

# Fair or Foul?

## *A Review of Federal Tax Laws Governing Unfair Competition*

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When nonprofits compete in spaces traditionally operated by for-profits, there are two primary legal issues to contend with: unrelated business income and restraint of trade—both of which were put in place to govern unfair competition, and neither of whose boundaries tend to be all that easy to determine. That these laws are necessary is clear; but, note the authors, “In light of all the constraints on a nonprofit running a profitable business, the alarm of unfair competition rings a little hollow.”

THERE ARE AT LEAST TWO TYPES OF NONPROFIT legal issues that can emerge from nonprofits and for-profits competing in the same field of endeavor.<sup>1</sup> One has to do with unrelated business income, and this is generally resolved between a nonprofit and the IRS (see sidebar on pages 55 through 58 for regulations); the other has to do with allegations of “restraint of trade,” or practices that have an anticompetitive effect on the market.

The second type of problem has emerged most recently when nonprofits have tried to enter or expand into a field dominated by for-profits and where for-profits want to limit the market nonprofits can attract. It is often professional associations that initiate this type of effort, alleging that nonprofits enjoy an unfair advantage or do not meet professional standards—and in many instances the issues are resolved at the local or state level.

Recent examples of such interactions include the Alabama Dental Association’s (ALDA) opposition to the expansion of the Sarrell Dental Center,

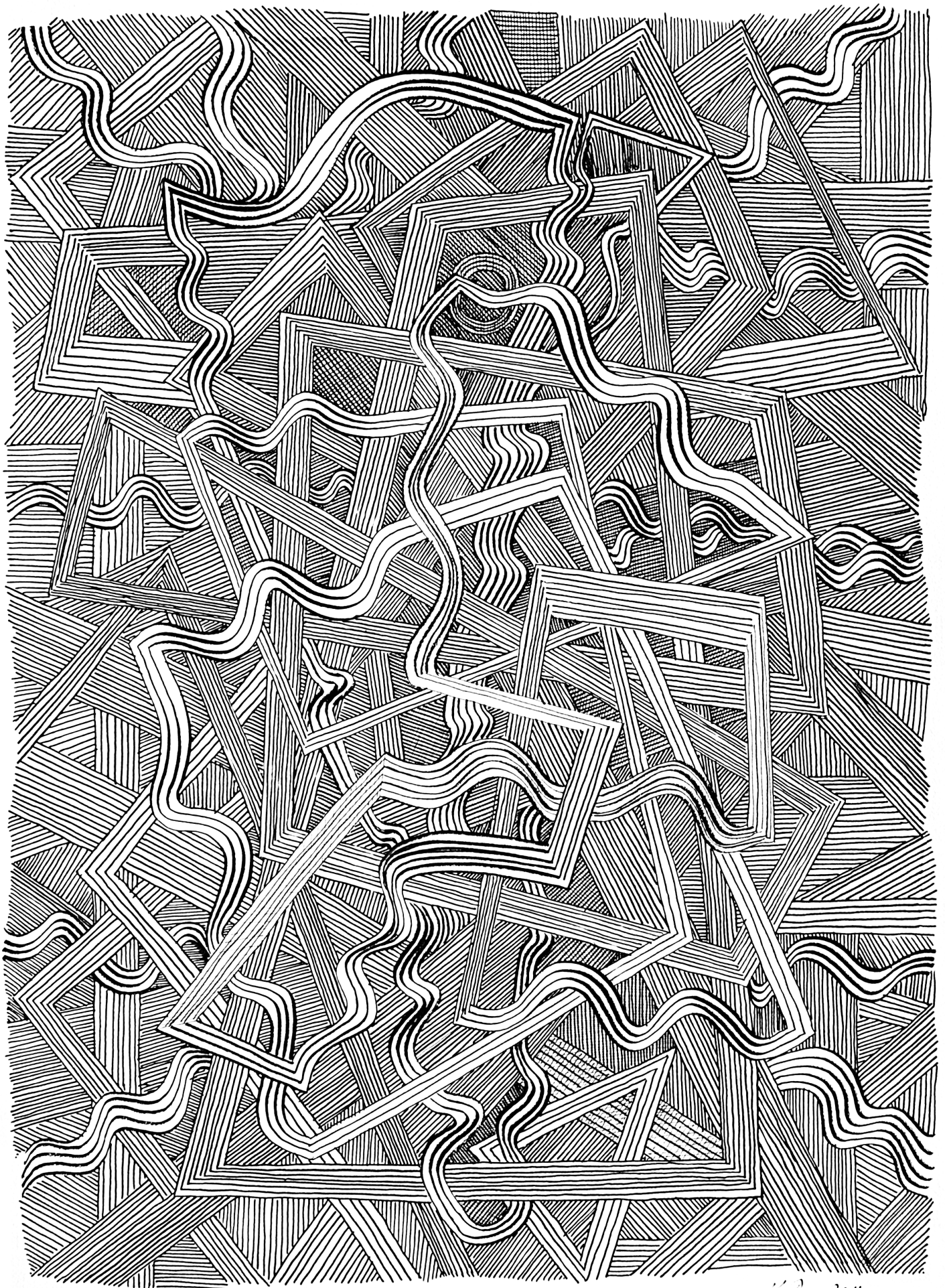
a nonprofit that provides dental services to children from low-income families. As Rick Cohen wrote in 2010, “The interim executive director of the ALDA acknowledged that there’s a problem of inadequate dental services for poor children, but the idea of nonprofit dental clinics in Alabama is ‘new,’ and ‘established dentists aren’t sure what it will mean in the long term.’ . . . At the meeting, participants complained that nonprofits had a business advantage over for-profit dentists, who faced business pressures that nonprofits didn’t. They discussed getting legislation considered by the state to ‘control’ nonprofits.”<sup>2</sup>

Eventually, the University of Alabama at Birmingham announced it would no longer make its dental students available to work at Sarrell clinics, and Sarrell sued, claiming that the school was being pressured by alumni and private dentists to prevent students from working there. Sarrell ended up filing an antitrust lawsuit against the ALDA in 2011, but later rescinded when Alabama Governor Robert Bentley signed into law Sarrell’s right to operate in the state. The situation was later featured in the *Frontline* documentary “Dollars and Dentists,” in 2012.

In a slight twist, the Idaho Veterinary Medical Association (IVMA) voted this past summer to back a campaign to prohibit animal welfare groups from providing veterinary care to pets of people who are not low income. The campaign was apparently sparked by the Idaho Humane Society’s having received state approval to establish a more centrally located shelter that would

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also be four times larger than its current facility. Dr. Robert Pierce, president of the IVMA board, said that the planned ten-thousand-square-foot hospital could potentially drive out other smaller, for-profit veterinary facilities.

The most classic conflicts, however, have involved recreational facilities—some of the more recent being challenges to YMCAs. One such conflict occurred in Idaho this past summer, when the Ada County Board of Equalization received a complaint from two for-profit clubs that the West Family YMCA in Boise was running programs similar to their own, and that this should call into question the Y's tax-exempt status. Idaho Athletic Club's chief financial officer Shaun Wardle said, "Those are really the same services that we offer—the health and fitness services. Is it charitable to run on a treadmill? Is it charitable to take a CrossFit class? I'm in that business, I don't necessarily feel that it's charitable and deserves an exemption."<sup>3</sup> The Board of Equalization initially agreed, reducing the Y's 100 percent tax-exempt status to 19 percent. The tax exemption was later brought back up to 100 percent, after the Y organized itself to protest.

Similar scenarios have played out across the country with day care centers, theaters, community newspapers, and management consulting firms. On the business playing field, nonprofits are increasingly entering into spaces traditionally operated by for-profits, and for-profits are increasingly entering into spaces traditionally operated by nonprofits. The line between the sectors is blurring, and the alarm of unfair competition is being rung on both sides.

### The Concerns of Unfair Competition

If a nonprofit can characterize its income-generating businesses as substantially related to its exempt purpose, the net income from such businesses will not be taxed. This financial incentive to characterize business activity as exempt has over time caused nonprofits to push the boundary of what has historically been recognized as exempt or nonexempt.

This is understandable, given that most nonprofit revenues are earned, not donated. According to the National Center for Charitable Statistics, in 2012 U.S. public charities reported over \$1.65 trillion in

total revenues. Of this, only 21 percent came from contributions, gifts, and government grants, while 73 percent came from program service revenues (including government fees and contracts), and an additional 6 percent came from other sources, including dues, rental income, special events income, and gains or losses from goods sold.<sup>4</sup>

In any event, nonprofits have generally not been criticized for operating enterprises primarily focused on serving socioeconomically disadvantaged individuals traditionally not targeted by for-profits or by government agencies contracting out social services. Cries of unfair competition, however, *are* raised in cases where nonprofits have expanded their services to compete with for-profits in the general public marketplace, with the goal of producing net income. Some nonprofits argue that the production of income from such expansion of services is necessary to subsidize the unprofitable businesses that historically are recognized as related to furthering an exempt purpose. But such justification is based on the old *destination of income* principle that no longer applies under the current tax laws and regulations.

The expansion of nonprofit services must instead be examined with consideration of the following regulation:

In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve. Thus, where income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business. Such income is not derived from the production or distribution of goods or the performance of services which contribute importantly to the accomplishment of any exempt purpose of the organization.<sup>5</sup>

The appropriate characterization of a nonprofit business as either related or unrelated to its exempt purpose is what drives most of the controversy over unfair competition. But it's not the entire story.

Many nonprofits counter such arguments by stating that their expansion of services to the broader public market still contributes importantly to accomplishing their exempt purpose. Thus, even as more and more members of the general public make use of nonprofit services (often at commercial market rates), YMCAs still run health clubs and yoga programs to improve community health, and SPCAs and humane societies operate veterinary clinics to promote animal welfare and prevent cruelty to animals. Under the same rationale, Girl Scouts have justified selling cookies, a nearly \$800 million business, as mission related in educating girls and building their courage, confidence, and character.<sup>6</sup>

Other commercial activities increasingly claimed as mission related and exempt—without any long-standing historical recognition as such—are less immune to objection. Consider the open source software movement.

The development of software as a charitable endeavor is a relatively new undertaking, with potential commercial implications. The two principal inquiries to determine whether an open source software organization qualifies or fails to qualify as exempt are:

1. Is it operated for a charitable or educational purpose?
2. Is it providing a private benefit to any person or entity that is more than incidental, quantitatively and qualitatively, to the furthering of the organization's charitable or educational purposes?

The development and distribution of open source software may be charitable where the goal is to provide access to such resources to disadvantaged populations that might otherwise not have such access for economic or other reasons. However, if the development and distribution of the software do not specifically target such populations, the organization may be conferring a prohibited private benefit upon other persons or entities that may be considered more than merely incidental and could adversely impact for-profit competitors.

For example, hypothetically, if a nonprofit developed open source software that could effectively

and efficiently replace Microsoft Office for all markets, and made that available to the general public for free, it would presumably confer a significant private benefit upon individuals making the switch, adversely impact Microsoft's market share in the office suite software space, and, consequently, reduce the amount of income taxes collected by the federal government (and sales taxes collected by the state government) by the amount that would have been generated by sales of Microsoft Office. If, on the other hand, the nonprofit somehow restricted the distribution only to its targeted charitable class of beneficiaries (e.g., socioeconomically disadvantaged communities that otherwise could not afford such software), the activity would more likely be regarded as related to its exempt purpose and not jeopardize its exempt status for violating the private benefit doctrine.

The same two inquiries applicable to open source software organizations can generally be applied to other types of organizations found in both the nonprofit and for-profit sectors, including schools, hospitals, and art galleries. The challenges for open source software organizations seeking 501(c)(3) exempt status are the lack of a strong tradition of recognizing the provision of open source software as an exempt activity, and the advocacy of for-profit software companies defending their turf. Not surprisingly, the IRS has flagged applications for tax exemption by open source groups for extra review, to the ire of many open source advocates.<sup>7</sup>

The appropriate characterization of a nonprofit business as either related or unrelated to its exempt purpose is what drives most of the controversy over unfair competition. But it's not the entire story. Indeed, even for a business activity that is inarguably related to a nonprofit's exempt purpose, notions of whether a nonprofit should receive tax exemption for income generated from that activity may differ. For example, even if a YMCA's operation of a new yoga program clearly and substantially contributes to its exempt purpose, some believe that significant issues about unfair competition remain because the YMCA can potentially take away all the customers from a small business that is also promoting a social purpose of improving community health.



Many academic scholars have pointed out that the private sector's complaints about the nonprofit sector's tax exemption with respect to the direct operation of businesses are misplaced and exaggerated.

Similarly, controversies regarding nonprofit veterinary clinics exist despite the relatedness of their commercial activities to their exempt purpose of "preventing cruelty to animals." Critics argue that offering low-cost services without discriminating based on a person's ability to pay unfairly harms private for-profit practitioners. Moreover, they rationalize that there is no point in subsidizing a nonprofit to provide services that can be performed just as efficiently by for-profits.<sup>8</sup>

What these examples illustrate is that whether nonprofit commercial activity is considered related or unrelated to an exempt purpose is not perfectly correlated to our notions of fairness. Even if it were possible to appropriately characterize all nonprofit businesses as purely related or unrelated, allowing related business income to be exempt may seem unjustified in cases where the nonprofit's activities are not correcting a failure in the market to provide goods and services of suitable quality, but is instead taking away customers already served by for-profit companies and potentially distorting the market rather than advancing important policy goals.

### A Rebuttal

Many academic scholars have pointed out that the private sector's complaints about the nonprofit sector's tax exemption with respect to the direct operation of businesses are misplaced and exaggerated.<sup>9</sup> From a nonprofit's perspective, since most forms of passive investment income are exempt from taxes, there is no reason for nonprofits to directly manage unrelated businesses if they can make the same return in a diversified portfolio of debt and equity, without all the burdens and risks of managing a wholly owned business. While there are exceptions to this rule, most notably when a nonprofit can leverage its charitable operations to reduce its costs and receive a higher return from running an unrelated business rather than passively investing, academics argue that overall the nonprofit charitable deduction has a minimal effect on competition.

The challenge, however, with these academic arguments is that they sometimes fail to capture much of what actually happens in the real world. These arguments are often based on an unstated

and implied assumption that nonprofits will always be operated pursuant to rational decisions to maximize financial returns or charitable impact. However, realities often dictate that nonprofits make decisions based upon a wide variety of factors other than purely maximizing impact or financial gain. Moreover, the arguments fail to consider that businesses operated by nonprofits often pursue a mix of social and financial goals where the law does not provide clear guidance on the sufficiency of their relatedness to the nonprofits' exempt purposes. Couple these issues with the problems of enforcement discussed on pages 55 through 58, and the argument regarding unfair competition warrants further examination.

As a side note, for the many nonprofits that operate with very little net income from their businesses, the advantage offered by exemption from taxes on their income may be far less important than the advantage offered by exemption from taxes on their property. Property tax, which generates more revenue for the states than do the individual and corporate income taxes combined, is a matter of state law.<sup>10</sup> And the states are where much of the battle over unfair competition and the charitableness of self-declared related businesses takes place.<sup>11</sup>

### The Future

The movement toward social enterprises that we've seen in the last decade is beginning to reshape both the nonprofit and for-profit sectors, and the line between the nonprofit and for-profit sectors continues to blur.

Nonprofit organizations are increasingly entering into traditionally commercial spaces in an effort to increase revenues as they face simultaneous challenges of uncertain philanthropic funding, diminishing governmental funding, unstable fundraising revenues, and increased competition for limited resources. For-profit entities are similarly operating in an increasingly competitive market and seeking to differentiate themselves and generate goodwill by self-identifying as social enterprises, sustainable businesses, and/or certified B Corps, sometimes with sincere motives and other times primarily for marketing purposes.

While tax exemption may be a significant advantage in operating a business within a nonprofit, there are also several disadvantages associated with a nonprofit business form, including the inability to raise equity capital, the limitations associated with the operational test, and the prohibitions against private inurement, private benefit, and excess benefit transactions. Further, unlike a for-profit, a nonprofit is subject to state laws regarding self-dealing, charitable trust, and prudent investment, all of which may constrain the most efficient use of business capital. Nonprofits must also overcome unique cultural issues, including mobilizing the support of stakeholders both inside and outside of the organization and overcoming public criticism of their commercial activities.

In light of all of the constraints on a nonprofit running a profitable business, the alarm of unfair competition rings a little hollow. But that assumes sufficient understanding, compliance, and enforcement of applicable laws—which is perhaps more than we have the right to assume for now.

#### NOTES

1. For the purpose of this article, the term “nonprofit/s” refers to nonprofit organizations exempt under Section 501(c)(3) of the Internal Revenue Code.
2. Rick Cohen, “Alabama: Nonprofit vs. For-Profit Dental Battle,” *NPQ*, April 13, 2010, [nonprofitquarterly.org/updates/2187-nonprofit-newswire-alabama-nonprofit-vs-for-profit-dental-battle.html](http://nonprofitquarterly.org/updates/2187-nonprofit-newswire-alabama-nonprofit-vs-for-profit-dental-battle.html).
3. Holly Beech, “Treasure Valley YMCA Retains Full Tax Exemption,” *Idaho Press-Tribune*, July 4, 2014, [www.idahopress.com/news/local/treasure-valley-ymca-retains-full-tax-exemption/article\\_944c4774-0320-11e4-8a00-001a4bcf887a.html](http://www.idahopress.com/news/local/treasure-valley-ymca-retains-full-tax-exemption/article_944c4774-0320-11e4-8a00-001a4bcf887a.html).
4. “Quick Facts About Nonprofits,” National Center for Charitable Statistics, accessed September 23, [nccs.urban.org/statistics/quickfacts.cfm](http://nccs.urban.org/statistics/quickfacts.cfm).
5. Treas. Reg. §1.513-1(d)(3).
6. Jessica Menton, “Girl Scout Cookies 2014: Where to Buy & Where Does the Money Go?,” *International Business Times*, February 7, 2014, [www.ibtimes.com/girl-scout-cookies-2014-where-buy-where-does-money-go-video-1553955](http://www.ibtimes.com/girl-scout-cookies-2014-where-buy-where-does-money-go-video-1553955).
7. Ryan Paul, “IRS Policy That Targeted Political Groups Also Aimed at Open Source Projects,” *Ars Technica*,

## IRS Regulations *for* Nonprofits Operating a Profitable Business

### Related versus Unrelated Businesses

The vast majority of earned income by nonprofits is reported to be from businesses substantially related to the advancement of their respective charitable or other tax-exempt purposes.<sup>12</sup> Less than 1 percent of nonprofits’ earned income is from unrelated businesses that do not substantially contribute to furtherance of their exempt purposes.<sup>13</sup> The distinction between mission-related business and unrelated businesses is important for three reasons:

1. The concern about unfair competition is more often raised where the nonprofit is operating a business that is completely unrelated to its exempt purpose (e.g., a university running a pasta manufacturing company).<sup>14</sup>
2. The concern about unfair competition with respect to such unrelated businesses has been partly addressed by the unrelated business income tax (UBIT), which was created to level the playing field between taxable and tax-exempt entities competing in the same commercial space.<sup>15</sup>
3. Net income from a nonprofit’s related businesses is not taxed in significant part for the same reason that its donative income is not taxed: Congress believes that the provision of goods and services that substantially contribute to advancing an exempt purpose should be encouraged and subsidized because they otherwise would not be provided by for-profits.<sup>16</sup>

### Unrelated Business Income Tax

Prior to the Revenue Act of 1950, which introduced the UBIT, charitable nonprofits were exempt from federal income taxes on all income, including earned income, regardless of whether such earned income derived from

related or unrelated businesses.<sup>17</sup> Further, whether a nonprofit was classified as charitable and qualified for tax-exemption depended not on how its income was earned but on whether it was used to further the nonprofit's exempt purpose. This "destination of income" principle allowed for the creation of tax-exempt "feeder organizations" that operated purely commercial businesses that passed on income to charitable nonprofits.<sup>18</sup> And because many nonprofits were not required to file information returns with the Internal Revenue Service, the pervasiveness and extent of nonprofit commercial activities was not well understood.

When the UBIT rules were enacted, the rationale was to eliminate unfair competition by imposing a tax on a nonprofit's net income generated from unrelated business activities. To be considered unrelated business income, the income must be generated by an activity that constitutes (1) a trade or business; (2) that is regularly carried on; and (3) is not substantially related to the furtherance of the organization's exempt purpose.<sup>19</sup> Whether an activity is a *trade or business* turns on whether it is carried on for the production of income from selling goods or performing services, and whether it is conducted with a profit motive. An activity is *regularly carried on* if it is conducted with similar frequency and continuity to a for-profit conducting the same activity. This means that a one-time fundraising event, such as a car wash or a charity auction, if not regularly carried on, will not generate unrelated business income. Finally, the revenues will only be subject to UBIT if the business activity is *not substantially related* to the organization's exempt purpose. This third factor is widely regarded as the most difficult factor to analyze, and involves a highly fact-sensitive inquiry.

To be substantially related, the activity must contribute importantly to accomplishing the organization's exempt purpose other than through the production of income, and whether the generated income is used to fund charitable programs is irrelevant to the determination.<sup>20</sup> This prohibition on looking to the manner in which generated income is spent reinforces the underlying rationale of UBIT—to prevent tax-exempt organizations from having an unfair competitive advantage over for-profit entities engaging in the same business activity.

Federal law provides multiple exceptions for activities that may otherwise be considered to generate unrelated business income subject to

taxation. Some of the more common of these exceptions include income generated from business activities for which substantially all of the work is performed by volunteers; a business carried on primarily for the convenience of an organization's members, students, patients, officers, or employees; a business selling merchandise if substantially all of the merchandise has been donated to the organization; and the distribution of low-cost items as part of charitable fundraising efforts.<sup>21</sup> Another exception applies to qualified sponsorship payments made to an exempt organization if there is no arrangement or expectation that the payor will receive any return benefit in connection with the payment. There are also exceptions from UBIT that generally apply to certain forms of passive income, including real property rental income; interests, dividends, and annuities; royalty payments; and certain capital gains from the sale of property.<sup>22</sup> A nonprofit's net unrelated business income that does not qualify for one of the applicable exceptions or exclusions is taxed at the rates applicable to corporations or trusts, depending on the organization's legal structure.<sup>23</sup>

### Operational Test and Commerciality Doctrine

Nonprofits are also subject to the operational test and the commerciality doctrine, which serve to restrict the income-generating activities they may engage in. The *operational test* provides that a 501(c)(3) organization must be operated primarily for one or more of the exempt purposes set forth in Internal Revenue Code Section 501(c)(3).<sup>24</sup> Only an "insubstantial part" of the organization's activities may be devoted to non-exempt purposes, such as operating an unrelated business.<sup>25</sup> While operating a related business would not adversely impact an organization's 501(c)(3) status, its primary purpose must not be to carry on an unrelated trade or business. The regulations provide that in determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the unrelated trade or business and the size and extent of the organization's activities that are in furtherance of one or more of its exempt purposes.<sup>26</sup>

Under the *commerciality doctrine*, a court-created derivative of the operational test, if a nonprofit is operating in a manner that is too commercial, it may risk losing its exempt status. In applying the commerciality doctrine, the IRS or the courts will generally look to

whether a nonprofit is engaging in activities that are in direct competition with those of for-profits.<sup>27</sup> In assessing commerciality, courts have considered such factors as:

- The extent to which the nonprofit provides below-cost services;
- Pricing policies, including whether the nonprofit is adopting pricing in order to maximize profits;
- The nonprofit's business and marketing practices, including whether the nonprofit is engaging in commercial marketing methods (such as advertising), employs a paid staff (as opposed to primarily relying on volunteers), and discontinues unprofitable programs;
- The reasonableness of the nonprofit's financial reserves;
- The nonprofit's customer base, including whether it primarily sells to the general public as opposed to a discrete charitable class;
- Whether the nonprofit is receiving substantial public charitable contributions.<sup>28</sup>

The limitations created by the operational test and commerciality doctrine make it difficult for a nonprofit to directly operate one or more unrelated businesses that collectively might appear to be substantial in size in relation to its total activities. Because failing the operational test would result in loss of exempt status, nonprofits with businesses that might be considered both substantial and unrelated are typically counseled to consider dropping such businesses into a wholly owned for-profit taxable subsidiary, which will be subject to the same taxation rules as other for-profits. For example, the nonprofit National Geographic Society operates its publishing services, digital media properties, and television channels through for-profit subsidiaries such as National Geographic School Publishing, Inc., National Geographic Ventures, and National Geographic Channel. Similarly, the nonprofit Mozilla Foundation wholly owns the Mozilla Corporation, which handles the development and commercial-revenue-generating activities of the popular Firefox browser.

The operational test and commerciality doctrine help to address the concern over nonprofits competing with for-profits in businesses that would be considered unrelated to the nonprofits' exempt purposes. Additionally, nonprofits face several other restrictions that would hinder their ability to enter into the purely commercial playing

field in competition with for-profits, including federal tax law prohibitions against private benefit, private inurement, and excess benefit transactions.<sup>29</sup>

### Private Benefit Restrictions

To qualify as exempt under Internal Revenue Code Section 501(c)(3), an organization must serve a public rather than a private interest.<sup>30</sup> To satisfy this requirement, referred to as the *private benefit doctrine*, the organization must establish that it is not operated for the benefit of private interests. This does not mean that the organization is entirely prohibited from conferring benefits to individuals; rather, it provides that such benefits must be incidental—quantitatively and qualitatively—to furthering of the organization's exempt purposes.<sup>31</sup>

An organization will similarly fail to qualify as a 501(c)(3) organization if any part of its net earnings inure to the benefit of any private shareholder or individual.<sup>32</sup> This requirement, known as the *private inurement doctrine*, generally prohibits a 501(c)(3) organization from using its assets for the benefit of a person having a personal and private interest in the organization's activities (i.e., an insider such as a director, officer, or key employee).<sup>33</sup> An organization that engages in an inurement transaction (e.g., paying an unreasonable compensation to an insider) may face revocation of its exempt status.

While the private benefit and private inurement doctrines appear very similar, there are two important differences. First, the private benefit doctrine is much broader than—and indeed subsumes—the private inurement doctrine, because it applies whenever an impermissible benefit is being conferred on any private party, not just insiders. Second, unlike the case with private inurement, a prohibited private benefit may not cause a loss or denial of exempt status. But if the transaction involves one or more insiders known as “disqualified persons,”<sup>34</sup> it may fall within the definition of an *excess benefit transaction*<sup>35</sup> and subject the organization, the disqualified person, and even board members who knowingly approved the transaction to significant penalty taxes.<sup>36</sup> These limitations, which for-profits are not subject to, serve to limit the ways in which individuals can personally benefit from the income generated by a nonprofit, including through unrelated business activities.



## Lack of Enforcement

The vagueness of the law surrounding what is substantially related to furthering an exempt purpose and what is not makes consistent compliance and enforcement impracticable. In a final report of its Colleges and Universities Compliance Project, the IRS stated that 90 percent of the examined institutions underreported unrelated business income ("UBI").<sup>37</sup> Among the primary reasons for the underreporting were the following: misreporting unrelated business activities as related activities; reporting losses as connected to unrelated business activities when they were not (thereby lowering their UBIT liability); and misallocating expenses that were used to carry out both exempt and unrelated business activities and then applying an excessive portion to offset UBI.<sup>38</sup> The report's executive summary concluded: "The examinations of college and universities identified some significant issues with respect to both UBI and compensation that may well be present elsewhere across the tax-exempt sector. As a result, the IRS plans to look at UBI reporting more broadly. . . ."<sup>39</sup>

In 2014, the Advisory Committee on Tax Exempt and Government Entities (ACT), appointed by the Department of the Treasury, recommended that the IRS Exempt Organizations Division publish a comprehensive revenue ruling on a range of UBI issues, including identification of categories of activities that would be considered related or unrelated.<sup>40</sup> The ACT further recommended rejecting application of the commerciality test as long as an organization's income and its financial resources were used commensurate in scope with its charitable program.<sup>41</sup> This recommendation likely stems from the uneven application of the commerciality doctrine and the ACT's assertion that "[n]either the tax law nor the implementing regulations provide support for a commerciality test."<sup>42</sup> It remains to be seen whether these recommendations will be adopted and implemented.

Vague regulations both contribute to and compound the weakness of IRS enforcement, which has faced particular scrutiny and criticism since the revelation in 2013 of its inappropriate handling of exemption applications containing certain names or political themes. With insufficient resources to adequately oversee a sector of over 1.4 million exempt organizations<sup>43</sup> and subject to crippling budget cuts that exacerbate the enforcement challenges it is already facing, it's unlikely that the Exempt Organizations Division of the IRS will be able to significantly strengthen its enforcement program in the near future.<sup>44</sup> The severity of this problem will likely be amplified by the July 2014 introduction of Form 1023-EZ, the short form exemption application that will allow a vast majority of smaller organizations to apply for and receive 501(c)(3) status while providing almost no description of their existing and contemplated activities.

July, 2, 2014, [arstechnica.com/tech-policy/2014/07/irs-policy-that-targeted-tea-party-groups-also-aimed-at-open-source-projects/](http://arstechnica.com/tech-policy/2014/07/irs-policy-that-targeted-tea-party-groups-also-aimed-at-open-source-projects/).

8. Henry B. Hansmann, "Unfair Competition and the Unrelated Business Income Tax," *Virginia Law Review* 75, no. 3 (April 1989): 605, 625.

9. *Ibid.*, 609–12. See also Michael S. Knoll, "The UBIT: Leveling an Uneven Playing Field or Tilting a Level One?," *Fordham Law Review* 76, no. 2 (November 2007): 857, 866–70.

10. Knoll, "The UBIT," 879.

11. See, for example, Ruth McCambridge, "Alabama's Persistent Nonprofit/For-Profit War Extends to Animal Clinics," *NPQ*, May 7, 2013, [nonprofitquarterly.org/policysocial-context/22251-alabama-s-persistent-nonprofit-for-profit-war-extends-to-animal-clinics.html](http://nonprofitquarterly.org/policysocial-context/22251-alabama-s-persistent-nonprofit-for-profit-war-extends-to-animal-clinics.html).

12. "Table 1. Unrelated Business Income Tax Returns: Number of Returns, Gross Unrelated Business Income (UBI), Total Deductions, Unrelated Business Taxable Income (Less Deficit), Unrelated Business Taxable Income, and Total Tax, by Type of Tax-Exempt Organization, Tax Year 2010," Department of the Treasury Internal Revenue Service, last modified April 23, 2014, [www.irs.gov/uac/SOI-Tax-Stats-Exempt-Organizations'-Unrelated-Business-Income-UBI-Tax-Statistics](http://www.irs.gov/uac/SOI-Tax-Stats-Exempt-Organizations'-Unrelated-Business-Income-UBI-Tax-Statistics). It states that \$7,115,467,000 in gross unrelated business income was reported by all 501(c)(3) organizations in 2010; compare to over \$1.1 trillion in program service revenues reported by 501(c)(3) public charities in 2010, in Paul Arnsberger, "Nonprofit Charitable Organizations, 2010," *Statistics of Income Bulletin* (Winter 2014): 75, [www.irs.gov/pub/irs-soi/14eowinbulcharitorg10.pdf](http://www.irs.gov/pub/irs-soi/14eowinbulcharitorg10.pdf).

13. *Ibid.*

14. See, for instance, *C. F. Mueller Company v. Commissioner*, 190 F.2d 120 (3rd Cir. 1951), in The Joint Committee on Taxation, *Historical Development and Present Law of the Federal Tax Exemption for Charities and Other Tax-Exempt Organizations* (JCX-29-05), April 19, 2005, 101–2.

15. Treas. Reg. §1.513-1(b) states that "[t]he primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete."

16. Heather Gottry, "Profit or Perish: Non-Profit Social Service Organizations & Social Entrepreneurship," *Georgetown Journal on Poverty Law & Policy* 6 (Summer 1999): 249, 256.
17. See the Joint Committee on Taxation, *Historical Development and Present Law of the Federal Tax Exemption for Charities and Other Tax-Exempt Organizations*, 100–101.
18. *Ibid.*, 101.
19. 26 U.S. Code §513. See also *Tax on Unrelated Business Income of Exempt Organizations*, IRS Publication 598 (Washington, DC: Department of the Treasury Internal Revenue Service, 2012), [www.irs.gov/pub/irs-pdf/p598.pdf](http://www.irs.gov/pub/irs-pdf/p598.pdf).
20. Treas. Reg. §1.513-1(d)(2).
21. 26 U.S. Code §513(a), (h).
22. 26 U.S. Code §512(b).
23. 26 U.S. Code §511(a)(1).
24. Treas. Reg. §1.501(c)(3)-1(c)(1).
25. *Ibid.*
26. Treas. Reg. §1.501(c)(3)-1(e)(1).
27. See *Airlie Foundation v. Internal Revenue Service*, 283 F. Supp. 2d 58, 63 (D.D.C. 2003).
28. *Ibid.* See also W. Marshall Sanders, "The Commerciality Doctrine Is Alive and Well," *Taxation of Exempts* (March/April 2005): 209, 211.
29. Private foundations face further restrictions under federal tax law that affect their ability to invest in and operate purely commercial businesses, including prohibitions against self-dealing, excess business holdings, jeopardizing investments, and taxable expenditures.
30. Treas. Reg. §1.501(c)(3)-1(d)(1)(ii).
31. Department of the Treasury, *Internal Revenue Service General Counsel Memorandum* 39862, Nov. 21, 1991.
32. See U.S. Code §501(c)(3).
33. Treas. Reg. §1.501(c)(3)-1(c)(2).
34. 26 U.S. Code §4958(f)(1) defines a *disqualified person* with respect to a transaction as "(A) any person who was, at any time during the five-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization [including directors of the corporation], (B) a member of the family of an individual described in subparagraph (A), (C) a 35-percent controlled entity. . . ."
35. 26 U.S. Code §4958(c)(1)(A) defines an *excess benefit transaction* as "any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit."
36. 26 U.S. Code §4958(a).
37. See Exempt Organizations Division, *Colleges and Universities Compliance Project Final Report*, revised May 2, 2013 (Washington, DC: Department of the Treasury Internal Revenue Service, 2013), 11, [www.irs.gov/pub/irs-tege/CUCP\\_FinalRpt\\_042513.pdf](http://www.irs.gov/pub/irs-tege/CUCP_FinalRpt_042513.pdf).
38. *Ibid.*, 10–14.
39. *Ibid.*, 6.
40. Advisory Committee on Tax Exempt and Government Entities (ACT), *2014 Report of Recommendations*, Publication 4344 (Rev. 6-2014), Catalog Number 38578D (Washington, DC: Department of the Treasury Internal Revenue Service, 2014), 160, [www.irs.gov/pub/irs-tege/tege\\_act\\_rpt13.pdf](http://www.irs.gov/pub/irs-tege/tege_act_rpt13.pdf).
41. *Ibid.*, 80.
42. *Ibid.*, 157–58. (The report further states that "the evidence is clear that the imposition of tax under the Corporation Excise Tax Act of 1909, from which the present income tax exemptions are derived, does not indicate any intention to limit the tax exemption of charities engaged in business or to limit the quantum of business activity, but rather indicates an intention to assure exemption of certain charities engaged in businesses.")
43. "Quick Facts About Nonprofits."
44. National Taxpayer Advocate, *2013 Annual Report to Congress Executive Summary: Preface and Highlights*, Publication 2104C (Rev. 12-2013), Catalog Number 23655L (Washington, DC: Department of the Treasury Internal Revenue Service, 2013), 3, [www.taxpayeradvocate.irs.gov/userfiles/file/2013-Annual-Report-to-Congress-Executive-Summary.pdf](http://www.taxpayeradvocate.irs.gov/userfiles/file/2013-Annual-Report-to-Congress-Executive-Summary.pdf). (The report states that "[t]he IRS has been chronically underfunded for years now, at the same time it has been required to take on more and more work, including administering benefit programs for some of the most challenging populations . . . [and] without adequate funding, the IRS will fail at its mission.")

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