Under United States tax law, most income accruing to charities and other nonprofit organizations is tax-exempt. However, the law treats income from “business related activities” differently. Such income can be taxed at normal corporate (or trust) rates under the Unrelated Business Income Tax (UBIT). To clarify the distinction between the two: nonprofits often collect revenue as part of their activities, such as hospital fees and university tuition. Human service charities also may collect revenue through service fees and government contracts. As long as fees generated by such activities are considered “substantially related” to the organization’s mission, they are exempt from taxes. Take, however, a nonprofit organization that raises revenue through means not related to its charitable purpose. Then this income is subject to taxation. For example, the tuition charged by a university is tax-exempt, but if the university also owns a restaurant which serves the general public outside the campus and which does not further the education of its students, then those profits are very likely not to be tax-exempt.

The rationale behind the Unrelated Business Income Tax is that tax-exempt nonprofits should not be given a competitive advantage over for-profit companies when it comes to non-charitable or non-exempt types of business activities. The initial writers of the law also expressed concern that if nonprofit organizations became increasingly involved in business, then this would erode the corporate tax base (Brody 2001).

Nonprofit organizations must strike a difficult balance between fulfilling their primary mission and the genuine need to develop revenues. Policymakers, in turn, worry about the blurring of lines between nonprofit organizations and business. In some cases the same types of organizations (such as hospitals) may be either for-profit or non-profit, but operate very similarly.

While businesses legitimately worry that tax exemption can give nonprofits an unfair advantage, the fear is not always correct even when it comes to unrelated activities. The income-tax exemption for nonprofits does not necessarily reduce the cost of purchasing goods or the opportunity cost of investing in one area versus another. Keep in mind that the passive income of nonprofits is nontaxable. Thus nonprofits face a tradeoff between investing in business activity and, say, bonds. If both the business income and the return on the bonds are tax-exempt, there is no tax reason to favor one over the other. Thus, even though nonprofits are nontaxable and businesses taxable, both often face the same calculation: invest in the business activity only when the return from the business activity is higher than the interest rate.

Thus nonprofits would not necessarily have an incentive to underprice goods or increase commercial activities even if such activity was tax exempt (Steuerle 1988). By the same token, taxing unrelated business activity may encourage nonprofits to avoid extraneous business activities and “stick to their knitting,” which may be part of the Congressional intent. Also, discouraging nonprofits from commercial activity may not be to the detriment of the nonprofit sector and society at large if nonprofits can make similar returns on their passive investments, and profit-making businesses can perform the business activity just as well.

The extent to which nonprofits underreport their unrelated income as opposed to simply avoiding unrelated commercial activity is difficult to determine. Unrelated business income is in fact a very small source of revenue for nonprofits. In tax year 2008, about 42,066 nonprofit organizations reported unrelated business income, 2.7 percent of total nonprofits organizations (Jackson 2012, NCCS 2009). Only half of these organizations reported net unrelated business income tax liability after claiming deductions, meaning only about 1 percent of all nonprofits paid any Unrelated Business Income Tax. In total, nonprofit organizations in 2008 reported about $10.3 billion in unrelated business income. For comparison, nonprofits reported over $1.35 trillion in revenue in 2008.

Yetman (2009) tests the reliability of nonprofit taxable activity disclosures by comparing matched samples of 990s and 990-Ts, two forms which both report taxable income, the former publically and the latter confidentially. The study finds that the correlation for total taxable revenues is 77 percent, interpreted as a relatively high degree of consistency. At the least, this indicates that nonprofits tend to report the same amount of taxable revenues to the IRS and the general public.

After claiming deductions close in value to the $10.3 billion in unrelated business income, nonprofit organizations paid only $336 million in taxes in 2008. Thus, the Unrelated Business Income Tax raises very little revenue for the government. These results are consistent with the interpretation that nonprofit organizations prefer to avoid unrelated business activity unless under pressing need (Hines 2000). In addition, Yetman (2001) found in an earlier year that nonprofits reported aggregate annual losses on their taxable activities of $1-4 billion, compared to aggregate profits of over $50 billion on their tax-exempt activities. Yetman also finds evidence that medical and educational nonprofit organizations allocate expenses from tax-exempt to taxable activities to lower their tax liability.

Reform of the Unrelated Business Income Tax has been discussed periodically. The main difficulty is in drawing a line between “related” and “unrelated” business activities. Some have concluded that the UBIT is so difficult to enforce that it could be considered a “voluntary tax” or a sanction on nonprofits earning “too much” commercial income (Brody 2001). John Colombo raised this point during his testimony on “Public Charity Organizational Issues, Unrelated Business Income Tax, and the Revised Form 990” before the Subcommittee on Oversight of the Committee on Ways and Means. Colombo suggested a drastic measure to solve this problem: make all commercial activity (related and unrelated) by nonprofits taxable, thereby removing incentives for nonprofits to switch activities from taxable to tax-exempt areas. The other extreme would be to repeal the Unrelated Business Income Tax entirely. Either option might remove the incentive for nonprofits to manipulate the allocation of expenses/revenues, but would also change significantly what it means to be a charity or other nonprofit.

Smaller possible reforms include increasing the $1,000 standard deduction for unrelated business income, changing the allocation rules, modifying the definition of excludable royalties, clarifying when a business is “regularly carried on” and thus taxable, and repealing the provisions taxing unrelated debt-financed income, e.g. various types of passive income (such as dividends, interest, royalties, and rents) arising from property acquired or improved with borrowed funds (Brody 2001).

The Unrelated Business Income Tax might raise little revenue but, without it, distinctions between business and charitable activity could become quite blurred. Furthermore, profit-seeking can crowd out rather than supplement charitable donations: Yetman (2002) finds that for nonprofits, each additional dollar of taxable revenues crowds out approximately $1.38 to $1.79 of private donations, with the exception of medical and educational organizations. In conclusion, maintaining a border between commercial and charitable/nonprofit activity might be hard to enforce, but the Unrelated Business Income Tax clearly does establish a border over which many nonprofits are unwilling to step.
References


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