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UNFAIR COMPETITION AND THE UNRELATED BUSINESS INCOME TAX

*Henry B. Hansmann**

I. INTRODUCTION

THERE has recently been considerable agitation from the business community, and particularly from small businesses, against unfair competition from nonprofit firms.¹ The source of the unfairness, as the business community sees it, is that nonprofit corporations often receive special legal privileges that are denied to competing for-profit firms. Most conspicuous among these privileges is tax exemption, particularly exemption from federal corporate income taxes.²

One key dispute over the nonprofits' exemption privilege centers on their unrelated business activities—that is, profit-making activities that a tax-exempt nonprofit corporation undertakes primarily as a source of income and that are not otherwise related to the principal purposes for which the nonprofit was formed and granted tax exemption. Since 1950, the portion of an exempt nonprofit's net income that derives from such activities has been subject to the corporate income tax under the so-called "unrelated business income tax" (UBIT).³ The business community has argued, however, that the tax is currently too narrowly and loosely defined and requires more rigorous application. In particular, critics claim that the test of whether income-producing activities are "related" to an organization's exempt

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¹ See, e.g., Off. of Advoc., U.S. Small Bus. Admin., Issue Alert: Unfair Competition with Small Business (1986) [hereinafter Issue Alert]; Off. of Advoc., U.S. Small Bus. Admin., Unfair Competition by Nonprofit Organizations with Small Business: An Issue for the 1980s (1984) [hereinafter Nonprofit Competition]; Calomius, Hutchison, Quade & Risinger, *There's Big Money in the 'Nonprofits,'* Newsweek, Jan. 5, 1987, at 38; Davis, *Profits vs. Nonprofits: The Competition Complex*, A. Mgmt., Aug. 1986, at 24.

² Exemption from local property taxes has also been controversial. See *infra* notes 79-84 and accompanying text. In general, the analysis of corporate income taxation offered here also applies to property taxation.

³ I.R.C. § 511 (1982).

purposes and are therefore exempt is too lax and should be substantially broadened.⁴ In response to these concerns, the House of Representatives recently held extensive hearings on the UBIT that resulted in draft proposals for legislation to further tighten the tax.⁵

In light of this agitation, it is striking that the three most prominent scholarly articles dealing with the UBIT—two written by legal scholars⁶ and one by an economist⁷—all reject the argument that the UBIT is necessary or useful in policing competition between nonprofit and for-profit firms. Indeed, the most recent of these articles⁸ explicitly argues, and another⁹ strongly implies, that the UBIT should be completely repealed and that we should return to the regime that prevailed before 1950 when businesses wholly owned by tax-exempt nonprofits were entirely exempt from income taxation. Moreover, this view seems to be shared by other prominent tax law scholars with whom I have spoken.

In this Article, I reexamine the purposes and consequences of the UBIT in an effort to provide a coherent foundation for the current policy debate and reach the following conclusions. First, the debate over the UBIT has been muddled by being cast in terms of “fairness,”

⁴ See, e.g., Issue Alert, *supra* note 1, at 5-6; Nonprofit Competition, *supra* note 1, at 27-31, 37-39.

Not surprisingly, the nonprofit sector has sought to defend its privileges, arguing that further tightening of the UBIT is not necessary and pointing to the substantial benefits provided to the business sector, and particularly small businesses, through the tax code and other government programs. See, e.g., H. Wellford & J. Gallagher, *The Myth of Unfair Competition by Nonprofit Organizations: A Review of Government Assistance to Small Businesses* (The National Assembly of National Voluntary Health and Social Welfare Organizations 1985); S. Pires, *Competition Between the Nonprofit and For-Profit Sectors* (The National Assembly of National Voluntary Health and Social Welfare Organizations 1985).

⁵ Unrelated Business Income Tax: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means, 100th Cong., 1st Sess. (1987) [hereinafter *Hearings*]. On June 23, 1988, the House Subcommittee on Oversight forwarded to the Committee on Ways and Means a draft of preliminary proposals for the reform of the UBIT. Subcomm. on Oversight of the House Comm. on Ways and Means, 100th Cong., 2d Sess., *Draft Report Describing Recommendations on the Unrelated Business Income Tax* (Comm. Print 1988) [hereinafter *Draft Report*].

⁶ See Bittker & Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 *Yale L.J.* 299, 316-26 (1976); Klein, *Income Taxation and Legal Entities*, 20 *UCLA L. Rev.* 13, 61-68 (1972).

⁷ See Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 *Stan. L. Rev.* 1017 (1982).

⁸ See *id.* at 1038-39.

⁹ See Bittker & Rahdert, *supra* note 6, at 322-26.

a term that some have interpreted to suggest that the basic issues are ones of equity. Although issues of equity are involved, they are not of fundamental importance here; rather, the more basic issues concern economic efficiency. Second, when viewed in terms of efficiency, the argument for retaining the UBIT in roughly its present form, rather than repealing it, is overwhelmingly strong. Third, most of the controversy surrounding the UBIT has involved situations in which exempt nonprofits experience economies of scope in undertaking commercial activities. Although application of the UBIT in such situations will always be difficult, a clear focus on the underlying economics reveals reasonable principles on which a more coherent policy can be based. Finally, despite the pleas of the business community, there is no compelling reason for substantially extending the current application of the UBIT. Although some broadening of the scope of the tax may be appropriate, the potential gains in either efficiency or equity appear modest.

In short, the case for either repealing or considerably broadening the UBIT is weak. On the other hand, there is good reason to believe that serious reform is called for in defining the scope of the basic underlying exemption for nonprofit organizations, which is a subject of far greater consequence than the UBIT.

II. THE BASIC STRUCTURE OF THE NONPROFIT EXEMPTION

In order to qualify for exemption from corporate income taxation, a nonprofit must be organized and operated to pursue one or more specific activities that are listed in the tax code. These activities, which I shall refer to as "exempt functions," include the provision of services of broad public benefit, such as charity, education, and scientific research, as well as narrower activities such as the operation of business leagues and cemetery associations.¹⁰ Those nonprofits, such as the American Automobile Association, that are not dedicated to one or another exempt function remain subject to the corporate tax.¹¹ Though one may fairly question whether all of the activities currently

¹⁰ The purposes qualifying for exemption are listed in I.R.C. § 501(c) (West 1988).

¹¹ See *Chattanooga Auto. Club v. Commissioner*, 182 F.2d 551 (6th Cir. 1950) (automobile service club not exempt); Gen. Couns. Mem. 23,688 (1943), modified, Rev. Rul. 69-635, 1969-2 C.B. 126 (same).

exempted deserve that privilege, for purposes of discussing the UBIT I shall take the scope of the underlying nonprofit exemption as given.

Exempt nonprofits have always been permitted to own and operate businesses that produce goods and services unrelated to their exempt purposes without losing their exemption, so long as such business activity is not too substantial a portion of a nonprofit's total activities. The prototypical and most familiar unrelated business is the Mueller Macaroni Company, which for nearly forty years was wholly owned by New York University, which used the company's profits to support the university's law school.¹² Prior to 1950, as noted above, income from wholly owned businesses of this sort—whether or not they were separately incorporated¹³—was also exempt from corporate tax so long as the income was used only to support the nonprofit's exempt functions.

The UBIT's enactment, as part of the Revenue Act of 1950,¹⁴ reversed that policy, and nonprofits have paid taxes on income derived from such businesses ever since. Subchapter F (Exempt Organizations) contains the statutory framework for the UBIT, and requires that most nonprofits¹⁵ pay taxes equal to the corporate tax rate times the amount of income derived from any unrelated trade or business.¹⁶

When discussing profit-making activities conducted by nonprofits, it is helpful to distinguish between those activities that exhibit economies of scope when undertaken jointly with the nonprofit's exempt functions and those activities that exhibit no such economies of scope. Economies of scope are present if the activity is less costly when

¹² See *infra* note 20.

¹³ To apply the UBIT to wholly owned businesses that are separately incorporated but not to those that are operated within the parent firm's nonprofit corporate shell would simply give rise to a strong incentive to formally merge unrelated businesses into the parent to avoid the tax. For this reason, it will be assumed throughout the Article that, in the absence of the UBIT, the regime would be as it was before the UBIT was enacted in 1950, when exemption was extended not only to unrelated businesses operated within the parent nonprofit's corporate shell but also to separately incorporated "feeder" corporations.

¹⁴ Ch. 994, §§ 421-422, 64 Stat. 906, 947.

¹⁵ Charitable trusts, however, calculate the UBIT with individual tax rates. I.R.C. § 511(b) (1982).

¹⁶ *Id.* § 511(a)(1) (1982). For a survey of the law's development prior to the UBIT's enactment, see Note, Colleges, Charities, and the Revenue Act of 1950, 60 *Yale L.J.* 851, 853-54, 861-63 (1951). The present application of the UBIT is extensively discussed in B. Hopkins, *The Law of Tax-Exempt Organizations* 697-806 (5th ed. 1987).

undertaken in combination with the nonprofit's exempt functions than when undertaken separately. Rental of a university's football stadium to professional sports teams over the summer, for example, would fall in this category; because the university would maintain such a stadium for its own winter sports programs,¹⁷ the additional cost involved in renting it out over the summer is small. In contrast, there were presumably no economies of scope involved in New York University's operation of a macaroni company.¹⁸

In the discussion that follows, I shall first focus on situations in which unrelated businesses exhibit no economies of scope. Then, in Part IX, I shall deal with the additional issues that arise when economies of scope are present.

III. THE COMPETITIVE IMPACT OF TAX-EXEMPT BUSINESS ACTIVITIES

A major function and purpose of the UBIT is to regulate competition between nonprofit and for-profit firms.¹⁹ Consequently, it helps to begin by considering the likely consequences of permitting nonprofit firms to enter profit-making businesses without being subject to corporate income taxation. In other words, what would the world look like without the UBIT?

At the time that the UBIT was enacted, some argued that without the tax businesses owned by exempt nonprofits would exploit their cost advantage to drive their for-profit competitors out of business. In this way, it was said, whole industries might ultimately be captured by nonprofits.²⁰ For reasons explained shortly, however, fears of great business dislocations are probably unfounded. Indeed, it is not obvious that, if the UBIT were entirely repealed, owners of existing for-profit businesses would on average suffer any losses at all.

¹⁷ I assume in this illustration that, as is the case under current law, providing athletic activities for students is an exempt function. Whether they should instead be considered unrelated business activities is discussed in Kaplan, *Intercollegiate Athletics and the Unrelated Business Income Tax*, 80 *Colum. L. Rev.* 1430, 1437-60 (1980).

¹⁸ See *supra* note 12 and accompanying text.

¹⁹ See H.R. Rep. No. 2319, 81st Cong., 2d Sess. 36-37 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 28-29, *reprinted in* 1950 U.S. Code Cong. & Admin. News 3053.

²⁰ Thus, fear was expressed that the New York University Law School might come to monopolize the macaroni business through their ownership of the Mueller Macaroni Company. See Note, *The Macaroni Monopoly: The Developing Concept of Unrelated Business Income of Exempt Organizations*, 81 *Harv. L. Rev.* 1280, 1281 (1968).

This conclusion holds regardless of one's view of the economic distortions engendered by the corporate income tax—a much-debated subject.²¹ For example, it is sometimes said that the corporate income tax is in effect just a tax on pure profits and does not affect the cost of capital at the margin. Under this view, exemption from the tax does not reduce marginal costs, and exempt businesses enjoy no competitive advantage over taxable ones.²² If this view were accurate, the failure to implement the UBIT would pose no threat to for-profit firms.

The more compelling view, on the other hand, is that the corporate income tax *does* affect the cost of capital at the margin and that, everything else being equal, tax-exempt corporations have higher rates of return on investment than those of taxable firms.²³ Thus, tax-exempt firms can earn a profit at prices below those at which taxable firms can break even. It might seem to follow that, in the UBIT's absence, a nonprofit that owns an unrelated business would have an incentive to expand that business by lowering its prices below the level at which competing nonexempt firms can make profits and thereby force those firms out of business.

Yet despite that intuition, widespread displacement of for-profit firms should not result from the UBIT's absence. As previous commentators have noted,²⁴ a nonprofit firm that owns an unrelated busi-

²¹ For an accessible survey of some of the main issues, see R. Brealey & S. Myers, *Principles of Corporate Finance* 408-20 (3rd ed. 1988). The relevant economics literature is briefly surveyed in Rose-Ackerman, *supra* note 7, at 1025 nn.30-31.

²² This argument is made in Note, *supra* note 16, at 876. The same argument appears to be offered in Note, *Preventing the Operation of Untaxed Business by Tax-Exempt Organizations*, 32 U. Chi. L. Rev. 581, 591-92 (1965), although it could also be interpreted as making an argument similar to that offered *infra* notes 24-26 and accompanying text; see Note, *supra*, at 592 n.62.

²³ An important reason for this is that debt and equity are not always perfect substitutes. Differences between those two financing methods include: (1) debt involves agency and transaction costs that can be avoided to some extent by equity financing; (2) the returns to debt are taxed differently than the returns to equity in the hands of individual security holders; and (3) the Internal Revenue Service is likely to treat debt like equity when a firm comes close to 100% debt financing. See R. Brealey & S. Myers, *supra* note 21, at 408-20; Rose-Ackerman, *supra* note 7, at 1025 nn.30-31.

²⁴ See Klein, *supra* note 6, at 64-66; Rose-Ackerman, *supra* note 7, at 1029.

One student argues that serious price competition from unrelated businesses owned by exempt nonprofits would be unlikely even in the absence of the UBIT, but then seems to make the following contradictory argument: because, without the UBIT, unrelated businesses owned by exempt nonprofits would have larger earnings than those of their taxable competitors, they could expand more quickly than could those competitors, and thus a rule

ness has an incentive to expand that business slowly if at all. In this manner, the nonprofit leaves undisturbed the price that prevails when only for-profit firms compete, and thereby maximizes the difference between cost and sales price. Nonprofits with substantial funds to invest—more than can be accommodated with ease in a single market or industry without entering on a scale, or expanding at a rate, sufficient to drive down prices—would have an incentive to spread those funds across a number of markets or industries and invest on a small scale in each industry to avoid disturbing existing price levels. Similarly, if a firm owned and operated as an investment a nonprofit that generated large earnings—earnings large enough so that, if reinvested in the firm, they would lead to a substantial increase in output and a consequent lowering of industry price levels—the nonprofit would have an incentive to withdraw a large portion of those earnings from the firm and invest them elsewhere.²⁵ Such a strategy would assure the maximum rate of return on investments in unrelated businesses. At the price level needed to cover costs for a for-profit firm paying taxes, a tax-exempt firm could potentially earn pure profits at least equal to the amount of taxes that would otherwise be assessed. Rapid increases in capacity through internal expansion would often reduce the price level and, hence, the rate of profit.

As a consequence, one would expect only a gradual displacement of for-profit firms even in the absence of the UBIT; no great dislocations should result from nonprofit entry or expansion.²⁶ Indeed, in the absence of the UBIT, one would expect nonprofit firms in most cases to displace for-profit firms, not by driving them out of business

should be adopted requiring such businesses to distribute a large fraction of their profits rather than reinvesting them. See Note, *supra* note 16, at 876.

²⁵ There is no tax cost to an exempt nonprofit from shifting funds among its unrelated businesses even if those businesses are separately incorporated because there is no separate tax on amounts distributed by those businesses to the parent nonprofit. Thus, the amount or cost of funds available to a business subsidiary of an exempt nonprofit is not a function of the amount of profits that a particular business has earned in the past. This point seems to have been missed by one student who argues that “the fast accumulation of capital made possible by tax-free profits is an advantage” that unrelated businesses owned by nonprofits would have over their competitors. Note, *supra* note 20, at 1282. Such an argument may apply to the portfolio of unrelated businesses owned by a nonprofit taken as a whole; it does not, however, apply to individual unrelated businesses.

²⁶ It must be kept in mind that we are concerned here with unrelated businesses that exhibit no economies of scope when operated by a nonprofit. Where such economies are present, a different analysis is called for, as discussed *infra* Part IX.

through price competition but rather by purchasing them. Although it has been argued that there are no potential tax gains from such purchases, in fact such gains would be substantial: without the UBIT, any business currently subject to the corporate income tax would yield a higher return in the hands of an exempt nonprofit than it does to its current shareholders because the corporate-level tax would be eliminated by such a transfer.²⁷ Moreover, purchasing has the advantage of permitting a nonprofit to take advantage of its exemption without requiring the wasteful duplication of assets and expensive price competition that would result if nonprofits sought to displace for-profits by expanding existing unrelated businesses or starting up new ones.²⁸ Moreover, if, as seems likely, nonprofits generally adopted this approach, owners of existing for-profit businesses might on average actually gain from repeal of the UBIT because the competitive environment in which they sold their products would be largely unaffected while the price at which they could sell their businesses would rise.²⁹

²⁷ Professor Klein argues that there would be no incentive to transfer assets from a tax-paying corporation to an unrelated business owned by an exempt nonprofit corporation even in the absence of the UBIT. Klein's argument, however, assumes that the assets would be transferred through a sale of assets by the tax-paying corporation to the nonprofit: the proceeds of the sale would then still be subject to the corporate tax in the hands of the seller. See Klein, *supra* note 6, at 61-66. But the way to structure such a transaction to take advantage of the exemption is to have the shareholders of the tax-paying corporation sell the entire corporation to the nonprofit, not just its assets. Because the corporation would be taxable in the hands of its initial shareholders, and exempt in the hands of the nonprofit, it would be worth more to the latter wherever the corporation had a positive tax liability prior to the transfer, and the proceeds of the sale would not be taxed to the selling shareholders at a rate appreciably higher than the rate of tax on the distributions the shareholders would receive from the corporation if they were to retain ownership.

This is also true even where—as in practice has often been the case—the corporate income tax acts as a relative subsidy in the sense that a business is subject to a lower rate of tax when organized as a corporation than as a partnership or sole proprietorship. So long as there is any positive tax liability under the corporate tax, that liability could potentially be avoided by sale to a nonprofit in the absence of the UBIT.

²⁸ Because there are mutual gains available to a for-profit corporation and a potential tax-exempt competitor from having the latter purchase the former rather than from driving it out of business through price competition, it should generally be possible to arrange such a sale so that it would be attractive to both parties.

²⁹ Just because an incorporated business would be worth more, after taxes, in the hands of an exempt nonprofit than in the hands of its original shareholders does not mean that all such businesses would be sold to nonprofits. Nonprofits would first have to obtain the capital to purchase such businesses. Moreover, because a nonprofit cannot sell equity, it is dependent on donations, retained earnings, and debt as sources of capital. The first two sources are

IV. THE FAIRNESS DEBATE

Observing that, for reasons such as those just discussed, existing profit-seeking firms would be unlikely to suffer substantial losses through competition from unrelated businesses owned by nonprofits even in the absence of the UBIT, some commentators have argued that the UBIT is therefore unnecessary and that the fears of "unfair competition" that supposedly justify the tax are unfounded.³⁰ Indeed, it has been argued that unfair competition is likely to be an even more serious problem *with* the UBIT than without it: with the UBIT in effect, nonprofit firms have especially strong incentives to invest in related businesses and avoid investment in unrelated businesses. In turn, this means that those for-profit firms that compete with nonprofits in the *related* fields will bear most of the disadvantage of tax-favored competition from nonprofit firms.³¹

Such analyses interpret the term "unfair competition" as referring only to situations in which substantial losses are suffered by for-profit firms at the hands of competitors that are specially favored by the government. Indeed, it has sometimes been said that unfair competition exists only when for-profit firms suffer *unforeseeable* losses of this sort.³² Pushed to the extreme, it follows from this view that problems of unfair competition generally arise only in transitions from one tax regime to another because that is usually the only time at which substantial unforeseeable tax-induced losses can arise. Thus, if the UBIT were repealed, for-profit firms in all industries would eventually adjust their expectations, and hence their levels of investment, to incorporate the possibility of competition from tax-exempt nonprofits, and would on average achieve a competitive rate of return. Under such a view, serious problems of unfair competition would never have arisen if the UBIT had never been enacted in the first place.

The principal difficulty with such analyses is that they take the term "unfair" too literally and conceive of the issue primarily as one

ultimately limited. The ability to finance such purchases with debt is discussed *infra* notes 47-53 and accompanying text.

³⁰ See Rose-Ackerman, *supra* note 7, at 1038; R. Steinberg, *Fairness and Efficiency in the Competition Between For-Profit and Nonprofit Firms* (Feb. 1988) (unpublished manuscript on file with the Virginia Law Review Association). Professor Steinberg acknowledges, however, that efficiency considerations must also be taken into account in evaluating the UBIT.

³¹ See Rose-Ackerman, *supra* note 7, at 1038.

³² See *id.* at 1025-26.

of equity. In other words, they view the problem only in distributional terms and simply ask whether, in the absence of the UBIT, there would be substantial undeserved redistributions of wealth from one group to another—and in particular from for-profit firms to the nonprofits with which they compete. The more serious problems addressed by the UBIT, however, involve efficiency. And, substantial economic inefficiency could be generated by the absence of the UBIT even if no owner of an existing profit-seeking business ever suffered losses as a result of competition from unrelated businesses owned by exempt nonprofits.

V. THE EFFICIENCY RATIONALE FOR THE UBIT

Failure to apply the corporate tax to unrelated businesses operated by exempt nonprofits could result in a variety of inefficiencies.

A. *Poor Diversification of Investments*

At present, most nonprofits with substantial financial reserves, such as endowed universities, private foundations, and pension funds, invest a substantial portion of those reserves in shares of common stock. Although these shares represent fractional ownership of the business corporations that issue them, their ownership by exempt nonprofits confers no fractional exemption from corporate income taxation for the issuing entities. Thus, if a university endowment holds five percent of the shares of the *XYZ* corporation, the tax code does not forgive five percent of the taxes otherwise owed by the *XYZ* corporation. Rather, the dividends paid to the university by the *XYZ* corporation, like those paid to other shareholders, are distributed after corporate taxes.

If the UBIT were repealed, however, this result would no longer hold true for corporations that are 100% owned by exempt nonprofits because such corporations would share the exemption. In other words, the acquisition of all common stock would convert the issuer into an exempt, unrelated business. (This is based on the assumption that, without the UBIT, the situation would be as it was before 1950, with the exemption extended only to unrelated businesses that are wholly owned by an otherwise exempt nonprofit.) As a result, the tax treatments of unrelated businesses in which a nonprofit has only partial ownership and those that it wholly owns would differ substantially, and nonprofits would have a strong incentive to abandon the

current practice of investing in a broad range of common stocks and to pursue instead a strategy of investing in firms that the nonprofits can completely own.

The result would be to create a strong incentive for many nonprofits to adopt investment portfolios that are very poorly diversified. Nonprofits with extremely large portfolios, such as the best-endowed universities and private foundations, may have sufficient funds to achieve reasonable diversification even if they were to invest only in wholly owned firms. But for most nonprofits, investing entirely in wholly owned businesses would mean owning only one or a few firms. As a consequence, the nonprofits would incur substantially increased investment risks.

This is not to argue that nonprofits would be worse off as a consequence. They would not be. They would still have the option of investing in a broad range of common stocks as they currently do; presumably they would choose instead to invest in a few wholly owned businesses only if they thought the increase in average rate of return from escaping the corporate tax outweighed the increased risk they incurred. Rather, the argument is that the increase in federal subsidy that would flow to nonprofits when they shifted from common stocks to wholly owned exempt businesses would in part be dissipated in the increased risk thereby incurred by the nonprofits involved. In other words, the incentive for nonprofits to incur additional risk would detract importantly from the efficiency of the subsidy.³³

³³ One might ask why, if the incentive is so great, nonprofits did not sell their common stocks and invest entirely in wholly owned businesses before 1950, when there was no UBIT. There are several possible reasons this did not happen. First, the case that (rather unexpectedly) interpreted the Code to grant total exemption of "feeder" corporations wholly owned by exempt nonprofits was decided only in 1938. See *Roche's Beach, Inc. v. Commissioner*, 96 F.2d 776 (2d Cir. 1938). Second, corporate tax rates became large only after the beginning of World War II; in 1931, for example, the maximum rate was only 12%, and by 1939 it had risen only to 19%, whereas by 1942 it had risen to 53%, at which it approximately stayed until 1986. See J. Pechman, *Federal Tax Policy* 321-22 (5th ed. 1987).

Further, there is evidence that in the 1940's, when for the reasons just mentioned the incentive to invest in wholly owned businesses became strong, exempt nonprofits quickly began to respond to it. By 1947, for example, New York University had acquired, in addition to the Mueller Macaroni Company, the American Limoges China Company, the Howes Leather Company, and the Rainsey Corporation, a manufacturer of piston rings. See Note, *supra* note 16, at 851. It was, in fact, in response to evidence of such activity that Congress adopted the UBIT. See *id.*

B. Managerial Inefficiency

Failure to tax unrelated businesses owned by nonprofits could also engender substantial inefficiency in the form of poor management.

Nonprofit firms are essentially unowned organizations. As a consequence, they may feel less incentive to minimize costs or to maximize revenues than do profit-seeking firms.³⁴ So long as nonprofit firms do not benefit from special subsidies, market selection can serve as a check in this regard: nonprofit firms will succeed in unrelated businesses only if they are at least as efficient as their for-profit competitors. But when businesses operated by nonprofits are exempted from being taxed, market selection is lost as a test of efficiency: nonprofits can survive in competition with for-profit firms even when nonprofits have higher costs. Consequently, some or even all of the value of tax exemption—that is, of the tax revenues forgone by the government—could simply be lost in inefficient operation of the unrelated businesses through which the subsidy is channeled to the nonprofits.³⁵

To be sure, nonprofit firms that own unrelated businesses presumably have much the same kind of interest in those firms that any other owner would have—namely, to maximize the financial return they yield. Thus, whatever the efficiency of their behavior in other respects, nonprofits owning such businesses might be expected to take as strong an interest in having them managed efficiently as would any other owner. But not all owners are equally effective, and the UBIT's repeal would create a strong incentive for some very inefficient patterns of ownership.

Consider, for example, the case of a private college with \$100 million in endowment, which is reasonably large by current standards.³⁶ In the absence of the UBIT, as noted above, there would be a very strong incentive for the college to invest that endowment in wholly

³⁴ See, e.g., Frech, *The Property Rights Theory of the Firm: Empirical Results from a Natural Experiment*, 84 *J. Pol. Econ.* 143, 147-51 (1976) (presenting empirical evidence suggesting that nonprofit insurance companies are less efficient than proprietary insurance companies).

³⁵ Cf. Rose-Ackerman, *supra* note 7, at 1024 (explicitly assuming for purposes of analysis that nonprofit firms manage unrelated businesses as efficiently as do investor-owned firms and, therefore, not dealing with this issue).

³⁶ Of the roughly 300 colleges and universities with endowments in excess of \$1 million, about 90 have endowments worth more than \$100 million. See *Growth of College Endowments Found to Have Slowed Last Year; Value of 296 Funds Placed at \$47.9-Billion*, *Chron. Higher Educ.*, June 1, 1988, at A33, col. 1.

owned firms rather than in a diversified portfolio of common stocks. Thus, the college might obtain full ownership of, for example, five relatively small businesses with \$20 million in equity capital each. The efficiency with which those businesses were managed would then depend very much on the quality of oversight provided by the college because there would be no market in the stocks of the firms in question (and in particular no market for corporate control); the officers of the college would be entirely responsible for selecting and monitoring the managers of the firms. In effect, the college would become a conglomerate. And, if the college sought diversification in its investments, and thus purchased businesses in five entirely different industries, it would become a highly diversified conglomerate.³⁷ The track record of conglomerates managed by large and sophisticated for-profit corporations is not impressive; there is little reason to believe that a private college would do better, or even nearly so well.

Tax exemption for unrelated businesses is, consequently, a poor way to subsidize nonprofit firms. It would be far more effective for the government simply to give nonprofit firms direct grants equal to the tax revenue that would be lost through exemption of unrelated business activities.

The same reasoning does not apply to the *related* activities of nonprofits—that is, to those activities included among nonprofits' exempt functions. The rationale for granting tax exemption to nonprofits that perform these functions, such as aiding the poor or performing scientific research, is presumably that the services involved would be underprovided in the absence of a subsidy.³⁸ Thus, one need not worry, as does one commentator,³⁹ about the bias that the UBIT creates in favor of investment by nonprofits in related as opposed to unrelated business activities, for that is precisely the result that is desired from the point of view of efficiency.⁴⁰

³⁷ This was in effect the strategy followed by New York University prior to the adoption of the UBIT. See *supra* note 33.

³⁸ For these two particular services, underprovision arguably results because they are, for many persons, public goods in the economist's sense. See Hansmann, *The Role of Nonprofit Enterprise*, 89 *Yale L.J.* 835, 848-51, 854-62 (1980) (discussing this and other forms of market failure that characterize services commonly provided by nonprofits).

³⁹ See Rose-Ackerman, *supra* note 7, at 1038.

⁴⁰ There remains the question of why the subsidy—that is, the exemption—is offered to nonprofit firms but not to for-profit firms. There are at least two possible reasons for this. First, the market for the service to be subsidized is insufficiently competitive to assure that for-

C. Corporate Tax Integration for Exempt Nonprofits

The two problems described above—incentives for underdiversification and for managerial inefficiency—might largely be avoided by not just repealing the UBIT but also granting partial exemption from corporate income taxes for those corporations whose stock is partially held by nonprofit organizations. This might be accomplished, for example, by refunding to exempt nonprofits the fraction of the corporation's taxes that corresponds to the fraction of the corporation's stock owned by the nonprofit. In effect, this would provide for integration of the corporate and personal income taxes so far as nonprofits are concerned.

Such a scheme would not, however, eliminate all difficulties. In addition to whatever administrative costs it would involve (which would probably be manageable, but not negligible, for the IRS, the nonprofits, and the business corporations involved), it would aggravate the other problems, discussed in the next Section, that would accompany repeal of the UBIT, including skewed incentives for saving and erosion of the corporate tax base.⁴¹

D. Saving Versus Spending

To exempt from taxation all unrelated businesses owned by nonprofit organizations would be to give those entities a higher rate of return on investment and of savings than is available to tax-paying corporations. As a result, without the UBIT, nonprofit firms might have too strong an incentive to save instead of spending currently, leading them to underfund current projects in order to build up their

profit firms would be forced to pass to their customers most or all of the benefit of the subsidy. Second, for-profit firms, for reasons of asymmetric information or "contract failure" will provide services of inferior quality to those offered by nonprofit firms. See Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 *Yale L.J.* 54, 69-70 (1981) [hereinafter *Hansmann, Exempting Rationale*]; Hansmann, *supra* note 38, at 843-45.

Moreover, there is empirical evidence suggesting that exemption from corporate income taxes for nonprofit firms in specific industries is effective at significantly increasing the market share of nonprofit vis-a-vis for-profit firms. See Hansmann, *The Effect of Tax Exemption and Other Factors on the Market Share of Nonprofit Versus For-Profit Firms*, 40 *Nat'l Tax J.* 71, 76-77 (1987).

⁴¹ The immediate loss of tax revenue would obviously be large, for example, if such a scheme were extended to pension funds, which hold a substantial fraction of the nation's equity securities.

investments. Universities, for example, would have a strong incentive to cut current spending on research, teaching, and student scholarships and to invest the money thereby saved in unrelated businesses.⁴² To be sure, the returns to those investments would be available to spend on more research, teaching, and scholarships in the future. Because the university would earn a much higher rate of return to savings than is available through other organizations,⁴³ however, it would value such future expenditures, relative to present expenditures, much more highly than does the society at large. Thus, tax exemption for unrelated businesses would distort the university's (or any other nonprofit's) choice between present and future expenditures by subsidizing expenditures in the future. The exemption would result in a larger overall amount of services from the university, but too many of those services would be provided in the future.⁴⁴ A subsidy of equal cost to the government (in terms of present discounted value at current—that is, after-tax—interest rates) that did not have such a bias in favor of future production would produce a stream of

⁴² It is hard to say unambiguously whether repeal of the UBIT would lead nonprofits actually to cut their current absolute levels of expenditure. Repeal of the UBIT would have both an income effect and a substitution effect: the former would encourage nonprofits to increase current expenditures, whereas the latter would have the opposite effect. The net result in any particular case depends on, among other things, the nonprofit's objectives.

⁴³ See *infra* note 44.

⁴⁴ Because it is ultimately the decisions and welfare of individuals that are affected by the tax system, it helps to view the issue in terms of its impact on ultimate consumers of services.

For example, imagine an individual who has \$100 currently in hand. She is contemplating whether to purchase \$100 of some service (such as a haircut or an education) with those funds now, or alternatively to postpone consumption until next year. If she postpones consumption, she can proceed in several different ways.

First, she can invest the \$100 in an incorporated business for the intervening year, disinvest at the end of the year, and use the amount invested plus net returns to purchase the service. Let us suppose, for simplicity, that the corporate tax rate is 34% and that her personal rate is 33%. And assume that the corporation obtains a 20% rate of return before tax. Then, at the end of the year, she will be able to purchase \$108.84 worth of services, using the original \$100 plus the \$20 corporate earnings minus taxes of 34% at the corporate level and 33% at the personal level.

Second, she can pay \$100 this year to a for-profit corporation, which will invest the funds for the year in other projects and then use the capital and net returns next year to provide the services directly to her. The corporation gets \$20 in earnings from using the funds, and pays \$6.80 in taxes, leaving it with a total of \$13.20 with which to provide services for the purchaser.

Third, she can pay \$100 this year to an exempt nonprofit, which will invest the funds in an unrelated business and use the proceeds to provide services directly to her next year. If we assume that the nonprofit is also able to get a 20% rate of return before tax on its unrelated

services from the university that would have a higher value to society (again, in terms of present discounted value).

Creating a tax bias in favor of saving might be unobjectionable if nonprofit organizations would otherwise be excessively inclined to spend rather than save—that is, to be too present-oriented. But there is every reason to believe that the reverse is the case. Even with the UBIT, nonprofit organizations tend to have a strong—perhaps undesirably strong—tendency to save rather than spend. Thus many nonprofits, such as universities, have already accumulated large capital surpluses in the form of endowments. The preferences of donors, who often wish to build monuments to themselves and thus prefer giving endowed funds rather than funds that can be spent currently, is one source of bias in favor of saving. Another may be a desire on the part of those who administer nonprofits to establish career security for themselves, as well as freedom from outside pressures, by accumulating financial reserves that limit their dependence on current revenue sources.⁴⁵ Whatever the source, however, nonprofits arguably already have too strong an inclination toward the accumulation of financial assets, and this tendency would be considerably reinforced by the absence of the UBIT.

Conceding the strength of the preceding arguments, it might nevertheless be argued that repeal of the UBIT is justified as a second-best approach to tax incentives. The corporate income tax, as presently structured, creates a bias against saving and investment. Encouraging investment by nonprofits by exempting their unrelated business activities from the corporate tax could be seen as a partial corrective to this bias. It is not at all clear, however, that any benefits along these lines would not be outweighed by the inefficiencies engendered by the

business projects and if unrelated businesses are exempt from the corporate tax, the nonprofit will then be able to provide \$120 worth of services for her.

She will, therefore, be much more inclined to forgo current consumption in favor of future consumption if she can structure the transaction in the third way rather than in the first or second ways.

Transactions are, in effect, often structured in this third way. For example, when a donor seeks to purchase educational services for third parties by donating to a university, she is using the third way if she makes the donation in the form of endowment.

⁴⁵ The reasons why nonprofits such as universities exhibit such a strong tendency to accumulate financial reserves in the form of endowments is explored in detail in Hansmann, *Why Do Universities Have Endowments?* (Jan. 1989) (unpublished manuscript on file with the Virginia Law Review Association).

absence of the UBIT. Moreover, there are far more direct ways to eliminate the antisaving bias in the corporate tax, such as a straightforward effort at integration of the corporate and personal taxes.

E. Subsidy Unrelated to Needs

All subsidies necessarily create some inefficiency through administrative costs and skewed incentives. If the subsidy serves a good purpose, these costs may be worth bearing. Failing to tax the unrelated business activities of exempt profits, however, would create a very poorly structured subsidy.

There is no reason to believe that the amount of subsidy that is appropriate for a particular nonprofit is proportional to its willingness or ability to invest in unrelated businesses—although that would in effect be the type of subsidy that would result if the UBIT were repealed. Rather, the contrary is arguably the case. When a nonprofit organization invests substantial sums in unrelated businesses it presumably either has more funds at its disposal than it can invest productively in its related activities (in which case further subsidy is obviously inappropriate) or else it is diverting funds away from related activities where they are needed and into unrelated businesses where for-profit firms would provide an adequate level of investment in any case. In short, exempting unrelated businesses from taxation would yield a subsidy inversely proportional to the needs⁴⁶ and social contributions of the recipient nonprofits. Subsidies for nonprofits should be structured to encourage them to expand their *related*, not their unrelated, activities.

VI. TAX BASE SHRINKAGE

In addition to regulating the balance of business activity between nonprofit and for-profit firms, the UBIT has the important purpose of raising revenue for the government. To be sure, the UBIT itself yields

⁴⁶ I have suggested, in another article, that corporate income tax exemption for some types of nonprofit firms might be justified as a crude way of compensating for nonprofits' difficulties in raising capital. Hansmann, *Exempting Rationale*, supra note 40, at 72-75. Exemption of unrelated business activities from the corporate tax, however, is difficult to justify on these grounds because it provides the largest subsidy to those nonprofits that have the largest capital surplus.

few tax dollars,⁴⁷ and probably always will no matter how it is reformed. Observing this, some commentators have claimed that the UBIT plays little part in raising revenue.⁴⁸ But this argument misses the essential point. The UBIT is far more important in protecting the corporate income tax base than it is in raising revenue directly.

For several reasons, the UBIT's repeal would noticeably shrink the corporate tax base. As described earlier in Part V, exempt nonprofits with endowments invested in a diversified portfolio of common stocks would have a strong incentive to sell those stocks and purchase instead wholly owned, and thus exempt, businesses. This would directly reduce the corporate tax base roughly in proportion to the amount of corporate securities currently held by exempt nonprofits.

The greatest reduction in the corporate tax base that would follow from repeal of the UBIT, however, would probably come from debt-financed acquisitions of business corporations by exempt nonprofits. In the absence of the UBIT, the value of an otherwise taxable business would be higher in the hands of an exempt nonprofit than it would be in the hands of ordinary taxable entrepreneurs or shareholders. Thus, there would be a potential gain from the sale of a business to a nonprofit equal to the discounted present value of all the future taxes that the business would otherwise pay. Leveraged financing should therefore be readily available for such a purchase, and nonprofits would likely often borrow a very large fraction, and in many cases perhaps close to 100%, of the capital needed for the acquisition of an unrelated business. The increased net income resulting from tax avoidance would provide the return necessary to cover the increased agency and transaction costs involved in such highly leveraged financing.⁴⁹ As a consequence, even nonprofits with modest net assets could hold large portfolios of business firms. In fact, as part of the rationale for enacting the UBIT in 1950, Congress cited the frequency with which exempt organizations were then acquiring businesses with no investment of their own.⁵⁰

⁴⁷ In fiscal year 1986, tax revenue from the UBIT was \$53 million. Hearings, *supra* note 5, at 28 (statement of O. Donaldson Chapoton, Deputy Assistant Secretary, Department of the Treasury).

⁴⁸ See, e.g., Note, *supra* note 16, at 875.

⁴⁹ See *supra* note 23 and accompanying text.

⁵⁰ House Comm. on Ways and Means, Report on the Revenue Act of 1950, H.R. Rep. No. 2319, 81st Cong., 2d Sess. 36-37 (1950).

The shrinkage of the corporate tax base that could result from leveraged acquisitions of businesses by exempt nonprofits⁵¹ would presumably be so obviously undesirable that repeal of the UBIT would have to be accompanied by strong restrictions on the use of debt financing in acquisitions by nonprofits. The Internal Revenue Code already imposes a tax on the "unrelated debt-financed income" of nonprofits, which is essentially all debt-financed unrelated business income that is not otherwise subject to the UBIT.⁵² But restrictions on debt financing are complex and difficult to police, and if the UBIT were repealed, the returns from avoiding any such restrictions would be sufficiently high that one would expect nonprofits, and the business firms owned by them, to borrow wherever and however they could without formally exceeding those restrictions. For example, both nonprofits and their for-profit subsidiaries would always face a strong temptation to lease rather than purchase, to seek trade credit wherever possible, or to encourage donors to make gifts currently and withhold a lifetime income interest rather than making a testamentary gift. The effort that would be required of the government to define and police barriers to such uses of debt, and the effort that would be induced in nonprofits to evade these barriers, are thus further costs that would accompany repeal of the UBIT.⁵³

⁵¹ Moreover, leveraged acquisitions may aggravate the other problems discussed above, such as increased riskiness in nonprofits' investment portfolios, less efficient management of the businesses involved, and an enlargement of the subsidy that is very poorly proportioned to the needs of the institutions involved.

⁵² I.R.C. § 514 (West 1988). This provision taxes the income from otherwise untaxed unrelated businesses to the extent the business is financed with debt. Thus, if a business were acquired with 80% debt financing, then 80% of its income would be subject to tax.

Prior to the stiffening of the tax on unrelated debt-financed income in 1969, nonprofits had managed to take advantage of gaps in the coverage of the UBIT (primarily related to passive income, discussed *infra* Part VIII) to engage in transactions whereby they effectively rented out their exemption to otherwise taxable business corporations. See B. Hopkins, *supra* note 16, at 794-95.

⁵³ Another reason, beyond those given *supra* notes 47-52 and accompanying text, why the tax receipts from the UBIT understate that provision's effect on overall tax revenue is that with the UBIT in effect there is little incentive not to incorporate separately as taxable for-profit firms many businesses that are wholly owned by exempt nonprofits. See Copeland & Rudney, *Business Income of Nonprofits and Competitive Advantage* (pt. 1), 33 Tax Notes 747, 750 (1986).

VII. WHEN DOES THE TAIL START WAGGING THE DOG?

In the absence of the UBIT, there would be no logical stopping point short of granting tax exemption to any business so long as it is conducted by a nonprofit corporation. To be sure, one might impose a rule withdrawing the basic tax exemption from a nonprofit firm when more than a certain percentage of its income or assets came to be associated with unrelated activities. But on what principle would the appropriate percentage be determined? Yale, for example, invests roughly half of its total assets, through its endowment, in unrelated businesses.⁵⁴ If those businesses were wholly owned and tax-exempt, would we find that these universities were so involved in unrelated businesses as to threaten their basic exemption? If not, at what level would that come to pass? Would it occur when ninety percent of an organization's assets are invested in unrelated businesses?⁵⁵

Critics of the UBIT respond that all of the returns from unrelated businesses must ultimately be spent on their related activities and that this justifies exemption for the unrelated businesses.⁵⁶ But this argument, without more, presumably applies no matter how small the related activities are in comparison to the unrelated activities. A twenty-child day-care center that owns businesses worth \$500 million could presumably make the same argument: even if it is currently reinvesting most of the earnings from its unrelated businesses in those or other businesses, the wealth so accumulated nevertheless remains dedicated, in the long run, to the day-care center because of the organization's nonprofit charter. The problem is, of course, that the long run may be very long indeed. In effect, the enterprise is simply accumulating, perhaps for the satisfaction of its managers, a large unowned tax-exempt mutual fund. Moreover, this situation is not meaningfully different from one in which the day care center is simply omitted.

In short, without the UBIT, we would essentially be in a situation in which all organizations formed as nonprofit corporations could secure exemption from the corporate income tax, regardless of the

⁵⁴ See Hansmann, *supra* note 45, at 29-30.

⁵⁵ Currently, there is no formal rule of this sort. Apparently, however, the IRS is likely to deny or revoke tax exemption for an organization that derives more than half of its income from unrelated business activities. See B. Hopkins, *supra* note 16, at 702.

⁵⁶ See, e.g., Bittker & Rahdert, *supra* note 6, at 317.

activities in which they engaged. This underlines the fact that the rationale for taxing unrelated businesses is basically the same as the rationale for granting the basic exemption, not to all nonprofit corporations, but only to those nonprofits that pursue activities deemed worthy of subsidy; there is no point in subsidizing nonprofit firms to provide services that can be performed just as efficiently by for-profit firms.⁵⁷

VIII. TREATMENT OF PASSIVE INVESTMENT INCOME

Certain forms of "passive" investment income, including dividends, interest, royalties, and rental income from real estate, are generally excluded from the scope of the UBIT.⁵⁸ It has been argued that this represents a fundamental inconsistency in the taxation of nonprofits and undercuts the case for the UBIT: If unfair competition is not a problem with respect to investments producing passive income, then why should it be a problem with respect to other forms of unrelated business income?⁵⁹

There is, however, a strong argument for continuing to exclude most of these forms of income from the UBIT. This is most obvious in the case of dividends. As noted in Part V, the fact that an exempt nonprofit owns a share of stock in a business corporation does not affect the latter's tax status. Thus, the corporation must pay taxes on all its earnings; the dividends received by its nonprofit shareholders are net of the corporate tax. To apply the UBIT to dividend income would therefore tax that income twice—once at the corporate level and a second time when received by the nonprofit. In contrast, income a nonprofit received from wholly owned businesses (or at least those that were not separately incorporated) would be subjected to the

⁵⁷ Thus, if corporate tax exemption would not be granted to a ball bearing manufacturer that changed its form of incorporation from a business corporation to a nonprofit corporation, such a firm should not be granted an exemption simply because it comes to be owned by a tax-exempt nonprofit university. Indeed, the rationale for taxing such a firm when it is held as income-producing property by an exempt nonprofit is even stronger than the rationale for taxing it when it is separately incorporated as a nonprofit, since in the former case, like any other taxable business, it is clearly being operated simply to maximize its net revenues.

⁵⁸ I.R.C. § 512(b)(1)-(3) (1982).

⁵⁹ See, e.g., Bittker & Rahdert, *supra* note 6, at 319; Kaplan, *supra* note 17, at 1466.

corporate tax only once.⁶⁰ Applying the UBIT to dividend income therefore would give nonprofits a strong incentive to avoid investments in common stock that represented less than full ownership of a company, and instead to invest their funds in wholly owned businesses, with the unfortunate consequences already described above. Exclusion from the UBIT of interest income, particularly interest on corporate bonds, can be supported with similar logic.⁶¹

It is harder to justify the exclusion from the UBIT of rental income from real estate. One might argue, nevertheless, that investments in real estate have (for other tax reasons) generally been held in partnership rather than in corporate form and thus usually have not been subject to the corporate tax in any event. Consequently, excluding them from the UBIT does not create a strong relative subsidy for nonprofits to pursue such investments. On the other hand, the adoption of the special tax on debt-financed real estate investments by exempt nonprofits⁶² suggests that this exclusion does create undesirable incentives.⁶³

IX. ECONOMIES OF SCOPE

The preceding discussion has focused on investments that nonprofits undertake purely because they produce income. More particularly, it has focused on investments in those businesses in which nonprofits have no inherent efficiency advantages over for-profit firms.

In some activities, however, a nonprofit can achieve economies of scope by engaging in a business activity that, while not in itself an exempt function (in the sense that a nonprofit formed to undertake that activity alone would qualify for exemption), can be undertaken at

⁶⁰ Even taxable business corporations, in computing their corporate income tax, are currently entitled to a deduction of 70% of the dividends they receive from other corporations. I.R.C. § 243(a)(1) (West 1988).

⁶¹ There is no coherent economic logic to support the deductibility, when computing the basic corporate income tax, of interest but not of dividends. Nevertheless, once we accept this fundamental inconsistency in the structure of the corporate tax, it becomes inconsistent within that scheme to exclude from the UBIT dividends received from investments in taxable corporations but not interest on corporate bonds.

⁶² See *supra* Part VI.

⁶³ The special exception for royalty income might also be justifiable in various situations. For example, following the logic suggested *infra* note 71, a case can be made for exempting as "royalties" fees that are received by art museums for licensing the right to make and sell reproductions of works in their collections.

lower cost because it exhibits cost complementarities with the nonprofit's exempt functions. Leasing of unused capacity on a university computer or operation of a commercial pharmacy by a hospital might be examples. Where true economies of this sort can be achieved, it will often be efficient for nonprofits to engage in such businesses even though it would not otherwise be efficient for such businesses to be conducted by nonprofit firms (that is, even though it would not be efficient for such a business to be conducted by a nonprofit firm if that business were the firm's only activity).

A. Principles for Applying the UBIT

Most of the activities that have recently been the focus of controversy concerning the application of the UBIT involve such economies of scope. This is not surprising, since there are competing considerations at play.

On the one hand, there is a good argument for extending the UBIT to the return from such activities. Where true efficiencies are involved, application of the tax will not discourage nonprofits from undertaking them; they will still provide a higher rate of return to the nonprofits than that provided by other unrelated business activities. In addition, application of the tax will have the desirable effect of discouraging excessive investment in such activities—for example, the purchase by a university of a computer that is so large as to exceed natural economies of scope and that will simply furnish services that could be provided equally or more efficiently by an independent commercial computing firm. Such logic would support the proposal, made by some representatives of the business community, that a "stand-alone" test be adopted under which the UBIT would be applied to income from any activity that would not qualify as an exempt function if it were the only activity engaged in by a nonprofit.⁶⁴

On the other hand, there are some good reasons to avoid extending the UBIT to cover at least some activities of this sort. Application of the tax in these cases is awkward and administratively costly for both the government and the nonprofits because it is difficult to allocate costs in any objective fashion between related and unrelated portions

⁶⁴ See Hearings, *supra* note 5, at 105 (testimony of Frank Swain, Chief Counsel for Advocacy, U.S. Small Business Administration).

of the activities involved. Further, there is the possibility that, because the boundary between related and unrelated activities is vague, the tax will end up being applied also to some related activities. Finally, we can turn around the argument that nonprofits will engage in these activities even if taxed, and note that it follows that the tax will therefore be unnecessary and ineffective at discouraging investment in such activities.⁶⁵

Fortunately, it probably does not make a great deal of difference, from the point of view of economic efficiency, precisely where the line is drawn in taxing activities of this sort. To maintain appropriate incentives, there is a strong argument for applying the UBIT at least at the margin where the magnitude of a nonprofit's investment in an activity—for example, in a computer—is likely to be governed by the opportunity to obtain extra commercial income. But in inframarginal cases in which profits are derived from investments clearly made for other purposes (as, for example, through the occasional rental of a stadium built long ago), there is little at stake; from an efficiency point of view, in the decision as to whether the returns from the activity are to be taxed, or in the way the accounting is done if taxes are levied, because the nonprofit will have an incentive to undertake the activity regardless of whether it is taxed on the earnings it receives.

As a consequence, the applications of the UBIT that are currently the most controversial are also, in terms of efficiency, the easiest to resolve: almost any arbitrary solution will do. As a matter of policy, it is perhaps most sensible simply to seek to draw a line between taxable and exempt activities at a point where it is reasonably easy to administer—that is, where the activity involved is sufficiently separable from the nonprofit's exempt functions so that separate accounting is not particularly burdensome.

B. Determining "Relatedness"

The current nominal standard for determining whether an activity falls within the scope of the UBIT is whether that activity is "substantially related" to the nonprofit's exempt functions.⁶⁶ Because the definitions of exempt functions and the reasons for exempting them have always been vague, and because what it means to be "related" has

⁶⁵ See *supra* note 46 and accompanying text.

⁶⁶ I.R.C. § 513(a) (1982).

never been spelled out well,⁶⁷ administration of this standard has not been simple. In practice, the standard has evolved as a "facts and circumstances" test, and the decisions of the IRS and courts have been roughly consistent with the principles suggested here to guide decisions in cases involving economies of scope—although some of the rules imposed by the Code, and some of the interpretations of the Code adopted by the IRS and courts, leave room for improvement.⁶⁸

To see more clearly the types of problems posed by activities exhibiting economies of scope, the approaches that are currently taken in applying the UBIT to such activities, and the ways in which the current approaches might be justified or modified in light of the policy considerations outlined above, it will help to focus on two prototypical examples.

1. Museum Gift Shops

Many art museums operate gift shops from which they derive income to subsidize their other functions. These shops commonly sell items of a type that are also available from taxpaying proprietary stores. The museums may, however, experience some economies of scope in selling such items: among other things, museum visitors are precisely the type of people most likely to patronize such a shop and may be particularly in the mood to purchase art-related items when in the museum. Consequently, museums are likely to operate such shops regardless of whether they are subjected to the UBIT. If all income from such shops were exempt from the UBIT, however, the museums would have an incentive to expand them well beyond their natural economies of scope and develop large stores selling a broad variety of items to the public at large.⁶⁹

⁶⁷ The IRS regulations state that a business is "related" when it "has a causal relationship to the achievement of exempt purposes (other than through the production of income)." Treas. Reg. § 1.513-1(d)(2) (as amended in 1983). This has the right spirit but does not move the ball very far.

⁶⁸ Among the specific statutory provisions governing application of the UBIT, for example, the exemption for university research activities is surely too broad. See Note, *Collaboration Between Nonprofit Universities and Commercial Enterprises: The Rationale for Exempting Nonprofit Universities from Federal Income Taxation*, 95 *Yale L.J.* 1857, 1866-71 (1986). Like most other conspicuous gaps in the current coverage of the UBIT, this will be largely remedied if the House committee proposals in Draft Report, *supra* note 5, are adopted.

⁶⁹ It might be argued that most or all profits from sales by museum gift shops should be exempted from tax on the grounds that these profits are essentially donations. People who purchase items in such shops, it could be argued, in fact often choose to patronize those shops

Presumably in recognition of this latter point, such shops have not been completely exempted from the UBIT. Rather, the IRS applies a "fragmentation rule" to their sales, subjecting the returns from sales of some types of items to the UBIT while judging sales of other types of items to be "related" and hence exempt. For example, income from sales of reproductions of objects in the museum's collection is generally exempt, whereas income from sales of reproductions of objects not in the museum's collection, including reproductions of art objects in other museums, is taxable.

This approach has two principal difficulties. First, it is administratively costly to both the IRS and the museums to be constantly classifying sales, and the resulting income, according to a variety of criteria that are necessarily often vague. Second, the criteria employed frequently reflect too literal an interpretation of "relatedness" and lose sight of the underlying purpose of the UBIT. Consider the distinction employed in the case of reproductions. The question here should be whether the production and distribution of such reproductions can be handled just as efficiently by commercial businesses as by nonprofit art museums. The answer, in general, is probably yes. Presumably an important reason that art museums are nonprofit is that the marginal costs of making original masterpieces of art available for public viewing are radically below the average costs: although a substantial capital outlay is necessary to acquire and house such works of art, once they are on display the marginal cost of admitting another member of the public to view them is close to zero. Under such circumstances, financing by public and private donations rather than by admission charges may be not only the most efficient but also the only feasible way to operate a museum—and an institution financed by donations

rather than commercial shops, and perhaps purchase more than they otherwise would, because they understand that the profits from the purchases will be used to support the museum. (Similar logic presumably would not extend to operations such as New York University's macaroni company because since the purchasers of Mueller macaroni are probably generally unaware of, and unconcerned about, who ultimately owns the company.) This argument, however, has two difficulties. First, it is not clear that its underlying empirical supposition—that people intend to make a donation—is true. Second, it would be very difficult to determine where to draw the line between taxed and untaxed activities. Such logic has been rejected in other circumstances. See *United States v. American Bar Endowment*, 477 U.S. 105 (1986) (holding income from sale of insurance to members subject to UBIT not exempt as charitable contributions).

must generally be organized as a nonprofit.⁷⁰

The uniqueness of the works of art involved, however, is an essential factor here. The same logic does not apply to reproductions for which average and marginal cost are very close. Moreover, this is true regardless of whether they are reproductions of items in the museum's own collection. For-profit firms can, and commonly do, make and sell art reproductions. It follows that there is no reason to subsidize nonprofit firms to engage in such manufacturing and merchandising.

On the other hand, exempting the ("passive") income a museum receives from licensing a (taxable) business firm to make and market reproductions of items in the museum's collection may be sensible: it is not an activity that a for-profit firm could perform instead. The museum's incentive to do it is unlikely to be affected by whether it is taxed on the proceeds; and exempting such profits produces a subsidy that is neatly proportioned to the publicly valuable service that the museum provides, which is acquiring expensive art works for display at low or no fees.⁷¹

The IRS employs other criteria to distinguish between taxable and nontaxable sales by museum gift shops, but those seem no more defensible.⁷² As a consequence, it might make better sense simply to abandon such distinctions and make all museum gift shop income subject to the UBIT.

2. *University Dining Halls*

The Internal Revenue Code contains a special exception to the UBIT for services that certain classes of exempt nonprofits operate "for the convenience of" individuals whom the nonprofits serve or employ.⁷³ Critics have charged that the various services exempted in

⁷⁰ On the economic role of nonprofit arts institutions generally, see Hansmann, *supra* note 38, at 854-59.

⁷¹ It is sometimes said that the proceeds from museum sales of art reproductions are exempted because selling reproductions helps promote the educational function that the museum is said to serve. This justification is unpersuasive. For one thing, it would seem to extend to the sale of any reproductions, not just those of works in the museum's own collection. Furthermore, it would also seem to call for exempting from corporate taxation the earnings that for-profit shops receive from the sale of art reproductions.

⁷² These criteria include, for example, whether or not the object sold bears the museum's logo and whether or not the object is "utilitarian." See B. Hopkins, *supra* note 16, at 739.

⁷³ I.R.C. § 513(a)(2) (1982).

the convenience exception should be subject to the UBIT.⁷⁴ Student dining halls operated by universities illustrate the issues involved in that claim.

Taxation of the income from university dining services might be supported with logic similar to that just outlined in the case of museum gift shops. Operation of a restaurant generally would not qualify for exemption if undertaken by a nonprofit corporation organized and operated exclusively for that purpose (that is, a restaurant would not pass a "stand-alone" test). Consequently, there is a presumption for subjecting food services to the UBIT even when they are operated by an otherwise exempt university. The fact that in most instances it should be relatively easy for universities to account separately for income and expenses associated with their dining hall operations makes the case for taxation even stronger. Moreover, the UBIT would help to discourage universities from expanding their food services beyond the point where they experience economies of scope.

There are, however, at least two arguments for treating university dining services differently from the approach suggested above for museum gift shops and for continuing to exempt them from the UBIT, at least so long as they do not make substantial sales to the public at large.

First, subsidizing food services for students furthers the underlying purposes of the basic exemption for educational services. Presumably the reason that educational institutions are exempted from tax is that, in the absence of subsidy, too little education will be consumed.⁷⁵ Any subsidy to services that must be consumed jointly with education will serve the same purpose. Students, of course, must eat. Consequently, a subsidy to food consumed by students will serve as an indirect subsidy to the consumption of education. Thus, exemption of student food services will further the purposes of the basic exemption

⁷⁴ See, e.g., Hearings, *supra* note 5, at 106 (testimony of Frank Swain, Chief Counsel for Advocacy, U.S. Small Business Administration).

⁷⁵ The best argument to support public subsidy to education is not, as is commonly supposed, that the education an individual acquires yields substantial external benefits to society at large since (at least short of the graduate level) education is overwhelmingly a private good. Rather, it is that an individual's inability to borrow against the human capital she accumulates in school, as well as the impracticality of devising contracts for insurance on the returns to investment in such capital, will commonly lead individuals to underconsume education even when it is viewed as a private good. See Hansmann, *supra* note 38, at 859-62.

for educational institutions.⁷⁶ (This argument might even be taken so far as to support a stand-alone exemption for organizations that provide no educational services but simply sell food exclusively to students.)

Second, economies of scope are so strong in this situation that universities are likely to provide food services regardless of whether the UBIT is applied to them. Moreover, if dining hall services were taxed, universities might simply adjust their dining hall fees to eliminate taxable net income and then increase tuition or other nontaxable charges correspondingly. Thus, application of the UBIT here might yield very little revenue and lead to no appreciable change in the extent of the dining services operated by universities.⁷⁷ Rather, it might simply reduce universities' flexibility in setting their fee structures and also increase administrative expenses for both universities and the IRS. Moreover, there is another natural point at which to draw the line between taxable and nontaxable food services—namely, at the point at which universities begin selling food to the public at large in appreciable quantities. This is probably the point where economies of scope rapidly disappear, and beyond which universities should not be encouraged to expand. Consequently, there is a reasonable case to be made for applying the UBIT to university dining halls only when they engage in substantial sales to the public.⁷⁸

⁷⁶ The same logic does not necessarily extend to cafeterias operated by art museums, at least if one accepts the marginal-cost-below-average-cost rationale for exemption described *supra* notes 69-71 and accompanying text. This would be true, moreover, even if it were generally necessary to eat while visiting an art museum. So long as the charge for viewing the art itself is set at marginal cost—which in most cases is close to zero—the level of consumption will be efficient, and there is no justification for further subsidy. Moreover, most art museums already are either free or charge only a minimal entrance fee that is not used in any important way to cover the cost of acquiring art.

Nevertheless, the House Committee proposals in Draft Report, *supra* note 5, at 44-45, specifically call for continuing exemption for museum cafeterias.

⁷⁷ On the other hand, although universities might establish student dining halls whether or not they are subject to the UBIT, it does not follow that the universities themselves will necessarily operate those services. Instead, they could license a for-profit food service firm to operate the dining halls for them. A university might be more inclined to contract out in this fashion if their dining services were subject to the UBIT, and this weighs in favor of application of that tax.

⁷⁸ The reforms recently recommended by the House Subcommittee on Oversight are roughly consistent with this latter line of argument. They call for repeal of the convenience exception in general but recommend that exemption be continued for, among other things, food services that a university provides to its students on its premises. Draft Report, *supra* note 5, at 44-45.

X. REFORMING THE SCOPE OF THE BASIC EXEMPTION

Although only modest reforms are called for in the UBIT, the same is not true of the basic nonprofit exemption to which the UBIT is appended. At present, many tax-exempt nonprofits—including perhaps most nonprofit hospitals, health maintenance organizations, and nursing homes—arguably serve no significant function beyond selling, on a commercial basis, services of a kind and quality that are also provided by profit-seeking firms.⁷⁹ This raises a serious question as to whether tax exemption should be withdrawn from most or all of the nonprofit firms in such industries.⁸⁰ Congress has already taken a first step in this direction with the Tax Reform Act of 1986,⁸¹ which withdrew exemption from nonprofit life and health insurance companies.⁸² Public debate should now focus on deciding whether the scope of the basic exemption should be even further rationalized and contracted.⁸³ This is an issue of far greater significance than the UBIT, and one that will be much harder to resolve from both an analytical and a political point of view.⁸⁴

XI. CONCLUSION

Although the academic literature has frequently viewed the UBIT with attitudes ranging from skepticism to hostility, analysis reinforces what common sense suggests: the UBIT serves an important function in avoiding inefficient distortions in the organization of economic

⁷⁹ Clark, *Does the Nonprofit Form Fit the Hospital Industry?* 93 Harv. L. Rev. 1416 (1980); Hansmann, *Economic Theories of Nonprofit Organization*, in *The Nonprofit Sector: A Research Handbook* 27 (W. Powell ed. 1987); Hansmann, *supra* note 38, at 863-68.

⁸⁰ Rep. Fortney H. Stark (D.-Cal.), the Chairman of the Health Subcommittee of the House Ways and Means Committee, has already suggested that tax exemption should be withdrawn from nonprofit hospitals. *Tax Exemption for Nonprofit Hospitals Assailed*, N.Y. Times, July 15, 1987, at A21, col. 1.

⁸¹ Pub. L. No. 99-514, 100 Stat. 2085 (to be codified in scattered sections of 26 U.S.C.).

⁸² I.R.C. § 510(m) (West 1988).

⁸³ This is an important issue, not just at the federal level but also at the state level, where courts and legislatures are beginning to question seriously the current broad scope of tax exemption for nonprofits. See, e.g., *Utah County v. Intermountain Health Care*, 709 P.2d 265 (Utah 1985) (substantially narrowing criteria for property tax exemption for nonprofit hospitals); Broadus, *For-Profit Backlash: Legislatures in Thirty-Two States Have Challenged the Tax Exemption of Nonprofits—and Are Redefining Charity in the Process*, *Foundation News*, March/April 1988, at 51.

⁸⁴ For an analysis of the policy underlying the basic exemption and some suggested guidelines for reform, see Hansmann, *Exempting Rationale*, *supra* note 40.

activity. On the other hand, despite the substantial agitation from the small business community recently pressing for broader application of the UBIT, there seems to be room for only modest reform in that direction. The truly difficult and important issue involving the tax treatment of nonprofits concerns not the UBIT but rather the scope of the basic exemption that underlies it, and that is where future debate should focus.

