# MUSEUMS AND THE TAX COLLECTOR: THE TAX TREATMENT OF MUSEUMS AT THE FEDERAL, STATE, AND LOCAL LEVEL

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## INTRODUCTION

Every spring, anticipation builds in advance of the annual Costume Institute Exhibition and Gala Benefit at the New York Metropolitan Museum of Art ("Met"). Last spring was no different. In May 2012, the Met launched *Schiaparelli and Prada: Impossible Conversations*, a series of "simulated conversations" between famed designer Miuccia Prada and the deceased Elsa Schiaparelli.[1] Before the doors opened to the public, however, the exhibit kicked off with the Costume Institute Gala Benefit hosted by Anna Wintour, the Editor-in-chief of *Vogue*. The gala is a key fundraising event for the Costume Institute, with tables priced at $150,000, and individual tickets selling between $5,000 and $15,000.[2] Organizers hoped that last year's Schiaparelli-Prada exhibit would be as popular and profitable as 2011's exhibit on the works of the late designer Alexander McQueen.[3] The McQueen exhibit proved to be one of the Met's most successful events, raising $10,000,000 at the Costume Institute Gala, and millions more from the increased admission fees and gift store sales.[4] Lavish parties, six-figure donations, and high revenue streams at famed museums, like the Met, have drawn attention to the commercial nature of such museums despite their being nonprofit and tax-exempt organizations.[5]

The City of Boston recently increased its requests for payments in lieu of taxes ("PILOTs") from cultural institutions and nonprofits.[6] PILOTs are negotiated voluntary payments made to municipalities by certain tax-exempt nonprofits.[7] PILOTs help cover the cost of municipal services

1. Press Release, The Metro. Museum of Art, Elsa Schiaparelli and Miuccia Prada's Impossible Conversations at Metro. Museum's Costume Inst. (May 7, 2012), http://www.metmuseum.org/about-the-museum/press-room/exhibitions/2012/schiaparelli-and-prada-press-release; *see also* Suzy Menkes, *In Conversation: Miuccia and 'Schiap',* INT'L HERALD TRIB., Feb. 25, 2012, at 13 (describing the exhibit).

2. *See* Amy Larocca, *The Charity Ball Game*, N.Y. MAG., May 21, 2005, http://nymag.com/nymetro/shopping/fashion/features/11894/ (noting that "[t]he money raised from the sale of tickets . . . constitutes the Costume Institute's entire annual budget").

3. *See* Eric Wilson, *McQueen's Final Showstopper*, N.Y. TIMES, July 31, 2011, at ST1 (discussing the success of the McQueen exhibit).

4. *Id.*

5. *See, e.g.*, Anna Somers Cocks, *Loan fees risk killing the goose that lays the golden eggs,* THE ART NEWSPAPER (July 27, 2008), *available at* http://www.theartnewspaper.com/articles/Loan-fees-risk-killing-the-goose-that-lays-the-golden-eggs/8663 (pointing to the fact that museums are tax-exempt for having certain charitable goals yet have expensive restaurants and stores and lavish parties, and suggesting that museums engaged in such activities forget their actual purposes of education).

6. Erica Cooke, *This is not a tax, says Boston's Mayor*, ART NEWSPAPER (Jan. 2012), *available at* http://www.theartnewspaper.com/articles/This+is+not+a+tax,+says+Boston%E2%80%99s+mayor/25330.

7. DAPHNE A. KENYON & ADAM H. LANGLEY, PAYMENTS IN LIEU OF TAXES:

provided to the nonprofit, but are not deemed taxes.[8] Such programs have existed for decades.[9] They are now receiving more attention as cities focus on them as sources of fresh revenue and pressure more large property-holding nonprofit organizations to make payments.[10] The growth of PILOT programs illustrates the move toward limiting the benefits of tax exemption.[11] The expansion of the Boston PILOT program may foreshadow future changes in the nonprofit world, and may set a significant precedent for pressure on large revenue-producing museums to defend and justify their tax-exempt status.

Due to the massive revenue streams and property wealth of some famed museums, programs like Boston's PILOT may impact some museums at the local level, and higher levels of government could consider possible changes in the tax treatment of museums, especially the more profitable institutions.[12] Many museums, like the Met, have acquired worldwide recognition. While these museums fund much of their operations through private donations, admissions, and membership dues, they have also leveraged their reputations to pursue various forms of profitable activities to help finance their operating budgets and enable their growth.[13] In order to explore the tax treatment of America's museums and to understand why tax exemption benefits are important for museums, even profitable museums, this Comment examines museum finances, the role

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BALANCING MUNICIPAL AND NONPROFIT INTERESTS 6 (2010), *available at* http://www.lincolninst.edu/pubs/1853_Payments-in-Lieu-of-Taxes.

8. *Id.*

9. *See, e.g.*, Janne G. Gallagher, *Charities Under Siege: Trends in the State and Local Tax Treatment of Charities*, SB30 ALI-ABA 69, 85 (1996) (noting that PILOTs date back to at least 1929 when Harvard first made a payment to the city of Boston).

10. KENYON & LANGLEY, *supra* note 7, at 7.

11. *Id.* at 7 ("Two major factors drive the high level of interest in PILOTs around the country: growing scrutiny of the nonprofit sector, and increasing pressure on municipalities to find new sources of revenue.").

12. *See* Andras Kosaras, Note, *Federal Income and State Property Tax Exemption of Commercialized Nonprofits: Should Profit-Seeking Art Museums be Tax Exempt?*, 35 NEW ENG. L. REV. 115, 175 (2000) (arguing that stricter application of tax exemption principles should apply to museums, and that although they should not lose tax exemption entirely, "exacting a fair price for operating their exempt activities as business ventures is entirely fair"); *see also* KENYON & LANGLEY, *supra* note 7, at 7 ("Commercial activity in the nonprofit sector and news reports scrutinizing the behavior of nonprofit organizations have raised issues about the nonprofit property tax exemption, and have possibly reduced public support for it.").

13. *See, e.g.*, *Report of the Chief Financial Officer*, THE METRO. MUSEUM OF ART 50 (2011), *available at* http://www.metmuseum.org/~/media/Files/About/Annual%20Reports/2010_2011/Chief%20Financial%20Officer [hereinafter *Report of CFO*] (noting that the Met receives most of its funding from its endowment, donations and admission fees, but that it also records revenue from "auxiliary activities" such as restaurants and gift shops).

museums play in the community, and the purpose and importance of tax exemption for museums.

In the coming years, it is probable that museums will see increased scrutiny of their more commercial activities and of their tax-exempt statuses. Consequently, they may have to defend their tax exemption and publicize the impact of their charitable activities. Although museums have not yet been largely impacted by tax reforms, state and local governments are pushing for stricter limits on tax exemption––museums have reason to be wary of possible changes.[14] To fully comprehend the tax-related issues museums confront, and to determine the likelihood of changes in tax policy toward museums, Section I of this Comment explores the purpose and current operations of museums, particularly the large, world-renowned institutions. Section II briefly explains the federal tax exemption of museums and addresses the fact that, at the national level, tax exemption is a settled norm and museums are unlikely to see changes in their federal tax treatment. Section III considers the tax treatment of the commercially-driven operations of museums. Section IV discusses the Commerciality Doctrine and its likely impact on museums, and Section V explores state nonprofit tax exemptions, which tend to be less uniform, less established, and more conservative than federal tax exemptions. Museums may find their tax exemption questioned at the state level based on commercial activities conducted on exempt property or due to changes within state laws or policies that tighten the definition of organizations that qualify for tax exemption. Finally, Section VI discusses the current use of PILOTs for property tax-exempt nonprofits and the likelihood that museums will be pressured to make contributions. While much of this Comment applies to nonprofits in general, this discussion addresses specific and unique issues for museums, such as improving public perceptions of their charitableness, the operation of commercially oriented activities, reasons for tax exemption, and the threat of local requirements for payments in lieu of taxes.

## I. MUSEUMS IN AMERICA

### *A. The Role Museums Play—Education and Entertainment*

The American Alliance of Museums, in its Code of Ethics for

14. *See, e.g.,* Rick Cohen, *Packard Museum Struggling to Retain Tax Exemption*, NONPROFIT QUARTERLY (June 12, 2012, 12:57 PM), http://www.nonprofitquarterly.org/policysocial-context/20484-packard-museum-struggling-to-retain-tax-exemption.html (highlighting a debate about the extent to which a museum's "non-charitable revenue-generating activities affect its tax-exempt status").

Museums, defines a museum as an institution that "[makes] a 'unique contribution to the public by collecting, preserving, and interpreting the things of this world.'"[15] By comparison, the federal government defines a museum as "a public or private nonprofit agency or institution organized on a permanent basis for essentially educational or aesthetic purposes, which, utilizing a professional staff, owns or utilizes tangible objects, cares for them, and exhibits them to the public on a regular basis."[16] While museums vary as much as these definitions do in their approaches to education and preservation, American museums tend to embrace both missions.

Charles Wilson Peale founded one of the first American public museums.[17] In establishing and heading the Philadelphia Museum, Peale created a framework for current museum governance.[18] Peale promoted museum access "to both the learned and the unwise."[19] Peale understood that the promise of education alone rarely attracts many visitors; he therefore aspired to make "culture not to be difficult and somehow painful, but fun and uplifting and entertaining."[20] Phineas T. Barnum purchased Peale's collection in 1840 and focused on entertainment, thus transforming the museum experience and marking a distinct change in museum operation and purpose.[21] Barnum opened the American Museum in New York City, which became a national landmark, amusing and entertaining visitors with exhibits of "freaks" and novelties alongside collections of arts and artifacts.[22] At the time, the American Museum was praised as having

15. Eugene Dillenburg, *What, if Anything, Is a Museum?*, EXHIBITIONIST, 2011, at 8, *available at* http://name-aam.org/uploads/downloadables/EXH.spg_11/5%20EXH_spg11_What,%20if%20Anything,%20Is%20a%20Museum__Dillenburg.pdf (quoting the AAM website). However, the AAM website page that originally listed this definition has since been taken offline.

16. *Id.*

17. Liane Hansen, *Philadelphia Museum Shaped Early American Culture*, NAT'L PUB. RADIO, July 13, 2008, http://www.npr.org/templates/story/story.php?storyId=92388477.

18. *See id.* ("[N]ot only did [Peale] create the first museum, but he created the first marketing campaigns, the first solicitations for gifts to his museum . . . .").

19. *Id.*

20. *Id.*

21. *A History of Museums, 'The Memory of Mankind'*, NAT'L PUB. RADIO, Nov. 24, 2008, http://www.npr.org/templates/transcript/transcript.php?storyId=97377145 [hereinafter *A History of Museums*]; *see also* John Richard Betts, *P.T. Barnum and the Popularization of Natural History*, 20 J. HIST. OF IDEAS 353 (1959) (suggesting that Barnum should be credited with making museums a popular form of American entertainment); *see also* Harold Skramstad, *An Agenda for American Museums in the Twenty-First Century*, 128 DAEDALUS 129, 131 (Summer 1999) (noting that the museum governance of Barnum and Peale was a preface for the evolution of museums in America).

22. *See* Betts, *supra* note 21, at 353–55 (discussing the "novelties" Barnum added to his exhibits, including animals, such as orangutan and elephants, as well as "pictures,

"served science and education well."[23]

The head of the American Alliance of Museums has suggested that "[m]useums are a part of the community . . . [but] their role is not well-understood or well-publicized."[24] Museums have long provided education to the American populace, and that remains their overarching goal.[25] However, most museums also find it necessary for their survival and success to entertain and amuse as well as to educate. Promoting entertainment has transformed the reputation of museums to the point where many no longer "think about museums as being a critical piece in our educational infrastructure in this country" or realize the community benefits museums provide.[26]

"[T]he American museum universe is more like the Milky Way than the solar system," therefore making it difficult to generalize the characteristics of a typical museum.[27] Today, so-called "superstar museums" offer the ultimate museum experience.[28] Superstar museums share certain key characteristics: they draw tourists, attract large numbers of visitors, exhibit famous works, are located in buildings celebrated for their unique architecture, and gain revenue from commercial activities while also benefiting the local economy.[29] The Met is one example of a

articles or curiosities."); KARL E. MEYER, THE ART MUSEUM: POWER, MONEY, ETHICS 92 (1st ed. 1979) (pointing to Thomas Pearsall Field Hoving as another influential figure in the entertainment archetype because of his "splashy shows, head-line catching acquisitions, and continuous capital expansion").

23. Betts, *supra* note 21, at 357.

24. *A History of Museums, supra* note 21.

25. *See* Kosaras, *supra* note 12, at 118–22 (noting that two of the first American museum directors, John Cotton Dana and Paul J. Sachs, emphasized the educational goals of museums, despite disagreeing on strategies to further those goals. Dana saw a museum as only serving its function if it benefitted the public, and thought that it should be centered in a metropolis so to educate as many people as possible. On the other hand, Sachs believed that museums should not serve as "a public playground," but rather as a place for scholars to learn and research.).

26. *A History of Museums, supra* note 21.

27. MEYER, *supra* note 22, at 58. One important distinction between museums is how they are operated. According to a 2012 study, approximately sixty percent of museums are privately operated and forty percent are run by the government, with only seven percent of these managed by the federal government. The Gale Group, *Museums and Art Galleries*, HIGHBEAM BUSINESS, (last visited Apr. 8, 2013), http://business.highbeam.com/industry-reports/business/museums-art-galleries (noting that most of the museums in the Northeast are privately operated and that government museums are more common in the South and West of the United States.). Museum ownership, organization, and funding sources relate to the type of financial scrutiny museums receive.

28. Bruno S. Frey & Stephan Meier, *The Economics of Museums*, *in* HANDBOOK OF THE ECONOMICS OF ART AND CULTURE 1018, 1035 (Victor A. Ginsburgh & David Throsby eds., 2006).

29. *Id*. at 1036–37.

superstar museum.[30] Other examples include the Guggenheim, the Museum of Modern Art, and the J. Paul Getty Museum ("Getty").[31] These museums have followed Barnum's model, merging entertainment and education to create famed institutions. However, these same superstar museums have sparked debates about profit-seeking and tax exemptions. Due to such attention, superstar museums should consider their public image and take care not to allow their business-minded operations to overshadow their charitable and tax-exempt missions in the eyes of the public, the state, and the local municipality. This Comment focuses on these "superstar museums" because of their influence and ability to provoke tax reforms that impact all museums.

### *B. Museum Operating Income and Funding*

There are at least 17,000 museums in America, and they annually host more than 800 million people for free or at a nominal fee.[32] The average price for admission is about seven dollars, and about one-third of museums do not charge any admission.[33] The median cost to museums per visitor is about $31.40, which forces museums to allocate part of their operating budgets toward subsidizing admission.[34]

Early-era American museums derived their funding from "men of fortune and estate."[35] Today, the average museum receives 24.4% of its funding from the federal, state, or local government; 36.5% from private donations; 27.6% from earned income; and 11.5% from investment income.[36] Corporate donations comprise a substantial proportion of operating income, but, in the wake of the recession, many corporate and private donors have reduced their donations to museums.[37] Government

30. *Id.*
31. *Id.*
32. *A History of Museums, supra* note 21.
33. Ford W. Bell, *How are Museums Supported Financially in the U.S.?*, EMBASSY OF THE UNITED STATES (Mar. 2012), *available at* http://photos.state.gov/libraries/amgov/133183/english/P_You_Asked_How_Are_Museums_Supported_Financially.pdf.
34. *Monday Musings: The Price of a Free Membership,* CTR. FOR THE FUTURE OF MUSEUMS (Dec. 3, 2012), http://futureofmuseums.blogspot.com/2012/12/monday-musings-price-of-free-membership_3.html.
35. Calvin Tomkins, MERCHANTS AND MASTERPIECES: THE STORY OF THE METROPOLITAN MUSEUM OF ART 21 (1989); *see also* Bell, *supra* note 33 (noting that private donations are the largest source of income for museums comprising about thirty-six percent of museum operating income, while about twenty-five percent is supported by government funding).
36. Bell, *supra* note 33.
37. *See* Jim Zarolli, *Museums Exhibit Signs of Economic Distress*, NAT'L PUB. RADIO,

funding also has declined, as economic downturns left cities unable to support local museums.[38] Furthermore, shrinking endowments have left many museums in difficult financial positions.[39] Since museums "must stitch together sustainable revenue streams from a range of sources, while being as much at the whim of the marketplace as for profit enterprises," they have been forced to increase attention to profitable activities and fundraising so as to avoid auctioning collection pieces or shutting down entirely.[40]

For a large source of revenue, museums depend on admissions, membership dues, and retail profits; these sources make up a median of 18% of museum operating budgets.[41] Museums, especially superstar museums, also report modest income-producing endowments.[42] The Met, a superstar museum with a much larger operating budget and revenue stream than the average museum, stated in its 2011 Annual Report that its revenue amounted to $226.2 million.[43] The Met outlined its sources of revenue as follows: 37% from its endowment, 22% from gifts and grants, 14% from admissions fees, 11% from membership dues, 6% from New York City utilities, 5% from New York City guardianship and maintenance, and 5%

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Jan. 5, 2009, http://www.npr.org/templates/story/story.php?storyId=99017732 (discussing the Queens Museum of Art, which relies primarily on corporate and private donors, who "have lost a lot of money in the stock market" ). Recently, however, "there are signs that things are starting to look up" for charities. Pam Fessler, *Charities Predict A Slight Increase in 2012 Donations*, NAT'L PUB. RADIO, Jan. 4, 2012, http://www.npr.org/2012/01/04/144659584/charities-predict-a-slight-increase-in-2012donations.

38. *See, e.g.*, Zarolli, *supra* note 37 (discussing "the hard-pressed city government['s]" need to cut $400,000 from the budget for the Queens Museum of Art).

39. *See* András Szántó, *Will US Museums Succeed in Reinventing Themselves?*, ART NEWSPAPER (Jan. 2010), *available at* http://www.theartnewspaper.com/articles/Will-US-museums-succeed-in-reinventing-themselves-/20030 (stating that museum endowments shrank greatly during the recession, and that the largest institutions were the most affected).

40. Bell, *supra* note 33; *see also* Edward Wyatt, *Museum of Contemporary Art Takes Broad's Lifeline, Appoints New Chief*, N.Y. TIMES (Dec. 23, 2008, 12:09 PM), http://artsbeat.blogs.nytimes.com/2008/12/23/museum-of-contemporary-art-takes-broads-lifeline-appoints-new-chief/ (explaining that the Museum of Contemporary Art in Los Angeles had to be bailed out by philanthropist Eli Broad because, although it has "one of the country's most esteemed collections of postwar art. . . .its equally esteemed and ambitious exhibitions program ha[d] for several years outstripped its financial means, causing the museum to eat through most of its endowment and land in a deep financial crisis").

41. Press Release, Am. Ass'n of Museums, AAM Releases Survey-Offers Fin. Snapshot of Museum Field (Nov. 13, 2006) (on file with the University of Pennsylvania Journal of Business Law).

42. *See* Bell, *supra* note 33 (noting that money from investments tends to comprise about 11.5% of museum revenue).

43. *Report of CFO*, *supra* note 13, at 50.

from auxiliary activities such as gift shops, parking, and restaurants.[44] The Met's Annual Report reveals that a large percentage of the institution's revenue depends on unstable sources that are heavily linked to the economy. The Met and similarly situated museums have therefore had to focus attention on other sources of revenue in order to make up for market instability in traditional revenue sources.

Although superstar museums report large revenue streams considering their nonprofit status, most superstar museums also report high operating costs that correlate with their revenue streams. In 2005, museums allocated a median of 46% of spending toward meeting their missions, and 9% toward caring for their general collections.[45] Personnel costs amounted to a median of 51% of museums' operating budgets.[46] The Met reported operating expenses of $224.9 million in its 2011 Annual Report, a figure relatively close to its annual revenue.[47] The Met spends 29% of its operating budget on curatorial expenses, 18% on maintenance and operating services, 17% on guardianship, 11% on administration, 7% on utilities and interest, 7% on membership and development, 6% on education and libraries, and 5% on its special exhibits.[48]

Public misperception regarding museum profits may be at the root of criticism toward museum tax treatment.[49] With media portrayals of museums as buyers and holders of multi-million dollar pieces, owners of prime real estate, and employers capable of providing for-profit level director salaries and perks, it may seem reasonable to assume that superstar

44. *Id.* Note that revenue from fundraising events, like the previously mentioned Costume Institute Gala at the Met, is recorded as gifts and donations. *See* 2010 ANNUAL REPORT, THE FIELD MUSEUM OF NATURAL HISTORY 8 (2010), http://fieldmuseum.org/sites/default/files/2010_Annual_Report.pdf (citing the revenue for the Field Museum in Chicago as $68 million and derived as follows: 17% from long-term investments, 16% from admissions, 14% from business enterprises, 11% from contributions, 10% from net assets used, 10% from government support, 9% from Chicago Park District, 5% from program service fees, 4% from membership dues, 3% from sponsorships, and 1% from other sources).

45. AAM Releases Survey-Offers Financial Snapshot of Museum Field, *supra* note 41.

46. *Id.*

47. *Report of CFO*, *supra* note 13 (the amount cited excludes auxiliary activities).

48. *Id.*; *see also* 2010 ANNUAL REPORT, *supra* note 44 (citing for the year 2010 an operating budget of $64.7 million for the Field Museum of Natural History with expenses as follows: twenty-one percent on collections and research, twenty percent on other museum services, thirteen percent on debt service, twelve percent on exhibitions, nine percent on business enterprises, seven percent on environment, culture and conservation, six percent on marketing and public relations, five percent on institutional advancement, four percent on education and its library, and three percent on administration).

49. *But see* MEYER, *supra* note 22, at 59, (noting that "criticism has been directed at [museum] performance as distinct from their existence," and that "nearly everybody, approves of the establishment of museums").

museums do not deserve tax exemption. Therefore, in order to avoid incorrect assessments of wealth, museums need to educate the public on the costs of collection maintenance and programming because in today's unstable economy financial responsibility is vital to a museum's existence. Notably, the Met stated that only five percent of its reported revenue was derived from tangential and more commercially driven activities.[50] Nevertheless, people focus on the inflow of money rather than considering the source or type of revenue, and the substantial costs of running a museum.

## II. FEDERAL TAX EXEMPTION OF MUSEUMS

Both the federal government and each of the fifty states provide tax exemption for nonprofit organizations that meet certain requirements.[51] Tax-exempt museums deny federal, state, and local municipalities a large source of revenue.[52] This untaxed revenue has garnered attention in recent years as museums and other charitable organizations, such as hospitals and universities, have drawn criticism[53] for transforming into what Andras Kosaras has termed "commercialized nonprofits."[54]

In order to analyze whether museums are likely to be affected by public pressure it is necessary to understand the basic structure of the current tax system. Section 501(c)(3) of the Internal Revenue Code ("the Code") allows income tax exemption for organizations that meet the

50. *Report of CFO*, *supra* note 13; *see also* Kosaras, *supra* note 12, at 133-37 (suggesting that museums have organized their finances so as to profit from tax-exempt activities and to avoid the Unrelated Business Income Tax and arguing that museums have become more profit-seeking in their tax-exempt activities and should be taxed for those gains).

51. KENYON & LANGLEY, *supra* note 7, at 10.

52. *See e.g.*, Keith Schneider, *Adding Profits to the Gift Shop*, N.Y. TIMES, Mar. 29, 2006, at G31 (noting that America's museums, which are largely tax-exempt, collectively amass about $5.9 billion in revenue a year).

53. *See* KENYON & LANGLEY, *supra* note 7, at 9 ("increasing public scrutiny has led to challenges of nonprofits' tax-exempt status"); *see also* Sebastian Smee, *Masterpieces on loan leave MFA Walls Lacking; The museum is sharing a glut of its most prized works, raising funds but frustrating some local supporters*, THE BOSTON GLOBE, Nov. 25, 2012, at A1 ("After all, why should [museums] be deserving of tax-free status, of donations from businesses and the rich, of being considered superior to ordinary commercial life if they themselves become so commercial as to rent out their collections?") (quoting Cocks, *supra* note 5).

54. Kosaras, *supra* note 12. *But see* Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 TAX L. REV. 283, 289 (2011) (suggesting that income tax exemption is only relevant when looking at dollars set aside rather than dollars spent on yearly operating expenses, since such costs are usually deductible).

"exempt purposes" cited in the provision.[55] To qualify as a "charitable organization" with tax-exempt status, an organization's mission must further an approved purpose, either "charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, [or] preventing cruelty to children or animals."[56] Museums qualify under section 501(c)(3) because of their educational purposes.[57]

To differentiate a tax-exempt organization from a non-tax-exempt organization, the IRS applies an organizational test and an operational test,[58] based on the requirement that "an organization must be both organized and operated exclusively for one or more of the purposes specified in [section 501(c)(3)]."[59] To satisfy the test, "the organizational documents must limit the mission of the organization to one or more exempt purposes; limit the organization's power to engage in non-exempt activities . . . and provide that the organization's assets must be distributed for other related exempt purposes upon dissolution."[60] The operational test focuses on behavior and whether the organization seeking section 501(c)(3) status operates in a way that meets the exempt purposes listed in the Code.[61]

Section 501(c)(3) entities are divided into private foundations and public charities.[62] Public charities receive more favorable tax treatment

55. 26 C.F.R. § 1.501(c)(3)–1 (2013).

56. I.R.C. § 501(c)(3), (last updated Jan. 14, 2013), *available at* http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Exempt-Purposes-Internal-Revenue-Code-Section-501(c)(3).

57. *See* Kosaras, *supra* note 12, at 128 ("The Treasury Regulations specifically qualify museums for tax exemption as "educational" organizations"); *see also* Micah J. Burch, *National Funding for the Arts and the Internal Revenue Code §501(c)(3)*, 37 FLA. ST. U. L. REV. 303, 332–33 (2010) (suggesting that the Code be revised to specifically provide arts organizations tax exemption rather than having them fall under the category of an educational charity, thereby lessening the tension between education and commerciality in arts organizations).

58. Kosaras, *supra* note 12, at 128.

59. 26 C.F.R. § 1.501(c)(3)–1; *see also* Burch, *supra* note 57, at 326 (noting that there is a "sliding scale" of commercial activities to charitable activities on which an organization can fall and that the amount of commerciality allowed while remaining tax-exempt is based on the charitable purpose of the organization).

60. Kosaras, *supra* note 12, at 128–29.

61. *See id.* at 129 ("The test will not be met only if 'more than an insubstantial part of its activities is not in furtherance of an exempt purpose.'") (quoting Treas. Reg. §1.501(c)(3)-1(c)(1)).

62. Adler & Colvin, *Qualifying for Public Charity Status: The Section 170(b)(1)(A)(vi) and 509(a)(1) Test and the Section 509(a)(2) Test*, (2003), *available at* http://www.adlercolvin.com/pdf/public_charities/A%20C%20Web%20Resource%20-%20Qualifying%20for%20Public%20Charity%20Status.%20The%20(00167455).PDF.

than private foundations, but must qualify for public charity designation under section 509 of the Code.[63] Under the Code, an organization can qualify as a public charity in three ways: "(1) by being a certain kind of institution, such as a church, school, or hospital; (2) by meeting one of two mathematical public support tests; or (3) by qualifying as a supporting organization to another public charity."[64] Museums are most likely to be classified as public charities under the public support test.[65]

The Code prohibits an exempt organization from benefiting any private shareholder or other individual, and from taking political action, such as by lobbying for changes in legislation.[66] The Code does not disqualify organizations from tax exemption for profit-seeking activities as long as the organization's mission is not commercial.[67] However, the IRS has created an exception in section 513 of the Code, the Unrelated Business Income Tax (UBIT).[68] Section 513 was enacted by Congress in 1950 in response to complaints of unfair competition by businesses conducting similar activities as tax-exempt organizations.[69] Section 513 defines "unrelated trade or business" as:

> any trade or business the conduct of which is not substantially

63. VIRGINIA G. RICHARDSON & JOHN FRANCIS REILLY, PUBLIC CHARITY OR PRIVATE FOUNDATION STATUS ISSUES UNDER IRC 509(A)(1)-(4), 4942(J)(3), AND 507 (FY 2003) 2–3, *available at* http://www.irs.gov/pub/irs-tege/eotopicb03.pdf.

64. Adler & Colvin, *supra* note 62 *see also Developments in the Law—Nonprofit Corporations: III. Tax Exemption*, 105 HARV. L. REV. 1612, 1616 (1992) [hereinafter *Developments in the Law*] ("The law of tax exemption cannot be understood without interpreting the term charitable. The term implies both a statutory definition of a category of exempt activities, and a common law requirement that the organization must advance charitable ends."); *see also Developments in the Law*, *supra* note 64, at 1616 ("[U]nderlying all relevant parts of the Code, is the intent that entitlement to tax exemption depends on meeting certain common-law standards of charity—namely, that an institution seeking tax-exempt status must serve a public purpose and not be contrary to established public policy.") (quoting *Bob Jones University v. United States*, 461 U.S. 574 (1983)).

65. *See Internal Revenue Manual 4.76.3*, I.R.S., http://www.irs.gov/irm/part4/irm_04-076-003.html (last visited Apr. 8, 2013) (defining the public support test as requiring that the organization receive at least one-third of its funding from public contributions, or, if the organization receives between 10% and 33.33% from public contributions, facts and circumstances as stipulated by the treasury must show that the entity is organized and run like a public charity and not a private organization.); Adler & Colvin, *supra* note 62 (providing general information about the various tests).

66. *See Developments in the Law*, *supra* note 64, at 1618-19 (specifying that any organization that engages in such activity will not be exempt from taxation).

67. *Id.* at 1617. Although profit-seeking activities do not disqualify an institution, income from commercial activity that does not mean that income from the commercial activity will be entirely untaxed if the Unrelated Business Income Tax provision (section 513) may still apply.

68. I.R.C. § 513 (2006).

69. Kosaras, *supra* note 12, at 130–31.

> related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501.[70]

The UBIT taxes unrelated business income of section 501(c)(3) entities at corporate tax rates.[71] This provision affects profits tangentially related to a museum's educational purpose, such as revenue from museum restaurants or gift shops.[72] The UBIT is interpreted and applied broadly, creating confusion over what constitutes unrelated business income for an organization's section 501(c)(3) tax-exempt purpose.[73] For this reason, the government has considered reforms to UBITs.[74] Although there have been no recent formal changes to UBITs, there may be changes in the application of UBIT as nonprofits become more commercial and it becomes increasingly difficult for the IRS, and nonprofits, to separate types of income streams.[75]

The public, although harboring misconceptions about museum finances, has increasingly begun to ask why such charitable organizations are tax-exempt when they receive hefty donations, maintain endowments, and profit from business-like ventures.[76] Some argue that commercially-driven museums do not deserve the same level of tax exemption as other charities, citing the amount of earned income such museums seemingly

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70. I.R.C. § 513 (2006).

71. I.R.C. § 511 (2006). The top tax bracket for corporations, (taxed at a rate of thirty-five percent35%, applies to taxable income in excess of $10,000,000. I.R.C. § 11 (2006).

72. Kosaras, *supra* note 12, at 133.

73. *Id.* at 171.

74. During the "Hearing on Public Charity Organizational Issues, Unrelated Business Income Tax and the Revised Form 990" on July 25, 2012, the IRS heard arguments and suggestions for reform of UBIT. PRICEWATERHOUSECOOPERS, HOUSE OVERSIGHT SUBCOMMITTEE TAX-EXEMPT HEARING FOCUSES ON COMMERCIAL ACTIVITIES, COMPLEX STRUCTURES, AND FORM 990 REDESIGN 1 (July, 31, 2012), http://www.pwc.com/en_US/us/washington-national-tax/newsletters/exempt-organizations-tax/assets/pwc-hearing-public-charity-organizational-issues.pdf. At the hearing, John Columbo, a professor at the University of Illinois College of Law, recommended that Congress "subject income earned by a public charity from all commercial activities to UBIT, regardless of whether the activity was substantially related to the organization's exempt purposes." *Id.* at 4.

75. *See id.* (evidencing the concern over the application of UBIT).

76. *See* Smee, *supra* note 53 ("[G]reat lending museums like the MFA 'risk killing the goose that lays the golden eggs. After all, why should they be deserving of tax-free status, of donations from business and the rich, of being considered superior to ordinary commercial life if they themselves become so commercial as to rent out their collections?'") (quoting Cocks, *supra* note 5). *But see* Frey & Meier, *supra* note 28 (suggesting that museums pursue commercial activities in response to reduced funds from other sources of revenue).

receive tax-free, the trend toward commercially-driven activities, and the notion that tax exemption has become less essential to museum survival.[77] These criticisms have developed partly because the IRS has not articulated why section 501(c)(3) tax exemptions exist in the first place,[78] and because fundamentally, "[t]here is nothing about the nature of the charitable organization that precludes income taxation. . . . [because it] often intends to make a profit and its income can be measured in the same way as for-profit companies."[79] Despite this, nonprofit tax exemption is well-established at the federal level and is unlikely to be greatly altered.[80]

Professor Nina J. Crimm suggests that tax exemption is a way for the government to reward nonprofits for "undertaking the provision of 'inherently risky' public goods and services."[81] This public benefit reasoning "is based on the theory that the government is compensated for the loss of revenue by its relief from financial burdens which would otherwise have to be met by appropriations from other public funds, and by the benefits resulting from the promotion of the general welfare."[82] Subsidy theory suggests that tax exemptions subsidize organizations that provide a benefit to society, thereby relieving the government from a duty

77. *See, e.g.*, Kosaras, *supra* note 12, at 155 (arguing that museums should not be fully tax-exempt, because "museums are moving to a point where profitability is not an incidental benefit of exempt activities, but the primary goal. . . . If exempt organizations choose to emulate for-profit firms, they should be taxed like them."); *see also*, Cocks, *supra* note 5 (positing that museums are losing sight of their real purposes).

78. Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLA. L. REV. 419, 426 (1998).

79. Halperin, *supra* note 54, at 284.

80. *See Developments in the Law*, *supra* note 64, at 1620 (noting that the subsidy theory is the most accepted view of why nonprofits are tax-exempt). Other theories of tax exemption for nonprofits include donative theory, income measurement theory, and capital formation theory. *Id.* Donative theory suggests that nonprofits should be tax-exempt because they run on donations. *See also* Kosaras, *supra* note 12, at 167 (noting that donative theory depends on "the proposition that there is near universal agreement that donative organizations . . . are and should be exempt from taxation."). Income measurement theory suggests that nonprofits are tax-exempt because it is difficult to quantify nonprofit income. *Developments in the Law*, *supra* note 64, at 1620. As much museum revenue is "readily quantifiable," income measurement theory does not offer a sound explanation for museum tax exemption. Kosaras, *supra* note 12, at 166. Capital formation theory, on the other hand, supports tax exemption because of the limits placed on nonprofits to raise capital through securities markets. *Developments in the Law*, *supra* note 64, at 1620.

81. Crimm, *supra* note 78, at 420. Professor Crimm also suggests that the logic behind tax exemption should be considered separately from specific issues of which organizations should be tax-exempt. *Id.* at 420.

82. NSFRE GOVERNMENT RELATIONS COMMITTEE, PAYMENTS IN LIEU OF TAXES 2 (1997) [hereinafter NSFRE] (quoting H.R. Rep. No. 1860, 75th Cong., 3d Sess. 19 [938]), *available at* http://www.afpnet.org/files/contentdocuments/pilot_position_paper.pdf.

to provide such services.[83] Subsidy theory can be separated into government burden theory and community benefit theory.[84] Government burden theory proposes that tax exemptions extend to nonprofit organizations that provide a service that the government would otherwise be expected to provide.[85] In comparison, community benefit theory suggests that tax exemptions subsidize the activities nonprofits provide that benefit the community.[86] Museums house, preserve, and protect cultural works and identities—tasks the government would be unable to undertake without spending billions of dollars. Museums also provide unique public benefits, including education, entertainment, community activities, and tourism revenue. The federal government therefore has an interest in continuing tax exemptions as a subsidy for the benefits provided by museums.

Commentators point out that the subsidy theory requires acknowledgement that tax exemptions, as a subsidy, are essentially government expenditures on nonprofits.[87] This raises concerns of resource scarcity and allocation efficiency, considering that those who are the least in need of help receive the most support.[88] Museums that can raise their own resources may not seem as worthy of such a discount from the federal government. These institutions, however, arguably have a broader impact because of their ability to reach a wider segment of society; by this logic, the subsidy rationale posits that larger museums do deserve a government subsidy for providing greater benefits that the government finds valuable. Such a government tax subsidy can be compared to one of the biggest tax subsidies—healthcare—which represents a major policy initiative undertaken through the tax code.[89] In the case of museums, the tax subsidy

83. *Developments in the Law*, *supra* note 64, at 1620. However, subsidy theory is not a complete explanation of tax exemption because it does not explain why such a subsidy needs to be provided through the tax law rather than in other forms. *Id.*

84. Kosaras, *supra* note 12, at 166.

85. *Id.* Kosaras dismisses this theory by claiming that there is no clear relief of government burdens by museums.

86. *Id.*

87. *See e.g.*, *Developments in the Law*, *supra* note 64, at 1621 ("Critics of tax expenditures point to the inefficiency of tax expenditures in allocating scarce government resources.").

88. *Id.*

89. *See* CATO HANDBOOK FOR POLICYMAKERS, CATO INSTITUTE 141–42 (7th ed. 2008) *available at* http://www.cato.org/sites/cato.org/files/serials/files/cato-handbook-policymakers/2009/9/hb111-14.pdf (noting that employer-provided healthcare that is employer-deducted and available as an employment benefit is not taxable to the employee, and is the largest employer tax break and causes the government to lose billions of potential dollars in revenue); Eric Pianin, *Top 10 Tax Breaks that May be Eliminated,* THE FISCAL TIMES, Sept. 13, 2012, http://www.thefiscaltimes.com/Articles/2012/09/13/Top-10-Tax-Breaks-that-May

fosters arts and culture.

Financial support of museums is an accepted governmental activity in the Western Hemisphere "because of the way in which it affects the quality of our cultural life . . . [and because] [t]he market on its own fails to properly account for [the] sociological/political/aesthetic qualities of art."[90] Most countries maintain ministries of culture and provide more direct national support for the arts.[91] In the United States, however, cultural development is furthered largely through the tax treatment of museums; because these tax provisions are "tucked away in provisions of the federal tax code that do not even use the word 'art,' they remain somewhat insulated from . . . discourse regarding arts funding."[92] The United States promotes both museums and cultural development through tax exemption laws.[93] Although increased scrutiny of nonprofits, and specifically museums, may lead museums to fear formal calls for tax reform, the federal government is unlikely to revoke tax exemption, even for the largest, most well-known museums. To do so would be, in a way, revoking national promotion of educational programming in the humanities and the protection of priceless collections.[94]

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-Be-Elimated.aspx#page1 (stating that the foregone revenue to the federal government from tax subsidies to healthcare totals around $184.4 billion); *Developments in the Law*, *supra* note 64, at 1620 ("Tax expenditures 'represent government spending for favored activities or groups, effected through the tax system.") (citations omitted).

90. Burch, *supra* note 57, at 310–11.

91. Bell, *supra* note 33.

92. Burch, *supra* note 57, at 303; *see also* Elizabeth Blair, *Does U.S. Need a Culture Czar?*, NAT'L PUB. RADIO, (Jan. 16, 2009, 6:00 AM), http://www.npr.org/templates/story/story.php?storyId=99450228 (noting the government's disjointed approach to the arts and culture in the United States); Christopher Beam, *What do Ministers of Culture Do?*, SLATE, (June 29, 2007, 6:36 PM), http://www.slate.com/articles/news_and_politics/explainer/2007/06/what_do_ministers_of_culture_do.html (noting that in the United States, the arts are largely privately funded and there is little government support compared to abroad). Other nations tend to support the arts more openly, and "assistance to the arts is a discrete and visible expenditure in the national budget." MEYER, *supra* note 22, at 64. Professor Micah Burch suggests that tax subsidies as applied in the United States are beneficial in that they remove the decision-making required in allocating direct funding. Burch, *supra* note 57, at 321. Note that the United States does maintain the National Endowment for the Arts, but its budget is much smaller than that of most other countries. For example, "the government subvention for Italy's major opera houses is nearly ten times larger than the annual Arts Endowment working budget." NAT'L ENDOWMENT FOR THE ARTS, HOW THE UNITED STATES FUNDS THE ARTS v (2d ed. 2007), *available at* http://infousa.state.gov/life/artsent/docs/how.pdf. European nations also offer tax benefits to the arts but these have tended to not be as large as the tax benefit in the United States. NAT'L ENDOWMENT FOR THE ARTS, *supra* note 92.

93. Burch, *supra* note 57, at 304.

94. *Id.* at 306 ("[A]rts policy is an important indicator of how the United States supports creative endeavors generally.").

## III. MUSEUM OPERATIONS THAT HAVE RAISED CRITICISM OF MUSEUM TAX EXEMPTION

Museums have two main goals: to educate their visitors, and to obtain funding.[95] Museums may prioritize their duties to educate the public and protect cultural, artistic, and scientific works, but to fulfill the charitable aim of education, they must meet their operating budgets. Some argue that because "[a]rt museums are moving to a point where profitability is not an incidental benefit of exempt activities, but the primary goal," they should not be allowed tax exemption for such activities.[96] While profitable activities may not be directly connected to charitable goals, raising capital from any source is vital to the furtherance of public benefits and education. With donations (which once served as the main support for museums) on the decline, and costs to sustain museum activities and the protection of priceless pieces on the rise, museums have been forced to tap into other sources of revenue to stay afloat and to stabilize their budgets.[97]

Critics of museum marketability and profit-making seem to suggest that since museums are tax-exempt nonprofits, they must not operate as businesses or seek revenue. However, the Code realizes the possibility of profit-seeking nonprofits and allows exempt organizations to run profitable activities as long as their overall mission remains charitable.[98] Revenue from tangential and commercial activities is funneled back into museum operations and helps to support museums' tax-exempt purposes.[99] Plus, in today's economy, business-minded governance is important in helping museums meet their funding requirements.

Museums raise capital through profitable ventures such as gift shops, restaurants, blockbuster exhibits, private events, and loan arrangements. Such activities are often not captured by the UBIT exception, because UBIT explicitly excludes unrelated business that is "substantially related . . . to the exercise or performance by such organization of its

95. Sandra Mottner & John B. Ford, *Measuring Nonprofit Marketing Strategy Performance: The Case of Museum Stores*, 58 J. BUS. RESEARCH 829, 829 (2005).

96. Kosaras, *supra* note 12, at 155. *But see* Frey & Meier, *supra* note 28, at 1035 (stating that museums often have to become more commercial to make up for reduced funding from other sources).

97. Many nonprofits have been forced toward such a model. Organizations like the Red Cross, the National Alzheimer's Association, and the Susan G. Komen Fund have held events and galas with celebrities and expensive tickets to raise revenue toward their charitable purposes.

98. *Developments in the Law*, *supra* note 64, at 1617.

99. Frey & Meier, *supra* note 28, at 1035.

charitable, educational, or other purpose or function constituting the basis for its exemption . . . ."[100] Many museums, especially superstar museums, also own expensive real estate in the center of cities, and, since most are exempt from property taxes, tax exemption for these valuable holdings also garners negative attention. It is such aspects that many find difficult to reconcile with tax exemption and which need to be explored in detail to determine how much of such activity is actually tax-exempt and whether that which is not tax-exempt should be.

### *A. Gift Shops and Retail Outlets*

Today, retail outlets have become a common fixture in museums—an internet search for "museum gift shop" will generate hundreds of links to gift shops at museums worldwide.[101] Museums profit from purchases at on-site shops, as well as from online and offsite stores, and for superstar museums revenue can be in the millions of dollars.[102] Superstar museums, like the Museum of Modern Art (MoMA) or the Met, are examples of institutions that have capitalized on their reputation to launch successful offsite stores.[103] Notably, offsite stores are not property tax-exempt because offsite stores are seen to have a clear commercial nature that is less connected to museum operations.[104] In its 2011 annual report, the Met reported revenues of $68,160,000 in income from "merchandising," but expenses of $64,153,000,[105] while the MoMA reported income from "auxiliary activities," including gift store profits, as $50,493,000 and related expenses of $47,507,000.[106] However, for the average museum, the

100. I.R.C. § 513(a) (2006).

101. *See* AAM Releases Survey-Offers Financial Snapshot of Museum Field, *supra* note 41 (noting that eighty percent of museums that responded to the AAM survey operate a gift store).

102. *See* Schneider, *supra* note 52 (noting that the Met generated $39 million in profits in 2003 from sales of commodities, and that the Museum of Modern Art reaped $12.5 million in profits from gift store sales).

103. *See MoMA Store*, THE MUSEUM OF MODERN ART, http://www.momastore.org/museum/moma/StoreCatalogDisplay_-1_10001_10451_ (listing offsite stores in Japan and Korea) (last visited Apr. 8, 2013); *see also International Locations,* THE METRO. MUSEUM ART STORE, http://store.metmuseum.org/the-met-store-locations/international-locations/scat/international/ (listing off-premises stores in Thailand, Australia, Japan, and Mexico as well as eight stores in the United States) (last visited Apr. 8, 2013).

104. Kosaras, *supra* note 12, at 158.

105. *Report of CFO*, *supra* note 13.

106. *Annual Report for the Fiscal Year Ended June 30, 2011*, THE MUSEUM OF MODERN ART (2011), http://www.moma.org/docs/about/AnnualBondDisclosureFY2011.pdf; *see also* 2010 ANNUAL REPORT, *supra* note 44 (reporting that Chicago's Field Museum derived

net profits from retail sales are relatively small. The Museum of Fine Arts (MFA) in Boston, a wealthy museum subject to PILOTs, stated in its 2011 annual report that it spent $6,472,000 on merchandising operations and earned $6,870,000 from such operations, earning a net profit of only $398,000.[107]

Museum stores are unique retail sites in that they are intended to be profitable while at the same time serving the greater mission of the museum—education and enlightenment of visitors.[108] These dual aims can be met and museum shops are able to avoid paying UBIT by ensuring that the products sold are related to their exhibits and collections.[109] It is not the case that the sale of such items is tax-exempt due to a loophole in UBIT. The IRS has considered the sale of gift store items that are related to a museum's collection and has determined that they should not be subject to UBIT because they further the charitable mission of the museum by educating more people about the museum's collections.[110] Stores carry a wide variety of goods, from prints of paintings and art history textbooks to souvenir magnets, and so each item must be considered separately for application of UBIT.[111] For tax purposes, museums are incentivized to ensure that the majority of products sold are substantially connected to museum collections or purposes.[112]

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fifteen percent of its sixty-eight million dollar operating budget from "business enterprises").

107. *Museum of Fine Arts Annual Report*, MUSEUM OF FINE ARTS (2011), http://www.mfa.org/annual-report-2011/downloads/MFA-operatingResults2011.pdf.

108. Mottner & Ford, *supra* note 95, at 830.

109. Kosaras, *supra* note 12, at 134 ("[W]here the primary purpose behind the sale of the item is 'utilitarian, ornamental, a souvenir in nature, or only generally educational in nature,' the income generated from the sale of the item will be subject to UBIT."). Although museums may have to pay UBIT on some items, it is likely that the products are sold due to their expected popularity and after tax, such goods still net a profit and provide much needed revenue to the museum. *Id.* at 137 n. 118.

110. *See* Susan R. Bills, *Keeping Ahead of UBIT Consequences of a Gift Shop*, J. TAX'N OF EXEMPT ORGS. 3 (2001) (referencing the IRS Revenue Ruling Rev. Rul. 73-105, 1973-1 CB 264 in which a gift shop sold reproductions of works in the museum's collection, books and souvenirs). As Bills notes, although the IRS concluded that sale of such items related to the charitable purpose of the museum should be excluded from UBIT, the IRS found that items with no relationship to the work in the museum or art generally were subject to UBIT; these items included scientific books and city souvenirs. *Id.*

111. *Id.* (noting a process known as the "fragmentation rule," where the IRS has issued private letter rulings that analyze individual items in a gift store to determine whether they further the charitable purposes or should be subject to UBIT).

112. Some museums have been creative in connecting goods to the museum's exhibits. *See, e.g.*, Stephanie Murg, *Pigments of Their Imagination*, ARTNEWS, at 28 (Jan. 2012) (announcing that the Guggenheim has launched its own interior paint brand, Classical Colors by Guggenheim, which is based on color palettes in famous works showcased at the museum).

### *B. Dining Facilities*

Restaurants are another feature that add not only to the museum experience, but also to a museum's revenue. At superstar museums restaurants have evolved from little cafes serving sandwiches and drinks to trendy eateries or fine dining establishments that are destinations independent of the museums in which they are housed.[113] These restaurants may not be fully tax-exempt because many museums, especially superstar museums, outsource restaurant operations to private for-profit companies that pay taxes on income generated.[114]

Taxation on income from food establishments may depend on public access to the dining facility.[115] For example, if a restaurant is only accessible through the museum, the restaurant is considered a convenience to visitors that furthers charitable purposes and therefore is not subject to UBIT.[116] The IRS has reasoned that museum restaurants further the charitable purposes of the museum by allowing visitors to optimize their time at the museum, rather than having to leave the museum when hungry.[117] However, if a restaurant can be accessed via a separate entrance and is thus open to the public at large without a museum admission fee or during hours when the museum is not open to the public, then museum revenue from the restaurant is taxable.[118] Most of the trendy dining facilities in superstar museums are open to the public, making them subject to taxation. However, it is possible that small cafeteria-style shops may escape UBIT and taxation.[119]

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113. *See, e.g.*, Larry Rohter, *After the Putti, the Baby Calamari*, N.Y. TIMES, Jan. 28, 2010, at C21 (noting that the days of museum basement cafeterias "are gone, or at least numbered. Increasingly museums are moving away from the middle-school approach to feeding visitors, . . . in favor of stylish restaurants that offer fine dining to go with the fine art").

114. *See id.* (illustrating that many of the famed restaurants found in museums are operated by private companies or restauranteurs).

115. *See* Jeffrey Hurwit, *Candlelight, A Glass of Wine, and UBIT: A Food and Facilities Primer,* HURWIT & ASSOCIATES 1 (2008) http://www.hurwitassociates.com/p_l_unrelated_candlelight.pdf ("[I]f a dining facility is accessible not only through the museum but also through a door directly to the street, then it has been held by the IRS not to be primarily for visitor convenience but for general public use, and therefore taxable.").

116. *Id.*

117. *Restaurant is not Unrelated Business*, 72 J. TAX'N 121 (1990).

118. *Id. But see* Hurwit, *supra* note 115 (noting that the fragmentation rule applied to gift shops is also used for restaurants, in that income can be separated based on whether the money is generated by museum visitors or the outside public).

119. *See* Hurwit, *supra* note 115, at 1-2 (noting that a museum restaurant that was "larger

### C. *Blockbuster Exhibits*

Museums, especially superstar museums, attract attention from "blockbuster exhibits."[120] Blockbuster exhibits are limited-time events showcasing famous works, and tend to draw large audiences willing to pay the extra charges.[121] Blockbuster exhibits provide unique education and programming and are normally a response to the community's interests, and their profits reflect that.[122] Blockbuster exhibits, although often profitable, do wholly further the charitable purpose of museums to educate, and so revenue generated remains tax-free.[123]

While admission to blockbuster exhibits may be expensive, that price tag seldom reflects net profit as money raised is often funneled back into the museum.[124] Without larger admissions fees and heavy advertising, museums may not be financially capable of bringing such collections to their communities since lending fees are often millions of dollars.[125]

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than needed for visitors and staff" did not qualify under the convenience exclusion for a variety of reasons, including its size, outside advertisements, and lack of admission fees).

120. *See, e.g.*, Emily Bauman, *To Blockbuster or Not to Blockbuster*, F NEWSMAGAZINE, Apr. 6, 2009, http://fnewsmagazine.com/2009/04/to-blockbuster-or-not-to-blockbuster/ (defining "blockbuster exhibits" as exhibits that "draw in huge crowds of out-of-towners and, thereby, huge sums of money for both the museums that host them (which often charge an additional fee for admission to the special exhibitions), the cities they are in, . . . the galleries that surround them, the curators who produce them, collectors who own works by artists in the shows, and more"); *see also* Kosaras, *supra* note 12, at 160 ("The attraction of a blockbuster exhibition is not only the sheer number of people it can attract, but also the opportunity to charge extra admissions for admittance to the exhibition, apart from admittance to the museum's general collections.").

121. *See* E.H. Gombrich, *The Museum: Past, Present and Future*, 3 CRITICAL INQUIRY 449, 460 (1977) (noting that museums' special exhibitions entice locals to visit the museum to see something that is only available for a limited time). *Compare Van Gogh Up Close*, PHILA. MUSEUM OF ART, http://www.philamuseum.org/exhibitions/743.html?page=2&ticket=1 (last visited Apr. 8, 2013) (listing the admission price of a recent Van Gogh exhibit at the Philadelphia Museum as $25.00), *with Plan Your Visit*, PHILA. MUSEUM OF ART, http://www.philamuseum.org/visit/12-270.html (lasted visited Apr. 8, 2013 (listing the normal admission price to the Philadelphia Museum of Art for a two-day period as $20.00).

122. *See* Gombrich, *supra* note 121, at 460 (noting "tourism social pressure" that encourages people to go to special exhibits).

123. Kosaras, *supra* note 12, at 160.

124. *See* Bauman, *supra* note 120 (implying that revenue from blockbuster exhibitions may simply plug holes in a museum's existing budget: "[D]uring recessions, or when public funding has been cut, or even during a renovation, the publicity and funds that a blockbuster can bring to a museum can prove invaluable.").

125. *See e.g.*, Tyler Green, *Pay Per View*, PORTFOLIO.COM, May 12, 2008, http://www.portfolio.com/culture-lifestyle/culture-inc/arts/2008/05/12/Art-Museums-Charging-Big-Fees/

Importantly, blockbuster exhibits offer a wider community benefit in that they tend to draw tourists, thereby raising revenue for the municipality and other local businesses.[126]

### *D. Lending*

The other side of the transaction is the lending of portions of general collections at high rates. In the past, museums would charge to cover the expenses of transporting and caring for the pieces, but now there is profit involved in lending.[127] For example, in 2008 the Art Institute of Chicago loaned the Kimbell Art Museum in Texas ninety-two Impressionist paintings at a fee of two million dollars.[128] As noted by the Met, loaning pieces or collections is regarded as furthering the charitable purposes of a museum, as loans educate and expose a larger populace to the pieces.[129] Not only do museums raise revenue from lending out their collections, but many superstar museums have procured deals to expand abroad, often in return for a hefty donation from the local government.[130] The Guggenheim,

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(discussing a loan of ninety-two paintings for $2 million dollars).

126. *See* Urban Partners, *Technical Memorandum: Economic Impact of the* Salvador Dali *Exhibition* (July 28, 2005), a*vailable at* http://c0526532.cdn.cloudfiles.rackspaceclou d.com/Economic_Impact_of_the_Salvador_Dali_Exhibition.pdf (studying the economic impact of the Salvador Dali exhibit on the city of Philadelphia and noting that the exhibit was viewed by over 370,000 people, caused about 52,000 trips to other Philadelphia tourist spots, benefited at least 145 local business owners, created at least 830 full time jobs, and produced tax revenue measured at $2.17 million for Philadelphia and $2.29 million for the state of Pennsylvania).

127. *See* Kosaras, *supra* note 12, at 161 ("Until the 1990s, . . . most loans were conducted 'at cost.' . . . Since the 1990s, several institutions have entered into loan arrangements for the purpose of raising money for capital improvements."); Bauman, *supra* note 120 (noting that blockbuster exhibits may not only make money for the hosting museum, but also raise "hefty sum[s]" for the lending museum).

128. Green, *supra*, note 125; *see also* Kosaras, *supra* note 12, at 162 (noting that the Whitney Museum charged the San Jose Museum of Art $1.4 million for a loan and in the 1990s the Barnes Foundation charged about $7 million for part of its collection to tour Paris and Tokyo, but pointing out that for the Barnes Foundation this was the alternative to selling pieces from the collection to finance general museum operations).

129. *See Collections Management Policy*, THE METROPOLITAN MUSEUM OF ART, (Nov. 12, 2008), http://www.metmuseum.org/about-the-museum/collections-management-policy#l oans (calling loans "an important means of fulfilling the educational and scholarly purposes of the Museum's charter").

130. *See, e.g.*, Sheppard Mullin, *Would You Like Fries with that Picasso? The International Franchising of World Class Museums*, ART L. GALLERY BLOG (Jan. 29, 2009), http://www.artlawgallery.com/2009/01/articles/museums-private-collectors/would-you-like-fries-with-that-picasso-the-international-franchising-of-world-class-museums/ (discussing international museum franchising and a recent $1.3 billion "cultural accord" between France

once just a New York City fixture, can now be found in Venice, Bilbao, Berlin, and Abu Dhabi.[131]

The increase in lending fees is partly due to the higher costs of shipment and insurance, but some argue that lending museums are making profits on the agreements.[132] However, the director of the Art Institute of Chicago suggests that high prices do not necessarily indicate that such loans are offered to raise revenue.[133] When considering the revenue gained from the borrowing of collections, lending fees do not appear exorbitant or solely revenue generating.[134] Lending agreements and expansion provide necessary funding, thereby suggesting a rationale for museums to take advantage of traditional supply and demand economics.[135]

### *E. Renting Museum Property and Ticketed Events*

Private and museum-sponsored functions are also a source of earned income. Many museums, including the Met, charge large sums to rent out their facilities.[136] Others host ticketed after-hours events, such as the American Museum of Natural History's "A Night at the Museum," a $129

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and the United Arab Emirates to open a Louvre franchise in Abu Dhabi); Kosaras, *supra* note 12, at 162–63 (noting that when the Bilbao branch of the Guggenheim opened in 1997 the Basque government signed a seventy-five year agreement to cover the construction of a $100 million structure, the creation of a $50 million acquisition fund, the payment of a one-time $20 million fee to the Guggenheim, and the subsidizing of the new museum's annual $12 million budget).

131. *Annual Report 2010*, THE GUGGENHEIM (2010), http://www.guggenheim.org/images/content/pdf/foundation/ar2010.pdf.

132. *See* Green, *supra* note 125 (noting that "industry watchdogs" argue that museums should be able to cover the costs of lending but should not be able to profit as they appear to be doing in recent lending agreements).

133. *Id.*

134. *Id.* (noting that the loan from the Art Institute of Chicago to the Kimbell Art Museum in Fort Worth, which cost the Kimbell Art Museum $2 million, would generate the Kimbell Art Museum more than $8 million).

135. *See* Alan Riding, *A Gleaming New Guggenheim for Grimy Bilbao*, N.Y. TIMES, June 24, 1997, at C9 (explaining that the Spanish government paid for the construction of the Guggenheim Bilbao Museum, created a $50 million dollar acquisitions fund for the museum's expansion, made a $20 million dollar payment to the Guggenheim, and agreed to subsidize the Guggenheim's $12 million dollar annual budget in return for the Guggenheim lending part of its New York collection to Bilbao and running the museum's operations). Government support and private donations in the United States do not reach this level, and with costs of museum operations so high, when another country is willing to foot the bill, it may be reasonable for museums to take advantage of such hospitality.

136. *See Entertaining at the Met*, THE METROPOLITAN MUSEUM OF ART, http://www.metmuseum.org/about-the-museum/entertaining-at-the-met (last visited Apr. 16, 2013) (providing information on the Met's private entertainment venues).

sleepover at the Natural History Museum.[137] Renting of museum space is considered a passive source of revenue for tax treatment, and is therefore excluded from UBIT.[138] Revenue produced has a close connection with usual museum business and charitable goals; by renting out museum spaces and opening the museum for special after-hours access, the museum is increasing viewership of its collections and increasing its educational reach.

There are also large fundraising events, like the previously discussed Costume Institute Gala at the Met, which raise museums millions of dollars in tax-exempt donations.[139] Renting museum space provides opportunities for a unique museum experience and meets the overarching goal of educating and enlightening visitors, and money raised from such events offset the costs of allowing such access.

### *F. Property Holdings*

According to a 1997 study, 1,904, or forty-four percent, of museums own real property.[140] This number may seem low because many museums, including some superstars, do not own the buildings in which they operate.[141] For many museums, like the Met or the Philadelphia Museum of Art, the city owns the buildings that house their collections.[142] However, there are museums like the Guggenheim for which the city does not own the museum's building.[143] This latter type of museum, attracts the most

137. *AMNH Sleepovers*, AM. MUSEUM OF NATURAL HISTORY, http://www.amnh.org/plan-your-visit/amnh-sleepovers (last visited Apr. 8, 2013) (describing sleepover events at the American Museum of Natural History).

138. I.R.C., IRM § 7.27.6, *available at* http://www.irs.gov/irm/part7/irm_07-027-006.html (last visited Apr. 8, 2013); *see* Hurwit, *supra* note 115 (noting that if the museum provides services in addition to renting out the space, such as catering, then such activities are taxable).

139. I.R.C. § 501(c)(3).

140. KENYON & LANGLEY, *supra* note 7, at 17. The Lincoln Institute of Land Policy report cites data on real estate ownership and notes that the average tax savings to museums owning real estate is $133,682 per year.

141. *See* Pamela Skillings, *The Metropolitan Museum of Art, New York City's Famous Met Museum*, ABOUT.COM, http://manhattan.about.com/od/artsandculture/a/metmuseumnyc.htm (last visited Apr. 8, 2013) (noting that New York City owns the Met's main buildings and also provides much of the building's utilities); *Administration*, PHILA. MUSEUM OF ART, http://www.philamuseum.org/information/43-323.html (last visited Apr. 8, 2013) (noting that Philadelphia owns the building in which the Philadelphia Museum of Art is situated).

142. Skillings, *supra* note 141.

143. Guggenheim New York, USA: Architecture Information, E-ARCHITECT, http://www.e-architect.co.uk/new_york/guggenheim_new_york.htm (last visited Apr. 8,

attention from states and municipalities because of the revenue lost due to the property tax exemption for museum real estate. These may be at particular risk for state challenges and PILOTs.

## IV. THE COMMERCIALITY DOCTRINE

The commerciality test has been considered as a way to limit profit-seeking nonprofits.[144] The commerciality doctrine is a non-statutory tool that brings income earned by certain commercial activities into the realm of taxation and can operate as a way to successfully challenge a nonprofit's tax-exempt status.[145] It focuses on profits when considering tax exemption, and measures whether there is a "commercial hue" in the nonprofit's activities, and whether such "activities are largely animated by [a] commercial purpose."[146] The test analyzes the "manner in which an exempt organization undertakes an activity," rather than the purpose for which the nonprofit commences the activity, which UBIT considers.[147]

The commerciality doctrine originated in a 1924 Supreme Court decision on a challenge to the commercial activity of a nonprofit religious group that owned real estate and stocks and had retail activity.[148] It was expanded in 1945 by the Supreme Court and applied in a line of 1960's cases to deny tax exemption to nonprofits that were publishing and selling materials for profit.[149] There are two tests under the commerciality doctrine—the counterpart test and the aggregation test.[150] The counterpart test considers whether the nonprofit is directly competing with for-profit

2013) (stating that the Solomon R. Guggenheim Foundation owns and operates the Guggenheim Museum on Fifth Avenue).

144. John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487, 495 (2002); Kosaras, *supra* note 12, at 140.

145. Kosaras, *supra* note 12, at 137–40.

146. *Id.* at 139 (quoting *Better Bus. Bureau of Wash., D.C., Inc. v. United States*, 326 U.S. 279, 283 (1945)); *see also* Colombo, *supra* note 144, at 503–04 (noting that the consideration of a nonprofits activities having a commercial hue has not been systematically applied by the IRS or courts and citing as examples the Third Circuit, which stated that a charity should be able to turn a profit in order to further its charitable goals and the IRS's approval for tax exemption of hospitals and universities opening health clubs with for-profit type fees, noting though that income from such activities is subject to UBIT).

147. Kosaras, *supra* note 12, at 138.

148. Colombo, *supra* note 144, at 497–98 (noting that this organization's tax exemption was not revoked because the court found that the commercial enterprises were a small portion of overall activities, but that the case is the first to have considered a nonprofit's commerciality).

149. Kosaras, *supra* note 12, at 138–39.

150. *Id.* at 138–39.

firms in its activities, and the aggregation test notes the difference between nonprofits that conduct profitable activities as part of their larger operations and those that do so as their main purpose.[151]

IRS regulations suggest that if the commercial activity is insubstantial compared to overall charitable activity that is acceptable, and that tax-exempt status is affected only if the commercial activity is "substantial," with the exception that if the activities are "in furtherance of an exempt purpose," they are excusable from taxation.[152] However, the issue is confused by the fact that the IRS sometimes applies the stricter commerciality doctrine's limit on commercial activity, which does not usually consider the charitable purposes for the commercial activity, and that neither courts nor the IRS have created a clear rule in addressing commercial activity of nonprofits.[153]

Unless its scope is expanded, the commerciality doctrine is unlikely to be applied to museum shops or profitable ventures, since such commercial activities, despite garnering attention as museums increase their focus on these enterprises as sources of revenue, are never the main purpose of museums.[154] Such activities do adhere to the Code's allowing nonprofits to earn revenue through commercial activity as long as the primary purpose of the organization is a charitable mission under section 501(c)(3).[155] Under the commerciality doctrine, museums accused of excessive commercial activity and competing with for-profits may fail the counterpart test, but will most likely pass the aggregation test because commercial activities further their main charitable purpose and do not exist as a separate goal or function on their own.[156] Therefore, while museums should pay attention to the method in which they conduct their profitable activities and should

151. *Id.* at 138–39.

152. Colombo, *supra* note 144, at 504.

153. *Id.* at 501–03.

154. *See* Kosaras, *supra* note 12, at 140 (suggesting that although museums may fail the counterpart test, the aggregation rule offers protection from the commerciality doctrine. Kosaras cautions that this view is narrow and that museums could fall within the commerciality doctrine if museum are considered to provide entertainment, in which case almost the entire operation of the museum may fail the counterpart test and would suggest museum purposes to be entertainment for the aggregation test). While this is one argument to suggest the commerciality doctrine can be expanded, it requires a very broad reading of the commerciality doctrine and is therefore unlikely to be applied based on the precedent.

155. David A. Brennan, *The Commerciality Doctrine as Applied to the Charitable Tax Exemption for Homes for the Aged: State and Local Perspectives*, 76 FORDHAM L. REV. 833, 847 (2007) (noting that under the commerciality doctrine "it is not necessary that an institution seeking tax-exempt charitable status be 'exclusively' charitable, only that it be 'primarily' so").

156. *But see* Kosaras, *supra* note 12, at 140 (suggesting that this is an overly narrow take).

be aware of the commerciality doctrine, the likelihood that they will be affected, based on the way it is currently applied, is remote.

## V. STATE AND LOCAL TAX EXEMPTION

State governments tend to apply similar tax principles to charitable organizations as those imposed by the federal government.[157] State law regarding nonprofits is not uniform, but generally allows for property tax exemption, as well as income tax exemption for museums.[158] On average, states lose about five percent of property tax revenue from tax-exempt nonprofits.[159] Since museums, especially superstar museums, tend to sit in large metropolises with high concentrations of nonprofits, the lost source of revenue from exempt organizations in these cities can be drastic.[160]

At the state level, tax exemption is not as settled as it is federally. Seventeen states mandate charitable exemption in their constitutions, while twenty-five states provide for charitable exemption constitutionally but do not require it, thereby leaving the specifics within the control of the legislature and courts.[161] Most states base tax exemption on charitable purposes similar to those required of section 501(c)(3) organizations at the federal level, and so museums are often exempt from state tax due to their educational missions.[162] To meet the requirements of property tax exemption, twenty-seven states require that an organization qualify under section 501(c)(3).[163] Many states then apply a narrower test to section 501(c)(3) organizations to establish that tax exemption is warranted.[164] Often a two-part test is used to exempt a nonprofit from property tax—first, that the organization be a nonprofit that does not benefit any shareholders,

157. *Id.* at 117.

158. *Id.* at 141; *see also* KENYON & LANGLEY, *supra* note 7, at 10 (noting that state property tax exemption for nonprofits is based on precedential case law that dates back to British common law, but that annual property tax exemption only became the accepted standard in the 1830s).

159. KENYON & LANGLEY, *supra* note 7, at 18.

160. *See id.* at 18, 23 (noting that a high density of nonprofits reduces tax revenue in big cities, considering that major revenue-producing hospitals and educational institutions, along with other nonprofits, including museums, may cause a city to forego a massive amount of tax dollars and suggesting that Boston loses over $340 million merely from universities and hospitals exemptions).

161. *See id.* at 11 (citing Louisiana and New York as states that mandate charitable exemption in their constitutions; and Florida, Texas, Massachusetts, California, and Pennsylvania as states that constitutionally provide for tax exemption but do not mandate it).

162. Kosaras, *supra* note 12, at 142.

163. KENYON & LANGLEY, *supra* note 7, at 11.

164. KENYON & LANGLEY, *supra* note 7, at 11.

and second, that "its assets must be irrevocably committed to serving charitable purposes."[165] Seventeen states leave the determination of qualification for property tax exemption to local municipalities.[166] Generally, the courts play a much larger role at the state level in interpreting tax exemption requirements.[167] Kosaras notes that "the statutory language for property tax exemption is sufficiently ambiguous concerning arts organizations that the courts have broad discretion in characterizing arts organizations as engaging in educational activities or merely providers of entertainment . . . "[168] Collectively, this means that a museum can be tax-exempt under section 501(c)(3), but not under state tax laws.[169]

At the state level, there are two major justifications for property tax exemption, according to the Lincoln Institute of Land Policy: (1) because nonprofits provide community benefits and their property is operated for the public, such property should not be taxed; and (2) since nonprofits benefit the public and relieve the government from the responsibility to

165. *Developments in the Law*, *supra* note 64, at 1619.

166. KENYON & LANGLEY, *supra* note 7, at 11; *Developments in the Law*, *supra* note 64, at 1620 (noting that state property tax exemption is interesting in that exemption is often granted at the state level, but the consequences of tax exemption (lost revenue) are felt more by local governments than by the state).

167. KENYON & LANGLEY, *supra* note 7, at 12; *see* Evelyn Brody, *All Charities are Property-Tax Exempt, But Some Charities are More Exempt Than Others*, 44 NEW ENG. L. REV. 621, 626 (2010) (noting that when state constitutions use limiting terms such as "institutions of purely public charity" in order to restrict tax exemption, courts are given more discretion in establishing the requirements for nonprofits to obtain tax exemption; Brody argues that this contributes to the lack of uniform state tax treatment of nonprofits); *see e.g.* Brody, *supra* note 167, at 627 (citing *Hosp. Utilization Project v. Pennsylvania*, 487 A.2d 1306 (Pa. 1985), as creating limits for exemption by establishing a five-part test that a nonprofit must meet in order to be tax-exempt); Kelly Kleiman, *Illinois and the Amazing Disappearing Property Tax Exemption*, SAMEFACTS.COM, Aug. 26, 2011, http://www.samefacts.com/2011/08/health-care/illinois-and-the-amazing-disappearing-property-tax-exemption/ (examining an Illinois Supreme Court ruling that stated that there are only three types of exempt organizations—religious institutions, schools, and charities—which led to three hospitals losing their tax-exempt status and has spurred challenges of other nonprofits).

168. Kosaras, *supra* note 12, at 143. Kosaras points to the strict application and understanding of "educational purpose" to pertain to only "the expansion of knowledge, by teaching, instruction or schooling" in New York in the 1970s, which excluded museums from tax exemption. *Id.* at 143 (quoting *Swedenborg Found., Inc. v. Lewisohn,* 351 N.E.2d 702, 706 (N.Y. 1976)).

169. KENYON & LANGLEY, *supra* note 7, at 11; *see e.g.* Cohen, *supra* note 14 (discussing Ohio's challenge to the state tax exemption of the Packard Museum, which is tax-exempt under section 501(c)(3)); Kleiman, *supra* note 167 (illustrating that the Illinois Supreme Court's ruling may block organizations' property tax exemption even if they are classified as nonprofits under section 501(c)(3)).

provide services, that justifies a subsidy in the form of property tax exemption.[170] This latter rationale is very similar to the subsidy theory of federal income tax exemption for nonprofits.[171] However, states rely on more than considerations of public support, and many take into account public access and general community benefit provided by the organization.[172] In application, Professor Evelyn Brody notes that states tend to place more importance on a quid pro quo justification for tax exemption as opposed to the federal rationale of subsidizing nonprofits because of their charitable nature.[173]

Since states are not uniform in their treatment of tax-exempt organizations, similarly structured museums can be taxed differently based on location; thus, museums have to be versed in different state requirements and restrictions.[174] Notably, some states do not allow exempt organizations to make a profit, even if such profits are used for charitable purposes.[175] This has a direct effect on superstar museums.

As more attention is paid to the commercial endeavors of nonprofits, some states have questioned whether all nonprofits deserve the same level of tax exemption.[176] Minnesota and Oregon, for example, are two states that have examined the amount of public support nonprofits are providing for free or at a discount to determine whether they deserve the subsidy of

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170. KENYON & LANGLEY, *supra* note 7, at 10 (pointing out that the second rationale is also termed the "quid pro quo theory" and that it has grown in popularity as states have used stricter classifications of charitable organizations for the purpose of property tax exemption and have relied on the quid pro quo theory to determine eligibility for property tax exemption).

171. Kosaras, *supra* note 12, at 144.

172. *Id.*; *see also id.* at 144, n. 160 (citing *Commonwealth v. Barnes Found.*, 159 A.2d 500, 506 (Pa. 1960) as illustrating the city of Philadelphia pushing for the Barnes Foundation to not qualify as a public charity for property tax exemption due to limited access for the public and the court stating that even a public library restricts access to the public and that is not enough to determine that the art gallery was not a public charity); *see also* KENYON & LANGLEY, *supra* note 7, at 12 ("[R]elief of a government burden is not normally interpreted narrowly to mean services that government actually provides, but rather, services that government views as beneficial.").

173. Brody, *supra*, note 167, at 622 (noting also that there are four basic considerations for state tax exemption: charitable purposes, court and constitution based tests, donations and government assistance, and the role of commercial activities).

174. *See* KENYON & LANGLEY, *supra* note 7, at 12 (noting that states vary in whether they allow tax-exempt organizations to charge admissions or fees, or make a profit even if to further the organization's charitable mission).

175. *See id.*

176. *See* Stephanie Strom, *Tax Exemptions of Charities Face New Challenges*, N.Y. TIMES, May 26, 2008, at A1 (citing Evelyn Brody as stating that there has been an increase in state challenges to property tax exemptions of nonprofits based on their merit for such subsidies).

property tax exemption.[177] This suggests that states are indeed moving toward a model in which tax exemption is based on a nonprofit's ability to measure and prove its economic benefit.[178] Quantifying how much is given to the public may be difficult for museums, due to the myriad of services museums provide directly and indirectly at subsidized or no cost.[179] Other states have considered changing tax laws, such as Louisiana, where the Mayor of New Orleans was pushing for constitutional amendments allowing the city to tax exempt property.[180] However, the Mayor decided not to pursue such amendments after the release of the New Orleans Nonprofit Property Tax Exemption Survey by the Louisiana Association of Nonprofit Organizations, which illustrated the need for property tax exemption and the harms of revoking the subsidy, citing the important role nonprofits play, the reasons that they should be tax-exempt, and the effect of reduced donations on nonprofits.[181] The state of Montana considered imposing a requirement that a nonprofit's property tax exemption be reviewed yearly by the Department of Revenue, but dropped the idea due to impracticability and cost.[182] Despite efforts to reform state tax exemption of nonprofits, nonprofits have successfully convinced many politicians of the necessity of such benefits, thereby staving off far-reaching changes to state tax law.[183] The frequency with which such issues are being raised, however, illustrates the shift in public perception toward the role nonprofits, including museums, play in their communities.

Many museums hold large property interests in the center of commercial hubs making property tax exemption a huge relief.[184] A 1997 study showed that museums on average saved sixteen percent a year from the property tax exemption.[185] For museums, regardless of size, the savings

177. *Id.*

178. Brody, *supra* note 167, at 622

179. *See* Maxwell L. Anderson, *METRICS OF SUCCESS IN ART MUSEUMS,* THE GETTY LEADERSHIP INSTITUTE (2004), *available at* http://www.cgu.edu/pdffiles/gli/metrics.pdf (noting that museums present a unique problem in that it is hard to quantify the success and benefits of operations and suggesting ways in which museums can measure the fulfillment of their purposes such as education).

180. National Counsel of Nonprofits, *Taxes, Fees, and PILOTs (Payment in Lieu of Taxes)* (2012), http://www.councilofnonprofits.org/public-policy/state-policy-issues/government-taxes-fees-and-pilots.

181. *Id.*

182. *Id.*

183. *See* Brody, *supra* note 167, at 623 (stating that nonprofits have largely been able to fend off challenges to their tax exemption and suggestions for state legal reform).

184. *See* KENYON & LANGLEY, *supra* note 7, at 17–18 (showing the savings of different types of nonprofits from property tax exemption and noting that nonprofits are often in cities).

185. *Id.* (noting that this includes museums with a full range of incomes and that the

of property tax dollars is vital for programming. Arguments against the property tax exemption suggest that rather than subsidizing those organizations that most benefit the community, the property tax exemption offers the largest subsidies to those organizations with the most expensive real estate, and the city is forced to bear the costs while the benefits are more widely spread.[186] While this may be partly true for superstar museums, it ignores the direct benefits on local municipalities created by these museums. For example, the total economic impact on the city of Philadelphia and surrounding areas from the Salvador Dali exhibit at the Philadelphia Museum of Art was measured at a surplus of $54.9 million.[187] In turn, this additional revenue generated $2.17 million in revenue for the city in the form of taxes.[188]

States often require that property be owned and operated for charitable purposes in order to qualify for tax exemption.[189] This can cause issues for museums operating profitable activities, such as parking lots.[190] States are split on their treatment of property not utilized solely for exempt or non-exempt purposes.[191] In some states, an organization may fully lose its tax-exempt status for commercial operations conducted on premises.[192] In

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median savings is four percent). Nonprofits earning over ten million dollars receive two-thirds of overall savings from property tax exemptions despite such organizations representing around four percent of nonprofits with property. *Id.* at 18. Superstar museums fall within this category of nonprofits generating over ten million dollars in income.

186. *Id.* at 18; *see also id.* at 11 (noting that local city governments bear the cost of nonprofits in their cities, but most nonprofits are appreciated and accessed by people from outside the city).

187. Urban Partners, *supra* note 126, at 103 (measuring the impact as $30.7 million directly and $24.2 million indirectly).

188. *Id.* at 103.

189. *See* Kosaras, *supra* note 12, at 145 (observing that there are three main categories of property exemption applied at the state level: "(1) statutes requiring that property must be used exclusively for the organization's charitable purposes; (2) statutes requiring the primary or dominant use of the property for the organization's charitable purposes; and (3) statues that allow partial use of the property for other than charitable purposes."); *see also* KENYON & LANGLEY, *supra* note 7, at 13 (noting that many federally exempt organizations do pay property taxes because the property they own that is not used for charitable purposes, is being held for later development or is being rented).

190. *Compare* KENYON & LANGLEY, *supra* note 7, at 13 (discussing how parking lots have become a source of litigation because their operation amounts to a commercial use of property without clear furtherance of an exempt purpose), *with Bowers v. Akron City Hosp.*, 243 N.E.2d 95, 97 (Ohio 1968) (stating that the profits from a parking lot associated with a school, hospital or museum do not preclude the parking lot from property tax exemption as long as the profits were used toward the expense of providing such a convenience to visitors and noting that what is important is the use of the property in question and not the fact that profits are made from the property).

191. KENYON & LANGLEY, *supra* note 7, at 13.

192. *Id.*; *see also* Joanne Huist Smith, *Packard Museum Fights for Tax Exemption*,

other states, property tax is calculated based on the fraction of the building employed for non-exempt functions.[193] Museums, especially superstar museums with sizeable or increasing commercial endeavors, may be affected by this issue.

Since state tax exemption as it relates to museums is often unstable and poorly defined, museums have reason to worry that fiscally struggling states in search of sources of revenue may review and challenge the tax exemption of profitable museums. The Packard Museum in Ohio has been so questioned.[194] The Packard Museum, a federally tax-exempt museum, has been challenged on its state tax exemption due to its profitable activities—specifically "income it earns from admission fees, the rental of the museum for private events, museum store sales, and the rental of vintage cars."[195] Ohio's concern relates back to its requirement that tax-exempt property be used for a proper charitable goal, and that tax-exempt property "not be used with a view to profit and cannot be in competition with other commercial enterprises."[196] Ohio's challenge of the tax status of the Packard Museum may imply that the state is more concerned with the economics of tax exemption rather than the rationales behind exemption, such as the provision of a benefit to the community, relieving the government of a burden, or the financial costs of operating a museum.

Realizing that state tax exemption is not as clear as federal tax exemption, and may often have stricter qualification requirements, museums need to be wary of state policies toward nonprofits.[197] To avoid

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DAYTON DAILY NEWS, http://www.daytondailynews.com/news/news/local/packard-museum-fights-for-tax-exemption-1/nPR8S/ (last updated June 10, 2012, 3:17 PM) (noting that the state of Ohio wants to revoke the Packard Museum's tax-exempt status due to the museum charging admissions, renting property for private uses, renting vintage cars, operating a gift store and holding a yearly sale of car-parts).

193. KENYON & LANGLEY, *supra* note 7, at 13; *see, e.g.*, *Property Tax Exemptions in Alaska*, STATE OF ALASKA (2003), *available at* http://www.commerce.state.ak.us/dca/logon/tax/tax-exemptions.htm (stating that if a portion of exempt property is used for a non-exempt purpose that part of the property that is used for the non-exempt purpose will be taxed).

194. *See* Cohen, *supra* note 14 (pointing to the implementation of PILOTs and state challenges to tax exemption as raising concerns for nonprofits, and specifically citing the current issues with the Packard Museum in Ohio).

195. *Id.* The author notes that there is a second issue at play with the Packard Museum in that the President and CEO of the museum was also the property owner when the museum first applied for tax exemption and the museum reports revenue in the millions of dollars but has low operating costs which are considered to be under $300,000, but that this issue should be considered distinct from non-profit tax exemption concerns.

196. Smith, *supra* note 192 (quoting Richard A. Levin, former tax commissioner, in the most recent rejection of tax-exempt status for the Packard Museum).

197. *But see* Brody, *supra* note 167, at 623 (noting that nonprofits have been able to rally together to lobby against challenges at local levels to tax exemption).

unnecessary scrutiny, museums must ensure compliance with state-specific laws and clearly communicate the economic and social benefits they provide to their state communities. Additionally, since profitable activities may lead states to question a museum's charitable status, even if the museum is federally tax-exempt, museums would be prudent not to generate revenues vastly larger than their operating costs, investment in collections, and public services.[198]

## VI. PAYMENT IN LIEU OF TAXES[199]

Many superstar museums, because of their property holdings and appearance of great wealth, are potentially affected by the growth of PILOTs. The recent development of PILOT programs has been attributed to a push to limit tax exemption and to expand revenue streams to the state or local government.[200] There is also a correlation between the growth of PILOTs and the increase in skepticism toward many nonprofits.[201] The expansion of the Boston PILOT program, currently the largest PILOT program, may foreshadow future changes in the nonprofit world, and may set a significant precedent for pressure on superstar museums to contribute

198. *See, e.g.*, COMMUNITY LEGAL RESOURCES, PROPERTY TAX EXEMPTION FOR AFFORDABLE HOUSING, LEGAL LINES: LEGAL ISSUES FOR NONPROFITS 3 (2005), http://www.clronline.org/resources/legal-lines/property/propertytax.pdf (noting that the Michigan Court of Appeals reversed the Michigan Tax Tribunal's rejection of tax exemption for the Kalamazoo Aviation History Museum with attention to the education the museum provides the public, concentrating on the fact that admission fees were low and revenue did not meet operating costs, and noting that admission fees were subsidized).

199. PILOTs are defined in the Lincoln Institute of Land Policy Report as "payments 'made voluntarily by tax-exempt nonprofits as a substitute for property taxes.'" KENYON & LANGLEY, *supra* note 7, at 4. There are at least four distinct types of PILOT programs. First, PILOTs from a larger government body (like the federal government) to a smaller government body (like a state) to reimburse for exempt property. An example of this might be a federal courthouse on city land. Second, PILOTs from a state to a city for a tax-exempt state-run program. This might be a state university. Third, government programs such as publicly owned utilities, housing authorities or airport commissions contribute PILOTs to municipalities from their profits. Finally, nonprofits that remain tax-exempt can make PILOTs to local municipalities for community services the nonprofit otherwise uses free of cost. The focus of this discussion is on the fourth category—PILOTs made by nonprofits to municipalities to contribute toward the cost of city provided services. Edward A. Zelinsky, *The Once and Future Property Tax: A Dialogue with my Younger Self*, 23 CARDOZO L. REV. 2199, 2215 (2002).

200. *See* KENYON & LANGLEY, *supra* note 7, at 7 ("Two major factors drive the high level of interest in PILOTs around the country: growing scrutiny of the nonprofit sector; and increasing pressure on municipalities to find new sources of revenue.").

201. *Id.*

tax-like payments at the local level.[202]

Cambridge, Massachusetts is the first known local government to apply PILOTs, dating the program back to 1929 when Harvard University started paying PILOTs to the city.[203] The use of PILOTs has increased steadily since then and various versions have been applied in at least 117 municipalities in 18 different states.[204] Boston currently runs the largest PILOT program in the country and generates the most revenue.[205]

While PILOT programs have existed for decades, they are receiving increased attention as cities are turning to nonprofits as fresh sources of revenue to meet increasing city budgets.[206] In a 1996 study of state and local tax treatment of charities, Janne Gallagher suggests that the following common municipal issues encourage cities to seek PILOTs:

- Cities that are in poor financial condition because industrial and residential flight reduced their tax base, while the population that remains is increasingly in need of expensive services.
- A high degree of fragmentation among local governments, with a consequent narrowing of any particular jurisdiction's tax base.
- Heavy reliance on the property tax to finance schools and local services.
- Voter resistance to tax increases, even when growth demands more spending, as with the growing number of school-age children.
- The virtual disappearance of federal aid to cities.
- Cuts in state aid to local governments.[207]

Gallagher also notes cities that have "downtown benefit districts," in which extra city services such as security or street cleaning are provided, often impose PILOTs on nonprofits.[208]

The Lincoln Institute of Land Policy report suggests that PILOTs

202. *See* National Counsel of Nonprofits, *supra* note 180 (noting that several cities are considering PILOTs, have requested certain nonprofits pay PILOTs, or are increasing requested PILOT payments. Examples include Hartford, Connecticut; Jamaica Plain, Massachusetts; and Providence, Rhode Island.).

203. Gallagher, *supra* note 9, at 85.

204. KENYON & LANGLEY, *supra* note 7, at 2.

205. *Id.*

206. *Id.* at 3.

207. Gallagher, *supra* note 9, at 73.

208. *Id.* at 88 (listing cities with such downtown business districts, including Wilmington, Delaware, and Baltimore, Maryland).

target faults in tax exemption policy.[209] PILOT programs account for the skewed application of the property tax exemption, which is to the advantage of nonprofits with expensive landholdings rather than those offering the most public benefit.[210] PILOTs also collect contributions that cover a nonprofit's share of municipal services in order to reduce the costs that the local community is forced to bear while a much larger population uses the nonprofit's services.[211] This is often true with superstar museums, which serve a broader community and thus allow out-of-town visitors access and benefits without their sharing in the cost of subsidizing city services. Museums are generally exempt from property taxes due to the benefits and services they provide the state or city thereby releasing the government of certain responsibilities.[212] However, in cities where nonprofits, such as superstar museums, have vast land wealth, local governments may push for PILOTs because they view certain nonprofits as taking more from the community in terms of local services than they provide the locality.[213]

PILOT agreements tend to be negotiated when land is acquired by a nonprofit or tax exemption is requested.[214] PILOTs may range from the more formal and uniform programs, such as the program currently implemented by Boston, to case-by-case arrangements, as in most other cities.[215] Calculations and suggested payment amounts tend to vary widely, making them difficult to predict and uneven in application.[216] Some scholars consider PILOTs a "middle-ground" because the programs allow nonprofits to remain property tax-exempt, while creating agreements whereby cities receive some of the funds they require to provide municipal services to nonprofits.[217]

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209. KENYON & LANGLEY, *supra* note 7, at 2.

210. *Id.*

211. *Id.* ("[N]onprofits impose a cost on municipalities by consuming public services, such as police protection and roads.").

212. Kosaras, *supra* note 12, at 142.

213. Marsha S. Shaines, *Legal Issues in Museum Administration, Tax Update*, ST024 ALI-ABA 213, 219 (2012).

214. KENYON & LANGLEY, *supra* note 7, at 22 (noting that PILOT negotiations are more likely to occur when expansion of a nonprofit includes previously-taxed land).

215. *Id.* at 6.

216. *Id.* at 39 (referencing different types of calculations: Some are based on a percentage of what the property tax would be, some are calculated using a measure of the size of the property, some are figured based on economic services provided by the nonprofit, and others are just ad hoc with no clear logic).

217. *Id.* at 9. The Lincoln Institute of Land Policy also notes that there are alternatives to PILOTs that can address the mismatch between funding and benefiting from nonprofit services, such as state governments providing grants to local governments that have a lot of their property held by tax-exempt nonprofits. *Id.* at 26.

PILOTs are not legally mandated payments.[218] They are technically voluntary gentleman's agreements, making the negotiations between cities and individual nonprofits important to the successful implementation of PILOT programs.[219] Cities implementing PILOTs appear to honor and promote the rationales for museum tax exemption—relief of the government burden of educating the public and the provision of community benefits—by insisting that PILOTs are completely distinct from a museum's tax-exempt status.[220] By exempting nonprofits from property taxes, states and cities are accepting that nonprofits do not have to contribute toward city services that are largely supported by property tax revenue.[221] It appears, however, that cities supporting many large nonprofits use PILOTs to reduce the economic assistance they provide to nonprofits, essentially circumventing nonprofit tax exemption.

The fact that PILOTs are not enforceable by law distinguishes them from compulsory taxes.[222] PILOTs are considered "nominally voluntary outlays by the exempt institution, [but] the political reality is usually more complex as the municipality brandishes any number of potential sanctions to induce the PILOT payment."[223] Some cities go so far as to threaten to revoke nonprofit status for those refusing to negotiate PILOTs.[224] Even if a city does not obviously threaten a nonprofit when requesting a PILOT, refusing PILOTs after a city's request can create negative consequences and sour the relationship between the nonprofit and the city.[225] Due to the

218. *Id.* at 6.

219. *Id.* at 6.

220. *See* Gallagher, *supra* note 9, at 90 (advising cities planning on instituting PILOTs that they should avoid any language related to tax exemption).

221. *See* Laurence S. Seidman, PUBLIC FINANCE 252 (2008) (stating that as of 2006, on average twenty-one percent of state and local revenue is raised by property tax, and that the majority of local governments rely on property taxes for more than half their tax revenue).

222. KENYON & LANGLEY, *supra* note 7, at 43.

223. Zelinsky, *supra* note 199, at 2215–16 ("These sanctions range from the municipality marshaling public opinion against the exempt entity if it declines to make PILOT payments to the denial of zoning relief or building permits desired by the tax-exempt entity to, in the extreme case, the municipality's threat to seek political or judicial revocation of the entity's tax exempt status.").

224. *Developments in the Law*, *supra* note 64, at 1625 (noting that revocation of tax exemption by cities has usually been upheld for hospitals, as well as fitness centers run by the YMCA). In the past, cities have revoked tax exemption, but courts usually overturn such city action; however, in unique circumstances where a clear lack of charitable purpose exists, courts have affirmed city revocation of property tax exemption. *See id. Cf.* KENYON & LANGLEY, *supra* note 7, at 24 (citing The MacDowell Colony in Peterborough, New Hampshire as an example of a city attempting to revoke tax exemption but being overturned by the state on the grounds that the organization provided community benefits worthy of tax exemption).

225. Shaines, *supra* note 213, at 219 (suggesting that nonprofits feel pressure to

power of city agencies over zoning, building permits, and local services, municipalities can create obstacles for nonprofits that refuse to negotiate favorable PILOTs.[226] For this reason, PILOTs tend not to be entirely voluntary, and under some definitions may come very close to the nature of a tax.[227]

The amount of revenue PILOTs create for most cities is minimal.[228] Theoretically, both the city and its nonprofits further community welfare, which suggests that PILOTs merely reallocate resources from certain types of community benefits to others.[229] This raises the question of whether such programs are ideal, considering the benefits nonprofits, like museums, provide for cities, and whether in the future cities are likely to approach museums for PILOTs.

### *A. PILOTs in Boston*

Boston operates the most formal and highest revenue-producing PILOT program in the country.[230] In 2009, Boston's Mayor Menino initiated a PILOT Task Force to analyze the program and suggest

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contribute); *see, e.g.*, KENYON & LANGLEY, *supra* note 7, at 24 (discussing a case in which the MacDowell Colony was asked to pay a PILOT to account for issues with the Colony's tax exempt-status, and which the MacDowell Colony refused to pay, thus resulting in the town denying the organization its previous tax-exempt status).

226. KENYON & LANGLEY, *supra* note 7, at 6; *see also* Zelinsky, *supra* note 199, at 2216 ("In practice, it is typically in everyone's interest to compromise on a 'voluntary' PILOT payment which is often less than the full taxes that would be paid on loss of exempt status, but which, from the municipality's perspective, provides immediate financial succor.").

227. *See* BLACK'S LAW DICTIONARY 1496 (Bryan A. Garner, 8th ed. 1999) ("'Taxes are the enforced proportional contributions from persons and property, levied by the state by virtue of its sovereignty for the support of government and for all public needs.' This definition of taxes, often referred to as 'Cooley's definition,' has been quoted and indorsed, or approved, expressly or otherwise, by many different courts. While this definition of taxes characterizes them as 'contributions,' other definitions refer to them as 'imposts,' 'duty or impost,' 'charges,' 'burdens,' or 'exactions'; but these variations in phraseology are of no practical importance." (quoting 1 THOMAS M. COOLEY, THE LAW OF TAXATION 61–63 (Clark A. Nichols ed., 4th ed. 1924))).

228. *See* KENYON & LANGLEY, *supra* note 7, at 33 (noting that revenue from PILOTs represent a miniscule portion of city budgets and that based on a 1990's study PILOT revenue constituted only .15% of Baltimore's budget, .54% of Philadelphia's and 1.37% of Boston's).

229. *See* NSFRE, *supra* note 82, at 1 ("The theory behind income tax exemption for section 501(c)(3) organizations is that they are providing needed community services ('public good'), and to extract payments for taxes from these organizations would decrease the amount of service or 'public good' these organizations could provide.").

230. KENYON & LANGLEY, *supra* note 7, at 21 (citing statistics that in 2009 Boston received $15.7 million in PILOTs).

changes.[231] In 2010, the Task Force provided suggestions, which included making the program more consistent by equalizing PILOTs through a uniform method for calculating contributions and broadening the range of nonprofits contributing by including nonprofits previously not asked to participate.[232] Boston has subsequently increased its suggested payment amounts and has widened its scope, partly by including museums that previously did not contribute (original payments were largely from educational and medical institutions).[233]

The Task Force suggestions led Mayor Menino to amend the city's PILOT program.[234] Boston now requests contributions of nonprofits with property holdings over $15 million, and calculates the payment as twenty-five percent of what the property tax would be.[235] By exempting $15 million of property value, the program focuses on larger nonprofits.[236] Discount credits of up to fifty percent were recommended, but they correlate with the level of benefit the organization is perceived to directly provide city residents.[237] Mayor Menino has defended the program's inclusion of museums and maintains that the program is not equivalent to a tax and rather is a request to "increase the 'voluntary' contributions cultural institutions make through" PILOTs.[238] However, the fact that the payments are considered 'in lieu of taxes,' have a formalized and defined method of assessment, and are calculated based on what would be the nonprofit's property tax if it were not tax-exempt suggests a strong link between PILOTs and taxes. While PILOTs do provide much needed funding to Boston, the revenue they brought in during 2010 accounted for only around one percent of the city budget.[239]

The Boston Museum of Fine Arts ("MFA"), arguably a superstar

231. KENYON & LANGLEY, *supra* note 7, at 22.

232. *Id.* at 22–24 (illustrating that the previous program was quite random, an example being that Harvard University paid a PILOT of close to two million dollars while Boston College gave a payment close to three hundred thousand dollars).

233. *See id.* at 23 (stating that Boston has pursued museums in its recent requests for PILOTs); *Pilot Task Force*, CITY OF BOSTON (2009), *available at* http://www.cityofboston.gov/assessing/pilot.asp (stating that most of Boston's tax-exempt educational and medical organizations contributed PILOTs pre-2009).

234. *Pilot Task Force, supra* note 233.

235. KENYON & LANGLEY, *supra* note 7, at 29, 38; *see also* Shaines, *supra* note 213, at 219 (noting that Boston's revised program will be implemented over five years).

236. KENYON & LANGLEY, *supra* note 7, at 38; Shaines, *supra* note 213, at 219.

237. KENYON & LANGLEY, *supra* note 7, at 41; *see also* Cooke, *supra* note 6, at 13 (stating that such discount credits will be offered to organizations that positively impact Boston residents and not those that indirectly benefit the city through tourism).

238. Malcolm Rogers, *Don't Kill the Goose*, ART NEWSPAPER (Jan. 2012), at 214.

239. KENYON & LANGLEY, *supra* note 7, at 22; Rogers, *supra* note 238 (pointing out that this small amount of the annual budget did fully cover snow removal costs for the year).

museum, had been making payments since 1988, but started to push back due to the suggested increase in voluntary contribution.[240] The MFA made a PILOT of $55,000 to the city in 2010/2011, but in 2012, the city requested an increased payment of $250,000, increasing to $1,025,000 by 2016.[241] Likewise, the Institute of Contemporary Arts was asked to pay $17,000 in PILOTs in 2012, but was informed that the fee would increase to $86,000 by 2016.[242] Museums have voiced frustration about being excluded from Task Force discussions regarding PILOT amendments due to the considerable effect the amendments have on cultural institutions.[243] In Boston, disgruntled museums have argued that as nonprofit entities that generate social services and income for the city, "there should be investment in the arts, not taxation."[244]

Though the requested $250,000 contribution is only a small percentage of the MFA's total revenue, it is money that is likely to be diverted from programming, salaries, or growth.[245] Furthermore, there is a fear that the increased PILOT payments will harm donations, as philanthropists may be deterred from donating if they believe their money is used for PILOTs and city services rather than directly supporting the museum.[246] The city, in its quest to tap all sources of revenue, may overlook the fact that the current economic environment negatively impacts museums as well as municipalities, and, by further squeezing museum budgets, the city indirectly may reduce museum services and jobs for Boston residents.[247] If museums were to reallocate funds toward the payment of PILOTs, other museum spending would need to be cut,

240. Rogers, *supra* note 238

241. *Id.*

242. Cooke, *supra* note 6, at 13.

243. *Id.* (highlighting that since PILOTs are technically voluntary payments negotiations are critical to their success).

244. *Id.* (citing the director of the MFA).

245. *See* Eric Weinberger, *What the MFA Owes Boston, Why the MFA's Director Should Stop Complaining About the City Looking for Money and Start Opening up His Wallet,* THE BOSTON GLOBE, Feb. 19, 2012, http://www.bostonglobe.com/magazine/2012/02/19/what-mfa-owes-boston/fEpIUXJLl03YJCr1rXDweI/story.html (citing the MFA director's speculations over how the $250,000 would cost the museum employees and programming).

246. *See* Rogers, *supra* note 238 (noting that the MFA is a fiduciary of the public trust, as are many museums, and that donations therefore are made with the intent that they provide for a certain benefit); NSFRE, *supra* note 82, at 2 (citing the NSFRE's worry that philanthropists will change their donating patterns if they realize that their funds are going toward PILOTs).

247. *See, e.g.*, Weinberger, *supra*, note 245 (noting that the MFA believes that having to pay increased PILOTs will have a negative effect on other services that the museum provides); NSFRE, *supra* note 82, at 2 (noting that PILOTs may cause nonprofits to raise their prices for services or reduce services provided).

admissions fees would need to be raised, or more attention would need to be given the more commercial aspects of museum operations.[248] Malcolm Rogers, director of the MFA, stated "the PILOT scheme will simply mean cuts in [the museum's] outreach programs and a reduction in jobs."[249]

There is a concern that if the Boston program is successful in implementing this broad and formal expansion of PILOTs, many other large municipalities will follow suit.[250] Museums are closely monitoring the situation in Boston, and there is hope that Boston museums will negotiate a more favorable PILOT agreement with the city.[251]

### B. *Will Many Museums be Affected by Future Implementation of PILOTs?*

Nationwide nonprofits are concerned with the possible spread of PILOTs. This makes sense—cities are not transparent in their application of PILOT programs and PILOTs are not uniform since they tend to extract different contributions from like institutions.[252] However, the growth of Boston's PILOT program is not necessarily indicative of growth in other cities, given that Boston is in a unique position that encourages PILOTs due to its high concentration of high revenue-producing nonprofits that own property.[253] Although there is evidence that cities are increasingly starting to explore the idea of PILOTs, cities may be unlikely to ask museums for PILOTs, since museums are not the traditional PILOT targets. Additionally, as noted, PILOT revenue covers a small percentage of city expenditures; the effort and resources needed in negotiating PILOTs may not be worth the PILOT revenue gained from most museums, which, if not tax-exempt, would be subject to low property taxes (recalling that the average savings for a museum from property tax exemption is $133,682

248. NSFRE, *supra* note 82, at 2.

249. Weinberger, *supra* note 245.

250. *See* Cooke, *supra* note 6 (citing a Boston City Council election candidate's suggestion that if Boston is successful with PILOTs other cities are likely to consider PILOTs as an option as well).

251. *Id.* At the time this Comment was written, both the Institute of Contemporary Art and the MFA are in discussions with the city regarding their PILOT fees, and there is feeling that as a unified coalition more would be gained.

252. EVELYN BRODY ET AL., INSTITUTE ON NONPROFITS & PHILANTHROPY (Aug. 2012), http://www.taxpolicycenter.org/UploadedPDF/412640-The-Charitable-Property-Tax-Exemption-and-PILOTs.pdf; KENYON & LANGLEY, *supra* note 7, at 3.

253. KENYON & LANGLEY, *supra* note 7, at 21–22 (noting that if taxed, universities and hospitals alone would provide 24.6% of city property tax).

and the median savings is $20,181).[254] However, that does not mean that museums will not be considered in expansions of existing PILOT programs that are attempting to raise more revenue or equalize the use of PILOTs across nonprofits.

Since Boston's PILOT program expansion made headlines, other cities have considered similar strategies to raise revenue. Philadelphia, where PILOTs have been implemented for years but which has lost much of its contributions, has refocused on its PILOT program.[255] In Connecticut, the city of Hartford has asked larger nonprofits to pay PILOTs, and the city of New London requested increased payments from hospitals and universities already paying PILOTs.[256] In Massachusetts, the city of Belmont has requested PILOTs amounting to $530,000 of revenue.[257] In New Jersey, several cities are organizing committees to consider implementing PILOTs.[258]

In deciding whether to organize a PILOT program there are several issues for municipalities to consider. PILOTs tend to be unsystematic and lack consistent application.[259] When implementing a PILOT program, a city has to decide whether to have an extensive program like Boston's, or to approach PILOTs on a case-by-case basis.[260] Since nonprofits have no legal obligation to contribute, it is important for municipalities to negotiate with the nonprofits rather than simply impose payments.[261] Negotiations require investment of time and effort, yet funds raised from PILOTs compose only a small fraction of city revenue, raising questions of administrative efficiency.[262] PILOTs may not be worth the cost of implementation in most cities. If PILOTs are applied, they may make sense only for nonprofits that own large, expensive, and currently untaxed real estate, as is the case in the Boston program.[263] Most cities support few,

254. *Id.* at 17.

255. *How Philly Works: An Answer to Increased City Revenue?* COMMITTEE OF SEVENTY, http://www.seventy.org/OurViews_How_Philly_Works_An_Answer_to_City_Revenue.aspx (last visited Apr. 8, 2013).

256. National Counsel of Nonprofits, *supra* note 180.

257. *Id.*

258. *Id.*

259. KENYON & LANGLEY, *supra* note 7, at 3; *see also* National Counsel of Nonprofits, *supra* note 180 (detailing differences in state taxes, fees, and PILOTs).

260. KENYON & LANGLEY, *supra* note 7, at 38.

261. *Id.* at 3 (noting that individual negotiations are ideal when there are few nonprofits worth asking for PILOTs, and a more uniform program is best in cities with more nonprofits).

262. *Id.* at 22 (citing that Baltimore receives 0.33% of its budget from PILOTs, Boston receives 0.66%, Detroit receives 0.17%, Pittsburgh receives 0.89%, Providence receives 0.56% and New Haven is at the high end receiving 1.16% of its revenue from PILOTs).

263. *Id.* at 22.

if any, such nonprofits, and museums make up a small portion of the nonprofits that fall within this category.

The success of PILOTs in Boston is based largely on the fact that Boston supports many nonprofits, particularly large educational, medical, and cultural institutions with expansive tax-exempt property.[264] PILOTs are found most beneficial to cities that rely on revenue from property taxation and also have a large portion of their property wrapped up in nonprofit activities.[265]

Additionally, hospitals and educational institutions are more likely to be targets of PILOT programs than museums.[266] These types of organizations have traditionally paid the bulk of PILOT revenue, and will most likely be the organizations further impacted as PILOTs expand nationwide.[267] Hospitals represent a much larger portion of section 501(c)(3) revenues, as 40.2% of nonprofit revenues are from hospitals, and only 2.1% are related to the arts, culture or humanities.[268] Hospitals and higher education institutions also own over 40% of nonprofit assets, compared to museums, which, along with other cultural and humanities-oriented nonprofits, own only 3.1% of nonprofit assets.[269] In cities considering implementing or expanding PILOTs, museums are less likely to be approached for initial PILOT requests than hospitals and universities mainly because museums represent a smaller portion of landowning nonprofits.[270] Only 44% of museums own real estate, compared to 62% of

264. PILOT TASK FORCE REPORT, MAYOR'S PILOT TASK FORCE: FINAL REPORT & RECOMMENDATIONS 6 (2010), *available at* http://www.cityofboston.gov/Images_Documents/PILOT_%20Task%20Force%20Final%20Report_WEB%20_tcm3-21904.pdf.

265. KENYON & LANGLEY, *supra* note 7, at 3; *see also Pilot Task Force*, *supra* note 233 (noting that property tax revenue makes up sixty-four percent of Boston's budget); Daphne A. KENYON & ADAM H. LANGLEY, THE PROPERTY TAX EXEMPTION FOR NONPROFITS AND REVENUE IMPLICATIONS FOR CITIES 4 (2011), http://www.taxpolicycenter.org/UploadedPDF/412460-Property-Tax-Exemption-Nonprofits.pdf (noting that a study has estimated the amount of land cities have wrapped up in property owned by tax-exempt nonprofits and has stated that the following cities have the highest percentage of tax-exempt property: Philadelphia, Boston, Baltimore, New York City, Denver, Columbus, Portland, Fort Worth, Charlotte, San Francisco, Seattle, Jacksonville, Washington, D.C., San Jose, Houston, Dallas, Los Angeles, San Diego, Phoenix, Nashville, Tucson, El Paso, and Memphis).

266. *See* BRODY ET AL., *supra* note 252, at 4 (explaining that nonprofit hospitals and universities are the most at risk for expanding PILOT programs, and have been the most often targeted for PILOTs, largely because of their vast real estate holdings).

267. *Id.* Nonprofit hospitals are seen as particularly uncharitable due to their close ties to for-profit institutions like insurance companies and pharmacies. *Id.* at 4. They also suffer a perceived likeness to for-profit hospitals. *Id.* at 4.

268. KENYON & LANGLEY, *supra* note 7, at 5.

269. *Id.*

270. *Id.*

higher education institutions and 70% of hospitals.[271] Additionally, the estimated foregone property tax revenue from the average museum is only $133,682, which is low when compared to $1,736,467 for hospitals and $1,477,483 for higher education organizations.[272]

Cities considering PILOTs for museums must acknowledge the negative impact increased PILOTs would have on the community. In order to pay city PILOTs, museums would likely have to reduce public services and programming, raise admission fees, or decrease local employment, as the MFA is now considering.[273] Cities considering PILOTs would also be faced with strong resistance from museums that provide measurable and positive economic impacts on the cities.[274] If a museum can quantify its economic benefits and illustrate why it should not have to contribute toward municipal services, it may have a better chance at resisting PILOT requests.

Cities are increasing their search for untapped sources of revenue, and PILOTs are a way to do so without agitating too many voters.[275] Although museums are unlikely to be approached in a city's first round of PILOTs, they should prepare themselves for related pressure and scrutiny.[276] If Boston successfully raises funds from its reformed PILOT program, many more cities are likely to explore PILOTs, and the museums most likely to be pushed into negotiations are superstars with land wealth as well as commercial activity.[277] As noted by Professor Brody, cities are asking for

271. *Id.* at 17.

272. *Id.* Note that the median museum's tax savings from property tax exemption is $20,181, and that a few wealthy organizations are able to largely impact the average, suggesting that perhaps those few museums (the superstars) may be individually targeted for PILOTs.

273. *See* Weinberger, *supra* note 245.

274. *See, e.g.*, Cooke, *supra* note 6 (discussing the MFA and Institute of Contemporary Art as pushing back slightly and requesting further discussions regarding PILOTs before paying the suggested amounts).

275. *See* KENYON & LANGLEY, *supra* note 7, at 3 (noting that PILOTs are best for cities in which city residents end up supporting nonprofits). It can be assumed that a straight tax increase to cover growing city operating budgets would not be considered favorable to local taxpayers. Cooke, *supra* note 6, at 13.

276. *See* KENYON & LANGLEY, *supra* note 7, at 9 ("[C]ity fiscal conditions typically lag behind economic conditions by about two years, many municipal officials expect budget shortfalls to worsen through 2012."); *see also id.* at 7 (noting that PILOTs are related to the pressure on nonprofits and the effort of cities to find ways to meet their budgets). While the economy remains unstable, cities are likely to continue to search for new revenue streams, which implies that nonprofits are likely to be pressured to prove their deservedness of tax exemption.

277. *See,* Cooke, *supra* note 6 (citing a local politician as speculating that PILOTs will be mimicked by other cities if Boston is successful with the program); *see also* KENYON & LANGLEY, *supra* note 7 (noting how wealthy land owning museums pull up the average of

proof of community benefit in return for tax exemption, and are supporting property tax exemption on a quid pro quo rationale.[278] Thus, museums should preemptively prepare for PILOT negotiations by compiling measurements of community impact and pushing for clear and specific formulas to calculate PILOT fees.[279] Museums should also highlight the benefits they provide such as: the indirect positive effects on the tourism industry, the public nature of museums, the protection and preservation of historical and cultural pieces, and most importantly, the provision of education and learning. For museums, cities may be convinced of their positive economic and educational impact and consider it unnecessary to appropriate funds that would otherwise benefit the community through reinvestment in the museum.

## CONCLUSION

Museums are increasing their focus on profit-making activities and have begun to operate as commercially savvy institutions. However, their often large untaxed revenue streams and property wealth make superstar museums easy targets for changes in tax exemption at the state level and requests for PILOTs at the local level. Federal tax exemption rests on strong policy motivations to provide support for the arts as is the norm in developed nations. At the state level, tax exemption is less of a rule, so is more easily manipulated by public sentiment and economic stress. Thus, museums should be prepared for challenges to their commercial activities and calls for state legislative action on nonprofit tax laws. The growing popularity of PILOTs at the local level also suggests that public perception of nonprofits is changing.

Museums are increasingly criticized for their commercially-oriented governances. To avoid tax policy changes at the local level, and challenges to federal and state tax exemption, museums face the burden of shifting public perceptions of the benefits they provide to society. In order to weather the storm of criticism regarding profit-seeking activities, museums must do more than enlighten the public on culture, art, science, and history. Museums must also educate and remind visitors, their communities, and the nation at large, of the critical role they serve the general public as educators and custodians of our past, present, and future.

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tax savings for museums considering the average savings is $133,682 while the median savings is $20,181).

278. Brody, *supra* note 167, at 4.

279. *See* Anderson, *supra* note 179 (illustrating ways in which museums can measure success and impact).