

# A NEW MODEL FOR OVERSIGHT OF COMMERCIAL ACTIVITIES BY NONPROFITS?

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*This Note discusses a New Jersey tax case, *Fields v. Trustees of Princeton University*, that settled in 2016 after motion practice. The plaintiffs were twenty-eight municipal taxpayers in Princeton who challenged Princeton University’s entire property-tax exemption on the ground that the way the University distributed royalty payments from patents to faculty inventors and licensed these patents in joint ventures and other partnerships ran afoul of the “profit test” that applies to educational property-tax exemptions in New Jersey. This Note uses this litigation to discuss a potential conflict between the Bayh-Dole Act, which encourages academic patent development, and such profit tests on charitable and educational property exemptions in several states. It concludes that while the model of litigation in *Fields* could offer a new procedural oversight means over nonprofits, a better solution involves substantive legislative reform that regularizes current ad hoc payments between municipalities and large nonprofits and better aligns local property taxes with federal policy.*

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#### INTRODUCTION

From 2011 to 2016, a curious case wound itself through the New Jersey Tax Court.<sup>1</sup> In 2011, a small group of Princeton residents sued Princeton University (the “University”) and the municipality where it is located, then known as the Borough of Princeton,<sup>2</sup> challenging the tax-exempt status of

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1. See *Fields v. Trs. of Princeton Univ.*, No. 7672-2016 (N.J. Tax Ct. Apr. 13, 2016); *Fields v. Trs. of Princeton Univ.*, 28 N.J. Tax 574, 578 (2015) (discussing the progress from an initial filing to a denied interlocutory appeal); see also Complaint at 1, *Estate of Lewis v. Trs. of Princeton Univ.*, No. 010656-2011 (N.J. Tax Ct. July 8, 2011) [hereinafter 2011 Complaint]. This Note refers to these related actions as *Fields*.

2. The former Borough and Township of Princeton merged in 2013, partly to reduce tax bills through efficiency. See Jon Offredo, *Princeton Consolidation Pays Off: \$61M Budget*

twenty-one properties that the University owns.<sup>3</sup> In 2014 and 2015, four of the plaintiffs filed a related suit, *Fields v. Trustees of Princeton University*,<sup>4</sup> to challenge all of the University's property-tax exemptions in Princeton.<sup>5</sup> When the case settled in October 2016, it encompassed twenty-eight plaintiffs challenging Princeton University's property-tax exemption in toto.<sup>6</sup> The plaintiffs had argued that the University's collection and distribution of patent revenues was too oriented around private profit to be exempt.<sup>7</sup>

This Note argues that this litigation demonstrates a new but fraught means of oversight over nonprofit organizations. It also uses *Fields* to reveal tensions between state and federal laws over the proper borders of the revenue-generating activities of nonprofits and points to potential reforms to resolve those tensions.

Part I presents the doctrinal background on how tax law regulates the boundaries of the revenue-generating activities of nonprofits. It demonstrates the differences between the federal exemption and state-level property-tax exemptions before discussing how the Bayh-Dole Act's incentivizing of patent development by nonprofit institutions is situated in this framework.

Part II discusses the substantive tension between state laws with profit tests for property-tax exemptions and the Bayh-Dole Act, which encourages nonprofits to develop and commercialize patents. It concludes that the discrepancies between the Bayh-Dole Act and profit tests for state property-tax exemptions do not result in a direct legal conflict between federal and state laws.

This Note explains why the tension results in neither preemption nor serious concerns from dormant Commerce Clause doctrine. Yet, this Note presents pragmatic policy arguments for why the federal and state-level laws should be brought into closer alignment or delineated from each other with greater clarity. This Note then contrasts the litigation enforcement model used in *Fields* against recent and proposed legislative reforms in several states. It analyzes how the legal doctrine that allows municipal taxpayer suits could reshape the oversight of nonprofit organizations if *Fields* is taken up

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*Comes with Tax Rate Decrease*, NJ.COM (Apr. 2, 2013), [http://www.nj.com/mercer/index.ssf/2013/04/princeton\\_consolidation\\_pays\\_o.html](http://www.nj.com/mercer/index.ssf/2013/04/princeton_consolidation_pays_o.html) [<https://perma.cc/DBD3-3Q8C>]. *But see* Krystal Knapp, *Christie Perpetuates Myth That Consolidation Reduced Princeton Budget by \$3 Million*, PLANET PRINCETON (Jan. 15, 2014), <http://planetprinceton.com/2014/01/15/christie-perpetuates-myth-consolidation-reduced-princeton-budget-3-million/> [<https://perma.cc/F3P8-PB7B>] (disputing the reduction).

3. New Jersey law allows partial taxation of properties. *See* N.J. STAT. ANN. § 54:4-3.6 (West 2017) (providing "that if any portion of such buildings are leased to profit-making organizations or otherwise used for purposes which are not themselves exempt from taxation, said portion shall be subject to taxation and the remaining portion only shall be exempt"); *see also infra* Part I.B.2. The initial suit challenged particular buildings along these grounds. *See* Complaint, *supra* note 1, at 2–6; W. Raymond Ollwerther, *Challenge over Taxes*, PRINCETON ALUMNI WKLY. (Sept. 18, 2013), <https://paw.princeton.edu/article/challenge-over-taxes> [<https://perma.cc/4ULH-49V9>].

4. 28 N.J. Tax 574 (2015).

5. *See id.* at 578.

6. *See* Complaint at 2, *Fields*, No. 7672-2016 [hereinafter 2016 Complaint]; *Fields*, 28 N.J. Tax at 578 (discussing the progress from filing to a denied interlocutory appeal).

7. *See* 2016 Complaint, *supra* note 6, at 12.

as a litigation model by other plaintiffs, as well as how different reform statutes balance interests and concerns at stake in exemption policy.

Part III argues that while municipal taxpayer suits may represent a new enforcement model for policing the borders of revenue generating and distributing activities in the nonprofit sector, substantive legislative reform would be preferable. It warns that local oversight through third-party challenges cannot resolve the disconnect between local and federal laws. Therefore, it concludes that substantive legislative reform provides a better opportunity to address the concerns raised in *Fields*. This Part then examines legislative models proposed or adopted in New Jersey, Connecticut, Massachusetts, Michigan, and California.

Finally, Part IV advocates for reform modeled primarily after the California legislation, which takes a nuanced approach to the linkages between entity-level income, property use, and *ad valorem* taxation.

### I. THE REGULATION OF NONPROFITS THROUGH TAX LAW

Part I introduces the issue of oversight of nonprofit business activities at the federal and state levels. Part I.A sketches the broad contours of the federal framework and presents the doctrinal context for how federal income tax regulates the ways nonprofit corporations may generate revenue and what they may do with it. Part I.A.1 explains that nonprofits can have positive revenue, while Part I.A.2 clarifies that charitable organizations must provide primarily public rather than private benefits. Part I.A.3 explains that nonprofits are subject to what scholars call the “nondistribution constraint.”<sup>8</sup>

Part I.B clarifies that federal tax law and property-tax exemptions for charitable organizations exist independently. Part I.B.1 explains New Jersey law and uses it to illustrate how frameworks for local property-tax exemption can differ significantly from the federal income-tax exemption. Part I.B.2 demonstrates that the “profit test” in New Jersey is a more restrictive nondistribution constraint than that imposed under the federal framework. Part I.B.3 presents how profit tests in several other states work.

Part I.C discusses how the Bayh-Dole Act functions as well as its history and legacy. It explains that this federal law encourages universities and other nonprofits to develop and commercialize patents. Thus, this law exacerbates the discrepancies between the federal- and state-level schemes regulating nonprofit revenues.

#### A. Introductory Doctrinal Background

Nonprofit law is often divided into two broad areas: (1) state laws governing corporate status and (2) federal laws and policies connected to tax-exempt status under § 501(c)(3) of the Internal Revenue Code.<sup>9</sup> This latter status confers such extensive advantages that it has become a synecdoche for

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8. This term was coined by Henry Hansmann. *See infra* note 31 and accompanying text.

9. *See, e.g.*, JAMES J. FISHMAN, STEPHEN SCHWARZ & LLOYD HITOSHI MAYER, NONPROFIT ORGANIZATIONS: CASES AND MATERIALS, at xiii–xiv (5th ed. 2015); *see also* I.R.C. § 501(c)(3) (2012).

the entire sector<sup>10</sup> and functions as a “signaling” device<sup>11</sup> for a multitude of actors who rely on it. The regulations tied to it are primary oversight tools governing the sector.<sup>12</sup> Local property-tax exemptions form a third body of law affecting nonprofits; their considerations are not fully congruent with those that apply to federal tax status. As this Note focuses on an intersection between local property-tax exemptions and federal law, it sketches key considerations for federal qualification to provide a contrasting background for the legal issues at stake.

### 1. Nonprofits Can Generate Positive Revenue

Nonprofit organizations include major hospitals, universities, museums, and other cultural institutions, some of which generate significant revenue.<sup>13</sup> Scholars of urban economies often stress the importance of having robust “meds and eds” sectors within municipalities and regions.<sup>14</sup> Although many outsiders assume the term “nonprofit” refers to a lack of substantial net earnings,<sup>15</sup> nonprofits can have significant annual earnings from their own activities as well as from investment of very large endowments.<sup>16</sup> The distinction between nonprofit and for-profit corporations is not based on a lack of substantial revenue; rather, the distinction lies in the purposes of the organization, who may control it and how, and how revenues are spent.

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10. See Evelyn Brody & Joseph J. Cordes, *Tax Treatment of Nonprofit Organizations: A Two-Edged Sword?*, in NONPROFITS AND GOVERNMENT: COLLABORATION AND CONFLICT 133, 134 (Elizabeth T. Boris & C. Eugene Steuerle eds., 3d ed. 2017).

11. Susannah Camic Tahk, *Crossing the Tax Code’s For-Profit/Nonprofit Border*, 118 PENN ST. L. REV. 489, 491 (2014).

12. See, e.g., Brody & Cordes, *supra* note 10, at 142 (noting the role of the Internal Revenue Service (IRS) in policing the “nonprofit-government border and the nonprofit-commercial border” as well as payments to insiders).

13. See Elise Young, *Princeton’s Neighbors Say to Heck with Freebies—We Want Cash*, BLOOMBERG (May 2, 2016), <http://www.bloomberg.com/news/articles/2016-05-02/princeton-s-neighbors-say-to-heck-with-freebies-we-want-cash> [<https://perma.cc/2D2S-KWRH>] (estimating Princeton University’s endowment at \$22.7 billion).

14. See, e.g., Carolyn Adams, *The Meds and Eds in Urban Economic Development*, 25 J. URB. AFF. 571, 572 (2003); Adam John Parrillo & Mark de Socio, *Universities and Hospitals as Agents of Economic Stability and Growth in Small Cities: A Comparative Analysis*, 11 INDUS. GEOGRAPHER 1, 2 (2014).

15. See, e.g., Jeanne Bell, *Nonprofit Budgets Have to Balance: False!*, BLUE AVOCADO, <http://www.blueavocado.org/content/nonprofit-budgets-have-balance-false> [<https://perma.cc/J4BU-U7DC>] (last visited Feb. 14, 2018); *Myths About Nonprofits*, NAT’L COUNCIL NONPROFITS, <https://www.councilofnonprofits.org/myths-about-nonprofits> [<https://perma.cc/BM5T-TV46>] (last visited Feb. 14, 2018).

16. At least one hundred nonprofits in New York State reported revenues over \$10 million in their most recent 990 filings, and many report assets worth hundreds of millions of dollars. See *Search Active Organizations*, NAT’L CTR. CHARITABLE STAT., <http://www.nccs.urban.org/sites/all/nccs-archive/html/PubApps/search.php> [<https://perma.cc/Q9GQ-PJTA>] (search with “Location—State” as “New York” and “Revenue Size” as “\$10 million or more”) (last visited Feb. 14, 2018). See generally Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980).

## 2. Nonprofits Must Exist for Public Benefit

Not-for-profit corporation laws and federal tax-exemption laws require that such organizations pursue either specifically protected purposes or more generally defined charitable purposes that provide public benefits.<sup>17</sup> Various state and federal provisions incorporate these requirements.<sup>18</sup> These legislative schemes put a premium on education.<sup>19</sup> Still, all qualifying organizations must show that their activities serve a primary purpose designed to create public benefits.<sup>20</sup>

Broadly, when the Internal Revenue Service (IRS) or a court determines that an organization's other commercial activities are de minimis, revenues from those activities are subject to federal unrelated business income tax (UBIT).<sup>21</sup> Otherwise, the organization may lose its exempt status.<sup>22</sup> While one scholar describes this as a system of rigid borders between nonprofit and for-profit enterprises,<sup>23</sup> others see these borders as murky.<sup>24</sup> Sporadic enforcement in this area contributes to a lack of clarity.<sup>25</sup> This Note does not delve deeply into this federal doctrine but rather examines how similar activities are treated in the local property-taxation context where they are perhaps even more politically controversial.<sup>26</sup>

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17. See Treas. Reg. § 1.501(c)(3)-1(d)(ii) (2017) (requiring “a public rather than a private interest”).

18. See *id.*; see also N.Y. NOT-FOR-PROFIT CORP. LAW § 102(a)(3-a), (3-b) (McKinney 2017) (defining “charitable corporation” and “charitable purposes”).

19. See Janne Gallagher, *The Legal Structure of Property Tax Exemption*, in PROPERTY-TAX EXEMPTION FOR CHARITIES 3, 5 (Evelyn Brody ed., 2002) (noting that most states exempt educational institutions from property tax); see also I.R.C. § 170(b)(1)(A) (2012) (setting preferential deductibility for certain entities like churches and schools); I.R.C. § 509(a) (defining private foundations as a default category with exceptions related to deductibility of donations and public support); VIRGINIA G. RICHARDSON & JOHN FRANCIS REILLY, INTERNAL REVENUE SERV., 2003 EO CPE, PUBLIC CHARITY OR PRIVATE FOUNDATION STATUS: ISSUES UNDER IRC 509(a)(1)-(4), 4942(j)(3), AND 507, at 16–26 (2003), <https://www.irs.gov/pub/irs-tege/eotopicb03.pdf> [<https://perma.cc/Y9JW-8N9Z>] (discussing the preferential “public charity” status that applies to educational institutions).

20. See Treas. Reg. § 1.501(c)(3)-1(c)(1) (2017); see also RICHARDSON & REILLY, *supra* note 19, at 16–19, 29–31, 33–34.

21. See I.R.C. §§ 511–513; Treas. Reg. § 1.513-1 (including examples); see also Joseph J. Cordes & Burton A. Weisbrod, *Differential Taxation of Nonprofits and the Commercialization of Nonprofit Revenues*, 17 J. POL'Y ANALYSIS & MGMT. 195, 197, 201 (1998); Thomas Kelley, *Rediscovering Vulgar Charity: A Historical Analysis of America's Tangled Nonprofit Law*, 73 FORDHAM L. REV. 2437, 2439, 2472, 2479, 2483–85 (2005). See generally Ethan G. Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 EMORY L.J. 1475 (2005).

22. See, e.g., *Airlie Found. v. IRS*, 283 F. Supp. 2d 58, 65 (D.D.C. 2003) (revoking a conference center's exemption because of the “‘commercial hue’ to the way Airlie Carrie[d] out its business”); see also Kelley, *supra* note 21, at 2474.

23. See Tahk, *supra* note 11, at 491.

24. See, e.g., John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487, 508 (2002) (“Case law sheds virtually no light on the overall interface between taxing commercial activity and revoking tax exemption because of it.”); see also Kelley, *supra* note 21, at 2476 (calling this doctrinal terrain “vague and malleable”).

25. See Kelley, *supra* note 21, at 2484–85.

26. See Robert T. Grimm, Jr., *Targeting the Charitable Property-Tax Exemption to Collective Goods*, in PROPERTY-TAX EXEMPTION FOR CHARITIES, *supra* note 19, at 321, 321.

Finally, all charitable nonprofits, even educational institutions, must demonstrate a primary public purpose as well as a lack of inurement or substantial private benefit.<sup>27</sup> The latter is found when an organization is set up to provide an overwhelming amount of benefit to outsiders who are not incidental members of a broad class of charitable beneficiaries.<sup>28</sup> Inurement, on the other hand, is found where key insiders are able to control and extract charitable assets.<sup>29</sup> Under current federal law, there is a regime of intermediate sanctions that allows the IRS to apply excise taxes and penalties if excessively beneficial transactions to specific insiders are not unwound.<sup>30</sup>

### 3. Nonprofits Are Subject to the “Nondistribution Constraint”

The concepts of private benefit and inurement in federal tax law are part of what scholars deem the “nondistribution constraint” governing nonprofits.<sup>31</sup> This means that nonprofits cannot distribute assets as profits or shares and must instead devote them to charitable purposes.<sup>32</sup> State corporation laws also enforce this principle. For example, New York’s Not-for-Profit Corporations Law embodies it in rules on institutional funds,<sup>33</sup> the sale of substantially all assets,<sup>34</sup> and on dissolution.<sup>35</sup> Taken together, state-level not-for-profit corporations laws and federal tax-exemption law create a regulatory framework that encourages nonprofits to pursue innovative charitable ends for public benefit<sup>36</sup> so long as they do not create or distribute overly private benefits.<sup>37</sup>

#### *B. Property-Tax Exemptions for Charitable Organizations Are Independent of Federal Tax-Exempt Status*

Local property-tax exemptions are independent from federal law. They reside in state constitutions and state-level laws as well as in local adoptions

27. See Treas. Reg. § 1.501(c)(3)-1(c)(2); § 1.501(c)(3)-1(d)(1)(ii); see also John D. Colombo, *In Search of Private Benefit*, 58 FLA. L. REV. 1063, 1064–66 (2006); Peter G. Dagher Jr., Note, *Social Impact Bonds and the Private Benefit Doctrine: Will Participation Jeopardize a Nonprofit’s Tax-Exempt Status?*, 81 FORDHAM L. REV. 3479, 3487–98 (2013) (providing a doctrinal overview).

28. See Colombo, *supra* note 27, at 1064–65.

29. See, e.g., *Airlie Found., Inc. v. United States*, 826 F. Supp. 537, 551–52 (D.D.C. 1993) (revoking exemption where an organization’s director transferred land and wealth to other entities he and his family controlled), *aff’d*, 55 F.3d 684 (D.C. Cir. 1995).

30. See I.R.C. § 4958 (2012); Treas. Reg. § 53.4958. The law refers to these insiders as disqualified persons. See I.R.C. § 4958(f)(1). See generally Treas. Reg. § 53.4958–3 (2017).

31. See Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 501 (1981).

32. See *id.*

33. See N.Y. NOT-FOR-PROFIT CORP. LAW §§ 550–558 (McKinney 2017).

34. See *id.* §§ 509–511.

35. See *id.* § 1001(d)(3).

36. See, e.g., *Bob Jones Univ. v. United States*, 461 U.S. 574, 609–10 (1983) (Powell, J., concurring) (noting the importance of a pluralistic philanthropic sector); Evelyn Brody, *Legal Theories of Tax Exemption: A Sovereignty Perspective*, in PROPERTY-TAX EXEMPTION FOR CHARITIES, *supra* note 19, at 145, 153 (discussing pluralism as a justification for tax exemption).

37. See, e.g., Colombo, *supra* note 27, at 1081–86.

and assessments. All fifty states provide for some charitable exemptions.<sup>38</sup> Many preexist the federal charitable exemption by decades;<sup>39</sup> New Jersey's dates to 1851.<sup>40</sup> Certain universities, including Yale, Columbia, Harvard, and Princeton, can trace a tax-exempt status to a colonial charter that predates federal law altogether.<sup>41</sup>

Given their longevity, educational and charitable property tax exemption statutes do not anticipate the modern "knowledge economy," in which universities and other nonprofits play a driving role.<sup>42</sup> Property tax exemptions often have tighter restrictions on the generation and use of revenues than either the federal exemption or state nonprofit corporation laws. Neither a federal tax exemption under § 501(c)(3) nor even state status as a not-for-profit corporation acts as a guarantee of a local property-tax exemption.<sup>43</sup>

Federal law exempts nonprofits from tax on corporate income, which functions both as a subsidy to capital formation<sup>44</sup> and as an endowment subsidy.<sup>45</sup> The property-tax exemption, however, works much more like a pure subsidy.<sup>46</sup> Because it can significantly reduce an organization's ongoing costs compared to the costs faced by for-profit competitors and local neighbors, property-tax exemption can subsidize production factors in addition to capital asset formation.<sup>47</sup>

Yet for many small nonprofits, especially many religious organizations, the property-tax exemption protects the sole major asset of the organization—one that is essential to the organization's ability to fulfill its functions.<sup>48</sup> Some scholars argue that protecting religious property from tax

38. See Gallagher, *supra* note 19, at 4.

39. The federal exemptions date to 1894. See Paul Arnsberger et al., *A History of the Tax-Exempt Sector: An SOI Perspective*, STAT. INCOME BULL., Winter 2008, at 105, 106, <https://www.irs.gov/pub/irs-soi/tehistory.pdf> [<https://perma.cc/4Y6S-GMJD>].

40. See AHS Hosp. Corp. v. Town of Morristown, 28 N.J. Tax 456, 465 (2015).

41. See, e.g., Peter Dobkin Hall, *Is Tax Exemption Intrinsic or Contingent? Tax Treatment of Voluntary Associations, Nonprofit Organizations, and Religious Bodies in New Haven, Connecticut, 1750-2000*, in PROPERTY-TAX EXEMPTION FOR CHARITIES, *supra* note 19, at 253, 256–58 (detailing the early history of Yale). These were complex documents; at one point, Princeton's charter restricted it to an annual income equivalent to 20,000 bushels of wheat. See ALEXANDER LEITCH, *A PRINCETON COMPANION* 89–90 (1978).

42. See, e.g., *infra* notes 177–79 and accompanying text (discussing how the Bayh-Dole Act spurred this economic shift).

43. See, e.g., *infra* notes 62–67 and accompanying text.

44. See Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 TAX L. REV. 283, 285, 296 (2011).

45. *Id.* at 298–300, 306–08.

46. See, e.g., Joseph J. Cordes, Marie Gantz & Thomas Pollak, *What Is the Property-Tax Exemption Worth?*, in PROPERTY-TAX EXEMPTION FOR CHARITIES, *supra* note 19, at 81, 81; Dick Netzer, *Local Government Finance and the Economics of Property-Tax Exemption*, in PROPERTY-TAX EXEMPTION FOR CHARITIES, *supra* note 19, at 47, 58–60.

47. Philadelphia used this argument to justify its Voluntary Contribution Plan in the early 1990s. See David B. Glancey, *PILOTS: Philadelphia and Pennsylvania*, in PROPERTY-TAX EXEMPTION FOR CHARITIES, *supra* note 19, at 211, 224; see also Netzer, *supra* note 46, at 69–74 (discussing when charging nonprofits for local services makes sense).

48. See, e.g., Cordes, Gantz & Pollak, *supra* note 46, at 85; Stephen Diamond, *Efficiency and Benevolence: Philanthropic Tax Exemptions in 19th-Century America*, in PROPERTY-TAX EXEMPTION FOR CHARITIES, *supra* note 19, at 115, 117; see also Deirdre Dessingue, *The*

liens is at the historical core of all nonprofit law.<sup>49</sup> They suggest that the separate sovereignty of the church is the root of why nongovernmental organizations that create public goods receive tax exemption.<sup>50</sup> State laws and cases, meanwhile, tend to stress that exemptions are grants by the sovereign state and that the burden of demonstrating qualification must be on the applicant.<sup>51</sup>

From a fiscal point of view, property-tax exemptions tend to provide the greatest subsidies to nonprofits that own property in municipalities with high property values and high tax assessments,<sup>52</sup> although tax-rate competition between municipalities plays a role as well.<sup>53</sup> Such subsidies may reduce incentives for nonprofits to rent office space and other property in areas with lower property values that might benefit from investment in the local economy.<sup>54</sup> Importantly, property taxes are often the largest source of municipal revenues,<sup>55</sup> making choices about rates and exemptions highly controversial. The recent limitation of the deductibility of state and local taxes coupled with the near-doubling of the standard deduction will likely exacerbate tensions over local charitable exemptions from property tax as both home owners and charities find their budgets tightened as a result of the federal tax reform.<sup>56</sup>

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*Special Case of Churches*, in PROPERTY-TAX EXEMPTION FOR CHARITIES, *supra* note 19, at 173, 173–74, 176–77.

49. See Dessingue, *supra* note 48, at 173; Diamond, *supra* note 48, at 116–17; see also Brody & Cordes, *supra* note 10, at 141 (citing *Genesis* 47:26 for a land tax excluding priestly property).

50. See Dessingue, *supra* note 48, at 176.

51. See *Fields v. Trs. of Princeton Univ.*, 28 N.J. Tax 574, 580 (2015) (“Statutes granting exemption from taxation represent a departure and consequently they are most strongly construed against those claiming exemption.” (quoting *Princeton Univ. Press v. Borough of Princeton*, 172 A.2d 420, 422 (N.J. 1961))); see also *infra* note 225 and accompanying text.

52. See, e.g., Charles Brecher & Thad Calabrese, *CityLaw: Three Policy Questions for Nonprofit Property Tax Exemptions*, CITYLAND (May 5, 2015), <http://www.citylandnyc.org/citylaw-three-policy-questions-for-nonprofit-property-tax-exemptions/> [<https://perma.cc/6FAN-WVCN>] (providing New York City estimates). But see Joan M. Youngman, *The Politics of the Property-Tax Debate: Political Issues*, in PROPERTY-TAX EXEMPTION FOR CHARITIES, *supra* note 19, at 23, 27–29 (noting valuation difficulties). Furthermore, problems with using property taxes as a proxy for taxing wealth have been noted by scholars for decades. See, e.g., Comment, *Judicial Restoration of the General Property Tax Base*, 44 YALE L.J. 1075, 1075 n.1 (1935).

53. See, e.g., Peter M. Mieszkowski & George R. Zodrow, *Taxation and the Tiebout Model: The Differential Effects of Head Taxes, Taxes on Land Rents, and Property Taxes*, 27 J. ECON. LITERATURE 1098, 1099–1100 (1989) (discussing competition in tax rates and services).

54. This is because most states only exempt properties owned by nonprofits, not those rented by nonprofits. See Gallagher, *supra* note 19, at 6–9. But see Cordes, Gantz & Pollak, *supra* note 46, at 99–106 (arguing that decisions to own or to lease property also depend on the deductibility of depreciation).

55. See, e.g., DIV. OF LOCAL GOV'T & SCH. ACCOUNTABILITY, OFFICE OF THE N.Y. STATE COMPTROLLER, PROPERTY TAX EXEMPTIONS IN NEW YORK STATE 1 (2013), [https://www.osc.state.ny.us/localgov/pubs/research/propertytax\\_exemptions.pdf](https://www.osc.state.ny.us/localgov/pubs/research/propertytax_exemptions.pdf) [<https://perma.cc/DZF9-NE9Y>] (noting that they are the largest source of revenue for New York State municipalities).

56. See, e.g., *Tax Cuts and Jobs Act, H.R. 1: Nonprofit Analysis of the Final Tax Bill Proposal*, NAT'L COUNCIL NONPROFITS (Jan. 24, 2018), <https://www.councilofnonprofits.org/sites/default/files/documents/tax-bill-summary-chart.pdf> [<https://perma.cc/WBL4-D7DT>].

Because local property taxes support very local benefits like police, fire, sewage, road maintenance, and school services, some states and municipalities request that large nonprofits pay annual payments in lieu of taxes (PILOT) to partially compensate local governments for such services.<sup>57</sup> Over the past few decades, such PILOTs have become a regular part of the budgets of the largest nonprofits, especially colleges and universities.<sup>58</sup> Princeton University's PILOT to the municipality and the neighboring West Windsor Township is the tenth-highest in the nation.<sup>59</sup>

In many states, property-tax exemptions have a two-prong test: (1) whether the property is owned by a favored legal entity (e.g., a nonprofit, educational institution, or church) and (2) whether it is held for a favored use (e.g., charitable, public, educational, or religious).<sup>60</sup> Other states, however, including New Jersey, apply additional prongs or requirements, including "profit tests."<sup>61</sup>

Yet, even in states without a separate profit test, fears of private benefit shape how courts interpret claims of exemption. A New York case from 2015, *Greater Jamaica Development Corp. v. New York City Tax Commission*,<sup>62</sup> illustrates how a two-prong test works. There, the court denied an exemption for parking lots via the use prong.<sup>63</sup> Although a community development corporation with § 501(c)(3) status owned the lots and made a credible argument that they advanced its federally exempt purposes,<sup>64</sup> these purposes did not fit the use categories of New York's Real Property Tax Law section 420-a.<sup>65</sup> The court also concluded that the lots provided private benefit that "inure[d]" to local businesses,<sup>66</sup> even though under federal law, inurement is understood to be benefit to key insiders that control the organization rather than private benefit per se.<sup>67</sup>

*Ocean Pines Ass'n, Inc. v. Commissioner*<sup>68</sup> shows the different approach federal law takes. There, a nonprofit homeowners' association owned beach parking lots and a clubhouse accessible only to its members.<sup>69</sup> The court construed parking-lot income to be derived from activities creating private benefits rather than ones advancing the organization's social welfare

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57. See generally Adam H. Langley, Daphne A. Kenyon & Patricia C. Bailin, *Payments in Lieu of Taxes by Nonprofits: Which Nonprofits Make PILOTs and Which Localities Receive Them* (Lincoln Inst. of Land Policy, Working Paper No. WP12AL1, 2012), [https://www.lincolnst.edu/sites/default/files/pubfiles/langley-wp12al1-full\\_0.pdf](https://www.lincolnst.edu/sites/default/files/pubfiles/langley-wp12al1-full_0.pdf) [<https://perma.cc/6LHD-9JFW>].

58. *Id.* at 3.

59. *Id.* at 6.

60. See, e.g., N.Y. REAL PROP. TAX LAW § 420-a(1)(a) (McKinney 2017); N.C. GEN. STAT. § 105-278.3 (2017).

61. See *infra* Part I.B.1.

62. 36 N.E.3d 645 (N.Y. 2015).

63. *Id.* at 652–53.

64. *Id.* at 651–52.

65. *Id.* at 652–53; see also N.Y. REAL PROP. TAX LAW § 420-a.

66. *Greater Jamaica Dev. Corp.*, 26 N.E.3d at 653.

67. See Colombo, *supra* note 27, at 1067–73; Jill S. Manny, *Nonprofit Payments to Insiders and Outsiders: Is the Sky the Limit?*, 76 FORDHAM L. REV. 735, 744–45 (2007).

68. 672 F.3d 284 (4th Cir. 2012).

69. *Id.* at 289.

mission.<sup>70</sup> It concluded that the association had to pay UBIT;<sup>71</sup> the overall exemption was preserved.<sup>72</sup>

In some ways, the outcomes of these cases were quite similar. In each, a nonprofit had to pay taxes on its parking lots. In the federal case, an organization had to pay UBIT on parking-lot income, while in the New York case, one had to pay property taxes on its parking lots. Yet one involved a partial tax, while the other denied exemption for a particular parcel of real property. Additionally, the cases demonstrate that a property used to generally advance a charitable purpose may not qualify under the specific “actual use” standards for charitable property-tax exemptions that exist in every state.<sup>73</sup> Property-tax exemptions are thus not available on a general basis to nonprofits. In states that apply a further profit test, even tighter limits may constrict nonprofit activities.

### 1. Profit Tests Differ Significantly from Federal Exemption Law

The New Jersey Supreme Court stated its exemption doctrine as a three-part test in *Paper Mill Playhouse v. Millburn Township*<sup>74</sup>: “(1) [the corporation] must be organized exclusively for the [purposes of the exemption category]; (2) its property must be actually and exclusively used for the tax-exempt purpose; and (3) its operation and use of its property must not be conducted for profit.”<sup>75</sup> Although statutory changes rendered the exclusive-use question moot in 1985<sup>76</sup> and similar limits on schools had already been removed in 1913,<sup>77</sup> New Jersey courts still apply the rest of test. Its “prongs [are] respectively referred to as (1) the ‘organization test,’ (2) the ‘use test,’ and (3) the ‘profit test.’”<sup>78</sup>

This framework for property tax exemption is not a mirror of the tests for federal income tax exemption under § 501(c)(3). Yet the tests seem comparable at first glance. The “organization test” under New Jersey law closely resembles the “organized test” under federal law,<sup>79</sup> in that it focuses on whether charters, bylaws, and other documents show an exclusively

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70. *Id.* at 289–92.

71. *Id.*

72. *See id.* at 287–89, 292.

73. *See* Gallagher, *supra* note 19, at 9. *But see* N.Y. REAL PROP. TAX LAW § 494-a (McKinney 2017) (allowing exemptions to be granted retroactively to the date of deed in New York City); *Not-For-Profit (NFP) Organization Property Tax Exemptions/Reductions*, N.Y.C. DEP’T FIN., <http://www1.nyc.gov/site/finance/benefits/benefits-not-for-profit-organizations.page> [https://perma.cc/XW65-DEQA] (last visited Feb. 14, 2018) (documenting New York City’s related policy of allowing a contemplated use exemption).

74. 472 A.2d 517 (N.J. 1984).

75. *Id.* at 518.

76. *See* Int’l Sch. Servs., Inc. v. West Windsor Township, 21 A.3d 1166, 1174 (N.J. 2011).

77. *See* Pingry Corp. v. Hillside Township, 217 A.2d 868, 870–71 (N.J. 1966) (noting that exclusive use language for schools was added in 1903 and removed in 1913); *see also* N.J. STAT. ANN. § 54:4-3.6 (West 2017).

78. *Borough of Hamburg v. Trs. of Presbytery of Newton*, 28 N.J. Tax 311, 318 (2015) (exempting buildings used to store church documents because the use was “reasonably necessary”).

79. *See* Treas. Reg. § 1.501(c)(3)-1(b) (2017).

exempt purpose.<sup>80</sup> This purpose, however, must be enumerated in the property-tax exemption statute. Neither status as a not-for-profit corporation under New Jersey law<sup>81</sup> nor being organized for purposes exempt under § 501(c)(3) is sufficient.<sup>82</sup>

The New Jersey statute is complex and contains targeted language for specific types of exemption, but all categories are subject to the limitation that “*in case of all the foregoing, the buildings, or the lands on which they stand, or the associations, corporations or institutions using and occupying them as aforesaid, are not conducted for profit . . .*”<sup>83</sup> The New Jersey Tax Court has stressed that the “profit test” is a “pragmatic inquiry”<sup>84</sup> with a limited de minimis exception that will not protect a property where substantial nonexempt activity occurs.<sup>85</sup> Although de minimis profits and commercial activities can be permissible,<sup>86</sup> New Jersey does not consider an organization’s exempt status under § 501(c)(3) controlling for property tax disputes.<sup>87</sup> The application form indicates that “a for-profit motive, as evidenced by the facts, invalidates exemption, i.e., is the organization’s structure, financial agreements, tuitions, fees set etc. with the intent to make a profit.”<sup>88</sup>

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80. *See, e.g.*, Black United Fund of N.J., Inc. v. City of East Orange, 17 N.J. Tax 446, 455 (1998), *aff’d*, 772 A.2d 65 (N.J. Super. Ct. App. Div. 2001) (“[The organization’s] certificate of incorporation provides that its purpose is to [distribute funds] . . . to other federally tax-exempt organizations . . . . The organization’s bylaws provide for the same . . . . These purposes . . . are not identified as exempt purposes in N.J.S.A. 54:4-3.6.”).

81. *Id.* at 449.

82. *Id.*

83. N.J. STAT. ANN. § 54:4-3.6 (West 2017) (emphases added). For properties exempt on “charitable, benevolent, or religious” grounds, the statute continues:

the exemption . . . shall extend . . . where the [exempt] work therein carried on is supported partly by fees and charges received from or on behalf of beneficiaries using or occupying the buildings; provided the building is wholly controlled by and the *entire income* therefrom is used for said *charitable, benevolent or religious purposes* . . . .

*Id.* (emphases added).

84. AHS Hosp. Corp. v. Town of Morristown, 28 N.J. Tax 456, 496 (2015) (applying a requirement for a “pragmatic inquiry into profitability. . . . [where] mechanical centering on income and expense figures is to be avoided” (quoting Paper Mill Playhouse v. Millburn Township, 472 A.2d 517, 526 (N.J. 1984))).

85. *See* Princeton Univ. Press v. Borough of Princeton, 172 A.2d 420, 424 (N.J. 1961) (denying exemption as press works regularly served outside businesses); Phillipsburg Riverview Org. v. Town of Phillipsburg, 27 N.J. Tax 188, 194 (N.J. Super. Ct. App. Div. 2013) (denying exemption to an arts organization that allowed artists to profit from classes and exhibitions on its premises); Greenwood Cemetery Ass’n of Millville, Inc. v. City of Millville, 1 N.J. Tax 408, 414 (1980) (denying exemption for cemetery parsonage where an inhabitant regularly used it for a side business).

86. *See* AHS Hosp. Corp., 28 N.J. Tax at 534 (collecting cases).

87. *See, e.g.*, Essex Props. Urban Renewal Assocs., Inc. v. City of Newark, 20 N.J. Tax 360, 368, 370 (2002) (confirming federal nonprofit status is irrelevant and concluding that the plaintiff provided insufficient evidence that its senior and disabled housing was run in a charitable manner); *see also supra* note 80 and accompanying text.

88. *See Initial Statement of Organization Claiming Property Tax Exemption*, N.J. DEP’T ST., [http://www.state.nj.us/treasury/taxation/pdf/other\\_forms/lpt/initialstment.pdf](http://www.state.nj.us/treasury/taxation/pdf/other_forms/lpt/initialstment.pdf) [https://perma.cc/TJ5Q-YSL8] (last visited Feb. 14, 2018).

In the leading case for the “dominant motive” test, *Kimberley School v. Town of Montclair*,<sup>89</sup> the New Jersey Supreme Court clarified that the relevant inquiry was “not so much for . . . whether [a school’s] income exceeds the cost of operation in any particular year or years, but rather whether charges are fixed with the obvious intention of yielding a profit.”<sup>90</sup> It considered factors that could show inurement to insiders as well as

excess of income over costs, and the actual and possible use of such excess; the existence and extent of [the school’s] accumulated surplus and the purpose to which it may be put; . . . the scale of salaries paid to its teachers and officials as compared with similar schools, public as well as private . . .<sup>91</sup>

These criteria are less clearly defined than those used in federal law. The IRS has issued detailed regulations for calculating reasonable compensation to key employees.<sup>92</sup> These rules focus on “excess benefit” transactions where the charitable organization transfers more than the value of the consideration it receives.<sup>93</sup> They exclude most initial contracts,<sup>94</sup> which allows nonprofits to negotiate for top talent. New Jersey’s factors for evaluating reasonable compensation are independent from this scheme and have been more restrictively applied.<sup>95</sup>

Yet neither surplus revenues nor tuition rates set to produce such is evidence of a profit motive, according to an influential case, *City of Trenton v. State Division of Tax Appeals*.<sup>96</sup> There, a court evaluating an exemption claimed by Rider College (now known as Rider University) held that such surpluses represented “plan[ning] on a sound fiscal basis for the replacement of antiquated facilities or the expansion of facilities.”<sup>97</sup> Importantly, the court distinguished the school’s governance and compensation from its past practices, noting that it had ceased paying its “vocational advisers” high commissions for generating admissions.<sup>98</sup>

A more recent case demonstrates that private benefit to outsiders is still a significant disqualification in New Jersey. In *Phillipsburg Riverview Organization v. Town of Phillipsburg*,<sup>99</sup> an appellate court affirmed Judge Vito Bianco’s decision to deny exemption to a community arts center that let artists derive profits for exhibitions, classes, and performances at the space.<sup>100</sup> Although the plaintiff argued that the question of profit making

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89. 65 A.2d 500 (N.J. 1949).

90. *Id.* at 505.

91. *Id.*

92. See I.R.C. § 4958 (2012) (taxing excess benefit transactions by nonprofits); Treas. Reg. § 53.4958 (2017) (providing definitions and many other specifics).

93. See I.R.C. § 4958(c)(1)(A).

94. See Treas. Reg. § 53.4958-4(c).

95. See *AHS Hosp. Corp. v. Town of Morristown*, 28 N.J. Tax 456, 515–25 (2015) (rejecting the federal rules as determinative of the reasonableness of salaries and compensation).

96. 166 A.2d 777 (N.J. Super. Ct. App. Div. 1960).

97. *Id.* at 781–82.

98. See *id.* at 781 n.12.

99. 27 N.J. Tax 188 (N.J. Super. Ct. App. Div. 2013).

100. *Id.* at 194.

should focus on the owning organization,<sup>101</sup> the court disagreed. It noted that exemption statutes are read strictly against claimants and held that the plaintiff failed to show that “the entire income” from the space would be reinvested in the organization.<sup>102</sup> Importantly, the “entire income” reinvestment requirement applies to properties with a charitable or religious exemption but not to educational ones.<sup>103</sup>

Other New Jersey cases consider additional factors as evidence of a profit motive. In a recent unpublished opinion, the New Jersey Tax Court found above- or at-market rates for ballet classes to be sufficient grounds to deny exemption for a dance school building, even though the owner had a broader nonprofit purpose it pursued more fully at other locations.<sup>104</sup> Although this case is not precedential, it shows that reinvesting surpluses from seemingly commercial activities at a specific location towards an overall exempt purpose may not protect a property-tax exemption because of the interaction of the use test and the profit test.

In a more significant case, *AHS Hospital Corp. v. Town of Morristown*,<sup>105</sup> Judge Bianco revoked the entire property tax exemption of a large hospital. He saw its commercial operations and collaborations with for-profit entities as too interwoven with its exempt activities.<sup>106</sup> In that case, he applied the standard from *City of Trenton*: “[I]f [the court] can trace [profit] into someone’s personal pocket [the organization will] not be entitled to tax exemption.”<sup>107</sup>

The most recent edition of the New Jersey Tax Assessors’ Manual requires that a parcel be neither owned nor operated for profit,<sup>108</sup> but it excepts academic properties partially leased to profit-making organizations. There, it allows a partial exemption on the remainder of the building or a complete exemption only if the lease (1) lasts less than four months (2) is not a profit-seeking transaction, (3) is de minimis, and (4) only produces income devoted to the organization’s exempt purpose.<sup>109</sup> This administrative practice suggests that profit limits on academic property are intended to be fairly strict.

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101. *Id.* at 192.

102. *Id.* at 193 (quoting N.J. STAT. ANN. § 54:4–3.6 (2017)).

103. *See supra* note 83; *infra* notes 135–38 and accompanying text.

104. *Township of Cranbury v. Princeton Ballet Soc’y*, No. 010651-2012, 2014 WL 4417744, at \*1 (N.J. Tax Ct. Sept. 3, 2014).

105. 28 N.J. Tax 456 (2015).

106. *Id.* at 513.

107. *Id.* at 496 (first and second alterations in original) (quoting *City of Trenton v. State Div. of Tax Appeals*, 166 A.2d 777, 782 (N.J. Super. Ct. App. Div. 1960)).

108. *See* PROP. ADMIN., HANDBOOK FOR NEW JERSEY ASSESSORS 96, 274–78, 297–300 (2017), <http://www.state.nj.us/treasury/taxation/pdf/assessorshandbook.pdf> [<https://perma.cc/HKA9-ZGSD>].

109. *Id.* at 297.

2. New Jersey's De Minimis Exception Has Been More Strictly Interpreted than Federal Analogs and Fails to Accommodate Complex Business Practices

New Jersey case law shows that while the “profits test” has been gradually modified, its exceptions are narrow. Older cases demonstrate little tolerance for buildings used for multiple purposes, both charitable and commercial. In *Greenwood Cemetery Ass'n of Millville, Inc. v. City of Millville*,<sup>110</sup> the New Jersey Tax Court denied exemption for a cemetery parsonage, where the caretaker's wife used it to run a side business selling memorial plaques.<sup>111</sup> The court found that the activity was substantial, not de minimis.<sup>112</sup>

Similarly, in *Princeton University Press v. Borough of Princeton*,<sup>113</sup> the New Jersey Supreme Court ruled that Princeton University Press's exemption claim failed because its facilities were not exclusively used for exempt purposes: beyond its own academic publishing activity, it regularly contracted with various businesses to serve their printing needs. The court held this that “[was] not an occasional or incidental activity, or, if engaged in regularly, one which [was] of an inconsequential or *de minimis* character.”<sup>114</sup> Although the legislature has adjusted the exemption statute since this case, making the use test now one of actual rather than exclusive use, the holding is still substantially good law.

These older cases show that, although each prong must be independently met,<sup>115</sup> there was a great deal of interaction between the profit test and the exclusive use test. Activities that generated a profit for insiders, employees, or outsiders were not necessarily suspect because courts were persuaded that these proved the “dominant motive” sought in *Kimberley School*.<sup>116</sup> Rather, they also demonstrated uses of the property for nonexempt purposes.<sup>117</sup>

The newer partial exemption framework is much closer to the “fragmentation” principle under UBIT.<sup>118</sup> The relevant language allows an educational or charitable organization to lease out portions of property to for-profit institutions or use them for nonexempt activities as long as those portions are taxed.<sup>119</sup> The parcel-by-parcel nature of property-tax exemptions would also seem suited to splitting off nonexempt activities and revenues from exempt uses and functions.<sup>120</sup> As the parking-lot cases show, some profitable uses can be isolated to specific taxed parcels. Yet the

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110. 1 N.J. Tax 408 (1980).

111. *Id.* at 411, 414.

112. *Id.* at 414.

113. 172 A.2d 420 (N.J. 1961).

114. *Id.* at 424.

115. *See* *Hunterdon Med. Ctr. v. Township of Readington*, 951 A.2d 931, 941 n.13 (N.J. 2008) (noting the use test is “superfluous” if either of the others is not met).

116. *Kimberley Sch. v. Town of Montclair*, 65 A.2d 500, 505 (N.J. 1949).

117. They also do not adhere to the “entire income” reinvestment requirement. *See supra* notes 83, 102 and accompanying text.

118. *See* *Stone*, *supra* note 21, at 1488. Under this concept, the IRS taxes discrete activities, like advertising, even if conducted within the broad scope of exempt operations.

119. *See supra* note 3.

120. *See supra* notes 62–73 and accompanying text.

complexity of modern business practices puts strain on the partial exemption framework.

The New Jersey Supreme Court directly addressed difficult-to-isolate mixtures of commercial and exempt activities in a recent case, *International Schools Services, Inc. v. West Windsor Township*.<sup>121</sup> There, a nonprofit serving international schools abroad had various partnerships with other entities, including some for-profit ones that it leased property to within the same complex at below-market rates.<sup>122</sup> Although the organization never claimed a property-tax exemption for those areas, the court nonetheless found the arrangement improper as the support for the for-profit entities was commingled in the use of the entire property.

Similarly, the treatment of joint ventures in *AHS* diverges significantly from federal exemption standards. Under federal law and many state incorporation statutes, joint ventures can be tricky for nonprofits; their permissibility can depend on the degree of control by related parties that could take the nonprofit beyond the limits of its exempt purposes.<sup>123</sup> Many such arrangements are possible for nonprofits, however, as nonprofits may generally invest their assets in any investments they find prudent.<sup>124</sup> As long as the joint venture is a separate legal entity and fiduciary responsibilities are met, the nonprofit should be able to receive after-tax dividends or profits from the subsidiary.<sup>125</sup>

Yet, these collaborations, which Judge Bianco described as “labyrinthine corporate structures” in *AHS*,<sup>126</sup> present obstacles to maintaining a property-tax exemption in New Jersey. The main issue in the case involved commingling of uses rather than simply revenues. Although the fact that many of the same actors were involved at highest levels of the collaborations and joint ventures raised concerns,<sup>127</sup> the main crux was not whether there was separate accounting of arms-length transactions.<sup>128</sup> Rather, Judge Bianco considered how the profit-oriented entities used the property, looking for a mixing of exempt uses with for-profit uses such that the property benefitted the for-profit actors.<sup>129</sup> His analysis included whether particular profit-making physicians worked throughout the hospital buildings.<sup>130</sup>

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121. 21 A.3d 1166 (N.J. 2011).

122. *Id.* at 1178.

123. *See* Dagher, *supra* note 27, at 3495–98 (discussing the IRS policy on nonprofit participation in joint ventures).

124. *See, e.g.*, N.Y. NOT-FOR-PROFIT CORP. LAW § 552 (McKinney 2017). Some assets may be restricted by deed or contract. Fiduciary duties also apply to nonprofit board investments, while significant disposition of assets may be subject to other regulations. *See, e.g.*, §§ 509–510.

125. *See, e.g.*, David A. Levitt & Steven R. Chiodini, *Taking Care of Business: Use of a For-Profit Subsidiary by a Nonprofit Organization*, A.B.A. (June 2014), [https://www.americanbar.org/publications/blt/2014/06/03\\_levitt.html](https://www.americanbar.org/publications/blt/2014/06/03_levitt.html) [<https://perma.cc/7EFX-BRER>].

126. *AHS Hosp. Corp. v. Town of Morristown*, 28 N.J. Tax 456, 465 (2015).

127. *See id.* at 474, 513–14 (noting overlapping high-level personnel and finding it impossible to construe the operations as arms-length transactions).

128. *Id.* at 500–02.

129. *See id.* at 501, 506.

130. *See id.* at 501–02.

These questions illustrate how hard it is to borrow an income fragmentation approach and apply it to a property-tax exemption law like the current one in New Jersey. Assessors can fairly easily separate different types of income and selectively apply taxes to certain streams. This targeted taxation is harder with *ad valorem* taxation of property, where the assessment is based on the relative value of an asset. Scholars of taxation call the real property tax a tax on land rent<sup>131</sup> but also consider assessment a proxy for measuring capital accumulation,<sup>132</sup> that is, the increase in wealth attributable to increased value or utilization of the property.<sup>133</sup> But it is difficult to break out a piece of increased value and attribute it to a commercial or profitable use of the property, particularly if this use cannot be physically demarcated.

Finding it impossible to make such a demarcation, Judge Bianco denied the hospital the property-tax exemption. In reaching this holding, he tackled the hospital's assertion that it would mean "*the traditional and historic means by which hospitals throughout New Jersey provided hospital services* will have always violated the Statute and the Statute is a nullity."<sup>134</sup> Discussing the legislative history and case law on hospital exemptions, he concluded that there was no endorsement of profit making by hospitals when the exemption was codified.<sup>135</sup>

Here, he noted an early case, *Bancroft Training School v. Borough of Haddonfield*,<sup>136</sup> which examined the shift from an 1895 statute to one enacted in 1903. The former exempted certain institutions solely on their incorporation status, while the latter included the "not conducted for profit" limit on academic property and the "entire income" reinvestment requirement for charitable exemption.<sup>137</sup> The New Jersey Supreme Court reasoned there that this clearly demonstrated "the legislative purpose . . . to exclude . . . enterprises which may be benevolent in spirit, but which are conducted for private gain."<sup>138</sup>

This was a landscape of obstacles for Princeton University in *Fields*, given its technical collaborations and many partnership investments.<sup>139</sup> Although

131. See RICHARD A. MUSGRAVE & PEGGY B. MUSGRAVE, PUBLIC FINANCE IN THEORY AND PRACTICE 413 (5th ed. 1989).

132. See *id.* at 411–13 (contrasting benefit theory with land rent); *id.* at 417–18 (discussing market-value assessment); *id.* at 419–21 (illustrating how these dynamics affect capital); see also Mieszkowski & Zodrow, *supra* note 53, at 1099–101, 1140–41 (modeling theories of real property taxation and concluding that the scale of the inquiry, that is, metropolitan, regional, or national, affects accuracy, but that nationally property taxation depresses returns to capital, while land rents may be regionally efficient).

133. See MUSGRAVE & MUSGRAVE, *supra* note 131, at 417–18.

134. *AHS Hosp. Corp. v. Town of Morristown*, 28 N.J. Tax 456, 479 (2015).

135. See *id.* at 494–95 (discussing the statute that first introduced a hospital exemption). The court noted that "[p]erhaps this reflects . . . recognition of the evolving importance of hospitals . . . and the differing purposes between hospital uses and charitable uses. . . . [Yet] it is clear that the Legislature in 1913 did not condone the use of hospital property for-profit." *Id.*

136. 82 A. 20 (N.J. 1911); see also *AHS Hosp. Corp.*, 28 N.J. Tax at 491.

137. *Bancroft Training Sch.*, 82 A. at 21.

138. *Id.*

139. Princeton University's Form 990-T filing for 2015 lists multiple partnership agreements as well as unrelated business taxable income of negative \$34,221,249. Trs. of

the “entire income” limit applies only to organizations with “charitable, benevolent or religious” use exemptions,<sup>140</sup> academic institutions are subject to the “not conducted for profit” requirement.<sup>141</sup> This distinction might have meant that the court would view profit to outsiders or faculty less strictly, yet continuing the litigation could have been risky for Princeton University. Furthermore, Judge Bianco was presiding, and he showed no willingness in *AHS* to accede to legislative acquiescence to business practices in the sector. As such, property-tax exemption laws and judicial interpretations of them have created a precarious compliance landscape for nonprofits with budgetary concerns.

### 3. Some Other State Laws Operate in a Similar Way

While New Jersey’s charitable and educational property-tax exemptions are quite narrow, they are not unique: several other states apply profit tests to property-tax exemptions. Ohio’s exemption for colleges and academies specifically includes a profit limitation.<sup>142</sup> The state’s limits on other charitable or educational institutions are weaker yet also apply a profit limit on leased property.<sup>143</sup>

Profit motive plays a central role in Ohio property-tax exemption law, yet the test applied is somewhat more lenient than in New Jersey. Under Ohio’s standard, “profit is defined as the excess of price over cost,”<sup>144</sup> but courts distinguish between the mere presence of surpluses and “a view to profit.”<sup>145</sup> This standard was set by an early Ohio decision, which extended statutory property-tax exemptions to private schools as purely public charities precisely because such schools might be run “without any view to profit.”<sup>146</sup> Under this principle, Ohio courts have judged lease terms harshly.<sup>147</sup> Yet

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Princeton Univ., Return of Organization Exempt from Income Tax (2015 Form 990-T) (on file with Princeton University, Office of the Treasurer, Tax Department).

140. See *supra* notes 83, 102, 137 and accompanying text.

141. See *supra* notes 83, 137 and accompanying text. Any creation of intellectual property, even beyond Bayh-Dole Act activities, could pose property-tax problems if faculty were bound by holdings like that in *Phillipsburg Riverview Organization v. Town of Phillipsburg*, 27 N.J. Tax 188, 194 (N.J. Super. Ct. App. Div. 2013). See *supra* notes 99–103 and accompanying text.

142. See OHIO REV. CODE ANN. § 5709.07(A)(4) (West 2017) (exempting “[p]ublic colleges and academies . . . not used with a view to profit”).

143. See *id.* § 5709.121(A)(2) (exempting indirect use only if the property is “under the direction or control of such institution . . . for use in furtherance of or incidental to its charitable, educational, or public purposes and not with the view to profit”).

144. 250 Shoup Mill, L.L.C. v. Testa, 60 N.E.3d 1254, 1259 (Ohio 2016); see also *Seven Hills Sch. v. Kinney*, 503 N.E.2d 163, 165 (Ohio 1986) (defining profit similarly, but noting “[t]he legislature is of course free to define profit in any manner it sees fit”).

145. See *Craftsmen Recreation Club, Inc. v. Testa*, 31 N.E.3d 154, 157 (Ohio Ct. App. 2015).

146. *Gerke v. Purcell*, 25 Ohio St. 229, 247 (1874) (noting that “private property . . . is often used for . . . education, like property in ordinary business, as a means of profit”).

147. See, e.g., *250 Shoup Mill*, 60 N.E.3d at 1255 (denying exemption even where lessor funneled profits to lessees because Ohio “bars a claim of vicarious exemption”); *Anderson/Maltbie P’ship v. Levin*, 937 N.E.2d 547, 554 (Ohio 2010) (noting profit to either the lessor or the lessee voids exemption).

they also broadly allow exemptions for activities reasonably necessary to a charitable or educational purpose, such as restaurants,<sup>148</sup> parking lots,<sup>149</sup> and a Girl Scout memorabilia store.<sup>150</sup>

Ohio law specifically determines that a scientific research organization will be considered charitable and educational even if it “operates in a manner that results in an excess of revenues over expenses”<sup>151</sup> as long as the surplus is reinvested toward its exempt purposes. The law further specifies that “any scientific information diffused by the organization . . . of particular . . . benefit to any of its individual members [shall not] be used to deny the exemption . . . provided [that it] is available to the public for purchase or otherwise.”<sup>152</sup> It is unclear whether these provisions are congruent with the Bayh-Dole Act,<sup>153</sup> as they seem primarily aimed at undoing the holding in *American Society for Metals v. Limbach*,<sup>154</sup> where the Ohio Supreme Court had strictly applied a profit test to deny exemption to a scientific membership society with ongoing net positive income from publications, conferences, and lectures.<sup>155</sup>

Pennsylvania places high statutory and constitutional barriers to tax exemption.<sup>156</sup> The state constitution limits exemptions to only “[i]nstitutions of purely public charity, but in the case of any real property tax exemptions only that portion of real property of such institution which is actually and regularly used for the purposes of the institution.”<sup>157</sup> Academic property should fall within these general bounds.<sup>158</sup> Pennsylvania courts apply a five-part test, which has been codified,<sup>159</sup> to an organization claiming an exemption:

- (1) it must advance a charitable purpose; (2) it must donate or render gratuitously a substantial portion of its services; (3) it must benefit a substantial and indefinite class of persons who are legitimate subjects of charity; (4) it must relieve the government of some of its burden; and (5) it must operate entirely free from private profit motive.<sup>160</sup>

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148. See *Ohio N. Univ. v. Tax Comm’r*, 255 N.E.2d 297, 299 (Ohio Ct. App. 1970).

149. See *Bowers v. Akron City Hosp.*, 243 N.E.2d 95, 97 (Ohio 1968) (exempting hospital parking lot with positive revenue where fees ensured patients and doctors rather than the public could use it).

150. See *Girl Scouts-Great Trail Council v. Levin*, 862 N.E.2d 493, 496 (Ohio 2007).

151. OHIO REV. CODE ANN. § 5709.12(D)(1) (West 2017).

152. *Id.* This special provision is also tied to an exit tax on such property when sold to a nonexempt entity. See *id.* § 5709.12(D)(2).

153. See *infra* Parts I.C, II.

154. 569 N.E.2d 1065 (Ohio 1991).

155. *Id.* at 1067.

156. See Gallagher, *supra* note 19, at 13–14.

157. See PA. CONST. art. VIII, § 2.

158. See Gallagher, *supra* note 19, at 4.

159. See Institutions of Purely Public Charity Act of 1997, 10 PA. STAT. AND CONS. STAT. ANN. §§ 371–385 (West 2016).

160. *Fayette Res., Inc. v. Fayette Cty. Bd. of Assessment Appeals*, 107 A.3d 839, 845 (Pa. Commw. Ct. 2014).

This is a high bar, yet the test distinguishes between reinvested surpluses and money flowing to private individuals.<sup>161</sup> The courts acknowledge that “tax-exempt charitable institutions will have revenue, including surplus revenue, but . . . it is how such revenue is used that will determine whether it evidences a private profit motive.”<sup>162</sup>

In *City of Washington v. Board of Assessment Appeals*,<sup>163</sup> the Pennsylvania Supreme Court concluded that a nonprofit college had satisfied the profit prong as it neither compensated trustees nor distributed any profits or dividends to any individuals.<sup>164</sup> The school’s finances also showed that it provided education below cost.<sup>165</sup> The test’s codification carved out “state-related universities”<sup>166</sup> but left other colleges subject to its burdens. Many nonprofits make PILOTs to satisfy it.<sup>167</sup>

Minnesota applies a six-part test, looking at the nonprofit corporation’s purpose, its reliance on donations, and charging of fees, as well as the presence of profits to the organization, an open class of beneficiaries reasonably related to the charitable purposes, and distributions to private entities of any material dividends or profits either during the undertaking or on dissolution.<sup>168</sup> This test was set forth in *North Star Research Institute v. County of Hennepin*,<sup>169</sup> which predates the Bayh-Dole Act and deals directly with scientific research and external partnerships between nonprofits and for-profit companies. In *North Star*, the Minnesota Supreme Court focused on the fact that a research institute gave marketplace advantages and proprietary interests in subsequent patents to private businesses.<sup>170</sup> Furthermore, the organization could not demonstrate that these agreements covered an insubstantial fraction of the research.<sup>171</sup> The court denied the property-tax exemption.<sup>172</sup>

Although a recent case clarified that the *North Star* factors are not a multiprong test,<sup>173</sup> the same case also denied property-tax exemptions to charitable organizations that charge fees.<sup>174</sup> In *North Star*, the court did not examine the test factors closely as the case represented a departure from then-standard charitable practice.<sup>175</sup> Instead, the court distinguished between

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161. See *id.* at 846; *In re Dunwoody Vill.*, 52 A.3d 408, 422–23 (Pa. Commw. Ct. 2012) (denying exemption where retirement community executives received annual bonuses for financial performance).

162. *Wilson Area Sch. Dist. v. Easton Hosp.*, 747 A.2d 877, 880 (Pa. 2000).

163. 704 A.2d 120 (Pa. 1997).

164. *Id.* at 125–26.

165. *Id.*

166. See 10 PA. STAT. AND CONS. STAT. ANN. § 374 (West 2016).

167. See Pamela Leland, *PILOTs: The Large City Experience*, in PROPERTY-TAX EXEMPTION FOR CHARITIES, *supra* note 19, at 193, 195.

168. See *N. Star Research Inst. v. County of Hennepin*, 236 N.W.2d 754, 757 (Minn. 1975).

169. 236 N.W.2d 754 (Minn. 1975).

170. *Id.* at 755.

171. *Id.*

172. *Id.*

173. See *Under the Rainbow Child Care Ctr., Inc. v. County of Goodhue*, 741 N.W.2d 880, 885 (Minn. 2007) (noting that “*North Star* did not establish six mandatory elements”).

174. See *id.* at 886.

175. See *N. Star*, 236 N.W.2d at 757.

indirect economic benefits to society from increased innovation and direct public benefits from fostering and making abstract knowledge publicly available.<sup>176</sup> Furthermore, it saw creating competitive advantages for outside partners as stretching the concept of a charitable purpose beyond the breaking point.<sup>177</sup>

### C. *The Bayh-Dole Act Complicates This Framework*

State property-tax exemptions with profit tests would be more restrictive than federal regulation of business activities by nonprofits, particularly in the academic context, if strictly enforced. Many state-level property-exemption statutes seem out of sync with the modern “knowledge economy,”<sup>178</sup> where research universities develop key innovations that drive American economic growth.<sup>179</sup> Much of this shift is traceable to the 1980 adoption of a federal law to accelerate commercializing such research.<sup>180</sup> The fact that so many of these profit tests were established in case law before Bayh-Dole activities became such a significant part of the economy indicates that this is an area of law that deserves reevaluation.

The University and Small Business Patent Procedures Act,<sup>181</sup> better known as the Bayh-Dole Act, was intended “to promote collaboration between *commercial* concerns and nonprofit organizations, including universities; . . . [and] *to promote the commercialization* and public availability of inventions made in the United States . . . .”<sup>182</sup> The law gave universities a green light to exploit patents invented by faculty and staff, to remit a portion of the proceeds as royalties to the inventors, and to license the patents to small businesses.<sup>183</sup>

The Act’s required royalties resemble a share of profits that would otherwise violate the nondistribution constraint, while the preference for small businesses similarly appears to convey private benefits on those

176. *See id.* at 757–58.

177. *See id.* at 758.

178. *See generally* ORGANISATION FOR ECON. CO-OPERATION & DEV., THE KNOWLEDGE-BASED ECONOMY (1996), <https://www.oecd.org/sti/sci-tech/1913021.pdf> [<https://perma.cc/S79A-H5EJ>]; Walter W. Powell & Kaisa Snellman, *The Knowledge Economy*, 30 ANN. REV. SOC. 199 (2004).

179. *See generally* NAT’L RESEARCH COUNCIL, *Universities as Innovation Drivers*, in BEST PRACTICES IN STATE AND REGIONAL INNOVATION INITIATIVES: COMPETING IN THE 21ST CENTURY 49 (Charles W. Wessner ed., 2013); *see also* Hansmann, *supra* note 16, at 835 n.1; Christopher M. Kelly, Book Note, 8 HARV. J.L. & TECH. 521, 522–23, 527–28 (1995) (reviewing ANNALEE SAXENIAN, REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128 (1994)). *But see* Powell & Snellman, *supra* note 178, at 204–06, 214–16 (noting that this pattern correlates with weak labor productivity and uneven growth).

180. *See, e.g.*, Brief of Amici Curiae Wisconsin Alumni Research Foundation et al. in Support of Stanford’s Petition for Certiorari at 1, 8–9, Bd. of Trs. of Leland Stanford Junior Univ. v. Roche Molecular Sys., Inc., 563 U.S. 776 (2011) (No. 09-1159).

181. 35 U.S.C. §§ 200–212 (2012).

182. *Id.* § 200 (emphasis added).

183. *See id.* § 207(c)(7) (providing “a requirement that the contractor share royalties with the inventor” and a requirement that “a preference in the licensing of subject inventions shall be given to small business firms”).

organizations.<sup>184</sup> Yet, as the U.S. Supreme Court clarified in *Board of Trustees of Leland Stanford Junior University v. Roche Molecular Systems, Inc.*,<sup>185</sup> Bayh-Dole does not mandate such activities but rather authorizes them with guidelines and restrictions tied to federal funds.<sup>186</sup> In another case, a federal district court held that the law was not intended to precisely regulate the relationship between universities and faculty inventors.<sup>187</sup> Although the regulations impose standard contract clauses as the general norm,<sup>188</sup> it is well established that the royalty requirement does not set a minimum rate of disbursement.<sup>189</sup> It is not clear, however, whether the elective nature of Bayh-Dole implicates some proportionality test for nonprofits vis-à-vis either the extent of other exempt purposes or the size of private benefits conferred to for-profit businesses.<sup>190</sup>

The Bayh-Dole Act succeeded in spurring the changes it sought. One study found annual patents granted to universities expanded from 380 in 1980 to 3088 in 2009.<sup>191</sup> The Association of University Technology Managers, founded in 1974, now counts over three thousand members.<sup>192</sup> Economists estimate the law's positive impact in the tens of billions of dollars.<sup>193</sup> Still, critics charge that these benefits have concentrated in relatively few hands, accruing primarily to corporate shareholders, patent holders, and university endowments.<sup>194</sup>

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184. *See id.* Other federal statutes also incentivize partnerships between nonprofits and for-profit businesses. *See, e.g.,* Bradley Myers, *The Low-Income Housing Tax Credit: A Proposal to Address IRS Concerns Regarding Partnerships Between Non-Profit and For-Profit Entities*, 60 TAX LAW. 415, 415 (2007).

185. 563 U.S. 776 (2011).

186. *Id.* at 787; *see also* Christopher S. Hayter & Jacob H. Rooksby, *A Legal Perspective on University Technology Transfer*, 41 J. TECH. TRANSFER 270, 279 (2016).

187. *See* Fenn v. Yale Univ., 393 F. Supp. 2d 133, 141–42 (D. Conn. 2004), *aff'd*, 184 F. App'x 21 (2d Cir. 2006).

188. *See* 37 C.F.R. § 401.3 (2017).

189. *See* Platzer v. Sloan-Kettering Inst. for Cancer Research, 787 F. Supp. 360, 367–68 (S.D.N.Y.), *aff'd*, 983 F.2d 1086 (Fed. Cir. 1992).

190. *Cf.* 35 U.S.C. § 207(a)(3) (2012) (requiring federal agencies to license only federally owned inventions through transactions in the public interest); *see also* Colombo, *supra* note 27, at 1066 (arguing private benefit should be curtailed where “the charity enters into a transaction with a for-profit entity . . . involving [the charity’s] core services that confers a competitive advantage on the for-profit in its own business activities”).

191. *See* Howard Markel, *Patents, Profits, and the American People—The Bayh–Dole Act of 1980*, 369 NEW ENG. J. MED. 794, 794 (2013); *see also* Hayter & Rooksby, *supra* note 186, at 271 (discussing trends).

192. *See* About AUTM, ASS'N U. TECH. MANAGERS, <http://www.autm.net/autm-info/about-autm/> [<https://perma.cc/8MQE-JCBX>] (last visited Feb. 14, 2018).

193. *See* Markel, *supra* note 191, at 794.

194. *See* JACOB H. ROOKSBY, THE BRANDING OF THE AMERICAN MIND: HOW UNIVERSITIES CAPTURE, MANAGE, AND MONETIZE INTELLECTUAL PROPERTY AND WHY IT MATTERS 9, 132–43, 151 (2016). *See generally* Amy Kapczynski, *Addressing Global Health Inequalities: An Open Licensing Approach for University Innovations*, 20 BERKELEY TECH. L.J. 1031 (2005); Rachael A. Ream, *Nonprofit Commercialization Under Bayh-Dole and the Academic Anticommons*, 58 CASE W. RES. L. REV. 1343 (2008).

### 1. Bayh-Dole Activities Can Fit Within the Federal Exemption

Is the Bayh-Dole framework a rational exception from the overall legal system guiding nonprofit activities? The Bayh-Dole Act seems to discount the possibility that it might conflict with the tax code. It takes precedence over other laws, yet omits § 501(c)(3) from a long list of affected statutes.<sup>195</sup> It does contemplate interaction between the two, however, as its definition for “nonprofit organization” includes organizations tax exempt under § 501(c)(3).<sup>196</sup> Yet its definition is broader than a reference to that section, which indicates that the meaning of this term is not controlled by the tax code.

The overall goals of the Bayh-Dole Act are tied to ideas of public benefit. It incentivizes research useful to society but also encourages it to occur at nonprofits, where researchers may be more likely to pursue foundational inquiries and engage in teaching. Furthermore, the prior system was criticized for wasting valuable publicly funded innovations.<sup>197</sup>

The current federal tax law presents no real conflict with Bayh-Dole. The framework of intermediate sanctions for excess-benefit transactions coupled with UBIT can accommodate the likely collaborations. Income from partnerships can be structured as passive investment income, income substantially related to a university or research institute’s exempt purposes,<sup>198</sup> or UBIT.<sup>199</sup> Many faculty inventors likely have royalty agreements covered by the initial contract exception to excess benefit transactions.<sup>200</sup> Others will not even be disqualified persons under the law if they do not run departments or laboratories or exercise significant control of the organization.<sup>201</sup>

The remaining question is whether other private benefits to outsiders and nondisqualified employees should be considered necessary byproducts of the modern scientific research institution.<sup>202</sup> The intent of the Bayh-Dole Act to foster such efforts reveals no great qualms on the issue, and IRS policy decisions reflect this.<sup>203</sup> Even if the collaborative structures for licensing patents necessarily create substantial private benefits, this is likely

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195. See 35 U.S.C. § 210.

196. See *id.* § 201(i).

197. See Markel, *supra* note 191, at 794 (noting estimates that only 5 percent of such patents reached the market).

198. See Treas. Reg. § 1.513-1(d)(2) (2017); *IIT Research Inst. v. United States*, 9 Cl. Ct. 13, 21 (1985) (construing a research institute’s income from work carried out for industrial clients as substantially related to its exempt purpose).

199. See, e.g., Treas. Reg. § 1.501(c)(3)-1(d)(5); see also Peter D. Blumberg, Comment, *From “Publish or Perish” to “Profit or Perish”: Revenues from University Technology Transfer and the § 501(c)(3) Tax Exemption*, 145 U. PA. L. REV. 89, 93–94 (1996) (arguing some Bayh-Dole income should be taxable under UBIT).

200. See *supra* note 94 and accompanying text; see also I.R.S. Tech. Adv. Mem. 85-01-082 (Oct. 10, 1984) (allowing a foundation to create a for-profit subsidiary whose joint-owners would be researchers recruited via equity shares).

201. See I.R.C. § 4958(f)(1) (2012); Treas. Reg. § 53.4958-3 (2017).

202. See I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987); see also I.R.S. Tech. Adv. Mem. 85-01-082 (Oct. 10, 1984) (construing private benefit to the related for-profit entity as “entirely incidental to the major purpose and effect of the proposed transaction”).

203. See I.R.S. Gen. Couns. Mem. 39,598 (Jan. 23, 1987).

permissible under federal law: internal IRS guidance states that a nonprofit may create qualitatively incidental private benefits if these are “a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by benefiting certain private individuals.”<sup>204</sup>

The elective nature of the Act—that is, the fact that universities and other nonprofits are only bound by Bayh-Dole to the extent that they choose to patent federally funded research<sup>205</sup>—means that questions of proportionality may emerge. How much benefit to outside partners or faculty inventors would be too much? There does not appear to be a single case where a nonprofit acting in accordance with Bayh-Dole has lost federal tax exemption on private-benefit grounds. The new excise taxes on high compensation to key nonprofit employees and on very large university endowments,<sup>206</sup> however, show some willingness from Congress and the federal government to rein in the generation and distribution of wealth in the sector. It is possible that some border-drawing enforcement could occur.

## 2. The Federal Nondistribution Constraint Is Weaker and More Flexible than State Profit Tests

Because the federal framework looks for excess benefit or private inurement to insiders, or substantial private benefit to outsiders,<sup>207</sup> the required royalty distributions under Bayh-Dole can be structured so that even significant regular payouts could be permissible.<sup>208</sup> Although large annual remittances may seem like profit sharing to casual observers, the IRS likely would not agree. The interaction between the Bayh-Dole Act and local property-tax exemptions is more complicated.

204. *Id.* For state-level exemptions IRS positions would not control, see, e.g., *North Star Research Institute v. County of Hennepin*, 236 N.W.2d 754, 757 (Minn. 1975) (denying a pre-Bayh-Dole arrangement as only creating remote public benefits while directly allowing “a person or corporation [to] gain[] a profit or commercial advantage as the immediate and intended direct consequence of the ‘charity’”).

205. See *supra* notes 185–86 and accompanying text.

206. See Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, §§ 13602, 13701, 131 Stat. 2054 (to be codified at I.R.C. § 4960); see also Ray Gronberg, *Congress Throws Flag on Duke for Paying Krzyzewski and Cutcliffe as Much as It Does*, HERALD SUN (Dec. 26, 2017, 6:00 AM), <http://www.heraldsun.com/news/local/counties/durham-county/article191416419.html> [<https://perma.cc/NT86-XGBX>]; Jamie D. Halper, *Harvard to Pay “Unprecedented” Endowment Tax*, CRIMSON (Dec. 20, 2017), <http://www.thecrimson.com/article/2017/12/20/endowment-tax-passed/> [<https://perma.cc/7982-DHPC>]; Ben Myers & Brock Read, *If Republicans Get Their Way, These Colleges Would See Their Endowments Taxed*, CHRON. HIGHER EDUC. (Dec. 5, 2017, 11:31 AM), <https://www.chronicle.com/article/If-Republicans-Get-Their-Way/241659> [<https://perma.cc/V42X-27A4>] (tabulating schools affected, with Princeton at the top); Jake Novak, *How Tax Reform Will End the Nonprofit Executive Pay Scam*, CNBC (Dec. 20, 2017, 2:47 PM), <https://www.cnbc.com/2017/12/20/tax-reform-smacks-down-excessive-nonprofit-executive-pay-commentary.html> [<https://perma.cc/46GW-4NXN>]; Dan Spinelli, *Under the Final GOP Tax Plan, Penn Will Pay a Landmark Excise Tax on Its Endowment*, DAILY PENNSYLVANIAN (Dec. 22, 2017, 12:44 AM), <http://www.thedp.com/article/2017/12/republican-tax-plan-trump-upenn-graduate-students-endowment-gutmann> [<https://perma.cc/LAU2-2YA6>].

207. See *supra* notes 27–30, 67 and accompanying text.

208. See *supra* notes 30, 92–94, 200–02 and accompanying text.

The substance of the complaint in *Fields* targeted the university's commercial incomes, particularly its patents and licenses, examining revenues and alleged profit sharing with both the faculty whose research produced the patents as well as outside corporate partners.<sup>209</sup> The plaintiffs alleged that the university received over \$500 million in such revenue over nine years<sup>210</sup> and shared over \$100 million of it with faculty<sup>211</sup> in a way that would seem to violate the "nondistribution constraint" applied by state law.<sup>212</sup> They also alleged that the university made its research facilities available to private corporations through rental agreements, licensing agreements, and joint ventures.<sup>213</sup>

For the purpose of evaluating a property-tax exemption, should it matter that a university structures hiring, retention, and resource investment around financially beneficial patent-development systems?<sup>214</sup> Or should the key considerations be the size of the royalty compensations to inventors?<sup>215</sup> Should a court consider the direct use of shared facilities by joint ventures?<sup>216</sup> Or should it focus on the ability of outside partners in joint ventures to benefit from the research use of laboratories and other facilities by the university's own employees?<sup>217</sup> As there do not seem to be directly related property-tax exemption cases decided on the merits since the enactment of Bayh-Dole,<sup>218</sup> it is difficult to say what standards should apply. Yet it appears that nonprofits engaging in significant Bayh-Dole activities could forfeit property-tax exemptions if statutory profit tests were strictly enforced as barriers to employees or outside partners making a substantial profitable use of an otherwise exempt property.

## II. THE POLICY CONFLICT BETWEEN THE BAYH-DOLE ACT AND STATE PROFIT TESTS

This Part focuses on whether there is a legal conflict between the Bayh-Dole Act and profit tests applied to state-level charitable and educational property-tax exemptions. Part II.A explains that Bayh-Dole should not be

209. See 2016 Complaint, *supra* note 6, at 2–12; see also Ollwerther, *supra* note 3.

210. See Complaint at 3, *Fields v. Trs. of Princeton Univ.*, 28 N.J. Tax 574 (2015) (No. 7556-15) [hereinafter 2015 Complaint]; Young, *supra* note 13.

211. See 2015 Complaint, *supra* note 210, at 3; see also Anna Merriman, *24 More Residents Challenge Princeton U.'s Tax Exempt Status*, NJ.COM (Apr. 6, 2016, 4:29 PM), [http://www.nj.com/mercer/index.ssf/2016/04/24\\_more\\_residents\\_challenge\\_princeton\\_us\\_tax\\_exemp.html](http://www.nj.com/mercer/index.ssf/2016/04/24_more_residents_challenge_princeton_us_tax_exemp.html) [<https://perma.cc/L4TH-5TPP>]; Ollwerther, *supra* note 3.

212. See N.J. STAT. ANN. § 54:4-3.6 (West 2017); Hansmann, *supra* note 31, at 501.

213. See 2015 Complaint, *supra* note 210, at 2.

214. See Janet Rae-Dupree, *When Academia Puts Profit Ahead of Wonder*, N.Y. TIMES (Sept. 6, 2008), <http://www.nytimes.com/2008/09/07/technology/07unbox.html> [<https://perma.cc/9VNW-Z7N3>]; see, e.g., *Office of Technology Licensing*, PRINCETON U. (May 16, 2017), <https://www.princeton.edu/patents/> [<https://perma.cc/F3GA-KBFV>] (providing an overview of Princeton University's patenting and licensing efforts).

215. See 2016 Complaint, *supra* note 6, at 3–5; cf. Manny, *supra* note 67, at 747–50.

216. See *supra* notes 123–30 and accompanying text.

217. See *supra* notes 99–103, 113–14 and accompanying text.

218. *American Society for Metals v. Limbach* dealt with revenue from conferences, lectures, and publications, rather than patents. See *Am. Soc'y for Metals v. Limbach*, 569 N.E.2d 1065, 1067 (Ohio 1991); *supra* note 154 and accompanying text.

construed as preempting state-level laws on educational and charitable property-tax exemptions and argues that although patent regulations are reserved to federal law, local property tax exemptions are independent expressions of state sovereignty.

Part II.B then clarifies that dormant Commerce Clause concerns should not act as a bar to the persistence of these two disparate systems. Part II.C warns, however, that there are strong policy arguments in favor of greater alignment between federal and state-level tax exemptions and that there are negative practical consequences of nonalignment.

*A. The Bayh-Dole Act Should Not  
Preempt Local Property-Tax Exemptions*

Although there is a great deal of tension between the aims of the Bayh-Dole Act and state-imposed restrictions on the revenue-generating activities of nonprofits, there is likely no legal conflict between these two systems of incentives and regulations. The following Part addresses the question of express and implied preemption over state law. Part II.A.1 concludes that there is no express preemption, while Part II.A.2 presents reasons why there should be no implied preemption.

1. There Is No Express Preemption

The Bayh-Dole Act does not expressly preempt state tax-exemption laws, although it may preempt state nonprofit incorporation laws. The Bayh-Dole Act specifically contemplates the nature of nonprofit corporations as creatures of state law. It defines “nonprofit organization” to include “universities and other institutions of higher education or an organization of the type described in section 501(c)(3) of the Internal Revenue Code . . . or any nonprofit scientific or educational organization qualified under a State nonprofit organization statute.”<sup>219</sup> This definition could be seen to defer to state law qualifications for such organizations, or rather to preempt those rules to the extent that they might clash with Bayh-Dole. On the one hand, Congress clearly meant to set a national policy for all such organizations, and it is fairly clear that Congress intended that an otherwise qualified nonprofit should not lose its nonprofit status due to its engagement in Bayh-Dole activities. On the other hand, however, federal nonprofit status does not create a general entitlement to property-tax exemptions at the state level, and Congress made no mention of state-based tax exemptions in Bayh-Dole.

2. There Is Likely No Implied Preemption

The next steps in preemption analysis involve examining whether state law might have been implicitly displaced by Congress.<sup>220</sup> Such preemption can

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219. 35 U.S.C. § 201(i) (2012).

220. *See* *Freightliner Corp. v. Myrick*, 514 U.S. 280, 287 (1995) (finding implicit preemption when a federal law’s scope “indicates that Congress intended [it] to occupy a field exclusively,” or when “state law is in actual conflict” with it, or “where it is ‘impossible for a private party to comply with both state and federal requirements,’ . . . or where state law

occur when the state law intrudes on a field that is reserved for Congress or which Congress has occupied.<sup>221</sup> Implied preemption may also occur if the state law directly conflicts with or frustrates the federal law.<sup>222</sup> Congress has the power to shape and encourage particular economic activities.<sup>223</sup> Deference would seem to be all the more warranted here as patents are reserved to federal law under the Progress of Science and Useful Arts Clause.<sup>224</sup> Nonetheless, as taxation is a strong expression of state sovereignty,<sup>225</sup> it is a stretch to say that federal patent law should necessarily preempt state tax-exemption law.

Furthermore, even though there is tension between Bayh-Dole and state property-tax exemptions, it is clear that the latter do not directly regulate the same subject or field as Bayh-Dole.<sup>226</sup> Courts resolving disputes tied to the Bayh-Dole Act or patents have refused to dismiss state-law claims. One district court noted that “states are not precluded from enforcing complementary laws that may involve patent issues.”<sup>227</sup> It quoted *Aronson v. Quick Point Pencil Co.*,<sup>228</sup> where the Supreme Court held “[s]tate law is not displaced merely because the contract relates to intellectual property which may or may not be patentable . . . .”<sup>229</sup> Because these state property-tax exemptions, which determine an organization’s tax liability to a local sovereign, do not clearly intrude into the regulation of intellectual property, they need not be preempted, despite Bayh-Dole’s reference to state-level not-for-profit corporation statutes.

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‘stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.’” (citation omitted) (first quoting *English v. Gen. Elec. Co.*, 496 U.S. 72, 78–79 (1990); then quoting *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941))).

221. *See, e.g.*, *Arizona v. United States*, 567 U.S. 387, 401, 403 (2012) (denying Arizona any authority to establish immigration laws that it argued were complementary to federal immigration law).

222. *See id.* at 399–400.

223. It can do so under either the Commerce Clause or through its spending power. *Compare* *Gonzales v. Raich*, 545 U.S. 1, 25 (2005) (approving the regulation of home-grown marijuana as an economic activity), *with* *South Dakota v. Dole*, 483 U.S. 203, 206 (1987) (“Congress may attach conditions on the receipt of federal funds . . .”).

224. U.S. CONST. art. I, § 8, cl. 8. *See generally* Edward C. Walterscheid, *To Promote the Progress of Science and Useful Arts: The Anatomy of a Congressional Power*, 43 IDEA 1 (2002). *But see generally* Jeanne C. Fromer, *The Intellectual Property Clause’s External Limitations*, 61 DUKE L.J. 1329 (2012) (arguing that this clause limits congressional power).

225. *Compare* *Gen. Motors Corp. v. Tracy*, 519 U.S. 278, 311 (1997) (“Indeed, ‘in taxation, even more than in other fields, legislatures possess the greatest freedom in classification.’” (quoting *Madden v. Kentucky*, 309 U.S. 83, 88 (1940))), *with* *Princeton Univ. Press v. Borough of Princeton*, 172 A.2d 420, 422 (N.J. 1961) (“[O]rdinarily all property shall bear its just and equal share of the public burden of taxation. As the existence of government is a necessity, taxes are demanded and received in order for government to function.” (citations omitted)).

226. *Cf.* *Arizona v. United States*, 567 U.S. 387, 402 (2012) (“[T]he basic premise of field preemption—[is] that States may not enter, in any respect, an area the Federal Government has reserved for itself.”). The federal government has never attempted to reserve local property taxation for itself.

227. *Fenn v. Yale Univ.*, 393 F. Supp. 2d 133, 141 (D. Conn. 2004), *aff’d*, 184 F. App’x 21 (2d Cir. 2006).

228. 440 U.S. 257 (1979).

229. *Id.*

Preemption may also be implied through the nature of the conflict between the laws in question. If the state law makes it impossible for a person or corporation to comply with both the state and federal law, the state law will be preempted.<sup>230</sup> Similarly, if a state's legal scheme is so at odds with the federal one that it fundamentally frustrates the federal purpose, the state laws will be preempted.<sup>231</sup> Here, it would be possible for a university or research institute to rigorously engage in Bayh-Dole activities while complying with state laws even in a state with a very strict "profit test" as long as it is willing to forgo property-tax exemption. It could still retain federal income-tax exemption as well as other benefits of nonprofit status. Furthermore, although the Constitution bars state interference with patent regulation, so far there is insufficient evidence that incidence of real property taxes on universities and research institutes would necessarily frustrate Congress's goals for Bayh-Dole.<sup>232</sup> Indeed, the recent endowment excise tax may indicate that some additional incidence of tax on universities with large revenues should not be construed as frustrating Congress's purpose of promoting the commercialization of patentable research.<sup>233</sup>

Thus, the apparent conflict between Bayh-Dole and state-level profit tests can be resolved by distinguishing between laws governing state-level incorporation from those governing property tax. Because the latter are independent, Bayh-Dole's definitional reference to nonprofit corporate status need not encompass them.

*B. Dormant Commerce Clause Concerns  
Do Not Invalidate These State Laws*

Dormant Commerce Clause concerns also do not present a legal barrier to the persistence of the tension between the federal and state-level regimes, although they do have a persuasive role. Exemptions, including property-tax exemptions, can violate the dormant Commerce Clause.<sup>234</sup> If exemptions merely encourage domestic industry, they generally survive under the "legitimate local interest" standard unless conditioned on further

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230. *See Arizona*, 567 U.S. at 399–400.

231. *See id.*

232. *But see* Abhiroop Mukherjee, Manpreet Singh & Alminas Žaldokas, *Do Corporate Taxes Hinder Innovation?*, 124 J. FIN. ECON. 195, 195–96 (2017) (examining the effects of increases in state corporate tax rates on the patenting and research activity of for-profit corporations).

233. *See supra* note 206 and accompanying text. It is worth noting, however, that subsequent legislation is disfavored as a guide to Congress's original purpose for any statutory scheme still in effect. *See, e.g., United States v. Price*, 361 U.S. 304, 310 (1960) (explaining in this taxpayer dispute that "subsequent legislative developments [do not] change the view we have of the statute"). The Court also warned that "the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one." *Id.* at 313.

234. *See Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 574 (1997) (striking an exemption limited to nonprofits serving Maine residents and stating that "[a] tax on real estate, like any other tax, may impermissibly burden interstate commerce" and that "the States may [not] impose real estate taxes in a manner that discriminates against interstate commerce").

discrimination against interstate commerce or consumers.<sup>235</sup> Still, even seemingly neutral statutes may not create disproportionate burdens on interstate commerce.<sup>236</sup> As with preemption, there is as yet insufficient evidence that profit tests on real property tax exemptions create such burdens.

### C. Practical Considerations Argue Against Nonalignment

There are strong policy arguments in favor of greater alignment between federal and state-level tax exemptions. When a certain way of doing business is encouraged by Congress, is widespread across the entire sector and nation, and plays a significant role in defining the modern university, it deserves acknowledgment at the state and local levels. Universities compete for top talent across state lines and international borders. Their ability to do so is an economic engine for municipalities, regions, and nations.<sup>237</sup>

Whether such patent commercialization activities should be encouraged, forbidden, or permitted subject to partial taxation is a large policy question rather than a narrow issue of statutory interpretation. The Bayh-Dole Act was a dramatic change when introduced.<sup>238</sup> Since then, it has been heralded<sup>239</sup> and criticized<sup>240</sup> for its effects on academia and the broader economy. Skeptics, including a former president of Harvard,<sup>241</sup> worry that commercialization of academia has a corrosive effect on higher education.<sup>242</sup> Critics point to low pay for adjunct faculty<sup>243</sup> and graduate-student

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235. *Compare* *Trinova Corp. v. Mich. Dep't of Treasury*, 498 U.S. 358, 385 (1991) (noting that tax incentives stimulate growth), *and* *Cuno v. DaimlerChrysler, Inc.*, 386 F.3d 738, 747–48 (6th Cir. 2004) (discussing exemption cases), *vacated on other grounds sub nom. DaimlerChrysler Corp. v. Cuno*, 547 U.S. 332 (2006), *with* *Dep't of Revenue v. Davis*, 553 U.S. 328, 338–39 (2008) (stating the more general rule). *Cuno* also demonstrates federal standing hurdles facing taxpayer suits. *See generally* Edward A. Zelinsky, *Putting State Courts in the Constitutional Driver's Seat: State Taxpayer Standing After Cuno and Winn*, 40 HASTINGS CONST. L.Q. 1 (2012).

236. *See* *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 142 (1970) (providing the doctrinal test).

237. *See, e.g.*, NAT'L RESEARCH COUNCIL, *supra* note 179, at 49–54; Adams, *supra* note 14, at 572–73.

238. *See* Michael Sweeney, Comment, *Correcting Bayh-Dole's Inefficiencies for the Taxpayer*, 10 NW. J. TECH. & INTELL. PROP. 295, 296 (2012); Opinion, *Innovation's Golden Goose*, ECONOMIST (Dec. 12, 2002), <http://www.economist.com/node/1476653> [<https://perma.cc/FL7E-JBYYY>].

239. *See* Opinion, *supra* note 238.

240. *See* ROOKSBY, *supra* note 194, at 142–44, 175; JENNIFER WASHBURN, UNIVERSITY, INC.: THE CORPORATE CORRUPTION OF AMERICAN HIGHER EDUCATION 148–52 (2005); Sweeney, *supra* note 238, at 296–97.

241. *See* Blumberg, *supra* note 199, at 91. *See generally* Risa L. Lieberwitz, *The Marketing of Higher Education: The Price of the University's Soul*, 89 CORNELL L. REV. 763 (2004) (reviewing DEREK BOK, *UNIVERSITIES IN THE MARKETPLACE: THE COMMERCIALIZATION OF HIGHER EDUCATION* (2003)).

242. *See generally* WASHBURN, *supra* note 240.

243. *See, e.g.*, Kim Clark, *Does It Matter That Your Professor Is Part Time?*, U.S. NEWS (Nov. 7, 2008, 4:46 PM), <https://www.usnews.com/education/articles/2008/11/07/does-it-matter-that-your-professor-is-part-time> [<https://perma.cc/AB4Z-VPA7>]; Kate Guarino, *Adjunct Faculty Seek to Unionize*, DAILY TROJAN (Apr. 15, 2015), <http://dailytrojan.com/on-the-money/#tab-id-3> [<https://perma.cc/T3VQ-LMM2>].

instructors,<sup>244</sup> high student debts,<sup>245</sup> and profit-oriented research<sup>246</sup> as outcomes of commercialization. Such concerns have spurred campaigns for labor rights on campus,<sup>247</sup> increased regulation of for-profit colleges,<sup>248</sup> and the new excises taxes on very large university endowments<sup>249</sup> as well as on individual compensation to nonprofit employees who earn more than \$1 million a year.<sup>250</sup> Elite nonprofit universities face pressure from a society uncertain about the public benefits they create. The fact that they gain support not only from tax exemptions but also from direct public funding via research grants and tuition support heightens the pressure.<sup>251</sup>

Academic commercialization, though exacerbated by Bayh-Dole, cannot be traced solely to it. Commercialization is widespread not only in academia but also throughout the nonprofit sector.<sup>252</sup> Some scholars see benefits to blurring boundaries between for-profits and nonprofits,<sup>253</sup> but others are concerned that current law already drifts far from an understanding of charitable efforts as serving society's neediest.<sup>254</sup>

At the same time, there is a long, sporadic history of municipalities engaging in tax disputes with nonprofits.<sup>255</sup> These disputes often emerge at moments of social tension and upheaval.<sup>256</sup> Still, municipalities may be loath to challenge a local tax-exempt golden goose, especially if they have already

244. See, e.g., Avi Asher-Schapiro, *NYU's Graduate Student Union Just Won a Historic Contract*, NATION (Mar. 11, 2015), <https://www.thenation.com/article/nyus-graduate-student-union-just-won-historic-contract/> [<https://perma.cc/KN2U-X8PX>]; Jennifer Klein, *Opinion, Why Yale Graduate Students Are on a Hunger Strike*, N.Y. TIMES (May 9, 2017), <https://www.nytimes.com/2017/05/09/opinion/why-yale-graduate-students-are-on-a-hunger-strike.html> [<https://perma.cc/3VVG-RCZT>].

245. See, e.g., Editorial, *Student Debt's Grip on the Economy*, N.Y. TIMES (May 20, 2017), <https://www.nytimes.com/2017/05/20/opinion/sunday/student-debts-economy-loans.html> [<https://perma.cc/V6P9-4CGE>].

246. See Blumberg, *supra* note 199, at 91; Sweeney, *supra* note 238, at 301–03.

247. See *supra* notes 243–44.

248. See, e.g., Editorial, *Protecting Students from Bad Colleges*, N.Y. TIMES (June 20, 2016), <https://www.nytimes.com/2016/06/20/opinion/protecting-students-from-bad-colleges.html> [<https://perma.cc/C5PC-7XNT>].

249. See *supra* note 206.

250. See *supra* note 206; see also Andrea Fuller, *Charity Officials Are Increasingly Receiving Million-Dollar Paydays*, WALL ST. J. (Mar. 6, 2017, 9:59 AM), <https://www.wsj.com/articles/charity-officials-are-increasingly-receiving-million-dollar-paydays-1488754532> [<https://perma.cc/K6PA-3SZC>].

251. See Christopher S. Hayter, *Public or Private Entrepreneurship? Revisiting Motivations and Definitions of Success Among Academic Entrepreneurs*, 40 J. TECH. TRANSFER 1003, 1004 (2015); Press Release, Am. Insts. for Research, *Taxpayer Subsidies for Most Colleges and Universities Average Between \$8,000 to More than \$100,000 for Each Bachelor's Degree, New Study Finds* (May 12, 2011), <http://www.air.org/news/press-release/taxpayer-subsidies-most-colleges-and-universities-average-between-8000-more> [<https://perma.cc/X5LE-JSCM>].

252. See generally TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NONPROFIT SECTOR (Burton Weisbrod ed., 1998).

253. See Tahk, *supra* note 11, at 506.

254. See Kelley, *supra* note 21, at 2490–93 (proposing that charities specifically serving the poor should be given further preferential legal status).

255. See Evelyn Brody, *Introduction to PROPERTY-TAX EXEMPTION FOR CHARITIES*, *supra* note 19, at ix, ix–xi.

256. See *id.*

negotiated a PILOT with it.<sup>257</sup> Because assessments are often local, this can result in inequitable enforcement. Mid-size nonprofits may face strictly enforced profit tests that larger nonprofits have been able to ignore.<sup>258</sup> Meanwhile, the latter may face PILOT demands that look increasingly like property taxes. Although this discretion is arguably appropriate in the context of municipal competition in tax rates and services,<sup>259</sup> as currently practiced, nonprofits face an uncertain and incoherent enforcement landscape. Greater alignment between local and federal policy would reduce the regulatory compliance burden for nonprofits.<sup>260</sup> Reshaping the border between for-profits and nonprofits through legislation also offers a chance to redesign incentives for creating public goods and benefits.<sup>261</sup>

### III. ATTEMPTS AT RECONCILIATION

This Part examines various attempts to address the dilemmas posed by the local burdens and impacts of wealthy nonprofits as well as attempts to reconcile the disparities between federal and state laws regulating the sector. Part III.A focuses on the *Fields* litigation as a model for laissez-faire enforcement of state-level regulation, while Part III.B examines reforms in a number of states that have sought to bring rules governing charitable and educational exemptions from *ad valorem* property taxes closer to the rules governing the federal income-tax exemption.

Most property-tax exemption statutes were drafted well before the twentieth-century expansion of academia or the Bayh-Dole Act. New laws at the state level could resolve substantial disconnections between state and federal regulation of nonprofits. Some state legislatures are starting to address these issues; the *Fields* case indicates that they should move more rapidly towards thoroughgoing reform.

#### A. *The Fields Litigation Is a Fraught Model for Citizen Enforcement*

*Fields* can be seen as a test of whether local taxpayers can participate in oversight of entities with significant power in their communities. Under the current framework, there are barriers to oversight by public actors. The IRS is unlikely to challenge universities for their patent activities given the clear intent of the Bayh-Dole Act and its own past practice.<sup>262</sup> State attorneys general enforce nonprofit corporation laws regarding fiduciary duties of

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257. See, e.g., *supra* notes 57–59 and accompanying text.

258. See generally Mieszkowski & Zodrow, *supra* note 53 (discussing the application of the Tiebout model to tax rates).

259. See generally *id.*

260. See, e.g., Evelyn Brody, *The 21st Century Fight over Who Sets the Terms of the Charity Property Tax Exemption*, 77 EXEMPT ORG. TAX REV. 259, 259 (2016) (describing the current property tax-exemption landscape as “a multilevel framework for mischief lead[ing] to legal incoherence”).

261. See Tahk, *supra* note 11, at 494; see also Dagher, *supra* note 27, at 3481 (discussing why social impact bonds, an innovation in nonprofit financing, may not be tax exempt).

262. See *supra* notes 198–204 and accompanying text.

boards and protect charitable assets;<sup>263</sup> they do not interfere in local tax disputes. Municipalities, meanwhile, have both incentives and disincentives to challenge exemptions.<sup>264</sup>

If the litigation model used in *Fields* becomes widespread, it could transform the nonprofit landscape. In a drafted amicus brief to a denied appeal during the case, New Jersey's Center for Non-Profit Corporations, an umbrella organization for the state's thirty-thousand nonprofit entities, argued that a loss for the defendants could damage the entire sector.<sup>265</sup> While expanding this model could give an oversight voice to citizens often excluded from municipal power, it could also put nonprofits at risk of repeated suits by opportunists and have a chilling effect on nonprofits engaged in controversial public services.<sup>266</sup> To understand why *Fields* has the potential to change the landscape of nonprofit oversight, it is helpful to understand the outcome of the case as well as the broader relationship between Princeton University and its surrounding community. Part III.A.1 sketches the social context for this exemption challenge, while Part III.A.2 closely examines the standing model that the plaintiffs employed.

### 1. The Social Context for *Fields*

The first iteration of the *Fields* suit began after a controversial municipal reassessment in 2010 that was deemed valid by a local commission in 2011.<sup>267</sup> This reassessment significantly increased many property valuations and related tax bills.<sup>268</sup> When *Fields* settled in October 2016,<sup>269</sup> the number of plaintiffs had increased more than sixfold.<sup>270</sup> Among these was Shirley Satterfield, a prominent local citizen who grew up in Princeton, worked at the public high school, and served on the boards of the historical society and a group dedicated to fighting local racial prejudice.<sup>271</sup> She joined the suit

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263. See, e.g., *About the Charities Bureau*, CHARITIES NYS.COM, [https://www.charitiesnys.com/about\\_new.html](https://www.charitiesnys.com/about_new.html) [<https://perma.cc/NHW7-77R3>] (last visited Feb. 14, 2018).

264. See *supra* notes 255–59 and accompanying text.

265. See Motion for Leave to Appear as Amici Curiae of Center for Non-Profit Corporations, Inc. et al., at 5, *Fields v. Trs. of Princeton Univ.*, No. AM185-15 (N.J. Super. Ct. App. Div. Dec. 7, 2015), [http://www.njnonprofits.org/12072015Amici\\_sMotionForLeaveToAppearAsAmiciCuriae.PDF](http://www.njnonprofits.org/12072015Amici_sMotionForLeaveToAppearAsAmiciCuriae.PDF) [<https://perma.cc/4PSY-ZAY6>].

266. See *id.* at 6.

267. See Krystal Knapp, *Panel Finds Princeton Property Tax Revaluation Is Accurate, Despite Flaws*, NJ.COM (Apr. 4, 2011, 9:39 AM), [http://www.nj.com/mercer/index.ssf/2011/04/panel\\_2010\\_princeton\\_property.html](http://www.nj.com/mercer/index.ssf/2011/04/panel_2010_princeton_property.html) [<https://perma.cc/9VD2-FDJL>].

268. See *id.* (noting that tax bills doubled for some residents).

269. See Office of Commc'ns, *Princeton to Assist Lower-Income Homeowners Under Tax Litigation Settlement*, PRINCETON U. (Oct. 14, 2016, 4:55 PM), <http://www.princeton.edu/main/news/archive/S47/64/64E38/> [<https://perma.cc/2838-EUBS>].

270. See *supra* note 1 and accompanying text. Compare 2016 Complaint, *supra* note 6, at 1 (listing plaintiffs), with 2011 Complaint, *supra* note 1, at 1 (listing plaintiffs).

271. See 2016 Complaint, *supra* note 6, at 1; Jean Stratton, *Princeton Resident Shirley Satterfield Is a Concerned and Committed Citizen*, TOWN TOPICS (Mar. 7, 2007), <http://www.towntopics.com/mar0707/stratton.html> [<https://perma.cc/L47F-ZBZ8>]; see also Shirley Satterfield, Letter to the Editor, *Princeton's African American Community Should Be Remembered Every Month*, TOWN TOPICS (Mar. 15, 2015), <http://www.towntopics.com/>

along with roughly two dozen plaintiffs who primarily resided in a historically African American neighborhood known as Witherspoon-Jackson, where she grew up.<sup>272</sup> This neighborhood has residents whose grandparents and great-grandparents were displaced from a central district, now known as Palmer Square, during a redevelopment initiative around 1930 aimed at improving the prestige of the University.<sup>273</sup> That project ejected African Americans from the municipal center, which intensified residential segregation in Princeton.<sup>274</sup> The Witherspoon-Jackson neighborhood was particularly affected by the 2010 revaluation.<sup>275</sup> Neighborhood residents argue that gentrification is pushing them out of this historic community.<sup>276</sup> The commission noted the large proportion of exempt properties and recommended the review of exemptions.<sup>277</sup>

These pocketbook concerns for affordability and community diversity drove the litigation.<sup>278</sup> One analysis estimated that in-court victory for the plaintiffs could have reduced the average property-tax burden in Princeton from about \$17,700 per year to roughly \$11,800.<sup>279</sup> Such concrete financial impact is due in part to Princeton University's significant wealth, which includes substantial local real property. As of 2014, Princeton University

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wordpress/2015/03/18/princetons-african-american-community-should-be-remembered-every-month/ [https://perma.cc/6VAA-3WFA].

272. See Merriman, *supra* note 211; Hannah Waxman, *23 Town Residents Join Tax-Exemption Lawsuit Against U.*, DAILY PRINCETONIAN (Apr. 6, 2016), <http://dailyprincetonian.com/news/2016/04/23-town-residents-join-tax-exemption-lawsuit-against-u/> [https://perma.cc/9ZEQ-ZTL7].

273. See WISE PRES. PLANNING LLC, SURVEY AND DISTRICT EVALUATION, WITHERSPOON-JACKSON COMMUNITY 55–57 (2015), <http://www.princetonnj.gov/HP/wj-survey-report.pdf> [https://perma.cc/DQB8-V79G].

274. See *id.*

275. See Knapp, *supra* note 267. The settlement took notice of this area's needs and set aside funds to support housing affordability there. See Office of Commc'ns, *supra* note 269.

276. See, e.g., Philip Sean Curran, *Witherspoon-Jackson Neighborhood Wants to Maintain Its Heritage, Diversity and Affordability*, CENTRALJERSEY.COM (Aug. 17, 2015), [http://www.centraljersey.com/news/article\\_efc9c7d2-43ae-11e5-ba16-7bf7495b34fe.html](http://www.centraljersey.com/news/article_efc9c7d2-43ae-11e5-ba16-7bf7495b34fe.html) [https://perma.cc/2YLK-YX6X]; Krystal Knapp, *Residents Voice Support, Concerns About Witherspoon-Jackson Historic District*, PLANETPRINCETON.COM (Dec. 4, 2015), <https://planetprinceton.com/2015/12/04/witherspoon-historic-district-debate/> [https://perma.cc/AG3R-HRT7] (quoting residents discussing friends and family who felt forced to sell after tax increases).

277. See Knapp, *supra* note 267 (noting that, in 2011, more than 40 percent of borough properties and nearly 20 percent of township properties were tax exempt).

278. They were also highlighted in the settlement. See Office of Commc'ns, *supra* note 269.

279. See Young, *supra* note 13 (noting the average property tax in Princeton is nearly double the state's average, which is itself the highest in the nation, and discussing the combination of taxes, PILOTs, and free and subsidized services the University provides to local residents); see also Philip Sean Curran, *Princeton: Trial on Lawsuit Challenging University's Property Tax Exemption Pushed Back to Oct. 17 (Updated)*, CENTRALJERSEY.COM (Oct. 3, 2016), [http://www.centraljersey.com/news/article\\_c60fcd02-8975-11e6-99d0-3f627ac01cae.html](http://www.centraljersey.com/news/article_c60fcd02-8975-11e6-99d0-3f627ac01cae.html) [https://perma.cc/6N9R-FSDU] (quoting former Borough Councilman Roger Martindell's estimate that bills could drop by a third). *But see* Knapp, *supra* note 2 (calculating a lower average bill based on the estimated burden for a home with an average assessed value rather than an overall average).

valued its total net assets at over \$21 billion.<sup>280</sup> Its physical property includes about 190 buildings on 500 acres of land.<sup>281</sup> That acreage is equivalent to roughly 4 percent of the current municipality,<sup>282</sup> or roughly 42 percent of the former borough, where most of the University's real property is located.<sup>283</sup> The University engages in its own planning process in developing this property independent from the municipality's planning board.<sup>284</sup>

Not all of the University's property, however, is located within Princeton; some of its real estate stretches into two neighboring towns.<sup>285</sup> Additionally, the University holds interests in mortgages and tenancy-in-common agreements offered to qualifying faculty and staff who purchase newly acquired homes within nine miles of campus or within the city of Trenton.<sup>286</sup> It also has repurchase rights to 160 homes in two Princeton neighborhoods.<sup>287</sup> The University employs over 13,000 people, many of whom live in the surrounding area.<sup>288</sup> It has an immense impact on its local economy and effectively controls much of the real property that surrounds it and on which it is located.

In terms of its wealth and economic impact on its local community, Princeton University may be an extreme example. Yet it is not alone. The nonprofit sector is large;<sup>289</sup> its revenues grew almost twice as fast as the rest

280. See Trs. of Princeton Univ., Return of Organization Exempt from Income Tax 1 (2014 Form 990), [https://projects.propublica.org/nonprofits/download-filing?path=2015\\_08\\_EO%2F21-0634501\\_990\\_201406.pdf](https://projects.propublica.org/nonprofits/download-filing?path=2015_08_EO%2F21-0634501_990_201406.pdf) [https://perma.cc/FR6L-P774].

281. See *Facts and Figures*, PRINCETON U., <https://www.princeton.edu/meet-princeton/facts-figures> [https://perma.cc/C8DD-T8F4] (last visited Feb. 14, 2018). But see John De Looper, *How Many Buildings Are on Campus?*, PRINCETON U. (Apr. 23, 2009), <https://blogs.princeton.edu/mudd/2009/04/how-many-buildings-are-on-campus/> [https://perma.cc/S99U-VXUD] (noting that the number is hard to verify due to construction as well as buildings with multiple names, departments, and functions).

282. This figure is calculated from statistics given on Wikipedia. See *Princeton, New Jersey*, WIKIPEDIA, [https://en.wikipedia.org/wiki/Princeton,\\_New\\_Jersey#cite\\_note-CensusArea-1](https://en.wikipedia.org/wiki/Princeton,_New_Jersey#cite_note-CensusArea-1) [https://perma.cc/4WS8-3CM2] (last visited Feb. 14, 2018).

283. This figure is calculated from statistics given on Wikipedia. See *Borough of Princeton, New Jersey*, WIKIPEDIA, [https://en.wikipedia.org/wiki/Borough\\_of\\_Princeton,\\_New\\_Jersey#Geography](https://en.wikipedia.org/wiki/Borough_of_Princeton,_New_Jersey#Geography) [https://perma.cc/6UT2-N8FL] (last visited Feb. 14, 2018).

284. See, e.g., *Princeton Campus Plan: Planning for 2016–2026 and Beyond*, PRINCETON U., <http://campusplan.princeton.edu/2026plan> [https://perma.cc/GQX3-658L] (last visited Feb. 14, 2018).

285. See Daniel Day, Office of Commc'ns, *University Gives Town Residents, Officials Update on Development of 2026 Campus Plan*, PRINCETON U. (Sept. 20, 2016, 1:15 PM), <http://www.princeton.edu/main/news/archive/S47/43/87O32/> [https://perma.cc/DTF6-8BXH].

286. See *Standard Mortgage Program*, PRINCETON U., <https://hres.princeton.edu/faculty-staff/home-ownership-programs/standard-mortgage-program> [https://perma.cc/3MPW-4L4Y] (last visited Feb. 14, 2018); *Tenancy-in-Common Program*, PRINCETON U., <https://hres.princeton.edu/faculty-staff/home-ownership-programs/tenancy-in-common-program> [https://perma.cc/NW3A-86ZF] (last visited Feb. 14, 2018).

287. See *Princeton Faculty Residential Purchase Plan*, PRINCETON U., <https://hres.princeton.edu/faculty-staff/home-ownership-programs/princeton-faculty-residential-purchase-plan> [https://perma.cc/5VN4-MER3] (last visited Feb. 14, 2018).

288. Princeton University's Form 990 filing for the fiscal year ending June 2014 lists 13,869 employees and 15,000 volunteers. See Trs. of Princeton Univ., *supra* note 280, at 1.

289. See DAPHNE A. KENYON & ADAM H. LANGLEY, LINCOLN INST. OF LAND POLICY, *THE PROPERTY TAX EXEMPTION FOR NONPROFITS AND REVENUE IMPLICATIONS FOR CITIES 2* (2011),

of the economy from 1995 to 2010.<sup>290</sup> Nonprofit organizations hold substantial assets, transact complex business, and are key players in local economies.<sup>291</sup> Many municipalities have large nonprofit sectors that occupy significant proportions of locally assessable land.<sup>292</sup>

## 2. The Standing Model Used in *Fields*

*Fields* tests whether individual citizens can separately oversee laws governing nonprofit entities. Importantly, the plaintiffs had not simply claimed that certain research facilities should be added to the tax roll. Instead, they argued that the entire institution was sufficiently profit seeking so that all of its properties would no longer merit exemption.<sup>293</sup> The plaintiffs were thus asserting a large role in enforcing substantive requirements for property-tax exemption in New Jersey. A key moment in the case was Judge Bianco's decision on the burden of proof and standing; he affirmed the plaintiffs' right to bring a third-party challenge and confirmed that they would not bear the burden of proof at trial.<sup>294</sup>

New Jersey has allowed third-party tax-exemption suits since at least 1941.<sup>295</sup> In that year, a former volunteer fireman, suing pro se, challenged the status of the firehouse where he had volunteered.<sup>296</sup> Profit was not at issue as it was not wholly excluded in the statutory exemption for firehouses.<sup>297</sup> The specific point in that case is now moot,<sup>298</sup> but the court's holding on the plaintiff's right to sue remains valid.

In another case from the civil rights era, citizens tried to challenge property-tax exemptions and liquor licenses of all Elks Lodges in New Jersey,<sup>299</sup> alleging that the organizations' ban on African Americans and the

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<http://www.urban.org/sites/default/files/publication/26756/412460-The-Property-Tax-Exemption-for-Nonprofits-and-Revenue-Implications-for-Cities.PDF>  
[<https://perma.cc/XLR4-PTQM>].

290. *See id.*

291. *See, e.g., Economic Impact*, NAT'L COUNCIL NONPROFITS, <https://www.councilofnonprofits.org/economic-impact> [<https://perma.cc/X6PY-JBT4>] (last visited Feb. 14, 2018).

292. *See Brody, supra* note 255, at x (noting that this is particularly true in the Northeast).

293. *See* 2015 Complaint, *supra* note 210, at 2–11.

294. *See Fields v. Trs. of Princeton Univ.*, 28 N.J. Tax 574, 587 n.11 (2015).

295. *See Post v. Warren Point Volunteer Firemen's Ass'n*, 19 A.2d 636, 636 (N.J. B.T.A. 1941) (disagreeing with the defendant's argument that the statute should not permit an exemption challenge); *see also* N.J. STAT. ANN. § 54:3-21 (West 2017) (“[A] taxpayer . . . feeling discriminated against by the assessed valuation of other property in the county . . . may . . . appeal . . .”). Because a codicil, § 54:3-21(b), denies this right for one exemption, and because another New Jersey law, § 54:4-27, clarifies that exemption status is an assessment, New Jersey courts have held that this language gives taxpayers within the same county the general right to challenge exemptions.

296. *See Post*, 19 A.2d at 636; ELAINE B. WINSHELL & JANE LYLE DIEPEVEEN, FAIR LAWN 27 (2001) (reproducing a photograph showing Peter Post among volunteer firemen).

297. *See Post*, 19 A.2d at 636. The current version of this exemption continues to allow for a limited form of profit making. *See* N.J. STAT. ANN. § 54:4-3.10.

298. It now follows an actual-use standard rather than an exclusive-use standard. *See* N.J. STAT. ANN. § 54:4-3.10; *see also supra* notes 73–78 and accompanying text.

299. *See Brunson v. Rutherford Lodge No. 547 of Benevolent & Protective Order of Elks*, 319 A.2d 80, 82 (N.J. Super. Ct. Law Div. 1974) (describing the history of the case).

state's beneficial treatment of the organizations violated the state and federal constitutions. When that case was decided, it had been narrowed to the county of the plaintiffs' residence in accordance with New Jersey's taxpayer standing law, but the plaintiffs won on the merits.<sup>300</sup> These cases demonstrate that New Jersey law currently provides county-level standing for third-party exemption challenges.<sup>301</sup>

Although many states lack laws that so clearly allow such cases, municipal taxpayers in other jurisdictions may be able to bring similar third-party exemption challenges. Municipal taxpayers have standing to bring constitutional challenges to local levies.<sup>302</sup> Whether this standing can be extended to third-party statutory challenges remains to be determined based on specific legal frameworks in other states.<sup>303</sup> Some states, like New Jersey, incorporate taxpayer standing by statute,<sup>304</sup> while in others permissive rules are judge made.<sup>305</sup> Some states only allow such suits if they are particularly important.<sup>306</sup> Both Ohio and Pennsylvania allow for some taxpayer standing if the underlying issues are of great significance.<sup>307</sup>

The Minnesota Supreme Court allows even broader taxpayer standing not only for constitutional claims but also statutory ones. It has held that "a state or local taxpayer has sufficient interest to challenge illegal expenditures."<sup>308</sup> Although legislative grants of exemption are fiscally equivalent to expenditures,<sup>309</sup> it is possible that states that do permit taxpayer standing may not extend it to third-party exemption challenges.

The rationale for municipal taxpayer standing in federal courts when asserting constitutional injuries is that the pocketbook injury to the municipal taxpayer is palpable and particular, transcending a mere general interest in the vindication of the law.<sup>310</sup> Yet as critics have pointed out, this grants about 8.5 million citizens of New York City more ability to contest a tax than about

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300. *See id.* at 91.

301. For another discussion of this standing model in New Jersey, see David B. Wolfe, Maria H. Yoo & Douglas M. Allen, *When a Stranger Calls: Municipal and Third-Party Property Tax Appeals*, N.J. LAW., Apr. 2017, at 38.

302. *See* Nancy Staudt, *Taxpayers in Court: A Systematic Study of a (Misunderstood) Standing Doctrine*, 52 EMORY L.J. 771, 803 (2003).

303. For example, third-party suits alleging egregious administrative error in exemption have been possible in New York since 1981. *See* *Dudley v. Kerwick*, 421 N.E.2d 797, 800 (N.Y. 1981); Catherine P. Bonnette, Note, *Third Party Taxpayer Challenges Under the New York Real Property Tax Law*, 11 FORDHAM URB. L.J. 341, 347 n.18 (1982). Yet in 2000, New York's highest court clarified that plaintiffs in exemption suits lack standing where the property constitutes a minimal proportion of the municipality. *See* *Colella v. Bd. of Assessors*, 741 N.E.2d 113, 116 (N.Y. 2000).

304. *See* Zelinsky, *supra* note 235, at 42–46.

305. *See id.* at 36.

306. *See id.* at 37–39 (discussing standards in Arizona, Alaska, Iowa, and South Carolina with public importance thresholds).

307. *See id.* at 39.

308. *McKee v. Likins*, 261 N.W.2d 566, 570 (Minn. 1977). Such potential state-level claims are not abrogated by Bayh-Dole. *See infra* Part II.A.

309. *See* Linda Sugin, *Invisible Taxpayers*, 69 TAX L. REV. 617, 620, 629, 644 (2016).

310. *See* Staudt, *supra* note 302, at 826, 831–32; *cf.* *Hollingsworth v. Perry*, 133 S. Ct. 2652, 2663 (2013) (denying federal standing to "concerned bystanders . . . vindicat[ing] . . . value interests" (quoting *Diamond v. Charles*, 476 U.S. 54, 62 (1986))).

1.9 million citizens of Nebraska.<sup>311</sup> Because the federal standing bars are generally higher than those in state courts, the existence of federal standing for municipal taxpayers' constitutional claims suggests that, where state law provides no explicit bar, local statutory challenges asserting pocketbook injuries may be legally cognizable—even as third-party exemption challenges.

If other citizens take *Fields* as a model, they could enforce laws intended to bind nonprofits, even where public actors are unwilling to do so. To succeed in any challenge, such municipal taxpayers need meritorious claims that the exemptions are undeserved. In *Fields*, the main claim was that Princeton University's Bayh-Dole activities ran afoul of New Jersey's limits on how exempt properties may be used to produce profit.<sup>312</sup> The model may lend itself particularly well to plaintiffs, like the Witherspoon-Jackson residents, who may share in fewer of the local benefits that an elite institution provides.<sup>313</sup> Because most jurisdictions view exemptions skeptically—placing burdens of proof on claimants<sup>314</sup>—litigation modeled after *Fields* would force nonprofits to reprove their exemption claims at trial, as in *Fields*.<sup>315</sup>

This balance of power creates strong incentives for settlement. Yet without a decision on the merits, a challenged organization would not be protected against the next set of aggrieved taxpayers.<sup>316</sup> Nonprofits fear these dynamics will undermine their financial stability.<sup>317</sup> Although few plaintiffs have made use of this standing model, nonprofits worry it will become a tool of harassment in the future.<sup>318</sup> Proposed legislation in New Jersey, however, would eliminate this standing.<sup>319</sup>

### B. Legislative Reforms Offer the Best Solutions

Because of current disincentives to oversight, the model of litigation pioneered in *Fields* could offer a unique opportunity for citizens to enforce existing laws governing the nonprofit sector. Underlying problems, however, often result from conflicting frameworks, rather than just a lack of oversight. Therefore, such suits do not represent the best means for drawing lines on nonprofits' revenue-generating activities. Although the current framework

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311. See Neb. Databook, *Total Population*, NEBRASKA.GOV (Dec. 21, 2017), <http://www.neded.org/files/research/stathand/bsect1.htm> [<https://perma.cc/PBR2-EUQW>].

312. See 2016 Complaint, *supra* note 6, at 2–12; 2015 Complaint, *supra* note 210, at 3.

313. See, e.g., Hall, *supra* note 41, at 254, 274–78 (discussing exemptions benefitting small elites as having redistributive effects contrary to common notions of charity).

314. See *supra* notes 51, 291 and accompanying text; see also *supra* note 225 and accompanying text.

315. See *supra* note 51 and accompanying text.

316. See, e.g., *In re Liquidation of Integrity Ins. Co./Celotex Asbestos Tr.*, 67 A.3d 587, 596 (N.J. 2013) (upholding New Jersey's collateral estoppel standard, which bars only claims fully litigated against a prior party or one in privity where no unfairness to plaintiffs results).

317. See Motion for Leave to Appear as Amici Curiae of Center for Non-Profit Corporations, Inc. et al., at 5–7, *Fields v. Trs. of Princeton Univ.*, No. AM185-15 (N.J. Super. Ct. App. Div. Dec. 7, 2015).

318. See *id.*

319. See *infra* Part III.B.1.

lacks incentives to equitable enforcement, expanding this model of litigation could have significant negative implications for nonprofits. This Note argues that enforcing the current boundaries of nonprofit law via citizen lawsuits would have a less beneficial effect on the sector than thoroughgoing reforms of those boundaries at the state level. Such reform should focus on better aligning state and federal law or formalizing PILOTs rather than enacting procedural barriers to eliminate suits like *Fields* without addressing substantive weaknesses in current law.

Part III.B.1 examines the initial statutory response to *Fields* in New Jersey, while Part III.B.2 surveys how Connecticut law has approached its large nonprofit sector. This Note continues its search for workable statutory schemes in Part III.B.3, which examines proposed legislation in Massachusetts, and in Part III.B.4, which argues that proposed legislation in Michigan in 2015 was overly deferential to federal law. Finally, Part III.B.5 concludes that California's nuanced approach provides a better balance of interests.

### 1. Legislative Responses in New Jersey

Recently proposed legislation in New Jersey ignores the key challenge by sidestepping the tension between state law and the federal policy favoring research revenues. After Princeton University faced setbacks during motion practice, a veteran state assemblyman, who had formerly represented the Borough of Princeton, proposed legislation to prevent all third-party property-tax challenges.<sup>320</sup> His bill was amended shortly before the settlement to further limit tax-exemption challenges where a PILOT is in place.<sup>321</sup> A state senator incorporated his proposal in a matching bill at the end of February 2017.<sup>322</sup> The bill was passed by the New Jersey State Senate but not scheduled for a vote in the Assembly before the session expired.<sup>323</sup> As this Note discusses, this type of procedural reform is not an ideal solution to the substantive problems presented by this case. Legislation in other states offers better models for reform.

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320. See Gen. Assemb. 3888, 217th Leg., 1st Reg. Sess. (as introduced by N.J. Assembly, June 6, 2016).

321. See Gen. Assemb. 3888, 217th Leg., 1st Reg. Sess. (as amended and substituted by N.J. Assembly, Sept. 19, 2016).

322. See S. 2212, 217th Leg., 1st Reg. Sess. (as amended and substituted by N.J. Senate, Feb. 27, 2017). The original version contains a statement of the proposed effect. See S. 2212, 217th Leg., 1st Reg. Sess. (as introduced by N.J. Senate, May 16, 2016) (prohibiting “property taxpayers from filing property tax appeals with respect to the property of others” and noting that “under current law, property taxpayers may challenge the assessment or exempt status of their own property as well as that of any other property in their county”).

323. See *NJ A3888*, LEGISCAN, <https://legiscan.com/NJ/bill/A3888/2016> [<https://perma.cc/46G2-QTE6>] (last visited Feb. 14, 2018); *NJ S2212*, LEGISCAN, <https://legiscan.com/NJ/bill/S2212/2016> [<https://perma.cc/4EQV-VBPZ>] (last visited Feb. 14, 2018).

## 2. The Connecticut Model

Connecticut has long been a leader in designing innovative reforms to regulate nonprofits. Its stated-funded PILOT system, introduced in the 1970s,<sup>324</sup> is a better way to balance the statewide interest in flourishing nonprofits with local impacts on services. Outside Connecticut, exempt institutions often make PILOTs directly to municipalities on a pseudovoluntary basis.<sup>325</sup> By having the state disburse PILOT payments to municipalities, the burden of such institutions is spread among a wider constituency that chooses democratically to support them. Connecticut and the world may benefit more from Yale than the citizens of New Haven; the Connecticut model accommodates for this.

Yet even in Connecticut, tensions over nonprofit property tax exemptions remain. In 2015, the Connecticut House of Representatives passed a bill to deny new exemptions to properties acquired by colleges and hospitals beyond their “main campuses.”<sup>326</sup> A bill in the state senate would have increased state funding for PILOT reimbursements to municipalities.<sup>327</sup> Though neither was adopted, both demonstrated not only a legislative will to address the strain large nonprofits put on municipalities but also that the Connecticut model itself is stressed by the expansion of wealth within the sector.

## 3. Standardization of PILOTs in Massachusetts

Legislation to reform PILOTs has been regularly introduced and rejected in Massachusetts since 2012.<sup>328</sup> The most recent bill would permit any municipality or taxing district to convert ad hoc PILOTs into regularized required payments at 25 percent of the full tax rate otherwise applicable, further discounted for a nonprofit’s local services.<sup>329</sup> While critics argue that this is only a lower level of tax for nonprofits, giving municipalities permission to tax nonprofits at a discount could balance social goals by acknowledging needs of municipalities as well as the benefits that nonprofits create. Implementing something similar in most states, however, could

324. See Nicholas R. Carbone & Evelyn Brody, *PILOTs: Hartford and Connecticut*, in PROPERTY-TAX EXEMPTION FOR CHARITIES, *supra* note 19, at 233, 235–36, 241–42.

325. See Langley, Kenyon & Bailin, *supra* note 57, at 1, 7–8, 13–14. One surprise in *Fields* was that the settlement did not include a long-term increase of the PILOT agreement Princeton University remits. See Office of Commc’ns, *supra* note 269.

326. See Keith M. Phaneuf, *House Approves Bill to Restrict Tax Exemption for Colleges, Hospitals*, CONN. MIRROR (May 22, 2015), <http://ctmirror.org/2015/05/22/house-approves-bill-to-restrict-tax-exemption-for-colleges-and-hospitals/> [<https://perma.cc/MUR8-JB4L>].

327. See S. 1070, 2015 Gen. Assemb., Jan. Sess. (Conn. 2015). See generally Carbone & Brody, *supra* note 324.

328. See *Are PILOTs About to Land in Massachusetts?*, LEGAL CTR. NONPROFITS (Feb. 24, 2013), <http://www.legalcenterfor nonprofits.org/2013/02/24/are-pilots-about-to-land-in-massachusetts/> [<https://perma.cc/CQK7-RN2S>]; *MMA Legislative Package*, MASS. MUN. ASS’N, <https://www.mma.org/advocacy/mma-legislative-package> [<https://perma.cc/YSB6-NLLF>] (last visited Feb. 14, 2018).

329. See H.R. 1565, 190th Gen. Court, 7th Sess. (Mass. 2017); *MMA Legislative Package*, *supra* note 328; see also Woods Bowman, *Impact Fees: An Alternative to PILOTs*, in PROPERTY-TAX EXEMPTION FOR CHARITIES, *supra* note 19, at 301, 302 (discussing flaws with PILOTs).

require constitutional amendments or significant statutory reform to allow not only for the tax itself but also for the inequality in the rate scheme.<sup>330</sup>

#### 4. Greater Alignment in Michigan?

In Michigan, legislation was introduced in 2016 to align property-tax exemptions more directly with federal exemptions after nonprofits across the state received unexpected tax bills.<sup>331</sup> The tabled bill would have considered a § 501(c)(3) status to be proof that an organization is charitable; property use consistent with federally exempt purposes would be exempt. This change would have removed an exclusive-use test in Michigan law and given nonprofits assurance that complying with federal standards would protect them at the state level.<sup>332</sup> Thus, this proposed system would have essentially deferred questions regarding qualification for state exemptions to compliance with federal law. But where the federal law uses UBIT to tax revenues that cross over into the zone of commerciality, the Michigan proposal did not provide a means for municipalities to receive partial payments for complex property uses. After being tabled in the session ending 2016, this Michigan proposal has not yet been reintroduced.<sup>333</sup>

#### 5. California's Sophisticated Formula

California has long had one of the better solutions to the problem of the complex nature of nonprofit business.<sup>334</sup> In 1988, the state legislature incorporated the federal UBIT system in its assessment.<sup>335</sup> Where a UBIT fragmentation does not map onto a physical piece of property, the law applies a specific formula for factoring the income proportion of UBIT into the valuation and tax assessment.<sup>336</sup> This schema encompasses academic properties<sup>337</sup> as well as ones with exemptions for “religious, hospital, scientific, or charitable purposes.”<sup>338</sup> It creates certainty and better aligns with federal policy. Importantly, it employs a mechanism for assessment when a nonexempt use is neither the primary use of the property nor isolated in a specific portion of it.

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330. This is because nonprofit tax exemptions are found in many state constitutions, as are requirements for substantial equality in taxation. See William B. Barker, *The Three Faces of Equality: Constitutional Requirements in Taxation*, 57 CASE. W. RES. L. REV. 1, 14–18 (2006); Gallagher, *supra* note 19, at 4.

331. See S. 570, 2015–2016 Leg., Reg. Sess. (Mich. 2015); Sherri Welch, *Property Tax Debate: What Is a Charity? Communities Question Status of Some, Send Property Tax Bills*, CRAIN'S DET. BUS. (Oct. 23, 2016, 8:00 AM), <http://www.craigslist.com/article/20161023/NEWS/161029936/property-tax-debate-what-is-a-charity> [https://perma.cc/L5J3-YM38].

332. See MICH. COMP. LAWS ANN. § 211.7o (West 2018).

333. See *Search Bills by Category*, MICH. LEGISLATURE, [http://www.legislature.mi.gov/\(S\(eactru4zirjossoihsv4mvhw\)\)/mileg.aspx?page=CategorySearchM](http://www.legislature.mi.gov/(S(eactru4zirjossoihsv4mvhw))/mileg.aspx?page=CategorySearchM) [https://perma.cc/8W47-ZB6Z] (last visited Feb. 14, 2018) (search category “Property tax”).

334. See CAL. REV. & TAX. CODE § 214.05 (West 2017); Gallagher, *supra* note 19, at 8.

335. See CAL. REV. & TAX. CODE § 214.05(a).

336. See *id.* § 214.05(b)(3).

337. See *id.* § 214(b)–(c), (e).

338. *Id.* § 214(a).

In many states, UBIT is only integrated in corporate income-tax exemptions,<sup>339</sup> not ones for property tax. Yet as this Note argues, as long as *ad valorem* property taxes provide the main source of revenues for municipalities, property-tax exemptions for complex nonprofit businesses will remain controversial. Because property ownership is a key factor in producing revenues, untaxed commercial uses of property will continue to require justification. Most existing partial taxation laws allow for flexibility with leases and nonexempt activities but are still too tied to ideas of physically separable space. California's system is more nuanced, while its reference to the federal UBIT rules allows for relatively simple compliance.

#### IV. A RESOLUTION?

The next round of state law reform regarding nonprofits or property taxes should tackle these discrepancies directly by leaning on both the California and Connecticut statutory regimes as well as aspects of the proposed legislation in Massachusetts.

Legislative reforms that give nonprofits certainty are preferable to piecemeal litigation.<sup>340</sup> Good reform would clarify the law, better align with federal policy, and give consistency to PILOTs now made on an ad hoc basis. States with profit tests should either make explicit that Bayh-Dole activities will not void property-tax exemptions or indicate precisely how such activities will be assessed.

State property-tax laws should face up to the contemporary business practices of universities, hospitals, and other large nonprofits. Compensation to local communities for the distorting effects of large tax-exempt institutions on local revenues and costs should be more coherent. Using a state-mediated mechanism, as in the Connecticut model, would add an important level of fairness to any PILOT regime. Yet, as discussed above, this alone is insufficient. Instead, payments from nonprofits should be tied to a new formula that uses UBIT or other clear guidelines to assess truly nonexempt property uses, as in the California model, possibly with discounts for local benefits provided, as in the Massachusetts proposal. Just as states have begun requiring that hospitals provide community benefits,<sup>341</sup> similar standards for academic institutions could clarify local service expectations now negotiated

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339. See, e.g., Marianne Evans, Allison Hedges & Kathleen Zack, *State Taxation of Exempt Organizations' Unrelated Business Income*, TAX ADVISOR (June 1, 2013), <http://www.thetaxadviser.com/issues/2013/jun/clinic-story-03.html> [https://perma.cc/P3NT-ED3N].

340. See *supra* notes 316–18 and accompanying text.

341. See Brody, *supra* note 260, at 260; Gallagher, *supra* note 19, at 12.

ad hoc.<sup>342</sup> Constitutional limits on state laws would provide further assurances of consistency and fairness.<sup>343</sup>

An ideal reform might combine all of these mechanisms. Thus, a hospital or university would pay *ad valorem* taxes for identifiable fractions of parcels used for nonexempt purposes by applying a set fraction derived from the institution's UBIT or via a clearly defined calculation of non-exempt revenues. Additionally, it would be eligible for credits or deductions for qualifying provision of state or local benefits. These taxes would be collected at the state level and remitted to municipalities. Such reforms may not satisfy the harshest critics of elite universities, but they would better balance complex social needs.

Whether or not states adopt comprehensive reform measures, a repeal of Bayh-Dole is unlikely. Thus, states with profit tests should at least resolve how a nonprofit engaged in patenting can maintain a property-tax exemption.

#### CONCLUSION

Although the case settled, *Fields* challenges the current status quo and reveals its shortcomings. Questions about how to best favor the public's interest in a thriving and independent charitable sector have provoked controversy for decades. Still, state laws have failed to adequately understand, accommodate, foster, and regulate the changing nature of universities and other nonprofits. The most reasoned response would be to see these issues as policy choices better submitted to legislatures than judges.

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342. See, e.g., *Community Benefits Agreement*, COLUMBIA U., <http://gca.columbia.edu/content/community-benefits-agreement> [<https://perma.cc/X9MR-SF99>] (last visited Feb. 14, 2018). See generally Trs. of Columbia Univ. & W. Harlem Local Dev. Corp., *West Harlem Community Benefits Agreement* (May 18, 2009), [https://gca.columbia.edu/sites/default/files/2016-11/CBA Agreement.pdf](https://gca.columbia.edu/sites/default/files/2016-11/CBA%20Agreement.pdf) [<https://perma.cc/6FQS-DY69>].

343. See *supra* notes 234–36 and accompanying text.