U8213 Colloquium on Policy Analysis Section 3
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Group Project 1

"If something is not done, the macaroni monopoly will be in the hands of universities."
— Congressman Dingell, 1950.

Life as one of the staff members in the House of Representatives is very busy these days, always a new tax to repeal. Last week were capital gains taxes and estate taxes; this week, the subject is the unrelated business income tax (UBIT).

UBIT is the tax on the "unrelated income" of non-profit organizations — income that is not somehow related to the purpose for which the non-profit was organized. It was enacted by Congress in 1950 in response to a number of interesting incidents, the best known of them benig the donation to NYU Law School of the CF Mueller Company — the country's largest manufacturer of noodles. This tax applies to the income that a non-profit organization realizes from "any trade or business in the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived" to the exercise of performance by such organization of [the purpose] constituting the basis for its exemption."

This unrelated income is taxed at the corporate rate. UBIT was substantially amended in 1968 such that profits in one unrelated business may be offset by losses in another unrelated business, but not losses in a related business.

Sorting out which activities are "related" and which are not has been difficult. Some of the things that have been ruled taxable are: rental mailing lists, a travel agency that serves outsiders, income derived from the sale of excess capacity on a regular basis (e.g. when Fairleigh Dickinson rents its athletic fields to the NJ Giants), advertising and commercial-style businesses. Some of the things that are exempt are: "passive income" (dividends, interest, royalties, rents on real property, annuities, capital gains), government contracts, businesses run by volunteers, businesses run for the convenience of students or staff (e.g. a gasoline station at Hofstra), sale of donated items and by-products (e.g. milk at Texas A&M), bingo games and trinkets sold in fundraising. College athletics (including the NCAA tournament and the bowl games) is exempt because it is related to the colleges' tax-exempt purposes, and so is the $10 million a year in royalties the Children's Television Workshop receives in licensing fees for Sesame Street.

UBIT is not a big revenue-raiser for the federal government. The net take was around $100 million in the early 90s. Rather, it was designed to even the playing field and promote fairness in competition. The 1950 Ways and Means Committee report states: "The problem at which the tax on unrelated business income is directed here is primarily that of unfair competition. The tax-free status of [non-profit] organizations enables them to use their profits tax-free to expand their operations, while their competitors can only expand with profits remaining after taxes."

In the beginning, for instance, taxable macaroni companies were worried about unfair competition from an NYU noodle-maker that did not have to pay corporate income taxes. Today, commercial gyms want UBIT extended to YMCAs, and campus pizza places are afraid of what would happen if universities start making pizza.

Your job is to make a recommendation of what to do about UBIT: reform it, repeal it, or keep it as it is. You might also go all the way and recommend the repeal of 501(c)(3) exemption; why should non-profits be exempt anyway? Or possibly attribute the benefits of non-profit activities to their recipients and taxing those benefits as part of the individual income tax. (You may not think this is a good idea for GMHC, for instance, although your bosses may think differently, but what about the Metropolitan Opera and the Tobacco Industry Council?)

You might also consider keeping UBIT but making some changes. Why should passive income like Sesame Street royalties be excluded? (In 1988, the House Ways and Means Oversight Committee investigated applying UBIT to royalties, but why stop there?) What's so special about operating the business, as opposed to realizing the profits? Why not include college football and basketball? In 1998, the House Ways and Means Oversight Committee also considered including under UBIT gift shop and bookstore income, income from the sale or rental of medical equipment, travel and tour services, adjunct food sales, many veterinary services, hotel facility income, affinity card income, and income from health, fitness, and recreational activity (unless the program is available to a reasonable cross-section of the general public). You might want to think about these changes too.

Do the offset rules make sense?

Be sure to think about what unfair competition means. If you take Susan Rose-Ackerman seriously, you would probably want to abolish the whole thing. But in the absence of UBIT would non-profits really enter randomly chosen industries? Perhaps you would want to reverse UBIT: tax related fields but not unrelated ones.