

# THE UNRELATED BUSINESS INCOME TAX, COST ALLOCATION, AND PRODUCTIVE EFFICIENCY

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**Abstract** - *Organizations that otherwise are exempt from federal income taxes are taxed on their net income from business activities that are unrelated to their exempt purpose. This paper examines three settings in which an exempt organization receives income subject to tax. Whether the tax promotes or deters efficiency depends on the extent to which the accounting costs that are deducted for tax purposes correspond to the economic costs of the activity, excluding the cost of equity capital.*

## INTRODUCTION

Most nonprofit organizations are exempted from federal income taxes by Internal Revenue Code (IRC) §501. An exception to this general rule is the unrelated business income tax (UBIT) imposed by IRC §511. Profits from a trade or business that is unrelated to the

exempt purpose of the nonprofit organization are subject to tax at the regular corporate income tax rates. The tax was enacted in 1950 in response to the operation of business enterprises by universities, such as the ownership and operation of the Mueller Macaroni Company by the New York University Law School. Congress wanted to prevent exempt organizations from competing unfairly with for-profit firms and to protect the federal tax base. Simon (1987) provides an extensive review of the tax treatment of exempt organizations.

The leading articles on the economic effects of UBIT are by Rose-Ackerman (1982) and Hansmann (1989). Rose-Ackerman shows that the claims regarding the unfairness of competition from tax-exempt organizations do not withstand the scrutiny of formal economic analysis. When an industry is competitive and investors anticipate the possible entry of exempt organizations into the market, investors in for-profit enterprises will earn the market return despite the presence of tax-exempt competitors. Although competition from exempt organizations may have an

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effect in imperfectly competitive markets or if investors have biased expectations regarding entry, she concludes that the appropriate tax policy is to repeal UBIT.

Hansmann (1989) argues that efficiency, not equity, is the relevant issue in evaluating UBIT. The UBIT enhances efficiency by deterring exempt organizations from investing in commercial activities in which they are less efficient than their for-profit counterparts. Furthermore, UBIT does not deter exempt organizations from exploiting economies of scope made possible by their exempt activities, although here problems arise in allocating costs between taxable and tax-exempt activities.

The purpose of this paper is to analyze formally the economic effects of UBIT when there is an interaction between the exempt and taxable activities of the organization. This includes many widely publicized controversies in the UBIT area, including the renting of mailing lists by exempt organizations, the sale of merchandise unrelated to the exempt purpose in a store that also sells merchandise related to the exempt purpose, and the sale of advertising in conjunction with an exempt activity. Each of these activities involves economic common costs. The costs that can be deducted when computing UBIT depend on the accounting method used to allocate common costs between the taxable and tax-exempt activities.

Treasury Regulation §1.512(a)-1(c) only requires that common costs be allocated among activities on a reasonable basis. The effect of UBIT depends on how the common costs are allocated. Regardless of how the allocation is made, UBIT will affect the circumstances under which an exempt organization engages in an unrelated business.

I analyze three settings. The first setting is a benchmark case in which there are no common costs. This setting corresponds to the operation of the Mueller Macaroni Company by the New York University Law School. In this setting, costs are separable between taxable and tax-exempt activities, so the costs related to the unrelated business are deductible and the costs related to the exempt activities are not.<sup>1</sup> The separability of the cost function means the taxable income of the unrelated business can be measured without ambiguity.

The second setting features a common cost that must be allocated between taxable and exempt activities. Examples of this setting include the following:

- (1) the cost of a university's football stadium that is leased to a professional team;<sup>2</sup>
- (2) the cost of a folk art museum gift shop that sells both nontaxable items related to its exempt purpose and taxable city souvenirs;<sup>3</sup>
- (3) the cost of a laboratory that both engages in exempt basic medical research and conducts taxable product testing for commercial pharmaceutical firms;<sup>4</sup> and
- (4) the cost of a school's ski facility that is used in its physical education program, by students, and by the general public; revenues received from the general public are taxable.<sup>5</sup>

When common costs are present, they are allocated between the exempt and taxable use of the facilities to which the costs relate. The portion allocated to taxable use is deductible for purposes of computing the UBIT. Common costs must be allocated among taxable and exempt activities on a "reasonable

basis."<sup>6</sup> The leading court case in this area is *Rensselaer Polytechnic Institute v. Commissioner*.<sup>7</sup> This case involved the allocation of the cost of a field house between taxable activities, such as rental of the field house to "Ice Capades" and "Roller Derby," and exempt activities, such as collegiate ice hockey and commencement exercises. This case established that a portion of common costs are deductible, even though they would have been incurred in the absence of an unrelated business.

In the third setting, the unrelated business requires no additional expenditures by the exempt organization. An example of this is the sale of advertising, which generates taxable income for the exempt organization. However, no expenses related to the exempt activity are deductible, even though it is the existence of the exempt activity that makes the venue attractive for advertisers in the first place.<sup>8</sup> Although there is no interaction on the expenditure side, the sale of commercial advertising may decrease nontaxable sources of revenue, such as ticket sales to the event, the sale of broadcast rights, or donations from contributors. The opportunity cost of lost revenues due to the presence of commercial advertising is not deductible in computing UBIT.

Analysis of the model demonstrates that the ability of UBIT to promote efficiency depends on whether the exempt organization can deduct the economic costs associated with the taxed activity.<sup>9</sup> This, in turn, depends on the extent to which accounting costs correspond to economic costs. In the first setting, UBIT deters investment in activities in which the exempt organization has no comparative advantage, without deterring investments in which it does have a comparative advantage.

In the second setting, there would be excessive investment in unrelated business activities without UBIT. With UBIT, investment in these activities may be either inefficiently high or low. Given that the allocation of common costs need only be "reasonable," however, exempt organizations have an incentive to choose allocation methods that allocate as many costs as possible to the taxable activities. The exempt organization's ability to avoid UBIT by allocating common costs to taxable activities implies that investment in unrelated businesses activities will generally be inefficiently high, in spite of UBIT.

In the third setting, UBIT creates two countervailing effects. It decreases the level of advertising because it taxes the advertising revenues without allowing a deduction for the opportunity costs that the exempt organization bears in the form of decreased exempt function revenues due to the presence of commercial advertising. It also deters inefficiently high levels of advertising that arise to the extent that the exempt organization acts to maximize its total revenues, as opposed to the sum of its advertising revenues and the social value of the good or service it produces. The net effect of these two factors on overall efficiency is ambiguous, and so recently enacted IRC §513(i), which in effect allows exempt organizations to receive advertising revenue in a way that is exempt from UBIT, may either increase or decrease efficiency.

The next section of this paper analyzes the setting in which costs are separable. Subsequent sections analyze the setting in which common costs are present and the setting in which the cost of the taxable activity is the opportunity cost of reduced tax-exempt revenues. The final section presents conclusions.

## UNRELATED BUSINESS WITH SEPARABLE COSTS

In this section, I examine the effect of UBIT on an investment decision of the exempt organization in a setting in which the cost of the unrelated business is economically separate from the cost of the organization's exempt activities.

Consider an economy with firms that produce two types of goods or services,  $x$  and  $y$ . Product  $x$  is manufactured and sold by for-profit firms in a competitive market. Each firm acts as a price taker and has access to a production technology that exhibits constant returns to scale. An investment of  $k_x$  on date 0 permits the firm to produce one unit of  $x$  on date 1, which is sold on date 1 at the market price  $p_x$ . For simplicity, variable production costs on date 1 are assumed to be zero; equivalently, the parameter  $p_x$  can be interpreted as price minus variable cost. The accounting income from the production and sale of one unit,  $(p_x - k_x)$ , is taxed at a flat rate of  $t$  on date 1. The investment generates an after-tax rate of return  $R$ , which is the competitive market rate of return on equity required by shareholders. Therefore,

$$p_x(1-t) + tk_x = k_x(1+R),$$

which simplifies to

$$p_x = \frac{k_x(1+R-t)}{1-t}.$$

Product  $y$  is not produced and sold by for-profit firms, because the cost of the investment is too high relative to the

return. The desire on the part of some people in the economy to see good  $y$  produced, however, leads to the formation of exempt organizations to produce it. Individuals donate capital to these organizations. The exempt organization's manager allocates donated funds between investment in the production of good  $y$  and investment in firms that produce  $x$ , which generates income for the exempt organization's endowment. An investment of  $k_y$  on date 0 permits the firm to produce one unit of  $y$ , which is sold on date 1 at the market price  $p_y$ . The production and sale of  $y$  generate a pretax rate of return  $r$ ,  $r < R$ , where

$$p_y = k_y(1+r)$$

The pretax rate of return  $r$  reflects only the financial return to the exempt organization from the production and sale of  $y$ . The production and consumption of  $y$  also create positive externalities, which induce people to donate capital to the exempt organization in the first place.

Donated funds in excess of  $k_y$  are invested in for-profit firms to obtain the rate of return  $R$  required by investors in for-profit firms. Neither the pretax return on the capital invested in the production of  $y$  nor the after-tax return from the funds invested in the for-profit firms is subject to income tax. Therefore, if the total capital donated to the exempt organization on date 0 is  $\kappa$ ,  $\kappa \geq k_y$ , the accumulated capital on date 1 is

$$k_y(1+r) + (\kappa - k_y)(1+R).$$

Now suppose the exempt organization uses some of its endowment that is invested in for-profit firms making  $x$  and invests it directly in the production of  $x$ . Let  $k_z$  denote the cost the exempt organization must incur on date 0 in order to sell one unit of  $x$  on date 1. In this section, I assume the cost function of the exempt organization is separable, which means that the cost of producing  $q_x$  units of  $x$  and  $q_y$  units of  $y$ ,  $C(q_x, q_y)$ , can be written as  $C(q_x, q_y) = G(q_x) + H(q_y)$ . Consider first the consequences of this investment in the absence of UBIT, so the income from the production of  $x$  goes untaxed. Investing  $k_z$  in the production of  $x$  on date 0 increases the value of the endowment by  $p_x$  and decreases it by  $k_z(1 + R)$ , the cost of the investment plus what that investment would have earned had it remained in the endowment. The investment changes the net value of the endowment on date 1 by

$$5 \quad p_x - k_z(1 + R)$$

The exempt organization will make the investment when expression 5 is positive, i.e., when the revenue generated by the investment exceeds the return that could have been obtained by investing in for-profit firms. Using expression 2, expression 5 is positive when

$$6 \quad k_z \leq k_x \left[ 1 + \frac{tR}{(1 + R)(1 - t)} \right]$$

Equation 6 indicates that, whenever the exempt organization has a comparative advantage in the production of  $x$ , i.e., whenever  $k_z \leq k_x$ , it will choose to invest

in the production of  $x$ . This equation further indicates that there are also times when  $k_z > k_x$  that the exempt organization will invest in the production of  $x$  instead of investing in firms that produce  $x$ , because the tax advantage of exempt organizations outweighs their comparative disadvantage in production efficiency. For example, if  $R = 0.12$  and  $t = 0.35$ , exempt organizations will produce  $x$  even when their production costs are five percent higher than those of their taxable counterparts.

Now suppose exempt organizations are taxed on their net income from unrelated business activities. Because the cost of producing  $x$  and  $y$  is separable, the calculation of taxable income is unambiguously  $p_x - k_z$ . Therefore, the change in the nonprofit's accumulated capital when it produces one unit of  $x$  is

$$7 \quad p_x(1 - t) + tk_z - k_z(1 + R)$$

Using equation 2, expression 7 is positive when  $k_z \leq k_x$ . Therefore, when the exempt organization's cost function is separable, UBIT deters the nonprofit from investing in an unrelated business when it has a comparative disadvantage, without deterring investment when it has a comparative advantage. In this setting, UBIT unequivocally increases productive efficiency.

## UNRELATED BUSINESS WITH COMMON COSTS

Although the analysis in the preceding section provides a convenient benchmark, it is only a special case because it assumes the exempt organization's cost function is separable. More commonly, UBIT controversies arise when an exempt organization engages in a

business that is not related to its exempt purpose, but is economically related in that the cost function  $C(q_x, q_y)$  is not separable. Therefore, the cost must be allocated between exempt and taxable activities in order to determine the exempt organization's tax liability.

As in the previous section, product  $x$  is produced and sold by for-profit firms, which earn an after-tax rate of return of  $R$  on invested capital. An exempt organization can invest  $k_y$  to produce and sell product  $y$ , earning an untaxed rate of return  $r$ . Alternatively, an exempt organization can invest  $k_x$ , which enables it to produce one unit of  $y$  and  $\alpha$  units of  $x$ . The exempt organization has a comparative advantage in the production of  $x$  when  $k_x - k_y \leq \alpha k_x$ , because then the incremental cost to the exempt organization of producing  $\alpha$  units of  $x$  in addition to one unit of  $y$  is less than the cost to its for-profit counterpart of producing  $\alpha$  units of  $x$ .

First, consider the case in which unrelated business income is not subject to tax. The change in the exempt organization's accumulated capital if it produces both  $x$  and  $y$  instead of just  $y$  is

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$$\alpha p_x - (k_x - k_y)(1 + R).$$

Using equation 2, expression 8 simplifies to

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$$\frac{\alpha k_x(1 + R - t)}{1 - t} - (k_x - k_y)(1 + R).$$

As before, the exempt organization will produce  $x$  instead of investing in for-

profit firms when expression 9 is positive, which occurs when

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$$k_x - k_y \leq \alpha k_x \left[ 1 + \frac{tR}{(1 + R)(1 - t)} \right].$$

As in the previous section, failure to tax the income from unrelated business activities induces the exempt organization to produce  $x$  even in cases in which it has a comparative disadvantage in productive efficiency.

Next, consider the case in which the production and sale of  $x$  is taxed. Let  $\delta$  denote the fraction of the capital expenditure  $k_x$  allocable to the taxable activity. The change in the exempt organization's accumulated capital if it produces both  $x$  and  $y$  instead of just  $y$  is

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$$\alpha p_x(1 - t) + \delta t k_x - (k_x - k_y)(1 + R).$$

Using equation 2, expression 11 simplifies to

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$$\alpha k_x(1 + R - t) + \delta t k_x - (k_x - k_y)(1 + R)$$

The exempt organization will produce  $x$  instead of investing in for-profit firms when expression 12 is positive. The sign of expression 12 depends jointly on two factors: (1) the relative efficiency of production and (2) the allocation of costs between taxable and exempt activities. Suppose  $\delta = [(k_x - k_y)/k_x]$ , which implies that only the incremental cost of the taxable activity is deductible.

Then expression 12 simplifies to

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$$[\alpha k_x - (k_z - k_y)](1 + R - t).$$

Expression 13 implies that, if  $\delta = [(k_z - k_y)/k_x]$ , then taxing the unrelated business induces the efficient production decision by the exempt organization; it will not produce  $x$  when it does not have a comparative cost advantage, and it will produce  $x$  despite the tax when it does have a comparative cost advantage. Henceforth,  $\delta^*$  denotes the value of  $\delta$  that induces efficient production decisions by the exempt organization.

This leads to the key accounting question: in general, will the allocation of accounting costs ensure  $\delta = \delta^*$ ? The parameter  $\delta^*$  reflects the cost that was incurred,  $k_x$ , as well as what could have been incurred had the exempt organization decided to only produce  $y$ ,  $k_y$ . The former is observable; the latter is not. Accounting records can reveal the cost of a research laboratory that conducts both basic medical research and commercial product testing; they cannot reveal how much a different laboratory that could not have been used to profitably conduct commercial product testing would have cost. As Rogerson (1992) points out, accounting is good at establishing what costs were incurred, but is poor at determining whether a cost that was incurred was necessary. There is no theoretical reason to expect accounting allocations to correspond to  $\delta^*$ .

How does cost allocation occur in practice? Typically, the common cost  $k_x$  is allocated among activities in accordance with an allocation base, some-

times called a cost driver, which is a physical measure of activity or capacity associated with the cost being allocated. Suppose that the capital expenditure  $k_x$  creates a medical research facility that is used for both basic medical research and commercial product testing. Two possible allocation bases are the time spent by researchers on each activity and the number of hours medical research equipment is used by each activity. Let  $\omega$  represent the fraction of researcher time spent on commercial product testing, and let  $\theta$  represent the fraction of machine hours devoted to commercial product testing. The fractions  $\omega$  and  $\theta$  are likely to differ, perhaps substantially; for example, if basic medical research is the more labor intensive activity, then  $\omega > \theta$ . Because the allocation of fixed costs only affects the exempt organization's UBIT liability, I expect the organization to allocate a fraction  $\delta = \max\{\omega, \theta\}$  of fixed costs to the taxable activity. The greater the difference between  $\omega$  and  $\theta$ , the greater the ability of the exempt organization to find a cost allocation base that allocates enough common costs to the taxable activity to eliminate its income tax liability from unrelated business activities.

There is no reason to expect  $\max\{\omega, \theta\}$  to equal  $\delta^* = [(k_x - k_y)/k_x]$ . The economic irrelevance of fixed cost allocations is the rule rather than the exception. As Demski (1994) points out,

"At one level, the study of cost allocation is disconcerting. We can find too many ways to do it, and too few defenses for any particular method. This is as it should be. We are creating the appearance of separability when cost function separability is not necessarily present."

Because the Treasury Regulations require only that the allocation be reasonable, and the exempt organization controls

the information system that supports the cost allocation method, exempt organizations, in practice, will be able to use allocation methods that reduce or even eliminate UBIT. The more heterogeneous the activities are with respect to the use of activity measures, the easier it is for the exempt organization to find an allocation base that enables it to eliminate its tax liability. So, although UBIT, in principle, can achieve efficiency in this setting, in practice, it probably does little more than induce nonprofit managers to spend time finding cost allocations that minimize, if not eliminate, UBIT.

This analysis suggests that, when common costs are present, UBIT will generally fail to remove the tax advantage enjoyed by exempt organizations because they can deduct more costs than their for-profit counterparts. This conclusion was arrived at by Judge Mansfield in his dissent in the *Rensselaer* case. Judge Mansfield argued

“The university will therefore always have an incentive to minimize the allocation of expenses attributed to the educational function, and correspondingly to maximize the deduction for unrelated business activity . . . To whatever extent Congress sought to place wholly taxable and exempt organizations on the same footing, it was concerned not with such technical legal tests but with the real after-tax situations of the two different types of organization. Yet the majority’s approach, which claims to provide equal treatment, actually leaves the tax-exempt organizations with the very advantage that the majority claims Congress was trying to eliminate.”

Mansfield argued that no common costs should be deductible in determining an

exempt organization’s unrelated business income, because they would have been incurred regardless of whether the unrelated business was undertaken, and therefore are not “directly connected” to the commercial business activity, as IRC §512(a)(1) requires. This approach is too strict when the exempt organization incurs additional common costs to undertake the unrelated business activity. To see this, consider expression 12 when  $\delta = 0$ . The exempt organization will invest in the unrelated business activity only when

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$$(k_z - k_y) \left[ 1 + \frac{t}{1 + R - t} \right] \leq \alpha k_x$$

Judge Mansfield’s approach will cause an exempt organization’s investments in unrelated business activities to be inefficiently low, because the organization will not undertake the investment when expression 13 is positive but small.

But it is equally clear that permitting any “reasonable method” of allocating common costs is too lax. The former policy deters exempt organizations from exploiting cost efficiencies by overtaxing their unrelated business income, whereas the latter fails to deter them from engaging in businesses in which they have a cost disadvantage. Congress has, at least implicitly, acquiesced to the latter policy in light of the *Rensselaer* case by not changing IRC §512 to limit the deductibility of common costs.

#### NO MARGINAL EXPENDITURE ACTIVITIES

In this section, I consider a setting in which the exempt organization receives unrelated business income in a manner



that “exploits” its exempt activities.<sup>10</sup> An example of such exploitation is the sale of advertising. If an exempt organization allows a commercial enterprise to exhibit advertising at its otherwise nontaxable event, the advertising revenue is unrelated business income. However, no costs attributable to the exempt activity are deductible in computing the exempt organization’s unrelated business income.<sup>11</sup> This is a case in which the exempt organization produces a joint product, consisting of its exempt activity plus advertising space. However, the cost allocation rule imposed by the Treasury Regulations allocates all of the costs of the event to the exempt activity.

If there are really no costs associated with the advertising activity, then taxing the advertising revenue does not impose an inefficiency. However, it is reasonable to assume that commercial advertising detracts in some way from the attractiveness of the event. To the extent this reduces the demand for tickets to the event, or the attractiveness of the organization to donors, both of which provide nontaxable sources of revenue to the organization, then advertising does impose a cost on the exempt organization. However, this is an opportunity cost, rather than an allocable expenditure. The opportunity costs of advertising are not deductible in computing UBIT.

There is some evidence to suggest that commercial advertising reduces the revenue from exempt activities. One of the most prominent ways exempt organizations are used to advertise commercial products is the corporate sponsorship of amateur athletic events. The national collegiate football champion in the 1995–96 season was determined in the Tostitos Fiesta Bowl. Frito-Lay pays the exempt organization

to run the Fiesta Bowl to rename the event and display the Tostitos logo prominently at midfield and elsewhere (including having the officials keeping track of the yardage needed for a first down wear tortilla chip costumes). In contrast, the national collegiate basketball champion was crowned at the Final Four (run by the NCAA), which has no commercial sponsor. While it is difficult to identify the economic forces that induce entities managing similar events to make different choices, the decision by the NCAA to not have a corporate sponsor of its basketball tournament suggests that the costs of having a corporate sponsor are substantial.

As in the earlier section, the exempt organization invests  $k_y$  on date 0, which permits the organization to produce one unit that it sells for price  $p_y$  on date 1. The consumption of this good creates a positive externality, and so the social value of its private consumption is  $v_y \geq p_y$ . The organization can also sell advertising  $q_x$  at a price  $p_x$  per unit, which interferes with the enjoyment of the exempt organization’s product or service. This interference causes the price of the good or service to fall to  $p_y[1 - \beta(q_x)]$ , and its social value falls to  $v_y[1 - \beta(q_x)]$ . I assume that  $\beta'(q_x) > 0$ ,  $\beta''(q_x) > 0$ ,  $\beta(0) = 0$ ,  $\beta'(0) = 0$ ,  $\beta(1) = 1$ , and  $\beta'(1) > (p_x/p_y)$ . These assumptions ensure that the socially optimal level of  $q_x$  lies between zero and one. The socially optimal level of advertising, denoted  $q_x^*$ , solves

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$$\max_{q_x} p_x q_x + v_y [1 - \beta(q_x)]$$

Differentiation shows that the optimal level  $q_x^*$  of advertising solves

$$\beta'(q_x) = \frac{p_x}{v_y}$$

The effect on the level of advertising of taxing advertising revenues depends on the value that the exempt organization places on the social value of its output that is not reflected in the organization's revenues. I assume that the exempt organization wants to maximize the function

$$p_x q_x (1 - t) + \{w p_y + (1 - w) v_y\} [1 - \beta(q_x)]$$

if advertising is subject to UBIT. If advertising is not subject to UBIT, then the exempt organization maximizes equation 17, letting  $t = 0$ . The parameter  $w$ ,  $0 \leq w \leq 1$ , reflects the organization's preferences regarding the social value of its product, which is not reflected in its revenues. If  $w = 1$ , the organization attaches no importance to the value not reflected in revenues and simply maximizes profits; if  $w = 0$ , it maximizes the social value of its output, regardless of whether it receives this value in the form of revenues.

The exempt organization chooses  $q_x$  that solves

$$\beta'(q_x) = \frac{p_x(1 - t)}{w p_y + (1 - w) v_y}$$

Comparing equations 16 and 18 shows that taxing advertising revenues achieves efficiency when

$$t = \frac{w(v_y - p_y)}{v_y}$$

I denote the tax rate  $t$  that satisfies equation 19 as  $t^*$ . The UBIT induces too little (too much) advertising when the tax rate  $t$  is greater than (less than)  $t^*$ . When either  $v_y = p_y$ , which implies the organization receives in revenue an amount equal to the social benefits that it creates, or  $w = 0$ , which implies the organization chooses the socially efficient level of advertising irrespective of whether it receives the full social benefits it creates,  $t^* = 0$ ; i.e., it is socially efficient to exempt advertising from UBIT. Taxing advertising results in an inefficiency in these cases because the cost of advertising is in the form of an opportunity cost of foregone social benefits,  $v_y \beta(q_x)$ , instead of an expenditure. It is the nondeductibility of opportunity costs that causes UBIT to create an inefficiency.

When  $w > 0$  and  $v_y > p_y$ , the inefficiency created by not allowing the deductibility of opportunity costs is offset by the fact that the nonprofit would choose an inefficiently high level of advertising if it were not taxed. The taxation of advertising increases efficiency to the extent  $t \leq t^*$ . If  $t > t^*$ , the taxation of advertising causes the level of advertising chosen by the nonprofit organization to be inefficiently low.

The Treasury Department, in effect, has virtually exempted certain advertising from UBIT by characterizing certain advertising revenues received by exempt organizations from corporate sponsors to be nontaxable "sponsorship acknowledgments" rather than advertising, drawing a distinction between displaying the sponsor's product logo and

promoting the sponsor's product. Example 4 in the proposed Treasury Regulations explicitly allows the advertising done by sponsors of collegiate football games to be characterized as exempt donations.<sup>12</sup> Wirtschafter (1994) provides a thorough analysis of the corporate sponsorship issue and a critique of the Treasury's proposed regulations. Congress rendered the debate moot in 1997 by enacting IRC §513(i), which explicitly exempted corporate sponsorship payments from UBIT. Commercial sponsorship of other exempt activities, such as the Olympic Games, suggests that the diversion of otherwise taxable advertising dollars to tax-exempt organizations via corporate sponsorships will only grow over time.

## Conclusions

The effect of the UBIT on the efficiency with which goods and services are provided depends on whether the economic cost of providing them, excluding the cost of equity capital, is deducted in computing the tax. If the costs of running an unrelated business are separable from the costs of the organization's exempt activities, then UBIT deters inefficient investments without deterring efficient investments.

The issues are more difficult when the costs of taxable and exempt activities are not separable. If the exempt organization is permitted to allocate a portion of its common costs to the taxable activities constrained only by the reasonableness standard in the Treasury Regulations, then in practice UBIT will generally fail to deter economically inefficient investments by exempt organizations. On the other hand, if no deduction for common costs is allowed, then exempt organizations will face a tax barrier that deters efficient investment in unrelated businesses. Congress

has implicitly embraced the former policy.

When an exempt organization earns unrelated business income that does not increase its expenditures, but does decrease its exempt revenues, UBIT decreases efficiency because the opportunity cost of lost revenues is not deductible for tax purposes. However, to the extent the exempt organization would have sold advertising so as to maximize the organization's revenues instead of the sum of its revenues and the social value of the good or service it produces, subjecting advertising to UBIT enhances efficiency. The net effect of these two factors is ambiguous. However, what Congress took away with UBIT, the Treasury gave back with the proposed corporate sponsorship regulations, which in effect made much of the advertising revenues received by exempt organizations nontaxable anyway. These regulations were subsequently codified when Congress enacted IRC §513(i).

The overriding theme of the analysis is that economic cost and accounting cost are different. When they do not coincide, tax rules that determine deductions based on accounting costs rather than economic costs can tax the unrelated business activity either too little or too much relative to the tax that induces productive efficiency.

## ENDNOTES

I thank participants in research workshops at the Yale School of Management and the Tuck School of Business Administration and three anonymous referees for helpful comments.

<sup>1</sup> Treas. Reg. §1.512(a)-1(b)

<sup>2</sup> Rev. Rul. 80-298, 1980-2 CB 197

<sup>3</sup> Rev. Rul. 73-105, 1973-1 CB 264

<sup>4</sup> IRS Letter Ruling 8020009

<sup>5</sup> Rev. Rul. 78-98, 1978-1 CB 167

<sup>6</sup> Treas. Reg. §1.512(a)-1(c)

- <sup>7</sup> 732 F.2d 1058 (2nd Cir. 1983)
- <sup>8</sup> Treas. Reg. §1.512(a)-1(d)
- <sup>9</sup> Excluding the return to equity capital, which cannot be deducted by either for-profit or exempt firms.
- <sup>10</sup> Treas. Reg. §1.512(a)-1(d)
- <sup>11</sup> Treas. Reg. §1.512(a)-1(d)(1)
- <sup>12</sup> Prop. Treas. Reg. §1.513-4(g)

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