

Rapid Response Commentary

## **Commercialization of the Nonprofit Sector: A Discussion and Critical Analysis**

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### **Introduction**

Traditionally, human service nonprofit organizations (HSO's) have relied on private giving and public funding as sources of revenue generation. However, since the end of the 1970's, HSO's have become increasingly involved with selling services, products and other commercial activities. This trend has been termed the "commercialization" of the nonprofit sector and refers to a process whereby HSO's are oriented towards sales revenues rather than donations or government grants (Guo, 2006).

The growing trend towards commercialization has fueled a fierce debate which remains unresolved. For example, those in favor of commercialization believe that it allows HSO's to become more self-sufficient, particularly at a time when funding from government sources has declined substantially. Opponents of this trend argue that the profit seeking behavior of HSO's stands in contradiction to their moral adherence to social goals (Guo, 2006). While there is much to be said about this fascinating topic, this paper will consider commercialization from the perspective of nonprofit taxation. In doing so, the paper will initially describe the current tax treatment of nonprofit organizations and it will explore the rationale underlying their tax exemption status. The paper will then discuss the Unrelated Business Incomes Tax (UBIT) and it will explore some of the questions surrounding public policy.

### **Tax Treatment of Nonprofit Organizations**

In order to understand the manner in which nonprofits are taxed, it is useful to firstly describe the tax treatment of for profit enterprises. The earned income of for profit organizations is subject to various forms of taxation. Most businesses pay both federal and state level taxes on their earned income as well as state and local level property taxes. Nonprofit organizations are generally exempt from all of these taxes. Section 501(c)(3) of the federal tax code exempts an organizations income from taxation if the organizations purpose is religious, charitable, scientific, literary, educational or public safety testing (Cordes and Weisbrod, 1988). Under these circumstances, "nonprofits are exempt from federal and state corporate income taxes on income from activities that, even if commercial, are deemed to be substantially related to the organization's primary exempt purpose" (Cordes and Weisbrod, 1998: 197). Furthermore, nonprofit organizations are

generally exempt from paying state and local property taxes if the property is used “primarily” for the organizations exempt purpose (Cordes and Weisbrod, 1998).

### **Rationale for Nonprofit Tax Exemption**

Gomes and Owens (1988) note that some have argued that 501 (c)(3) organizations earn their exemption status by undertaking activities in the interest of the public good for which the federal government would have to pay if it carried out these tasks by itself. However, they go on to note that a more satisfying explanation for the tax exemption status of nonprofits concerns the idea that nonprofits generally have difficulties in raising capital. In this light, exemption is seen as a device which is designed to compensate for these difficulties. In terms of this argument, nonprofits are limited to three sources of capital: debt, donations and retained earnings. “Because donational support is an uncertain source of revenue, and because the riskiness of debt makes lenders unwilling to completely finance the capital needs of nonprofits, the accumulation of retained earnings is critical for capital expansion (and would enhance the ability to acquire debt)” (Gomes and Owens, 1988: 12). Consequently, tax exemption subsidizes capital formation.

### **The Unrelated Business Income Tax**

While nonprofit organizations are generally exempt from the above mentioned taxes, Section 511 of the Federal tax code does stipulate that income from 501 (c)(3) organizations that is unrelated to the organizations charitable or tax-exempt purpose will be taxed at the prevailing corporate tax rate. “Section 512 defines UBTI as: (1) gross income; (2) from any unrelated trade or business; (3) that is regularly carried on by the organization; (4) less deductions regularly connected with the business” (Cain, 1999: 351). While Section 511 appears to be sound public policy at a surface level, it has become a source of major controversy for a couple of reasons. For example, Cain points out that the IRS and the federal courts have not been consistent in their interpretation of what activities actually fall within the UBTI definition. Owens (1988) points out that the UBTI has two objectives, namely, to eliminate unfair competition between tax exempt and taxable organizations and to increase federal revenues by eliminating tax loopholes. However, due to problems with implementing the provision only a small percentage of unrelated revenues have been collected over the years.

### **Public Policy Issues**

Several questions surrounding this debate are ripe on the public policy stage. For example, should nonprofits in the first place have a tax-exempt status? If so, should these tax-exempt organizations be allowed to engage in for-profit activity? Does the commercialization of nonprofits constitute unfair competition for the for-profit sector? While there are no clear-cut answers to these questions, some have argued that there is nothing inherently wrong with nonprofits engaging in for-profit behavior as long as

public policy promotes a “leveling of the playing field”. Various reforms have been proposed in this regard, such as “implementing more stringent reporting requirements for nonprofits, the elimination or restriction of exemptions to and from the UBIT, requiring that commercial activities of nonprofits be pursued through for-profit subsidiaries, and the outright prohibition of all unrelated business activities” (Gomes and Owens, 1988: 15).

As Gomes and Owens (1988) point out, the claim of “unfair competition” raises the more general issue of distributive justice i.e., how should society’s resources be distributed among society’s members in light of the objectives of efficiency, equity and justice. I think there is much insight in this observation. I believe that it important to formulate policies that are balanced in the sense that they reflect at some level, all of these values. With this in mind I believe that the problem with UBIT lies more in the implementation of the policy than in the policy itself. On the one hand the commercialization of the nonprofit sector is a positive development in the sense that it allows nonprofits to become more self-sufficient. Nonprofits promote both efficiency (it can be argued that the nonprofit sector is a response to both market and government failure) and equality (for example, they provide services to individuals that could otherwise not afford them) in our society and it is important that the relevant policies are in place to encourage their survival. On the other hand, I feel that the pursuit of profits unrelated to the core purpose of the organization, is problematic in the sense that it allows nonprofits to compete unfairly with tax paying businesses. A balanced and just policy should seek to protect the interests of both nonprofit and for-profit organizations. Therefore, while the objectives of UBIT are worthy, steps need to be taken to ensure that the legislation is enforced in an effective manner.

In sum, while I believe that the commercialization of the nonprofit sector is an innovative and promising development, I believe that reforms are needed to ensure that nonprofit organizations do not unfairly exploit their tax-exempt status.

## References

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