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When Nonprofits Conduct Exempt Activities as Taxable Enterprises

Eugene Steuerle*

Why would an organization decide to pay more tax—or at least appear to pay more tax—than the law requires?

In recent years, a number of tax-exempt organizations have pursued related activities that normally qualify for tax exemption as for-profit, taxable enterprises. Examples include a university opting to create a for-profit distance learning program, a hospital packaging software for commercial sale, an art museum selling special reproductions, or a housing group participating in a consortium to build low-income housing.

When a nonprofit engages in business activities unrelated to its nonprofit purposes, taxability is usually not a question of choice; various laws and regulations require that the organization pay taxes on this income and, typically, on sales and property. For related activities, however, a nonprofit that can claim tax exemption sometimes chooses to carry out these activities in the form of a taxable enterprise. But why would an organization decide to pay more tax—or at least appear to pay more tax—than the law requires?

This puzzling question was the subject of the fourth seminar on emerging issues in philanthropy sponsored by the Urban Institute's Center on Nonprofits and Philanthropy and the Hauser Center at Harvard University. The seminar, held on November 30, 2000, brought together a wide range of private practitioners representing nonprofit organizations, clients, legal counsel to nonprofit organizations, academics, and researchers.

Information on nonprofits that structure certain activities as for-profit enterprises is scarce because most data on for-profit enterprises of exempt organizations are not public. But the anecdotal evidence suggests that this type of activity, while still only a small part of the nonprofit sector's overall activity, reflects an increasing desire among nonprofits to take advantage of perceived market opportunities—in particular, through the co-investment of taxable parties.

According to the participants' discussion, the taxable form appears desirable when a nonprofit would like to attract outside capital; more efficiently apportion control among private and nonprofit participants and among various parts of the nonprofit itself; provide certain forms of incentive compensation to nonprofit executives or other key employees; or show good citizenship by paying property taxes in the local community.

Tax-Exempt Activity in Nonprofits

Has reliance on revenues ancillary to nonprofit organizations' exempt purposes—from fees, sales, or royalties—increased in recent years? Ancillary revenue can come from both related activities and unrelated activities. Although no overall measure of such income is available, tax return records filed by nonprofit organizations provide

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some insight into their taxable activities. In a panel of 6,000 nonprofit organizations that filed IRS Form 990 returns in 1993 and 1998,[1] the number of taxable subsidiaries grew by more than 50 percent—from 1,449 in 1993 to 2,244 in 1998. Nonprofit organizations with one or more taxable subsidiaries also increased 35 percent, from 980 in 1993 to 1,324 in 1998.

Over the same period, median ownership in a taxable subsidiary among the 6,000 nonprofits dropped from about 90 percent in 1993 to about 50 percent in 1998. This drop, given the rise in taxable subsidiaries, suggests that the number of partners to such activities has increased. In dollar terms, the most material shift has been in income from the "related income" to "unrelated, excluded" category—probably as a result of increased royalties. By contrast, the level of unrelated, taxable income has not changed very much; indeed, about a third of organizations reported net taxable losses, implying that nonprofit organizations classify income and expenses in a way that keeps the amount of tax on unrelated income quite small.

Still, commercial income for nonprofits as a whole has increased in terms of absolute dollars. In a panel of 130,000 organizations that filed IRS Form 990 returns in both 1993 and 1998,[2] 66 percent reported an increase in the amount of commercial income. The increase was most prevalent among higher education organizations and hospitals; commercial income rose in three out of four of these types of organizations.

Much of that increase may reflect greater sales of related services within the exempt part of the organization, but we have no way of knowing for sure. The growth in commercial revenue may simply reflect the rapidly expanding health sector, which generates a sizable share of its revenues from hospital fees for service. It would not be surprising, however, if growth in program revenue and growth in nonexempt revenue were strongly correlated over time, since both types of revenue generally come from the sale of goods and services.

Taxable Activity: Well Considered and Diverse

Panelists concluded that most activities undertaken as taxable by nonprofits appear to be well planned and designed to meet a definite purpose. Beyond this common feature, the taxable activity of nonprofits varies considerably and can take many forms, including limited liability companies, partnerships, trusts, or corporations. Participants named several types of activities that have been pursued under a for-profit structure:

- *Low-income housing* (e.g., a community development corporation engaging in a consortium to build the housing).
- *Other rental housing* (e.g., a nonprofit with large property ownership in a community).
- *Distance learning and executive education* (e.g., a university capitalizing on what it already does).
- *Biotechnology* (e.g., a nonprofit research organization engaging in a venture with a profit-making research organization).
- *Business incubators* (e.g., a start-up software company flowing out of a health or educational organization).
- *Information systems* (e.g., disease-management software developed by a large health system to be spun off).
- *Dot-coms* (e.g., a sales operation conducted by commercial businesses for dot-orgs, museum stores, and other nonprofits, often with a percentage of the sales going to the nonprofit).

The Search for For-Profit Partners

Participants identified several reasons for adopting a taxable entity. Often, such initiatives are designed to acquire the expertise of, and coordinate activities with, a particular for-profit partner. The presence of a business partner does not require that a nonprofit give up exemption for the activity in question; the organization usually makes that choice.

Often, the decision to acquire a nonexempt partner is a matter of convenience and will have little effect on the overall activity of both parties. As one panelist observed, "Nonprofits often resist furthering their core mission…through a taxable entity, and the for-profit participant probably doesn't want to learn too much about the nonprofit world."

Panelists described several reasons why nonprofits sometimes forgo tax-exempt status:

To raise financial capital or gain access to human capital. For enterprises that require a great deal of start-up risk capital, a nonprofit may want to lay off the cost of developing programs to a for-profit partner in exchange for giving up a share of the resulting revenues. By creating or partnering with a for-profit entity, a nonprofit can allocate shares of ownership relatively easily. The pure for-profit form also helps minimize the risk that profits will be siphoned off or used to subsidize another group (e.g., a nonprofit-related organization). To the for-profit partners, taxable status increases the likelihood that management of the activity will be directed toward maximizing profit.

Participants pointed out that in some cases, such as electronic commerce, a business initiative might be taken more seriously if organized as a for-profit activity. Such partnering seems especially fruitful when the nonprofit does not have the necessary internal business expertise to ensure the initiative's success. One panelist noted that a for-profit partner can add a dose of pragmatism to a business plan: "A nonprofit's projections of profitability—like Ambrose Bierce's definition of remarriage in *The Devil's Dictionary*—represent the triumph of hope over experience. By contrast, venture capitalists are particularly realistic."

To cash in and sell a new venture. A clearly separate for-profit venture (especially one that begins as a partnership with one or more for-profit organizations) may be easier to sell successfully in the open market. For example, some ventures may create attractive short-term opportunities. Running an enterprise for decades, however, is not always in the long-term interest of the nonprofit organization as a whole. Thus, a nonprofit might raise capital, act as a partner or shareholder for a short time, and then sell the venture. Even when a new venture is pursued as a for-profit activity, the tax consequences of investing in it are often minimal for two reasons:

- When an organization expects most income to come in the form of future capital gains, the venture's early net operating income often will be negative or very small and require minimal to no income tax payments. In general, a tax-exempt organization's sales of capital shares are not subject to tax. Another possibility is to structure any income generated during the start-up phase as royalty payments, which are deductible by the enterprise and nontaxable to the exempt recipient. In effect, then, operation as a for-profit subsidiary would leave most of the nonprofit's returns tax-exempt.

- A nonprofit might develop a product for internal purposes that has large initial costs but potential external application (e.g., a large health care organization develops fee-tracking software). If development costs can be pushed into a for-profit subsidiary, these costs can then be written off against taxable income rather than simply reported as an expense incurred by the nonprofit.

To address tax aspects of the activity itself. In joint ventures between exempt and taxable participants, an important IRS concern is that impermissible private benefit might result. Accordingly, the IRS carefully screens such joint ventures and looks for evidence that the exempt participant controls the enterprise in a way that protects its primary exempt purpose. In some transactions, before giving clearance the IRS calls upon the exempt organization to make a guarantee, such as meeting an environmental condition or dedicating a percentage of revenues to services to low-income individuals.

Using a taxable vehicle for the nonprofit's investment can eliminate the need for such close scrutiny, although it raises other problematic issues. In particular, for-profit initiatives often raise questions about how expenses are allocated between partners and about compensation paid to staff with dual employment.

In addition, recent changes to the tax laws limit a nonprofit's ability to exclude certain income. Under the revised law, a tax-exempt organization must report as income all interest, rents, and royalties paid by taxable subsidiaries in which it directly or indirectly owns more than a 50 percent stake. Thus, economically equivalent transactions can produce different tax results. For example, to exclude royalties from licensing arrangements, the nonprofit must take a passive role and let the for-profit partner regulate the activity. By contrast, to exclude income from a joint venture with a taxable partner, the nonprofit must retain control over the activity.

To simplify tax filing for certain activities. For initiatives that are financed by commercial or similar revenue, a nonprofit may be subject to unrelated business income tax (UBIT). For example, some organizations finance Web sites or television activities with advertising revenues. By setting up taxable affiliates or subsidiaries, a nonprofit can simplify accounting procedures and steer clear of UBIT requirements. Moreover, the tax consequences are sometimes favorable when expenses can be allocated to an affiliate.

To make payments in lieu of taxes. Nonprofit organizations that own large amounts of commercial or residential real estate typically try to maintain good relations with the local governments supplying important services, such as roads, water, police, and fire protection. Some nonprofit organizations achieve this goal by making payments in lieu of taxes (PILOTs). Nonprofits with large amounts of rental real estate, however, may forgo exemption on some portion of their real estate and pay the appropriate property tax. By moving this real estate into the profit sector, an organization will pay some property tax; because of depreciation and interest expenses, however, it often will incur little or no income tax.

Establishing Separate For-Profit Entities

In addition to engaging in taxable activities with for-profit partners, nonprofit organizations can establish separate entities to pursue related or unrelated activities. An organization can structure these separate entities as for-profit to meet certain objectives.

To ensure accountability to the IRS. A nonprofit that operates a for-profit activity directly may face increased scrutiny from the IRS. The IRS generally wants to ensure that the nonprofit governing board protects the charitable purposes of the exempt organization. The nonprofit needs to appropriately reflect any sharing of personnel, facilities, or resources between its for-profit and nonprofit arms. The IRS considers some types of activity, such as management services, to be inherently taxable. To minimize any threat to the exempt status of the nonprofit—especially when net income is not likely to be significant—the nonprofit might prefer to relegate the activity to a for-profit subsidiary.

To maintain accountability to the nonprofit's board and members. In addition to the IRS, a nonprofit's board and members monitor an organization's adherence to its mission. Several participants gave examples of nonprofits that did not want to give even the appearance of tainted activities or a weakening commitment to their organizations' primary purposes. As one panelist put it, "Losing your soul is even worse than losing your tax-exempt status—and you might even be able to keep your tax-exempt status." The nonprofit board may lead the charge toward separating nonprofit and for-profit functions, or the officers of the nonprofit may make the separation to ensure that contributors are not misinformed about the exempt organization's main pursuits.

To limit nonprofit's liability. By separating activities into different corporations, a nonprofit can sometimes take advantage of the limited liability laws that apply to individual corporations. Bankruptcy laws can make it easier to abandon a failed venture; the ability to contain lawsuits helps protect other parts of the nonprofit.

To gain some flexibility in compensation. A taxable entity has more flexibility in the area of compensation. Particular nonprofits may have explicit or implicit caps on employees' salaries to reflect the culture of the organization or to keep salaries from discouraging outside contributions. Within a for-profit entity, such limits often do not apply. When compensation can help attract or retain the talent needed to run a separate activity, an organization might set up a for-profit subsidiary.

A for-profit can also offer additional types of compensation, such as deferred compensation and equity-based compensation (e.g., participating stock, deeply discounted stock, stock appreciation rights, and options of all kinds) to potential leaders of the enterprise. In other cases, the exempt organization might try to increase the compensation of some its own employees by putting them on the for-profit board or by making them officers with a significant stake in the venture.

Enhanced compensation, however, can be a mixed blessing. First, in some circumstances, the goal of the for-profit entity may be to reduce transparency of the organization's activities. Unlike compensation paid to top officers and board members of the nonprofit, compensation paid by the for-profit subsidiary is not disclosed to the public. With less disclosure, a nonprofit risks becoming less accountable to the public whose support it seeks. Moreover, recent legislation imposes penalties on nonprofit insiders who receive "excess benefits" from the nonprofit and its affiliate combined.

Second, compensation packages offered in the for-profit subsidiary can cause dissension in the ranks. Employees of the exempt entity might want to shift to the for-profit venture if compensation gains are potentially higher. In addition, within a complex organization, these structures can create winners and losers. For example, within a university conducting for-profit scientific research, the biology staff stands to gain more than, say, the humanities staff.

Concerns Raised by the Taxable Activities of Nonprofits

Most participants at the meeting agreed that the level of taxable activity among nonprofits is small relative to the level of assets. Moreover, this activity is generally confined to well-defined marketplaces and, in many cases, comprises one-time or limited profitability opportunities.

Nonetheless, even a small increase in taxable activities has important implications for the nonprofit sector. All charities have some obligation to ensure that assets and human capital within the organization are not diverted toward noncharitable purposes. In addition to legal and tax consequences, nonprofits are governed by other fiduciary obligations to the public and to past donors.

Given the unique legal and social position of nonprofits, the structuring of normally exempt activities as for-profit business raises important regulatory, competitive, and structural questions. As one panelist stated, "We're used to thinking about abuses from for-profits using the exempt form to conduct business activities, but this is the other way around. Instead of tax avoidance, the issues are strategic and philosophical: Is this a prudent or program-related investment? Is there a diversion of charitable assets or nonprofit managers' attention? Do private parties inappropriately benefit?"

States attorneys general and the IRS often find it difficult to measure and monitor a nonprofit's unrelated business activities. Regulating nonprofits has become even more difficult as a result of the inexpensive, universal marketing opportunities made possible by the Internet. At the same time, nonprofits would like to avoid calls for disclosure of all activities by exempt organizations—not just of unrelated business income earned directly, but of income earned by a taxable affiliate or subsidiary. Any stringent reporting requirement would make nonprofits a less appealing source of capital to commercial partners making taxable investments. It could also provide an unfair advantage to taxable competitors that do not have exempt investors.

The current tax-exemption structure is based on organizational form rather than on specific activities. Nonprofit outputs, however, are difficult to observe and quantify. Consequently, we must rely on proxies to try to ensure that truly charitable activity is undertaken with the charitable contributions of donors. For example, the law, as well as nonprofit boards themselves, prohibits payment of excess compensation or profits to executives.

Profit-seeking activities put pressure on these form-based rules. Moreover, if a nonprofit charges full market prices for otherwise program-related activities—as is clearly the case with taxable subsidiaries—it can ultimately price some of the very people that it wants to help out of the market. In the long term, the visible commercial activity of a few nonprofits could invite closer scrutiny of the unrelated business income tax. If this kind of activity increases significantly, it could call into question the tax exemption of certain nonprofit industries, or even the exemption of the entire sector.

This line of discussion left participants with a broad, thought-provoking question by the meeting's end: Will we see a transformation of entity-based exemption that requires activities with different levels of social value to adhere to different tax regimes?

Endnotes

1. This panel was created from an IRS Statistics of Income Division sample that includes all 501c(3) organizations with assets

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THE URBAN INSTITUTE
2100 M Street, N.W.
Washington, D.C. 20037

Phone: (202) 833-7200
Fax: (202) 467-5775
E-mail: pubs@ui.urban.org

THE HAUSER CENTER
For Nonprofit Organizations
70 John F. Kennedy Street
Cambridge, MA 02138
Phone: (617) 496-5675
Fax: (617) 495-0996
www.ksghauser.harvard.edu

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