANIZATIONS (3rd ed. 1983). For nonprofit organizations, perhaps some measurement of reputation and trustworthiness might be based on social performance and organizational effectiveness, but the measurement of these is more qualitative than quantitative in nature.

139. *See supra* note 98 and accompanying text.

140. *See supra* notes 86-87 and accompanying text.

141. *See id.* (discussing the bifurcation of mixed public goods and services).

142. *See id.*

143. The firm’s determination may be difficult to quantify on a practical level. First, it may be

perceives the private portion to outweigh the public portion, or if the firm has opportunities to offer additional private goods or services, it may or may not provide the mixed public good or service depending on the firm's level of risk aversion and the level of expected returns over time from all projects. For example, a firm may choose to provide an urban renewal program in which it replaces slum housing with modern, low-cost dwellings. Let us assume that a substantial portion of the benefits of a low-cost public housing project inure to the public, which can be valued. It follows that the public portion would produce only losses, and the amount of those losses would exceed the gains produced by the quantitatively less substantial private goods portion. Even in the best instance, if mixed public goods and services were viewed to entail speculative risk rather than pure risk, where the significant portion of the benefits of the low-cost public housing inures to the public, realistically the project could not be expected to produce high returns without a tax credit or other tax advantage. The loss potential (or minimal potential for return) would conflict with the high return required to induce the firm to engage in a high risk investment.

### iii. Summary

A rational for-profit start-up firm would not choose to provide a pure public good or service if it were the only possible project for the firm. Similarly, it would decide against undertaking a project consisting solely of the provision of a mixed public good or service where, theoretically, it could determine that a substantial or significant portion of such good or service benefits the public. Because in the real world it is unlikely that the private and public portions could be bifurcated for purposes of evaluating potential return, it would be unexpected that a for-profit start-up firm would decide to provide a mixed public good or service knowing the pure risk associated with the provision of a public good and service. Absent the government's willingness to directly provide these public goods and services, another mechanism would be required if the public (or a group of the public) so demanded.<sup>144</sup>

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impossible to bifurcate the probable values to be received from the private portion and from the public portion of the mixed public good or service. *See id.* The difficulty may be compounded by an inability to attach a true value to enhanced reputation that may be part of the gain from the provision of a mixed public good or service. *See supra* note 138.

144. Powerful demand by a fairly small group of citizens can induce the creation of a charitable organization. *See* Nancy J. Knauer, *Reinventing Government: The Promise of Institutional Choice and Government Created Charitable Organizations*, 41 N.Y.L. SCH. L. REV. 945, 991 (1997).

## (b) The Nonprofit Charitable Organization—Risk Compensation

The nonprofit sector provides the mechanism needed to fill the resultant void. By law, nonprofit charitable organizations are constrained to make decisions and conduct activities largely in conformance with their charitable purposes or missions.<sup>145</sup> This “purpose constraint” effectively restricts charitable organizations from providing pure and mixed public goods and services—and on a practical level, most charitable organizations provide exclusively public services—because these are the types of goods and services that fit the definition of “charitable” in its “generally accepted legal sense.”<sup>146</sup> The purpose constraint means for the most part that noncharitable organizations’ portfolios of projects cannot be substantially diversified because they must consist “exclusively” of public goods and services.<sup>147</sup> Even in multi-faceted organizations such as the United Way, the portfolio of projects and organizations that it supports is limited to those that comport with its purpose constraint. As we have seen, the provider of pure public goods and services, and of mixed public goods and services, when focusing on the significant public portion (that portion of the mixed goods and services that benefits the public), assumes pure risk, for which no pecuniary gains are possible.

Moreover, the expectation of risk of loss may be heightened by the lack of direct accountability of nonprofit organizations’ decision-makers to stakeholders. Unlike for-profit enterprises, the nondistribution constraint proscribes stakeholders in nonprofit organizations, and under state laws,

145. See I.R.C. § 501(c)(3); see also *supra* note 24 and accompanying text. Although charitable organizations may undertake an “insignificant” amount of noncharitable activities and retain their exempt status, they may be subject to taxation on income earned from those noncharitable activities. See, e.g., I.R.C. §§ 512-513 (1998). State statutes also impose a similar purpose constraint to that of I.R.C. § 501(c)(3). See, e.g., N.Y. Not-For-Profit Corp. Law § 201(b) (McKinney 1998) (providing that “[a] not-for-profit corporation of this type [Type B] may be formed for any one or more of the following non-business purposes: charitable”).

146. See *supra* notes 24-30 and accompanying text. A majority of nonprofit organizations produce mixed goods or services. See Cyril F. Chang & Howard P. Tuckman, *The Goods Produced By Nonprofit Organizations*, 24 PUB. FIN. Q. 25, 38-40 (1996).

147. The exclusivity language is found in I.R.C. § 501(c)(3)(1998), and has been interpreted to mean “primarily.” Treas. Reg. § 1.501(c)(3)-1(c) (as amended in 1990).

This is not to say that, despite the constraints imposed on charitable organizations, many nonprofit organizations have not diversified by forming for-profit subsidiaries. The health care subsector of the nonprofit sector is a prime example of this diversification through the formation of a variety of entity arrangements and ventures. For a general discussion of some of these entity arrangements and ventures, see Crimm, *supra* note 3, at 84-100; Darryll K. Jones, *Creating Complex Monsters: Joint Operating Agreements and the Logical Invalidity of Treas. Reg. 1.502-1(b)*, 19 EXEMPT ORG. TAX REV. 165, 165-88 (1998); Nicole A. Reuschel, Note, *The Centerpiece of Health Care Reform—Integrated Delivery Systems: Confronting Tax Code Challenges That Threaten Health Care Integration*, 30 SUFFOLK U. L. REV. 825, 841-50 (1997); Reed Abelson, *Charities Use For-Profit Units to Avoid Disclosing Finances*, N.Y. TIMES, Feb. 9, 1998, at A1.

nonprofit organizations are not the agent of particular donors or beneficiaries.<sup>148</sup> Consequently, unlike for-profit firms, “in most nonprofits there is no clear category of principals” to whom agents, the governing boards, officers, and managers, are directly answerable.<sup>149</sup> Although nonprofit decision-makers/agents are indirectly accountable to the public with respect to their charitable missions and practices, the lack of direct accountability to a category of principals has meant occasional, and sometimes infamous, abuses with significant pecuniary and reputational losses by the charitable organization.<sup>150</sup>

Despite the lack of expected gains, the literature reveals that nonprofit organizations make project investment decisions in the same manner as do for-profit entities.<sup>151</sup> The same economic forces motivate for-profit and nonprofit organizations.<sup>152</sup> Management must make investment decisions in light of expected risks and uncertainties. Then, as with for-profit firms, charitable organizations likely are risk averse.<sup>153</sup> It should follow that as providers of goods and services, nonprofits must be compensated, albeit for furnishing public goods and services.

Without some form of compensation, even nonprofit organizations would not be enticed to supply public goods and services. Economists Kenneth J. Arrow and Robert C. Lind have demonstrated the importance of compensating for risks associated with investments in public goods and

148. For example, in New York, a charitable corporation holds full ownership rights in donated assets and is not considered a trustee over the assets. *See* N.Y. Not-for-Profit Corp. Law § 513(a) (McKinney 1970 & Supp. 1998). Nonetheless, a charitable corporation’s governing board is obligated to use those assets earmarked by the donor in accordance with the donor’s stated purpose. *See id.* § 513(b). It is the state Attorney General who generally has supervision and oversight responsibilities on behalf of donors and the public. *See, e.g., id.* § 112; CAL. CORP. CODE §§ 5142, 5250, 6511, 9230 (Deering 1997); Rev. Model Nonprofit Corp. Act §§ 1.7, 3.04, 8.10, 14.03-14.04.

149. Brody, *supra* note 53, at 465.

150. *See, e.g.,* Thomas J. Billitteri, *Goodwill Looting: California Scam Yields Lessons for Charity Managers*, CHRON. PHILANTHROPY, Feb. 12, 1998, at 39; Brett D. Fromson, *Stock Sale to Multiply Robertsons’ Riches*, WASH. POST, Apr. 14, 1992, at D1; William H. Honan, *Campus in Turmoil: A Special Report; Adelphi, a Little University With Big Ideas*, N.Y. TIMES, Feb. 5, 1997, at B1; Lawrence Ingrassia, *Boston University Targeted by State For Alleged Abuses*, WALL ST. J., Mar. 16, 1993, at B10; Jennifer Moore, *2 Years Later, a Scandal’s Legacy*, CHRON. PHILANTHROPY, May 17, 1994, at 28.

151. *See* FROMM & TAUBMAN, *supra* note 86, at 28-51, 69-72, 306-11; LEVY, *supra* note 83, at 135-46.

152. *See* Brody, *supra* note 53, 460.

153. *See* FROMM & TAUBMAN, *supra* note 86, at 71. This notion may be supported under public finance theory, especially for those nonprofits that metamorphose into *de facto* government enterprises as their dependency on the public sector increases, or functionally are identical or nearly the same as government operations. *See id.* at 528; ELI GINSBERG, et al., *THE PLURALISTIC ECONOMY* 23 (1965); FROMM & TAUBMAN, *supra* note 86, at 71-72; *infra* notes 154-55.

services in the same manner as for private investments.<sup>154</sup> It is clearly accepted under public finance theory that such compensation is achievable through the risk premium or expected return over time.<sup>155</sup> Yet, in the real world there is no high risk premium directly generated by the provision of public goods; the provider directly realizes only loss or, at best, minimal gain.<sup>156</sup> Therefore, to entice a charitable organization to offer public goods and services, there must be an “insurer” to provide some level of expected return. That “insurer,” historically and currently, is the government, and it has employed the tax exemption as the “insurance” mechanism.<sup>157</sup>

#### 4. Risk Compensation Theory as Universally Defensible

The question arises as to whether the tax exemption is a universally

154. See Kenneth J. Arrow & Robert C. Lind, *Uncertainty and the Evaluation of Public Investment Decisions*, 60 AM. ECON. REV. 364, 364 (1970).

155. See *supra* notes 111-34 and accompanying text; see also J. Hirshleifer, *Investment Decision Under Uncertainty: Choice-Theoretic Approaches*, 79 Q. J. ECON. 509, 531 (1965); J. Hirshleifer, *Investment Decision Under Uncertainty: Applications of the State-Preference Approach*, 80 Q. J. ECON. 252, 268-77 (1966). It has been argued that if risk were treated differently for public investment than for private investment, the public sector would over-invest at the expense of private investments yielding higher returns. See *id.*

156. See *supra* notes 135-47 and accompanying text.

157. It is widely accepted that a proportional tax having a full loss offset increases personal risk taking. In other words, investors will be enticed to engage in risky activities if they know that any gains yielded from the activities may be directly offset by losses. This is accomplished through tax credits, deductions, and capital gains preferences. See, e.g., Evsey D. Domar & Richard A. Musgrave, *Proportional Income Taxation and Risk-Taking*, 58 Q. J. ECON. 388, 388-90 (1944) (analyzing investment projects as independent, and originally suggesting proposition that complete loss offset increases risk activity); J. Tobin, *Liquidity Preference as Behavior Towards Risk*, 25 REV. EC. STUDIES 65, 80-82 (1958) (applying an expected utility, indifference curve analysis to demonstrate that a tax with full loss offset results in taking an increased public risk). *But see* Martin S. Feldstein, *The Effects of Taxation on Risk Taking*, 77 J. POL. ECON. 755, 755 (1969) (disagreeing with assertion that proportional taxation causes persons who maximize expected utility to increase risk). Some economists have indicated that certain taxes are more effective than others in accomplishing the inducement goal. See, e.g., J. E. Stiglitz, *The Effects of Income, Wealth, and Capital Gains Taxation on Risk-Taking*, 83 Q. J. ECON. 263, 279 (1969). Economists disagree as to the effect of progressive taxation on risk-taking. See, e.g., Syed M. Ahsan, *Progression and Risk-Taking*, 26 OXFORD ECON. PAPERS—NEW SERIES 318, 325-26 (1974) (indicating that risk-taking is greater under linear progressive income taxes than under strictly proportional income taxes); John C. Fellingham & Mark A. Wolfson, *Progressive Income Taxes and the Demand for Risky Assets*, 37 NAT'L TAX FIN. 127, 127-29 (1984) (stating that a progressive income tax induces a strict preference for risk-free assets); Michael Waterson, *On Progressive Taxation and Risk-Taking*, 37 OXFORD ECON. PAPERS 510, 510 (1985) (demonstrating undue specificity of assertion that progressive taxation promotes public risk-taking investments). A number of scholars have questioned or encouraged the appropriateness of income tax mechanisms for encouraging investment in risky activities. See, e.g., Michael Livingston, *Risky Business: Economics, Culture, and the Taxation of High-Risk Activities*, 48 TAX L. REV. 163, 163-82 (1993) (discussing appropriateness); Stiglitz, *supra*, at 281 (questioning the appropriateness).

defensible means of inducing all types of risk averse charitable organizations to provide public goods and services. On one level, it appears universally appropriate. The government represents the public and pools public funds via taxation. By exempting certain organizations from income taxation, but subjecting other entities and individuals to taxation, the government redistributes wealth to the exempt organizations (that is, the government pays a risk premium). Moreover, the government shifts to, and spreads among, taxpayers the risk of loss associated with the provision of public goods and services by tax supported charitable organizations.<sup>158</sup> This spread of risk can be illustrated most easily with a public good that is supplied solely by the government, national defense. The risk of loss associated with the provision of national defense is spread among all investors in the government, that is, among all taxpayers who pay for national defense and cannot expect to receive (and do not receive) pecuniary gain from it. The same analysis would apply to public goods and services provided by charitable organizations, for which the tax exemption represents the expected return for risk of loss associated with the public portion of the goods or services. Because the tax exemption is considered by some as a loss of revenue for the government, from the perspective of taxpayers, they are bearing the costs of the charitable organization's provision of pure public goods and services, and of the expected returns associated with the public portion of mixed goods or services. Yet, taxpayers expect and receive no pecuniary return for investing their funds (through tax payments) in the government's support of charitable organizations and their projects. This approach argues that the tax exemption is universally defensible, yet, on another level, every charitable organization may not deserve the tax exemption.<sup>159</sup>

## 5. Deservedness—A Separate Issue

### a. In the Beginning—A Start-Up Charitable Organization

Relying on the above economic theories alone, a new or start-up charitable organization deserves tax exempt treatment on its initial income source, the receipt of donations.<sup>160</sup> As a result of the purpose constraint, a

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158. See Arrow & Lind, *supra* note 154, at 375 (indicating that the costs of risk-bearing are negligible when shouldered by the public at large, which the government represents); Livingston, *supra* note 157, at 176-77.

159. Professors Hall and Colombo concluded that all charitable organizations may not deserve the tax exemption, and that deservedness should depend on the level of donations that an organization is able to attract. See Hall & Colombo, *supra* note 66, at 1446-73. For a discussion of the donative theory, see *supra* notes 66-76 and accompanying text.

160. Even without this theory, the charitable organization would be entitled to exempt from taxation the value of a charitable donation received. See I.R.C. § 102(a)(1998).

start-up charitable organization must dedicate all donations received “exclusively” to projects that carry out its specified charitable mission.<sup>161</sup> Expected returns will be required not only to entice the donations from donors, but also to induce management to carry out the wishes of donors to provide the “inherently risky” public goods and services. In other words, without the tax deduction for the donors,<sup>162</sup> and absent the tax exemption for a start-up charitable organization on which we are focused, returns would be nonexistent or inadequate.<sup>163</sup> The tax exemption is a charitable

161. *See supra* notes 24, 147 and accompanying text.

162. There has been frequent criticism of the charitable contribution deduction. Some critics argue that wealthy donors wield more power to prompt the formation of charitable organizations and are advantaged more than the poor or the majority of the voting public. These representation and upside-down effects are viewed as inequitable. *See, e.g.*, Mark G. Kelman, *Personal Deductions Revisited: Why They Fit Poorly in an “Ideal” Income Tax and Why They Fit Worse in a Far From Ideal World*, 31 STAN. L. REV. 831, 856-58 (1979). These offensives have met return criticisms. *See* Professor A. Burton Weisbrod indicates that the representation effect is a naive expectation that the voting public and its elected politicians would always produce optimal results. Burton Weisbrod, *Toward a Theory of a Voluntary Nonprofit Sector in a Three-Sector Economy*, in THE ECONOMICS OF NONPROFIT INSTITUTIONS 21 (S. Rose-Ackerman ed., 1986). Harold M. Hochman and James D. Rodgers respond that the upside-down effect is not disturbing if the cost of a deduction to the less wealthy in the form of foregone governmental services or increased taxes is offset by the benefit to them of the additional expenditure on charity by the wealthy. Harold M. Hochman & James D. Rodgers, *The Optimal Tax Treatment of Charitable Contributions*, 30 NAT. TAX J. 1, 10-13 (1977).

In some respects, a donor to a new charitable organization is similar to a venture capitalist considering investment in a risky venture and requiring compensation in the form of higher expected returns. *See supra* notes 118-20 and accompanying text. For a donor, the expected return may take several forms. First, the philanthropist will obtain the charitable deduction of I.R.C. § 170. Second, the donor may receive in return an intangible benefit, such as religious benefits, of access to tickets for usage of pews on particular religious holidays. *See* Rev. Rul. 70-47, 1970-1 C. B. 49; Gregory I. Devorkin, *Dual Character Contributions: A Proposed Penalty to Deter Charities from Providing Erroneous Information Regarding Deductibility*, 76 MARQ. L. REV. 277-300 (1992); Daniel Rattin Mitz, *Save Your Local Church or Synagogue: When Are Taxpayer Contributions to Religious Organizations Deductible Under Section 170?*, 63 N.Y.U. L. REV. 840, 855-57 (1988); Jacob L. Todres, *Internal Revenue Code Section 170: Does the Receipt by a Donor of an Intangible Religious Benefit Reduce the Amount of the Charitable Contribution Deduction? Only the Lord Knows for Sure*, 64 TENN. L. REV. 91, 92 (1996); Note, *A Line Drawn by Unsteady Hands: Section 170 Charitable Contributions, and Return Benefits in Hernandez v. C.I.R.*, 23 AKRON L. REV. 575, 581 (1990). Third, the benefactor may receive a return in the intangible form of feeling a sense of self-satisfaction from “altruism.” *See* Crimm, *supra* note 80, at 687-89.

163. Critics might assert that the tax exemption as a substitute for a return on investments is flawed by attempts to achieve indirectly what properly should be addressed directly and more efficiently through grants and by inequities. Both sides to the former criticism have been argued in the literature for years. These are the same arguments for and against the subsidy theory. *See supra* notes 34-38 and accompanying text. The second argument is a proportionality argument. However, as with the donative theory, because the theory uses as a foundation the failure of the government and the private market to provide public goods, “[t]he political stalemate that prevents a direct government subsidy means that, however flawed, an implicit subsidy through the tax system is the

organization's return on its investment in the public portion of public goods and services, and its very nature assures non-volatile returns.<sup>164</sup>

Another supporting argument justifying the tax exemption is culturally based. The start-up charitable organization merely represents an expression of the interests of the initial groups of donors; it is the legal form of carrying out their intent. These donors are pioneering efforts to provide risky public goods and services, and to exempt from taxation donations received by the charitable organization, approval is communicated that this country continues to support and revere risk taking, especially those associated with socially admirable goals.<sup>165</sup> Thus, the tax exemption is justified initially for a start-up charitable organization.

#### b. Beyond the Initial Start-Up Phase—Evolution or the Cloning Effect?

As a charitable organization proceeds through time, several things often occur. First, the institution hopes to, and may continue, to receive additional charitable contributions. Second, it may expand the type and nature of its projects. Third, it may receive funds from other sources, such as returns from providing the private portion of mixed public goods or services and income from noncharitable activities. I suggest that these occurrences will bear on the deservedness of the charitable organization to retain its tax exemption beyond its initial start-up phase.

The most important measure of success of a charitable organization is the accomplishment of its mission-related purposes. Two scholars have suggested that this achievement can be measured by the magnitude of donations received by a charitable organization.<sup>166</sup> As a charitable organization develops and continues to receive additional donations, the tax exemption is justified as long as the donations are used to fund projects that meet the organization's purpose constraint. The same should be true of relatively insignificant returns realized from providing the private portion of mixed public goods and services and from other sources. These

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only available mechanism for subsidy." Hall & Colombo, *supra* note 66, at 1386. The tax exemption does not suffer from the same criticisms of inequities, overbreadth, and discouragement to the disposition of capital assets due to potential tax effects from the bunching of income. For a discussion of these issues, see WILLIAM A. KLEIN ET AL., *FEDERAL INCOME TAXATION* 826-28 (8th ed. 1990); Walter J. Blum, *A Handy Summary of the Capital Gains Arguments*, 35 *TAXES* 247 (1957); Livingston, *supra* note 157, at 191-93; James M. Poterba, *Capital Gains Tax Policy Toward Entrepreneurship*, 42 *NAT'L TAX J.* 375, 382 (1989).

164. Investors obviously prefer stable returns over volatile returns because stable returns clearly make an investment less risky. The stable returns of the tax exemption are effectively the government sharing the risk of loss. See *supra* notes 154-58 and accompanying text (commenting on the government acting as the insurer and effectively pooling the risk among the public).

165. See Livingston, *supra* note 157, at 165.

166. See Hall & Colombo, *supra* note 35, at 316, 390; Hall & Colombo, *supra* note 66, at 1450-58; see also *supra* notes 66-76 and accompanying text (discussing the donative theory).

resources should be permitted to cross-subsidize charitable activities without negatively impacting the organization's tax exemption.<sup>167</sup>

However, as time progresses, initial donors and managers will become more removed from the organization. New contributors, managers, and beneficiaries will replace the original players.<sup>168</sup> Public needs will evolve. Suppose these subsequent generations of philanthropists, managers, beneficiaries, and public needs venture far from satisfying the intent of the initial pioneering benefactors and managers and from fulfilling the original purpose of the organization. When a charitable organization's projects are related only remotely to its original purpose, a moral ethic that creates an obligation and expectation from one generation to the next is breached. Under this notion, I would submit that the moral ethic is cloning—that is, the replication over time of the nonprofit organization and its original purpose—and the tax exemption may not be justified for those organizations that do not continue to “clone” themselves as time progresses.<sup>169</sup> Pursuant to this rather myopic view, the exemption may not be justified for charitable organizations that evolve over time.<sup>170</sup>

167. For example, a nonprofit academic hospital may collect from the government, a private insurer or the patient amounts in excess of the costs incurred in providing the private portion of the mixed public good. That gain could be utilized to support basic scientific research or to facilitate teaching residents, part of the charitable mission of an academic health center. For a discussion of cross-subsidization and academic health centers, see Crimm, *supra* note 80, at 677-84; see also Estelle James, *How Nonprofits Grow: A Model*, 2 J. POL'Y ANALYSIS & MGMT. 350, 352-354 (1983) (demonstrating that nonprofits can use surplus funds from selling private goods to cross-subsidize production of public goods); Dennis Young, *Entrepreneurship and the Behavior of Nonprofit Organizations: Elements of a Theory*, in THE ECONOMICS OF NONPROFIT INSTITUTIONS (Susan Rose-Ackerman ed., 1988) (cross-subsidization can be accentuated by nonprofits headed by entrepreneurs).

168. The indefinite class of public beneficiaries will not really change unless public needs evolve and the charitable mission of the organization changes in tandem. However, where a charitable organization provides mixed public goods or services, the specific private beneficiaries will change. For example, if a nonprofit hospital is created to serve the general public, its customer base likely will remain fairly constant, but its specific patients will change through the years.

169. For a brief discussion of moral ethics in the context of choice, see Edmund S. Phelps, *The Indeterminacy of Game Equilibrium Growth in the Absence of an Ethic*, in ALTRUISM, MORALITY, AND ECONOMIC THEORY 87, 101 (Edmund S. Phelps ed., 1975).

170. This lack of justification might be magnified if the charitable organization provides mixed public goods or services only, such as a church, synagogue or health care organization. The subsequent generations of donors, managers, and consumers may change dramatically in interests, attitude and composition. This evolution in persons may force the evolved church, synagogue, or hospital to be substantially different from the original organization. For example, a synagogue may be formed and funded by individuals who represent the Orthodox branch of Judaism. Over time, however, because of externalities, such as migration patterns, the congregation (i.e., the donors and direct beneficiaries) may consist of persons who represent either the Conservative, Reform, or Progressive branch of Judaism.

This idea is alluded to by Professor Avner Ben-Ner without reference to the passage of time. See Avner Ben-Ner, *Who Benefits from the Nonprofit Sector? Reforming Law and Public Policy*

However, “the role of morals may be filled more primitively by a myth that recounts the evil consequences to a society that would depart from some traditional pattern of behavior.”<sup>171</sup> If every generation were to act “in such a way as to validate earlier assumptions as to how it will act and, given these assumptions, no generation acting alone can increase its estimated overall utility . . . then cooperative action among the generations,” assuming it was enforceable, “could produce an improvement in every generation’s utility.”<sup>172</sup> And, is not improvement in every generation’s utility desirable? As one economist has summarized this sentiment:

Under the Paretian ethic—where any change that is preferred by at least one person is counted a social gain if it is not opposed by the others—each generation would presumably anticipate the economy’s approach to the Golden Rule state because each prefers that [growth] equilibrium path to the other ones. Then the game-equilibrium growth path, shaped by the partially selfish preferences of each passing generation, would indeed approach the Golden Rule state.<sup>173</sup>

Another argument supporting tax exemption for certain evolving charitable organizations is one of transitivity or dynamic gamesmanship over a sequentially indefinite time frame.<sup>174</sup> This gamesmanship, suggested by economist Peter Hammond, is based on cooperation among players where the cooperation takes the form of holding a certain set of beliefs about the strategy of other players.<sup>175</sup> It provides that a donor in one generation takes into account the expected generosity of subsequent generations of donors, and that subsequent generations of donors take into account past generosity.<sup>176</sup> Specifically, it envisions that individual A (first

*Towards Nonprofit Organizations*, 104 *YALE L. J.* 731, 761-62 (1994). He suggests that many nonprofits suffer from “control failure,” which he defines as the failure to engage in control or to exercise sufficient control by demand-side stakeholders (including some consumers, donors, and sponsors). *See id.* Professor Ben-Ner indicates that nonprofit control failure can result in nonprofits’ providing—“services based on the preferences of those who control them, leading others to patronize the organization less than they otherwise would have, or to leave it entirely.

Policy towards nonprofit organizations should target the customers, donors and sponsors.” *Id.*

171. Phelps, *supra* note 169, at 101. Professor Phelps argues that this strict moral path approach would be a disservice to society. *See id.*

172. *Id.* at 87.

173. *Id.* at 101-02.

174. *See* Peter Hammond, *Charity: Altruism or Cooperative Egoism?*, in *ALTRUISM, MORALITY, AND ECONOMIC THEORY*, *supra* note 169, at 115-17.

175. *See id.* at 123; *see also, generally*, JOHN VON NEUMANN & OSKAR MORGENSTERN, *THEORY OF GAMES AND ECONOMIC BEHAVIOR* (3d ed. 1953).

176. *See* Hammond, *supra* note 174, at 117-20, 124-29.

generation) can only expect individual B (second generation) to be charitable later if individual B also expects individual C (third generation) to be charitable still later.<sup>177</sup> Each A, B, and C cooperate only if he or she determines that the earlier generation has cooperated in the agreement, and believes that later generations will cooperate in the future. If one individual breaches the individuals' "intertemporal agreement," the stream of donations will cease and the charitable organization that A pioneered will be forced to dissolve for lack of funding. There is great incentive to live up to the intertemporal agreement, particularly if some personal benefit—pecuniary through a charitable tax deduction, or nonpecuniary, such as maintenance of elite social status, access to special goods or services,<sup>178</sup>—is obtained by each donor. There is nothing in the theory to wed each generation of donors to the same view of the purpose for which the donation will be utilized by the donee organization. Although perhaps a leap, one might suggest that it is more important to donors that the charitable organization continue to thrive and to broadly carry out its purpose constraint than to be so restricted by the initial donor's intent that subsequent generations of donors would be unwilling to make donations.

A final argument supporting the tax exemption for certain evolving charitable organizations is founded on the concept of the term "charitable." As previously indicated, its amorphousness has prevented it from becoming a stagnant notion.<sup>179</sup> It has taken into account the facts, that over time, demands on society have changed, social needs have evolved, and public policy has developed.<sup>180</sup>

177. *See id.*

178. For a discussion of why individuals donate to charitable organizations, see John A. Baird, *Why People Give*, in CHARITABLE GIVING AND SOLICITATION ¶510, at 641 (1995); Chang & Tuckman, *supra* note 146, at 29; Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving*, in PHILANTHROPIC GIVING: STUDIES IN VARIETIES AND GOALS 105, 111 (Richard Magat ed., 1989); *see also* Crimm, *supra* note 80, at 687-89; Michael F. Luck, *The Mystique of Reciprocity*, 2 ASS'N FOR HEALTHCARE PHILANTHROPY J. 41, 41 (1992); Burton A. Weisbrod, *Toward a Theory of the Voluntary Non-profit Sector in a Three-Sector Economy*, 171, 187-88, in ALTRUISM, MORALITY AND ECONOMIC THEORY, *supra* note 169; Laura Sessions Stepp, *Focus on Self Has Changed Language of Sacrifice: Charitable Groups Report Attitude of Giving to Feel Good, Not Giving Until It Hurts*, WASH. POST, Mar. 24, 1991, at A20.

179. *See supra* note 30 and accompanying text. By virtue of the courts having explicitly indicated that the concept of charitable must take into account public policy, what is considered charitable will not be entirely constant. *See Bob Jones Univ. v. United States*, 461 U.S. 574, 585-88 (1983) (holding that public policy must enter into determination of whether an organization is charitable); 97th Cong., 225, 229-32 (1982) (Statement of R.T. McNamar, Deputy Secretary of the Treasury) Hearings on Legislation to Deny Tax Exemption to Racially Discriminatory Private Schools (commenting on the concern of the federal district court in *Bob Jones University* about permitting IRS to determine on its own public policies that would deny tax exemption, especially since federal public policy constantly changes).

180. *See Bob Jones Univ.*, 461 U.S. at 586-90.

### c. Summary

In summary, a strong argument can be made for the continued justification of a charitable organization's tax exemption as long as the organization's resources are employed to cultivate its purpose constraint in a constructive, progressive, and tolerant fashion. The same argument cannot be made if, as time proceeds, an organization uses resources to engage in some noncharitable activities—that is, activities that are unrelated to its purpose constraint.

In the latter instance, the organization may invest resources in noncharitable activities for a variety of reasons, including the perceived need to compete with other nonprofit or for-profit entities, or the perception that expected return on investment might be substantially greater for noncharitable activities. Regardless of the reason for investing resources in noncharitable activities, it seems appropriate that, at the very least, the organization should lose its tax exemption with respect to income from those activities. If the investment in noncharitable activities is more than insubstantial in magnitude and thus rivaling the charitable purpose constraint, the organization's tax exemption should be revoked. This treatment is sanctioned currently by Internal Revenue Code provisions and the courts.<sup>181</sup>

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181. I.R.C. §§ 501, 512-514 (1998). Under the judicially created “commerciality doctrine,” the courts and the Internal Revenue Service (IRS) have considered that an activity conducted in a “commercial manner” is not in furtherance of an exempt purpose and hence is a “nonexempt activity.” *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578, 581-82 (1924). In *Sagrada Orden*, the commerciality doctrine was first created in the context of a religious order that the IRS allegedly engaged in activities that were not tax-exempt but “operated also for business and commercial purposes.” *Id.* at 581. The Court stated there was no “competition” although the “transactions yield some profit” which was deemed “in the circumstances a negligible factor.” *See also* *Better Business Bureau, Inc. v. United States*, 326 U.S. 279, 283-84 (1945) (in which the Court connected the doctrine with the “exclusivity requirement” of I.R.C. § 501(c)(3) and denied the tax exemption because the institution had a “commercial hue” and its activities were “largely animated by this commercial purpose”); *Church of Scientology v. Commissioner*, 83 T.C. 381 (1984) (discussing and applying commerciality doctrine to a religion founded by L. Ron Hubbard). For a discussion of the commerciality doctrine, see James Bennet & Gabriel Rudney, *A Commerciality Test to Resolve the Commercial Nonprofit Issue*, 36 TAX NOTES 1095 (1985); Crimm, *supra* note 3, at 36-38; HOPKINS, *supra* note 28, at 833-42; Bruce R. Hopkins, *The Most Important Concept in the Law of Tax-Exempt Organizations Today: The Commerciality Doctrine*, 5 EXEMPT ORG. TAX REV. 459 (1992); Paul J. Streer, *Obtaining and Preserving Tax-Exempt Status Under Section 501(c)(3): Judicially Developed Factors for Detecting the Presence of Substantial Nonexempt Activities*, J. AM. TAX ASS'N, Spring 1985, at 63.

## CONCLUSION

The issue of the deservedness of a charitable organization to the tax exemption is separate from the question of what is the rationale for conferring the tax exemption on charitable organizations. This Article has sought primarily to address the latter by relying primarily on economic theory. It proposes that the tax exemption for charitable organizations is compensation for the provision of public goods and services, which are inherently risky activities for which positive financial expected return is otherwise zero or minimal. The tax exemption essentially creates a marketplace for the provision of public goods and services where no market otherwise would exist. It induces charitable organizations to provide these goods and services which neither the private sector, which is not unlike the nonprofit sector in its investment decision-making processes, nor government is willing or able to provide in adequate quantity.

As a separate issue, the Article suggests that not all charitable organizations deserve the tax exemption. It attempts to propose broad guidelines for determining whether a charitable organization should be entitled to the exemption. It suggests that basic to worthiness are the projects carried on by the institution and the degree to which those activities comport with the organization's initial purpose constraint.

The benefits to society of fostering the continued development of the nonprofit sector cannot be overemphasized. As time proceeds, public policy and industries change. The crucial role of charitable organizations in the provision of essential goods and services to the public will persist. Therefore, it is imperative that tax policy supports these nonprofit institutions.