COMMERCIAL NONPROFITS, UNTAXED ENTREPRENEURIALISM, AND "UNFAIR COMPETITION"

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ABSTRACT: COMMERCE SANS BUT LUCRATIF, ENTREPRISES NON IMPOSABLES, ET "CONCURRENCE DELOYALE"

Lorsqu’elles s’engagent dans une activité commerciale, les organisations à but non lucratif, non imposables, se trouvent dans une position privilégiée par rapport aux entreprises à but lucratif, non exonérées. Le problème posé par une situation qualifiée de “concurrence déloyale” est analysé dans ce contexte. Cet article examine le rôle et le statut des organisations à but non lucratif, leur récente entrée sur le marché de l’entreprise commerciale, les fondements d’un système de privilège fiscal, et la prise de position publique à l’égard des activités commerciales du secteur non lucratif. Cette situation soulève des questions de juste répartition réclamant des mesures appropriées de la part des services publics.

In August 1986, delegates to the White House Conference on Small Business alleged that “unfair competition” was being waged by nonprofit and governmental organizations that provide commercial services in direct competition with the private sector. Delegates called for the prohibition of (or, at minimum, protection from) such practices and demanded the passage of new legislation embodying a strict governmental policy of reliance on private enterprise for the performance and provision of commercial activities. More recently, in the summer of 1987, the Subcommittee on Oversight of the U.S. House of Representatives Committee on Ways and Means held hearings to review the federal tax treatment of the commercial activities of tax-exempt organizations.

The controversy stems from the alleged inherent unfairness of business competition when one group of competitors enjoys a government-subsidized competitive advantage. In this case, the competitive advantage in question is the tax-exempt status enjoyed by most nonprofit organizations. The income tax exemption is a crucial competitive issue when nonprofit organizations pursue commercial (i.e., for-profit) activities—“untaxed entrepreneurialism”—in direct competition with private enterprise.

The current spirited debate over “unfair competition” involves emotional rhetoric on both sides. On the one hand, the small business community and its lobbyists (e.g., Office of Advocacy, Small Business Administration; Business Coalition for Fair Competi-
tion) claim that nonprofit organizations are destroying the very fabric and strength of the domestic economy by taking unfair advantage of existing public policy. The nonprofit sector and its lobbyists (e.g., Independent Sector), on the other hand, claim that nonprofit organizations contribute important and indispensable services that would not be provided if public policy did not support and protect nonprofit enterprise through tax exemptions and other privileges.

To claim that competition is "unfair" immediately raises legal and ethical questions. What constitutes unfair competition? Does present public policy unfairly provide nonprofit organizations with an artificial competitive advantage over for-profit organizations? If so, what public policy changes are required? If not, how can present public policy be justified? To clarify these issues, this article:

- briefly surveys the legal interpretation of "unfair competition" and traces the statutory response to it;
- examines the economic role of nonprofit organizations, including the increasing commercialization of their activities;
- identifies rationales for tax exemption and the implications of tax-favored status; and
- reviews the public policy response toward the commercial activities of nonprofit organizations.

Unfair Competition and the Law
There is neither a clear theory of unfair competition nor a precise generally accepted definition of the term. A recent court decision maintained that, in a society that encourages aggressive economic competition, unfair competition is an "anomalous creature" whose scope is limited to three categories of behavior: (1) passing off one's goods as those of another; (2) engaging in activities designed solely to destroy a rival; and (3) using methods that are illegal. Another case defined unfair practices as those actions that offend public policy, or that are immoral, unethical, oppressive, and unscrupulous. In its most basic form, unfair competition exists when a business takes unfair advantage over its competitors by violating its duty to abide by the "rules of the competitive business game," and the law has evolved to prevent such practices.

Statutes such as the Sherman Antitrust Act (1890), the Clayton Act (1914), the Federal Trade Commission Act (1914), and the Wheeler-Lea Act (1938), remain the major legislative response to unfair competitive practices. It is apparent, however, that the claim of unfair competition now being levied by the small business community against the nonprofit sector has little to do with legislation of monopoly power, restraint of trade, or deceptive business practices. Rather, the claim of unfair competition is based on an alleged inequit-
able distribution of competitive advantages and a breach of trust arising from abuses of the tax-exempt status of nonprofit organizations engaged in commercial enterprise. To appreciate the origins of this claim, we must examine the growing influence of the nonprofit sector on the domestic economy.

**Nonprofit Organizations and the Third Sector**

The claim of unfair competition is directed primarily at the commercial activities of the “Third Sector,” those voluntary associations and nonprofit institutions organized to serve the public interest, but which are neither governmental (i.e., state-operated) nor private (i.e., for-profit). This public service sector includes, for example, charitable, educational, scientific, social welfare, and religious organizations.*

The most common explanation for the existence of the Third Sector is based on the premise of *pro bono publico*. It exists to provide socially desirable goods and services that would not otherwise be provided by for-profit organizations in the amounts required or desired by society. A related explanation focuses on the fiduciary role of nonprofit organizations in the presence of market and contract failure. The Third Sector plays a “quality assurance” role in those industries where complex personal services may be difficult to evaluate (e.g., health care and education), where consumers are unable to constantly monitor the quality of the services provided (e.g., day care centers), or where services have a “public goods” quality.⁸

Although “Third Sector” and “nonprofit” have become synonymous terms, “nonprofit” is not an entirely accurate descriptor of the economic conduct of Third Sector organizations. Because they are not organized primarily to pursue profits, perhaps “not-for-profit” is a more appropriate designation, but even this characterization is both misleading and partially incorrect. Third Sector organizations, which are usually exempt from certain taxes, are not prohibited from earning a surplus (i.e., the excess of revenues over costs and expenses). On the contrary, many nonprofits consistently earn accounting surpluses, but they are barred from distributing any surplus earnings to individuals or groups who may exercise control over them. This “nondistribution constraint” prohibits the distribution of profits to officers, directors, trustees, or members, and it requires that earned surpluses retained in the organization be devoted to the continuation of the organization’s tax-exempt purposes.

The primary distinguishing characteristic of the nonprofit corporation is the absence of stock or other evidence of ownership whereby profits and con-

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Control over the organization are simultaneously shared. The enforcement of the nondistribution constraint is minimal, however, and nonprofits have been accused of distributing surplus earnings through excessive salaries and fringe benefits. Nonprofit organizations may also be categorized by the primary source of their funding. If nonprofits receive most or all of their income from donations and grants, they are “donative”; alternatively, nonprofits are “commercial” if most of their income is derived from the surpluses earned from selling goods and services. Traditionally, nonprofits have been equated with the donative form and were assumed to operate outside the market economy occupied by business; today, however, commercial nonprofits dominate the nonprofit sector.

The Third Sector is a rapidly growing contributor to domestic economic activity. Nonprofit organizations have expanded their traditional presence in areas such as education, health care, and the arts, and they increasingly compete directly with private, for-profit firms in a wide variety of industries. Although statistics are incomplete and sometimes contradictory, it has been estimated that the nonprofit sector, comprising over 850,000 entities, contributes as much as $300 billion to national income (about 8 percent of GNP), and its contribution has steadily increased since the Great Depression.

In a survey of nonprofit organizations conducted by the Urban Institute in 1982, two-thirds of the respondents were formed since 1962; moreover, since 1975, two-thirds of all nonprofits have initiated some kind of commercial activity. The Third Sector will continue to grow in size and economic importance for three reasons: (1) the nonprofit corporation statutes of the states are becoming more permissive; (2) nonprofit organizations are typically concentrated in the service-related industries of the service-oriented economy; and (3) nonprofit organizations usually obtain special tax advantages and exemptions, which is perhaps the dominant legal explanation for the existence and size of the nonprofit sector.

Nonprofits have increased their commercial activities in response to cuts in federal grants and intensified competition for private gifts. This “profitization” of nonprofits is an attempt to stabilize budgets and diversify revenue bases, and the phrase “strategic piggybacking” was coined to describe the process by which deficit-producing primary activities are subsidized by for-profit ventures. In many cases, the move toward self-sufficiency through commercial activities is viewed as the only alternative that will ensure the survival of the organization. In a free market economy, the intrusion of nonprofits into competitive markets traditionally dominated by for-profit firms would not be sufficient cause to warrant the claim of unfair competition; rather, the alleged artificial com...
petitive advantage created by the tax-exempt status of most nonprofits under present tax law is the basis for complaint.

**Tax-Exempt Status and Untaxed Entrepreneurialism**

Favored tax status for charitable and religious organizations dates back to the British Statute of Charitable Uses of 1601. In the United States, tax-exempt status is determined primarily under the provisions of Section 501 of the Internal Revenue Code, and organizations qualifying for the tax exemption are primarily engaged in activities which accomplish at least one of the purposes established in Section 501(c) of the Code. Although many types of organizations may qualify for tax-exempt status, most qualify under section 501(c)(3), which encompasses religious, charitable, scientific, and educational corporations.

The legislative history clearly reveals that Congress's basic rationale for exempting certain organizations from taxation was "based on the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare." Section 501(c)(3) organizations, for example, earn their tax exemption by virtue of undertaking tasks for which the federal government would have to pay if it undertook those tasks itself. Other rationales for the income tax exemption have been offered, including: the incongruence between the concept of income and the purposes of nonprofits, and the "public service" nature of their missions.

While it is generally believed that the exemption represents a subsidy for the particular kinds of goods and services that nonprofits provide society, this subsidy theory fails to account for the fact that for-profit firms providing similar goods and services are denied the exemption. Notwithstanding other possible explanations for the nonprofit's favored status, including the assumed beneficial pass-through effects of the nondistribution constraint, the public goods character (in the economic sense) of the product mix of nonprofits, and the quality assurance role played by nonprofits in light of contract failure, none of these rationales taken alone adequately explains or justifies the tax exemption.

A more satisfying explanation, Hansmann argues, is that the exemption is designed to compensate nonprofits for the difficulties they encounter in raising capital; in other words, the exemption is a subsidy to capital formation in view of the capital constraints imposed on nonprofit organizations by their lack of access to equity capital (because the nondistribution constraint prohibits the issuance of ownership shares in the enterprise). 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). The exemption from income tax liability thus subsidizes capital formation.

The claim that the "untaxed entrepreneurialism" of the commercialized Third Sector results in unfair competition with non-exempt for-profit firms rests on two assumptions. The first is that the tax exemption threatens competitive equality because it allows nonprofits to cut prices and to ac-

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19Bittker and Rahdert, "Exemption of Nonprofit Organizations.
20Hansmann, "Rationale for Exempting Nonprofit Organizations."
21Hansmann, "Rationale for Exempting Nonprofit Organizations"; cf. Bittker and Rahdert, "Exemption of Nonprofit Organizations."
cumulate retained earnings (and thus grow) at an accelerated pace. The second is that tax exemption is often applied to income derived from activities that are not substantially related to the tax-exempt purposes of the nonprofit organization.

The unfair competition claim has been examined from an economic perspective by several scholars. It has been argued, for example, that unfair competition is not an issue when an industry is perfectly competitive, when there are no barriers to entry or exit, or when for-profit firms, upon their initial commitment to the industry, could reasonably have anticipated the subsequent entry of nonprofits. However, if competition from nonprofits could not reasonably have been anticipated, but tax-favored status subsequently induces nonprofits to enter the industry, some for-profit firms may earn sub-competitive returns because of "excessive entry." The subsequent entry of nonprofits will shift the supply curve with the effect of lowering equilibrium prices and gross returns. Under these conditions, a case for "unfairness" could be made.22

Given the potential to lower industry prices through excessive entry, is it reasonable to assume that nonprofits would be motivated by their tax-exempt status to engage in predatory pricing behavior that would drive for-profit firms from the industry? Moreover, would the advantages of tax-exempt status cause investment to flow away from for-profit firms? Some scholars argue that predatory pricing would violate rational economic decision-making axioms and would entail formidable legal and economic barriers and risks. The concern that investment will shift from for-profit to nonprofit firms is mitigated by the fact that the possession of the tax exemption requires foregoing all claims by individuals to any earnings surplus due to the nondistribution constraint.23

If certain for-profit firms are experiencing lower-than-hoped-for profit margins, one must ask whether such performance is the direct result of the tax-exempt status of some of their competitors, or a result of the competitors' market-derived competitive advantages independent of their tax status. Indeed, there is some evidence that nonprofit organizations are less efficient than their for-profit counterparts within the same industry, and that they may not be able to exploit the cost advantages of their tax-exempt status.24 The federal government has not been insensitive to the possibility that tax-exempt status might cause unfair competition. To minimize the risks of such a possibility, the primary public policy response has been a tax on "unrelated" trade of business income.

The Unrelated Business Income Tax
Prior to 1950, the taxability of a nonprofit's income from commercial activities was determined by the income's ultimate destination, and not its source. The Revenue Act of 1950, however, refocused attention on the source of income and imposed the regular corporate income tax on the "unrelated" income of certain nonprofit, tax-exempt organizations.25 The legislative history indicates that the unrelated business income tax (UBIT) had two objectives: (1) to eliminate the basis for unfair competition between exempt and taxable organizations; and (2) to increase federal revenues by

25I.R.C., Sections 511-515.
closing tax loopholes. Despite minor amendments to the statute since then, this remains the only significant statutory limitation on the tax-exempt activities of nonprofits.

The UBIT pertains only to income from a regularly conducted trade or business not substantially related to the tax-exempt purpose of the organization; it was not intended to apply to all income from activities that may compete with non-exempt firms. Moreover, the presence or absence of actual competition does not altogether determine whether the income of an exempt entity’s commercial activities should be subject to UBIT—it is merely necessary to show that the activity is conducted in a competitive, commercial manner and that it is not substantially related to the organization’s tax-exempt purposes.

An organization endangers its tax-exempt status if more than an insubstantial portion of its activities is unrelated to or does not further the organization’s exempt purpose. As a result, the UBIT is often criticized by non-exempt firms for its inability to eliminate the alleged unfair competition from non-profits. Tax-exempt organizations seeking to minimize their tax liability will not be quick to voluntarily declare UBIT in light of the ambiguous test of what constitutes a substantial relationship. This ambiguity surely inhibits consistent compliance with, and enforcement of, the UBIT statutes. Moreover, numerous exemptions and exceptions to the UBIT provisions considerably reduce the level of taxable unrelated income. As a revenue source, the UBIT has never lived up to expectations, and it accounts for a miniscule portion of the total corporate income tax collected by the IRS. As a means of ensuring fair competition, the UBIT leaves the non-exempt private sector unconvinced to the point of calling for additional protective legislation as a matter of public policy.

Public Policy and Distributive Justice

Taxation is not only a source of revenue; it is also an element of industrial and public policy. Tax exemptions and similar subsidies have long been used to promote activities and investments deemed desirable and in society’s collective interest. There are two “laws” of subsidies, however: (1) once granted, they tend to persist; and (2) they are always defended in terms of their real or imagined contributions to the collective social welfare. A subsidy’s value is a matter of judgment and vision, and its continuation (or discontinuation) is the result of the relative bargaining power of opposing factions.

It was the intent of Congress to prevent unfair competition by balancing the effects of the tax exemption subsidy with the UBIT. Advocates and lobbyists for the small business sector claim, however, that the tax-exempt status of commercial nonprofit enterprises, under an ambiguous and weakly-enforced UBIT, is an unfair subsidy that fosters unfair competition at the
expense of tax-paying businesses. Some argue that there is nothing inherently wrong with commercial nonprofits engaging in competition with small businesses so long as public policy effects a "leveling of the playing field."^^ Numerous reforms have been proposed, including, for example, more stringent reporting requirements for tax-exempt organizations, the elimination or restriction of exceptions to and from the UBIT, higher tax rates on unrelated business income, requiring that commercial activities of nonprofits be pursued through for-profit subsidiaries, and the outright prohibition of all unrelated business activities.

The nonprofit sector might argue, however, that another element of public policy—the creation of the Small Business Administration by the Small Business Act of 1953—provides its own leveling effect and counterbalances whatever advantages attach to the tax exemption. In establishing the SBA, it was the legislative intent of Congress to "aid, counsel, assist, and protect, insofar as is possible, the interests of small-business concerns in order to preserve free competitive enterprise."^^ Recent cutbacks notwithstanding, the aid, protection, and subsidies provided by the SBA (e.g., set-aside contracts, loan guarantees, publications, management assistance and training, and the Office of Advocacy) continue to have significant economic value to the small business sector.

The balance of subsidies reflects prevailing public policy concerning the just distribution of the nation's income. If it exists at all, unfair competition exists because current public policy is either unfair or is administered unfairly or unevenly with respect to three performance criteria: efficient resource utilization, equitable distribution of society's benefits and burdens, and economic growth. The legality of the commercial activities of nonprofits is not at issue. The fairness of current public policy and its enforcement is at issue, particularly as it pertains to the scope and enforcement of the unrelated business income tax provisions of the Internal Revenue Code.

Policy makers undeniably have a responsibility to justify resource reallocation decisions if and when competitive losses can be traced to specific government policies and subsidies. The claim of "unfair competition," tied as it is to the more general issue of taxation and subsidies, raises the fundamental question of distributive justice: How should benefits and burdens, and gains and losses, be distributed among society's members in light of the objectives of efficiency, equity, and growth?

**Conclusion**

The "unfair competition" controversy raises important public policy concerns. The opportunities for additional research in this area are exciting for the challenges they present, and for the prospects they hold for resolving the issue of unfair competition between nonprofits and for-profits. Consistent with the charge of the Congressional Subcommittee on Oversight, fruitful areas for future research include determining the areas in which organizations are competing with small businesses; the extent to which they compete directly with non-exempt firms; and the extent to which they earn a surplus. Other questions to be explored are whether or not the UBIT is an efficient, effective, and equitable public policy, and the extent to which tax-exempt organizations voluntarily comply with existing laws.

At another level of analysis, "unfair competition" may be studied using ethical reasoning paradigms. From the utilitarian perspective of efficiency, for example, untaxed entrepreneurialism...
is inherently unfair if the tax exemption fosters economic inefficiencies and thus actually diminishes aggregate social welfare. An important public policy question is raised: Does the tax-exempt status of nonprofits, including the supposed competitive advantage accruing to them, lead to an overall increase in efficiency and a net improvement in aggregate welfare?

Alternatively, from the perspective of equity and justice, equals should be treated equally and unequals, unequally. The relative merits of a particular distribution of benefits and burdens might be judged on a number of criteria, including strict equality, need, ability, merits or achievement, efforts or sacrifices, productive contributions, requirements of the public welfare, legal entitlements, contractual relationships, or legitimate claims based on desert. Another important public policy question becomes: How should benefits and burdens be allocated between for-profit and nonprofit organizations, and what are the appropriate criteria for establishing a just and equitable distribution?

The violation of the rules of the competitive business game is the essence of any claim of "unfair competition." Government, as arbitrator and referee, must be able to effectively determine what the rules of the game are or should be, how they should be communicated to and understood by the respective players, and what leveling of the playing field is required to best achieve society's objectives. Public policy creates the playing field and establishes the rules of the game. Effective policymaking requires no less than a thorough reexamination and clarification of the roles, expectations, and contributions of two of the most important players: the small business, private enterprise sector and the nonprofit sector.

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