The Nonprofit Advantage: Fire or Smoke?

If you've been caught in the "unfair competition" crossfire, here's the ammunition you need.

BY JEFFRY R. HABER

The unfair competition debate has evolved to a shouting match. For–profits claim that nonprofits have an unfair advantage, due to tax exemptions and other special treatments.[1] Nonprofits have answered these charges in two main ways:

1. Since the benefits were given to nonprofits, using those advantages can't be unfair competition.
2. Nonprofits' missions serve a useful purpose in society, and they relieve government of a burden. Therefore, they deserve an advantage.

But there is a third argument, rarely voiced. What if there *is* no advantage? Or what if the advantage is negligible?

The problem is lack of research measuring the nonprofit advantage. In some reports, the Treasury Department has calculated nonprofits' financial benefit over for–profits as 35% to 40%. But that is merely a guess. No one has quantified the nonprofit advantage, till now.

Most studies assume that nonprofits enjoy a large financial advantage. But what if we can show that a nonprofit uses few of the benefits available? Then the "unfair advantage" contention would be specious. The nonprofit would have *no* financial advantage, fair or unfair.

So far, anecdote rather than research has fueled the debate. What we need are case studies of nonprofits suspected of competing with small businesses. This article provides a model for such studies.[2]

Potential Nonprofit Advantages

Researchers have compiled an extensive list of potential nonprofit advantages.[3] These include:

1. Sales tax exemption
2. Reduced postal rates
3. Antitrust exemption
4. Exemption from federal unemployment tax
5. Property tax exemption
6. Ability to issue tax–exempt bonds
7. Ability to receive tax–deductible contributions
8. Income tax exemption
9. Income tax–deferred retirement and compensation plans
10. Broad array of special tax treatments
    - Federal estate tax charitable deduction
    - State inheritance and succession taxes
    - Federal tax deduction for inter–vivos gifts
11. Federal excise taxes
12. Securities regulation exemptions
13. Labor regulation
    - Federal wage and hour laws
    - Federal collective bargaining laws
    - Federal anti–discrimination laws
    - State workers' compensation acts
14. Copyright law
15. Exemption from criminal and civil liability
16. Government assistance programs
17. Surplus government property
18. Financial reporting and accounting standards

FIRE?

Case Study

Now let's see how one nonprofit uses each of these benefits. The nonprofit studied is a private school serving children with a disabling condition.[4] We'll call it Outreach School. Its annual expenses are shown in Table 1.

We studied Outreach School's records for one fiscal year.[5] From these records, we calculated the dollar amount Outreach School received from each benefit. Here is what we found:

1 **SALES TAX EXEMPTION.** As a tax–exempt entity, Outreach School pays no sales taxes. To assess this benefit, we analyzed the school's financial report. We listed the expenses ordinarily subject to sales tax. These expenses amounted to $71,843 (see Table 2). We multiplied this figure by the tax rate (7.25%).[6] The result ($5,209) is the benefit of sales tax exemption.

2 **REDUCED POSTAL RATES.** Nonprofits are eligible for discounted postal rates. The discount depends on two things: (1) the size of the mailed pieces, and (2) the amount of pre–sorting and bundling the nonprofit does.

To receive reduced rates, a nonprofit must complete postal form 3602N. This form accompanies the mailing and gives such information as number of pieces, size, weight, bundling, and level of pre–sort. Using this form, we can easily compute the value of reduced postal rates. We simply take the cost a for–profit would pay for the same mailing, less the cost to the nonprofit, times the number of mail pieces.

Outreach School told us that they did not use reduced mailing rates. Our review of their records supported that fact. Thus, Outreach School received no benefit from this item.

3 **ANTITRUST EXEMPTION.** As Table 3 shows, nonprofits are exempt from only one major antitrust law—the FTC Act.[7] Since Outreach School did not merge or acquire any company, it didn't benefit from FTC exemption. Outreach School is highly regulated, just as for–profits are. Therefore, this item provides no financial benefit.

4 **EXEMPTION FROM FEDERAL UNEMPLOYMENT TAX.** Nonprofits are exempt from federal unemployment tax (FUTA).[8] They are not, however, exempt from state unemployment tax. Thus, Outreach School files a state payroll return. We used this tax return for our calculations. As our figures show, the benefit Outreach School received by not paying FUTA is $9,564. (See Table 4.)

Outreach School does not use volunteers, but if it did, we would add the value of volunteer labor (up to $7,000 per volunteer) to the wage base.[9] Since for–profits don't have access to a volunteer pool, they would have to pay wages and payroll tax to obtain similar services.

5 **PROPERTY TAX EXEMPTION.** Nonprofits can be exempt from real estate taxes when they own property. To obtain this exemption, they must prove that they use their property solely to fulfill their charitable mission.[10] They can also be exempt when they rent from another nonprofit that has obtained property tax exemption. Nonprofits that rent from commercial landlords pay real estate taxes in the same way as for–profits, either inherently in the

> **The unfair competition debate has evolved to a shouting match.**

SMOKE?

monthly rent payment or as a separate pass–along.

Outreach School shares a building, and the entire building is tax exempt. To determine this benefit's value to Outreach School, we first searched the property tax rolls to find the building's assessed value.[11] Then we multiplied the assessed value ($5,688,300) by the tax rate (2.0663%). This gave us the total exemption for the building ($117,537). Finally, we multiplied that total by the percent of square feet that Outreach School used (23%). The result ($27,034) is the value of property tax exemption to Outreach School. (See Table 5.)

6 **ABILITY TO ISSUE TAX–EXEMPT BONDS.** Nonprofits can issue bonds that exempt the purchaser from paying taxes on the interest. This has the effect of lowering the interest rate the nonprofit must pay to get financing. There are sometimes high costs to float tax–exempt financing, but these costs tend to mitigate the benefit rather than fully offset it.

Outreach School did not use tax–exempt financing. If it had, we would have based our benefit calculation on the cost of conventional financing less the tax–exempt financing cost.

In the year of our study, Outreach School partially financed operations through nonpayment of costs allocated to it by a related entity. The related entity paid the costs and charged them to Outreach School. The related entity's financial statements show that it used conventional financing, which would have been available to a for–profit. If the related entity had used tax–exempt financing, then we would have computed an allocated benefit.

7 **ABILITY TO RECEIVE TAX–DEDUCTIBLE CONTRIBUTIONS.** Nonprofits can receive contributions that yield a tax deduction to the donor. Some nonprofits also receive donations of volunteer time.

Outreach School did not receive donations of any type. If it had, we would have totaled the amount of donated money, fair value of donated goods, and market value of donated labor. These calculations would have given us the benefit of receiving tax–deductible contributions.

8 **INCOME TAX EXEMPTION.** As part of our study, we analyzed Outreach School's financial records. We found that the school recalculates its revenues retroactively to equate revenues and expenses. Therefore, Outreach School broke even (neither surplus nor deficit) for the year. There is no benefit to income tax exemption, since no net income was generated. Had Outreach School been a for–profit, there would have been no income taxes due, either, as the for–profit would have had the same retroactive, break–even funding.

For–profits pay a minimum state and local tax from which nonprofits are exempt. On the other hand, nonprofits must pay a state and local filing fee. Since the filing fee and minimum tax are about the same amount, no financial advantage exists.

9 **INCOME TAX–DEFERRED RETIREMENT AND COMPENSATION PLANS.** Nonprofits can set up retirement plans similar to those of for–profits. They also have access to retirement plans unavailable to for–profits. These take the form of tax–deferred annuities (TDAs) or tax–sheltered annuities (TSAs).

Outreach School has set up a variety of TDA plans. The school does not contribute any money to the retire-

So far, anecdote rather than research has fueled the debate.

FIRE?

ment funds. It simply gives employees the option of putting their own pre–tax wages into the funds. This 403(b) plan is comparable to the for–profit 401(k) plan. Thus, there is no financial benefit to this item.

10 **BROAD ARRAY OF SPECIAL TAX TREATMENTS.** All three elements under this heading (federal estate tax charitable deduction, state inheritance and succession taxes, and federal tax deduction for inter–vivos gifts) fall under Item #7, "ability to receive tax–deductible contributions." Since Outreach School did not receive any contributions, there is no value to this benefit.

11 **FEDERAL EXCISE TAXES.** Nonprofits are exempt from a variety of federal excise taxes. Two apply to Outreach School. First, Outreach School is exempt from part of the gasoline excise tax. However, in New York, where Outreach School operates, a nonprofit must pay this tax at the time of purchase and fill out a form to recapture the tax paid. Outreach School did not apply for the refund because of the insignificant amount involved. Therefore, there was no benefit.

Second, Outreach School is exempt from the communications excise tax. This represents a 3% savings on the cost of telephone usage, or $236. See Table 6.

> **In some cases, the nonprofit advantage is a smokescreen created by for-profits to cover their own inefficiencies.**

12 **SECURITIES REGULATION EXEMPTION.** Nonprofits are exempt from some federal and state securities regulations. As Outreach School did not transact any business that took advantage of these exemptions, there was no benefit.

13 **LABOR REGULATION.** All labor laws, with a few specific exceptions, apply to nonprofits. Outreach School is subject to all labor regulations, including wage and hour laws, anti–discrimination laws, and workers' compensation laws. As there is no union at Outreach School, collective bargaining laws and any related exemptions are not germane.

14 **COPYRIGHT LAW.** Certain nonprofits (such as teaching facilities) have wider latitude than for–profits in using copyrighted publications. Outreach School does photocopy materials for its educational programs. Through our review, we found that the publisher designed these materials for educational purposes. Outreach School put the publications to their intended use, and for-profits could have used them in the same way. Hence, no benefit arises.

15 **EXEMPTION FROM CRIMINAL AND CIVIL LIABILITY.** Nonprofits are exempt from certain types of liability in specific, limited circumstances. Outreach School did not benefit from these exemptions.

16 **GOVERNMENT ASSISTANCE PROGRAMS.** Several government programs benefit nonprofits. For example, the U.S. Department of Agriculture uses nonprofit status as a threshold for its programs.[12] Outreach School has not benefitted from such programs.

SMOKE?

17 **SURPLUS GOVERNMENT PROPERTY.** Nonprofits can receive surplus federal property. Outreach School does not take advantage of this potential benefit.

18 **FINANCIAL REPORTING AND ACCOUNTING STANDARDS.** Nonprofits' reporting standards are similar to for–profits' standards in some ways and dissimilar in others. The differences give nonprofits no advantage. Indeed, our conversations with bankers, credit analysts, and rating–company staff suggest that few people understand how to read nonprofit financial statements—a definite drawback. Thus, for–profits probably have an advantage over nonprofits when it comes to financial reporting differences.

FIRE OR SMOKE?

Now let's add up all the financial benefits Outreach School received in the year under study. (See Table 7.) Our figures show that the annual advantage Outreach School receives from its nonprofit status is $42,043.

As we noted in Table 1, Outreach School's expenditure for the year was $1,446,506. Therefore, a similar for–profit

Conjecture should not be the basis for eliminating competition.

TABLE 1
ANNUAL EXPENSES, BY TYPE

Salaries	$ 933,162
Fringe Benefits	223,208
Purchase of Services	12,878
Supplies & Equipment	16,592
Gasoline Purchases	186
Rent—Equipment	7,434
Rent—Vehicles	1,974
Utilities	22,046
Repair & Maintenance	15,758
Telephone	7,853
Postage	2,847
Depreciation	30,146
Administration	116,960
Food	1,486
Activities	2,132
Dues and Licenses	1,880
Subscriptions	505
Conference	137
Help Wanted Ads	830
Legal and Audit	16,000
Insurance	32,492
Total	$1,446,506

TABLE 2
BENEFIT FROM SALES TAX EXEMPTION

Expenses Normally Subject to Sales Tax	Amount
Supplies & Equipment	$16,778
Rent—Equipment	7,434
Rent—Vehicles	1,974
Utilities	22,046
Repair & Maintenance	15,758
Telephone	7,853
Total	**$71,843**
Tax Rate	.0725
Benefit	**$ 5,209**

TABLE 4
BENEFIT FROM FUTA EXEMPTION

Quarter	Taxable Base	State Rate	Applicable Rate*	FUTA Benefit
Sept 92	18,255	2.4%	3.8%	694
Dec 92	16,174	2.4%	3.8%	615
Mar 93	207,790	3.1%	3.1%	6,441
Jun 93	58,529	3.1%	3.1%	1,814
Total Benefit				$9,564

*Derived by taking the federal rate of 6.2% and subtracting the state rate.

TABLE 3
WHICH ANTITRUST ACTS APPLY TO NONPROFITS?

Act	Covers	Applicable?
FTC Act	mergers and acquisitions	No
Sherman Act	monopolies, combinations in restraint of trade	Yes
Clayton Act	anti–competitive mergers and acquisitions	Yes
Hart–Scott–Rodino	reporting mergers and acquisitions before they happen	Yes

TABLE 5
BENEFIT FROM REAL PROPERTY TAX EXEMPTION

Assessment:	
Land	$ 242,100
Building	5,446,200
Total Assessment	5,688,300
Tax Rate	.020663
Real Property Taxes	117,537
Share of Square Footage	23%
Total Benefit	$ 27,034

TABLE 6
BENEFIT FROM EXEMPTION FROM FEDERAL EXCISE TAXES

Telephone Costs	$7,853
Excise Tax Rate	3%
Value of Benefit	$236

much benefit is actually used, rather than relying on assumptions and gut feelings. Conjecture should not be the basis for eliminating competition. ■

TABLE 7
SUMMARY OF TOTAL BENEFIT

Benefit from:	
1. Sales tax exemption	$ 5,209
2. Reduced postal rates	0
3. Antitrust exemption	0
4. Exemption from federal unemployment tax	9,564
5. Real property tax exemption	27,034
6. Ability to issue tax–exempt bonds	0
7. Ability to receive tax–deductible contributions	0
8. Income tax exemption	0
9. Income tax–deferred retirement & compensation plans	0
10. Broad array of special tax treatments	0
11. Federal excise taxes	236
12. Securities regulation exemption	0
13. Labor regulation	0
14. Copyright law	0
15. Exemption from criminal & civil liability under certain circumstances	0
16. Government assistance programs	0
17. Surplus government property	0
18. Financial reporting & accounting standards	0
Total	$42,043

business would have had expenditures of $1,488,549 ($1,446,506 plus $42,043).

As a percentage, then, Outreach School's financial advantage is 2.82%. Whether a 2.82% advantage is significant is a matter of opinion. It is probably far less than most people would have expected.

Of course, this 2.82% advantage is not representative of all nonprofits. We can, however, use the same calculations described here to obtain the benefit percentage for any nonprofit.

This percentage is a useful figure to have available. It's a good idea to perform these calculations for your own organization.[13] Then you will have the figure at your fingertips whenever the question of "advantage" is raised.

When you do these calculations, you may find that you have a significant advantage over for–profits. Or you may find that the advantage is immaterial—a smokescreen created by a for–profit to cover its own inefficient operations or substandard service.

The key is to understand how

Footnotes

[1]See Haber in "Selected References."

[2]We obtained the information used in this article from public information and government filings. Figures are given in the tables. For more information, contact the author.

[3]Bennett and DiLorenzo identified items 1–9 in 1989. Facchina, Showell, and Stone added items 10–18 in 1993. See "Selected References."

[4]This 10–year–old school, with $1.5 million annual revenues, is located outside New York City. It is a 501(c)(3) nonprofit, receiving the broadest array of potential benefits. We chose the school for this study because: (1) It was accessible and cooperative. (2) It has a single location, reducing data–gathering complexity. Simplicity is desirable, since our main concern is the path to results, not the results themselves.

[5]Our calculations were for the fiscal year ended June 30, 1993.

[6]A nonprofit with more than one location might have different tax rates. Since the school has a single location, however, there is only one rate. Outreach School bought everything locally, so the local rate applies to all its purchases.

[7]Information from L. Edward Bryant, "Should Not–For–Profit Organizations Be Exempt from Antitrust Laws?", *Healthcare Financial Management*, June 1988, pp. 70–85.

[8]FUTA is based on a rate of 6.2% applied to the taxable wage base. This base is the first $7,000 paid to each employee during the year. Outreach School's state unemployment tax has a similar base. As Table 4 shows, Outreach School had two state tax rates for the year.

Rather than using a tax rate to pay the state, nonprofits can pay unemployment claims on an "as incurred" basis. If Outreach School had used this option, we would have compared what it paid on the "as incurred" basis with what it would have paid based on a state tax rate.

[9]See Dalsimer in "Selected References."

[10]See Lane in "Selected References."

[11]Though no tax is due, the building is still assessed.

[12]For a good discussion, see Facchina, Showell, and Stone (listed in "Selected References.")

[13]For more details on obtaining quantifiable figures, see Haber in "Selected References."

Selected References

Bennett, James T. & Thomas J. DiLorenzo, *Unfair Competition: The Profits of Nonprofits*, Maryland: Hamilton Press, 1989.

Bennett, James T. & Thomas J. DiLorenzo, "Are Nonprofits Wolves in Sheep's Clothing?" *Business & Society Review*, Fall 1988, pp. 40–44.

Nonprofit World • Volume 15, Number 2 March/April 1997
Published by the Society for Nonprofit Organizations
6314 Odana Road, Suite 1, Madison, WI 53719 • (800) 424-7367

Broadhead, William M., *Competition Between For–Profits & Nonprofits*, Washington, D.C.: Independent Sector, 1984.
Chilingerian, Jon A. & H. David Sherman, "For–Profit vs. Non–Profit Hospitals: The Effect of the Profit Motive on the Management of Operations," *Financial Accountability & Management*, Autumn 1987, pp. 283–306.
Copeland, John & Gabriel Rudney, "Business Income of Nonprofits & Competitive Advantage—II," *Tax Notes*, December 1986, pp. 1227–1236.
*Dalsimer, John Paul, "Financial Records & the Value of Volunteers," *Nonprofit World*, May–June 1986.
Davis, Karen, "Economic Theories of Behavior in Nonprofit, Private Hospitals," *Economic & Business Bulletin*, Winter 1972, pp. 1–13.
Davis, Nancy M., "Profits vs. Nonprofits: The Competition Complex," *Association Management*, August 1986, pp. 24–34.
Facchina, Bazil, Evan Showell & Jan E. Stone, *Privileges & Exemptions Enjoyed by Nonprofit Organizations: A Catalog & Some Thoughts on Nonprofit Policymaking*, New York University, 1993.
Fisch, Jennifer, "National Survey Attempts to Quantify the Sector," *The Nonprofit Times*, January 1992, pp. 1,8.
General Accounting Office, *Competition Between Taxable Businesses & Tax–Exempt Organizations*, Washington, D.C.: U.S. General Printing Office, February 1987.
*Haber, Jeffry R., "Nonprofit Competition with Small Business: A Roadmap Leading to Answers," *Nonprofit World*, May– June 1994, pp. 14–18.
Herzlinger, Regina E. & William S. Krasker, "Measuring the Economic Performance of For–Profit & Nonprofit Organizations," *Research in Governmental & Nonprofit Accounting*, 1986, pp. 151– 172.
Hodgkinson, Virginia A., *Dimensions of the Independent Sector*, Washington, D.C.: Independent Sector, 1984.
La Barbera, Priscilla Ann, "Commercial Ventures of Religious Organizations," *Nonprofit Management & Leadership*, Spring 1991, pp. 217–234.
*Lane, Marc, "Why Is Our Property–Tax Being Challenged?", *Nonprofit World*, January–February 1992.
Lumsdon, Kevin, "Pressure Growing in the Fight to Stay Tax Exempt," *Healthcare Financial Management*, January 1991, pp. 21– 28.
*Millman, Judith, "Unfair Competition? The Answer Will Shape Nonprofits' Future," *Nonprofit World*, July–August 1989.
*Muehrcke, Jill, *Law & Taxation*, *Leadership Series*, *Vol. I & II.*
Newhouse, Joseph P., "Toward a Theory of Nonprofit Institutions: An Economic Model of a Hospital," *The American Economic Review*, March 1970, pp. 64–74.
Nielsen, Waldemar A., *The Endangered Sector*, New York: Columbia University Press, 1979.
O'Neil, Joseph F., "Do Nonprofits Have an Unfair Advantage in the Marketplace?", *CFO*, December 1987, pp. 8,11.
Ogur, Jonathan, "The Nonprofit Firm: A Test of the Theory for the Hospital Industry," *The Journal of Economics & Business*, 1974, pp. 115–129.
Rose–Ackerman, Susan, "Unfair Competition & Corporate Income Taxation," *Stanford Law Review*, May 1982, pp. 1017–1039.
Skloot, Edward, "Should Not–For–Profits Go Into Business?", *Harvard Business Review*, January–February 1983, pp. 20–24.
Sloan, Frank A. & Robert A. Vraciu, "Investor Owned & Not–For–Profit Hospitals: Addressing Some Issues," *Health Affairs*, 1983, pp. 25–37.
Steinberg, Richard, " 'Unfair' Competition by Nonprofits & Tax Policy," *National Tax Journal*, Vol. XLIV No. 3, pp. 351–364.
Tuckman, Howard P. & Cyril F. Chang, "Cost Convergence Between For–Profit & Not–For–Profit Nursing Homes: Does Competition Matter?", *Quarterly Review of Economics & Business*, Winter 1988, pp. 50–65.
U.S. Congress, House Committee on Energy & Commerce, *State of the Nonprofit Sector*, Washington, D.C.: General Printing Office, 1989.
U.S. Congress, House Committee on Small Business, *Nonprofit Competition*, Washington, D.C., U.S. General Printing Office, 1988.
U.S. Congress, House Committee on Ways & Means, *Unrelated Business Income Tax*, Washington, D.C.: U.S. General Printing Office, 1988.
U.S. Small Business Administration, *Unfair Competition by Nonprofit Organizations With Small Business: An Issue for the 1980s*, Washington, D.C.: U.S. General Printing Office, June 1984.
Wacht, Richard F., "Nonprofits: Are They Really Businesses?", *New Accountant*, February 1989, pp. 44–48.
Webster, George D., "Will Nonprofit Postal Rates Last?", *Association Management*, January 1988, pp. 122–123.
Weisbrod, Burton A., *The Voluntary Nonprofit Sector*, Massachusetts: Lexington Books, 1977.
Weisbrod, Burton A., *The Nonprofit Economy*, Massachusetts: Harvard University Press, 1988.
Wellford, W. Harrison & Janne G. Gallagher, *Unfair Competition? The Challenge to Charitable Tax Exemption*, Washington, D.C.: The National Assembly, 1988.

*Starred publications are available through the Society for Nonprofit Organizations' Resource Center. For ordering information, see the Society's *Resource Center Catalog*, included in this issue, or contact the Society at 6314 Odana Road, Suite 1, Madison, Wisconsin 53719 (800–424–7367).

Jeffry Haber, Ph.D., C.P.A., is the executive vice president and chief operating officer of Western Capital Financial, Palladian Marketing Group, Asset Protection Group, and Capital Conservation Group. Until recently, he was the chief financial officer of the Astor Home for Children in Rhinebeck, New York. Dr. Haber is a certified public accountant. with B.S. and M.S. degrees in accounting from Syracuse University and a Ph.D. from Rensselaer Polytechnic Institute in Troy, New York. He serves on many committees and task forces dealing with nonprofit and human service issues. He may be reached at 291 Hope Street, Suite 11–A, Stamford, Connecticut 06906 (phone 203–353–9117, fax 203–353–9118).