

## The Unrelated Business Income Tax: All Bark and No Bite?

Evelyn Brody and Joseph Cordes\*

Nonprofit organizations engage in a range of income-producing activities: Universities charge tuition, hospitals collect fees, and social-service organizations enter into government contracts. To the extent that an activity is “substantially related” to the organization’s tax-exempt purpose, the income is tax-free (and the associated expenses are, essentially, not deductible). By contrast, net income from “unrelated business activities” is subject to the Unrelated Business Income Tax (UBIT), which generally taxes such income at ordinary corporate (or trust) tax rates. Congress, however, has exempted dividends, interest, rents, and royalties from the UBIT.

The UBIT has spurred much debate among policymakers, nonprofit organizations, and private businesses. Policymakers both inside and outside the nonprofit community are concerned that tax-exemption encourages nonprofits to become more commercial than is desirable. People in the nonprofit sector worry about potential conflicts between their primary mission and their need to rely more heavily on commercial sources of income. Those who compete with nonprofits are concerned about unfair competition. Government policymakers and regulators worry about blurring the boundaries between (tax-favored) nonprofits and traditional businesses.

In November 1999, the Urban Institute’s Center on Nonprofits and Philanthropy and Harvard University’s Hauser Center for Nonprofit Organizations convened the second Seminar on Emerging Issues in Philanthropy. The day-long roundtable brought together researchers, government officials, and nonprofit execu-

tives and advisors to discuss the rationale for the UBIT, its influence on nonprofit behavior, and alternatives to the “related” versus “unrelated” business tax structure.

### Rationale for the UBIT

Before 1950, the tax system followed a “destination of income test” under which income, whatever the source, could be earned tax-free if profits were dedicated to a charitable purpose. The Treasury Department regulations state that the UBIT was adopted “to eliminate a source of unfair competition” between taxpaying entities and exempt organizations engaged in money-making activities. Today, most courts do not require the identification of a specific injured competitor; they are satisfied simply to find an unrelated activity conducted in a commercial manner for the production of profit (Brody 1998).

The 1950 tax writers also expressed revenue concerns—specifically, preservation of the corporate income-tax base (Hansmann 1989). One congressman, referring to the infamous ownership of Mueller Macaroni by New York University Law School, complained that without reform, “[e]ventually all the noodles produced in this country will be produced by corporations held or created by universities . . . and there will be no revenue to the Federal Treasury from this industry.”

### A Difficult Balance

In recent years, charities have found themselves caught in a balancing act between increasing their unrelated business activities

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while broadening what they consider to be a related activity. When federal grants declined in the 1980s, charities felt they needed to find more creative ways to raise revenue. Often, this meant selling goods or services to the public in areas related only tangentially to the organization's original purpose. Moreover, the increase in the corporate tax burden in the Tax Reform Act of 1986 increased the relative value of the nonprofit tax exemption, but only for "related" activities (Cordes and Weisbrod 1998). Thus, charities increasingly pushed the envelope when defining which activities were "related" to their tax-exempt purpose.

These new activities, in turn, attracted the attention of businesses complaining of "unfair competition" and, finally, of a "tax-hungry Congress." At intensive hearings in 1987 and 1988, witnesses debated issues ranging from whether existing rules are fully enforced to whether the "relatedness" test should be replaced with a "commerciality" test. In the end, though, the small business lobby proved no match for the charity lobby and the law remained unchanged (Spitzer 1989; Brody 1998). However, the debate stimulated public awareness of existing rules and UBIT collections subsequently skyrocketed, although the ratio of tax dollars paid to the total revenue of the sector is still small.

More recently, charities have expanded their use of statutorily-exempted income streams, particularly royalties. Special issues arise in transactions with for-profit affiliates; most recently, some nonprofit hospitals are testing their very entitlement to exemption by engaging in "whole hospital" joint ventures with unrelated taxpaying partners.

## Does UBIT Create Unfair Competition?

Although many in the business community feel the UBIT gives nonprofits

an unfair advantage when they venture into money-making activities, analyses reveal flaws in this rationale (Steuerle 1988). An income-tax exemption is not an input subsidy; it does not reduce the charity's cost of purchasing goods. Viewed this way, the zero rate for charity is no more "unfair" to a 35-percent-taxed competitor than are the progressive income-tax rates on individuals who conduct business activities in a sole proprietorship or through a partnership, limited liability company, or S corporation. Nor is a nonprofit organization likely to underprice its for-profit competitor (the "unfair" part of the competition), just as it would not accept a lower return on an (untaxed) passive investment (Weisbrod 1988). Thus, the UBIT may be necessary to provide a one-level-of-tax result regardless of whether a charity conducts an unrelated business directly or invests in the stock of a taxable corporation (Hansmann 1989).

Purely as matters of comparative advantage and economies of scale and scope, the types of unrelated business most attractive to an exempt organization will be ones that make use of the organization's exempt-purpose assets, including labor (Cordes and Weisbrod 1998). This type of unrelated business activity accordingly can be economically efficient. To minimize its tax, however, the organization will seek to allocate as much as possible of the costs of such "dual-use" assets to the unrelated activity.

## Are Unrelated Business Activities Unprofitable?

If the data are to be believed, charities' unrelated business activities are not very profitable. In fact, the sector as a whole is running at a loss. Total UBIT paid by all exempt organizations—not just charities—came to \$56.0 million in 1986, \$132.0 million in 1992, \$181.0 million in 1993, and \$191.5 million in 1994 (Riley 1997,

1998). Payments as a result of UBIT surged in 1995 to \$277.5 million, although less than one-fourth of this came from section 501(c)(3) organizations, or charities (Riley 1997). Fewer than 10,000 charities (just under 6 percent) report enough unrelated business income to make them subject to the UBIT. The average UBIT return filed by charities is less than \$400,000; after deductions are taken, only 3,187 actually paid a total of \$59 million in tax, or less than \$20,000 per return. The \$3.6 billion in gross unrelated business income in 1995 represented only one-half of one percent of the \$663.4 billion in total revenue of all section 501(c) organizations (other than private foundations, small charities, and most churches) (Hilgert and Whitten 1998-99).

However, the appearance of unprofitability may be deceptive. Because of self-reporting and the improbability of an IRS audit, a nonprofit organization may underreport unrelated business activities or make them appear less profitable than they actually are (Hines 1998).

## Is Reform a Possibility?

UBIT may be difficult to reform. The line between "related" and "unrelated" activities can be blurry, as can the line between nontaxable corporate sponsorship and taxable advertising, or nontaxable royalties or rent and taxable services. The panel also considered transactions between exempt organizations and their affiliates and criticized the rules that automatically tax interest, rents, and royalties received from controlled subsidiaries. The panelists and conference participants concluded that the UBIT has, in effect, become a voluntary tax and has served, at most, as an "intermediate sanction" short of the loss of tax exemption for charities earning "too much" commercial income.

While major reforms are typically considered unviable, some policymakers suggest improvements such as increasing the \$1,000 standard deduction, changing the allocation rules, modifying the definition of excludable royalties, and clarifying when a business is “regularly carried on” (particularly for Web-based commerce). At the other extreme, policymakers might redirect the rationale from eliminating unfair competition back to a destination-of-income regime, and repeal the UBIT. A less radical measure would repeal just the provisions taxing income from debt-financed income. Finally, some policymakers suggest a neutral policy toward joint ventures between taxable and tax-exempt partners.

However, larger reform could produce efficiency gains. In practice, UBIT generally fails to deter economically inefficient investments by exempt organizations (Sansing 1998). If the unrelated business results in nondeductible lost opportunity costs—such as decreased donations because of donors’ distaste for excessive commercialism—then the UBIT could inefficiently deter activity. Much of the debate during the late 1980s concerned the nature of the exemption itself. For example, the proposed price limits for UBIT-free sales by museum gift shops indicated that Congress wanted to limit goods sold for profit by an exempt cultural and educational institution (Aprill 1989).

At the same time, most of the recent legislative changes to the UBIT have been charity-favorable. A reasonable inference is that the appearance of a check on unrelated business activity offered by the current system has at least symbolic value to policymakers.

## Policy Questions about UBIT’s Future Role

Both the IRS and nonprofit organizations currently devote resources to a regime that produces comparatively little tax. Does the UBIT nevertheless serve a useful function? If the UBIT cannot be reformed, should it be repealed? If so, what effect would exemption for charities’ unrelated business income have on the corporate tax base – and, indeed, on other tax regimes for charity (Brody 1999)? Would we see a complete blurring of exempt and unrelated commercial activities by nonprofit organizations? Or would a distinction continue to be policed by the rules on deductible charitable contributions?

The group agreed that answering these broad questions requires a deeper understanding of the underlying motivations of nonprofits when they pursue income that is unrelated to their primary purpose. For example, does the organizational culture of nonprofits create an aversion to pursuing unrelated business income; and is such an aversion strong enough to keep nonprofits from excessive pursuit of profit absent a UBIT? Is the culture of nonprofit managers changing in a way that may reduce such an aversion in the future?

Consideration must also be given to the administrative feasibility of properly allocating income and costs between the taxed and untaxed activities of a nonprofit. Most notably, can workable guidelines be developed for better allocating joint costs between taxable and nontaxable activities?

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