UNRELATED BUSINESS INCOME TAX AND NONPROFIT ADMINISTRATIVE OPTIONS

by

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[1] Alan Ullberg and Patricia Ullberg, Museum Trusteeship, with a forward by Katherine S. White, (Washington D.C., American Association of Museums, 1981), 4.

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INTRODUCTION

Current unrelated business income tax proposals are the result of the nonprofit sector's attempt to generate income. If proposed recommendations of the Congressional Subcommittee for Oversight are passed as legislation, nonprofits could be forced to increase business activities.

Complaints of nonprofit organizations competing unfairly with for-profit businesses are at the heart of the unrelated business income tax issue (UBIT). The federal government has been addressing these same complaints since ratification in 1913 of the 16th amendment which allowed Congress to collect income taxes.[2]

In the past forty years, Congress has passed two pieces of legislation and is in the development of a third, in an attempt to correct the issue of unfair competition. This paper will attempt to explain the theory of nonprofit organizations and unrelated business income tax law as it

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[2]James J. McGovern, "The Use Of Taxable Subsidiary Corporations By Public Charities - A Tax Policy Issue For 1988," Tax Notes, March 7, 1988, 1125.

currently exists. It will also discuss implications of current UBIT proposals and the choices available to nonprofit organizations in light of those proposals.

There are terms used by the author throughout this paper that the reader needs to understand. Because certain terms are used interchangeably and they may not mean the same thing to each individual, a basic definition has been identified.

Nonprofit organizations is used synonymously with "not-for-profit organizations." Nonprofit organization refers to a 501(c)3 organization as defined by the Internal Revenue Codes. For further understanding the author specifically dealt with nonprofit organizations in the field of arboreta, botanic gardens, museums and zoos. It is assumed by the author that administration is similar in all these organizations.

Earned income describes all areas of revenue in a nonprofit organization originating from sources other than grants, endowments, contributions, admission fees or government appropriations.

Proposals is in reference to the House Ways and Means Subcommittee on Oversight's draft proposals on unrelated business income tax as published in June, 1988.

For this thesis all reference to proposals will refer to that draft.

Unrelated business income tax refers to the tax imposed on income generated by nonprofit activities which are not substantially related to the exempt purpose of the organization.

In the development of this thesis a survey was conducted. The basic premise was to gather information on earned income within the museum field. This information was not available from the American Association of Museums (AAM) or the American Association of Botanic Gardens and Arboreta (AABGA).

Criteria for selecting organizations for the survey were, they must: 1) represent one of the five regions of the United States as designated by the AABGA; 2) be a 501(c)3 organization; 3) have some category of earned income within their organization, such as giftshop income and 4) must be a member of AAM or AABGA.

Each of the participating organizations was given background information on the subject of UBIT. This was done to provide each participant the same basic information necessary to answer the questions correctly.

The general format of this thesis is to explain the elements of UBIT and how they relate to the nonprofit organization. There is a chapter on the purpose and qualifications for tax exemption and the development of the issue of UBIT. There is chapter on the current status of nonprofit organizations and UBIT. The third chapter summarizes UBIT proposals, the choices for nonprofits and a conclusion dealing with the issue of UBIT. The final chapter suggests options for nonprofit administrators in dealing with current UBIT law.

CHAPTER 1

NONPROFIT ORGANIZATIONS AND THE DEVELOPMENT OF THE UNRELATED BUSINESS INCOME TAX

The Purpose of and Qualifications for Tax Exempt Status

Tax exemption plays an important role in our pluralistic society. Unlike may European countries the charitable sector of the United States is supported by means other than government appropriations.

Exemption from income taxes is one way for the government to compensate the charitable sector for its contribution to the general welfare of the country.[3] As stated by the House Ways and Means Subcommittee on Oversight:

> Charitable and other tax exempt organizations are an essential part of our society. Nonprofit organizations have promoted the general welfare stimulated scientific and technological progress, cultivated educational, cultural and artistic endeavors, fostered religion and provided a

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[3]Paul Treusch, Tax Exempt Charitable Organization, Third Edition (Philadelphia: American Legal Institute-American Bar Association, Committee on Continuing Professional Education, 1988), 5.

wealth of independent thought and innovative ideas. They continue to do so today with renewed vigor in ever increasing numbers.[4]

Historically the precedent for tax exemption was set in English Common Law in 1601, by means of the Statute of Charitable Uses.[5] The U.S. Congress adopted this as a principle of early American law in the Revenue Act of 1894 in which charitable, religious and educational organizations were given tax exempt status. Present day statutory law, developed from years of tax reform, continues to embrace this same charitable concept.[6]

In the last half of the 1980's the House Ways and Means Subcommittee on Oversight has been examined the issue of tax exemption and allegations of unfair competition were made by representatives of the taxable sector. In 1983, the Small Business Administration published a report on unfair competition resulting from nonprofits competing with private businesses.[7] This report urged Congress to limit commercial activities of nonprofits.

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[4]Ibid.,2.

[5]Ibid.,5.

[6]Ibid.,5.

[7]Independent Sector, "Questions and Answers Regarding the Issue of Unfair Competition Between Nonprofit Organizations and Small Business," (October 21, 1986).

<u>Qualification For Tax Exemption</u>

Fundamental to the argument against unfair competition are the principles upon which tax exemption is granted. An organization under section 501(c)3 of the Internal Revenue Code will qualify for tax exemption if it is organized and operated exclusively for the following activities or purposes: charitable, religious, educational, scientific, literary or testing for public safety.

Presently the Internal Revenue Service (IRS) has two tests an organization must pass in order to qualify for tax exemption: the organizational and the operational.

The organizational test requires the exemption candidate to limit its purpose for existing to one or more of the qualifying activities. The organization must not engage in any activities beyond those proposed in its exempt purpose unless a portion of those activites would comprise an insubstantial part. The candidate organization must also provide a recipient for allocation of assets if it were to dissolve.[8]

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[8]Touche Ross, "Review of Tax Laws," <u>Unrelated Business Income Tax and Other Current Tax Issues Facing Exempt Organizations</u> (Washington, D.C.: Touche Ross Seminar and Conference Division, Touche Ross & Co. , 1989), 1.

The operational test requires the exempt candidate to operate specifically in one or more of the activities qualifying for exemption. To fulfill this test an organization must engage primarily in activities accomplishing the proposed exempt purpose.[9]

Another requirement of the operational test is the private inurement rule. This rule insures the organization engages in activities that will benefit the interests of the general public rather than the interests of private individuals such as the founder, trustees or staff members.

The private inurement rule promotes dedication of the organization to charitable, tax-exempt purposes. It insures that an institution functions within the purposes for which it was established and insures there be no payments of dividends or premiums from net earnings to any individual. This is the major difference in principle between nonprofit and for-profit organizations. If a nonprofit organization engages in the inurement of private individuals it would lose its tax exempt status. It must operate exclusively for charitable public purposes.[10]

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[9]Ibid.,3.

[10]Ibid., 1.

UBIT and the Unfair Competition Issue

Unfair competition is a complaint by small private businesses against a perceived unfair advantage held by nonprofits. The small business community feels nonprofit organizations have a competitive edge because of their exemption from things such as income taxes, property taxes and reduced postal rates. Unfair competition has been a tax issue from the early 1900's.

Early 1900's

The first revenue act dealing specifically with the issue of unfair competition dates to 1950. Prior to that date the rule used in determining unfair competition was the "destination of income test." In that test, the determining factor of paying income taxes depended upon the end-use of the income. If revenue or income was used for charitable purposes no tax was imposed on it. A case using this test took place in 1913.

In 1913 the Sixteenth Amendment to the U.S. Constitution was ratified which allowed Congress the power to collect taxes on income. In that year a case was brought before the U.S. Supreme Court dealing with the issue of unfair competition, or operating outside of an exclusively charitable purpose.

The case took place in the Philippine Islands in which a religious corporation was in dispute with the Insular Collector of Revenue. The dispute arose over the way in which the nonprofit corporation generated its revenue. It derived its income from interest, rents and dividends. It also sold wines, chocolates and other articles purchased and supplied for use in its churches and schools. The tax collector felt the nonprofit was operating for purposes other than religious ones. The ruling of the Supreme Court was in favor of the nonprofit based upon "income destination".[11]

Between 1913 and 1950 there were other cases of unfair competition. As one author states in reference to the income destination test, "in the first half of this century, tax-exempt organizations availed themselves of virtually unlimited commercial opportunities".[12]

Another case involving income destination includes the use of a feeder organization. Feeder organizations, or

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[11] McGovern, Subsidiary Corporations by Public Charities, 1125.

[12] Ann Worley, "The Unrelated Business Debate: Wait Until Next Year," History News, (November/December 1988): 8.

taxable subsidiaries, are formed to pass income from a commercial business to an exempt organization. This case involved a macaroni company merger with a corporation organized to profit the School of Law of New York University. In this case the IRS contended that the feeder organization was being organized or operated for reasons other than charitable purposes. The ruling was in favor of the nonprofit corporation by "destination of income."

Reform of 1950

The Revenue Act of 1950 was the first act to deal with the issue of unfair competition. The primary purpose of the act was to prevent unfair competition from tax exempt organizations like the School of Law of New York University. The act was passed to prevent exempt organizations from expanding their business holdings with tax exempt monies. Congress was concerned that exempt organizations had an unfair advantage over their tax-paying competitors who could expand only with after-tax profits.[13]

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[13]Draft Report Describing Unrelated Business Income Tax Recommendations, For Consideration by Subcommittee and Proposed Letter to House Ways and Means Committee Chairman Dan Rostenkowski, Along with Memorandum to Ways and Means Oversight Subcommittee Members, report by J.J. Pickle, Chairman of Committee on Oversight (Washington, D.C.: The Bureau of National Affairs, Inc., 1988), L-9.

The 1950 statute was developed in two sections. The first section eliminated the "income destination" test and the second section imposed taxes on unrelated income.

The elimination of the "income destination" rule was directed at stopping exempt organizations from expanding with tax free dollars. They could no longer operate active business, commercial holdings that were not substantially contributing to their charitable purposes. If they did the profits would become taxable at the current corporate rate. This tax was imposed only on incomes categorized as active and unrelated. It did not include passive income in the form of dividends, interest, rent and royalties.[14]

Because the 1950 Revenue Act did not include passive income in the taxable category, exempt corporations used wholly owned companies or subsidiaries to manage business holdings. What was classified as taxable "active income" was passed on to the exempt organization, which was in reality the stockholder. The income was passed in the form of dividends and royalties and then classified as passive.

Passing income generated by active business holdings in the form of passive income defeated the purpose of the

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[14]McGovern, <u>Subsidiary Corporations by Public Charities</u>, 1126.

revenue act. Through carefully planned transactions the law could be circumvented. This did not eliminate unfair competition between taxable and exempt organizations. Private foundations were owning numerous businesses with their primary purposes focused on business ventures, not charitable purposes. This brought about the Tax Reform of 1969.

Reform of 1969

The basic premise of the 1969 tax reform was to control the extent to which businesses may be controlled by private foundations. Congress was concerned about the amount of involvement private, exempt foundations were having with industry and that other exempt organizations would become involved in unrelated income activities.

In the 1969 tax reform Congress instituted the 80% rule. This rule limits the percentage amount of control foundations can have over business enterprises. If a foundation controls more than 80% of the stock of a business enterprise, any form of income going from it to the foundation is subject to unrelated business income tax. This is an attempt to control the amount of revenue generated from what Congress defines as unfair competition or as activities unsubstantially related to the exempt purpose.[15]

Another rule enacted in 1969 is the fragmentation rule. "By application of this rule, the unrelated parts of a trade or business can be separated from the related and taxed".[16] With this rule a representative of the IRS can audit an organization and separate-out those activities it feels do not "relate substantially" to the exempt purpose of the organization.

The substantially related requirement as it exists is one of great controversy. It has never been clearly defined by the IRS and is open to interpretation by the individual IRS auditors. The interpretation of the substantially related rule as stated in the IRS Auditors 1970 Training Manual states:

> The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question - the activities, that is, of producing or distributing the goods or performing the services involved and the accomplishment of the organization's exempt purposes.[17]

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[15]Ibid., 1127.

[16]Internal Revenue Service, Exempt Organizations Annual Technical Review Institute for 1979, training manual for use in annual training session for auditing agents, March 1979, 2.

[17]Ibid.,3.

An example of the interpretation of this rule is within the area of gift shop sales. Merchandise which is for sale in museum gift shops must have a relationship to the museum's collections and exempt purpose. An auditor has the authority to inventory a gift shop and select merchandise which does not have a substantial relationship to the museum's collections. This is known as fragmentation.

The penalty for having merchandise or activities which are not substantially related to the exempt organization's purpose is the imposition of the unrelated business income tax. This rule gave Congress greater authority over the income-producing activities of exempt organizations.

With the Tax Reform Act of 1969, Congress has greater authority over the revenue activities of exempt organizations. This includes the types of activities that take place outside of the exempt organization in the form of taxable subsidiaries and those activities taking place within the organization relevant to its daily operation.

Since 1969 there have been two tax reforms. In these reforms provisions were made to exclude certain types of incomes from UBIT. In 1976 a provision was made to exclude income from qualified entertainment activities and qualified trade shows and convention activities and income from certain hospital services. And in 1986 exceptions to UBIT included income from the sale of mailing lists among charities and from the distribution of certain low-cost items which are used to solicit charitable contributions.[18]

[18] Draft Report, L-5.

CHAPTER 2

CURRENT STATUS OF NONPROFIT ORGANIZATIONS AND UBIT

Complaints of Unfair Competition In the 1980's

The issue of unfair competition did not end with the Tax Reform of 1969. The issue intensified and more complaints were made. In 1983 a report, "Unfair Competition by Nonprofit Organizations with Small Business: An Issue for the 1980's" was issued by the Small Business Administration (SBA) which claimed exempt-organizations were competing head-to-head with private businesses. The report urged legal limitations on unfair competition and taxation of nonprofit incomes where directly competing with small businesses.[19]

In response Dan Rostenkowski, Chairman of the House Ways and Means Committee, asked the Subcommittee on Oversight to conduct a review of federal taxation of commercial and other income producing activites of

[19] Independent Sector, "Questions and Answers Regarding the Issue of Competition Between Nonprofit Organizations and Small Business," (October 21, 1986), Question 2.

organizations under section 501 of the Internal Revenue Code.[20]

<u>Subcommittee Review of UBIT</u>

In this subcommittee review three areas were investigated: the types of revenue activities taking place within exempt organizations; the purpose of the IRS and the courts in reviewing and administering the law; and the compliance of exempt organizations within the law.

The review proceeded through numerous phases. There were public hearings on income activities of tax exempt organizations and the administration of UBIT. With the results of these hearings the subcommittee developed preliminary discussion options proposing changes to the law. Public comments were solicited about the options, a second series of public hearings were then held. Comments were received from organizations ranging from the Small Business Administration to the Independent Sector, a nonprofit association for the encouragement of giving, volunteering and not-for-profit initiative. From the discussion option hearings the subcommittee developed a draft report of recommendations for the improvement of UBIT law.

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[20] <u>Draft Report Describing Unrelated Business Income Tax</u>, L-4.

Review Findings

An important finding was that there was no available data on the commercial activities of tax-exempt organizations which is important because the arguments of the Small Business Administration are based upon unsubstantiated information. The IRS was not able to confirm the figures used in its report on unfair competition. This and other findings prompted recommendations by the subcommittee to revise the IRS General Information Return Form 990.

Form 990 is filed by tax-exempt organizations to report their annual incomes. The revised form will include an explanation of all income activities as they relate to the exempt purpose of the institution. This revision will require tax-exempts to be accountable to their exempt purpose and to compliance with the tax laws. The revised form will also help the IRS in monitoring exempt activities and the courts and Congress in administering the laws. A revised form will further provide information for a database on the commercial activities of tax exempt organizations for future reviews.[21]

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[21] Ibid., L-8.

There were other findings as well. In its report, the subcommittee acknowledges the importance of tax exemption to society and to the general welfare of the country. The subcommittee supports the special exemption afforded the charitable sector " fosters and encourages their existence".[22] The subcommittee also believes that because of this encouragement the number of tax exempt organizations within the United States has grown dramatically.

According to the IRS the number of tax exempt organizations has doubled in the last twenty years. The combined revenues of these 860,000 organizations, excluding the 340,000 churches, represented 7% of the GNP or $300 billion in 1986.[23] Of those numbers, museums represent 6,000.[24]

The Subcommittee acknowledges federal funding cuts and the need for nonprofits to generate revenue from other sources. From its study the subcommittee estimates the commercial activities of nonprofits have increased from

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[22]Ibid., L-14.

[23]Ibid., L-14.

[24]American Association of Museums, <u>Comments on Discussion Options Relating to Unrelated Business Income Tax: Submitted to the House WAys and Means Subcommittee on Oversight</u>, (Washington, D.C.: American Association of Museums, 1988), 2.

59% in 1946 to 78% in 1983. These figures combined with those from an IRS special study on tax return Form 990T, a form filed to report unrelated business income, indicate tax revenue from commercial activities of nonprofits doubled between the years of 1986 and 1987 (see Table 1).

Table 1 **Internal Revenue Service Special Study On 990-T* Forms**

Fiscal Year	No. of 990-T's Filed	Taxable Income
FY 1985	24,103	$30.2 Million
FY 1986	22,224	$54.9 Million
FY 1987	33,286	$120 Million

* reports unrelated business income tax

What do these figures mean? Of the 860,000 tax exempt organizations in existence in 1986 only 2% filed unrelated business taxable income(UBTI). Using 1986 figures of 990T's filed, an average tax payment would have been $2,470. At a corporate rate of 40% this would have calculated to an UBTI of $6,175. These figures and the comments from public hearings developed the recommendations for UBIT.

The figures presented in the subcommittee report are the result of a number of changes in society. Nonprofit organizations play an important charitable role in our country. They do not come into and remain in existence merely because of the tax benefits afforded to them. They are created, founded and established because of a perceived need. Commitment, dedication and hard work are needed to develop and maintain them. If the need, driving force, ambition and ingenuity of nonprofit administrators are great enough they will develop UBTI to keep the organization alive and healthy.

Nonprofit programs were encouraged and funded during the late 60's and early 70's by the U.S. government. Why have the numbers grown during the last twenty years? Why has funding become a problem?

The 1960's

In the 1960's President Lyndon B. Johnson instituted the Great Society programs. These were established to "help the nation cope with an increasingly complex social and technological society."

One of the individual programs established through this was the Community Development Corporation Program (CDC). This CDC program was used in economically disadvantaged areas to encourage small business development. The program offered an array of solutions including development-oriented programs that included operation of business enterprises. This CDC program is considered to have had a filtering-down effect throughout the nonprofit sector by encouraging the development of enterprise activites.[25]

During the Great Society period there was an increase in federal funding. Nonprofit programs expanded and their income demands increased. The entire nonprofit sector was experiencing growth and looking for ways to supplement incomes.

The 1970's

Throughout the 1970's nonprofits were becoming increasingly aware of assets they possessed within their organizations. These assets included their facilities, staff and in some cases their clientele. Some nonprofits were realizing that funding was not as easily obtainable for their programs as it was for others. Such was the case for some drug and alcohol rehabilitation centers. They used the abilities of their clientele to develop products and services as part of their therapy programs. These were then sold and the monies were used to support the organization.

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[25] James C. Crimmins and Mary Keil, Enterprise In the Nonprofit Sector, with foreword by Robert H. McNulty (Washington, D.C.: Partners For Livable Places; New York: The Rockefeller Brothers Fund, 1983), 20.

The expansion of nonprofits in the 60's and 70's occurred due to the increase of federal funding and the use of enterprise activities. The growth of federal appropriations to the states, which in turn was shared with nonprofits during that period grew from $10.9 billion in 1965 to $89.8 billion in 1980.[26]

The 1980's

The growth period of federal funding came to a halt. With the advent of the economic recession of the late 70's and the increasing federal deficit, Ronald Reagan was elected to the presidency in 1980. In 1981, he cut the federal budget and funding for nonprofits decreased. The private sector and private philanthropy were expected to carry the burden of funding for nonprofits. It is estimated by the Urban Institute that the decrease in federal support for nonprofits would cost nonprofits $25.5 billion between the 1980 and 1984. Laster Salamon, Director of Public Management of the Urban Institute, stated that private giving during the first five years of the 1980's would have to increase 144% to make up for government cutbacks and an

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[26]Ibid.,22.

increasing inflation rate.[27] That represents a four fold growth rate compared to the previous five years.

In 1986 Congress passed another tax reform act in which the after-tax cost of contributing to charities was significantly affected. The reform eliminated or cut personal deductions and "drastically reduced the tax rate system."[28] The American Association of Museums in a presentation to the subcommittee hearings focused specifically on the elimination of the non-itemizer deduction and the inclusion of appreciated property into the alternative minimum tax bracket. As stated in the testimony these changes, coupled with the proposed changes in UBIT, could have an overall negative affect on the ability of museums to maintain collections and educate visitors.[29]

Also during the time period between the tax reform of 1969 and the subcommittee review of 1986 an increase of private letter rulings (PLR) was being issued by the Internal Revenue Service. Between 1967 and 1976 there were

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[27]Ibid., 22.

[28]David M. Donaldson and Carolyn Osteen, "Impact of The Tax Reform Act of 1986 on Charitable Giving," in American Legal Institute-American Bar Association: Legal Problems of Museum Administration, March 18,1987, by American Legal Institute-American Bar Association (Philadelphia: ALI-ABA. 1987),203.

[29]American Association of Museums, Comments on UBIT, 4.

8 PLR's issued involving nonprofit organizations. Between 1977 and 1986 there were 593 issued on nonprofit organizations' compliance with the tax codes. These were written by the IRS in response to questions of individual auditing agents. The letters from the central agency make determinations on individual situations involving compliance with the tax codes. The letters contain rulings about questions field auditors can not resolve by themselves.

All of these factors including increased complaints of unfair competition and reports from organizations like the Small Business Administration lead to the review of the subcommittee. Chairman Rostenkowski felt that a thorough review of the federal tax codes on commercial and other income producing activities of section 501(c)3 organizations was overdue. Once completed, these reviews resulted in proposals to change UBIT.

CHAPTER 3

UBIT PROPOSALS AND NONPROFIT CHOICES

Summary of UBIT Proposals Affecting Museums

Proposals of the Subcommittee on Oversight are a result of public comment hearings and a historical review of UBIT. The proposals cover the range of nonprofit income activities and are an attempt to address the issue of unfair competition which has been described as direct head-on competition between tax-exempt and taxable organizations.

Some examples of nonprofit activities mentioned by the Small Business Administration as unfair competition include fitness centers; day care facilities; nursing homes; hearing aid sales; hospital services; university bookstores, printing operations, computer services and research-development services; travel and consulting services.[30]

Few of the above activites have any relationship to the earned income areas of museums. The majority of complaints are directed towards the health care industry and

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[30] Independent Sector, question 2.

universities which compose 70% of all nonprofits.[31] It has been pointed out by AAM that few of these complaints have anything to do with museums. In fact, in the hearings of 1987 there was one passing reference to unfair competition between a museum and a taxable business. Even subcommittee chairman J.J. Pickle stated he could see no real competition between cultural organizations and taxable organizations.[32]

Recommendations on Substantially Related Income

UBIT recommendations involved a number of proposals in areas of interest for museums. One key decision was to retain the substantially related rule. One of the discussion options would have eliminated this and replaced it with a "directly related" rule in its place. This suggestion created debate. If adopted it would have required every income activity of an organization to meet the exempt purpose. For example, items in a decorative arts museum gift shop would have to be reproductions of that collection to be directly related. They could not be items representative of the same period of time as that of the collection which under current law are substantially related.

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[31]Draft Report, L-15.

[32]American Association of Museums, 4.

The recommendation to keep the substantially related ruling included the development of clearer interpretation of its application. This was done by focusing on different categories of income activities. Past complaints about substantially related rulings have been concerned with the inconsistency of application. Because interpretation of the law is totally dependent upon the auditor of the district, past revenue ruling decisions have been made on a case-by-case basis.

The substantially related categories of interpretation focused on all areas of unfair competition complaints. Those most directly affecting museums included: gift shop, bookstore, catalog, mail order activities; tour and travel activities; affinity credit cards and affinity merchandising; and, hotel facility activities.

In gift shop, bookstore, catalog and mail order activities the interpretation becomes specific to the dollar amount and types of retail merchandise. Items considered educational and related to the organization will not be affected by the recommendations. Items that are primarily mementos of the institution will be considered unrelated unless they sell for $15 or less, regardless if the sale takes place on or off the premises. Examples given of items that would qualify as tax-exempt include tote bags, T-shirts, paperweights, pencils, etc. Also given as a standard is the sale of reproduction items. Museums selling reproductions of their collections could do so without incurring UBIT if the individual items sold for under $50 each.

This presents a number of problems for museums. Many museums belong to the Museum Store Association (MSA), an organization "to promote professional standards and to foster a climate of integrity within the museum store profession."[33] MSA has adopted a code of ethics for all its members. This code of ethics promotes the philosophy of the museum store as an extension of the educational purpose of the institution. MSA feels the term "museum store" carries an obligation to the public to provide quality merchandise with authenticity. This philosophy and and the obligation of a 501(C)3 organization to be educational in nature is somewhat contradictory to the proposed sale of tote bags and T-shirts, as proposed by the draft report.[34]

The introduction of the MSA code states that museum stores have evolved dramatically over the years from souvenir stands to retail operations. Museum stores have moved away from selling mementos like T-shirts and tote bags

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[33]Museum Store Association, Code Of Ethics, 1981.

[34]Also in the past, T-shirts have been interpreted, by the IRS, as functional items not relating to the exempt purposes of museums.

because they are not always educational and have been consistently classified as unrelated by the IRS. The subcommitee proposal is indirectly promoting the sale of souvenirs by allowing the sale of low-cost items. The sale of mementos by museum stores would be a regression in terms of quality, educational merchandising promoting the educational nature of the institutions.

The purpose of interpreting the substantially related rule is for ease of application. Placement of a $15 limitation on merchandise, an arbitrary figure subject to inflation, is not going to help. As inflation rates increase, prices for merchandise will increase. Tote bags now costing $10 could possibly sell for $20 in ten years. Where will the interpretation of the rule then be? It would be back in the hands of the individual auditors, where it originated.

Arbitrary dollar amounts for merchandise will not solve a complex problem of interpretation. This includes the $50 category for the sale of reproductions. In speaking with a staff member of a local historical society about reproduction programs, he commented that quality reproduction products cost big dollars to produce.

Items sold as reproductions in a world renowned decorative arts museum must meet the strict criteria of its curators. Its reproductions must be as authentic as possible to originals in interpretation of the type of craftsmanship and materials. For a decorative arts museum producing reproductions of period furniture from its collections, $50 is not a reasonable figure. Few reproductions meeting curator-criteria can be done for this amount. And once again, what happens when inflation affects the merchandise prices? New interpretation of the rule must be made by the IRS.

Tour and travel programs are proposed taxable as unrelated income. The interpretation of the proposal indicates travel programs are allowable to the extent that they promote the furtherance of a degree program curriculum in an educational institution. This would exclude museums from developing educational travel programs. A comment made by many individuals on this proposal is that most programs developed by museums use commercial travel services to develop and conduct programs. Taxable organizations which benefit from nonprofit tour and travel programs will be adversely affected by this recommendation.

Affinity credit cards and affinity merchandise would become taxable under UBIT. These are usually arranged as royalty programs with museums. The institution's name is affixed to the credit card or merchandise and the organization receives a royalty fee for the transaction. Normally the organization's mailing list is also shared in the transaction. This is viewed as an unrelated activity to the exempt purpose of the institution, regardless of the fact that it is a royalty arrangement.

Nonprofit hotel facility activities will be viewed as unrelated. In most cases a museum's involvement with a hotel would be handled in a taxable subsidiary fashion. This proposal is mainly directed at the health care industry.

<u>Other Recommendations</u>

Other proposals involving museums include the repeal of the convenience exception, modification of the royalty exclusion, and the development of rules relating to subsidiaries of nonprofits and computational changes in advertising income.

The repeal of the convenience exception will have a widespread effect on museums. The convenience exception allows museums to have restaurants and to sell items like film. Conveniences are viewed as things provided as a service to extend the visitor's museum visit by adding to his comfort and convenience. Previous to the draft proposals these types of things were seen as contributing importantly to the mission of the institution.

Modification of the royalty exclusion is directed at preventing tax exempt organizations from receiving monies from taxable subsidiaries and commercial businesses in the passive income form of royalties. This proposal is especially focused towards royalties from products having little to do with the museum's exempt purpose. An example would be the licensing of a logo or trademark to foster name recognition or affiliation and would not be considered tax-exempt.[35]

Modifications have been made in the area of subsidiary control by tax exempt organizations. The proposal suggests limiting control of commercial organizations by tax-exempts. This is to include 50% voting power, an inclusion of ownership attribution rules, and the combined ownership by two or more tax exempts. The proposals also include computational rule changes for income of the taxable subsidiary. These are all an attempt to control the amount of involvement tax exempts have in commercial businesses. The expansion of tax exempt organizations into the realm of subsidiaries was never contemplated by Congress in the 1950 Tax Reform.

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[35]Touche Ross, "UBIT Proposals," 11.

Computational modifications were proposed for advertising activities. All income from advertising in exempt journals and publications are proposed taxable. This proposal will not allow organizations to deduct costs against the net advertising income.[36]

Nonprofit Reaction to Proposals

These proposals, as summarized, were presented to a number of nonprofit museums across the United States for their reaction. The survey inquired about income activities of the institutions and are listed as a percentage in Table 2. Ninety-two percent of the survey institutions responded positively when asked if they are dependent upon the revenue from these activities and they all have bookstore or gift shop sales.

[36]Draft Report, L-25.

Table 2 **Income Activities of Institutions Surveyed**

Income Activities	% of Institutions
Bookstore/ Gift shop Sales	100%
Other	80%
Facility Rental	77%
Joint Ventures	69%
Tour and Travel Programs	62%
Reproduction Programs	38%
Royalty Programs	38%
Taxable Subsidiaries	23%

Nonprofit Choices

Administrators of 501(c)3 organizations must realize the draft proposals are recommendations in the subcommittee. They have not been accepted or acted on. All income activities are currently interpreted under the substantially related rule. However, administrators should not over look the issue. In order for museums to survive in the changing political, social, financial and global climate that exists today, they must be prepared to make administrative decisions.

There are choices that could be made if current proposals become law. Organizations in the institutional survey were given four choices: they could drop the activity, pay UBIT, increase income activities to generate more income or develop a taxable subsidiary.

Drop the Activity

They could drop the revenue-generating activity but none of the participating museums chose this option. Programs and activities are developed out of need. Eighty percent of the participants commented that their income activities relate to the exempt purpose of their institution and are essential to their financial survival. One institution commented they would have to drop half their programs if forced to rely on their endowment and charitable contributions.

Pay the Taxes/ Increase Activity

Sixty-nine percent opted to pay the taxes and twenty-three percent would increase their activities to generate more income. Museums are relying on these activities to generate income for programs and are dependent on these funds; any decrease in net income will cause a funding problem and a decrease in programs. Museums have operational costs that must first be met before programs can be run.

UBIT history is fund related. Nonprofits have had to generate income in nontraditional areas in order to meet their program demands and increasing operational costs. The American Association of Museums calls the funding cuts of cultural organizations a "devastating squeeze." Museums are organizations with animate and inanimate collections having associated costs of care, conservation and feeding.

Museums are capital and labor intensive. Many require special physical plants to maintain their operations. Their operational costs are high and increase with the inflation rate. According to the AAM in the last six years, the aggregate appropriations for federal support of museums through the National Endowment for The Arts, the National Endowment for The Humanities, and the Institute Of Museum Services have dropped below the general inflation rate.[37]

Develop Taxable Subsidiaries

They could also develop feeder organizations or taxable subsidiaries to umbrella their income generating activity. Forty-six percent selected this as one alternative. Organizations having large profit making activities which are essential to their existence could choose to investigate this alternative. If proposals are adopted, activities which are now substantially related could be reclassified by the IRS as unrelated. This could threaten the exempt status of the institution. With the aid

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[37]American Association of Museums, 3.

of legal counsel, museum administrators would need to seriously evaluate the circumstances of their situation and their options for subsidiary development under the adopted tax reforms.

One comment made by a survey institution mentioned increasing fees to offset taxes. This is another solution. This choice moves nonprofits toward the elimination of service opportunities to certain economic sections of the general public. Museums are charitable organizations established to provide services to the general public. By raising fees as a solution to our funding problems we exclude those whom we are trying to help and educate. The charitable aspect of the institution becomes threaten.

Conclusion on Unfair Competition and UBIT

Ubit has been an issue from the initiation of the income tax law in 1913. The development of UBIT in 1950 was a starting point for Congress to address a significant issue for public policy. It had to be addressed then and needs to be addressed now.

The perception of unfair competition and the income activities of nonprofit organizations need to be examined. An in-depth policy analysis of subcommittee draft proposals on UBIT needs to be conducted previous to any decisions on policy change. This must include funding requirements of nonprofit organizations and how these proposals will affect those requirements. Previous decisions dealing with the issue of UBIT have been incremental in solution, a bandaid or muddling-through approach to policy decision making.

An incrementalist feels he can afford to make only minor changes and mistakes in developing policy because policy-making is serial and fragmented. He also believes problems are never solved by policy changes. Charles Lindblom, an authority on public-policy making, believes the only changes politically feasible are incremental or marginally different from existing policy. This option of decision making does not solve problems; it only prolongs them. In incrementalism limited analysis takes place and decisions are made. Problems arise from the decision and more analysis must take place. Then another decision must be made to correct the additional problem(s). Solutions are never found because in-depth studies into the problem and the consequences of decisions are not considered.[38] Solutions are reactive, not proactive.

E. S. Quade in his book, Analysis for Public Decisions states, "effective policy analysis of reasonably

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[38]E.S. Quade, Analysis For Public Decisions, Second Edition (New York: North-Holland, 1982), 26-28.

high quality is still a scarce commodity, even in many parts of the federal government.[39]" Through careful analysis, a policy decision maker can make the best decision for policy change based on research. Effective policy analysis looks for alternative courses of action for solving a problem. It weighs the pros and cons of those actions, if adopted and implemented, examining each action's benefits and consequences.[40]

The incrementalist approach in this case overlooks the effect of policy change on the funding of nonprofit organizations. This issue of unfair competition has been addressed and readdressed for over thirty years. If effective change is going to be made the examination of funding problems of nonprofits caused by proposed policy change must be completed. This should also include the impact of existing law, with increased compliance requirements and clearer definitions of those requirements.

Administrators of the nonprofit organizations involved in the institutional survey were asked if they felt the unrelated business activities, as defined by the draft proposal, were an integral part of their institution's mission? Eighty percent answered, yes.

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[39]Ibid., 8.

[40]ibid., 5.

The perception of unfair competition has little merit when considering the ultimate destination of the proceeds of nonprofit revenue. To whom is it unfair? The ultimate purpose of any nonprofit organization in generating funds is to provide public services. Nonprofit organizations are by definition created or established to generate no profit. This is ensured in the private inurement law of the IRS code of 501(c)3 organizations. By law their activities must relate to their exempt purpose.

Nonprofit organizations are being forced to become business-minded in their actions. Administratively, museums are becoming more sophisticated every day. Forward-thinking boards of trustees are looking for administrators with sound management backgrounds. They have to function in the competitive atmosphere that exists in today's nonprofit world where there is more competition for each and every charitable dollar.

Today's nonprofit manager must run an organization in the most efficient manner for each dollar spent. Endowments may not continue to totally support the operating expenses of the organization. The days of wealthy trustees writing checks to cover the museum deficit are gone. By necessity, museums are having to be run by dollarconscience managers. An indication of the importance of this is from granting foundations. Foundations are looking for healthy, stable organizations to choose as recipients for foundation grant money by examining financial statements.[41]

The world of nonprofit management is becoming as sophisticated and complicated as that of a corporate business. Boards of trustees and directors of museums are responsible for the success and the failure of their institutions. If they are to carry out their fiduciary responsibility, they must become sophisticated in their income generation. The cost of running museums is not going to decrease and if past trends are any indication, government support is not going to increase in the near future.

Proposed changes in the UBIT law will not eliminate the problem of unfair competition. Nonprofits are faced with funding problems. With decreased government funding, changes in tax reform causing decreased giving, increased operational costs, increased social demands, increased competition for corporate charitable dollars, a change in taxation of unrelated business income further limiting nonprofit organizations will not solve the unfair

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[41]Susan Kenny Stevens, "Measuring Financial Health," Foundation News (September/October 1988): 33-35.

competition issue. The problem has increased with each tax reform. Nonprofits become financially more sophisticated with each time. Tax reform has become a game of survival of the fittest.

This is not saying that nonprofit abuse does not occur. Museums and other nonprofit organizations cannot be allowed to do anything in the name of charity. They must comply with the substantially related law and not carry it to the extreme. Boards of trustees need to be aware of the funding issues that their organizations face. They must be realistic in how they will responsibly meet their financial needs. They have a fiduciary responsibility to the public and public law.

If nonprofit organizations lose more sources of funding and are forced to cut back on programs and services who will carry the burden? The corporate world exists for profit. An unprofitable venture, in the corporate world, will be dropped as soon as financial figures can substantiate a loss. Corporations operate on the basis of private inurement. On the other hand, a nonprofit organization will operate a profitable program for the sake of sustaining an unprofitable one. Public services and programs are the benefactors of unfair competition, if it really does exist.

CHAPTER 4

ADMINISTRATIVE OPTIONS UNDER CURRENT LAW

There are numerous choices available to the forward thinking administrative staff and trustees of nonprofit organizations under current UBIT law. Administrators need to remember that current proposals are just that, proposals. No action has been made on them since their release in June of 1988. Nonprofit organizations are still working under the substantially related ruling of the 1969 tax reform.

My advice is intended for the nonprofit administrator. This information is to be used as a proactive approach to revenue generation for nonprofit organizations. It can be used in whole or in part.

Compliance with the Internal Revenue Service

Review Exempt Purpose

Trustees and administrators of nonprofits need to review their tax exempt purpose. They must start by reviewing their articles of organization[42] and the qualifications for tax exemption. The administrators need to know if the organization is in compliance with the organizational and operational tests the IRS has established for tax exemption. There is no excuse for an organization to have its exemption revoked because of ignorance in this area.

Examine Mission Statement

Institutions should examine their mission statement. If a mission statement does not exist one should be developed. Does it reflect the exempt purpose(s) the nonprofit was founded upon?

Do all of the trustees, employees and visiting public understand the organization's mission? It may not be clear by the mission statement just what the exempt purpose is. Clarify and distribute it. If it is clear to all parties involved in an organization there is less chance of confusion or wandering from the exempt purpose. A clarified mission statement will help to unify the

[42] Articles of organization can be for any organization be it a corporation, community chest, fund, or foundation. Any of these may qualify for tax-exemption if it is organized and operated exclusively for charitable, religious, educational, scientific, literary, and testing for public safety purposes. Touche Ross, "Review of Tax Laws," 1.

organization, develop professionalism and accountability.

The mission statement should be made available to the visitor. Allow the general public to know what the organization is about and make a connection between what the organization says it is doing through the mission statement and what they see. The public can support an organization with clearer understanding by knowing its mission statement.

Callaway Gardens in Pine Mountain, Georgia does an excellent job of distributing its mission statement. It is printed on many of the available pieces of free public literature. There is a clear connection between the mission's purpose and how it is accomplished throughout the gardens and resort.

Visitors can observe by walking through the gardens and staying in the resort facilities that Callaway's purpose is "to provide a wholesome family environment where all may find beauty, relaxation, inspiration and a better understanding of the living world."[43] Throughout the gardens and resort Callaway promotes its educational, and horticultural exempt purpose through displays and interpretation. Callaway even explains the purpose and

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[43]Callaway Gardens, John A. Sibley Horticultural Center Brochure, (March 1989).

relationship of its wholly-owned subsidiary to the nonprofit foundation.

Once an organization has examined its mission statement it needs to examine what it is doing to accomplish it, specifically in the area of earned income. Do all its programs relate substantially to the exempt purpose? Is that exempt purpose clearly conveyed in the mission statement?

Know IRS Regulations

Know what is allowable by law. Be informed about the current views that the IRS is taking on tax issues. Is it crucial for the organization to have earned income activities? If so, it is important to know the general IRS guidelines. The IRS makes publications readily available on tax exemption and unrelated business income.

Examine how the institution complies with the IRS regulations. Is it operating in a substantially related manner? If not, how can it?

Work With The IRS

Find out who the IRS agent is in the organization's region. The interpretation of income activities complying with IRS regulations is dependent upon the auditing agent.

If the organization works with the agent in development of ideas it can save itself time and possibly lost revenue.[44]

Internal Structuring

There are a number of things nonprofits can do to to promote and develop enterprise within the organization.

Organizational Policy Development

Any organization's long term success depends upon long-range plans. It is the board of trustees responsibility to see to the long term financial health of an organization:

> Nonprofit institutions are discovering the value of long-range strategic and financial planning as a means of balancing anticipated resources against future financial needs. The board's insistence upon such planning will demonstrate its commitment to permanence, to systematic growth and to the wise utilization of revenues and funding from outside sources.[45]

According to a 1989 news release, Colonial Williamsburg Foundation's seven-year plan has established as a priority, "to enlarge financial resources to assure the

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[44]Keil, 93.

[45]Alan D. Ullberg and Patricia Ullberg, Museum Trusteeship, with a forward by Katherine S. White (Washington, D.C.: American Association of Museums, 1981), 13.

future strength and security of the Foundation.[46]" The Foundation has recognized the importance and necessity of increasing revenue from its enterprises in order to fund its educational programs and support operations.[47]

As a component of a long-range plan, an organizational policy can be developed on revenue or enterprise activities. This is a general policy just as many organizations have a collections management policy. It would outline guidelines for the type of revenue activities in which the organization should be involved. A subcommittee of members of the board of trustees could be created to develop this.

Policy development should start with an overall analysis of all the issues involved with IRS compliance. This includes review of the articles of organization, the purpose of tax exemption, and current IRS guidelines on tax exemption. It should also include examination of the mission statement of the organization. Once this analysis

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[46]Colonial Williamsburg Foundation, "Seven Year Plan Charts Growth For Colonial Williamsburg's Future," A press release from the Colonial Williamsburg Foundation, May 5, 1989, Williamsburg, Virginia.

[47]Ibid., 4.

has been done, the administrators should develop general guidelines for directing future revenue activities.

There are certain questions that should be considered in the revenue guidelines. Does a particular revenue activity comply with the law and IRS interpretation of UBIT? Does it help the organization further its exempt purpose? Does this include the mission statement? Does it fit within the standards and the goals for programs and services the organization wants to have? Each organization will need to develop its own general goals for revenue development as well as the accompanying questions it needs to ask.

The next step is to review current revenue activities. The guidelines may or may not incorporate these. If current activities fall outside of the guidelines, a decision will have to be made about continuing them.

The overall purpose of any of these recommendations is to insure nonprofit compliance with tax exempt purposes. If organizations work successfully within the boundaries of tax law, there is less opportunity for revocation of exempt status and complaints by outside parties. There is also greater assurance of long term organizational stability.

Director of Enterprise

Director of enterprise is a staff level position within the organization handling enterprise activities. Depending upon the size and complexity of the organization, this may be a position with no other job responsibilities or it may be in addition to current responsibilities. In a position where mixed job responsibilities exist, efforts should be made to limit any extra resposibilities.

The position of director of enterprise should be a priority position. If the nonprofit organization is dependent upon earned income the understanding and handling of income activities should be of major importance.

The person serving as director of enterprise should be aware of current issues in the area of earned income, tax exemption, current legislation and organizational revenue policies. They should know what current trends are within the museum field and should report these on a regular basis to the director and board of trustees.

Old Sturbridge Village has this type of position. The merchandising director at Sturbridge is responsible for product development, national product promotions, royalty programs, and leasing of properties.[48] At Old Sturbridge Village, earned income is a large percentage of the revenue budget and the merchandising director coordinates many of the earned income activities.

Organizational Awareness

The entire staff needs to understand the organization's purpose. This includes the mission, programming and enterprise activities. Everyone, including trustees and part-time staff, needs to understand the direction and purpose for the organization's activities.

This is especially important in the area of enterprises. If an organization has a taxable-subsidiary it is important that all staff understand the reasons for the enterprise and how it relates to promoting the exempt purpose of the organization.[49]

If staff members understand the relationship of enterprise activities with promoting the organization's purpose it will help foster better morale and insure greater success.

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[48]Crawford Lincoln, interview with the President of Old Sturbridge Village by the author, October 2, 1898, Sturbridge, Massachusetts.

[49]Keil, 109.

Membership in Professional Associations

There are a number of associations such as the American Association of Botanical Gardens and Arboreta (AABGA), the American Association of Museums (AAM) and the Museum Store Association (MSA) in which museums can be involved . These associations can help in developing professional standards for the organization. They can also act in political advocacy roles, as does the American Association of Museums.

Publications by these organizations provide a variety of pertinent information. There is information on current trends in the museum field. There are guidelines on ethical procedures and policy development. And there is available information on current legislative issues and IRS rulings. The publications catalog of AAM has a wide selection of topics available for purchase. For any institution with an Enterprise Director, or a person acting in a similar position, they should have access to publications from these sources. Membership in any of these includes monthly or semi-monthly publications and newsletters.

Promotional Outreach of Exempt Purpose

There are a number of things an organization can do to promote its tax-exempt purpose within the community to increase visitation and support.

Nonprofit Marketing

Promote the institution through nonprofit marketing.[50] Nonprofit marketing uses general marketing principles to promote the organization's purpose: the approach of marketing intangible products.

Understand the Visitor's Perception

In order an for organization to promote itself, it needs an understanding of the consumer's perception or the visiting public's perception of the institution.[51] This can be achieved through a visitor study or a psychographic study.

Psychographics is a specialized approach to visitor studies using a combination of demographics and surveys to

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[50]James D. Bigley, "Marketing Museums: Background and Theoretical Foundation," Museum Studies Journal (Fall/Winter 1987): 14.

[51]Ibid.,18.

determine the lifestyle dimensions of individuals.[52] Psychographics can help organizations recognize the personal values held by the community and why they do or do not visit the museum. This information can be used in developing any or all of the museum's future plans.

Educate Visitors and Potential Visitors

The first step in marketing a product is to educate the visitor; then sell the product. Once the public's perception is determined, they need to be educated about the organization.[53] Why should they come there? Museums have an intangible product to develop and promote. An organization must determine what its product is: the mission statement might be of help. This is a decision in which all staff could have input.

At Longwood Gardens in Kennett Square, Pennsylvania, the mission statement includes "promoting the art and enjoyment of horticulture."[54] The intangible product mentioned could be "the enjoyment of horticulture." As an

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[52]Marilyn Hood, "A Comprehensive Approach to Audience Development," The Public Garden, Volume 3, Number 3 (July 1988):16.

[53]Laura Landy, Something Ventured, Something Gained: A Business Development Guide For Nonprofit Organizations, (New York: American Council For The Arts, 1989) 71.

[54]Longwood Gardens, "Mission Statement," Longwood Gardens, Kennett Square, Pennsylvania.

intangible product it has to be experienced, by each individual, in order to receive it. It cannot be purchased, or given as a gift. As an example this intangible product can be illustrated and promoted through the children's garden.

Callaway Gardens markets, "Everything Comes Naturally At Callaway." The mission statement indicates the garden is a man-made landscape in a unique natural setting."[55] Callaway is promoting an intangible product; an image. What does "naturally" indicate to the individual? Can one buy naturally? No, but one can and does experience it at Callaway.

Promote The Product

In addition to determining the public's perception and educating them about the organization's intangible product, there is a threefold stage of promotion to consider. The visitor's perceived benefits must be enhanced. There must be a limitation of the visitor's perceived costs. In addition, there must be an acceptable level of return benefits to the museum.

Increasing the visitor's perceived benefits can be enhanced by increasing services and making the organization

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[55]Callaway Gardens.

a people-oriented place. Through a visitor study or psychographic study, the museum can determine the types of services and amenities visitors want or need. These could include increased directional-signage, improved guide maps, the addition of benches and drinking fountains, wheelchair availability for the handicapped and the provision of enterprise services such as restaurants and gift shops.

Limiting visitor's perceived costs can be encouraged by making the most of the organization. This can include increasing interpretation, developing interactive displays, providing free lectures, concerts and family activities. Increase the number of activities in which the visitor can participate, and provide free information to help reduce the their perceived costs.

Achieving an acceptable level of return benefits has to be determined by each organization. Do the most allowable within the budget. Nonprofits exist to provide services and programs for the public. Make the most of the organization for the visitor. Give the visitor a reason to come back. Enterprise revenue can be used to develop the type of suggested programs.

Community Cooperation

Be involved in the community, know its wants and needs. Do all that the organization can do to meet those needs.

Develop a relationship with the business community. Have members of the business community involved with the board, possibly on a subcommittee for revenue policy. When ideas involving enterprise are developed secure community input. This will lessen the chance of complaints of unfair competition. Do not enter into areas of revenue that will compete with area businesses.[56]

Promote a sense of goodwill between your organization and the community and have community free-days. Residents of Sturbridge, Massachusetts receive free admission to Old Sturbridge Village. This is done because of the large percentage of tax-free property owned by the museum.[57] By promoting goodwill, developing outreach programs and working with area businesses your institution will become a vital part of the community.

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[56]Roland Woodward, interview with Director of Chester County Historical Society by author, May 1989, West Chester, Pennsylvania.

[57]Crawford Lincoln interview.

Obtain Legal Counsel

Most important for all nonprofit organizations to remember is to obtain legal counsel on all decisions involving policies of public organizations, including enterprise activities. In a recent issue of Museum News, Geoffrey Platt Jr., director of governmental affairs, titled his article, "Controversy: No Longer a Question of If, but When."[58] Publicly funded organizations are coming under scrutiny more and more often. It is best to be prepared.

Concluding Remarks

I believe that UBIT is an on-going policy issue. Unfair competition has not been eliminated with any of the past revenue acts and the probability of its solution in the near future is questionable. There are administrative steps that can be taken to structure a nonprofit organization to deal with this legislative issue. It is my opinion that the advice given here should be considered.

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[58] Geoffery Platt Jr., "Controversy: No Longer a Question of IF, but When," Museum News Vol.69, No.2, (March/April 1990): 40.

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APPENDIX A

The following is a list of the organizations that responded to the institutional survey. Originally, fifteen organizations were contacted. Also included in this appendix is a copy of the questionnaire. The organizations are listed according to their location within the AABGA national regions.

<u>Northeast Region:</u>

Mystic Seaport, Inc. ; Mystic, CT.

Old Sturbridge Village; Sturbridge, MA.

<u>Mid-Atlantic Region:</u>

Longwood Gardens; Kennett Square, PA.

Monticello; Charlottesville, VA.

Winterthur Museum; Winterthur, DE.

<u>Southeastern Region:</u>

Callaway Gardens; Pine Mountain, GA.

Marie Selby Botanical Garden; Sarasota, FL.

Memphis Botanical Garden; Memphis, TN.

Midwestern Region:

Chicago Botanical Garden; Chicago, IL.

Chicago Historical Society; Chicago, IL.

Children's Museum of Indianapolis; Indianapolis, IN.

Western Region:

Monterey Aquarium; Monterey, CA.

San Diego Zoological Society; San Diego, CA.

INSTITUTIONAL QUESTIONAIRE

1. What has been your net revenue, non-endowment, earned income for fiscal years:

   a. 1979 ____________ Total operating budget ____________.

   b. 1984 ____________ Total operating budget ____________.

   c. 1988 ____________ Total operating budget ____________.

   As a suggestion, this information could come from Internal Revenue Form 990/ Return of Organization Exempt From Income Tax, part 1, lines 9, 10 and 11.

2. In what income-generating activities is your institution involved ? (Circle those appropriate.)

   a. Bookstore sales and gift shop sales of items
   b. Reproduction programs
   c. Tour and travel programs
   d. Royalty income
   e. Taxable sudsidiaries
   f. Joint ventures or concessions such as food services
   g. Facility Rental
   f. Other ______________________________
   ____

3. Is your institution dependent upon these funds for operating expenses?

   a. yes
   b. no

4. If UBIT were passed would your institution, if involved in unrelated activities: (Circle the appropriate answer.)

   a. drop the revenue generating activity?
   b. pay the taxes?
   c. increase activities to generate more income?
   d. develop a feeder organization to umbrella the activity, such as a profit making subsidiary?
   e. other ______________________________
   ______________________________.

5. Do you feel the unrelated business activities, as defined by the draft proposal, are an integral part of your institutions mission? Please comment briefly.

UNRELATED BUSINESS INCOME TAX AND

NONPROFIT ADMINISTRATIVE OPTIONS

By

Susan G. Olson

An abstract of a Thesis submitted to the Faculty of the University of Delaware in partial fulfillment of the requirements for the degree of Master of Science in Public Horticulture Administration.

August 1990

Approved: James E. Swasey
James E. Swasey, Ph.D.
Professor in charge of Thesis

ABSTRACT

Unrelated business income tax (UBIT) is an ongoing policy issue. It provides challenges and opportunities to the nonprofit administrator for revenue generation: opportunities for promoting exempt purposes and public service.

Before I could make recommendations a background study of UBIT had to be completed. This included the underlying issue of unfair competition. Unfair competition has been a complaint since the ratification of the Sixteenth Amendment which empowered Congress to collect income taxes. Over the years numerous attempts have been made by Congress to address the unfair competition issue including the tax reform of 1950 which instituted UBIT and the tax reform of 1969.

A 1983 report by the Small Business Administration (SBA) on the issue of unfair competition asked for Congressional action limiting nonprofit, commercial activities. In 1986 the Congressional House Ways and Means Subcommittee on Oversight initiated a study of UBIT, a

review of nonprofit income activities and of the Internal Revenue Service and the court system in administering the law. The subcommittee subsequently developed the UBIT proposals in June of 1988 which will affect nonprofit income activity if legislated.

In this thesis the UBIT proposals have been summarized according to those most affecting museums. A small national survey was conducted to gather information on museum income activity and results are presented.

Historically the issue of UBIT has been a result of nonprofit revenue generation. A study of nonprofit funding is critical to the issue of UBIT and included is a brief review of the funding of nonprofits.

My conclusion on the issue of UBIT is the necessity for an indepth study on nonprofit funding by the subcommittee. Also included in this subcommittee study should be the effect of UBIT proposals on nonprofit funding.