THE UBIT: LEVELING AN UNEVEN PLAYING FIELD OR TILTING A LEVEL ONE?

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INTRODUCTION

If you take a walk along the Upper West Side of Manhattan, you will see numerous restaurants, especially on the avenues. There is, however, a stretch of the west side of Broadway, between 60th and 65th Streets, where there are no restaurants open to the public. Occupying that land are two prominent New York institutions: the Lincoln Center for the Performing Arts and Fordham Law School. The difficult time that pedestrians walking past Lincoln Center and Fordham have finding a bagel or a latte will change when the remodeled Lincoln Center opens in 2010. The current renovation plans call for tearing down the wall that separates Lincoln Center from the pedestrian traffic along Broadway and opening the plaza, famous for its fountain, to the street. Like much contemporary urban architecture, the buildings at Lincoln Center seek to integrate that institution into its neighborhood by removing barriers that keep out pedestrians. Lincoln Center will also reach out to its neighbors by hosting several restaurants open to the public. The managers of Lincoln Center hope that those restaurants will attract not only individuals attending events at the center, but also passersby and neighborhood residents. By operating restaurants open to the general public, Lincoln Center will find itself in direct competition with numerous private restaurants in the area.[1] However, unlike almost all of the establishments with which it will compete, the Lincoln Center restaurants will be owned and operated by a nonprofit organization. As a nonprofit under § 501(c)(3) of the Internal Revenue Code, Lincoln Center is exempt from federal tax on its income from activities that are related to its exempt function. Almost all competing establishments—whether owned by individuals directly, through pass-through entities, or through corporations—are not tax exempt. That

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1. Currently, the eating establishments within Lincoln Center cannot be seen from the street and are mostly inside of venues that require tickets for entry. They also compete with private restaurants, but not as directly as will the new restaurants.

situation raises two policy questions: Will the Lincoln Center restaurants have a tax-induced advantage over other restaurants in competing for diners? And if so, would a tax on the unrelated business income of nonprofits, if it applied to the Lincoln Center restaurants, undo that advantage?

Although the Lincoln Center renovation raises the two questions posed above, they are not unique to it. For-profit businesses frequently find themselves in direct competition with nonprofits. Universities, religious institutions, museums, and other nonprofit organizations frequently operate restaurants. They also operate bookstores, gift shops, coffee shops, hotels, gyms, and other facilities that are open to the public. These facilities, which compete directly with for-profit facilities, often fall within the nonprofit's tax exemption.

In some instances, the competition from nonprofits might appear to be an insignificant threat to private enterprise. Think, for example, of one Girl Scout selling cookies. In aggregate, however, the Girl Scouts sell many cookies, some portion of which reduces the sales of for-profit bakeries. In other cases, the competition might seem small from a national perspective, but still constitutes a serious threat to a small group of local competitors. In some instances, nonprofits have started ventures that were narrowly focused on taking customers away from competing for-profit businesses. For example, in Chicago in the 1990s, several major museums, including the Art Institute, Shedd Aquarium, and the Field Museum, began holding afternoon cocktail parties where they produced revenue through admissions fees and drink sales. These events, which were in direct competition with more traditional watering holes, were specifically aimed at shifting customers from bars and restaurants to the museums.[2]

In still other fields, for-profit and nonprofit businesses regularly compete head-to-head. For example, there are both nonprofit and for-profit day care facilities, nursing homes, hospitals, and schools. In all of these fields, for-profit businesses and nonprofits exist side by side. They regularly compete against one another for customers, and, in many markets, both nonprofits and for-profit businesses hold substantial market shares.

Although the commercial activities of nonprofits are most visible when nonprofits sell directly to consumers, nonprofits also compete with for-profit entities in the business-to-business sector of the economy. For example, in Nashville, Tennessee, Baptist Hospital, the region's largest nonprofit hospital, built a $15 million, eighteen-acre office and training facility that it rents to the Tennessee Titans professional football team.[3]

2. Helmut K. Anheier & Stefan Toepler, *Commerce and the Muse: Are Art Museums Becoming Commercial?*, *in* To Profit or Not to Profit: The Commercial Transformation of the Nonprofit Sector 233, 233–48 (Burton A. Weisbrod ed., 1998).

3. *Id.* at 288. This source was published before the completion of the hospital facility and refers to the Houston Oilers, now the Tennessee Titans.

Many nonprofits have embraced the opportunity to compete head-to-head with for-profit enterprises by venturing outside of their traditional range of activities. One nonprofit that was an early and enthusiastic entrant into commercial businesses is the Young Women's Christian Association (YWCA). Starting in the late 1980s, the YWCA began buying and building businesses. Over a fifteen-year period, the YWCA developed a computer software company, purchased a plastics company, started a clothing design line, opened a charter school, operated a ceiling tile business, and invested in real estate in partnership with other investors. These endeavors, however, were largely unsuccessful, and the YWCA has since shuttered or sold almost all of those businesses.[4]

In spite of nonprofits' mixed track record in commercial endeavors, the trend toward greater competition between nonprofits and for-profit firms shows little sign of slowing. Some sophisticated parties are betting that the trend will continue. For example, Yale's School of Management has established a program to help charities develop business plans for entry into commercial markets.[5]

The commercial activities of nonprofits have not gone unnoticed by their for-profit competitors. For-profit firms have been critical of nonprofits venturing into commercial activities. Of course, most business owners would like to have fewer competitors. However, the complaint that for-profit firms have voiced about nonprofits has not been regarding competition generally. Instead, their complaint is narrower and more focused. For-profit firms, and their supporters, argue that nonprofits enjoy a tax-induced competitive advantage by virtue of their exemption from the federal income tax.

Nonprofits are taxed differently than are for-profit businesses. For-profit businesses and their owners are subject to tax on the income generated from operations,[6] even if the income is reinvested in the business. In contrast, nonprofits are generally exempt from tax.[7] That exemption from tax is widely perceived as providing nonprofits with an unfair competitive advantage over competing for-profit businesses. Congress agreed and in 1954 enacted the Unrelated Business Income Tax (UBIT),[8] which taxes nonprofits on their income from commercial activities that are unrelated to

4. Bruce Murphy, *Missions Collide When Non-profits Try Business*, Milwaukee J. Sentinel, May 31, 2004, at 1A. Some of these ventures were for-profit while others were not.

5. Press Release, Yale Sch. of Mgmt., Yale School of Management Receives Twin Grants Totaling $4.5 Million from the Goldman Sachs Foundation and the Pew Charitable Trusts to Foster Business Growth Among Nonprofit Organizations; Partnership Creates First-of-Its-Kind Business Plan Competition (Feb. 7, 2002), *available at* http://mba.yale.edu/news_events/CMS/Articles/203.shtml. Universities are frequently in competition with for-profit entities in providing postgraduate training programs.

6. *See* I.R.C. § 61(a)(2) (2000).

7. *See id.* § 501(c)(3).

8. The statute was drafted on August 16, 1954.

their exempt function.[9] The UBIT is seen as leveling the playing field between for-profit firms and nonprofit firms when the latter enter into commercial activities in competition with for-profit firms.[10]

The purpose of this essay is to reexamine the level playing field argument for the UBIT. Specifically, the essay addresses the question of whether and under what circumstances the tax exemption granted to nonprofits gives them an advantage in competition with for-profit firms. The essay attempts to determine whether the UBIT is an appropriate response to whatever advantage might exist. In addition, if the UBIT does not level the playing field, the essay examines how the commercial activities of nonprofits should be taxed to ensure that taxes do not provide any competitors with an advantage or disadvantage.[11]

I. THE HISTORY SURROUNDING ENACTMENT OF THE UBIT

From the very beginning of the U.S. federal income tax, the Internal Revenue Code (the Code)[12] has recognized the unique role played by private, nonprofit charities by exempting such organizations from tax.[13] That exemption, which now appears in § 501(c)(3), excludes from federal income taxation corporations "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes or to foster amateur sports or for the prevention of cruelty to children or animals."[14]

In order for a § 501(c)(3) organization to maintain its exemption from federal income taxation, it must meet two requirements. First, "no part of the net earnings" of the organization can inure "to the benefit of any private shareholder or individual."[15] That requirement, which has been termed the "nondistribution constraint" by Henry Hansmann, prevents charitable organizations from issuing equity or from paying out their profits through

9. *See* I.R.C. § 511 (2000).

10. The unrelated business income tax (UBIT) is sometimes also justified as protecting tax collections against erosion.

11. This essay, which is part of a broader project on the relationship between taxes and competitiveness, is an outgrowth of Michael S. Knoll, *Taxes and Competitiveness* (Univ. of Pa. Law Sch., Inst. for Law & Econ., Research Paper No. 06-28, 2006).

12. Throughout this essay, all section references, unless otherwise indicated, refer to the Internal Revenue Code of 1986, as amended and codified in title 26 of the U.S. Code.

13. Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 Yale L.J. 299 (1976) (tracing taxable exemption back to the Revenue Act of 1894, the corporation income tax of 1909, and the Revenue Act of 1913).

14. I.R.C. § 501(c)(3).

15. *Id.*

incentive-based pay.[16] Second, the organization must refrain from engaging in prohibited lobbying and political activities.[17]

Prior to the enactment of the UBIT in 1954, charitable organizations were completely exempt from tax. That exemption included income from both related and unrelated businesses. Because a charity's business income was not subject to tax, the only potentially harmful tax consequence to a charity from operating a business was loss of its exempt status. Although the courts were reluctant to impose such a draconian penalty, the government repeatedly challenged charities' exempt status on the basis of their commercial activities.

Thus, in *Trinidad v. Sagrada Orden,* the taxing authority sought to tax a religious order on the income it received from investments and commercial activities.[18] The order derived about three percent of its income from the sale of wine, chocolate, and other items for use in its churches and schools, with the rest of its income coming from passive investments.[19] The government argued that the order, because it engaged in the sales, was operated for business purposes, and thus was not entitled to the exemption.[20] In the courts, the tax collector went 0 for 3, losing in the trial court, the appellate court, and the U.S. Supreme Court. The Supreme Court held that the sales did not constitute a trade.[21] The Court also held that the order could not be taxed on its income from commercial and investment activities because all of the income from the challenged sales went to support the organization's exempt activities.[22] *Trinidad* has come to stand for the proposition that it is the destination, not the source, of the income that determines whether a corporation is organized for charitable purposes. That principle is called the destination principle, and courts have used it for more than eighty years to define the scope of the charitable exemption.

Although the commercial activities of the religious order in *Trinidad* were small by almost any measure and closely related to the order's exempt function, following *Trinidad*, some charities began to operate purely commercial activities. One such entity was Roche's Beach, Inc. Roche's Beach rented bathhouses and umbrellas and sold refreshments to bathers. It turned over its profits to a tax-exempt charitable foundation for the relief of poor women and children. Citing the destination principle in *Trinidad*, the U.S. Court of Appeals for the Second Circuit held that Roche's Beach was exempt from the federal income tax.[23]

16. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 Yale L.J. 835, 838 (1980). Henry Hansmann has cataloged the consequences of nonprofits enjoying a tax-induced advantage in competitiveness over for-profit businesses, interference with diversification, and encouragement of managerial inefficiency.

17. I.R.C. § 501(c)(3).

18. Trinidad v. Sagrada Orden, 263 U.S. 578, 579 (1924).

19. *Id.* at 580 n.1.

20. *Id.* at 580–81.

21. *Id.* at 582.

22. *Id.* at 581.

23. Roche's Beach, Inc. v. Comm'r, 96 F.2d 776, 778–79 (2d Cir. 1938).

Roche's Beach opened the door for charitable organizations looking to operate for-profit commercial businesses, and many charities followed the path laid out by the federal courts in *Trinidad* and *Roche's Beach*. Charities would organize feeder corporations, separately incorporated entities that owned and operated commercial businesses.[24] These feeder corporations would not directly advance the charity's exempt purpose. Instead, they would be operated in a businesslike manner with the goal of earning a profit. However, unlike traditional, for-profit corporations, these feeder corporations would funnel their profits, if any, to their charitable parents for the benefit of the exempt charitable organizations. Except for transferring their profits to their charitable parents, such feeder corporations were otherwise indistinguishable from their traditional for-profit competitors.

By far, the most famous feeder corporation was the spaghetti and macaroni manufacturer, the C.F. Mueller Co. In the 1940s, alumni from New York University (NYU) School of Law purchased Mueller, at that time the country's largest producer of macaroni, for the benefit of the university's law school. The group organized a Delaware corporation for the charitable purpose of operating Mueller's business and distributing the profits thereby earned to the school. The corporation borrowed roughly $3 million—the full purchase price—and used the proceeds to buy all of the outstanding stock of Mueller, which it then merged into itself. In effect, NYU acquired Mueller by assuming $3 million in debt. The feeder corporation operated Mueller's business profitably, distributing all profits to NYU for the benefit of its law school. Neither the feeder corporation nor NYU paid any federal income taxes on Mueller's profits.

The Commissioner of Internal Revenue challenged the transaction and sought to tax the feeder corporation on its profits. The commissioner was successful in the Tax Court,[25] but he was shot down by the U.S. Court of Appeals for the Third Circuit, which saw no difference except for size between *Roche's Beach* and *Mueller*.[26]

Although larger than the amounts at issue in *Trinidad* and *Roche*, the amount of money involved in *Mueller* was still not very large. Of course, Mueller was not the only feeder corporation owned and operated by a charity. In fact, Mueller was not the only business owned and operated by NYU. At the time, NYU also owned American Limoges China, Ramsey Corporation (which manufactured pistons), and Howes Leather Company. The last, Howes, was valued at $35 million—more than ten times as much as the value NYU placed on Mueller.

Moreover, NYU was not the only university to own and operate commercial businesses. In December 1948, *The New York Times* published what it called a nationwide study that described how educational institutions were "investing their endowment funds in real estate, large-

24. *Id.*
25. *See generally* C.F. Mueller Co. v. Comm'r, 14 T.C. 922 (1950).
26. C.F. Mueller Co. v. Comm'r, 190 F.2d 120, 122 (3d Cir. 1951), *rev'g* 14 T.C. 922.

scale commercial ventures and other various businesses."[27] Among the varied businesses that *The New York Times* listed as owned and operated by educational institutions were (in addition to the NYU businesses) the following: a street car company, an airport, a cattle ranch, a walnut grove, and filling stations.[28] Furthermore, according to the *New York Times* report, universities and colleges were also major investors in commercial real estate. Among the high profile real estate holdings of educational institutions at the time were Union College's ownership of the real estate of Allied Stores and Abraham & Straus, Columbia University's ownership of Rockefeller Center, and Cooper Union's ownership of the land on which sits the Chrysler Building.[29]

The entry of tax-exempt educational institutions into commercial businesses and real estate in competition with private, taxable owners raised questions of unfair competition. Thus, from the first page of *The New York Times* in December 1948:

> Concern has been expressed by both the House Ways and Means Committee and the Internal Revenue Bureau over this turn of events. The charge of "unfair competition" has been raised in some quarters. Since the profits of college-owned or college-operated corporations go to the institution and are used for educational purposes, they are tax-exempt.[30]

That concern soon took the form of a law. In 1954, Congress enacted the UBIT.[31] The UBIT imposes tax on many otherwise tax-exempt institutions, including private universities, on the incomes they earn on activities that are unrelated to their exempt functions.[32] The UBIT is generally imposed at the same tax rates that apply to corporations.[33]

The rationale for the UBIT was and is that without such a provision charities would enjoy an unfair tax-derived competitive advantage over their taxable competitors.[34] The UBIT offsets that advantage by subjecting

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27. Benjamin Fine, *University Dollars Yielding Tax-Free Business Profits*, N.Y. Times, Dec. 13, 1948, at A1.

28. *Id.*

29. *Id.* Educational institutions that owned commercial real estate generally leased the land to long-term tenants. In many cases, the tenant was also the party that had sold the land to the school. Such a transaction is called a sale-leaseback because the seller leases the property back from the buyer.

30. *Id.*

31. Imposition of Tax on Unrelated Business Income of Charitable, etc., Organizations, ch. 736, 68A Stat. 169 (codified as amended at I.R.C. § 511 (2000)).

32. *Id.* § 511(a)(2)(B).

33. *Id.* § 511(a)(1). The corporate income tax schedule is set out in I.R.C. § 11.

34. *See* Evelyn Brody, *Of Sovereignty and Subsidy: Conceptualizing the Charity Tax Exemption*, 23 J. Corp. L. 585, 605–06 (1998); Charles T. Clotfelter, *Tax-Induced Distortions in the Voluntary Sector*, 39 Case W. Res. L. Rev. 663, 677–79 (1989); Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 Ohio St. L.J. 1379, 1442–43 (1991); Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 Va. L. Rev. 605, 605–07 (1989). *But see* Ethan G. Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 Emory L.J. 1475, 1484 n.29 (2005) (arguing that the purpose behind the

otherwise tax-exempt organizations to tax on their income from unrelated commercial operations. The UBIT, thus, levels what would otherwise be an unlevel playing field. It works by placing both for-profit and nonprofit entities on similar tax terms when they engage in commercial activities.

The legislative history of the UBIT contains numerous statements that the purpose behind the tax is to protect for-profit businesses from unfair competition from tax-exempt businesses. Most famously, Representative John Dingell warned his colleagues that unless the UBIT is enacted "the macaroni monopoly will be in the hands of the universities . . . . Eventually all the noodles produced in this country will be produced by corporations held or created by universities . . . ."[35] Similarly, both the House and Senate reports accompanying the final bill underscored the problem of unfair competition:

> The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of [§ 501(c)(3)] organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes.[36]

And to this day, the Treasury Regulations continue to sound the same theme: "The primary objective 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 non-exempt business endeavors with which they compete."[37]

II. HOW THE UBIT OPERATES

The UBIT applies to virtually all tax-exempt organizations, including those exempt under § 501(c)(3). If an exempt organization carries on unrelated business activities to such an extent that its primary purpose is no longer the exempt purpose, it will lose its exemption.[38] If it carries on the activities to a lesser extent, those activities will be subject to the UBIT. In order for an activity of an exempt organization to be subject to the UBIT, it must meet the following three criteria:

UBIT was not to prevent unfair competition, but to protect and justify (politically) the tax exemption of charities by discouraging them from engaging in commercial activities).

35. *Revenue Revision of 1950: Hearings Before the Comm. on Ways and Means, H. of Reps.*, 81st Cong. 580 (1950) (statement of Rep. John Dingell, Member of the H. Comm. on Ways and Means).

36. S. Rep. No. 81-2375, at 28 (1950), *reprinted in* 1950 U.S.C.C.A.N. 3053, 3081; *see also* H.R. Rep. No. 81-2319, at 38 (1950).

37. Treas. Reg. § 1.513-1(b) (2006).

38. The language of § 501(c)(3) requires that an exempt organization be organized and operated "exclusively" for exempt purposes. Interpreted literally, § 501(c)(3) would prevent an exempt organization from engaging in any commercial activity. The courts, however, have never interpreted the requirement of exclusive operation literally. Instead, in order to maintain the exemption, the courts require than an entity must be organized and operated "primarily" for exempt purposes.

(1) the activity must be a trade or business;

(2) the activity must be regularly carried on; and

(3) the activity must be unrelated to the organization's exempt purpose.[39]

The most frequently litigated of these three criteria is the last one. An unrelated trade or business is defined in § 513 as any trade or business that is not substantially related to the exercise or performance by such organization of its charitable, educational, or other exempt function. Whether an activity is related to the entity's exempt purpose is often a complicated factual determination involving difficult line drawing. The cases and other authorities are numerous, and often seemingly in conflict.[40]

Although the line between related and unrelated business activities is often unclear, the consequences of falling on the wrong side of the line are clear. The unrelated business income of a tax-exempt organization is subject to tax, generally at the corporate rate.[41] Unrelated business income is defined as the gross income derived from an unrelated trade or business less allowable deductions directly connected with carrying on the unrelated trade or business.[42] In other words, the UBIT is imposed on net income, not gross income, just like the regular federal income tax.[43]

The logic for the UBIT is also clear. The exemption from tax enjoyed by charities that own and operate commercial businesses translates into an advantage in competitiveness over for-profit businesses. Subjecting the unrelated business income of charities to tax on roughly the same terms as the income of private competitors eliminates the charity's tax advantage and its resulting competitive advantage.[44]

39. I.R.C. §§ 512(a)(1), 513 (2000).

40. John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 Wm. & Mary L. Rev. 487, 500–07 (2002). For an in-depth survey of the cases interpreting the phrase "unrelated trade or business," see Carla Neeley Freitag, *Unrelated Business Income Tax*, 874-2d Tax Mgmt. Portfolio (BNA), at A-43–A-90 (2001).

41. I.R.C. § 511(a). Corporations are taxed under I.R.C. § 11. Trusts are subject to tax under I.R.C. § 1(e). *See also id.* § 511(b).

42. *Id.* § 512(b). The limitation that deductible expenses be directly related to the unrelated business is considered to be narrower than the limitations of deductible business expenses to those that are ordinary and necessary.

43. However, with a tax-exempt entity there is an obvious incentive for the entity to allocate as much of its expenses from exempt activities to the unrelated business activity as possible. When so allocated, such expenses reduce tax liability, whereas if they are allocated to the exempt activity they generate no tax savings. Thus, to limit the expenses that can be allocated, the Internal Revenue Code (the Code) only allows the direct expenses of earning the unrelated income to be allocated to that income.

44. Section 514, which sweeps the income from debt-financed property into the UBIT, is discussed Part IV.C.

III. THE EXEMPTION OF NONPROFITS FROM TAX: DOES IT PROVIDE AN ADVANTAGE IN COMPETITIVENESS?

The legislative statements accompanying the UBIT suggest two possible routes by which the charitable tax exemption advantages nonprofits relative to for-profit firms. First, as described by the 1950 House and Senate reports, the exemption increases nonprofits' cash flow relative to that of competing for-profit firms. If both nonprofit and for-profit firms reinvest their after-tax profits in commercial businesses, a profitable business owned by a nonprofit will grow faster than an otherwise identical business owned by a for-profit firm.[45] The problem with that argument is that it contains an implicit assumption about raising equity capital. While it is true that nonprofits cannot raise equity, for-profit firms can and often do raise equity.[46] If there are good investment opportunities available, for-profit firms can finance them by raising additional equity. Thus, the faster growth through reinvestment argument is without merit.

Second, as implied by Representative Dingell's famous remark, nonprofits and for-profit firms compete to acquire businesses and real estate. There are numerous possible owners of a given business or building, and the party that values a given asset the most will usually outbid others to acquire it.[47] Value is affected by many factors, but one of the most important is the cash flow generated by an asset. The more cash an owner can generate from an asset, the more value it will place on that asset. Thus, if by virtue of their tax exemption nonprofits can generate more cash flow than their competitors from the same assets, they will likely value those assets more highly than their competitors and be able to outbid them to acquire those assets. That is the usual logic behind the argument that taxes, and specifically the exemption from taxation, can be the basis for nonprofits' advantage in competitiveness. [48]

I illustrate that second argument by modeling the competition between nonprofits and for-profit businesses as an auction for a single asset with two bidders.[49] Denote the nonprofit bidder by N and the for-profit bidder by P. Assume that the candidate investment will produce $100,000 a year in perpetuity before tax whether the asset is owned by N or P. In the case of a passive financial asset such as a stock or bond, that assumption is obvious and trivial. However, when the asset is an actively managed business, that assumption is not obvious and, if made, has real content. It implies that the

45. *See supra* Introduction.

46. Although firms listed on stock exchanges are often reluctant to issue new equity publicly, they often issue equity in other forms.

47. The New York University alumni group was not the only possible or even feasible purchaser of Mueller. In addition to the former owners, who had to be induced to sell through an acceptable offer, there were other potential buyers.

48. *See* Hansmann, *supra* note 34, at 610 (arguing that the charitable tax exemption reduces the cost of capital and thereby provides an advantage for nonprofits relative to for-profit firms).

49. The argument follows that in Knoll, *supra* note 11.

two firms are equally efficient managers of the asset. Some readers might find that assumption dubious. Nonetheless, it plays an important role in the argument below by isolating the tax consequences of the differential tax treatment of nonprofits and for-profit businesses.

Next, introduce taxes into the equation. Assume P pays tax at 35% and N is exempt from tax. Because N is exempt, N will not have to pay any tax on its income from the candidate investment. N, therefore, will earn $100,000 a year after taxes.

Now consider P. P has to pay tax on its income from the perpetuity. Assuming that there is no depreciation allowance, which is the economically accurate result,[50] P will report $100,000 of income each year from the candidate investment. Taxed at 35%, P will pay $35,000 in tax each year, leaving P with $65,000 after tax.

The conclusion that N will value the candidate investment more highly than P is usually thought to follow directly from such a comparison of after-tax cash flows. The argument goes as follows: If N purchases the asset, N can avoid P's annual $35,000 tax obligation. N should, therefore, value the asset more than P because the asset generates an additional $35,000 more in cash flow in N's hands than in P's. Accordingly, N will outbid P to acquire the asset. That is also the logic behind Representative Dingell's alarmist remark about a macaroni monopoly. Although that remark seems naïve, Representative Dingell was only following the above widely accepted argument to its logical conclusion. The problem is not with the logic—although there are solid reasons unrelated to tax for believing that there are limits on the ability of nonprofits to displace for-profit firms—but with the premise. That there is no advantage in competitiveness from tax exemption can be illustrated by continuing with the example.

The information given above is not sufficient to calculate the value N and P each place on the asset. To convert a stream of cash flows into a present value requires a discount rate. Typically, the discount rate is a function of the interest rate at which additional funds can be invested. Assume further that N and P can both invest excess cash at 10% before tax.[51] Moreover, assume that excess funds are readily invested in assets whose returns are taxed fully each year at ordinary rates. Such an asset is commonly referred to as the benchmark asset.[52]

The information provided above is now sufficient to calculate the value of the candidate investment to both N and P. Start with N. The cash flow is untaxed so N will receive $100,000 a year. N can earn 10% on its investments (ignore risk). The formula for the present value of a (constant) perpetuity is the quotient of the after-tax cash flow and the after-tax

50. Because the perpetuity does not decline in value as payments are made, but rather holds its value, no depreciation allowance is necessary.

51. The assumption that all parties earn the same before-tax cash flow on their funds is common.

52. *See* Myron S. Scholes et al., Tax and Business Strategy: A Planning Approach 120 (2005).

discount rate. Because N is tax-exempt, the before- and after-tax cash flows are $100,000 and the discount rate is 10%. Thus, the present value (PV) of the asset to N, PV(N), is given by the following equation:[53]

(1) PV(N) = $100,000/.1 = $1,000,000

What it means for the present value of the candidate investment, PV(N), to equal $1 million is that if N had $1 million in cash available to invest, N could deposit that money in the bank and generate the same cash flow stream as it gets from owning the candidate investment. Thus, the maximum amount that N will bid for the candidate investment is $1 million. Any higher, N is better off with the money in the bank; any lower, N is better off with the investment.

Now consider P. P earns $65,000 a year after tax. The difference between $65,000 and $100,000 is the basis for the claim that P is at a disadvantage relative to N. P earns less from the asset than does N solely because P is taxed, whereas N is tax exempt. However, P also has a different discount rate than does N. P can invest excess funds at 10%. Because P pays tax at a rate of 35%, P earns 6.5% after tax. Thus, in discounting the after-tax cash flows from the candidate investment, P will use an after-tax discount rate of 6.5%. Hence, the present value of the asset to P, PV(P), is given by the following equation:[54]

(2) PV(P) = $65,000/.065 = $1,000,000

Thus, the present value of the candidate investment to P, which is also the maximum amount P will bid for that asset, is $1 million. N and P, therefore, both value the candidate investment at $1 million. Accordingly, neither N nor P has a tax-induced competitive advantage over the other in the competition to acquire the candidate investment. Therefore, in spite of their different tax treatments, N and P compete on equal terms for the candidate investment.

Accordingly, if either party is slightly more efficient than the other in owning or operating the candidate investment, then that party will be able to outbid the other party. For example, if P can squeeze an additional $10 a year before tax from the investment (1/100th of 1% of the cash flow), then P will receive an additional $6.50 after tax each year. Discounted at 6.5%, that cash flow has a present value of $100, pushing P's maximum bid to $1,000,100. In such a circumstance, P's small advantage in managing the candidate investment means that it will be able to outbid N, even though P is taxed at 35% and N is tax exempt. Alternatively, if N can squeeze the

53. The calculation in the text can be expressed more generally. Let the annual before-tax cash flow from the candidate investment be c and the before-tax interest rate on the benchmark asset be r. In that case, the present value (PV) of the candidate investment to a tax-exempt investor, PV(N), is as follows: $PV(N) = c/r$.

54. This calculation can also be expressed more generally. Denote the tax rate paid by the taxable owner as t. Thus, the taxable owner earns $c(1 - t)$ on the candidate investment and earns $r(1 - t)$ on the benchmark asset. Thus, the present value of the candidate investment to the taxable owner, PV(P), is as follows: $PV(P) = c(1 - t)/r(1 - t) = c/r$.

additional $10 in before-tax cash flow from the candidate investment, but P cannot, then N will be able to outbid P by $100. In this example, therefore, whoever can generate more before-tax cash flow from an asset can outbid the other party for that asset. In other words, relative tax rates are irrelevant in determining how much a party will bid to acquire an asset. Thus, the charitable exemption, although it increases the cash flow of nonprofits relative to that of for-profit firms, it does not provide nonprofits with a tax-induced advantage over for-profit firms so long as the charitable exemption applies across the board to all investments that nonprofits make.

As the principal example above illustrates, the asset is worth the same in the hands of N and P, even though their after-tax cash flows differ. The reason why the asset is worth the same amount to N and to P, in spite of their different after-tax cash flows, is because the tax affects the transaction in two opposite and offsetting ways. First, and most obviously, N's tax exemption increases N's cash flow relative to P's. Second, and not as obviously, N's tax exemption also increases N's cash flow from any alternative investments N might make with those funds. The first effect tends to increase the value that N places on the investment; the second effect tends to reduce that value. Because the two effects exactly offset one another, there is no difference in the value that N and P place on the investment. Therefore, in the example, N does not enjoy an advantage in competitiveness over P in spite of being exempt from tax.

Although the two effects of the tax exemption are equal and operate in opposite directions, they are not equally salient. The first effect—the reduction in cash flow—is more salient than the second—the reduction in return from alternative investments. Start with the first effect. The consequences of being taxed are, with time, very clear. Whether P is an individual or a corporation, the tax liability of the investment through P will often be evident from the annual return that P files. The bite those taxes take will also be evident from the tax payments that P or the investors in P make. Thus, the immediate impact to investors in P of subjecting the income from that investment to tax will be clear to those individuals involved in P, to those involved in N, and to many others who have no relation to N or P.

In contrast, the second effect—the reduction in return on alternative investments foregone—is largely hidden from view. The other investment is not made by the party that acquires the candidate investment. For the other party, it is not common for investors to think of one investment as the result of not making another investment. More generally, each party does not see the other party's investments, let alone the investments they forego and the tax consequences to the other party of the investments they do not make. In addition, the parties do not know what hurdle rate the other party uses for investments.[55] Moreover, there is no transaction or payment to

55. In practice, hurdle rates are further obscured by risk, which differs across assets and is often difficult to measure. The discussion in this essay ignores risk.

point to that illustrates or makes clear the effect of the reduction in return on alternative investments. The argument can be understood and even illustrated, but it is not readily observed in the world. It has, thus, been widely ignored.[56]

The discussion above assumed that both N and P financed the purchase of the candidate investment using cash on hand. That might not be the case. First, it might be possible for P, but not for N, to finance the acquisition of the asset by issuing equity. That is because N is prohibited by the nondistribution constraint from issuing equity.[57] Of course, P can issue equity. P, however, must presumably pay any equity investors the same 10% on their investment.[58] Thus, using only the investment to repay the loan, P can at most raise $1 million, and in order to raise that amount P must give up the entire cash flow stream from the investment. Thus, with outside equity, the investment is still worth $1 million to P.[59]

Second, both N and P can issue debt to outsiders to fund that investment. Assume both N and P can issue debt that pays interest at 10%. In that case, N can use the proceeds from the asset to pay the interest on $1 million of debt—$100,000 a year. Thus, the possibility of raising funds through market-rate debt does not increase the value of the asset to N.[60] As for P, P can also use the proceeds from the asset to pay the interest on $1 million of debt. Although P has only $65,000 after tax from the asset, the interest P pays on the debt is tax deductible. Thus, P can borrow $1 million and pay out $100,000 in interest. Because the interest is deductible by P, it offsets P's income from the asset. Thus, if P borrows to purchase the asset, P can again bid $1 million for the asset.[61]

The above example shows that the exemption of nonprofits from tax did not provide them with a tax-based competitive advantage relative to for-profit firms. That raises the question, What is the effect of the UBIT on the competitiveness of nonprofits? For example, it might be thought that subjecting nonprofits to tax through the UBIT will not reduce their

56. The argument has not been totally missed. Similar arguments have been made by others. *See, e.g.*, William A. Klein, *Income Taxation and Legal Entities*, 20 UCLA L. Rev. 13, 61–68 (1972).

57. For a proposal to allow charities to issue equity and in effect become for-profit enterprises, see Anup Malani & Eric A. Posner, *The Case for For-Profit Charities* (Univ. of Chicago Law Sch., John M. Olin Law & Econ. Working Paper No. 304 (2d Series), 2006), *available at* http://ssrn.com/abstract_id=928976.

58. Assume for now that P is a pass-through entity for tax purposes. The possibility of a corporate P is taken up later. *See infra* Part IV.A.

59. I ignore risk, which would complicate the exposition markedly, but should not change the qualitative results substantially. For a discussion of how to adjust tax-based calculations for risk, see Scholes et al., *supra* note 52, at 127–30.

60. I discuss both leveraged investments and the possibility of issuing tax-exempt debt in detail below.

61. The result reported in the text—that if P borrows to purchase the asset, the most P can bid for the asset is still $1 million—holds whether P is taxed as a separate corporation or as a pass-through entity.

competitiveness. After all, the higher tax on nonprofit firms did not affect their competitiveness.

Returning to the example, assume that N would be subject to the UBIT, which is assessed at 35%, if it acquired the candidate investment. N would report $100,000 of unrelated business taxable income (UBTI) and will pay $35,000 in tax. Thus, N would be left with the same $65,000 as P from the investment. That is the intent behind the UBIT and the sense in which it levels the playing field. However—and this is the key—the UBIT does not change N's discount rate. Because N still pays no tax on its other investments, including portfolio investments and investments in related businesses, N still uses a 10% discount rate. That is because N can continue to invest excess funds in the market, where N will earn 10% both before and after tax. Thus, the present value of the candidate investment to N assuming that N is subject to the UBIT, $PV(N_{UBIT})$, is given by the following equation:[62]

(3) $PV(N_{UBIT}) = \$65{,}000/.1 = \$650{,}000$

N, therefore, will value an asset subject to the UBIT less than P will value the same asset. In an environment where N is subject to the UBIT, the UBIT will provide P with an advantage in competitiveness. That advantage exists even though N and P both earn the same amount from the candidate investment on an after-tax basis. P's relative advantage arises because N is taxed more heavily on the candidate investment than on other investments. That higher tax rate reduces the value of the candidate investment to N relative to other investments available to N. It therefore follows that, rather than eliminating a tax-induced competitive advantage, the UBIT creates one. Instead of putting for-profit and nonprofit competitors on an equal footing, the UBIT disadvantages nonprofit competitors relative to for-profit competitors in the competition for unrelated businesses. The UBIT, thus, tilts what would otherwise be a level playing field between for-profit firms and nonprofits to the advantage of for-profit firms and to the disadvantage of nonprofits.

IV. EXTENSIONS

This part considers several extensions of the analysis given above. First, this part looks at situations where assets are subject to different tax rates. In such circumstances, there can be tax-induced advantages and disadvantages in competitiveness. Moreover, depending on the tax treatment of the asset, the advantage might belong to the tax-exempt nonprofit or to the competing taxable for-profit entity. Second, this part considers the exemption from property taxes at the state and local level. Such an exemption will not provide nonprofits with an advantage in acquiring such assets if the tax base

62. Expressed more generally, the present value of the candidate investment to the nonprofit if the investment is subject to the UBIT, $PV(N_{UBIT})$, is as follows: $PV(N_{UBIT}) = c(1 - t)/r$. That is obviously less than $PV(N) = PV(P) = c/r$ when t is positive.

is very broad. However, it will provide nonprofits with an advantage in acquiring such assets if the tax base is narrow. Also, the UBIT is poorly designed to offset that advantage. Third, this part looks at a provision in the tax law that sweeps debt-financed assets within the UBIT. The essay shows that borrowing at market interest rates by issuing taxable debt does not provide a nonprofit borrower with a competitive advantage over its for-profit competitors. Fourth, the essay considers the possibility of nonprofits borrowing through the use of private activity bonds. Private activity bonds are tax exempt to the holder and so typically pay lower interest rates than taxable bonds. When such bonds finance investment at the margin, they can provide nonprofits with a competitive advantage. There are, however, hurdles to their use.

A. *Differentially Taxed Investments*

There are several explicit and implicit assumptions that are behind the conclusion that the exemption from taxation granted to § 501(c)(3) entities does not provide those entities with a competitive advantage over taxable competitors. One important assumption that was not made explicit above is that the candidate investment is taxed in the same manner as the benchmark asset (the investment each party would make with excess funds). This part considers the consequence for competitiveness of the tax exemption when not all investments are taxed the same.

In order to give more content to the notion of being taxed the same, use the concept of the effective marginal tax rate (EMTR). The EMTR of an investment is the present value of all future taxes on an investment divided by the present value of the before-tax return on that investment.[63] If the EMTRs on two investments are equal, then the two investments are taxed the same. If they are not equal, then the investment with the higher EMTR has the heavier tax burden. In the previous parts, the hypothetical assumed that the candidate investment and the benchmark asset had the same EMTR for both N and P.[64]

In most cases, the EMTR for an asset is a function of who owns that asset. For example, the EMTR of the candidate investment in the hands of N is zero. That is obvious because N is not subject to tax. However, the same investment in the hands of P has an EMTR of 35%. That 35% is calculated as follows: Each year, the investment generates $100,000 cash. That cash is taxed at 35% and so P's annual tax payment is $35,000. The present value of a perpetual stream of $35,000 discounted at 10% is $350,000. That present value has to be compared to the present value of the before-tax stream. Each year, the investment generates $100,000. Discounted at 10%, the cash flow stream has a present value of $1 million. Thus, the ratio of the present value of P's tax to the present value of the

63. See Scholes et al., *supra* note 52, at 184.

64. As used in this essay, the term "effective marginal tax rate" (EMTR) excludes implicit taxes.

before-tax cash flow stream from the asset is the quotient of $350,000 and $1 million or 35%. Note that if P can invest excess funds at 10% with the interest fully taxable, then P will earn 6.5% after tax and have an EMTR of 35% on such investments. Similarly, because N is exempt, it earns 10% both before and after tax on the candidate investment, and N has an EMTR of zero on both investments. Thus, for both N and P, the candidate and benchmark investments have the same EMTR, even though the EMTR differs depending upon who is holding the investment. Under those conditions, the candidate investment is worth the same to both N and P.

In the example given above, the EMTR always equaled the statutory tax rate. That, however, is not always the case. For many investments, the EMTR differs from the statutory tax rate. Specifically, assets that are taxed more heavily than the benchmark asset—either because they are subject to a higher tax rate, more than the full amount of income is taxed, or the income is taxed before it is earned—will have an EMTR above the statutory rate. Conversely, assets that are taxed less heavily than the benchmark asset—either because they are subject to a lower tax rate, some of the income is excluded from tax, or the income is deferred—will have an EMTR below the statutory rate. Thus, when the candidate investment is either an overtaxed or under taxed asset (relative to the benchmark asset), the value of that asset to the taxpayer will differ as the taxpayer's tax rate changes. In such circumstances, taxes can affect competitiveness.

Assume, for example, that the candidate investment is exempt from tax. Accordingly, anyone who holds the candidate investment will not have to pay tax on the income generated by that asset. Thus, if the asset is held by N or P, the owner will receive $100,000 a year exempt from tax. Obviously, the candidate investment is taxed differently than other assets in the economy, where the owner must include the income from the asset in taxable income and pay tax on that income at the owner's own tax rate (which is 35% for P and zero for N).

For N, exempting the income from the candidate investment from tax has no effect on N's cash flow from holding that asset. Thus, N will still value that asset at $1 million.

Consider P. Exempting the income from the candidate investment from tax will increase P's after-tax cash flow. If P owns the candidate investment, P will receive $100,000 a year after tax, which is a $35,000 increase in after-tax cash flow compared with owning an otherwise identical taxable asset. Because P earns only 6.5% after tax on other investments, the present value of the candidate investment to P, $PV(P_{untaxed})$, is given by the following formula:[65]

65. Expressed more generally, the present value of an untaxed investment to P, $PV(P_{untaxed})$, is as follows: $PV(P_{untaxed}) = c/r(1 - t)$. That is obviously greater than $PV(N) = PV(P) = c/r$ when t is positive. More generally still, assume that only the portion a of the income from the asset is taxed, or that the asset is taxed at the rate at. Such an asset is under taxed if a is less than one and overtaxed if a is greater than one. The present value of the differentially taxed investment to P, $PV(P_{differentially\ taxed})$, is as follows: $PV(P_{differentially\ taxed}) =$

(4) $PV(P_{untaxed}) = \$100{,}000/.065 = \$1{,}538{,}462$

Thus, the candidate investment is worth more than $1.5 million to P. Accordingly, because the candidate investment is worth only $1 million to N, in a competition between N and P for the tax-exempt candidate investment, P will outbid N. In such a case, N's tax exemption is actually a hindrance to N, not a help. Thus, in competing for an untaxed asset, the tax exemption of nonprofits is not a source of competitive advantage, but of disadvantage.

More generally, high-bracket taxpayers have an advantage over low-bracket taxpayers when the competition is over assets taxed less heavily than the benchmark asset. That result is well-known in the tax law. It is an example of a clientele effect. High-bracket taxpayers will bid up the price of under-taxed assets. The resulting higher price translates into a reduced return. Such a reduction in return is called an implicit tax.[66] In selecting assets, buyers trade off implicit and explicit taxes. The higher a party's explicit tax rate, the more attractive it finds replacing explicit taxes with implicit taxes. Conversely, the lower a party's explicit tax rate, the less attractive it finds replacing explicit taxes with implicit taxes.[67]

Over the years, techniques have been developed that separate the tax benefits from owning an asset from the use of an asset. One of the simplest and most effective of such techniques is a capital lease. If the exemption from tax is for the benefit of the owner of the asset (not the user), then high-bracket investors will often find it attractive to hold title to assets taxed at reduced rates and to lease those assets to low-bracket parties that can get the most value out of using those assets, but which do not value the tax benefits as much as the high-bracket investors value those benefits. To the extent that leasing is inexpensive, easy, and effective in transferring tax benefits, tax considerations will tend to be irrelevant in determining who will use an asset in business. The party who can make the best use of the asset will use it, although another party might hold title. Arguably, in such circumstances, tax considerations have little impact on competitiveness because they do not determine who uses an asset, only who holds title.[68] Conversely, if leasing is expensive and difficult, it will not be effective, and so, in transferring tax benefits, tax considerations will tend to play a large role in determining who uses a given asset.[69]

There are numerous examples of under-taxed assets. These include assets for which depreciation, amortization, or depletion exceed economic depreciation. Because economic depreciation is often very slow, most assets that can be depreciated, amortized, or depleted are under taxed. In

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$c(1 - at)/r(1 - t)$. That is obviously greater than $PV(N) = PV(P) = c/r$ when t is positive and a is less than one.

66. *See* Scholes et al., *supra* note 52, at 125–27.
67. *See id.* at 130–32.
68. *See* Knoll, *supra* note 11.
69. *See* David F. Bradford, Untangling the Income Tax 113 (1986).

such circumstances, the tax system will generally encourage high-bracket taxpayers to own those assets. Thus, for under-taxed assets, the tax-induced competitive advantage does not go to tax-exempt and low-bracket bidders as one would naturally assume, but instead it counterintuitively belongs to the high-bracket bidders.

The consequences are the reverse if the asset is overtaxed (that is to say, for taxpayers with positive tax rates, the candidate investment has a higher EMTR than the statutory tax rate). Assume, for example, that the owner of the candidate investment has to pay tax on double the income (or at twice the normal statutory rate). Thus, N and P will pay tax on $200,000 income from the asset. That will have no effect on N with a tax rate of zero. Thus, N will continue to receive $100,000 after tax from the investment. P, however, will be adversely affected. P will have to pay $70,000 tax, and so P will be left with only $30,000 from the investment after tax. Obviously, P could do better depositing the $1 million purchase price in the bank. P will receive $100,000 interest, pay $35,000 tax, and so P will be left with $65,000. P will view the investment as no more valuable than a bank account that generates $30,000 a year in after-tax interest. The present value of such an investment to P, $PV(P_{overtaxed})$, is given by the following formula:[70]

(5) $PV(P_{overtaxed}) = \$30{,}000/.065 = \$461{,}538$

Thus, the most that P will pay for the candidate investment is roughly $460,000. Accordingly, if the asset is up for bid, N, which still values the investment at $1 million, will outbid P.

Once again, the result is an example of a clientele effect. The overtaxed asset generates a negative implicit tax, sometimes called an implicit subsidy.[71] If P sets the price so that N will buy the asset at just above $461,538, then the asset will return almost 22% to N. In effect, N is receiving a negative subsidy for taking on a tax obligation that does not harm N.

The literature discusses more frequently positive implicit taxes than negative implicit taxes (or implicit subsidies).[72] There is, however, one prominent and very important example of negative implicit taxes. That example is for assets held in corporate form through equity.[73] The income

70. Expressed more generally, the present value of the differentially taxed investment to P, $PV(P_{differentially\ taxed})$, is as follows: $PV(P_{differentially\ taxed}) = c(1 - at)/r(1 - t)$. That is obviously less than $PV(N) = PV(P) = c/r$ when t is positive and a is greater than one.

71. In a series of articles, I argue that negative implicit taxes are the key to understanding the cross-border, dividend-stripping transactions in *Compaq Computer Corp. v. Commissioner of Internal Revenue*, 277 F.3d 778 (5th Cir. 2001), and *IES Industries v. United States*, 253 F.3d 350 (8th Cir. 2001). *See* Michael S. Knoll, *Implicit Taxes and Pretax Profit in Compaq and IES Industries*, 114 Tax Notes 679 (2007); Michael S. Knoll, *Compaq Redux: Implicit Taxes and the Question of Pre-tax Profit*, 26 Va. Tax Rev. 821 (2007).

72. Scholes mentions implicit negative taxes only in a footnote. *See* Scholes et al., *supra* note 52, at 125 n.4.

73. There is extensive finance literature that shows that some assets can support proportionately more debt than other assets.

from such assets incurs two levels of tax—the corporate level and the individual level. The top statutory corporate level tax is also the maximum individual statutory tax rate on ordinary income—35%.[74] Assets held through corporate equity are also taxed to the individual when stock is sold or dividends are received. The top tax rates for dividends and capital gains today are 15%.[75] That tax, however, can be deferred. Thus, the top federal tax rate on investments held through corporate equity is, at most, nearly 45% (44.75%). That exceeds the 35% tax rate for the benchmark asset. Thus, for corporate assets financed by equity, tax considerations provide nonprofits with a tax-induced incentive to hold such assets.

Return to the example and assume that the combined (individual and corporate) tax rate if P owns the candidate investment is 44.75%. In that case, P will pay $44,750 in taxes and be left with $55,250 a year. The present value of the asset to P when the asset is held through corporate equity, $PV(P_{corp\ equity})$, is calculated as follows:[76]

(6) $PV(P_{corp\ equity}) = \$55{,}250/.0625 = \$850{,}000$

The value of the candidate investment to P when it is held through corporate equity is $850,000.[77] Thus, the most P will bid for the investment is $850,000.

In contrast, the investment is still worth $1 million to N if N can hold it directly and avoid both levels of tax.[78] Thus, for assets that for-profit owners will hold through corporate equity, nonprofits will have a tax-induced competitive advantage over their for-profit rivals. That advantage, however, is not simply due to the exemption from tax enjoyed by nonprofits. It is instead a combination of that advantage and the overtaxation of such investments. If the overtaxation of investments financed through corporate equity is removed, then the nonprofit's advantage disappears.

Moreover, the UBIT is a very blunt instrument to offset the advantage enjoyed by nonprofits for investments financed with corporate equity. The UBIT, which subjects the entire investment to tax at the corporate rate, places nonprofits at a disadvantage. Returning to the example, N receives $100,000 income annually. That income is UBIT taxable at 35%. After paying $35,000 tax, N is left with $65,000 each year. The present value to

74. I.R.C. § 1 (2000).

75. *Id.* § 1(h). In the discussion that follows, I ignore the possibility of deferral.

76. The calculation in equation (6) can also be expressed more generally. To do so, denote the second level tax, usually thought of as the individual level tax on dividends and capital gains, as t_2. The present value of the candidate investment to P when it is held through corporate equity, $PV(P_{corp\ equity})$, is as follows: $PV(P_{corp\ equity}) = c(1 - t)(1 - t_2)/r(1 - t) = c(1 - t_2)/r$. That is obviously less than $PV(N) = PV(P) = c/r$ when t_2 is positive.

77. The federal corporate tax rate is 35%. The federal individual tax rate is 15% on dividends and capital gains. Because the individual level tax is on income after the payment of corporate level tax, the incremental tax due to the individual level tax is 9.75%. That incremental tax liability is calculated as follows: $9.75\% = (1 - 35\%)(15\%)$.

78. It is worth much less (only $650,000) to N if N can only hold some shares, and so the corporate tax still must be paid.

N of a perpetuity paying $65,000 a year, $PV(N_{UBIT})$, which was calculated in equation (3), is $650,000.

Thus, the present value of the candidate investment to N—$650,000—is substantially less than the present value of the candidate investment to P—$850,000. Thus, when the asset is held by for-profit investors through corporate equity, the UBIT imposes too much tax on N, more than offsetting N's advantage, and thereby leaving N at a disadvantage relative to P.

As the example above suggests, N's advantage over P when the competition is for assets held through corporate equity is not because P pays tax when N does not. N has an advantage over P when competing for such investments because P pays a higher tax on such assets than on the benchmark asset, whereas N pays the same tax on both investments. That is to say, P's disadvantage is a result of the additional tax that P pays on investments held through corporate equity.[79] That disadvantage is roughly the difference in P's tax rates between the candidate investment and the benchmark asset.

The discussion above suggests two alternative means of leveling the playing field between for-profit firms and nonprofits. The first and most obvious method is to eliminate the differential treatment of assets generally and, in particular, the disadvantageous tax treatment of investments financed through corporate equity. For example, by integrating the corporate and individual tax systems into a single tax system that imposes the same total tax rate on corporate and noncorporate investments, Congress could eliminate the need for the UBIT.[80]

Second, the UBIT could be reformed and tailored to offset the advantage enjoyed by nonprofits over for-profit firms when the latter hold investments through corporate equity. Such a UBIT would tax nonprofits in order to eliminate the advantage that they would otherwise enjoy on investments made through corporate equity.

Unfortunately, there is no simple and general solution to what the UBIT tax rate should be in such circumstances. However, in one special case, there is a simple solution. That occurs when the asset is a (constant) perpetuity, the individual tax on the taxable investor is a fixed percentage of

79. Although our conclusions are similar—without the UBIT, nonprofits would generally have a tax-induced advantage in the competition to acquire assets held by for-profit investors through corporations—the analysis in the text differs from that of Hansmann, *supra* note 34, at 610. Nonprofits have a tax-induced incentive to acquire for-profit businesses, but not because their cash flows would exceed those earned by taxable buyers, as Hansmann argues. Instead, nonprofits have an incentive to acquire businesses that would generate large amounts of income taxed at both the corporate and individual level because high-bracket investors pay a higher total tax rate on such investments than on the benchmark asset, whereas nonprofits pay the same tax (zero) on both investments.

80. For a discussion of different methods of integrating the corporate and personal income taxes, see, for example, Michael J. Graetz & Alvin C. Warren, Jr., Integration of the U.S. Corporate and Individual Income Taxes: The Treasury Department and American Law Institute Reports (1998).

the income remaining after paying the corporate tax, and the corporate tax rate equals the individual tax rate on noncorporate investments. In that case, the UBIT should be at the same rate as the individual tax on corporate investments.

To illustrate, return to the example of a perpetuity that pays $100,000 a year. Assume the additional tax is a 15% tax on the income remaining after paying the 35% corporate tax.[81] If P buys the asset and pays both taxes, P will have $65,000 after payment of the corporate tax. That $65,000 is subject to an additional 15% tax. Thus, P will pay an additional $9,750 for a total tax payment of $44,750. That will leave P with $55,250. The corresponding present value of the asset to P, $PV(P_{rev\ UBIT})$, is given by the following formula:[82]

(7) $PV(P_{rev\ UBIT}) = \$55{,}250/.065 = \$850{,}000$

If N is subject to UBIT at 15%, then N will pay $15,000 a year and is left with $85,000. Discounted at 10%, the asset then is worth $850,000 to N. Thus, applying a 15% UBIT to N offsets the benefit that N would otherwise enjoy by virtue of a second level tax at 15% (on top of the basic 35% tax rate) over P.[83]

The above result has several implications for the UBIT. First, there is an argument to be made that nonprofits have a tax-induced competitive advantage when competing against for-profits to acquire assets that are otherwise held by for-profit firms through corporate equity. The advantage arises because for-profit investors are overtaxed on such investments and therefore devalue them. Second, the UBIT that offsets that advantage is roughly equal to the second level tax on that portion of the investment that is equity financed. Third, the above analysis makes clear that the existing UBIT is generally too high and so disadvantages nonprofits relative to for-profit firms.[84] Fourth, the analysis above suggests that given current tax rates the UBIT tax rate should be set as the product of the individual tax on

81. Because of the commutative property of multiplication, the total tax burden with flat taxes is the same whether state taxes are deductible from federal income or federal taxes are deductible from state income.

82. More generally, when the differential tax on the candidate investment takes the form of a second level tax on after-tax income at the rate t_2, then, if the UBIT is assessed at that second rate, the present value of the candidate investment to N, $PV(N_{rev\ UBIT})$, is as follows: $PV(N_{rev\ UBIT}) = c(1 - t_2)/r$. That is obviously equal to $PV(P_{corp\ equity})$. Note that if the second tax takes the form of an additional tax on before-tax income at the rate t', then the UBIT tax rate, t_2, should be assessed at the rate $t_2 = t'/(1 - t)$.

83. This result is easy to see algebraically. The present value of a perpetuity that pays c annually when the interest rate is r and the tax rate in the economy and on the asset are both t is just $PV = c(1 - t)/r(1 - t) = c/r$. If there is a second level tax on the after tax income at the rate t_2, then the value of the asset is given by $PV = c(1 - t)(1 - t_2)/r(1 - t) = c(1 - t_2)/r$. The value of that asset to a tax-exempt nonprofit, PV(N), is $PV(N) = c/r$. If the UBIT is at the rate t_2, then the value of the asset to the nonprofit is given by $PV(N) = c(1 - t_2)/r$, which is also the value to the for-profit entity.

84. It is too high because it uses the corporate tax rate, not the capital gains/dividends tax rate, and because it applies to the entire business, not the portion that would be financed by corporate equity.

corporate income, 15%, and the share of such assets financed by equity. The latter number obviously will have to be an approximation. It might be set across industries generally or industry by industry.

B. *The Exemption from Property and Other Taxes*

The discussion so far of the consequences for competitiveness of the UBIT and of the exemption from tax enjoyed by § 501(c)(3) entities has focused exclusively on the federal income tax. State tax laws also frequently exempt charities from various state taxes. To the extent that states have income tax systems that are similar to the federal income tax system, including the exemption of charities from tax, the analysis given above under the federal income tax also applies to state income taxes. However, the introduction of states changes the nature of the taxes and hence the nature of the exemption.

In 2003 to 2004, state and local governments collected over $300 billion in property taxes.[85] After the sales tax, the property tax is the largest source of tax revenue to state and local governments.[86] The property tax generates more revenue for the states than do the individual and corporate income taxes combined.[87] Yet most states exempt charities from property taxes.[88] This section looks at the consequences for competitiveness of states exempting charitable nonprofits from property taxes.

A property tax is a form of wealth tax. An income tax imposes a tax on the income earned by a taxpayer over a period of time, typically a year. A wealth tax assesses tax based on a taxpayer's wealth at a certain point in time. In the jargon of economics, an income tax is a tax on a flow and a wealth tax is a tax on a stock. The two concepts are related in that a stock of wealth produces a flow of income and a flow (or series of flows) has a present value, which is a stock. Thus, an income tax is similar to a wealth tax.[89] However, in order for both taxes to impose a similar burden, the wealth tax should be assessed at a rate equal to the product of the income tax rate and the market interest rate. In terms of the example (where the

85. Economic Report of the President: 2007 Report Spreadsheet Tables, State and Local Government Revenues and Expenditures, Selected Fiscal Years, 1938–2004, tbl.B-86, *available at* http://www.gpoaccess.gov/eop/2007/B86.xls.

86. *Id.*

87. *Id.*

88. *See* Jill R. Horwitz, *Does Nonprofit Ownership Matter?*, 24 Yale J. on Reg. 139, 144 (2007) ("[C]harities . . . are largely eligible for state . . . property tax exemptions."); David E. Pozen, *Remapping the Charitable Deduction*, 39 Conn. L. Rev. 531, 533 (2006) (describing the property tax exemption accorded nonprofits as one of the cornerstones of U.S. nonprofit tax law); Richard D. Pomp, *Revise the Property-Tax Exemption*, 14 Chron. of Philanthropy, May 2, 2002, at 37 ("Most states grant property-tax exemptions for charities.").

89. For thoughtful discussions of the similarities and differences between a wealth tax and an income tax, see Deborah H. Schenk, *Saving the Income Tax with a Wealth Tax*, 53 Tax L. Rev. 423, 435–41 (2000); David Shakow & Reed Shuldiner, *A Comprehensive Wealth Tax*, 53 Tax L. Rev. 499, 500–31 (2000).

interest rate is 10%), a wealth tax at a rate of 3.5% is similar to an income tax at a rate of 35%.[90]

It follows from the discussion above (which was in the context of an income tax, but which applies as well to a wealth tax) that exempting charities from the obligation to pay property taxes would not provide them with an advantage over for-profit entities if the property tax was part of a comprehensive wealth tax. Such a tax would have to be universal, applying to all forms of wealth—tangible, intangible, financial, and real—without limitation, and impose an equal burden on property and other forms of wealth.[91] If all wealth were taxed at the same rate, nonprofits would not have a tax-induced incentive to prefer to hold some assets and to avoid holding other assets. It is because only a small portion of wealth is subject to property taxes (in many jurisdictions only real property is subject to property tax) that the exemption of nonprofits creates an incentive for nonprofits to hold real property. The logic, which is as above, is that assets subject to property taxes are overtaxed relative to other assets. That creates an incentive for high-bracket taxpayers (e.g., for-profit entities and individuals) to avoid assets subject to property taxes and for low-bracket taxpayers (e.g., nonprofits) to hold them.[92] That incentive is likely to manifest itself by nonprofits using more real estate in their exempt activities than otherwise and acquiring commercial real estate that they lease to tenants.

The obvious policy response to nonprofits acquiring and leasing commercial real estate is to limit the property tax exemption to property that nonprofits use in their exempt function. An economist's more general response, which also addresses the advantage that nonprofits have in acquiring real estate for use in their exempt function, might be to advise governments to be more evenhanded in taxing different assets. A real property tax is too narrow because it invites just this kind of planning to exploit clientele effects.

Furthermore, any advantage in competitiveness that nonprofits enjoy as a result of their exemption from state and local property taxes is a tenuous basis on which to justify the UBIT. The tax liability from the UBIT poorly matches up against any advantage provided by the states through the property tax exemption. The UBIT is at a flat rate, generally 35%, whereas

90. The wealth tax rate is calculated as follows: 3.5% = 35% × 10%. Because a stock of capital generates income at a rate of 10%, a wealth tax of 3.5% has the same expected burden as an income tax of 35%.

91. Such a tax would also treat issued debt (borrowings) as a reduction in wealth.

92. This result can be expressed mathematically. Assume that a parcel of non-depreciable real estate produces a cash flow of c per period in perpetuity. If we denote the before-tax interest rate by r and the tax rate paid by the taxable owner by t, then the charity will value the real estate at c/r. Similarly, the taxable investor will value the real estate at $c(1 - t)/r(1 - t)$, which also equals c/r. If we denote the property tax by p, then the taxable investor will value the property at $[c(1 - t) - p]/r(1 - t)$, which equals $c/(r - p)/r(1 - t)$. If, however, the charity is exempt from the property tax, it will still value the property at c/r. Thus, the charity will be able to outbid the taxable investor for the real estate.

property tax rates vary from state to state and even across communities within states. Also, the UBIT applies to the unrelated business income of nonprofits regardless of source, whereas the exemption from property taxes advantages only nonprofits that purchase property subject to tax (usually only real estate) and only to the extent of such purchases.[93]

Moreover, protecting state treasuries from nonprofits that avoid state property taxes by acquiring property that would be taxable if held by individuals or for-profit entities is not a solid foundation for the UBIT. First, it is unclear why a federal law is needed to protect state tax revenues. The states can protect their revenues themselves if they think it necessary or appropriate. Second, because the scope of the state property tax exemption and the UBIT differ, the UBIT provides little protection to states; the UBIT might even channel investment away from unrelated businesses into real estate. Third, because the UBIT tax rate matches up so poorly with the tax benefit from the state property tax exemption, there are costs from using the UBIT. In effect, the UBIT is a penalty that increases the cost to nonprofits of engaging in unrelated business activities. Accordingly, in order for a nonprofit to engage in an activity where the UBIT applies, it must be more efficient than the competing for-profit. When a more efficient nonprofit is deterred by the UBIT from an unrelated business, there is a welfare cost.[94] Finally, if Congress wanted to eliminate the tax savings and competitive advantages enjoyed by nonprofits by virtue of the state property tax exemption, it could require nonprofits to pay to the federal government an amount equal to the tax saving from any state or local property tax exemption. The UBIT, which is a wide-ranging and broad tax, is assessed at too high of a tax rate and applies too broadly to address such a narrow concern.

C. *Debt-Financed Property*

Although charitable institutions frequently operate commercial businesses that compete with for-profit businesses, few charitable institutions own and operate unrelated businesses with little or no connection to their exempt activities. The days of Mueller appear to be behind us. Of course, nonprofits still invest heavily in unrelated businesses, but they do so indirectly. These investments generally take one of two forms. First, wealthy nonprofits invest large portions of their endowments in stocks, bonds, and derivatives. Second, many wealthy nonprofits invest heavily in private equity funds, which invest directly in businesses, and

93. In addition, nonprofits might not even have an advantage in competitiveness from the exemption. If, for example, the tax benefits of the exemption can be easily transferred through leasing, then nonprofits do not have a substantial advantage in obtaining use of the property, only title. *See* Knoll, *supra* note 11.

94. *See* Hansmann, *supra* note 16 (arguing the converse—that without the UBIT, the exemption of nonprofits from the federal income tax will discourage mere efficient for-profit firms, thereby imposing a welfare cost).

hedge funds, which often invest in stocks.[95] These funds are often located offshore so that their nonprofit investors can avoid a provision in the UBIT that would otherwise apply to many of these investments.[96]

The UBIT distinguishes between passive income, which is tax exempt, and active income, which is subject to the UBIT if it is not related to the charity's exempt purpose. However, both passive income and related active income are subject to the UBIT, under § 514, if the income is from debt-financed assets.[97] Debt-financed income is included in UBTI in the same proportion that the property is financed by debt. Thus, if a covered investment has a debt-to-basis ratio of three to four, then 75% of the nonprofit's income from that investment would be subject to the UBIT by virtue of § 514. Because private equity and hedge funds often employ large amounts of leverage, much of the profits earned by universities and other charitable investors in these funds would be subject to UBIT if the funds were located in the United States. By locating these funds offshore—and introducing a blocking entity—nonprofits can avoid the debt-financed UBIT rules of § 514.[98]

In 2007, these offshore strategies caught the attention of legislators, who, in their search for additional sources of revenue, began eyeing universities' investments in private equity funds and hedge funds.[99] Viewing the offshore location of these funds as a tax loophole, some legislators support taxing charities on their profits from investments in private equity funds and hedge funds that employ leverage.[100]

Enacted more than fifty years ago (and expanded significantly in 1969), § 514 was not aimed at charities' investments in private equity and hedge funds. Instead, § 514 was enacted in order to address a specific transaction that was viewed as abusive. The transaction was a type of sale and leaseback known as a charitable bootstrap. Critics argued that a charity engaging in a charitable bootstrap was trading on its exemption by borrowing to acquire property and using tax-free income to pay off the debt.[101] The charitable bootstrap is illustrated by a 1965 Supreme Court case, *Commissioner v. Brown*.[102]

95. Other nonprofits, which are not themselves educational institutions, also invest in private equity and hedge funds. For example, the Rockefeller Foundation has one-third of its $3.7 billion endowment invested in such funds. Stephanie Strom, *Nonprofits Face Threat to a Tax Loophole*, N.Y. Times, May 16, 2007, at A15.

96. *Id.*

97. The original 1950 Act contained a limited inclusion of income from debt-financed property. The Tax Reform Act of 1969 substantially expanded the scope of that provision to cover a much broader range of transactions.

98. *See* Andrew W. Needham & Christian Brause, *Hedge Funds*, 736 Tax Mgmt. Portfolio (BNA), at A-4, A-46–A-48 (2007).

99. *See* Strom, *supra* note 95.

100. *Id.*

101. Comm'r v. Brown, 380 U.S. 563, 580 (1965) (Harlan, J., concurring).

102. *Id.*

Simplifying somewhat, Clay Brown sold a closely held sawmill and lumber business to a charitable organization for $1.3 million.[103] A negligible portion of that price was paid up front in cash.[104] The balance was to be paid over time. The latter obligation was evidenced by a ten-year, nonrecourse note that bore no interest. The charity then leased the property back to Brown. Brown agreed to pay 80% of his profits to the charity as rent, and the charity agreed to pay Brown 90% of the rent it received as payment on the notes. The Commissioner contended that the transaction was not a sale for tax purposes and sought to tax Brown at ordinary income tax rates. The Supreme Court, which accepted the lower courts' finding that the transaction was at a reasonable arm's-length price, held for Brown.[105]

Under the UBIT rules in effect at that time, the charity was not taxed on the rental income that it received from Brown. For Brown, however, the rent was an ordinary and necessary business expense, which reduced his ordinary income from operating the sawmill to 20% of his profit. In contrast, Brown claimed that the payments he received from the charity on the note—$72 out of every $100—were capital gain in spite of being paid out of operating profits. Moreover, because the note bore no interest, Brown did not receive any interest income, which would have been ordinary. Thus, the only ordinary income Brown had was from the 20% of profits he did not pay to the charity on the lease. Putting together all of the pieces, every $100 of pre-tax profit earned by Brown generated $8 for the charity (untaxed), $72 of long-term capital gain, and $20 of ordinary income. Assuming an ordinary income tax rate of 50% and a long-term capital gains tax rate of 20%, Brown earned $68.60 after taxes. Had he owned the saw mill directly, he would have earned only $50 after taxes.[106] Thus, the transaction increased Brown's after-tax income by 37%.

Critics looking at the *Brown* transaction saw a charity putting up no money and receiving 8% of Brown's pre-tax income in exchange for allowing Brown to use its tax exemption. As described above, Brown benefited from the transaction by converting 80% of his remaining income into capital gain, thereby reducing his tax rate on that income substantially. The tax savings from the charitable bootstrap concerned legislators and commentators with an interest in protecting the U.S. Treasury. Critics also argued that taxable owners, such as Brown, benefited by receiving above market prices when they sold assets to nonprofits. The latter complaint, that the charitable bootstrap inflated prices, raises questions of competitiveness between nonprofits and for-profit buyers. Because the

103. The discussion in the text ignores Clay Brown's partners.

104. Only $5000, which was paid out of the company's assets, was immediately paid in cash.

105. *See Brown*, 380 U.S. at 579.

106. At higher ordinary income tax rates, assuming that the long-term capital gains rate is 40% of the ordinary income tax rate, the tax benefit to the seller from the charitable bootstrap is even larger.

charitable bootstrap employs a tax-exempt purchaser, it appears to provide nonprofits with a competitive advantage over for-profit entities in acquiring productive assets.[107]

The latter concern, at least in part, appears to have motivated Congress to enact § 514. The legislative history of § 514 expresses Congress's concern with unfair competition. In language reminiscent of Representative Dingell's famous remark about the macaroni monopoly, a 1950 committee report asserted that, if the charitable bootstrap were allowed to continue unchecked, "exempt organizations in the not-too-distant-future may own the great bulk of the commercial and industrial real estate in the country."[108]

In determining whether the charitable bootstrap provided nonprofits with a tax-induced competitive advantage over their for-profit competitors, one must be careful to distinguish actual price increases from merely apparent ones. The face amount of the note in *Brown* is an apparent purchase price. The charity did not pay $1.3 million for the sawmill. There are several problems with taking that price at face value. First, it ignores time value of money because the note carries no interest. Second, although the courts held that $1.3 million was a reasonable arm's-length price for the sawmill, it need not have been. The sale price was linked to the lease payments, and it was in Brown's interest to overstate both in order to convert more ordinary income into capital gain. Such tax-induced exaggerations should not be mistaken for actual increases in purchase prices.

In analyzing the charitable bootstrap, it is important to separate the tax benefits, if any, of using debt from the tax benefits of exploiting other provisions in the tax law. One also has to be careful to distinguish the benefits from transacting with a tax-exempt purchaser as opposed to a taxable purchaser. One factor that made the charitable bootstrap attractive to Brown was that the note he held from the charity bore no interest.[109] Because the note was without interest, no portion of the money Brown received from the charity was taxable as ordinary income. That was clearly attractive to Brown and the charity was indifferent, because it was tax exempt, whether it paid a higher purchase price and no interest or a lower price and interest. With a taxable purchaser, the substitution of purchase price for interest might not have been as attractive. The higher purchase price would have increased basis, which increases depreciation deductions over time. Under reasonable assumptions, the value of the increased deductions is less than the cost from the lost interest deductions. Under such circumstances, a taxable buyer is worse off by substituting a higher purchase price for interest.

107. Carla Neeley Freitag, *Debt-Financed Income (Section 514)*, 875-2d Tax Mgmt. Portfolio (BNA), at A-2 (2001).

108. S. Rep. No. 81-2375, at 30–31 (1950), *reprinted in* 1950 U.S.C.C.A.N. 3053, 3084.

109. That failing has since been remedied by other provisions of the tax law.

Nonetheless, the incentive to overstate purchase price is not confined to sales to nonprofits. As long as the purchaser's interest payments and the seller's lease payments are equal, neither party has ordinary income from the transaction. Moreover, as the purchase price increases, so does the purchaser's basis. And with the increase in basis comes larger depreciation deductions. If these depreciation deductions are accelerated relative to actual declines in value,[110] then the purchaser's depreciation deductions will generate a tax shelter, but only for a taxable investor.[111] There is, thus, a similar incentive for taxable buyers to overstate their purchase prices.[112] Thus, at the end of the day, there was probably as great of an incentive to inflate the purchase price with a tax-exempt buyer as with a taxable buyer.

Moreover, in the more than forty years since *Brown*, tax jurisprudence has advanced markedly. There is much greater appreciation of what an economically accurate tax system requires and the consequences of failing to provide such a system. Today, a loan must bear interest and transactions can be rigorously scrutinized for their legitimacy. Even without § 514, it is very unlikely that a charitable bootstrap will be respected. Thus, the most that can be said in favor of § 514 is that it might play a prophylactic role by discouraging parties from even attempting to use the charitable bootstrap. Even so, § 514 is too broad. It is not limited to the charitable bootstrap, but applies to almost all debt-financed investments.[113] That raises the question, Is there an abuse when nonprofits acquire assets using debt financing?

As described in Part III, nonprofits do not have a tax-induced competitive advantage, and hence there is no abuse when a nonprofit uses borrowed funds to acquire an asset, the income from which is taxed each year at ordinary rates. That is to say, a charity cannot profit from borrowing money at a market interest rate, say 10% in the example, and investing it at the same rate of return.[114] As described in Part IV, nonprofits are at a tax-induced competitive disadvantage when they seek to acquire overtaxed assets. That disadvantage remains when the asset is acquired using debt. Thus, again, there is no abuse.

As described in Part IV, however, tax-exempt nonprofits have a tax-induced competitive advantage only when the competition is to acquire an

110. That is the case now and was the case at the time of *Brown* for most productive assets.

111. The value of the shelter increases with the buyer's tax rate. Furthermore, overstating the sales price does not harm the seller as long as the seller can report gain using the installment method without having to pay interest on the deferred gain.

112. The classic example is *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976). In *Estate of Franklin*, the owners of a motel transferred title to a group of doctors for a small amount of cash and a large amount of seller-financed nonrecourse debt, which no one expected to be repaid. The operators of the motel leased the facility back from the doctors. The purpose behind the transaction was to increase the depreciation deductions generated by the hotel markedly and to transfer those deductions to high-bracket taxpayers.

113. *See* William K.S. Wang, *Apply UBIT to De Facto Leverage, But Not to 'Spurious Leverage,'* 95 Tax Notes 925 (2002) (arguing and criticizing § 514 for being so broad as to apply to "spurious" leverage—debt that is offset by held bonds).

114. *See* Bittker & Rahdert, *supra* note 13, at 322–23.

overtaxed asset. The principal example is assets held in corporate form that are financed through equity. A second example, which is described in Part IV, is real estate on which the nonprofit does not have to pay property tax, but on which a for-profit owner would have to pay tax.

Start with the first example. The advantage that nonprofits have in acquiring corporate assets only exists for equity-financed assets; there is no such advantage with debt-financed assets. Presumably, if a nonprofit can finance an asset with debt, so can a competing for-profit corporation. In both cases, the income is passed through to the bondholder as interest. Thus, the ability to leverage a corporate investment does not leverage the nonprofit's tax-induced advantage in competitiveness, but instead dissipates it.

Consider the second example. The exemption of charities from the property tax creates an incentive for such tax-exempt entities to acquire real estate that would otherwise be subject to the property tax through debt. Because that benefit—the property tax exemption—is tied to ownership, charitable purchasers of real estate can leverage that benefit by applying their exemption to as much real estate as possible. In effect, charities can purchase real estate and receive additional (tax-exempt) cash flow because they are exempt from property taxes. And the more leverage they use, the more real estate they can own, and so the larger is their total cash flow.[115]

Of course, with risk, leverage usually increases. The tax benefit enjoyed by charities and their need to manage risk encourage charities to lease the property they own under long-term leveraged leases. In a typical leveraged lease, the owner borrows a large portion of the purchase price. The owner also leases the property for a long term to a third party. The lease payments are usually set in advance so that the rent covers the interest and principal on the loan and provides the lessor with a largely preset return on its investment, which might be minimal.[116]

Such long-term leveraged leases not only ensure that the party who can best use the property controls the asset, but they also reduce the risk to the nonprofit lessor.[117] Such long-term leases are widely recognized by

115. Although charitable investors have an advantage when competing against for-profit investors for real estate subject to property taxes, the existence of such an advantage does not mean that they will own all the real estate. There are numerous factors that limit their ownership of real estate. First, charities' investment funds are limited and they are prevented from raising equity because of the non-distribution constraint. Second, another party might be a more efficient owner, manager, or user of real estate. That will allow it to increase its bid relative to the less efficient nonprofit. Third, charities like other investors are careful to diversify their investments. Holding an undiversified portfolio of assets increases risk exposure without compensation. Fourth, lenders are usually reluctant to lend the full purchase price of an asset.

116. If the rent escalates, it is usually based on a set schedule or set to an index, such as the consumer price index (a measure of inflation).

117. If the lessee is creditworthy, then the only risk borne by the lessor is the risk associated with the change in the property's value at the end of the lease. If the lease is sufficiently long, then the present value of the residual is small and so the risk is small. If the lessor is not as creditworthy, then the risk is the joint risk that the property declines in

economists as a substitute for owning the property and issuing debt against it.[118] The lessor's risk can be further reduced by having the lessor borrower nonrecourse against the property. In that case, the risk of nonpayment is borne by a lender, which presumably is also willing to lend against the property when it is owned by the lessee. The lessor's risk can also be mitigated when the lessee is the original owner and the property is sold to the lessor in order to engage in a sale-leaseback. If the seller is also the lender, then the lessor can reduce its risk by not having to invest cash in the property.

Although nonprofits can increase their competitive advantage in obtaining title to real estate by using leverage, that is a tenuous basis on which to justify either § 511 or § 514. First, the advantage exists in a small range of situations, whereas the tax provisions are very broad. Second, depending upon how effective leasing is in transferring the use as well as the benefits and burdens of ownership, the advantage might only go to acquiring title. The advantage might do little to advance either economic ownership or use. Third, there are narrower solutions. Once again, a better solution would be to eliminate the overtaxation of certain assets. Barring that, another alternative that is still better than the existing UBIT would be to redesign the UBIT to capture the advantage that exists with overtaxed assets. Because the only significant example where nonprofits can use debt to leverage their tax exemption is real estate subject to a property tax, a simple solution would be for states to deny the exemption when the property is leased.

As discussed above, nonprofits can use debt financing to leverage the benefit of their exemption from tax. However, that only provides them with an advantage in acquiring overtaxed property (higher EMTR). It does not provide them with an advantage when the candidate investment is taxed the same as the benchmark asset (same EMTR). And the advantage goes in the opposite direction, in favor of the taxable party, when the asset is under taxed (lower EMTR). With the exception of real estate subject to a real property tax, leveraged and overtaxed assets are rare. In contrast, leveraged and under taxed assets are common. Yet § 514 sweeps nearly all debt-financed income of nonprofits into the UBIT. That is so without regard to whether there is a tax saving or competitive advantage.

D. *Private Activity Bonds*

In the previous section, I showed that nonprofits do not generally enjoy an advantage in competitiveness by virtue of their exemption from taxation when they finance their investments using market rate debt. Thus, it

value and that the lessee cannot pay. Such a risk, of course, varies depending on the property and the lessee.

118. *See* Richard A. Brealey et al., Principles of Corporate Finance (8th ed. 2006); Stephen A. Ross et al., Corporate Finance (6th ed. 2002). Similarly, the lessor's position is analogous to lending to the lessee to purchase the property.

follows that neither § 514, which imposes UBIT on debt-financed investments of nonprofits, or § 511, which taxes nonprofits on their income from unrelated businesses, can be justified on the ground that market rate debt financing generally provides nonprofits with an advantage in competitiveness over taxable competitors.

However, some charitable organizations, including many universities and hospitals, have access to below-market financing. Section 103(a) excludes interest earned on state and local bonds from federal gross income. Most bonds, including bonds issued by corporations and the federal government, pay taxable interest. The holder of a taxable bond includes interest received as income[119] and pays tax on that interest at her own rate. In contrast, the holder of a state or municipal bond can exclude from federal income the interest on such a bond.[120] As a result, tax-exempt bonds pay lower interest rates than equivalent taxable bonds. In effect, taxable investors bid up the price and down the return on tax-exempt bonds. Such a reduced return is an implicit tax to the lender, but it is a subsidy to the borrower.[121]

Charitable organizations cannot issue tax-exempt bonds directly. However, state and local governments can issue tax-exempt private activity bonds on their behalf. Private activity bonds are bonds issued by state and local governments where the proceeds are directed toward a trade or business carried on by a nongovernmental person.[122] One of the entities on behalf of which state and local governments can issue tax-exempt private activity bonds are § 501(c)(3) organizations.[123] Thus, when private activity bond financing is available, it can provide tax-exempt charities with a tax-induced competitive advantage over for-profit entities. This section looks at the significance of such financing for the UBIT.

Return to the example and assume that the nonprofit can use private activity bonds to finance its purchase of the candidate investment. In order to calculate the nonprofit's maximum purchase price, we need to make an assumption about the interest rate paid on such bonds. For example, if the taxpayer who sets the price of tax-exempt bonds (the marginal investor in tax-exempt bonds) is in the 35% tax bracket, such a taxpayer will be indifferent to holding a taxable bond or an otherwise identical tax-exempt bond if the tax-exempt bond pays 65% as much interest as the taxable bond. Thus, given a 10% interest rate on taxable bonds, the tax-exempt bond will pay 6.5%. Alternatively, if the marginal investor is in the 20% tax bracket, the tax-exempt bond will pay 8%.[124] Thus, if N can finance the candidate investment by borrowing the full purchase price at 8%, then the maximum

119. I.R.C. § 61(a)(4) (2000).
120. *Id.* § 103(a).
121. *See* Scholes et al., *supra* note 52, at 196–97.
122. *See* I.R.C. § 141(b)(1).
123. See *id.* §§ 103, 141.
124. There is evidence that long-term, tax-exempt bonds pay interest at rates that imply implicit tax rates below the top statutory tax rate.

amount that N will pay for the asset, $PV(N_{exempt\ finance})$, is calculated as follows:[125]

(8) $PV(N_{exempt\ finance}) = \$100{,}000/.08 = \$1{,}250{,}000$

It therefore follows that if N can finance the full cost of the candidate investment using tax-exempt debt, N will outbid P for the project. Recall that the present value of the cash flow from the candidate investment to P was $1 million. Nonprofits will, thus, have a tax-induced competitive advantage over for-profit entities in competing for commercial assets that can be financed using tax-exempt debt.

There are, however, various requirements that a § 501(c)(3) organization must meet in order for any private activity bonds issued on its behalf to generate tax-exempt interest. If the organization does not meet these requirements, the interest on the disqualified bonds is taxable. Among the principal requirements that qualified § 501(c)(3) bonds must meet are the following: (1) at least 95% of the net proceeds of a qualified 501(c)(3) bond must be used to finance property owned by a § 501(c)(3) organization or a governmental unit; (2) at least 95% of the property financed by the bond issue must be owned either by the § 501(c)(3) organization or by a state and local government; and (3) the bonds must be repaid both directly and indirectly from funds received by the nonprofit in its exempt function.[126]

The above requirements prohibit nonprofits from using private activity bonds to fund investments in unrelated businesses and commercial real estate. They also make it very difficult for nonprofits to indirectly finance such investments. Of course, money is fungible and whether an unrelated business is making an issuance of private activity bonds feasible might not be clear. Thus, there might be an incentive to try to fund such enterprises indirectly. Even so, there are additional reasons to believe that in many cases, private activity funding is not available at the margin for commercial enterprises of nonprofits.

First, there is a maximum amount of private activity bonds that a borrower can have outstanding. The limit is set at $150 million for nonhospital bonds.[127] For some borrowers, such as major universities, the nonhospital limit is binding and so they cannot borrow more to finance their unrelated business activities. For nonprofits that are at the cap, any new investment must be financed internally or through market rate debt.[128]

125. Denote the tax-exempt interest rate at which N can borrow by r_e. The present value of the candidate investment to N, $PV(N_{exempt\ finance})$, is as follows: $PV(N_{exempt\ fnance}) = c/r_e$. That is obviously greater than $PV(N) = PV(P) = c/r$ when r_e is less than r.

126. *See* Washlick, *supra* note 98, at 152.

127. I.R.C. § 145(b).

128. There is no maximum on hospital debt. *See id.* § 145(b)(1). There is, however, still a prohibition on using hospital bonds to finance unrelated activities—they count towards the 5% bad use. Because many activities carried out by nonprofit hospitals as part of their exempt function are also carried out by for-profit hospitals, that raises the question whether

Second, nonprofits cannot issue tax-exempt bonds themselves. They can only issue them through state and local governments and only with the explicit permission of the issuing government. That approval makes it less likely that the bonds will be issued to finance unrelated businesses, either directly or indirectly.

Third, there is another set of restrictions on § 501(c)(3) bonds, called the arbitrage bond rules. Like other tax-exempt bonds, § 501(c)(3) bonds are subject to the anti-arbitrage rules in § 148. These rules prohibit the issuer from investing the proceeds raised by issuing tax-exempt bonds, or the funds replaced by such proceeds, at a materially higher yield than the yield on the borrowings. An arbitrage bond is defined as a tax-exempt bond issue, the proceeds of which are reasonably expected at the time of issuance to be used directly or indirectly to acquire higher yielding investments or to replace funds that are used to acquire directly or indirectly higher yielding investments. The issuer of an arbitrage bond is required to rebate to the Treasury the difference between the amount earned on the bond proceeds over the amount that would have been earned if the proceeds of the bond issuance were invested at the yield on the tax-exempt bonds.[129] One consequence of these rules is that they make it more difficult to use tax-exempt debt to finance business investments indirectly because the proceeds cannot be parked in financial assets, without triggering the arbitrage bond rules.

One argument that has been made in favor of both §§ 511 and 514 is that tax-exempt debt financing, when it is available, provides nonprofits with a tax-induced advantage in competitiveness over their for-profit rivals. As a solution to such a narrow problem, §§ 511 and 514 are extraordinarily broad. The most intense competition between for-profit firms and nonprofits financed with tax-exempt debt probably involves hospitals, where Congress elected to lift the limitation on tax-exempt debt. However, the UBIT, if it applied to projects financed with tax-exempt debt, would not generally level the playing field between nonprofit and for-profit firms. That can be seen with the example. The UBIT would reduce the annual cash flow to $65,000. At an 8% discount rate, the project has a present value of $812,500.[130] Thus, in the example, the UBIT would place N at a disadvantage.

A better response than the UBIT comes from the arbitrage penalties. In that instance, the borrower pays the difference between yield and tax-exempt borrowing costs. Such a penalty, if it can be enforced, will tend to

the differences in the services provided by nonprofit and for-profit hospitals are significant enough to justify the subsidy. *See also* Horwitz, *supra* note 88.

129. I.R.C. § 148(f)(2).

130. Note that if the tax-exempt borrowing rate was 6.5%, the project with the UBIT would have a present value of $1 million. That the UBIT gives the right answer in that circumstance, however, is a coincidence. It occurs because the UBIT tax rate, which is the corporate tax rate of 35%, is also the personal tax rate that sets the interest rate on the tax-exempt bond.

make the borrowing cost to charitable organizations the taxable rate. That will tend to eliminate any advantage from using tax-exempt debt financing to acquire commercial assets. Of course, that would also eliminate any reason for using tax-exempt financing and take away the benefit Congress provided nonprofits by allowing them to use tax-exempt financing.

CONCLUSION

The traditional argument for the UBIT is that the UBIT is necessary in order to level the playing field between nonprofits and for-profit businesses when both compete in the same market. Without the UBIT, the nonprofits' exemption from tax would provide them with a competitive advantage over their for-profit rivals. The argument is as follows: The exemption increases the cash flow a nonprofit earns from a given investment relative to that of an equally efficient for-profit owner. Because an investor who earns more is willing to pay more for an asset, it is reasonable to expect that if competition from nonprofits were not restrained, then nonprofits would outbid for-profit entities for many assets.

That situation, the argument goes, is further exacerbated by the availability of debt financing, which allows investors to control assets that are worth more in aggregate than their total capital. Viewed from this perspective, it is easy to see why Congress was concerned that charities might control a large proportion of the economy's productive assets. Moreover, the above line of thought suggests that if charities do not control a large portion of the economy's assets it is likely because they are inefficient managers. Even here, there is a problem. That is because the tax system encourages inefficient charities to replace more efficient for-profit owners. The logic behind the UBIT, then, is that it prevents less efficient nonprofits from taking control of assets from more efficient, but tax disadvantaged for-profit actors.

Although intuitively appealing, the logic underlying the UBIT is wrong. Under ordinary circumstances, the exemption from tax does not provide nonprofits with the ability to outbid their for-profit competitors for business assets. That is because the nonprofits' tax exemption, which increases the nonprofits' after-tax cash flow from any active business it operates relative to that of a taxable competitor, also increases the nonprofits' after-tax cash flow from any alternative investment relative to that of a taxable competitor. Thus, the exemption has two offsetting effects: It increases the cash flow from operating an active business, which tends to advantage nonprofits, and it increases the cash flow from any alternative investment the nonprofit would make, which tends to disadvantage nonprofits. These two effects move in opposite directions and tend to offset one another. When the asset under consideration is taxed the same as the alternative use of funds, then the two effects exactly offset one another. Thus, the net effect is generally to leave nonprofits and for-profit businesses on equal competitive footing before consideration of the UBIT. The only assets for which nonprofits have a tax-induced advantage in competitiveness are those

that are taxed more heavily than typical alternative assets. The two most significant examples are investments made through corporate equity and real estate that would be subject to a real property tax if it were held by an individual or a business.

Once the UBIT is taken into account, the effect is to disadvantage the nonprofit relative to the competing for-profit business. The UBIT reduces the nonprofit's cash flow from unrelated active businesses only. Specifically, it has no effect on the cash flow from passive investments. Because investing in passive assets is always an alternative use of funds for a § 501(c)(3) entity, the UBIT reduces the charities after-tax return from investing in the unrelated active business relative to investing in a passive asset. Thus, the UBIT will generally reduce the value of investments in unrelated active businesses relative to passive investments. It is by virtue of such an effect that the UBIT tilts what would otherwise be a level playing field against nonprofits in favor of for-profit competitors.

Also, § 514, which taxes nonprofits on their income from debt-financed investments, cannot be justified on the grounds of leveling the playing field between nonprofits and for-profit businesses. Nonprofits do not enjoy an advantage in competitiveness when they finance their investments using market rate debt. Accordingly, § 514, which was enacted in response to a narrow and specific abuse, is too broad.