2013

What We Talk About When We Talk About Tax Exemption

Philip T. Hackney
Louisiana State University Law Center, phackney@lsu.edu

WHAT WE TALK ABOUT WHEN WE TALK ABOUT TAX EXEMPTION

Philip T. Hackney[*]

Certain nonprofit organizations are granted exemption from federal income tax ("tax exemption"). Most theories assume tax exemption is a subsidy for organizations such as charities that provide some underprovided good or service. To make the subsidy case, these theories assume that there should be a tax on nonprofit organization income but provide no justification for this assumption. This article contributes to the literature by considering corporate income tax rationales as a proxy for why we might tax nonprofit organizations. The primary two corporate tax theories hold that the corporate tax is imposed to: (1) tax shareholders ("shareholder theory"), and (2) regulate corporate manager control over large sources of wealth ("regulatory theory"). The article concludes that under the shareholder theory, tax exemption for charitable organizations is not a subsidy because such organizations have no shareholders to tax. Nonetheless, tax exemption for mutual benefit organizations such as business leagues qualifies as a subsidy because their members are arguably the equivalent of shareholders. Adopting the regulatory theory suggests tax exemption is a subsidy for all tax exempt organizations, as this rationale should apply to any tax exempt organization with the potential to amass significant wealth. Adopting this theory also suggests that to exempt an organization from income tax is to exempt that organization from a regulatory regime. Tax exempt organizations, however, become subject to federal oversight of political activity and self-dealing transactions. This article considers whether this separate regulatory regime is a sufficient substitute. While this article concludes that the charitable organization

[*] Assistant Professor of Law, Louisiana State University Law Center. I thank the participants of the 2012 SEALS New Scholars Program, and the 2012 Junior Tax Scholars Workshop. I also particularly thank Blake Hudson, Elizabeth Carter, Chris Tyson, Michelle Kwon, Ellen Aprill, Lloyd Mayer, and Edward Richards for valuable feedback. Thanks to Jill Manny for introducing me to the world of tax exempt organizations, and thanks to Cathy Livingston for giving me my first legal job in the exempt organization sector. Thanks also to my research assistants Justin Mannino, Cameron Snowden, and Joshua Dierker.

regulatory regime is a sufficient substitute for the corporate income tax, it also concludes that the regulatory regime for mutual benefits is lacking. This article proposes that it is time to revamp our tax exempt structure for mutual benefit organizations.

TABLE OF CONTENTS

I. INTRODUCTION

Nonprofit organizations carry on economic activity within and without our country like many other legally recognized entities that are required to pay tax; nonprofit organizations, however, are generally exempted from paying income tax.[1] Most theories assume tax exemption, most typically from the corporate income tax,[2] is a subsidy for nonprofit organizations that provide some good or service that benefits society or is otherwise under-produced.[3] The subsidy presumption, however, is not grounded in a

[1] Specifically, organizations exempted from the federal income tax under section 501(a) of the Internal Revenue Code (Code) include charitable organizations, social welfare organizations, labor organizations, business leagues, social clubs, and many others. This exemption is not the same as the charitable contribution deduction under section 170, which is a separate and distinct issue that is available as a benefit to only a few of the organizations that are exempt from tax under section 501(a). Although generally an organization exempt under section 501(a) is not required to pay a tax on its income, if it carries on a trade or business unrelated to its exempt purpose it must pay the unrelated business income tax under section 511.

[2] Most nonprofits exempt from federal income tax under section 501(a) are formed as corporations. *See, e.g.*, JAMES J. FISHMAN & STEPHEN SCHWARZ, TAXATION OF NONPROFIT ORGANIZATIONS 38 (3d ed. 2010). The Code imposes a tax on the income of these nonprofit organizations formed as corporations under section 11. Of course, exemption under section 501(a) is used to ensure exemption in a sense from the individual income tax as well under section 1, as income earned in any activity could be attributed to an individual if that individual does not have some credible claim that the income is associated with some entity that is recognized for tax purposes. Some nonprofit organizations exempt under section 501(a) might be established as trusts (and become exempt from tax under subchapter J), organized as cooperatives (and become exempt from tax under subchapter T), or organized as unincorporated associations (and treated as corporations under section 7701).

[3] *See* Ellen P. Aprill, *Regulating the Political Speech of Noncharitable Exempt Organizations After* Citizens United, 10 ELECTION L.J. 363 (2011); Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 B.C. L. REV. 501 (1990) [hereinafter *Altruism*]; Rob Atkinson, *Theories of the Federal Tax Exemption for Charities: Thesis, Antithesis, and Syntheses*, 27 STETSON L. REV. 395 (1997) [hereinafter *Theories of Exemption*]; Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299 (1976); Evelyn Brody, *Of Sovereignty and Subsidy:*

rationale for why we would tax the income of nonprofit organizations in the first place. The subsidy rationale requires that in a normal income tax we believe that an income tax should apply to these organizations. The subsidy only results because the government forgoes tax revenue. This article reframes the tax exemption rationale debate by considering the rationales for imposing a corporate tax in our income tax system as a proxy for why we might tax nonprofit entities. Focusing on the two major rationales of the corporate tax, (1) to tax shareholders ("shareholder theory"), and (2) to regulate corporate manager control over large sources of wealth ("regulatory theory"), this article examines the implications of those theories for tax exemption. This article concludes that the corporate tax rationale implications generally suggest that we have little rationale for applying a corporate tax on the charitable activities of charitable organizations; however, it recommends reconsidering tax exemption for mutual benefit organizations such as social welfare organizations and business leagues. The two primary rationales for imposing the corporate income tax apply most specifically to the activities of mutual benefit organizations.

Adopting the shareholder theory as a base for why we would tax a nonprofit organization supports tax exemption for organizations without shareholders. In fact, because charitable organizations have no shareholders, this article argues that tax exemption is not a subsidy for such organizations. On the other hand, mutual benefit organizations are operated for the benefit of specific individuals or entities controlling the actions of the organization through voting, i.e., mutual benefits arguably have individuals akin to shareholders. Thus, under the shareholder theory, because a tax would normally apply to a mutual benefit's income, tax exemption is a subsidy to mutual benefits. There are, as yet, no robust arguments setting forth a positive rationale warranting the tax exemption of

Conceptualizing the Charity Tax Exemption, 23 J. CORP. L. 585 (1998); Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLA. L. REV. 419 (1998); Mark A. Hall & John D. Colombo, *The Charitable Status of Nonprofit Hospitals: Toward a Donative Theory of Tax Exemption*, 66 WASH. L. REV. 307 (1991) [hereinafter *Nonprofit Hospitals*]; Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L.J. 1379 (1991) [hereinafter *Donative Theory*]; Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 TAX L. REV. 283 (2011) [hereinafter *Exemptions a Subsidy*]; Daniel Halperin, *Income Taxation of Mutual Nonprofits*, 59 TAX L. REV. 133 (2006) [hereinafter *Taxation of Mutual Nonprofits*]; Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54 (1981); Lawrence M. Stone, *Federal Tax Support of Charities and Other Exempt Organizations: The Need for a National Policy*, 20 MAJOR TAX PLAN. 27 (1968).

the vast majority of mutual benefits.[4]

Adopting the regulatory theory as a rationale for taxing corporate entities supports a conclusion that tax exemption is a subsidy for all tax exempt organizations, as by its terms the theory should apply to any organization controlled by managers that might control significant sources of wealth and over whom there is little oversight from owners. The nonprofit sector by definition has weak ownership oversight. Nevertheless, viewing tax exemption from the regulatory theory highlights that exempting an organization from the corporate income tax exempts that organization from a form of regulation. Tax exempt organizations become subject to a new regulatory regime that limits political activity and self-dealing.[5] This article examines the impact of this substitution of regulatory regime; it concludes the regulatory regime imposed on charitable organizations is sufficient, but contends that the regulatory regime for mutual benefits is lacking. This article suggests it is time to revamp our tax exempt structure for mutual benefit tax exempt organizations.

Mutual benefit organizations such as business leagues and social welfare organizations are often used to impact the political process.[6] The modern conception of the regulatory function suggests that the corporate tax serves to reign in the political strength of corporate managers and to direct managers towards using the assets of the corporation for more socially desirable purposes.[7] While the regulatory function of the corporate tax is perhaps controversial,[8] there can be no doubt that exempting an

---

4 *But cf*. Bob Jones Univ. v. United States, 461 U.S. 574, 609 (1983) (Powell, J., concurring) (describing the "role played by tax exemptions in encouraging diverse, indeed often sharply conflicting, activities and viewpoints."); Bittker & Rahdert, *supra* note 3 (suggesting that some of the efforts of mutual benefits might be justifiable as exempt on the theory that they might do the activity itself on their own without having to pay a tax); Hansmann, *supra* note 3. Developing a theory of subsidizing the most efficient provider of a service, described below in Part II, could potentially support some mutual benefits, though Hansmann noted at least its inapplicability in the case of social clubs. *Id*.

5 Tax exempt organizations are subject to a regulatory regime under the Code. Among other things, these organizations must annually comply with the requirements for qualifying under section 501(c), and almost all of them must file an information return under section 6033, disclosing a significant amount of information regarding their activities each year. They must make the information available to the public. Additionally there are prohibitions on their involvement with the political process. *See infra* Part V.C.1.

6 *See, e.g*., Kim Barker, *How Nonprofits Spend Millions on Elections and Call it Public Welfare*, PROPUBLICA (Aug. 18, 2012, 11:25 PM), http://www.propublica.org/article/how-nonprofits-spend-millions-on-elections-and-call-it-public-welfare.

7 *See* Reuven S. Avi-Yonah, *Corporations, Society, and the State: A Defense of the Corporate Tax*, 90 VA. L. REV. 1193, 1211–12 (2004).

8 *See, e.g*., STEVEN A. BANK, FROM SWORD TO SHIELD: THE TRANSFORMATION OF THE CORPORATE INCOME TAX, 1861 TO PRESENT xvii (2010).

organization from the tax limits the power of Congress over the organization. For instance, Congress loses the ability to provide incentives to tax exempt organizations through deductions from taxes. Congress has responded in part to this need for a regulatory function over tax exempt entities by limiting in part the political activities of exempt organizations through prohibitions,[9] imposing public disclosure requirements,[10] and applying some taxes.[11] This article contends those efforts do not go far enough for mutual benefit organizations. It proposes imposing a greater tax burden on mutual benefit organizations, such as requiring them to pay a tax on their investment income, to both properly apply a tax burden on individuals who are shareholders and to properly tax the fullness of the political activities of these organizations.

The recent scandal involving the Internal Revenue Service (Service) exempt organizations division allegedly targeting Tea Party applicants for extra scrutiny for tax exempt status[12] also suggests a strong need for a rethinking of our tax exemption system for mutual benefit tax exempt organizations. The Tea Party organizations primarily appear to have sought status as social welfare organizations under section 501(c)(4) of the Internal Revenue Code (Code), a type of organization that arguably fits under the mutual benefit organization rubric; such organizations tend to be more focused on member interests than they are in fulfilling some public need. Social welfare organizations are allowed to intervene in a political campaign as long as that is not the organization's primary purpose.[13] Determining whether a social welfare organization's primary purpose is not political turns out to be a challenging exercise, as the Tea Party scandal clearly illuminates.[14] If we were to impose a net-investment income tax on

---

[9] *See, e.g*., I.R.C. § 501(c)(3) (limiting charitable organizations from intervening in a political campaign or engaging in lobbying that is more than a substantial part of its activities).

[10] *See, e.g*., I.R.C. § 6033 (requiring organizations to file an annual return, made publicly available, supplying substantial information regarding the activity of tax exempt organizations).

[11] *See, e.g*., I.R.C. §§ 527, 4911.

[12] *See* TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, DEP'T OF THE TREASURY, REF. NO. 2013-10-053, INAPPROPRIATE CRITERIA WERE USED TO IDENTIFY TAX EXEMPT APPLICATIONS FOR REVIEW (2013).

[13] Treas. Reg. § 1.501(c)(4)-1(a) (as amended in 1990).

[14] *See, e.g*., Stephen Ohlemacher, *Holly Paz, IRS Supervisor, Admits Scrutinizing Applications From Tea Party Groups*, THE HUFFINGTON POST (June 16, 2013, 8:08 PM), http://www.huffingtonpost.com/2013/06/16/irs-scandal-holly-paz-tea-party-applications_n_3451684.html (quoting a statement Holly Paz, then Director of the Internal Revenue Service's (Service) Rulings and Agreements division, made to investigators: "[The 501(c)(4) political determination is] very fact-and-circumstance intensive. So it's a difficult issue.").

all mutual benefit organizations, as this article proposes, we would take a great deal of pressure off of the Service in making this political call. Additionally, requiring public disclosure of donors to most mutual benefit tax exempt organizations would be a beneficial move to make the requirements for such potentially politically active organizations more in line with the requirements of a section 527 political organization that already lives under such a requirement.[15]

Our tax system employs a number of different forms of taxation for various legal entities, such as trusts,[16] cooperatives,[17] partnerships,[18] and a host of special industry taxation systems such as insurance and banking.[19] Thus, in considering a basis for imposing an income tax on a nonprofit organization, one might begin by asking: why focus on corporate tax rationales to the exclusion of other entity tax systems? The first answer is practical: the vast majority of organizations we exempt from tax are formed as corporations.[20] Thus, while there may be some benefit to a consideration of trust-based or cooperative-based tax rationales, without exemption, most organizations that would have qualified as exempt would be responsible for the corporate income tax.[21] Furthermore, in structure, nonprofit organizations look much like our large publicly traded corporations where there is a separation between firm ownership and management.[22] There are no "owners" of a nonprofit organization; consequently we cannot use a pass-through taxation system like we do for partnerships where it is clear who owns the firm. Therefore, in a nonprofit context, a first order

15 I.R.C. § 527(j).

16 Trusts are taxed under subchapter J of Title A of the Code.

17 Cooperatives are generally taxed under subchapter T of Title A of the Code.

18 Partnerships are taxed under subchapter K of Title A of the Code.

19 Insurance companies and banks are taxed under subchapters L and H of Title A of the Code, respectively.

20 *See* FISHMAN & SCHWARZ, *supra* note 2, at 52. Also, on an anecdotal level, a review of the Form 990 of each organization listed in the Top Ten Nonprofit Charitable Organizations, by Size of Total Assets, Tax Year 2008, a collection of organizations holding over $186 billion dollars, shows that each of these organizations formed as a corporation. *See* INTERNAL REVENUE SERVICE, STATISTICS OF INCOME: CHARITIES & OTHER TAX EXEMPT ORGANIZATIONS, *available at* http://www.irs.gov/pub/irs-soi/11esgiftsnap.pdf (last visited July 3, 2013).

21 Of course, even if subject to tax this does not mean that all of these organizations would owe tax. A nonprofit that receives donations to carry out its activities would generally be able to use section 102 to exclude this income from tax.

22 *See* HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 239 (1996) (discussing the great similarity in particular between some large nonprofit organizations such as hospitals and publicly traded companies); *see also* RICHARD GOODE, THE CORPORATION INCOME TAX 16 (1951).

consideration must be to employ an entity tax like the corporate income tax. Finally a focus on corporate tax rationales brings substantial complexity; adding other rationales to the mix might lead to a lack of clarity. Thus, I leave an examination of these other systems for another article. Because mutual benefits so closely resemble cooperative organizations, a review of cooperative taxation in connection with tax exemption might be particularly fruitful.

This article is not about the charitable contribution deduction under section 170 of the Code. This provision is related to one of the benefits of some of the tax exempt organizations described in section 501(c) of the Code, such as the charitable organizations described in section 501(c)(3). The charitable contribution deduction has its own rationales that are distinct from the consideration of whether to allow certain entities to operate without paying tax upon their income.[23]

Part II briefly describes the tax exempt sector and the theories regarding that sector. Part III provides a brief history of corporations and their taxation in the United States. Part IV reviews the rationales for imposing an income tax on corporations. Part V considers what corporate tax rationales suggest about tax exemption for nonprofit organizations. The article concludes with Part VI.

II. ORGANIZATIONS EXEMPT FROM FEDERAL INCOME TAX

A. Brief Description of the Tax Exempt Sector

Under section 501(a) of the Code, organizations described in sections 501(c), (d) (generally, nonprofit organizations), and 401(a) (pension plans) of the Code are exempt from federal income tax ("tax exempt organization"). This article focuses on tax exempt organizations described in section 501(c). Tax exempt organizations under section 501(a) comprise a diverse group: charitable organizations,[24] social welfare organizations,[25] social clubs,[26] business leagues, and others all qualify within the section.[27]

---

[23] *See* William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972); Miranda Perry Fleischer, *Equality of Opportunity and the Charitable Tax Subsidies*, 91 B.U. L. REV. 601 (2011); Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393 (1988); Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343 (1989); David E. Pozen, *Remapping the Charitable Deduction*, 39 CONN. L. REV. 531 (2006).

[24] I.R.C. § 501(c)(3).

[25] I.R.C. § 501(c)(4).

[26] I.R.C. § 501(c)(7).

[27] I.R.C. § 501(c)(6).

Tax exempt organizations aid the poor, operate hospitals, advocate for the interests of members of business and labor, educate children and adults, operate pools and athletic facilities, and manage museums. In 2009, tax exempt organizations held over $4.3 trillion in assets.[28] Tax exempt organizations are typically formed as a corporation,[29] although some are formed as a trust, cooperative or unincorporated association. They are unified by the "non-distribution constraint."[30] This means tax exempt organizations may not distribute profits to owners.[31] There is no constraint on earning a profit, only one on distributing profits to owners.

Tax exemption provides exemption from income tax for income earned by an organization while engaged in activities promoting the purpose of the tax exemption.[32] It does not generally exempt income from activities that are not related to an organization's exempt purpose. A tax exempt organization may lose tax exemption status if it operates for a substantial or primary non-exempt purpose.[33] For example, if a charitable organization organized to relieve poverty adopted as a substantial purpose the operation of a restaurant, it should lose tax exemption if the restaurant has little connection to the exempt purpose of relieving poverty.[34] Additionally, an exempt organization is required to pay the unrelated business income tax (UBIT) under sections 511–514 of the Code if it earns a profit from an activity unrelated to its exempt purpose. The unrelated business income tax generally does not apply to investment income or other sources of primarily passive income.[35]

Tax exemption, if it is a subsidy, provides a financial benefit equal to the applicable tax rate multiplied by an organization's annual income.[36] Of

[28] KATIE L. ROEGER ET AL., THE URBAN INST., THE NONPROFIT SECTOR IN BRIEF: PUBLIC CHARITIES, GIVING, AND VOLUNTEERING 2 (2011), *available at* http://www.urban.org/UploadedPDF/412434-NonprofitAlmanacBrief2011.pdf. This amount may not include the assets of organizations that do not file a return, such as churches.

[29] *See supra* note 2.

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

[31] *Id*.

[32] I.R.C. § 501(c).

[33] *See* Treas. Reg. § 1.501(c)(3)-1(c)(1) (as amended in 2008) ("An organization will not be . . . regarded [as operating exclusively for one or more exempt purposes] if more than an insubstantial part of its activities is not in furtherance of an exempt purpose."). Nonetheless, the actual point at which an organization should lose its exempt status, and not just pay the unrelated business income tax, for failure to operate for an exempt purpose is subject to much debate. *See id*.

[34] *See id*.

[35] *See* I.R.C. § 512(b).

[36] *See, e.g.*, Bob Jones Univ. v. United States, 461 U.S. 574, 588 (1983); *see also*

course, if it is the case that tax exemption is such a subsidy, and this article questions that assumption, it is only a subsidy to the extent that the organization earns a profit during a taxable period. If a tax exempt organization earns no income, it gains no financial benefit from tax exemption. Thus, under a subsidy theory, a manager helps an organization to benefit from tax exemption only if she saves the earnings of the firm for a future year. Naturally, those organizations with greater financial resources and thus opportunities to earn income in the year will reap a greater benefit from the subsidy. An organization that earns $100,000 in income at a constant 36 percent tax rate receives a subsidy of $36,000, while an organization that earns $1,000,000 earns a $360,000 subsidy. Such a subsidy is not connected to the positive values promoted by the organization, but only to how much income the organization earns. Because this article concludes that tax exemption for mutual benefit organizations is a subsidy, this quality of tax exemption, giving greater benefit to those with greater resources, seems an odd policy choice.

Scholars have attempted to categorize the tax exempt sector because of the assortment of tax exempt organizations it encompasses. The most basic distinction made is between "public benefit" and "mutual benefit" organizations.[37] Public benefit organizations, as the name suggests, are operated for the benefit of the public. Charitable organizations, for instance, are considered public benefit organizations. A mutual benefit organization, on the other hand, is operated for the benefit of its members.[38] For example, a beer league is operated for its members who are likely from a segment of the beer industry. Boris Bittker and George Rahdert categorize charitable organizations, social welfare organizations, and political parties as public benefit organizations and categorize social clubs, cooperatives, labor unions, and trade associations as mutual benefit organizations.[39] Others have recognized a similar dichotomy but labeled these main distinctions as charitable and noncharitable.[40]

Henry Hansmann categorized nonprofit organizations based on revenue

---

Regan v. Taxation with Representation of Washington, 461 U.S. 540, 544 (1997) ("Both tax exemptions and tax deductibility are a form of subsidy that is administered through the tax system. A tax exemption has much the same effect as a cash grant to the organization of the amount of tax it would have to pay on its income.").

[37] Bittker & Rahdert, *supra* note 3, at 305.

[38] *Id*.

[39] *Id*.

[40] John Simon et al., *The Federal Tax Treatment of Charitable Organizations*, *in* THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 267, 268 (Walter W. Powell & Richard Steinberg eds., 2d ed. 2006).

source and control.[41] Donative nonprofits receive the bulk of their revenue via donations or grants. Commercial nonprofits, on the other hand, receive the bulk of their revenue via sale of services or goods.[42] Organizations controlled by patrons obtaining services from the organization are deemed mutual organizations. Organizations not controlled by patrons are considered entrepreneurial organizations.[43] These categories can be viewed as a matrix. There might be a donative entrepreneurial, a donative mutual, a commercial entrepreneurial or a commercial mutual.

Most scholars view tax exempt organizations as a sector of our economy distinct from the for-profit and the government sectors.[44] The for-profit sector provides control rights, profit rights, and ownership transfer rights,[45] whereas a democratic government sector provides the electorate with ownership rights and control to elect representatives.[46] In reality, these distinctions are not so easy to make. After discussing tax exemption rationales below, the following part addresses how for-profit corporations grew directly from corporate bodies that initially started as government and nonprofit corporate bodies.

B. Tax Exemption Rationales

What follows is a very brief consideration of exemption rationales. It is brief as this is territory well covered in many articles and books.[47]

1. Subsidy Theories

The prevailing theory continues to be that we provide tax exemption to nonprofit organizations providing some benefit to the state that is at least equal in value to the tax subsidy from the government.[48] The theory presumes that the state would normally tax all entities within its borders. Thus, the state exercises legislative grace in exempting certain corporations from tax. The Court uses the subsidy theory. It has stated, "Congress sought to provide tax benefits to charitable organizations, to encourage the

---

[41] Hansmann, *supra* note 30, at 841.

[42] *Id*.

[43] *Id*. Hansmann defines patrons as "all persons who transact with a firm either as purchasers of the firm's products or as sellers to the firm of supplies, labor, or factors of production." HANSMANN, *supra* note 22, at 12.

[44] Richard Steinberg & Walter W. Powell, *Introduction* to THE NONPROFIT SECTOR, *supra* note 40, at 2.

[45] *Id*.

[46] *Id*.

[47] *See* sources cited *supra* note 3.

[48] Stone, *supra* note 3, at 45.

development of private institutions that serve a useful public purpose or supplement or take the place of public institutions of the same kind."[49]

There are a number of theorists who have used the subsidy theory. For example, Burton Weisbrod argues that we subsidize the tax exempt sector to solve government failure.[50] Governments only provide public goods desired by the median voter. Nonprofits can provide those public goods for the voters outside the median and tax exemption serves as a subsidy to help this good activity take place.[51] Hansmann argues that the exemption provides a subsidy to solve market-failure.[52] Nonprofits tend to provide services and goods in situations that make patrons hesitant to purchase those service or goods because they believe managers are likely to shirk their responsibility and will possibly abscond with money. For instance, a donor is unable to determine whether the manager delivered charity to a third party. The nondistribution constraint assures such donors that the managers will not abscond with the money because they cannot make a profit. We provide tax exemption as a crude subsidy to encourage the right level of these efficient market providers.

Other subsidy exemption rationale scholarship focuses solely on charitable organizations.[53] Mark Hall and John Colombo focus on a donation market to determine whether we should provide tax exemption to charities. They argue, "the primary rationale for the charitable exemption is to subsidize those organizations capable of attracting a substantial level of donative support from the public."[54] Rob Atkinson suggests we should provide tax exemption to public charities because they generate collective goods and services that benefit the public and are deemed inherently good.[55] Atkinson argues that altruism is an inherently valuable meta-benefit produced by nonprofits and therefore it deserves tax subsidization.[56]

Daniel Halperin questions whether tax exemption is a subsidy by

---

[49] Bob Jones Univ. v. United States, 461 U.S. 574, 588 (1983); *see also* Regan v. Taxation with Representation of Washington, 461 U.S. 540, 544 (1997) ("Both tax exemptions and tax deductibility are a form of subsidy that is administered through the tax system. A tax exemption has much the same effect as a cash grant to the organization of the amount of tax it would have to pay on its income.").

[50] Burton A. Weisbrod, *Toward a Theory of the Voluntary Nonprofit Sector in a Three-Sector Economy*, *in* THE ECONOMICS OF NONPROFIT INSTITUTIONS: STUDIES IN STRUCTURE AND POLICY 21, 22–24 (Susan Rose-Ackerman ed., 1986).

[51] BURTON A. WEISBROD, THE VOLUNTARY NONPROFIT SECTOR 66–67 (1977).

[52] Hansmann, *supra* note 3, at 67.

[53] *Altruism*, *supra* note 3, at 510; *Theories of Exemption*, *supra* note 3, at 396; *Nonprofit Hospitals*, *supra* note 3, at 316; *Donative Theory*, *supra* note 3, at 1384.

[54] *Nonprofit Hospitals*, *supra* note 3, at 390.

[55] *Theories of Exemption*, *supra* note 3, at 402–04.

[56] *Altruism*, *supra* note 3, at 628–38.

considering the normal income tax base.[57] He concludes there is no subsidy to charitable organizations associated with the exemption for contributions and money earned from exempt related activities where those monies are clearly used for direct spending on charitable purposes.[58] Exemption for capital investment and investment income, however, are subsidies because exempting that income diverges from normal measurement of income principals.[59] Halperin examines mutual benefits as well and contends that investment income and nonmember income is effectively a subsidy for these organizations and should not be exempt.[60] He argues, however, that tax exemption for member income for organizations such as social clubs is legitimate as it would not result in any substantial income.[61]

2. Income Measurement Theory

Bittker and Rahdert believe that public service organizations "should be wholly exempted from income taxation, because they do not realize 'income' in the ordinary sense of that term and because, even if they did, there is no satisfactory way to fit the tax rate to the ability of the beneficiaries to pay."[62] They conclude that these organizations cannot easily measure their income.[63] Based on the challenge in determining income and the impact the tax would have on the less fortunate, they found the exemption from income tax for charitable organizations to be justified for all purposes.[64] They argue that "mutual benefit" organizations should be viewed as a conduit and that we should tax any income that could be imputed to the members to the extent the entity earned investment income and income from nonmembers.[65] In other words, to the extent such an organization earned investment income or earned money providing a service or good to a nonmember, the members should be individually taxed on their distributive share of income of the organization much like a partnership. Bittker and Rahdert accept exemption to the extent a mutual benefit earns income while its members are doing things they could do on

57 *Exemptions a Subsidy*, *supra* note 3; *Taxation of Mutual Nonprofits*, *supra* note 3.

58 *Exemptions a Subsidy*, *supra* note 3, at 285.

59 *Id*. at 285−86.

60 *Taxation of Mutual Nonprofits supra* note 3, at 135.

61 *Id*. at 135–36.

62 Bittker & Rahdert, *supra* note 3, at 305. Note that William Andrews seems to similarly find this as a justification in part for the exemption. Andrews, *supra* note 23, at 360 (noting the "impracticality of measuring individual benefits . . . .").

63 Bittker & Rahdert, *supra* note 3, at 307.

64 *Id*. at 358.

65 *Id*.

their own without being taxed.[66] They argue it is impractical to collect what they expect would be a minute amount of income.[67]

3. Concluding Thoughts on Rationales

Tax exemption scholarship tends to focus on the exemption for charitable organizations. The charitable sector is by far the largest of the nonprofit sector. Additionally, there is significant diversity in the whole of the tax exempt sector such that we may need a unique explanation for tax exemption for each organization. Nonetheless, finding common traits could help foster better rules for all of these organizations in the future. Along these lines, tax exemption scholars seem to assume tax exemption is a subsidy without critically examining this claim. None of the exemption theories consider what rationale we would use to justify taxing nonprofit organizations. Hansmann notes the oddity of taxing entities rather than individuals, but states that since the corporate tax is so entrenched it makes sense for purposes of his article to take the tax for granted.[68] Thus, we are left with a set of theories that are arguably not properly grounded. This article contends that a rationale for why we might tax nonprofit organizations is necessary to a more complete theory for a rationale of tax exemption.

In the following part I provide a history of corporations and their taxation in the United States. I believe this story helps in understanding the rationale for taxing corporations.

III. A BRIEF HISTORY OF CORPORATIONS AND THEIR TAXATION IN THE UNITED STATES

A. History of Corporations

A corporation is a legal fiction that started as bodies of people serving important public functions rather than serving the private for-profit function that we typically envision of corporations in the United States today. Nonprofit and for-profit corporations originate out of the same legal entity form. This fact suggests that certain corporations may exist in a twilight space between public and private where there may be an ambiguity in whether an entity should be taxed by the sovereign.

[66] *Id*. at 305.

[67] *Id*. at 354–57. Such an issue is not a problem with respect to social clubs because they are not able to exclude investment income and income from nonmembers from the unrelated business income tax.

[68] Hansmann, *supra* note 3, at 56.

A corporation provides a fictional place in which multiple people can own property in common and act together in some endeavor.[69] William Blackstone places the creation of companies with the Romans,[70] where *publicani* formed companies called Societates, in some instances to collect taxes to pay for Roman conquest.[71] According to Friedrich Carl von Savigny, the first corporate bodies in Rome were villages, towns, and colonies, and then gradually extended outward.[72]

In England, the country from which America adopted its corporate legal regime, the first corporate bodies formed as "peace-guilds, the members of which were pledged to stand by each other for mutual protection."[73] From these peace guilds sprung municipalities and trade guilds.[74] These trade guilds were more like today's trade unions, protecting member interests, rather than seeking out economic innovation.[75] The substantial commercial corporations, still deeply connected to the crown, began to form in the sixteenth and seventeenth centuries with the exploration of the new world.[76] Companies such as the African Company, the Russian Company, and the Company of Merchants of London formed in the nature of these peace guilds to issue shares and pool money necessary for complex and long-term financial endeavors for profit to the crown and private interest.[77] These types of corporations played a significant role in the colonization of America.[78] The Virginia Company, for instance, introduced representative democracy into the colonies, while the Massachusetts Company changed its stockholders (referred to as "freemen") into state citizens.[79]

Early in the history of the United States, the citizenry did not

---

[69] *See* JOHN MICKLETHWAIT & ADRIAN WOOLDRIDGE, THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA 1–15 (2003).

[70] WILLIAM BLACKSTONE, 1 COMMENTARIES ON THE LAWS OF ENGLAND 456 (1765, reprinted 1992); *see also* Oscar Handlin & Mary F. Handlin, *Origins of the American Business Corporation*, 5 J. ECON. HIST. 1, 1 (1945).

[71] MICKLETHWAIT & WOOLDRIDGE, *supra* note 69, at 4.

[72] Samuel Williston, *History of the Law of Business Corporations Before 1800*, 2 HARV. L. REV. 105, 106 (1888), (citing 2 SYSTEM DE HEUTIGEN REUMISCHEN RECHTS § 86, et. seq.).

[73] *Id*. at 108 (citing LUJO BRENTANO, ON THE HISTORY AND DEVELOPMENT OF GILDS, AND THE ORIGIN OF TRADE-UNIONS (1870)).

[74] Williston, *supra* note 72, at 108.

[75] MICKLETHWAIT & WOOLDRIDGE, *supra* note 69, at 13.

[76] Williston, *supra* note 72, at 109.

[77] *Id*.

[78] JOSEPH STANCLIFFE DAVIS, 16 ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS 3 (1917).

[79] MICKLETHWAIT &WOOLDRIDGE, *supra* note 69, at 34.

distinguish between private and public corporations.[80] Legal authorities considered corporations either clerical or lay, and lay corporations were considered either eleemosynary or civil.[81] During the 18th century, boroughs, universities, the Bank of England, and the East India Company, along with insurance and manufacturing companies, were all categorized as "civil."[82] Early Americans initially conceived of corporations as "agenc[ies] of government, endowed with public attributes, exclusive privileges and political power, and designed to serve a social function for the state."[83]

The earliest general incorporation statutes in the United States were for religious congregations, educational institutions such as Harvard and Dartmouth, libraries, charitable and beneficial societies, municipalities, and agricultural societies.[84] The earliest for-profit corporations in the United States consisted primarily of public-minded infrastructure projects such as turnpikes, bridges, canals, banks, and insurance companies.[85] Although modern for-profit corporations began development in the early part of the 19th century, it was not until around 1865, with the rise of railroad corporations, that more significant corporations formed.[86]

Throughout the evolution of the corporation, scholars adopted three distinct views regarding the personality of the corporation.[87] Each of these views becomes important in the corporate tax rationale, and is therefore important to considering why we might (not) tax nonprofit organizations. Originally, corporations were thought of as "artificial entities" existing solely as constructs of the state.[88] As Chief Justice John Marshall said, "[a] corporation is an artificial being . . . . Being the mere creature of the law, it possesses only those properties which the charter of its creation confers upon it."[89] The second view considers corporations as an aggregate of

---

80 Handlin & Handlin, *supra* note 70, at 19.

81 *Id*. at 20.

82 *Id*.

83 *Id*. at 22.

84 *See generally* RONALD E. SEAVOY, THE ORIGINS OF THE AMERICAN BUSINESS CORPORATION, 1784-1855: BROADENING THE CONCEPT OF PUBLIC SERVICE DURING INDUSTRIALIZATION 9–32 (1982).

85 ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 10 (1932).

86 Reuven S. Avi-Yonah, Citizens United *and the Corporate Form*, 2010 WIS. L. REV. 999, 1012 (2010).

87 For a discussion of these theories, see, e.g., Reuven S. Avi-Yonah, *The Cyclical Transformations of the Corporate Form: A Historical Perspective on Corporate Social Responsibility*, 30 DEL. J. CORP. L. 767 (2005).

88 Trs. of Dartmouth Coll. v. Woodward, 17 U.S. 518, 636 (1819) (discussing a corporation as an "artificial being").

89 *Id*.

individuals having ownership of the entity acting on their behalf. This will be referred to as the "aggregate theory." Finally, as for-profit corporations grew well beyond the collective interest of their shareholders during the Progressive Era, with managers controlling corporations, a "real entity" view became the prevailing theory.

B. History of Corporate Taxation

1. The Beginning in the States

As corporations spread through the United States, individual states, which relied largely upon property taxes for revenue, had to transition from taxing tangible property to taxing intangible property.[90] Because corporations made capital more movable, they made the taxation of property more challenging.[91] As discussed by Steven Bank, these challenges sparked an evolution towards a general corporate tax beginning with property tax and special industry tax regimes.[92] Initially, states attempted to treat corporations no differently than individuals in their property tax regimes.[93] Yet this effort met with little success.[94] States also tried special industry taxes for businesses such as banks, insurance companies, railroads, and transportation companies.[95] These special industry taxes applied to any business entity conducting that special business, but typically these industries almost all conducted business as corporations.[96] Special industry taxes ultimately began to morph into general taxes upon corporations, as happened in Pennsylvania.[97]

2. Federal Taxation of Corporations

The United States began to tax corporations at the federal level in earnest in 1864 as a component of the income tax enacted by the Union. The Civil War income tax taxed shareholders on the profits of the

---

90 BANK, *supra* note 8, at 1.

91 EDWIN R. A. SELIGMAN, ESSAYS IN TAXATION 136 (6th ed. 1909).

92 BANK, *supra* note 8, at 3-11.

93 *Id*. at 8.

94 R. RUDY HIGGENS-EVENSON, THE PRICE OF PROGRESS: PUBLIC SERVICES, TAXATION, AND THE AMERICAN CORPORATE STATE, 1877 TO 1929 13–14 (2003).

95 BANK, *supra* note 8, at 9.

96 *Id*. at 10.

97 SELIGMAN, *supra* note 91, at 166. The Pennsylvania corporate tax provided that "'banks and all corporations whatever' which declared a dividend of one per cent should pay 'in addition to all present taxes' one-half mill for each dollar of the dividend or profit, and an additional one-half mill for every additional one per cent of dividend." *Id*.

corporations whether distributed or not,[98] and imposed a separate entity tax on the earnings of special industries such as banks, insurance companies, and transportation companies.[99] The public apparently viewed these special industry taxes as a withholding tax on corporations to enforce the individual income tax on dividends received.[100] Although the system effectively operated as a conduit system whereby the corporation was essentially the collection mechanism for taxing shareholders on dividends, Bank contends that this tax presented the seeds of the modern corporate tax.[101] Even then, the federal government determined that the tax did not apply to all corporations subject to its influence by exempting "literary, scientific, or other charitable institutions" from the ambit of the tax.[102]

After Congress let the income tax of the Civil War expire in 1872,[103] it was not until 1909 that Congress again enacted a corporate entity tax by enacting an excise tax on the income of all corporations.[104] The tax consisted of one percent of the net income of the corporation in excess of $5000.[105] The Act additionally required corporations with income in excess of $5000 to file a return that became a public record.[106] Much in the way the public viewed the Civil War tax on corporations as a conduit system intended to tax the earnings of a corporate shareholders, the public primarily viewed the 1909 Corporate Excise Tax as a tax on shareholders and a substitute for an income tax.[107] In that regard, in addition to limiting its effect primarily to larger corporations, Congress again exempted certain corporations from this tax regime; exempted entities included organizations such as "labor, agricultural or horticultural organizations, . . . fraternal beneficiary societies, . . . domestic building and loan associations," and those corporations or associations "organized and operated exclusively for religious, charitable, or educational purposes, no part of the net income of

[98] BANK, *supra* note 8, at 13–14.

[99] Act of June 30, 1864, ch. 173, §§ 120, 122, 13 Stat. 223, 283–84 (1864); BANK, *supra* note 8, at 15.

[100] FREDERIC C . HOWE, TAXATION AND TAXES IN THE UNITED STATES UNDER THE INTERNAL REVENUE SYSTEM 1791-1895 96–97 (1896) (discussing the implementation of "stoppage at the source" principles); BANK, *supra* note 8, at 19.

[101] BANK, *supra* note 8, at 14.

[102] GEORGE S. BOUTWELL, A MANUAL OF THE DIRECT AND EXCISE TAX SYSTEM OF THE UNITED STATES 275 (1863).

[103] RANDOLPH E. PAUL, TAXATION IN THE UNITED STATES 27 (1954).

[104] Tariff Act of August 5, 1909, ch. 6, § 38, 36 Stat. 11, 112.

[105] *Id*.

[106] Tariff Act of August 5, 1909, ch. 6, § 38, 36 Stat. 11, 116.

[107] BANK, *supra* note 8, at 56–57.

which inures to the benefit of any private stockholder or individual."[108]

Although the public primarily viewed the 1909 Corporate Excise Tax as a tax on shareholders,[109] Marjorie Kornhauser has demonstrated that many proponents of the excise tax also viewed it as serving a regulatory function to reign in the excess of the "trust" problem.[110] Arising during the Progressive Era, the "trust" problem involved large corporations combining and defrauding investors by overcapitalization, along with monopolization and the destruction of individual enterprise.[111] Part of the solution to this "trust" problem was believed to be publicity of corporate information and supervision.[112] Kornhauser marshals evidence that the excise taxes' proponents consistently highlighted regulatory functions of the tax.[113] For instance, President William Howard Taft stated that if the tax was enacted, "we [will] have made a long step toward that supervisory control of corporations which may prevent a further abuse of power."[114] The reformers focused their efforts on large corporations: the final bill, for instance, exempted the first $5000 of income from corporation tax.[115] Although the most explicit regulatory aspect of the bill, its publicity function, was almost immediately eliminated after enactment,[116] Kornhauser still maintains that the tax was a first moderate step toward regulating corporate entities.[117] With tax returns, the statute allowed the federal government to collect data on corporations, thus beginning the process of supervising corporate activity on a federal level.[118]

On February 3, 1913, Delaware ratified the 16th Amendment, the 36th requisite state to do so, eliminating the potential constitutional infirmity of an individual income tax. Congress quickly enacted an income tax on October 3, 1913, as part of the Tariff Act of 1913, and with it a corporate

---

[108] Tariff Act of August 5, 1909, ch. 6, § 38, 36 Stat. 11, 113.

[109] BANK, *supra* note 8, at 56–57.

[110] Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 56 (1991); *see also* Ajay K. Mehrotra, *The Public Control of Corporate Power: Revisiting the 1909 U.S. Corporate Tax from a Comparative Perspective*, 11 THEORETICAL INQUIRIES L. 497, 536–38 (2010) (coming to similar conclusions regarding the motivations of the proponents of the 1909 Corporate Excise tax).

[111] Kornhauser, *supra* note 110, at 56.

[112] *Id*. at 57.

[113] 44 CONG. REC. 3344 (1909).

[114] *Id*.

[115] Kornhauser, *supra* note 110, at 106.

[116] Act of Aug. 5, 1909, ch. 6, § 38(3), 36 Stat. 11, 114-15; *see also* Kornhauser, *supra* note 110, at 132.

[117] Kornhauser, *supra* note 110, at 134.

[118] *Id*. at 134–35.

income tax.[119] Once more, Congress provided an exemption for those organizations originally exempted from the Corporate Excise Tax of 1909.[120] Additionally, Congress added new exempt organizations such as social welfare organizations, chambers of commerce, and business leagues.[121]

The 1913 income tax adopted a "normal tax" of one percent, applied to both individuals and corporations.[122] The statute allowed the deduction of dividends from the "normal tax," such that this income tax again applied a pass-through regime to corporate income;[123] however, there was a wrinkle. Congress imposed a surtax on incomes above $20,000 with a top rate of six percent.[124] Because the corporate rate was only one percent, shareholders owing tax at the higher rates could leave earnings in the corporation where the income would only be taxed at the lower one percent rate, providing an opportunity for tax deferral. Congress attempted to lessen the deferral opportunity by imposing a tax on the "unreasonable accumulations of earnings" of corporations.[125] This strategy proved ineffective and became a constant irritant to progressive interests looking to see shareholder income properly taxed.[126]

During the teens and twenties, Congress struggled with how to handle the tax deferral problem caused by the rate differential between the individual and corporate rates.[127] This struggle led to the adoption of the pure corporate entity tax that we know today. In the 1930s, based on a public belief that undistributed corporate earnings were in part a cause of the Great Depression, Congress passed an undistributed profits tax on corporations at a twenty-seven percent rate, maintained the normal tax on corporations with a top rate of fifteen percent, but, critically, eliminated the individual dividend exemption from the normal tax.[128] This was the fruition of the movement toward the classical system of corporate taxation with a tax on corporate income clearly separate and apart from individual shareholders. Although businesses were quickly able to convince Congress through lobbying efforts to remove the undistributed profits tax by 1939,

---

119 Tariff Act of 1913, ch. 16, § II, 38 Stat. 114, 166–72.

120 Tariff Act of 1913, ch. 16, § II, 38 Stat. 114, 172.

121 *Id*.

122 Tariff Act of 1913, ch. 16, § II, 38 Stat. 114, 166, 172.

123 Tariff Act of 1913, ch. 16, § II, 38 Stat. 114, 167.

124 Tariff Act of 1913, ch. 16, § II, 38 Stat. 114, 166.

125 BANK, *supra* note 8, at 85.

126 *Id*.

127 Steven A. Bank, *A Capital Lock-in Theory of the Corporate Income Tax*, 94 GEO. L.J. 889, 926–27 (2006).

128 Revenue Act of 1936, § 14(b), 49 Stat. 1648, 1656.

the double tax regime was in place.[129]

C. Concluding Thoughts on History of Corporations and Its Impact on Nonprofits and Tax Exemption

The corporation as an idea is a fictional entity that plays a role in both public and private spaces that has served to organize our cities, universities and churches, and operated to facilitate our most complex private business. Nonprofits present a tax challenge in this area as they occupy a twilight space between the very clearly public and very clearly private. While we seem to easily conclude that public entities such as states and municipalities, all generally organized as corporations, are exempt from federal income tax,[130] and have a general sense that private for-profit corporations should bear a tax of some sort in our income tax system, when we start moving away from the clear public state-based activity we encounter difficulty in categorization. In the relationship between corporations and our society, we also see a struggle with the outsize impact these organizations have on our citizenry and the opportunity they provide to individuals for obtaining monetary advantages through their use. As discussed above, the United States has used the corporate tax to attempt to tax the wealth stored and utilized within corporations and to attempt to regulate the activities of corporations. The following part assesses the rationales for imposing the corporate income tax. The notion is that an examination of this rationale might help to better define the twilight space between what we conceive of as public space (nontaxable) and private space (potentially taxable). Additionally this examination might shed some light on why we may or may not think certain nonprofit entities are proper subjects of taxation.

IV. WHY IMPOSE AN INCOME TAX ON CORPORATIONS?

Why impose a corporate income tax as a part of our income tax? I ask this question because I assume the rationale for imposing the corporate income tax should have some relationship to our rationale for exempting certain corporations from that tax. Additionally, if the rationales do not apply to tax exempt organization income, we need some other rationale for imposing a tax or we cannot speak of exemption from tax as a "subsidy" in

---

[129] Bank, *supra* note 127, at 938.

[130] For a discussion of the basis upon which state and local governments derive exemption, see Ellen P. Aprill, *Excluding the Income of State and Local Governments: The Need for Congressional Action*, 26 GA. L. REV. 421, 430–32 (1992).

the way exemption is regularly conceived.[131] If there is no rationale for taxing these organizations, calling exemption a subsidy makes no sense. For instance, although governmental entities are generally exempt from income tax, no one talks of this exemption as a subsidy.

A. What is the Corporate Tax and Who Bears Its Burden?

What is the corporate income tax? The corporate income tax is imposed under section 11 of the Code and applies to a legal entity that (1) incorporates under the laws of a U.S. state, (2) allows its ownership interests to be publicly traded, or (3) elects to be treated as a corporation.[132] A corporation calculates its income similarly to the way the Code requires an individual to calculate his income for tax purposes.[133] Such similarities include interest payments that are deductible[134] and dividend payments that are generally not. In turn, dividends are generally taxable to the person who receives them. Because dividends are by definition the earnings and profits of a corporation, the taxation of income at the corporate level combined with the denial of a deduction for paid dividends leads people to label the corporate tax a double tax. The income is taxed at the corporate level and again at the shareholder level.[135] These features of the current corporate income tax steer many to conclude that the corporate tax system is not ideal from an efficiency perspective.[136] It leads to economic distortions because

[131] *See supra* Part II.B.1 (discussing the theories and court opinions adopting the subsidy theory of tax exemption).

[132] *See* I.R.C. § 7701 and the regulations thereunder. Nonprofit organizations organized as corporations meet the requirements of (1) and thus the general rule regarding a nonprofit corporation would be that it is taxed unless it meets one of the exemption requirements.

[133] *See, e.g.*, DANIEL N. SHAVIRO, DECODING THE U.S. CORPORATE TAX 4 (2009).

[134] I.R.C. § 163(a).

[135] If A forms a corporation by putting $100 into the corporation, he does so tax free to himself and to the corporation. Assume the corporation borrows $900 at 5% simple interest and must pay $45 to the lender in each year. After deducting salaries and interest payments and depreciating its assets, the corporation earns $100 of taxable income in year 1. Assuming a 35% tax rate, the corporation would pay $35 and have $65 to distribute to A. If the corporation distributed the $65 to A at the end of the year, A would pay 15% of $65 ($9.75) on the dividend received, leaving A with $55.25, for an effective tax rate of 44.75% on the income earned in that corporation. In comparison, on the $45 of interest paid to the lender during the year, the corporation deducts that amount, and the lender must pay ordinary rates of only 35%. Thus, the holder of corporate equity bears a higher tax burden (44.75%) as compared to the holder of corporate debt (35%) under this scenario. A also bears a higher burden than if he carried on the same actions as a sole proprietor or partnership.

[136] *See, e.g.*, Steven A. Bank, *The Story of Double Taxation: A Clash Over the Control of Corporate Earnings*, *in* BUSINESS TAX STORIES 153 (Steven A. Bank & Kirk J. Stark eds., 2005).

of the incentives to choose debt over equity in the corporate form and to choose other entity forms over corporations because of the "double tax."[137]

That we think of this corporate tax structure as a double tax intuitively demonstrates the concept of the incidence of a tax. Because a corporation is fictional we do not think of it as bearing a tax; rather, some human bears its incidence. The corporate tax causes some human to have less wealth and consequently a lesser ability to enjoy life. Describing the corporate tax as a double tax thus illustrates that many intuitively believe that shareholders bear the burden of the corporate income tax, i.e., shareholders of corporations are believed to have a lesser ability to enjoy life as a result of having to pay the corporate tax. Nevertheless, economists find the corporate tax to be born by some combination of all holders of capital or perhaps some significant portion of worldwide labor.[138]

B. Presumption Regarding Purpose of the Income Tax and Its Connection to Corporations

There are two main questions regarding why we impose an income tax on a corporate entity. The first focuses on why we impose a tax at the entity level rather than tax the shareholders. The second asks why we impose both an entity-level tax and an individual tax. This second question is often thought to be a question of fairness because of the "double tax" on corporate income mentioned above. This article is concerned mostly with the first question regarding why we might impose a tax on an entity because of its relationship to the tax exempt organization, where we evaluate an entity tax alone. Nevertheless, the second question regarding why there is a "double tax" on corporate income often informs the debate regarding the corporate tax rationale. In reviewing corporate tax rationales, it is important to keep this fact in mind because this feature of the corporate tax is not particularly apposite to a tax exempt organization where there would only be one level of tax.

Without getting caught up in the debate over the proper tax base, I note that to consider the corporate tax rationales, we must also at least briefly consider the rationale for the individual income tax. Why do we choose income as a tax base? There are generally thought to be three primary

[137] For a current consideration of all the efficiency problems associated with the corporate tax, see SHAVIRO, *supra* note 133, at 25; *see also* Michael J. Graetz & Alvin C. Warren, Jr., *Integration of Corporate and Individual Income Taxes: An Introduction*, 84 TAX NOTES 1767, 1768 (Sept. 27, 1999).

[138] For an excellent review of debate regarding the incidence of the corporate tax, see Alan J. Auerbach, *Who Bears the Corporate Tax?: A Review of What We Know* (Nat'l Bureau of Econ. Research, Working Paper No. 11,686, 2005).

criteria in evaluating a tax: equity, efficiency, and administrability.[139] Much has been written on each of these criteria but such a discussion is beyond the scope of this article. I focus on the equity rationale as perhaps the most important for the purpose of this article. The equity rationale refers to whether the tax system is fair to individuals. In *The Wealth of Nations*, Adam Smith set out the most common notion regarding equity as follows: "[t]he subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to . . . the revenue which they respectively enjoy . . . ."[140] Today, this is commonly thought of as ability to pay.[141] While there is much debate as to whether ability to pay, a benefit principle, or any other idea of distributive justice properly states a coherent metric for considering equity,[142] surely we adopt an income tax base as a measuring device to assess each individual's level of welfare.[143] Efficiency refers to the impact a particular tax imposes on an economy. Administrability refers to the ease of administration of a tax. Although these latter two factors are discussed below, each is secondary to the question of equity for purposes of the income tax rationale.

If our income tax system goal is to measure some quantity of benefit or ability to pay, imposing a tax on an entity such as a corporation is an indirect way of accomplishing that goal. It makes it challenging to determine who bears the burden of the tax, and it distorts the ability to pay calculus. Thus, the question is set for why we impose a corporate income tax. If we are genuinely interested in allocating the burden of government among citizens according to ability to pay, choosing to impose the income tax on corporate entities likely leads to some people overpaying and some people underpaying. Additionally, if we have imposed a tax on the income of a corporation, why are we additionally applying a tax on dividends received by shareholders?

---

139 *See, e.g.*, Victor Thuronyi, *The Concept of Income*, 46 TAX L. REV. 45, 100 (1990); Alvin C. Warren, Jr., *Three Versions of Tax Reform*, 39 WM. & MARY L. REV. 157, 166 (1997).

140 ADAM SMITH, THE WEALTH OF NATIONS 777–78 (1776).

141 JOSEPH BANKMAN ET AL., FEDERAL INCOME TAXATION 11 (Vicki Been et al. eds., 16th ed. 2012); *see also* STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2005 BUDGET PROPOSAL 6 (Comm. Print 2004).

142 *See, e.g.*, LIAM MURPHY & THOMAS NAGEL, THE MYTH OF OWNERSHIP: TAXES AND JUSTICE 12 (2002) (extensive discussion of whether ability to pay or a benefit principle presents a coherent theory of fairness); *see also* Stephen Utz, *Ability to Pay*, 23 WHITTIER L. REV. 867 (2002) (critiquing the ability to pay principle).

143 *See, e.g.*, MURPHY & NAGEL, *supra* note 142, at 20.

C. Administrative Convenience/That's Where the Money Is

One reason we might tax the entity itself is administrative convenience. Corporations provide a convenient place from which to collect tax — they have money and they have the administrative capacity to easily deliver the money to the government.[144] This theory might garner support from a political calculus. It is easier for a political system to adopt needed taxes if there is a sense that no one is really being taxed. The government provides important public goods, but might have trouble getting the citizenry to pay enough money for the optimal level of those goods if they have to pay those taxes in a way in that makes them believe they are being overburdened. Because the corporate tax is not a particularly salient tax for the vast majority of the voting population,[145] if a legislator is looking for a way to pay for the optimal level of public goods, the corporate tax could be a useful tool in collecting the money for these goods.[146] Using salience terms coined by David Gamage and Darien Shanske, we could say that the corporate tax lacks "political salience" for the vast majority of the population, that is, its imposition is unlikely to influence citizens to vote for or against a politician because they are unlikely to be particularly aware of the corporate tax. We could also say that it lacks "market salience," because much of the population is likely not aware that they are paying the tax.[147]

This is not much of a justification for the tax from an equity perspective if that equity perspective is based upon using income as the best metric of ability to pay. The principal justification for this perspective is that the State needs money and the corporate entity is an administratively easy place from which to collect that money. Of course, if we do not adopt the notion that fairness in taxation (and perhaps more broadly government operation) must exist at the point of tax collection, and focus instead on ultimate outcomes, we may not be bothered with the result of collecting revenue through such a corporate tax.[148]

---

[144] Richard M. Bird, *Why Tax Corporations?* (Technical Comm. on Bus. Taxation, Working Paper No. 96-2, 1996); SHAVIRO, *supra* note 133, at 11; s*ee also* GOODE, *supra* note 22, at 26.

[145] For a discussion of the burgeoning literature on the idea of salience and tax policy, see David Gamage & Darien Shanske, *Three Essays on Tax Salience: Market Salience and Political Salience*, 65 TAX L. REV. 19 (2011).

[146] *See* J. GREGORY BALLENTINE, EQUITY, EFFICIENCY, AND THE U.S. CORPORATION INCOME TAX 7 (1980).

[147] Gamage & Shanske, *supra* note 145, at 24–25.

[148] *See, e.g.*, MURPHY & NAGEL, *supra* note 142, at 8 (arguing "taxes must be evaluated as part of the overall system of property rights that they help to create.").

D. Aggregate Theory/Tax on the Shareholders

When the United States adopted a corporate income tax first during the Civil War, then in 1909 and again in 1913, proponents supported it largely because they believed it operated as a tax on wealthy shareholders.[149] As discussed above in reference to the history of taxation, the early versions of the corporate tax effectively adopted a conduit system where the corporation paid a tax, but it was thought of as a withholding system to ensure payment from shareholders on dividends received. Although there is now both an entity tax and a shareholder level tax, a primary justification for the corporate tax remains that it is a tax on shareholder income.[150] The theory arises from an aggregate view of the corporation: the corporation is the property of its shareholders who are taxed based on their share of corporate income through the corporate income tax.

What do we mean by the term shareholder? A shareholder owns a share of stock in a corporation.[151] As defined in a basic text on corporations, a share of stock is "primarily a profit-sharing contract, a unit of interest in the corporation based on a contribution to the corporate capital."[152] That profit-sharing contract entitles the shareholder to three rights: (1) control, (2) proprietary rights, and (3) certain ancillary and remedial rights.[153] Under the shareholder theory, we believe this profit sharing contract makes the annual income of a corporation subject to the income tax. Shareholders with these profit sharing contracts presumably have a greater ability to pay, and therefore it is fair to include the corporation's income as part of the tax base.

A few problems arise with this theory. Corporate tax incidence analyses suggest that the burden of the corporate tax is born by individuals other than the actual corporate shareholders.[154] Additionally, taxing shareholders on corporate income before they have "realized" that income

---

[149] *See supra* Part III.B.

[150] SHAVIRO, *supra* note 133, at 23; Bird, *supra* note 144, at 9.

[151] MERRIAM WEBSTER'S DICTIONARY OF LAW 454 (1996); *see* Reid Thompson & David Weisbach, *Attributes of Ownership* 1 (Univ. of Chicago Law Sch., Institute For Law and Economics, Working Paper No. 621, 2012), *available at* http://ssrn.com/abstract=2177022 (discussing what it currently means to own a share of stock and noting that title to most shares of stock today are held by Cede & Co. rather than the individual who we think of as the owner).

[152] JAMES D. COX & THOMAS LEE HAZEN, COX & HAZEN ON CORPORATIONS § 13.01, at 718 (2d ed. 2003).

[153] *Id*. § 13.01, at 718–19.

[154] *See* Avi-Yonah, *supra* note 7, at 1204.

could be thought to violate the realization principle of our income tax.[155] Finally, the tax rate applied to corporations bears no resemblance to the rates we apply to individuals based on their income levels.[156] Nonetheless, there are practical reasons consistent with this aggregate shareholder view that support tax at the corporate level. First, without the corporate tax, shareholders could use a corporation as a tax deferral device. In other words, if no tax applied to corporate income, individuals who controlled a corporation could defer tax by leaving income within the corporation at a zero percent tax rate annually. Such annual tax savings for owners of corporate equity, as compared to owners of other business entities such as partnerships whose income is taxed annually whether distributed or not, would add up to significant amounts. Secondly, the administrative convenience identified above may play at least a part in justifying a tax on shareholders at the corporate level; given the massive number of shareholders in modern public corporations, finding a means of determining the distributive share of income and loss of each shareholder could be a terrible logistical nightmare. Imposing a current income tax on the corporation is a potential imperfect solution to that problem. Thus, the shareholder theory, while not perfect, does at least provide some satisfactory equitable and practical grounds for the corporate tax.

E. Real Entity/Regulatory Function

Some argue that the corporate tax regulates managers acting on behalf of publicly traded entities.[157] Publicly traded entities are defined by the separation of ownership and control.[158] As a result of this separation in publicly traded corporations, "important decision agents do not bear a substantial share of the wealth effects of their decisions."[159] Under these circumstances managers may not act as the best agents of the shareholders;[160] also, managers of very large sources of wealth may act in

---

155 *See* Eisner v. Macomber, 252 U.S. 189, 211 (1920).

156 *Compare* I.R.C. § 1, *with* I.R.C § 11.

157 Reuven S. Avi-Yonah & Amir C. Chenchinski, *The Case for Dividend Deduction*, 65 TAX LAW. 3, 7 (2011); Kornhauser, *supra* note 110, at 61; *see also* Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211 (1991) (arguing that employing a separate corporate tax aligns the manager of the corporation as an agent working in the tax interests of the shareholders).

158 *See, e.g.*, BERLE & MEANS, *supra* note 85, at 4; Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

159 Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 301 (1983).

160 BERLE & MEANS, *supra* note 85, at 3.

ways inconsistent with the good of the larger public.[161] The corporate tax arguably can act to rectify these problems. As discussed above, the enactors of the 1909 Corporate Excise Tax thought the corporate tax would regulate corporate managers.[162] This view of the corporate tax takes a real entity view, that is, we tax the corporation because we are trying to have an impact on the behavior of the corporation.

Reuven Avi-Yonah argues that the separation of ownership and control in publicly traded companies leads to significant power concentration in the hands of a few: the corporate tax, he argues, serves as a check on that corporate managerial power.[163] Additionally, it affords the government a tool to ensure the corporation acts broadly in the interests of shareholders and the public.[164] Avi-Yonah states: "the corporate tax is justified as a means to control the excessive accumulation of power in the hands of corporate management, which is inconsistent with a properly functioning liberal democratic polity."[165] Avi-Yonah argues the corporate tax (1) limits the amount of money a corporation manager has at her disposal to influence the political process (the "limiting function"), and (2) provides a tool to incentivize or discourage a corporate manager's use of corporate resources (the "incentive function").[166]

The limiting function is justified, Avi-Yonah contends, because unreasonable accumulations of wealth are not healthy for a democracy.[167] As Kay Lehman Scholzman, Sidney Verba and Henry Brady state, "[a]mong the requirements for a functioning democracy are mechanisms for the free expression of political voice so that members of the public can communicate information about their experiences, needs, and preferences and hold public officials accountable for their conduct in office."[168] If certain individuals amass vast amounts of wealth, this might so significantly tilt the balance of political voice such that the democracy would be one in name only.[169] Given (1) the separation of ownership and control, (2) the

[161] Avi-Yonah, *supra* note 7, at 1243.

[162] Kornhauser, *supra* note 110, at 53.

[163] Avi-Yonah, *supra* note 7, at 1225.

[164] *See* GOODE, *supra* note 22, at 40; *see also* Avi-Yonah, *supra* note 7, at 1244.

[165] Avi-Yonah, *supra* note 7, at 1244–45.

[166] Avi-Yonah refers to this latter function as the "regulatory function." *Id*. at 1246. I have used a different term, the incentive function, to clarify it from the term it modifies.

[167] *Id*. at 1244; *see also* Reuven S. Avi-Yonah, *Why Tax the Rich? Efficiency, Equity, and Progressive Taxation*, 111 YALE L.J. 1391, 1412–13 (2002).

[168] KAY LEHMAN SCHLOZMAN ET AL., THE UNHEAVENLY CHORUS: UNEQUAL POLITICAL VOICE AND THE BROKEN PROMISE OF AMERICAN DEMOCRACY 2 (2012).

[169] Admittedly, the Court may not countenance this idea. Citizens United v. Fed. Election Comm'n, 558 U.S. 310, 349–50 (2010) ("[T]he concept that government may

fact that corporations need not distribute earnings to its owners, and (3) that there is power in control of large sources of money, Avi-Yonah argues that it is essential to our democracy to assess a tax on corporations to limit the power of these entities to ensure a more well-functioning democracy.[170]

The incentive function uses the tax system to incentivize the managers of the entity to use its resources in a socially valuable manner, and to discourage the managers from using the resources in a socially harmful manner.[171] For instance, Congress prohibits deductions for bribes paid to foreign officials,[172] and empirical research suggests this has had an impact on the behavior of corporate managers.[173] Avi-Yonah cites investment incentives and incentives toward research and development as examples of the types of devices Congress has used to incentivize managers to exercise their resources in ways that are helpful to society.[174]

The regulatory justification of the corporate tax springs from a need to justify taxing corporate income twice. Avi-Yonah believes that the only appropriate place for this double level of taxation is with respect to publicly traded corporations.[175] He believes that taxing owners is sufficient for all other businesses.[176] The key to this argument for Avi-Yonah is the separation of ownership and management.

Some question the regulatory function theory. Bank, for instance, contends that even if the tax served a regulatory function, the tax fails in fulfilling this function.[177] Secondly, Bank claims that corporate managers are likely able to shift the incidence of the tax such that the tax does not impact a manager's behavior.[178] It would be helpful if we had additional empirical work to determine whether corporate taxation has a real regulatory impact. Recent scholarship considers the relationship between tax sheltering activity and corporate governance.[179] As described by Mihir Desai and Dhammika Dharmapala, the "basic intuition for how corporate

restrict the speech of some elements of our society in order to enhance the relative voice of others is wholly foreign to the First Amendment") (quoting United States v. Automobile Workers, 352 U.S. 567, 597 (1957) (Douglas, J., dissenting)).

170 Avi-Yonah, *supra* note 7, at 1244.

171 *Id*. at 1248–49.

172 I.R.C. § 162(c); *see also* Avi-Yonah, *supra* note 7, at 1248.

173 Avi-Yonah, *supra* note 7, at 1248–49.

174 *Id*. at 1249.

175 Avi-Yonah & Chenchinski, *supra* note 157, at 7–8.

176 *Id*. at 8.

177 BANK, *supra* note 8, at xvii.

178 *Id*.

179 *See generally* MPA STUDIES ON INTELLECTUAL PROP., COMPETITION & TAX LAW, TAX AND CORPORATE GOVERNANCE (Wolfgang Schön et al. eds., 2008).

governance and taxation interact is that tax avoidance demands complexity and obfuscation to prevent detection. These characteristics, in turn, can become a shield for managerial opportunism."[180] In other words, efforts to stamp out corporate tax avoidance may be complementary to establishing good corporate governance such that the corporation is managed in the interests of the shareholders rather than on behalf of the managers themselves. There are some initial positive results to suggest a corporate tax may positively impact corporate managerial behavior in such a way.[181] Continued research in this area should be profitable.

Michael Doran argues that the regulatory justification seems to justify taxing any large collection of wealth.[182] In this regard, he argues that the United States has managed to "exert substantial public control over [the] private concentrations of wealth . . . ." of pension plans and charitable organizations without a tax.[183] While there are limited taxes imposed on pensions and other tax exempt organizations, as Doran notes, it is not clear that the government has "exercised substantial public control" over all private concentrations of wealth. This article does not quibble with Doran's claim, but instead examines whether the regulatory theory should be expanded to cover these other large concentrations of wealth, and if not, whether the public control over these concentrations of wealth is an effective substitute for the corporate tax.

Another critique contends that such a regulatory function at the federal level violates principles of federalism. Corporate law is within the domain of the states. When Congress debated the 1909 Corporate Excise Tax, many argued vociferously against the publicity portion of the tax because it encroached on state regulatory territory.[184] In a modern context, James Fishman recently argued, in part on federalism grounds, that the Service lacks authority to regulate nonprofit corporate governance.[185] Such regulatory activity, in his opinion, should be left to the states. Of course, a willingness to allow the federal government broad authority over corporate governance through the Securities Exchange Commission would seem to suggest that this federalism concern is not widely shared among the public, at least with respect to publicly traded corporations.

---

[180] Mihir A. Desai & Dhammika Dharmapala, *Tax and Corporate Governance: An Economic Approach*, *in* TAX AND CORPORATE GOVERNANCE, *supra* note 179, at 13, 14.

[181] *Id*. at 19–20.

[182] Michael Doran, *Managers, Shareholders, and the Corporate Double Tax*, 95 VA. L. REV. 517, 530 n.47 (2009).

[183] *Id*.

[184] *See* Kornhauser, *supra* note 110, at 97.

[185] James J. Fishman, *Stealth Preemption: The IRS's Nonprofit Corporate Governance Initiative*, 29 VA. TAX REV. 545, 548–49 (2010).

The regulatory theory could benefit from more empirical work demonstrating its effectiveness. Given current rising levels of income[186] and political voice[187] inequalities, it seems to be in our interest to continue exploring this function of the corporate tax. A tax that could both raise revenue and direct the use of wealth toward more beneficial purposes, both for the country and for shareholders, seems ideal. If it is in fact a tax that is less salient on a market and political basis, it also seems ideal as a means towards meeting our current long-term fiscal imbalance. On a final analysis the regulatory theory of the corporate tax seems to offer some potential as a real rationale for the corporate tax. While more work is needed in considering its impact, it should not be thrown out simply because of inconsistencies in its application or based on a simple determination that it has not achieved its goal: we must also keep this regulatory function of the corporate tax in mind when considering organizations we might determine should be exempted from the corporate tax.

F. Artificial Entity/Benefits Theory

One theory claims the corporate tax is a charge for the benefits of the rights to incorporation. The right to form a corporation is a valuable right giving those who use it the ability to aggregate wealth for business purposes and obtain limited liability. Under this benefits theory, individuals who use such rights should pay a tax for those benefits. For example, when the Court initially upheld the Corporate Excise Tax of 1909, it referred to the tax as "an excise upon the particular privilege of doing business in a corporate capacity . . . ."[188] Because many organizational forms — such as a limited liability company, a limited partnership, or even S corporation tax status — provide benefits like those of a corporation without application of an entity tax, the benefits claim lacks a coherent rationale. At the same time, Rebecca Rudnick argues the tax could be consideration in exchange for the opportunity to sell equity on a public market.[189] Under this theory, the separate corporate income tax is justified only on corporations with access to a public equity market. This theory does provide a plausible basis for the corporate tax as currently structured. Still, it is only a rationale that the corporate tax possibly has grown to include. This article contends, however, that it has less explanatory power from an intuitive or evidentiary basis than

[186] *See, e.g.*, Anthony B. Atkinson et al., *Top Incomes in the Long Run of History*, 49 J. ECON. LITERATURE 3 (2011).

[187] *See, e.g.*, SCHLOZMAN ET AL., *supra* note 168.

[188] Flint v. Stone Tracy Co., 220 U.S. 107, 151 (1911).

[189] Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965, 985–86 (1989).

either the shareholder or regulatory rationales.

G. Bank's Capital Lock-in Theory

Bank argues that we have a corporate tax in addition to a shareholder tax because corporate managers preferred to maintain strong capital lock-in features of a corporation.[190] Capital lock-in refers to a feature of a business entity that involves little pressure from owners to return equity.[191] Organizations featuring substantial capital lock-in exhibit a greater longevity than those without. Corporate law itself works to ensure that there is little pressure on a corporation to return equity upon the request of a shareholder. This distinguishes a corporation from a partnership, which generally has to return equity upon request of a partner. If the United States were to tax shareholders currently on their share of corporate income, shareholders would put pressure on corporations to distribute dividends sufficient to pay such taxes. Because corporate managers highly value capital lock-in, they resist any efforts to impose such a flow-through tax system.[192]

While Bank's capital lock-in theory is persuasive in its argument that corporate managers work to maintain a separate entity tax in order to have a more powerful entity in their control, Bank's theory assumes the natural order for an income tax would be to tax the shareholders on corporate income. Thus, Bank seems to accept the aggregate view that the corporate tax is imposed to tax shareholders; however, he simply contends that allowing corporate entities to maintain their capital in order to increase the size and scope of their business trumps a possibly more equitable arrangement. The reverse, i.e., applying a partnership-like flow-through regime on corporations, would reduce corporate managerial power because the managers would be forced to distribute money as dividends so that the shareholders could pay taxes on their share of earnings.

Thus, for purposes of examining tax exemption, this benefits theory seems more of a gloss on the shareholder rationale rather than its own independent rationale. Nonetheless, these practical considerations of managerial power working to maintain entity wealth through tax policy could play a part in the story of why we have maintained tax exemption for certain nonprofit entities and should be kept in mind as we examine tax exemption rationales.

---

[190] *See* Bank, *supra* note 127.

[191] For a discussion of the idea and arguably positive role played by capital lock-in, see Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387 (2003).

[192] *See* Bank, *supra* note 127.

H. Odds and Ends

The theories discussed above ignore the fact that corporate tax applies whether or not an entity has shareholders who can receive distributions. Under the Code, a corporation includes a business entity organized under federal, state, and federally recognized Indian tribe statutes referring to the entity as a corporation or as incorporated.[193] Yet the corporate tax is written broadly, such that it could apply, and under certain circumstances does apply, even when connected to a governmental entity.[194] For instance, an organization carrying out an essential governmental function with an income that accrues to a state or political subdivision thereof is allowed to exclude its income from the corporate tax under section 115 of the Code, but must still file a corporate return (Form 1120) with the Service. Any nonprofit organized as a corporation also meets this definition of an organization subject to the corporate income tax. Thus, the suggestion that the corporate income tax is a backstop to ensure that shareholders are paying tax on earnings, or that it is serving a regulatory function for the managers of publicly traded companies, does not explain the corporate income tax as it applies to entities within our system.

We are thus left with a series of imperfect explanations for the corporate income tax. The two most publicly accepted theories, both now and at the times of enactment, continue to be the shareholder theory and the regulatory theory. Given their imperfect explanatory nature, we cannot expect these theories to provide a perfect means of assessing nonprofit rationales. Nevertheless, they are the content we have for justifying the

---

[193] Treas. Reg. § 301.7701-2(b)(1) (2012).

[194] Although not strictly under consideration in this article, state, municipal entities and entities connected with such governmental groups are also generally organized as corporations. *See* Aprill, *supra* note 130, at 430–32 (discussing I.R.S. Gen. Couns. Mem. 14,407 (1935), where the Service concluded that although a corporation, a state governmental entity is not a corporation for purposes of the Code); *see also* Ellen P. Aprill, *The Integral, the Essential, and the Instrumental: Federal Income Tax Treatment of Governmental Affiliates*, 23 IOWA J. CORP. L. 803 (1998) (discussing the tax status of this vast and complex array of state and municipal governmental affiliates). Federal instrumentalities are expressly excluded from the income tax too, via section 501(c)(1), but there are plenty of challenging twilight organizations connected with the federal government that are potentially subject to corporate income tax — for instance, consider the National Railroad Retirement Investment Trust, which Congress exempted from tax under section 501(c)(28). The subtext of such an inclusion in a list of exempt organizations is that it could be subject to the corporate income tax. The Railroad Retirement Trust is theoretically subjected to the unrelated business income tax under sections 511–514 of the Code because it is exempt from tax under section 501(a) because it is described in section 501(c). In other words, this federally connected entity is at least in part arguably subjected to the corporate income tax presumably because it is a corporation.

corporate tax as an entity income tax. If these rationales do not support the taxation of nonprofits as well, we either have to look for some other rationale to support their taxation such that we can call tax exemption a subsidy, or we can accept that tax exemption is not really a subsidy at all.

V. IMPLICATIONS FOR EXEMPTION

A failure to consider corporate tax theories leaves our tax exemption rationales incomplete.[195] Because most tax exempt organizations would face the corporate tax if not exempt,[196] comparing rationales for applying a corporate tax at the entity level should provide feedback information regarding why we should exempt certain entities from that tax. Although this article contends that the two significant theories that likely have the most explanatory power with respect to the corporate tax are the shareholder and regulatory theories, this part will analyze each of the other theories. The focus however will be upon the former two theories. The focus on the shareholder theory serves to highlight and question the assumption of most rationales explaining that exemption serves as a subsidy. The article concludes that it is likely not a subsidy for truly charitable organizations. On the other hand, tax exemption is a subsidy for mutual benefit organizations because these organizations have individuals who are akin to shareholders, that is, individuals who control the organization and can direct its benefits in their direction. The focus on the regulatory theory highlights the fact that our exemption rationales ignore the potential regulatory function that the corporate tax serves. The point being that a choice to exempt is not just an exemption from an obligation to pay revenue, but also an exemption from a regulatory regime.

A. Administrative Convenience/That's Where the Money Is

If we tax corporations because they have the money and organizational means to easily pay a tax, then the assumption that tax exemption is a subsidy that is commonly made is likely reasonable for almost all tax exempt organizations. Such a "corporate income tax" should apply to all corporate entities including nonprofit corporate entities. Tax exempt organizations hold substantial assets, earn significant revenue, and often have the organizational means to pay the tax just like publicly traded

---

195 *See, e.g.*, SHAVIRO, *supra* note 133, at 3 ("Look at one [article of the corporate tax] without the others, and it is easy to draw myopic and inaccurate conclusions about the overall landscape.").

196 *See* FISHMAN & SCHWARZ, *supra* note 2.

corporations.[197] The tax should therefore apply to all except possibly small nonprofit organizations under this theory. Thus, any determination to exempt nonprofit organizations from this corporate income tax can be said to be a subsidy because we would tax these organizations in the normal course of this notion of the income tax. By exempting nonprofit organizations we are relieving them from an obligation they would have in the normal course of business of our country.

What might rules for tax exempt organizations look like under this administrative convenience corporate tax rationale? The rationale might suggest tax exemption only where revenue-neutral to the government. We might require an organization to demonstrate that it lessens the burdens of government.[198] We might also impose a payout requirement as is imposed on private foundations.[199] Yet because this corporate rationale has little justification other than ease of administration it could just as easily be used to support tax exemption as a broad subsidy that Congress decides to grant to particular organizations. Because this rationale has such little explanatory value from an equity perspective, however, it provides little in the way of guidance to tax exemption rationales.

B. Aggregate Theory/Tax is on Shareholders

Given the history of the corporate tax, the popular conceptions regarding the tax, and the simple practical aspect of administering the income tax, a major purpose of the corporate tax appears to be to tax shareholders.[200] Although this rationale suffers substantial imperfections, as discussed in the notes above in Part IV.G, there are simply too many practical realities of our income tax system that suggest our public common intention in imposing corporate tax is to tax shareholders.

This aggregate theory of corporate taxation leaves taxing nonprofit

---

[197] A significant amount of our economy is held and earned in nonprofit tax exempt solution. According to the Service business master file numbers from 2010, as recorded by the Urban Institute, organizations exempt under section 501(c), exclusive of those described in section 501(c)(3), held over $1 trillion in assets and earned over $384 billion in revenue, while those described in section 501(c)(3) held over $2.48 trillion in assets and earned over $1.3 trillion in revenue. *See Number of Nonprofit Organizations in the United States*, NAT'L CTR. FOR CHARITABLE STATISTICS, http://nccsdataweb.urban.org/PubApps/profile1.php?state=US (last visited July 5, 2013).

[198] Robert Louthian & Amy Henchey, *Lessening the Burdens of Government*, *in* INTERNAL REVENUE SERV., EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION (CPE) TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 1993 (1992), *available at* http://www.irs.gov/pub/irs-tege/eotopicb93.pdf.

[199] *See* I.R.C. § 4942.

[200] *See* discussion *supra* Part IV.G.

entities on somewhat shaky ground. The shareholder rationale requires shareholders — individuals who own shares in the corporation. By definition, nonprofit organizations should have no such individuals. If a nonprofit organization earns income in a year, to whom should we attribute the earning of that income? If we were concerned about the realization principle with respect to a for-profit corporation, we should be doubly concerned with that principle with respect to a nonprofit organization. There is no one to whom we can easily attribute the benefits and the burdens of a nonprofit organization.

What does the shareholder rationale suggest about the rules for tax exemption? The shareholder theory could lead to the simple conclusion that we must exempt organizations that have no shareholders or individuals equivalent to shareholders. Of course, the Code generally prohibits tax exempt organizations from allowing earnings to inure to the benefit of private shareholders or individuals,[201] and there are also rules prohibiting most of these organizations from benefitting only members.[202] This simple version of the shareholder theory supports a claim that tax exemption for nonprofit organizations is not a subsidy as most theories on exemption presume, but is instead the natural order for nonprofit organizations. The income should only be taxed upon being realized by an individual.

Nevertheless, this assessment oversimplifies the shareholder theory because it does not consider the broader practical justification for the shareholder theory. The practical basis of the shareholder theory provides that without a tax upon income within an entity on an annual basis, those who obtain its earnings in the future have obtained tax deferral. The impact of this practical corporate tax rationale on tax exemption depends on how much emphasis we put on the practical component and how much we put on the simple fact of ownership of shares leading to taxation. The ownership feature is a strong component of the shareholder justification, suggesting that we can tax corporate income currently because we are taxing the earnings of each shareholder and we can tax each shareholder's share of income because of the control and right to earnings they have with respect to the corporation. The practical justification is mostly implicated where there are individuals who exhibit a similar ability to control via voting on board members and who have a right to earnings.

Adopting the shareholder rationale with a strong ownership component but a weak practical tax deferral justification suggests that our tax exemption system should provide tax exemption to those entities where the likelihood of individuals who might control the entity and direct its retained

[201] *See, e.g.*, I.R.C. § 501(c)(3), (4).

[202] *See, e.g.*, rules regarding operating as a business league under I.R.C. § 501(c)(6).

earnings to themselves is low. I will refer to this as the "shareholder rationale requirements." These shareholder rationale requirements keep the focus of the shareholder theory on the fact of ownership as leading to a right to tax the entity, but are wary of the potential for tax deferral. The potential for tax deferral is greatest where there is an individual who controls the entity and who has the right to direct its earnings accordingly.

The rules applicable to charitable organizations that qualify as tax exempt, because described in section 501(c)(3),[203] impose requirements that make it rather difficult to direct earnings toward an individual who controls the organization. In addition to requiring such an organization to operate exclusively for a charitable purpose, section 501(c)(3) directly prohibits the distribution of earnings "to the benefit of any private shareholder or individual" of a charitable organization.[204] In other words, it prohibits a big part of what we consider to be ownership — the right to the earnings of an entity. The regulations further provide that a charitable organization must operate for the public interest, not private.[205] Although by no means foolproof, these requirements and others significantly constrain the ability of individuals to use a charitable organization for their private purposes. These rules require significant monitoring by the Service to ensure the system is not abused; but the rules provide the Service bounds within which it can police charities to prohibit the use of these organizations for personal gain or even for general tax deferral purposes.

Thus, if our rationale for taxing a corporate entity is a desire to tax shareholders, such a rationale does not pertain to a charitable organization. Operated in an ideal manner, a charitable organization presents no individuals approaching the status of a shareholder. Consequently, there is no subsidy at all for truly charitable organizations. Because in the normal course of taxation we would have no basis upon which to apply a tax to such an organization, the state is giving the charitable organization nothing by not taxing it. The state had no right, under a shareholder taxation theory to tax a charitable organization in the first place.

The rules applicable to tax exempt mutual benefit organizations,

[203] "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . 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 (or in opposition to) any candidate for public office." I.R.C. § 501(c)(3).

[204] *Id*.

[205] Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (as amended in 2008).

however, typically allow members to control the organization via voting,[206] and those members are the primary recipients of the benefits of the organization. I contend that mutual benefit organizations thus have a close equivalent to shareholders. The shareholder theory of corporate taxation with a strong ownership component and weak practical justification would suggest that tax exemption for mutual benefits is a subsidy. Thus, whereas the structure required of charitable organizations alone meets the shareholder rationale requirements, mutual benefit organizations do not. To justify exemption for mutual benefits we need a reason for providing a subsidy.

To illustrate the argument regarding mutual benefits, consider a beer league, exempt from income tax because described under section 501 of the Code.[207] A business league is formed specifically to promote the common interests of the organization's members.[208] The members pay dues and typically elect the board of directors and the directors in turn hire management to run the operations.[209] The managers provide the services desired of the members as long as these are not particular services for individuals, such as providing insurance to the members.[210] The beer league would most likely promote the business of selling beer, and would probably advocate to legislative and executive authorities for laws and enforcement of laws that are in the interest of the beer industry as a whole. Hansmann refers to such an organization as a "commercial mutual" because it derives its income from dues and it provides its services to the individuals who control the organization.[211]

For simplicity, assume members pay $1 million in dues to the beer league during the year. The league invests the money while it is not using it and earns just $5000 in interest during the year. By the end of the year, it spends $1,005,000 on carrying out the interests of the members. The $5000 is clearly earnings of the organization. Although the beer league does not distribute the $5000 in interest as a "dividend," the expenditure of this money on behalf of the members is the equivalent of a dividend in kind.

[206] The members of a business league described under section 501(c)(6) generally vote for the directors of the organization. *See, e.g.*, John Francis Reilly et al., *IRC 501(c)(6) Organizations*, *in* INTERNAL REVENUE SERV., EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION (CPE) TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 2003 K-1, K-10 (2002), *available at* http://www.irs.gov/pub/irs-tege/eotopick03.pdf.

[207] I.R.C. §501(c)(6).

[208] *Id*.; Treas. Reg. § 1.501(c)(6)-1 (1960); *see also* FRANCES R. HILL & DOUGLAS M. MANCINO, TAXATION OF EXEMPT ORGANIZATIONS ¶ 14.3 (2012).

[209] Reilly et al., *supra* note 206, at K-10.

[210] I.R.C. § 501(c)(6); Treas. Reg. § 1.501(c)(6)-1 (1960).

[211] *See* discussion *supra* Part II.

This dividend in kind goes untaxed both at the entity level and at the recipient level.

Tax exemption allows beer distributors the right to establish a tax exempt vehicle for supporting their interests in the future. In comparison, a beer corporation will likely not sell its goods primarily to its shareholders. Nonetheless, its shareholders vote on a board of directors, that is, they have voting control, and they have a right to the earnings of the corporation. The biggest distinction is that the beer league member does not have a share she can sell. Yet the beer league member is not paying the price she might pay to purchase a share entitling her to transfer the interest in the future. She is paying the amount that will promote her interests currently and into some time in the future. This article argues that the shareholder theory of the corporate tax would require that the earnings of this beer league should bear a burden of tax, like its for-profit corporate counterpart. Individuals control the entity, receive its earnings, and defer what should be taxable gain. Thus tax exemption for an organization like this beer league is a subsidy that needs to be justified.

The critical point is that there may be two different levels of tax exemption. The first is built upon the fact that there are no shareholders or "owners" of the entity, and charitable organizations meet this first level of tax exemption. The latter must be built upon an argument that an organization is providing some underprovided good or service that society deems worthy of a subsidy. Whether a business league actually provides such services or goods is certainly open to question.

Mutual benefits are much more likely to be benefitting wealthy interests. It is difficult to establish and run a nonprofit and doing so takes significant resources. Additionally, as discussed above, the potential benefits of exemption naturally accrue in greater amounts to those with significant resources. The tax benefit increases with greater income. Generally those with greater wealth earn greater incomes. Thus, the current regime likely increases the current growing income inequality and political voice inequality in the United States.[212]

Perhaps responding to such basic concerns, in the late nineties, the Clinton administration proposed imposing the unrelated business income tax on a business league's net investment income.[213] The idea was that "such organization should be subject to tax on earnings attributable to amounts collected in excess of the amounts needed to fund current

[212] *See* Atkinson et al., *supra* note 186, at 3–71; SCHLOZMAN ET AL., *supra* note 168.

[213] *See* STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2000 BUDGET PROPOSAL 278–81 (Comm. Print 1999).

operations of the organization."[214] The proposal failed after a massive business league lobbying attack. The Chamber of Commerce claimed the plan was a "stake driven at the very heart of nonprofit organizations."[215] The shareholder theory of the corporate tax provides support for the adoption of this Clinton proposal. Most theorists who have considered tax exemption for mutual benefit organizations generally conclude that at least the investment income of these organizations should be taxed.[216] Congress already applies an investment income tax and a tax on nonmember income from social clubs.[217] It is time to at least apply an investment income tax on most mutual benefit organizations.

Some argue for the exemption of income a mutual benefit earns from members while providing member services that each member could do on his own without being taxed.[218] Bittker and Rahdert believe it generally impractical to collect what they expect would be a minute amount of income because the entities would simply zero out their income every year.[219] They argue that we should consider any amount in excess of cost as simply an overcharge, and therefore not income at all.[220] The shareholder theory provides little direction regarding such an argument. The shareholder theory as considered here simply suggests that to the extent individuals control an entity and tend to direct its benefits their way it should be taxed. This claim suggests that there is no income benefit at all on individuals who pool their resources to accomplish some group aim.

Because tax exempt mutual benefits bear such a strong resemblance to cooperatives, we could consider taxing tax exempt mutual benefits under sub-chapter T of the Code.[221] Under a cooperative regime, a corporate tax is applied at the entity level, but the cooperative is allowed a deduction for patronage dividends.[222] The members of the cooperative pay tax on

---

[214] *Id*. at 279.

[215] Jacob M. Schlesinger, *Clinton Plan to Tax Lobbyists' Investment Gains Hits Home in a Fury of Faxes, Letters, Web Sites*, WALL ST. J., Feb. 17, 1999, at A24 (quoting Bruce Josten, Executive Vice President, U.S. Chamber of Commerce).

[216] *See* Bittker & Rahdert, *supra* note 3, at 358 ("There is no reason to permit [investment and nonmember] income . . . to escape taxation when acquired under the umbrella of [a mutual benefit] organization."); s*ee also Taxation of Mutual Nonprofits*, *supra* note 3, at 135 (concluding "consumer mutuals generally ought to be taxed at least on . . . profits from dealing with nonmembers.").

[217] I.R.C. § 512(a)(3).

[218] Bittker & Rahdert, *supra* note 3, at 305.

[219] *Id*. at 357 (discussing this idea with respect to business leagues).

[220] *Id*. at 348.

[221] I.R.C. §§ 1381–88

[222] I.R.C. §§ 1381–82.

patronage dividends they receive.[223] This article focuses on the implications of the corporate tax, however, and will leave discussion of cooperative taxation for another article. Nevertheless, we may prefer maintaining tax exemption for mutual benefits that are used to impact the political process. Many of the most-consequential tax exempt mutual benefits such as business leagues, social welfare organizations, and labor organizations are used in this manner. Tax exemption likely allows the government more ability to demand public disclosure, and we may prefer public disclosure to any marginal benefit that we obtain from the revenue associated with member income.

To conclude, the shareholder theory of the corporate income tax would only support tax on tax exempt organizations where those organizations have individuals akin to shareholders. The rules regarding charitable organizations when operating for charitable purposes appear to meet this requirement. Mutual benefit tax exempt organizations arguably do not. Yet, that is not the end of the analysis for either type of organization. As demonstrated by the corporate tax rationales, the corporate tax has more than one function. Other functions may provide an argument for or against the taxation of tax exempts. A lack of ownership alone also seems an insufficient criterion for tax exemption. Because of the potential for tax deferral mischief through a tax exempt entity, further precautions such as requiring some publicly useful purpose seem necessary.

C. Real Entity/Regulatory Function

No tax exemption theory considers that the corporate tax serves a regulatory function. Yet, early proponents of the corporate tax intended for the corporate tax to regulate the increasingly ubiquitous and politically powerful corporation in the Progressive Era.[224] Avi-Yonah makes the modern case that the corporate tax still regulates publicly traded corporations.[225] Highlighting the separation of ownership and control found in a publicly traded corporation, Avi-Yonah argues that corporate managers control substantial sources of wealth[226] and that taxation of large amounts of wealth is needed to limit the political power of wealth in a democracy.[227] The corporate tax provides that limiting function for publicly traded corporations.[228] Avi-Yonah also argues that the corporate tax provides a

223 I.R.C. § 1385.

224 *See supra* Part III.B.2.

225 *See* Avi-Yonah, *supra* note 7, at 1210.

226 *Id*. at 1210.

227 *Id*. at 1238–39.

228 *Id*. at 1243–44.

tool for the government to direct the actions of managers toward desired shareholder and public uses of resources.[229] The Code imposes a regulatory regime on tax exempt organizations. That regime primarily consists of purpose requirements, prohibitions on self-dealing and politically related activity, and required public disclosure. This article is a call to examine the tradeoff in regulatory effects we make in moving an organization from taxable status to tax exempt status, substituting one regulatory regime for another.

Tax exempt organizations necessarily exhibit the separation of ownership and control found in publicly traded entities.[230] In other words, because of the nondistribution constraint, the managers who control a nonprofit organization do not bear a substantial share of the wealth effects of their decisions. Many managers of tax exempt organizations also manage vast quantities of assets for the public benefit. The top ten charitable organizations held assets of between $10 and $40 billion as of 2009.[231] If it is important in a democracy to limit the ability of a finite group of individuals to control significant amounts of wealth, and the corporate tax serves to limit this finite group, we should consider the impact of exempting nonprofit organizations from the corporate tax. Following the logic of the regulatory theory of the corporate tax, tax exempt organizations either need that regulation or should be regulated by some other regime.

1. Managerial Nonprofit Corporation Power/Avi-Yonah's Limiting Function

According to the limiting function of the regulatory theory we should tax entities where managers control an organization they do not own that has some quantum of wealth and income.[232] The limiting function is necessary for a well-functioning democracy to prevent finite individuals from amassing too much power. By "limiting power in a democracy," I mean limiting the power to elect certain candidates (political campaign intervention), and to limit the power to influence our government actors once in place (lobbying). Is there a need for such a limiting function within

[229] Whether the corporate tax directs resources to a good use is highly questionable, but the fact that the tax is imposed provides Congress such a tool through incentives and limitations on deductions. *See* Desai & Dharmapala, *supra* note 180, at 14 (discussing its potential to aid in aligning managers with shareholder interests).

[230] *See* Fama & Jensen, *supra* note 159.

[231] *See Largest Organizations*, *(NCCS Core 2010 Public Charities File)*, NAT'L CTR. FOR CHARITABLE STATISTICS, http://nccsweb.urban.org/PubApps/showTopOrgs.php?cat=ALL&amt=ass_eoy (last visited July 5, 2013).

[232] *See* Avi-Yonah, *supra* note 7, at 1246–47.

the tax exempt sector?

The corporate tax is not the only means to prevent the harm to a democracy from corporate managerial political power. Congress has attempted to limit or ban expenditures in the political sphere.[233] Such limitations implicate freedom of speech and after *Citizens United*, however, where the Court held unconstitutional a federal ban on corporate independent expenditures on "electioneering communications" or for speech that expressly advocates for a candidate, such a strategy now seems out of the question.[234] Congress sometimes requires disclosure and disclaimers.[235] This type of regulation fared better under *Citizens United*.[236] The Court expressly stated, "[t]he Government may regulate corporate political speech through disclaimer and disclosure requirements, but it may not suppress that speech altogether."[237] Congress has utilized each of these solutions to some degree in the Code for the tax exempt sector.

A charitable organization is prohibited from engaging in lobbying as a substantial part of its activities.[238] It is absolutely prohibited from intervening in a political campaign.[239] Lobbying for charitable organizations involves a complex analysis but in general involves attempts to influence legislation,[240] while intervening in a political campaign refers to publicly advocating for or against a candidate for public office.[241] Under the Code, a tax applies to charitable organizations that engage in

[233] *See* Lloyd Hitoshi Mayer, *Breaching a Leaking Dam?: Corporate Money and Elections*, 4 CHARLESTON L. REV. 91, 98 (2009) (discussing the history of the efforts of Congress to limit political campaign intervention expenditures).

[234] Citizens United v. Fed. Election Comm'n, 558 U.S. 310, 367 (2010).

[235] The Bipartisan Campaign Reform Acts (BCRA) disclaimer and disclosure requirements, BCRA §§ 201 and 311, 116 Stat. 88, 105, are examples of such efforts. *See* Lloyd Hitoshi Mayer, *Disclosures About Disclosure*, 44 IND. L. REV. 255 (2010) (discussing the potential for disclosure to have a useful impact on regulating the political process); *see also* Richard L. Hasen, *The Surprisingly Complex Case for Disclosure of Contributions and Expenditures Funding Sham Issue Advocacy*, 48 UCLA L. REV. 265 (2000); Ciara Torres-Spelliscy, *Has the Tide Turned in Favor of Disclosure? Revealing Money in Politics After* Citizens United *and* Doe v. Reed, 27 GA. ST. U. L. REV. 1057 (2011); Ciara Torres-Spelliscy, *Hiding Behind the Tax Code, the Dark Election of 2010 and Why Tax Exempt Entities Should Be Subject to Robust Federal Campaign Finance Disclosure Laws*, 16 NEXUS: CHAP. J.L. & POL'Y 59 (2011).

[236] *Citizens United*, 558 U.S. at 349–50.

[237] *Id*. at 319.

[238] I.R.C. § 501(c)(3).

[239] *Id*.

[240] Treas. Reg. § 1.501(c)(3)-1(c)(3) (as amended in 2008); *see also* I.R.C. § 501(h) and the regulations thereunder.

[241] Treas. Reg. § 1.501(c)(3)-1(c)(3) (as amended in 2008); *see also* Rev. Rul. 2007-41, 2007-1 C.B. 1421.

disqualifying lobbying,[242] and another tax applies if a charitable organization engages in political expenditures.[243] Additionally, charitable organizations are required to make an annual disclosure on Form 990, Return of Organization Exempt from Tax.[244] On this form, charities must disclose a substantial amount of information regarding their activities during the year including gross income, substantial donors, highest paid employees, and all sorts of confirmations that their organization has been in compliance with the requirements of section 501.[245]

Because of this substantial regime limiting the political involvement of charities through a combination of prohibitions, limitations, taxes, and public disclosure, it appears Congress has thoroughly handled the limiting function portion of the regulatory function with respect to charitable organizations. It is hard to imagine that imposing the corporate tax would be needed for the limiting function on top of this regime. The one caution is that after *Citizens United* these limitations focused on prohibiting communication are in question.[246] In *Regan v. Taxation with Representation of Washington*, the Court accepted congressional tax limitations on lobbying tax exempt organizations primarily because the Court viewed tax exemption as a subsidy.[247] Ironically, the analysis of this article arguing that tax exemption is not a subsidy for charitable organizations, at least under a shareholder theory analysis, would take some weight away from the *Regan* decision. Congress, however, still may be subsidizing charitable organizations through the charitable contribution deduction.[248]

---

[242] I.R.C. § 4912.

[243] I.R.C. § 4955.

[244] This information return is required by I.R.C. § 6033.

[245] I.R.C. § 501(c)(3). On the political campaign intervention prohibition, Part IV, question 3 of Form 990 asks, "Did the organization engage in direct or indirect political campaign activities on behalf of or in opposition to candidates for public office?" On lobbying, Part IV, question 4 of Form 990 asks, "Did the organization engage in lobbying activities, or have a section 501(h) election in effect during the tax year?"

[246] For articles considering the impact of *Citizens United* on the constitutionality of these types of limitations, see Aprill, *supra* note 3; *see also* Lloyd Hitoshi Mayer, *Charities and Lobbying: Institutional Rights in the Wake of* Citizens United, 10 ELECTION L.J. 407 (2011).

[247] Regan v. Taxation with Representation of Washington, 461 U.S. 540, 544 (1983). There is some thought that Justice Blackmun's concurrence in *Regan* is equally as important. Justice Blackmun believed that the only thing that rescued the limitation on lobbying was the fact that a section 501(c)(3) organization could establish a section 501(c)(4) organization to lobby on its behalf. 461 U.S. at 553 (Blackmun, J., dissenting); *see also* Aprill, *supra* note 3, at 5–6 (discussing the importance of Justice Blackmun's concurrence).

[248] *See* I.R.C. § 170.

Political limitations on mutual benefit organizations are much less substantial. For instance, social welfare organizations,[249] labor organizations,[250] and business leagues[251] all may engage in lobbying as their sole activity, [252] and may also intervene in a political campaign as long as it is not the primary activity of the organization.[253] To the extent a tax exempt organization engages in political intervention, a tax is imposed on the lesser of its investment income or the amount spent on political activity.[254] It is possible though to avoid this tax by setting up a segregated fund for all funds to be used for politicking.[255] An organization "organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures or both . . . " for political intervention is instead described in section 527 of the Code, assuming the organization follows the requirements of that section.[256] Under section 527, an organization's income from political contributions, dues, political fund-raising events or sales, and bingo games is exempt from taxation.[257] A tax is applied generally on the net investment income, but it is apparently fairly easy to structure the organization so it pays little if any tax.[258] Mutual benefit organizations must also file a Form 990 and disclose substantive information regarding their activities, although that form has a much more substantial focus on the activities of charitable organizations.

Social welfare organizations are very often used to lobby and are attacked in the news for being engaged in too much political activity.[259]

---

[249] Treas. Reg. § 1.501(c)(4)-1 (1960).

[250] Treas. Reg. § 1.501(c)(5)-1 (1997).

[251] Treas. Reg. § 1.501(c)(6)-1 (1960).

[252] *See* John Francis Reilly & Barbara A. Braig Allen, *Political Campaign and Lobbying Activities of IRC 501(c)(4), (c)(5), and (c)(6) Organizations*, *in* INTERNAL REVENUE SERV., *supra* note 206, at L-1, *available at* http://www.irs.gov/pub/irs-tege/eotopicl03.pdf; *see also* Rev. Rul. 61-177, 1961-2 C.B. 117; Aprill, *supra* note 3, at 375.

[253] Petition from Democracy 21 and the Campaign Legal Center, to Douglas H. Shulman, Commissioner, Internal Revenue Serv. (July 27, 2010), *available at* http://www.democracy21.org/uploads/D21_and_CLC_Petition_to_IRS_7_27_2011.pdf (asking that the Service revise section 501(c)(4) regulations to state that a social welfare organization must operate "exclusively" for social welfare purposes rather than just "primarily").

[254] I.R.C. § 527(f).

[255] I.R.C. § 527(f)(3).

[256] I.R.C. § 527(e)(1).

[257] I.R.C. § 527(e).

[258] I.R.C. § 527(b); *see* Aprill, *supra* note 3, at 51.

[259] For instance, Karl Rove's Crossroads GPS is notably an organization described in section 501(c)(4). ProPublica has invested significant resources looking at the use of social welfare organizations to influence the political process. *See* Kim Barker, *Karl Rove's Dark*

Crossroads GPS, for instance, the social welfare organization Karl Rove helped form and lead, had spent $70.9 million on the 2012 federal elections as of December 7, 2012, mostly on behalf of Republican Party candidates and causes.[260] The Planned Parenthood Action Fund, LLC, to include a Democratic leaning organization as well, spent over $6 million on the 2012 federal elections.[261] Business leagues also play a role in the political process. The U.S. Chamber of Commerce, for instance, spent over $33 million on the 2012 federal elections.[262] The Associated Builders and Contractors, Inc. spent $280,000 on the elections.[263]

Given the separation of management and control and the substantial wealth of these organizations, the rationale for applying the limiting function of the corporate tax should apply to mutual benefit organizations. Additionally, the limitations on the political use of mutual benefits are not substantial in the way they are for charitable organizations. Thus, if you accept the need for the limiting function then either the certain additional limitations should be imposed on charitable organizations, or a tax should be placed on the income of these organizations. There are a number of proposals arguing for either greater disclosure or greater limitations on how much political activity in which these organizations engage.[264]

Money Group Promised IRS It Would Spend 'Limited' Money on Elections, PROPUBLICA (Dec. 14, 2012, 11:19 AM), http://www.propublica.org/article/what-karl-roves-dark-money-nonprofit-told-the-irs. The money contributed to social welfare organizations for political purposes has come to be referred to as "dark money" because these organizations are not required to disclose the names of donors from whom they ultimately received their money. *See* Barker, *supra* note 6.

[260] Al Shaw & Kim Barker, *What and Where are the Super-PACs Spending?*, PROPUBLICA (Dec. 7, 2012), http://projects.propublica.org/pactrack/#committee=all (last updated Dec. 7, 2012).

[261] *Id*.

[262] *Id*.

[263] *Id*.

[264] The DISCLOSE Act of 2012, sponsored by Senator Sheldon Whitehouse, would amend the Federal Election Campaign Act of 1971 to provide for additional disclosure from corporations, labor unions, and other organizations when they make an "independent expenditure" effectively advocating for a candidate. *See* Democracy is Strengthened by Casting Light on Spending in Elections Act of 2012, S.3369, 112th Cong. (2012); *see also* Donald B. Tobin, *Campaign Disclosure and Tax Exempt Entities: A Quick Repair to the Regulatory Plumbin*g, 10 ELECTION L.J. 427 (2011) (calling for disclosure of contributions to certain tax exempt organizations for political action on a rapid basis); Greg Colvin, *A Silver Bullet that Would End Secret Tax Exempt Money in Elections*, CAMPAIGN FOR 'AM.'S FUTURE BLOG (April 11, 2012), http://blog.ourfuture.org/20120411/A_Silver_Bullet_That_Would_End_Secret_Tax-Exempt_Money_in_Elections (proposing a cap on political intervention spending by any organization organized under section 501(c) of the lesser of $100,000 or 10% of expenditures).

Thus, ironically, a business that the corporate tax is supposed to regulate may put money aside in a mutual benefit organization, a tax-free vehicle, to defend its interests in the future. These membership dues are generally deductible as an ordinary and necessary business expense under section 162 of the Code. While not deductible if for political or lobbying purposes,[265] the investments can grow tax free. Such a subsidy allowing special industries the ability to save tax free in the same way we allow individuals to save for retirement, health care expenses, or education seems questionable. It allows a larger business a greater subsidy based on greater return from greater assets and essentially entrenches long-term power for a larger industry. The limiting function of the corporate tax should be extended to these organizations. This is a good reason to reconsider at least the exemption on investment income from UBIT for organizations described in section 501(c)(6), and possibly, given their significant use these days for political purposes, organizations described in section 501(c)(4).[266]

2. Manager Incentive Alignment/Avi-Yonah's Incentive Function

The corporate income tax also serves an incentive function.[267] This function provides Congress with a tool to direct managerial behavior in ways that will be beneficial to the shareholders of a company and to the general public. If the corporate tax indeed can incentivize managers to use resources in a manner more consistent with shareholders and the public, it would stand to reason that we should consider whether this is a better tool for regulating tax exempt entities as well.

The Code imposes requirements on tax exempt organizations encouraging them to use their assets in ways that are in the interest of the organizations' respective constituents and the public at large. Charitable organizations must be organized and operated exclusively for a charitable purpose.[268] Mutual benefit organizations likewise must generally operate exclusively or primarily for their particular exempt purpose.[269] A social welfare organization, for instance, must operate exclusively for social

---

[265] I.R.C. § 162(e).

[266] Notably, we already impose this obligation on social clubs, and where a business league or social welfare organization extends its activities such that it is engaged directly in intervening in a political campaign on a primary basis, it becomes a political organization described in section 527 and is thereby subject to taxes on its net investment income.

[267] *See supra* Part IV.F.

[268] I.R.C. § 501(c)(3).

[269] *See*, *e.g*., I.R.C. § 501(c)(4)–(6).

welfare purposes.[270] With the charitable sector, the Service requires substantial disclosure about an organization on its Form 990 including some on the governance of the organization. The Service also expresses publicly that it believes part of its function is to regulate the governance of the sector.[271] Charitable and social welfare organizations are subject to limitations on the amount of "private benefit" they can provide to individuals,[272] and are also subject to a tax that effectively polices self-dealing transactions.[273]

Nevertheless, by exempting organizations from tax Congress gives up a tool in taxation to positively or negatively incentivize nonprofit organization managers towards certain behavior. With the current structure governing tax exempt organizations, Congress's almost exclusive tool is to penalize such organizations to try to encourage ideal managerial behavior. For instance, if a charitable organization fails to operate for an exempt purpose, the Service can revoke its exemption and make the organization subject to the income tax. A hospital that does not to comply with a charitable needs assessment requirement should theoretically lose its exemption.[274] Congress has tried to alleviate this problem of revoking

[270] I.R.C. § 501(c)(4).

[271] Sarah Hall Ingram, Commissioner, Tax Exempt and Government Entities, Internal Revenue Service, Remarks at the Georgetown University Law Center Continuing Legal Education: Nonprofit Governance — The View from the IRS (June 23, 2009), *available at* http://www.irs.gov/pub/irs-tege/ingram__gtown__governance_062309.pdf ("[T]he IRS has a clear, unambiguous role to play in governance. Some have argued that we do not need to be involved, because we can count on the states to do their job and the sector to stay on the path of self-regulation. . . . we cannot delegate to others our obligation to enforce the conditions of federal tax exemption.").

[272] Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (as amended in 2008) ("An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest."); *see* Am. Campaign Acad. v. Commissioner, 92 T.C. 1053 (1989); Ginsberg v. Commissioner, 46 T.C. 47 (1966) (organization provided too much private benefit by maintaining a navigable waterway mostly for the private use of the homes fronting the waterway and thus was not operated primarily for a charitable purpose). For its application to social welfare organizations, see Vision Serv. Plan v. United States, 265 Fed. App'x 650 (9th Cir. 2008) (finding a vision services health maintenance organization not to be organized for social welfare because it "benefits [the organization]'s subscribers rather than the general welfare of the community."); Contracting Plumbers Coop. Restoration Corp. v. United States, 488 F.2d 684 (2d Cir. 1973), (membership organization of plumbers that repaired potholes of streets only its members had an obligation to repair found to not be operated for a social welfare purpose because "each individual member receives far more in economic terms precisely to the extent he uses the restoration service.").

[273] I.R.C. § 4958.

[274] I.R.C. § 501(r).

exemption as the primary penalty for missteps to allow the Service more flexibility in enforcing the requirements for tax exempt organizations. For instance, it enacted section 4958 to apply to the self-dealing acts of insiders of charitable and social welfare organizations. This provides a more modulated penalty and one that applies to malfeasors rather than the organization, but the Service still must enforce a penalty.

Congress could consider revising exemption such that a tax applies unless the organization complies with a particular requirement. For instance, an organization might be required to pay an income tax unless it can demonstrate that it in fact accomplished exempt purposes during the year. This might look a bit like a payout requirement under section 4942 that already applies to private foundations. Instead of pulling the exempt status of an organization that fails to meet the payout requirement, however, we could simply apply a tax on the organization. If the organization meets the required amount of expenditures on its charitable purposes in a future year, it would not owe a tax.

Intuitively it seems harder to employ penalties upon managers to incentivize good behavior, rather than to use taxes with certain deductible and nondeductible expenses. Arguably, the nondeductibility of foreign bribes serves as a more immediate disincentive to engaging in bribery than trying to penalize a manager once caught. One could also consider making credits more available to exempt organizations in the way the small employer health insurance tax credit has been made available to exempt organizations under the Patient Protection and Affordable Care Act.[275] The message here is that a choice to exempt organizations comes with a loss of power over these organizations in seeking out certain desirable behaviors.

Some object to the federal government regulating both the for-profit and the nonprofit corporate sectors. Fishman, for instance, objects to the Service engaging in regulating the governance policies of charitable organizations.[276] He contends that this is not within the bounds of the federal government's authority.[277] Others have considered the proper role of the different authorities, including asking whether there should be some other federal agency that regulates charitable organizations.[278] Some have

[275] I.R.C. § 45R; *see* INTERNAL REVENUE SERVICE, SMALL BUSINESS HEALTH CARE TAX CREDIT QUESTIONS AND ANSWERS: WHO GETS THE TAX CREDIT, http://www.irs.gov/uac/Small-Business-Health-Care-Tax-Credit-Questions-and-Answers:-Who-Gets-the-Tax-Credit (last updated Jan. 24, 2013) (explaining that the credit is available to tax exempt organizations).

[276] Fishman, *supra* note 185.

[277] *Id*.

[278] *Id*.; Benjamin Moses Leff, *Federal Regulation of Nonprofit Board Independence: Focus on Independent Stakeholders as a "Middle Way"*, 99 KY. L.J. 731 (2011); Lloyd

argued that even within the tax exempt sector there is less need for regulation of mutual benefits because the membership structures of those organizations should ensure proper operation.[279]

Because there is already regulation of for-profit organizations effectively taking place within the Code as a result of the imposition of the income tax, considering the use of the income tax as a means for regulating tax exempt organizations with a bit more precision seems fully within Congress's power. As more empirical work is needed to determine whether corporate tax regulatory efforts actually work, the same is needed for nonprofit organizations. Finally, while mutual benefit organizations may have membership structures that ensure a closer affinity to such organization's primary constituents, its members, than perhaps one can achieve through a charitable organization management structure, we have no reason to think that somehow mutual benefits would not present the same agency issues that lead to a concern regarding managerial behavior in publicly traded corporations. The same separation of ownership and control exists leading to a challenging agent/principal problem.

D. Artificial Entity/Benefits Theory

The artificial entity theory in its original form held that nonprofit corporations should be subject to the corporate income tax to pay for the benefit of operating in the corporate form. The modern version of this rationale, however, holds that the tax is imposed on publicly traded entities in exchange for their ability to sell equity on public markets.[280] Thus, this theory does not support a tax on nonprofit organizations; nonprofits are absolutely prohibited from selling equity on a public market. If this is the main theory for applying a corporate income tax, which as noted before seems questionable, then there is no subsidy to tax exempt organizations.

E. Bank's Capital Lock-in Theory

This article excluded capital lock-in theory as an independent equity based rationale of the corporate income tax. Capital lock-in theory contends that our current corporate tax system exists because corporate managers did not want to be forced to distribute dividends. If Congress converted the

Hitoshi Mayer & Brendan M. Wilson, *Regulating Charities in the Twenty-First Century: An Institutional Choice Analysis*, 85 CHI.-KENT L. REV. 479 (2010).

[279] *See* Dana Brakman Reiser, *Dismembering Civil Society: The Social Cost of Internally Undemocratic Nonprofits*, 82 OR. L. REV. 829, 890 (2003).

[280] Of course, this is not the way the tax is applied. It is applied on any organization organized as a C corp. that does not elect S corp. status.

corporate tax to a conduit system like a partnership tax, shareholders would place significant pressure on corporate managers to pay dividends so that the shareholders could pay the taxes on corporate income. This would harm the capital lock-in feature of a corporation and lead to a less efficient and powerful business. The theory assumes shareholders should be taxed and that the entity tax is imposed in lieu of imposing a conduit system. Except to the extent capital lock-in reinforces the shareholder theory as the basis of the corporate tax, this artifact of our corporate tax history appears mostly useless in considering tax exemption.

Nonetheless, the behavior of corporate managers to uphold capital lock-in by maintaining a corporate tax system that many of its shareholders consider unfair could be instructive for the tax exempt sector. Nonprofit organizations are also typically corporations and they cannot distribute earnings. This is a capital lock-in policy that allows the tax exempt sector to grow without having to worry about paying out investors. Presumably a charity's distributions should be for its charitable purpose and, arguably, some in the charitable sector do not expend enough annually for that purpose. Congress's imposition of payout requirements on charitable organizations such as supporting organizations and private foundations suggests that Congress has been concerned about such behavior.[281] Thus, it might be fruitful to consider whether the managers of exempt organizations have behaved like managers of for-profit corporations.

F. Place for Theories Regarding Exemption

The contention of this article is fairly narrow. It argues simply that we must understand why we would tax tax exempt entities in order to understand what makes an organization tax exempt. In considering a number of limitations on tax exempt organizations, the Court placed great importance on the fact that exemption is a subsidy.[282] Thus, shedding more light on whether we have a rationale for taxing these entities is important.

The contributions of Hansmann and Weisbrod on government failure and market failure, respectively, are important insights that provide strong explanatory reasons for the existence of the sector and efficiency bases for exempting the sector.[283] Both authors also support the absence of owners,

[281] I.R.C. §§ 509(a), 4942.

[282] *See, e.g.*, Bob Jones Univ. v. United States, 461 U.S. 574, 588 (1983); *see also* Regan v. Taxation with Representation of Washington, 461 U.S. 540, 544 (1997) ("Both tax exemptions and tax deductibility are a form of subsidy that is administered through the tax system. A tax exemption has much the same effect as a cash grant to the organization of the amount of tax it would have to pay on its income.").

[283] *See supra* Part II.B.

or "shareholders" in tax exempt organizations.[284] Rather than focusing explicitly on any tax rationale, however, their rationale focuses primarily on the market, identifying these organizations as the most efficient provider of some good or service.[285] This article contends that the tax rationale has an important role to play in the analysis of the question of ownership, and in assessing the potential importance of regulating the sector. Understanding why we would tax an organization to begin with has very specific implications for how exemption should be structured. As a review of corporate tax rationales demonstrates, there may be multiple rationales for the imposition of a corporate tax and each rationale causes us to think slightly differently about the meaning of "tax exemption."

The search for positive qualities of the charitable sector has been a useful endeavor. We have better vocabulary and political justifications for exempting charitable organizations as a result. Nevertheless, an obsessive focus on charitable organizations leaves out a whole realm of organizations that also have an important impact on our society and need a justification for their tax status. More tax scholarship is needed on the mutual benefit sector. The Tea Party scandal demands it. This article argues that many mutual benefits likely have members that are equivalent to shareholders and therefore should likely face some greater tax burden than they currently face. Additionally, because these organizations often manage significant sources of wealth, they could potentially benefit from the regulatory function of the corporate tax. We could benefit from a closer analysis of the mutual benefit sector to determine if it might behave in greater public interest with a tax on net investment income along with greater disclosure regarding their donors.

V. CONCLUSION

This article considered the rationales for exempting nonprofit organizations from income tax by considering why we impose a corporate income tax in the first place. Because so many theories for the rationale for tax exemption rely on a premise that tax exemption is a subsidy, this article asserts that we must have a legitimate basis for calling tax exemption a subsidy. In order to call it a subsidy we must have a rationale for why we would impose an income tax on these nonprofit organizations in the first place. Two reasons stand out: (1) to tax shareholders, and (2) to regulate corporate managers. Adopting the shareholder theory suggests that if an

[284] *See supra* Part II.B. For both Weisbrod and Hansmann, the nondistribution constraint is critical to these organizations efficient functioning within our governmental/market system.

[285] *See supra* Part II.B.

organization has individuals who have significant attributes of ownership similar to a shareholder, we have a strong rationale to impose an entity tax on that organization. Thus, we could conclude under this rationale that tax exemption for charitable organizations, which have no individuals resembling shareholders, is not a subsidy; however, tax exemption for mutual benefit organizations, which have individuals that resemble shareholders, is in fact a subsidy. Because there are only tepid rationales providing a basis for a subsidy to such mutual benefit organizations, this article contends we should reconsider tax exemption for mutual benefits. At the very least, we should tax their net investment income, as has been proposed for business leagues in the past and as we already apply to tax exempt social clubs. Such a move might be a means to take some of the pressure off the Service in making a call as to whether one of these mutual benefit organizations is too political. Adopting the regulatory theory suggests that when we choose to exempt nonprofit organizations we must recognize the loss of the two regulatory functions of the corporate tax: the limiting function, and incentive function. Substantial disclosure requirements and limitations on the political activity of charitable organizations make the corporate tax as regulatory device unnecessary as to charitable organizations. Yet the same cannot be said for mutual benefit organizations. The corporate regulatory tax rationale thus offer another reason to reconsider the current tax exempt structure for mutual benefits.