

---

5-15-2012

## Charitable Organizations and Commercial Activity: A New Era - Will the Social Entrepreneurship Movement Force Change?

Jaclyn Cherry

Follow this and additional works at: <https://digitalcommons.pepperdine.edu/jbel>



Part of the [Business Organizations Law Commons](#), [Social Welfare Law Commons](#), and the [Tax Law Commons](#)

---

### Recommended Citation

Jaclyn Cherry, *Charitable Organizations and Commercial Activity: A New Era - Will the Social Entrepreneurship Movement Force Change?*, 5 J. Bus. Entrepreneurship & L. Iss. 2 (2012)  
Available at: <https://digitalcommons.pepperdine.edu/jbel/vol5/iss2/6>

This Article is brought to you for free and open access by the Caruso School of Law at Pepperdine Digital Commons. It has been accepted for inclusion in The Journal of Business, Entrepreneurship & the Law by an authorized editor of Pepperdine Digital Commons. For more information, please contact [bailey.berry@pepperdine.edu](mailto:bailey.berry@pepperdine.edu).

---

# CHARITABLE ORGANIZATIONS AND COMMERCIAL ACTIVITY: A NEW ERA

## WILL THE SOCIAL ENTREPRENEURSHIP MOVEMENT FORCE CHANGE?

JACLYN CHERRY\*

Abstract .....	346
I. Introduction .....	346
II. What is Social Entrepreneurship?.....	348
III. Hybrid Organizational Forms .....	349
A. The Low-Profit Limited Liability Company (L3C).....	349
1. Statutory Language .....	351
2. Examples .....	352
a. MOO Milk Co. ....	352
b. H2O for Humanity .....	352
B. The B Corporation.....	353
1. Statutory Language .....	353
2. Examples .....	354
a. Dansko .....	354
b. Seventh Generation.....	355
IV. The Traditional Tax-Exempt Social Entrepreneurial Model.....	356
A. Statutory Requirements .....	356
1. Examples .....	357
a. Educational Testing Services .....	357
b. Citizens Energy Corporation.....	357
V. The Applicable Tests.....	358
A. Internal Revenue Code “Operational Test” for Tax Exemption .....	358
1. Commercial Activity .....	359
a. The Commerciality Doctrine.....	359
b. Applying the Doctrine: What Are “Substantial” Non- Exempt Commercial Purposes.....	361
c. Commensurate Test.....	364
B. Recent Decisions .....	364
C. Unrelated Business Income Tax and Social Enterprise .....	365
VI. Proposed Changes.....	370
VII. Policy Considerations .....	371
VIII. Conclusion .....	371

## ABSTRACT

It is no longer a new trend for charitable organizations to become involved in commercial activities. Thousands of nonprofit organizations have embraced the social entrepreneurial concept and have either created “commercial” type ventures as part of their nonprofits, have created spin-off organizations or subsidiary organizations, or have moved into the new area of hybrid organizations.

Because there are no clear rules or guidelines for dealing with this issue, the third sector finds itself with rogue components and a spin-off group of hybrid organizations being loosely termed “social entrepreneurs.” Though these groups have grown in numbers in recent years, they have faced their own trials and tribulations, and success has been mixed.

The purpose of this article is to take a broad look at where we are now as a result of the continuing confusion regarding the “commerciality doctrine”, the test being used by courts to interpret the operational test of IRC § 501(c)(3), which has pushed many an organization into these murky waters. It will focus on three areas influencing and defining organizations that are struggling with the law in this sector: 1) it will briefly define commercial activity in terms of social entrepreneurship and provide examples of organizations that have entered this hybrid sector as L3C Organizations and B Corporations; 2) it will give an overview of the law that has developed as the “commerciality doctrine”; and 3) it will discuss the unrelated business income tax and suggest that this test needs to be utilized by courts in conjunction with the “commerciality doctrine” for there to be any semblance of order. Finally, this article concludes by suggesting that changes within the system are overdue and proposes a three-part analysis to be used going forward.

## I. INTRODUCTION

It is no longer a new trend for charitable organizations to become involved in commercial activities. Thousands of nonprofit organizations have embraced the social entrepreneurial concept and have either created “commercial” type ventures as part of their nonprofits, have created spin-off organizations or subsidiary organizations, or have moved into the new area of hybrid organizations. The trend began in the 1980s, in part because funding sources encouraged exempt organizations to pursue revenue-generating activities, which turned out to be mostly commercial in nature.<sup>1</sup> It grew, and took on many new forms because there were no clear federal statutory or case law guidelines for exempt organizations to follow as they created these new ventures.<sup>2</sup>

---

\* Jaclyn Fabean Cherry, Assistant Professor of Law, University of South Carolina School of Law. The author would like to thank Amanda Bleu Turner, Michelle Boykin, and Courtney Grosenick for their research assistance.

<sup>1</sup> See Robert Lang & Elizabeth Carrott Minnigh, *The L3C History, Basic Construct, and Legal Framework*, 35 VT. L. REV. 15 (2010).

<sup>2</sup> See NICHOLAS P. CAFARDI & JACLYN FABEAN CHERRY, *TAX EXEMPT ORGANIZATIONS: CASES AND MATERIALS* (LexisNexis, 2d ed. 2008). Even the current White House encourages social innovation. It has created the White House Office of Social Innovation and Civil Participation, which is

Not knowing whether the activities would violate the “commerciality doctrine”, the test being used by courts to interpret the operational test of Internal Revenue Code (I.R.C.) § 501(c)(3),<sup>3</sup> or whether the activities were subject to the Unrelated Business Income Tax (UBIT),<sup>4</sup> organizations turned to lobbying for the creation of new state legislation which allowed for establishing organizations which were hybrid in nature and outside the realm of the Internal Revenue Service (I.R.S.).<sup>5</sup> The new structural forms combined for-profit and nonprofit components, allowing for some greater funding opportunities and some unique corporate management techniques which could be adopted by these organizations.<sup>6</sup>

In 2002, in his article “Commercial Activity and Charitable Tax Exemption”<sup>7</sup> Professor

John Colombo discusses the odd administrative rulings and court decisions regulating commercial activity by nonprofits and suggests some restructuring to our approach in this area.<sup>8</sup> Though nine years have passed, there are no clearer rules or guidelines for dealing with this issue (there may even be more confusion) and the third sector now finds itself with rogue components and a spin-off group of hybrid organizations being loosely termed “social entrepreneurs.” These organizations are called Low Profit Limited Liability Corporations (L3C’s), For-Benefit Corporations (B Corporations), nonprofit and for-profit partnerships, and joint ventures. Though they have grown in numbers in recent years, they have faced their own trials and tribulations, and success has been mixed.<sup>9</sup>

The purpose of this article is to take a broad look at where we are now as a result of the continuing confusion regarding the “commerciality doctrine.”<sup>10</sup> It will focus on three areas influencing and defining organizations that are struggling with the law in this sector: 1) it will briefly define commercial activity in terms of social entrepreneurship and provide examples of organizations that have entered this hybrid sector as L3C Organizations and B Corporations; 2) it will give an overview of the law that has developed as the “commerciality doctrine;” and 3) it will discuss the UBIT and suggest that this test needs to be utilized by courts in conjunction with the “commerciality doctrine” for there to be any semblance of order for nonprofits to follow. Finally, this article concludes by suggesting that changes within the system are overdue. It suggests a three part analysis requiring

---

a \$50 million fund to boost the efforts of the country’s most cutting-edge nonprofits and social entrepreneurs. See Jeremy Caplan, *White House Chief of Social Innovation*, TIME, Sept. 21, 2009, at 51.

<sup>3</sup> I.R.C. § 501(c)(3) (West 2010); Treas. Reg. § 1.501(c)(3)-1(e) (2008).

<sup>4</sup> I.R.C. § 511(a) (West 2011); Treas. Reg. § 1.513-1 (1967).

<sup>5</sup> CAFARDI & CHERRY, *supra* note 2.

<sup>6</sup> *Id.*

<sup>7</sup> John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487 (2002).

<sup>8</sup> *Id.* at 491.

<sup>9</sup> See Stephanie Strom, *Hybrid Model for Nonprofits Hits Snags*, THE N.Y. TIMES, Oct. 26, 2010 (comparing these organizations to “Dr. Dolittle’s pushmi-pullyu, the animal that had trouble moving because its two heads could not agree on a single direction”).

<sup>10</sup> See I.R.C. § 501(c)(3) (West 2010); Treas. Reg. § 1.501(c)(3)-1(c)(1) (2008) (though it is the courts that have created this doctrine as they have interpreted these sections).

that the I.R.S. and courts apply the UBIT tests in coordination with, and not separate from, the “commerciality doctrine” (with a new definition of “substantial commercial activity”); second, that the “commerciality doctrine” be defined more clearly by synthesizing the courts tests from *Presbyterian and Reformed Publishing*<sup>11</sup> and *Airlie Foundation*;<sup>12</sup> and third, that an “intermediate sanction” type penalty be developed which would be triggered by failure to meet the above tests, before the loss of tax exempt status occurs.<sup>13</sup>

If nothing is done to address this issue, which may well end up being the case, then organizations will drift between the nonprofit and for-profit worlds in a very counter-productive manner for the sector and for the individuals they are created to benefit.

## II. WHAT IS SOCIAL ENTREPRENEURSHIP?

A brief review of some of the terms that have developed through the years gives some perspective to the parameters of this phenomenon. Though there is no singular definition, Michael Edwards notes in *Just another Emperor? The Myths and Reality of Philanthrocapitalism*, that the London based School for Social Entrepreneurs defines a social entrepreneur as “someone who works in an entrepreneurial manner, but for public or social benefit, rather than to make money.”<sup>14</sup> Other business and academic authors<sup>15</sup> use the following criteria when defining social entrepreneurship:

- Using innovative methods to address social and environmental goals that draw ideas and resources from different sectors, organizations and disciplines.
- Generating all or most of their income from commercial revenue, user fees, service contracts and equity investments (rather than foundation grants, member dues, or individual donations), but not accruing profit for personal gain.
- Engaging directly in the production and/or sale of goods and services, especially in areas like health, education, social welfare, environmental sustainability, organizational development and employment training.
- Forming and governing themselves through more inclusive and democratic practices than in a normal business, with avenues for participation by users and other stakeholders and a high degree of

---

<sup>11</sup> *Presbyterian and Reformed Publ'g Co. v. Comm'r*, 743 F.2d 148 (3d Cir. 1984).

<sup>12</sup> *Airlie Found. v. IRS*, 283 F. Supp. 2d 58 (D.D.C. 2003).

<sup>13</sup> *Id.*

<sup>14</sup> See MICHAEL EDWARDS, *JUST ANOTHER EMPEROR? THE MYTHS AND REALITIES OF PHILANTHROCAPITALISM*, 16, (Demos 2008).

<sup>15</sup> See PETER C. BRINCKERHOFF, *SOCIAL ENTREPRENEURSHIP: THE ART OF MISSION-BASED VENTURE DEVELOPMENT* (John Wiley & Sons, Inc., 2000); JOHN ELKINGTON & PAMELA HARTIGAN, *THE POWER OF UNREASONABLE PEOPLE: HOW SOCIAL ENTREPRENEURS CREATE MARKETS THAT CHANGE THE WORLD* (Harvard Business Press, 2008).

organizational autonomy.<sup>16</sup>

It is easy to see why this term as thus defined fits nicely into the nonprofit world, but it is the absence of acknowledgement of federal tax-exempt laws that has caused great difficulty. Social enterprise, a different term that is being used, has come to define organizations that have applied market-based strategies to nonprofit organizations to promote social change and is referred to as a new or fourth sector that is distinct from the conventional nonprofit world;<sup>17</sup> though many see this as just a repackaging of traditional nonprofit services under a new, fancier title in order to attract greater resources.<sup>18</sup>

Philanthrocapitalism,<sup>19</sup> another term being used refers to “the profit motive to achieve social good,”<sup>20</sup> usually engaged in by wealthy individuals who have been successful in their for-profit ventures. Warren Buffett and Bill Gates are examples of successful entrepreneurs attempting to improve philanthropy by applying capitalist techniques to the world of social problems.<sup>21</sup>

Each of these concepts, mostly similar but somewhat different, make up a component of what is known collectively as social entrepreneurship. The following examples illustrate the structural forms that have been chosen by organizations adopting a hybrid existence and abandoning the tax-exempt form.

### III. HYBRID ORGANIZATIONAL FORMS

The Low Profit Limited Liability Company (L3C) and the For-Benefit Corporation (B Corporation) are two examples of hybrid organizations.<sup>22</sup> Though these corporate forms allow organizations to branch out and meet their goals, their choices are not free from problems.

#### A. *The Low-Profit Limited Liability Company (L3C)*

The low-profit limited liability company (L3C) is a new corporate form, which combines the for-profit limited liability corporate form (LLC) with a nonprofit social mission.<sup>23</sup> An organization that chooses this form is expected to

<sup>16</sup> EDWARDS, *supra* note 14, at 17.

<sup>17</sup> *Id.* at 18.

<sup>18</sup> *Id.* “Public charities in the United States already receive over 70 percent of their income from fees for goods and services, so it is difficult to see why so much fuss is made about the newness of social enterprise.” *Id.* (citing Thomas H. Pollak & Amy Blackwood, *The Nonprofit Sector in Brief: Facts and Figures from the Nonprofit Almanac 2007*, THE URBAN INST. (Aug. 3, 2007), [http://www.urban.org/UploadedPDF/311373\\_nonprofit\\_sector.pdf](http://www.urban.org/UploadedPDF/311373_nonprofit_sector.pdf)).

<sup>19</sup> A term now so commonly used that it is the title of several books and articles. See MATTHEW BISHOP & MICHAEL GREEN, *PHILANTHROCAPITALISM: HOW GIVING CAN SAVE THE WORLD* (Bloomsbury Press, 2009).

<sup>20</sup> *Id.* at 6.

<sup>21</sup> *Id.* at 2. “Today’s Philanthrocapitalists see a world full of big problems that they, and perhaps only they, can and must put right.” *Id.* at 3.

<sup>22</sup> Michael D. Gottesman, *From Cobblestones to Pavement: The Legal Road Forward for the Creation of Hybrid Social Organizations*, 26 *YALE L. & POL’Y REV.* 345, 352 (2007).

<sup>23</sup> See Lang & Minnigh, *supra* note 1. See also Tim Morrals, *L3C Business Structures*, <http://www.gaebler.com/L3C-Business-Structures.htm> (last visited Apr. 2, 2012).

put mission before profit and is what Robert Lang calls “the for-profit with the nonprofit soul.”<sup>24</sup> Because most nonprofit organizations experience strains in funding (more so in the current economy), and private investors are generally loath to donate money to them because there is no return on investment, the L3C has become attractive.<sup>25</sup> The L3C does not rely on charitable donations but makes most of its money through attracting investors. It is an accepted corporate form in many states,<sup>26</sup> being first adopted in Vermont in 2008 and later in Michigan, Utah, and Wyoming. There are no great tax benefits, but the fact that foundations may act as investors, through program related investments (PRI’s),<sup>27</sup> has caused growth in this area.<sup>28</sup>

Though foundations are required to distribute 5% or more of their assets each year toward furthering their charitable activities,<sup>29</sup> an exception that allows all or part of this amount to be invested in for-profit businesses with social benefit missions was created as PRI’s. PRI’s are exempt from excise tax under jeopardizing investment rules,<sup>30</sup> as long as the investment in the for-profit venture does not have as a primary purpose the expectation of a return, and it cannot jeopardize the foundations’ exempt purpose.<sup>31</sup> Because whether an investment qualifies as a PRI is subject to a facts and circumstances test, and carries large penalties for violation, many foundations are cautious about making these investments.<sup>32</sup> The determination lies with federal authorities, mainly the I.R.S., and this occurs on a case-by-case basis.<sup>33</sup> There is no specific guideline or rule for foundations to be assured that any program related investment will qualify as a PRI and thereby avoid the jeopardizing investment taxes.

---

<sup>24</sup> Lang & Minnigh, *supra* note 1, at 17.

<sup>25</sup> Morrals, *supra* note 23.

<sup>26</sup> 2010 N.C. Sess. Laws 187; Gottesman, *supra* note 22, at 352; John Tozzi, *Turning Nonprofits into For-Profits*, BUS. WK. (June 15, 2009), [http://www.businessweek.com/smallbiz/content/jun2009/sb20090615\\_940089](http://www.businessweek.com/smallbiz/content/jun2009/sb20090615_940089).

<sup>27</sup> See I.R.C. § 4944(c) (West 2006). PRI’s are permitted by § 4944 when given to a for-profit with a social mission. *Id.*

<sup>28</sup> See Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion?* 63 ARK. L. REV. 243, 252 (2010), stating that:

Specifically, a private-foundation investment in a business-purpose L3C will subject the foundation to jeopardy taxes under § 4944 of the Internal Revenue Code unless the investment is a PRI, and, even if so, the foundation must carefully monitor the investment to assure it is used for the intended purpose. Failure to do so may subject even a PRI to a § 4945 excise tax on taxable expenditures.

See I.R.C. §§ 4944, 4945 (West 2006).

<sup>29</sup> See I.R.C. § 501(c)(3) (West 2010), I.R.C. § 509(a) (West 2012).

<sup>30</sup> I.R.C. § 4944(c), where foundations are prohibited from investing “any amount in such a manner as to jeopardize the carrying out of its exempt purposes.” *Id.*

<sup>31</sup> See Lang & Minnigh, *supra* note 1, at 16.

<sup>32</sup> *Id.* at 19. See I.R.C. § 4944(a)-(b) which imposes a ten percent tax on a foundation for engaging in a jeopardizing investment, with the possibility of an additional twenty-five percent if not corrected in a timely manner. This section also imposes a tax on foundation managers.

<sup>33</sup> Treas. Reg. § 53-4944-1(a)(2)(i) (2009). See also Bishop, *supra* note 28, at 250 (“The determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation’s portfolio as a whole.”).

To further complicate the situation, states cannot “[e]xempt or relieve any person from any obligation, duty, responsibility, or other standard of conduct provided in [IRC §] 4944 and the regulations there under,”<sup>34</sup> so it is often very difficult for organizations to take advantage of this PRI “benefit.” Foundations that invest in L3Cs are required to monitor the use of their funds carefully in order to meet current state and federal law and avoid financial penalties or worse yet, loss of exemption.<sup>35</sup>

### 1. Statutory Language

The L3C integrates business and mission in a profit-making corporate venture; therefore, an organization that chooses this form is expected to put mission before profit.<sup>36</sup> The originating Vermont statute requires in part that “(A) [t]he Company: (i) significantly furthers the accomplishment of one or more charitable or educational purposes . . . and (ii) would not have been formed but for the company’s relationship to the accomplishment of charitable or educational purposes.”<sup>37</sup> It continues that:

(B) No significant purpose of the company is the production of income or the appreciation of property . . . .

(C) No purpose of the company is to accomplish one or more political or legislative purposes . . . .

(D) If a company that met the definition of this subdivision (27) at its formation at any time ceases to satisfy any one of the requirements, it shall immediately cease to be a low-profit limited liability company, but by continuing to meet all the other requirements of this chapter, will continue to exist as a limited liability company.<sup>38</sup>

This illustrative section of this statute makes clear that much of it is based on I.R.C. § 501(c)(3).<sup>39</sup> If an organization’s activities fall outside of its charitable mission, thereby causing it to function outside of the requirements for L3C organizations, its status can be revoked, which shadows federal tax exemption.

<sup>34</sup> Bishop, *supra* note 28, at 256; Treas. Reg. § 53-4944-1(a)(2)(i).

<sup>35</sup> Treas. Reg. § 53-4944-1(a)(2)(i).

<sup>36</sup> Robert M. Lang, Jr., *The L3C: The New Way to Organize Socially Responsible and Mission Driven Organizations*, SN036 ALI-ABA 251, 253 (2007). See also Robert R. Keatinge, *LLCs and Nonprofit Organizations – For-Profits, Nonprofits, and Hybrids*, 42 SUFFOLK U. L. REV. 553, 581 (2009).

If a private foundation makes investments in a manner as to jeopardize the carrying out of any of its exempt purposes, the foundation and its management may be subjected to a tax equal to 10 percent of the amount invested. The tax, however, will not apply to a “program-related investment.” A program related investment is one in which the primary purpose is to accomplish one or more of the private foundation’s charitable purposes, “and no significant purpose of which is the production of income or the appreciation of property.”

*Id.* at 580–81 (footnotes omitted); see also I.R.C. § 4944(a), (c) (West 2006); Treas. Reg. § 53.4944-3 (2009).

<sup>37</sup> VT. STAT. ANN. tit. 11, § 3001.27 (2008).

<sup>38</sup> VT. STAT. ANN. tit. 11, § 3001.27 (2008); see VT. STAT. ANN. tit. 11 § 3005(a) (2008).

<sup>39</sup> I.R.C. § 501(c)(3) (West 2010).



The organization converts to an LLC, whereas in the exempt statute the organization reverts to its original state designation: nonprofit, trust, or unincorporated association.<sup>40</sup>

If, as this statute illustrates, the L3C statutes closely align with the I.R.C. and issues surrounding foundation PRI funding remain, it is realistic to question whether this new form is effective and can survive the tests of time and meet the needs of the nonprofit sector. It is possible that this group of nonprofits, too frustrated with current tax-exempt law to remain in the sector, will end up just as unsatisfied by this new corporate form.

## 2. Examples

### a. MOO Milk Co.

Maine's Own Organic Milk Company (MOO Milk Co.), founded in January 2010, is composed of 10 organic dairy farmers from Maine, the Maine Farm Bureau, and Maine Organic Farmers and Gardeners Association (MOFGA).<sup>41</sup> Its mission "is to educate the consuming public on the value and intrinsic worth of preserving the local family farm while developing a line of premium quality milk products."<sup>42</sup> It incorporated as an L3C (low-profit, limited liability corporation) in Vermont.<sup>43</sup>

MOO Milk's ownership division and profit allocation<sup>44</sup> is divided as follows: farmers - 45%, investors - 45%, three member team of Farm Bureau members - 4%, Farm Bureau - 0.5%, MOFGA - 0.5%, and future employee benefit incentives - 5%.<sup>45</sup> Profits of 90% go directly to the farmers as payment for their milk while 10% is retained for expansion, maintenance, and cash flow.<sup>46</sup> The Farm Bureau and MOFGA see very little return but the company provides a stable and profitable market for the dairy farmers of Maine, which indirectly affects both organizations.<sup>47</sup> All other investors receive their return only upon leaving the company.<sup>48</sup>

### b. H2O for Humanity

H2O for Humanity provides clean water systems to towns in developing countries.<sup>49</sup> Its goal is to provide "good water and good jobs to the world's

---

<sup>40</sup> See NICHOLAS P. CAFARDI & JACLYN FABEAN CHERRY, UNDERSTANDING NONPROFIT AND TAX EXEMPT ORGANIZATIONS § 2 (2006) [hereinafter UNDERSTANDING NONPROFIT].

<sup>41</sup> MAINE'S OWN ORGANIC MILK, <http://moomilkco.com/index.php/our-story> (last visited Apr. 3, 2012).

<sup>42</sup> *Id.*

<sup>43</sup> *Id.* MOO Milk chose to incorporate in Vermont as the state of Maine has yet to adopt L3C legislation. *Id.*

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> Malika Zouhali-Worrall, *For L3C companies, profit isn't the point*, CNNMONEY.COM (Feb. 9, 2010, 10:49 AM), [http://money.cnn.com/2010/02/08/smallbusiness/l3c\\_low\\_profit\\_companies/](http://money.cnn.com/2010/02/08/smallbusiness/l3c_low_profit_companies/).

<sup>49</sup> H2O FOR HUMANITY, L3C, <http://www.h2oforhumanity.com/6301.html> (last visited Apr. 2,

underserved communities.”<sup>50</sup> In each country, it partners with NGOs to understand the needs of the community and establishes operations in the locale.<sup>51</sup> The company was originally 100% financed by its founders, but as the need for funding grew, H2O for Humanity incorporated as an L3C and started receiving loans and grants from various foundations.<sup>52</sup>

### B. The B Corporation

The B Corporation, which has been adopted by over 200 companies to date, allows organizations to incorporate under current state statutes (being subject to private sector tax laws) but requires that their corporate governing documents provide for their commitment to social causes.<sup>53</sup> An organization interested in the B Corporation label must amend its Articles of Incorporation to include specific language required for this designation, must pass a test that measures its environmental and social impact, and pay an annual fee based on its revenues. Because these organizations are subject to a certification and rating entity, they are not only able to tap into the for-profit capital market but are eligible for foundation program related investments (PRIs), traditionally available only to nonprofit organizations,<sup>54</sup> just as the L3Cs discussed above.

B Corporations are defined as “a new type of corporation which uses the power of business to solve social and environmental problems.”<sup>55</sup> The B Corporation website explains that these organizations are different from “traditional responsible businesses because they: meet comprehensive and transparent social and environmental performance standards; institutionalize stakeholder interests; and build collective voice through the power of a unifying brand.”<sup>56</sup>

#### 1. Statutory Language

The B Corporation structure was created out of a nonprofit project called B Lab (itself a 501(c)(3)). It has grown into a movement which includes organizations ranging from million dollar companies to start up organizations. Over thirty states have adopted statutes recognizing this corporate form.<sup>57</sup> Bart

---

2012).

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *About Us*, H2O FOR HUMANITY, <http://www.h2oforhumanity.com/7601/index.html> (last visited Apr. 2, 2012).

<sup>53</sup> Gottesman, *supra* note 22, at 355–56.

<sup>54</sup> *Id.* at 356.

<sup>55</sup> *What is a B Corp.?*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/about> (last visited Jan. 2, 2012).

<sup>56</sup> *Id.*

<sup>57</sup> See CONN. GEN. STAT. ANN. § 33-756 (West 2008); FLA. STAT. ANN. § 607.0830 (West 2009); GA. CODE ANN. § 14-2-202 (West 2009); IDAHO CODE ANN. § 30-1-830 (West 2008); 805 ILL. COMP. STAT. ANN. 5/8.85 (West 2009); IND. CODE ANN. § 23-1-35-1 (West 2009); IOWA CODE ANN. § 490.1108A (West 2008); KY. REV. STAT. ANN. § 271B.8-300 (West 2009); LA. REV. STAT. ANN. § 12:92 (2009); ME. REV. STAT. ANN. tit. 13-C, § 831 (2009); MD. CODE ANN., CORPS. & ASS’NS § 2-

Houlahan, a co-founder of B Lab, who like his partners came from the for-profit business world,<sup>58</sup> states that:

B Corp provides three things: standards to define a sustainable company, a legal framework that allows companies to scale and raise capital, and a brand that makes it easy to support and patronize good business. To become a B Corp, you have to change the legal framework of the company to include the interests of stakeholders and embed them in the business . . . . We actually make you change your articles of incorporation and expand the responsibilities of the company to include consideration of employees, community, and environment.<sup>59</sup>

Since the laws governing corporations differ from state to state, forming a B Corporation requires different things in different states. In approximately nineteen states, the law requires that shareholders come first; therefore, an organization incorporating in one of these states could not form a B Corporation. If an organization is serious about becoming a B Corporation, it must incorporate in the thirty or so states that do allow incorporation and have legislation to support it.<sup>60</sup>

## 2. Examples

### a. Dansko

Founded in 1990, Dansko is a shoe company with a social conscious.<sup>61</sup> Its “goal is to be every stakeholder’s favorite shoe company.”<sup>62</sup> It is an employee-owned company focused not only on shoes, but also improving the community and environment.<sup>63</sup>

Dansko is a founding B Corporation,<sup>64</sup> meaning it was one of the first eighty companies to become a B Corporation.<sup>65</sup> A certified B Corporation is a for-profit

405.1 (West 2009); MASS. GEN. LAWS ch. 156D, § 8.30 (2009); MINN. STAT. ANN. § 302A.251 (West 2008); MISS. CODE ANN. § 79-4-8.30 (West 2008); MO. ANN. STAT. § 351.347 (West 2009); NEV. REV. STAT. ANN. § 78.138 (West 2009); N.J. STAT. ANN. § 14A:6-1 (West 2009); N.M. STAT. ANN. § 53-11-35 (West 2008); N.Y. BUS. CORP. LAW § 717 (McKinney 2009); N.D. CENT. CODE, § 10-19.1-50 (2009); OHIO REV. CODE ANN. § 1701.59 (West 2009); OR. REV. STAT. ANN. § 60.357 (West 2007); 15 PA. CONS. STAT. ANN. § 1715 (West 2009); R.I. GEN. LAWS § 7-1.2-801 (2009); S.D. CODIFIED LAWS § 47-1A-830 (2009); TENN. CODE ANN. § 48-18-301 (West 2009); VT. STAT. ANN. tit. 11A, § 8.30 (2009); WIS. STAT. ANN. § 180.0827 (West 2008); WYO. STAT. ANN. § 17-16-830 (2009).

<sup>58</sup> See Leslie Berliant, *B Corporation, a New Way of Doing Business?*, INSIDE CLIMATE NEWS (July 13, 2009), <http://solveclimate.com/blog/20090713/b-corporation-new-way-doing-business>. Mr. Houlahan ran a \$250 million footwear and apparel brand: AND 1. *Id.* His co-founders of B-Lab, Jay Coen Gilbert and Andrew Kassou, are also from the for-profit world. *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> See Susan Adams, *Capitalist Monkey Wrench, Can a new corporate structure get companies to do good by not always putting shareholders first?*, FORBES (Apr. 12, 2010, 1:20 PM), <http://www.forbes.com/forbes/2010/0412/rebuilding-b-lab-corporate-citizenship-green-incorporation-mixed-motives.html>.

<sup>61</sup> *About Dansko*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/dansko> (last visited Apr. 2, 2012).

<sup>62</sup> *Media Kit – Mission*, DANSKO, <http://www.dansko.com/Press%20Room/Media%20Kit/Mission/> (Apr. 2, 2012).

<sup>63</sup> *Id.*

<sup>64</sup> *About Dansko*, *supra* note 61.

<sup>65</sup> GreenBiz Staff, *Two Years In, B Corps Gain Currency*, GREENBIZ.COM (Oct. 9, 2009), <http://www.greenbiz.com/news/2009/10/09/b-corp-certification-gains-currency>.

corporation that uses its business power for social and environmental purposes.<sup>66</sup> In order to become a B Corporation, a company must complete three steps: (1) take and pass the B Impact Rating System; (2) adopt the B Corporation legal framework; and (3) sign a term sheet.<sup>67</sup> In order to pass the impact rating system, a company must score eighty out of two hundred. The assessment looks at the impact a company has on its entire stakeholders<sup>68</sup> as well as the company's social and environmental performance.<sup>69</sup> The B Corporation team then returns a report with scores in five categories: accountability, employees, consumers, community, and environment.<sup>70</sup> On the B Impact Report, Dansko scored an 83.8 and garnered an "area of excellence" designation in the categories of accountability and employees.<sup>71</sup> Thus, it qualified for B Corporation certification for a set term and once the term is up, it will be reevaluated by the B Corporation team.<sup>72</sup>

b. Seventh Generation

Seventh Generation creates and sells natural household cleaning products.<sup>73</sup> The company's mission is "to inspire a more conscious and sustainable world by being an authentic force for positive change."<sup>74</sup> Seventh Generation is also a founding B Corporation.<sup>75</sup> On the B Impact Report, Seventh Generation scored a 111 and garnered an "area of excellence" designation in the categories of accountability, employees, and environment.<sup>76</sup> Thus, like Dansko above, it qualified for B Corporation certification for a set term and once the term is up, it will be reevaluated by the B Corporation team.<sup>77</sup>

As with the L3C, the B Corporation has state law hurdles, increased fees for maintenance, and PRI issues. Changes in current tax-exempt law to the "commerciality doctrine" and "UBIT" (discussed later), could provide organizations the option of remaining within the sector. It might prove more palatable for those already within the sector to confront a well organized, thought out set of laws addressing socially motivated "commercial" ventures as opposed to

<sup>66</sup> *What is a B Corp?*, *supra* note 55.

<sup>67</sup> *Id.*

<sup>68</sup> *Become a B Corp*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/become-a-b-Corp> (last visited Apr. 2, 2012).

<sup>69</sup> *The B Impact Assessment*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/become/BRS> (last visited Apr. 2, 2012).

<sup>70</sup> *About Dansko*, *supra* note 61.

<sup>71</sup> *Id.* For a more detailed report visit, *Dansko: 2010 Rating*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/index.cfm/fuseaction/company.report/ID/34bc0bc7-ca3f-4cbf-abcf-3179f511ed0c> (last visited on Apr. 2, 2012).

<sup>72</sup> *Id.*

<sup>73</sup> *About Seventh Generation*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/seventh-generation> (last visited Apr. 2, 2012).

<sup>74</sup> *Our Mission*, SEVENTH GENERATION, <http://www.seventhgeneration.com/seventh-generation-mission> (last visited Apr. 2, 2012).

<sup>75</sup> *About Seventh Generation*, *supra* note 73.

<sup>76</sup> *Id.* For a more detailed report, see *Seventh Generation: 2010 Rating*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/index.cfm/fuseaction/company.report/ID/ff4298a1-5da9-49ae-920d-435a93008899> (last visited on Apr. 2, 2012).

<sup>77</sup> *Id.*

navigating this new, untried and developing area.

#### IV. THE TRADITIONAL TAX-EXEMPT SOCIAL ENTREPRENEURIAL MODEL

Organizations choosing to remain “traditional” I.R.C. § 501(c)(3) tax-exempt organizations have restructured portions of their organizations into what can loosely be termed social ventures over the last several decades.<sup>78</sup> The organizations maintain their § 501(c)(3) status while venturing into other mission driven activities to increase their revenue streams.<sup>79</sup> Though in some cases this has been successful, the current inconsistent treatment of these activities by the I.R.S. and the courts has made it more difficult, if not impossible to navigate; driving the hybrid movement.<sup>80</sup> The traditional nonprofits that follow are examples of organizations that have “adopted complex structures using separate corporate subsidiaries in an effort to isolate themselves from the exemption risks posed by direct commercial activity.”<sup>81</sup> To date, this is an accepted format for protecting charitable organizations because the I.R.S. has consistently held that the activities of a subsidiary cannot be attributed to the parent unless it is proved that such organization is acting only as an arm of the parent organization.<sup>82</sup>

##### A. Statutory Requirements

The tax-exempt organizational form<sup>83</sup> under I.R.C. § 501(c)(3)<sup>84</sup> exempts from federal income tax:

Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.<sup>85</sup>

---

<sup>78</sup> See CAFARDI & CHERRY, *supra* note 2.

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

<sup>81</sup> Colombo, *supra* note 7, at 514 (citing *Moline Props. v. Comm’r*, 319 U.S. 436 (1943)).

<sup>82</sup> *Id.* at 515. See also I.R.S. Gen. Couns. Mem. 39,326 (Jan. 17, 1985).

<sup>83</sup> “A tax exempt organization is a type of nonprofit organization not subject to the federal income tax.” UNDERSTANDING NONPROFIT, *supra* note 40, at § 3.

<sup>84</sup> I.R.C. § 501(c)(3) (West 2010).

<sup>85</sup> *Id.*

### 1. Examples

#### a. Educational Testing Services

Educational Testing Services (ETS) is a nonprofit that designs and administers standardized or assessment tests, such as the GRE<sup>®</sup>, and conducts educational research.<sup>86</sup> Its purpose or mission is to “advance quality and equality in education for people worldwide by creating assessments based on rigorous research.”<sup>87</sup> However, ETS has a handful of activities that are off mission and help fund ETS’s mission.<sup>88</sup> Thus ETS established multiple for-profit subsidiaries to run these activities, such as Prometric and ETS Global BV.<sup>89</sup>

ETS purchased Prometric, which was originally part of Sylvan Learning Systems, in 2007.<sup>90</sup> It delivers technology-enabled testing and assessment services to third party clients.<sup>91</sup> Prometric offers a wide range of testing services including, but not limited to, pre-employment assessments, professional certifications, and academic assessments.<sup>92</sup> ETS Global BV is another subsidiary of ETS that focuses on ETS’s international operations and development.<sup>93</sup>

#### b. Citizens Energy Corporation

This organization was founded by Joe Kennedy in 1979 to provide low-cost heating oil to the poor and is an example of a long existing traditional model organization.<sup>94</sup> Citizens Energy has grown and now includes seven subsidiaries, some that are for-profit.<sup>95</sup> Citizens Energy Corporation’s mission is “to help make life’s basic needs more accessible and affordable”<sup>96</sup> and also to use “market opportunities to help the poor and needy.”<sup>97</sup> It has formed several other organizations and developed programs including Citizens Wind, Citizens Unite, and Business Initiatives.<sup>98</sup> The Business Initiatives generate millions of dollars in revenue that are channeled to social ventures and charitable causes in the United

---

<sup>86</sup> *Who We Are*, ETS, <http://www.ets.org/about/who> (last visited Apr. 2, 2012).

<sup>87</sup> *Id.*

<sup>88</sup> RANDY ELLIOT BENNETT, WHAT DOES IT MEAN TO BE A NONPROFIT EDUCATIONAL MEASUREMENT ORGANIZATION IN THE 21<sup>ST</sup> CENTURY? 1, 19 (2008), available at <http://www.ets.org/Media/Research/pdf/Nonprofit.pdf>.

<sup>89</sup> *Id.*

<sup>90</sup> Hanah Cho, *ETS Buys Prometric*, THE BALTIMORE SUN (July 3, 2007), [http://articles.baltimore.sun.com/2007-07-03/business/0707030146\\_1\\_prometric-testing-and-assessment-assessment-services](http://articles.baltimore.sun.com/2007-07-03/business/0707030146_1_prometric-testing-and-assessment-assessment-services).

<sup>91</sup> *Company*, PROMETRIC, <https://prometric.com/Services/company/default.htm> (last visited Apr. 2, 2012).

<sup>92</sup> *Prometric, Inc.*, HOOVERS, [http://www.hoovers.com/company/Prometric\\_Inc/jrciff-1-1njg4g.html](http://www.hoovers.com/company/Prometric_Inc/jrciff-1-1njg4g.html) (last visited Apr. 2, 2012).

<sup>93</sup> *ETS Worldwide*, ETS, <http://www.ea.etsglobal.org/ea/about-ets/ets-worldwide/> (last visited Apr. 2, 2012).

<sup>94</sup> Abby Goodnough & Sara Rimer, *Massachusetts Waits for a Kennedy to Decide on Race*, N.Y. TIMES, Sept. 4, 2009, at A13.

<sup>95</sup> CITIZENS ENERGY CORPORATION, <http://www.citizensenergy.com/main/Home.html> (last visited Apr. 2, 2012).

<sup>96</sup> *Id.*

<sup>97</sup> *Id.*

<sup>98</sup> *Id.*

States and abroad.<sup>99</sup> The variety of commercial activities includes “oil trading, oil exploration and production, electric power and natural gas marketing, mail-order service pharmaceuticals and environmental business consulting.”<sup>100</sup>

#### V. THE APPLICABLE TESTS

The tests that I.R.C. § 501(c)(3) tax-exempt organizations must meet in order to maintain their status as they venture into “commerciality” waters are not clear. Though there have been many court decisions in this area, the courts cannot settle on one precise approach to this issue. New tests have been added through the years that are mostly subjective and base analysis on the facts and circumstances of each rising case; and the tests that are being used are not applied consistently, thereby leaving organizations to second guess the courts in their attempts to comply.

##### A. Internal Revenue Code “Operational Test” for Tax Exemption

Section 501(c)(3) tax exemption requires that the organization be “organized and operated exclusively for an exempt purpose.”<sup>101</sup> In construing the statute, “exclusively” does not take on the common dictionary meaning of “solely” or mean to the exclusion of all other purposes.<sup>102</sup> Rather, the statute’s exclusivity requirement means that an organization must be operated *primarily* for exempt purposes,<sup>103</sup> often referred to as the “primary purpose” test.<sup>104</sup>

Thus, in applying the operational test, the I.R.S. focuses on the organization’s operations through its activities.<sup>105</sup> Under the operational test, the purposes towards which an organization’s activities are directed, and not the nature of the activities themselves, is ultimately dispositive of the organization’s right to be classified as a § 501(c)(3) organization.<sup>106</sup> In applying the operational test, the I.R.S. has determined that the presence of even one non-exempt activity, if substantial in nature, violates the operational test. Such an organization is not operated exclusively (i.e. primarily) for exempt purposes.<sup>107</sup> Determining the purposes of an organization is a factual question, which concerns “both the actual as well as the stated purpose for the existence of the organization and the activities

---

<sup>99</sup> *Business Initiatives*, CITIZENS ENEGRY CORPORATION, <http://www.citizensenergy.com/english/pages/BusinessInitiatives> (last visited Apr. 2, 2012).

<sup>100</sup> *Id.*

<sup>101</sup> I.R.C. §501(c)(3) (West 2010); *see also* Treas. Reg. § 1.501(c)(3)-1(c)(1) (2008); Treas. Reg. § 1.501(c)(3)-1(a)(1).

<sup>102</sup> *See* Orange County Agric. Soc’y, Inc. v. Comm’r, 55 T.C.M. (CCH) 1602 (1988), *aff’d*, 893 F.2d 529 (2d Cir. 1990).

<sup>103</sup> *See* Better Bus. Bureau of D.C. v. United States, 326 U.S. 279, 283 (1945); Universal Church of Jesus Christ, Inc. v. Comm’r, 55 T.C.M. (CCH) 143, 144 (1988).

<sup>104</sup> Treas. Reg. § 1.501(c)(3)-1(a)(1); Treas. Reg. § 1.501(c)(3)-1(c)(1).

<sup>105</sup> *See* Treas. Reg. § 1.501(c)(3)-1(c)(1); Treas. Reg. § 1.501(c)(3)-1(a)(1).

<sup>106</sup> Golden Rule Church Ass’n v. Comm’r, 41 T.C. 719, 728 (1964).

<sup>107</sup> *See* Am. Campaign Acad. v. Comm’r, 92 T.C. 1053, 1066 (1989).

it engages in to accomplish those purposes.”<sup>108</sup>

### 1. Commercial Activity

The I.R.S. and the courts also apply the operational test to an organization’s activities by comparing the exempt organization’s activities to similar activities carried out by for-profit entities. Operating a commercial business does not automatically cause the organization to fail the operational test, as we have seen previously, since numerous exempt organizations operate commercial businesses.<sup>109</sup> The operational test simply requires that these otherwise commercial activities be substantially in furtherance of the organization’s exempt purposes.<sup>110</sup> In making its comparison to the for-profit sector, the I.R.S. looks to: 1) the particular manner in which the commercial activities of an exempt organization are carried out; 2) their commercial hue; and 3) the presence of a profit-making motive, in effect any characteristic which admits of a non-exempt purpose for these activities.<sup>111</sup>

To the extent the I.R.S. can determine that the commercial activities of an exempt organization are too commercial to be in furtherance of its exempt purposes, the organization will fail the operational test. This is frequently referred to as the “commerciality” doctrine, which is a separate court fashioned test.<sup>112</sup> It is an application of the operational test, and any exempt organization that carries on substantial, commercial activities, unrelated to its exempt purposes, will fail the operational test.

#### a. The Commerciality Doctrine

Courts have broadened the operational test through their development of the commerciality doctrine.<sup>113</sup> This court-made doctrine proposes that organizations which act in a commercial manner have a primary purpose, namely their commercial activities, which are a non-exempt purpose, thereby disqualifying them from exempt status.

The I.R.C. and tax regulations provide no reference to the “commerciality doctrine” as a requirement for exempt status and are relatively silent on commercial activity as it relates to tax-exempt organizations.<sup>114</sup> The

<sup>108</sup> *Christian Manner Int’l Inc. v. Comm’r*, 71 T.C. 661, 668 (1979).

<sup>109</sup> *Monterey Pub. Parking Corp. v. United States*, 321 F. Supp. 972, 976 (N.D. Cal. 1970), *aff’d* 481 F.2d 175 (9th Cir. 1973); *San Francisco Infant Sch., Inc. v. Comm’r*, 69 T.C. 957, 966 (1978); Treas. Reg. § 1.501(c)(3)-1(c)(1) (2008); Treas. Reg. § 1.501(c)(3)-1(e)-(1).

<sup>110</sup> See *Orton v. Comm’r*, 56 T.C. 147, 158 (1971); *Golden Rule Church Ass’n*, 41 T.C. at 728–29.

<sup>111</sup> See *B.S.W. Group, Inc. v. Comm’r*, 70 T.C. 352, 358 (1978); *Am. Inst. for Econ. Research v. United States*, 302 F.2d 934, 938 (Ct. Cl. 1962); *Scripture Press Found. v. United States*, 285 F.2d 800, 803–04 (Ct. Cl. 1961).

<sup>112</sup> See UNDERSTANDING NONPROFIT, *supra* note 40, at § 7.03.

<sup>113</sup> Treas. Reg. § 1.501(c)(3)-1(e). See John D. Colombo, *Why is Harvard Tax-Exempt? (And Other Mysteries of Tax Exemption for Private Educational Institutions)*, 35 ARIZ. L. REV. 841, 848 (1993) [hereinafter *Why is Harvard Tax-Exempt?*]. The commerciality doctrine is sometimes referred to as the business activity doctrine. *Id.* at 848.

<sup>114</sup> I.R.C. § 501 (West 2010) was added to the I.R.C. in 1986 and deals with the denial of tax exemption to commercial-type insurance companies. While the Tax Regulations do not refer to the



“commerciality doctrine” is a creation of the courts without a clear basis in the I.R.C. or the underlying regulations, though the I.R.S. began using this concept as a justification for denial of tax exemption.<sup>115</sup> Because the development of the doctrine is based on less than clear language in a number of cases, its application has been uneven.<sup>116</sup>

A further problem with the “commerciality doctrine” is that it has long been settled law that exempt organizations are not barred from commercial activities, but only those commercial activities which are not in furtherance of their exempt purposes.<sup>117</sup> As a result, the mere performance of commercial activities by an exempt organization, even highly successful commercial activities, is not determinative of exempt status. Commercial activities must be unrelated to exempt purposes to be disqualifying.

The commerciality doctrine finds its foothold in *Better Business Bureau of Washington, D.C. v. United States*.<sup>118</sup> The Bureau sought tax exemption as an educational organization that focused on teaching merchants to conduct their businesses honestly, and teaching consumers to avoid being victimized and to purchase goods intelligently.<sup>119</sup> The Court denied tax exemption to the Bureau finding that it engaged in the non-exempt purpose<sup>120</sup> of promoting a profitable business community, thereby basing their holding on the presence of a substantial, non-exempt commercial purpose.<sup>121</sup>

In *Better Business Bureau*, the Court did not apply an operational test analysis,<sup>122</sup> but instead discussed the commercial hue<sup>123</sup> of the organization.<sup>124</sup>

---

commerciality doctrine, they do refer to commercial activities as they relate to the imposition of unrelated business income tax (UBIT). See Treas. Reg. § 1.513-1, which states that the use of commercial advertising can be considered in determining trade or business. Treas. Reg. § 1.513-1(c)(1) and Treas. Reg. § 1.513-2(ii) state that the frequency and continuity of commercial activities can be considered in determining whether an activity is regularly carried on. Treas. Reg. § 1.501(c)(3)-1(e) discusses trade or business as it applies to unrelated business income. Treas. Reg. § 1.501(c)(3)-1(e)(1) states that an organization’s primary purpose shall be determined by all the facts and circumstances, including the size and extent of the trade or business and the size or extent of the activities which are in furtherance of one or more exempt purposes.

<sup>115</sup> See, e.g., *Scripture Press Found. v. United States*, 285 F.2d 800, 802 (Ct. Cl. 1961).

<sup>116</sup> See, e.g., *Manning Ass’n v. Comm’r*, 93 T.C. 596 (1989); see *Fed’n Pharm. Serv. Inc. v. Comm’r*, 625 F.2d 804 (8th Cir. 1980); *B.S.W. Group, Inc. v. Comm’r*, 70 T.C. 352, 358 (1978); *Am. Inst. for Econ. Research v. United States*, 302 F.2d 934, 938 (Ct. Cl. 1962).

<sup>117</sup> *Monterey Pub. Parking Corp. v. United States*, 481 F.2d 175 (9th Cir. 1973); *San Francisco Infant Sch., Inc. v. Comm’r*, 69 T.C. 957 (1978); Treas. Reg. § 1.501(c)(3)-1(c)(1); Treas. Reg. § 1.501(c)(3)-1(e)(1).

<sup>118</sup> *Better Bus. Bureau of Wash. D.C. v. United States*, 326 U.S. 279 (1945).

<sup>119</sup> *Id.* at 282–83.

<sup>120</sup> “[T]he presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes . . .” *Id.* at 283; see also Treas. Reg. § 1.501(c)(3)-1(c)(1).

<sup>121</sup> *Better Bus. Bureau*, 326 U.S. at 283.

<sup>122</sup> See Treas. Reg. § 1.501(c)(3)-1(c)(1).

<sup>123</sup> *Better Bus. Bureau*, 326 U.S. at 283.

<sup>124</sup> The Bureau’s charter which the Court claimed was commercial in nature and only incidentally educational provided for five activities including: (1) prevention of fraud by informing and warning merchants and the general public; (2) fighting fraud by bringing fraudulent practices to the public’s attention; (3) elevating business standards by convincing businesses that *caveat emptor* is not a good business practice and that misleading advertising, extravagant claims, and price comparisons are not

The Court determined that this commercial hue was “directed fundamentally to ends other than that of education [and that] any claim that education is the sole aim of [the Bureau’s] organization is thereby destroyed.”<sup>125</sup>

b. Applying the Doctrine: What Are “Substantial” Non-Exempt Commercial Purposes

Determining whether a “substantial” non-exempt commercial purpose is present in an organization is considerably more difficult than determining whether or not the organization is operated for non-exempt purposes. Courts have differed in their approach in determining what constitutes “substantial” non-exempt commercial purposes, and based their analysis on the facts and circumstances of each case.

Several courts have used a quantitative approach to determine what constitutes substantial non-exempt activities. The tax court, has at one turn, determined that spending twenty percent of revenues on a non-exempt purpose is substantial.<sup>126</sup> Several years later, the tax court found that less than ten percent of revenues spent on non-exempt purposes was not substantial,<sup>127</sup> however it refused to create a safe harbor ten percent ceiling on substantial non-exempt activities.<sup>128</sup> Other courts have focused on a qualitative approach to determining whether commercial activity is substantial,<sup>129</sup> setting forth tests which include questions such as: 1) is there competition with for-profit commercial entities?;<sup>130</sup> 2) is there provision for below cost services?;<sup>131</sup> 3) what are the pricing policies?;<sup>132</sup> 4) are there reasonable financial reserves?;<sup>133</sup> 5) how are commercial promotional methods used (i.e. advertising)?;<sup>134</sup> 6) are there appropriate levels of charitable

---

good business; (4) educating consumers to be intelligent buyers; and (5) cooperating with various governmental agencies. *Id.* at 281–82.

<sup>125</sup> *Id.* at 284.

<sup>126</sup> *Church in Boston v. Comm’r*, 71 T.C. 102, 108 (1978); *see also* *Copyright Clearance Ctr. v. Comm’r*, 79 T.C. 793, 804 (1982), where the Court recognized that “a nonexempt purpose even perhaps somewhat beyond de minimis level has been permitted without loss of exemption.”

<sup>127</sup> *World Family Corp. v. Comm’r*, 81 T.C. 958, 967–68 (1983).

<sup>128</sup> *See Manning Ass’n v. Comm’r*, 93 T.C. 596, 611 (1989).

<sup>129</sup> *See, e.g., Manning*, 93 T.C. at 610.

<sup>130</sup> *See, e.g., Easter House v. United States*, 12 Cl. Ct. 476, 486 (1987) (holding that the plaintiff’s competition with other commercial organizations gives its activities an impermissible commercial hue); *B.S.W. Group, Inc. v. Comm’r*, 70 T.C. 352, 358 (1978) (determining that competition with commercial firms is strong evidence of a nonexempt commercial purpose); *Am. Inst. for Econ. Research v. United States*, 302 F.2d 934 (Ct. Cl. 1962). Courts may engage in a counterparts test to determine if there is unfair competition between a for-profit business and a tax-exempt organization. *See BRUCE HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS* 85 (John Wiley & Sons, Inc., 8th ed. 2003).

<sup>131</sup> *See, e.g., Fed’n Pharm. Serv. Inc. v. Comm’r*, 625 F.2d 804, 806 (8th Cir. 1980) (where the court reiterates that some degree of free or below cost services must be provided before tax exemption can be granted); *B.S.W. Group*, 70 T.C. at 356; *Easter House*, 12 Cl. Ct. at 480.

<sup>132</sup> *See, e.g., Living Faith, Inc. v. Comm’r*, 950 F.2d 365, 373 (7th Cir. 1991) (where the use of retail pricing methods was used as a factor in finding the organization operated in a commercial manner).

<sup>133</sup> *See, e.g., Presbyterian and Reformed Publ’g Co. v. Comm’r*, 743 F.2d 148, 157 (3d Cir. 1984).

<sup>134</sup> *See, e.g., Living Faith, Inc.*, 950 F.2d at 373 (where the use of advertising and promotional materials was used as a factor in finding the organization operated in a commercial manner).

donations?;<sup>135</sup> and 7) are there an excessive amount of profits?<sup>136</sup> On this last point, courts are inconsistent on whether financial success can be detrimental to obtaining or maintaining tax-exempt status.<sup>137</sup>

In applying the commerciality doctrine, courts disfavor exempt organizations that appear to be competing with for-profit companies that provide similar goods or services.<sup>138</sup> When deciding cases where the focus is the commercial nature of the nonprofit organization, courts often refer to the unfair competition it poses to its for-profit counterparts.<sup>139</sup> With the underlying premise that tax-exempt organizations ought not to be competing with for-profits, the courts compare the commercial activity of the exempt organization to that of the for-profit, and if the similarity is too great, they find that the commerciality doctrine has been violated.<sup>140</sup>

In *Federation Pharmacy Services, Inc. v. Commissioner*, the organization provided prescription drugs to the elderly and disabled persons.<sup>141</sup> Qualified persons were able to receive five percent of the cost of the drugs, while others were charged market rates.<sup>142</sup> The court found (1) the organization relied financially on the sale of prescription drugs to the public; and (2) there was no accommodation made for those unable to pay, therefore it operated for a substantial commercial purpose.<sup>143</sup> The court also found that granting tax exemption to Federation would “necessarily disadvantage other for-profit drug stores with which Federation competes.”<sup>144</sup>

In *Living Faith, Inc. v. Commissioner*, the organization operated vegetarian restaurants and health food stores in furtherance of the Seventh Day Adventist Church’s doctrine that healthful eating promoted virtuous conduct.<sup>145</sup> In determining that the organization operated in a commercial manner, the court looked at factors that indicated the activities the organization engaged in were commercial in nature. The factors were: (1) the organization sold goods and services to the public which made the operations presumptively commercial; (2)

---

<sup>135</sup> See, e.g., *Am. Inst. for Econ. Research*, 302 F.2d at 556.

<sup>136</sup> See *Scripture Press Found. v. United States*, 285 F.2d 800, 803 (Ct. Cl. 1961) (where the court rejected the notion that large profits automatically preclude tax exemption, but the court added that “[profits are] at least some evidence indicative of a commercial character”).

<sup>137</sup> *Id.*; see also DARRYLL K. JONES ET AL., *THE TAX LAW OF CHARITIES AND OTHER EXEMPT ORGANIZATIONS*, 166–67 (West Group, 2003); *Why is Harvard Tax-Exempt*, *supra* note 111, at 848; Bruce R. Hopkins, *The Most Important Concept in the Law of Tax-Exempt Organizations Today: The Commerciality Doctrine*, 5 EXEMPT ORG. TAX REV. 459, 463 (1992); see Paul J. Streer, *Obtaining and Preserving Tax-Exempt Status Under Section 501(c)(3): Judicially Developed Factors for Detecting the Presence of Substantial Nonexempt Activities*, 6 J. AM. TAX ASS’N 63, (1985).

<sup>138</sup> See *B.S.W. Group, Inc. v. Comm’r*, 70 T.C. 352, 358 (1978).

<sup>139</sup> See *Am. Inst. for Econ. Research*, 302 F.2d at 934; *Scripture Press*, 285 F.2d at 805; *Fed’n Pharm. Serv. Inc. v. Comm’r*, 625 F.2d 804, 809 (8th Cir. 1980); *Living Faith*, 950 F.2d at 372.

<sup>140</sup> See *Presbyterian and Reformed Publ’g Co. v. Comm’r*, 743 F.2d 148 (3d Cir. 1984) (where the court made this comparison, but came down on the side of exemption anyway).

<sup>141</sup> *Fed’n Pharm. Serv. Inc.*, 625 F.2d at 805.

<sup>142</sup> *Id.* at 806.

<sup>143</sup> *Id.* at 809.

<sup>144</sup> *Id.* at 808.

<sup>145</sup> *Living Faith, Inc.*, 950 F.2d at 365.

there was direct competition with similar for-profit organizations in the area; (3) there was no below-cost pricing (all prices were retail); (4) the organization advertised and used promotional materials; (5) the restaurants and stores had hours of operation similar to their for-profit counterparts; (6) the organization had salaried employees instead of relying on volunteers; and (8) the organization solicited no charitable contributions.<sup>146</sup>

The decisions in the publishing house cases<sup>147</sup> in this area contradict one another, though the courts attempt to distinguish these cases<sup>148</sup> stating that there is a difference between organizations that have commercial activities as a part of their overall activities (*Saint Germain* and *Forest Press*) and those that have commercial activities as their sole activity (*Scripture Press*).<sup>149</sup>

Imbedded within the decisions are the views on the effect of financial success in regards to maintaining an organization's exempt status. In *Scripture Press*, the I.R.S. tried to distinguish *Forest Press* and *Saint Germain* cases by arguing that exemption was allowed in those cases partially based on the small profits realized by those organizations.<sup>150</sup> The difference in the *Scripture Press* case was the substantial profits it realized. The court of claims rejected this argument stating that, "[i]f the [I.R.S.] seeks . . . to suggest that where an organization's profits are very large a conclusion that the organization is noncharitable must follow, we reject such a suggestion."<sup>151</sup> The court goes on to agree that profits are "evidence indicative of a commercial character . . ."<sup>152</sup>

In *Presbyterian and Reformed Publishing Co. v. Commissioner*, another religious publishing house was initially denied exemption because of the "commercial hue" it generated by virtue of its profits, professional staff, and competition with commercial publishers.<sup>153</sup> The appellate court, however, determined that the company should be given exemption because it maintained its religious affiliation in accordance with § 501(c)(3), though it cautioned that if "an organization's management decisions replicate those of commercial enterprises, it is a fair inference that at least one purpose is commercial . . ."<sup>154</sup> The court continued by stating that exempt status should not be jeopardized by success.<sup>155</sup>

The analysis in these cases not only confuses the issue but highlights a "catch 22"<sup>156</sup> created by the courts when they attempt to apply the "commerciality doctrine" based on an organization's profits. If an organization is successful and generates a profit it "attacks one of the economic justifications for [its] tax

<sup>146</sup> *Id.* at 372–75.

<sup>147</sup> See *Scripture Press Found. v. United States*, 285 F. 2d 800 (Ct. Cl. 1961); *Fed'n Pharm. Serv. Inc.*, 625 F.2d at 804; *Elisian Guild, Inc. v. United States*, 412 F.2d 121 (1st Cir. 1969).

<sup>148</sup> 22 T.C. 265 (1954); 26 T.C. 648 (1956).

<sup>149</sup> *Scripture Press*, 285 F.2d at 803.

<sup>150</sup> *Id.*

<sup>151</sup> *Id.*

<sup>152</sup> *Id.*

<sup>153</sup> *Presbyterian & Reformed Publ'g Co. v. Comm'r*, 743 F.2d 148, 152–54 (3d Cir. 1984).

<sup>154</sup> *Id.* at 155.

<sup>155</sup> *Id.* at 158.

<sup>156</sup> JONES ET AL., *supra* note 137, at 134.

exemption.”<sup>157</sup> Yet if it operates at a loss, the organization jeopardizes its very existence since no organization can long survive operating consistently in the red.

c. Commensurate Test

In addition to the “commerciality” test, the I.R.S. has returned to its earlier use of the “commensurate” test when determining whether an organization has failed the operational test, though this has not played a large role in assessing commercial activity. This test simply asks whether the exempt organization is performing adequate exempt activities commensurate with its resources.<sup>158</sup> If the organization is paying too much to outside consultants, e.g., fundraisers, and spending too little on actual charitable work, then it is not performing exempt activities commensurate with its mission. In other words, it has a primary activity (funding the fund-raisers) that is not exempt, thereby disqualifying itself under the operational test.

B. Recent Decisions

Recent decisions in this area are of no help. The court in *Airlie Foundation v. IRS* bludgeons the “commerciality doctrine” using a “commercial hue” analysis combined with its own subjective interpretation of the facts and circumstances to determine that *Airlie Foundation* is operating in a commercial manner and therefore does not qualify as a tax-exempt organization.<sup>159</sup>

In *Airlie*, Plaintiff conducted educational workshops and seminars at its conference center in Washington, D.C., consistent with its mission, and argued that its fees were comparable or lower than other nonprofit conference centers operating in the area. It engaged in little advertising, and accumulated reasonable reserves.<sup>160</sup> In fact, the expected pre-tax profit margin for commercial conference centers was approximately twenty percent, while Plaintiff’s margin was not even four percent during the years in question.<sup>161</sup> Defendant argued that there was a distinct “commercial hue” to *Airlie’s* conference center activities, citing income from wedding and special event bookings and a commercial website as proof.<sup>162</sup>

While the court agreed that certain factors including the foundation’s fee structure and subsidization practice were indicative of a non-commercial purpose, it stated that other factors, such as the nature of its clients, competition with for-profits, advertising expenditures, and substantial revenues strongly suggested a commercial purpose.<sup>163</sup> The court denied exemption finding a “distinctive commercial hue” to the way the foundation carried out its business.<sup>164</sup> It stated

---

<sup>157</sup> *Id.*

<sup>158</sup> *United Cancer Council, Inc. v. Comm’r*, 109 T.C. 326 (1997), *rev’d and remanded* 165 F.3d 1173 (7th Cir. 1999); Rev. Rul. 64-182, 1964-1 C.B. 186.

<sup>159</sup> *Airlie Found. v. IRS*, 283 F. Supp. 2d 58 (D.D.C. 2003).

<sup>160</sup> *Id.* at 63.

<sup>161</sup> *Id.* at 60.

<sup>162</sup> *Id.* at 64.

<sup>163</sup> *Id.* at 65.

<sup>164</sup> *Id.*

that:

In applying the operational test, courts have relied on what has come to be termed the “commerciality” doctrine. In many instances, courts have found that, due to the “commercial” manner in which an organization conducts its activities, that organization is operated for nonexempt commercial purposes rather than for exempt purposes.<sup>165</sup>

The court claims to have considered the totality of the facts and circumstances in its determination.<sup>166</sup> Factors such as fee structure and subsidization of a number of clients were outweighed by the nature of the clients, competition with for-profits, advertising costs, and revenue.<sup>167</sup> Though the court allowed that an organization might carry on activities that are for “nonexempt purposes,”<sup>168</sup> and cites the appropriate prior case law on the subject, its analysis of the facts in the case in its effort to determine the “manner” in which *Airlie* carries on its activities leaves many questions. The factors depended on by the court in making its decision include: “competition with for profit commercial entities; extent and degree of below cost services; pricing policies; reasonableness of financial reserves; . . . [and] use of commercial promotional methods and extent to which the organization receives charitable donations.”<sup>169</sup> *Airlie* competed with some for-profits but mostly nonprofit organizations, it offered below cost services and pricing policies to allow for those who could not afford the services, it had reasonable financial reserves, promoted its activities on the internet (like many other nonprofits), and received charitable donations, yet the court found that the level of commercial activity warranted the loss of tax exemption.<sup>170</sup>

Several recent I.R.S. public letter rulings<sup>171</sup> have denied tax exemption, based on *Airlie*, because the I.R.S. determined that the organizations operated in a commercial manner—though none of the rulings clarify this issue.<sup>172</sup>

### *C. Unrelated Business Income Tax and Social Enterprise*

The legislative history of the unrelated business income tax provides that one purpose of the tax on the unrelated business activities of otherwise exempt organizations was to deal with the problem of unfair competition between untaxed businesses operated by tax-exempt organizations and similar businesses operated

---

<sup>165</sup> *Id.* at 63; *see also* *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924); *Why is Harvard Tax-Exempt*, *supra* note 111, at 848; 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); Carolyn Wright, *Commerciality Doctrine Poses Substantial Threat to EOs*, 96 TAX NOTES TODAY 53–56 (1996).

<sup>166</sup> *Arlie, Found.*, 283 F. Supp. 2d at 65.

<sup>167</sup> *Id.*

<sup>168</sup> *Id.* at 63.

<sup>169</sup> *Id.*

<sup>170</sup> *Id.* at 65.

<sup>171</sup> *See* I.R.S. Priv. Ltr. Rul. 201007060 (Feb. 19, 2010); I.R.S. Priv. Ltr. Rul. 201009018 (Mar. 5, 2010).

<sup>172</sup> I.R.S. Priv. Ltr. Rul. 201025079 (Jun. 25, 2010).

by for-profit corporations that were fully taxable.<sup>173</sup> Yet, nowhere in the statutory provision enacted by Congress is there a reference to “a requirement of unfair competition before the tax applies.”<sup>174</sup> The I.R.S. adopted the UBIT, which allowed for the operation of a “trade or business” if it were “substantially related” to the “exercise or performance by such organization of its charitable, educational or other purpose or function constituting the basis for its exemption under 501 . . . .”<sup>175</sup> Had it so intended, the I.R.S. could have issued a complete ban on commercial activity;<sup>176</sup> however, since it did not, there is the implication that related activity may be acceptable but that unrelated activity will be taxed.

Unrelated business taxable income is defined as the gross income derived by any organization from any unrelated trade or business regularly carried on, less allowable deductions.<sup>177</sup> UBIT is payable by tax-exempt organizations on their net income from: (1) a trade or business; (2) regularly carried on; and (3) substantially unrelated to the organization’s exempt purposes.<sup>178</sup>

The courts have not been uniform in endorsing the prevention of unfair competition as the only basis of the unrelated business income tax.<sup>179</sup> Any activity that is carried on for the production of income from the sale of goods or the performance of services is considered a “trade or business.”<sup>180</sup> “[A]n activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities . . . which may, or may not, be related to the exempt purposes of the organization.”<sup>181</sup>

Any activity which is carried on for the production of income and which otherwise possesses the characteristics required to constitute a “trade or business” within the meaning of § 162 constitutes a trade or business as those terms are used in I.R.C. § 511.<sup>182</sup> I.R.C. § 162 details allowable trade or business deductions,

---

<sup>173</sup> H. Rep. No. 2319, 81<sup>st</sup> Cong., 2d Sess. 36-37 (1950); S. REP. NO. 81-2375 (1950), as reprinted in 1950 U.S.C.C.A.N. 3053. See also *Hope School v. United States*, 612 F.2d 298 (7th Cir. 1980); Treas. Reg. § 1.513-1(b) (1967). This rationale was re-iterated in 1976 in S. REP. NO. 94-938(I) (1976), as reprinted in 1976 U.S.C.C.A.N. 3438.

<sup>174</sup> Donald C. Haley, *The Taxation of the Unrelated Business Activities of Exempt Organizations: Where Do We Stand? Where Do We Seem To Be Headed?*, 7 AKRON TAX J. 61 (1990).

<sup>175</sup> Treas. Reg. § 1.513-1(a).

<sup>176</sup> Columbo, *supra* note 7.

<sup>177</sup> I.R.C. § 512(a)(1) (West 2010).

<sup>178</sup> Treas. Reg. § 1.513-1. Before 1950, the law was quite generous to tax-exempt organizations and allowed all of their income, from whatever source, to be tax-exempt, as long as it met the “destination” test. This test was first described in *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924). The Sacred Order of Preachers, otherwise known as the Dominicans, a Roman Catholic religious order, owned multiple interests in the Philippines, including rental properties, a chocolate confectionery and a winery. The income from all of these activities was found to be tax-exempt as long as the profits were destined for and supported the exempt activities of the organization. Congress amended the I.R.C. to levy a tax on the unrelated business activities of all I.R.C. Section 501(c)(3) tax-exempt organizations in 1950 allowing some exceptions. Although since 1969 all 501(c) organizations are subject to this tax.

<sup>179</sup> See *Am. Med. Ass’n v. United States*, 887 F.2d 760 (7th Cir. 1989); *La. Credit Union League v. United States*, 693 F.2d 525 (5th Cir. 1982); *Clarence LaBelle Post No. 217 v. United States*, 580 F.2d 270 (8th Cir. 1978); I.R.C. § 511(a) (West 2006).

<sup>180</sup> I.R.C. § 513(c) (West 2006).

<sup>181</sup> *Id.*

<sup>182</sup> Treas. Reg. § 1.513-1.

premised on the fact that a trade or business is operated to generate a profit, and that expenses used to generate that profit are deductible.<sup>183</sup> As the Second Circuit stated in applying § 162, “it is well established that the existence of a genuine profit motive is the most important criterion for the finding that a given course of activity constitutes a trade or business.”<sup>184</sup> In addition to the presence of a profit motive, it has been held that § 162s definition of a “trade or business” requires “extensive activity over a substantial period of time during which the [t]axpayer holds himself out as selling goods or services.”<sup>185</sup>

A trade or business is regularly carried on if it manifests a frequency and continuity and is pursued in a manner generally similar to comparable commercial activities of nonexempt organizations.<sup>186</sup> The treasury regulations specifically direct that this part of the test must be applied in light of the purpose of the unrelated business income tax to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they

---

<sup>183</sup> I.R.C. § 162 (West 2011).

<sup>184</sup> *Lamont v. Comm’r*, 339 F.2d 377, 380 (2d. Cir. 1964); *see also* *St. Joseph Farms of Ind. Bros. of the Congregation of Holy Cross, Sw. Province, Inc. v. Comm’r*, 85 T.C. 9 (1985). In another version of the “profit motive” requirement, the court of claims has said that an activity must be carried on in a commercial and competitive manner in order to qualify as a trade or business. *Id.* at 26.

<sup>185</sup> *McDowell v. Ribicoff*, 292 F.2d 174, 178 (3d. Cir. 1961).

<sup>186</sup> Treas. Reg. § 1.513-1(c)(1). In *Suffolk Cnty Patrolmen’s Benevolent Ass’n v. Comm’r*, 77 T.C. 1314 (1981), the Patrolmen’s Benevolent Association, a § 501(c)(5) labor organization, sponsored annual vaudeville shows as a form of fund-raiser. To put on these shows, it contracted with for-profit organizations which, in exchange for a fixed share in the proceeds, provided the performers for the shows and sold advertising in the programs that were distributed at the shows. *Id.* at 1317. In any year, the show gave three or four performances. *Id.* The I.R.S. sought to tax the Patrolmen’s Benevolent Association’s share of the advertising proceeds. *Id.* There was no doubt that the sale of advertising qualified as a trade or business unrelated to the Patrolmen’s exempt purposes. The issue was whether or not the activity was regularly carried on. *Id.* The I.R.S. argued that the relevant period on which to base this determination was the entire time during which the ads were sold, which was eight to sixteen weeks prior to the time of the show, or the six-year period during which the Patrolmen had a contract with the for-profit promoter. *Id.* The court rejected both of these arguments and found the advertising income to be non-taxable. *Id.* It cited the regulations, which specifically state that the annually recurrent nature of an intermittent activity will not cause it to be regarded as regularly carried on. *Id.* The court also observed that it could find nowhere in the legislative history or the regulations themselves where any time period was relevant apart from the actual duration of the event, which in this case was three or four days a year. *Id.* To buttress its decision, the court further cited the regulations, which cite publication of advertising in programs for sports events or music or drama performances as not being a business “regularly carried on.” *Id.* In *NCAA v. Comm’r*, 914 F.2d 1417, 1418 (10th Cir. 1990), the I.R.S. sought to tax the NCAA on the advertising income it received from a for-profit company for ads published in programs for the 1982 NCAA championship tournament. Again the question was what time period would be used to determine whether or not the activity was regularly carried on. *Id.* at 1423. The I.R.S. argued it was the time spent soliciting and preparing the ads, which was a substantial period. *Id.* The NCAA argued that it was only the eight-day period over three weeks during which the tournament games were played. *Id.* The Tenth Circuit agreed with the NCAA, relying on *Suffolk County Patrolmen’s* and on the language in the regulations which specified that certain intermittent activity occurs so infrequently that neither its recurrence nor the manner of its conduct will cause it to be regarded as a trade or business regularly carried on. *Id.* The court found the NCAA’s sale of advertising was just such an infrequent activity. *Id.* The court went on to consider the impact that the NCAA’s sale of advertising would have on its competition, such as sports magazines that sold the same type of advertising. *Id.* Since the NCAA’s ads were only a once-a-year event, the court found there to be no unfair competition, so that application of the unrelated business income tax in this case would not serve the statutory purpose. *Id.*



compete.<sup>187</sup>

If the nonexempt business activity with which the unrelated business activity competes is normally conducted on a year-round basis, then the unrelated business activity must be conducted on a year-round basis to be considered “regularly carried on.” On the other hand, if the competing nonexempt business is only seasonal, then the competing unrelated business activity need only be conducted on a seasonal basis to be considered “regularly carried on.”<sup>188</sup>

In order to be tax-exempt, income had to come from activities that were “substantially related” to the organization’s exempt purposes,<sup>189</sup> called “exempt function income.”<sup>190</sup> Income from these related activities passes without tax to the organization, even in the case of § 501(c)(3) when those activities are commercial in nature, as long as they are in furtherance of the organization’s exempt purposes.<sup>191</sup> However, a business or activity which simply raises money for an exempt organization, is not considered to be “substantially related,” even when all of the money goes to pay for exempt function activities.<sup>192</sup>

If unrelated business activities become too large a part of the organization’s overall activities, they will jeopardize the organization’s exempt status under the operational test. An exempt organization, a substantial part of whose activities are for non-exempt purposes, flunks the operational test.<sup>193</sup>

To determine whether a business activity is related to an organization’s exempt purposes requires an examination of the relationship between the business activities and the accomplishment of the organization’s exempt purposes.<sup>194</sup> A business is related to an organization’s exempt purposes only where the conduct of the business activities has a substantial causal relationship to the achievement of exempt purposes.<sup>195</sup> A business activity which simply produces income for the exempt organization, is not considered to be in furtherance of exempt purposes.<sup>196</sup>

In order to determine whether a substantial causal relationship exists between a business activity and an organization’s exempt purposes, the performance of the business activity, such as the production or distribution of goods, or the performance of services, must contribute importantly to the organization’s exempt

---

<sup>187</sup> Treas. Reg. § 1.513-1(c)(1).

<sup>188</sup> *Id.*

<sup>189</sup> I.R.C. § 513(a) (West 2006).

<sup>190</sup> I.R.C. § 512(a)(3)(B) (West 2010).

<sup>191</sup> Treas. Reg. § 1.501(c)(3)-1(e)(1) (2008).

<sup>192</sup> Treas. Reg. § 1.501(c)(3)-1.

<sup>193</sup> See *People’s Educ. Camp Soc’y, Inc. v. Comm’r*, 331 F.2d 923 (2d Cir. 1964); *Orange County Agric. Soc’y, Inc. v. Comm’r*, 55 T.C.M. (CCH) 1602 (1988), *aff’d*, 893 F.2d 529 (2d Cir. 1990) (where exemption was denied based on the fact that one-third of the organization’s income came from unrelated business activities); see also *United States v. Cmty. Serv., Inc.*, 189 F.2d 421 (4th Cir. 1951); *Fides Publishers Ass’n v. United States*, 263 F. Supp. 924 (N.D. Ind. 1967); *Scripture Press Found. v. United States*, 285 F.2d 800 (Ct. Cl. 1961).

<sup>194</sup> Treas. Reg. § 1.513-1(d)(1) (1967).

<sup>195</sup> Treas. Reg. § 1.513-1(d)(2).

<sup>196</sup> Treas. Reg. § 1.513-1(d)(1); see also *Indep. Ins. Agents of Huntsville, Inc. v. Comm’r*, 998 F.2d 898 (11th Cir. 1993).

purposes.<sup>197</sup> This determination will always turn on the facts and circumstances of each case. For example, income to an exempt inter-collegiate athletic association from the sale of broadcast rights to the athletic events it sponsored was held not to be subject to the unrelated business income tax.<sup>198</sup> The I.R.S.'s reasoning was that an athletic program furthered an exempt university's educational purposes, and that income from these events, whether from ticket sales or broadcast rights, was related income.<sup>199</sup>

An exempt museum gift shop that sells greeting cards, which carry reproductions of artworks either in the museum or in other museums, does not throw off any unrelated business taxable income from this activity.<sup>200</sup> Because these sales are related to the museum's exempt purpose of increasing art appreciation, the income is related and untaxed. But the gift shop of an exempt museum that not only sells reproductions from its collection and those of other museums, but also sells scientific books and souvenir items of the city where the museum is located, does throw off unrelated business income for the scientific books and the souvenirs because they are unrelated to the museum's exempt purposes.<sup>201</sup>

In accordance with UBIT,<sup>202</sup> only if an exempt organization's primary purpose is to operate an unrelated business is there an exemption problem.<sup>203</sup> Because, according to the regulations,<sup>204</sup> if an activity is substantial, yet in furtherance of an exempt purpose, there is no tax issue. The test seems to imply that even if the activity is related, but gets too substantial, that we have an "operational test" problem<sup>205</sup> and the courts must apply the operational test; though as of yet, there is no clear point where the operational test and, ultimately, the commerciality doctrine analysis begins.

---

<sup>197</sup> Treas. Reg. § 1.513-1(d)(2). In *San Antonio Bar Ass'n v. United States*, SA-79-CA-159, 1980 WL 1624 (W.D. Tex. May 14, 1980), the San Antonio Bar Association, a § 501(c)(6) business league, sold forms for real estate transaction. *Id.* at 1. These forms had been drawn up by volunteer members of the bar association and were accompanied by an instruction manual. *Id.* They were meant to replace standard forms created and used by title companies. *Id.* The San Antonio Bar Association's standard forms program was so successful that it was soon selling forms state-wide in conjunction with the State Bar of Texas. *Id.* The I.R.S. sought to tax the income from the sale of these forms as an unrelated business activity. *Id.* The district court did not agree. *Id.* at 4. It found that the sale of these forms was substantially related to the bar association's exempt purposes, "as an integral part of an overall project to design, maintain, provide and encourage the use of a basic real estate practice system, [which] primarily promoted the common business interest of the legal profession, advanced the professional interest of persons licensed to practice law, and improved the relations between the bench, bar, and public." *Id.*

<sup>198</sup> Rev. Rul. 80-206, 1980-2 C.B. 18.

<sup>199</sup> *Id.*

<sup>200</sup> Rev. Rul. 73-104, 1973-1 C.B. 263.

<sup>201</sup> Rev. Rul. 73-105, 1973-1 C.B. 264.

<sup>202</sup> Treas. Reg. § 1.513-1(a) (1967).

<sup>203</sup> *Id.*

<sup>204</sup> *Id.*

<sup>205</sup> I.R.C. § 501(c)(3) (West 2010).

## VI. PROPOSED CHANGES

The starting point in any attempt to lend clarity and order to the commercial activity issue must begin with the I.R.S., and a redrafting of the regulations. A clear definition of what amount of commercial activity is acceptable by exempt organizations must be set out in a consistent manner, and “substantial” activity must be defined. For instance, if the commercial activity is in furtherance of the organization’s exempt purpose yet becomes substantial, at what point is it so substantial that the organization is no longer operating for its exempt purpose.<sup>206</sup>

In what might be a counterintuitive approach, I would propose that the first hurdle should always be an UBIT analysis.<sup>207</sup> If an organization’s “primary purpose” is to operate an unrelated business, it has an exemption problem,<sup>208</sup> if not, a “commerciality doctrine” analysis would be in order. Though seemingly obvious, this has not consistently been the approach used by decision makers. One test is applied without the acknowledgement that there should be a more complete analysis.

I would also propose that a designation, similar to I.R.C. § 501(h),<sup>209</sup> be devised to determine whether an organization’s commercial activities are “substantial,” allowing an organization this option instead of confronting the courts’ subjective analysis.

Internal Revenue Code § 501(h) was enacted as an alternative to the “insubstantial part test”<sup>210</sup> for those organizations wishing to engage in lobbying without jeopardizing their tax-exempt status. Without this choice, organizations that choose to lobby are subject to various court interpretations of the “insubstantial part test.”<sup>211</sup> The percentage of permitted lobbying activity consequently falls within a range based on the individual facts and circumstances of each case. Internal Revenue Code § 501(h), the expenditure test, allows an organization to elect a clear, dollar-based limit on its lobbying through a tax filing.<sup>212</sup> The code section sets out definitions, and the form allows an organization to calculate permissible nontaxable dollar amounts for lobbying.<sup>213</sup> For exempt purpose expenditures less than \$500,000, an organization is permitted twenty percent of the exempt purpose expenditure as nontaxable lobbying with calculations up to \$1 million. Though perhaps not an ideal solution, the ability to calculate permissible commercial activity might encourage organizations to remain in the sector.

An approach might look like the following: (1) is there non-exempt income-

---

<sup>206</sup> Colombo, *supra* note 7.

<sup>207</sup> Treas. Reg. §1.513-1.

<sup>208</sup> *Id.*

<sup>209</sup> I.R.C. § 501(h) (providing a formula for exempt organizations to apply to calculate the amount of political activity they intend to carry on within a permitted range, as generally this activity is forbidden under I.R.C. § 501(c)(3)).

<sup>210</sup> Treas. Reg. § 1.501(c)(3)-1(c) (2008).

<sup>211</sup> *Id.*

<sup>212</sup> I.R.C. Form 5768.

<sup>213</sup> I.R.C. § 501(h); I.R.C. § 4911 (West 1978).

generating (commercial) activity; (2) if so, is the activity “substantially in furtherance” or not (with a subpart that defines “substantial”); (3) can the organization still qualify as exempt under a formula through a new designation (like § 501(h)); (4) if so, then an UBIT is imposed, and the organization remains exempt.

To assure compliance, if there is substantial commercial activity, to the level of failing the “operational test,”<sup>214</sup> and no § 501(h) type designation is chosen, then two options could become available to the I.R.S. and courts: (a) an intermediate sanction could be imposed (pay fine and cut back activity); or (b) the organization loses its tax-exempt status.

In an effort to provide a remedy for the breach by organizations of the private inurement test,<sup>215</sup> the I.R.S. created sanctions that impose an excise tax on excess benefit transactions.<sup>216</sup> This allows an excise tax to be imposed as an initial remedy before or instead of revocation of tax exemption. The sanctions are an intermediate step between revocation of exemption and no remedy at all,<sup>217</sup> and might serve the commercial activity conundrum well. The imposition of an intermediate sanction on an organization when commercial activity has become too substantial would give the organization the opportunity to correct the situation and remain within the exempt sector.

This approach requires the drafting of new regulations, and perhaps the passage of new legislation, though there are a multitude of examples—I.R.C. § 501(h)<sup>218</sup> and intermediate sanction regulations—that could help facilitate this change.<sup>219</sup>

## VII. POLICY CONSIDERATIONS

I have not addressed policy concerns though they must be a part of any decision in this area. There are at least four policy concerns: (1) mission drift as the organization becomes involved in commercial activity; (2) managerial diversion from the purpose and mission;<sup>220</sup> (3) misuse of charitable assets (though more likely than not this would not be intentional); and (4) unfair competition.

## VIII. CONCLUSION

Not everyone will agree on what the tests for gauging commercial activity and social entrepreneurship should be, but one thing is clear; changes must occur. If there is any belief that the nonprofit, tax-exempt sector continues to hold value for society, then this call to action must be heeded. Hybrid organizations, though not essentially bad, are the wrong solution to this “commerciality” problem.

---

<sup>214</sup> Treas. Reg. § 1.501(c)(3)-1.

<sup>215</sup> Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

<sup>216</sup> I.R.C. § 4958 (West 2010).

<sup>217</sup> *Id.*; I.R.C. §§ 4961–4962 (West 1992).

<sup>218</sup> I.R.C. § 501(h).

<sup>219</sup> I.R.C. § 4958.

<sup>220</sup> *See* Colombo, *supra* note 7 (setting forth six potential policy considerations).