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# *Why are Nonprofits Exempt from the Corporate Income Tax?*

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## *Abstract:*

This paper considers the nonprofit exemption from the Corporate Income Tax (CIT), which has typically been justified either on the grounds that a subsidy to the nonprofit sector is warranted, or that the nonprofit sector enjoys a degree of sovereignty from the state. It argues a different rationale: that the corporate tax as applied to for-profit businesses is meant to capture in the tax system income ultimately owned by individuals but that otherwise might escape tax, and the nonprofit exemption is a consequence of nonprofit income not being attributable to any individual. In order to explain why nonprofits are exempt from the CIT, we should begin by asking why there is a CIT at all, rather than by asking what is so special about nonprofits. The argument is then applied to the debate over the rationale for the Unrelated Business Income Tax.

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The basic structure of how nonprofits are treated under the Corporate Income Tax (CIT) in the U.S. can be summarized as follows. Under the Internal Revenue Code Section 501(c)(3), an organization is exempt from the CIT if it designed for a charitable purpose, which includes “religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.” The organization must not distribute net earnings to any private shareholder or individual (the “nondistribution constraint” which Hansmann (1980) took as the defining feature of nonprofits) and is restricted in its ability to carry out political lobbying. For such organizations, the Unrelated Business Income Tax (UBIT), which is very similar to the CIT, applies to any net earnings from business regularly carried out by the organization but which is unrelated to the purpose under which the organization claimed tax exemption under Section 501(c)(3) (unrelated except, obviously, for raising funds for the charitable purpose). Finally, exemption from the CIT under 501(c)(3) may be denied if the organization engages in too much unrelated business.

In the preceding paragraph there are many gray areas: how do we determine what specifically constitutes a “charitable purpose”? How do we define “unrelated business”? How do we calculate the net earnings of an unrelated business when some of its costs are inseparable from the costs of the primary purpose of the organization? When does the scope of unrelated business cross the threshold leading to denial of the tax exemption altogether?

That being said, in this paper I want to ask whether the overarching structure of the corporate tax treatment of nonprofits is efficient. The gray areas are important, and there are occasions where an evaluation of the big picture must take into account how organizations and their accountants will exploit the gray areas to their advantage. But the focus here is on the general structure.

Two terms that frequently arise in debates over tax reform are efficiency and fairness. It is worthwhile stating at the outset how these terms will be treated.

Efficiency means that the productive resources of the economy – labor, land, and investments in productive capital – are allocated across sectors of the economy, both in terms of what goods and services are produced and in what amounts, and in terms of organizational form, between for-profit corporations, other types of for-profit business, and nonprofits, such that there is no possible reallocation of resources that could increase the total value of production. An efficient tax system is one that collects revenue while keeping the total value of production as high as possible. A corporate income tax with rules that discouraged investments in new machines even when the value of those machines would be greater than their cost, or that induced firms to adopt nonprofit status when in the absence of taxes the for-profit form of organization would lead to greater value of output, would not be efficient.

Fairness, in terms of the tax system, means first that individuals who are in similar economic circumstances should pay similar amounts of tax, i.e. there should not be arbitrary differences in tax burden across like individuals (horizontal equity), and second that those individuals with a higher ability to pay tax should pay more tax (vertical equity). Clearly fairness will be more contested than efficiency; the value of output can

be measured, and so inefficiencies in the tax system can be estimated, but fairness depends on subjective accounts of what it means to be in “similar economic circumstances”, on what constitutes the best measure of “ability to pay”, and on the rate at which taxes should rise with ability to pay (i.e. the optimal degree of progressiveness in the tax system).

With those definitions in mind, I suggest that the analysis of the treatment of nonprofits in the corporate tax system should focus on efficiency, and in practical terms whether there are low administration and compliance costs, but that claims of “unfair” treatment of for-profit firms relative to nonprofits do nothing to further the analysis. Investors choose in which industries to invest based on where they expect to earn the highest return, with due consideration for the risk of the investment (i.e., other things equal they will require a higher expected return on the investment if it is riskier). Among the risks investors face are changes in consumer demands, changes in government policies that might affect costs or demands, and increased competition from new, or old but expanding, sources. There is nothing unfair in the fact that in some sectors, for a time, returns to investment are higher than in other sectors. Investment will flow to where the rates of return are highest, and that serves to generally equalize the rates of return investors receive across industries (again, adjusting for the levels of risk). Nonprofits were exempt from the CIT from its introduction in 1913, and the only significant change since was the introduction of the UBIT in 1950, so it can hardly be the case that for-profit investors are earning low returns as a result of recent changes favoring nonprofits.

Since we have a political system that rewards lobbying by organized groups of producers for protection against competition, we have such lobbying. Although the

statements by industry lobbyists will use the word “unfair” (almost as often as they use the phrase “in the public interest”), in reality the sole concern is for those who have investments in an industry to find new restrictions on their competition so that their own profits can rise, whether it is for-profit firms claiming the tax treatment of nonprofits is unfair, or firms claiming that competition by government is unfair, or firms lobbying for regulatory rules that would restrict the entry of new firms (Stigler, 1971), or firms lobbying for tariffs and quotas on foreign competition which somehow has an unfair advantage (Bhagwati, 1989), and all the way back to manufacturers of candles seeking regulations to protect them from the unfair competition by the sun (Bastiat, 1845).

Impartial analysis of tax policy is only sidetracked when it ventures into discussions of the so-called “unfairness” of the nonprofit tax exemption. The true concern is efficiency: is the tax treatment of nonprofits structured such that our economy uses its productive resources to produce the highest value of goods and services. In particular, does the tax system encourage goods and services to be produced by for-profit or nonprofit firms according to which organizational form provides a better mix of high quality and low costs? Many of the papers on the tax treatment of nonprofits raise the question of “unfairness”, and in their defense it must be noted that even the Treasury Regulations regarding the UBIT state that “the primary objective of adoption of the [UBIT] 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” (Section 1.513-1(b)), but this paper will not pursue that particular definition of “unfairness.”

## THE CORPORATE INCOME TAX

Why is there a tax on corporate income? If there is a consensus that individual (or household) income is the best measure of ability-to-pay for the purposes of a horizontally and vertically equitable tax, then in an ideal world it would make sense to attribute all income earned, whether through corporations, partnerships, self-employment or as an employee, to the individual or household that receives it, and then to tax the individual on that basis. In fact for the most part that is what is done except for C corporations, which has its income taxed first through the CIT, and then at the personal level in the taxation of dividends and capital gains.

Why not integrate income earned through corporations into the Personal Income Tax? As a theoretical ideal, integration of corporate income into personal income taxation is commonly advocated by economists. But while there is a sound economic argument for integration, in practice there is the difficulty of how to treat the retained earnings of firms. If a corporation earns profits one year, and re-invests those profits into the acquisition of capital in order to enhance future profits, there is the challenge of how to attribute to shareholding individuals the increase in wealth they have just experienced, although the challenge is not obviously insurmountable.

If there is to be a CIT at all, a difficulty is that by its design it might raise the cost of capital at the margin to firms and so discourage investment. Without taxation, the cost of capital has two parts: depreciation ( $\delta$ ), and the rate of return ( $r$ ) that needs to be paid to the investors who financed the capital purchase. Letting the purchase price of a unit of capital be  $q$ , then the cost of using a unit of capital, say a machine, for one year is:

$$q(\delta + r).$$

In the absence of any taxation, firms would continue to invest in acquiring productive capital so long as for each new investment the contribution of the new machine to firm revenues would exceed its cost. On the assumption of diminishing returns to new investments, the firm invests in machines up to the point where the contribution to revenues from the last unit of investment, called the value of marginal product of capital ( $v$ ), is equal to the cost of capital:

$$v = q(\delta + r).$$

Could we design an ideal tax on corporate income such that the optimal amount of investment was unchanged by the tax? Suppose we taxed according to the following rule: Tax income at rate  $t$ . Allow a full deduction for the purchase of capital goods when they are purchased, but have no deductions for depreciation or finance costs. Then our equation for the optimal level of investment by the firm becomes:

$$v(1 - t) = q(1 - t)(\delta + r).$$

In other words, the firm earns revenues  $v$  from the marginal investment but keeps only  $v(1 - t)$ , and the firm pays  $q$  for a unit of capital, but with the tax deduction the true cost is only  $q(1 - t)$ . But when we divide each side of the equation by  $(1 - t)$  we simply return to our pre-tax rule:

$$v = q(\delta + r).$$

This tax method is known as cash-flow taxation, and has been recommended by many economists as a way to have efficient taxation of corporate income in a simple design (certainly simpler than the current corporate tax structure). See King (1986), Bradford and Auerbach (2001), and, where it has been discussed in the context of “real world” tax

reform, Meade et. al. (1978) and the President's Advisory Council on Tax Reform (2005, Chapter 7).

A common way to measure the effect on investment from the CIT is to think in terms of the effective marginal tax rate (EMTR), which is the percentage increase in (pre-tax)  $v$  required to cover the cost of capital, resulting from the CIT (Auerbach, 1987). As stated above, the “neutral” CIT has an EMTR of zero, generating tax revenue only from the profits on infra-marginal investments; in this case there is no harmful effect from the CIT on the level of new investment (which is why it is the marginal rate that is of most concern (Fullerton, 1984)). Also notice that it is quite possible for the EMTR to be negative, if depreciation allowances are “accelerated” (i.e. awarded at a faster rate than the capital truly depreciates) and there are generous provisions for deductions on financing costs (as occurred in the early 1980s). If the allowances for depreciation exactly match true depreciation, and there are no deductions of any kind for financing costs, then the EMTR exactly equals the CIT rate  $t$ ; this case is sometimes called a “pure” income tax (Auerbach, 1987; Gordon, Kalambokidis, and Slemrod, 2003).

Detailed calculations by Mackie (2002), which also account for the taxation of corporate earnings that occur through the personal income taxation of dividends and capital gains, give an average EMTR in the corporate sector of about 32 percent. The rate is lower for equipment and higher for structures, a result of the favorable treatment of depreciation in equipment. The corporate EMTR exceeds the rate for the non-corporate business sector, where it is about 20 percent. Estimates of the distortionary effects of taxing corporate income at a higher effective rate than non-corporate income vary widely; Gravelle and Kotlikoff (1988; 1989) claim the excess burden (the costs to the economy

from distortions in decisions as a result of tax incentives, expressed as a proportion of collected tax revenues) of the CIT can be over 100 percent when corporate and non-corporate firms are producing the same good, although Mackie-Mason and Gordon (1997) state the excess burden is in the range of 16 percent of tax revenues, and that non-tax factors are more important in the choice of for-profit organizational form. Using state-level organizational data Goolsbee (2002) suggests that Mackie-Mason and Gordon probably understate the distortions from the CIT since they use data from time-series that does not vary enough to provide a robust analysis, and that his own cross-sectional study indicates an excess burden somewhat higher than their 16 percent (although he does not come to a precise estimate himself).

## PRIOR THEORIES OF THE NONPROFIT CORPORATE INCOME TAX EXEMPTION

Three classes of arguments have been put forth on why nonprofits are exempt from the CIT: that “net income” cannot be coherently defined for nonprofits; that nonprofits are deliberately being subsidized by government through the exemption; and that nonprofits have an historic degree of sovereignty from government, of which the CIT exemption is but one manifestation (for a survey of theories of the nonprofit CIT exemption, see, in addition to the references that follow in this section, Fishman and Schwarz (2003)).

The first argument is that public service (as opposed to mutual benefit) nonprofit organizations “do not realize ‘income’ in the ordinary sense of the word” (Bittker and Rahdert, 1976, p. 305). Bittker and Rahdert state that net income is well-defined for for-profit organizations, since they are in the business of maximizing it. For nonprofits, they

claim, we cannot define the tax base coherently because there is no pursuit of profit. But it is not easy to see why the definition of net income is so difficult for nonprofits. The definition of profit as applied to for-profits for tax purposes does not hinge on their being effective at profit-maximization. As for nonprofits, “one has the sneaking suspicion that Harvard could come up with a taxable income number if pressed to do so” (Colombo and Hall, 1995, p. 24).

There are multiple arguments for explaining the CIT exemption as a deliberate subsidy. One is that the CIT exemption represents a subsidy to the sector (in addition to the deductibility from the Personal Income Tax of donations made to nonprofits, and various other tax exemptions) in order to encourage its provision of services that are generally in the public interest. A possible way to define public interest is to use the evidence provided by the fact that individuals are willing to donate to the organization above-and-beyond payments for goods and services received; Hall and Colombo (1991) would restrict the tax exemption only to those organizations receiving a significant proportion of their income from donations (hence their proposal is known as a “donative” theory of the tax exemption; also see Colombo (2002)). In this model commercial nonprofits would not receive a tax exemption. Atkinson (1990; 1997) sees room for a broader scope of the tax exemption, noting that even for commercial nonprofits, the founders who invested the initial capital have made a decision to forgo personal profit from that capital, and this represents a form of donation.

Does the subsidy argument for the nonprofit tax exemption need to be tied to the charitable nature of the organization? Not necessarily. Hansmann (1981) suggests that a good reason to subsidize the entire nonprofit sector is that the nondistribution constraint

hampers the ability of nonprofits to raise equity capital, and so a CIT exemption is needed so that nonprofits can use all retained earnings for capital expansion if needed. Crimm (1998) notes that since nonprofits are restricted in terms of which sectors are deemed eligible for the tax exemption, they cannot diversify risks in the way that shareholders of for-profits can, and so an exemption from the CIT is a justifiable subsidy.

Of course there are many sectors where nonprofits and for-profits share the market, which leads to questions of whether for-profits in such sectors should also receive a subsidy, or conversely whether the tax exemption for a specific nonprofit organization should be contingent upon its providing a service distinctly different from its for-profit competitors. But as it stands there is a difference in tax treatment between for-profit and nonprofits generally, and this has allocation effects. Hansmann (1987) provides evidence from US states and those sectors where nonprofits and for-profits tend to compete, that the higher the state corporate income tax rate, and thus the greater the difference in tax treatment between for-profit and nonprofit firms, the higher the proportion of businesses will be nonprofit. He suggests there might be a justification for the exemption if (1) there is a public policy reason to favor nonprofit providers (e.g., perhaps they better serve the poor), or (2) it corrects for another market failure, such as the difficulties nonprofits face in raising capital (Hansmann presents evidence on this front, showing that when demand for a service increases rapidly it is generally for-profits who move to increase supply faster). Steinberg (1991) supports the general tax exemption, even where there are no clear external benefits, on the grounds that nonprofits often generate important innovations in the delivery of services, and constitute an alternative, and in turn useful competition, to government. Beyond that, as Atkinson

(1990; 1997) notes, a subsidy for nonprofits can be a way for the government to make a statement of sorts about the values it places on altruism and volunteerism by the public.

The third argument is that the tax exemption is in recognition of the “sovereignty” of the nonprofit sector, an acknowledgement by the state of the value of an independent sector with minimal duties to report to the state (and in turn with obligations to refrain in its involvement with political affairs, hence the restrictions on 501(c)(3)’s on lobbying activity). This view is argued by Brody (1998; 1999). The sovereignty view explains why there are tax subsidies to nonprofits instead of direct grants (a way of avoiding state-nonprofit entanglement) and the existence of the UBIT (to limit the sphere of the nonprofits).

#### THE CORPORATE TAX EXEMPTION: A NEW THEORY

All of the theories recounted above, for all their differences with one another, have something in common: they all seek to explain the nonprofit CIT exemption by asking “what is it that makes nonprofits special?”. They provide a variety of answers – nonprofits don’t have a clearly definable measure for net income; they cannot easily raise equity capital or diversify risks; they provide goods and services in the public interest; they are the place where we can mobilize our altruistic and volunteer impulses; they have a long tradition of independence from the state – but they all begin with the same question. I would like to begin with a different question.

Return to the question of why for-profit corporations are taxed at the corporate level. It is because the goal is to ensure that the income individuals earn on their investments does not escape taxation by flowing through a corporation. The goal of the

Corporation Income Tax is not so much to tax corporations as it is to tax income. This is why a perfectly integrated personal tax capturing, and not distinguishing between, income earned through businesses and through labor earnings remains the desiderata of economists.

Nonprofits are exempt from the CIT because net income earned by nonprofits is not attributable to, and does not have the ultimate destination of, a private individual. This is not to say that individuals do not benefit from the existence of nonprofits; employees benefit from having a place to work, and clients benefit from the goods and services provided by nonprofits (even when they are paying a market price for a good provided by a nonprofit, most individuals will be placing a value on the good higher than the price paid – i.e. they will be receiving some consumer surplus). But the wages of nonprofit employees are taxed through the Personal Income Tax, and we do not attempt in any circumstance to tax the consumer surplus received by individuals, which in any case is unobservable. What net income is left after paying for inputs (including wages) and delivering outputs must ultimately be re-invested by the organization. That is the essence of the nondistribution constraint. For-profit corporate income is taxed precisely because it can be distributed, and the CIT is a way, albeit imperfect, of ensuring it does not escape taxation at the personal level.

The tax exemption appears to be a “subsidy” only as the result of an inefficiently-designed CIT that creates an effective tax rate even on marginal investments when ideally they should face zero tax. If there were an effective means of attributing and taxing at the individual shareholder level all net profits earned through corporations, there would be no need for the CIT, and the apparent subsidy to nonprofits from the CIT-exemption would

disappear. This would not be the result of changing views of the need to subsidize nonprofits, or of their sovereignty from government, or of the impossibility of defining their net income, but simply as a result of repairing an inefficiently designed corporate tax.

In other words, there has been misplaced emphasis on the CIT exemption for nonprofits, where it has been treated as a departure from the norm of taxation. Instead, it is the tax levied on for-profit corporations that requires explanation, and which is explained as a practical measure not so much to tax businesses as it is to ensure that all income accruing to individuals is taxed. Notice that this new explanation for the tax exemption can also explain why the tax exemption is not treated as a “tax expenditure” in the federal budget; that it represents income outside the normal tax base (this question is raised by Brody and Cordes, 1999, p. 152).

But if we accept this rationale for the nonprofit tax exemption – that there is no need to subject nonprofit net income to tax since it does not and will not end up in the hands of a private shareholder – then how do we explain the UBIT, which does tax part of the net earnings of nonprofits? Hansmann (1989, p. 625) justifies the UBIT using the “subsidy” argument for the general tax exemption: “The rationale for taxing unrelated business 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.” But since this paper asserts that “subsidy” is not the rationale for the general tax exemption, where does that leave the UBIT?

## THE UNRELATED BUSINESS INCOME TAX

Recent scholarship on the UBIT has looked into how nonprofit organizations reduce tax liability by reporting as many costs as possible from all the organization's activities as being associated with the commercial "unrelated" business (Sansing, 1998; Yetman, 2003), and into whether a nonprofit's willingness to engage in commercial activities is related to its ability to shift costs (Cordes and Weisbrod, 1998). Evidence suggests that cost-shifting is prevalent, and so the government revenues from the UBIT are strikingly low (although, as Hansmann (1987) points out, repeal of the UBIT might still be costly, as it would not only forfeit the (small) revenues collected from UBIT but would also likely greatly reduce CIT revenues, as for-profit firms would have increased incentives to convert to nonprofit status).

But the question remains as to whether an effective UBIT is efficient in the first place. If it makes sense, as we explained above, to make nonprofits' net earnings from mission-related activities tax exempt, why not exempt all their earnings? Analysis of the UBIT cannot be separated from the nonprofit exemption from the corporate income tax (CIT).

How does the nonprofit exemption from the CIT in their mission-related activities affect investment in the for-profit corporate sector? Begin with Rose-Ackerman's (1982) critique of the notion that the exemption harms for-profit business. She points out that if it is easy for investment capital to shift from one sector to another, then even if the nonprofit tax exemption causes a lower rate of return to investment in the related for-profit part of the sector, capital will simply move to where it can earn a higher return, so no investor is at a loss. Investment in firms that compete with nonprofits only occurred at

all because the returns that could be earned from such investment were at least as high as could be earned elsewhere.

However, suppose it is not so easy to shift investment capital, and that the competition from nonprofits was not anticipated by investors. Rose-Ackerman goes on to say that the entry of nonprofits into the sector will only lower returns to for-profit investors if the nonprofits enter the sector to a larger degree than it was expected that other for-profits would. For example, suppose an investor in a for-profit long-term care facility expects that she will face competition from twelve other for-profit facilities, and no nonprofits. If it turns out to be the case that the competition is from just six other for-profits, and six nonprofits, there should be no effect on the return to investment. Only if there is “excessive” entry by nonprofits would the return to the for-profit investor fall. But why would nonprofits ever enter a sector, like long-term care, in numbers that exceed what for-profits would have done? This would occur if “nonprofits have excess cash to invest and the return they can obtain by lending their money on the bond market is lower than the rate of return on active, entrepreneurial investments” (Rose-Ackerman, 1982, pp. 1027-8). But she points out that for-profits can only be harmed by nonprofit entry if (1) nonprofits are so concentrated in certain sectors that their presence is able to lower the return to for-profit investment, (2) there are for-profits earning just competitive returns to investment and no more, and (3) nonprofits have the excess cash available to make these investments.

But nonprofits do not represent a large proportion of the total investment capital in the country, and if it were spread evenly across all sectors would have no discernable impact on the returns to for-profit firms. And those for-profit firms earning better than

competitive returns will remain in business in any case. And finally, nonprofits might not have such cash available for investments. If nonprofits are managed less efficiently (in terms of profit-maximization), they may have to pay higher interest rates to lenders worried about the nonprofit enterprise failing.

Rose-Ackerman's conclusion is that the UBIT is exactly the wrong policy to deal with the potential losses to for-profit investors from nonprofit competition: the UBIT, by design, concentrates nonprofit investments in a limited number of sectors, and it is only through this concentration that returns to for-profit investors are lowered:

By permitting nonprofits to enter any profitmaking industry, repeal [of the UBIT] will reduce the pressure on for-profit firms in areas that are "related" to the primary activities of nonprofits. While this new freedom may increase the overall level of nonprofit entrepreneurial activity, the diffusion of this activity throughout the economy reduces the chance that investment in a particular industry will suffer substantial unanticipated losses from nonprofit entry (Rose-Ackerman, 1982, p. 1039).

Hansmann (1989), on the other hand, supports the UBIT, and argues for a narrow reading of the tax-exemption from the CIT. How does he come to the opposite conclusion from Rose-Ackerman? On one point they agree: if the UBIT were removed, so that nonprofits could invest in any sector and remain tax-exempt, it is unlikely that they would cause a decrease in returns to for-profit firms. After all, presumably nonprofits are only engaged in "unrelated" activities to earn profits to fund mission-related work, and it would not be profit-maximizing to invest so heavily in a sector that prices would be pushed downward. Instead, Hansmann writes, "in the absence of UBIT, one would expect nonprofit firms to

displace for-profit firms, not by driving them out of business through price competition but rather by purchasing them” (1989, pp. 611-2). There would be significant incentives to purchase such firms, especially those subject to high rates of CIT.

The principal focus of Hansmann is how repeal of the UBIT would have unintended inefficiencies. First, nonprofits would find that since CIT would remain on for-profit firms in which the nonprofit might have invested in stock, but there would be no CIT on for-profit firms wholly-owned by the nonprofit, there would be a tax incentive for nonprofits to shift to the riskier investment strategy of wholly-owned businesses rather than a portfolio of common-stock. After all, as Steinberg (1991) writes, as it stands nonprofits have sound reasons to favor passive income in diversified investments, and there are not good reasons to change that situation.

Second, Hansmann worries that without the UBIT the return to investment in nonprofits is above that for the economy as a whole, and so nonprofits will tend to over-save and under-spend on current mission-related activities. Given that it might well be the case that the endowments of large nonprofits are already too big (see Hansmann (1990) on universities, Gentry (2002) on hospitals, and Fisman and Hubbard (2003) on the governance problems that arise from big endowments), the UBIT might put a brake on excessive savings.

Third, in sectors where nonprofits compete with for-profits, the advantage to nonprofits from the tax exemption would allow leeway for poor management practices; the UBIT ensures that nonprofits only enter a sector, other than those defined as having a public purpose, where they can perform at least as well as for-profits; this result is also established by Sansing (1998). In addition, it might well be the case that nonprofits only

enter a commercial sector when its rate of return exceeds the return to passive investments by a non-trivial amount, since donors might not be pleased by investments in running commercial activities and so would reduce their giving by some amount (Cordes and Weisbrod, 1998).

Following on this last point, we can begin to see a rationale for the UBIT even in the face of the earlier argument that nonprofits are generally tax exempt not because they are deserving of subsidy, or that they represent a sovereign sector in the economy that warrants a greater degree of non-interference by the state, but because their net earnings are not ultimately personal income for shareholders. The goal is to ensure that nonprofit investments in unrelated business activities are not treated differently than proprietary firms, so as to avoid a distortion in the choice of organizational form. Without the UBIT, nonprofits would enter unrelated activities where they were less efficient than for-profit firms, again, not so much because the nonprofit is “subsidized” as it is that the for-profit sector is “penalized” by the inefficient design of the CIT. Were the CIT to be redesigned such that the effective marginal tax rate were zero, the UBIT would become unnecessary, as even without the UBIT a nonprofit would only open an unrelated business where through some advantage (say economies of scope) it could produce the service at lower cost than its for-profit competitors.

## CONCLUSION

This paper advanced the following two hypotheses. First, the exemption of nonprofits from the corporate income tax is best explained by the fact that nonprofit income is not ultimately owned by any individuals, while the corporate income tax is an (inefficiently

designed) attempt to ensure that individual income does not escape taxation by being earned behind the corporate veil; this is a different argument than the traditionally advanced arguments that the tax exemption is either (a) a result of the lack of a coherent definition of nonprofit net income, or (b) a deliberate subsidy to the nonprofit sector, or (c) a consequence of the state's recognition of the sovereignty of the nonprofit sector. Second, the Unrelated Business Income Tax is made necessary by the effective marginal tax rate on for-profit corporations arising from the CIT's inefficient design, to ensure that nonprofits are not given an artificial cost advantage in unrelated businesses.

One implication of the paper, yet to be explored, is that it is premature to discuss reform of the corporate tax treatment of nonprofits without thinking about the design of the Corporate Income Tax itself, and the distortions it levies on the economy. As the CIT penalizes proprietary investment at the margin, the impression of a subsidy to nonprofits is created, but it might be misplaced effort to investigate how the design of this artificial subsidy ought to be refined.

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