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DOING WELL BY DOING GOOD* AND VICE VERSA: SELF-SUSTAINING NGO/NONPROFIT ORGANIZATIONS

*Barbara K. Bucholtz***

“We must cultivate our [own] garden.”

Voltaire***

* TOM LEHRER, *The Old Dope Peddler*, on THE REMAINS OF TOM LEHRER (RCA 2000) (original recording at Kresge Auditorium, MIT, Cambridge MA 11/23/59 and 11/24/59).

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Earlier, and somewhat different, versions of this paper were presented in England at the “Researching the Voluntary Sector” Conference, University of Warwick, August 31, 2005; New York City at the “Conference on Entrepreneurship and Human Rights,” Fordham University Law School, August 1, 2005; Athens, Greece at the International Law Conference, University of Athens, July 15, 2007; and in Canada at the “Quo Vadis: The Boundaries of Modern Law” Conference, at Osgood Hall Law School, York University, May 9, 2008. This final version benefits from the insights and comments of conference colleagues and those of James Fishman and Russell Christopher.

*** The complete sentence, “That is well said; but we must cultivate our garden,” is the last sentence in Voltaire’s *Candide or Optimism*, translated by Peter Constantive, with an introduction by Diane Johnson (Modern Library, 2005). The sentence has traditionally been interpreted as a maxim, commanding not only the protagonists in the book but also individuals in general. See P.N. Furbank, *Cultivating Voltaire’s Garden*, N.Y. REV. BOOKS, Dec. 15, 2005, at 68. It is because Voltaire’s sentence depends for its effect upon an ambiguity—not so much in the word “garden” as in the words “our” and “cultivate.” For “our” is to be understood in the plural—where it refers literally to Candide, Cunegorde, Pangloss, etc., the owners of the garden—and in the singular, where it is addressed metaphorically to any or every man or woman. As a maxim, it instantly takes hold of the reader’s imagination, and there are really no other words in which it can be expressed.

Here, I intend that Voltaire’s injunction apply to nonprofit organizations

“I will do it myself: said the Little Red Hen, and she did!”
The Little Red Hen****

INTRODUCTION

The nonprofit sector is under siege. Recent articles pointing out the astonishing rise of for-profit activity by associations in the nonprofit sector advocate various forms of corrective regulation to restrict or reform the sector.¹ While acknowledging the proliferation and the threat business activity may pose to the integrity of the nonprofit sector, this Article argues that regulation, alone, does not address the underlying problem: a significant impetus for the increase in for-profit activity by nonprofits has been the diminution in government services and resources to deal with societal issues.² Given the current bias against government, a more complete description of the phenomenon must surely include

that feel compelled to raise money through various forms of entrepreneurial activity, given the ideological context in which they operate. But, given the risks commercial activity by nonprofits entails both to the sector itself, and to the society in general, it is also addressed to the public and the sector through which it acts: the government sector.

**** THE LITTLE RED HEN (Penguin Group 2006). The reference here is to the same effect. Nonprofits today often feel constrained to raise money by going beyond traditional sources (donations; grants) for funding their respective missions because the public, through its government sector, has withdrawn its own support.

¹ See John D. Colombo, *Reforming Internal Revenue Code Provisions on Commercial Activity by Charities*, 76 *FORDHAM L. REV.* 667 (2008) [hereinafter Colombo, *Reforming I.R.C. Provisions*]; James J. Fishman, *Wrongway Corrigan and Recent Developments in the Nonprofit Landscape: A Need for New Legal Approaches*, 76 *FORDHAM L. REV.* 567 (2007); see also John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 *WM. & MARY L. REV.* 487 (2002); John D. Colombo, *Regulating Commercial Activity by Exempt Charities: Resurrecting the Commensurate-in-Scope Doctrine*, 39 *EXEMPT ORG. TAX REV.* 341 (2003).

² See, e.g., Fishman, *supra* note 1, at 569 (“As government support declined as a result of the Reagan revolution, there was a convergence of the for-profit and nonprofit sectors. In the latter decades of the twentieth century, nonprofits moved into activities, providing them with sources of revenue that were not normally considered charitable[.]” (citations omitted)).

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a recognition of the role played by ideological policy choices in contemporary American society, with its evident and generalized preference for problem-solving through free market forces. This Article explores some of the consequences of that policy preference for the nonprofit sector, but it also insists that recognition of the causal link between ideological policymaking and the hazards unleashed by the expansion of commercial activity by nonprofits must inform any reform of the law. The reduction in services from the government has increased the pressure on nonprofits to expand their own projects. New projects have required new resources. The emergent entrepreneurial initiatives can largely be explained by that phenomenon. A more pragmatic, less ideological, approach to societal problem-solving will serve as a significant corrective to commercial excesses in the nonprofit sector and may point the way to a systemic overhaul rather than merely restrictive reforms of the sector.

After an overview of the three associational sectors in contemporary society (Part I) and the federal regulatory scheme under which they operate (Part II), the Article describes various forms of commercial activity by nonprofits and the dangers to the sector that ineluctably attach to those activities (Part III). In Part IV, I summarize the available evidence about the cause and effect of nonprofit business ventures and argue that any reform of the nonprofit sector must abandon ideological judgments of the public, nonprofit and market sectors in favor of a pragmatic approach.

I. SOCIETY'S THREE GOVERNANCE SECTORS

A. Attributes of Each Sector

In the United States, society is conceptualized as a tripartite of sectoral divisions: the public (government) sector; the private (business or market) sector and the not-for-profit (nonprofit or NGO) sector.³ Each sector is presumed to have unique strengths

³ I use "NGO" and "nonprofit organizations" as interchangeable labels for voluntary organizations in civil society which are neither governmental bodies nor for-profit business associations, and exist to pursue a mission which is important to their membership and which confer a recognized "public benefit"

and singular weaknesses.⁴ The public sector always has the powers of purse and sword⁵ and, operating as a constitutional democracy, is said to have the advantages of legitimacy, accountability and transparency. However, the very democratic processes that produce its legitimacy and require its accountability and transparency simultaneously detract from its responsiveness, its flexibility and its capacity to address unpopular but important societal problems. Constitutional democracies are (undoubtedly) ponderous, cumbersome and majoritarian as well as (presumably) legitimate, accountable and transparent. Scholars call government's weaknesses "government failure."⁶ Conversely, both

upon society at large. See Margaret Gibelman & Sheldon R. Gelman, *A Loss of Credibility: Patterns of Wrongdoing Among Nongovernmental Organizations*, 15 VOLUNTAS: INT'L J. VOLUNTARY & NONPROFIT ORGS. 355, 357 (2004). However, there is a vigorous debate over labels and definitions about and within the sector because of the precision required for effective research about nonprofits. Conceptual clarification and the necessity of defining categories precisely affect the credibility of empirical findings. See Helmut K. Anheier, *Reflections on the Concept and Measurement of Global Civil Society*, 18 VOLUNTAS: INT'L J. VOLUNTARY & NONPROFIT ORGS. 1 (2007). Under the U.S. Internal Revenue Code ("Code"), the tax that describes and regulates various kinds of nonprofit organizations—those which are deemed to confer a "public benefit"—are designated as "501(c)(3)" organizations (for the Code section defining them), while other nonprofits (including various trade, political, advocacy, social associations) are considered to be "mutual benefit" organizations and are defined at sections 501(c)(4) through 501(c)(25) of the Code. I.R.C. § 501(c) (2006). This paper's focus is 501(c)(3) or public benefit organizations.

⁴ See generally LESTER M. SALAMON, *AMERICA'S NONPROFIT SECTOR: A PRIMER* 11–13 (2d ed., Foundation Center 1999). Salamon points out that the inherent weaknesses of the business sector ("market failure") account for the necessity of a nonprofit sector.

⁵ The power of the purse: to raise money through compulsory taxation. See, e.g., U.S. CONST. art. I, § 8, cl. 1 ("Congress shall have [p]ower [t]o lay and collect [t]axes . . ."). The power of the sword: to enforce its commands through authorized force. Both are surely strengths. See, e.g., U.S. CONST. art. II, § 3 (The President "shall take [c]are that the [l]aws be faithfully executed . . .").

⁶ SALAMON, *supra* note 4. A related problem of government is that not only are its actions directed by majority will, but they are constrained by rules of equality. In contrast, nonprofit organizations in the private sector are free to allocate resources without regard for majority will or equal treatment of

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the business sector and the nonprofit sector lack the powers of purse and sword but have the advantages of expeditious action, flexibility and the authority to operate without majority support from the public-at-large. Nonetheless, they can never claim the legitimacy of a democratic government. Nor, as private organizations, are they required to be transparent and accountable to the larger society. Moreover, the business sector can be distinguished from the nonprofit sector on the crucible of profitability. Businesses famously avoid unprofitable projects that are otherwise important—scholars call this trait “market failure.”⁷ Therefore, nonprofits can be considered the sector of last resort or the safety net for worthy projects rejected by the government (as unpopular) and by the market (as unprofitable).⁸

Understanding these characteristics helps develop an analytical baseline from which to assess each sector’s aptitude for addressing specific societal projects and to predict the degree of success a particular sector is likely to attain by engaging a particular societal task.⁹ In the larger sense, however, the suitability of a sector for a particular task is dependent upon more than its inherent strengths and weaknesses. The political, economic and social milieu in which the societal project is situated must be considered. Different societies may assign various projects to different sectors. Furthermore, within a given society, project assignments may shift over time.¹⁰ Soldiers might be government employees in one war

recipients. Discussing this aspect of private foundation work, Steven Heydemann calls this “positive discrimination.” *See generally* Steven Heydemann, *Doing Democracy’s Work? Studying The Transformation of Global Philanthropy in the Twentieth Century*, 2 DEMOCRACY & SOCIETY 5 (Spring 2005).

⁷ SALAMON, *supra* note 4, at 7.

⁸ *See generally* Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54 (1981).

⁹ A suggestive example might be the problems associated with the use of mercenary forces under the direction of private corporations. *See, e.g.*, JEREMY SCAHILL, *BLACKWATER: THE RISE OF THE WORLD’S MOST POWERFUL MERCENARY ARMY* (Nation Books 2008). Do the profit motive and the lack of accountability, transparency and legitimacy lend themselves to a satisfactory result in this context?

¹⁰ *See generally* Peter Dobkin Hall, *Historical Overview of the Private*

and mercenaries in the next. Jails might be government-owned in one era and privately-owned in the next, and so forth.¹¹ In any event, while the inherent attributes of each sector do not preordain its assignment to a particular societal problem, policy choices that lack a pragmatic appreciation for the importance of these characteristics seem questionable.¹² On that basis alone, one may reasonably challenge the efficacy of policy choices driven by a dominant political philosophy that disparages the government sector and reifies the business sector.¹³

Nonprofit Sector, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK (Walter W. Powell ed., 1987); see also Gibelman & Gelman, *supra* note 3, at 357. A recent example has emerged in California where private firefighting companies have become big business. Other states evince a rise in private companies' presence in the industry as well, but California's situation—owing to its recent problems with wildfires—is the most publicized example. Interestingly, this trend toward private contracting in the firefighting industry recalls colonial times when firefighting was exclusively the purview of the private sector. Experts are concerned about the trend for the very reasons that firefighting became a public sector obligation and private firefighting was abandoned: lack of transparency and accountability in training and performance standards in private sector firefighting and a concern about the public interest and common good. “[F]ire protection should be available to all citizens regardless of how much money they have.” Malia Wollan, *For Hire: Private Firefighters*, TULSA WORLD, July 16, 2008, at A5 (quoting Lori Moore-Merrell, a researcher for the International Association of Firefighters).

¹¹ An interesting instance was New York University's dominance in the pasta manufacturing business during the 1940s and 1950s. See, e.g., *C.F. Mueller Co. v. Comm'r*, 190 F.2d 120 (3d Cir. 1951). There, the court held that C.F. Mueller, a manufacturer and seller of macaroni and related products, qualified for exemption under § 501(c)(3) because its profits were distributed to its sole shareholder, New York University, for the exclusive benefit of its School of Law. *Id.* at 123.

¹² Imagine a statute mandating that prisons maintain high standards protecting inmate rights and that they institute practices designed to diminish recidivism. Imagine further that traditional prisons with practices designed simply to warehouse prisoners in order to protect the public from them are highly profitable. Finally, imagine that on economies of scale, the larger the prison population, the more profitable the prison. Pragmatically speaking, would the government sector or private businesses be more likely to implement the statute effectively?

¹³ In an earlier article, I argued that U.S. efforts to privatize human rights initiatives are fundamentally flawed. The attempt to develop quasi-constitutional

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As a consequence of America's current suspicions of the public sector, the United States has undergone a massive "downsizing" of government services either by way of "out-sourcing" its traditional functions to business and nonprofit organizations, or by "privatizing" services simply by failing to provide them. Government downsizing has placed a significant burden on the nonprofit sector: NGOs are now asked to provide many outsourced services under government contract and to fill the societal void left by unprofitable services the government has abandoned.¹⁴ In tandem, these two dimensions of government downsizing have stretched the financial resources of nonprofits—flowing from their traditional sources of donations and grants—to the limit.

In response, nonprofit organizations have increasingly turned to for-profit business activity as a venue for supporting their respective missions. And while nonprofits have historically engaged in for-profit activities to raise money, these new commercial initiatives in this new era of government downsizing are often different in degree and kind. This new path from traditional sources of financial support to some measure of commercially generated financial independence is as fraught with

human rights norms through voluntary codes of conduct which have been developed exclusively by multi-national corporations and their trade groups appears to be an ineffective substitute for government-generated rules. As a practical matter, voluntary codes suffer from two major shortcomings: disclosure (or transparency) and compliance (or enforcement). Quite obviously, no one expects rigorous adherence to rules when disclosure and compliance are merely voluntary. Moreover, and putting the problem of their enforceability to one side, it is questionable whether codes drafted by various business entities can ever lay claim to the gravitas of constitutional legitimacy. Barbara K. Bucholtz, *Privatizing Human Rights Initiatives: How Asian Countries Can Avoid the Flaws in the U.S. Model*, 17 J. ASIAN ECON. 41 (2006). See also SALAMON, *supra* note 4, at 7–10.

¹⁴ Gibelman & Gelman, *supra* note 3, at 357. The authors point out that the downsizing phenomenon has affected NGOs worldwide: "The growth and development of NGOs in the last quarter of the 20th century related, in part, to the worldwide quest to find alternatives to government service provision, a quest largely borne out of disillusionment with government's handling of the welfare state." *Id.* (internal citations and references omitted).

peril as it is with promise. Teasing out both aspects of the phenomenon adds to our understanding as to whether, or to what extent, this commercial turn in nonprofit activity is beneficial. However, both the pragmatic dimensions of commercialization and the effects of statutory constraints should be considered.

II. STATUTORY CONSTRAINTS ON THE NONPROFIT SECTOR

A. Overview of Exempt Organization Regulation under the Internal Revenue Code

As described by the Internal Revenue Code, the nonprofit universe is large and diverse, encompassing some twenty-eight categories of not-for-profit associations.¹⁵ That universe is divided into two fundamentally different kinds of association: those that are organized for some “public benefit” and those that are organized for some “mutual benefit”¹⁶ or shared interest of their members.¹⁷ The public benefit associations are also divided by the Code into two categories: (1) private grant making and operating foundations¹⁸ and (2) public operating charities. While all 501(c) organizations enjoy income tax exemption, § 501(c)(3) operating charities and most § 509 private foundations also benefit from a tax deduction for their donors.¹⁹

This Article is concerned exclusively with § 501(c)(3) operating charities. It is within this category that commercial activity is burgeoning and it is this activity which most concerns recent scholarship calling for reform.²⁰ One place to begin a

¹⁵ See generally I.R.C. § 501(c) (2006).

¹⁶ “Mutual benefit” organizations include shared trade, political and social interests. See *id.* § 501(c)(4)–(28); see also *id.* §§ 501(d), 501(e), 501(f), 501(k) & 521.

¹⁷ See I.R.C. § 509 (2006).

¹⁸ See *id.* §§ 170(c)(2), 2055(a)(2) & 2522(a)(2).

¹⁹ Fishman, *supra* note 1, at 569–71.

²⁰ See, e.g., *Trinidad v. Sagrada Order de Predicadores*, 263 U.S. 578, 582 (1924). Tax breaks for charities are, thus, often rationalized as a “quid pro quo.” NONPROFIT ORGANIZATIONS 328 (James J. Fishman & Stephen Schwarz eds., Foundation Press, 3d ed. 2006).

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discussion of the statutory constraints on these charitable organizations is with the legislative purpose or policy behind the statutory sections that confer the tax benefits they enjoy under the Internal Revenue Code. Not always an exemplar of legislative clarity, the tax code itself gives no indication of the legislators' intent, nor does the congressional bill from which the Code sections derive.²¹ Undoubtedly, the tax breaks enjoyed by charities are part of a philanthropical tradition with its roots in Western history and, surely, they are derived from the Elizabethan era's Statute of Charitable Uses in England.²² But the tax exempt status of nonprofits has, perhaps, been rationalized best by Supreme Court case law which has explained that exempt charities provide a "public benefit" by conferring resources and services which the government (and, therefore, taxpayers) would otherwise have to finance.²³ In that sense, it can be said that a charity's activities contribute to the tax base by providing goods and services that taxes would be obliged to finance. As a preliminary legal matter, then, any charitable entity claiming § 501(c)(3) status but engaging in commercial activity must demonstrate that it is providing a public benefit.²⁴

The concept of "public benefit," in turn, can best be described by the categories of "charitable purposes" codified in the Statute of Charitable Uses, and listed in the Restatements (Second) and (Third) of Trusts;²⁵ under the 2006 draft of the American Law Institute (ALI) Principles of the Law of Nonprofit Organizations;²⁶ and in the Treasury Regulations promulgated under § 501(c)(3) of

²¹ RESTATEMENT (SECOND) OF TRUSTS § 368 cmt. a (1959); RESTATEMENT (THIRD) OF TRUSTS § 28 cmt. a (2003).

²² PRINCIPLES OF THE LAW OF NONPROFIT ORGS. § 370 (Discussion Draft 2006).

²³ Treas. Reg. § 1.501(c)(3)-1 (2006); *Bob Jones Univ. v. United States*, 461 U.S. 574, 591 (1983) (stating that "charitable exemptions are justified on the basis that the exempt entity confers a public benefit . . . which the society or the community may not itself choose or be able to provide").

²⁴ *See, e.g.*, Treas. Reg § 1.501(c)(3)-1 (2006).

²⁵ RESTATEMENT (SECOND) OF TRUSTS § 368 cmt. a (1959); RESTATEMENT (THIRD) OF TRUSTS § 28 cmt. a (2003).

²⁶ PRINCIPLES OF THE LAW OF NONPROFIT ORGS. § 370 (Discussion Draft 2006).

the tax code.²⁷ As Marion R. Fremont-Smith has explained, all of these authorities identify similar categories of charitable purposes and share the same broad view of their interpretation.²⁸ These categories are: “relief of poverty, advancement of knowledge or education, advancement of religion, promotion of health and governmental or municipal purposes and ‘[o]ther purposes . . . which are beneficial to the community.’”²⁹

In addition to the overarching requirement of a public benefit mission and the necessity of fitting within a recognized charitable category, a § 501(c)(3) charity must observe the following requirements:

1. The Exclusivity Test: it must be operated “exclusively” for its charitable purpose mission.³⁰
2. The Nondistribution Constraint or the No Private Inurement Rule: its net income may not “inure to the benefit” of an insider (member; employee) within the organization.³¹

²⁷ Treas. Reg. § 1.501(c)(3)-1 (2006).

²⁸ Marion R. Fremont-Smith, *The Search for Greater Accountability of Nonprofit Organizations: Recent Legal Developments and Proposals for Changes*, 76 FORDHAM L. REV. 609, 616–17 (2008).

²⁹ *Id.* at 617. Section 501(c)(3) provides that organizations receive the tax exemption for public charities if they are:

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 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 . . . the political campaign of any candidate for public office.

I.R.C. § 501(c)(3) (2006).

³⁰ I.R.C. § 501(c)(3). The term “exclusively,” however, is a term of art that is not applied literally or narrowly. *See* Treas. Regs. §§ 1.501(c)(3)-1(d)(1), (2) (as amended in 2008).

³¹ Treas. Regs. §§ 1.501(c)(3)-1(d)(1), (2) (as amended in 2008). Unlike

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3. Lobbying and Campaigning Prohibitions: while a charity is absolutely precluded from campaigning for a political candidate, it is permitted to engage in limited lobbying efforts as long as “no substantial part” of its operations is engaged in attempting to influence legislation.³²

Business activity can threaten the exempt status of a charity under the legislative constraints of the exclusivity test and the non-distribution rule as well as other statutory rules governing nonprofit associations.

B. Federal Tax Code Restraints That Affect Commercial Activity by Nonprofits

1. The Exclusivity Test

For purposes of constraining commercial activity, the exclusivity test is obviously most relevant.³³ To what extent or at what point might a nonprofit’s business cause it to fail the exclusivity requirement? Case law and agency regulation have not imposed a strict standard of exclusivity on nonprofit operations.³⁴ Some deviation from activities that are “exclusively” mission-related has been consistently permitted. Furthermore, early case law interpreting § 501(c)(3) established a longstanding precedent

for-profit corporations, insiders in nonprofit organizations cannot “profit” from income generated by charities. Although charities may very well be profitable, that profit, after expenses of running the charity have been paid, must inure to the benefit of the charitable mission, not the charity’s members or employees. In order to save the exempt status of otherwise qualified charities who may run afoul of this private benefit rule by providing excess benefits to insiders, Congress has provided intermediate sanctions or penalties in lieu of revocation of the organization’s nonprofit status, which remains the ultimate sanction for violation of the no private inurement rule. *See* I.R.C. § 4958 (2006); I.R.C. § 6033(b)(12) (2006).

³² Treas. Reg. § 1.501(c)(3)-1(c)(3) (as amended in 2008). Charities can protect themselves from the vagaries of the “no substantial part” language by electing 501(h) formulas for determining permissible levels of lobbying activity or by channeling lobbying efforts through a 501(c)(4) affiliate. *Id.*

³³ *See* I.R.C. § 501(c)(3) (2006).

³⁴ *See* Treas. Reg. § 1.501(c)(3)-1(c)(3) (as amended in 2008).

that some commercial activity, extraneous to the charitable mission, was permitted without violating the exclusivity test.³⁵ Indeed, for decades following the *Trinidad* decision, any amount of commercial activity was permitted under the exclusivity test as long as the net proceeds of the business were dedicated to the charitable mission.³⁶ This was called the “destination of income” test; its zenith, now celebrated in law school lore, is the *C.F. Mueller* case,³⁷ which exonerated a successful pasta business operated exclusively for profit because its net profits supported the New York University law school.³⁸ Whether the safe harbor for commercial activity provided by the “destination of income” rule has been completely eliminated by subsequent legislation and regulation is still somewhat unclear.

2. *The Unrelated Business Income Tax*

The Unrelated Business Income Tax (“UBIT”), as well as the Treasury regulation promulgated under it, is the second major legislative constraint upon business activity by nonprofit associations.³⁹ Facially, UBIT appears not to foreclose nonprofit status for charities that engage in commercial projects. Rather, it imposes a tax on a nonprofit’s business income generated through activities not related to its charitable mission. Congress did, however, expressly foreclose nonprofit status for organizations that are exclusively for-profit but dedicate net proceeds to affiliated charities (“feeder organizations”).⁴⁰ Thus, with the exception of

³⁵ See *Trinidad v. Sagrada Order de Predicadores*, 263 U.S. 578, 582 (1924) (holding that sales of specialty foodstuffs by a religious organization, even though commercial and not the organization’s charitable mission, did not cause it to fail the exclusivity test).

³⁶ Colombo, *Commercial Activity and Charitable Tax Exemption*, *supra* note 1, at 497–98.

³⁷ *C.F. Mueller Co. v. Comm’r*, 190 F.2d 120 (3d Cir. 1951).

³⁸ *Id.*

³⁹ I.R.C. §§ 511–514 (2006). Section 513 provides that any “trade or business” which is regularly carried on by a nonprofit and “not substantially related” to its charitable mission will be taxed as ordinary business income. *Id.* § 513.

⁴⁰ *Id.* § 502.

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feeder organizations, one could argue that UBIT only taxes charities for business activity unrelated to their mission. It does not appear to jeopardize their exempt status under § 501(c)(3). But a closer look at the Treasury regulations and Revenue Rulings of the Internal Revenue Service (“Service”) call that conclusion into question. Specifically, it is possible to detect an ambiguity, if not a contradiction, between the language of different regulations. Treasury Regulation § 1.501(c)(3)-1(b)(1)(i), dealing with tax exempt status, says that to attain or maintain its exempt status, a nonprofit’s charter may permit only an insubstantial part of its operations to consist of “activities which in themselves are not in furtherance of one or more exempt purposes.”⁴¹

Is business activity to support its exempt purpose considered an “in furtherance of” activity? Experts have concluded that only substantial unrelated business activity not “in furtherance of” an exempt purpose would disqualify a nonprofit from exempt status.⁴² Thus, business activity that supports the charity but is not substantial will not threaten the charity’s mission. Is this interpretation of the exemption rules consistent with UBIT regulations? Are the terms “in furtherance of” under § 501(c)(3) regulations and “unrelated activity” under UBIT consonant? Ambiguity lurks in key terms: is any “unrelated activity” under UBIT “in furtherance of” a charitable mission or not?⁴³ The final

⁴¹ Treas. Reg. § 1.501(c)(3)-1(b)(1)(i)(b) (2006).

⁴² A nonprofit engaged in business activity may be exempt in spite of the fact that

it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization’s exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513.

Id. § 1.501(c)(3)-1(e)(1). Professor Colombo concludes the pivotal provision is “in furtherance of” and seems to give that kind of commerce an imprimatur. But as he incisively points out, it is not clear whether UBIT activity is “in furtherance of.” Colombo, *Reforming I.R.C. Provisions*, *supra* note 1, at 671 (citing Jessica Pena & Alexander L.T. Reid, *A Call for Reform of the Operational Test for Unrelated Commercial Activity in Charities*, 76 N.Y.U. L. REV. 1855, 1863–64 (2001)).

⁴³ Colombo, *Reforming I.R.C. Provisions*, *supra* note 1, at 671.

regulations issued under UBIT suggest that they are not: to avoid the UBIT tax, an activity like a commercial venture must be “substantially related” to the exempt purpose, requiring that the venture intend “to further (other than through the production of income)” the exempt purpose.⁴⁴ The “other than through the production of income” language of UBIT is in conflict with the “in furtherance of” language of the regulation on exemption at Treasury Regulation § 1.501(c)(3)-1(e).⁴⁵

One way to synthesize the language is to read the two provisions as serving two different legislative purposes. Then “substantially related” and “to further” (or “in furtherance of”) can mean something quite different when you are speaking about the § 501(c)(3) exemption or about UBIT taxation. In citing a 1964 revenue ruling, Professor John Colombo argues that the regulations should be, and have been, harmonized by interpreting UBIT regulations to preclude income generation as passing an “in furtherance of” test while income generation in furtherance of § 501(c)(3) exemption is permissible.⁴⁶ Some commentators have argued that this same 1964 revenue ruling gives guidance to nonprofits that seek to ensure their for-profit activity passes regulatory muster by creating a “commensurate in scope test.”⁴⁷ That test, upon which the ruling was based, simply says that even where a nonprofit relies solely on business-generated income, it will not lose its exempt status as long as its charitable operations are “commensurate in scope” with the amount of financial resources dedicated to its charitable mission.⁴⁸ Further assurance may be found in a memorandum from IRS General Counsel upon which the 1964 revenue ruling itself relied. It stated that the

⁴⁴ Treas. Reg. § 1.513-2(a)(4) (2006).

⁴⁵ See Colombo, *Reforming I.R.C. Provisions*, *supra* note 1, at 671–72.

⁴⁶ *Id.* at 672–73 (citing Rev. Rul. 64-182, 1964-1 C.B. 186, for the proposition that rental income as a principal source of revenue for a nonprofit would not cause it to lose its exempt status but would be taxable as unrelated to its charitable mission).

⁴⁷ See Thomas Kelley, *Rediscovering Vulgar Charity: A Historical Analysis of America's Tangled Nonprofit Law*, 73 *FORDHAM L. REV.* 2437, 2486 (2005).

⁴⁸ *NONPROFIT ORGANIZATIONS*, *supra* note 20, at 598.

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“primary purpose” test, which elaborates and liberalizes the “exclusivity” requirement of § 501(c)(3), looks to “the dedication of net revenues from an unrelated business to charitable purposes”⁴⁹ By logical contrast, only where business income is not significantly dedicated to the charity’s mission will the charity fail the exclusivity test and lose (or never receive) its exempt status.⁵⁰

Despite these reassuring interpretations, however, indeterminacies and ambiguities in pivotal statutory language construed under an “all the facts and circumstances” test⁵¹ counsel caution for charities engaged in commercial activity. Business activity by a charity may not only be taxed under UBIT, it may threaten a charity’s exempt status. Given those risks, a charity may (as many have done) separate itself from its business activity by creating a for-profit subsidiary to house its business operations.⁵² But that strategy may prove an illusory safe harbor.

3. *Section 509 Foundations*

Other Code sections reveal different hazards for this kind of entrepreneurial activity by a wholly owned subsidiary of a charity. It is possible that a nonprofit that sustains itself with an unrelated business may find itself recategorized as a more heavily regulated private foundation rather than as a public charity.⁵³ The problem might arise whenever a charity is primarily supported by a

⁴⁹ Colombo, *Reforming I.R.C. Provisions*, *supra* note 1, at 673.

⁵⁰ Professor Colombo quotes a more recent General Counsel Memorandum to that effect. *Id.* at 674 n.30.

⁵¹ NONPROFIT ORGANIZATIONS, *supra* note 20, at 597–98 (“[T]he primary purpose test looks to ‘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.’”(quoting Treas. Reg. § 1.50(c)(3)-1(e) (2006)).

⁵² *See infra* Part III.D.

⁵³ Private foundations are § 501(c)(3) nonprofit organizations but they are not public charities. *See* I.R.C. § 509(a) (defining a private foundation in contrast to public charities). Operating charities are § 501(c)(3) public charities. *Id.* § 501(c)(3).

financially successful business subsidiary owned by the charity.⁵⁴ As the parent corporation,⁵⁵ the charity could receive enough financial support through subsidiary dividends so that it does not have to rely on any support from outside sources, in the form of donations and government or private grants. Members of the parent organization govern the organization without including outside directors⁵⁶ on the subsidiary's or its own governing board of directors. In that situation, the organization would strongly resemble a private foundation with respect to the attributes for which Congress determined that foundations required special regulation.⁵⁷ From the legislative perspective, private foundations may be distinguished from operating (public) charities by their funding source (a family or an individual, as opposed to a disparate group of donors from the public-at-large) and by their governing body (a policy-making board that directs the activities of the organization whose directors are drawn from the family or a small insular group, as opposed to a governance board drawn from diverse members of the community).

Another distinguishing feature of foundations is that they are usually grant-making institutions that give financial support to operating charities rather than perform charitable services themselves.⁵⁸ For decades, private foundations were treated like operating charities under the federal tax code. But during the 1950s

⁵⁴ For a discussion of this kind of self-sustaining nonprofit, see *infra* Part III.D.

⁵⁵ "Parent corporation" is a term of art in corporate governance law that usually indicates that one corporation (the "parent") owns another corporation (the "subsidiary") because it owns all the shares of stock of the subsidiary ("sole shareholder"). See generally WILLIAM T. ALLEN, REINIER H. KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 306–11 (2d ed. 2007).

⁵⁶ "Outside directors" in corporate governance law parlance means directors who are not members or employees—that is, "insiders"—in the organization. *Id.* at 322–23.

⁵⁷ See generally the Tax Reform Act of 1969, *infra* note 60 and accompanying text.

⁵⁸ NONPROFIT ORGANIZATIONS, *supra* note 20, at 753–54 (quoting F. EMERSON ANDREWS, PHILANTHROPY IN THE UNITED STATES 43 (Philanthropic Foundations 1974)).

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and 1960s, Congress began to take legislative steps to distinguish these two kinds of § 501(c)(3) organizations by ratcheting up the regulatory structures applied to private foundations.⁵⁹ That movement culminated in the Tax Reform Act of 1969.⁶⁰ Public outcry that led to this new regulatory regime for private foundations included concerns about financial corruption (using tax breaks to benefit insiders rather than exempt purposes) and political influences (using foundation money to support leftist causes).⁶¹ But the overarching concern seems to have been the insularity of the private foundation: its privileged ability to sustain itself and its selected causes coupled with its undiluted authority to champion its own notions of what causes were in the public interest.⁶²

Succinctly, one might ask: If charities must perform a public benefit, who gets to say which causes within a charitable category most benefit the public and should be supported by a foundation? Public charities that rely on financial support from the public must, to a great extent, rely on a consensus notion of public benefit to maintain the public's financial support. Foundations, however, are self-sustaining and thus do not solicit public monies. As a consequence, they are not dependent upon public support to advance the causes they select. The same can be said for self-sustaining operating charities financed by sufficiently profitable business subsidiaries. Both avoid public accountability. By analogy, self-sustaining charities might be considered "operating foundations" if not "grantmaking foundations."⁶³ Both are more heavily regulated than operating public charities.⁶⁴ Thus, a charity

⁵⁹ *Id.* at 592–99 (quoting WALDEMAR A. NIELSON, *The Big Foundations: The Twentieth Century Fund Study* 7–17 (Columbia University Press 1972)).

⁶⁰ Tax Reform Act of 1969, Pub. L. No. 91-172, § 1(a), 83 Stat. 487 (1969) (codified as amended at I.R.C. § 1).

⁶¹ See NONPROFIT ORGANIZATIONS, *supra* note 20, at 827–29.

⁶² *Id.* at 761.

⁶³ Tanya D. Marsh, *A Dubious Distinction: Rethinking Tax Treatment of Private Foundations and Public Charities*, 22 VA. TAX REV. 137, 141 (2002)

⁶⁴ The distinction between "operating foundations" and private foundations is that operating foundations operate organizations that perform charitable or

supported by its for-profit subsidiary is open to a judicial challenge as to whether the corporate veil, which sets up a protective wall of separation between it and its subsidiary, should be pierced.

Under most state corporate governance statutes, the owner (individual shareholder or corporate parent) of a for-profit subsidiary will be protected by a shield of limited liability for the debts of the corporation she/it owns.⁶⁵ Delaware, for example, provides that owners/shareholders “shall not be personally liable for the payment of the corporation’s debts except as they may be liable by reason of their own conduct or acts”⁶⁶ But the shield itself has been limited by an equitable doctrine of the common law known as “piercing the corporate veil.”⁶⁷ The doctrine permits courts to disregard the separate corporate existence that shields the owners from the debts of their corporation under a two-pronged test.⁶⁸

The first prong asks whether the formalities required by corporate governance statutes have been observed so that the business appears to be operating as a legal entity separate from its owners, or whether it appears to be a “mere instrumentality” of its owners because there is “such unity of interest and ownership that the separate personalities of the corporation and its shareholders . . . are indistinct”⁶⁹ The second prong asks whether the corporate form is being used to evade other “legal obligations.”⁷⁰ To be sure, the “piercing” doctrine has been applied

public benefit services. Museums are an example; their mission is to advance public understanding and appreciation of art by exhibiting art collections. But, because they are typically supported and dominated by a small and insular group, they retain the status of foundations, not charities. *See* NONPROFIT ORGANIZATIONS, *supra* note 20, at 827–29.

⁶⁵ *See, e.g.*, DEL. CODE ANN. tit. 8, § 102 (2006); KAN. STAT. ANN. § 17-6002 (2006); OKLA. STAT. tit. 18, § 1006 (2006).

⁶⁶ DEL. CODE ANN. tit. 8, § 102(b)(6) (2006); *accord* MODEL BUS. CORP. ACT § 6.22(b) (2004).

⁶⁷ *See, e.g.*, NLRB v. Greater Kansas Roofing, 2 F.3d 1047, 1051–55 (10th Cir. 1993) (providing discussion on the doctrine); Mobridge Cmty. Ind. v. Toure, 273 N.W.2d 128, 132 (S.D. 1978) (same).

⁶⁸ *Greater Kansas Roofing*, 2 F.3d at 1052.

⁶⁹ *Id.*; *see also* *Mobridge*, 273 N.W.2d at 132.

⁷⁰ *Greater Kansas Roofing*, 2 F.3d at 1052 (“[W]ould adherence to [the

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sparingly as an instrument to protect creditors.⁷¹ Furthermore, there are strong public policy reasons for maintaining the legal fiction of a shield.⁷² Nonetheless, there is nothing to preclude application of this intractably vague doctrine⁷³ where, as here, the separate corporate entities are, arguably, being used to evade either income taxation under UBIT, termination of exempt status under § 501(c)(3) regulations, or the stringent regulations applicable to

legal] corporate fiction sanction fraud, promote injustice or inequitable consequences or lead to an evasion of legal obligations.”).

⁷¹ See *Dole Food Co. v. Patrickson*, 538 U.S. 468, 475 (2003) (“The doctrine of piercing the corporate veil, however, is the rare exception, applied in the case of fraud or certain other exceptional circumstances . . . and usually determined on a case-by-case basis.”).

⁷² “Piercing the corporate veil” to hold shareholders liable for the liabilities of a corporation is indeed a rare judicial act. See generally ALLEN, KRAAKMAN & SUBRAMANIAN, *supra* note 55, at 151.

The most frequently invoked—and radical—form of shareholder liability in the cause of creditor protection is the equitable power of the court to set aside the entity status of the corporation and hold its shareholders liable directly One common formulation [of the doctrine] requires that plaintiff shows the existence of a shareholder who completely dominates corporate policy and uses her control to commit . . . a “wrong” Another formulation . . . calls on courts to disregard the corporate form whenever recognition of it would extend the principle of incorporation “beyond its legitimate purposes and [would] produce injustices or inequitable consequences.” [citation omitted]. All courts agree that veil piercing should be done sparingly

Id. See also Colombo, *Reforming I.R.C. Provisions*, *supra* note 1, at 674 n.57 and accompanying text.

⁷³ In his case book, Chiappinelli calls the doctrine “a mystery.” ERIC A. CHIAPPINELLI, *CASES AND MATERIALS ON BUSINESS ENTITIES* 276 (Aspen 2006). He comments,

[i]t is one of the most frequently litigated issues in corporate law but, although the doctrine is quite old, courts are vague and inconsistent in their statement of the legal principles involved. When courts apply the doctrine, their opinions are nearly always simply gestalt results rather than genuinely articulated decisions [In *Berkey v. Third Ave. Ry. Co.*, 155 N.E. 58, 61 (N.Y. 1926),] Judge Cardozo called piercing the corporate veil a doctrine “enveloped in the mists of metaphor.”

Id.

foundations. Charities that sustain their operations financially through the business ventures of for-profit subsidiaries are vulnerable to the charge that they are, in tandem with their for-profit subsidiaries, operating as private foundations.

A court might reason that the purposes for which shareholders are granted limited liability under corporate governance laws—to protect a parent shareholder from liability for the debts of its subsidiary—should not be used to evade laws designed to act as surrogates for public participation in the decision-making of foundations, to force public accountability or to ensure public benefits.⁷⁴ On those grounds, a court might pierce the corporate veil between the charitable parent and the commercial subsidiary that finances its operations under a theory of “enterprise entity.”⁷⁵ The analogy seems to work; enterprise entity theory allows parent-subsidiary or brother-sister corporations to be treated as single entities whenever the operations of each form a single business enterprise. A charity and its own business subsidiary that sustains it might also be considered a single enterprise.⁷⁶ As a single enterprise, a public charity of this sort could be deemed either a private foundation or an operating foundation, depending on whether its charitable operations are grant-making (like a private foundation) or charitable activities (like a public operating charity). Like the charity that engages in commerce itself, the charity that seeks to separate its business activity through a subsidiary corporation risks exposure to the constraints of the Internal Revenue Code’s provisions regulating nonprofits.

4. *The Non-Distribution Constraint*

Finally, while the exclusivity test under § 501(c)(3) is a most obvious hazard for nonprofits supported by commercial activity, the Code’s private inurement prohibition might also pose a threat

⁷⁴ For a discussion on the evolution of private foundation regulation, see NONPROFIT ORGANIZATIONS, *supra* note 20, at 760–62.

⁷⁵ For a discussion of enterprise entity theory (enterprise liability), see CHIAPPINELLI, *supra* note 73, at 284–85.

⁷⁶ *Id.* at 284–85.

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to a charity's nonprofit state if it engages in business activity.⁷⁷ Private inurement is the *sine qua non* of for-profit activity; the purpose of commercial enterprise is to generate a return on the owner's investment—net profit in the form of dividends in a corporate form of doing business, along with an appreciating value of the enterprise owned. As noted before, though, § 501(c)(3) prohibits profit generated by a nonprofit to be paid over to “insiders” within the association. Thus, as public charities ally themselves with commercial enterprise they must be wary of the “no private inurement” prohibition, especially with regard to compensation paid to employees and other insiders.⁷⁸

Without question, commercial activity can be a crucial financial resource for nonprofits that are faced with important societal problems that are not being addressed by the two other sectors, but lack sufficient income from traditional sources to meet the challenge. At the same time, putting aside a pragmatic consideration of which of the three sectors is best suited to manage a particular societal problem, hazards lurk in the federal tax code for nonprofits engaged in business activity. Moreover, and in addition to the statutory hazards discussed above, commercial activity may jeopardize the status of nonprofits in other respects. A review of the various kinds of nonprofit/entrepreneurial activity that we observe today and the risks business activity poses, both within and beyond the Internal Revenue Code, will illustrate the point.

III. CATEGORIES OF COMMERCIAL ACTIVITY BY NONPROFITS: THEIR CHARACTERISTICS, ADVANTAGES, AND DOWNSIDE RISKS

Scholars and journalists have reported extensively on the significant increase in commercial activity by nonprofit associations.⁷⁹ As these texts demonstrate, there are several ways

⁷⁷ See Treas. Reg. § 1.501(c)(3)-1 (2006).

⁷⁸ I.R.C. § 501(c)(3) (2006).

⁷⁹ See, e.g., *TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NON-PROFIT SECTOR* (Burton A. Weisbrod ed., Cambridge University Press 2000); *NONPROFITS & BUSINESS: A NEW WORLD OF INNOVATION AND ADAPTATION* (Joseph J. Cordes & C. Eugene Steuerle eds.,

to categorize and analyze the various kinds of nonprofit/business activity.⁸⁰ This Article employs a template based upon the way nonprofits treat their business activity and it identifies five types of structures nonprofits use for their businesses.

A. Type 1

A nonprofit may confine its for-profit activity to business activity that is integral to its mission—for example, selling tickets to opera productions sponsored by a nonprofit opera group, or charging tuition and fees to students enrolled in a nonprofit college or university.⁸¹ Similarly, a nonprofit may conduct for-profit business activity that the IRS would consider so closely-related to the charitable mission that it is not “unrelated” to its mission and, therefore, will escape UBIT—for example, an art appreciation organization formed to educate the public about art by selling artwork at its gallery.⁸²

These kinds of commercial activities are not likely to run afoul of the federal tax code, as long as a related purpose is identified within one of the charitable categories mentioned in Part II.⁸³ But perhaps it should not be enough for a nonprofit to claim merely a patent affinity with a charitable mission. Professor Colombo advances this argument. An example that he gives to illustrate the point is that of a nonprofit hospital—facially a public charity and traditionally considered to be so because it appears, unquestionably, to fit into the charitable categories as it is related

The Urban Institute 2008); Colombo, *Reforming I.R.C. Provisions*, *supra* note 1, at 667–68 (identifying several media reports and scholarly texts analyzing the phenomenon); Fishman, *supra* note 1, at 571–72.

⁸⁰ See, e.g., Colombo, *Reforming I.R.C. Provisions*, *supra* note 1, at 683 (separating the spectrum into five categories).

⁸¹ See, e.g., *Goldsboro Art League v. Comm’r*, 75 T.C. 337, 346 (1980). While the express rationale for the ruling in *Goldsboro* was premised on the exclusivity test, the court also stated that art sales assisted the Art League’s charitable mission of art education. *Id.* at 343–44. In that sense, it can be said that sales of artwork, while commercial in nature, were not unrelated to the League’s exempt purpose.

⁸² *Id.*

⁸³ See *supra* Part II.

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to serving the advancement of health.⁸⁴ But if, as is often the case in today's economy, nonprofit hospitals operate in a way that is "virtually identical to for-profit hospitals in similar markets,"⁸⁵ Colombo observes that the commercial activity of selling their health care services for a fee appears not to qualify as an activity substantially related to a charitable purpose. Furthermore, its mission should have difficulty surviving an "exclusivity" analysis; in Internal Revenue Service parlance, it should not be considered to have passed the "operational test."⁸⁶ The reason that nonprofits operating like for-profit hospitals escape operational test analysis has largely to do with a slippage or liberalization in the regulatory standards the Service has applied to hospitals over time.⁸⁷

⁸⁴ Colombo, *Reforming I.R.C. Provisions*, *supra* note 1, at 683–84; *see also* John D. Colombo, *The Failure of Community Benefit*, 15 HEALTH MATRIX 29, 30–37 (2005).

⁸⁵ Colombo, *Reforming I.R.C. Provisions*, *supra* note 1, at 683–84.

⁸⁶ *See* NONPROFIT ORGANIZATIONS, *supra* note 20, at 351–52; Colombo, *Reforming I.R.C. Provisions*, *supra* note 1, at 597.

⁸⁷ As Fishman and Schwarz explain:

When § 501(c)(3) was first enacted, most nonprofit hospitals operated like traditional charities by treating indigent patients and relying on volunteer labor. The Service's first articulation of a standard for hospital tax exemptions was consistent with this traditional concept of charitable. In a 1956 ruling, the Service relied on "relief of poverty" as the underlying rationale for exemption and required a tax-exempt hospital to treat indigent patients without regard to their ability to pay. Rev. Ruling 56-185, 1956-1 C.B. 202 [In 1969,] the Service discarded the charity care requirement, replacing it with a community benefit standard that mirrored the "charitable" concept articulated in the 1969 Treasury Regulations.

NONPROFIT ORGANIZATIONS, *supra* note 20, at 384. The 1969 ruling, Rev. Ruling 69-545, stated that the revised standard, "community benefit"—which relied on the traditional charitable categories of education and promotion of health but diminished the importance of relief—retained a vestige of the poverty relief standard. It required nonprofit hospitals to provide emergency room services. However, boutique hospitals (hospitals specializing in a certain kind of healthcare: plastic surgery, cancer treatment, etc.) were an exemption from the emergency room care requirement as long as they passed other tests that assured the Service they were, somehow, providing a community benefit. As matters now stand, the Service—in the face of the onslaught of HMOs in the 1990s—has modified its liberalized standard regarding health care facilities but has

Nevertheless, society derives no benefit from conferring nonprofit status on for-profit commerce simply because it can make a facial claim to be a charity. The pragmatic scrutiny Colombo advocates makes good public policy sense.

Hospitals, though, are not the only entities claiming nonprofit status that deserve closer scrutiny. In a larger context, all fee-for-service nonprofits and those in which business activities are closely related to a facially charitable mission should undergo the same pragmatic scrutiny to ascertain whether and to what extent:

1. They operate more as for-profits than as charities;
2. Their designation as § 501(c)(3) charities tends to dilute or compromise the designation and its public policy rationale; and
3. The mission itself would be best performed by a for-profit institution or a governmental counterpart rather than a nonprofit. The salient questions are: what is it that society requires from hospitals and other fee-for-service nonprofits or business activities related to a charitable mission, and—given the characteristics of each sector—which is more likely to perform those functions adequately?

This analytical template should be applied to all fee-for-service charities and those with related commercial activities.⁸⁸ While

never returned to the traditional standard. *Id.* at 392–93. For a detailed description of the current standard, *see* *IHC Health Plans, Inc. v. Comm’r*, 325 F.3d 1188, 1198 (10th Cir. 2003).

⁸⁸ Fee-for-services have represented a significant proportion of commercially-generated revenues for nonprofit association. Since 1977—well before the downsizing of government and the wave of new commercial enterprises by nonprofits that followed in its wake—established nonprofit theaters reported that two-thirds of their incomes were generated by their fee-for-services box office tickets. Robert J. Anderson, Jr. & Sonia P. Malfezou, *The Economic Condition of the Live Professional Theatre in America*, in *RESEARCH IN THE ARTS: PROCEEDINGS OF THE CONFERENCE ON POLICY RELATED STUDIES OF THE NATIONAL ENDOWMENT OF THE ARTS* 63–65 (1977). That figure seems to have remained stable even after government downsizing. In 2000, the IRS reported that fee-for-service income represents about two-thirds of nonprofit budgets. Michael H. Shuman & Marrian Fuller, *Profits for Justice*, *NATION*, Jan. 24, 2005, at 13–14 (discussing fee-for-service revenues from tuition fees for students matriculating in a private nonprofit university and membership dues for

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existing analytical tests, like the “commensurate in scope” test, shed some light on the primary purpose and operational realities, it is important to extend the analysis beyond the scope of the Code and its regulations to policy concerns about the integrity of the nonprofit sector and pragmatic concerns about each sector’s aptitude to undertake a particular societal challenge.

B. Type 2

Fee-for-service revenues are synonymous with or closely related to a charity’s mission, but a second category of the way a nonprofit structures its business activity may be totally unrelated to its mission. An example of this kind of commercial activity engages the nonprofit in lending its reputation to support a business enterprise in exchange for an often substantial fee. A notable collaboration of this kind was that of the American Medical Association, which bound itself contractually to Sunbeam Corporation to endorse Sunbeam’s products in exchange for lucrative endorsement fees.⁸⁹ Not surprisingly, these kinds of collaborations raise concerns that an endorsement could jeopardize the reputation and credibility of the nonprofit, or even undermine its mission. One could reasonably inquire: does the American Medical Association really believe that all of Sunbeam’s appliances offer an unalloyed health benefit to the American public? If not, does the diminution in its credibility, reputation and even its mission constitute a poor bargain for the income received from the endorsement?

The flipside of endorsements by nonprofits of for-profit business is sponsorships by for-profits to support nonprofit missions. While both kinds of collaborations may offer substantial revenues to the nonprofit, sponsorships appear to cause less

health clubs owned and operated by YMCAs and YWCAs).

⁸⁹ Burton A. Weisbrod, *The Nonprofit Mission and Its Financing: Growing Links Between Nonprofits and the Rest of the Economy*, in *TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NON-PROFIT SECTOR* 1, 2 (Cambridge University Press 1998). It should be noted, however, that the American Medical Association is a nonprofit trade association, a § 501(c)(6) organization and not a § 501(c)(3) organization.

reputational concern. However, they may trigger UBIT. Sponsorships, since the 1990s, have become increasingly visible, especially in the world of college sports.⁹⁰ But they also abound in the larger nonprofit universe.⁹¹ The Service initially found them to be more than mere “donor acknowledgments” and, therefore, taxable under UBIT.⁹² But Congress, acceding to public pressure, carved out an exception to UBIT for what it deemed “Qualified Sponsorship Payments” (“QSPs”) at § 513(i) of the Code.⁹³ QSPs

⁹⁰ In Tech Adv. Memo 9147007, the Service ruled that income received by nonprofits in, for example, the naming of sporting events were taxable. In the Memo, the Mobil Cotton Bowl and the John Hancock Bowl were the specific sporting events considered by the Service. The Service decided that the signs and memorabilia associated with the events, and bearing the name of the businesses, were tantamount to valuable advertising for the businesses. A rather benign example is given in the following news item:

Forget about getting a building named after yourself. The cash-strapped Scripps Institution of Oceanography is offering what might be an even better deal to someone looking to make a mark in history: A rare hydrothermal vent worm will forever be emblazoned with your name if you fork over \$50,000. For those on a smaller budget, a mere \$15,000 will land you in the annals of marine biology as the namesake of an orange, speckled nudibranch, also known as a sea slug.

Randy Dottinga, *Want to Name a Sea Slug? A Nonprofit Might Let You.*, CHRISTIAN SCI. MONITOR, Jun. 23, 2008, at 14, available at <http://features.csmonitor.com/environment/2008/06/25/want-to-name-a-sea-slug-a-nonprofit-might-let-you>. Members of the scientific community look askance at the name-for-money game as compromising, but scientific institutions undergoing financial crises feel compelled to play the game.

Every year there's a little bit less money to go around Institutions that rely on federal funds to keep their research going are finding it much tougher to get that money and are having to get creative in either finding other sources or rethinking what kinds of research they do.

Id. (quoting Kei Koizumi, director of the American Association for the Advancement of Science's Research & Development budget and policy program). Professors whose office doors are graced with a metal plaque appearing to name the office for some august donor are reminded of the game on a daily basis.

⁹¹ Examples are “donor acknowledgments” that may appear on brochures or invitations announcing a nonprofit event supported by named donors.

⁹² See Fishman, *supra* note 1.

⁹³ Under the statute, nonprofits can receive revenues from sponsorships

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permit a limited amount of exposure for the sponsor as long as it does not amount to “advertising.”

Advertising revenues are another form of nonprofit/for-profit collaboration. Typical examples are for-profit advertising revenues generated by nonprofit publications.⁹⁴ Advertising income is often a necessary supplement for financing nonprofit publications. Subscription income alone rarely generates enough money to sustain an educational, professional or scholarly journal. But courts have not found the apparent necessity of advertising revenues sufficient reason for these revenues to escape UBIT. UBIT analyzes nonprofit revenues under a three-part test:

1. Is the activity generating the revenue a “trade or business?” If not, there is no tax. If it is a trade or business,
2. Is it “regularly carried on?” If not, there is no tax. If it is a trade or business regularly carried on,
3. Is it “substantially related” to the organization’s exempt purposes? If it is, there is no tax. If not, UBIT applies and the income will be taxed at business income tax rates.⁹⁵

“Trades or businesses” are considered to be activities intended to generate profit.⁹⁶ “Regularly carried on” looks to the regularity with which for-profit enterprises carry on the activity.⁹⁷ Both are relatively straightforward tests. The “substantially related” test is

without income tax consequences (UBIT) as long as the sponsor’s return benefit consists of nothing more than the public identification of its name, symbol or other identifying information along with other “insubstantial” benefits, defined as benefits that are valued at no more than 2% of the sponsorship contribution. Based upon those parameters, “name the species” fundraisers for scientific nonprofits, like Scripps Institution of Oceanography, can escape UBIT for the \$15,000 it will receive from a donor who, in turn, can get a sea slug named for him. Dotinga, *supra* note 90, at 14.

⁹⁴ See, e.g., *United States v. Am. Coll. of Physicians*, 475 U.S. 834, 847 (1986) (rejecting a *per se* rule to tax all commercial revenue from advertisements for tax-exempt journals but insisting that advertising revenues were taxable income).

⁹⁵ Internal Revenue Service, *Unrelated Business Income Defined*, <http://www.irs.gov/charities/article/0,,id=96104,00.html> (last visited Mar. 1, 2009).

⁹⁶ *Id.*

⁹⁷ *Id.*

somewhat more difficult to grasp and has been interpreted by Treasury's regulations to mean that the business income must "contribute importantly" to the nonprofit mission of the charity, and the contribution must be more than revenues.⁹⁸ Under that analysis, advertising will usually fail the "substantially related test," but not as a *per se* rule.⁹⁹ Nonetheless, UBIT income from advertising will not cause the entire mission-driven enterprise in which it is generated to fail the UBIT test. Rather, Congress has adopted the Service's "fragmentation" test by which the two sources of income (subscription fees and advertising revenues, for example) are to be treated separately.¹⁰⁰ The "contribute importantly" and "fragmentation" rules also apply to other forms of business income that is a part of, but not subsumed by, the charitable activity.¹⁰¹

A final example of commonly structured collaborative activities between nonprofits and for-profits and their UBIT implications are revenues generated "passively" by the nonprofit for some benefit it confers upon a business. Common examples are affinity credit cards (credit cards that bear the name and/or logo of a nonprofit—like a university) or rentals of the nonprofits' membership lists. Generally, UBIT has excluded from its purview passive investment income.¹⁰² Passive investment income has traditionally encompassed income generated by investments in for-profit businesses (dividends and capital gains on sales of securities unless the securities are leveraged), rents (limited to rental income from real estate and from personal property but only if it is identified within the real estate rental agreement and is incidental to it) and royalties (limited to income generated from revenues for

⁹⁸ Treas. Reg. § 1.513-1(d)(2) (2006).

⁹⁹ See *Fraternal Order of Police Ill. State Troopers Lodge No. 41 v. Comm'r*, 87 T.C. 747, 756 (1986) (finding that advertising was "obviously conducted with a profit motive").

¹⁰⁰ Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (codified at 26 U.S.C. § 513 (c)).

¹⁰¹ Examples include commercial products sold in a museum gift shop (taxable income) along with art-related items (nontaxable income). See Rev. Rul. 73-105, 1973-1 C.B. 264.

¹⁰² See generally I.R.C. § 512 (a)–(b) (2006).

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the right to use intangible property, like copyrights and trademarks).¹⁰³

Assuming that a nonprofit passes § 501(c)(3) muster, and that UBIT has done a good job of properly carving out commercial activity not entitled to the income tax exemption,¹⁰⁴ the challenges to this type of commercial activity (collaborative efforts totally unrelated to the exempt purpose of the nonprofit) are:

- a. Do they compromise the nonprofit's reputation or its credibility and;
- b. To what extent is their provenance to be found in a public policy dominated by ideological considerations at the expense of practical considerations. That is to say, are nonprofits driven to embrace all kinds of fundraising gimmicks because government services and support have been so severely curtailed?;
- c. A related issue is whether these entrepreneurial gymnastics contribute to "mission drift" by ineluctably introducing a partial "mission shift." More pointedly, does fundraising become a dominant mission of the nonprofit when traditional sources of income prove inadequate?

C. Type 3

A third type of structure for generating nonprofit revenues from commercial activity is situated between the fee-for-services or substantially related businesses that are integral to the nonprofit's operation (type 1) and the occasional collaborations with businesses that are extraneous to the charitable mission and its operations (type 2). In type 3 structures, the nonprofit seeks a closer connection with an unrelated business but tries to avoid

¹⁰³ See Treas. Reg. §§ 1.1245-1 (1976), 1.512(b)-1(a) to (b) (1992); *Sierra Club, Inc. v. Comm'r*, 86 F.3d 1526, 1532 (9th Cir. 1996) (discussing the passivity requirement as it applies to rents such as mailing list rentals and "royalties" from affinity credit cards).

¹⁰⁴ For a challenge to UBIT, see Michael S. Knoll, *The UBIT: Leveling an Uneven Playing Field or Tilting a Level One?*, 76 *FORDHAM L. REV.* 857 (2007).

being subsumed by it. Joint ventures, either of the contractual variety or those deemed to be partnerships, are common examples of this type of income-generating structure. In the United States, most well publicized instances of this sort of commercial activity occur in the health care industry.¹⁰⁵ Over time, a variety of joint venture structures have evolved and the I.R.S. has developed a less rigid, more nuanced approach to evaluating the tax law consequences of these structures.¹⁰⁶ Ultimately the Service is

¹⁰⁵ Other industries where joint ventures have proved to be attractive structures for financial support include low income housing nonprofits and higher education joint ventures. Judy Kindell, IRS & T.J. Sullivan, Gardner, Carton & Douglas, IRS' Judy Kindell Discusses Joint Ventures after Rev. Rul. 2004-51, Remarks Before the Annual Tax Program of American Health Lawyers Association (Oct. 21, 2004), in 10 EO TAX J. 40 (2005). An example of a joint venture of a contractual nature in higher education was the contract between the University of California at Irvine and Capella University, an online for-profit university, in which Capella paid U.C. Irvine \$500 per student referred to it. While considered legal by the U.S. Department of Education, the arrangement met with criticisms that it compromised the reputation and integrity of the public university and raised conflict-of-interest issues. Paul Basken, U. of California Campus Benefits from Referring Students to Profit College, Sept. 28, 2007, available at <http://www.calstate.edu/pa/clips2007/september/28sept/refer.shtml>.

¹⁰⁶ See NONPROFIT ORGANIZATIONS, *supra*, note 20, at 711–43 (providing a lucid review of the evolution of joint venture forms and the Service's evolving attitude toward them). One typical illustration of joint ventures that emerged in the 1980s in the health care industry was the "whole charity" merger, in which a § 501(c)(3) hospital would transfer all of its assets and activities to a joint venture business entity in exchange for an interest in the new entity, while a for-profit business would contribute cash to receive a similar ownership interest in the entity. Courts ruled that the nonprofit retained its tax-exempt status as a § 501(c) organization only if it maintained dominant control over policy issues in the operation of the new (joint venture) entity. *See, e.g., St. David's Health Care Sys. v. United States*, 349 F.3d 232 (5th Cir. 2003). That is to say, the charitable mission of the nonprofit, not wealth maximization, must be the prevailing concern of the joint venture. *Id.* at 237–38. Thus, the issue of control can jeopardize the tax-exempt status of the nonprofit and cause it to be subsumed within a dominantly profit-driven enterprise.

Complex legal structures can hide the reality of power retained by the for-profit entity. And that should not surprise us. When nonprofit organizations partner with for-profit businesses, relative bargaining power inherently resides in the for-profit enterprise. In *St. David's*, the court stated,

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The present case illustrates why, when a nonprofit organization forms a partnership with a for-profit entity, courts should be concerned about the relinquishment of control. St. David's, by its own account, entered the partnership with HCA [the for-profit company] out of financial necessity (to obtain revenues needed for it to stay afloat). HCA, by contrast, entered the partnership for reasons of financial convenience (to enter a new market). The starkly different financial position of these two parties at the beginning of their partnership negotiations undoubtedly affected their relative bargaining strength. Because St. David's "needed" this partnership more than HCA, St. David's may have been willing to acquiesce to many (if not most) of HCA's demands for the Final Partnership Agreement. In the process, of course, St. David's may not have been able to ensure that its partnership with HCA would continually (*sic.*) provide a "public benefit" as opposed to a private benefit for HCA.

Id. at 247. Another form of joint venture that was developed was called "ancillary" because the charity, itself, was not integrated within the joint venture, but rather maintained its separate status and partnered with a for-profit in an "ancillary" business venture by transferring part of its assets, services or money to the venture. *See* Rev. Rul. 04-51, 2004-1 C.B. 974. The Service lent its imprimatur to ancillary joint ventures under the same basic control guidelines it has maintained for "whole charity" joint ventures. *Id.* This revenue ruling involved a 50-50 joint venture between a university and a for-profit company. The venture was a distance learning program in which the university controlled the curriculum and the faculty appointments while the for-profit contributed its expertise in how to run a distance program through interactive video. The Service approved the joint venture under both the exclusivity test and UBIT in spite of the 50-50 structure because the university retained control of the exempt purpose: education. *Id.* Where the nonprofit retains control over a § 501(c)(3) purpose, the Service's analysis is fairly straightforward. This is particularly the case where the joint venture represents only a small part of the operations of the nonprofit (an "ancillary" operation). However, where the expertise each entity brings to the venture is the same (a for-profit hospital and a nonprofit hospital; a for-profit university and a nonprofit university) then the control issue is more complex and ownership shares and managerial power become more important, and the legal outcome for the nonprofit less predictable. Complexity arises not just from the substantial ownership and management provisions but from the structure under which the venture operates (LLC; general partnership; limited partnership; joint venture of the partnership model vs. joint venture of the contract model) because state governance laws may differ and "in many cases the critical questions are not addressed by state laws, regulations or cases." Kindell & Sullivan, *supra*, note 105, at 33. For a discussion of the Service's informal guidelines for LLC exempt organizations, see Bradley T. Borden,

concerned with whether the joint venture, as it is structured and operated, is primarily driven by a tax-exempt purpose (“exclusivity” rule); 2) engaged in businesses not substantially related to that purpose (UBIT); and 3) whether distribution of profits violates the private benefit constraint (“non-distribution” or “no private inurement” rule).¹⁰⁷

To be sure, joint ventures can be a lucrative source of revenues, but they come with certain risks:

1. The risk that the nonprofit might lose its exempt status;
2. Or that its gain from nonexempt sources of income might be significantly reduced by UBIT;
3. Or that the culture of the organization might shift away from one driven by charitable ends to one driven by profitable means (a subtle but discernible transformation in the organization’s culture usually called “mission drift”);
4. Or that its association’s close relationship with a business partner might result in some loss of reputation.

D. Type 4

A fourth type of business activity is a structural alternative to the mission drift, reputational and regulatory risks associated with type 3 joint ventures. Through structural formalities, parent-subsidiary arrangements help the nonprofit (“parent” organization) distance itself from the for-profit enterprise that sustains it.¹⁰⁸ Type 4 is a clear instance of the deference courts have traditionally shown to the formal organization structures businesses elect to form under corporate governance laws.¹⁰⁹ As discussed earlier in this Article, the general rule is that courts will honor the corporate

Limited Liability Companies as Exempt Organizations, 33 ESTS. GIFTS & TRS. J. 150 (2008), available at <http://ssrn.com/abstract=1142924>.

¹⁰⁷ See *supra* p. 111.

¹⁰⁸ In addition to separating itself from the subsidiary business to protect itself from the risks associated with type 3 structures, nonprofit parent organizations might also reap tax and liability exposure advantages from the use of subsidiary businesses they control.

¹⁰⁹ See generally *supra* Part II.B.2.

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formalities of state corporate governance laws that separate a corporation from its owners and affiliates against appeals by creditors to “pierce the corporate veil” of limited liability (that generally shields owners and affiliates from the liabilities of a corporation) unless the case reveals that the corporation’s structure protects fraud or similar wrongdoing which the shield of limited liability was not intended to protect.¹¹⁰

In the very different legal context of the federal code, courts have adopted the same kind of deference.¹¹¹ The corporate “shield” between a for-profit subsidiary and its nonprofit owner will not be “pierced”: they will not be treated as one entity and the business activities of the subsidiary will not be attributed to the charity absent probative evidence of the same kinds of deception that lead courts under state corporate governance laws to pierce the corporate veil. Nonetheless, Congress has considered eliminating the shield for a controlled subsidiary of a nonprofit parent organization and that legislative policy change may yet be realized.¹¹² In any event and in the absence of that kind of legislation, subsidiary businesses have become an increasingly prevalent venue for sustaining the charitable projects of nonprofits. Michael H. Shuman and Merrian Fuller have described the phenomenon.¹¹³ In type 4 organizations, a business entity (the subsidiary, typically a for-profit corporation) simply runs its business and distributes net profits (dividends) to its nonprofit owner (the parent corporation that owns its shares). A successful example of this model is the Used Book Café in New York, a for-profit, wholly owned subsidiary of its parent corporation, Housing

¹¹⁰ *Id.*

¹¹¹ *See, e.g.,* *Moline Props., Inc. v. Comm’r*, 319 U.S. 436, 439 (1943). *But see* *Orange County Agric. Soc’y v. Comm’r*, 893 F.2d 529 (2d Cir. 1990).

¹¹² *See generally* NONPROFIT ORGANIZATIONS, *supra* note 20, at 710–11, 744–50 (discussing the Draft Report of the Subcommittee on Oversight of the House Ways and Means Committee on proposed revisions of UBIT, 100th Cong. 2d Sess. (Comm. Print 1988)). Fishman and Schwarz comment, “This and other proposals were never enacted, but the controversy over complex structures lingers as a major policy issue in the law of tax-exempt organizations.” *Id.* at 710.

¹¹³ Shuman & Fuller, *supra* note 88, at 13–14.

Works, a nonprofit association that assists homeless people with HIV/AIDS. Shuman & Fuller have described the relationship between the two entities this way:

Used Book Café . . . an independent bookstore . . . enjoys regular visits from leading agents and publishers in the city and boasts a fabulous events calendar that reads like a Who's Who of contemporary writers and musicians. What's truly revolutionary about the café, however, is that [since 2004] the business, along with sister thrift shops, provided [annually] more than \$2 million to its parent nonprofit, Housing Works¹¹⁴

This fourth option seems to offer a “new paradigm” for commercial activity by charities without the downside risks of the other three options. The new paradigm separates the for-profit activity from the nonprofit mission by establishing a subsidiary business entity, owned by, but legally separate from, the nonprofit parent corporation. The legal separation of the two entities alleviates some of the problems associated with the other forms of commercial activity by nonprofits. Because the nonprofit has no direct legal control over the subsidiary's operations,¹¹⁵ there is no compromise of the nonprofit's reputation.¹¹⁶ Because the subsidiary's business income is taxed before it distributes its net profits to the nonprofit parent, there is no UBIT tax problem that could arise if the nonprofit generated the business income itself.¹¹⁷ Because the subsidiary exerts no control over the parent nonprofit,

¹¹⁴ *Id.* at 13.

¹¹⁵ Shareholders (owners) of corporations do not run the operations of the corporation under state corporate governance laws. Rather, the company is managed by executives hired by the Board of Directors who are accountable to it. *See generally* JESSE CHOPER, JOHN C. COFFEE, JR. & RONALD J. GILSON, BASIC NORMS AND DUTIES FOR MANAGEMENT OF CORPORATIONS: CASES AND MATERIALS ON CORPORATIONS 55 (Coth ed., Aspen 2004).

¹¹⁶ By stark contrast, the AMA's lucrative endorsement of Sunbeam's products is a clear example of commercial activity that was damaging to the nonprofit's reputation. *See supra* note 89.

¹¹⁷ However, collaborations between nonprofits and for-profit businesses, along with fee-for-services, can result in UBIT exposure. *See supra* notes 81–86 and accompanying text.

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there is no business dominance or control problem of the kind associated with joint ventures and other types of partnerships.¹¹⁸ The business entity simply runs its separate commercial activity and distributes net profits (dividends) to its nonprofit owner. This model of a nonprofit sustaining itself through commercial activity appears to be an idea whose time has come; the current era of anti-government bias necessitates that nonprofits expand their services while simultaneously meeting the increased financial requirements of an ever-expanding nonprofit sector without tarnishing its reputation, shifting nonprofits' attention away from their charitable mission or jeopardizing their legal status. That said, there are downside risks to this model of entrepreneurship as well.

Unlike the other three options, the parent-subsidiary model appears to pose none of the legal, reputational or mission drift problems because the structured separation of the entities seems to protect the nonprofit from any taint of profit-driven motives. However, even this otherwise promising model may compromise a fundamental public interest. Nonprofits, under § 501(c)(3), are deemed to be "public benefit" organizations.¹¹⁹ That is, they supply some important service to the public by their charitable works. And this notion of "public benefit" is often used to justify the various tax advantages the law affords § 501(c)(3) charitable organizations. As explained in Part II, above, tax advantages supply the consideration for the nonprofits and act as the "quid pro quo" for the "public benefit" society derives from their charitable works.¹²⁰ But who determines which specific projects from the vast array of societal problems that might be addressed should be selected? Should the public have any voice in these kinds of decisions? In that regard, and as addressed in Part II, the parent-subsidiary model can be seen as analogous to private foundations because it raises similar concerns. Congress originally treated private foundations like other § 501(c)(3) organizations.¹²¹ But in the 1960s, Congress became concerned that private foundations

¹¹⁸ See I.R.C. §§ 512(a)–(b) (2006); Treas. Reg. § 1.512(b)-(1)(a) (2006).

¹¹⁹ See I.R.C. § 501(c) (2006).

¹²⁰ See Treas. Reg. § 1.501(c)(3)-1 (2006).

¹²¹ Marsh, *supra* note 63, at 138–39.

were deriving “public benefit” status without any input or influence from the public itself.¹²² In a democracy, Congress reasoned, the citizens at large (or, at least the relevant community of citizens) should have a voice in determining what kind of nonprofit activity is a “public benefit.” Congress thus ratcheted up the regulation regime for monitoring and directing the activities of private (grant-making) foundations and it diminished the unfettered power of “operating foundations” to act without public influence.¹²³ Congress did so by requiring operating foundations to accede to public opinion about the selection of their public benefit projects. Public opinion enters the decision-making process in two ways: operating foundations must put a certain number of outsiders (members of the public) on their boards and a certain percent of their capital must come from public donations.¹²⁴

Like these foundations, a self-sustaining nonprofit that can generate all of its financial support from its own for-profit subsidiary runs the risk of being charged with a kind of solipsism: it no longer needs public financial support in the form of individual donations or government and institutional grants. Thus, there is no longer any financial incentive for the nonprofit to reach out to constituents in the community to participate, as members of the governing board or as donors, in formulating the nonprofit’s policies or in monitoring its operations. Therefore, like a private foundation, within its self-selected mission it has inordinate power to decide which charitable projects most benefit the public. It seems reasonable to predict that, as was the case with private grant-making and operating foundations, their otherwise enviable position as self-sustaining will eventually subject them to public outcry, public scrutiny and government regulation.

E. Type 5

Certainly the most innovative of recent nonprofit efforts to

¹²² *Id.* at 148.

¹²³ See I.R.C. §§ 507–09 (2009)

¹²⁴ See NONPROFIT ORGANIZATIONS, *supra* note 20, at 596, 753–54, 760–62; ALLEN, KRAAKMAN & SUBRAMANIAN, *supra* note 55, at 322–23.

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engage in commercial activity in order to sustain their charitable activities is the “social business” or “social enterprise.” Charles King, speaking on behalf of the Social Enterprise Alliance, a group that advocates new venues for making nonprofits self-sustaining has said, “What we are about . . . is the business of changing the entire paradigm by which not-for-profits operate and generate the capital they need to carry out their mission—a new paradigm based on sustainability and social entrepreneurship.”¹²⁵ Many new forms of commercial endeavors might logically be called “social enterprises” but the most revolutionary form of the paradigm is a very specific kind of entrepreneurship: an organization (for profit or nonprofit) that identifies a disadvantaged segment or group in a population and seeks to transform (not merely ameliorate) the living conditions of that group by developing a sustainable commercial opportunity for them or by otherwise providing an exit route from an untenable situation. This form of a social business is distinguishable from a for-profit commercial enterprise because its mission is not to generate profit for its investors but to meet a “social objective” of transforming the capacity of underprivileged populations to escape poverty and other debilitating conditions.¹²⁶ At the same time, this form of social entrepreneurship can be distinguished from a traditional social services charity which seeks to aid and assist with funding that may derive from business profits (as well as from donations and grants) but not to transform the disadvantaged group through commercial enterprise.

It should be emphasized, however, that this emergent form of self-sustaining organizations, like the competing terms for and definitions of the Third Sector, (“nonprofits,” the U.S. term; or “NGOs,” the E.U. term) may go by different names which generally describe the same kind of entity but may also imply distinct characteristics that make an analytical difference.¹²⁷ Thus,

¹²⁵ See Shuman & Fuller, *supra* note 113, at 13.

¹²⁶ See Muhammed Yunus, *The Nobel Peace Prize 2006: Nobel Lecture*, 13 L. & BUS. REV. AM. 267 (2007).

¹²⁷ See Gibelman & Gelman, *supra* note 3, at 357; see also Jean Proulx, Denis Bourque & Sebastien Savard, *The Government - Third Sector Interface in Quebec*, 18 VOLUNTAS: INT’L J. VOLUNTARY & NONPROFIT ORGS. 293, 295 n.1 (2007) (noting that the U.S. term of “nonprofit” and the E.U. term of “NGO”

while the most revolutionary form is described above by the narrow definition of social business or social enterprise so as to distinguish it from typical business forms in the for-profit sector and from other kinds of commercial activities by nonprofits, the larger context of empirical research describes two broader but somewhat different perspectives on social businesses: the U.S. model and the E.U. model. It may be instructive to describe these two broader definitions in order to clarify the challenges social businesses face.¹²⁸ Both the U.S. understanding and the E.U. perspective view social businesses as nongovernmental, market-based approaches to address social issues.¹²⁹ Empirical studies, however, indicate that the U.S. perspective emphasizes the “revenue generation” aspect of social enterprise while the European tradition emphasizes a “social economy” or cooperative aspect of social enterprise. The European tradition is foreign to U.S. sensibilities but deeply rooted in the historical antecedents of the European model.¹³⁰ Thus, social enterprise in Europe can be seen as an outgrowth of the cooperative movement—an anti-authoritarian labor movement. In Europe, the emphasis is on participation in governance by the enterprise’s beneficiaries and on social and employment objectives, which goes well beyond the U.S. emphasis on revenue generation.¹³¹

Research also indicates that within the U.S., academia conceptualizes social enterprise somewhat differently: scholars, especially within leading business schools, tend to situate social enterprise within the category of for-profit businesses that engage,

connote two different research traditions: “an American tradition stressing non-lucrativity” and “a European tradition stressing collective entrepreneurship and identifying the third sector with social economy” (references omitted).

¹²⁸ An excellent article illuminating the differences between the U.S. and E.U. traditions is Janelle A. Kerlin, *Social Enterprise in the United States and Europe: Understanding and Learning from the Differences*, 17 VOLUNTAS: INT’L J. VOLUNTARY & NONPROFIT ORGS. 247 (2006).

¹²⁹ *Id.* at 247.

¹³⁰ *Id.* at 251–53.

¹³¹ *Id.* at 250. For an historical perspective on the evolution of the European model, see generally Heydemann, *supra* note 6, at 20, 22 (noting how differences in national experiences help to explain differences in national models of nonprofit associations).

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at some level, with social issues or causes. Practitioners, on the other hand, think of social businesses as organized under § 501(c)(3) operating charities.¹³² The practitioners' version of the U.S. model seems to fit the use of social enterprise in the 1970s when nonprofits developed businesses to generate jobs for the unemployed. That model was expanded during the decade of the 1970s when the economy suffered a downturn and the government began to downsize. To make up for shortages in financing from government, nonprofits expanded the model to sustain their social services work during that decade. Today, the social entrepreneurship model continues to expand, taking different forms and adopting different goals: nonprofit vs. for-profit; job-creation vs. mission support; revenue-generation vs. community development or transformation of the living conditions of a targeted group, and so forth.¹³³

Like the four other types of commercial activity by nonprofits, the social business has proven to be an effective way for charities to sustain themselves and their missions in an era where government downsizing has deprived them of an important source of support. But like the other four types of (entirely or partially) self-sustaining nonprofits, they too face challenges and risks. Those risks and challenges may vary with the choice among the different social enterprise models identified above. An obvious

¹³² Kerlin, *supra* note 128, at 251.

¹³³ Examples of the various kinds of social businesses abound. Perhaps the most famous are the Grameen businesses pioneered by Muhammad Yunus who won the Nobel Peace Prize for his microcredit bank Grameen Bank, which he founded along with Grameen Shakti of Grameen Energy, which has brought renewable energy to Bangladesh; Grameen Kalyan (Grameen Welfare) bringing affordable healthcare to the poor in Bangladesh, which has spawned a network of for-profit and nonprofit social businesses dedicated to transforming the health of the poor; and recently Grameen Danone, a social business partnership with Groupe Danone, the French yogurt conglomerate, which provides low cost highly nutritious food for the poor. For an overview of Yunus' pioneering and very successful work in social businesses, see generally MUHAMMAD YUNUS, *CREATING A WORLD WITHOUT POVERTY: SOCIAL BUSINESS AND THE FUTURE OF CAPITALISM* (Public Affairs-Perseus Books 2007). *See also* PHIL SMITH & ERIC THURMAN, *A BILLION BOOTSTRAPS: MICROCREDIT, BAREFOOT BANKING AND THE BUSINESS SOLUTION FOR ENDING POVERTY* (McGraw-Hill 2007).

example is the form the entrepreneurs select: when creating a nonprofit social enterprise, they must consider whether or to what extent their enterprise will be jeopardized by the exclusivity test or by UBIT taxation discussed in Section A of Part II above.¹³⁴ If, on the other hand, they elect to form the enterprise as a for-profit, while they will avoid the limitations of the tax code for § 501(c)(3), they may run the risks of mission drift and diminution of the credibility and reputation that § 501(c)(3) organizations appear to enjoy.¹³⁵ Moreover, scholars have identified the following problems confronting every form of social enterprise in the U.S.:

1. Exclusion of Specific Groups

Because private sector organizations have the latitude to be selective in their choice of form, mission and beneficiaries, some groups of individuals may be overlooked by a social business model driven by revenue generation. Unlike both the government, which is constrained by constitutional and statutory requirements mandating a more even-handed approach, and the European model, which is historically premised upon community development and the ideal of inclusion of outlier groups, the U.S. model may result in the unintended consequence of exclusion or—at least—inadvertent omission.¹³⁶

2. Risks to Civil Society

Nonprofit scholarship is replete with paeans about the contribution the nonprofit sector makes to civil society by developing “social capital.”¹³⁷ Scholars argue that social capital

¹³⁴ See the discussion of “type 1” self-sustaining nonprofits at notes 81–88 and accompanying text.

¹³⁵ See *supra* notes 101–106 and accompanying text.

¹³⁶ Kerlin, *supra* note 128, at 258.

¹³⁷ *Id.* at 258 n.6: “Social Capital includes the social norms of trust, cooperation, and reciprocity that develop through positive citizen interaction and which undergirds the effective functioning of democracy and a market economy.” (citing E. Backman & S.R. Smith, *Health Organizations, Unhealthy*

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development (and, with it, the vibrancy of civil society) may be diminished by the social enterprise movement in the following respects:

- a. “[A] growing focus on the bottom line may lead organizations to abandon less efficient practices that strengthen social capital, such as running a volunteer program.”¹³⁸
- b. As organizations, like social businesses, become self-sustaining they may discover they do not need to rely on “traditional stakeholders and networks such as private donors, members, community volunteers and other community organizations with the result that opportunities to promote social capital are lost.”¹³⁹
- c. Finally, the mission shift to revenue generation may lead to a shift in board membership from community leaders and volunteers to financial experts and business advisors.¹⁴⁰

3. *Lack of Oversight Assistance and Public Policy Direction
From the U.S. Government*

“In the United States virtually no new policy has been created over the past 50 years to accommodate the business activities of the growing number of nonprofits involved in social enterprise.”¹⁴¹ In that regard, the U.S. lags significantly behind E.U. countries. Beginning with Italy in 1991, legislation has made provision for, and given guidance to, social business forms in Belgium (1995),

Communities?, 10 NONPROFIT MGMT. & LEADERSHIP 355 (2000)). De Tocqueville was perhaps the first to recognize the salutary effect of grass-roots nonprofits on developing the skills to sustain a strong civil society. See Barbara K. Bucholtz, *Reflections on the Role of Nonprofit Associations in a Representative Democracy*, 7 CORNELL J. L. & PUB. POL’Y 555, 557 (1998).

¹³⁸ Kerlin, *supra*, note 128, at 258.

¹³⁹ *Id.* But see Fishman, *supra* note 1, at 605 (“Public benefit corporations arose originally in England as for-profit companies that provided a social benefit.”). The U.K.’s new Office of the Third Sector uses that definition for social businesses. *Id.* at 601.

¹⁴⁰ Kerlin, *supra* note 128, at 258.

¹⁴¹ *Id.* at 253.

Portugal (1998), Greece (1999), France (2001) and most recently the U.K. (2005).¹⁴² In describing the British model, Professor Fishman notes the hybrid nature of the social business: it has both a charitable mission and a revenue-generation mission. Thus, it represents a new form of social organization and should, perhaps, be considered a “‘fourth sector’ of society.”¹⁴³

Social business has a proven track record of revenue generation for charitable causes but it obviously carries with it significant risks. The risks to the sector and to society invite legislative reform to define and give direction to this new sector. The social enterprise phenomenon, however, is only one example of the need to “rethink” the regulation of nonprofit associations as Fishman¹⁴⁴ and other experts have suggested.¹⁴⁵

¹⁴² *Id.* at 254. For an expanded discussion of the “CIC” (Community Interest Company) under the new British statute, see Fishman, *supra* note 1, at 600–03. He notes that differences between the U.S. model and the U.K.’s CIC are an asset lock and a partial distribution constraint. *Id.* at 606.

¹⁴³ Fishman, *supra* note 1, at 598.

¹⁴⁴ *Id.* at 606–07. Fishman has suggested that much of the regulatory regime that polices the lapses in fiduciary obligations by nonprofits should be returned to the state and local level. *Id.* But he also observes that the emergence of the social enterprise model itself (in all its varieties and permutations) challenges us to broaden our reformist perspective. *Id.* at 603–07.

¹⁴⁵ Examples of scholarship counseling regulatory reform include Ellen P. Aprill, *What Critiques of Sarbanes-Oxley Can Teach About Regulation of Nonprofit Governance*, 76 *FORDHAM L. REV.* 765 (2007); David A. Brennen, *The Commerciality Doctrine as Applied to the Charitable Tax Exemption for Homes for the Aged: State and Local Perspectives*, 76 *FORDHAM L. REV.* 833 (2007); Evelyn Brody, *The Board of Nonprofit Organizations: Puzzling Through the Gaps Between Law and Practice*, 76 *FORDHAM L. REV.* 521 (2007); Marion R. Fremont-Smith, *The Search for Greater Accountability of Nonprofit Organizations: Recent Legal Developments and Proposals for Change*, 76 *FORDHAM L. REV.* 609 (2007); Gibelman & Gelman, *supra* note 3; Garry W. Jenkins, *Incorporation Choice, Uniformity, and the Reform of Nonprofit State Law*, 41 *GA. L. REV.* 1113 (2007); Lloyd H. Mayer, *The Much Maligned 527 and Institutional Choice*, 87 *B.U. L. REV.* 625 (2007); Dana Brakman Reiser, *Director Independence in the Independent Sector*, 76 *FORDHAM L. REV.* 795 (2007); Dana Brakman Reiser, *There Ought to Be a Law: The Disclosure Focus of Recent Legislative Proposals for Nonprofit Reform*, 80 *CHI. KENT L. REV.* 559 (2005); Linda Sugin, *Resisting the Corporatization of Nonprofit Governance: Transforming Obedience into Fidelity*, 76 *FORDHAM L. REV.* 893

DOING WELL BY DOING GOOD AND VICE VERSA 445IV. REFORMING THE NONPROFIT SECTOR TO RESTRAIN ITS
COMMERCIAL ACTIVITY: AN ASSESSMENT

There can be no doubt that a legislative reappraisal of the nonprofit sector is overdue.¹⁴⁶ The emergence of the social enterprise model, alone, signals the need for a reappraisal. But social businesses are only one example of the types of commercial vehicles charities are employing to sustain themselves and their missions today. Furthermore, taken as a whole these forays into business ventures now represent a large portion of nonprofit finances today:

Data from the National Center for Charitable Statistics at The Urban Institute suggest that social enterprise [in the broad sense of revenue-generating ventures of all kinds] continues to rise in the United States. The commercial activities of nonprofits were tracked over 20 years (1982-2002) using a database of financial information that nonprofits with \$25,000 and over in revenue file with the U.S. Internal Revenue Service. Commercial revenue included program service revenue (fee-for-service), net income from sales of goods, net income from special events and activities and membership dues and assessments for which members received comparable benefits. Analysis found that over the 20 year period, commercial revenue was not only consistently the largest income producer but

(2007). *But see* Michael S. Knoll, *The UBIT: Leveling an Uneven Playing Field or Titling a Level One*, 76 *FORDHAM L. REV.* 857 (2007) (demonstrating that UBIT could be an example of regulation that goes too far and puts nonprofits at an unfair disadvantage).

¹⁴⁶ Congress has tacitly acknowledged as much in hearings held recently, although a reform consensus has yet to emerge. *See Overview of the Tax-Exempt Sector: Hearing Before the H. Comm. on Ways and Means*, 109th Cong. (2005), available at <http://waysandmeans.house.gov/hearings.asp?formmode=detail&hearing=400>; *Charities and Charitable Giving: Proposals for Reform: Hearing Before the S. Comm. on Finance*, 109th Cong. (2005), available at <http://finance.senate.gov/sitepages/hearing030505.htm>; Elizabeth Kingsley & John Pomeranz, *A Crash at the Crossroads: Tax and Campaign Finance Collide in Regulation of Political Activities of Tax-Exempt Organizations*, 10 *EO JOURNAL* 186 (2005).

also that it grew substantially. From 1982 to 2002, the commercial revenue of nonprofits increased by 219%, private contributions by 197% and government grants by 169%. Most significantly, it also grew as a share of total revenue. In 1982 commercial income made up 48.1% of nonprofit revenue but by 2002 it accounted for 57.6%. Meanwhile, private contributions only grew from 19.9% to 22.2% and government grants from 17.0% to 17.2%.¹⁴⁷

These studies mentioned above conclusively demonstrate that for-profit activity in the nonprofit sector is expanding at an accelerated rate and that the decline in government services and financial support has at the very least exacerbated this trend, if it has not been a principal driver of it.

Reform-minded scholars are unquestionably right to advocate a retrospective analysis of the sector with a view to its overhaul. Leading scholars should also persuade us that the narrow attention that the media and Congress are paying to perennial scandals as the focus of reform legislation is hopelessly short-sighted and inadequate.¹⁴⁸ The broader agendas advocated by scholars will surely result in better outcomes.¹⁴⁹

¹⁴⁷ Kerlin, *supra* note 128, at 252 (citations omitted).

¹⁴⁸ See Fishman, *supra* note 1, at 572, 587. “Additional regulation merely increases the burdens of nonprofit status, or in economic jargon, transaction costs, at the expense of focusing on mission.” *Id.* at 568. Fishman also suggests that there is a need to get beyond these “erroneous assumptions” and “incremental approaches.” *Id.* at 567.

¹⁴⁹ See, e.g., *id.* at 567, 570, 574–79, 584 (arguing for a reassessment of the “proper scope of the 501(c)(3) universe,” a “redefinition of the charitable sector,” and a shift from federal regulation of the fiduciary obligations of nonprofit boards and managers to state and local authorities). See also Brennan, *supra* note 145 (discussing the abandonment of the historical understanding of what it meant to be a “charitable” institution as it pertains, especially, to eldercare facilities and using eldercare as an exemplar of how to parse the commerciality doctrine in order to make a useful distinction between exempt and nonexempt organizations for purposes of assessing local property taxes); Colombo, *Reforming I.R.C. Provisions*, *supra* note 1 (advocating a reassessment of the proper role of the federal tax code as it relates to charities); Fremont-Smith, *supra* note 145 (surveying the current legislative landscape of reformist proposals); Jenkins, *supra* note 145 (presenting an empirical study of how state governance law for nonprofits is shaped primarily by private law making

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In this Article, I have argued that, as a preliminary matter, the reformist perspective should be enlarged to include an appreciation of the impact that a pro-business ideology has had on public policy choices in contemporary America, and an understanding of the effects that this ideological policy driver has had for the nonprofit sector, the government sector, and ultimately the representative democracy of which they are a part. An adequate analysis of those phenomena invites both quantitative and qualitative research projects.

A preliminary assessment of the evidence currently available can be summarized as follows: At a minimum, circumstantial evidence suggests that anti-government fervor in recent decades has led to the downsizing of government and either an outsourcing of many of its programs or a privatization of them.¹⁵⁰ Especially in the social services sector, nonprofits have tried to meet the societal need created by the downsizing phenomenon with efforts to expand their own services. This, in turn, has led nonprofits to seek new sources of income to support their expansion. These new sources have included government contracting through privatization and, especially, commercial activity.¹⁵¹ What have we observed from that experience? We can acknowledge that the success of commercial activity, in its various forms, has provided the capital necessary to fill (at least partially) the infrastructure gap left by government downsizing. That recognition is important because a reform program seeking to curtail perceived excesses of entrepreneurial activity by nonprofits that fails to appreciate this

groups—ALI; ABA; NCCUSL—with minimal input from nonprofit associations themselves and the consequences of that for the reform movement in nonprofit law); Knoll, *supra* note 145 (demonstrating that UBIT unfairly burdens the nonprofit sector's commercial activities); Reiser, *There Ought to Be a Law*, *supra* note 145 (demonstrating that legislative reform of nonprofit regulation at both the federal and state levels will be ineffectual because of the political reality that government enforcement systems at all levels of government are critically under-funded); Reiser, *Director Independence*, *supra* note 145 (arguing that the "best practices" model for for-profit corporate boards comprised of a majority of independent directors may be an inappropriate model for nonprofit boards because their situation is inapposite).

¹⁵⁰ See Gibelman & Gelman, *supra* note 3 and accompanying text.

¹⁵¹ *Id.*

point will surely confront the effects of unintended consequences. We can also observe, as an empirical fact, that the effort to engage in commercial enterprise to support nonprofit missions has inspired important innovative forms of associational hybrids, like the social business form.¹⁵² As reformers rethink the nonprofit sector, the characteristics and experiences of these new associational forms should be an invaluable resource.

At the same time, there are significant downsides to the business activity of nonprofits. In this Article, I have observed that, in addition to the statutory hazards posed by commercialization in the sector, business ventures in all forms create other risks: mission drift; reputational hazards; and (as discussed below) the diminution of the sector's capacity to generate social capital requisite to the maintenance of a representative democracy. Taking a larger view, research suggests that, as a contiguous matter, the phenomenon we now observe in the nonprofit sector impacts the public sector in a

¹⁵² Among the surfeit of creative solutions developed by the nonprofit sector, the media has given attention to the following, which I include for purposes of illustration:

1. Teach for America: a nonprofit organization that prepares graduates from elite colleges to teach underprivileged children. Among other things, it works in conjunction with the Knowledge is Power Program (KIPP), a network of charter schools dedicated to improving the educational opportunities for these children. Sam Dillon, *2 School Entrepreneurs Lead the Way on Change*, N.Y. TIMES, June 19, 2008, at A15.
2. Farm Rescue: a volunteer organization that helps farmers hit by disasters to get back on their feet by supplying the agricultural labor required. Blake Nicholson, *Businessman Creates Hope for Struggling U.S. Farmers*, CHRISTIAN SCI. MONITOR, July 2, 2008, available at <http://www.csmonitor.com/2008/0702/p12s01-usgn.html>.
3. ShopRite Supermarket: a for-profit grocery store providing low cost nutritional food to inner city neighborhoods "aimed at squashing obesity and related concerns such as heart disease and diabetes." The project was initially funded by a loan from Pennsylvania's Fresh Food Financing Initiative and may be the first successful public-private program of its kind. Sarah More McCann, *Wanted: Inner City Supermarkets*, CHRISTIAN SCI. MONITOR, June 26, 2008, available at <http://features.csmonitor.com/innovation/2008/06/27/wanted-inner-city-supermarkets>.

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negative way as well. As government has diminished its capacity to serve the community by outsourcing (contracting its programs to nonprofits and for-profits) or privatizing (abandoning) them, and as nonprofits have stepped in to fill the gap with resources generated by commercial activity, both the public sector and the nonprofit sector have suffered.

Studies indicate several trends. First, the social capital that forms the matrix which binds the elements or factions of civil society and of representative democracies together is weakened.¹⁵³ Privatization of government programs and services has burgeoned in the past quarter-century.¹⁵⁴ Empirical studies of the phenomenon indicate that the dominance of these contractual arrangements weakens democratic decision-making,¹⁵⁵ as well as the doctrine of state action and constitutional accountability in government.¹⁵⁶ Thus, representative democracy itself is weakened and with it the public's belief in government accountability and transparency.¹⁵⁷ Evidence shows privatization also weakens the nonprofit sector.

¹⁵³ The idea of "social capital" is nascent in the work of de Tocqueville and his observations that grass roots voluntary associations in the U.S. develop the organizational skills requisite to citizenship in a representative democracy, *see* Bucholtz, *supra* note 137 and accompanying text, and the work of James Madison and his observations about the importance of memberships in overlapping factions. *See* THE FEDERALIST No. 51 (James Madison). But the concept was famously developed by ROBERT PUTNAM, *BOWLING ALONE: THE COLLAPSE AND REVIVAL OF AMERICAN COMMUNITY* (Simon & Schuster 2000). There are two constituent categories of social capital: "bridging social capital" (building "norms of trust and reciprocity" among factions in society) and "bonding social capital" (developing "norms of felt solidarity"). Sheila Sues Kennedy & Wolfgang Bielefeld, *Hollowing Out Civil Society? Government Contracting and Social Capital*, *DEMOCRACY & SOCIETY* 6 (2004). Grass roots voluntary organizations are believed to foster both kinds of social capital.

¹⁵⁴ *See* Kennedy & Bielefeld, *supra* note 153, at 7 ("Government contracts in the United States now account for nearly 40% of all voluntary sector income, and by some estimates 80% of the income of social-service-providing nonprofits.").

¹⁵⁵ *See* Shelia S. Kennedy, *When is Private Public? State Action in the Era of Privatization and Public-Private Partnerships*, 11 *GEO. MASON U. CIV. RTS. L.J.* 203, 204-08 (2001).

¹⁵⁶ *Id.* at 207.

¹⁵⁷ *See id.*

Nonprofit contracting parties become beholden to the terms of the contract and their contracting partners in the public sector, rather than to their boards and donors.¹⁵⁸ Contracting with the government erodes the voluntariness of nonprofit organizations and, thereby, the social capital networks they are said to provide, just as it erodes the accountability and transparency of the government. Moreover, the dominance of the government as a contracting partner may create a financial dependency upon the government to sustain nonprofit projects, further compromising their status as members of a voluntary and independent sector, perhaps even “stifling grass-roots advocacy efforts by private voluntary organizations.”¹⁵⁹ One has to ask whether America’s infatuation with the business sector is worth that price.

Second, commercialization also has a negative effect on the voluntary characteristic of the nonprofit sector. Like contracts with government agencies, studies have shown that commercial projects decrease active participation by volunteers.¹⁶⁰ Voluntary contributions of work and finance are the *sine qua non* of nonprofit organizations and the foundational characteristic that develops social capital. Studies show that this vital element is weakened by both the privatization and the commercialization precipitated by government downsizing.

Third, while the public and nonprofit sectors have suffered some injury from the phenomenon, the evidence suggests that the for-profit sector has enjoyed a distinct advantage from downsizing the public sector. As examples, the well-publicized contracts of

¹⁵⁸ “When nonprofit organizations contract with the State, they become accountable in ways that are qualitatively different from the accountability owed to board members and even donors.” Kennedy & Bielefeld, *supra* note 153, at 7.

¹⁵⁹ *Id.* (citing U.S. GEN. ACCOUNTING OFFICE, *PRIVATIZATION: LESSONS LEARNED BY STATE AND LOCAL GOVERNMENTS* (1997)); MATTHEW CRENSON & BENJAMIN GINSBURG, *DOWNSIZING DEMOCRACY: HOW AMERICA SIDELINED ITS CITIZENS AND PRIVATIZED THE PUBLIC* (Johns Hopkins University Press 2002).

¹⁶⁰ See Bernard Enjolras, *Commercialization of Voluntary Organizations and Members’ Participation: The Case of Norwegian Voluntary Sport Organizations*, 2 *DEMOCRACY & SOCIETY* 8 (2004). This study chronicled the decline in volunteerism in proportion to the increase in commercial activity by the sports organizations and found that “[t]here exists apparently a crowding out effect of voluntary work by commercial incomes.” *Id.* at 10.

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Halliburton and Blackwater in the Bush administration's Iraq War have been enlightening.¹⁶¹

Fourth, and finally, since much of the debate about downsizing and privatization centers on the extent to which government should provide a social safety net for its citizens, some attention should be paid to that complex issue as well.

A useful place to access the available evidence is found in Jeffery Sachs' recent book *Common Wealth*.¹⁶² There he summarizes recent statistics that challenge the efficacy of a pro-business ideology. He divides capitalist societies into three groups: 1) "social welfare societies" (Denmark, Finland, Norway and Sweden); 2) "mixed economies" (Austria, Belgium, France, Germany, Italy, and the Netherlands); and 3) "(relatively) free-market countries" (Australia, Canada, Ireland, New Zealand, the United Kingdom and the United States). These three groups represent the spectrum of government spending to provide citizens with a social safety net as a percent of national income (GNP). And he uses empirical evidence to answer two questions raised by the claims of a pro-business, anti-government ideology:

1. Do strong social safety net programs threaten the economic strength of a capitalist society by "under min[ing] market mechanisms and . . . distort[ing] the incentives vital to healthy economic growth and performance?"¹⁶³
2. Are attempts to provide a safety net for the disadvantaged futile?

¹⁶¹ The publicity surrounding those contracts has been ubiquitous and needs no elaboration here, although Paul R. Verkuil gives the problem an interesting overview. PAUL R. VERKUIL, *OUTSOURCING SOVEREIGNTY: WHY PRIVATIZATION OF GOVERNMENT FUNCTIONS THREATENS DEMOCRACY AND WHAT WE CAN DO ABOUT IT* (Cambridge University Press 2007). Verkuil attempts to reintroduce pragmatism and balance to the debate over privatization and to analyze whether particular societal tasks should be assigned to a particular sector, using the outsourcing of military and related functions as his focus. *Id.*

¹⁶² See generally JEFFERY D. SACHS, *COMMON WEALTH: ECONOMICS FOR A CROWDED PLANET* (The Penguin Press 2008).

¹⁶³ *Id.* at 257.

The research Sachs provides suggests that not only are the claims upon which these two questions are premised false but there is abundant evidence showing that the opposites appear to be true. Sachs argues that “[t]he evidence suggests that the high social spending in the social-welfare states is indeed very effective in reducing poverty and inequality and in promoting health and prosperity”¹⁶⁴ He continues that, “[i]n terms of wealth and per capita income, the social-welfare states again defy the [ideological] stereotype that high taxation leads to lower living standards.”¹⁶⁵ Further, the social welfare states have achieved high levels of income, low rates of poverty and a more equal distribution of income than the free-market societies.¹⁶⁶ By contrast, “[t]he United States, among the richest of all the countries in per capita, GNP, also has the highest poverty rate by far, at 17.1 percent of households living on 50 percent or less than average household income.”¹⁶⁷ Social welfare states also appear to have lower rates of corruption and high public confidence in the government: “They are rated very highly in their international competitiveness . . . [and t]hey achieve high rates of national saving, despite the high tax burden. They achieve balanced budgets, despite the large social outlays, because the high public spending is matched by adequate taxation.”¹⁶⁸ “Another striking fact about the social-welfare states is their very high rate of technological excellence . . . [t]hey are heavy investors both in R&D and in higher education and they have very high rates of patents per capita as well.”¹⁶⁹

All of this evidence is presented not to suggest that the Scandinavian approach can be a panacea for U.S. problems. After all, the homogeneity of those societies must account for some of their abundant successes.¹⁷⁰ But neither does ethnic homogeneity vitiate the evidence that strong, well-funded government infrastructure programs can improve the operations of the economy

¹⁶⁴ *Id.* at 261.

¹⁶⁵ *Id.* at 262.

¹⁶⁶ *Id.*

¹⁶⁷ *Id.* at 261.

¹⁶⁸ *Id.* at 262.

¹⁶⁹ *Id.* at 263.

¹⁷⁰ *Id.* at 265.

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as well as the living conditions of the citizens. It is the kind of evidence that challenges the current U.S. ideology and helps us to rethink its assumptions.

A retrospective analysis that incorporates what we have learned about the way societies employ, or assign roles to, the three governance sectors and the consequences of those choices must surely precede and inform attempts to reform the nonprofit sector.

CONCLUSION

Commercial activity by nonprofit associations has allowed the nonprofits to sustain and expand their operations in an era of government downsizing. But this activity comes with significant risks to individual nonprofit organizations, to the nonprofit sector and, I argue, to society. Calls for reform of the sector are undoubtedly justified, but reformers need to rethink the ideological policy choices that encouraged the entrepreneurial turn in the nonprofit sector and the effects of those policies on the fabric of society. Reform must begin with a pragmatic reassessment of the effective roles each sector might play in achieving societal goals.