IS INCOME TAX EXEMPTION FOR CHARITIES JUSTIFIED?

THE ISSUE IS INVESTMENT INCOME

By Daniel Halperin

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1 Stanley S. Surrey Professor, Harvard Law School. Please do not cite this draft without permission. Part V on the treatment of endowments has since been presented at a number of conferences and workshops, including at Flinders University and the University of Sydney in Australia. I thank all participants and readers of earlier drafts for their comments. As will be clear from a perusal of the footnotes, I owe a great debt to the prior scholarship of Henry Hansmann and Evelyn Brody. I also want to particularly thank Takeshi Fujitani, a SJD candidate at the Harvard Law School, for particularly helpful discussions.
Is Income Tax Exemption for Charities Justified?– The Issue is Investment Income

Daniel Halperin

I. Introduction

A. In General

Most of us, particularly, those who itemize deductions in computing their Federal Income tax, are aware that contributions to charitable, educational, and religious organizations are deductible in determining taxable income. These organizations are also favored in many other circumstances. Contributions are deductible for income, gift and estate taxes purposes. IRC §§170, 2055, 2522. Qualifying organizations are described in section 170(c)(2) of the Internal Revenue Code which generally corresponds to section 501(c)(3), which govern income tax exemption. Charitable deductions are allowed in a limited number of other circumstances. See IRC §170(c)(3), (5). Other so-called public benefit organizations, see e.g. California Corporation Code §§5130, 7111, Revised Model Nonprofit Corporation Act §17.07, may be exempt under 501(c)(4). Contributions to the latter are not deductible. Section 501(c)(4) will be discussed.

2 The origin of this paper was a presentation to the 2000 Conference on Taxing Charitable Investments sponsored by the National Center on Philanthropy and the Law, NYU School of Law. The original paper, which is a comprehensive overview of the income taxation of Nonprofit Organizations, is available online at www.law.nyu.edu/ncpl/libframe.html. This paper generated two previously published articles. For a discussion of the taxation of mutual nonprofits, see Daniel Halperin, Income Taxation of Mutual Nonprofits, 59 Tax L. Rev. 133 (2006). See also Daniel Halperin, The Unrelated Business Income Tax and Payments from Controlled Entities, Tax Notes December 12, 2005 at 1443.
additional ways. They are often exempt from income, property, and sale taxes. They can issue bonds, the interest from which is exempt from Federal taxes. They may pay lower postal rates. They are frequently not subject to various regulatory restrictions.4

There is much discussion in the literature about the essential characteristics organizations must exhibit in order to qualify for such special treatment. This article will not contribute to that discussion since it will start from the assumption that the charitable deduction for contributions to certain organizations is justified. I want to focus, instead, on the income tax treatment of charities. I consider to what extent exemption constitutes a departure from normal tax principles, and, if so, is the special subsidy justified. As the title implies, I conclude that the principal issue is whether the exemption of investment income can be defended. As just suggested, I do not believe that entitlement to the other aforementioned special benefits, or even tax exemption, necessarily accompanies qualification for the charitable deduction. Rather, I maintain that we need to examine all benefits separately in light of their intended purpose. In that vein, this article asks whether curtailment of the income tax exemption can be consistent with retention of the other benefits.

This seems potentially plausible because exemption from income tax has a different impact than other benefits available to charities. In short, the charitable deduction and other subsidies, such as real property tax exemption, can be said to reduce the cost of current briefly. See part VI. Section 501(c) exempts 28 categories of organizations from tax. Most of these can be described as mutual organizations or government related entities, which are not the subject of this paper. See Taxation of Mutual Nonprofits supra note 2.

4Add examples
operations. Income tax exemption, on the other hand, will in most circumstances affect only the relative cost of setting aside funds for the future (including by way of capital items), as compared to providing current benefits. It will not seriously concern those organizations that spend nearly all their funds on current activities.  

Thus, a hospital which spent all its income on the current cost of serving paying patients would not have taxable income. It would be irrelevant whether or not it was exempt from income tax. However, the exemption would be important for a hospital which sets aside funds as a reserve against future costs or used some of its profits to purchase new buildings or equipment. On the other hand, both hospitals could benefit from the charitable deduction and the real property tax exemption.

The charitable deduction, in effect, reduces the price of certain goods and services or put another way allows donors to purchase more of such items for a given out of pocket cost. For example, an individual in a 35% bracket, who earns $100 would retain $65 after tax to spend on goods or services. Alternatively, by making a $100 deductible contribution, he can purchase $100 of charity while forgoing only $65 of private spending. This can be justified as alleviating the failure of the market adequately to supply public goods or to provide a fair distribution of

5 But see parts IV and VC2 infra.

income, or, as it is sometimes put, “lessening the burdens of government.”

Similar results can be achieved by lowering the costs of the organization. Thus, an exemption from sales taxes lowers the cost of purchasing otherwise taxable goods. The charity gets goods which normally cost more than $100 for a $100 expenditure, thus, further increasing what can be purchased from the donor’s $65 sacrifice. Real property tax exemption lowers the cost of using real estate owned by the organization. Postal rate reduction reduces mailing costs. The ability to issue tax-exempt bonds lowers borrowing costs and so on. Unlike, the charitable deduction, availability

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7 Treas. Reg. §1.501(c)(3) – 1(d)(2).


9 See generally W. Harrison Wellford and Janne C. Gallagher, Unfair Competition? The Challenge to Charitable Tax Exemption (National Assembly 1988). Property Tax Exemption for Charities (Evelyn Brody ed.)(2002) Note possibly articles by Netzer and Cordes are most relevant. The exemption could encourage the purchase of real estate. This may depend on the value of the tax benefits to the lessor of real estate to charities and whether this is passed through in lower rents. CITE?

10 See 39 C.F.R. 111.1

11 IRC §145

12 Wage costs would also likely be reduced if employees of exempt organizations were exempt from income taxes. While this was never the case, section 501(c)(3) organizations were given the choice to be exempt from FICA (which finances Social Security) until 1983 and are still exempt from unemployment taxes. IRC §3306(c)(8). See P.L. 98-21, §102(b)(1) amending
of these subsidies depends upon spending money in the specified way. The charitable deduction can be thought of as general rather than a specific price reduction.

A charitable deduction or the other benefits previously mentioned are not the only means to accomplish the apparent goal. Subsidies for the provision of particular goods and services could also be provided by direct government grants or by tax benefits either to the purchaser of these goods or services or to for-profit suppliers.\(^{13}\) For example, a deduction could be provided to the “purchaser” of disaster relief who makes a transfer directly to the party in need or through an intermediary for-profit organization, rather than through the Red Cross. This suggests that even though we allow a charitable deduction for contributions to organizations meeting certain characteristics, it does not follow that such an organization must itself be exempt from tax.

Because of the charitable deduction, however, even taxable corporations do not pay tax on sums contributed to charity up to 10% of net income.\(^{14}\) Putting aside the limit, would consistency with the charitable deduction require that charitable organizations themselves be exempt from income tax, which could be said to be equivalent to an unlimited charitable deduction? Surprisingly, however, even partial exemption of income earned by a charity is not generally necessary to achieve parity with an individual or a taxable corporation entitled to a


\(^{14}\) §170(b)(2).
charitable deduction. Because deductible contributions permit a charity to invest from untaxed income, exemption for the charity would, generally, have a larger impact than the mere allowance of a charitable deduction to a taxable party. It allows a larger accumulation than if the contributor continued to hold the funds.

However, in some circumstances exemption for income seems to be consistent with the charitable deduction. For example, this may be so when income is derived from exploiting charitable assets or in return for access to the organization’s beneficiaries or contributors. Moreover, even though the impact of the charitable deduction differs from the effect of an exemption for income, acceptance of the charitable deduction may be an indication that a special subsidy is nevertheless appropriate. Still, it remains true that the assumption that the charitable deduction is justified and will continue, is not determinative of whether income should be taxable.

Under current law, although, generally exempt from income tax, all charitable organizations are taxed on income from an unrelated business\textsuperscript{15} and on debt financed income.\textsuperscript{16} Private foundations pay a small excise tax on investment income.\textsuperscript{17} These levies are based on special considerations and not on any overall notion that income should be taxed. Thus, the tax on unrelated business income, known as UBIT, is intended to eliminate what is said to be an unfair advantage over taxable competitors or to preclude inefficient efforts to avoid the corporate tax.

\textsuperscript{15} IRC §511.

\textsuperscript{16} IRC §§514, 512(a)(4). The tax does not apply if borrowing is related to the exempt function. IRC §512(b)(1)(A).

\textsuperscript{17} IRC §4940
tax by investing directly in business as opposed to owning shares in public corporations. It is also said to be necessary to preclude loss of revenue.\textsuperscript{18}

The private foundation excise tax was, at least in part, intended to pay for the cost of oversight given the potentially abusive behavior identified when the restrictions on private foundations were enacted in 1969. The tax on debt financed income was originally focused on sale lease backs. The goal was to prevent the purported sale to an exempt entity in order to convert ordinary income into capital gain. Extension to all debt financed income was said to be needed because otherwise the charitable sector could expand without additional contributions.

The appropriateness of these provisions will not be explicitly discussed here. Rather the focus of this paper is on the overall income tax exemption for charities – to what extent it is special and if it is special can it be justified. In my view, this matter does not implicate the issue of whether a separate corporate tax is appropriate.\textsuperscript{19} Since there are no shareholders, there obviously would no second level tax on distributions. Therefore, any tax on the charity should be considered, at least as far as tax policy is concerned, as a proxy for the tax that should be paid by the donor or beneficiary, who stand in lieu of shareholders.

\textsuperscript{18} See Halperin Tax Notes \textit{supra} note 2 at 1445-47.

\textsuperscript{19} Hansmann seems to view the issue to be whether a nonprofit should be subject to the corporate tax, stating that the discussion is handicapped by the lack of any consensus concerning the purpose and consequences of the corporate tax. Rationale \textit{supra} note 6 at 56. However, he also assumes the issue is the same if the trust form is used. Id. at 55, note 6.
Some would argue that if a tax were to be imposed, the appropriate rate would reflect the tax situation of the beneficiaries who could be exempt or taxed at low rates. However, Hansmann has suggested that the ultimate incidence of a tax on nonprofits would not be particularly regressive. Donors would likely share the tax burden with beneficiaries and in any event those organizations most affected by a change in policy, presumably those with large endowments, would have relatively affluent beneficiaries. I discuss below whether taxation of charity should depend upon the existence of donor control or the likely income level of beneficiaries.

In short, I believe the appropriate tax treatment of a charity’s income, particularly investment income, should depend upon the public policy implications of deferred versus current spending. In particular it rests on whether public policy should favor relatively more current spending, and, if so, whether taxation of investment income would be a sensible way to further this goal. Even if this turns out to be true, however, it does not follow that the current subsidy for charitable organizations is excessive. Therefore, if income were taxed, it would be preferable to keep the resources of the charitable sector constant by offering additional aid in other forms, for

20 Boris I. Bittker & George K. Rahdert, The Exemption of Nonprofit Organizations from Federal Income Taxation, 85 Yale L.J. 299, 314-6 (1976) (hereinafter Bittker). The incidence of the burden as between the donor and the beneficiary depends upon the donor’s behavior. If the donor keeps her after tax contribution constant, the beneficiary bears the burden of any additional tax. On the other hand, if the donor has a target benefit to the organization in mind, she would bear the burden.

21 Rationale supra note 6 at 66
example, a tax credit as opposed to a deduction for low earners, a deduction in addition to the standard deduction or perhaps by raising or eliminating the limit on deductions. In that way, taxation of income will not reduce the overall subsidy to the charitable sector.

Thus, another way to approach this paper is to ask whether if the charitable sector received the same amount of government largesse, would it be an improvement if some or all of income were fully or partially taxable. Such a change could favor organizations which currently spend more of their assets and accumulate less for the future.

Data on size of endowments
Percentage and nature of organizations with significant endowments
Percentage and nature of organizations with limited or no endowments
Percentage of giving to endowments

Would it be consistent with public policy to reduce the tax subsidy for these large accumulations? Could some tax on investment income, in particular, make sense?

B. Prior Literature

In prior articles, particularly one by Bittker and Radhart, it has been claimed that a non-profit organization, by its very nature, is not an appropriate subject for a tax based on income. However, Henry Hansmann, among others, have noted that a so-called non-profit organization, for example, a hospital, often intends to make a profit and its income can be measured in the same way as for-profit companies. I agree. Nevertheless, as explained below, in my view for the most part only exemption for investment income is special. Exemption for other receipts,

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22The Tax Expenditure budget does not list tax exemption for non-profits as an item representing departure from the normal income tax.
including importantly income from related activities, is generally consistent with normal income
tax principles or, in limited situations, the existence of the charitable deduction.

I believe that this can be better understood if we examine each element of income separately. Thus, charities can raise funds from dues or contributions, receipts from performance of charitable activities, investment income, including receipts from unrelated business activities, and from what I will call exploitation of charitable assets or its donors. In some of these cases, for example, donations and in many situations income from services which is the basis of the organization’s exemption, I agree with Buttker that exemption is not inconsistent with normal income tax treatment. Unlike Bittker, who often merely states his conclusion without sufficient analysis or justifications, I try to offer more specific reasons to support this claim.

Consistency with normal income tax treatment is definitely not the case, however, with respect to exemption for investment income, particularly income from an endowment. Even with respect to income from related goods and services, exemption can be said to be special if profits are diverted to an activity unrelated to the production of this income or invested in long-term improvements, such as real estate, machinery and equipment. Exemption in these circumstances requires a demonstration that a subsidy to the organization can be justified.

In this vein, Henry Hansmann has asserted that the best case for an income tax exemption is what he referred to as a capital subsidy to non-profits, which, while the most efficient supplier of certain goods and services, could have difficulty raising sufficient capital to meet consumer demand. My demonstration that exemption generally provides special treatment only when income is immediately invested in capital expenditures, or set aside for future investment in such...

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23 See infra
items, gives more context to Hansmann’s argument and may make it stronger. As discussed below, I would not tax income set aside for capital expenditures. I offer several rationales for this subsidy including reliance on Hansmann.

C. Outline of Paper

Thus far, I have suggested the following ideas. First, each of the tax preferences and other benefits for charitable organizations should stand on its own. The fact that a charitable deduction is allowed for contributions to an organization does not mean that the organization itself must be exempt from tax on its income.

Second, much of the income tax exemption for charities is not special, in that it is consistent with normal tax principles. This relates primarily to income from related activities set aside for future expenditures that would be deductible when made.

Third, an exemption for income from related activities used for capital expenditures is special. However, a special subsidy recognizing exemption can be justified.

Fourth, the most important way in which the tax treatment of charities is special is the exemption for investment income. As, summarized next and developed more fully below, this exemption has both equity and efficiency implications. Ultimately whether a subsidy is appropriate may depend upon whether public policy should favor relatively more current spending by charities, and, if so, whether taxation of investment income would be a sensible way to further this goal.

There has been an ongoing debate between supporters of the income tax and those who favor some form of consumption tax as to whether equity requires explicit taxation of investment income as the income tax does. While we continue to employ an income tax, there are
exceptions to taxation of investment income. Thus, the current income tax, perhaps because of the importance attached to encouraging retirement savings for rank and file employees, does not reach investment income under employer sponsored retirement plans, 401(k) plans or IRAs.24 The question is whether similar favorable treatment for charitable savings is warranted, perhaps because it does not implicate the same inequity as an exemption for private savings.

It is also not clear whether “neutrality” requires exemption or taxation of income, particularly investment income. In other words does the exemption cause donors to inefficiently favor gifts for future as opposed to current use? Alternatively, is exemption required so that charities would be neutral between current and future spending? Whatever may be neutral, it is possible that various factors cause charities to inefficiently favor future spending. If it is believed that donors and or trustees are likely to error in favor of deferred spending, we could choose to mandate a certain level of current spending or encourage it by taxing investment income. In this regard, it may be relevant whether spending on capital items, such as buildings or art works, may be considered current rather than future spending.

As noted above, charities can raise funds from dues or contributions (including fund-raising events), receipts from performance of charitable activities (including sale at a profit of assets, such as a painting or a building, used in such activities), investment income (including receipts from unrelated business activities), and from what I will call exploitation of charitable assets or its donors (including advertising revenue and so-called sponsor payments).

Part II looks briefly at donative contributions. Part III considers income from related activities. Part IV concerns income from exploitation of charitable assets or its contributors and

24 See infra.
customers. Part V, which is the heart of this paper deals with investment income. Part VI briefly
looks at the special case of organizations exempt from tax under section 501(c)(4)—public benefit
organizations contributions to which are not deductible. The conclusion (Part VII) summarizes
my findings.

In sum, I first explain why much of the income tax exemption of charities is consistent
with income tax principles. This conclusion, as explained below, depends, in part, upon a time
value approach, namely timing is not determinative if an amount is adjusted by the after-tax rate
of return so that measured in present value the deduction is correct even though it is allowed too
early. The paper then discusses the arguments for and against an exemption for investment
income. While no definitive solution is offered, I hope in this paper to describe the relevant
considerations that would affect the role, if any, tax exemption for investment income should
play as part of the arsenal of subsides to charitable organizations.

My principal point is that income from related activities of charities is probably
appropriately exempt but the exemption for investment income is more problematic and should
depend upon a public policy judgment regarding the trade off between current and future
spending.

II. Donative Contributions

For some organizations the large bulk of their funds comes from contributions which,
under normal tax principles, should be exempt as gifts.\(^{25}\) In fact in Branch Ministries, a case in
which the IRS revoked the exemption of a church alleged to have engaged in political activities,
the court noted that the IRS explicitly represented, both in its brief and at oral argument, that

\(^{25}\)Bittker supra note 20 at 308-9.
donations were nontaxable as gifts even if the organization lost its exemption for engaging in political activities.\textsuperscript{26}

Charitable contributions, of course, differ from family gifts in that they are deductible by the donor. Thus, if neither the organization or the ultimate beneficiary is taxable, income will escape taxation. This would not be true of gifts to family members.

It is possible, therefore, that the goal of the charitable deduction is to recognize that the donor has reduced her consumption in favor of consumption by the beneficiaries of the organization. On this assumption, the organization could be taxable at a rate dependent on the income level of the likely beneficiaries. Professor Andrews, who advances an argument along these lines in his claim that the charitable deduction accurately measures income, suggests that the appropriate rate in these circumstances would often be zero.\textsuperscript{27} There would be many cases, however, where the beneficiaries of the organization are likely taxable at a higher rate. In this case, if the contribution were taxable, the benefit of the charitable deduction would be offset.

If one believes, as I do, that Congress intends the charitable contribution to provide a benefit in these circumstances, it seems clear that an exemption for donative contributions is supported by the policy behind charitable deductions. This would seem even more obvious if the charitable deduction were converted to a credit. A credit would reflect an intended price reduction for charitable spending and there is no logical reason to offset the price reduction by taxing the organization particularly if the tax were at a higher rate.

\textsuperscript{26} Branch Ministries v. Rossotti, 211 F.3d 137, xxx (D.C. Cir 2000).

\textsuperscript{27} William Andrews
Contributions may perhaps be thought of as the purchase of goods or services rather than gifts to the organization. Henry Hansmann has noted that even though the donor may be making a gift to the ultimate beneficiary, it may not be a gift to the charitable organization. The Red Cross, for example, could be deemed to be selling disaster relief (in Hansmann’s words “like Tiffany’s sells wedding gifts”).\textsuperscript{28} From this perspective, contributions to the Red Cross would be gross income from the performance of related activities which will be considered in the next section.

In some cases, the transferor is not making a gift at all and is clearly purchasing goods or services. This may be true of that portion of so-called membership dues which entitles the member to receive goods or services without charge or at a reduced price. This is clearly gross income from related activities which will be discussed in the next section.

Fund-raising activities involve some mixture of donations and sale of goods or services. The goods or services may be sold at cost or above but below market, at market, or above market.

Suppose, an artist contributes a painting with a market value of $1000 to be sold by the charity at auction. Although, the artist’s charitable deduction is limited to the cost of materials, she has effectively made a donation equal to her normal selling price for the painting. A patron who pays $1000 or less has merely purchased goods from the charity. The money that the charity receives is derived from the artist’s donation, not the sale of property. It should not be taxable. If the patron pays more than $1000, at least if she had a donative intent, the excess would be a charitable contribution which like other contributions should be exempt from tax.

\textsuperscript{28} Rationale \textit{supra} note 6 at 61.
It would seem possible that the charity could be said to sell goods or services above cost but not above market. Suppose, tickets for a concert, sold at the normal rate for such events, nets the charity $15,000 in excess of all expenses. The performer waives her normal fee for a concert or $10,000. As before, $10,000 retained by the charity should be considered a donation by the performer even though no charitable deduction is allowed. The other $5000, however, seems to be a profit from running the concert.

Under current law, this amount would not be taxable under UBIT unless the activity is regularly carried on. However, under normal tax principles, this amount would be taxable. Whether, this income should nevertheless be exempt seems to involve similar issues to those raised in Part IV (relating to Exploitation of donors or beneficiaries) and will be discussed at that point.

III. Income from Related Activities

This part considers whether income of charities derived from related activities should be exempt. Obvious examples are hospital fees and tuition revenue. I include here sale at a profit of assets, such as a painting or a building, used in such activities.

In the early stages of our income tax, not for profit entities may have been considered by their very nature not to be a proper subject for income taxation. As Professor Bittker states, it was “suggested that an income tax could appropriately be imposed only on activities conducted for profit, and that crucial statutory notions like ‘net income’ and ‘business expenses’ do not ring true when applied to nonprofit organizations.”29 However, we have come to understand that

29 Bittker supra note 20 at 302.
many nonprofit organizations do engage in activities with the intent of earning a profit and this profit can be measured.

A for-profit organization will clearly have taxable income if it sets aside profits for current or future distribution to shareholders or owners. However, a charitable organization is distinguished from a for-profit entity by what has been referred to as the “non-distribution constraint,” which precludes remittance of profits to shareholders or members. Further, since a charitable organization, unlike a business corporation, will not have shareholders or owners who demand a return on their investment, it need not operate at a profit over the long term. In fact, over time the organization should have no net income. It will have current earnings only if amounts, in excess of nontaxable receipts, are set aside to meet future costs or it makes capital expenditures (such as for buildings and equipment— the cost of which is only deductible over time) out of current cash receipts in excess of current depreciation deductions. Nontaxable receipts would include the cost or basis of assets used in the related activity which may have been sold during the year.

It can be demonstrated that if funds will be used for a future deductible expense, exemption, which amounts to a current deduction for the present value of the future expenditure, will correctly measure income. Thus, a mismeasurement of income occurs only with respect to

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31 For example, if a business has taxable income of $1000 before depreciation deductions of $200, net income will be $800. However, there will be an additional $200 which can be reinvested in buildings or equipment.
capital expenditures. However, since the special treatment benefit amounts to exemption for investment income, it implicates the question of whether investment income should be taxed as discussed in Part V. What follows develops these points in greater detail.

A. Current expenses

If receipts are for services performed by the organization in the performance of its exempt function, the organization should be able to offset such receipts by deductions for its expenses related to the supply of such goods or services. Boris Bittker has expressed concern that the receipts of a nonprofit might be considered taxable while expenditures in carrying out the charitable or exempt function would not be deductible, since they are not related to activities carried on for profit. However, we do ordinarily allow expenses even for activities not carried out for profit to the extent of income from that activity. Thus, even if the activity is not for

32 Taxation of Mutual Nonprofits, supra note 2 at 145. As discussed below, see text at note 45 (Part IIIC), the question of special treatment also arises when expenditures are made for activities unconnected with the production of income.

33 Bittker supra note 20 at 309-11. See Eden Hall Farm v. U.S. 389 F. Supp. 858 (W.D. Pa 1975). In that case the government asserted that the organization was not exempt and denied deductions, presumably, on the grounds that the activity was not carried on for profit. The issue was moot because the court found the organization to be exempt. See also Synanon Church 1989 TC Memo #270 (Court rejected similar argument raised by IRS and allowed expenses to extent of the income from that activity.)

34 Synanon Church 1989 TC Memo #270, GCM 39813, 90 TNT 71-6. Cf IRC Section 183.
profit, the organization should be able to offset income by its expenses related to the production of that income. At most, only net receipts would be subject to tax.

As noted above, similar treatment could apply to contributions by donors, if it is deemed a sale of goods or services by the organization. Thus, as noted above, Henry Hansmann has suggested that the Red Cross, for example, could be deemed to be selling disaster relief. From this perspective, contributions to the Red Cross would be gross income and the costs of providing relief would be deductible expenses. It seems clear that the expenses are related to the receipts.

B. Set Asides for Future Expenses

If we assume that eventually all funds will be used for related deductible expenditures, income could be said to be properly measured even if current income is exempt. In that case, an exemption will not reduce the present value of taxable income as compared to the normal rule which would allow deductions for future expenditures when incurred. This is so because exempting income used for future expenditures is equivalent to allowing a deduction for the present value of the expenditure. Therefore, taking account of the time value of money, income is correctly measured. From this perspective the income tax treatment of charities does not amount either to exemption or a deduction for the acquisition of unrelated investments purchased with the funds set aside.

To illustrate, let us assume a 10% return on investment, which, for the moment, we will assume to be taxable at a 35% tax rate. Consider, a charitable hospital which produces $100 surplus of income over expenses in year 1. This amount is set aside for future needs. At the

35 Rationale supra note 6 at 61.
assumed interest and tax rate the hospital will accumulate $113.42 at the end of year 3. Suppose
at that time this amount (the original $100 plus the accumulated income) is spent on deductible
items. Under normal tax principles, $113.42 would be deductible in year 3. Tax exemption for
the hospital, effectively allows a $100 deduction in year 1. However, at a 6.5% interest rate,
which reflects the hospital’s after-tax rate of return on investment, the two amounts are
equivalent. At 6.5%, $113.42 is the future value of $100 in two years or, conversely $100 is the
present value of the future expenditure of $113.42. Exemption for the amount set aside, which is
equivalent to a current deduction of $100, would, thus, correctly measure the future deduction.
Since this is so, taxing income currently and allowing a later deduction for the full amount of the
future expenditure would, under certain assumptions, including that tax losses were usable, have
no impact on the tax burden of the organization. This can be illustrated by the following example
which is more fully developed in the footnote.\textsuperscript{36}

As noted, if $100 set aside for future expenses is exempt but investment income is taxed,
the organization (assuming a 10% return and a 35% tax rate) will accumulate $113.42 after two

\begin{tabular}{lcc}
\textsuperscript{36} & No current tax & Current tax \\
Income & $100 & $100 \\
Tax at 35\% & $35 & \\
Investment & $65 \\
Earnings at 10\% & 10 & 6.50 \\
Tax at 35\% & 3.50 & 2.27 \\
Earnings at 6.5\% & 6.50 & 4.23 \\
Investment-year 2 & $106.50 & $69.23 \\
Earnings at 10\% & 10.65 & 6.92 \\
Tax at 35\% & 3.73 & 2.43 \\
Earnings at 6.5\% & 6.92 & 4.49 \\
Accumulation & $113.42 & $73.72 \\
Tax Savings & 39.70 & \\
Expenditure & $113.42 & \\
\end{tabular}
years. But the same amount could be available even if the profit of $100, which is set aside, is taxed. Initially, of course, only $65 would available for investment accumulating to $73.72 after two years. However, if a $113.42\textsuperscript{37} expenditure made at that point is deductible, the tax savings from the deduction, $39.70, combined with the accumulation of $73.72, would be sufficient to enable an expenditure of $113.42 to be made. Even if there were no current income to be offset by the deduction, assuming the organization had through borrowing or otherwise the ability to expend $113.42 before receiving the tax refund, a carry back, if available, of the deduction of $113.42 could produce a refund of $39.70, the amount of the previous tax payments.\textsuperscript{38} Thus, if tax rates do not change, tax exemption may not affect the position of the organization.

The position of the government may also not be affected by whether the initial $100 surplus is taxable. This is so if we assume a relevant interest rate of 10\%. If there is no tax in year 1, the IRS would receive the tax on the investment income in the two year period. This would be $3.50 in year 2 and $3.73 in year 3.\textsuperscript{39}

If the $100 surplus were taxable, the taxpayer would have only $65 to invest and the tax on investment income would be only $2.27 in year 2 ($1.23 less) and $2.43 in year 3 ($1.30 less).\textsuperscript{38}

\textsuperscript{37} It may be noted that the expenditure ($113.42) would be technically in excess of income ($100) even if not so in present value terms. Thus, there maybe a claim that a rule allowing expenditures up to the amount of income, even if the transaction is not entered into for profit, would not in itself allow the full amount to be deducted.

\textsuperscript{38} The sum of the tax payments in the current tax column in footnote 36 is $39.70 ($35+2.27+2.43).

\textsuperscript{39} See note 36.
However, the IRS would also receive $35 in year 1 subject to a refund $39.70 in year 3. This amount would be available at a 6.5% rate of return ($2.27 of interest in year 2 (on $35) and $2.43 of interest in year 3 (on $37.27). At a 10% rate, the government would earn $3.50 in year 2 (on $35), the extra $1.23 making up the shortfall from the tax on investment income. If it reinvests $37.27 (holding back the $1.23) it would earn $3.73 in year 3. The extra $1.30, in addition to the amount needed to finance the refund ($2.43) would make up the shortfall from the tax on investment income.  

Thus, under these assumptions, in either case, the IRS collects an amount equivalent to the tax on the investment income earned from the $100 set aside for future expenditures. This is a sensible result because even though $100 is the present value of the future expenditure of $113.42, spending $113.42 in two years is not totally equivalent to spending $100 now. In the former case, funds are set aside for two years and there is investment income which would normally be taxed. It also demonstrates that an early deduction does not affect revenue if the amount of the deduction is the present value of the future expenditure not the face amount. In contrast, if an immediate deduction of $113.42 were allowed, investment income would escape taxation.

The important variable is not the timing of the deduction but the treatment of investment income. Thus, if investment income were not taxed, the future expenditure could be $121. If

40 Id.

41 See Taxation of Mutual Nonprofits, supra note 2 at 159 (note 97); see also Interest in Diguising: Taxing the Time Value of Money, 95 Yale L.J. 506, 532 at note 98 (1986).

42 See Part V.
$100 were set aside, assuming a 10% rate, the organization would accumulate $121 after two years. But the same amount would be available even if the profit of $100, which is set aside, is taxed. Initially, as before, only $65 would available for investment accumulating to $78.65 after two years. However, if a expenditure of $121 made at that point is deductible, the tax savings from the deduction, $42.35, combined with the accumulation of $78.65, would be sufficient to enable an expenditure of $121 to be made.\(^43\) At a 10% rate, the present value of the future expenditure ($121) would be equal to the amount set aside ($100).

The government is also indifferent, essentially collecting no net tax in either case. There is no tax on investment income. If the hospital is nevertheless taxable on the $100 surplus, the IRS would receive $35 in year 1 but would refund $42.35 in year 3. This amount would be available at a 10% rate of return ($3.50 of interest in year 2 (on $35) and $3.85 of interest in year 3 (on $38.50).

\[^{43}\] No current tax

<table>
<thead>
<tr>
<th>Income</th>
<th>$100</th>
<th>Current tax</th>
<th>$100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax at 35%</td>
<td>____</td>
<td>35</td>
<td></td>
</tr>
<tr>
<td>Investment</td>
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<td>65</td>
<td></td>
</tr>
<tr>
<td>Earnings at 10%</td>
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<td></td>
</tr>
<tr>
<td>Investment-year 2</td>
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<td>$71.50</td>
<td></td>
</tr>
<tr>
<td>Earnings at 10%</td>
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<td>7.15</td>
<td></td>
</tr>
<tr>
<td>Accumulation</td>
<td>$121</td>
<td>$78.65</td>
<td></td>
</tr>
<tr>
<td>Tax Savings</td>
<td></td>
<td>42.35</td>
<td></td>
</tr>
<tr>
<td>Expenditure</td>
<td></td>
<td>$121.00</td>
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</tr>
</tbody>
</table>

If there were no current income, a carry back, if available, of the deduction of $121 could produce a tax refund of $42.35. In this case, however, the previous tax payments from this transaction would only be $35.
Of course, this discussion is not meant to suggest that the current exemption for charities is not advantageous. The full surplus of $100 and the income thereon is always on hand and is not dependent on a future tax deduction which could be affected by a change of rates or the availability of a loss carry back to provide a tax refund. Even if the future tax benefit were certain, it is not clear that creditors and others would view potential tax refunds as the equivalent of money in the bank. Tax liability could also discourage the retention of sensible contingency funds.44

C. Capital Expenditures and Shifting

In contrast to what has been said about amounts set aside for future deductible costs, failure to tax amounts set aside or used for a capital expenditures amounts to a subsidy. Exemption would be equivalent to immediate deduction (or expensing) for a capital expenditure. Such an immediate deduction is greater than the present value of the depreciation deductions, which would normally be allowed over time. It has been described as equivalent to tax exemption for investment income earned from the investment in capital items.45

44 As discussed below, incentive for undue accumulation could depend on whether or not investment income is taxed.

45 See William D. Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113, 1127 (1974). Assume a corporation earns $100 and invests the after-tax income ($65) in an item which will be sold for $68.50 in one year. After tax it will earn $2.23 or a 6.5% return on its $65 investment. If the purchase is immediately deductible, it can invest $100 and produce $110 on sale. This amount will be fully taxable since basis has been previously deducted. After tax ($38.50) the corporation will retain $71.50. The $6.50 profit is a
Similar issues arise if expenditures are for purposes which are, at least arguably, not related to the production of income. For example, a hospital uses the surplus from paying patient to provide free care to the indigent.

If income from unrelated investments were to be taxed, as discussed below, the question would be whether income derived from related activities used for capital items or unrelated expenditures should nevertheless continue to be exempt. Of course, if investment income were generally not taxed, the treatment of capital expenditures would not raise any special concern. This issue will be considered below at Part VC.

IV. Exploitation of Assets or Beneficiaries

In some cases, income could be derived from the exploitation of assets otherwise used in an exempt activity without any additional investment. An example would be royalties earned by an art museum from allowing others to make reproductions of its holdings. An exempt organization could also be compensated for allowing access to the nonprofit’s “customers” or beneficiaries. This may include payments to a university for the exclusive right to sell a particular brand of beverage on campus, royalties on an affinity credit card, or advertising or corporate sponsorship payments in connection with an event or publication.

Aside from the question of whether the tax on unrelated business income (UBIT) should exist and, if so, should it apply here, if we accept the legitimacy of the charitable deduction, an 10% return (the pre-tax rate) on what would have been its investment if tax were properly applied.
exemption for this income seems appropriate. Like the charitable deduction, these receipts reduce the net cost of a current charitable activity. Moreover, in the above examples, there does not appear to be any investment unrelated to the charitable purpose. There could be an argument for taxation, however, if there is a mixture of related and unrelated purposes. For example, a university builds a larger field house than needed to accommodate school activities in order to attract outside events, such as rock concerts.

It is also probable that these receipts do not represent a return on an investment purchased with pre-tax dollars or, if they do, they may reflect an amount in excess of a market return on investment. If so exemption is consistent with the allowance of a charitable deduction to for-profit corporations, except for the fact that the 10% limit is not applied. Perhaps, the reasons, if any, that justify the limit on the deduction do not seem applicable in these circumstances.

V. Investment Income

A. Tax Policy

1. In General

I believe the appropriate tax treatment of investment income should depend upon the public policy implications of deferred versus current spending. In particular, we should determine whether public policy should favor, disfavor or be neutral with respect to endowments and the

46 See discussion at V A 1

rule that neutrality would imply.\textsuperscript{48} In the end, whether or not investment income should be taxable, and at what rate, depends upon a complex balancing of competing considerations.

A tax on investment income is said to encourage current over future spending as opposed to the situation when investment income is exempt.\textsuperscript{49} Therefore, from the organization’s perspective, tax exemption may be essential to achieve neutrality as to the timing of expenditures. It may also provide neutrality between investment in capital expenditures, such as buildings, as opposed to adding to an endowment and renting space. On the other hand, from the donor’s perspective, because the donor’s investment income is taxable reducing the amount available for future expenditures, tax exemption for the charity’s investment income appears to favor contributions to an endowment for future spending by the charity more than it does gifts for current expenditures. I consider here whether an exemption for investment income of charities maintains neutrality between current and future spending or, in fact is distortionary in light of the fact that the income tax would apply to investments by donors.

Apart from neutrality, fairness may be a concern. Many feel that, since the wealthy have proportionally greater savings in relation to earned income, a tax on individual investment income is required to achieve an equitable distribution of the tax burden. This part considers

\textsuperscript{48} If a tax on investment income is to effectively establish a bias in favor of current expenditures, it would be necessary to consider investment income as a separate class of income not affected by other income or deductions. Another way to explain this result is if all other income is exempt, expenditures related to that income should not be deductible against investment income as would be true of individuals in their personal life.

\textsuperscript{49} Andrews, Weisbach
whether equity similarly requires that the investment income of charities be taxed. If so, exemption could be considered inconsistent with the distributional goals of the income tax.

Finally, in the next part, I consider whether there is a case for public policy to abandon neutrality, whatever that might require, in favor of encouraging more current spending on charitable activity. In other words, is there some reason to believe that a preference for current spending by charities may be desirable? These points are now developed in greater detail.

2. Implication of Charitable Deduction

I start by noting that the existence of the charitable deduction does not provide clear guidance as to the treatment of investment income. As noted above, the rationale for the charitable deduction does not necessarily imply that all income of recipient organizations must be exempt from tax. First, the impact of the charitable deduction differs from the effect of an exemption for income. In short, the charitable deduction and other subsidies, such as sales tax exemption, can be said to reduce the cost of current operations. Income tax exemption, on the other hand, will in most circumstances affect only the relative cost of setting aside funds for the future as compared to providing current benefits. It will not seriously concern those organizations that spend nearly all their funds on current activities.

Second, exemption of investment income earned by a charity is a greater benefit than allowance of a charitable deduction to an individual or corporation. Because a charity’s investment is generally derived from deductible contributions, exemption for the charity allows a larger accumulation than if the contributor continued to hold the funds.

50 See part I supra.

51 But see IV and VC2 infra.
For example, an individual in a 35% bracket, who earns $100, may make a $100 deductible contribution or invest $65 after tax. At a 10% return, the $65 investment would provide the investor with $6.50, which can be donated to charity without further tax. The charity, on the other hand, would earn $10 on the $100 contribution. A 35% tax would only reduce the amount available to the $6.50 earned and donated by the contributor. Tax exemption is not essential for parity.

Finally, a delay in spending will not necessarily reduce the value of the charitable expenditure. Such a delay will ordinarily be accompanied by an interim investment return, so that future spending, which will be greater than the amount contributed, can be said to be equivalent to the present value of the deduction. Of course, this determination depends, in the first instance, on a comparison between the appropriate discount rate and the rate of return earned by the charity. If the charity does not produce a market return on its investment, the charitable deduction could exceed the eventual benefit to the beneficiaries which might be a reason to be wary of delay, particularly if self dealing is a concern. Of course, some institutions are able to earn an above market return (Harvard Yale) which could be said to increase the ultimate benefit to an amount in excess of the charitable deduction. On balance, I think it is reasonable to assume a market rate of return.

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52 As discussed later when the charity should spend currently might depend upon a comparison between the market rate of return and the social return on the charitable investment. See Klausner: When Time Isn’t Money: Foundation Payouts and the Time Value of Money and articles cited therein. This discussion should be expanded.
However, from another perspective, the allowance of a current charitable deduction may be viewed as inconsistent with deferred spending for charitable purposes or at least suggest that a tax on investment income which would penalize such deferral is appropriate. Thus, unless the revenue loss from the charitable deduction merely increases deficit spending, current taxpayers will bear the burden of the charitable deduction which could lead to a possible increase in tax rates or a reduction in government spending. Therefore they may deserve to benefit from the contribution as opposed to postponing the benefit to future generations which will likely be richer. Deferring the deduction until the charity spends the funds seems impractical. Tracing the funds is awfully difficult and the donor might be deceased at that point.

3. Neutrality
   a. Donor’s perspective

   This discussion contrasts the subsidy to a charitable donation which is currently expended by the organization with the potential subsidy for a gift to be used in the future. Thus, a donor who contributes to an endowment is effectively prepaying for future charitable services while avoiding the tax on investment income that would be imposed if the donor continued to hold the investment. Therefore, the absence of a tax on the investment income of the charity provides a larger discount for the purchase of future charitable goods and services than for current charitable spending, as compared in both cases to private consumption at the time of the expenditure by the charity.

   For example, due to the charitable deduction, a donor in a 35% bracket can purchase $100 worth of charitable activities for $65 of after tax income (a price reduction of 35%). However, the discount would increase if future personal consumption were compared to a current gift for
future consumption by the charity. For example, assuming all income were fully and immediately
taxed at ordinary income rates, if the individual neither spent her money on personal
consumption nor made a charitable contribution, after one year, she would, if she earned 10%,
have $69.23 available.\textsuperscript{53} This would support a charitable contribution of $106.50 (again a 35% discount).\textsuperscript{54}

On the other hand, if the gift is made initially and investment income of the donee is not
taxed, the charity would have $110 after one year,\textsuperscript{55} while the donor is giving up just $69.23 of personal consumption at that time, effectively a discount of 37%. These charitable services could, of course, directly benefit the donor, as, for example, gifts to a church or local orchestra,

\textsuperscript{53} If she invested the $65 of after-tax income to earn 10%, she would earn $6.50 before tax. After paying tax at 35%, she would have $69.23.

\textsuperscript{54} The tax savings from the contribution of $106.50 ($37.27) when added to the accumulation of $69.23 totals $106.50.

\textsuperscript{55} The example assumes a contribution in one taxable year which is not spent until a later year. There may no advantage if the expenditure by the charity occurs in the same taxable year. In that case, the donor could contribute $110 to charity at the same out-of-pocket cost. If withholding could be adjusted, she would be able to invest $100 and earn $10 of investment income. The charitable deduction would offset both the wage income and the $10 of investment income. See Endowments supra note 6 at 944. However, this is a relatively trivial case since frequently the charity would not spend the gift for many years. For a general discussion of the potential opportunities because taxation is periodic and not continuous, see Victor Thuronyi, The Concept of Income, 46 Tax L. Rev. 45, 65-8 (19XX).
or, could provide intangible benefits, in the form of long-term recognition or good feelings.\textsuperscript{56} The discount would increase significantly as consumption is further delayed. Accordingly, the income tax exemption for charities may be said to favor contributions for an endowment over gifts for current spending.

Of course, the actual distinction in particular cases depends upon the rate of tax the donor would face on personal investments. As we know, capital gains and dividends are currently taxed at 15\%, in most cases, and, since the tax falls only on realized gains, the effective tax rate is further reduced if appreciated assets are not sold or otherwise disposed of. Moreover, in some cases even realized gains are not recognized. In the case of property which appreciates in value, rather than producing current income, since a charitable contribution of market value is allowed without including the appreciation in income, investment income is exempt even though the gift is delayed. The closer the tax rate is to zero, the smaller the difference in the subsidy to current and deferred gifts.

Empirical data on tax rates

Examples at 15\%, 35\%, realization deferred

In fact in certain circumstances, the donor could actually gain from deferring the gift by effectively investing in the tax deduction which would appreciate totally tax free. This may create a contrary incentive to delay the gift. Assume the donor earns $100 and would owe tax of $35 unless she makes a charitable contribution. If the contribution is deferred and $65 of after-tax income is invested in property which doubles in value to $130,\textsuperscript{57} the donor (subject to a 35\% 

\textsuperscript{56} Particular examples

\textsuperscript{57} If investment income of charity were taxable, the charity should take a fair market value
marginal rate) can contribute $200 to charity by adding her tax-savings from the contribution to
the value of the property. This matches the amount the charity would accumulate if the $100
collection had been made initially and it had invested $100 in this property.

However, while the charity is not affected, the donor could gain by deferring the gift. Suppose the gift is delayed and the donor increases her investment in the property by $35 from
$65 to $100. If she contributes the property to charity, when it is worth $200, the tax savings
would provide $70 for the donor. Since she uses her appreciated investment to fund the
charitable contribution, her share, the tax savings from the deduction, would also increase tax-
free. On the other hand, if the gift is made initially and the donor had invested another $35 in
identical property, although she would similarly have property worth $70 if the property doubles
in value, there would be $35 of deferred gain which would be taxable if the property were sold.58

Whether this strategy would be successful depends on the extent to which the taxpayer
could count on appreciation or on being able to choose appreciated property to donate. Large
donors may also have an incentive to contribute to charity on a regular basis to maximize the
charitable deduction (up to 50% of adjusted gross income each year) which can be claimed over a
lifetime. Further if gifts are not completed before death, the value of the charitable deduction is
lost. Thus, donors probably would ordinarily expect to reduce their tax burden by an early gift
basis for contributed property. If we want to tax the appreciation at the time of the gift, which I
believe we should, Halperin, Appreciated Property supra note 47 at 36, we should tax at the
donor level. It is true, however, that even taxing post-gift appreciation could deter sales and
possibly spending.

58See Halperin Appreciated Property supra note 47 at 25.
even though spending by the charity is deferred. Nevertheless, if the donor’s investment income is taxed at relatively low rates, the advantage may be small.

Further, as noted above, the advantage is not with respect to the timing of the charitable deduction. Since a delay in spending would ordinarily be accompanied by an interim investment return, future spending by the charity, no matter how long delayed, can be said to be equivalent to the future value of the $100 deduction. From this perspective, at least if we assume the funds will be spent at some point, a deduction is not excessive merely because it is allowed before the recipient actually uses the funds for charitable purposes. Rather, the benefit from the earlier contribution is the ability to exempt the intervening investment income from tax. In the previous example, if the investment income were taxed at 35%, the charity would have $106.50 available after one year and the price reduction would not vary as between current and future purchases. In sum, since investment income is normally taxed, the price reduction for future as opposed to current charitable spending holds steady if income is taxed to charities and increases if the charity’s investment income is exempt.

b. Charity’s perspective

On the other hand, from the charity’s perspective, neutrality may require exemption for investment income. If a tax on investment income reduces the return to savings, future spending becomes less advantageous because the amount available would increase by the after-

59 See V2 supra.

60 Perhaps, this is also necessary in order to be neutral between current consumption by the donor and a contribution for future charitable services.
Although, the impact of a reduced rate of return on savings is uncertain because those individuals that have a specified target in mind would save more if the rate of return were decreased, most observers believe that an tax on savings increases current spending and reduce savings. In order to achieve what they view as neutrality as to the timing of expenditures, some people favor replacing the income tax with a form of taxation that effectively eliminates investment income from tax. Similarly a tax on investment income of charities may be said to create a bias in favor of spending for current needs.

An income tax appears to tax all investment income. A wage tax, on the other hand, by definition does not reach income from capital. A so-called cash flow consumption tax, may under some circumstances produce similar results, except for abnormal returns. Some have argued that an income tax similarly does not burden marginal returns in excess of the risk-free rate of _________

61 This would be offset if interest rates rise in response to an income tax. If this occurs, adoption of an income tax would increase the return to exempt nonprofits.

62 For a general discussion of the impact on savings if investment income is exempt, see Eric M. Engen and William G. Gale, the Effects of Fundamental Tax Reform on Saving in Economic Effects of Fundamental Tax Reform (Henry J. Aaron and William G. Gale eds. 1996).

63 See e.g. Robert E. Hall & Alvin Rabushka, The Flat Tax (2d ed. 1995). So far we have maintained a hybrid system, an income tax in form with a number of exceptions which alleviate the burden on investment income.

64 Andrews, supra note 45 at ___.

Thus, the extent to which an income tax imposes a burden on investment income can be said to be uncertain. All agree, however, that the income tax imposes a burden on the risk-free return from capital. This can be said to impact savings since it imposes a burden on savers as compared to those who spend all income currently.

4. Equity

There are two issues here. First, does distributional equity among individuals require that investment income be subject to tax, as it would be under an income tax. Second, assuming the answer is yes, is departure from the normal income tax treatment justified in the case of charitable organizations. Since, for the purpose of this paper, I assume we continue to employ an income tax, I will limit the discussion of the first issue to a brief summary. The focus will be on the second question.

Those who favor an income tax argue that income or power to consume is a better reflection of ability to pay than consumption. While it is possible to adopt a consumption tax that has the same burden with respect to income as the current income tax, it is asserted that this is unlikely to occur. Some also believe that investment earnings can represent additional consumption potential, not merely just the amount necessary to maintain the present value of assets. While recognizing the potential impact on savings, opponents of consumption taxation have asserted that any positive impact on savings would be more than offset by the adverse

66 Id. at __. Weisbach An exempt charity would not have to gross up would expect less risky portfolio

67 Warren supra note 65 at __.

68 Koppelman. Barbara Fried
impact on distribution of income.\textsuperscript{69} Hence, many believe that a consumption tax would be unfair and investment income should generally be taxed. For the purpose of this paper, I assume this position prevails.

The question here is whether departure from the normal income tax treatment is appropriate in the case of charitable organizations. Thus, in the case of organizations devoted to providing retirement savings, it seems to be accepted that the permanent exemption of investment income,\textsuperscript{70} the very essence of the special treatment,\textsuperscript{71} is justified in order to encourage

\textsuperscript{69}See e.g., Alvin C. Warren, Jr., Fairness and a Consumption-type or Cash Flow Personal Income Tax, 88 Harv. L. Rev. 931 (1975).

\textsuperscript{70}It is often stated that the benefit is deferral because all the income, including the investment return, will eventually be taxed upon distribution. However, since the distribution is equivalent in present value to the original contribution, taxation of the distribution merely substitutes for taxation of the contribution. The investment earnings are effectively exempt. This is confirmed by the existence of Roth IRAs which do not allow deductible contributions but exempt income and “qualified” distributions. Nevertheless, they are said to be equivalent to traditional IRAs. Daniel I. Halperin, Special Tax Treatment for Employer-Based Retirement Programs: Is It “Still” Viable as a Means of Increasing Retirement Income? 49 Tax L. Rev. 1, 13 (1993).

\textsuperscript{71}The Treasury offered this as a reason not to oppose a special rule which would allow only pension funds, among all exempt organizations, to invest in debt-financed real estate without being subject to the unrelated business income tax. IRC §514(c)(9)(C)(ii). See, Suzanne Ross McDowell, Taxing Leveraged Investments of Charitable Organizations: What is the
savings for retirement. Perhaps, it could be argued that it is equally important to encourage savings for charitable and educational purposes. Exemption of investment income will facilitate the buildup of an endowment due to both the tax savings and the increased investment flexibility that comes from not having to take taxes into account.

This may make sense if the donor can no longer use the funds for private consumption. Since the income may no longer represent power to consume by the donor, the conflict between equity in the distribution of the tax burden and neutrality between current and future consumption may be minimized when the investment income is earned by a charitable organization. This may be particularly true in those cases where the donor does not control the charity and there is a clear separation between donors and beneficiaries of the charitable enterprise; perhaps, especially if the beneficiary’s rate might be zero.\textsuperscript{72} In these circumstances, the potential unfairness of a universal consumption tax would be alleviated and taxation of investment income may not be necessary to protect the distributive goal of an income tax. Society may get additional savings with less harmful effects.\textsuperscript{73}

On the other hand, the case for special treatment of the investment income of charities is weaker if donors and beneficiaries of charitable organizations are at the same income level, particularly where there is a substantial overlap between the two. This is perhaps, most prevalent in a church or synagogue but is also present to some degree in the case of cultural institutions such as an orchestra or opera company. An overlap may exist with respect to so-called

\textsuperscript{72} See Bittker \textit{supra} note 20 at 314-16.

\textsuperscript{73} Endowments \textit{supra} note 6 at 929.
“commercial non-profits,” supra note 6 at 59. Possibly hospitals, which receive relatively little current charitable contributions and principally supply goods and services to customers who may pay market price. Exempting investment income, in these circumstances, would privilege the set aside of funds for future consumption through the organization as compared to an investment by customers themselves. Even if one feels comfortable with exemption for investment income when there is a clear separation between donors and beneficiaries, this seems less justified if contributors and beneficiaries overlap. In this case the charitable organization resembles a mutual where a tax on investment income is appropriate. It is even more troublesome if the donor maintains control over future spending as she could with a private foundation, donor advised fund, or a charitable remainder trust.

It must be acknowledged that overlap of donors and beneficiaries does not necessarily challenge the charitable deduction. If the charitable deduction is available for contributions to the organization, why should the overlap be relevant in deciding upon the treatment of investment income. Whether or not there is a problem with the charitable deduction when the overlap reaches a very high level, the exemption for investment income is more significant. As noted

74 Rationale supra note 6 at 59.

75 Daniel Halperin, Taxation of Mutual Nonprofits supra note 2 at 137.


77 § 664
above, the discount for deferred spending can be appreciably greater than the discount for current spending. This seems more troublesome when the deferred spending benefits the donor.

To recapitulate, an exemption for investment income may be necessary to make the charity neutral as between current and future spending. On the other hand, because other future consumption by the donor is affected by the income tax on earnings produced by funds accumulated for this purpose, the price reduction for charitable spending, as compared to other deferred consumption, is relatively greater the longer consumption is deferred. Put another way, a tax on investment income would be consistent with an income tax. However, it may be that the arguments, which favor income as opposed to consumption taxation, do not apply as strongly to at least some charities. This may support an exemption for investment income.

B. Endowment Policy

As noted above, a number of institutions have accumulated extremely large endowments, both in absolute terms and, in the case of universities, on a per student basis. This has come under fire in recent congressional hearings. In particular, there was an attempt to link endowment size to tuition increases with the suggestion that such increases would be unnecessary if the institutions were willing to spend only a little more out of the endowment. This raises the question of whether public intervention is advisable and if so whether tax policy has a role to play.

An endowment provides protection against short-term financial downturns or temporary donor unhappiness and alleviates the need for constant fund-raising, thereby freeing managers to spend more time on the organization's mission. For an organization dependent on foundation grants for support, an endowment may be the only source for administrative expenses since
grants for that purpose are difficult to obtain. Donors may prefer giving to an endowment to be used for the support of specific programs as away of preserving their influence into perpetuity and, thus, cheating on mortality. Trustees may view endowment growth, not only as providing for the future security of the organization and freedom from fund-raising restraints, but also as an end in itself, perhaps, as an indication of their success which they can more easily measure and control than the activities of the organization. In other words, trustees may be judged as much by how much is retained as they are by how much is raised.

James Tobin has described an endowment as maintaining intergenerational equity by preserving the ability of an institution to continue to support the same set of activities indefinitely, without regard to the prospects of future gifts or other sources of funds. This is achieved when the real level of the current endowment is preserved and additional funds are raised to provide for program growth. In the case of a university, the resulting stability is

78 See Howard F. Tuckman and Cyril F. Chang, Accumulating Financial Surpluses in Nonprofit Organizations 253, 259-60, in Governing, Leading and Managing Nonprofit Organizations (Dennis R. Young, Robert M. Hollister and Virginia A. Hodgkinson eds 1992); Hansmann supra note 121 at 37; Endowments supra note 16 at 935.

79 James Tobin, What Is Permanent Endowment Income?, 64 Am. Econ. Rev. 427 (1974). Tobin states: “The trustees of an endowed institution are the guardians of the future against the claims of the present....Sustainable consumption is their conception of permanent endowment income.... [T]hey must regard as a principal criterion of endowment income the fixing of student fees and educational quality across generations.” Ibid.
consistent with the interest of alumni and entering students in preserving the reputation of the institution that provides their degree.\textsuperscript{80}

Others argue that, just as appropriations require current political support, a subsidized charity should not be able to continue a program in perpetuity independent of a continuing level of support.\textsuperscript{81} Moreover, retaining funds for the future may be unfair to the current generation that bears the burden of the reduction in tax revenues and may not be as rich overall as future generations. \textbf{Does size of endowment impact on spending efficiency}

This diversion of views may be illustrated by Professor Bittker's example concerning two retirement homes. One provides services at cost and would thus have no taxable income; the second uses income from its endowment to provide shelter at no cost to the indigent. The latter is an example of an organization that arguably will survive in perpetuity based entirely on funds raised at its inception. For Bittker, it would be absurd to tax the income of the latter while the former is exempt.\textsuperscript{82} In other words, the latter mode of operation should be encouraged, perhaps, consistent with the interest of alumni and entering students in preserving the reputation of the institution that provides their degree.\textsuperscript{80}

\textsuperscript{80} Henry Hansmann, Why Do Universities Have Endowments?, 19 J. Legal Studies 3, 27 (1990).

\textsuperscript{81} See Robert Eisner, Discussion, 64 Am. Econ. Rev. 438-41 (1974). “We clearly do not want to squander all our capital in expenditures of this week or year. But neither do most of have any good reason to reserve our capital to provide equal expenditures forever and ever and ever.” Id at 441; Endowments \textsuperscript{supra} note 6 at 921-2, 933, 948. Some donors to Private Foundations have specified a limited life. Olin Atlantic

\textsuperscript{82} See Bittker \textsuperscript{supra} note 20 at 310-11.
in this case because the organization arose from the generosity of one donor and the nature of the organization suggests no built-in constituency as a source of future funding.

As suggested above, an endowment could be maintained at the level necessary to provide a continuing level of support if income above inflation, that is the real rate of return, was distributed. Obviously, to achieve this goal over time earnings in a good or exceptional year may have to be preserved to protect against future low rates of return or even losses. However, given the extraordinary rates of a return that some institutions have enjoyed, a long-term payout rate around 5% is hard to square with Tobin’s theory of endowment policy. UPMIFA also has an optional provision which would create an assumption of imprudence if the organization spent more than 7% of its assets.

In general, an organization should compare the social benefit of current spending with the potential benefit of future spending, taking into account both the likelihood of future contributions as well as intergenerational equity between current contributors to charity and the ultimate beneficiaries who may be from a different generation.\(^{83}\) Obviously a legislative directive that would be sensible in all circumstances is difficult if not impossible to craft. Still we may not be willing to leave this difficult decision solely to the discretion of donors, trustees and directors.

**How has payout fluctuated with market results**

**Does it fluctuate with fund-raising success**

**Does it respond to fluctuating costs**

Gifts to an endowment tie the organization's hands and may inefficiently affect the timing and manner of expenditures for charitable needs. Under UPMIFA, in the absence of clearly

\(^{83}\) Endowments [*supra* note 6].
expressed. instructions, trustees should spend what is prudent taking into account the purposes of the fund, relevant economic factors and the donor’s wish that the fund continue in perpetuity. However, the trustees must follow the donor’s clearly expressed. instructions even if they believed it were mere prudent to do otherwise. In such cases, more flexibility in expenditures could be achieved by prohibiting donor restrictions that last beyond a certain period or by liberalizing the cy pres doctrine to give the trustees of the organization more discretion to deviate from a donor's wishes. Still, any tendency of the trustees to favor giving for endowment or to add unrestricted gifts to the endowment would remain.

If it is believed that donors and or trustees are likely to error in favor of deferred spending, we could choose to mandate a certain level of current spending or encourage it by taxing investment income. A tax on investment income at a moderate rate has previously been proposed. Such a tax could conceivably be limited to undistributed profits.

84 Id. at 944.

85 Endowments supra note 6 at 945. See George A. Break & Joseph Pechman, Relationship Between the Corporation and Individual Income Taxes 28 Nat'l Tax J. 341, 344 (1975):

“Investment income in moderate amounts does indeed provide both independence and valuable protection against unforeseen contingencies, but in large amounts it may serve mainly to protect the recipient institution from any market test of the value of its activities. A moderate tax on this investment income then, would not destroy the protected position of highly endowed philanthropies, but it would reduce their ability to finance activities that are not directly supported by the public.”
As discussed below,\textsuperscript{86} one justification for exemption of income from related activities is the need for a subsidy for expansion. While a buildup of assets may reflect a need for expansion in the near future, high earnings on an unrelated business or investments could also be an indication that expansion is neither needed nor feasible. Perhaps the demand for the services is such that if supply increases, it cannot be sold at a price that will cover costs.\textsuperscript{87} In that case a capital subsidy may not be required and taxation of investment income will mitigate the problem of excessive capital locked into a nonprofit.

Alternatively, we could expand the rule applicable to Private Foundations which now must distribute 5\% of their assets annually.\textsuperscript{88} The restriction on activities of private foundations is sometimes justified as needed because of the lack of oversight that results from not seeking public support. For reasons noted above, however, there may be cause to believe that public

\textsuperscript{86} Text at note 95 infra.

\textsuperscript{87} Hansmann at 621 (n.46) ?75 Va.L.Rev.? \textbf{I am not sure which article this is from}

\textsuperscript{88} IRC §4942.
charities may not always make the wisest decision on distribution. Of course, it is easy to find fault with the payout requirement. As one author put it:\textsuperscript{89}

The payout rate is inflexible, the rate itself is arbitrary and the requirement poses constraints on both investment policy and grant making. [It draws] criticism on the one-hand from those who want to see more immediate benefits to society from assets that are tax exempt, and on the other hand from those that would like the payout rate reduced so as to assure that future societal needs will be adequately met.

It is also difficult to enforce a payout rate if an organization is continually raising funds. Current gifts could be added to the endowment, in lieu of being spent, in order to replace a required distribution viewed by the organization as excessive. Perhaps because of these difficulties, there is no explicit payout requirement for public charities. The IRS merely requires that the charitable program be commensurate in scope with the organization's financial resources,\textsuperscript{90} a requirement that appears to be violated only when the State Attorney General would be able to bring an action compelling additional charitable activities.\textsuperscript{91} Nevertheless, despite the difficulties of developing a sensible rule, an alternative to curtailing the current exemption for investment income would be an annual distribution requirement from the endowment of public charities akin to that that now applies to private foundations. Unlike a tax that may merely encourage distribution, a payout requirement would mandate it. While such a

\textsuperscript{89} Marion Fremont-Smith, Governing Nonprofit Organizations 276 (2004).


\textsuperscript{91} See G.C.M. 34682 (Nov. 17, 1971).
requirement may be less disruptive in the sense that it would have no practical impact on the behavior of many organizations, some organizations might consider this more invasive than a tax on investment income.\textsuperscript{92}

Any new restrictions need not apply across the board. We could recognize that some level of endowment is prudent and organizations which fall short of that level would, prudently, not make any distribution. Such an exception could depend on absolute size or the relation of the endowment to some norm such as annual expenditures or contributions or in the case of Universities per student.

In sum, the treatment of investment income may depend upon the degree to which one feels it is desirable for our tax system to channel long-term savings through charitable endowments and upon whether or not one believes that “the non-distribution constraint” – which means that the donor can no longer directly use the funds for private consumption- justifies, at least in some circumstances, abandoning the income-tax ideal in favor of exemption for investment income. Exemption would be reinforced if it were felt that the tax law should support or at least be neutral with respect to building an endowment. On the other hand, if it is felt that under the current system endowments and charitable savings are likely to be larger than public policy would suggest, one might want the tax system to place a thumb on the scale in favor of current spending by mandating distributions or imposing a tax. These are difficult questions whose answer may depend more on a value judgment than logic.

\textsuperscript{92} Brody Tennessee L.R. ???
C. A Subsidy for Capital Expenditures and Shifting

The prior discussion has left two questions open. First, is the exemption of the investment return from an investment in capital items used for the exempt purpose of the organization justified. As noted above, this issue arises when income from related activities is invested in capital items. It also can be a concern when contributed funds or distributions from an endowment are so invested. Secondly is the exemption of income used for expenditures unrelated to the purpose of that income appropriate.

1. Return on Capital Expenditures

The prior section found the case for of exemption of investment income uncertain. Since the donor can no longer directly use the funds for private consumption abandoning the income-tax ideal in favor of exemption for investment income may be justified, with the case being stronger where the donor does not control the activities of the organization and there is not a close relationship between contributors and beneficiaries, particularly if the beneficiaries are in a lower income class. On the other hand, exemption encourages adding funds to an endowment which delays support for charitable activities.

When the investment is in assets related to the organization's mission, the latter concern is mitigated or eliminated. Boris Bittker has stated that there is 'little to be served’ by taxing income related to capital expenditures, stating that “Since . . . capital outlays are irrevocably dedicated to the institution's non profit objectives, ... we do not regard this alternative method of computing a nonprofit's income as very appealing: nor can we say that it has any economic or

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93 See part V A supra.
social advantages over a regime of complete exemption"\textsuperscript{94} While Bittker merely states the conclusion without offering any supporting reasoning, he does note the dedication of the funds to the institution’s nonprofit objective presumably as opposed to unrelated investments. In these circumstances, the argument in favor of exemption is on balance stronger.

\begin{quotation}
This argument does not necessarily apply to all capital expenditures. Some could be akin to unrelated investments in terms of the current benefit to charity. Thus, the purchase of a painting or environmentally sensitive land offers current benefits even though the asset will last for a long time. These items cannot easily be rented. The same may not be said about the purchase of a building in lieu of renting space. Purchase, as opposed to renting, may limit the possibility of other current expenditures. However, the two activities are comparable if the purchase is made, in part, with borrowed funds and the loan is paid off over the period of use in amounts comparable to the rental cost of the space.
\end{quotation}

In any event, this paper suggests a direct correlation to Hansmann’s well-known contract failure argument in support of a subsidy to capital formation by certain organizations, which, he believes to be the best case for an income tax exemption.\textsuperscript{95} Hansmann suggests that there are good and services for which nonprofits are the most efficient providers, in that customers prefer to deal with nonprofits and would value good and services from them more highly. \textsuperscript{96} However, because non-profits have no access to the equity market and limited access to borrowed funds,

\begin{flushright}
\textsuperscript{94} Bittker \textsuperscript{supra} note 20 at 312.
\textsuperscript{95} Rationale \textsuperscript{supra} note 6.
\textsuperscript{96}Id at 69.
\end{flushright}
they would tend not to grow fast enough to meet the demand.\textsuperscript{97} Therefore, in some circumstances, it could make sense for the government to provide capital to the organization by not taxing profits used for expansion.\textsuperscript{98} As noted above, while Hansmann is not as explicit as one would like, I believe his article is focused on income from related goods and services earned by charitable organizations.\textsuperscript{100}

\textsuperscript{97} Id. at 72-4

\textsuperscript{98} Of course, a case has to be made that expansion of the supply of particular goods and services by nonprofits merits government aid. Hansmann himself notes that contract failure might not be a problem in some circumstances and that many exempt organizations seem to be over capitalized. Id. at 89. See Daniel Shaviro, Assessing the “Contract Failure” Explanation for Nonprofit Organizations and Their Tax-Exempt Status, 41 N.Y. L. School L. R. 1001 (1997)

\textsuperscript{99}See Rationale supra note 6 at p. 55 “the focus here will be largely on the exemption as it is applied to the primary activities of nonprofit organizations”

\textsuperscript{100}The article purports to be about non-profit organizations in general, many of which, for example, trade associations a social clubs, are not eligible to receive deductible charitable contributions. Hansmann notes that the income tax exemption, the subject of his article, is not confined to organizations that qualify for deductible contributions. Id. at 72. But later he suggests that exemption is not justified for some mutual nonprofits such as social clubs. Id. at 94. Thus, in the end, I believe he limits his argument for a capital subsidy to charitable organizations. I believe that mutual nonprofits should generally be fully taxable although an exemption for income from transactions with members for certain organizations, including social clubs is sound. See Income Taxation of Mutual nonprofits supra note 2 at 136-48.
In the long run, the income tax exemption would be consistent with the goal of lower prices for the subsidized services.\textsuperscript{101} Thus, a nonprofit would expand until costs equal revenue but, unlike a for-profit, prices need not be high enough to provide a return on capital investment.\textsuperscript{102} Therefore, if nonprofits eventually replace for-profit competitors, competition could cause the price of the goods or services to fall. Moreover, in equilibrium, there should be no net income since capital expenditures would merely replace depreciation.\textsuperscript{103}

Hansmann’s argument for the subsidy has been referred to repeatedly in the literature, sometimes very critically.\textsuperscript{104} I have demonstrated, however, that failure to tax current income from related activities could be thought of as special treatment only when income is immediately invested in capital expenditures, such as buildings and long-lived equipment, or set aside for future investment in such items.\textsuperscript{105} A tax on investment income would impact a delay in expenditures. Without necessarily agreeing with Hansmann's rationale, this gives more context

\textsuperscript{101} Id. at 80.

\textsuperscript{102} Id. at 71-8.

\textsuperscript{103} Id. at 79. This would not be the case if there were no inflation adjustment since in those circumstances, replacement costs would exceed allowable depreciation.

\textsuperscript{104} For a skeptical view of Hansmann's thesis see, Brody Agents Without Principals supra note 13.

\textsuperscript{105} Hansmann “admits” that exemption of income from related activities would be a “crude mechanism,” for a capital subsidy, Rationale supra note 6 at 75, but suggests that high earnings would correlate with expansion needs, in that such earnings would reflect the fact that demand for services exceeds supply. Id. at 74.
Similarly, at least at one time, hospitals financed charity care out of fees received from paying patients. Bloche

§183. No explicit statutory rule for corporations. look for case or article that nevertheless took this approach
Moreover, it is clear that students are paying for services and are not intending to make a gift.\textsuperscript{108} I have also argued above, that the analogy to the charitable deduction allowed to a taxable business which uses some of their profits for charitable contributions is not applicable because the charity is investing pre-tax profits. Thus, allowing a charitable deduction is not necessary in order to achieve parity with donations by a taxable businesses.

In some cases profits could be derived, not as a return on investment, but rather from cost savings due to the subsidies available to the charitable sector. Thus, a non-profit hospital by avoiding sales tax or property tax or by reducing the interest paid on borrowing may be able to make a profit on services while charging the same fees as for profit hospitals. This profit could be used to subsidize services for the poor While reduced costs has not lead to lower charges for services to customers, it makes funds available for charitable care. Tax exemption for this profit is consistent with the goal of the subsidy. Taxation would take away part of the intended benefit.

Subsidizing care for the poor out of profits that would be distributed to shareholders of for profits does represent a return on investment. But as with the case with capital expenditures discussed in the prior section, this comes from investment in related assets and exemption could be justified on the same basis.

VI. Section 501(c)(4) organizations

Section 501(c)(4) is somewhat of an anomaly in that certain organizations benefitting the general welfare are deemed worthy of income tax exemption but not deserving of deductible

\textsuperscript{108} Moreover, it is clear that students are paying for services and are not intending to make a gift.
charitable contributions. This seems to encompass primarily organization that cannot qualify under section 501(c)(3) because they are engaging in lobbying or political activities.\textsuperscript{109} It may also include some organizations that are deemed to serve too narrow a class. Since I do not intend here to undertake a full investigation of the justification for section 501(c)(4) or the appropriate characteristics for qualification under that section, my conclusions can only be brief and tentative.

In my view, the treatment of investment income does not depend importantly on the presence of the charitable deduction. Further, there is now a constraint on distributions from section 501(c)(4) organizations.\textsuperscript{110} Therefore, normal tax principles would support an exemption for income from related activities unless funds are used for capital expenditures or used for unrelated non-income producing activities.

The exemption of investment income for organizations qualifying under section 501(c)(4) could, like that for section 501(c)(3) organizations, be supported on the grounds that because of the separation of donors and beneficiaries, consumption tax treatment is appropriate. As such the exemption raises similar issues with respect to the impact on current and future spending. The exemption would be more questionable if the organization was denied section 501(c)(3) treatment on the grounds that it was deemed to serve too narrow a class.


\textsuperscript{110} Section 501(c)(4)(B) as added by P.L. 104-168, §1311(b) (1). Previously, there may have been a prohibition under State law.
Exempting contributions from tax, which should in any event be nontaxable gifts, seems necessary to avoid discouraging contributions that are nondeductible. However, the exemption for gain on the sale of appreciated property\textsuperscript{111} transferred by a donor seems inappropriate, not only in the case of section 501(c)(4) but, if not for all nonprofits other than 501(c)(3)s, at least those that are exempt on investment income.\textsuperscript{112} The justification for a fair market value deduction without gain recognition in the case of section 501(c)(3) organizations is that it appropriately enhances the incentive for charitable contributions. No case has been made for encouraging contributions to organizations qualifying under section 501(c)(4).

Finally, to the extent, exemption, for what I called exploitation of the members or beneficiaries of the charitable organization, is defended by analogy to the charitable deduction it would be inappropriate in the case of a (c)(4). Thus, if the organization receives royalties in connection with an affinity credit card it is in some way equivalent to the customer paying an additional amount in order to benefit the organization. Allowing this amount to be received tax-free is perhaps equivalent to allowing a charitable deduction.

VII. Conclusion

It has been argued that an income tax is inconsistent with the nature of a nonprofit organization. However, many nonprofits, for example hospitals or schools, operate in a similar manner to for profit entities engaged in similar activities. Whether exemption is justified should

\textsuperscript{111} Check law

\textsuperscript{112} Compare IRC §84 which taxes the built-in gain on transfers to political parties.
be determined by analyzing all source of receipts in the light of the intended subsidy to the organization.

Whether the investment income of public benefit organizations should be taxed depends upon a value judgment regarding the trade off between current and future spending. Given an income tax which taxes investment income, the preference for deferred spending for charitable purposes may be greater than the preference for current spending. However, for the organization to be neutral between current and future spending, investment income may have to be exempt. Such exemption could encourage savings without the potential harm of a universal consumption tax, at least in some circumstances. Exemption would be reinforced if it were felt that the tax law should support or at least be neutral with respect to building an endowment. On the other hand, one might want a bias in favor of current spending if it is felt that under the current system endowments and charitable savings are likely to be larger than public policy would suggest. This tilt could be achieved by a tax on all or part of investment income or by requiring a minimum distribution from endowments as is now required from private foundations. On balance, some measure to encourage current spending is justified.

Even if investment income were to be taxed, income from related activities is probably appropriately exempt. Here accumulation of an excessive endowment is not a concern. What distinguishes charities is the nondistribution constraint which prohibits distribution to shareholders or owners which means that eventually all funds will be used for charitable purposes. In fact, taking account of the time value of money, exempting income set aside for future expenditures is equivalent to a future deduction for such expenses. Because of this factor, in many cases, exemption could be justified as consistent with proper measurement of income.
Even if tax would normally apply, as might be the case of funds used for a capital expenditure, exemption could facilitate the expansion of the organization, which in some circumstances could be desirable public policy. Moreover, in this situation accumulation of an excessive endowment is not an important concern.

In cases where income is derived from the exploitation of assets otherwise used in the exempt activity without an additional investment, an exemption from income follows from the policy behind the charitable deduction.

Since tax exemption for income does not, except as stated in the prior paragraph, depend importantly on the charitable deduction, income tax treatment of section 501c)(4) organizations should generally track the treatment of section 501(c)(3)s. However, transfer of appreciated property to a section 501(c)(4) organization and, at, least, other non-profit organizations that are not taxed on investment income should be considered a realization event.