

# OVERVIEW OF THE TAX-EXEMPT SECTOR

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## HEARING

BEFORE THE

### COMMITTEE ON WAYS AND MEANS

### U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

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APRIL 20, 2005

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## Serial No. 109-6

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## **OVERVIEW OF THE TAX-EXEMPT SECTOR**

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**WEDNESDAY, APRIL 20, 2005**

U.S. HOUSE OF REPRESENTATIVES,  
COMMITTEE ON WAYS AND MEANS,  
*Washington, DC.*

The Committee met, pursuant to notice, at 10:40 a.m., in Room 1100, Longworth House Office Building, Hon. William M. Thomas (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

# **ADVISORY**

## **FROM THE COMMITTEE ON WAYS AND MEANS**

FOR IMMEDIATE RELEASE  
 April 13, 2005  
 No. FC-7

CONTACT: (202) 225-1721

### **Thomas Announces Hearing on an Overview of the Tax-Exempt Sector**

Congressman Bill Thomas (R-CA), Chairman of the Committee on Ways and Means, today announced that the Committee will hold a hearing titled "An Overview of the Tax-Exempt Sector." **The hearing will take place on Wednesday, April 20, 2005, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:30 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. Invited witnesses will include Honorable David Walker of the U.S. Government Accountability Office, Douglas Holtz-Eakin of the Congressional Budget Office, George Yin of the Joint Committee on Taxation, and several legal experts. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

#### **BACKGROUND:**

According to the Internal Revenue Service (IRS), there are over 1.8 million tax-exempt organizations under § 501(c), not including churches and religious organizations. Between 1998 and 2002, the assets of tax-exempt organizations grew from \$2 trillion to more than \$3 trillion.

Congress first defined the exemption for charitable organizations and allowed the first deductions for charitable contributions approximately 100 years ago. Over time, Congress has vastly expanded eligibility to include a wide array of entities. Since 1954, there have been some 35 changes made to § 501(c). There are now 28 tax-exempt categories under § 501(c) covering organizations ranging from public charities and religious organizations to labor unions, trade associations, social clubs, fraternal societies, credit unions, cemetery companies and cooperatives.

In announcing the hearing, Chairman Thomas stated, "This continues the series of hearings we held last year examining the tax-exempt sector. Congress needs a better understanding of how vast and diverse this sector is today. Tax-exemption is an important benefit and the Congress has a responsibility to oversee and assure the American taxpayer that the tax-exempt sector is living up to its legal responsibilities."

#### **FOCUS OF THE HEARING:**

The hearing will examine the legal history of the tax-exempt sector; its size, scope and impact on the economy; the need for congressional oversight; IRS oversight of the sector; and what the IRS is doing to improve compliance with the law.

#### **DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:**

**Please Note:** Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, <http://waysandmeans.house.gov>, select "109th Congress" from the menu entitled, "Hearing Archives" (<http://waysandmeans.house.gov/Hearings.asp?congress=17>). Se-

lect the hearing for which you would like to submit, and click on the link entitled, “*Click here to provide a submission for the record.*” Once you have followed the on-line instructions, completing all informational forms and clicking “submit” on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You **MUST REPLY** to the email and **ATTACH** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Wednesday, May 4, 2005. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225-1721.

#### **FORMATTING REQUIREMENTS:**

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-226-3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

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Chairman THOMAS. Good morning. This is the Committee’s second in a series of hearings on the tax-exempt sector. Last year, the Oversight Subcommittee in a narrow, purposeful hearing focused on the hospital pricing system and its relationship to tax-exempt status, but that focus was primarily on hospitals and their pricing system given profit and not-for-profit in the hospital area. Today’s hearing really is the fundamental hearing to provide a broad overview of the tax-exempt sector. Our government witnesses will provide information about the laws governing tax-exempt organizations, how they are administered, and their economic effects. We have an exceptionally qualified panel of legal experts who will discuss how a patchwork of laws has evolved, leading one of our witnesses to describe it as disparate, irregular, unbalanced, and uneven. The tax-exempt sector has grown significantly since its creation more than 100 years ago. A growth in any area isn’t in and of itself bad, but revenue reported by tax-exempt organizations has grown from about \$3 billion in 1975 to \$1.2 trillion in 2001, according to the Joint Committee on Taxation. In 2001, this amount represented 12.2 percent of the gross domestic product. According to

the government Accountability Office, the tax-exempt sector employs at least 9 percent of the civilian workforce.

Despite the significant size, scope, and economic impact of tax-exempt organizations, there has been no comprehensive oversight by Congress in nearly two decades, and I hesitate to call what occurred two decades ago a comprehensive oversight because I was on the Committee and the Subcommittee. The Committee conducted examinations in hearings on the question of business activities of tax-exempt organizations and whether they should be subject to an Unrelated Business Income Tax. Many charitable organizations provide critical social services to those in need. These organizations benefit greatly from their legal status because they do not pay taxes and because donors can deduct contributions they make to charitable organizations. However, many goods and services provided by tax-exempt organizations are similar, if not identical, to goods and services provided by tax-paying entities. This raises a fairly fundamental question of what makes these organizations unique and, hence, deserving of a tax-exempt status. It is also worth comparing Congressional interest in tax-exempt organizations to its interest of traditional for-profit corporations. When reports of abuse in the corporate world emerged, there was a swift and comprehensive response. Tax-exempt organizations should not be immune from similar scrutiny. The Senate Finance Committee recently held a hearing in which they reviewed abuses in the tax-exempt sector and discussed potential reforms. Our hearing is not intended and will not duplicate their work by examining specific proposals. Instead, it establishes a foundation from which Members can systematically begin to examine the tax-exempt sector and determine what remedies, if any, are needed to provide greater clarity, transparency, and enforcement. Now I recognize the gentleman from New York, Mr. Rangel, for any comments he may wish to make.

Mr. RANGEL. Thank you, Mr. Chairman. I am glad that you shared with me the reason for this hearing. I think the subject matter is very important, especially in view of the explosion of the number of not-for-profits and the amounts of moneys that are involved. I can't for the life of me see how this panel, as distinguished as they are, can help me to deal with some of the problems that it appears as though we are having from organizations, from the Heritage Foundation to the audit of the National Association for the Advancement of Colored People. These are real problems as to whether or not lobbyists are laundering money into these not-for-profits with trips for Members of Congress. There are a lot of things that I would have hoped that the Internal Revenue Service, who has oversight jurisdiction, might help and guide the Congress, but as you indicated, this is going to be an overview of the history of not-for-profits and people who don't pay taxes, so I would hope that some wealthy people would be included, because they don't pay taxes, either, and I don't know what contribution they are making. At a time where there are severe cutbacks in Federal programs and more and more of the majority are saying that people should rely on charitable organizations, I would hope that the testimony we hear today is how we can more effectively support these organizations that tend to provide services for the lower-income

people and the poor people that the for-profits don't have as a priority. May I ask the Chair, do you intend to do oversight of religious organizations, as well?

Chairman THOMAS. I will tell the gentleman that one of the questions that I would begin with is do these people have a constitutional right to tax-exempt status. The answer is for most of them in the area that we are looking at, no. Pretty obviously, religion has another location in the Constitution which gives them a position different than most of these other organizations. That obviously is the First amendment.

Mr. RANGEL. Would not the Internal Revenue Service determine what is a religious organization?

Chairman THOMAS. I will tell the gentleman that is eventually something that could be looked at, because as is commonly known, a number of churches have activities which border on—that don't border on, they are in competition with tax-paying entities. This has been examined in the past. It is, I think, worthy of an examination. The problem is, until you understand the abject failure of Congress to provide adequate statutory direction and oversight of IRS and other agencies is to not understand how we reached the point that the gentleman indicated in his opening statement was of concern to him. Once we establish and understand that, we can then go in and examine various areas. Without this initial understanding of how little has been done in the past and how much needs to be done to create a structure and definitions and transparency, we either go into the knot with a sword and cut it or we learn how to untie it, and the Chair believes that learning how to untie it is the way we ought to go and that is what we are going to begin.

Mr. RANGEL. So, they—

Chairman THOMAS. This will be "Un-Knot-Tying 101."

Mr. RANGEL. They will share with us how a religious organization, what do you have to do to be entitled to be considered a religious organization, since they are giving this broad background, because we have a whole lot of groups out there that call themselves religious and they are nuts, but we will see where we go with this.

Chairman THOMAS. I tell the gentleman that is exactly the problem, because there are people who call themselves charitable. There are people who call themselves—so terminology—

Mr. RANGEL. —religious organizations. I just wanted to—

Chairman THOMAS. Eventually, we will.

Mr. RANGEL. This panel is broad, so they will, too.

Chairman THOMAS. This panel could briefly touch on that. In fact, if the gentleman has, and I know he has, looked at the written testimony, there are offerings of definitions for what should be allowed under this section, which certainly would circumscribe today's activities. Frankly, regulations issued by the IRS have caused additional groups to be qualified as nonprofits when there is no direct relationship in the law that allows them. That is part of the problem.

Mr. RANGEL. IRS is not here—

Chairman THOMAS. No, no.

Mr. RANGEL. This group is. I just hope they venture and give me some guidelines as to what should be a religious organization's

exemptions, Islamic and Muslims and other groups and communities should be given tax exemption.

Chairman THOMAS. The gentleman will have ample time to ask the IRS why they have done what they have done in the past. Without an understanding and structure of what has occurred in the past, it probably would be not as worthwhile an exchange. As we look at the theory and practice of tax-exemption and you begin to get a structure which you believe is appropriate, we can then examine past behavior, and the Chair believes most of the Members of the Committee will be quite surprised at the failure of Congress to exercise its legitimate oversight function in this area. The problem is, without the structure, it is difficult to oversee.

Mr. RANGEL. I thank the Chairman for his generosity, but could I ask, is the IRS in the house? Okay. Thank you.

Chairman THOMAS. That doesn't mean they aren't in the house.

Mr. RANGEL. Well, they can't speak up.

Chairman THOMAS. That just means they don't want to be identified.

[Laughter.]

Mr. RANGEL. Officially, they are not here.

Chairman THOMAS. No, because we aren't going to go into that level of detail. The Chair hopes—in fact, this hearing is for the purpose of a broad outline of the concept, the theory, and the practice of charity and tax exemption.

Mr. RANGEL. Let the games begin.

[Laughter.]

Chairman THOMAS. First at bat—

[Laughter.]

Chairman THOMAS. Welcome back, David Walker, the Comptroller General of the U.S. GAO. Thank you. As I will indicate to all the witnesses, the written testimony that you have in front of you will be made a part of the record and you may address this Committee as you see fit in an appropriate period of time. The Chair wants to underscore, I have no interest in limiting the panel members to a narrow, confined 5 minutes. I would hope that they try to sum up their position and not repeat what others have said to try to create a broad, immediate record in front of the Members as we begin this investigation. Mr. Walker?

[The opening statement of Mr. Larson follows:]

**STATEMENT OF DAVID M. WALKER, COMPTROLLER GENERAL, U.S. GOVERNMENT ACCOUNTABILITY OFFICE; ACCOMPANIED BY MIKE BROSTEK, U.S. GOVERNMENT ACCOUNTABILITY OFFICE**

Mr. WALKER. Thank you, Chairman Thomas, Ranking Member Rangel, other Members of the Ways and Means Committee. It is a pleasure to be back before you today to speak about the tax-exempt sector and related oversight activities. As many of you know, under section 501(c) of the Internal Revenue Code, it covers a diverse number of entities currently estimated to be in excess of 1.5 million entities, varying in size and purpose. Before addressing the topics that the Committee asked, I think it is important to note that in many ways, this sector is indicative of the need for a fundamental review and reassessment of the entire Federal Government

that is mentioned in the document that I mentioned before this Committee before called "Reexamining the Base of the Federal Government," the 21st century Challenges booklet, because what has happened is over many decades, there has been a layering and layering of new tax-exempt entities, new different types of requirements, a significant change in the nature and composition of the tax-exempt portion of the economy, and there is a need to step back and engage in a fundamental review and reexamination of this sector, just as there is in connection with many others. In that regard, I would respectfully commend to each of the Members some of the key questions that are noted on page two of my testimony as an example of some of the broader type of questions that ultimately, hopefully, the Congress will get into at some point down the road with regard to this sector.

Specifically, the Chair has asked that I briefly address the growth of the tax-exempt sector, certain governance practices and transparency mechanisms, related IRS oversight activities, and then what are some issues that the States are involved in. You have the typical very thick GAO testimony that has been provided. I will give you an executive summary. With regard to the size, it is estimated that there are currently over 1.5 million tax-exempt entities and that the reported assets, revenues, and expenses for these entities have grown significantly over the years. For example, between 1998 and 2002, which is the most recent year that we have data available, the reported assets grew by 15 percent to over \$2.5 trillion. Accordingly, the tax-exempt sector represents an increasingly significant part of the Nation's economy and work force, and as the Chairman mentioned, 11 to 12 percent of the economy. With regard to work force, if I can show the first slide, which is on page ten of my testimony, you will see that the tax-exempt sector as of the year 2002 was estimated to employ about 9 percent of the civilian work force. So, not only with regard to the size of the economy, but also the size of the work force.

Clearly, good governance and transparency mechanisms are essential elements to assure that tax-exempt entities operate with integrity and effectiveness and to prevent potential abuse. All of us are aware of recent concerns about certain abuses in the tax-exempt sector and, therefore, renewed attention to good governance practices and to enhancing transparency and improving oversight is called for. At the same time, I think we all can recognize a vast majority of these entities and the individuals who comprise them try to do their jobs in accordance with laws and to the best of their ability every day. With regard to staffing trends, you will see that based upon this first slide, that there has been a decline in the overall exam rate within the IRS, but that actually, while the overall exam rate has started to increase, the increase started earlier in the tax-exempt sector than it did overall. Yet, the tax-exempt exam rate is still far below average, and as one might expect, far below for-profit entities.

In addition to that, you will see that for fiscal year 2005, the number of full-time equivalents, or employees, who are being assigned to the examination process in the tax-exempt area is increasing for the first time in the last several years. So, there is a marked increase in 2005. Furthermore, you will note that the num-

ber of “no changes” that result in exams as a review of the Form 990, which is the annual report that these tax-exempt entities have to file, has declined. Stated differently, the number of changes has increased in the last year, as can be demonstrated by this particular graphic. With regard to activities by the States, in addition to the Internal Revenue Service focusing on this sector to the extent of its ability, the information that it has and the resources that have been allocated to it, the States also often oversee tax-exempt entities, frequently focusing on trying to protect the public from fraudulent activities and guarding against misuse of charitable assets. The States and the IRS believe that it would be in the public interest to enhance data sharing between the Internal Revenue Service and the States in order to be able to share more information on their respective enforcement activities. GAO has recommended in the past that steps be taken to increase this data sharing while protecting certain sensitive information from public disclosure.

In summary, because I am trying to make sure that everybody else has an opportunity to speak, tax-exempt entities provide an incredibly diverse set of services to our equally diverse population. They enrich our lives and improve our country. Yet, like all organizations, they are run by human beings. As a result, tax-exempt entities can sometimes engage in inappropriate and unlawful practices. Ensuring that tax-exempt entities run as effectively and efficiently as possible and in line with the purposes of Congress, the reason that they receive their tax-exemption, can be enhanced through strengthening sound governance practices; number two, improving transparency over certain of their operations; and number three, enhanced oversight by the IRS, the States, as well as the U.S. Congress. Regarding oversight by the States and IRS, as I mentioned, additional data sharing would be desirable in order to target enforcement efforts, minimize necessary overlap, and enhance the effectiveness of both parties’ respective activities. Ultimately, the Congress is going to have to decide what activities should benefit from a tax-exemption and what organizations must do in exchange for this tax advantage. As I have testified before this Committee before, it is important to keep in mind that in many years, the tax preferences under the Internal Revenue Code, the total value of those tax preferences, including tax exemptions, exceed total discretionary spending. So, this is a large and growing part of our economy, a large and growing part of our work force, and it is important not to let it be off the radar screen. It is important to relook at this area and reexamine it in light of 21st century changes and challenges. Periodic Congressional oversight is, therefore, critical to ensuring that the tax-exempt sector remains a vibrant contributor to the quality of life in America, at the same point in time while operating with integrity and making sure that entities that are granted tax-favored status, in fact, are serving a public purpose above and beyond entities that have not been granted that status, and as we know, there are many sectors of the economy where you have both not-for-profit and for-profit entities in the same business, health care and education being two examples. There should be some meaningful distinction between those two in order for one to be able to be granted tax-exempt status and an-

other not. As always, the GAO stands ready to help the Congress in reviewing this area, in examining this area, and we look forward to answering any questions you may have, Mr. Chairman. Thank you.

Chairman THOMAS. Thank you very much, Mr. Walker.  
 [The prepared statement of Mr. Walker follows:]

**Statement of The Honorable David M. Walker, Comptroller General, U.S.  
 Government Accountability Office**

Chairman Thomas and Members of the Committee:

I am pleased to participate in today's hearing about the tax-exempt sector and oversight of it. The sector recognized under section 501(c) of the Internal Revenue Code (IRC) covers a diverse group of over 1.5 million entities with varying sizes and exempt purposes (see app. I for types of section 501(c) exempt entities). The breadth and diversity of the tax-exempt sector allows it to address the specific needs of many of our citizens and the general needs of society. The exempt sector, and those that volunteer to assist, also supplements government programs to meet various needs. For example, charities can supplement programs by providing comfort to the aging, health care to the uninsured, and education to the uneducated.

As the nation's tax administrator, the Internal Revenue Service (IRS) has a key role in overseeing the tax-exempt sector. Oversight can help sustain public faith in the sector and ensure that exempt entities stay true to the purposes that justify their tax exemption. It also can help protect the entire sector from potential abuses initiated by a small minority.

Before discussing the work we did for the Committee, I want to frame today's hearing within a broader context. GAO recently issued a report entitled, *21st Century Challenges: Reexamining the Base of the Federal Government*.<sup>1</sup> This report provides examples of a number of key questions that need to be explored in light of our current and projected fiscal imbalances as well as other changes and challenges. It highlights the need for a re-examination of all major federal policies and programs in light of 21st century realities. Although that report did not specifically cover the tax-exempt sector, the sector is a microcosm of the issues raised in the report. While the provisions granting federally recognized tax-exempt status and associated policies have been layered upon one another to respond to challenges at the time, a comprehensive re-examination of the tax-exempt sector has not been done in recent times. On a broad scale, a comprehensive re-examination could help address whether exempt entities are providing services to our citizens commensurate with their favored tax status, whether the current number and nature of exemptions continue to make sense, whether restrictions on the activities of tax-exempt entities remain relevant, and whether the framework for ensuring that exempt entities adhere to the requirements attendant to their status is satisfactory.

Today's hearing provides an excellent forum to launch such a re-examination. Some of the more specific issues that may merit re-examination for the tax-exempt sector include:

- Should the criteria for granting exempt status be reconsidered and do we need as many types of tax-exempt entities?
- Do we need to modify the model used in overseeing tax-exempt entities to ensure that the tax-exempt purpose is met and that fraud or other misuse is deterred?
- What governance standards should apply to the tax-exempt sector, and should particular types of exempt entities have more specific standards?
- Are the operations and activities of tax-exempt organizations sufficiently transparent to support oversight by the public, news media, and federal, state, and local governmental agencies?
- Beyond revoking tax-exempt status and various currently available intermediate sanctions, do we need more intermediate sanctions to deter abuse and enhance accountability while minimizing any damage to those served by the exempt entity?
- Should certain federal audit and internal control requirements apply to tax-exempt entities, and if so, how should the requirements vary according to entities' size or other characteristics?

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<sup>1</sup> GAO-05-325SP.

- Is there sufficient transparency over the total compensation package and its justification for executives and other officials at tax-exempt entities?
- What should be the allowable “lobbying and political” activities in which different types of tax-exempt entities can engage and how should such activities be reported?
- What are the differences between nonprofit and for-profit entities that perform similar missions, such as nonprofit and for-profit hospitals, and do the nonprofit entities provide sufficiently different services to justify their exemption?
- Based on your request, I will discuss
- The growth of the tax-exempt sector, focusing on those entities whose tax-exempt status falls under section 501(c) of the IRC.
- The role of sound governance practices and transparency in ensuring that tax-exempt entities function with integrity and perform their missions effectively.
- IRS's capacity for overseeing those exempt from taxation under section 501(c), results of its oversight activities, and efforts to address critical compliance problems.
- The states' role in overseeing tax-exempt entities and their relationship with IRS in conducting oversight.

To summarize the growth of the tax-exempt sector, we analyzed data filed annually with IRS by section 501(c) entities. To summarize governance practices and transparency in the tax-exempt sector, we reviewed documents published by IRS and others, and official statements made in testimony before Congress. To summarize IRS's oversight capacity, results, and efforts to deal with critical compliance problems, we reviewed IRS's data and interviewed IRS officials. To summarize the role of states and their relationship with IRS, we reviewed our previous reports<sup>2</sup> and outside articles and reports. To the extent possible, we sought data from 1998 through the most recent year available for all descriptive statistics. We reviewed the reliability of the data used and found them reliable for our purposes. We did our work from December 2004 through March 2005 in accordance with generally accepted government auditing standards.

Let me begin by highlighting key points I will make.

- The 501(c) tax-exempt sector has grown steadily in reported assets, revenues, and expenses. For example, between 1998 and 2002 (the most recent year of available data), their reported assets grew 15 percent to over \$2.5 trillion. Accordingly, the tax-exempt sector comprises a significant part of the nation's economy and workforce. For example, spending in the tax-exempt sector appears to be about one-tenth of our economy and the paid exempt workforce appears to be comparable in size to some of the largest sectors of the U.S. civilian workforce, such as food and lodging. The sector's significance in the economy might be greater because the asset, revenue, and expense data are likely understated to some unknown amount. For example, the data do not include all tax-exempt entities under section 501(c) because not all entities are required to file, such as religious entities, and some entities do not file required Form 990.
- Good governance and transparency are essential elements to ensure that tax-exempt entities operate with integrity and effectiveness in carrying out their missions. Governance facilitates well-run operations that dissuade abusive behavior. Transparency sheds light on entities' practices, which enhances incentives for ethical, efficient, and effective operations and facilitates oversight by the public and others. With recent concerns about abuses within the tax-exempt sector, renewed attention is being given to improving governance practices and expanding and increasing the transparency of the sector's operations.
- Staffing trends and insufficient data have contributed to IRS being challenged in executing its oversight role. IRS has begun to increase staffing during 2005, which results in 467 FTE to examine the compliance of about a half million section 501(c) entities that file Forms 990. However, IRS does not know the extent to which these entities comply. Recognizing this, IRS started efforts in 2002 to obtain compliance data for various segments of the exempt sector but had to suspend most of these efforts to use those resources on higher priorities such as pursuing known types of noncompliance. For example, IRS has ongoing special compliance initiatives dealing with critical issues such as excessive compensation and abusive tax transactions involving exempt entities. IRS is also

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<sup>2</sup>See *Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities*, GAO-02-526 (Apr. 30, 2002); *Political Organizations: Data Disclosure and IRS's Oversight of Organizations Should Be Improved*, GAO-02-444 (July 17, 2002); and *Vehicle Donations: Benefits to Charities and Donors, but Limited Program Oversight*, GAO-04-73 (Nov. 14, 2003).

seeking ways to access and better analyze existing data at IRS or elsewhere on exempt entities.

- States often oversee tax-exempt entities, frequently focusing on protecting the public from fraudulent activities and guarding against misuse of charitable assets. States and IRS believe that more data sharing would make their oversight more efficient and effective. Consistent with our earlier recommendations, IRS has improved its processes for sharing data and Congress has been considering a legislative proposal to expanded IRS's authority to share data with specified state officials under appropriate restrictions and protections related to using the data.

My statement today will address each of these topics in turn. Before that, I will provide some background on the tax-exempt sector and IRS's oversight of it.

## BACKGROUND

Internal Revenue Code (IRC) section 501(c) specifies 28 types of entities that are eligible for tax-exempt status and over 1.5 million entities have been recognized as exempt as of 2003.<sup>3</sup> Section 501(c) entities are involved in a variety of activities and exempt purposes. Congress authorized the tax exemption for each type of entity to meet specific purposes, such as health care for the uninsured.

Almost two-thirds of these entities—over 960,000 in 2003—were classified as 501(c)(3) charities, which have exempt purposes such as serving the poor; advancing religious, educational and scientific endeavors; protecting human rights; and addressing various other social problems.<sup>4</sup> About another 20 percent of exempt entities were social welfare organizations, labor unions, and business associations—501(c) (4 through 6), respectively. The remainder covered an array of types of exempt entities with varying purposes and numbers. In 2003, such types included 15 teacher retirement funds, over 10,000 cemetery companies, over 4,000 state-chartered credit unions, an employee-funded pension trust, 20 corporations to finance crop operations, and over 35,000 veteran organizations.

An entity that believes it meets the requirements set by Congress must apply to IRS to obtain tax-exempt recognition by submitting the following:<sup>5</sup>

- Form 1023 (Application for Recognition of Exemption under Section 501(c) (3) of the Internal Revenue Code) or Form 1024 (Application for Recognition of Exemption under 501(a));
- organizing documents, such as the Articles of Incorporation, Articles of Association, Trust Indenture, Constitution, or other enabling documents;
- 4 years of financial data;<sup>6</sup> and
- a full description of the purposes and the activities of the entity.

After receiving tax-exempt recognition, many entities must annually file a Form 990 to report their financial transactions and activities for a “tax year” (see app. II for a copy of Form 990) if annual gross receipts are normally more the \$25,000. Those that have less than \$100,000 in gross receipts and year-end assets of less than \$250,000 may use Form 990-EZ. Generally, entities with gross receipts below \$25,000 are not required to file. Certain types of entities such as churches and religious organizations also are not required to file. Form 990 has information on revenues, expenses, and assets. For 2003, the form had 105 line items on 6 pages as well as 46 pages of instructions plus two schedules. Schedule A covers several areas such as compensation, lobbying, and revenue sources. Schedule B covers the source of contributions to charities and certain other exempt entities, such as IRC Section 527 political organizations.

IRS oversight relies on two activities. First, IRS reviews applications for tax-exempt status to determine whether a tax-exempt purpose is envisioned. IRS can approve or deny the application. Once an application is properly completed, the criterion for approving or denying the exemption is whether the applicant provides sufficient evidence that its operations will match an allowable exempt purpose. Second,

<sup>3</sup>Other types of tax-exempt entities are authorized under other Section 501 subsections such as for cooperative hospital service or educational investment organizations or under other sections such as Section 521 (farmer cooperatives) and Section 527 (political organizations), among others.

<sup>4</sup>Taxpayers may deduct from their taxable income the value of donations to charities, unlike for almost all other types of tax-exempt entities.

<sup>5</sup>Entities that are not required to apply include those that are not private foundations and that have gross receipts of less than \$5,000 as well as churches and church-affiliated entities.

<sup>6</sup>If the entity has operated for less than a year or has not begun operations, a proposed budget for two full accounting periods and a current statement of assets and liabilities will be acceptable. Otherwise, entities that have operated for less than four years should report data for those years.

IRS annually examines some Forms 990 to determine whether selected exempt entities meet various requirements (such as restrictions on political activities). In general, IRS attempts to select entities that it believes are likely to have violated requirements. IRS can accept the Form 990 as filed or change the status of the entity, impose excise taxes for certain types of violations, or revoke the exempt status if the violations are serious enough. IRS can also assess taxes if an entity has not fully paid employment taxes or taxes on unrelated business income.

Given concerns about the tax-exempt sector, the Senate Committee on Finance asked that a panel of experts make recommendations to Congress to improve oversight, transparency, and governance in the sector. To do so, the Independent Sector<sup>7</sup> convened a Nonprofit Sector Panel in October 2004, which includes 24 nonprofit and philanthropic leaders.<sup>8</sup> It provided an interim report of findings and recommendations in March 2005 and plans to issue a final report in June 2005.

#### **TAX-EXEMPT ASSETS, REVENUES, AND EXPENSES HAVE GROWN, MAKING IT A SIGNIFICANT SECTOR IN THE NATION'S ECONOMY**

The tax-exempt sector is growing. During 1998 through 2002, more entities have been filing Forms 990 and reporting higher amounts of assets, revenues, and expenses. These reported amounts indicate that the tax-exempt sector is a significant part of the economy and the civilian workforce.

The data on the growth in assets, revenues, and expenses reported on the annual Form 990 are likely to be understated because not all tax-exempt entities under section 501(c) are included. Entities below certain asset or gross receipt tolerances are not required to file. Nor are various types of religious entities. Further, an unknown number of tax-exempt entities do not file the required Form 990. The number and finances of those not included are unknown.

##### *Tax-exempt Entities Have Reported Increased Assets, Revenues, and Expenses*

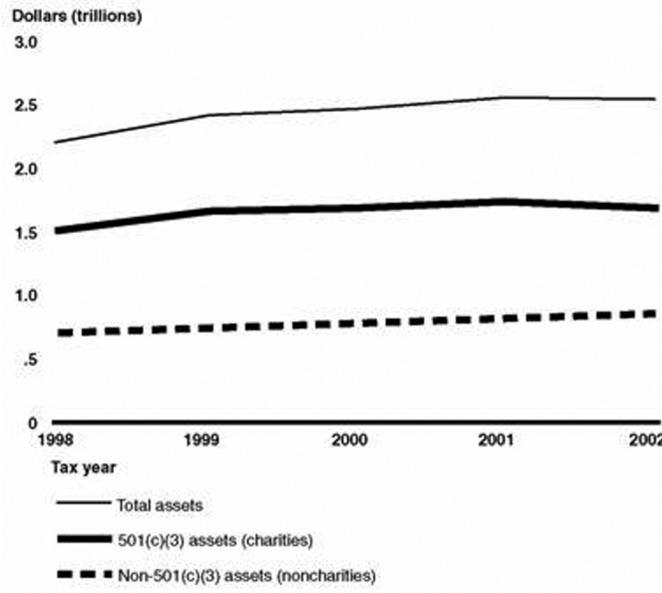
For tax years 1998 through 2002, the number of section 501(c) exempt entities filing a Form 990 grew from about 450,000 to 465,000—about 3 percent (see table 1 in app. III). These Forms 990—of which between 63 and 65 percent are filed by charities—have been reporting higher asset amounts. Figure 1 shows the growth in reported assets for tax years 1998 to 2002 (the most recent year of data). The reported assets grew 15 percent to over \$2.5 trillion—about 12 percent growth for section 501(c)(3) charities and about 22 percent growth for the other 27 types of non-charities covered under section 501(c). (See table 2 in app. III.)

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<sup>7</sup>The Independent Sector is a national coalition of nonprofit organizations, private foundations, and corporate-giving programs that is to support the tax-exempt sector.

<sup>8</sup>The Panel is assisted by over 100 nonprofit executives and other experts on five work groups.

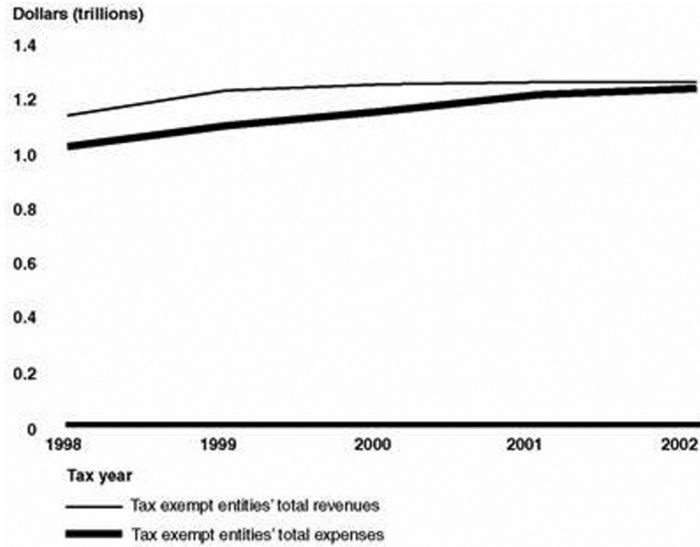
FIGURE 1: ASSETS REPORTED BY SECTION 501(C) ENTITIES IN 2004 CONSTANT DOLLARS, TAX YEARS 1998–2002



Source: Tabulation of data from IRS's Return Inventory Classification System, 1998–2002.

The reported revenue and expense amounts also grew from tax years 1998 through 2002 (see tables 3 and 4 in app. III). However, the amount by which reported revenues exceeded expenses has been closing for exempt entities filing Forms 990—from about 9 percentage points in 1998 to 2 percentage points in 2002 (see figure 2).

FIGURE 2: REVENUE AND EXPENSES REPORTED BY SECTION 501(C) ENTITIES IN 2004  
CONSTANT DOLLARS, TAX YEARS 1998–2002



Source: Tabulation of data from IRS's Return Inventory Classification System, 1998–2002.

#### *Tax-exempt Sector Is a Significant Part of the Economy and Civilian Workforce*

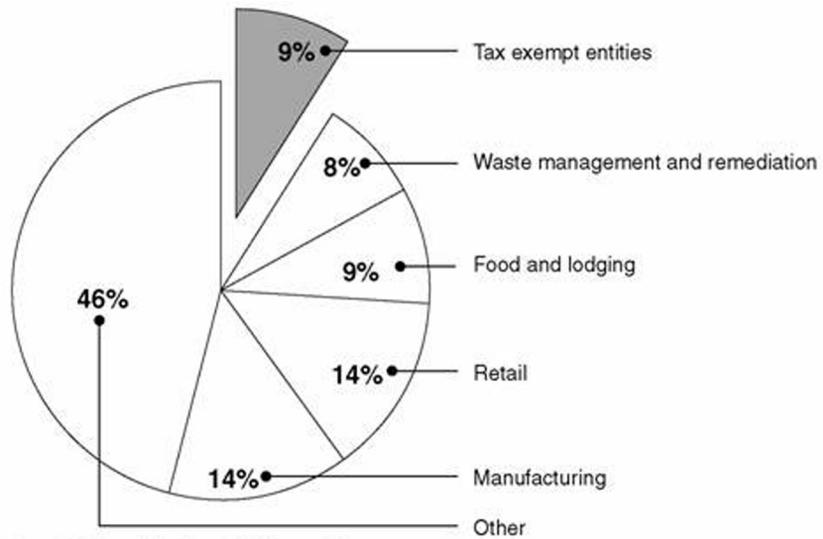
The growth in the tax-exempt sector indicates that it has become a major part of our economy and workforce. From 1975 to 1995, the real assets of entities filing Forms 990 more than tripled while the economy grew 74 percent during the same 20-year period, according to an IRS study.<sup>9</sup> More recently, based on data reported on Forms 990 during 1998 through 2002, spending by tax-exempt entities was roughly 11 to 12 percent of the United States' gross domestic product (GDP).<sup>10</sup> (See table 5 in app. III.) Because the tax-exempt sector is not measured as a specified GDP sector, its percentage of GDP cannot be compared to official GDP sectors such as medical care or housing, which likely include spending by tax-exempt entities. Even so, no single sector accounted for more than 15 percent of the GDP in 2002.

Figure 3 indicates that tax-exempt entities appear to account for a major portion of the civilian workforce. Data from the U.S. Census indicates that over 9.6 million employees in the tax-exempt sector accounted for about 9 percent of the civilian workforce in 2002. Although generally aligned with section 501(c), the Census definition of a tax-exempt entity excluded certain types of entities (such as universities, labor unions, religious organizations, and public administration), which means that the number of tax-exempt employees is understated.

<sup>9</sup> A 20-Year Review of the Nonprofit Sector, 1975–1995, Compendium of Studies of Tax-exempt Organizations, Volume 3, IRS Statistics of Income.

<sup>10</sup> Gross domestic product is the market value of all goods and services produced within a country during a given time period.

FIGURE 3: PAID EMPLOYEES BY ECONOMIC SECTOR AS PERCENTAGE OF U.S. WORKFORCE, 2002



Source: U.S. Bureau of the Census, 2002 Economic Census.

Note: "Other" category includes 13 economic sectors that individually accounted for less than 8 percent of the workforce in 2002, including educational services such as technical, driving, and other specialized training schools; mining; utilities; construction; and real estate.

In addition to paid workers, one study<sup>11</sup> suggests that the number of volunteers at certain tax-exempt entities (which account for at least 60 percent of the sector) grew about 27 percent from 4.5 million in 1982 to 5.7 million volunteers in 1998.

#### **STRONG SELF-GOVERNANCE AND TRANSPARENCY ARE ESSENTIAL ELEMENTS FOR A THRIVING AND EFFECTIVE EXEMPT SECTOR**

Strong self-governance and transparency are essential elements to help provide assurance that tax-exempt entities operate with integrity and effectiveness in meeting their missions while maintaining public trust. A number of requirements help establish governing structures while required public disclosure of information about exempt entities enhances transparency. However, recent concerns about abuses in the tax-exempt sector have prompted consideration of and support for enhanced governance and transparency.

##### *Good Governance Helps Provide Assurance that a Tax-exempt Entity Effectively Manages Funding and Programs*

Governance can be viewed as the collective policies and oversight mechanisms in place to establish and maintain sustainable and accountable organizations that achieve their missions while demonstrating stewardship over resources. Good governance helps ensure that tax-exempt entities are well run and that abusive behavior is minimized. Generally, an organization's board of directors has a key role in governance through its oversight of executive management, corporate strategy, risk management and audit processes, and communications with external stakeholders. This is implicitly recognized in some of the statutory and regulatory requirements for the tax-exempt sector.

For example, to obtain federal tax-exempt recognition, applying entities must include charters and bylaws with their application. The states in which they are established specify what must be included in the charters and/or bylaws and the

<sup>11</sup> IRS does not transcribe data on the numbers of paid workers and volunteers. The Independent Sector issued a nonprofit almanac with data through 1998 on volunteers at entities classified as 501(c) (3) charities, 501(c) (4) social welfare and civic organizations, and religious congregations.

states' requirements help create a basic governance structure for exempt entities. Some states, for instance, have requirements for audited financial statements of tax-exempt entities. For example, in one state, charities with gross revenue in excess of \$100,000 and not more than \$250,000 are required to file financial statements accompanied by a report from a licensed certified public accountant. If gross revenues exceed \$250,000, the state requires an audited financial statement with an independent auditor's report.

In addition, Congress and IRS have various requirements to help ensure that tax-exempt entities do not engage in activities that are inconsistent with their exempt purpose and to promote stewardship over the use of the funds. For instance, to ensure that tax-exempt assets are for public rather than private benefit, IRS has issued regulations affecting tax-exempt entities on "excessive compensation" to officers, directors, or other employees. IRS requires market comparability studies and a review of compensation by boards of directors. If excessive compensation is found, excise taxes under section 4958 for charities and section 4941 for private foundations can be levied against the overpaid individual and certain managers who knowingly approved the payments. (See app. V for an explanation of such excise taxes imposed against private foundations and other tax-exempt entities.)

The federal government also has certain accountability requirements that affect some tax-exempt entities. OMB Circular A-133, for instance, requires those entities, including tax-exempt entities that receive federal awards of \$500,000 or more per year to perform an audit of federal funds received and expended and of the programs for which the funds were received.

#### *Transparency complements good governance*

While strong governance practices can help ensure that tax-exempt entities operate effectively and with integrity, public availability of key information about the entities—i.e., transparency—can both enhance incentives for ethical and effective operations and support public oversight of tax-exempt entities, while helping to achieve and maintain public trust. Recognizing the importance of transparency for tax-exempt entities, Congress provided for substantial transparency regarding tax-exempt entities by making their Forms 990 publicly available documents. This is in stark contrast to the strong protections for the privacy of individuals' tax returns.

Since tax exemptions are granted to entities so that they can carry out particular missions or activities that Congress judged to be of special value, the public availability of the entities' Forms 990 is one means to help ensure that the public has information to judge whether those missions are carried out properly. Presumably, when "sunshine" is let in, inappropriate activities are less likely to occur. In the particular case of charitable organizations, the availability of their Forms 990 provides some information for individuals to use in judging whether to make a donation. Thus, publicly available information helps establish a "free market" in which charities compete for donations, which should encourage efficiency and effectiveness.

At various times, Congress has reinforced the commitment to transparency over the operations of tax-exempt entities. For instance, when some exempt entities were found to be imposing inappropriate fees or other requirements on those seeking to obtain a copy of their Form 990, Congress modified the law to provide that copies must be provided without charge to the individual other than a reasonable fee for any reproduction and mailing costs.<sup>12</sup>

#### *Recent Concerns about Abuses Have Led to Support for Enhanced Governance Processes and Transparency*

With recent concerns about abuses in the tax-exempt sector, attention has been renewed on improving the sector's governance and transparency. Among the proposals being considered for improved governance are enhancing the controls and processes for determining executive compensation, guarding against other misuse of charitable assets, and forestalling tax-exempt entities' participation in tax avoidance schemes. Proposals for enhanced transparency include requiring more information in a more timely and user-friendly fashion on the Form 990.

In recent years, media accounts have publicized certain alleged abuses in the tax-exempt sector that speak to failures in tax-exempt entities' governance. For example, a series of articles in 2003 highlighted possible misuse of foundations and trusts, citing numerous cases of excess compensation, insider loans, self-dealing, ex-

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<sup>12</sup> See IRC Section 6104(d) and changes made by the Tax and Trade Relief Extension Act of 1998, P.L. 105-277.

travagant perks, and other questionable activities.<sup>13</sup> The articles cited, for instance, alleged abuses such as:

- A foundation in New York more than tripled its president's compensation to over \$900,000 between 1997 and 2001.
- A family-based foundation in Chicago paid two family members over \$1 million during a 5-year stretch and donated only \$175,000 to charities.

Another series of articles pointed to the apparent misuse of easements.<sup>14</sup> An easement is when an owner voluntarily restricts changes to real property, such as to preserve historic buildings and the environment. Donation of the easement to an exempt entity provides an income-tax break to the donor. In some cases, insiders at the charities charged with policing the restrictions imposed by the easements on development may have benefited the most. In other cases, individuals may have claimed tax deductions for easement donations even though local or other laws already required preservation of the property.

Concerns about excessive compensation and whether some tax-exempt entities provide sufficient services to justify their exempt status have surfaced regarding nonprofit hospitals. An example of concerns in these areas has been offered by the Minnesota Attorney General who recently testified on such abuses.<sup>15</sup> Among other things, his office found that certain tax-exempt health care systems paid for trips to vacation resorts by executives and board members without a clear business purpose, and that some nonprofit hospitals provided inadequate levels of "charity" care to patients without the resources to pay. Across the United States, little is known about the extent to which these potential abuses involving excess compensation and the level of services provided by nonprofit hospitals occur. More information about the practices employed by exempt entities to compensate executives and others, and by nonprofit hospitals to serve their patients, would be valuable.

Even as these abuses were surfacing, some organizations within the tax-exempt sector were seeking to improve the governance and transparency within the sector. For example, in recent years, the National Association of State Charity Officials (NASCO), the Independent Sector, and the National Committee for Responsive Philanthropy, among others, have called for revisions to the Form 990.

Others have taken the initiative to establish self-regulatory standards independent of those set by IRS. For example, the Better Business Bureau has established a seal of approval program to help donors make informed decisions and foster public confidence in charities. Charities participating in the program are to provide documentation that the bureau uses to determine whether its 20 standards have been met. These standards address governance and oversight, effectiveness, finances, and public information materials. For example, 5 standards are used to measure governance and oversight such as through an active and independent governing board, and 7 standards are used to ensure that spending is honest, prudent, and in accordance with fund-raising appeals.

Concerns about abuses in the tax-exempt sector also have spurred congressional interests. This House Committee on Ways and Means' hearing exemplifies that interest. In June 2004, the Senate Committee on Finance released a discussion draft of proposals for tax-exempt reforms. The draft discussed more than three-dozen proposals to generate comments about possible legislation. The proposals addressed conflict of interest, federal-state coordination, transparency, governance, best practices, funding for enforcement, among many others. Such proposals mirror similar types of recent requirements to increase accountability and oversight of other types of large public and private organizations, such as corporations, in which ethical, financial, and other abuses have occurred.

The Panel on the Nonprofit Sector responded to such proposals in its March 2005 interim report. In discussing governance and ethical conduct, the report pointed to the need for best practices, accepted standards, self-regulation, and education. To improve governance, the report recommended that charities enforce a conflict-of-interest policy, select board members with some financial literacy, and encourage disclosure of illegal practices. The report also advocated more transparency to enable public oversight and confidence in tax-exempt entities. It concluded that IRS should promote transparency while recognizing the burdens that reporting more data can

<sup>13</sup> The *Boston Globe* ran a series of articles between October and December of 2003 that uncovered questionable practices among foundations and trusts.

<sup>14</sup> The *Washington Post* has been running periodic articles about alleged abuses within the tax-exempt sector. The most recent series, in December 2004, concerned the alleged donation of historic facade easements to obtain inflated charitable contributions.

<sup>15</sup> Testimony of Mike Hatch, Attorney General for State of Minnesota, before the Senate Committee on Finance, April 5, 2005.

place on exempt entities that are small and lack resources. The report supported revising the Form 990, mandating electronic filing in coordination with the states for the Forms 990 and 1023, and increasing the sanctions for not filing an accurate or timely Form 990. The report acknowledged that these steps would not fully dissuade those who want to violate standards, and concluded that some government oversight is necessary.

More specifically, among the proposals being considered to improve governance and transparency are:

- Governance Proposals:

- Require that compensation for all management positions at a charity must be approved annually and in advance, and must be justified in a manner that can be understood by those with a basic business background.
- Require the board of directors of a charity to establish a conflict-of-interest policy, a compliance program to address regulatory and liability concerns, and program objectives and performance measures, among other duties.
- Prohibit board membership to those not permitted to serve on the board of a publicly traded company.
- Establish a prudent investor rule for the investment activities of charities.

- Transparency Proposals:

- Require the chief executive officer of a tax-exempt entity to sign under penalty of perjury that the Form 990 and other forms filed comply with the Internal Revenue Code and that reasonable assurances were given of the accuracy and completeness of the information reported.
- Require disclosure of relationships of a tax-exempt entity with other exempt and nonexempt entities, including the formation of taxable subsidiaries and transactions with these other entities.
- Require disclosure of annual performance goals and measures by charities with over \$250,000 in gross receipts.
- Require disclosure of investments by public charities.

#### **IRS HAS BEEN CHALLENGED TO OVERSEE TAX-EXEMPTS AND IS BEGINNING STEPS TO ENHANCE ITS OVERSIGHT CAPACITY**

Staffing and insufficient data have constrained IRS's oversight of the tax-exempt sector. IRS is in the midst of increasing tax-exempt staffing in fiscal year 2005 and improving its data on tax-exempt entities as well as enhancing its ability to analyze data to help in targeting compliance efforts. IRS has identified compliance problems it deems critical and is taking actions to address them.

##### *IRS Oversight Resources Have Been Relatively Flat Until Recently*

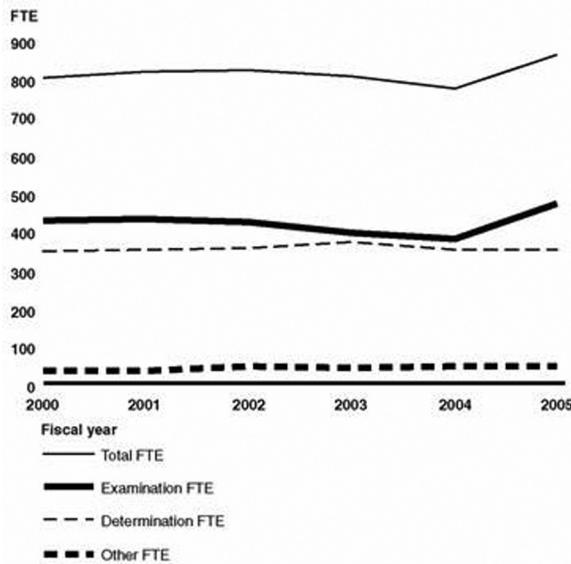
Based on a 1997 IRS memorandum and more recent data, it is apparent that the staffing level for the functions that are now within the Tax Exempt and Governmental Entities (TE/GE) division has been essentially flat since 1974—2,075 in 1974 versus 2,122 in 2004. These are total staffing levels for all of the work done within the current TE/GE, which includes reviewing employee pension plan issues and certain other matters. Although we did not obtain a measure of the overall change in TE/GE workload from 1974 to 2004, the number of 501(c) tax-exempt entities increased from around 670,000 to over 1.5 million.

From fiscal year 2000 through 2004, IRS staffing for overseeing tax-exempt entities stayed relatively flat as measured by the number of full-time equivalent (FTE) staff assigned to oversee tax-exempt entities.<sup>16</sup> For fiscal year 2005, IRS increased the number of FTEs assigned for such work. The assigned FTEs dropped about 4 percent from fiscal years 2000 through 2004 but increased about 11 percent for fiscal year 2005, resulting in a 7 percent increase in assigned FTEs overall (see fig. 4). This 2005 increase is due to the FTEs assigned to do examinations since the FTEs assigned to do determinations of exempt status stayed relatively flat. As of 2005, IRS assigned 467 FTEs to examine the hundreds of thousands of entities who generally file Forms 990 (see table 6 in app. IV).

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<sup>16</sup> An FTE equals 2,087 hours in a year. IRS did not have comparable FTE data for its exempt activities back to 1998 due to its reorganization in 2000. FTEs assigned are what IRS budgets for this work. We were unable to obtain reliable data on the FTEs used for tax-exempt oversight in time for this testimony. However, because IRS may not use the FTEs assigned to examination or determinations for those purposes, the number of hours that staff charge to these oversight tasks may be a better indicator of the level of effort.

Figure 4: Assigned FTEs by Type of IRS Activity, Fiscal Years 2000–2005



Source: IRS Exempt Organization officials.

Note: “Other FTE” includes technical staff who issue rulings, the Director’s staff, and education and outreach.

Competition within IRS for resources helps explain why resources for tax-exempt oversight have not increased much until fiscal year 2005. IRS has many other priorities in collecting the proper amount of tax from tens of millions of individuals and businesses. IRS’s budget emphasizes areas that produce tax revenue rather than areas that are regulatory. IRS oversight of the exempt sector is primarily regulatory rather than revenue producing. IRS exempt officials also said that an ongoing issue is the proper mix of resources budgeted for oversight versus other activities such as providing guidance or education. Beyond tax-exempt entities, TE/GE must also budget resources to deal with pension plans, Indian tribal governments, and other types of government entities.

Congressional tax-writing committees have attempted to provide dedicated funding for exempt oversight. For example, in 1969, Congress added section 4940 to the Internal Revenue Code, which imposes an excise tax on the net investment income of private foundations (see app. V for an explanation of this tax and tax rates). The legislative history indicates that the tax committees intended for the amounts collected from the excise taxes would operate as user fees to fund IRS oversight of exempt entities. To date, congressional appropriation committees, which have jurisdiction over annual funding, have not earmarked these tax collections for this purpose.<sup>17</sup>

IRS has not maintained data on how much excise tax it has assessed or collected under Section 4940 (or any other excise tax that can be assessed against tax-exempt entities either overall or by type of excise tax). However, IRS did have data that showed tax-exempt entities reported owing (i.e., self-assessed), in 2004 constant dollars, at least \$247 million in this excise tax annually (about \$1.5 billion overall) for 2000 through 2003 (see table 10 in app. V). For comparison, the fiscal year 2003 budget for all of TE/GE (i.e., not just tax-exempt oversight functions) was around \$205 million.

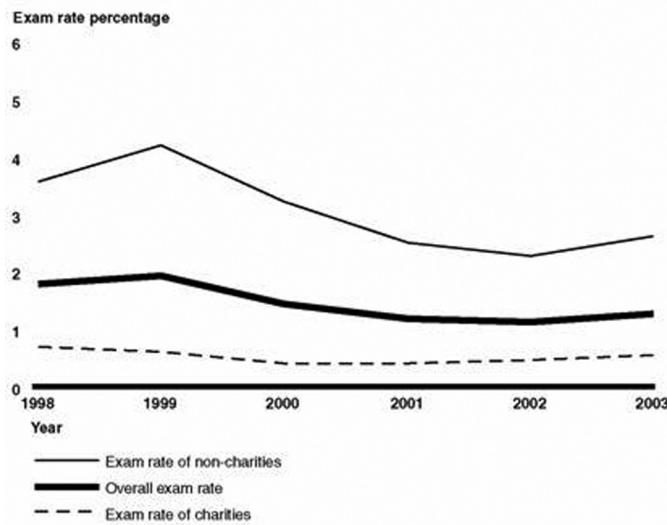
<sup>17</sup> The Nonprofit Sector Panel interim report concluded that Congress should increase resources, and earmark some penalty, fee, and excise tax amounts for IRS exempt oversight and education.

*IRS's Oversight Caseload Has Been Increasing in Recent Years and IRS Has Had Difficulties Sustaining Its Oversight*

For section 501(c) entities, IRS's oversight caseload has been increasing. In its determinations' work involving applications for tax-exempt status, in fiscal years 1998 through 2004, applications increased about 17 percent from 78,358 to 87,080, with some annual fluctuations (see table 7 in app. IV). IRS officials said that IRS must review each application to make a determination of exempt status. IRS's potential tax-exempt examination universe has grown more slowly. As mentioned earlier, the number of exempt entities filing a Form 990 grew from about 450,000 to 465,000 during tax years 1998 through 2002—or about 3 percent.

IRS has had difficulty sustaining a consistent examination rate for tax-exempt entities. As figure 5 shows, the rate at which IRS examined filed Forms 990 fell from 1.8 percent in 1998 to 1.1 percent in 2002 before rising to 1.3 percent in 2003 (see table 8 in app. IV).

Figure 5: IRS Examination Rates for Section 501(c) Entities, Fiscal Years 1998–2003



Source: GAO tabulation of IRS's Audit Information Management System and IRS's Return Inventory Classification System, 1997–2002.

IRS officials said that the declining examination rates primarily resulted from a decline in FTEs for examinations and an increase in the average hours spent per examination. The number of tax-exempt entities that IRS examined decreased from 8,290 in fiscal year 1998 to 5,889 in 2004, or about 29 percent, after dropping as low as 5,423 examinations in 2002. IRS officials said that they have examined more returns since 2002 because they used more of their examiners to examine Forms 990 rather than help elsewhere such as with determinations, and expedited examinations, such as by limiting their scope and depth.

In terms of determinations' results, during fiscal years 1998 through 2004, IRS annually denied about 1 percent of the applications while the approval rate was 74–80 percent (see table 7 in app. IV).<sup>18</sup> Denials occur when IRS determines that an applicant has not met the statutory requirements for exemption. In accordance with the statutory guidance on qualifying for tax-exempt status, IRS is not likely to deny the recognition of tax-exempt status as long as the applicant provides all required documents, files a complete Form 1023, and provides an appropriate statement about its intent to serve an approved exempt purpose.

Regarding examination results, during fiscal years 1998 through 2003, IRS revoked exempt status in 1.2 percent of its examinations. Revocations occur when IRS determines that the entity omitted or misstated a material fact, operated materially

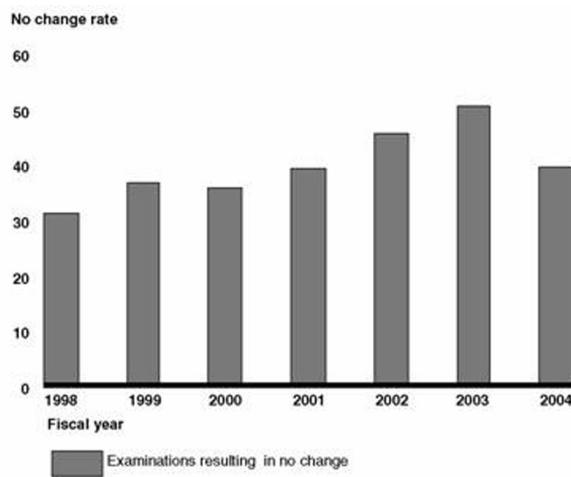
<sup>18</sup>The rest of the applications included those for which IRS had not made a determination for reasons such as applications that were withdrawn or incomplete.

different from its stated exempt purpose, or engaged in a prohibited transaction in conflict with its exempt purpose. IRS does not often revoke tax-exempt status because the need for revocation often does not arise and when it does, IRS focuses more on getting the tax-exempt entity to comply with federal laws rather than on taking away its exempt status.

Beyond revocations, IRS examinations can produce one or more other changes<sup>19</sup> such as in the section 501(c) paragraph,<sup>20</sup> foundation status of a 501(c)(3) entity,<sup>21</sup> and assessed tax.<sup>22</sup> Changes in paragraph are important because of rules governing permissible activities. For example, a tax-exempt entity classified as a charity under 501(c)(3) can accept donations that are tax deductible for the donor unlike those classified as a social welfare entity under Section 501(c)(4). However, such charities are more restricted in their ability to lobby and engage in political activity compared to social welfare entities. Changes in foundation status are important because foundations generally are subjected to more requirements than public charities, such as in the requirement to annually distribute a minimum amount of income towards its exempt purpose.

Figure 6 shows that the percentage of examinations that produced no change rose from 31 percent in fiscal year 1998 to 39 percent in 2004, with higher rates in 2002 and 2003 (see table 9 in app. IV). In general, IRS is not likely to find a change in every examination given the focus on getting exempt entities into compliance and the need for better data to select the most noncompliant entities for examination. Higher no-change rates mean that IRS spends resources examining compliant entities. IRS officials said that they are working to reduce the no-change rate to or below the 1998 level.

Figure 6: No-Change Rate for Examinations of Forms 990, Fiscal Years 1998–2004



Source: Tabulation of data from IRS's Audit Information Management System, 1998–2004.

#### *IRS Has Had Insufficient Reliable Information to Guide Oversight Efforts but Is Working to Obtain Better Information*

IRS has acknowledged that it lacks sufficient data to effectively find and address noncompliance among tax-exempt entities. At the same time, IRS is aware that im-

<sup>19</sup> IRS examiners can make 12 “other” types of changes such as those involving related returns, delinquent returns, appeals, closing agreements, referrals to other IRS divisions, and claims.

<sup>20</sup> “Paragraph” refers to the types of 501(c) entities such as (c)(3) or (c)(4). When an entity applies for exempt status, it must tell IRS the section 501(c) paragraph under which it qualifies.

<sup>21</sup> An entity that qualifies under section 501(c)(3) is a private foundation unless it meets the criteria for a public charity, such as having broad public support. Beyond an examination, status can be changed when (a) an entity requests an IRS determination letter on its status, and (b) 5 years have elapsed for an entity that has been permitted to be a public charity for its first 5 years.

<sup>22</sup> Tax-exempt entities could owe employment taxes, various types of excise taxes, or income taxes if they operate a business activity not related to their exempt purpose.

ovement to the Form 990 data made available to the public could better support public, media, and others' oversight of tax-exempt entities. To better enable it to collect and analyze such data, IRS is taking a number of steps. IRS is also trying different actions to enhance its ability to address critical and other types of noncompliance.

To help identify noncompliance, IRS is revising the data requested on the Form 990. IRS has determined that the Form 990 does not provide sufficient data to identify tax-exempt entities that merit an examination due to noncompliance. Nor can IRS easily compare Form 990 data with data reported on the Form 1023.<sup>23</sup> For example, the current Form 1023 requests data on hospitals and low-income housing that are not captured in the Form 990. Being able to compare similar data on both forms would better enable IRS to see whether the stated exempt purpose is being pursued and met.

To enhance the usefulness and ease of preparation of the Form 990, IRS officials stated that the IRS is undertaking a large-scale revision. IRS officials said that the revision process has key steps to be taken before IRS shares the specific changes. However, IRS officials identified some general changes being developed. To ease preparation, IRS is attempting to write all questions in plain English and group questions related to an issue. Further, IRS officials explained that the revised Form 990 is to consist of one form applicable to all tax-exempt entities and a series of organization and activity schedules. The organization schedules would be tailored to filers such as hospitals or veteran's organizations while the activity schedules would be tailored to issues such as compensation packages and grant making that may be financing terrorism.

An IRS team completed a first draft of the revised Form 990 in December 2004. Before setting milestones for publishing the Form 990, IRS wants to allow for review by various parties inside and outside IRS. IRS also plans to consider recommendations on the Form 990 of the Nonprofit Sector Panel to be presented in its final report in June 2005. Finally, IRS plans to make the revised Form 990 suitable for electronic filing in a cost-effective manner.

IRS has also recognized that it has insufficient data on the extent or causes of noncompliance for segments of the tax-exempt sector. IRS has done a few studies to measure the compliance of exempt entities filing Forms 990 and reporting items such as the unrelated business income tax owed. IRS did these studies in the 1970s, except for a smaller compliance study done during the 1980s.

To alleviate such data shortcomings, in 2002, IRS began over 30 studies of "market segments," which are homogeneous groups of tax-exempt entities such as charities, social clubs, and business leagues, or of exempt issues such as business income unrelated to an exempt purpose. These studies were to develop reliable data on the types and extent of compliance problems. IRS planned to use the data to refine selection criteria for identifying noncompliant returns for examination as well as help identify other strategies to improve compliance such as through improved guidance or instructions. However, IRS has had to delay most of these studies due to higher priorities (such as dealing with abusive tax transactions).

Given its concern about insufficient data, IRS also is taking steps in fiscal year 2005 to improve its capabilities to analyze data. IRS has been establishing a Data Analysis Unit to provide trend analysis intended to improve the selection of tax-exempt entities for examination and the identification of compliance issues to pursue. The unit is to make better use of internal and external databases.<sup>24</sup> A driving force in creating the unit was the lack of research tools and staff trained in using data. As described below, IRS has several other efforts underway or planned to improve the use of electronic data on the tax-exempt sector.

- IRS plans to expand electronic filing of returns, which could help IRS to more quickly identify noncompliance and improve public access to Form 990 data.<sup>25</sup>

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<sup>23</sup> IRS revised Form 1023 in 2004 to provide information that helps identify potential problems early in the application process, including potentially abusive situations involving tax-exempt entities such as those claiming to provide credit counseling.

<sup>24</sup> The Data Analysis Unit plans to use data-mining techniques to identify patterns and establish relationships to uncover compliance issues. For example, by comparing state bingo databases to IRS files, IRS could identify entities with gross receipts in excess of the \$25,000 filing threshold that failed to file a required Form 990.

<sup>25</sup> IRS has a network to image the paper Forms 990 filed by charities. The imaged forms, minus sensitive data such as social security numbers and donor names, are sold to groups that want such data. Due to resource limitations, IRS transcribes little data from Forms 990 into electronic databases. To have more electronic data from Forms 990, IRS has contract to have the imaged Form 990 data keypunched.

IRS began accepting the Form 990<sup>26</sup> electronically on a voluntary basis in 2004, and plans to expand voluntary electronic filing to Form 990-PF filed by private foundations in 2005 and to create a single point for electronic filing of federal and state returns in 2006. IRS plans to require electronic Form 990 filing for exempt organizations with assets in excess of \$100 million for 2006 and in excess of \$10 million for 2007. Private foundations would be required to file electronically for 2007 regardless of the amount of their assets.<sup>27</sup>

- IRS's Exempt Organizations Electronic Initiatives Office<sup>28</sup> is developing a "Better Data Initiative" intended to synthesize IRS's electronic data for compliance purposes, such as examination selection and compliance trend analysis. The goal is to have an effective database management infrastructure in place by 2007. This office also is to help find and use electronic data sources that would be useful for trend analysis.

*IRS Has Identified Priority Compliance Issues and Is Working to Address Them*

Because of increasing concerns about specific types of noncompliance, IRS has created initiatives to address specific abuses across the tax-exempt sector. IRS also is attempting to build a stronger enforcement presence during 2005 through new processes to supplement examinations of compliance among exempt entities.

IRS has identified four critical compliance problems, which it plans to address through enforcement during fiscal year 2005, as follows.

- Anti-terrorism—examine a sample of exempt entities that make foreign grants to ensure that the funds are used for the charitable purpose and not for terrorist activity.
- Credit counseling—examine credit counseling and consumer credit organizations that appear to operate as businesses rather than provide the educational or charitable services required under tax-exempt status.
- Excessive compensation—conduct compliance checks and examinations of charities and private foundations to identify potential excessive compensation paid to insiders.
- Abusive tax avoidance transactions—focus on four types of transactions that are intended to exploit tax-exempt status for personal gains, including:
  - using non-life mutual insurance companies<sup>29</sup> and producer-owned reinsurance companies<sup>30</sup> to earn tax-free profits.
  - establishing donor-advised funds<sup>31</sup> to generate questionable deductions, benefits to donors, or management fees for promoters.
  - misusing tax-exempt entities that are to support other exempt entities by, for example, making large loans to the founder of the supported entity or by not providing the required tax-exempt support.
  - abusing Department of Housing and Urban Development programs such as through personal use of program property.

IRS plans to address other compliance problems as well. The problems to be addressed involve charitable gaming, disaster relief organizations whose distributions result in private benefit or fraud, tax-exempt political organizations that fail to annually report all required information, and prohibited political intervention by charities.<sup>32</sup> In addition, IRS is addressing excess deductions for conservation easements,

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<sup>26</sup> IRS is developing electronic filing for Form 1023, which is used to apply for tax-exempt status. IRS hopes to begin accepting the electronic Form 1023 by 2007.

<sup>27</sup> Consistent with IRC section 6011(e), only large organizations, including exempt organizations and private foundations, that are required to file 250 or more returns with IRS will be required to file their Form 990 electronically. Such returns include Forms 990, annual employee wage and tax statements (Form W-2), quarterly payroll tax returns (Form 941), and annual information returns, such as payments to vendors for services (Form 1099 MISC).

<sup>28</sup> The Electronic Initiatives Office manages the development and implementation of automation efforts on exempt organizations in support of the strategic plan.

<sup>29</sup> Insurance companies or associations that provide other than life insurance are generally tax exempt under IRC section 501(c)(15) if their gross receipts do not exceed \$600,000 and more than 50 percent of their receipts consist of premiums.

<sup>30</sup> A producer-owned reinsurance company provides reinsurance for a producer group's business; reinsurance transfers part or all of the risk from one insurer to another.

<sup>31</sup> Donor-advised funds allow donors to advise how the charitable contribution is to be used.

<sup>32</sup> IRS plans to contact over 100 charities identified as having potentially violated the prohibition, to educate the organizations and prevent future violations of the law.

vehicle donations and other noncash contributions, as well as abuses involving charitable trusts, and a "corporation sole".<sup>33</sup>

To enhance enforcement overall, IRS has been developing new units or processes. For example, IRS created the Exempt Organization Compliance Unit in 2004 to help deal with growth in the number of tax-exempt entities coupled with the limited examination resources. It is to check exempt entities' compliance with record-keeping and information-reporting requirements via correspondence rather than a review of books and records in an examination. During fiscal year 2004, the unit sent over 2,000 letters to check compliance and over 8,000 letters to educate the entities about how to comply. If an entity does not respond or has questionable activity identified in the compliance check, IRS could initiate an examination.

IRS also is developing a Financial Investigations Unit to specialize in complex fraud and tax-avoidance schemes involving the exempt sector. IRS recognized that it lacked staff in its tax-exempt unit trained to trace funds through complex transactions but was being asked to ensure that charitable assets are not diverted for illegal purposes. IRS plans to hire specialists that can identify fraud and track foreign grants. Furthermore, IRS has established a group to review exempt applications for names of individuals that appear on a Department of the Treasury Office of Foreign Assets Control listing of suspected terrorists or that IRS knows to be tax-scheme promoters as well as for types of entities with a history of noncompliance, such as in credit counseling. The presence of such names or entities would likely result in a referral to the examination group, or for a suspected terrorist, to IRS Criminal Investigation group.

#### **STATES PLAY AN IMPORTANT ROLE IN OVERSEEING TAX-EXEMPT ENTITIES AND MAY BENEFIT FROM ADDITIONAL COORDINATION WITH IRS**

In addition to IRS oversight, states oversee tax-exempt entities, often focusing on potential fund-raising fraud and misuse of charitable assets. The states believe that their oversight could be more effective if IRS were able to share additional information with them. We have previously recommended that IRS work with states on data-sharing proposals that Congress could consider.

##### *States Provide Critical Oversight*

Many states oversee some aspects of the tax-exempt sector through their attorney general and/or state charity offices. Although some overlap in responsibility with IRS exists, state oversight differs. IRS focuses on whether the tax-exempt entities meet tax-exempt requirements and comply with federal laws. States have an interest in whether tax-exempt charities' fund-raising is fraudulent and whether the entity is meeting the purpose for which it was created.

In general, exempt entities are to incorporate in a state or the District of Columbia. State attorneys general have broad power to regulate the charities that are established or operate in their states. States monitor charities for compliance with statutory and common-law standards, and can correct noncompliance through litigation and other means.

States can impose requirements on tax-exempt entities incorporated or operating in their jurisdictions that specifically affect governance or transparency. For example, some states require fund-raisers to register and file information regarding fund-raising or monitor charity solicitations through their consumer protection bureaus to protect against fraud. Through its Nonprofit Integrity Act of 2004, California established governance requirements for financial audits, audit committees, disclosure of audited statements, and review and approval by the board of directors of compensation paid to the chief executive officer and chief financial officer. The act also established requirements related to fundraising.

##### *Coordination between IRS and the States in Sharing Data About Tax-Exempt Entities Could Enhance Oversight and the Use of Limited Resources*

State officials believe, and IRS officials agree, that state oversight of tax-exempt entities could benefit if IRS and states coordinated on sharing IRS's data. IRS is working on improved data sharing consistent with recommendations we made in 2002.<sup>34</sup> First, we recommended that IRS consult with state charity officials on how to regularly share IRS data that federal law allowed to be shared (e.g., data on denials or revocations of tax-exempt status). State charity officials told us that IRS has

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<sup>33</sup> A corporation sole is an entity authorized under state law to allow religious leaders to hold property and conduct business for the benefit of a religious entity.

<sup>34</sup> See GAO-02-526.

implemented this recommendation and has been open to input from the states on how to better share the data on a regular basis.

Second, we recommended that IRS work with state charity officials and the Department of the Treasury to identify other types of IRS data that states would find useful and provisions to protect the data from improper disclosure or misuse, and to develop a legislative proposal that would expand state access to such IRS data. State and IRS officials believe that revising statutes to allow IRS to share more data, such as about ongoing and closed examinations of charities, would help IRS and states to better use limited resources and the states to more quickly respond to noncompliance. Congress is now considering a proposal to allow IRS to share more information with the states, including their charity regulators.

#### **CONCLUDING OBSERVATIONS**

Tax-exempt entities provide an incredibly diverse set of services to our equally diverse population. Our lives are enriched and improved through the work of this sector. In sum, the tax-exempt sector has become an indispensable part of American life. Yet, like all organizations run by human beings, tax-exempt entities' operations can at times be flawed.

Ensuring that tax-exempt entities run as effectively and efficiently as possible, and in line with the purposes for which Congress established their tax exemption, can best be accomplished through a series of complementary controls. At the organization level, a sound governance structure can establish the set of checks and balances that help steer an entity towards result-oriented outcomes consistent with their purposes while also guarding against abuses. Transparency over the operations of the exempt entity provides an incentive to help ensure the governance practices function as intended and when they do not, transparency helps increase the chances that inappropriate behavior will be detected and corrected. Oversight by IRS and the states brings to bear the powers of government to investigate errors made among tax-exempt entities, to change the rules when necessary, and to provide consequences when rules are not followed.

Regarding oversight by states, IRS and states believe greater sharing of federal data would help states target their enforcement efforts and minimize unnecessary overlap with federal oversight of exempt organizations. As we recommended, we look forward to IRS, the Department of the Treasury, and states identifying the specific information that should be shared and procedures for sharing it consistent with taxpayer privacy rights, to help Congress in deliberating changes to current restrictions on IRS sharing such data with the states.

Ultimately, Congress determines what activities should benefit from tax exemption and what organizations must do in exchange for that advantage. Periodic congressional oversight is therefore critical to ensuring that the exempt sector remains a vibrant contributor to the quality of American lives and operates with integrity in achieving results commensurate with the tax-favored status it has been granted. As noted earlier, the hearing today provides an excellent forum from which to launch a comprehensive re-examination of this vital sector as we work to address the challenges arising in the 21st century. We stand ready to assist Congress as it considers such a re-examination and continues its oversight of this critical sector of our national economy.

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Mr. Chairman, this concludes my prepared statement. I would be happy to respond to any questions you or other Members of the committee may have.

For further information on this testimony, please contact Michael Brostek at (202 512-9110) or [brostekm@gao.gov]. Individuals making key contributions to this testimony include Perry Datwyler, George Guttman, Shirley Jones, Bob McKay, John Mingus, Jeff Schmerling, and Tom Short.

#### **Appendix I: Types of Tax-Exempt Entities under Section 501(c)**

The following lists the 28 types of tax-exempt entities under the subsections of section 501(c) of the Internal Revenue Code.

- (1) Corporations organized by Act of Congress; Central Liquidity Facility for Federal Credit Unions; Resolution Trust Corporation; Resolution Funding Corporation
- (2) Title-holding corporations
- (3) Public charities, private foundations, religious, charitable, scientific, testing for public safety, literary, or educational, fostering national or international amateur sports competition, prevention of cruelty to children or animals
- (4) Civic leagues, social welfare organizations, local associations of employees dedicated to charitable, educational, or recreational purposes

- (5) Labor unions, agricultural, or horticultural organizations
- (6) Trade associations, professional football leagues
- (7) Social and recreational clubs
- (8) Fraternal benefit societies providing payment of certain benefits to members
- (9) Voluntary employees' beneficiary associations providing payment of certain employee benefits
- (10) Domestic fraternal societies whose net earnings are devoted to religious, charitable, scientific, literary, educational, and fraternal purposes, which do not provide benefits to members
- (11) Teachers' retirement fund associations
- (12) Benevolent life insurance associations, mutual ditch or irrigation companies, mutual or cooperative telephone, electric, or water companies
- (13) Cemetery companies
- (14) Credit unions
- (15) Small mutual insurance companies
- (16) Corporations to finance crop operations
- (17) Supplemental unemployment benefit trusts
- (18) Pre-June 25, 1959 trusts to fund pension benefits
- (19) Veterans' groups
- (20) Group legal service organizations
- (21) Black lung benefit trusts
- (22) Multi-employer pension plan trusts
- (23) Armed Forces insurance organizations established before 1880
- (24) ERISA trusts for certain terminated plans
- (25) Multi-parent holding companies
- (26) State-sponsored, high-risk insurance organizations
- (27) State-sponsored worker compensation reinsurance organizations
- (28) National railroad retirement investment trust

## Appendix II: Copy of Form 990

990		Return of Organization Exempt From Income Tax		OMB No. 1545-0047	
Under section 501(c), 527, or 4049(e)(6) of the Internal Revenue Code (except block lung benefit trust or private foundation)				2004	
				Open to Public Inspection	
Department of the Treasury Internal Revenue Service					
<b>A. For the 2004 calendar year, or tax year beginning</b> <b>2004</b> and ending <b>2004</b>					
<b>B. Check if applicable:</b> <ul style="list-style-type: none"> <li><input type="checkbox"/> Check if applicable</li> <li><input type="checkbox"/> Address change</li> <li><input type="checkbox"/> Name change</li> <li><input type="checkbox"/> Initial return</li> <li><input type="checkbox"/> Final return</li> <li><input type="checkbox"/> Amended return</li> <li><input type="checkbox"/> Application pending</li> </ul>		<b>C. Name of organization</b> <input type="text"/>		<b>D. Employer identification number</b> <input type="text"/>	
		<b>E. Telephone number</b> <input type="text"/>			
		<b>F. Accounting method:</b> <input type="checkbox"/> Cash <input type="checkbox"/> Accrual <input type="checkbox"/> Other (specify) ►			
		<b>G. Web site ►</b>			
<b>J. Organization type</b> (check only one) ► <input type="checkbox"/> 501(c)(1) ( ) <input type="checkbox"/> 501(c)(3) ( ) <input type="checkbox"/> 4049(e)(6) ( ) <input type="checkbox"/> 527 ( )					
<b>K. Check here ►</b> If the organization's gross receipts are normally not more than \$25,000. The organization need not file a return with the IRS, but if the organization received a Form 990 Package in the mail, it should file a return without financial data. <b>Some states require a complete return.</b>					
<b>L. Gross receipts.</b> Add lines 6b, 16, 18, 19, and 10b, to line 12 ►					
<b>Part I Revenue, Expenses, and Changes in Net Assets or Fund Balances (See page 18 of the instructions.)</b>					
<b>Revenue</b> 1 Contributions, gifts, grants, and similar amounts received. a Direct public support . . . . . <b>1a</b> b Indirect public support . . . . . <b>1b</b> c Government contributions (grants) . . . . . <b>1c</b> d <b>Total</b> (add lines 1a through 1c) (cash \$      noncash \$      ) . . . . . <b>1d</b> 2 Program service revenue including government fees and contracts (from Part VII, line 9d) . . . . . <b>2</b> 3 Membership dues and assessments . . . . . <b>3</b> 4 Interest on savings and temporary cash investments . . . . . <b>4</b> 5 Dividends and interest from securities . . . . . <b>5</b> 6a Gross rents . . . . . <b>6a</b> b Less: rental expenses . . . . . <b>6b</b> 6 Net rental income or (loss) (subtract line 6b from line 6a) . . . . . <b>6c</b> 7 Other investment income (describe) ► <b>7</b> 8a Gross amount from sales of assets other than inventory . . . . . <b>8a</b> b Less: cost or other basis and sales expenses . . . . . <b>8b</b> c Gain or (loss) (attach schedule) . . . . . <b>8c</b> d Net gain or (loss) (combine line 8c, columns (A) and (B)) . . . . . <b>8d</b> 9 Special events and activities (attach schedule) If any amount is from <b>gambling</b> , check here ► <input type="checkbox"/> a Gross revenue (not including \$      of contributions reported on line 1a) . . . . . <b>9a</b> b Less: direct expenses other than fundraising expenses . . . . . <b>9b</b> c Net income or (loss) from special events (subtract line 9b from line 9a) . . . . . <b>9c</b> 10a Gross sales of inventory, less returns and allowances . . . . . <b>10a</b> b Less: cost of goods sold . . . . . <b>10b</b> c Gross profit or (loss) from sales of inventory (attach schedule) (subtract line 10b from line 10a) . . . . . <b>10c</b> 11 Other revenue (from Part VII, line 10d) . . . . . <b>11</b> 12 <b>Total revenue</b> (add lines 1d, 2, 3, 4, 5, 6c, 7, 8d, 9c, 10c, and 11) . . . . . <b>12</b> 13 Program services (from line 44, column (B)) . . . . . <b>13</b> 14 Management and general (from line 44, column (C)) . . . . . <b>14</b> 15 Fundraising (from line 44, column (D)) . . . . . <b>15</b> 16 Payments to affiliates (attach schedule) . . . . . <b>16</b> 17 <b>Total expenses</b> (add lines 16 and 44, column (A)) . . . . . <b>17</b> 18 Excess or (deficit) for the year (subtract line 17 from line 12) . . . . . <b>18</b> 19 Net assets or fund balances at beginning of year (from line 73, column (A)) . . . . . <b>19</b> 20 Other changes in net assets or fund balances (attach explanation) . . . . . <b>20</b> 21 Net assets or fund balances at end of year (combine lines 18, 19, and 20) . . . . . <b>21</b>					
For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions.      Cat. No. 11282Y      Form 990 (2004)					

Form 990 (2004)

**Part II Statement of Functional Expenses** Page 2

All organizations must complete column (A). Columns (B), (C), and (D) are required for section 5110(E) and (E) organizations and section 4947(a)(1) nonexempt charitable trusts but optional for others. (See page 22 of the instructions.)

Do not include amounts reported on line 6b, 8b, 9b, 10b, or 16 of Part I.	(A) Total	(B) Program services	(C) Management and general	(D) Fundraising
22 Grants and allocations (attach schedule) . . . . .	22			
23 Specific assistance to individuals (attach schedule)	23			
24 Benefits paid to or for members (attach schedule)	24			
25 Compensation of officers, directors, etc.	25			
26 Other salaries and wages . . . . .	26			
27 Pension plan contributions . . . . .	27			
28 Other employee benefits . . . . .	28			
29 Payroll taxes . . . . .	29			
30 Professional fundraising fees . . . . .	30			
31 Accounting fees . . . . .	31			
32 Legal fees . . . . .	32			
33 Supplies . . . . .	33			
34 Telephone . . . . .	34			
35 Postage and shipping . . . . .	35			
36 Occupancy . . . . .	36			
37 Equipment rental and maintenance . . . . .	37			
38 Printing and publications . . . . .	38			
39 Travel . . . . .	39			
40 Conferences, conventions, and meetings . . . . .	40			
41 Interest . . . . .	41			
42 Depreciation, depletion, etc. (attach schedule)	42			
43 Other expenses not covered above (itemize) a . . . . .	43a			
b . . . . .	43b			
c . . . . .	43c			
d . . . . .	43d			
* . . . . .	43e			
<b>44 Total functional expenses (add lines 22 through 43; Organizations completing column (D); carry these totals to line 12-15)</b>	<b>44</b>			

**Joint Costs:** Check  if you are following SOP 98-2. Are any joint costs from a combined educational campaign and fundraising solicitation reported in (B) Program services?  Yes  No If "Yes," enter (B) the aggregate amount of these joint costs \$ . . . . . (B) the amount allocated to Program services \$ . . . . . (B) the amount allocated to Management and general \$ . . . . . and (B) the amount allocated to Fundraising \$ . . . . .

**Part III Statement of Program Service Accomplishments** (See page 25 of the instructions.)

What is the organization's primary exempt purpose?  . . . . . All organizations must describe their exempt purpose achievements in a clear and concise manner. State the number of clients served, publications issued, etc. Discuss achievements that are not measurable. (Section 501(c)(3) and (E) organizations and 4947(a)(1) nonexempt charitable trusts must also enter the amount of grants and allocations to others.)

a . . . . .	Program Service Expenses (Required for 501(c)(3) and (E) organizations and 4947(a)(1) nonexempt charitable trusts, but optional for others.)
(Grants and allocations \$ . . . . .)	
b . . . . .	
(Grants and allocations \$ . . . . .)	
c . . . . .	
(Grants and allocations \$ . . . . .)	
d . . . . .	
(Grants and allocations \$ . . . . .)	
* Other program services (attach schedule) (Grants and allocations \$ . . . . .)	
<b>f Total of Program Service Expenses</b> (should equal line 44, column (B), Program services), . . . . . <input checked="" type="checkbox"/>	

## Part IV Balance Sheets (See page 25 of the instructions.)

	(A) Beginning of year	(B) End of year
<b>Assets</b>		
45 Cash—non-interest-bearing	45	
46 Savings and temporary cash investments	46	
47a Accounts receivable	47a	
b Less: allowance for doubtful accounts	47b	47c
48a Pledges receivable	48a	48c
b Less: allowance for doubtful accounts	48b	
49 Grants receivable		49
50 Receivables from officers, directors, trustees, and key employees (attach schedule)		50
51a Other notes and loans receivable (attach schedule)	51a	
b Less: allowance for doubtful accounts	51b	51c
52 Inventories for sale or use		52
53 Prepaid expenses and deferred charges		53
54 Investments—securities (attach schedule)	► <input type="checkbox"/> Cost <input type="checkbox"/> FMV	54
55a Investments—land, buildings, and equipment basis	55a	
b Less: accumulated depreciation (attach schedule)	55b	55c
56 Investments—other (attach schedule)		56
57a Land, buildings, and equipment basis	57a	
b Less: accumulated depreciation (attach schedule)	57b	57c
58 Other assets (describe ► _____)		58
<b>59 Total assets</b> (add lines 45 through 58) <small>(must equal line 74)</small>	59	
<b>Liabilities</b>		
60 Accounts payable and accrued expenses	60	
61 Grants payable	61	
62 Deferred revenue	62	
63 Loans from officers, directors, trustees, and key employees (attach schedule)		63
64a Tax-exempt bond liabilities (attach schedule)		64a
b Mortgages and other notes payable (attach schedule)		64b
65 Other liabilities (describe ► _____)		65
<b>66 Total liabilities</b> (add lines 60 through 65)	66	
<b>Net Assets or Fund Balances</b>		
Organizations that follow SFAS 117, check here ► <input type="checkbox"/> and complete lines 67 through 69 and lines 73 and 74.		
67 Unrestricted	67	
68 Temporarily restricted	68	
69 Permanently restricted	69	
Organizations that do not follow SFAS 117, check here ► <input type="checkbox"/> and complete lines 70 through 74.		
70 Capital stock, trust principal, or current funds	70	
71 Paid-in or capital surplus, or land, building, and equipment fund	71	
72 Retained earnings, endowment, accumulated income, or other funds	72	
<b>73 Total net assets or fund balances</b> (add lines 67 through 69 <b>or</b> lines 70 through 72; column (A) <b>must</b> equal line 19; column (B) <b>must</b> equal line 21)	73	
<b>74 Total liabilities and net assets / fund balances</b> (add lines 66 and 73)	74	74

Form 990 is available for public inspection and, for some people, serves as the primary or sole source of information about a particular organization. How the public perceives an organization in such cases may be determined by the information presented on its return. Therefore, please make sure the return is complete and accurate and fully describes, in Part III, the organization's programs and accomplishments.

76 Did any officer, director, trustee, or key employee receive aggregate compensation of more than \$100,000 from your organization and all related organizations, of which more than \$10,000 was provided by the related organizations?  Yes  No  
If "Yes," attach schedule—see page 28 of the instructions.

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<b>Part VI Other Information (See page 28 of the instructions.)</b>		
		<b>Yes</b> <b>No</b>
76	Did the organization engage in any activity not previously reported to the IRS? If "Yes," attach a detailed description of each activity.	76
77	Were any changes made in the organizing or governing documents but not reported to the IRS? . . . . . If "Yes," attach a conformed copy of the changes.	77
78a	Did the organization have unrelated business gross income of \$1,000 or more during the year covered by this return?	78a
78b	b If "Yes," has it filed a tax return on <b>Form 990-T</b> for this year? . . . . .	78b
79	Was there a liquidation, dissolution, termination, or substantial contraction during the year? If "Yes," attach a statement.	79
80a	Is the organization related (other than by association with a statewide or nationwide organization) through common membership, governing bodies, trustees, officers, etc., to any other exempt or nonexempt organization? . . . . .	80a
	b If "Yes," enter the name of the organization ► . . . . . and check whether it is <input type="checkbox"/> exempt or <input type="checkbox"/> nonexempt.	80a
81a	Enter direct and indirect political expenditures. See line 81 instructions. ► . . . . . <b>81a</b>	81b
82a	Did the organization receive donated services or the use of materials, equipment, or facilities at no charge or at substantially less than fair rental value? . . . . .	82a
	b If "Yes," you may indicate the value of these items here. Do not include this amount as revenue in Part I or as an expense in Part II. (See instructions in Part III). ► . . . . . <b>82b</b>	82b
83a	Did the organization comply with the public inspection requirements for returns and exemption applications?	83a
83b	b Did the organization comply with the disclosure requirements relating to quid pro quo contributions? . . . . .	83b
84a	Did the organization solicit any contributions or gifts that were not tax deductible? . . . . .	84a
84b	b If "Yes," did the organization include with every solicitation an express statement that such contributions or gifts were not tax deductible? . . . . .	84b
85	501(c)(6), (7), or (9) organizations. a Were substantially all dues nondeductible by members? . . . . .	85a
	b Did the organization make only in-house lobbying expenditures of \$2,000 or less? . . . . .	85b
	c If "Yes" was answered to either 85a or 85b, do not complete 85c through 85h below unless the organization received a waiver for proxy tax owed for the prior year.	85c
	d Dues, assessments, and similar amounts from members. ► . . . . . <b>85d</b>	85e
	e Aggregate nondeductible amount of section 6033(w)(1)(A) dues notices. ► . . . . . <b>85e</b>	85f
	f Taxable amount of lobbying and political expenditures (line 85d less 85e) . . . . .	85f
	g Does the organization elect to pay the section 6033(e) tax on the amount on line 85f? . . . . .	85g
	h If section 6033(w)(1)(A) dues notices were sent, does the organization agree to add the amount on line 85f to its reasonable estimate of dues allocable to nondeductible lobbying and political expenditures for the following tax year? . . . . .	85h
86	501(c)(7) orgs. Enter: a Initiation fees and capital contributions included on line 12. ► . . . . . <b>86a</b>	86b
	b Gross receipts, included on line 12, for public use of club facilities . . . . . <b>86b</b>	87a
87	501(c)(12) orgs. Enter: a Gross income from members or shareholders . . . . . <b>87a</b>	87b
	b Gross income from other sources. (Do not net amounts due or paid to other sources against amounts due or received from them) . . . . . <b>87b</b>	88
88	At any time during the year, did the organization own a 50% or greater interest in a taxable corporation or partnership, or an entity disregarded as separate from the organization under Regulations sections 301.7701-2 and 301.7701-3? If "Yes," complete Part IX.	88
89a	501(c)(8) organizations. Enter: Amount of tax imposed on the organization during the year under section 4911 ► . . . . . section 4912 ► . . . . . section 4955 ► . . . . . <b>89a</b>	89b
	b 501(c)(3) and 501(c)(4) orgs. Did the organization engage in any section 4958 excess benefit transaction during the year or did it become aware of an excess benefit transaction from a prior year? If "Yes," attach a statement explaining each transaction . . . . .	89b
	c Enter: Amount of tax imposed on the organization managers or disqualified persons during the year under sections 4912, 4955, and 4958 . . . . . ► . . . . .	89b
	d Enter: Amount of tax on line 89c, above, reimbursed by the organization . . . . . ► . . . . .	89b
90a	List the states with which a copy of this return is filed ► . . . . .	90b
91	b Number of employees employed in the pay period that includes March 12, 2004 (See instructions) ► . . . . . <b>90b</b>	91
	c The books are in care of ► . . . . . Telephone no. ► (.....) . . . . .	91
92	Located at ► . . . . . ZIP + 4 ► . . . . .	92
	d Section 4947(a)(1) nonexempt charitable trusts filing Form 990 in lieu of <b>Form 1041</b> —Check here, and enter the amount of tax-exempt interest received or accrued during the tax year. ► . . . . . <b>92</b>	92

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**Part VII Analysis of Income-Producing Activities (See page 33 of the instructions.)**

**Notes:** Enter gross amounts unless otherwise indicated.

Line No.	Description	Unrelated business income	Excluded by section 512, 513, or 514	(E) Related or exempt function income
(A) Business code	(B) Amount	(C) Exclusion code	(D) Amount	
93 Program service revenue:				
a				
b				
c				
d				
e				
f Medicare/Medicaid payments				
g Fees and contracts from government agencies				
94 Membership dues and assessments				
95 Interest on savings and temporary cash investments				
96 Dividends and interest from securities				
97 Net rental income or (loss) from real estate:				
a debt-financed property				
b not debt-financed property				
98 Net rental income or (loss) from personal property				
99 Other investment income				
100 Gain or (loss) from sales of assets other than inventory				
101 Net income or (loss) from special events				
102 Gross profit or (loss) from sales of inventory				
103 Other revenue: a				
b				
c				
d				
e				
104 Subtotal (add columns (B), (D), and (E))				
105 Total (add line 104, column (B), (D), and (E))				

**Note:** Line 105 plus line 1d, Part I, should equal the amount on line 12, Part I.

**Part VIII Relationship of Activities to the Accomplishment of Exempt Purposes (See page 34 of the instructions.)**

Line No.	Explanation
▼	Explain how each activity for which income is reported in column (E) of Part VII contributed importantly to the accomplishment of the organization's exempt purposes (other than by providing funds for such purposes).

**Part IX Information Regarding Taxable Subsidiaries and Disregarded Entities (See page 34 of the instructions.)**

(A) Name, address, and EIN of corporation, partnership, or disregarded entity	(B) Percentage of ownership interest	(C) Nature of activities	(D) Total income	(E) End-of-year assets
	%			
	%			
	%			
	%			

**Part X Information Regarding Transfers Associated with Personal Benefit Contracts (See page 34 of the instructions.)**

(a) Did the organization, during the year, receive any funds, directly or indirectly, to pay premiums on a personal benefit contract?  Yes  No

(b) Did the organization, during the year, pay premiums, directly or indirectly, on a personal benefit contract?  Yes  No

**Note:** If "Yes" to (b), file Form 8870 and Form 4720 (see instructions).

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than officer) is based on all information of which preparer has any knowledge.

**Please Sign Here**

Signature of officer	Date
Type or print name and title	
Preparer's signature	Date
Form's name (or yours if self-employed), address, and ZIP + 4	Check if self-employed <input type="checkbox"/> Preparer's SSN or PTIN (See Gen. Inst. W)
	EIN <input type="checkbox"/> Phone no. <input type="checkbox"/> 1 <input type="checkbox"/> 2

Form 990 (2004)

### Appendix III: Form 990 Data

The following tables summarize data reported on the annual Form 990 by tax-exempt entities under section 501(c) of the Internal Revenue Code. The tables cover reported assets, revenues, and expenses overall and, where appropriate, broken out by charities and the rest of the section 501(c) entities (i.e., noncharities).

**Table 1: Form 990 Returns Filed by Section 501(c) Entities, Tax Years 1998–2002**

Tax year	Number of returns filed		
	Charities	Noncharities	All entities
1998	281,228	168,309	449,537
1999	299,204	173,239	472,443
2000	301,612	168,963	470,575
2001	301,359	171,006	472,365
2002	302,464	162,134	464,598

Source: Tabulation of data from IRS's Return Inventory Classification System, 1998–2002.

**Table 2: Assets Reported by Section 501(c) Entities in 2004 Constant Dollars, Tax Years 1998–2002**

Tax year	All entities		Charities		Noncharities	
	Assets (in millions)	Percent change	Assets (in millions)	Percent change	Assets (in millions)	Percent change
1998	\$2,208,676	N/A	\$1,509,209	N/A	\$699,467	N/A
1999	\$2,413,917	9.3%	\$1,664,857	10.3%	\$749,059	7.1%
2000	\$2,474,471	2.5%	\$1,696,064	1.9%	\$778,407	3.9%
2001	\$2,552,606	3.2%	\$1,733,734	2.2%	\$818,872	5.2%
2002	\$2,545,189	−0.3%	\$1,694,435	−2.3%	\$850,754	3.9%

Source: Tabulation of data from IRS's Return Inventory Classification System, 1998–2002.

**Table 3: Revenues Reported by Section 501(c) Entities in 2004 Constant Dollars, Tax Years 1998–2002**

Tax year	All entities		Charities		Noncharities	
	Revenues (in millions)	Percent change	Revenues (in millions)	Percent change	Revenues (in millions)	Percent change
1998	\$1,121,387	N/A	844,224	N/A	277,163	N/A
1999	\$1,214,807	8.3%	925,849	9.7%	288,958	4.3%
2000	\$1,240,216	2.1%	944,131	2.0%	296,085	2.5%
2001	\$1,258,046	1.4%	953,841	1.0%	304,205	2.7%
2002	\$1,250,914	−0.6%	941,197	−1.3%	309,718	1.8%

Source: Tabulation of data from IRS's Return Inventory Classification System, 1998–2002.

**Table 4: Expenses Reported by Section 501(c) Entities in 2004 Constant Dollars, Tax Years 1998–2002**

Tax year	All entities		Charities		Noncharities	
	Expenses (in millions)	Percent change	Expenses (in millions)	Percent change	Expenses (in millions)	Percent change
1998	\$1,017,582	N/A	\$768,280	N/A	\$249,303	N/A
1999	\$1,091,788	7.3%	\$826,572	7.6%	\$265,215	6.4%

**Table 4: Expenses Reported by Section 501(c) Entities in 2004  
Constant Dollars, Tax Years 1998–2002—Continued**

Tax year	All entities		Charities		Noncharities	
	Expenses (in millions)	Percent change	Expenses (in millions)	Percent change	Expenses (in millions)	Percent change
2000	\$1,145,280	4.9%	\$867,063	4.9%	\$278,217	4.9%
2001	\$1,210,670	5.7%	\$912,200	5.2%	\$298,470	7.2%
2002	\$1,221,859	0.9%	\$917,528	0.6%	\$304,330	2.0%

Source: Tabulation of data from IRS's Return Inventory Classification System, 1998–2002.

**Table 5: Section 501(c) Entities' Reported Expenses as a Percentage of U.S. Gross Domestic Product, 1998–2002**

Year	U.S. GDP (in Millions)	Section 501(c) Entities' Expenses (in Millions)	Section 501(c) Entities' Expenses as a Percentage of U.S GDP
1998	8,747,000	\$1,017,582	11.6%
1999	9,268,000	\$1,091,788	11.8%
2000	9,817,000	\$1,145,280	11.7%
2001	10,128,000	\$1,210,670	12.0%
2002	10,487,000	\$1,221,859	11.7%

Source: Tabulation of data from IRS's Return Inventory Classification System, 1998–2002 and U.S. Department of Commerce figures.

#### **Appendix IV: IRS Data on Its Tax-Exempt Oversight**

The following tables summarize data provided by IRS on its oversight activities involving tax-exempt entities under section 501(c) of the Internal Revenue Code. The tables cover resources, applications, examinations, and examination results.

**Table 6: Assigned FTEs as IRS Budgeted for Exempt Activities, Fiscal Years 2000–2005**

Fiscal year	Examination FTE	Determination FTE	Other FTE	Total FTE
2000	424	342	32	798
2001	432	347	33	812
2002	421	351	44	816
2003	394	370	38	802
2004	378	348	43	769
2005	467	347	42	856

Source: IRS Exempt Organization officials.

Note: "Other FTE" include technical staff who issue rulings, director's staff, and education and outreach. FTEs assigned are what IRS budgets for this work.

**Table 7: Actions Taken on Applications for Tax-Exempt Status, Fiscal Years 1998–2003**

Fiscal year	Total applica-tions	Approved	Percent ap-proved	Denied	Other
1998	78,358	58,162	74.2%	593	19,603
1999	73,605	59,264	80.5%	585	13,756
2000	82,707	67,267	81.3%	482	14,938
2001	81,636	65,409	80.1%	646	15,581
2002	87,342	70,214	80.4%	557	16,571
2003	91,439	72,092	78.8%	1,192	18,155
2004	87,080	69,315	79.6%	1,050	16,715

Source: GAO Analysis of IRS's Exempt Determination System, 1998–2004.

Note: The “Other” category includes applications withdrawn; applications that did not provide the required information; incomplete applications; IRS refusals to rule on applications because the information submitted was insufficient to conclude whether to approve the exemption request; and applications forwarded to other than the IRS National Office.

**Table 8: Examination Rate of Section 501(c) Entities, 1998–2003**

Fiscal year	Returns filed in pre-vious year	Returns examined in fiscal year	Examination rate
1998	458,014	8,290	1.8%
1999	449,537	8,780	2.0%
2000	472,443	6,866	1.5%
2001	470,575	5,471	1.2%
2002	472,365	5,423	1.1%
2003	464,598	5,964	1.3%

Source: GAO Tabulation of IRS's Audit Information Management System and IRS's Return Inventory Classification System, 1997–2002.

**Table 9: Examinations Resulting in No Change to Forms 990 Filed by Section 501(c) Entities, Fiscal Years 1998–2004**

Fiscal Year	Examinations	Examinations result-ing in no change	No-change rate
1998	8,290	2,552	30.8%
1999	8,780	3,191	36.3%
2000	6,866	2,431	35.4%
2001	5,471	2,112	38.6%
2002	5,423	2,445	45.1%
2003	5,964	2,965	49.7%
2004	5,889	2,299	39.0%

Source: GAO analysis of IRS's Audit Information Management System, 1998–2004.

#### **Appendix V: Tax-Exempt Excise Taxes by Code Sections**

Over the years, Congress has imposed various excise taxes that affect tax-exempt entities, particularly private foundations under Section 501(c)(3). Private foundations differ in several ways from public charities. Public charities have broad public

support and tend to provide charitable services directly to beneficiaries. Private foundations are often tightly controlled and receive a significant portion of their funds from a small number of donors, and tend to make grants directly to other entities rather than directly provide charitable services. Since these differences create the potential for self-dealing or abuse by a small group, private foundations are subject to anti-abuse rules not applicable to public charities. In addition, public charities and private foundations generally are prohibited from engaging in certain types of transactions. Excise taxes are to be levied on public charities and private foundations, as well as a few other types of tax-exempt entities, who violate the rules. Details on these rules and excise taxes follow.

#### Section 4940 Excise Tax on Private Foundation Investment Income

Section 4940 was added by the Tax Reform Act of 1969, P.L. 91-172. The related Senate Report<sup>35</sup> described the excise tax as an "audit fee tax" that was believed to be necessary to cover IRS's costs for increased supervision over private foundations under the act. Section 4940 imposes a 2 percent excise tax on the net investment income of tax-exempt private foundations. Net investment income includes income from interest, dividends, and net capital gains that is reduced by the expenses incurred to earn it. This tax is 1 percent if a private foundation meets certain distribution requirements. Private foundations that meet the requirements to be an "exempt operating foundation" are not subject to this excise tax. Among these requirements are stipulations that the foundation be publicly supported for at least 10 years and that it have a governing body that is broadly representative of the general public. Private foundations that are not exempt from taxation are subject to this excise tax and unrelated business income tax.

#### Section 4941 Excise Tax on Private Foundation Acts of Self-Dealing

Because a tax-exempt entity cannot operate to confer a benefit on private parties, Section 4941 was enacted by the Tax Reform Act of 1969. According to the Senate Report, generally prohibiting self-dealing transactions would minimize the need to apply the subjective arm's-length standard that was used for loans, payments of compensation, and preferential availability of services under the 1950 amendments. Section 4941 imposes a 5 percent excise tax on acts of self-dealing between a private foundation and disqualified persons. This tax is to be paid by the disqualified person who participated in the self-dealing. An additional tax equal to 200 percent of the amount involved is to be imposed if the self-dealing is not corrected during the taxation period. A separate tax equal to 2  $\frac{1}{2}$  percent of the amount involved is to be imposed on the foundation's manager if that manager knowingly participated in the act of self-dealing. If this additional tax has been imposed on the foundation manager and that manager refuses to agree to part or all of the correction, an additional tax equal to 50 percent of the amount is to be imposed. Acts of self-dealing include sales, exchanges, or leases of property; lending of money or other extensions of credit; and payment of compensation. Disqualified persons include substantial contributors to the foundation, foundation managers, an owner of more than 20 percent of a business enterprise that is a substantial contributor, and certain government officials.

#### Section 4942 Excise Tax on Private Foundation Failure to Distribute Income

Section 4942 was enacted by the Tax Reform Act of 1969. Prior to it, a private foundation could lose its exemption if it failed to make distributions towards its charitable purposes instead of just accumulating income. According to the Senate report, the committee believed that loss of exempt status as the only sanction was often ineffective or harsh, and that substantial improvement could be achieved by providing a graduation of sanctions if income is not distributed. Section 4942 imposes a 15 percent excise tax on the undistributed income of a private foundation for any taxable year in which the required amount has not been distributed before the first day of the next taxable year. If an initial tax has been imposed under section 4942 and the income remains undistributed at the end of the taxable period, a tax equal to 100 percent of the remaining undistributed amount is to be imposed. This excise tax does not apply to private operating foundations that meet distribution requirements or to the extent that the failure to distribute is due solely to an incorrect valuation of assets as long as other requirements are met.

#### Excise Tax on Private Foundation Excess Business Holdings (Section 4943)

Section 4943 was enacted by the Tax Reform Act of 1969. According to its Senate Report, the use of foundations to maintain control of a business appeared to be in-

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<sup>35</sup> S. Rep. No. 91-552 (1969).

creasing, and some who wished to use a foundation's stock holdings to control a business were relatively unconcerned about producing income for charitable purposes. Where the charitable ownership predominated, the business could unfairly compete with businesses whose owners were required to pay taxes on their business income. The committee concluded that a limit on the extent to which a private foundation may control a business was needed. Section 4943 imposes a 5 percent excise tax on certain excess business holdings of a private foundation. Permitted holdings generally include up to 20 percent of the voting stock of an incorporated business enterprise (reduced by the percentage of the voting stock owned by all disqualified persons). Similar holdings are also permitted in partnerships and other unincorporated enterprises (except sole proprietorships). If the excise tax has been imposed, foundations that fail to make the required divestiture of excess holdings above the permitted amounts are subject to an additional tax equal to 200 percent of the excess holdings. In certain cases, foundations are allowed a 5-year period to dispose of the excess holdings and may receive an additional 5-year extension.

Excise Tax on Private Foundation Investments which Jeopardize Charitable Purpose (Section 4944)

Section 4944 was enacted by the Tax Reform Act of 1969. Under prior law, a private foundation could lose its exemption if it invested in a manner that jeopardized its exempt purpose. In the Senate Report, the committee concluded that limited sanctions were preferable to the loss of exemption. Section 4944 imposes an initial 5 percent excise tax on the amount involved if a private foundation invests in a manner that jeopardizes its exempt purpose (e.g., investing with the purpose of income production or property appreciation). If such a tax is imposed on the foundation, a separate 5 percent excise tax is to be imposed on the foundation manager if that manager knew that making the investment would jeopardize the foundation's exempt purpose. If an initial tax is imposed, an additional tax equal to 25 percent of the amount of the investment is to be imposed on the foundation if the investment is not withdrawn within the taxable period. An additional tax equal to 5 percent of the amount of the investment is to be imposed on the foundation manager if the investment is not withdrawn.

Excise Tax on Private Foundation Taxable Expenditures (Section 4945)

Section 4945 was enacted by the Tax Reform Act of 1969. Under prior law, the only sanction against prohibited political activity by a foundation was loss of exemption. The Senate committee report noted that the standards for determining the permissible level of political activity were so vague as to encourage subjective application of the sanction. As a result, section 4945 was added to clarify the types of impermissible activities and provide more limited sanctions. Section 4945 imposes an initial 10 percent excise tax on each taxable expenditure made by the foundation. An additional 2½ percent excise tax is to be imposed on the foundation manager if that manager knowingly participated in the taxable expenditure. Taxable expenditures include amounts paid to carry on propaganda or otherwise influence legislation or the outcome of a public election, or to directly or indirectly carry on a voter registration drive. If the expenditure is not corrected within the taxable period, an additional tax equal to 100 percent of the amount of the expenditure is to be imposed on the foundation and additional tax equal to 50 percent of the amount of the expenditure is to be imposed on the foundation manager.

Excise Tax on Section 501(C) (3) Political Expenditures (Section 4955)

Section 4955 was added by the Revenue Act of 1987, P.L. 100-203. According to the House Report<sup>36</sup> for the act, the committee believed that the excise tax applicable to private foundations for making prohibited political expenditures (section 4945) should also apply to a public charity. Section 4955 imposes an initial 10 percent excise tax on each political expenditure of a section 501(c) (3) organization. An additional 2½ percent excise tax is imposed on the organization's manager if the manager knew that it was a political expenditure. Political expenditures include any amounts paid or incurred by the organization in any participation or intervention in any political campaign on behalf of any candidate for public office. If an initial tax has been imposed regarding a political expenditure and that expenditure is not corrected, an additional tax equal to 100 percent of the amount is to be imposed on the organization. An additional tax equal to 50 percent of the amount of the expenditure is to be imposed on the organization's manager if that manager refuses to agree to part or all of the correction.

<sup>36</sup> H. Rep. No. 100-391 (1987).

#### Excise Tax on Section 501(C) (3) and (4) Excess Benefit Transactions (Section 4958)

Section 4958 was added in 1996 by the Taxpayer Bill of Rights 2, P.L. 104–168. According to the related House Report,<sup>37</sup> this excise tax was added to ensure that the advantages of tax-exempt status benefit the community and not private individuals. The act provided for this intermediate sanction (i.e., something short of a loss of tax exemption) to be imposed when nonprofit organizations engage in transactions with certain insiders that result in private inurement. Section 4958 imposes an initial tax of 25 percent on each excess benefit transaction entered into between a disqualified person and tax-exempt organizations under sections 501(c)(3) and (4). The initial tax is to be paid by this disqualified person, including any person who at any time during the 5-year period ending on the date of the transaction was in a position to exercise substantial influence over the organization, a member of such person's family, and a 35 percent controlled entity. Such an entity exists when a disqualified person owns more than 35 percent of the voting power of a corporation, more than 35 percent of the profit interest of a partnership, or more than 35 percent of the beneficial interest of a trust or estate. If an initial tax is imposed on the disqualified persons, an additional tax of 10 percent is to be imposed on the organization's manager if that manager participated knowing that it was an excess benefit transaction. If the excess benefit transaction is not corrected within the taxable period, a tax equal to 200 percent of the excess benefit transaction will be imposed on the disqualified person. Private foundations are not subject to this excise tax.

#### Abatement of Taxes When Corrective Action Taken (Sections 4961–4963)

Sections 4961–4963 provide for abating the various excise taxes described above. Section 4961 stipulates that additional taxes shall not be assessed if corrective action is taken within the applicable correction period. Similarly, it stipulates that if the additional tax is already assessed, it will be abated if corrective action is taken. For example, the additional tax of 200 percent for self-dealing shall not be assessed if corrective action is taken within the applicable period. Section 4962 provides that excise taxes shall not be assessed if the event that gave rise to the excise tax was (1) due to reasonable cause, (2) not due to willful neglect, and (3) corrected within the applicable period. If already assessed under these circumstances, the excise tax shall be abated. Section 4963 sets out the instances in which the abatement provisions apply.

#### Excise Taxes Owed for IRC Violations

IRS did not maintain data on how much excise tax involving tax-exempt entities was ultimately assessed or collected either overall or by the various types of violations. These assessments can result from IRS examinations but IRS's system did not maintain information on these types of assessments. These assessments may also arise from tax-exempt entities "self-assessing" excise taxes by reporting the violations to IRS. IRS did record excise taxes owed for certain types of IRC section violations as reported by tax-exempt entities on Form 4720, *Return of Certain Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code* and on Form 990–PF, *Return of Private Foundation or Section 4947(a) (1) Non-exempt Charitable Trust Treated as a Private Foundation*.

As table 10 shows, tax-exempt entities reported self-assessments of at least \$247 million in 2004 constant dollars each year or about \$1.5 billion in 2004 constant dollars for tax years 2000 through 2003.

**Table 10: Excise Tax Amounts That Tax-exempt Entities Self Assessed on Forms 4720<sup>a</sup> and 990–PF<sup>b</sup> by Code Section, Tax Years 2000–2003 (2004 Constant Dollars in Thousands)**

Code section	Tax year				
	2000	2001	2002	2003	Total
<b>Taxes on organizations</b>					
Section 4942—Undistributed income	\$2,196	\$4,608	\$3,802	\$2,421	\$13,027

<sup>37</sup> H. Rep. No. 104–506 (1996).

**Table 10: Excise Tax Amounts That Tax-exempt Entities Self Assessed on Forms 4720<sup>a</sup> and 990-PF<sup>b</sup> by Code Section, Tax Years 2000–2003 (2004 Constant Dollars in Thousands)—Continued**

Code section	Tax year				
	2000	2001	2002	2003	Total
Section 4943—Excess business holdings; Section 4944—Investments that jeopardize, other <sup>c</sup>	385	178	196	35	794
Section 4945—Taxable expenditures	1,112	702	408	316	2,538
Section 4955—Political expenditures	1	4	8	0	13
<b>Subtotal</b>	<b>3,694</b>	<b>5,492</b>	<b>4,414</b>	<b>2,772</b>	<b>16,372</b>
<b>Taxes on individuals</b>					
Section 4941—Self-dealing	438	665	415	204	1,722
Sections 4944, 4945, 4955, and Section 4958—Excess benefits	70	46	35	46	197
<b>Subtotal</b>	<b>508</b>	<b>711</b>	<b>450</b>	<b>250</b>	<b>1,919</b>
<b>Tax on net investment income</b>					
Section 4940—Investment Income	683,767	320,811	242,187	244,627	1,491,392
<b>Total</b>	<b>687,969</b>	<b>327,014</b>	<b>247,051</b>	<b>247,649</b>	<b>1,509,683</b>

Source: GAO analysis of IRS data.

<sup>a</sup>Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code.

<sup>b</sup>Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation.

<sup>c</sup>Includes Section 4911—Excess Lobbying Expenditures and 4912—Disqualifying Lobbying Expenditures. (450383)

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Chairman THOMAS. Mr. Yin is obviously the Chief of Staff of the Joint Committee on Taxation, and thank you.

**STATEMENT OF GEORGE K. YIN, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION**

Mr. YIN. Mr. Chairman, Mr. Rangel, Members of the Committee, thank you very much for asking me to testify today. In my brief comments, I am going to cover just three areas. One is to provide some highlights about the sector. Second is to discuss briefly some compliance issues concerning the sector. Third, I am going to talk briefly about the rationale for tax exemption. You should have before you a pamphlet prepared by the staff which includes a wealth of information about the tax-exempt sector, including a historical development as well as a description of present law rules. If I could draw your attention, however, to a smaller document which you should also have before you, it is a summary table of types and tax treatment of section 501(c) organizations. The number on the bottom is JCX-30-05. I just want to walk you through a little of that table to hit a few of the highlights of the sector before going on to my other two areas.

Chairman THOMAS. If you will wait just a moment, Mr. Yin. Members are going through trying to find it. It is the one with the eagle on the cover and it is printed sideways—

Mr. YIN. It is just about a six- or seven-page document.

Chairman THOMAS. It is done on the long side. Thank you.

Mr. YIN. You will see, if you turn to the first page, that we list here the 28 separate categories of exempt organizations under section 501(c). Now, I should preface by saying that these are not all of the exempt organizations allowed under the Internal Revenue Code. There are a whole group of additional organizations that are exempt. Most significantly, of course, are the ones involving retirement and other benefit vehicles. Here, we are focusing simply on the 501(c)s and you have 28 categories. If you look at the third column, you will see, just glancing down, that there are a range of dates in which these exemptions came into being. In general, there were no one or two watershed events when Congress sat down and determined that certain organizations should be exempt. They largely have come into the law piecemeal. You also notice in the dates that some of the dates are quite old. Some of the exemptions date back to 1894, which is even before the passage of the 16th amendment. Some of them, of course, are quite recent. If you look to the far right-hand column, you will see the number of entities within each of these categories as listed under the IRS master file. Now, I need to give you a little caution about the numbers in the master file because the master file does not necessarily exclude all organizations that have dissolved, if the IRS hasn't received notice of that. It also does not include all organizations. Most particularly, some churches, are not recorded in the IRS master file. Having said that, as Mr. Walker indicated, there are about a million-and-a-half entities listed in the IRS master file, and if you notice on that first page, the third line, the charitable category, 501(c)(3), makes up the bulk of that, about a million entities in the charitable sector that are on the master file. Within that million, about 10 percent of them comprise 80 percent of the assets and revenue in the charitable sector.

There are other categories which have a large number of organizations, but there are a number of categories which have very few. In fact, nine of the categories have under 50 organizations and four of the categories have fewer than five organizations. The remaining columns simply identify some of the common features that are applicable to some or most exempt organizations. If you look under the column called "Subject to UBIT," that is the Unrelated Business Income Tax, that is your fifth column, you will see that virtually all of these organizations are subject to a UBIT. If you look under the column called "Taxed on Investment Income," you will see that, generally, the organizations are not taxed on their investment income, except there are some important exceptions to that. If you look at the next column, about contributions, whether contributions to the organizations are deductible, you will see that, in general, it is limited to charitable organizations and a couple of others that allow charitable deductions. Some of the organizations' contributions are deductible as business expenses, but not as charitable contributions.

Finally, if you look at the next column involving “Subject to Private Inurement”—this is the doctrine which prohibits the use of organizations’ assets to benefit the insiders of the organization—you will see a somewhat mixed group. That is, some of them are subject to those rules and some of them are not subject to those rules. Turning now to compliance issues, I just wanted to highlight a couple of points. In terms of the entity, the key point is that exemption is a privilege and not a right and it is a privilege subject to certain specific conditions laid out by Congress. Most of the compliance questions in this area as it relates to the entity relate to whether one or more of the conditions are being satisfied or not. There are, of course, various policy tools which Congress has enacted, including taxes, which attempt to encourage or discourage certain types of activity on the part of one or more of these organizations, and in that regard, the effectiveness of a tax is not necessarily measured by how much revenue it raises, but rather on how successful it is in encouraging or curbing the particular behavior that the tax is designed to address. Before I leave the compliance area, I should mention that there is another compliance issue in this area not relating to the entities as such but on the contribution side, and on that score, there is a balance. The balance is between the amount of additional charitable giving that would be induced by a policy tool that would “not otherwise occur,” and those last words are very important. Then to determine the nature of the policy tool that tries to induce that type of change in behavior and whether the policy tool is susceptible to noncompliance or not. Last, I want to address briefly what I suspect many of you may have in your minds, which is now that we see there are all these different categories of exempt organizations and they have come in in different times and they have different labels and all of that, is there some master scheme here? Is there some overriding purpose in which we say that some organizations are exempt and others are not? The short answer to that question, which is certainly a very fair one to ask, as best we can determine, there is no master scheme. I suppose that would be expected, given the fact that many of these exemptions came into the law piecemeal so that there wasn’t a master plan as such that was laid down.

However, having said that, there are a few general explanations that one can use to explain some or many of the exemptions, and let me just mention four explanations. Some of these explanations overlap with one another. First, it is important to know that when an organization is exempt from Federal taxes, that determination is an issue of the Federal tax code and that that is different from whether an organization is a nonprofit organization, which is largely a determination based on State law. In general, under State law, what nonprofit means is an organization is prohibited from distributing its earnings to members. Not all nonprofit organizations under State law are tax-exempt, and conversely, some tax-exempt organizations may not necessarily be subject to this constraint that is typically applied to nonprofit organizations. Despite that, some have argued that the distinctive characteristics of a nonprofit organization may make certain classes of them appropriate choices for Federal tax exemption. A second general explanation is that if you review the organizations, you will quickly see that some number of

them carry out activities that one might classify as governmental functions in nature. Just as it would generally not be productive for the government, for example, to tax itself, it is argued sometimes that it is not productive for the government to tax an organization that is carrying out largely a governmental function. Certain charities and organizations may fit within this general explanation.

A third explanation would be that certain organizations, because of their structure, and in particular their relationship to their members, don't provide the kinds of circumstances in which taxation would be appropriate. Let me try to give you a simple example. Let us assume that all of the Members of the Committee decided to form a social club together in which you all agreed to assess yourselves certain membership fees which are then used to essentially purchase certain kinds of activities in which you all wish to engage in. Let us assume that in a given period, the amount of fees that are collected by the club are in excess of the costs of the club, and so in some general sense, one could argue that the club has made a profit. When you realize that if, in fact, under the terms of the club that you formed, all of the excess, if you will, is simply reinvested into the club to provide additional benefits, future benefits for the members, I think it is easy to realize that in some sense, this arrangement that you have made is no different from simply each of you purchasing on your own, spending some money to purchase current and future benefits, perhaps in current benefits or capital expenditures, and that there is really no income in this picture at all. Some part of the explanation for some of the organizations' exemption may be attributable to this type of an explanation. Finally, the fourth explanation I will offer is that some organizations are exempt because it is an explicit attempt by Congress to provide an incentive, which the exemption represents. A good example of that, of course, might be some of your retirement vehicles and other employee benefit vehicles. Thank you very much. I would be happy to answer any questions.

Chairman THOMAS. Thank you very much. You were obviously trying to get the attention of the Members. As soon as you mentioned the social club, every Member was trying to figure out who was going to be the social Chairman.

[Laughter.]

[The prepared statement of Mr. Yin follows:]

**Statement of George Yin, Chief of Staff, Joint Committee on Taxation**

Mr. Chairman, Mr. Rangel, members of the Committee, I am pleased to testify today on the tax-exempt sector. I first provide a brief overview of the size and growth of the exempt sector, discuss some of the reasons why organizations have been granted tax-exempt status, and describe some common tax law features of exempt organizations. I conclude my testimony by focusing on charitable organizations, the largest category by far of exempt organizations. I summarize the requirements for exempt status as a charitable organization and review selected current issues relating to those organizations.

**A. Overview of Organizations Exempt from Federal Income Tax**

**Size and growth of the exempt sector generally**

Since the inception of the Federal income tax, the Congress has exempted certain types of entities from income taxation. Many exempt entities, such as charitable organizations, are familiar. Yet charitable organizations are but one type of exempt entity. The benefit of tax exemption is extended to groups as diverse as social wel-

fare organizations, title holding companies, fraternal organizations, small insurance companies, credit unions, cooperative organizations, and cemetery companies. The statistics reported in this document do not include churches, which are not required to file returns with the Internal Revenue Service ("IRS"), and are not recorded in the IRS Master File of Exempt Organizations.

There are now 28 different types of organizations listed in the main exemption section of the Code (section 501), and numerous other exemptions provided elsewhere.<sup>1</sup> The number and financial holdings of these organizations are large and have grown significantly since record-keeping began in 1975. The revenue reported to the IRS by such organizations has increased from approximately \$0.3 trillion (in 2001 dollars) in 1975 to about \$1.2 trillion in 2001. The 2001 revenue represented approximately 12.2 percent of gross domestic product in that year. The assets reported by the organizations have similarly increased, from approximately \$0.5 trillion (in 2001 dollars) in 1975 to almost \$2.9 trillion in 2001.

While a large majority of exempt entities fall into familiar categories, such as charitable organizations, there are also a fair number of organizations that fall into more obscure categories. Eight categories have fewer than 150 qualifying entities each, with four categories having fewer than five entities each.

#### **Size and growth of the charitable sector**

Charitable organizations described in section 501(c)(3) represent by far the largest category of exempt organizations, comprising about two-thirds of all exempt organizations. The 2004 IRS Master File of Exempt Organizations shows 1,010,365 charitable organizations. In terms of asset size and revenues, the share of charitable organizations in the exempt sector is similar. In 2001, the total revenue of charitable organizations (including private foundations but not including churches and other organizations not required to file) was about 9.3 percent of gross domestic product.

Among charitable organizations not including churches, the largest categories of organizations are hospitals and post-secondary educational organizations. In 2001, hospitals held 29 percent of total assets and collected 42 percent of total revenues in the exempt sector. Colleges and universities held 21 percent of the total assets and collected 11 percent of total revenue.

There has been significant recent growth in the number and size of charitable organizations. The number of such organizations has increased from 259,523 in 1976 to 1,010,365 in 2004, an increase of 289 percent. The total asset value and revenues (in 2001 dollars) reported to the IRS by charitable organizations similarly increased from about \$360 billion and \$155 billion, respectively, in 1975, to over \$2 trillion and about \$942 billion, respectively, in 2001.

The growth in the number and size of charitable organizations has been accompanied by growth in the amount of charitable deductions. In 1975, the total amount claimed as charitable deductions was about \$43.7 billion whereas in 2002, the total was about \$145 billion (both numbers in constant 2000 dollars).

#### **B. Reasons for Tax Exemption**

There is no unifying theme or singular principle that explains tax exemption for the many diverse organizations in the exempt sector, although there are some factors that may help to explain the exemption for certain of them.

Over the years, Congress has granted tax exemption only to certain types of organizations. As an initial matter, not all "nonprofit" organizations are afforded tax exemption, and not all tax-exempt organizations have the typical characteristics of a "nonprofit" organization. The term "nonprofit" generally refers to an organization's form under State law, not its Federal tax status. State law generally does not prohibit "nonprofits" from earning a profit, as one might expect. Instead, State law typically prohibits the distribution of earnings by nonprofit corporations (but not necessarily by other forms of entities) to their members.

The Federal exemption is extended in some instances to organizations that are not subject to a State-law constraint on distributions, as some entities are not required for exemption purposes to be organized in corporate form. Therefore, exemption may be obtained by some organizations that do not fit the classic definition of "nonprofit." However, the Federal tax laws applicable to certain types of exempt organizations (though not all) contain prohibitions, such as the "no private inurement" and "no private benefit" doctrines, that are in some respects similar to the State-law constraint.

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<sup>1</sup> In general, my testimony does not discuss entities that are exempt under section 401 of the Code, which are subject to a completely different regulatory apparatus than those exempt under section 501.

For some organizations, exemption from tax may be explained based on the nature of its activities. For example, charitable activities or activities that provide a public benefit may be viewed as governmental in nature and therefore not appropriate subjects of taxation. This may explain the exemption for charitable organizations, social welfare organizations, U.S. instrumentalities, and State and local governments. Promotion of certain activities may also be viewed as desirable policy, and therefore tax exemption is intended to encourage the activity. This may explain the tax exemption for arrangements to provide employee benefits, arrangements for individuals to save for health, retirement, and education, and the exemption for small or rural commercial organizations that engage in certain activities, such as farming, provision of financial services, insurance, electricity, or other public good.

Exempt status may also be attributable to the structure of an organization. Some organizations are funded exclusively by their members and expend all funds exclusively for members. If such an organization collects more in membership dues than its expenses, the excess is reinvested in the organization for the benefit of the members. Under general tax principles, the organization may not be considered as having any income because there has not been a shifting of benefit from the member to the organization—the organization merely facilitates a joint activity of its members. Thus, in some cases, the Code adopts a result that might occur even in the absence of statutory law, e.g., social clubs, fraternal organizations, voluntary employees' beneficiary associations, cemetery companies, and homeowners associations.

Another factor that may explain some cases of tax exemption is the nature of the legislative process. As noted, Congress did not provide exemption for all organizations that are not organized for profit; rather, the general rule is that an organization is subject to tax absent a specific exemption. Such a rule means that once broad categories of exemption are codified, there will be specific classes of organizations that do not fit within the broad category and that seek and receive exempt status. Social welfare organizations, business leagues, labor, agricultural, and horticultural organizations and other organizations may be examples.

Another factor to consider is simple expediency, in that taxing certain small organizations was viewed at the time the exemption was granted as too costly to administer, especially when often little or no tax would be due. This appears partially to explain the reason for exempting single-parent title holding companies from tax as well as social clubs. As stated in 1916 legislative history: “the securing of returns from them has been a source of annoyance and expense and has resulted in the collection of either no tax or an amount which is practically negligible.”

### C. Common Tax Law Features of Exempt Organizations

#### In general

Despite varying standards regarding qualification for exempt status, different categories of exempt organizations share some common characteristics. For example, many types of exempt organizations are subject to a prohibition against “private inurement,” and most exempt organizations are subject to the general rules regarding the taxation of unrelated business income. Contributions to a limited number of exempt organizations are deductible as charitable contributions, while contributions to others may be deductible as a business expense but not as a charitable contribution. Most exempt organizations also are subject to rules regarding lobbying and political campaign activities and are required to file annual information returns.

#### Private inurement prohibition.

The doctrine of private inurement generally prohibits an exempt organization from using its assets for the benefit of a person or entity with a close relationship to the organization. For example, section 501(c)(3) provides that an organization will qualify for charitable exempt status only if “no part of the net earnings [of the organization] inures to the benefit of any private shareholder or individual.” The regulations under section 501(a), which generally apply to organizations subject to the inurement proscription, define “private shareholder or individual” as “persons having a personal and private interest in the activities of the organization.” Inurement thus applies to transactions between applicable exempt organizations and persons sometimes deemed “insiders” of the organization, such as directors, officers, and key employees. The issue of private inurement often arises where an organization pays unreasonable compensation (i.e., more than the value of the services) to such an insider. However, the inurement prohibition is designed to reach any transaction through which an insider is unduly benefited by an organization, either directly or indirectly.

There is no “de minimis” exception under the inurement prohibition, and an organization that engages in an inurement transaction may face revocation of its exempt status. Until 1996, there was no sanction short of revocation of exempt status in the event of an inurement transaction. In 1996, however, Congress imposed excise taxes, frequently referred to as “intermediate sanctions,” on “excess benefit transactions” between certain exempt organizations and “disqualified persons.” The intermediate sanctions rules, which apply only to transactions involving organizations exempt under sections 501(c)(3) and 501(c)(4), impose excise taxes on a disqualified person who receives an excess benefit and, under certain circumstances, on organization managers who approved the transaction. No such sanctions are presently imposed against the organization itself.

Section 501(c)(3) organizations (but not other organizations) also are subject to a prohibition against conferring more than incidental “private benefit.” The private benefit prohibition applies to non-fair market value transactions with individuals or entities, not merely with insiders, and thus is in some respects broader than the private inurement prohibition.

#### **Unrelated business income tax**

In general, an exempt organization may have revenue from four sources: contributions, gifts, and grants; trade or business income that is related to exempt activities (e.g., program service revenue); investment income; and trade or business income that is not related to exempt activities. In general, the Federal income tax exemption extends to the first three categories, and does not extend to an organization’s unrelated trade or business income. In some cases, however, the investment income of an organization is taxed as if it were unrelated trade or business income.

The unrelated business income tax was introduced in 1950 to address the problem of unfair competition between for profit companies and non profit organizations conducting an unrelated for profit activity. The unrelated business income tax generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization’s tax-exempt functions. Most exempt organizations are subject to the tax.

Most exempt organizations generally may operate an unrelated trade or business so long as it is not a primary purpose of the organization. Therefore, engaging in a substantial amount of unrelated business activity before jeopardizing exempt status is permitted. By contrast, a charitable organization may not operate an unrelated trade or business as a substantial part of its activities.

Certain types of income are specifically exempt from the unrelated business income tax, such as dividends, interest, royalties, and certain rents, unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.

For the tax year 2001, 35,540 organizations filed unrelated business income tax returns, reporting a total of \$7.9 billion of gross unrelated business income. This translated into unrelated business taxable income (after taking into account allowable deductions) of approximately \$792 million and total tax of approximately \$226 million.

#### **Contributions**

Another feature of a minority of tax-exempt organizations is that contributions to such organizations may be deductible by the donor as charitable contributions for income, estate, and gift tax purposes. Contributions to charitable organizations, for example, generally are deductible for income, estate, and gift tax purposes, although the amount of deduction may be affected by such factors as the recipient organization’s classification as a public charity or private foundation and the type of property contributed. Other types of organizations that are eligible recipients of charitable contributions include: certain Federal, State, and local government entities, if the contribution is exclusively for public purposes; certain fraternal beneficiary societies, if the contributions are used for charitable purposes; cemetery companies, if the contributions are used for certain purposes; and certain organizations of war veterans.

Contributions to other types of exempt organizations generally are not deductible as charitable contributions. Under certain circumstances, however, contributions to a membership organization, such as a social welfare organization or trade association, may be deductible as a business expense under section 162. In addition, contributions to tax-exempt employee benefit arrangements (e.g., qualified retirement plans) or individual savings arrangements (such as individual retirement accounts) may be deductible.

### **Lobbying and political activities**

Tax-exempt organizations are also subject to rules regarding the permissible level of lobbying and political campaign activities. In general, the lobbying and political activity rules applicable to charitable organizations are more severe than the rules applicable to other types of exempt organizations.

### **Information returns**

Exempt organizations are required to file an annual information return, stating specifically the items of gross income, receipts, disbursements, and such other information as the Secretary may prescribe. The requirement that an exempt organization file an annual information return does not apply to certain exempt organizations, including organizations (other than private foundations) the gross receipts of which in each taxable year normally are not more than \$25,000. Also exempt from the requirement are churches, their integrated auxiliaries, and conventions or associations of churches; the exclusively religious activities of any religious order; certain state institutions whose income is excluded from gross income under section 115; an interchurch organization of local units of a church; certain mission societies; certain church-affiliated elementary and high schools; and certain other organizations, including some that the IRS has relieved from the filing requirement pursuant to its statutory discretionary authority.

### **D. Summary of Requirements of Exempt Status of Charitable Organizations and Selected Issues Relating to Such Organizations**

#### **In general**

In general, the requirements for exempt status of an organization under section 501(c)(3) of the Code are that (1) the organization must be organized and operated exclusively for certain purposes; (2) there must not be private inurement to organization insiders; (3) there must be no more than an incidental private benefit to private persons who are not organization insiders; (4) no substantial part of the organization's activities may be lobbying; and (5) the organization may not participate or intervene in political activities. Permitted purposes are religious, charitable, scientific, testing for public safety, literary, educational, the fostering of national or international amateur sports competition, or the prevention of cruelty to children or animals. Failure to satisfy any of these requirements should result in an organization not qualifying for exempt status under section 501(c)(3), or should result in a loss of such status once a violation is detected by the IRS. Most of the Federal law of charitable organizations is designed around ensuring that each of the requirements is satisfied by an organization initially and on an ongoing basis. Each of the requirements is simple to state, but none are simple, as each carries with it a significant body of statutory, common, and administrative law.

If an organization satisfies each of the requirements, there is a further question of what type of charitable organization it is. A section 501(c)(3) organization is either a public charity or a private foundation. In general, the basis for distinguishing between public charities and private foundations is the level of public support an organization receives over time. Organizations with widespread public support tend to qualify as public charities; organizations funded by just a few donors tend to be classified as private foundations. There is a substantial body of law detailing how to determine whether an organization is publicly supported. Certain organizations also may qualify as public charities as a matter of law (e.g., churches, hospitals). The classification matters because private foundations generally are subject to more restrictions on their activities than are public charities, are subject to tax on their net investment income, and contributions to private foundations generally do not receive as favorable treatment as do contributions to public charities for purposes of the charitable contribution deduction.

Satisfaction of the requirements for exemption, classification of an organization as a public charity or private foundation, plus the resulting benefit that contributions to charitable organizations generally are tax deductible provides the simplest snapshot of the law of charitable organizations.

#### **Exempt purposes of section 501(c)(3) organizations**

##### **The meaning of charity—present law**

In general, there are two approaches to the meaning of the term charitable—the legal sense and the ordinary and popular sense. The legal definition is derived from the law of charitable trusts and is broader than the ordinary sense of the term, which generally means the relief of the poor and distressed. Since 1959, Treasury regulations have defined the term "charitable" in the legal sense, to include:

Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or ((i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

This definition is broad, encompassing several ideas that would not generally be considered as charitable in the ordinary sense. In addition to meeting the regulatory definition of charitable, an organization described in section 501(c)(3) is not organized and operated for exempt purposes if a purpose of the organization is against public policy or is illegal.

In addition to the public policy requirement, certain common law principles inform the Federal tax law definition of charity. The charitable class requirement provides that an organization be organized to benefit a sufficiently large or indefinite class of people. The community benefit doctrine permits exemption as a charitable organization if the result of an activity inures to the benefit of the community, even though a private person is the immediate beneficiary of the activity.

The meaning of charity and the rationale for tax exemption and charitable deductions

There is no agreed upon explanation of the rationale behind the charitable tax exemption and tax deduction. Some of the basic rationales that have been offered, described in greater detail in Part II.C of this pamphlet, may be summarized as follows: (1) charitable organizations serve the public and therefore should be supported through provision of tax benefits; (2) charitable organizations provide goods and services that otherwise would have to be provided by the Government and therefore should be supported by the Government; (3) it is difficult to measure the net income of charitable organizations, and therefore they should be exempt from tax; (4) charitable organizations promote pluralism; (5) charitable organizations are efficient providers of services but have inherent limits on their ability to raise capital compared to for-profit entities and therefore need government support in the form of tax exemption (and charitable contributions); and (6) exemption is afforded to those organizations that can prove their worth through sustained donations.

Educational purposes

Tax exemption for educational organizations was provided in the Tariff Act of 1894, and has been replicated in each subsequent income tax act. Educational organizations have been eligible to receive tax deductible contributions since 1917. Like the term charitable, the term educational has no precise meaning. The Treasury regulations set forth the basic definition as relating to the "instruction or training of the individual for the purpose of improving or developing his capabilities." This definition is consistent with provision of exemption for organizations that fit within the common conception of an educational organization, such as schools, colleges, and universities. Yet educational organizations are not limited to such traditional forms. The "instruction of the individual standard" may be met by many other types of organization. The Treasury regulations also provide that educational means the "instruction of the public on subjects useful to the individual and beneficial to the community." The IRS and the courts have permitted a broad array of organizations to be considered educational under this standard.

A primary issue in determining whether some method the organization uses to convey information, irrespective of content. In general, the analytical exercise is to determine whether an organization's presentation of information is objective and balanced, or whether the organization instead is an advocate or a mouthpiece for propaganda.

Religious purposes

The Federal tax exemption for organizations operated for religious purposes was, along with charitable and educational purposes, provided for originally in the Tariff Act of 1894, and religious organizations were designated as eligible for charitable contributions in 1917. There is no definition of "religious" provided by regulation. The manifest reason is the constitutional law framework that limits Federal involvement in religion. The IRS has developed a multi-factor list of characteristics that inform whether an organization may be considered a church (which is a kind of religious organization), and the IRS is careful to point out that this list is not comprehensive and that in each case, the facts and circumstances will be considered. In many cases in which a religious organization's claim to exempt status is ques-

tioned, the issue of whether the organization serves religious purposes often is not addressed because exempt status may be denied on other grounds, for example, private benefit or private inurement, commerciality, or violation of the political activities prohibition.

The Constitutional concerns regarding Federal involvement in religious organizations extend to the application of regulatory requirements. For example, certain religious organizations are exempted from the requirement to apply for tax exempt status, from annual information return requirements, and special audit procedures apply to churches. As a result, although religious organizations, particularly churches, constitute a significant part of the charitable sector, information about such organizations is scarce.

#### Scientific purposes

Scientific purposes were the first addition to the original three exempt charitable purposes and were added in 1913. Charitable contributions to scientific organizations were made deductible in 1917. A tax exempt scientific purpose hinges on the performance of basic or fundamental research in the public interest. Scientific research that is "applied" or "practical" may be subject to the unrelated business income tax, but generally is not inconsistent with exempt purposes. There is no precise definition of scientific research, and, in general, courts and the IRS have determined whether an organization is engaged in scientific research on a case-by-case basis. Scientific research must be in the public interest. Scientific research does not include activities of a type ordinarily carried on as incidental to commercial or industrial operations.

#### **Selected issues involving charitable organizations**

##### Selected issues relating to the public charity-private foundation distinction

In 2005, thirty-six years after Congress first drew a meaningful legal distinction between publicly supported organizations and private foundations, it may not be as clear, given the growth and diversity of publicly supported organizations, why some of the private foundation rules are not relevant for certain public charities, or whether some of the private foundation rules are performing their intended purpose. For example, the retention of substantial holdings in a commercial business, the making of investments or expenditures that jeopardize or are inconsistent with exempt purposes, or the maintenance of large endowment funds raise some of the same concerns whether conducted by a public charity or a private foundation.

In defining a private foundation, the 1969 Act provided that an organization that provides support to a public charity (a "supporting organization") is considered a public charity and not a private foundation. Thus, supporting organizations receive the benefit of the favorable charitable contribution deduction rules and avoid the excise tax regime applicable to private foundations. Donors to supporting organizations may take a fair market value deduction for contributions of capital gain property such as closely held stock, which would not be permitted for gifts to private foundations. As a public charity, supporting organizations also are not subject to the private foundation self-dealing rules (e.g., barring loans and other transactions with insiders), limitations on business holdings, or subject to the private foundation payout rules. However, unlike other public charities but like private foundations, supporting organizations generally do not have broadly based support, and may resemble private foundations in other respects.

Community foundations and donor advised funds, which generally qualify as public charities, offer limited ways for donors to exercise post-transfer control or direction over the use of funds or other property transferred to a charity for which the donor is entitled to a deduction in the year of transfer. Contributors to community foundations and donor advised funds receive the benefit of the favorable public charity rules and some elements of the control over distributions without being subject to the legal constraints placed on a private foundation. Thus, a donor can fund an account in a community foundation or donor advised fund with cash or capital gain property, take a fair market value deduction, accumulate income in the fund, and from time to time recommend that amounts be paid out of the fund for charitable purposes. Community foundations and donor advised funds, like supporting organizations, resemble private foundations in many ways, but are considered.

##### Selected issues relating to the unrelated business income tax

In general, exempt organizations have greater discretion than taxable organizations in determining whether to report income as taxable or not, through the questions of whether income is from a regularly conducted trade or business, and whether the conduct of such a trade or business is "substantially related" to exempt purposes. In addition, even if an exempt organization treats income as unrelated and

therefore as subject to tax, an exempt organization might allocate expenses for an exempt activity to an unrelated activity in order to minimize or eliminate the tax.

Issues often arise regarding whether certain types of receipts constitute royalties, which generally are excluded in determining an organization's unrelated business taxable income. Two issues that have been the source of considerable debate in this area are: (1) whether income from an affinity credit card program constitutes a royalty and (2) whether income from a mailing list rental constitutes a royalty. Notwithstanding several court decisions, a taxpayer that provides more than a small amount of clerical services may risk having payments received in exchange for a license classified as payments for services rather than as excludable royalties.

#### Charitable hospitals

##### In general

The Code does not provide a *per se* charitable exemption for hospitals. Rather, a hospital qualifies for exemption if it is organized and operated for a charitable purpose and meets additional requirements of section 501(c)(3). The promotion of health has long been recognized as a charitable purpose that is beneficial to the community as a whole. It includes not only the establishment or maintenance of charitable hospitals, but clinics, homes for the aged, and other providers of health care.

Medical care generally is provided by government-owned, for-profit, and tax-exempt organizations. In the hospital sector, tax-exempt organizations dominate, with approximately 60 percent of the nation's hospitals operating as charitable institutions. Historically, charitable hospitals were characterized as voluntary because they generally were supported by philanthropy, staffed by doctors who worked without compensation, and served, almost exclusively, the sick poor. However, the character of the charitable hospital sector has changed significantly over the past several decades due to the growth of such resources as employer-provided health insurance and governmental programs such as Medicare (for the elderly and disabled) and Medicaid (for the poor). Today, charitable hospitals generally provide medical and other health-related services in a manner similar to their for-profit counterparts. They operate under the same healthcare regulations, compete for the same patients and doctors, and derive funding from many of the same sources as other types of hospitals.

##### Evolution of the legal standard

*Financial Ability Standard.*—Much like the nature of the health-care industry itself, the definition of the term charitable as applied to hospitals has not been static. In 1956, the IRS adopted the "financial ability standard," requiring that a charitable hospital be "operated to the extent of its financial ability for those not able to pay for the services rendered and not exclusively for those who are able and expected to pay." This standard effectively meant that a charitable hospital could not refuse to accept patients in need of hospital care who could not pay for such services. However, the IRS acknowledged that hospitals normally charge patients who are able to pay for services in order to meet the hospital's operating expenses and stated that the "fact that the hospital's charity record is relatively low is not conclusive that a hospital is not operated for charitable purposes to the full extent of its financial ability." The ruling's requirement that charitable hospitals provide some amount of free or reduced-rate care reflected the view that hospitals and other health care institutions were only charitable if they both provided relief to the poor and promoted health.

*Community Benefit Standard.*—The financial ability standard governed charitable hospitals until 1969. Congress had criticized the financial ability standard as imprecise concerning the extent to which a hospital must accept patients who are unable to pay. In addition, the creation of Medicare and Medicaid in 1965 had a fundamental effect on hospitals; a substantial portion of the free care previously subsidized by charitable hospitals now was reimbursed through these governmental programs. In response to these developments, the IRS adopted the "community benefit standard," which remains the test applied by the IRS for determining whether a hospital is charitable. Under the community benefit standard, the promotion of health care is "one of the purposes in the general law of charity that is deemed beneficial to the community as a whole even though the class of beneficiaries eligible to receive a direct benefit from its activities does not include all members of the community, such as indigent members, provided that the class is not so small that its relief is not of benefit to the community." Applying this community benefit standard, the IRS found that a hospital's operation of a generally accessible emergency room open to all persons, regardless of ability to pay, provided a benefit to a suffi-

ciently broad class of persons in the community. The requirement of the financial ability standard that charitable hospitals provide care to patients without charge or at rates below cost was removed. The community benefit standard applies not only to traditional hospitals, but also other health care provider organizations, such as clinics or health maintenance organizations (HMOs).

Credit counseling organizations

In a 1969 ruling, the IRS concluded that a credit counseling organization was exempt as a charitable or educational organization described in section 501(c)(3) by virtue of aiding low-income people who had financial problems and providing education to the public. The organization had two functions: (1) educating the public on personal money management, such as budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications; and (2) providing individual counseling to low-income individuals and families without charge. As part of its counseling activities, the organization established debt management plans for clients who required such services, at no charge to the clients. The organization was supported by contributions primarily from creditors, and its board of directors was comprised of representatives from religious organizations, civic groups, labor unions, business groups, and educational institutions. In 1978, a court held that the law did not require that an organization must perform its exempt functions solely for the benefit of low-income individuals to be considered charitable. The court found the debt management plans of the agency at issue were an integral part of its counseling function.

During the period from 1994 to late 2003, 1,215 credit counseling organizations applied to the IRS for tax exempt status under section 501(c)(3), including 810 from 2000 to 2003. As of late 2003, the IRS has recognized more than 850 credit counseling organizations as tax exempt under section 501(c)(3). A number of new credit counseling entities have engaged in aggressive marketing and advertising while providing very little legitimate credit counseling or financial training. In addition, many of today's credit counseling organizations conduct as their primary activity, and derive most of their revenues from, debt management planning and other activities. Because of these changes in the industry, Congress and the IRS have expressed concern that tax-exempt credit counseling organizations are not fulfilling their exempt purpose. The IRS has commenced a broad examination and compliance program with respect to the credit counseling industry. The IRS concluded in a recent legal memorandum that many credit counseling organizations may not qualify for exemption under section 501(c)(3) because of operation for a substantial non-exempt purpose, substantial private benefit, and private inurement.

Thank you for the opportunity to testify. I would be pleased to answer any questions.

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Chairman THOMAS. Mr. Holtz-Eakin, head of the Congressional Budget Office. Welcome. Thank you.

**STATEMENT OF DOUGLAS HOLTZ-EAKIN, DIRECTOR,  
CONGRESSIONAL BUDGET OFFICE**

Mr. HOLTZ-EAKIN. Thank you, Mr. Chairman, Congressman Rangel, and Members of the Committee. The CBO is pleased to have the opportunity to be here today. We have submitted our written statement and I will briefly make four points. Point number one, which has been touched on already, is that there are economically significant, measured by sales or employees or purchases, economically significant entities who compete with traditional for-profit firms and who are exempt from Federal income taxation. The key characteristic of these entities is that their ownership structure differs from a traditional structure in which there are conventional shareholders, and that as a result of this traditional—the absence of this traditional owner claimant, the managers of these entities have greater incentives to lower prices, increase costs, or bolster their retained earnings instead of returning any profit to their owners. For this reason, the responses to any attempted taxation

of these entities might lead to a much lower tax liability and a lower receipt than any initial appearance might suggest, and I thought I would briefly expand on those. These entities, which have been touched on by both Mr. Walker and Mr. Yin, are significant. They generate substantial revenues by selling goods and services. They incur substantial costs. In particular, they hire a great many workers in the economy and they purchase many inputs from other firms. These entities, which we call business entities and which collectively we refer to as the untaxed business sector, form an economically significant component of the U.S. economy.

Three types of entities appear to stand out in this regard. The first are nonprofits, for example, nonprofit hospitals, engaged in business-like activities, at least in part, or universities with spin-off businesses such as R&D partnerships or private firms. The second are cooperatives, such as credit unions and others, in which the clients are often the owners of the activity itself. Finally, business enterprises of State and local governments, such as municipal utilities that are operated on a fee-for-service basis. They are large. It is difficult to get a handle on the absolute magnitude both because size can be measured in output, size can be measured in employment, it can be measured in investment and assets. We provide some estimates, as well. I think it is fair to say that this is an important aspect of the U.S. economy. Let me talk a bit about the two issues that might present a policy maker. First, the issue of economic policy. What is the impact of having side-by-side traditional for-profit firms and these business entities competing in retail markets? There, the question really depends on how any apparent surplus, any excess of price per unit over cost per unit, and that would include tax costs, how that surplus affects managerial behavior. One possibility is that that surplus simply gets translated into higher input costs—pay the workers more, live in bigger offices with nicer furnishings, and if so, the fact that you can have the same price with a higher cost interferes with traditional market discipline that rewards economic efficiency and allows these entities to maintain their competitive status. An alternative possibility is that this surplus is translated into lower prices and allows these entities to expand and, indeed, could allow the sector as a whole to expand, drawing more workers, drawing more capital into that sector at the expense of other parts of the economy. So there is a policy level efficiency issue that arises in examining them. The second is what would happen to budgetary impacts if there were any attempt to bring them into the Federal income tax system, and there, you essentially run the same logic in reverse. How would an attempt to tax the apparent surplus lead managers to respond? It could be that they, again, lower prices, and if so, and if sales were to other businesses, you could raise profits elsewhere and capture that indirectly, although you wouldn't get it directly from these entities. Alternatively, if there are sales, final sales to consumers, it is unlikely you would get them. It could be that in the process of doing that, you would expand them at the expense of their competitors by giving them an incentive to lower prices even more. It could be that they do this in the form of higher compensation, in which case it could be picked up under the individual income tax if this was wages or salaries, for example. In either event, that attempt

would have the impact, to the extent that the managers followed these incentives, to lower any retained surplus and thus affect their ability to grow in the future if those retained earnings are the source of expansion in the untaxed business sector. So, we thank you for the chance to be here today and I will look forward to your questions.

Chairman THOMAS. Thank you very much.

[The prepared statement of Mr Holtz-Eakin follows:]

**Statement of Douglas Holtz-Eakin, Ph.D., Director, Congressional Budget Office**

Mr. Chairman and Members of the Committee, I am grateful for the opportunity to appear before you.

My testimony addresses several tax policy, budgetary, and economic issues that arise from the presence of economic entities whose revenue comes primarily from selling goods and services in direct competition with traditional for-profit firms and whose income is exempt from both the federal corporate and individual income taxes. In my discussion of the Congressional Budget Office's (CBO's) analysis of those issues, I will refer to such organizations individually as "business entities" and collectively as "the untaxed business sector." Three types of business entities have the characteristics noted above:

Certain nonprofit institutions—for example, nonprofit hospitals that are wholly engaged in businesslike activity or universities that have undertaken "spinoff" business activities (such as research development partnerships with private firms);  
 Cooperatives, including credit unions, which differ from other businesses primarily because their clients are their owners; and  
 Business enterprises of state and local governments, such as municipally owned utilities, that are operated on a fee-for-service basis.

CBO's analysis—which was restricted to the exemption from federal income taxation and does not consider any other tax treatment received by these entities—leads to several conclusions:

The ownership structure of untaxed business entities differs significantly from that of conventional for-profit firms in that there are no separate claimants, such as shareholders, for the entities' residual profits. The lack of owners in the usual sense is what primarily determines how any attempt to tax such entities is likely to affect federal revenues and the economy. Because of the absence of owner-claimants, managers of these entities have different incentives from those of managers of privately owned businesses. Instead of seeking to return profits to owners, the entities' managers have incentives to lower prices, increase costs, or bolster retained earnings. Accordingly, taxation of these entities might not generate as much revenue as initially anticipated. Taxation would bolster managers' incentives to reduce or eliminate entities' tax liabilities by using more of any surplus to cut prices, boost costs, or both. As a consequence of being taxed, however, those entities would retain fewer funds for expansion.

**What Is an "Untaxed Business"?**

Business activity can be thought of as the provision of goods and services for a price. Only those consumers who pay the price receive the goods or services, and the entities that provide them finance their production with the receipts from those private transactions. In the United States, most business activity is undertaken by privately owned for-profit firms. The government often provides and finances through taxation services that are not amenable to being provided by businesses, such as those whose benefits reach beyond the buyer or seller and benefit others as well.

There is no bright line, of course, between the kinds of goods and services that conventional businesses produce and those that have broad public benefits. Non-profit entities, which are deemed to serve a public purpose and for that reason are not taxed, provide a number of them. Some nonprofit entities, such as nursing homes and mental institutions, may be less likely than their for-profit counterparts to take advantage of consumers who have limited information. In the case of cooperatives and state and local government businesses, the tax benefit that they re-

ceive has been justified in the past as an offset to the monopoly power of for-profit firms, power that might cause prices to be too high. Tax exemption may also encourage the provision of services when there are too few customers in an area to motivate a for-profit entity to engage in business activity. Over time, however, economic growth, technological advances, and increases in population may have altered the circumstances that justified the formation of many of those entities in the past.

Many untaxed business entities sell goods and services that compete directly with those provided by traditional for-profit firms. The surplus generated by untaxed entities escapes the income tax system if it is passed on to retail customers in the form of lower prices or if it is retained for reinvestment. But the income tax system does capture surplus that is passed on to workers or managers as higher pay or to commercial customers as lower prices that then allow them to increase their profits.

The Internal Revenue Code subjects the surplus generated by most business activity to the income tax. Profits generated by firms that are organized under the tax code as C corporations are taxed once at the corporate level and a second time at the individual level, when they are received as dividends or capital gains. Firms organized as proprietorships, partnerships, limited liability companies, S corporations, and other so-called pass-through entities are not subject to the corporate tax. However, the surplus they generate is taxed at the individual level.

#### **Which Businesses Make Up the Untaxed Sector?**

Three types of entities have the characteristics of businesses but are not subject to income taxation either at the “firm” level or through the pass-through mechanism. The three are nonprofit institutions, cooperatives, and state and local government enterprises.

#### **Nonprofit Institutions**

Many nonprofit institutions produce output that is sold to customers in much the same way that private businesses sell goods and services. The most prominent example is nonprofit hospitals that finance virtually all of their health care services with revenue from sales. On average, nonprofit health care institutions receive relatively few donations, garnering 92 percent of their income from program revenue (revenue from the sale of services). Those health care institutions alone represent about half of the total revenue of all nonprofit entities that must file financial information returns. (All nonprofit entities whose gross receipts exceed \$25,000 must file financial information with the Internal Revenue Service.)

Many nonprofit institutions whose primary activity fulfills a public purpose also engage in substantial business activity. The tax code contains provisions to tax income from business activity that is unrelated to a nonprofit’s public purpose. In practice, however, much of that unrelated business income (such as income from royalties, payments from corporations for the right to associate their name with a nonprofit organization’s activities, and income from the sale of membership lists) has been classified under tax law as related to the entity’s public purpose and thus is not subject to taxation. Universities, for example, receive royalties from research development partnerships with private business and receive income from athletic events that compete with professional sports leagues.

CBO estimates that businesslike nonprofit institutions add roughly \$314 billion of value to the economy, or 3.4 percent of net domestic product (see Table 1). That estimate is based on the share of each entity’s revenue that comes from payments made by customers. Of the revenue for all nonprofit institutions, 65 percent accrues to entities whose program revenue exceeds 75 percent of their total revenue. CBO assumed in its calculation that their share of net domestic product (the net value added to the economy) was proportional to their share of total revenue.

#### **Cooperatives**

A second type of untaxed entity is cooperatives—businesses whose owners are also its clients. Virtually all of the activity of cooperatives is conducted in a businesslike fashion—that is, their goods and services are sold to (or for) their client-owners. They operate under several different sections of the tax code but, with only a few exceptions, are exempt from taxes on their income.

**Table 1. Estimated Size of the Untaxed Business Sector and Its Share of Net Domestic Product**

Type of Entity	Billions of Dollars	Percentage of Total Net Domestic Product <sup>a</sup>
Nonprofit Institutions that Serve Households	314.0	3.4
Cooperatives (Four industries) <sup>b</sup>	32.1	0.5
State and Local Business Enterprises	127.4	1.4

Source: Congressional Budget Office based on data for 2000 through 2003 from a variety of sources including the national income and product accounts, Census of Governments, and the National Center for Charitable Statistics.

<sup>a</sup> U.S. net domestic product in 2002 totaled \$9,192 billion.

<sup>b</sup> The four industries are credit unions and three types of utilities providing electric, telephone, and water services.

Many cooperatives are small and generate only a modest volume of sales, but some cooperatives are quite substantial enterprises. The larger credit unions compete effectively with segments of the commercial banking industry. Moreover, cooperatives include such large and well-known firms as Land O'Lakes, Southern States, and Welch's. Information on the size of the cooperative sector is not available, but in 2001 and 2002, four industries together—credit unions and three types of utilities providing electric, telephone, and water services—earned \$77 billion in total revenue.

CBO estimates that cooperatives in those four industries added roughly \$32 billion in value to the economy in 2002, or about 0.3 percent of net domestic product. Again, CBO's estimate incorporated the assumption that those cooperatives' share of businesses' contribution to net domestic product was proportional to their share of businesses' total output.

#### **State and Local Government Businesses**

The third category of untaxed entities comprises firms owned by state and local governments that are operated on a fee-for-service basis but that are typically exempt from federal taxation under the doctrine of intergovernmental tax immunity. The most common of those entities are utilities—primarily electric, water, and gas—which have many private-sector analogues. Others, such as water and sewer services and solid waste collection, have fewer for-profit counterparts. States and localities also operate a number of transportation and recreation businesses. (Transportation enterprises include parking garages, ferry boats, wharves, and airports. Businesses related to recreation include swimming pools, golf courses, hotels, and motels.) Miscellaneous commercial activities undertaken by states include a commercial bank and a flour mill in North Dakota and the manufacture of vaccines by a public entity in Massachusetts. In addition, states and localities operate such businesses as liquor stores and lotteries to generate additional revenue.

CBO estimates that the value added to the economy by state and local entities that might be performing tasks similar to those carried out in the for-profit sector is roughly \$127 billion, or 1.4 percent of net domestic product. (Again, CBO assumed that the state and local government sector's share of net domestic product was proportional to its share of total revenue.) The state and local sector received a total of \$93 billion in revenue from operating water, electric, and gas utilities in fiscal year 2002. Another \$194 billion of charges and miscellaneous revenue is attributable to the sale of private goods, such as motel room rentals.

#### **Issues Surrounding the Tax Treatment of Untaxed Businesses**

Several objections have been raised to the differential tax treatment granted to these business entities. Competitors of tax-exempt businesses have objected that it is unfair, and analysts have been concerned about its effects on economic efficiency. Evaluating fairness is problematic. To begin with, such an exercise reflects the values of the observer. In addition, fairness is best evaluated with respect to the owners of firms; the institutions are merely legal constructs that exist to organize and facilitate production. But owners change over time, making it impossible to trace how former owners of competing or potentially competing firms were affected. Eliminating the differential tax benefit would not redress any past inequities and could introduce new ones.

Differential tax treatment could lead to inefficiency in several ways. Untaxed firms have the opportunity to use their surplus (which includes their tax savings)

to offset any higher production costs they might incur and still compete with taxed firms on the basis of price. Consequently, the tax benefit may interfere with the market's discipline, which rewards efficient firms and penalizes inefficient ones. Alternatively, using the tax savings to reduce the price of the firm's output could shift the economy's mix of production toward less-valued goods and services.

The favored treatment of untaxed businesses, however, stems from their public-purpose nature, and the continuation of that treatment will depend on the judgments of policymakers.

#### **The Tax Exemption and Forgone Receipts**

The three categories of untaxed businesses have a significant attribute in common: the absence of conventional owners, which relieves them of the need to report and distribute profits in the usual sense. The incentives of managers of untaxed businesses thus differ from those of managers of commercial businesses. Not seeking to maximize profits or surplus, they have greater latitude with regard to their costs of production and prices. Indeed, the purpose of some untaxed entities in part is to sell output at prices lower than its costs. As a result, taxing the untaxed business sector may yield much less revenue than might be expected, given the scale of its activities.

The scope of tax-avoidance options available to for-profit firms is limited by the necessity to deliver a return to the firms' owners. The tax-avoidance strategies that nonprofit businesses, cooperatives, and state and local government enterprises can command are more numerous because of those entities' ownership structure. That statement is true regardless of whether the entity attempts to reduce the price and increase the availability of the good it sells or whether it takes less care to adopt lowest-cost methods of production and as a result pays its operators and employees higher wages than they would otherwise receive. Hence, if a tax was imposed, a nonprofit business entity could more easily distribute any surplus to its managers or customers than a for-profit firm could; a cooperative would have more latitude to deliver its surplus to its owner-clients as lower prices than to parcel it out; and state and local government businesses could distribute their surplus in several different ways without necessarily handing it over as explicit profits to the state or locality. (They could distribute it as lower prices to their customers, higher wages to employees and managers, or some combination of lower taxes and more public services to the voters who ultimately control those businesses.)

A surplus that is passed on in the form of lower prices or higher pay reduces profits. Without conventional owners and the necessity to distribute profits as dividends or retain them as earnings, untaxed business entities could avoid a tax by passing on the surplus and minimizing taxable profits (see Box 1).

If a tax was imposed, previously untaxed business entities would probably choose among tax-avoidance strategies on the basis of their circumstances. For an electric utility owned by a state and local government, for example, the shares of the surplus received by individuals in the jurisdiction differ depending on whether the surplus is distributed as a lower price, higher pay, or reduced tax burden. Similarly, the shares of any surplus received by an individual owner-client of a cooperative will differ if the surplus is distributed as a reduction in prices instead of as profits. Regardless of the particular strategy an untaxed business entity chooses, the difference between its ownership structure and that of a private firm provides it with substantially more flexibility in undertaking measures to avoid taxes and still meet its objectives.

**Box 1.****Taxing the Surplus from a Hypothetical Municipal Golf Course**

As an illustration, imagine a municipal golf course that is run as efficiently as a private competitor and priced the same—say, \$40 per round. The municipal course incurs \$36 in costs per round and generates a surplus of \$4. The corporate tax rate is assumed to be 30 percent and the individual rate, 20 percent.

Presented as an equation, price (\$40) = cost per round (\$36) + before-tax profit per round (\$4). In the absence of any taxes, the entire surplus of \$4 per round can be paid to the untaxed municipal treasury to offset other costs of local government. In contrast, the private competitor must record the equivalent \$4 per round as a profit and pay a 30 percent tax (\$1.20).

Should a corporate tax be imposed on the municipal firm, rather than paying it, the firm might distribute the surplus to its customers as a price cut and charge only \$36 per round. Costs would equal revenue, and the surplus would still escape the tax. The golf course's books would show the following:  $\$36 = \$36 + 0$ .

Alternatively, the golf course might pay its employees higher wages. The price per round would still be \$40, but costs would be increased to \$40, leaving no surplus to tax. In that case, however, the surplus would be subject to individual income taxes. If the individual rate was 20 percent, only 80 cents would be collected rather than the \$1.20 that would be collected from a for-profit firm. The golf course's books would show the activity this way:  $\$40 = \$40 + 0$ .

Another option for the municipal firm would be to convert the \$4 surplus to the local government's general fund by shifting \$4 of its general fund costs to the golf course. No tax is collected on revenue that goes into the general funds of state and local governments. The golf course's books would, again, show the following:  $\$40 = \$40 + 0$ .

The opportunities for tax avoidance are even greater for secondary business activity carried on by untaxed entities whose primary activity is pursuing socially beneficial objectives. Profits from any business activity in which such an entity engages—whether related or unrelated to its main activity—are difficult to segregate from profits earned in the pursuit of its primary purpose. As a result, the taxation of any non-primary-activity profits becomes extremely difficult in the face of skillful management and accounting. In tax year 2000, a total of \$4.8 billion of gross unrelated business income was reported by more than 11,000 organizations classified as 501(c)(3) under the tax code. The organizations reported total deductions for business expenses of about the same amount—for a net loss of \$49,000. Fewer than half reported unrelated business income that was subject to taxation, and the revenues raised totaled only \$4.1 million.

Because of those opportunities and incentives, any shift toward taxing the currently untaxed business sector can be expected to yield considerably less revenue than the size of the sector might otherwise suggest. The Joint Committee on Taxation has estimated that taxing some of the institutions in the sector in a manner analogous to the taxation of C corporations would yield about \$2 billion in revenue a year. If the estimates covered more of the sector's businesses, the revenue gain would probably be larger. But it appears that the amounts involved are small relative to the size of the entire economy—and might in fact be even more modest if the estimates did not take into account the scope such firms have for tax avoidance.

**The Economic Effect of Taxing the Untaxed Business Sector**

Taxation of currently untaxed business entities would be unlikely to generate much revenue for the government, but it would have the economic consequence of constraining their growth. Taxation of their surplus would amplify the incentives they already have to lower their prices and incur higher costs, which could significantly reduce the amount of internal capital that those institutions accumulated. That constraining effect of taxation on growth would tend to be much stronger than it is for privately owned for-profit firms, which must pay tax on their profits but face strong incentives to retain the after-tax surplus or distribute it to owners.

Chairman THOMAS. Dr. Colombo, and I will just go from left to right across the panel with our guest witnesses. Dr. Colombo is a professor of law at the University of Illinois College of Law. Obviously, based upon his written testimony, he has spent a long time looking at this area. Dr. Colombo?

**STATEMENT OF JOHN D. COLOMBO, PROFESSOR, UNIVERSITY OF ILLINOIS COLLEGE OF LAW, URBANA-CHAMPAIGN, ILLINOIS**

Mr. COLOMBO. Thank you, Mr. Chairman, and I want to thank the Committee for inviting me today. I am a professor of law at the University of Illinois at Urbana-Champaign and I have taught and written about tax-exempt organizations for the past 18 years. I would like to make three points about tax exemption that I think are useful in organizing this area. First, when you think about tax exemption, it really is helpful to divide the world into charities exempt under 501(c)(3) and everything else. When people hear the phrase "tax-exempt organization," they tend to equate it with the charitable contributions deduction under section 170, but that is not the way things work. section 501(c) lists 28 different kinds of organizations that are tax-exempt, but with a couple of exceptions, only charitable organizations are eligible to receive deductible contributions. In addition, the underlying rationales for exemptions vary between charitable organizations and everything else. Most of us think that charitable organizations are exempt because they are improving general public welfare in some way. For non-charitable entities, however, the rationale tends to be much more entity-specific, for example, the social club pooling of resources rationale that you heard from Mr. Yin. Finally, charitable organizations, as Mr. Yin pointed out, are by far the largest subset of exempt organizations, both numerically and financially.

Second, it is useful to remember that within this special group of charitable organizations, we also have two categories, public charities and private foundations. Again, people sometimes get confused about this, but a private foundation is an exempt charity under section 501(c)(3) just as much as a church or a private school. We do more highly regulate private foundations, and the reasons for that heightened regulation relate to the public accountability concept. Public charities get their money from a broad cross-section of the general public and hence are accountable to the general public. Private foundations generally get their money from a single donor or family and hence are accountable to their primary donor. If you have public accountability, then you have some reason to believe that the managers of a charity will be careful about what they do because the public is watching them. Think back to the outcry that happened when the Red Cross announced that it was going to divert some money donated to it for 9/11 victims to other needs. People got mad, this Committee got involved, and the Red Cross changed its mind. When you do not have this public accountability, then there is enormous room for abuse, which is why Congress adopted the much tighter regulatory scheme for private foundations in 1969, including the prohibitions on self-dealing, the stricter limits on the kinds of investments private foundations can hold, and stricter limits on deductions for donations to private

foundations. The accountability principle tells us that there are two particularly important issues here. One is transparency, is the public getting information it needs to hold charities accountable, and the other is whether taxpayers have found structures that avoid the private foundation regulations but yet are not truly accountable to the public.

My final point concerns the overall system for identifying exempt organizations, and here, I want to talk specifically about that subgroup of exempt charities. Charitable tax exemption just sort of happened. We never really agreed on a core rationale for exempting charities. The operation of charities has changed dramatically over the years. Private nonprofit hospitals, for example, were largely shelters for the poor until World War II. Now, they are mostly very large fee-for-service businesses. So, why are they still exempt? Some people think it is because they provide free care to the poor, but free care is not currently required by the tax laws for hospitals to be exempt. So, here is an example, and there are others, where we have ended up with a disconnect between our traditional views of charities and how they operate in the real world today. Over a decade ago, my colleague, Mark Hall, and I suggested a system in which charitable tax-exemption under 501(c)(3) would be limited to entities that were substantially dependent on donations for their operating revenues each year. We still think that system would make a lot of sense. People donate to organizations because they see the needs these organizations serve and see a lack of resources to meet those needs. If an organization doesn't get significant donations, then either it isn't doing anything the public thinks is worthwhile or the public sees that they have ample resources without donations. In either case, such organizations don't need tax-exemption. Using donative status, therefore, seems to be a pretty good way to distinguish organizations that do things that ought to warrant tax-exemption from those organizations that don't. Whether you agree with our donative idea or not, I would urge the Committee to give some thought to the overall rationale for charitable exemption as it debates on these issues. If you don't like my theory, that is fine. There are lots of them out there. Find one that you do like and conform the law to that theory and you will have made an enormous improvement in the law relating to tax-exempt organizations. Thank you very much.

Chairman THOMAS. Thank you very much.  
 [The prepared statement of Mr. Colombo follows:]

**Statement of John Colombo, Professor, University of Illinois College of Law, Urbana-Champaign, Illinois**

Mr. Chairman, Members of the Committee:

My name is John Colombo. I am a professor of law at the University of Illinois College of Law in Urbana-Champaign, and I have taught about and written on issues of tax-exempt organizations for the past 18 years. I think my job today is to give you some background and context regarding tax exemption rules, particularly as they apply to private foundations and trade associations.

*Charitable Exemption vs. Other Exemption*

Let me start with two very basic and very useful distinctions to keep in mind when assessing policies regarding nonprofits and tax exemption. The first distinction is that when it comes to tax exemption, there are charities exempt under Code Section 501(c)(3) and then there is everything else. Section 501(c) grants exemption

to 28 different kinds of organizations, but the “charities vs. everything else” distinction is a very useful way to think about this for several reasons. First, in general only charities exempt under 501(c)(3) are eligible to receive additional major tax benefits like tax-deductible contributions. Other exempt entities, like trade associations (which are exempt under § 501(c)(6), rather than § 501(c)(3)), get exemption from having to pay the corporate income tax on their earnings, but are **not** permitted to receive deductible contributions.

Second, the underlying rationales for exemption vary between charitable organizations and everything else. Although we academics carry on a lively debate about the rationale for charitable tax exemption, all of us would agree, I think, that at some level exemption for charities is tied to a concept that they are improving general public welfare in some way. For non-charitable entities, however, the rationale tends to be much more entity-specific.

For example, trade associations are exempt if they carry on activities designed to promote a common business interest of its members; such organizations must not “engage in a regular business of a kind ordinarily carried on for profit.”<sup>1</sup> These organizations are exempt because they represent simply a pooling of resources by people with a common interest to conduct activities that, if conducted by the members themselves, would not be profit-making businesses. Hence we believe that creating an “association” for members to pool their resources in this manner should not result in taxation of those pooled resources. But if a trade association does conduct regular business activities or provides specific services for members, then the organization should not be exempt because it no longer represents this nontaxable collective pooling of resources, but rather is now engaging in a for-profit business.

Third, charities constitute the bulk of exempt organizations under 501(c). Data compiled in 2002 indicated that there were in excess of 900,000 exempt charitable organizations in the IRS’s master file, constituting well over half the total number of all exempt organizations.<sup>2</sup> Trade associations under 501(c)(6) were the next most numerous category, with approximately 84,000 organizations, but still less than a tenth of the number of charitable organizations.

#### *Public Charities vs. Private Foundations*

The second major distinction in tax-exemption law occurs within the charitable sector itself. This distinction is between public charities and private foundations. People often get confused about the tax-exempt status of private foundations; so the first thing to remember is that private foundations are charitable organizations eligible for exemption under Section 501(c)(3) just as much as a church or a private school. The IRS has long recognized that making monetary grants to other charities is itself a charitable activity, and that’s largely what private foundations do—make grants to other charitable organizations. Historically, in fact, private foundations preceded the income tax. The wealthy industrialists of the 19th century, such as Andrew Carnegie, for example, created trusts to benefit charitable organizations long before we had a functioning income tax. As a result, prior to 1969, private foundations and public charities were treated pretty much the same for tax purposes.

In the 1969 Tax Reform Act, however, Congress decided to subject private foundations to more specific regulation designed to prevent abuses of the private foundation form. The best way to understand why we have this heightened regulation of private foundations is to focus on two main differences between private foundations and public charities: accountability and continuing control.

Public charities are organizations that are accountable to the general public because they get their money in one way or another from a broad cross-section of the public. Private foundations, however, generally receive their funding from a single individual or family, and therefore are accountable to and controlled by that primary donor.

These two distinctions are the basis for our different regulation of public charities and private foundations. When you have true public accountability and “public control” over assets, then you have some reason to believe that the managers of the charity will be careful about their mission and the execution of that mission, because a publicized misstep will have significant adverse effects on the public funding of that organization. Think back to the adverse publicity for the United Way a couple of years ago when its CEO’s salary and perks were disclosed in the national media, or the outcry that happened when the Red Cross decided to divert some

<sup>1</sup> Treas. Regs. 1.501(c)(6)-1.

<sup>2</sup> Marion Fremont-Smith, *Governing Nonprofit Organizations* 6–7 (Belknap Press 2003). This number is likely significantly higher than what is reported, because churches do not have to file with the IRS for recognition of exemption under Section 501(c)(3) and therefore are not included in the IRS Master File.

money donated for 9/11 victims to other needs—I believe, in fact, that this Committee held hearings about the Red Cross's decision and was instrumental in bringing the weight of public accountability to bear on that.

When you do not have this public accountability, however, and you have significant continuing control by one person or family over donated wealth, then there is enormous room for abuse, which is why we have the much tighter regulatory scheme for private foundations. This tighter regulatory scheme generally is set forth in Sections 4940–4946 of the Code, and includes a requirement that a foundation pay out a certain amount of its assets each year to other charities, a prohibition on self-dealing transactions of any kind, limits on the kinds and size of certain business holdings of a foundation, limits on certain kinds of investments that a foundation can make, more stringent limits on lobbying, and so forth. In addition, in 1969 Congress also tightened the rules with respect to charitable donations to private foundations, again to avoid abuse situations in which individuals could eliminate tax liability by making gifts of certain kinds of property, like stock of a privately-held corporation, that could still be controlled for by the donor after the gift. So while individuals can make deductible donations of up to 50% of their adjusted gross income to public charities, and in many cases can take a deduction for the full fair market value of donated property to public charities, deductions to private foundations are limited to 30% of AGI and deductions for property gifts generally are limited to the taxpayer's tax basis in the property, not its market value.

#### *Defining “Charitable” Organizations for Tax Exemption*

While I think this short summary gives a useful overview of the two main distinctions in our tax exemption laws (charities vs. everything else, and within the “charity” category, public charities vs. private foundations), I would like to close with an additional thought about tax exemption, particularly as it applies to charitable organizations.

One of the core problems with tax exemption for charities over the years has been that exemption more or less “just happened” without a great deal of thought regarding why we hand out tax exemption. Many organizations, such as churches and private schools, for example, were already exempt from state property taxes when Congress passed the first corporate income tax law in 1894; these organizations were not businesses in any sense of the word, and hence exemptions were incorporated into the “new” income tax law without much debate.

As a result, while we have this vague notion that we grant exemption to charities because they “do good things” for society, there has never been a specifically-articulated rationale that allows us to tie down exactly what good behavior should be rewarded with exemption. Currently, the IRS relies on the 400-years of legal precedent in the law of charitable trusts to define charitable organizations. As the operation of nonprofit organizations has changed over time, however, difficult questions have come up regarding tax exemption for certain nonprofits. For example, in the 1800’s private nonprofit hospitals were essentially shelters for the poor. Today, most of them are very large fee-for-service businesses. So why are modern private nonprofit hospitals still exempt? Is it because they “do good things” for society? There is no question that nonprofit hospitals in fact do good things for their communities, but one could argue that many for-profit businesses do good things for their communities, as well. Is it because they provide free care for the uninsured poor in some cases? Maybe so, but that is not currently required by law and the empirical evidence on whether nonprofit hospitals provide significant charity care is mixed.<sup>3</sup> So in some cases we have ended up with a sort of disconnect between our traditional views of charities and the way they operate in the real world today.

Over a decade ago, my colleague Mark Hall and I suggested a system in which tax exemption under Section 501(c)(3) would be limited to entities that were substantially dependent on donations for their operating revenues each year.<sup>4</sup> There is a reason why limiting exemption to donative organizations makes sense—in brief, donations are the signal that people believe an organization is doing something worthwhile, and is not otherwise being sufficiently funded by the private market or by the government. People donate to organizations because they see the needs these

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<sup>3</sup> Under the “community benefit” test of exemption promulgated by the IRS in 1969, free care for the uninsured is not a requirement for a hospital to receive exemption under Section 501(c)(3). See Rev. Rul. 69-545, 1969-2 C.B. 117; John D. Colombo, *The Role of Access in Charitable Tax Exemption*, 82 Wash. U.L.Q. 343, 347 (2004). For a review of the empirical evidence, see John D. Colombo, *The Failure of Community Benefit*, 15 Health Matrix 29 (forthcoming 2005).

<sup>4</sup> John D. Colombo and Mark A. Hall, *The Charitable Tax Exemption* (Westview Press, 1995); Mark A. Hall and John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 Ohio St. L.J. 1379 (1991).

organizations serve and see a lack of resources to meet those needs. In contrast, organizations that do not get significant donations either aren't doing anything the public thinks is worthwhile, or the public sees that they have ample resources without donations. In either case, such organizations do not need tax exemption. Using donative status, therefore, seems to be a pretty good way to distinguish organizations that do the things that ought to warrant tax exemption from those organizations that do not. In fact, if I asked all of you to name your paradigm charities, I suspect that most of you would name donative entities—your church, the Salvation Army, the Red Cross, the United Way, maybe certain arts organizations.

I think that any discussion of reforming the rules for tax exemption ought to include some thought about the overall system for granting tax exemption, particularly for charitable entities under 501(c)(3), and whether you agree with my suggestion about using donations as this core rationale or not, I would urge the Committee to give some thought to this general point as it deliberates on these issues.

Thank you.

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Chairman THOMAS. Dr. Hill is a professor of law. Thank you for being with us, and we look forward to your testimony.

**STATEMENT OF FRANCES R. HILL, PROFESSOR, UNIVERSITY OF MIAMI SCHOOL OF LAW, CORAL GABLES, FLORIDA**

Ms. HILL. Thank you, Mr. Chairman, Mr. Rangel, and Members of the Committee for the opportunity to present testimony this morning. I am here to suggest that although there are many rationales that have been suggested over the years for exempt status, we have, in fact, not settled on one, but there is one that is, in fact, fundamental to the law, even as currently implied, and what we need to do is recognize it, make it operational, make it practical, and build the law around it. That is the fundamental message. The rationale is based on providing a public benefit to a defined category of beneficiaries. The exempt sector is large, growing, and diverse. It must be accountable, but it should not be improperly constrained. Evidence of malfeasance by certain organization managers or the inattentiveness or even dereliction by certain directors should not be generalized to the entire sector, just as these tacky, unacceptable, and thoroughly regrettable forms of behavior should not be excused by reference to the benefits provided by exempt organizations. Government oversight, both with regard to lapses and with regard to structure, continues to be vitally important.

Of all the multiple types of exempt organizations that we have had outlined to us today, they certainly differ in their requirements for exemption, the activities that support exempt status, but they share the common feature that in every case, exemption depends upon providing a public benefit to a defined class of beneficiaries. This public benefit rationale is an analytical framework for understanding current law and deciding whether current law and the way it is being administered are consistent with the proper use of the tax subsidy. Preventing misuse of exempt organizations' resources is a matter of central responsibility. In fact, we have probably focused exclusively on simply bad behavior, on what some have called a non-distribution constraint, what some have called a private benefit prohibition. This is what academic analyses have focused on. This is what Congress has focused on for a very long time, things like section 4958, the inurement concept and the private benefit concept. The idea of preventing impermissible private benefits is important, but preventing these impermissible private

benefits will not in itself assure that exempt entities operate for a public benefit, and that is what I am urging the Committee to focus on as its work goes forward. A rationale, a framework for understanding exemption is vitally important. It should not just be a justification for either the status quo or for one's preferred reform ideas. A framework ensures that the law in this area does not simply become a cluster of isolated requirements that are easily manipulated to support activities largely unrelated to the provision of a public benefit. When the law is easily manipulated, a classic moral hazard results. Aggressive actors pursuing problematic programs win at least passive acceptance, while entities that are attempting to comply are given little useful guidance and find few positive rewards for their efforts.

I am going to try to move the concept of a public benefit beyond some warm and fuzzy invocation of the good that exempt organizations do on to a usable, practical concept. This concept certainly requires that we reconceptualize exempt organizations, which I believe, despite all the good work that has been done by government agencies, private scholars over the years, remains incompletely described and incoherently conceptualized. Exemption should be efficient, and it is efficient only if it is dedicated to providing a public benefit to designated beneficiaries. Right now, it is impossible to answer the question of whether the increase in number and revenue of exempt entities means that there has been a commensurate increase in the provision of public benefits to a charitable or other exempt class. Part of this is because we have focused so long on simply preventing private benefits, and the other reason is that we have not conceptualized what constitutes a public benefit and we have not asked a number of fundamental questions about this sector. My testimony on page five in the written form outlines a number of questions that remain amazingly unaddressed after all of these years, and it is perhaps now time to address the longstanding question and move forward also to address the new challenges. We don't know what is meant by a public benefit. It is not simply a matter of saying zoos should not run gift shops because those things are commercial, or museums shouldn't have little coffee shops in them. I like a cappuccino when looking at the art. Personally, I don't think it does any harm. The question is how to tax it. There are obviously more substantial examples, but I use a somewhat trivial one to suggest that not everything that is commercial is in our capitalist republic tainted. It is a question of the terms of engagement.

It is the work of Congress, ultimately, I think, to think about public benefits and to exercise oversight and to work with the IRS and Treasury to help define it. Part of the concept of a public benefit is who is being benefited. What is the charitable class? As Professor Colombo referred to, certainly, there was dynamic testimony before this Committee in the past relating to what constitutes a charitable class when it was unfortunately suggested the 9/11 victims' surviving family members were not a charitable class because although they may well have certainly been quite distressed, they were not poor. The IRS, of course, clarified what it meant by this testimony immediately. I bring this up only to suggest that what constitutes a charitable class or an exempt class requires careful

thought and is not an easy question, but one we need to know. Number three, much of the diversion of resources from exempt functions to non-exempt functions occurs within exempt organizations not by just simply doing private benefits outside them and we need a mechanism to find out what is going on inside exempt organizations. At the moment, I would submit, we do not know. This is not to suggest malfeasance or a plot. It is not to suggest that people who work with data are ignorant or inattentive. We don't have the conceptual framework, and I have in my written testimony suggested how we might go about asking some of these questions. I would like to point out to the Committee that questions of operating through complex structures of multiple types of exempt entities, or exempt entities and taxable entities, should not be regarded as inherently wrong or problematic. The question remains, how do they operate, and then my fifth question, how are resources to be transferred?

There is no guidance on what kind of resource transfers can be engaged in consistent with various types of exempt status. Some of these are efficient and productive and necessary. Others are beyond problematic and should be interdicted fairly quickly. UBIT, what is it there for these days? It was enacted to make sure that taxable entities were not put at disadvantage when they were making spaghetti. Long ago, a Member of this Committee expressed the fear that all noodles in America would be made by universities, referring to the famous Mueller Macaroni New York University Law School example. Well, that didn't happen, but there was a justifiable concern about the tax advantage. The issue with UBIT, the Unrelated Business Income Tax issues now, is are resources being diverted inside the entity to business activities? Why are we capitalizing business activities with deductible charitable contributions? I submit we need to know to the extent this is happening and think about whether that is appropriate. Finally, a new issue. Tax shelter promoters are enticing exempt organizations to serve as accommodation parties in the niftily designed transactions that are undermining the very integrity of the Internal Revenue Code. I would urge this Committee to become engaged in making sure that whatever else is done with tax shelters, tax-exempt organizations are not made enablers of these unworthy schemes, and that I think the IRS has done a good job in this area of at least identifying the issue.

I would like to make one point about IRS staffing and funding. I am not an expert on IRS staffing, but I believe they need more people with a more finely developed expertise and they need to be able to retain them longer to develop experience in administering the tax law, and frankly, if you will pardon a professor for being a capitalist, that requires paying people. I believe that Congress could usefully exercise oversight to make sure that the IRS is hiring and keeping people with an appropriate level of expertise, because without expertise, the moral hazard of misusing exempt organizations will, in fact, become worse. There has been little precedential guidance in recent years, and I hope I have given you enough of a list to suggest to you that very fundamental issues remain unaddressed, but should not do so any longer. Thank you, and I look forward to questions.

Chairman THOMAS. Thank you very much, Professor Hill.  
 [The prepared statement of Ms. Hill follows:]

**Statement of Frances R. Hill, Professor, University of Miami School of Law, Miami, Florida**

Thank you for the opportunity to present this testimony. The comments presented are my personal views and do not represent the views, if any, of the University of Miami or the University of Miami School of Law.

Exempt entities provide important benefits to the public. Without a vibrant, diverse, dynamic and growing exempt sector, many important social, cultural, and economic needs of the American people could not and would not be served. All of us are beneficiaries of this sector no matter how fortunate or unfortunate our circumstances.

Maintaining the vibrancy and dynamism of the exempt sector that provides such important benefits to the public is enhanced by continuing oversight from Congress and responsible administration of the law by the Internal Revenue Service (the "Service"). Such efforts must protect the public interest in ensuring that exemption serves public purposes. At the same time, efforts to constrain the creativity of the exempt sector by unduly circumscribing the independence of exempt entities would be counterproductive. The exempt sector must be accountable but should not be constrained. Evidence of malfeasance by certain organization managers or the inattentiveness or even dereliction by certain directors should not be generalized to the entire sector, just as these unacceptable behaviors should not be excused by reference to the benefits provided by exempt organizations. Government administration and oversight should be seen as part of a larger process of ensuring accountability through participatory monitoring by organization members and beneficiaries.

The twenty-eight types of exempt entities enumerated in section 501(c) of the Internal Revenue Code of 1986, as amended (the "Code") differ in their requirements for exemption and the activities that support exempt status. But, they share the common feature that, in every case, exemption depends upon providing a public benefit to a defined class of beneficiaries.<sup>1</sup> This common feature provides a rationale for exemption and an analytical framework for understanding whether current law and the way it is being administered are consistent with the foundational reason for exemption.

While current law indeed provides that provision of benefits to the designated class of beneficiaries is the foundational requirement for exemption, this requirement has not been developed as an affirmative requirement. Instead, administrative efforts, policy discussions, and academic analyses focus largely on preventing impermissible private benefit. Preventing misuse of exempt organizations' resources is a matter of central importance. But, it does not provide either a rationale for exemption or an analytical framework for understanding exemption. As exempt entities engage in an ever-broadening range of activities and as the exempt sector grows larger, more dynamic and more diverse, this is an appropriate time to consider the reasons for the exemption and the relationships between these fundamental rationales and current law.

A rationale or framework addressing the reasons for exemption is an analytical and policy tool, not a justification offered to defend every element of current law. Without such a framework, a rationale rather than a mere rationalization, rules become isolated requirements that are easily manipulated to support activities largely unrelated to the statutory purposes exempt entities are created to serve. When the law is easily manipulated, resources are diverted from activities that serve exempt purposes to activities that serve other ends and confidence in the exempt sector erodes. The result is a classic moral hazard in which aggressive entities pursuing problematic strategies win at least tacit acceptance, while entities that are attempting to comply are given little useful guidance and find few positive rewards for their efforts.

This is not to suggest applicable law and acceptable practices will not or should not change. The world in which exempt entities operate is changing and the needs addressed by exempt entities are changing. Change in activities undertaken, structures created, and relationships with other sectors developed should be seen as practical adaptations to changing circumstances. At the same time, certain things need not and should not change. Exempt entities should always operate to provide a public benefit to the beneficiaries they have been organized to serve. Exempt entities

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<sup>1</sup> For analyses of these various types of exempt entities, see Frances R. Hill and Douglas M. Mancino, *Taxation of Exempt Organizations* Warren, Gorham & Lamont, 2002, with semiannual supplements ("Hill and Mancino").

should never be treated as the private domain of managers or board members or substantial contributors who treat either the tangible or intangible resources of the exempt organization as something to be used for personal benefit. The challenge is to reconcile useful change with these foundational principles. This is the work of every person who cares about the exempt sector. In a democracy, views on how to do this can be expected to differ.

My comments today will focus on a public benefit framework for exemption. I shall address the following topics: (1) the elements of a public benefit framework; (2) oversight priorities arising from a public benefit framework; (3) oversight priorities for data collection and research; (4) oversight priorities relating to guidance and compliance; and (5) oversight and ensuring that exempt entities operate for a public benefit.

#### I. Elements of a Public Benefit Framework

Exemption is a subsidy granted for defined public policy purposes.<sup>2</sup> The Code, the applicable regulations, and the legislative history all support the nexus between exemption and provision of a public benefit. No one would disagree that provision of the statutorily mandated public benefit is the essential activity of any exempt entity.

Yet, the concept of a public benefit has not figured centrally in either policy discussions or academic analyses of exempt entities. Instead, both policy makers and commentators have equated the absence of private benefit with the presence of a public benefit. The dominant academic framework in the last quarter century was based on the private benefit avoidance framework presented by Professor Henry Hansmann in terms of a "nondistribution constraint."<sup>3</sup> Much of policy focus during this same period was on developing an administrable private benefit provision, which was enacted in the excess benefit transaction provision of section 4958.

Concern with private benefit is a fundamentally important element in the law relating to exemption. But, the mere absence of a private benefit does not provide a rationale for exemption that can provide guidance for administration and oversight of the exempt sector. A rationale for exemption and a framework for analysis, policy, administration, and oversight depends on developing the concept of a public benefit, which provides an affirmative rationale for exemption consistent with the exempt purposes set forth in current law. A public benefit rationale for exemption points toward additional issues that are critical in determining whether entities are serving their intended exempt purposes.

Making public benefit a focal point of inquiry leads to the question of whether current law and the manner in which it is being administered are consistent with the efficiency of exemption. To the extent that exemption means that a public benefit is being provided to an appropriate class of beneficiaries, it is operating efficiently. To the extent that exemption serves simply as a mechanism for avoiding taxes on income that would be taxed if performed by another type of entity, then exemption is inefficient. A focus on efficiency in this sense permits one to raise the question of whether increases in the number and revenue of exempt entities mean that provision of public benefits has increased to a commensurate extent. The only response in light of current data is that no one can say with any certainty. As this testimony suggests below, development of a public benefit framework for exemption permits the kind of analysis that can lead to collection of the information required to answer this fundamental question.

A public benefit framework directs attention to a fact that has been curiously overlooked. Analyses of exempt organizations have overlooked the significance of the noun and focused instead on the adjective. Ignoring the fact that exempt activities are conducted through organizations is a central analytical error. This error is compounded by the unarticulated "organizational presumption" of current law and its administration.<sup>4</sup> Activities conducted by exempt organizations are generally presumed to be consistent with the organization's exempt status. In practice, the definition of an exempt activity is an activity conducted by an exempt organization. But, no one knows what exempt entities are in fact doing. Current law anticipates that exempt entities will engage not only in exempt activities but also in permissible activities that do not in themselves support exemption and which are not intended to be the organization's primary activity. But, to the extent that these permissible ac-

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<sup>2</sup>*Regan v. Taxation with Representation*, 461 U.S. 540 (1983).

<sup>3</sup>Henry Hansmann, *The Role of Nonprofit Enterprises*, 89 Yale L.J. 835 (1980); *Reforming Nonprofit Corporation Law*, 129 U. Pa. L. Rev. 497 (1981).

<sup>4</sup>Frances R. Hill, *Targeting Exemption for Charitable Efficiency: Designing a Nondiversion Constraint*, 56 Sn. Meth. L. Rev. 675 (2003) ("Targeting Exemption").

tivities become characterized as exempt activities by invoking the organizational presumption as the core element of characterization, exemption becomes inefficient.

A second problem obscured by the lack of attention to the concept of an organization is the difficulty of determining the primary purpose of an organization. Section 501 and the regulations there under provide that exempt organizations of all types are exempt only if they are organized and operated primarily for an exempt purpose. There is no guidance on what constitutes "primary" for this purpose. Is a peppercorn of exempt activity sufficient? No one can say, and there is no guidance on how to determine which activities in fact support exemption. This is not simply a problem of data but more fundamentally a problem of conceptualizing exempt organizations. This issue is particularly important in light of the dynamism of the exempt sector. Balancing this necessary dynamism with an administrable concept of what is a primary purpose is not an easy task but it is a necessary one which should no longer be deferred.

The dynamism of the exempt sector has led some to suggest that the kind of activities in which exempt entities are permitted to engage should be closely constrained. This not likely to be a useful or workable approach. The idea that certain activities should be performed solely by exempt entities or solely by taxable entities is no longer either plausible or desirable. Efforts to prohibit taxable schools or to ban gift shops at zoos or restaurants at museums would seem to serve no useful purpose. The question posed here is not what activities are permissible but what activities are consistent with the efficient provision of a public benefit to an appropriate class of beneficiaries. To the extent that exempt entities use resources for activities that do not provide a public benefit, exemption operates inefficiently. This kind of inefficiency cannot be addressed by a "nondistribution constraint" implemented through the private benefit provisions. The absence of private benefit does not establish the presence of a public benefit. Addressing exemption inefficiency requires specification of a public benefit framework implemented through a "nondiversification constraint" that imposes disincentives on the diversion of resources from exempt activities to other activities.<sup>5</sup>

## II. Oversight Priorities: Reconciling a Public Benefit Framework with Unaddressed Issues and Contemporary Developments

The following discussion of six contemporary developments in the exempt sector should not be read as identification of problematic or abusive behavior. As noted above, the dynamism of American social, cultural and economic life are strengths of our country. This is true with respect to the exempt sector as well as to the taxable sector. At the same time, exemption must continue to serve its public purposes by providing public benefits to appropriately defined beneficiaries. The six oversight priorities arising from a public benefit framework for understanding exemption are: (1) what constitutes a public benefit; (2) identifying beneficiaries; (3) overcoming internal diversions of resources; (4) operation of complex structures; (5) transfers of resources among various types of exempt and taxable entities; (6) the role of the unrelated business income tax ("UBIT") provisions from a public benefit perspective; and (7) interdicting the abuse of exemption represented by serving as accommodation parties in tax shelter transactions. Each of these will be discussed in turn.

### 1. Specifying What Is Meant By a Public Benefit

Some subsections of 501(c) specify permissible exempt benefits in some detail. The primary exception is section 501(c)(3). The broad range of exempt purposes under section 501(c)(3) is consistent with providing public benefits that range from such tangible benefits as food, clothing, and shelter to intangible benefits like education.

Efforts to address perceived abuses by restricting the nature of benefits, with only certain kinds of benefits treated as qualifying public benefits, would introduce a counterproductive inefficiency that robs the exempt sector of its dynamism and its ability to fulfill its purposes. The issue is not to restrict activities, but to determine what kinds of activities should be funded with exempt funds.

### 2. Identifying Appropriate Beneficiaries Entitled to Receive Public Benefits

Many types of exempt entities have clearly defined criteria for beneficiaries, who are also members of the organization. This is the case with respect to section 501(c)(5) labor organizations, section 501(c)(6) business leagues, section 501(c)(7) social clubs, section 501(c)(8) fraternal benefit organizations, section 501(c)(10) fraternal societies, section 501(c)(19) veterans organizations, and section 501(c)(21) black lung trusts.

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<sup>5</sup>For a discussion of a nondiversification constraint, see *Targeting Exemption*, *supra* note 4.

Section 501(c)(3) does not specify categories of persons who may receive the benefits providing the foundation for exemption. Beneficiaries of section 501(c)(3) are in some cases readily identified but in other cases are not. Generally recipients of more tangible public benefits are more readily identifiable, while recipients of less tangible but still vitally important benefits are not readily identifiable as a distinct "charitable class." This distinction causes significant confusion with respect to organizations providing intangible benefits to a charitable class that is not readily identifiable. In these cases, it is easy but wrong to take the position that the organization is providing no public benefit to appropriate beneficiaries. Greater attention to issues of the concept of a charitable class would help eliminate such confusion and would protect the diversity and dynamism of the exempt sector.

### 3. Overcoming Internal Diversion of Resources by Addressing the Organizational Presumptions

As discussed above, exempt purposes are pursued through exempt organizations. Current law requires that exempt purposes constitute an organization's primary purpose. However, current practice is based on an "organizational presumption" that treats activities as exempt activities if they are conducted by an exempt entity. The resulting circularity facilitates an internal diversion of resources to activities that are only tangentially, at best, related to exempt purposes.

There are two possible approaches to addressing this kind of internal diversion. One is to provide guidance on what constitutes an organization's primary purpose. While this would seem to be fundamental to administering current law, in fact there is no practical, useful guidance at all on this matter.

A second approach would be to direct tax benefits only to expenditures for exempt activity while not constraining other activities. This approach treats an exempt organization as an aggregate of activities, only some of which are treated as exempt, and makes the benefits of exemption available only with respect to funds used for exempt activities. This approach is based on targeting the benefits of exemption to those activities that in fact provide a public benefit to an appropriate class of beneficiaries.

### 4. Complex Structures

Exempt entities are increasingly operating in complex structures of related exempt entities of different types with different exempt purposes serving differently defined beneficiaries. How these various purposes and beneficiaries are to be appropriately served is a question of what public benefits are being provided. In the worst case, activities that are consistent with the exempt status of one type of exempt entity can jeopardize the exempt status of other types of exempt entities. The issue is to avoid inappropriate diversion of resources while at the same time appropriately protecting the exempt statuses of the various entities. Complex structures may also involve both taxable and tax exempt entities. These structures can create synergy that enables exempt entities to provide a public benefit more efficiently. At the same time, issues of diversion and potential conflicts of interest require more timely guidance and continuing oversight.

### 5. Transferring Resources

Exempt entities may choose to fund projects or programs operated by other exempt entities. There is virtually no guidance on such transfers. Unaddressed issues include questions of what kinds of transfers between what types of entities are permissible, what kind of oversight and recordkeeping are required, and under what circumstances transfers might jeopardize the exempt status of either the transferor or the recipient. These kinds of questions arise with respect to transfers between exempt entities of the same type, between exempt entities of different types, and between exempt and taxable entities.

### 6. UBIT and Public Benefit

The UBIT provisions exist to tax the income derived from unrelated trade or business activities. The original purpose of the UBIT provisions was to prevent unfair competition with taxable business engaged in the same activities. The issue now is more a matter of diversion of resources to capitalizing the unrelated trade or business than a matter of unfair competition with taxable entities. UBIT is not designed to address this kind of diversion and in fact does not do so. The issue is whether UBIT should be reconsidered or whether some other form of no diversion constraint should be considered. In addition, the extent of unrelated trade or business activity that is consistent with exempt status remains unaddressed. It should also be noted that those activities subject to the unrelated business income tax represent only a portion of the commercial activities exempt entities engage in because the exceptions to UBIT have come to be so expansively applied.

#### 7. Exempt Entities as Accommodation Parties in Tax Shelters

Serving as an accommodation party in a tax shelter can never be treated as an activity that provides a public benefit.<sup>6</sup> More attention is needed to efforts of shelter promoters to entice exempt entities to play this role.

The appropriate response is likely to involve some mixture of tax on the fee on the theory it is a taxable fee for providing a service, as well as penalties imposed on organizations, organization managers, and professional advisers and the possibility of revocation of exemption. Revocation by itself is unlikely to have much effect on special purpose exempt entities created for the purpose of serving as an accommodation party. In addition, the Service has historically been reluctant to revoke exempt status even in cases of quite egregious private benefit.

#### III. Oversight Priorities for Data Collection and Research

A public benefit framework directs attention to the question of whether the growth in the number of exempt entities and the increase in their revenue is matched by an increase in provision of benefits to appropriate beneficiaries. This question can be answered only by developing a more precise idea of what exempt entities are in fact doing.

There are two important components to this inquiry. The first relates to the sources of funds and the second relates to the uses of funds and what empirical patterns, if any, can be identified between sources and uses. Looking at the relationship between sources and uses of funds inside organizations creates an empirical basis for assessing claims that all funds, however derived, are used for exempt activities. This is a rationalization for ignoring the primary purpose issue and for defining virtually anything an exempt organization does as an exempt activity.

Current data provide little basis for addressing this issue. Most research is based on Form 990, which is publicly available. But, the data on Form 990 are collected for compliance, not for research. In addition, there is no external check on the reliability of this self-reported data.<sup>7</sup> The data needed will necessarily be based on the books and records of organizations, which poses a significant barrier to research. Such research should not be linked to enforcement efforts by the Service.

#### IV. Oversight Priorities Relating to Guidance and Compliance

Guidance and compliance are inextricably interrelated. Compliance initiatives are one means of identifying areas requiring issuance of additional guidance. Guidance permits organizations and their professional advisers to comply more effectively. Guidance is also a necessary predicate for compliance initiatives and public acceptance of such initiatives. Concerns about compliance burdens on exempt entities are important, and issuance of timely guidance will ease the compliance burden.

The Service has issued little precedential guidance in recent years. The lack of a program for issuing precedential guidance with respect to the most significant foundational issues exacerbates the moral hazard of giving greater scope for aggressive actions while failing to assist those seeking to comply. Any such comprehensive program for issuing guidance requires personnel with a high level of expertise and experience in the substantive area. The issues to be addressed call for a sophisticated understanding of the technical rules, an appreciation of the policy purposes being served, and a well-honed sense of what kinds of approaches the Service can administer.

Any priorities identified through the oversight process must necessarily lead to administrable tax policies. There are substantial questions about what the Service can administer at its current funding and staffing levels. The lack of guidance and the slow pace of compliance efforts suggest to this outside observer that the Service requires additional resources and additional personnel. The Service seems particularly short of persons with the required expertise in developing guidance. It is also important to provide funds for attracting, training, and retaining young lawyers who now may not be inclined to consider careers with the Service.

These comments should not be construed as lack of confidence in the skill and commitment of the many dedicated tax professionals who work on exempt organization matters. There are simply too few persons with the requisite expertise to provide the guidance needed by the exempt sector. I urge Congress to consider substantially increasing the funding for the exempt organization function at the Service.

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<sup>6</sup>See new Chapter 37, Exempt Entities and Tax Shelters, in the most recent supplement to Hill and Mancino, *supra* note 1.

<sup>7</sup>See, General Accounting Office, *Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities* (2002)(GAO-02-526).

V. Oversight and Public Benefit

Oversight efforts can help ensure that the provision of public benefits is the criterion for retaining exempt status. This is consistent with the mission of exempt entities and the commitments of the dedicated people who work in the exempt sector.

Oversight can help develop greater understanding of how the provision of public benefits is funded and what are the main reason that organizations divert particular types of funds to other uses. Such empirical research and consideration of the policy responses to such research are not likely to be developed rapidly or in response to one or another example of indefensible behavior. Incremental efforts based on greater understanding of what exempt entities in fact do and how they do it seems the most productive approach to ensuring that this vital sector can continue to make its unique contributions. Continued consideration of an appropriate framework for exemption will keep attention focused on what should never change in exempt organization law and what changes are appropriate accommodations to changing circumstances.

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Chairman THOMAS. Mr. Cohen, I didn't out you when the Ranking Member wanted to know if there were any IRS folk in the room—

[Laughter.]

Chairman THOMAS. —but obviously Mr. Cohen is a former Commissioner of the Internal Revenue Service and has at least a historically intimate understanding of the structure. I want to thank you. I want to thank you for your testimony, and the time is yours.

**STATEMENT OF SHELDON S. COHEN, PARTNER, MORGAN, LEWIS AND BOCKIUS, AND COMMISSIONER, INTERNAL REVENUE SERVICE, 1965-1969**

Mr. COHEN. Thank you, Mr. Chairman, Mr. Rangel, and Members of the Committee. I am pleased to appear before you, and I should preface my remarks by saying I appear on my own behalf, not on behalf of my clients or my firm. I did have ten wonderful years at the Revenue Service at various times and I have produced two daughters who both served for ten to 12 years at the Revenue Service, so—

Chairman THOMAS. That must be a genetic flaw.

Mr. COHEN. We have done our duty.

[Laughter.]

Mr. COHEN. If you will forgive me, I am going to skip around on my testimony because much of it has been covered and I know you don't want to hear that again. A piece of history would help you. George Boutwell was the first Commissioner of Internal Revenue. He was later Governor of Massachusetts and a U.S. Senator. Boutwell, in his manual on running the Revenue Service in 1862, spelled out that he was going to exempt—he had no statutory authority—he exempted most charities and what we would now call exempt organizations. He did it on the basis that it was impracticable and that it was useful. They served a useful purpose. Lest you think it is a late arrival in the income tax, it arrived in the 1862 version that Abraham Lincoln signed. Also, I would like to suggest that one of the problems of administration that occurs is if you give the Commissioner \$5 million, \$50 million more to help administer the tax laws, or \$500 million, as has been asked in the President's budget, and you were Commissioner of Internal Rev-

enue, how many of those dollars would go into exempt organizations? Do you remember Willie Sutton? Why did he rob banks? That is where the money is. You folks and your compatriots on the Appropriations Committees hold him responsible and the organization responsible for bringing in money, particularly at a time like this when they are running huge deficits. So, I doubt that much of that would be allocated. Now, if you express an interest, more of it will be.

One other aside. In the early seventies, there was a conference at Dichley, which is a conference center in Britain. Jack Nolan, who was then the immediate past Assistant Secretary of Treasury for Tax Policy under the Nixon Administration and I were representatives of the United States. Those Dichley conferences are about ten or 12 Americans and ten or 12 Brits and they talk about a topic of current interest for three, four, five days. They get into the depth of it. One of the things we discovered, Jack and I, was that the British use a different system of encouraging charities than we. They have a Charities Commission. That commission is composed, I think, of three commissioners—it was then—and their object is to encourage charity. They write the rules. They write the rules of what is charity, what qualifies for tax-exemption. Those rules are enforced by England Revenue. So, you don't have the Commissioner of Internal Revenue with the two hats, one to encourage and move charity forward and the other one to restrict it and audit it. We planted that idea in the Ways and Means Committee in the mid-seventies. Unfortunately, it went the way every—and I understand completely the charities. My own clients would react the same way. It is the devil I know for the devil I don't know every time, even though it might be better, it might be worse, and therefore I will take it as it stands. I have covered the same area as many others in my testimony in regard to the multiplicity of organizations. They arise with no rhyme or reason. Why is there a section 501(c)(2) and (c)(25), both of which cover title-holding organizations, both of which were enacted at various times, and because there was some restriction on (2), instead of amending (2) and allowing multiple entities to own the title-holding entity, (25) is enacted, and there are several areas like that. There are many veterans' organizations covered with different categories and different qualifications. There are, likewise many pension plans where they have just thrown in one—there are several categories where there either is one organization or no organization, as Mr. Yin has indicated, which would indicate that little thought had been given to the organizational structure.

Once we get past (c)(3), you and your staffs and the rest of the world really don't pay any attention, and yet there are at least a half-a-million other organizations. Of course, one of the things we said, we don't know about many of these organizations. These organizations are not required to file a 1023. So, they don't even have to tell the Service they exist. Now, normally, the Service will ask them to file a 1023 when they get the 990. They are required to file 9nineties. The small organizations that don't file 9nineties, those that make less than 25, in my day, they had to file a postcard that somebody had to sign certifying that they were in existence and that they were under—it was less. It was \$5,000 or \$10,000

then, but it is now \$25,000. Again, you don't know about them. You don't know about the churches because we don't have a list of churches. They don't have to apply. I have asked a variety of questions that are very much like the questions that others have raised on the—but I feel it is important that every organization should be registered. They should have to tell the Revenue Service, here we are. I don't have any problem with the exchange of information to the States, because most of those exchange agreements were signed while I was in office. States now have the same kinds of restrictions that the Federal government has on the passing on of that. That is, it is a Federal crime for a State official to violate the confidence of the information. The States' Attorney Generals, we have many of the State Attorney Generals are active and effective. Most are not. That is, the State Attorney General is generally the parent of the State entity which is the charity of whatever category and they pay no attention, and it is very difficult. I have been in situations where a client has felt the charity was abused. That is, he gave money to the charity, it didn't do what it was supposed to do, and tried to activate the State Attorney General. Many will, as I say, effectively try to make sure that the right thing is done. Many will ignore it. Thank you, Mr. Chairman.

Chairman THOMAS. Thank you very much, Mr. Cohen.  
 [The prepared statement of Mr. Cohen follows:]

**Statement of The Honorable Sheldon S. Cohen, Partner, Morgan, Lewis and Bockius, and Commissioner, Internal Revenue Service, 1965-1969**

Chairman Thomas and distinguished members of the Committee, I am Sheldon Cohen, senior counsel in the Washington D.C. office of the law firm of Morgan, Lewis & Bockius and a former Chief Counsel and Commissioner of the Internal Revenue Service. I am pleased to appear before you today at your request to testify on issues relating to the historical background of certain organizations that are tax-exempt under Section 501(c). My testimony today is in my personal capacity and represents my own views and not those of my firm or any of its clients. By way of background, I served in the Internal Revenue Service on several different occasions. During the period 1952-1956, I served as a legislative draftsperson during the drafting of the 1954 Code and Regulations. In the period from January 1964 through January 1969, I served as Chief Counsel for one year and then as Commissioner of the Internal Revenue Service for four years. I have also served as an officer and Trustee of the National Academy of Public Administration and have served as a panel member of several studies dealing with the administrative aspects of the Internal Revenue Service. I also served as Co-Chair of a study of the collection and privacy portions of the Internal Revenue Code for the Administrative Conference of the U.S. (The changes recommended by that group, co-chaired by Justice Scalia in one of his prior positions as chair of the Administrative Conference of the United States, were adopted by the Congress in 1976.)

Given our limited time today, I will first discuss some background information about a number of the numerous organizations that are tax-exempt under Section 501(c) and some of the changes Congress and the IRS have made over the years as various problems have arisen with respect to different exempt organizations. Then, I will briefly address some of the critical questions that arise with respect to evaluating these organizations' qualification for exemption from Federal income tax. I have attached an appendix to my written testimony listing all of the categories of organizations exempt under Section 501(c).

Questions about the tax-exempt sector are increasingly important given that the sector is growing in both size and assets and has been playing an ever more important role in our society. The number of organizations exempt from tax in the United States has increased tremendously in the past 30 years. According to the Statistics of Income Division, there were only about 220,000 organizations (excluding private foundations) exempt under Section 501(c) filing Form 990 annual information returns with the IRS in 1975. (Please note that this figure does not include churches and religious organizations and a few other organizations not required to file Form

990.) By 1995, the number of organizations filing an annual information return with the IRS had skyrocketed to approximately 1.2 million exempt organizations. The sector has even grown tremendously in the past 10 years alone—today, there are over 1.8 million organizations exempt from tax under Section 501(c) filing Form 990 with the IRS each year.

There are 28 categories of tax-exempt organizations under Section 501(c), and approximately 1 million of the organizations exempt under Section 501(c) are categorized under Section 501(c)(3). Section 501(c)(3) organizations stand apart from other exempt organizations, and have, over the years, received a good deal of the attention focused on the non-profit sector. In fact, they have received almost all of the attention.

Section 501(c)(3) organizations are distinguished by being considered charitable in nature and include organizations such as universities and schools, hospitals, scientific research organizations, social service organizations, community development groups, performing arts groups, and environmental support organizations. Also exempt under Section 501(c)(3) are private foundations, which operate programs, provide services and/or make grants in order to fulfill their charitable purposes.

Organizations exempt from Federal income tax under one of the other Section 501(c) subsections of the Internal Revenue Code provide an array of not-for-profit services, and are frequently formed as membership organizations to primarily benefit their members. These other tax-exempt organizations are distinguished from Section 501(c)(3) organizations because they are not considered to be charitable in nature or to primarily benefit the public. Unlike Section 501(c)(3) organizations, most of these other exempt organizations are not eligible to receive tax-deductible charitable contributions. The primary advantage they receive for qualifying under Section 501 is, therefore, exemption from Federal income tax. As you requested, I will not be addressing Section 501(c)(3) organizations or organizations that are exempt under Section 501(c)(5), which are labor, agricultural and horticultural organizations, or Section 501(c)(6) organizations, which are business leagues.

One of the hot topics in the exempt organizations field today concerns the exemption of credit unions. Credit unions can potentially be exempt under two sections—501(c)(1) and 501(c)(14). Section 501(c)(1) exempts federal instrumentalities from tax. Organizations exempt under this section include the FDIC, Federal Land Banks, Federal Reserve Banks and similar organizations. Also included are Federal credit unions organized and operated in accordance with the Federal Credit Union Act, which are considered instrumentalities of the United States. Section 501(c)(1) organizations are not required to file Form 990 annual informational returns, they are not subject to the unrelated business income tax and they are entitled to receive tax-deductible contributions. In the 1970s, the IRS conducted a review of the 1,000 or so organizations exempt under this Section. This review revealed that many of these organizations did not qualify as Federal instrumentalities and were classified under Section 501(c)(1) inadvertently. As a result, there are only about 150 Section 501(c)(1) organizations today.

Credit unions that are state chartered and other mutual financial organizations may obtain exemption under Section 501(c)(14) rather than Section 501(c)(1). Exemption under Section 501(c)(1) is preferable for credit unions because the IRS has assumed an audit position that 501(c)(14) credit unions are subject to the unrelated business income tax whereas 501(c)(1) organizations are not, given that the Internal Revenue Code does not address this point.

Organizations that are exempt under Section 501(c)(2) and Section 501(c)(25) are title holding companies for tax-exempt organizations. Section 501(c)(2) provides exemption for single parent organizations, and was added to the Code in 1916. Section 501(c)(25) was added to the Code in 1986 in response to the IRS' position that title-holding entities which otherwise qualified under Section 501(c)(2) could not be exempt if two or more of its parent organizations were unrelated.

Section 501(c)(4) was incorporated in the Code in 1913 and includes organizations to promote the common good and general welfare of the community, such as civic leagues, social welfare organizations, homeowners' associations, etc. They are similar to Section 501(c)(3)'s but they are permitted to engage in some legislative and political activities, so long as this does not constitute their primary activity. Section 501(c)(4) does not include social clubs or other clubs organized for pleasure or recreation. Such organizations are instead exempt under Section 501(c)(7) and have been exempt since 1916. A few years ago, the IRS made an enforcement drive to ensure that social clubs were properly paying the unrelated business income tax on their investment income.

Many veterans organizations used to be exempt under Section 501(c)(4) and (c)(7). In 1969, 501(c)(4) organizations were made subject to the unrelated business income tax. Given that veterans organizations often provide insurance, many were con-

cerned that their insurance activities would be taxable. As a result, Section 501(c)(19) was passed in 1972 to specifically provide exemption for veterans organizations offering insurance to their members.

Section 501(c)(8) exempts fraternal organizations which were historically created to provide insurance to their members. I believe there are about 30,000 Section 501(c)(8) organizations. Section 501(c)(10) was added in the Tax Reform Act of 1969 to exempt certain of these organizations that stopped providing insurance to their members, like the Masons.

Section 501(c)(9) is for VEBAs—Voluntary Employees' Beneficiary Associations, which provide for life, sickness, accident and other benefits to their members who must all have a common employment-related bond. In the early 1980s, VEBAs were used in an abusive scheme in which employers were seeking to take advance deductions for contributions to welfare plans that provided benefits in the nature of deferred compensation. Congress solved this problem by passing Section 419 in the Deficit Reduction Act of 1984, which places objective limits on the amount an employer can deduct for contributions to welfare plans for employees.

Section 501(c)(12) originated in 1916 and is designed for mutual and cooperative associations. Section 501(c)(13) has been around since 1913 and provides exemption for non-profit cemeteries.

There are several subsections of 501(c) that exempt very few organizations in practice. I understand that there are only 2 organizations currently exempt under Section 501(c)(23). Section 501(c)(23) was passed in 1982 to exempt associations organized before 1880 more than 75 percent of the members of which are present or past members of the Armed Forces and a principal purpose of which is to provide insurance and other benefits to veterans or their dependents. It is my understanding that there is also only a single remaining organization that is exempt under Section 501(c)(18) (Employee Funded Pension Trusts, which must have been created before June 25, 1959) and Section 501(c)(24) (Trust Described in Section 4049 of ERISA). I do not believe there are any organizations exempt as Section 501(c)(22) Trusts for Multiemployer Plans Under ERISA. Section 501(c)(20) (Group Legal Services Plan) expired in 1992, although there are still a handful of organizations exempt under this Section. Furthermore, I understand that there are only about 50 or significantly fewer organizations exempt under Section 501(c)(11) (Teachers' Retirement Fund Associations of a Purely Local Character), Section 501(c)(16) (crop financing organizations), Section 501(c)(21) (Black Lung Benefit Trusts), Section 501(c)(26) (State-Sponsored High-Risk Health Coverage Organizations) and Section 501(c)(27) (State-sponsored Workmen's Compensation Reinsurance Corporations).

These are just some examples of the numerous organizations that are exempt under Section 501(c), and some of the various considerations that have arisen over time. As Congress reviews exempt organizations, there are several questions to consider with respect to those organizations that are exempt under subsets of Section 501(c) other than Section 501(c)(3).

First, given that exempt organizations have been added to the Code piecemeal over time to address particular contemporary factors, the most basic issues in assessing these organizations are to determine whether they still serve their intended purpose and whether the Code should be amended to reflect current realities. As you can see from this review of Section 501(c), specific exemptions were made to address particular concerns at various points in time. In many instances, Congress and the IRS have reacted to the realities—the concerns, needs and abuses—of the tax-exempt sector. Nonetheless, although many, if not most, of these organizations are still serving the purpose for which they were granted exemption, others merit revisiting.

The second question is whether all organizations exempt under Section 501 should be required to apply to the IRS for recognition of their exempt status. Of all the Section 501(c) organizations, only those exempt under Section 501(c)(3) are required to apply to the IRS for recognition of their exempt status. Other organizations are nonetheless required to file an annual information return, Form 990, but only if they have gross receipts over \$25,000 a year. In practice, the IRS tends to request that any organization filing a Form 990 submit an application for recognition of tax exemption. But because organizations that have gross receipts of less than \$25,000 a year are not required to file Form 990, small organizations may escape the IRS' notice completely or for a long time.

Third, Congress may want to consider whether the Code should be amended to institute penalties against insiders who deal unfairly with all Section 501(c) exempt organizations. Although nine categories of organizations exempt under Section 501(c) are prohibited from having any benefits "inure" to insiders at an organization, only Section 501(c)(3) and (c)(4) organizations are subject to rules which sanc-

tion the actual individuals who deal improperly with an exempt organization. Attention has been focused on exempt organizations recently in part because of high profile cases in which private individuals received inappropriate benefits from charities with which they were affiliated. Private foundations are subject to the "self-dealing" rules of Section 4941 (passed by Congress in the Tax Reform Act of 1969) and public charities are regulated by the "intermediate sanctions" provisions of Section 4958 (passed in 1996). Section 501(c)(4) organizations were also specifically made subject to the intermediate sanctions rules. These rules are an important part of IRS oversight of exempt organizations, in large part because they provide a way to halt and redress abuse of tax-exempt resources without revoking the exempt status of an organization that may be making valuable contributions to our society.

Finally, although these categories of organizations exempt under Section 501(c) merit review, IRS resources are scarce. The question of whether the IRS is devoting appropriate audit attention to these organizations may depend to a large extent on budgetary constraints and the need for enforcement efforts in other areas.

In closing I would like to thank the Committee and its staff for allowing me to give you my views on this topic.

#### APPENDIX

##### TYPES OF EXEMPT ORGANIZATIONS UNDER INTERNAL REVENUE CODE SECTION 501(C)

Internal Revenue Code Section	Description of activities
501(c)(1)	Corporations organized under Act of Congress Instrumentalities of the United States
501(c)(2)	Title holding corporation for an exempt organization
501(c)(3)	Charitable, religious, educational, scientific, and literary organizations, international amateur sports competitions, organizations that prevent cruelty to children and animals, and organizations that test for public safety
501(c)(4)	Civic leagues, social welfare organizations and local employees' associations
501(c)(5)	Labor, agricultural, and horticultural organizations
501(c)(6)	Business leagues, chambers of commerce, and real estate boards
501(c)(7)	Social and recreational clubs
501(c)(8)	Fraternal beneficiary societies that provide life, sickness, or accident benefits to members
501(c)(9)	Voluntary employees' beneficiary associations, which provide for payment of life, sickness, accident, or other benefits
501(c)(10)	Domestic fraternal societies that do not provide life, sickness, or accident benefits to members
501(c)(11)	Teachers' retirement fund associations
501(c)(12)	Local benevolent life insurance associations, mutual ditch or irrigation companies, mutual or cooperative telephone companies, and like organizations
501(c)(13)	Cemetery companies
501(c)(14)	State-chartered credit unions and mutual financial organizations
501(c)(15)	Certain mutual insurance companies or associations that provide insurance to members substantially at cost
501(c)(16)	Farmers cooperatives organized to finance crop operations

Internal Revenue Code Section	Description of activities
501(c)(17)	Supplemental unemployment benefit trusts
501(c)(18)	Employee-funded pension trusts
501(c)(19)	War veterans organizations (e.g., American Legion Posts)
501(c)(20)	Group Legal Services Plan Organizations
501(c)(21)	Black Lung Benefit Trusts
501(c)(22)	Trusts for Multiemployer Plans Under ERISA
501(c)(23)	Association organized before 1880 more than 75% of the members of which are present or past members of the Armed Forces and a principal purpose of which is to provide insurance and other benefits to veterans or their dependents
501(c)(24)	Trust Described in Section 4049 of ERISA
501(c)(25)	Title-Holding Corporations or Trusts for Multiple Parents
501(c)(26)	State-sponsored high-risk health coverage organizations
501(c)(27)	State-sponsored Workers' Compensation Reinsurance Organizations
501(c)(28)	The National Railroad Retirement Investment Trust established under Section 15(j) of the Railroad Retirement Act of 1974

Chairman THOMAS. Mr. Hopkins, you are last not because you are least but because, based upon your testimony, I thought it would be appropriate that you would bat cleanup in terms of your background, the structure that you presented, and the, what I consider to be a kind of a withering analysis of what has been done recently and what could be done. The time is yours.

**STATEMENT OF BRUCE R. HOPKINS, ATTORNEY, POLSINELLI SHALTON WELTE SUELTHAUS, P.C., KANSAS CITY, MISSOURI**

Mr. HOPKINS. Thank you, Mr. Chairman, Mr. Rangel, and other Members of the Committee. Thank you very much for the opportunity to appear before you today. I do have a prepared statement and I will summarize it briefly here. Basically, my testimony consists of three segments. One is a summary of the history, the evolution of the Federal tax law pertaining to the tax-exempt sector in the United States. We have heard a bit of history, examples, and from the standpoint of a constitutional law, tax-exemption for these organizations is traceable to the Revenue Act 1913, but as we have heard, tax-exemption can be found in earlier laws. So, these rules are rapidly approaching, at least the constitutional ones, 100 years of existence. Second, I will provide the Committee with my view of the present day state of the statutory law of tax-exempt organizations. Then, third, if there is time, I have been asked to provide a summary of the law concerning tax-exempt labor organizations. My testimony essentially centers on four points. The first one is that the statutory law concerning tax-exempt organizations has evolved over the decades in a disorderly and unplanned fashion. My second point is that Congress made major revisions in this law in 1917, 1950, and 1969, but overall, Congress has frequently modified and expanded the law concerning the sector. Nearly 30 tax acts over

the decades have brought some revisions or addition to this area of the law. My third point is that the Federal tax law today concerning exempt organizations is unbalanced and uneven. The fourth point is that many aspects of today's law of exempt organizations are unclear. As the sector has grown, this sector has fostered or facilitated misunderstandings and abuses by certain tax-exempt organizations and tax law professionals. Federal tax law that addresses the gaps in the present day structure would provide a full legal regime that could address this problem. This, in turn, would facilitate the ability of the IRS to provide meaningful guidance within that framework.

In my prepared statement, I have provided the Committee with the history and evolution of the statutory law, summarizing each of the 28 Acts. This history illustrates the point I made a minute ago, that the statutory law in the exempt organizations area has, indeed, evolved in a disorderly fashion. Another factor shaping the evolution of the Federal statutory law of exempt organizations is Congressional reaction to positions taken by the Internal Revenue Service. In the attached statement, I have provided 18 instances where statutory exempt organizations law was created in response to a policy position of the agency. Today, the tax-exempt sector of the United States is confronted with a dazzling array of Federal tax law reform proposals, and many of these proposals are reflective of the inadequate state of the Federal statutory tax law of exempt organizations. In short, there are many more gaps in this body of law than there should be. I have been practicing in the field for 35 years and it never ceases to amaze me how redundant, disparate, irregular, unbalanced, and uneven the Federal tax statutory law can be. In my view, this aspect of the tax law consists of 20 elements, and I have listed these elements in my statement. What I think is striking is that of these elements, only six of them are generally adequately reflected in existing law. In my prepared statement, I have identified 12 areas where statutory exempt organizations law is necessary, and I will just take a minute to identify six of these at the present time. One, you have already heard testimony on, create laws spelling out the criteria for tax-exempt status, and this is just not confined to charitable, educational, scientific entities, but 501(c)(4) social welfare entities, (c)(5) labor organizations, and (c)(6) entities, business leagues, could use a great deal of clarification. Number two, spell out the elements of the private inurement doctrine and the private benefit doctrine. Number three, amplify the political activities rules, both for charitable entities and other forms of tax-exempt organizations. Number four, codify a version of the commerciality doctrine. Number five, develop statutory law concerning tax-exempt organizations' use of the Internet. Six, consider whether there is a need for more reporting and disclosure. There are a number of proposals being discussed, including a five-year review filing with the IRS, an annual notice requirement for small organizations, and certification as to compliance with the unrelated business rules. This type of statutory law is required to eliminate the imbalances in the present law and to provide the IRS with a complete regulatory framework within which to provide guidance in the form of regulations, revenue rulings, private determinations, and more. My sense here is that there

are a number of questions the Committee may have, and I think, unless directed otherwise, I will simply submit my discussion of the law concerning labor organizations to you in the form of the prepared statement and I will stop at this point and, like the other members of the panel, be happy to take any questions that you might have.

Chairman THOMAS. Thank you.

[The prepared statement of Mr. Hopkins follows:]

**Statement of Bruce Hopkins, Attorney, Polsinelli Shalton Welte Suelthaus, P.C., Kansas City, Missouri**

I have been asked to provide the Committee with a summary of the history and evolution of the federal tax law pertaining to the charitable sector of the United States. The term "charitable" includes charitable, educational, scientific, and religious organizations within the meaning of Internal Revenue Code section ("IRC §") 501(c)(3)). This sector thus embraces both public charities and private foundations.

Tax exemption for these organizations is traceable to the Revenue Act of 1913 and can be found in earlier laws. Therefore, we are rapidly approaching the centennial of these rules.

I have also been asked to provide the Committee with my view of the present-day state of the statutory law of tax-exempt organizations.

Further, I have been asked to provide a summary of the law concerning tax-exempt labor organizations.

**Summary of Testimony**

My testimony essentially centers on four points:

1. The statutory law concerning tax-exempt organizations has evolved over the decades in a disorderly, unplanned fashion. Congress has not been sufficiently explicit about the rules governing tax-exempt organizations.
2. Congress made major revisions in this law in 1917, 1950, and 1969. Overall, Congress has frequently modified and expanded the law concerning the exempt sector. Nearly 30 tax acts have brought some revision and/or addition to this area of the law.
3. The state of the federal tax law today is that it is unbalanced and uneven.
4. Many aspects of today's statutory law of tax-exempt organizations are unclear. As the sector has grown, this situation has fostered or facilitated misunderstandings and abuses by certain tax-exempt organizations and tax law planners. Federal tax statutory law that addresses the gaps in the present-day overall statutory regime would provide a full legal structure that would address this problem. This, in turn would facilitate the ability of the IRS to provide meaningful guidance within that framework.

As background, I have been in the private practice of law for 35 years, representing charitable and other tax-exempt organizations. I have taught in two law schools, and continue to present at conferences and seminars around the country. I have written several books, including *The Law of Tax-Exempt Organizations* (8th ed., annually supplemented). I write a monthly newsletter on exempt organizations law subject, *Bruce R. Hopkins' Nonprofit Counsel*.

**Summary of Statutory Law Evolution**

Tax exemption for charitable organizations began in 1913, when Congress enacted the first constitutional federal income tax. There have, of course, been many major pieces of tax legislation since then. The following acts are of major consequence: establishment of the concept of federal income tax exemption in 1913; enactment of the charitable contribution deductions in 1917, 1921, and 1932; enactment of the unrelated business rules in 1950; and enactment of the public charity and private foundation definitions and rules in 1969.

Thus, the statutory law of tax-exempt organizations was initiated in 1913, and given major boosts in 1950 and 1969. Indeed, today's statutory structure (along with the charitable giving rules) was shaped substantially by the 1969 legislation.

In somewhat of a second-tier categorization of important exempt charitable organizations legislation, the limitations on legislative activities were enacted in 1934, the prohibition on political campaign activities was adopted in 1954, public charity lobbying rules were enacted in 1976, excise taxes on legislative and political expenditures were enacted in 1987, and the excess benefit transactions (intermediate sanctions) rules were enacted in 1996.

Nearly every tax act of any consequence since then (particularly in 1974, 1976, 1982, 1984, 1986, 1987, 1993, 1996, 1997, 2000, 2002, 2003, and 2004) has added to this body of law. (Additional legislation that would have augmented this collection of law, passed in 1992, 1995, and 1998, was vetoed.)

Below, I have provided the Committee with the history and evolution of this statutory law, summarizing each of the 28 acts. Also, I traced the history of these acts by year and Internal Revenue Code sections. This history illustrates the fact that the statutory law of tax-exempt organizations has indeed evolved in a disorderly fashion.

Another factor shaping the evolution of the federal statutory law of tax-exempt organizations is Congressional reaction to positions taken by the IRS. In the attached statement, I have provided 18 instances where statutory exempt organizations law was created in response to a policy position of the agency.

#### **State of the Statutory Law**

Today, the tax-exempt sector of the United States is confronted with a dazzling array of federal tax law reform proposals. These are found in a recent report from the staff of the Joint Committee on Taxation, a paper prepared last year by the staff of the Senate Committee on Finance, the Administration's fiscal year 2006 proposed budget, and the interim report recently published by Independent Sector's Panel on the Nonprofit Sector.

Some of these proposals are referenced below. Before addressing them, however, I note that many of these proposals are reflective of the inadequate state of the federal statutory tax law of tax-exempt organizations. There are many more gaps in this body of law than there should be. The Department of the Treasury, the Internal Revenue Service, and the courts, from time to time, attempt to fill these voids but the absence of a full and balanced statutory regime contributes to the need for many of the reforms being advocated at this time.

The state of the federal statutory law of tax-exempt organizations can best be described in words that may be somewhat redundant: disparate, irregular, unbalanced, and uneven. This aspect of the tax law (other than the charitable giving rules) consists of the following 20 elements:

1. Criteria for exemption
2. Organizational test
3. Operational test
4. Public charities and private foundations
5. Private inurement
6. Private benefit
7. Intermediate sanctions
8. Legislative activities
9. Political activities
10. Commerciality
11. Unrelated business
12. Tax-exempt subsidiaries
13. For-profit subsidiaries
14. Exempt organizations in partnerships
15. Exempt organizations in other joint ventures
16. Internet use
17. Reporting requirements
18. Disclosure requirements
19. Corporate governance principles
20. Fundraising

Of these 20 elements, only six of them are generally adequately reflected in existing statutory law: the subjects of public charities and private foundations, the intermediate sanctions rules, the law as to attempts to influence legislation, the unrelated business rules, tax-exempt subsidiaries (often supporting organizations), and the reporting requirements.

By contrast, the statutory law concerning the income, gift, and estate tax charitable giving rules is far more complete and balanced, enabling the IRS to issue timely and meaningful guidance.

These gaps in the exempt organizations statutory law cannot be properly filled by tax regulations and rulings. Treasury and the IRS try this from time to time and often trigger litigation over whether the department and agency have the authority to promulgate the rules. Some examples of these attempts are the regulations concerning the facts-and-circumstances test for qualifying as a publicly supported charitable organization, and the advertising and travel tour regulations in the unrelated business context.

In fact, two law changes made by the IRS years ago reverberate in controversy today. Back in 1959, the IRS promulgated what was then radically new regulations defining what is charitable, educational, and the scientific. Before these rules, the definition of charitable and the like was quite narrow. Also, in 1969, the IRS ruled that promotion of health is a stand-alone definition of what is charitable, setting in motion today's ongoing debate over the scope of that term.

The IRS lacks the capability to promulgate sufficient regulations in this area and, to a large degree, should not be placed in that position. Indeed, these holes in the statutory structure create an environment where the IRS issues private letter rulings containing questionable, incorrect, and even ludicrous statements. Here are some examples of IRS private letter rulings that fit these criteria:

1. Ruling purporting to state the "traditional attributes of a charity" (none of which are correct) (Exemption Denial and Revocation Letter 20044044E).
2. Ruling that an exempt organization's website is evidence of unwarranted commerciality (Ex. Den. and Rev. Ltr. 20044045E),
3. Ruling stating that "avoidance of regulation" is nonexempt activity (Priv. Ltr. Rul. 200452036).
4. Ruling applying private benefit standard to social welfare organizations (Ex. Den. and Rev. Ltr. 20044008E).
5. Ruling applying commerciality doctrine to social welfare organizations (Priv. Ltr. Rul. 200501020).
6. Technical advice memorandum declaring that charities must devote assets of for-profit subsidiary to charitable ends (Tech. Adv. Mem. 200437040).

Ideally, then, the full statutory design would be established by Congress and then the IRS could provide meaningful guidance within that framework.

As noted, these voids are mirrored in the reform proposals being advocated in various quarters. For example, proposals to add law concerning tax exemption for hospitals, credit counseling agencies, fraternal beneficiary societies, donor-advised funds, and to some extent supporting organizations reflect the paucity of law concerning the criteria for tax-exempt status.

Here are some proposals for the Committee's consideration:

1. Create law spelling out the criteria for tax-exempt status. For example, legislation could address what is charitable, educational, and scientific. Other categories of exemption, however, could also benefit from this type of clarification, such as social welfare organizations (IRC § 501(c)(4) entities), labor organizations (IRC § 501(c)(5) entities, and business leagues (IRC § 501(c)(6) entities). It is in this setting that law could be created stating criteria for exemption for hospitals, donor-advised funds, fraternal beneficiary societies, and the like.

It may be noted that, as an example of this imbalance, the statutory law spelling out the criteria for exemption for multi-parent title-holding companies (IRC § 501(c)(25)), of which there are few, is three times the size of the statutory law concerning the bulk of the tax-exempt sector: entities referenced in IRC § 501(c)(3)–(7).

2. Develop law outlining an organizational test for at least the principal categories of tax-exempt organizations.
3. Spell out the elements of the private inurement doctrine, including the criteria for determining the reasonableness of compensation, lending arrangements, rental arrangements, and sales transactions.
4. Codify a version of the private benefit doctrine, in the process clarifying whether the doctrine applies to tax-exempt organizations other than charitable entities.
5. Amplify the political activities rules, both for charitable entities and other forms of tax-exempt organizations, particularly social welfare organizations (IRC § 501(c)(4) entities), labor organizations (IRC § 501(c)(5) entities), and associations (business leagues) (IRC § 501(c)(6) entities).
6. Codify a version of the commerciality doctrine, in the process clarifying whether the doctrine applies to tax-exempt organizations other than charitable entities.
7. Enact rules concerning the use of for-profit subsidiaries by tax-exempt organizations.
8. Enact rules concerning the involvement of tax-exempt organizations in partnerships and other joint ventures.
9. Develop statutory law concerning exempt organizations' use of the Internet, such as for advocacy, unrelated business, and fundraising purposes.

10. In the context of reporting and disclosure, consider whether the proposals for a five-year review filing with the IRS, an annual notice requirement for small organizations, and certification as to compliance with the unrelated business rules for large exempt organizations.
11. Enactment of federal law corporate governance principles.
12. Federal law concerning charitable fundraising.

This type of statutory law is required to eliminate the imbalances in the present law and to provide the IRS with a complete regulatory framework within which to provide guidance in the form of regulations, revenue rulings, private determinations, and more.

#### **History and Evolution of Statutory Law**

The original statutory tax exemption for nonprofit organizations in U.S. law for charitable organizations was part of the Tariff Act of 1894.<sup>1</sup> The provision stated that “nothing herein contained shall apply to . . . corporations, companies, or associations organized and conducted solely for charitable, religious, or educational purposes.”<sup>2</sup>

After ratification of the Sixteenth Amendment by the states in 1913, which provided Congress with the authority to enact an income tax, Congress enacted the **Revenue Act of 1913**, exempting from federal income tax “any corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes, no part of the net income of which inures to the benefit of any private shareholder or individual.”<sup>3</sup>

The federal income charitable contribution deduction was enacted when Congress passed the **Revenue Act of 1917**.<sup>4</sup> The **Revenue Act of 1921** brought the estate tax charitable contribution deduction, which was made retroactive to 1917.<sup>5</sup> The gift tax charitable contribution deduction can into being as part of the **Revenue Act of 1932**.<sup>6</sup>

In the **Revenue Act of 1918**, the enumeration of tax-exempt charitable organizations was expanded to include those organized “for the prevention of cruelty to children or animals.”<sup>7</sup> The **Revenue Act of 1921** further expanded the statute to exempt “any community chest, fund or foundation” and added “literary” groups to the list of exempt entities.<sup>8</sup> The Revenue Acts of 1924,<sup>9</sup> 1926,<sup>10</sup> 1928,<sup>11</sup> and 1932<sup>12</sup> did not provide for any changes in the law of exempt organizations.

The **Revenue Act of 1934** carried forward the tax exemption requirements as stated in the prior revenue measures and added the rule that “no substantial part” of the activities of an exempt charitable organization can involve the carrying on of “propaganda” or “attempting to influence legislation.”<sup>13</sup> The Revenue Acts of 1936<sup>14</sup> and 1938<sup>15</sup> brought forward these rules, as did the Internal Revenue Code of 1939.<sup>16</sup>

Tax-exempt organizations were required to file annual information returns, beginning in 1944. This requirement came into the federal tax law as part of the **Tax Revenue Act of 1943**.<sup>17</sup>

The unrelated business rules were enacted as part of the Revenue Act of 1950.<sup>18</sup> These rules tax the net income of charitable and other tax-exempt organizations when they regularly carry on businesses that are not substantially related to the achievement of exempt purposes. This was a radical addition to the law, in part be-

<sup>1</sup> 28 Stat. 556 (Act ch. 349).

<sup>2</sup> The income tax law enacted in 1894 was declared unconstitutional by the U.S. Supreme Court in *Pollock v. Farmer's Loan & Trust Co.*, 158 U.S. 601 (1895), overruled on other grounds in *State of S.C. v. Baker*, 485 U.S. 505 (1988). Congress first created the office of the Commissioner of Internal Revenue and enacted an income tax in 1862, to finance Civil War expenses; that tax was repealed in 1872.

<sup>3</sup> 38 Stat. 114, 166.

<sup>4</sup> 40 Stat. 300.

<sup>5</sup> 42 Stat. 227.

<sup>6</sup> 47 Stat. 169.

<sup>7</sup> 40 Stat. 1076.

<sup>8</sup> 42 Stat. 227.

<sup>9</sup> 43 Stat. 282.

<sup>10</sup> 44 Stat. 40.

<sup>11</sup> 45 Stat. 813.

<sup>12</sup> 47 Stat. 193.

<sup>13</sup> 48 Stat. 700.

<sup>14</sup> 49 Stat. 1674.

<sup>15</sup> 52 Stat. 481.

<sup>16</sup> 53 Stat. 1.

<sup>17</sup> 58 Stat. 21.

<sup>18</sup> 64 Stat. 906.

cause it introduced the concept that some or all otherwise tax-exempt organizations could be taxed. This would lead to many more federal taxes on or in connection with “tax-exempt” organizations.

The rules for charitable and like organizations, as stated in the tax exemption law provision that remains in use today,<sup>19</sup> came into being as a consequence of enactment of the **Internal Revenue Code of 1954**.<sup>20</sup> The previous rules were retained and two additions to the statute were made: The listing of exempt organizations was amplified to include entities that are organized and operated for the purpose of “testing for public safety,” and organizations otherwise described in the provision became forbidden to “participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.”

Enactment of the **Revenue and Expenditure Control Act of 1968** brought rules concerning cooperative hospital service organizations.<sup>21</sup> These rules were amended by provisions of the **Tax Reform Act of 1976**, the **Revenue Act of 1988**, and the **Taxpayer Relief Act of 1997**. The rules pertaining to cooperative service organizations of operating educational organizations were enacted in 1974<sup>22</sup> (as was statutory law concerning political organizations).<sup>23</sup>

The **Tax Reform Act of 1969**<sup>24</sup>—the most significant of the modern tax acts from the standpoint of the law of tax-exempt organizations—introduced a stupendous array of exempt organizations laws, including the exemption recognition application rules, rules differentiating public charities from private foundations, imposing taxes on various aspects of the operations of private foundations, and revising the unrelated debt-financed property rules.<sup>25</sup>

The **Tax Reform Act of 1976** brought law concerning declaratory judgment rules for charitable organizations, lobbying by public charities (the expenditure test), and amateur sports organizations.<sup>26</sup>

The **Tax Equity and Fiscal Responsibility Act of 1982** amended the law concerning amateur sports organizations.<sup>27</sup> The **Tax Reform Act of 1984** brought the church audit rules, changes in the U.S. instrumentalities rules, and the child care organizations rules.<sup>28</sup> The **Deficit Reduction Act of 1984** brought the tax-exempt entity leasing rules.<sup>29</sup>

The **Tax Reform Act of 1986** changed the Internal Revenue Code formal reference to the Code of 1986 (which, as amended, is its status today).<sup>30</sup> This act also introduced the law concerning provision of commercial-type insurance, liquidations of for-profit entities into tax-exempt organizations, and multiparent title-holding corporations; also, it revised the exempt entity leasing rules.

The **Revenue Act of 1987** brought taxes on public charities for engaging in excessive lobbying and political campaign activities, as well as fundraising disclosure requirements for noncharitable organizations.<sup>31</sup> Enactment of the **Omnibus Budget Reconciliation Act of 1993** introduced rules concerning the nondeductibility of expenses for lobbying and political campaign activities, and disclosure rules as to these activities for associations.<sup>32</sup> The 1993 legislation also introduced law in the charitable giving arena, concerning substantiation requirements and quid pro quo contributions.

Legislation known as the **Taxpayer Bill of Rights 2**, enacted in 1996, added the intermediate sanctions rules, expanded the penalties for failure to timely file complete annual information returns, expanded the contents of these returns, revised disclosure rules, and added the private inurement language to the law pertaining to tax-exempt social welfare organizations.<sup>33</sup> The **Small Business Job Protection**

<sup>19</sup> IRC § 501(c)(3).

<sup>20</sup> 68A Stat. 163.

<sup>21</sup> 82 Stat. 269.

<sup>22</sup> 88 Stat. 235.

<sup>23</sup> 88 Stat. 2108.

<sup>24</sup> 83 Stat. 487.

<sup>25</sup> While, as discussed, there was law pertaining to, and law practices concerning, tax-exempt organizations before 1969, enactment of the Tax Reform Act of 1969 ushered in the contemporary bases of this area of the law (other than the unrelated business law structure) and the modern exempt organizations law practice.

<sup>26</sup> 90 Stat. 1520.

<sup>27</sup> 96 Stat. 324.

<sup>28</sup> 98 Stat. 494.

<sup>29</sup> *Id.*

<sup>30</sup> 100 Stat. 1951.

<sup>31</sup> 101 Stat. 1330.

<sup>32</sup> 107 Stat. 312.

<sup>33</sup> 110 Stat. 1452.

**Act of 1996** added revisions to the unrelated business rules, exemption opportunities for charitable risk pools and state tuition programs, and the ability of exempt charitable organizations to own stock in small business corporations.<sup>34</sup>

The enactment of the **Taxpayer Relief Act of 1997** caused several changes and additions to the law of exempt organizations, including various modifications of the unrelated business income rules.<sup>35</sup>

The **Victims of Terrorism Tax Relief Act of 2001** brought rules concerning the provision of assistance by charitable organizations to individuals who are victims of terrorism and clarified the law concerning exempt organization-funded disaster relief programs.<sup>36</sup>

The **Jobs and Growth Tax Relief Reconciliation Act of 2003** changed the tax rates for dividends and capital gains, which has had an impact on charitable giving and rules pertaining to the administration of charitable remainder trusts.<sup>37</sup>

The **Military Family Tax Relief Act of 2003** introduced rules by which the tax-exempt status of charitable organizations could be suspended if designated as supporting or engaging in terrorist activity.<sup>38</sup> The **Working Families Tax Relief Act of 2004** extended the rules concerning charitable contributions of computer technology and equipment used for educational purposes.<sup>39</sup>

The **American Jobs Creation Act of 2004** introduced rules concerning the treatment of charitable contributions of patents and other forms of intellectual property, rules concerning the treatment of charitable contributions of motor and other vehicles, increasing reporting for noncash contributions, an exclusion from unrelated business income for gain or loss on the sale or exchange of certain brownfield properties, and extended the IRS user fee program.<sup>40</sup>

#### References by Present-Law Internal Revenue Code Sections

The following provisions of the Internal Revenue Code, concerning tax-exempt charitable organizations, are correlated by the year of enactment:

##### 1913

Tax exemption for charitable organizations created, with inclusion of private inurement doctrine (predecessor to IRC § 501(c)(3)).

##### 1917

Income tax charitable contribution deduction enacted (predecessor to IRC § 170).

##### 1918

Tax exemption for charitable organizations expanded (predecessor to IRC § 501(c)(3)).

##### 1921

Estate tax charitable contribution deduction enacted (predecessor to IRC § 2055). Tax exemption for charitable organizations expanded again (predecessor to IRC § 501(c)(3)).

##### 1932

Gift tax charitable contribution deduction enacted (predecessor to IRC § 2522).

##### 1934

Addition to law of prohibition on substantial legislative activities by exempt charitable organizations (predecessor to IRC § 501(c)(3)).

##### 1944

Tax-exempt organizations become required to file annual information returns (predecessor to IRC § 6033).

##### 1950

Unrelated business income rules enacted (predecessor to IRC §§ 511–514).

<sup>34</sup> 110 Stat. 1755.

<sup>35</sup> 111 Stat. 788.

<sup>36</sup> 115 Stat. 2427.

<sup>37</sup> 117 Stat. 752.

<sup>38</sup> 117 Stat. 1335.

<sup>39</sup> 118 Stat. 1166.

<sup>40</sup> 118 Stat. 1418.

1954

Tax exemption for charitable organizations expanded again (IRC § 501(c)(3)). Addition to law of prohibition on political campaign activities by exempt charitable organizations (*id.*).

1968, 1974, 1976, 1988, 1997

Enactment of rules concerning tax-exempt charitable cooperative entities (IRC § 501(e), (f)).

1969

Enactment of exemption notice rules (IRC § 508), definitions of public charities and private foundations (IRC § 509), the private foundation rules (IRC §§ 507, 4940–4948), expansion of the debt-financed income rules (IRC § 514), and introduction of the planned giving rules (such as for charitable remainder trusts (IRC § 664)).

1976

Enactment of declaratory judgment rules for charitable organizations (IRC § 7428), public charity lobbying rules (IRC §§ 501(h), 4911), and rules concerning amateur sports organizations (IRC § 501(c)(3)).

1982

Addition of rules concerning amateur sports organizations (IRC § 501(j)).

1984

Enactment of church audit rules (IRC § 7611), the child care organizations rules (IRC § 501(k)), and the tax-exempt entity leasing rules (IRC § 168(h)).

1986

Enactment of the commercial-type insurance rules (IRC § 501(m)), liquidations of charitable and other exempt organizations (IRC § 337), and revision of exempt entity leasing rules.

1987

Enactment of excise taxes on public charities for excessive lobbying (IRC § 4912) and for political campaign activity (IRC § 4955).

1993

Enactment of general charitable gift substantiation rules (IRC § 170(f)(8)) and quid pro quo contributions rules (IRC § 6115).

1996

Enactment of the intermediate sanctions rules (IRC § 4958) and extension of the doctrine of private inurement to exempt social welfare organizations (IRC § 501(c)(4) entities). The unrelated business rules (IRC §§ 512, 513) were revised, rules concerning charitable risk pools (IRC § 501(n)) and prepaid tuition plans (IRC § 529) were enacted, and charitable organizations were accorded the ability to own stock in small business corporations (IRC § 512(e)).

1997

The unrelated business income rules were modified again and the corporate sponsorship rules (IRC § 513(i)) were enacted.

2001

Congress clarified rules for providing assistance by charitable organizations to victims of terrorism and natural disasters.

2003

Tax rates for dividends and capital gains lowered (affecting the charitable remainder trust distribution ordering rules). The tax exemption suspension rules (IRC § 501(p)) were enacted.

2004

Enactment of rules concerning the treatment of charitable contributions of patents and other forms of intellectual property (IRC § 170(m)), rules concerning the treatment of charitable contributions of motor and other vehicles (IRC § 170(f)(12)), increasing reporting for noncash contributions (IRC § 170(f)(11)), an exclusion from unrelated business income for gain or loss on the sale or exchange of certain brownfield properties (IRC § 512(b)(19)), and extension of the IRS user fee program (IRC § 7528).

### Other Law

The foregoing statutory framework has been augmented and expanded over the decades by court opinions, Department of the Treasury Regulations, and Internal Revenue Service public and private determinations. Indeed, in some instances, the statutory law was enacted in response to the position of a court, the Treasury Department, or the IRS.

In the tax-exempt organizations context, for example, Congress has added 18 provisions to the Internal Revenue Code to overturn an IRS position. They are:

1. Enactment of law in 1950 (IRC § 513(a)(3)) to exempt from unrelated business income tax sales of items acquired by gift, to overrule IRS position that non-profit thrift shops were not tax-exempt.
2. Enactment of cooperative hospital service organization rules in 1968 (IRC § 501(e)), to overrule IRS position that cooperatives could not qualify for tax exemption by reason of IRC § 501(c)(3).
3. Enactment of cooperative service organization of educational organizations rule in 1974 (IRC § 501(f)), to overrule IRS position that this type of entity could not qualify for tax exemption by reason of IRC § 501(c)(3).
4. Enactment of definition of term agricultural in 1976 (IRC § 501(g)), to overrule IRS position that the term, for purposes of IRC § 501(c)(5), does not encompass the harvesting of aquatic resources.
5. Enactment of public entertainment rules in 1976 (IRC § 513(d)(2)), to overrule IRS (and courts') position that horse racing at exempt agricultural organizations' fairs was nonexempt activity.
6. Enactment of trade show rules in 1976 (IRC § 513(d)(3)), to overrule IRS position that order-taking and selling at these shows was nonexempt activity.
7. Enactment of law in 1976 (IRC § 513(e)) to allow exempt hospitals to provide certain services to other exempt hospitals, to overrule IRS position that these services were nonexempt functions.
8. Enactment of law in 1978 concerning securities lending transactions (IRC § 513(b)(1)), to overrule IRS position that securities lending by exempt organizations was unrelated business.
9. Enactment of law in 1978 (IRC § 513(f)) to exempt bingo games from unrelated business rules, to overrule IRS position to the contrary.
10. Enactment of special rules for amateur sports organizations in 1982 (IRC § 501(j)), to overrule IRS position that these organizations could not qualify for tax exemption by reason of IRC § 501(c)(3).
11. Enactment of child-care center rules in 1984 (IRC § 501(k)), to overrule IRS position that day care and like organizations could not be exempt educational entities because of too much private benefit.
12. Enactment of rules in 1986 (IRC § 513(h)) to allow charitable organizations to distribute low-cost articles in fundraising context, to overrule IRS position that charities were selling these articles.
13. Enactment of charitable deduction rule for certain payments to institutions of higher education in 1988 (IRC § 170(l)), to overrule IRS position that no portion of these payments was deductible as charitable gifts.
14. Enactment of a rule in 1993 that tax-exempt title-holding companies (IRC § 501(c)(2) and (25) entities can generate a certain amount of unrelated business taxable income, to overrule IRS position that these entities could not have any active unrelated business income.
15. Enactment of rules in 1996 (IRC § 512(d)) to exempt certain associate member dues from unrelated business income taxation, to overrule IRS attempt to tax many forms of these dues.
16. Enactment of rules in 1996 (IRC § 512(b)(17)) concerning foreign source income taxable as unrelated business income, to overrule IRS position that certain forms of this income were nontaxable dividends.
17. Enactment of rules in 1997 concerning revenue received by tax-exempt organizations from controlled subsidiaries (IRC §§ 512(b)(13), 318), to overrule IRS position that these rules did not extend to revenue from second-tier subsidiaries.
18. Enactment of corporate sponsorship rules in 1997 (IRC § 513(i)) to overrule IRS position that payments by corporate sponsors were forms of unrelated business income.

Some amendments to the Internal Revenue Code in this context were added at the request of the IRS. Examples of this are the intermediate sanctions rules (IRC § 4958) and the commercial-type insurance rules (IRC § 501(m)).

There is relatively little law on the federal tax exemption for labor organizations. This category of exemption, in present-day IRC § 501(c)(5), was first added to the statutory law in 1909 (Corporation Excise Tax Act of 1909, 36 Stat. 11). The statute provides merely that tax exemption is available for "labor" organizations. No criteria for exemption are provided—an instance of the need for statutory criteria for exemption if the federal statutory law in this context is to be brought into balance.

The tax regulations amplify this aspect of exempt organizations law. There it is provided that an exempt labor organization is an entity that has as its objects the betterment of the working conditions of its members and development among its members of a higher degree of efficiency in their occupations, and does not cause its net earnings to inure to the benefit of a member (Reg. § 1.501(c)(5)-1(a)). This category of exemption is not available for organizations that have as their principal activity the investing and management of funds associated with savings or investment plans, including retirement savings programs (Reg. § 1.501(c)(5)-1(b)). The regulations make it clear that exempt labor organizations are nonetheless subject to the unrelated business rules (Reg. § 1.501(c)(5)-1(c)).

There are a few court opinions and IRS revenue rulings on the subject. This law amplifies somewhat the concept of the exempt labor organization. One court held that a labor organization is an entity that is organized to "protect and promote the interests of labor" (Portland Cooperative Labor Temple Association v. Commissioner, 39 B.T.A. 450 (1939)).

Labor organizations have traditionally engaged in collective action directed toward the workers' common objective of improving working conditions. They include labor unions that negotiate with employers on behalf of workers for improved wages, fringe benefits, hours and similar working conditions, and certain union-controlled organizations, such as strike funds, that provide benefits to workers that enhance the union's ability to effectively bargain (Rev. Rul. 67-7, 1967-1 C.B. 137), and publishers of labor newspapers. Exempt labor organizations do not include strike funds that provide income to union members but are not controlled by unions (Rev. Rul. 76-420, 1976-2 C.B. 153).

Labor organizations may also meet the requirements for exemption by providing benefits that directly improve working conditions or compensate for unpredictable hazards that interrupt work. Examples of these benefits include operating a dispatch hall to match union members with work assignments and providing industry stewards who represent employees with grievances against management (Rev. Rul. 75-473, 1975-2 C.B. 213; Rev. Rul. 77-5, 1977-1 C.B. 148). Conversely, managing saving and investment plans for workers, including retirement plans, does not bear directly on working conditions (Rev. Rul. 77-46, 1977-1 C.B. 147). Accordingly, the IRS does not accord exemption to organizations that manage retirement savings as their principal activity (cf. Morganbesser v. United States, 984 F.2d 560 (2d Cir. 1993), which led to promulgation of the above-referenced Reg. § 1.501(c)(5)-1(b)).

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Chairman THOMAS. Given the sheet that Members have in front of them from Mr. Yin in terms of the catch-as-catch-can historical picture of how this developed, it appears to me, based upon the testimony that you made, notwithstanding understood rationales or not understood rationales as to why various provisions are in the law, yet all of you think it is possible to create a coherent definition, theory, and structure. Mr. Cohen?

Mr. COHEN. I was privileged to be the youngest person who drafted the 1954 Code. Before the 1954 Code, the Internal Revenue Code had not been really amended much since 1939. It was first enacted in 1939 as a Code, and then, of course, the war came and there was just emergency legislation. Nobody did it coherently. So, we had to do it coherently. Two of us were assigned. One was assigned to do only substantive provisions, to rearrange them in some kind of a substantive order. I was assigned to do all the administrative provisions. You can imagine what a job that was. There were separate administrative provisions for every single tax. That is, there was no unified set of rules. That took a year. It took us

a whole year to do that. Before we started the job, we had small groups—now, this is the kind of job where you would need a group like that, that would sit down for a sustained period of time—they may be insiders or outsiders or a combination of it—and try to rationalize and give you alternatives. That is, they will come back with policy decisions that only you folks can make. You can't assign this to your inside staff and give them 6 months and say, do it, while they are doing everything else because it will never get done that way. It has to be a special project in which there is a devoted set of staff that work on it and work to make it coherent. So, for example, we have insider penalties that apply to (c)(3)s, that apply to certain (c)(3)s. They don't apply to (c)(4)s. They did apply to (4)s, but they didn't apply to many of the other organizations. All those kinds of things and the things that Bruce and the others have raised need to be considered, but that takes time and staff.

Chairman THOMAS. I will tell you that in today's world, where we have a Presidential panel to look at fundamental tax reform and they have 6 months to report back, you just outlined a time line which the VH1 generation can't focus on in terms of length. If we were to pursue this, is it worthwhile at all to create a kind of an onion approach, or going down in a hierarchical way, to look at what is most important at the Federal level, which we obviously ought to be focusing on—the panel indicated that tax-exempt tends to be a State classification, and should we then look at what charity is and create a definition for charity first, or do you just have to jump into this and begin to sort out a structure with what is there, because I think you will find that this Committee and even any structure that we put together probably won't be able to agree on all of those particular levels and produce a product in any reasonable timeframe. Mr. Hopkins?

Mr. HOPKINS. I would like to respond to that. I think, as you have heard, the charitable sector does predominate and it performs—along this way we are made, I think the Committee would find that a lot of what it did in the 501(c)(3) context could be used in other areas, particularly (c)(4)s, (c)(5)s, and (c)(6)s. So, as a practical matter, it might make sense to start writing a better law as to what charitable, scientific, educational is, and work with the private inurement doctrine, private benefit doctrine, intermediate sanctions, and if that could be accomplished, then I think you would have a template that could be used in many respects with respect to other categories of exempt organizations.

Chairman THOMAS. Okay. Let us start with charity. Normally, if you talk about the charity area, lists were made, or at least referred to as to which ones were the most numerous. So, if I asked the panel if you were to select out the area in which there was the most dollar involvement in the charity area, and I don't know that the volume relates to dollar amount—you understand it better than I do—where would the—is there an area in which half of the charity concept is involved, or 25 percent, or do they all have 3 percent and you just have to look at the entire universe?

Mr. Colombo?

Mr. COLOMBO. Yes. The IRS can probably give you, or the GAO can probably give you more statistics. Financially, it is pretty clear that hospitals and health care providers are the 1,000-pound go-

rella of the charitable organization area, that they command a large portion of the revenue in the charitable area. In terms of the conceptual problems, I really don't think you can lay them out that way. There is this charitable sector, and I think you can divide charities from everything else and work in the charitable sector. I think it would be very hard to focus on a little piece of the charitable sector itself without focusing on the area as a whole.

Chairman THOMAS. Well, does anybody have the percentage that hospitals are of the charitable areas so that you know what we are biting off? We have to start somewhere. Anybody. You guys fight it out.

Mr. YIN. In our document, in the pamphlet on page 21, we actually have a table showing the breakdown of the charitable organizations and Professor Colombo is exactly right. The largest, at least by assets and revenue, is in the health area, and of that, the largest component would be hospitals. The next largest looks like it would be education. Of course, in that would be the colleges and universities. Then there are a couple of other areas that are somewhat large, as well.

Chairman THOMAS. Okay. I accept your structure and category. Now I turn to the definitions that are offered. Mr. Colombo, we are going to deal with charity. You want to define charities as those who live off of contributions or donations because it appears as though their services are recognized on a voluntary basis to be supported by people freely providing their money. If that is going to be the definition of charity, do nonprofit hospitals fit your definition?

Mr. COLOMBO. No, not most of them. I think there would be a few. Children's hospitals, the Shriners' hospitals probably get significant donations. As a sector, the last number I saw was that about two percent of their revenues come from donations, and I suspect most of that goes to like the children's hospitals.

Chairman THOMAS. Well, this goes to the point that the Ranking Member made early on in terms of IRS and is a real reason why IRS is going to have to appear before us, because in 1969 when they were defining charity, they decided that relief of the poor and distressed is not an essential criteria for charity, and so I would turn, Professor Hill, to your offering of a definition of public benefit to a defined population. If, in fact, nonprofit hospitals don't have to provide services to the poor or distressed to be classified as a charity, and it isn't based upon donation, then I appreciate the offers of definitions, but we are either going to have a wholesale revision of what is and what is not defined as a charity or both of your definitions are going to have to be boozed up quite a bit.

Ms. HILL. Definitions always have to be boozed up quite a bit, and those of us who come to hearings do so because we think maybe the process of having them boozed will be useful in the end. To be responsive to the question of how can a public benefit concept help and does it apply to hospitals, I would like to get on the table a consideration also of the human services sector. If you look at the table on page 21, we notice that that is also quite significant here in terms of revenue and the number of entities, and I think we can all think of the social services sector as the direct delivery of goods

and services to people who probably would come closest to a charitable class in our view—the hungry, the homeless, those needing clothes, food, shelter, assistance with various problems. I bring them into it because in my testimony, I raised the question, what is public benefit? What is a charitable class? The difficulty here in answering the question is to say, does a charitable class have to be the same for all kinds of charities? Does it only have to be poor people or distressed people? Well, that would leave out the arts organizations. If it is only the poor people, then, of course, social services are good, but churches become problematic because rich people also love God and wish to go to church. I think with hospitals, if we think only of charity care as the public benefit, and I do think there should be more charity care in this country across the board, of all kinds of health care providers, including out-patient clinics, but I think part of that problem isn't rooted in the exempt sector. Part of that problem, as this Committee knows much better than I, is rooted in the larger problem of health care policy and whether a health care insurance net linked to employment is the best way to go. These are huge questions which kind of transcend it. I would say that if we begin by saying what is the public benefit—let us take a university. Is it the students who presumably are going to get out and get nice jobs, are they the beneficiaries of education, or is it society more generally who has then this educated pool of young people who would be good citizens? I think one can ask the same question about hospitals. What are all the public benefits they represent? How do we count the public benefit? I think that charity care is one part. Education of doctors and other health care providers is another. Frankly, there is a benefit to all the rest of us who may not be ill at the moment, but we do not have to watch people die before our very eyes and have some hope.

Chairman THOMAS. Professor Hill, everything you said about that aspect, in my mind, corresponds to hospitals generically, some of which are for profit, some of which are not-for-profit. So, what is the criteria for placing some in not-for-profit and those others in for-profit except the self-definition that they have chosen, which if we are looking at for a rationale for all the money we are dealing with, the definitions that were provided early on in an abstract way, I think we start bumping up against reality immediately. All I am trying to do is get you to share the problems we are going to have as a Committee if you simply said, go in, begin defining, and structure the areas.

Ms. HILL. May I just follow up?

Chairman THOMAS. Sure.

Ms. HILL. One more perspective on this whole question of comparing activities conducted in the taxable sector, activities conducted in the exempt sector. I think we have to be careful when we talk about the comparison and the benefits with the exemption that we are sure that the taxable entities are making a profit, not generating losses and thereby not having a tax burden. I think it would be very useful to have side-by-side comparisons of universities, of hospitals, of schools that are taxable and tax-exempted social service providers. Then I think the discussion of the benefit of the exemption in the two and whether there is really a difficulty

in having the activities across two sectors, an inappropriate taxation becomes more real, and I do not have those data. Others may.

Chairman THOMAS. My problem when you introduce that is that one is a conceptual problem of defining somebody as a charity and not. The other one is an examination of the Tax Code to see if the deductions are appropriate for a for-profit to wind up not paying taxes, and those are two entirely different pursuits, both of which are probably worthwhile, but with setting aside the examination of the Tax Code and the deductible aspects of it for for-profits to examine the definition you have provided me with that I am now trying to apply to this area. Mr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. Let me pull out pieces of both of these concepts, largely because it supports the testimony that we submitted. The first is the notion of a public benefit. To the extent that the activity that an entity is engaged in has such broad public benefits that no single individual would be willing to write the check, you would see very little data to support that entity with sales. At the other extreme, if there is really just a private benefit or transaction that makes sense for the entity and the individual, you could support the entity's activities with sales like revenues. In the same way with charity, the ultimate of charity is to conduct a transaction at below the regular price or even give it away for free, and to the extent that you do that, you will be unable to support the entity with sales. To the extent that you do not, you will have a lot of sales. So, the index that we organized our testimony around was what fraction of the income comes from program revenue? How much does it look like a sales-driven entity? That encompasses both the flip side of public benefits/private benefits and the flip side of charity, collecting at market prices. That is a continuum. It is not a bright line, but it allows you to organize things, and they range greatly. The hospital number we have is 92 percent of income comes from program revenue in a hospital in the tax-exempt hospital sector. Food, agriculture, nutrition, 8.5 percent. So, there is an enormous diversity there.

Chairman THOMAS. Yes. We are using this only for illustrative purposes because I think it is a good example and it is a big segment, and if you are going to try to deal with changing the law, you probably ought to start with the big segment instead of dealing at the bottom end of you will never get to the bulk of the questions in front of us. So, I don't want anyone to think that I am focusing on a section for the purpose of doing that. I just thought, based upon the definitions you gave me and I began playing with them during the testimony, that I had one I couldn't find an easy category for and it turns out to be the biggest one right on top.

Mr. Walker, and then I will recognize the gentleman from New York.

Mr. WALKER. Mr. Chairman, obviously, you are not going to be able to decide on a definition today, but I think it illustrates a very fundamental point. As has been testified by a number of the individuals here, we have a number of different types of 501(c) entities that have come into effect over the last 100 years. If you look at the data that has been provided by the Joint Committee on Taxation, of the 28 categories, five have less than ten filers. Eleven have less than 1,000 filers. We have basically created a fragmented

and layered approach to this area, like many other areas in the Federal government, without adequate definitional guidance, without adequate transparency, and without appropriate accountability, and I would respectfully suggest that this is illustrative of a need to step back and say, what are we trying to accomplish? Who should benefit? We need some basic definitions so that we can rationalize this area, and it is illustrative of a much broader need, as well, I would suggest.

Chairman THOMAS. I thank the gentleman, but it seems to me that donations sounds like a perfectly good way to define charity if you need them, and then we run into a problem using that definition. The idea of benefit to a defined population sounds really good, but if you begin to apply it, you find out that IRS walked away from that in the fifties and especially in 1969 with hospitals in terms of saying that charitable service doesn't have to necessarily define the charity, or service to the poor. So, all I am saying is we need help. It is obvious that what we need is a degree of rigor and structure designed to, if you only did this, it is a great improvement, as somebody said. If you do this in addition, it is great. To throw the whole area of 501(c) on us means we don't know how to get out of the box. The gentleman from Florida just said this sounds like a can of worms, and I am thinking it is a bucket of worms rather than a can of worms. A quickly follow-up by Mr. Walker.

Mr. WALKER. Mr. Chairman, very quickly, obviously, we are in the fact-gathering business, and so if we can help this Committee try to be able to obtain some facts with regard to particular aspects of 501(c)(3) or organizations, we are happy to do that.

Chairman THOMAS. Facts are valuable, but structure to understand, analyze, and use the facts are probably more important to us.

Mr. JOHNSON OF TEXAS. Would the gentleman yield?

Chairman THOMAS. The gentleman from Texas.

Mr. JOHNSON OF TEXAS. I would just like to point out, concerning these hospitals, that we have now introduced Medicare and Medicaid, which were not, I don't think, in the law as heavily as they are now when the hospital charitable contribution was initiated. Therefore, I think there has to be a consideration of those items, as well, when you talk about that.

Chairman THOMAS. That is partially true, but Medicare began in 1965 and the definition I was referring to from the IRS was 1969 in which relief for the poor, distressed is not an essential criteria for charity, so it was even after Medicare was enacted into law. The gentleman from New York.

Mr. RANGEL. Thank you, Mr. Chairman. Mr. Cohen, you have indicated that no matter what amounts of money we give to IRS for oversight, that would probably go where they think they could get the best savings, but I know because of your great history in this area that the credibility of the system also is important. Even though the money may not be in these 501(c)s, if there is abuse and corruption, they have to send some type of a signal that people cannot get under the radar just because there is not a lot of money involved. Today, there is a lot of talk about 501(c)(3)s that are set up as educational institutions and that they are either violating the

law or the spirit of the law, and the question I would ask, I guess, Mr. Hopkins, is that if some lobbyist wanted to influence the conduct of Congress and they had clients, either domestic or foreign, but it would violate the law if they approached the Member directly, but yet the foundation would receive large sums of money from the lobbyist and then invite the Members of Congress to be educated by visiting with the country where these businessmen came from or the locations where they had their business, would that be legal under the law as you understand it as a lawyer?

Mr. HOPKINS. This does not sound like a hypothetical question.

[Laughter.]

Chairman THOMAS. I tell the gentleman that as long as we stay in the hypothetical area, I don't believe it violates the fundamental purpose of this hearing, but as soon as the hypothetical becomes specific, then I think we will be dealing with those issues with the IRS and others in front of us in a more systematic way. However—

Mr. RANGEL. Mr. Chairman, I appreciate—

Chairman THOMAS. —given the background and experience, Mr. Hopkins, of the panel members, you probably are the most appropriate to respond to the hypothetical as outlined by the gentleman from New York.

Mr. HOPKINS. Thank you, Mr. Chairman. The concept of what is educational and the concept of what is legislative overlaps a little bit, and I think, without getting into the details here, by the way, the regulations are fairly comprehensive on the point. If there is an attempt to objectively present facts and information about a particular topic, that is educational. If there is an advocacy element at some point, it can shift over to lobbying or even political campaign activity. The funding of it by itself shouldn't change the outcome. In other words, you were talking about lobbyists contributing money to an entity. It is the function, not the funding, if you will. So, what we try to do in the law is separate the presentation of objective material as contrasted with an efficacy—

Mr. RANGEL. I can understand that. My second and last question to you would be, if the not-for-profit then hired people that—strike that. If people that worked for the not-for-profit also was in the consulting business as a lobbyist and remainder under 501(c)(3), in your opinion, would that be a violation of the law?

Mr. HOPKINS. Well, that is a different body of law. Now, we are talking about educational versus private benefit, or in a more technical sense, private inurement. What we are talking about here is a situation where what looks to be educational on its face is, in fact, a shifting of the resources of the charity over to someone in an inappropriate manner. That would be a private inurement or a private benefit situation. I am not saying that is—

Mr. RANGEL. I am not either.

Mr. HOPKINS. It is hypothetical—

Mr. RANGEL. That would be an abuse of the system.

Mr. HOPKINS. If the resources were shifted unduly to someone in their private capacity, the answer is yes.

Mr. RANGEL. Now let me ask Professor Hill a question. We are getting more involved in not-for-profits being audited for political activities and dealing with an organization has historically been

known, in the hypothetical, for its efforts in the civil rights area and voter registration and things of that nature. If an office of not-for-profit makes a statement that is critical of the major parties and then the eve before the election, the IRS says that there is going to be an investigation, how would the IRS monitor, or how would the Congress be able to monitor the IRS and at the same time seek out to get rid of these abuses with subjective matters such as the one that I described in the hypothetical?

Ms. HILL. Yes. Your hypothetical raises important issues of conducting audits with respect to what is, in some of its elements, constitutionally protected First amendment political speech. When conducted through a 501(c)(3) organization, the Supreme Court has said in taxation with representation that lobbying in that case could be conditioned and those people believed that the political prohibition in section 501(c)(3) is constitutional and would be so held, and one did look to the *McConnell v. Federal Election Commission* comments in that case. The question that arises, and I am going to be a little hypertechnical here and mention code sections, and I apologize to anyone in the room whose eyes are going to glaze over, but I am a professor and inherently boring, so here we go. Generally, an organization is audited when it files its information return, but we know that the information return is filed long after an election and there is something of a mismatch in this area between interdicting improper political activity of 501(c)(3) and the time at which the IRS can normally take action. Congress enacted section 6852, in the larger scheme of things quite recently, to provide that in the case of a flagrant violation of the political prohibition of section 501(c)(3), Congress, the IRS could audit at that point in what constitutes a version of a jeopardizing assessment. They could close the taxable year and audit, but the violation has to be flagrant.

Further, there has been for a time now in the Code section 7409 that allows the IRS, with careful procedural limitations, to seek a declaratory judgment action in a court to interdict the behavior immediately in the case of flagrant participation in a political campaign in violation of the exempt status. I don't believe the IRS has ever used 7409. When the IRS begins to seek information, then, from a 501(c)(3) organization before the filing of a return, the technical issue which is now unaddressed is is that consistent or inconsistent with section 6852, especially if, hypothetically, the speech in question or the other activity in question doesn't appear to be flagrant. Passionate, maybe, but not flagrant. So, what we have here is a technical issue of great importance to the administration of the tax law and great importance to the conduct of our elections, and that is where I think the law stands now. Certainly the IRS may audit. It seems to be a requirement that the activity in question be flagrant and that there be a showing that it be flagrant. So, one would have to look case by case.

Mr. RANGEL. Thank you, Professor. Thank you, Mr. Chairman. Now that you have whetted my appetite as to the breadth of this serious problem that would demand these hearings, can you share with me as to when we can get to the rubber can hit the road with the IRS, because this distinguished panel certainly has laid out a

blueprint of something that demands and screams out for correction.

Chairman THOMAS. I tell the gentleman that we will, as we normally do, based upon minority witnesses—as you were aware, we worked with the staff in creating this particular hearing. We will do additional ones, but as is usually the case with this Committee, ultimately, a significant amount of the work will be turned over to the Subcommittee. The Subcommittee on Oversight has historically been the Subcommittee that reviews it periodically. It may be worthwhile to bring it back to the full Committee to take a look at this, because I do believe we need to move expeditiously, one, because we should, but two, I want to make sure that the press doesn't cover this as us rushing belatedly to an issue that the Senate initiated for the purpose of raising revenue, because I have been doing this for 22 years, as the gentleman from New York has. So, we will be working together to plan and structure additional hearings, one to look at theory and practice, but two, eventually, you have to put theory and practice to the test and we will be dealing with the IRS on some decisions they have made and querying them as to why they thought they could do what they did when they did it.

Mr. RANGEL. The reason I thought it was urgent, Mr. Chairman, is because I thought some in the majority wanted to pull up the tax code by its roots and start all over again, and I—we have John, how many do we have here, the Ambassador—and I wanted to ask the panel whether they would have any specific recommendations that they could send in to us during this period so that we could present them before Treasury and the IRS. Of course, if we are pulling up the Code by the roots, then we don't need any recommendations because we will start de novo. Just in case you decide not to do tax reform this year or next year, may I ask the panel to send what recommendations they have for this complicated code and the one that would follow this year or next year so that we can see what happens?

Chairman THOMAS. I tell the gentleman it might be most fruitful if we get our staffs together so that we can structure as a Committee the kinds of questions that we might want to submit to this panel and others, frankly, to begin to collect that kind of data so that we can, in the anticipation of the old dandelion concept, you want to try to pull it out by its roots and you don't and the root is still there and it grows back, we may need to do some gardening. So, I am looking forward to—

Mr. RANGEL. Could we get a statement from the IRS person as to what he thinks the problem is so that we can tell staff what we would be looking for in—

Chairman THOMAS. I think that will be useful in a structured manner, but as this panel clearly indicates, there is a lot of fruitful work that can be done conceptually to try to figure out where we need to go and how we need to get there, and then we can begin to apply it practically by dealing with the current world.

Mr. RANGEL. Thank you, Mr. Chair.

Chairman THOMAS. I look forward to working with the Ranking Member on that.

Mr. RANGEL. Thank you.

Chairman THOMAS. The Chair would only say for the record that in propounding his hypothetical, it might have been more appropriate if the hypothetical structure had included the fact that there were complaints filed with the IRS, hypothetically, and that the IRS examined 130 of those cases, hypothetically, and the one that the gentleman hypothesized over was the one that was publicly announced by the organization, meaning there were 129 additionally hypothetically that were being examined, as well. Does the gentlewoman from Connecticut wish to be recognized?

Ms. JOHNSON OF CONNECTICUT. Thank you very much. My question is going to go to Mr. Hopkins to enlarge on that portion of his testimony that he alluded to, tax-exempt labor organizations, because your testimony is very helpful. This goes to the whole panel. Lots of you made very specific recommendations as to how we go about it. I found that very helpful. I thought that it was interesting that in addition to your overall suggestions and your history, you did focus on one area, and I want you to have a couple of minutes to enlarge on that. I do want to, though, mention to Mr. Colombo, you may have a living, live example of the public benefit of nonprofit hospitals as we watch whole departments of delivering services move from the nonprofit to the for-profit setting where they can also earn more and be relieved of the responsibility to cross-subsidize charitable services or to take part in the mandates that govern the hospitals, that they must take anyone who comes, and so on. So, sometimes, you can see through people's behavior where the public benefit lies and where it collides with the underlying need to get fairly compensated for your work. Mr. Hopkins?

Mr. HOPKINS. Thank you very much. The reference in my presentation to labor organizations is in there, sort of a disconnect, I understand this, from the rest of the testimony. It is in there because the Committee staff asked me to briefly address the point. To put it in context, you have heard testimony from a number of witnesses, including Mr. Cohen, about how unbalanced the Code is today, and for example, he was making reference to 501(c)(25), which is the multi-parent title holding company provision which occupies about, what, three-quarters of a page of the Internal Revenue Code and reflects maybe four or five entities in the United States, contrasted with labor organizations, which obviously involve millions of individuals. There are two words in the Internal Revenue Code describing tax-exemption for labor organizations and the two words are "labor organizations." That is all the Code itself says about labor organizations. This category of exemption was added to the Code back in 1909, so it precedes even the constitutional law that Mr. Yin was referring to. The code provision is silent on criteria for exemption, and in my view, it is one of the examples of an area that should be remedied by this Committee. Now, briefly, in the tax regulations, you will find some law where it is provided that an exempt labor organization is an entity that has as its objects the betterment of the working conditions of its members, and to some degree, it functions to develop among its members a higher degree of efficiency in their occupations. The private inurement doctrine does apply in this context. There is a major regulation that was adopted a few years ago that makes it clear that entities that have as their principal activity the invest-

ing and management of funds associated with savings or investment plans cannot be exempt. There are a very few court opinions and IRS rulings on the subject. In this context, the law is amplified a bit and illustrates the fact that the exemption includes more than labor unions. It embraces entities like collective bargaining Committees, certain forms of strike fund entities, and publishers of labor newspapers. That is about the substance of the law that we have today concerning labor organizations.

Ms. JOHNSON OF CONNECTICUT. I thank the gentleman. I believe my time is about to expire. I will yield back.

Chairman THOMAS. Mr. McCrery?

Mr. MCCRERY. Thank you, Mr. Chairman. Before I get to the CBO Director on some of his comments about business activity, tax-exempt business activity, just to give you a heads-up, I want to get back to Professor Hill, Professor Colombo, on this question of some sort of conceptual framework for determining who should be tax-exempt, what entities should be tax-exempt, and Professor Hill, you used the term public benefit. We need to think in terms of the public benefit that is being served by this tax-exempt entity. Then there was some conversation about hospitals. I must admit, I am having a hard time conceptualizing the public benefit of a tax-exempt hospital, but I have to say in fairness, if I were to ask the not-for-profit hospitals if they like their situation now, they would say yes, and I would go to the for-profit hospitals and I would say, well, do you like your situation now, oh, yes, sure. So, I am not sure we would make either one happy if we were to change the current arrangement. If there is some public benefit to be served, and I suppose one could say that health care is a public benefit and providing the lowest-cost health care would be a public benefit, then we could justify, I suppose, exempting hospitals, and all health care providers, for that matter, from taxation. If that were the case, then we would probably want to require all health care providers to be tax-exempt and not-for-profit, I would assume. So, that gets into a real sticky wicket. So, help us further define that public benefit concept and how it would be applied in the real world.

Ms. HILL. I think that when one looks at the hospitals, that really the conceptual hurdle is bigger than public benefit. It is grasping exactly the idea that you have set out, but it very well may be appropriate to have the same activity conducted simultaneously by taxable and exempt entities, and there may be not a problem with that. I suggest that because we are living in a world now where, as you all know, there is a great deal of convergence of activities in taxable entities and tax-exempt entities. I teach at an exempt entity. I do not think that taxable universities should be closed down or forced to become tax-exempt. With respect to the hospitals, the idea of looking at who is the benefited class and doing it in a way that gets beyond simply the pricing structure of the provision of the service, I think may help here. Certainly, the question of the pricing structure of the service and whether it is any different in taxable or tax-exempt entities, as Professor Colombo notes in his testimony and as I believe to be the state of the research in this area, the data are inconclusive on pricing structure, whether there is a difference, and I think that they are

inconclusive as to sort of care provided to those who cannot pay and under what circumstances and do we count things like government payments to determine charity care. If we think only of the provision of free medical care to people who cannot pay, then, of course, hospitals have no—exempt hospitals have a much weaker case. If that is our criterion, then the question is, well, should they be partly exempt or fully not exempt, and if we then make that conclusion, the question is, what do we tax? In my previous comments, the related issue previously raised, I suggested that we look at how we determine whether taxable entities are making a profit, distributing dividends to shareholders, and whether that concerns us.

Frankly, I am not concerned that we have an economy in which there is a choice in certain areas to be taxable or tax-exempt, and whether Congress wishes to condition, for instance, education on do we provide scholarships based on need? Is it wrong to provide scholarships only on academic merit? Should all our scholarships be on need, which I think would be the analogous question? Should we provide care to people who cannot pay it? Is that the only criteria for exempt status? I believe that if we begin to ask those questions carefully, Congress would provide a useful role here. If we simply dig in our heels and become protective, we are not going to get very far.

Mr. MCCREERY. Thank you. I would be interested in hearing any comments in writing from Professor Colombo on that subject and also from Dr. Holtz-Eakin on the question of how do these tax-exempt businesses conflict with tax-paying businesses? How do they interact, and are tax-paying businesses hurt in certain cases by the existence of tax-exempt. You don't have time right now, but if you would like to point out something in your testimony that is relevant, I will look at it. Thanks.

[The information follows:]

Thank you for your question about the Congressional Budget Office's (CBO's) testimony presented at the Ways and Means Committee's April 20 hearing on the tax-exempt sector. As I understand it, you are interested in how nonprofit entities that are exempt from Federal income taxes compete with business entities that are subject to them, and how equalizing the tax treatment would affect that competition.

It is useful to focus on *activities* that are tax-exempt as opposed to *entities* that are tax-exempt. For that reason, CBO presented fractions of income generated by sales activities. Nonprofit organizations provide both goods and services that are not provided by the private sector and ones that are, at subsidized prices (or no cost) rather than at market prices. Many such entities have little sales revenue and are probably not in competition with firms in the for-profit sector. CBO's testimony focused on those tax-exempt entities that have substantial sales to the public and that compete with private firms.

The attached table identifies examples of that competition. The health sector, particularly hospitals, is the primary example of nonprofits that sell at market prices many of the same goods and services provided by for-profit firms. As shown in the second column, that sector receives almost 92 percent of its revenue from the sale of goods and services and provides a relatively small portion at subsidized prices to those with limited ability to pay. The entities in the sector look very much like for-profit entities, which receive almost all their revenue from sales.

The pervasiveness of competition offered by businesslike nonprofit entities is greater than is suggested by the data in column 2. Even in those categories where overall income from program revenue is very low, substantial competition exists. The last column of the table estimates the share of revenue earned by entities for which program revenue exceeds 75 percent of their total revenue. For example, for the category "Environmental Quality, Protection, and Beautification," the 19 percent share of program revenue (shown in column 2) suggests that those activities might

offer little competition with those provided by for-profit firms; however, almost 9 percent of total revenue in that category comes from entities earning more than 75 percent of their revenue from program sales (as shown in the last column). On the basis of that metric, some of those entities may compete substantially with for-profit entities.

Fully 65 percent of total revenue in the nonprofit sector is earned by entities for which program revenue exceeds 75 percent of total revenue. Those potential competitors with the for-profit sector are found in all categories of nonprofit organizations.

Universities and museums are examples of entities that are in competition with the for-profit sector and that are also engaged in activities that provide public benefits. They have increasingly moved into commercial activities in order to earn a surplus that can be used to further their provision of public benefits. Many universities have entered into research partnerships with for-profit firms that look very much like business enterprises, and they also compete with professional sports for advertisers' and sports fans' dollars. Museums have expanded their gift shops, selling many items not related or only tangentially related to their tax-exempt mission that are readily available from for-profit firms. The *Washington Post* has had several articles in recent weeks that detail the commercial activity of a range of nonprofit entities.

CBO's testimony concludes that taxing currently tax-exempt nonprofit organizations is not likely to level the competitive playingfield. The efforts of for-profit firms to avoid paying taxes are restrained by their need to deliver the surplus to shareholders. It is the absence of those shareholders that primarily determines a nonprofit organization's economic behavior: it is free to retain a surplus or dissipate it by lowering prices or increasing costs. A nonprofit's response to being taxed would be to shrink or eliminate the tax base by retaining less of its surplus. That surplus would instead be used to provide additional price reductions or to cover cost increases. If nonprofits used formerly retained surpluses to further reduce prices, competition with the for-profit firms might intensify in the short run. But over a longer period of time, those nonprofits' reduction in retained earnings might cause them to shrink.

Ultimately, the key to competition from tax-exempt entities is the variety of state laws that determine an entity's ability to organize itself as a nonprofit organization—not federal tax policy. Once an entity is organized as a nonprofit, managers have greater latitude with the uses of its surplus. That latitude, by itself, provides a substantial ability to compete through lower prices. As I noted in my testimony, the additional exemption from Federal income taxes contributes to the overall surplus, but is not the primary source of a nonprofit entity's ability to compete via lower prices.

I hope that you find this information useful. If you would like to discuss it, please call me at 226-2700 or Dennis Zimmerman at 226-2683.

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Mr. SHAW. [Presiding.] Thank you.

Mr. Levin, you may inquire.

Mr. LEVIN. Thank you for coming, all of you. I had the benefit of taking a taxation course from the very gifted professor, but I must say we did not spend very much time on this particular provision, this section, so I am not quite sure what is the purpose of this hearing except it does fill in some gaps of our legal education. So, let me just ask you, go down the row, and if you would, tell us what you think is the major problem in this section of the Code. I know you may not like to pick out one, but if you would do so. What do you think is the major issue or the major problem? Yes, Mr. Colombo?

Mr. COLOMBO. Well, I can start with that. I think the major problem is the lack of a core rationale for tax-exemption for charitable entities and the detail about how that tax-exemption is conferred. I think that is very important because this is a significant and growing sector of our economy. There is more and more money going into charitable organizations and more and more money com-

ing out of charitable organizations. That trend has accelerated over the past years and I think it is just going to accelerate further. So, we need to spend some time thinking about an area that is growing very rapidly and for which we don't have very good ideas about what the underlying rules are.

Mr. LEVIN. Ms. Hill?

Ms. HILL. I think the core problem in this area is that one of its very strengths, that the exempt sector is so dynamic and so malleable and so easy to enter is inviting abuse of the sector on all fronts and the IRS is incapable now at current funding levels, current expertise levels, and the current state of the law of stopping any of it. I simply want to express the hope that as Congress addresses it, we don't make this sector rigid and unable to function. The very creativity of it on all fronts is meaning that it is far beyond hospitals, it is far beyond universities, that charities are being used and abused for activities that have nothing to do with the provision of a public benefit. If you would like a more specific response in writing with detailed lists, I would be glad to do that for you, as well.

Mr. LEVIN. Okay. You can talk more in your answer about the IRS, if you would.

Mr. Walker.

Mr. WALKER. If I had to pick one, I would say a lack of a set of criteria or a clear definition of what should be tax-exempt and what should not.

Mr. YIN. Mr. Levin, if you would define this area broadly, I would suggest three areas that would be worth looking at. Certainly one would be the one that Mr. McCrery was questioning on just a moment ago. More broadly, I think the issue of oversight and transparency in the exempt area, to what extent do we have a handle on what is going on. Then, as I said, if you take the term, this area broadly, I would include the charitable contribution area as another area that is worth looking at.

Mr. LEVIN. Thank you. Dr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. With the caveat that this constitutes the sum total of my legal education in this area—

[Laughter.]

Mr. HOLTZ-EAKIN. —it sounds to me that one of the major things that is going on here is there is an attempt to apply a bright-line exemption to entities when it is, in fact, activities that are either public purpose or charitable in nature, and these entities have a great mixture of activities within them and it would be useful to distinguish between those two things.

Mr. LEVIN. Yes, Mr. Cohen?

Mr. COHEN. You will excuse my irreverence, but this is a perfect opportunity for my favorite quotation from Pogo. We have met the enemy and it is us. It is your lack of attention, our lack of attention. It is understanding that the Revenue Service's capacity is greater than it is. For example, Mr. Yin in good faith says we ought to have a five-year review of tax exemptions because people are abusing it and, therefore, we ought to look at it a second time. That is a wonderful idea, but we don't have the personnel to look at it the first time.

Mr. LEVIN. I like your irreverence. Yes?

Mr. HOPKINS. Mr. Levin, on page six and seven of my prepared statement, I have outlined in somewhat of a level of priority 12 areas that I would encourage the Committee to look at, and number one on the list, and you have heard this from at least two of the other witnesses, is create law spelling out the criteria for tax-exempt status. I think that seems to be a consistent theme that you have heard today. I will work in one more, which is the elements of the private inurement doctrine because the private inurement doctrine from a pure law point of view is the fundamental legal distinction between a nonprofit and a for-profit. Those two areas, I think you would find, would be very productive ones to look at very carefully.

Mr. LEVIN. Thank you.

Mr. SHAW. Mr. Camp, and I would like to announce that Mr. Walker is going to have to leave following Mr. Camp's questioning and he will be replaced by Mike Brostek of the government Accountability Office. Mr. Camp?

Mr. CAMP. Thank you. I will direct my question, my first question, to Mr. Walker, then. Do you think if we have greater enforcement of our current law and better oversight by the IRS that most of the abuses within the tax-exempt sector could be eliminated?

Mr. WALKER. I think you are going to need additional transparency and additional data sharing as a basis to have more targeted and more effective enforcement, as well as some supplemental intermediate sanctions to be made available to the IRS to provide more appropriate accountability mechanisms rather than merely pulling the tax-exempt status.

Mr. CAMP. Is that the timing issue that Professor Hill talked about that you are referring to there, in terms of the enforcement?

Mr. WALKER. I am not sure what—

Mr. Camp. Intermediate sanctions. Well, you mentioned—

Mr. WALKER. Well, that is, for example, in a prior life, I was Assistant Secretary of Labor for Pensions and Health, and there are tax-exempt entities that I had to deal with there, for example, 501(c)(9) VEBAs, Voluntary Employee Benefits Associations, also outside of 501(c), pension plans. It is very, very important that you have adequate transparency and intermediate sanctions other than pulling the tax-qualified status. There need to be sanctions that are there, that if people end up engaging in inappropriate or unacceptable activities, that you can bring to bear. For example, as is the case for foundations, I believe, you have prohibited transactions. If certain kinds of transactions occur between parties, then there can be excise taxes that can be imposed and sanctions that can be imposed on the violating individuals rather than necessarily the entity. That would be an example.

Mr. CAMP. It is my understanding that since 1996, the IRS has had an intermediate sanctions available for—if there has been a situation where there has been private inurement. Is it your opinion that that has been ineffective, or perhaps I should direct that to Mr. Yin, if that is not in your field.

Mr. WALKER. I will be happy to have him answer, but my understanding is that doesn't apply universally. It doesn't apply to all the 501(c) entities.

Mr. CAMP. All right. Mr. Yin, do you want to clarify that?

Mr. YIN. That is correct. It is likely directed at the 501(c)(3)s and the public charities within that. The private foundations have a separate set of rules that are more stringent than the public charities.

Mr. CAMP. What are the current restrictions and requirements on private foundations?

Mr. YIN. On private foundations, the analog would be the self-dealing rules, and essentially, they prohibit any kind of transaction with an insider. In contrast to that, the intermediate sanctions would allow a transaction with an insider, but supposedly at arm's length rates and so forth. Obviously the inquiry in the intermediate sanctions area is much more difficult because there, you have to judge to what extent is the inside transaction at fair, arm's length rates as opposed to some kind of internal benefit going to the insider.

Mr. CAMP. Aren't there also other requirements, like restrictions on holdings and—

Mr. YIN. In the private foundation area, that is correct.

Mr. CAMP. Yes.

Mr. YIN. I thought you were just addressing on the intermediate sanctions point.

Mr. CAMP. I would like to know what are some of the other requirements and restrictions on private foundations.

Mr. YIN. Well, there are restrictions on requiring them to make certain amounts of distributions each year. There are restrictions on—on ownership, exactly right. There are also restrictions on excess benefit holdings. They can't hold too much interest in the business.

Mr. CAMP. I would just like to comment briefly on your report, the options to improve compliance and reform tax expenditures, particularly with regard to conservation easements, your statement there. I just want to say that in Michigan, land conservation easements are becoming a really prominent way to preserve valuable land and shoreline. I just want to ensure that the highest standards are met in terms of land conservancies, obviously, as everyone else does, but I am afraid that the changes you suggest would make it virtually impossible for a landowner to take advantage of these provisions to, in effect, preserve their land forever, some of this incredibly beautiful land. So, I wonder, do you think stricter standards on appraisals and licensing for appraisals and increased penalties for overstated appraisals in this area might assist in this area?

Mr. YIN. I think that is a step in the right direction. In fact, in the staff options, we do lay out some improvements in the appraiser and the appraisal process. However, it would seem that that is just a small step in terms of addressing the underlying difficulty. The underlying difficulty is that for a variety of reasons, easements are unusually difficult to determine what the appropriate value is. It is just a partial interest in the property. It is a property interest which is crafted by the donor and, therefore, may have few, if any, comparables. Then, at least in certain circumstances, perhaps not the ones that you are describing, there are State and local restrictions on the use of property already in existence and, therefore, that would need to be taken into account

in figure out what the appropriate value of the easement right is. Because of the difficulty of the value, it becomes a very difficult both compliance problem for the donor and a very difficult enforcement problem for the Internal Revenue Service. If you put all of the change, if you will, into the appraisal process, it really doesn't address the underlying issue, which is that it is very difficult at the outset to figure out what circumstances should be examined at all.

Mr. CAMP. Thank you, Mr. Chairman. I see my time has expired.

Mr. SHAW. Mr. Cardin?

Mr. CARDIN. Thank you, Mr. Chairman. Let me thank all of our witnesses for their testimony. It is clear to me in hearing your testimony and looking at the material that has been submitted that the issue of oversight and compliance needs some attention.

Mr. Camp talked about, and Mr. Walker responded by perhaps the sanctions are not as broad or as much discretion to IRS as is needed in order to bring about more compliance with Congressional intent. There is a question as to whether we have enough exams. With the exam rates as low as they are, why would there be much concern about even the sanction authority of the IRS if the chances of sanctions being used are so minimal, considering the number of exams? There is also the question of political will, whether there really is a will of our Nation to be more stringent on tax-exempt organizations. Then there is the whole evolution of section 501. It has developed over a long period of time, as you all have pointed out, and it is not 100 percent clear as to what the expectations are for tax-exempt entities. So, do we need Congressional clarification? Let me start with Mr. Cohen, because he is a former Commissioner, and try to get his reaction as to how you would suggest we get a handle on appropriate oversight and compliance as to the role of the IRS and Congress as to trying to give fair notice to the taxpayers, but also to develop consistent oversight and compliance strategy on behalf of our Nation.

Mr. COHEN. I was fortunate, or unlucky, as the case may be, to be the object of Congressional inquiry by Mr. Patman, who ran several years of hearings, vigorous hearings, on tax-exemptions, which led to much of the 1969 Act that restricted them. So, I paid a lot of attention. He caught me. He had my attention. I have to say to you, but for that, it would have been a backorder. Before I came to the Revenue Service the second time as Commissioner in 1965, it was a backorder, and that is why he was taking on some fairly obvious problems. You had some Members of this Committee during the late 19seventies period that got involved in it again, but again, it has been an area that not much attention certainly by the full Committee and very little by the Oversight Committee. You just don't spend the time. Therefore, it is not number one for the top people down at 12th Street who mind this operation. Yes, in an ideal world, everybody would be paying attention to everything, but we know that is not the way the world works. The world works, what is important today is what is important to you folks.

Mr. CARDIN. Mr. Cohen, let me just interrupt you for a moment. Our Tax Code depends upon voluntary compliance. We depend upon—that is the hallmark of the American Tax Code. Is this

a satisfactory situation? Are we overreacting? Do we have enough voluntary compliance? Maybe we have the right policy today.

Mr. COHEN. We have just seen the Commissioner's new research study, and we have not had a research study since 1988, so we have had the first report of that. It shows a tax gap in the order of 15.5 to 16 percent. That is about 11 or 12 percent higher than it was the last time we did it about 11 or 12 years ago. So, surely, it is slipping. It is slipping, and you can almost look at the numbers. As you see the audit levels fall, you see compliance levels fall. People react to not seeing the cop on the beat, in the city parlance. So, yes, we need more compliance effort. The money is well spent. The Commissioner generally has a rule that he won't ask for a dollar unless he can bring in large multiples of that. Indeed, the problem is that as you cut the Commissioner's budget and personnel—personnel went from close to 120,000 down to about 95,000, between 95,000 and 100,000—you find that the Commissioner—the first thing that is cut is not proportional. It is compliance, because that is the only optional money he has. He has to produce returns. He has to process returns. He has to collect money. There are a number of functions that he has to do, and so he has no leeway there. He can audit more returns or less returns. He can audit the returns more intensively or less intensively. Of course, what happens is he slips off. You do some audits, but you do them less intensively and therefore they are less effective. You and I react to the fact that our neighbor is being audited. If a neighbor is being audited and talks about it, he talks about it, it has an effect on all of our behavior. It is like driving down a major superhighway. If we don't see a traffic policeman, we tend to go five or ten miles an hour above the limit. If we see a traffic policeman, we go two miles above the limit. We all chisel a little bit. Therefore, we need to see that audit to have an effect on our behavior. Now, we are not seeing it, so—

Mr. Mr. CARDIN. I agree with that comment and I appreciate your response. Thank you, Mr. Chairman.

Mr. SHAW. Thank you, Mr. Cardin. Mr. Herger?

Mr. HERGER. Thank you, Mr. Chairman. Mr. Yin, recently, the Joint Committee on Taxation made a number of recommendations to improve tax compliance, one of which would restrict the use of conservation easements. I welcome this proposal and I believe this is an area the Committee should focus attention on because there has been a large amount of evidence that taxpayers are taking inappropriate deductions related to conservation easements. Consider a Washington Post article from December of 2003 which quotes a Florida business consultant as advising his clients to purchase golf courses and prohibit building on the fairways as a way in which to reap large tax benefits. He refers to one investor who paid \$2.4 million for a golf course and received a \$4.8 million tax deduction. This taxpayer received a tax deduction worth twice what he paid for the property. This article also mentions luxury homebuilders in North Carolina who paid \$10 million for a tract in the mountains, developed a third of the land, and then claimed a \$20 million deduction. Evidence suggests these are not isolated incidents. Perhaps this is not surprising, given the easements are today held by various government agencies, national environmental groups such

as the Nature Conservancy, and according to the Post article, about 1,260 local trusts. Mr. Yin, my understanding is that your proposal would eliminate charitable tax deductions relating to conservation easements on personal residence and would limit the deductions related to other properties. This proposal is scored as raising \$1 billion over 10 years, not an unsubstantial amount of money. My question is simply this. Do we know how much fraud in dollar terms currently exists with respect to conservation easements? Two, does the Joint Tax Committee proposal go far enough to eliminate the potential for fraud relating to golf courses and other types of investments similar to what I mentioned earlier? If not, what more can be done to ensure that the Federal government, through the charitable deduction allowed for conservation easements, is not subsidizing large amounts of tax fraud?

Mr. YIN. Thank you, Mr. Herger. Obviously, it is very difficult to provide estimates of fraud because fraud involves a particular intention on the part of the taxpayer which would have to be judged on a very highly factual determination. I think that it is fair to say, however, that the IRS recently in connection with the hearing over on the Senate side published their letter which indicated the top areas of compliance difficulty in the EO area, and one of the areas that they clearly identified was the difficulty that they have in enforcing the laws relating to easements. Now, how much of that is fraud as opposed to simply overvaluation but not rising to the level of fraud, I don't know if they know. I don't believe we know, either. In terms of whether the Joint Committee proposal goes far enough, obviously, that is going to be your judgment and the Committee's judgment on those sorts of issues. We did try to offer a balanced approach. I am comfortable with—I am personally comfortable with the proposal as it is offered, but obviously, that is not my judgment. It is going to be your judgment.

Mr. HERGER. Thank you very much, Mr. Yin. I think we can see enough and enough has been pointed out again through the media, through yourselves, through these hearings, to indicate that perhaps we are just beginning to see the tip of the iceberg here. We all want to see legitimate deductions made, but we are also very concerned about what is perceived as—even if it may be within the law today, those exemptions that are being made that clearly, I think, in most of our judgments are not ethical, are not fair and not proper, and I would certainly like to urge your continued involvement in this and I thank you.

Mr. SHAW. Mr. Johnson?

Mr. JOHNSON OF TEXAS. Thank you, Mr. Chairman. I wonder if Mr. Holtz-Eakin and Mr. Brostek could talk about this subject. Almost 10 years ago, Congress put the immediate sanctions rules into place that allow the IRS to punish tax-exempt entities that break the private inurement rules. I would like to know whether this type of sanction has been effective and whether incremental change like this might serve as a model for reform of the tax-exempt laws by this Committee.

Mr. HOLTZ-EAKIN. I could go first and hand it to Mr. Yin, who I think knows a lot more about this than I do.

Mr. JOHNSON OF TEXAS. Okay.

Mr. YIN. Mr. Johnson, of course, as you do indicate, the law, though it has been in effect for 10 years, it is still—on the larger scheme of things, that is a relatively short period of time, so our experience is still somewhat limited. In the report that Mr. Camp referenced, the late January report by the Joint Committee staff, we did provide some options to improve the intermediate sanctions rules in areas where we felt that they did seem to be a little bit on the lax side. We put in some suggestions on modifying the initial contract exception and also on the rebuttable presumption of reasonableness. Now, these are relatively small changes in the procedure of how the rules would work. I think we are not really yet in a position of being able to give you guidance that they are completely ineffective or completely effective, and so it is a little bit early to make that—

Mr. JOHNSON OF TEXAS. Well, has the number of violators increased or decreased?

Mr. YIN. Well, in terms of the number of violators, of course, prior to the law, there wasn't a rule against it as such. That is that—well, I take that back. The prohibition or the penalty was to lose your tax exemption, and because that is such a draconian outcome, that was rarely imposed and so it is difficult to know, as comparison to what prior behavior is, whether the current behavior is improved. Again, I would suspect that, in time, we will get a better handle on how it is working.

Mr. JOHNSON OF TEXAS. Yes, sir?

Mr. BROSTEK. I think the point that Mr. Yin is making is an important one. IRS can apply those sanctions when it knows there is a problem that needs to be corrected. One of the things that IRS itself admits is that it doesn't have enough information to know the various kind of noncompliance that are occurring out there. They are trying to improve the Form 990 that gives them some of that type of information, but that will need to be married up with greater transparency so the news media and the public can help keep an eye on the entire universe, and probably with some improved governing standards to help ensure that within an organization, there is a check and balance to ensure that this kind of abuse doesn't occur.

Mr. JOHNSON OF TEXAS. Transparency, you have all mentioned that. It needs to be fixed. Let me ask one other question. I brought up Medicare and Medicaid earlier. It seems to me that there is plenty of appropriations from public funds for all sorts of health care providers for helping the poor and the elderly and it seems to me the absence of clear standards for the community benefit provided for not-for-profit hospitals may be a problem. In Texas, for example, we require a set percentage for charity care—I think it is four or 5 percent—and unreimbursed Medicaid costs in order to claim 501 status. It seems to me a step in the right direction, and I might add that hospitals in our district go way above that. A larger concern, though, is that standards, once they have been met, may breed a feeling of, we have crossed the line. We don't owe anything else to anybody. The problem is complicated further when one considers that some for-profit hospitals offer a notable amount of charitable unreimbursed care. Do you have any suggestions on ways to encourage a more equitable charitable care

across the board? I guess that is for GAO or CBO, as well, or all of you, if you have a comment.

Mr. BROSTEK. Well, we don't have a position at this time on that. We haven't looked at it.

Mr. HOLTZ-EAKIN. I think it is certainly the case that if you look back, and I think Mr. Cohen would know the history better than anyone on this, the notion of what constitutes charity was heavily influenced by the existence of Medicare and Medicaid and perhaps a false optimism that poverty would not be a problem in the presence of these programs. So, if one would like to come back and come up with a clearer standard of performance, you would have to probably not leave it in the hands of an administrative decision but actually have the Congress develop a standard that they felt was appropriate.

Mr. JOHNSON OF TEXAS. Thank you.

Mr. COHEN. I was at the meeting, the cabinet meeting at which the President decided to go for Medicare. It was accidental. I was there to report on something else. I was also Commissioner of Internal Revenue at the time that Medicare began to pay out, and it led the Revenue Service to that 1969 ruling. That is, if Medicare was going to pay a good piece of what used to be charity, then how are you going to deal with the hospital system and how are we going to deal with health care? The availability of health care is a public good, and that is what we had to deal with.

Mr. SHAW. I am going to have to cut that off. Mr. Pomeroy, then Mr. Beauprez. Mr. Pomeroy is going to share the time with Mr. Thompson and then we are going to wind this hearing up before this vote.

Mr. POMEROY. Thank you, Mr. Chairman. I will be very brief. It seems to me that this hearing, which has been extremely interesting, has highlighted basically two separate facets of this question. One is the very confused state of the Tax Code, which allows nonprofit status or tax-exempt status to be achieved through any number of ways. Second, the whole enforcement question, eyeballing whether or not those that have qualified are actually appropriately conducting themselves for purposes of maintaining that qualification. To that end, I would like to speak of while this Committee grinds along on the question of who has got this exemption and why, that is a long-term proposition that is going to be tough sledding. I would hope that we don't get distracted and not proceed on the enforcement question, which we can do something about very quickly through, among other things, resource commitment to the IRS and some clarity in terms of directing them to take this action. To that end, and underscoring the importance of taking that action, a couple of issues, items in the recent press I would like to put into the record, yesterday's Financial Times, as well as a story from the Business section of Sunday's Washington Post, both detailing abuses in trusts in this area. Specifically quoting from the Financial Times article, "Foundation directors and donors have come under fire for excessive pay, insider dealing, alleged conflict of interest between their foundations and their private business dealings, as well as outright tax fraud." Then on the Washington Post story, it is detailing how the founder of AmeriDebt, the bankrupt Maryland credit counseling firm, took \$70 million from its op-

eration between 1999 and 2003. I think this makes a compelling case for why we need to help the IRS with its enforcement activity. We need to raise their budget relative to being able to completely audit this activity, and especially in wake of passing the bankruptcy bill, we have got to, in the Oversight Subcommittee, really bear down on nonprofits—

Mr. SHAW. Without objection, the documents are placed in the record.

[The information follows:]

**April 16, 2005 Saturday**

**FTC Moves to Freeze Assets; AmeriDebt Founder Transferred Money to Off-shore Trusts, Agency Says**

**Caroline E. Mayer, Washington Post Staff Writer**

The founder of AmeriDebt Inc., the now bankrupt Maryland credit-counseling firm, took \$70 million from its operations between 1999 and 2003 and spent lavishly on his wife, girlfriend and himself, including paying \$179,000 to an interior decorator, \$13,500 to a yachting company and \$2,500 on a restaurant tab.

That's what the Federal Trade Commission said in court papers as it sought to freeze the assets of Andris Pukke. A hearing on the matter was held yesterday in Federal court in Greenbelt. Those assets included \$18.3 million transferred to domestic and offshore trusts, and \$2 million sent to an account in Latvia for his father, the agency said.

In 2003, the FTC sued Pukke, his wife, the nonprofit AmeriDebt, and DebtWorks Inc., the for-profit private firm Pukke set up to process AmeriDebt customer accounts. The suit alleged that the Pukkes and their companies deceived financially struggling consumers seeking help with their debts by charging high fees—hiding them by calling them voluntary contributions. They operated falsely as a nonprofit organization while siphoning off money through DebtWorks to make money for the Pukkes, the suit said.

A recent filing in a related class-action lawsuit alleged that Pukke and his girlfriend traveled to Tahiti, Bora Bora, San Tropez, Las Vegas, Aspen, the Cayman Islands and Cabo San Lucas, that he gave her a new Mercedes, and that he spent \$15,000 for a mattress and \$8,000 for sheets for his Malibu mansion. He sold a Miami Beach home for \$7 million, that suit said.

AmeriDebt, based in Germantown, was once one of the nation's largest and most aggressively marketed debt-management firms, advertising heavily on cable TV and the Internet. Also the target of several lawsuits by state attorneys general, AmeriDebt is now bankrupt and its accounts have been taken over by a third-party firm.

AmeriDebt is one of more than 50 nonprofit credit counseling firms under investigation by the Internal Revenue Service for misusing their tax-exempt status for the benefit of their operators. There is little Federal regulation of the firms. The bankruptcy bill that passed Congress this week contains a provision that requires debtors to seek debt counseling before filing for bankruptcy protection.

Last month, the FTC settled its lawsuits with AmeriDebt, but its case against Pukke and his wife continues, with the agency seeking \$170 million in consumer refunds.

"An individual profiting \$70 million on a fraudulent promotion is certainly among the largest we have seen," said Joel Winston, the agency's associate director for financial practices. "The question is where did it go? We're trying to freeze whatever money and property he has, seek repatriation of the money he has put overseas and have a receiver appointed by the court to audit his affairs and determine where all of his money and assets are."

John B. Williams, Pukke's attorney, did not return phone calls. Previously he has said that evidence shows that AmeriDebt benefits to all consumers far surpassed the \$170 million that consumers paid the credit-counseling firm because it was able to reduce interest rates and get rid of late fees and interest charges for many of its customers.

In court papers opposing the freeze, Pukke's lawyers said the FTC and the class-action plaintiffs have failed to prove consumers were injured.

The monetary transfers, the papers added, occurred in the past "when Mr. Pukke was in much better financial condition. Mr. Pukke now has limited assets and all of his available income goes to the IRS, Mr. Pukke's wife pursuant to court orders in a pending divorce case, and personal living expenses which are not extravagant."

In depositions with the FTC, Pukke invoked his Fifth amendment privilege, the agency said.

U.S. District Judge Peter J. Messitte said he would rule next week on the request to freeze his assets.

According to the FTC filing, "Mr. Pukke has dissipated assets" by transferring money to the trusts, close friends and relatives and by a "lavish lifestyle." The commission said that DebtWorks transferred \$200,000 to Pukke's girlfriend although she never worked at DebtWorks. The girlfriend also used a DebtWorks credit card to pay \$215,000 in charges, including a \$1,688 bill at a clothing store and a \$2,165 three-night stay at the Viceroy Hotel in Santa Monica, the lawsuit said.

Pukke's wife received \$250,000 from DebtWorks although she never worked for the firm, either, the FTC said, and another \$150,000 through the company's credit card.

The agency said that Pukke established the domestic and offshore trusts, including one in Nevis and another on Cook Islands in 2002, shortly after the FTC notified AmeriDebt and DebtWorks that they were under investigation. "Clearly," the agency said in legal papers, "Mr. Pukke created these trusts in an effort to put his assets out of reach of the FTC and other creditors." As of June 2004, the trusts were valued at \$18.3 million.

The class-action lawsuit said Pukke "has hardly been skimping on his domestic lifestyle. . . . His primary residence cost him \$27,906 per month, including over \$24,500 for mortgage, property taxes and utilities and \$1,400 for domestic help. This pales in comparison to the monthly cost of operating his secondary home, which is \$84,699."

In July 2004, the lawsuit said, Pukke spent \$8,119 for dining and \$6,583 for travel. His monthly car payment was \$10,653. With other personal and professional expenses and taxes of \$75,000, Pukke claims to spend more than \$390,000 a month, it said.

In opposing a motion by the class-action lawyers to appoint a receiver, Pukke lawyers argued that the plaintiffs were citing old spending habits and were not likely to succeed on the merits of the claim.

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Mr. POMEROY. We have to bear down on these nonprofits. I would like to finish my thought. We have to bear down on these nonprofits that are providing credit card counseling and debt counseling. I believe it is principally a scam and we need to get to the bottom of it. I yield the balance of my time to Mike Thompson.

Mr. THOMPSON. Thank you, Mr. Pomeroy. I want to align myself with Mr. Camp. I believe that conservation easements are critically important for protecting literally thousands of acres throughout my district, in my district for critical wildlife habitats, salmon and steelhead restoration. It is responsible for clean air and clean water. At the same time, Mr. Herger raised some valid issues. We need to make sure these are legitimate procedures done by the right reasons and it is something that benefits more than just the person making the donation. Mr. Yin, you have commented on numerous occasions now on these changes that I believe if they were taken at face value would do irreparable harm to the whole idea of conservation easements. So, I would like to ask that you do, and if you have already done it, let me know, but do some more work in this regard to see if we can't associate a value to the good conservation easements done by the legitimate contributors. These in many instances save governments a lot of money. They don't just protect valuable, important properties. So, before we rush into any reform in this regard, I haven't seen anything other than anecdotal references to problems, so I would encourage you to do and provide an analysis to this Committee that looks at both the potential problems, but the very specific values that these bring to the table.

Chairman THOMAS. [Presiding.] The gentleman from Colorado.

Mr. BEAUPREZ. Thank you, Mr. Chairman. I will be very quick and very direct. Mr. Colombo, many have talked about your comments, as well as many of the others on the panel, about the need to define what is a charitable contribution, what qualifies as a tax-exempt organization. I found your rather straightforward definition to be pretty useful, that an organization ought to be able to survive primarily on donations. Then it crossed my mind that any number of business entities out there that in a different environment we would call it profit margins, net income, might say that is the income that one who does business with that business entity provides so that it is sustainable. Does that fit your definition or not?

Mr. COLOMBO. The Internal Revenue Service and the courts have developed pretty good tests about what constitutes a donation and what doesn't. The test is generally what we call a quid pro quo test, or the absence of a quid pro quo, and there is not any question that normal sales transactions don't fit that kind of model. So, I just don't see a problem, to tell you the truth. We pretty much know what a donation is. At the edges, we may get into a little bit of a problem, at the edges of what donations are, but mostly, we know what it is, and mostly, I know when we get one.

Mr. BEAUPREZ. All right. Very quickly, type three supporting organizations. Mr. Yin, I am going to guess that you might be the one to opine on this. I know that they have come under intense scrutiny, especially in the other body, recently. There has been some concern. From personal experience back home in my own State, I know community foundations, private family foundations seem to do an enormous amount of good, as well. Is the abuse so rampant that we maybe are tempted to throw the baby out with the bathwater, or is what we really need, as has also been suggested here, more oversight and more accountability, more transparency?

Mr. YIN. Well, Mr. Beauprez, as you know, supporting organizations are granted public charity status as opposed to private foundation status and some have argued that they more closely resemble private foundations and should be more subject to those rules. The type three that you referred to are specifically the ones that have drawn the most attention because they are least under the control, if you will, of the organization that is being supported, and therefore least subject to the same level of scrutiny that the charitable organization which is being supported is normally subject to. So, that is the reason why that is an area that has drawn some attention recently.

Mr. BEAUPREZ. The solution would be, in your opinion?

Mr. YIN. Well, there are a variety of solutions. Obviously, you would first have to determine there is a problem sufficiently great enough to deserve a solution. Assuming that you did, there would be a variety of solutions, one of which would be to permit support organizations of type one and type two but to not permit the type three.

Mr. BEAUPREZ. I thank the entire panel very much and am sorry we have to rush.

Chairman THOMAS. The Chair would also like to thank the panel. The Chair believes that perhaps the government witnesses might want to get with staff. I think it would be very helpful for

Members if we prepare a glossary so that the terminology that is being used, they understand the meaning of as we move through these various structures. I want to thank the other panelists, and I hope that you aren't thankful that this is the only opportunity to assist the Committee, let me put it that way, because we are going to continue to examine the area, but we need to work on these fundamentals that we have talked about before we get excited and think we can fly in making judgments over real world events. So, I do want to thank you. The Committee owes you a debt of gratitude and we expect to use you more in the future. With that, the Committee stands adjourned.

[Whereupon, at 1:15 p.m., the hearing was adjourned.]

[Questions submitted from Representative Herger to George Yin, and his response follows:]

**Question Submitted by Representative Herger**

**Question:** Mr. Yin, recently the Joint Committee on Taxation made a number of recommendations to improve tax compliance, one of which would restrict the use of conservation easements. I welcome this proposal and I believe this is an area the Committee should focus attention on because there has been a large amount of anecdotal evidence that taxpayers are taking inappropriate deductions related to conservation easements.

Consider a Washington Post article from December of 2003, which quotes a Florida business consultant as advising his clients to purchase golf courses and prohibit building on the fairways as a way in which to reap large tax benefits. He refers to one investor who paid \$2.4 million for a golf course and received a \$4.8 million tax deduction. This taxpayer received a tax deduction worth twice what he paid for the property! This article also mentions luxury-homebuilders in North Carolina who paid \$10 million for a tract in the mountains, developed a third of the land, and then claimed a \$20 million deduction.

Evidence suggests these are not isolated incidents. Perhaps this is not surprising, given that easements are today held by various government agencies, national environmental groups—such as the Nature Conservancy—and, according to the Post article, about 1,260 local land trusts.

Mr. Yin, my understanding is that your proposal would eliminate charitable tax deductions relating to conservation easements on personal residences and would limit the deductions related to other property. This proposal is scored as raising \$1 billion dollars over 10 years, not an insubstantial amount of money. My question is simply this: Do we know how much fraud, in dollar terms, currently exists with respect to conservation easements?

Does the Joint Tax Committee's proposal go far enough to eliminate the potential for fraud relating to golf courses and other types of investments similar to what I mentioned earlier? And, if not, what more can be done to ensure that the Federal government, through the charitable deduction allowed for conservation easements, is not subsidizing large amounts of tax fraud?

*Response:*

Dear Mr. Herger:

This letter responds to your written request made in connection with a hearing of the House Committee on Ways and Means regarding charities and other tax-exempt organizations held on April 20, 2005. You asked: (1) whether it is known how much fraud, in dollar terms, currently exists with respect to conservation easements; and (2) whether the recent proposal of the staff of the Joint Committee on Taxation to limit the deductibility of certain contributions of conservation easements (the "easement proposal") is sufficient to eliminate fraud relating to golf course easements and other abusive easement donations, and what more could be done to eliminate such fraud. You also asked these questions orally at the hearing.

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<sup>1</sup>Joint Committee on Taxation, *Options to Improve: Tax Compliance and Reform Tax Expenditures* (JCS02-05), January 27, 2005, at section VIII.F.

The easement proposal was contained in a report that we prepared in response to a request from Senate Finance Committee Chairman Grassley and Ranking Member Baucus. The report contains options to improve lax compliance and reform tax expenditures in almost all areas of the Federal tax law. One of these options relates to the charitable contribution of easements. As explained in the report, the charitable contribution deduction for easements is an exception to the general rule that prohibits a charitable deduction for a contribution of a partial interest in property. This exception was enacted generally to encourage landowners to contribute property rights to a qualified organization in order to protect such rights in perpetuity for conservation purposes.

The report makes a number of observations about the contribution of easements and concludes that noncompliance concerns warrant consideration of curtailing the tax benefits provided with respect to such contributions.<sup>2</sup> In particular, the easement proposal notes that the proper amount of the charitable contribution deduction is difficult to determine because the valuation of the easement right being contributed is often highly speculative. For example, there is generally no ready market for such easements, the terms of which may vary from donor to donor, and no available data regarding comparable sales. This situation makes enforcement of the law very problematic, as the mere identification of potential overvaluations may require considerable administrative expense such as the cost of appraisals. A serious challenge to a claimed deduction would entail a greater commitment of resources. The easement proposal also raises the concern that the current definition of "qualified conservation contribution," which in most instances does not require that a contribution be pursuant to a clearly delineated governmental conservation policy, is not sufficient to ensure that conservation purposes are being served. We note further that the often difficult issues of valuation and assessment of the appropriate purpose of a contribution generally are even more difficult in the easement contribution context because the taxpayer retains an ongoing interest in the underlying property. To address these concerns, the easement proposal limits the extent of deductibility, modifies the definition of qualified conservation contribution, and imposes additional requirements on appraisers.

Regarding your first question, as discussed above, a primary compliance concern addressed by the easement proposal is overvaluation. An easement may be overvalued as a result of fraudulent intent on the part of the donor or because of more innocent reasons. In addition, an easement may be overvalued even if the easement serves a legitimate conservation purpose. The easement proposal is intended to reduce claimed overvaluations for purposes of the charitable deduction regardless of the reason or circumstances of the overvaluation. As a practical matter, even with a detailed review of taxpayer returns showing information regarding easements, we would be unable to determine whether an easement serves legitimate conservation purposes, or whether the contribution results from fraudulent intent on the part of the donor, without making an independent assessment of the circumstances surrounding each contribution. As a result, we are unable to determine the amount of fraud, in dollar terms, that exists with respect to conservation easements. However, because we are concerned that the current definition of conservation purpose is not adequate to address noncompliance, the easement proposal suggests, among other things, that the requirement that the conservation contribution serve clearly delineated governmental conservation policy — currently applicable only to a limited class of conservation contributions — be extended to all forms of conservation contributions. The intent is that such a change in the law would improve the integrity of the tax system by providing tax incentives only for donations that serve identified conservation or preservation purposes.

With regard to your second question, the easement proposal to curb noncompliance in easement donations in a number of ways. Your request gives two specific examples of potentially abusive conservation easement donations: (1) golf course easements; and (2) easements placed on a parcel of land to be developed by a builder of luxury homes. Such examples raise questions about the legitimacy of the conservation purpose purportedly served by the easement donation and the accuracy of the claimed value of the easement. The easement proposal was designed to address each of these concerns. For most conservation easements, the easement proposal seeks to ensure that a legitimate conservation purpose is served by requiring a

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<sup>2</sup>IRS Commissioner Everson has identified overvaluation of conservation easements as a top compliance concern of the IRS. See *Letter from IRS Commissioner Mark W. Everson to The Honorable Charles E. Grassley*, March 30, 2005; *Written Statement of Mark W. Everson, Commissioner of Internal Revenue, Before the Committee on Finance, United States Senate, Hearing on Exempt Organizations: Enforcement Problems, Accomplishments, and Future Direction*, April 5, 2005.

showing that an easement donation is pursuant to a clearly delineated governmental conservation policy—a showing that may be particularly difficult to make, for example, in the case of a golf course easement. In the absence of such a showing, no deduction would be allowed. In addition, even where a clearly delineated governmental conservation policy purportedly exists, the easement proposal would address the overvaluation of easements of the type you describe by: (1) denying a deduction where the property has been used or is reasonably expected to be used as a personal residence; (2) denying a deduction for 67 percent of the appraised value of a conservation easement where the property has not been used and is not reasonably expected to be used as a personal residence; and (3) imposing additional requirements on appraisers who value such easements. In short, we believe that the easement proposal would limit significantly noncompliance in connection with easement donations, particularly noncompliance involving the valuation of easements.

I hope this information is helpful to you. If we can be of further assistance in this matter, please let me know.

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[Submissions for the record follow:]

#### **Statement of America's Community Bankers**

America's Community Bankers ("ACB")<sup>1</sup> is pleased to submit this written statement in connection with the Committee's hearing on "An Overview of the Tax-Exempt Sector." ACB commends the Chairman for calling this important hearing to examine tax-exempt entities. Providing tax-exempt status to charitable, educational and other non-profit organizations can further important societal goals, but not in every instance.

Congress and the American taxpayers deserve to know whether the substantial tax benefits that have been granted under section 501(c) of the Internal Revenue Code are being used for the purposes intended by Congress and whether these benefits are being abused in ways that harm organizations and people that do pay federal income tax. ACB believes that it is also important for the Committee to examine whether the rationale used for granting specific tax exemptions continues to be valid.

#### **ACB Position**

ACB strongly believes that the rationale for the tax-exempt status of complex credit unions is no longer valid and gives credit unions an unfair government-created competitive advantage that harms community banks that compete against them. The strength of our economy is built on free and fair competition. However, the free market is frustrated by those credit unions that compete head-to-head with taxpaying community banks, particularly those banks and savings associations that are mutual in form.

We believe that the original policy rationale for granting credit unions tax-exempt status is no longer valid, particularly with regard to large, complex credit unions that are indistinguishable from taxpaying banks and savings associations. Approximately 100 credit unions have assets of \$1 billion or more. At the same time, there are 8,378 banks and thrifts that have assets of less than \$1 billion. Small community banks are competing against billion-dollar credit unions that are full-service financial service providers that compete in all aspects of the financial services market. Because of the tax-subsidy, these credit unions are able to grow faster than the community banks with which they directly compete.

The credit union tax exemption means that credit unions have a 40 percent price advantage over taxpaying banks and savings associations. According to the Congressional Budget Office ("CBO"), between 2006 and 2015, the credit union tax exemption will cost the federal government a cumulative total of \$15.2 billion. The CBO said on this issue, "With their current tax advantage, credit unions can use their retained earnings to expand and thus displace the services of other thrift institutions—even though the latter may provide those services more efficiently." Furthermore, the median American family pays \$4,038 in federal income tax, while the entire \$662 billion credit union industry pays \$0. Credit unions should not be per-

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<sup>1</sup> America's Community Bankers is the member driven national trade association representing community banks that pursue progressive, entrepreneurial and service-oriented strategies to benefit their customers and communities. To learn more about ACB, visit [www.AmericasCommunityBankers.com](http://www.AmericasCommunityBankers.com).

mitted to be full-service financial services providers at the expense of tax-paying depository institutions and the American taxpayer.<sup>2</sup>

**Credit Unions Are Not The Only Cooperatively Owned Financial Institutions.**

Many cooperative banks, savings associations, and savings banks are cooperatively owned—just like credit unions. Mutual savings institutions do not have shareholders. Their profits are reinvested in the institution, returned to members in the form of higher rates on deposits or lower rates on loans, or given to the community.

Mutual institutions have existed in this country for more than 100 years, well before credit unions. Mutual banks and associations lost their tax exemption in 1952, when Congress determined that they had reached a sufficient degree of maturity, were very “bank-like,” and competed with other taxpaying financial service providers. At that time, mutual banks and associations could not even offer checking accounts, much less business loans. Yet, many of today’s credit unions look more like commercial banks than the mutuals of 53 years ago—offering share draft accounts (checking) and small business loans.

Contrary to credit union industry statements forecasting that taxation will lead to their untimely demise, mutual savings institutions have not collapsed under taxation. Despite the revocation of their tax exemption in 1952, mutual savings institutions continue to experience growth. Last year, the nearly 700 mutual savings institutions (from the smallest with \$20 million in assets to the largest with \$8 billion in assets) paid nearly \$900 million in corporate taxes. By contrast, the credit union industry, which has over 2.5 times as many assets as the mutual institutions, paid \$0. Just as Congress determined that the safety and soundness argument was not persuasive in the context of expanding the tax on mutual savings institutions decades ago, the assertion that today’s credit unions cannot withstand taxation should also be rejected. And, as Congress concluded in 1952 about mutual institutions, complex credit unions have matured to be “bank-like.”

**Credit Unions Are Not Fulfilling Their Mandate to Serve Persons of Modest Means.**

Congress chartered credit unions in 1934 to serve persons of modest means. In return, credit unions were exempted from taxation. However, an October 2003 General Accounting Office (“GAO”) report indicates “that credit unions served a slightly lower proportion of low- and moderate-income households than banks.” Similarly, a 1991 GAO report found “no evidence that today’s credit union members are for the most part of small means.”

Further, the credit union industry has vehemently opposed efforts to require credit unions to engage in special efforts to serve low-income customers or neighborhoods like banks and savings institutions. In fact, in a March 30, 2005 editorial the *Credit Union Times*, by Mike Welch, stated: “ACB apparently thinks credits unions’ first obligation is to serve communities in which they operate. Wrong. CUs’ number one obligation is to serve the changing financial needs of the members who own it. Of course, the community will also be served as a by-product.” The comment is self-serving and ignores the substantial federal safety net provided to credit unions through the National Credit Union Share Insurance Fund, in addition to the substantial tax subsidy under discussion today. This would be like a bank saying that serving shareholders is sufficient and serving the bank’s community is a mere afterthought. Credit unions’ not-for-profit status is no excuse for an exemption from community reinvestment responsibilities. Banks and savings institutions have Community Reinvestment Act responsibilities regardless of whether they make a profit.

**Sophisticated Credit Unions Hide Behind the Small Credit Union Image.**

Over the years, two distinct credit union industries have emerged. The first adheres to its statutory mission. The other hides behind the small credit union image to preserve its federal tax exemption. Even the National Credit Union Administration recognizes that the expansion that it has allowed to occur within the credit union industry now makes many credit unions indistinguishable from banks and savings associations. At a November 18, 2004 NCUA Board meeting, Board Member Deborah Matz observed that many legislators consider small credit unions to be the symbol of all credit unions. As a result, she reasoned, it is important to preserve small credit unions so that the entire credit union industry will not be taxed.

We see no value in subsidizing credit union conglomerates that offer diverse, high-end financial products and services to the general public. It is a common misperception that credit unions offer only basic banking services to local hospital

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<sup>2</sup>Special Report No. 119, *The Tax Foundation*.

employees, schoolteachers, and government workers. In reality, many credit unions have evolved into complex financial institutions that do not have meaningful membership restrictions.

For example, credit unions offer commercial loans, stocks, mutual funds, margin and option accounts, trust services, and other sophisticated products. Furthermore, many credit unions do not have a distinct field of membership and offer financial products and services to the general public. For instance:

- LA Financial Credit Union's field of membership includes all of Los Angeles County and its 10.1 million residents. Los Angeles County is home to more than 25% of California's population and more people than reside in 42 of this nation's 50 states.
- Suncoast Schools FCU in Tampa, FL caters to persons in 14 counties and has assets of over \$4 billion.
- Citizens Equity First CU in Peoria, IL serves over 14 counties and employees of over 550 select companies.
- Rhode Island-based Greenwood Credit Union advertises that membership "is open to all responsible people who want to be members."
- \$800 million Greylock Federal Credit Union in Massachusetts recently ran radio advertisements telling listeners if they "have a pulse," they are probably qualified to join Greylock Federal Credit Union.

#### **CUSOs Contribute to Credit Union Growth.**

Many credit unions have formed subsidiaries known as credit union service organizations ("CUSO's) that have contributed significantly to the dramatic growth of complex credit unions. CUSOs offer sophisticated products such as trust administration and investment services. CUSOs also provide non-traditional financial services such as real estate brokerage, pre-paid legal service plans, and travel agency services. In many cases, CUSOs are established to offer services not permitted by a credit union's charter. Income generated from bank-like products and non-traditional financial services offered through CUSOs should not be exempt from taxation.

#### **Federal Credit Union Income Should Be Transparent.**

We urge the Committee also to examine a more narrow issue—the credit union exemption from filing a Form 990, Return of Organization Exempt from Income Tax. Under current law, all organizations exempt from tax under section 501(a) are required to file a Form 990 with the Internal Revenue Service ("IRS"). This form discloses items of gross income, receipts, disbursements and other information required under the tax regulations. In Revenue Ruling 89-94, the IRS exempted federal credit unions from filing these annual information returns under the theory that a federal credit union is an "instrumentality of the United States." Financial disclosures were required prior to 1989.

Federal credit unions should not be given the same rights and privileges that are afforded to the federal government. Federal credit unions are not owned by the United States, nor do they possess any special governmental attributes or purpose that would justify an exemption from these disclosure rules. In fact, credit unions are profitable, retail financial service organizations whose activities should be appropriately disclosed in order to efficiently administer the tax laws. Therefore, we believe that if federal credit unions remain tax-exempt, they should be required to file a Form 990.

#### **Conclusion.**

We reemphasize that our concern remains with the sophisticated credit unions that have grown beyond their common bond and are as bank-like as mutual institutions that are taxed. From a competitive perspective, these credit unions have become tax-free community banks, creating situations in which a billion dollar, tax-free credit union sits opposite a \$50 million, non-stock, taxpaying mutual savings bank. We commend the Committee for undertaking an examination of the tax-exempt sector, and we look forward to working with the Committee on this important issue.

**Taxes and Authorities: A Comparison of Credit Unions and Other  
Depository Institution**

Issue	2005 Credit Unions	1952 Mutual Savings Associations	2005 Federal Savings Associations Including Mutuals	2005 National Banks
<b>Income tax liability 2003</b>	\$0 Would have paid \$1.32 billion if taxed at the same rate as banks and savings associations. <sup>3</sup>	Lost exemption in 1952.	\$7.5 billion. <sup>4</sup> Federal mutual savings associations paid over \$285 million in 2003. All federally insured mutuals paid \$1 billion. <sup>5</sup>	\$30 billion. <sup>6</sup>
<b>CRA obligations</b>	No CRA obligations.	Predated the CRA. Mutual savings associations worked to maintain and foster the economic strength of communities they served.	The CRA requires insured depository institutions to serve and help foster growth in each of the communities they serve, including low- to moderate-income areas within their communities.	Same as federal savings associations.
<b>Interest on consumer checking accounts</b>	Federal credit unions may pay interest on both consumer and business checking accounts.	No. Checking accounts were not permitted.	Federal savings associations may not pay interest on business checking accounts. Offering interest bearing NOW accounts to individuals and nonprofit organizations is permissible.	Same as federal savings associations.

**Taxes and Authorities: A Comparison of Credit Unions and Other Depository Institution—Continued**

Issue	2005 Credit Unions	1952 Mutual Savings Associations	2005 Federal Savings Associations Including Mutuals	2005 National Banks
<b>Field of membership</b>	Federal credit unions may serve only persons within their field of membership. Over the years, membership restrictions have been liberalized legislatively and by regulation. In 2003, the NCUA greatly expanded its field of membership rules. At a minimum, the new rules will allow 56 million additional people to qualify for credit union membership. Separately, some states have very liberal field of membership interpretations.	Mutual savings associations were authorized to lend within their communities, which generally was defined to comprise a 50-mile radius.	Not applicable.	Not applicable.
<b>Lending limits</b>	A federal credit union may lend to any one member up to 10% of its deposits.	Historically, mutual savings associations could lend up to a percentage of assets, generally between 15–20% of assets to a single borrower, depending upon loan type.	Lending limits track those for national banks. Federal savings associations also have an additional lending limit authority for residential development loans.	The single borrower limit generally is 15% of the bank's capital and surplus on an uncured basis. An additional 10% limit is available if collateralized with fully marketable securities.

**Taxes and Authorities: A Comparison of Credit Unions and Other Depository Institution—Continued**

Issue	2005 Credit Unions	1952 Mutual Savings Associations	2005 Federal Savings Associations Including Mutuals	2005 National Banks
<b>Business lending authority</b>	Federal credit unions may make business loans of up to 12.25% of total assets. However, a recent rule adopted by the NCUA allows credit unions to exclude purchases of participation loans and non-member loans from the statutory cap if approved by the NCUA.	No.	Federal savings associations may make commercial loans in an aggregate amount totaling 20% of total assets, 10% of which must be in small business loans.	National banks have general commercial lending authority.
<b>Unsecured consumer loans</b>	Yes (12-year term limit).	No.	Yes.	Yes.
<b>Insurance/securities powers</b>	Yes.	No.	Yes.	Yes.

<sup>3</sup>Banks and savings associations pay approximately 40% of their income in federal and state taxes each year. According to the NCUA's 2003 Annual Report, Federal credit unions had a net income of \$3.3 billion, 40% of which is \$1.32 billion. President Bush's FY 2005 budget estimates that credit unions' federal tax exemptions will cost a cumulative total of \$7.88 billion between 2005 and 2009.

<sup>4</sup>SNL Database.

<sup>5</sup>*Id.*

<sup>6</sup>*Id.*

**Statement of American Association of Debt Management Organizations**

**About The American Association of Debt Management Organizations**

The American Association of Debt Management Organizations (AADMO) is an industry trade association representing the nation's independent debt management organizations. Founded in 2001, AADMO's focus has been on industry education with an emphasis on regulatory and compliance issues affecting its members.

AADMO is the credit counseling and debt management industry's largest trade association and has as its mission to promote and ensure the continued operation and viability of credit counseling and debt management organizations. AADMO provides its members and the consumer public with information about the credit and debt counseling industry. AADMO members are debt management organizations, personal finance educators, credit and debt information publishers, credit counselors, consumer lawyers and many others.

AADMO is the only trade association to have held state law compliance workshops with the New York State Banking Department and the California Department of Corporations prior to enactment of their respective laws governing credit counseling. AADMO is also the only trade association for the industry to publish a formal summary of state laws that has been reviewed by state regulators.

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#### **Introduction**

Since their creation, non-profit credit counseling agencies (CCAs) have provided invaluable assistance and education to American consumers in financial distress. For over twenty-five years, the Internal Revenue Service and the courts have recognized the educational work of CCAs by confirming their tax-exempt status pursuant to Section 501(c)(3) of the Internal Revenue Code. The explosive growth of unsecured consumer debt over the last fifteen years has increased the need for credit counseling, and the need for debt management plans (DMPs) which CCAs administer. This explosive growth has caused change and growth within credit counseling; it has also created an opportunity for abuse by some CCAs. The now notorious conduct of a few CCAs has caused the IRS to consider revoking tax-exempt status to all CCAs, including those who continue to fulfill their educational purpose. Such blanket revocation would be a drastic overreaction. Blanket revocation would fail to recognize the continued educational work of credit counseling, and the important role credit counseling plays in assisting financially distressed and vulnerable American consumers and in protecting all Americans from an epidemic of bankruptcy filings such as has never been seen.

#### **Overview**

Over 1.6 million Americans filed for personal bankruptcy in 2003<sup>1</sup> and another 1.6 million through the period ending September 30, 2004. Generally, the number of consumers declaring bankruptcy has increased by nearly 10% each year over the last several years.<sup>2</sup> These are alarming statistics. Of even greater concern for policy-makers are the millions of Americans and American families on the verge of bankruptcy, or at a point of financial distress where there appears to be little hope and few options. The well-being of our national economy is threatened if these people choose bankruptcy in ever-growing numbers. Most consumers do not want to choose bankruptcy, but they need real help with their immediate financial distress and their long-term ability to understand and manage their finances. Whether they succeed or fail affects not only the debtors themselves but their children, their employers, their communities, and the national economy.

Increasingly, financially distressed families have turned to non-profit credit counselors for relief from financial distress. In 2001, nearly 2.5 million consumers sought the assistance of credit counseling agencies. In 2004, it is estimated that closer to seven million people sought assistance from a credit counseling organization.<sup>3</sup> These numbers dwarf the already high numbers of bankruptcy filings, and make two facts undeniably clear: a substantial number of American families are in serious financial distress, and a substantial number of those distressed Americans are primarily burdened by unsecured credit card debt. If these Americans are abandoned, we risk a bankruptcy catastrophe.

Historically, the non-profit status and eligibility for 501(c)(3) tax exemption of credit counseling agencies was confirmed by the IRS and the courts in a series of early decisions. At that time, the model for credit counseling agencies reflected the nature and magnitude of the problem: small, community-based agencies who could provide helpful advice and general education to the many and tangible assistance to the few. The helpful advice and general education included one-on-one sessions

<sup>1</sup> [http://www.uscourts.gov/Press\\_Releases/fy04bk.pdf](http://www.uscourts.gov/Press_Releases/fy04bk.pdf)

<sup>2</sup> [http://www.uscourts.gov/Press\\_Releases/603b.pdf](http://www.uscourts.gov/Press_Releases/603b.pdf)

<sup>3</sup> According to the Executive Office for U.S. Trustees, "The credit counseling industry handles approximately \$6 billion annually, more than the amount distributed from chapter 7 and chapter 13 bankruptcy cases combined."

or lectures to groups on subjects such as family budgeting, expense reduction, and balancing a checkbook. The tangible assistance took the form of the debt management plan, which is discussed in greater detail below. Debt management plans provided financial resources to the CCA in the form of creditor "fair share" (again, discussed in greater detail below), but because the problem was small, a CCA would look for and receive funding from other sources as well; a commonly cited example is the United Way.

The past thirty-five years have seen an explosive growth of consumer credit. Between 1970 and 2004, consumer debt in the United States increased from 131 billion to over 2.05 trillion dollars.<sup>4</sup> Consumer credit is an essential element of the consumer-driven American economy, and the availability of credit is essential to the stability and self-improvement of millions of Americans. At the same time, the aggressive marketing of credit cards to consumers has become an accepted part of the credit card issuer's business model. With unsecured consumer debt being higher than ever and more concentrated than ever on less-than-perfect American consumers, that part of the American financial spectrum populated by consumers in financial distress tied directly to unsecured debt has grown substantially.

Over this time, credit counseling agencies grew in size and in number to meet the increased demand for their services, and in particular the increased demand for the tangible assistance of a debt management plan. CCAs developed new practices to reflect the new economies for credit counseling, and their increased role as financial trustees dictated that many CCAs took on a more professional business approach, departing further from the "church basement" model of a charitable organization. As more consumers came to CCAs needing the tangible assistance of a debt management plan, the "fair share" payments by creditors slowly displaced charitable support from other groups such as the United Way. CCAs moved increasingly toward a telephone-based counseling relationship, which permitted consumers to obtain counseling from home and on the consumer's schedule, without the need to take the day off work and arrange day care for children. CCAs also generally found that to the extent these distressed American consumers were embarrassed or ashamed at having gotten into such trouble with consumer debt, telephone counseling was less humiliating to these consumers, encouraged greater candor, and created a more productive platform on which to base counseling and educational efforts. Clearly, the move by CCAs toward a telephone-based counseling relationship also permitted CCAs to reach larger geographic regions.

Creditors also made adjustments, reducing their "fair share" contributions to reflect the economies of scale now common at CCAs. Credit card companies also encouraged CCAs to develop modern business practices, including computerized client data management systems and electronic payment systems.

Unfortunately, the rapid growth and reshaping of credit counseling also permitted the emergence of some of the worst-behaving entities in credit counseling. These worst entities abandoned any commitment to education, and moved fully into the mode of indiscriminately marketing Debt Management Plans to the general public. At one end of the consumer spectrum, they invited American consumers who were otherwise able to pay their credit card debt, at the contractual rates of interest, to use the debt management plan as a means of paying less than the agreed-on rate. This indiscriminate marketing of the debt management plan offended credit card companies, who historically had made substantial concessions to consumers on debt management plans—slashing interest rates or eliminating interest altogether, waiving accrued fees and penalties, and re-aging a consumer's delinquent account as a current debt.

Credit card companies responded to the indiscriminate marketing of debt management plans by limiting their concessions and further reducing their "fair share" contributions. Both of these moves had the unintended effect of hurting legitimate CCAs more than they hurt the worst players (who had no resources devoted to genuine education and counseling, who would always operate more leanly than legitimate CCAs, and who were constantly increasing their "market share" through aggressive and dishonest marketing). Where the worst CCAs had never committed to education, many legitimate CCAs struggled to meet their educational commitments with reduced creditor support. More significantly, the reduction in creditor concessions came to mean that the debt management plan provided a less substantial benefit to those Americans who desperately needed it. This fact did not matter to the worst CCAs, who have shown a willingness to aggressively market Debt Management Plans by promising what they cannot deliver.

At the other end of the consumer spectrum, the worst CCAs marketed their Debt Management Plans to consumers who were so deeply in financial distress that bank-

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<sup>4</sup>[http://www.federalreserve.gov/releases/g19/hist/cc\\_hist\\_mh.html](http://www.federalreserve.gov/releases/g19/hist/cc_hist_mh.html)

ruptcy was the only reasonable solution. These worst CCAs did not care that these consumers would be squeezed for their last few dollars before seeking bankruptcy protection; they did not care that the consistent failure of these consumers would eviscerate the CCA's retention rates for its Debt Management Plan. All the worst CCAs cared about was signing consumers up and getting exorbitant startup and monthly fees for as long as they could, regardless of the long-term effects on the consumer, the creditors, or the economy.

Not all the worst CCAs were "home-grown" products; a number of them were escapees from other legitimate attempts at consumer-friendly regulation. The Credit Repair Organizations Act and the National Do Not Call Registry are two examples of laws which prohibit certain predatory and/or deceptive practices, but which do not apply to non-profit organizations. It is widely claimed that a number of predatory and dishonest business entities took on the mantle of non-profit status in order to escape the application of these laws.

The primary source of regulatory oversight of credit counseling has been the various states. Some states do not regulate credit counseling at all.<sup>5</sup> Of the states that do, their laws often lack clarity and uniformity. Banks issue consumer credit on an interstate basis, and consumers freely move from state to state taking their unsecured debt with them. The growing need for credit counseling is not a local problem, and the growth of credit counseling has lessened the local quality of many credit counseling agencies. Nevertheless, these agencies still must contend with the divergent and/or redundant requirements of the various states' laws (including various requirements as to licensing, bonding, insurance, disclosure, and other compliance issues). At the same time, enforcement of these various states' laws is insufficient, ineffective, or altogether absent. What this means is that CCAs that intend to comply with the applicable laws have been burdened with exhaustive legal compliance costs,<sup>6</sup> while the worst CCAs were able to ignore legal compliance without fear of effective enforcement.

In a climate of explosive growth, rapid development, and ineffective regulatory oversight, the conditions were ripe for the worst CCAs to take a controlling position in the world of credit counseling. For every dollar that a legitimate CCA spent on genuine education and counseling, the worst CCAs had a free dollar they could spend on marketing. Nevertheless, other CCAs grew in size and geographic range, moved toward a telephone-based counseling relationship, and adopted a more professional business approach, yet remained true to their fundamental educational and charitable purposes.

Regrettably, it was the worst CCAs who of course finally caught the attention of the public, the IRS, and other regulators. These worst CCAs had a number of features that were shared by other CCAs which had grown and developed over time: they were large, telephone-based, they followed a professional business model, and they aggressively marketed their services. These are features that would not have been found the last time the regulators looked meaningfully at credit counseling agencies. Yet these features were not the ones that cried out for regulatory action against these worst CCAs: it was the fact that the worst CCAs were dishonest, predatory, and abusive to consumers. Their commitment to education was non-existent. Their marketing was widespread and dishonest. These worst CCAs promised what they could never deliver, then failed to deliver even what they could. They charged exorbitant upfront fees, which reflected a business model that focused on signing new consumers up for services, and did not focus as much (if at all) on actually providing those services. These worst CCAs not only failed to be legitimate 501(c)(3) educational or charitable organizations; they failed to even be legitimate businesses.

The current challenge to the IRS is to immediately address the status of these worst CCAs without letting the conduct of these few entities cloud IRS' understanding of the explosive growth of consumer debt and the corresponding growth and development of non-profit credit counseling.

As the IRS steps back in to provide regulatory oversight and guidance to these agencies, it must recognize that the core values and practices which originally justified 501(c)(3) exempt status for credit counseling still exist in modern CCAs. The fact that specific practices have changed or developed reflects changes and developments in our world, not an abandonment of those core values and practices.

Credit counseling agencies still provide low cost or free financial education and counseling to the public and still provide tangible assistance in the form of debt management plans to those American consumers for whom such plans are appro-

<sup>5</sup> For example, see Alaska and Colorado

<sup>6</sup> The New York State Banking Department announced in December 2004 to allocate all of the Department's operating expenses to its regulated entities—such as "budget planners" (i.e. non-profit credit counseling).

priate. Credit counseling agencies still provide a positive option to collection actions, lawsuits, and bankruptcy. The ability of legitimate credit counseling agencies of any size to carry on their educational and charitable purposes still depends on their continued status as 501(c)(3) organizations. Without this tax status, credit counseling agencies will no longer be able to provide financially distressed consumers with the affordable and reliable services they desperately need. A decision by the IRS to revoke 501(c)(3) status to all CCAs based on the abusive practices of the worst CCAs would be factually and historically baseless, and would have disastrous unintended consequences on American consumers and the American economy.

#### **Credit Counseling Agencies' Commitment to Education**

From their inception in the 1950s, credit counseling organizations have engaged in public education and have provided consumers with access to financial literacy programs. This commitment to education has always been, and should always be, an essential component to the maintenance of the 501(c)(3) tax-exempt status granted to credit counseling organizations. Credit counseling agencies seeking to obtain and retain 501(c)(3) status should devote a preponderance of available resources to the development, procurement and dissemination of client and community oriented financial literacy programs.

Each year, millions of financially distressed American households use the credit counseling and debt management services of CCAs, inclusive of their educational components. With proper oversight and guidance from the legislative and regulatory community, non-profit credit counseling organizations will continue to rehabilitate and educate financially distressed consumers.

#### **Educational Aspects of the Debt Management Plan**

It is difficult to teach long-term financial accountability to people in short-term, immediate financial distress. Distressed consumers typically seek immediate relief from their financial crisis, but what they really need is long-term behavioral change. Behavioral change is undeniably an educational goal. A debt management plan, when used appropriately, can serve both these short-term and long-term goals and is the best available educational tool for credit counseling.

In the short term, the debt management plan provides a "safe harbor" for the distressed consumer, who is otherwise consumed by fears over unpayable bills, creditor calls, collection agency calls, legal actions, late fees, over the limit fees, "default" credit card interest rates and, more generally, the fear of being financially out of control, in free fall, and on the verge of bankruptcy. This "safe harbor" permits the distressed consumer to look past "quick fixes": avoidance behavior (i.e. avoiding calls from creditors or collection agents), problem-shifting behavior (i.e. shifting old credit card debt onto new credit cards, or shifting unsecured credit card debt into secured home equity loan debt), or ultimately hopeless behavior (bankruptcy). This "safe harbor" gives the consumer the short-term practical stability necessary to begin to take long-term responsibility for the consumer's financial situation, with hope for the future. This stability extends to all aspects of the consumer's life, including the consumer's family and employment.<sup>7</sup>

In the long term, the debt management plan can provide education that is both informational and practical. The informational aspect begins with the first counseling session. A distressed consumer often does not have a working budget of personal income and expenses. A first counseling session should accomplish this goal (and must accomplish this goal if the CCA is going to claim that it only recommends a debt management plan to appropriate consumers). The informational aspect should continue throughout the debt management plan and beyond, and should touch on a wide range of issues in personal finance. Whether it does continue is a measure of the commitment to education of the individual CCA. The practical aspect is the consumer's exercise of living within a budget and incrementally paying down credit card debt with a long-term goal of paying the debt off. The CCA works with the consumer to understand how the debt management plan will work; to encourage the consumer to stay on the plan; to assist the consumer when new challenges make it difficult to stay on the plan; and to share the consumer's sense of accomplishment as steady, incremental payments begin to produce substantial reductions in the consumer's debt, a goal which the consumer once felt incapable of reaching.

By the end of a successful debt management plan, the consumer has learned from the practical experience of living within a budget. The consumer has accomplished the goal of reducing his or her debt. The consumer has gained factual information,

<sup>7</sup> <http://www.csus.edu/indiv/a/andersenj/Research/FinancialProblems.pdf>

Substantial research has concluded that financial problems are stressors that affect marital quality and satisfaction.

ongoing access to educational resources, and a better understanding about budgeting and debt. The informational and practical aspects of education through the debt management plan combine to encourage the consumer's long-term behavioral change and to ensure that these consumers, and their children, will not only get out of financial distress, but will not get into financial distress again.

#### **Identifying the Beneficiaries of Debt Management Plans**

Public benefit is simply the sum total of private benefits, when the benefits are numerous and broad in scope. For example, a halfway house for recovering drug addicts can narrowly be said to only provide private benefits to recovering drug addicts, a particularly narrow target audience, yet it takes very little consideration to realize that the families of these individuals also benefit, as does the community at large. Often the best way of identifying who benefits from a solution is to identify who is affected by the problem.

The American economy is a consumer-driven economy. The easy availability of credit to American consumers has become a necessary component of our economy, and credit card issuers have been largely unregulated in their marketing of credit to consumers. It is a predictable side effect of the easy availability and constant marketing of credit that some American consumers will end up in financial crisis because they overuse credit. As consumer credit card debt has exploded, the number of consumers in financial distress has predictably followed suit. When these distressed consumers cannot pay their credit card debts, it is not only the creditors that are affected. The distressed consumers are affected, by the wide range of negative financial events including higher fees, collection actions, legal actions, and bankruptcy. The consumers' families are affected, as it is known that financial distress is one of the leading causes for the breakup of families. The consumers' employers are affected, as employers recognize that financial difficulties are a leading cause of decreased employee productivity, increased absenteeism, and increased turnover. Responsible consumers at large are affected, as creditors increase the cost of consumer credit to account for the cost of bankruptcies and write-offs. Ultimately the economy as a whole is affected, as the increased cost of credit discourages consumer activity.

Credit counseling agencies are asked by consumers to assist and intervene in a pre-existing contractual relationship between the consumers and their creditors, where the creditors already have a contractual claim for repayment of a large and growing amount of debt. When administering debt management programs, credit counseling agencies fulfill a four-part role; acting as the agent, advocate, counselor and educator of financially distressed households. The immediate tangible benefits that a credit counseling agency can provide to its client, the consumer, can be measured by the concessions that the CCA obtains from the consumer's creditors, i.e. the agreement by the creditors to accept *less* from the consumer than that to which the creditors are otherwise entitled pursuant to their contracts with the consumer.

To treat the creditor's acceptance of *less* than the contractual amount as a *benefit* to the creditor is arbitrary. A CCA which asked a consumer's creditors to accept nothing, i.e. to simply write off a consumer's debt entirely, would be rejected by the creditors, and would be unable to provide any real benefit to the real beneficiary—the consumer.

Often the notion that a debt management plan confers a substantial private benefit on creditors is coupled with the accusation that CCAs are merely "collection agents" for the credit card industry. Anyone making this accusation has not been through a collection process, and does not understand it. In collection, the creditor writes off a debt, and writes off the consumer. The collection agent buys the debt, for pennies on the dollar. The collection agent does not work with the consumer to create a budget or to address the full range of the consumer's debts. The collection agent has no concern about the impact on the consumer of the collection process, and devotes no time to addressing the consumer's underlying financial management issues. In collection, various collection agents compete with each other to get a greater share of blood from a stone. The stone is the consumer. Collection is a degrading process.

While creditors do make a business decision to participate in debt management plans, the CCAs administering those plans are focused on the current and future financial well-being of the consumer.

The long-term educational work of credit counseling agencies, directed at clients on debt management plans, at non-DMP clients, at high school and college students who have not yet taken on credit card debt, and at the public at large, is substantially funded by creditor payments. These are often called "fair share" payments. As noted, the creditors who have aggressively marketed consumer credit share some re-

sponsibility for the explosive increase in the number of consumers in financial distress.

It is perfectly appropriate for these credit card issuers, as opposed to the public at large or charities such as the United Way, to take financial responsibility for funding the efforts of credit counseling agencies. The voluntary agreement by credit card issuers to take financial responsibility for a side effect of the product they market is certainly preferable to the approach of others, for example the tobacco industry, who denied the existence of a problem caused by their product, and let the public pick up the tab until they were forced to take responsibility.

The explosive growth of consumer credit caused the attendant growth in the numbers of consumers in financial distress and the number of consumers seeking the assistance of credit counseling. Undeniably, because the problem is large the numbers involved are also large. Large amounts of money are paid to creditors through debt management plans, and large amounts of money are paid by creditors to CCAs through "fair share" payments. Large numbers, however, do not equate with a fundamental change in the educational mission of credit counseling agencies, any more than the explosive growth in the number of colleges, and the larger amounts of money involved in college education, has changed their fundamental purpose.

When CCAs were first approved for 501(c)(3) status, CCAs were heavily controlled by creditors, creditor representatives sat on CCA boards of directors, and creditor "fair share" payments were typically set at 15 per cent of revenues paid through debt management plans. Today, credit counseling agencies are more independent of creditors, creditor representatives do not sit on CCA boards, and creditors pay "fair share" that is not only at an historic low percentage, but also based on a wider range of factors more directly focused on the CCA's commitment to education. While the numbers have gotten larger, the commitment to credit counseling's educational purpose has remained the same and, at least at the better CCAs, only gotten better.

Consumer credit, just like banking, is a public concern made up of millions of private concerns. Legislators and regulators sometimes prefer to treat banking issues and financial issues as private issues until such time as the private issues fester into public crises, like the Great Depression or the savings and loan scandal. Consumer debt today threatens to become another crisis. The proponents of bankruptcy reform recognize this fact.

Credit counseling is not the problem. It is part of the solution, and benefits all Americans. It is worthy of continued 501(c)(3) status. Increased regulatory oversight is of course appropriate; revocation of 501(c)(3) status is not.

#### **Volunteer Staffing and the Credit Counseling Process**

At one time, a consumer's issues with unsecured debt typically involved no more than three credit cards. Today, it is not surprising for a consumer to come to a CCA with twenty or more credit cards; the average is approximately ten. The range of issues relating to these credit cards has increased and become more complex, and the range of other consumer issues has changed in the same way. As a single example, thirty years ago the relationship between credit and divorce was not the issue that it is today. Moreover, the increased extension of unsecured credit card debt means that a consumer is often coming to a CCA with tens of thousands of dollars in unsecured debt. There is simply more at stake.

Because the size of and complexity of the problems have grown, a reliance by CCAs on volunteers would be not only impractical but irresponsible. Errant financial analysis or advice given by a well-meaning volunteer could have disastrous consequences for a consumer already on the brink of bankruptcy. Many CCAs rigorously train and educate their counselors. Indeed, many states require counselors to be certified as having demonstrated certain financial literacy skills.<sup>8</sup>

Moreover, many CCAs following best practices attempt to establish ongoing, long-term relationships between clients and individual counselors, because experience supports the belief that the client benefits more with a counselor who knows the client's story and progress. Reliance on part-time volunteers would diminish these benefits. Finally, effective credit counseling is based on a consumer providing detailed financial information to the counselor. Given current real concerns over privacy and identity theft, it is unreasonable to entrust such information to volunteers.

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<sup>8</sup>For example, see California and Virginia

**The Potential Impact of IRS Revocation of Credit Counseling's 501(c)(3) Tax-Exempt Status on Credit Counseling Agencies and American Consumers**

Financially distressed American consumers are in great need of short-term assistance and long-term education. They are also extremely vulnerable to the predatory practices of unethical organizations. As recent history makes clear, credit counseling is not immune from invasion by unethical organizations looking to make a quick buck at the expense of those who desperately need help. Greater regulatory oversight and effective enforcement is clearly needed. However, IRS revocation of credit counseling's 501(c)(3) tax-exempt status will not accomplish these goals. Instead, revocation will hurt legitimate credit counseling agencies, hurt vulnerable consumers, and hurt the American economy.

Revocation will hurt legitimate credit counseling agencies by giving an immediate unfair advantage to the CCAs that have abused their non-profit status and disregarded their educational mission. The organizational and operative decisions of these agencies have been geared to maximizing profit. These are the agencies that have caught the attention of the IRS, the FTC, the Congress, and other regulators. Yet in the for-profit world of credit counseling that IRS revocation would mandate, the practices of these very agencies would necessarily become the industry standard for any agencies that remain.

Moreover, many of these very agencies are already largely structured to operate as for-profit businesses, while legitimate CCAs may find it difficult or impossible to complete a successful transition of their operations and assets from a non-profit to a for-profit structure while meeting all state laws applicable to the winding up of a non-profit organization.

There has been no indication that IRS has made provision for such transitions, or for working with all the state regulatory entities to coordinate such transitions. Most legitimate CCAs will simply not survive the cost and service interruption occasioned by such a transition.

In a for-profit world, a CCA which commits time and resources to public education cannot compete with a CCA which does not. Public education will have to be abandoned. In a for-profit world, sign up fees will not be limited by regulation or by concern over the consumer's welfare, but instead will only be limited by "what the market will bear". In a market where the consumer base is financially distressed, "what the market will bear" typically equates with predatory practices; consider, for example, "what the market will bear" in payday lending rates.

Revocation will hurt vulnerable consumers. There is currently no "consumer-friendly" alternative to non-profit credit counseling agencies. Consumers in financial distress will be left to collection agents, payday lenders, predatory home equity lenders, litigation, and bankruptcy. Consumers currently enrolled in debt management plans with legitimate CCAs may find themselves without a plan if revocation ends or seriously disrupts the CCA's operations.

Further, revocation of the tax exempt non-profit status of credit counseling organizations would create an immediate dilemma for the hundreds of thousands of American families who are currently enrolled in debt management programs and who reside in States that require non-profit and/or 501(c)(3) tax exempt status as a condition of the licensing or legal<sup>9</sup> operation of a credit counseling agency.

Revocation will hurt the American economy. Bankruptcy filings will certainly double. The most recent versions of Congressional bankruptcy reform legislation contemplate that non-profit credit counselors will play a role in stemming the tide of bankruptcy filings. IRS revocation would be contrary to the expressed intent of Congress and will mean that non-profit credit counselors are not available to fill this important role. The social costs associated with financial distress will increase: broken families and loss of employment productivity are simply two examples of these social costs.

Without non-profit credit counseling, more Americans will turn to the high-risk option of taking out home equity loans to pay off high credit card debt. This practice is already a significant problem, and is only going to grow because a large number of these loans are adjustable-rate loans destined to increase as interest rates climb. Thus, in addition to bankruptcies, revocation of credit counseling's 501(c)(3) status will increase the number of home foreclosures. Home ownership is recognized as a powerful stabilizing force in the American consumer economy, and any measure that increases home foreclosures is perilous.

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<sup>9</sup> For example, see Kentucky, Maine, Oregon and Rhode Island

Finally, the costs of revocation detailed above will impact on all aspects of the American economy. As financially distressed consumers file for bankruptcy in increased numbers, the cost of credit will increase for all consumers, including those who use credit responsibly. As those costs increase, the consumer spending decisions of all Americans will be impacted. While non-profit consumer counseling assists the percentage of Americans who suffer ill consequences associated with a ready stream of available consumer credit, all Americans will suffer if increased costs turn that stream into a trickle.

#### **Recommendations**

1. AADMO recommends that the Internal Revenue Service complete its comprehensive review of the credit counseling industry, properly sanction those who have abused the 501(c)(3) status conferred upon them by the IRS and provide the industry with immediate and ongoing guidance relative to the application of the tax code to the credit counseling process.

2. AADMO encourages the IRS to treat credit counseling organizations fairly when making recommendations to Congress vis-a-vis the future look and feel of the credit counseling process. Legitimately operating credit counseling organizations are well aware that there are bad players in their midst. Unfortunately, these players have operated freely for far too long; long enough to seriously eclipse long established, well-intentioned and legitimate organizations through their negative actions. The tax laws and the rules and regulations necessary to properly supervise and control the non-profit segment of our economy, including non-profit credit counseling organizations, are already in place. All that is needed now is regular review, consistent guidance and fair enforcement of existing federal and state codes by the regulatory sector.

3. Enlightened legislative interaction is also needed. AADMO recommends and supports the passage of a uniform, pre-emptive federal statute to replace the myriad of conflicting state laws now in use to regulate credit counseling and debt management service providers. We respectfully suggest that model credit counseling and debt management agencies should be involved in the legislative drafting process and that credit counselors should be regulated through statutes developed solely for the credit counseling and debt management process.

4. Credit counseling and debt management are unique services as compared to debt collection and debt settlement. A single, pre-emptive federal credit counseling statute will create an even playing field for service providers and guarantee consumers equal access to quality products and services regardless of their state of residence.

5. AADMO encourages the legislative and regulatory community to allow time for recent increases in state and federal oversight activities, media scrutiny and IRS actions to have their impact on the credit counseling process. We recommend that those charged with oversight responsibility study the impact of recent actions taken by regulators against CCAs, determined to be abusing their 501(c)(3) status, on the consumers enrolled in the DMP programs of said providers. A cooling off period is needed to assess impacts of actions already taken and to guarantee millions of American households that they will not be thrust into deeper financial chaos as a result of hastily enacted and ill-advised regulatory schemes.

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#### **Statement of David Hayes, Independent Community Bankers of America**

The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. Founded in 1930, ICBA is celebrating its 75th anniversary year. For more information, visit ICBA's website at [www.icba.org](http://www.icba.org).

On behalf of the 5,000 members of the Independent Community Bankers of America, I am pleased to submit written testimony for the Ways and Means Committee hearing on the *Overview of the Tax-Exempt Sector*. The ICBA commends you and the Committee members for undertaking this important hearing and for examining the current state of the tax-exempt sector.

#### **Credit Union Tax Exemption Warrants Committee Examination**

As part of the examination into the current status of tax-exempts, the ICBA requests the Ways and Means Committee closely examine the tax system inequities posed by the rapidly growing \$655 billion tax-exempt credit union industry. The origins of the credit union tax exemption reach back to the Great Depression, a time when basic financial services were limited. Over time, the tax-exempt credit

union industry has dramatically changed to support the same customer base as tax-paying financial institutions.

Today there are more than one hundred credit unions with \$1 billion or more in assets providing sophisticated banking products and services to wealthy and middle-income members while benefiting from tax-exempt status. Another noteworthy aspect of today's tax-exempt credit union industry is that corporate credit unions have been set up to provide the same wholesale services as taxpaying correspondent banks. For example, U.S. Central Credit Union in Lenexa, Kansas holds more than \$35 billion in assets and is owned by 72 member credit unions.

#### **Research Indicates Tax Exempt Credit Unions Not Serving Special Purpose**

A growing body of research from the Congressional Budget Office, the General Accountability Office and the Tax Foundation indicate that there is little or no evidence that today's tax-exempt credit unions are better serving the moderate and low-income individuals their tax-exempt status was intended to foster. Instead, tax-exempt credit unions continue to push the envelope on expanding their commercial lending business.

The credit unions recently sought and won regulatory approval to increase their business lending through the Small Business Administration (SBA). Notably, these SBA loans are not subject to the legal 12.25 percent of assets business-lending cap Congress specifically placed on the credit unions. Credit unions continue aggressive measures to skirt the legal 12.25 percent business-lending cap, notably the advancement of the "Credit Union Regulatory Improvement Act" (H.R. 3579) in the 108th Congress. The bill would raise the current statutory limit on business lending by tax-exempt credit unions to 20 percent from 12.25 percent, double the size of loans that would be excluded from the cap from \$50,000 to \$100,000 and exclude certain other business loans from any limit.

This Ways and Means Committee hearing on tax-exempts provides a solid opportunity to examine such credit union activities and the ongoing justification for the special tax treatment the credit union industry enjoys.

#### **Tax-Exempt Credit Unions Compete Directly With Taxpaying Community Banks**

Today, tax-exempt credit unions compete aggressively against taxpaying community banks and continue to expand their financial service power, size, and scope. The top federal income tax rate applied to C corporation community bank income and S corporation community bank income allocated to shareholders is 35%. Additionally, income generated by C corporation community banks is subject to double taxation when distributed in the form of dividends or capital gains, creating a combined tax burden exceeding 57%.

In sharp contrast, tax-exempt credit unions pay no federal income tax yet compete directly with taxpaying community banks. The dramatic tax burden differential between taxpaying commercial banks and tax-exempt credit unions places community banks at a severe competitive disadvantage and highlights a specific example of where the tax code is extremely unfair. A fair and unbiased tax system would apply the same tax treatment to similar industries and economic actions and transactions.

#### **Tax Foundation Credit Union Study Shows \$31 Billion Tax Loss**

The ICBA would like to call to the Committee's attention the most recent independent research conducted on the credit union industry. Notably, a new Tax Foundation study concluded that credit unions have used their tax-subsidized status to greatly expand in size and scope. The nonpartisan Tax Foundation estimated that the rapidly growing credit union tax subsidy will cost \$31 billion in lost Federal revenue to the U.S. Treasury over the next decade.<sup>1</sup> This study noted how large, multi-group and geographic-based credit unions have far exceeded their original tax-exempt statutory mission and unfairly use their tax-free status to compete with taxpaying community banks.

Other important finding of the independent Tax Foundation's research into the tax-exempt credit union industry include:

#### **Who benefits from the credit unions' tax exemption?**

Corroborated by other studies of credit unions and banks, the direct and indirect evidence gathered for this study shows that the equity holders of credit unions receive the tax saving as unusual returns. These unusual returns do not show up as relatively high dividends, however. Instead, they occur as unusually large retained earnings accumulated as net worth in their credit unions. The shareholders' extra

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<sup>1</sup> "Competitive Advantage: A Study of the Federal Tax Exemption for Credit Unions," by Professor John A. Tatom, Ph.D. Tax Foundation, 2005. [www.taxfoundation.org](http://www.taxfoundation.org)

income reinvested in the credit union provides new capital that allows the credit union to grow faster than other institutions.

Of the 50 basis points in subsidy that the tax exemption provides, at least 33 basis points accrue to owners in the form of larger equity and larger assets. Approximately 6 basis points may accrue to credit union borrowers through lower interest rates, and not more than 11 basis points are absorbed by higher labor costs. There is little or no effect on deposit rates or other costs.

Today credit unions continue to grow faster than banks, have little practical limitations on membership, and make business loans that increasingly have no limits on who can borrow, how much or for what purpose.

- **Little justification for credit union tax exemption.**

Today the principal justification for the tax exemption would seem to be that it already exists and, therefore, removing it could adversely impact thousands of institutions and their customers. Under current law, as it is being enforced, there is no good policy argument based on equity or efficiency for maintaining the tax exemption. And these institutions and customers are perceived, incorrectly, to be relatively lower income or associated with the economic security and progress of lower income people.

- **Tax exemption no longer linked to special mission or meaningful restrictions.**

Credit unions are among the most rapidly growing financial firms in the country.

Congress eliminated the tax exemptions for savings and loans and mutual savings banks decades ago on the grounds that they were similar to profit-seeking corporations. Since then, large credit unions have come to resemble large thrifts and banks. The looser field of membership requirements also has allowed credit unions, especially large ones, to expand their growth opportunities, reinforcing the competitive advantage obtained from their tax advantages.

- **Tax reform and credit unions.**

Fiscal neutrality would require removing the special tax treatment of credit unions.

Taxing some financial institutions that offer the same consumer deposits and loans while not taxing others, in particular credit unions, distorts the allocation of resources. It promotes the employment of deposit and credit resources in the tax-free credit union sector at the expense of their competitors, banks, thrift institutions and finance companies.

Tax reform of credit union income taxation is a “no-brainer” when viewed in a broad tax neutrality context. It is also compelling when either the size of the revenue loss or the ineffectiveness of the tax break for achieving any social goal is considered.

This study could not find any net benefit to members that could not or would not be available in the absence of tax-subsidized credit unions. Most notably, the credit union subsidy, by its very nature, has largely failed to deliver financial services to low-income people.

Credit unions are not compelled by regulators to meet a higher standard in the service of low- and moderate-income customers, and there is no evidence that they do so voluntarily. The \$650 billion credit union industry may have outgrown in size and scope its original, tax-exempt mission.

### **Conclusion**

These points from the Tax Foundation’s study make a clear case that the Ways and Means Committee re-assess the tax-exempt status of the rapidly expanding credit union industry as part of the review of tax exempts. Community banks play a vital role in the U.S. economy as a critical source of lending for individuals, small businesses and farms across America. The ICBA respectfully requests the Ways and Means Committee further examine policies that would help make the tax code more equitable as it is applied to tax-exempt credit unions and taxpaying community banks. As the Ways and Means Committee examines the tax-exempts, we urge a fresh policy evaluation of the estimated \$31 billion in lost tax revenue from the tax-exempt credit union industry.

We sincerely appreciate the opportunity to offer our comments for this important hearing and to highlight areas where the tax code is unfair. The ICBA looks forward to working with the Committee and we are encouraged by your ongoing efforts to fairly assess the standing of tax-exempt entities such as the credit union industry.

### Submission of the American Bankers Association

The American Bankers Association (ABA) appreciates the opportunity to comment to the Ways and Means Committee on the tax-exempt sector. Our comments focus on the evolution of traditional credit unions serving "people of small means" to full service, financially sophisticated institutions that compete head-to-head with tax-paying banks.

ABA on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks—makes ABA the largest banking trade association in the country.

This statement addresses three central points:

- I.** A new breed of credit unions has emerged that offers products and services virtually indistinguishable from tax-paying banks. These "morphed" credit unions are a far cry from traditional credit unions, whose tax subsidy was intended to benefit individuals with limited resources who might not otherwise have access to financial services.
- II.** Being a non-profit cooperative does not, alone, justify a tax exemption. Fairness dictates equal tax and regulatory treatment for similarly situated institutions.
- III.** Congress has repeatedly recognized that there are limits to tax exemptions and has acted to eliminate them for entities that stray from their intended public policy goals.

#### **I. A New Breed Credit Unions Has Emerged**

As Chairman Thomas recently stated, "Tax-exemption is an important benefit and the Congress has a responsibility to oversee and assure the American taxpayer that the tax-exempt sector is living up to its legal responsibilities." ABA supports this view and would like to recommend that Congress examine certain credit unions' tax-advantaged status. While many credit unions remain true to their original mission, today growing a number of credit unions have abandoned their roots and inappropriately taken advantage of their tax-exempt status to gain ever-increasing market share.

Traditionally, credit unions were based on a simple concept: permit a closely-knit group of people to pool their resources and to provide small loans for one another. The focus was on individuals with limited resources who might not otherwise have access to financial services. Membership was limited to people with close bonds because familiarity was critical to the "character" loans made by credit unions. The commonality of interest among members—their common bond—was the essence of credit unions. It gave them a special and unique place in our financial system.

As the industry matured, however, a new breed of institution evolved that bears little resemblance to a traditional credit union. With the freedom to seek new markets almost without restriction and to offer a full range of banking and financial products, many aggressive credit unions have leveraged their tax advantage to grow rapidly. ***Today, there are 99 credit unions with assets greater than \$1 billion.*** In nearly half the states in this country, a credit union would rank among the top ten banks in terms of size. As Gene Portias, president of the Credit Union Association of Oregon, stated: "In a lot of places, credit unions are the major financial institution."<sup>1</sup>

These complex, aggressive institutions increasingly dominate the industry, yet still try to hide behind the veil of a "traditional" credit union. In spite of their metamorphosis into highly competitive financial institutions virtually indistinguishable from banks, these morphed credit unions enjoy the tax-preferred status conferred on the industry when it was comprised of small self-help organizations.

Continuing the special tax treatment for institutions that look and act like tax-paying banks has public policy consequences. The size of the "tax expenditure" as the Office of Management and Budget calls it, is already big—more than a billion dollars per year. And basic economics tells us that it will get bigger as tax-favored

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<sup>1</sup>"CUS, Banks Put Up Dueling Bills in Oregon," American Banker, March 25, 2003.

firms take business away from taxpaying firms. Simply put, as these morphed credit unions get larger, so does the tax expenditure.<sup>2</sup>

Not only is the credit union tax expenditure growing, but it is being misdirected to subsidizing financial services for individuals who clearly don't need it. The credit unions' own surveys suggest that their image of serving moderate—and lower-income people is no longer valid. The typical credit union member has higher than average income, more years of education, and is more likely to own a home than non-credit union members. And now with an aggressive push by credit unions into business lending, businesses can get taxpayer-supported financial services.

#### **New Breed of Credit Unions Serving Wealthy, Not "People of Small Means"**

The rapid growth of the credit union industry has been accompanied by significant changes in membership demographics. The focus on "people of small means" was clearly enunciated in the preamble to the Federal Credit Union Act. This vision has gradually diminished as the metamorphosis to big, wealthy and sophisticated credit unions has progressed.

Think Federal Credit Union exemplifies how that focus has changed in its 2003 Annual Report when it stated: "Yesterday our challenge was to provide financial services to members who could not get services elsewhere. Today our challenge is to provide financial services to members who can get services anywhere."

The profile of the average credit union member today—higher than average income, better educated, and more likely to be in a professional occupation than his or her non-member counterpart—is not one typically associated with people needing taxpayer-supported financial services. According to a recent demographic survey conducted by the Credit Union National Association (CUNA), the average household income of credit union members is 20 percent higher than nonmembers—\$55,120 versus \$45,790.<sup>3</sup>

A recent study by the GAO came to the same conclusion. Their analysis showed that 64 percent of households that primarily use a credit union are middle and upper income, as compared to 58 percent of households that primarily use banks. The fact is that bank customers are more likely to be from low- and moderate-income households than are credit union customers—yet credit unions continue to enjoy the tax expenditure purportedly because they serve people of modest means. As Bruce Shawkey of Credit Union Management magazine stated, "—[C]redit unions' 'bread and butter' members are middle-aged white males with mid-to-upper-incomes."

Even some credit union executives seem disturbed by the fact that credit unions have strayed so far from their original mandate to serve people of small means. Citing CUNA's numbers on the average household income of members served by credit unions, Armando Cavazos, president of Credit Union One in Ferndale, Michigan, said, "We should almost feel guilty about serving people of affluence."<sup>4</sup>

Jim Blaine, CEO of State Employees CU in Raleigh, NC, conceded "Maybe we've gotten so sophisticated we don't want to get our hands dirty with poor folks any more. That's what we were created to do, and sometimes I think we're forgetting that."<sup>5</sup>

And, Ed Gallagly, president/CEO of Central Florida Credit Union, says, "There's no question that subconsciously—and even consciously—some credit unions are trying to run-off unprofitable members. I hate to use that term run-off but that's what's happening."<sup>6</sup>

Communities are not being served, either. Credit unions, unlike banks, are not required to meet the obligations set forth in the Community Reinvestment Act (CRA). In a study of Virginia credit unions, professors Murphy and O'Toole found that "banks and savings institutions in Virginia are putting a greater percentage (88 percent) of their deposits back into the community in the form of loans than are credit unions (76.3 percent). In other words, tax treatment of credit unions has not

<sup>2</sup>Tax expenditures are defined in the law as "revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability."

<sup>3</sup>CUNA National Member Survey, 2002.

<sup>4</sup>"How to Head Off Coming Under CRA Dominates Debate at CUNA Convention," American Banker, October 14, 1994, p. 9.

<sup>5</sup>"Are Credit Unions Dodging Their Responsibilities? One CEO Thinks So." Credit Union Journal, December 2, 2002, p. 11.

<sup>6</sup>"Are Members Really Leaving Credit Unions? CEOs Offer Their Take," Credit Union Times, April 14, 2004, p. 42.

resulted in a higher proportion of loans going to better meet the credit needs of the communities they serve.”<sup>7</sup>

Is the tax benefit being passed on fully to credit union members? In more and more cases, the answer is no. In some cases, it is going to build elaborate corporate headquarters like Golden 1 Credit Union’s new 200,000 square foot headquarters in Rosemont, California, costing more than \$30 million and GTE Federal Credit Union’s new 125,000 square-foot headquarters located on a 12.5 acre campus in Tampa, at a cost of about \$22 million.

And Digital Credit Union in Massachusetts paid \$5.2 million for the *naming rights for an arena* in Worcester (MA) in 2004. Is this an appropriate use of the credit union tax exemption?

#### **Business Lending—Extending Tax-Subsidized Services to Commercial Entities**

In addition to serving a wealthier customer base, the new breed of credit unions is looking for profitable opportunities in commercial lending, thus further extending the tax exemption beyond its original purpose. Business lending by credit unions grew by almost 50 percent in 2004. More than 420 credit unions have at least 5 percent of their total loans in business loans and almost 240 have at least 10 percent of their loan portfolio in business loans. Nearly 200 credit unions are designated guaranteed lenders by the Small Business Administration (SBA), and approximately 300 credit unions have either purchased or participated in business loans made to non-members.

“Successfully banking the small-business owner is one of the keys to increased credit union profitability,” the Credit Union Executive Society noted. And many credit unions are following this course to boost profits. Jean Faenza, EVP for Telesis Community CU, describing her credit union’s pursuit of business owners, stated: “Remember, every business owner is a consumer who has other accounts—small business are employers. We’re greedy—we want all of those accounts.”<sup>8</sup>

Lending by credit unions is big business. For example:

- Less than one year after commencing operations, CU Business Group, LLC said it had processed more than \$50 million in business loans—with the average-sized loan worth more than \$600,000. Larry Middleman, CU Business Group’s President/CEO, noted that the “[l]oan packages are much larger than we anticipated.”<sup>9</sup>
- The average business loan outstanding at Florida’s Vystar Credit Union is \$487,000; at California’s Telesis Community Credit Union, it is \$769,000.
- Coastal Federal Credit Union with \$1.4 billion in assets has ventured into complex commercial real estate transactions where the average size loan exceeds \$4 million.<sup>10</sup>
- Texans CU’s credit union service organization, Texans Commercial Capital, LLC, has approximately \$214 million in business loans on its book and funded Prism Hotel’s acquisition and construction financing of the 280-room Radisson Memphis Hotel in Tennessee.<sup>11</sup>
- OmniAmerican CU has established a \$10.5 million line of credit and \$2 million for working capital to Wide Open Spaces LLC for a real estate development project.

These are loans for which any bank would compete.

#### **Subsidizing a “Super Competitor”**

Competition in financial services occurs on the local level. The fact that the banking industry as a whole is much larger than the credit union industry has no bearing on head-to-head competition in the local market. The credit union tax exemption adversely affects tax-paying banks. It gives credit unions a significant price advantage over tax-paying banks that offer the same products and services and enables credit unions to grow much more rapidly.

The fact is that in more and more communities, it is the credit union that is many times larger than the local banks. For example,

<sup>7</sup>A Study of the Evolution and Growth of Credit Unions in Virginia: 1997–2002, by Neil Murphy and Dennis O’Toole, November 2003.

<sup>8</sup>“Show of Hands Indicates CU Interest in Biz Lending,” Credit Union Journal, September 15, 2003, p 11.

<sup>9</sup>Credit Union Journal, September 1, 2003.

<sup>10</sup>Credit Union Times, March 30, 2005, p. 23.

<sup>11</sup>“Texans CU’s Business CUSO Taking Off; LoansRange from Multi-Million to Just Thousands,” Credit Union Times, February 2, 2005, pp. 1, 36.

- In North Carolina, State Employees Credit Union (SECU), which has assets of over \$12.1 billion and 176 branch locations, competes directly with almost one hundred community banks, but is 44 times larger than the average-sized community bank.
- The Credit Union of Texas, with \$1.5 billion in assets, is almost seven times larger than the 17 community banks it competes with in its market.
- Visions FCU with \$1.6 billion in assets boasts that it was the largest mortgage lender in Broome County (NY) for 2003.

Some aggressive credit unions are now so large that they dominate the deposit market in their areas, competing head-to-head with large and small banks alike. For example:

- With \$2.9 billion in assets, Vystar Credit Union in Northeast Florida dominates its market area with more deposits than First Alliance, Wachovia and Bank of America combined.
- With \$5.3 billion in assets, Boeing Employees' Credit Union in Washington State dominates its market area with more deposits than Washington Mutual and Bank of America combined.
- With \$1.8 billion in assets, ENT Federal Credit Union in Colorado dominates its market area with more deposits than Wells Fargo and World Savings Bank combined.

It is obvious that the tax subsidy provides credit unions a very large pricing advantage. For example, professors Murphy and O'Toole found that “—credit unions are enabled to offer a 67 basis point advantage in loan pricing and deposit pricing over banks as a direct result of the fact that credit unions do not pay state or federal taxes. In a highly competitive industry, the 67 basis point government subsidy is substantial.”<sup>12</sup>

And the competition is not just banks versus credit unions, but it is these morphed credit unions pitted against traditional credit unions. Lorraine Ratoni, CEO of Sacramento County Grange Credit Union noted: “We’re losing members to larger credit unions. We’re having a harder and harder time competing.”<sup>13</sup>

Laura Bruce, writing for Bankrate.com, states

“To say credit unions don’t compete with one another or with banks just doesn’t ring true anymore. There’s competition. Some of it’s for sheer survival; some of it’s for market share. Not all credit unions have jumped into the fray. Some employment or organization-based credit unions may have a very successful niche and be able to stay small and survive, maybe even thrive—but they’re part of a shrinking minority.”<sup>14</sup>

Should traditional credit unions be allowed to be squeezed out by larger, aggressive credit unions?

#### **Policies Fuel Credit Union Consolidation and Unlimited Growth**

Through *pro forma* approvals of multiple common bonds, rapid approvals of community charters beyond any reasonable definition of “local,” and liberal interpretations facilitating expansion of business lending and other service offerings, NCUA has fueled the evolution towards larger, more complex credit unions. Today, a single credit union can serve thousands of unrelated groups, or huge geographic areas with millions of people.

Mergers and acquisitions have also played an important role in the expansion of many large credit unions. The result is fewer, but larger, credit unions. Over the last 4 years, nearly 1,100 small credit unions have disappeared.<sup>15</sup>

Community charters are the fastest growing segment of the credit union industry. Federal law permits a credit union to serve anyone in a “well-defined, local community, neighborhood or rural district.”<sup>16</sup> In fact, the number of federal credit unions with community charters has more than doubled from 464 in 1999 to 1,051 as of year-end 2004.

The use of the term “community” has reached absurd proportions. NCUA and various state regulators have approved community expansions that include some of the

<sup>12</sup>A Study of the Evolution and Growth of Credit Unions in Virginia: 1997–2002, by Neil Murphy and Dennis O'Toole, November 2003.

<sup>13</sup>“Friendly Foes: Once Allies, Credit Unions Now Compete for Customers,” by Barbara Marquand, Sacramento Business Journal, May 24, 1999.

<sup>14</sup>“The Changing Face of Credit Unions” By Laura Bruce, Bankrate.com, December 19, 2003

<sup>15</sup><http://www.ncua.gov/news/speeches/2005/matz/463,20,Slide 20>.

<sup>16</sup> Public Law No.: 105–219.

largest cities in the country, entire Metropolitan Statistical Areas (MSAs), multiple counties across state lines and even entire states as part of a credit union's field of membership. The result, according to GAO, is that the average size of a community charter approved by NCUA jumped almost three-fold from a population of 134,000 people in 1999 to 357,000 in 2003.<sup>17</sup> And this growth occurred in spite of NCUA's acknowledgment that when Congress, in 1998 legislation, added the requirement that community credit unions be "local," it intended to limit the size of such credit unions.

As Scott Waite, Senior Vice President and Chief Financial Officer of the \$3 billion-plus Patelco Credit Union, said on the credit union's expansive community charter in Northern California: "[I]f you walk past our front door, you can join."<sup>18</sup>

A few of the many other examples that illustrate just how far the definition of "local community" has gone include:

- NCUA approved a community charter application for LA Financial CU to serve the 10 million plus residents of Los Angeles County—larger than the population in 42 states and a geographic area equivalent in size to the states of Rhodes Island and Delaware combined.
- Wescom Credit Union's field of membership includes the 16 million people living in Los Angeles, Ventura, Orange, Riverside, and San Bernardino Counties.
- In 1999 and 2000, Meriwest Credit Union added the three million residents of Alameda and Santa Clara Counties and expanded its reach into Contra Costa and San Mateo Counties with a combined population of 1.7 million, and into the City and County of San Francisco—representing another 750,000 people.
- Boeing Employees CU in Washington State amended its field of membership to include the whole state of Washington.

To evade field of membership limitations, credit unions have been forming charitable foundations. Anyone who makes a donation to the foundation is eligible to join the credit union. For example, \$1.9 billion GTE FCU advertises on its website: "You can join GTE FCU even if you are not eligible for membership through your employer or a family member. GTE FCU sponsors a non-profit educational financial club, CU Savers."

And some credit unions do not even go through the pretense of having a common bond. As Greenwood CU in Rhode Island states, "membership . . . is open to all responsible people who want to be a member."

## II. Being a Not-for-Profit Cooperative Does Not Justify the Tax Exemption

As morphed credit unions stretch their fields of membership across ever-larger geographic areas and venture into new business activities, an important justification for their tax exemption has disappeared. With the focus on people of small means displaced by marketing efforts to affluent individuals, another justification for the tax subsidy no longer applies.

Since morphed credit unions no longer embody the traditional characteristics that justify continuing their tax exemption, they have been forced to offer a new justification. According to Dick Ensweiler, Chairman of the Credit Union National Association, "Credit unions have the tax status that they do because they are not-for-profit, cooperatively owned, democratically governed, and generally led by volunteers from among the membership."<sup>19</sup>

But being a not-for-profit cooperative does not justify being tax exempt.

In fact, most financial institutions that had traditionally been described as "cooperative, member-owned and not-for-profit" are now subject to federal taxation. Those institutions include mutual insurance companies, mutual savings banks, and mutual savings and loan associations. Each of these financial institutions lost their tax exemption years ago—mutual insurance companies in 1942, and mutual savings banks and mutual S&Ls in 1951. Why?

In the 1951 decision, Congress determined that:

- These cooperative and mutual institutions were in "active competition" with taxable institutions and continuing their tax exemption would be "discriminatory," and,
- They had evolved into institutions whose "investing members are becoming simply depositors, while borrowing members find dealing with a savings and loan association only technically different from dealing with other mortgage

<sup>17</sup> Credit Unions: Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management. General Accounting Office, October 2003 (GAO-04-91), p 35

<sup>18</sup> Bankrate.com

<sup>19</sup> American Banker, April 2, 2004.

lending institutions in which the lending group is distinct from the borrowing group.<sup>20</sup>

Thus, Congress determined that mutuality alone was not sufficient to continue the tax exemption for these institutions. This conclusion is particularly telling because of the similarities between mutual savings institutions and credit unions, as noted by the U.S. Treasury Department: "Mutual thrifts are the federally insured depository institutions most similar in structure to credit unions, because like credit unions, mutual thrifts generally do not have corporate stock, are not-for-profit entities, and are owned by their depositors, or members, rather than by shareholders."<sup>21</sup>

The tax preference originally provided to credit unions was a way to subsidize financial services for individuals with low and moderate income. Many traditional credit unions still dedicate themselves to this purpose. But the metamorphosis to wealthy and sophisticated credit unions shows how quickly this goal can be abandoned.

If the tax exemption is no longer conditioned upon the policy goal of serving low- and moderate-income individuals, can the special tax treatment for morphed credit unions be justified?

### III. Congress Has Acted to Limit Tax Exemption

Financial entities that have retained their tax-exempt status are generally subject to limitations that restrict either their size or the breadth of their membership. Moreover, their tax-exempt status remains based on narrowly crafted congressional directives relating to the service of niche markets or to achieving limited policy goals. With the erosion of both the common bond and the easing of limits on credit union products and services, credit unions' are free to stray from their original mission.

The question of where the line should be drawn to control the taxpayer expenditure needs to be answered. Every expansion of a morphed credit union expands the tax expenditure. OMB estimates that the credit union "tax expenditure" will exceed \$7.5 billion over the next five years.<sup>22</sup> And most of the tax subsidy goes to the most aggressive credit unions—those that are least likely to embrace traditional credit union principles. In fact, the largest 100 credit unions absorb 40 percent of the tax expenditure—quite a contrast with the 29 percent of just 6 years ago.

This is a substantial subsidy and, with no restraints, it will grow rapidly. Basic economics tells us what happens when a tax-exempt firm and a taxpaying firm offer the same products: the tax-exempt firm grows at the expense of the taxpaying firm. As business flows to the tax-exempt firms and away from taxpaying institutions, the size of the tax expenditure will grow.

As mutual insurance companies and mutual savings banks became similar to, in the words of the Congressional Budget Office, "profit-seeking corporations", Congress eliminated their tax exemption.<sup>23</sup> The public deserves a thorough review to assure that the tax expenditures are being appropriately spent and not disadvantaging competing businesses that carry out the same activities on which they pay taxes.

Credit unions that have adhered to the traditional principles should continue to benefit from the tax preferences. Morphed credit unions that no longer serve a tight-knit group of people, that do not focus on people of limited resources, and that actively compete with tax-paying entities, however, should assume the same responsibilities to the public that other financial institutions do.

Congress needs to ask: *"At what point do these diversified credit unions cease to be the type of institutions the Congress envisioned to be worthy of a tax exemption?"*

### Conclusion

Complex, aggressive credit unions, which have evolved into full-service financial institutions serving the general public, are a far cry from the small, traditional credit unions that served distinct groups of "people of small means" that Congress sought to assist when it provided tax subsidies to credit unions in the 1930's.

Many credit unions continue to serve an important purpose in our financial system. They have maintained a limited common bond of membership and have focused on providing services to moderate and lower income individuals as laid out in the preamble to the Federal Credit Union Act. For many other credit unions, however,

<sup>20</sup> 56 Stat. 798.

<sup>21</sup> Comparing Credit Unions with Other Depository Institutions, United States Department of the Treasury, January 2001, p.25.

<sup>22</sup> OMB, February 2005, for the fiscal years 2006 through 2010.

<sup>23</sup> Budget Options, CBO, March 2003, p. 218.

this focus has been abandoned, and expansionist policies have enabled the conglomeration of hundreds of unrelated groups within a single credit union. The focus has vanished for many credit unions adopting so-called community charters. These morphed credit unions are indistinguishable from tax-paying banking institutions.

The growing size of the tax expenditure, the increasing evidence that credit unions are serving the affluent, and the competitive implications for taxpaying institutions raise the question of whether continuing the special tax treatment for all credit unions can be justified. There may be reasons to preserve special tax and regulatory treatment for the many credit unions that have remained true to the spirit of the original credit union charter. But, for many other morphed credit unions with community charters or hundreds of unrelated groups, which offer products and services identical to banks, the question must be asked: Are their special tax and regulatory treatments still appropriate?

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**Statement of John H. Graham IV, American Society of Association Executives**

**Testimony is submitted on behalf of the American Society of Association Executives (“ASAE”), 1575 I Street, NW, Washington, DC20005. The core purpose of ASAE is to advance the value of voluntary associations to society and to support the professionalism of the individuals who lead them.** ASAE’s more than 22,000 members manage more than 12,000 trade associations, individual membership societies and philanthropic organizations in the U.S. and in 50 countries around the world. The number of people who belong to associations represented by ASAE totals more than 200 million.

**BACKGROUND:**

According to the Internal Revenue Service (IRS), there are more than 1.8 million tax-exempt organizations in the U.S. Trade and professional associations, business leagues, and chambers of commerce comprise a relatively small percentage of that overall population. Slightly more than 86,000 501(c)(6) organizations are listed on the IRS exempt organization master file for fiscal year 2004. To meet the requirements of Section 501(c)(6), an organization must possess the following characteristics:

- a) It must be an association of persons having some common business interest and its purpose must be to promote this common business interest;
- b) It must be a membership organization;
- c) It must not be organized for profit;
- d) No part of its net earnings may inure to the benefit of any private shareholder or individual.

While the number of 501(c)(6) organizations has grown in recent years—from 82,706 in fiscal year 2001 to just over 86,000 in fiscal year 2004—that growth has been moderate in comparison with charities and foundations organized under Section 501(c)(3) of the tax code.

Because of the services and benefits derived from associations, Congress has determined they should benefit from tax exemption. The first integrated federal income tax statute, enacted in 1913, provided exemptions for business leagues, as associations were known at that time. The 1913 Act also provided exemptions for charitable, scientific, or educational organizations.

As tax-exempt entities, associations are barred from accumulating equity appreciation for private benefit. Instead, these organizations undertake programs or initiatives to benefit members and the public rather than private individuals. Their earnings, therefore, must be dedicated to furthering the purpose for which they were organized.

Congress first gave associations favored tax treatment largely in recognition of the benefit the public derives from their activities. The legislative history also indicates that the exemption was based upon the theory that the government is compensated for any loss of tax revenue by its relief from the financial burden that would otherwise have to be met through appropriating public funds. In simple terms, associations earn their exempt status by meeting many of the needs of their members and the general public that the government would otherwise have to meet.

In the case of trade associations and professional societies, advocacy activities to assist public decision-making constitute a part of many association agendas. Associations promote and encourage civic activism and involvement, providing their

members with the tools they need to speak effectively on the issues they believe in. Associations make significant contributions to the democratic process by serving as a bridge between elected officials and voters.

However, associations are engaged in much more than “special interest” advocacy. In fact, trade associations spend three times more on professional development and public information campaigns than on direct lobbying.

Ninety-five percent of associations offer educational programs to their members, making associations the primary professional development resource for America’s workforce post-college. This responsibility is significant and staggering.

Associations are the originating source for codes of ethics and professional and safety standards that govern a host of professions and disciplines in this country. As an example, dentists hold positions of trust in our society because organizations like the American Dental Association (“ADA”) hold their members to principles of ethics and codes of professional conduct that reflect a commitment to high standards of care. Quality education and academic freedom in this country is assisted by organizations like the American Association of University Professors (“AAUP”) that define fundamental professional values and standards for instructors of higher education, and whose procedures on academic due process remain the model for professional employment practices on campuses across the nation.

Businesses and the government depend heavily on associations for their research and statistical information, which is often not available elsewhere. As an example, when lawmakers were looking to keep our markets moving and investors trading after the tragedy of Sept. 11, 2001, they consulted the Security Traders Association (“STA”) about the possibility of reducing fees investors pay to the Securities and Exchange Commission (“SEC”).

Associations also promote volunteerism, logging nearly 200 million volunteer hours in community service per year, according to the most recent survey completed by ASAE.

The impact of association activities on segments of the economy is equally significant. Association-sponsored meetings and conventions now account for more than 26 million overnight stays in hotels each year. Associations drive the \$102 billion U.S. meetings industry. Ninety-two percent of associations hold meetings accounting for 67 percent of the total meetings business, according to a study by the Convention Industry Council (“CIC”).

#### **STATUTORY REQUIREMENTS & EXISTING OVERSIGHT:**

Trade and professional associations qualify for exempt status only if they meet strict statutory requirements that they be organized and operated in furtherance of their primary exempt purpose. Entities must submit an application to the IRS to obtain tax-exempt status and provide supporting evidence including Articles of Incorporation, Articles of Association, or other organizing documents; financial data; and a full description of the purposes and activities of the organization. The IRS can approve or deny the application. In fiscal year 2004, the IRS received 86,964 applications for Section 501(c) exempt status. The IRS approved 69,302 applications, and denied 1,049. The remaining 16,715 applications were not approved for various reasons, mostly because they were withdrawn by the organization or they were incomplete. Of the 86,964 applications in FY 2004, 1,813 were filed for Section 501(c)(6) trade association status; 1,489 were approved.

Upon receiving tax-exempt status, associations must annually file a Form 990 to disclose their financial transactions and activities for the year if annual gross receipts are more than \$25,000. Those that have less than \$100,000 in gross receipts and year-end assets of less than \$250,000 may file Form 990-EZ. In addition to entities with less than \$25,000 in receipts, certain types of exempt organizations such as churches and religious organizations are not required to file. **All tax-exempt organizations that file must make their last three Form 990s widely available for public inspection as well, either in person or through posting on a Web site.**

Since 1950, associations have also paid unrelated business income tax (“UBIT”) on net income earned from any activity unrelated to the organizations’ exempt purpose. Passive income such as dividends, interest, and income from certain research activities are not treated as unrelated business income. The courts and the IRS have developed standards over the years for determining when an activity will be treated as a trade or business regularly carried on by an exempt organization.

**In addition to the statutory requirements to receive and maintain exempt status, the IRS maintains oversight of the exempt community through the Tax-Exempt and Governmental Entities (“TE/GE”) Division. As mentioned earlier, the number of exempt applications filed with the IRS Exempt Organization (“EO”) Division has steadily increased each of the last five years.**

Despite this growth, EO staffing levels have not kept pace in previous years and were insufficient to maintain adequate oversight of the exempt sector, according to IRS Commissioner Mark Everson. Everson said in a statement April 5, 2005, that the agency's enforcement presence "faded" in the late 1990s. The U.S. Government Accountability Office ("GAO") submitted a report to this committee at its April 20, 2005 hearing stating, in part, that staffing levels for the TE/GE Division at the IRS have been essentially flat since 1974: 2,075 agents in 1974 versus 2,122 in 2004. The 2004 IRS Data Book states that 863,494 returns were processed from tax-exempt organizations in calendar year 2003, and the number of returns examined by the IRS in fiscal year 2004 was 5,800. More recently, the IRS followed through on its commitment to hire more than 70 additional Exempt Organization Division examination agents in fiscal year 2005 and improve its current training for agents and examiners.

The EO Division also continues to consider modifications to the Form 990 filed by tax-exempt groups. The goal appears to be to improve the scope and quality of the Form 990 and ensure more accurate and complete reporting from exempt organizations.

The IRS is also moving forward with implementing new regulations requiring certain large corporations and tax-exempt organizations to electronically file their income tax or annual information returns beginning in 2006. For tax year 2005 returns that are due in 2006, the regulations require that corporations with total assets of \$50 million or more file their Forms 1120 and 1120S electronically. In addition, tax-exempt organizations with total assets of \$100 million or more will be required to file their tax year 2005 Form 990 electronically. Beginning in 2007, the electronic filing requirement will be expanded to include the tax year 2006 tax returns of corporations and tax-exempt organizations with \$10 million or more in total assets. In addition, private foundations and charitable trusts will be required to electronically file their Form 990-PF electronically, regardless of their asset size.

#### **NONPROFIT GOVERNANCE:**

The tax-exempt community has been proactive and largely self-regulating in considering issues related to governance in recent years.

More than a year ago, ASAE and its members gathered for a first-ever National Consensus Conference on Nonprofit Governance in New York, Jan. 12-13, 2004. The discussion among the roughly 150 nonprofit executives in attendance focused on how, and to what extent, nonprofit organizations can voluntarily strengthen their governance principles and practices. The conference proved to be a good starting point for developing and disseminating guidelines for nonprofit governance. Among the principles considered were: the role of the nonprofit organization's governing board in setting policy and providing oversight; the independence of the governing board from management; the presence, composition and role of an audit committee, or at least a committee fulfilling the audit committee function; codes of organizational conduct for nonprofit governance; chief executive compensation review; accurate and complete financial disclosures; policies and procedures for investigating complaints; and policies and procedures for document destruction.

In considering the applicability of corporate governance provisions to nonprofits, however, it is important to note the diverse nature of the tax-exempt community, and recognize there is no "one size fits all" blueprint for governance standards. As pointed out earlier in this document, the nonprofit community is diverse, ranging from fraternal societies and small social clubs, to charities and scientific societies to trade associations and chambers of commerce. The size and resources of various nonprofit organizations impact the necessity for, as well as their ability to implement, certain governance practices.

Despite their complexity, tax-exempt organizations are not precluded, nor should they be excused, from responsible governance. The development of "best practices" for nonprofit governance requires realistic cost-benefit analysis, and careful attention that the essential work of these exempt organizations, and the value they bring to society, continues unabated by unnecessary and burdensome compliance measures.

Organizations representing the interests of the 501(c)(3) charitable community, such as Independent Sector, have also been working to enhance compliance and accountability in the nonprofit sector.

The Panel on the Nonprofit Sector, comprised of leaders of nonprofit organizations and convened by Independent Sector, released an interim report March 1, 2005, that lists recommendations in 15 major areas, including actions to be taken by the nonprofit sector itself, by the IRS, and by Congress. The panel encourages the nation's 1.3 million charities and foundations to adopt and implement a conflict of interest

policy; ensure its board includes individuals with financial literacy skills; and develop specific practices and procedures to encourage and protect whistleblowers.

The panel also is supporting stronger disclosure rules, such as: suspension of exempt status of any organization that fails to file required Form 990 returns with the IRS for two or more consecutive years; a requirement that chief executive officers certify that their Form 990 returns are correct and complete; mandatory electronic filing of Form 990 to improve the accuracy and timeliness of information; and a requirement that charitable organizations conduct an independent audit of their finances if they have annual revenues of \$2 million or more.

**CONCLUSION:**

ASAE appreciates the committee's consideration of the legal history of the tax-exempt sector, as well as its size, scope and impact on society, and agrees that tax exemption is an important benefit, and that Congress has a responsibility to oversee and assure that the tax-exempt sector is accountable and deserving of public trust.

**ASAE believes that disclosure and transparency benefit both nonprofit organizations and the communities they serve. By their very nature, tax-exempt nonprofit organizations are organized for a "higher purpose," often to provide a valuable role or function that might otherwise fall to the government, as earlier stated. The performance and long-term survival of these organizations is highly dependent on a measure of public confidence. While not untouched by isolated instances of fiscal mismanagement or ethical abuse, the vast majority of nonprofit organizations have embraced their responsibility to institute governing practices that ensure public trust.**

**Countless association activities today not only further the exempt purpose of the organization, but also contribute to improving the general welfare of communities across the country. ASAE urges the Committee, in its continued examination of the tax-exempt sector, to consider the important, growing role associations play in American society, and how changes to current statutory requirements might impact an enormous number of programs and services now offered by associations.**

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Association of the Fundraising Professionals  
Cleveland, OH  
April 26, 2005

The Honorable Bill Thomas  
U.S. House of Representatives  
2208 Rayburn House Office Building  
Washington, DC20515

Dear Congressman Thomas:

I am writing to urge you to protect the charitable sector from unnecessary and overly burdensome regulations such as those presented by the Senate Finance Committee, particularly those proposals that would modify the tax rules regarding non-cash charitable contributions (known as "in-kind" contributions).

The new proposals include recommendations to completely eliminate or substantially modify deductions for in-kind contributions. Many charities heavily rely upon non-cash donations, and there is no legitimate reason to attack this lifeline. I work for Cleveland State University as a Major Gifts Officer. I have helped the Fenn College of Engineering secure equipment gifts to upgrade laboratories and software gifts valued at \$1,000,000 (discounted educational value). In-kind gifts have enabled Cleveland State to offer some of the latest technological advances to our engineering students, especially during a time when the state of Ohio continues to cut funding for higher education and funds are not available for lab equipment and software upgrades!

Changing the in-kind contribution rules would unfairly compel charities to divert valuable time and resources to new valuation compliance schemes. The inability of the Internal Revenue Service to address improper donor behavior should not result in penalties for charities and the communities and populations that they serve. Significant revision of the in-kind contribution rules would greatly diminish my organization's ability to provide altruistic services.

Furthermore, these proposals are not based on any credible evidence of widespread abuse. In fact, empirical data indicates that there is NOT widespread abuse among the charitable sector and that proposals are unnecessary. Reports collected by the FBI, the Federal Trade Commission, State Attorneys General and even

watchdog groups like the Better Business Bureau show that reports of charity fraud are less than 1 percent of all complaints of *fraud*. This is consistent with every single year's annual findings in the annual report on *Fraud in the United States* published by the FTC.

It appears that many of the suggestions are driven by a desire to raise federal revenues from the charitable sector. Such an effort is completely inconsistent with the notion of tax-exempt status, and I hope you will strongly oppose such proposals.

The Senate Finance Committee's proposals to alter the non-cash charitable gift incentives come at a precarious time for charities. Americans are a generous people, but many charities are still recovering from the past several years when charitable giving has been flat and even decreased for many organizations.

At the same time, we understand that your committee seeks to gather information on the size, scope, and impact on the economy of the nonprofit sector; the need for congressional oversight; IRS oversight of the sector; and what the IRS is doing to improve compliance by the sector with the law. These are laudable objectives. We are interested in assisting the committee in identifying appropriate areas for further study as well as criteria and standards to better define and outline the sector and its players.

Again, I urge you to oppose changes to the in-kind contribution rules as well as any unreasonable and burdensome legislation that would harm the charitable sector. I very much appreciate your support.

Thank you for your consideration.

Sincerely,

Deborah S. Miller  
President, Association of Fundraising Professionals  
*Greater Cleveland Chapter*

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#### **Statement of David C. Jones, Association of Independent Consumer Credit Counseling Agencies**

Mr. Chairman and members of the Committee, the Association of Independent Consumer Credit Counseling Agencies (AICCCA) welcomes this opportunity to submit comments for the Committee's consideration on the important topic of the proper policy and enforcement mix for the tax-exempt sector. While credit counseling agencies are members of that broad sector they do have a unique role, responsibilities, and regulatory structure. This makes it important that Congress differentiate between them and other tax-exempt entities and adopt appropriate policies going forward. A "one size fits all" approach to tax-exempt organizations is not the right policy prescription.

#### Ongoing Federal and State Oversight and Regulation

We were privileged to have our testimony heard at the November 20, 2003 hearing held by your Subcommittee on Oversight regarding *Non-Profit Credit Counseling Organizations*. At that hearing, we described the difficult challenges and regulatory issues that our industry faced. We also expressed strong support for the consumer protections that the credit counseling industry must implement and enforce to protect some of our most vulnerable citizens: Individuals and families that have become burdened by unmanageable levels of debt. AICCCA continues to strongly support these consumer protections; we continually demonstrate our commitment by undertaking strong self-regulation for our Association members.

The consumer credit counseling sector continues to receive intense government scrutiny due to the practices of a few rogue agencies. On April 13, 2005, the Senate Permanent Subcommittee on Investigations (PSI) issued a bipartisan Subcommittee report on abusive practices committed by certain "bad actor" credit counseling agencies. This report incorporated information from a PSI hearing held in March 2004 and associated staff investigations; AICCCA applauded that investigation and provided written testimony in support of that hearing. The PSI's report contains five important recommendations for the nation's creditors, the FTC and IRS, and the credit counseling industry. *AICCCA supports the intent of all five of these recommendations.*

Those PSI recommendations are:

1. Complete elimination of abusive practices through ongoing IRS audits and FTC enforcement actions.
2. Establish regular periodic review of an agency's tax-exempt status.

3. Ensure that each tax-exempt agency provides affirmative financial counseling and education programs.
4. Continue creditor support of and standards for the credit counseling sector, including a requirement to maintain accreditation within the industry.
5. Clarification of IRS and FTC standards regarding tax-exempt status and acceptable trade practices in regard to accreditation; independent boards; assurance of public benefits; full disclosure of relationships with creditors and for-profit service providers; reasonable fees; and controls on improper incentives for client enrollment or referrals.

While AICCCA supports the broad scope of all these recommendations, we do believe that certain clarifications and fine-tuning are required. For example, we applaud the PSI's recognition of the key role that agency accreditation plays in assuring consumer protection. However, we believe that PSI erred in only mentioning the standards of the Council on Accreditation (COA). While the AICCCA accepts COA accreditation, it believes that accreditation through the International Standards Organization (ISO) to specific credit counseling sector requirements is considerably more rigorous. For example, ISO accreditation employs more frequent compliance audits.

The AICCCA also supports the credit counseling provisions included in section 106 of S. 256, the bankruptcy reform legislation signed into law by the President on April 20, the same day as your hearing. That legislation requires every consumer to consult with an approved credit counseling agency before filing for bankruptcy, and to complete an approved financial education course before receiving their bankruptcy discharge from debt. The new powers vested in the Justice Department's Executive Office for United States Trustees (EOUST) are intended to enforce minimum standards for non-profit credit counseling agencies approved to provide pre-bankruptcy counseling to the nation's consumers. Once issued, these standards will be in addition to the many and varied existing state regulations as well as the powers of the IRS to audit and regulate the industry to assure compliance with tax-exempt status requirements. For many consumers, a counseling agency's participation in the pre-bankruptcy counseling program as an EOUST-approved agency will become a critical stamp of approval when they seek financial advice and assistance.

States continue to have the lead role in regulating the credit counseling sector, and they have been quite active on two fronts. First, many states have revised and strengthened their existing state laws in response to the well-publicized abuses of a few rogue agencies. Second, the states are engaged in the process of promulgating a new model law for statehouse consideration. On April 7th through 9th, 2005, the National Conference of Commissioners for Uniform State Laws (NCCUSL) met under the guidance of bankruptcy Judge William Hillman to consider the final draft of the model *Uniform Debt Management Act*. Over the past two years, the AICCCA has participated continuously with the NCCUSL in this drafting effort, and we support the great majority of the provisions of this proposed uniform law intended for adoption by all states beginning with the 2006 legislative sessions.

#### Joint Committee on Taxation Proposal

On January 27, 2005, the staff of the Joint Committee on Taxation issued *JCS-02-05, Options to Improve Tax Compliance and Reform Tax Expenditures*. While this large report covers the non-profit universe as well as other tax and enforcement matters, it includes specific recommendations regarding the treatment of the credit counseling industry. These recommendations appear on pages 327 through 337 in section L entitled, *Establish Additional Standards for Credit Counseling Organizations (sec. 501(c)(3) and 501(c)(4))*. This report suggests that additional legislation is required and proposes the enactment of a number of specific requirements beginning on page 331 entitled, *Description of Proposal, Additional requirements applicable to all credit counseling organizations*. Some of these proposals are eminently reasonable and are consistent with current regulation as well as AICCCA self-regulatory standards. For example, requirements (1) through (8) on pages 331 and 332 are in alignment with AICCCA standards and the Code of Practice requirements for our members; agree with, expand, or restate current laws and regulations; and represent reasonable regulatory application.

However, there is one unrealistic recommendation that threatens the viability of the non-profit credit counseling sector and its ability to carry out the critical new "gatekeeper" role assigned to it by the new bankruptcy reform legislation. The section entitled, *Additional requirements for charitable or educational organizations*, on page 332, is poorly conceived and represents an alarming lack of understanding of the credit counseling industry. This section would require that, **"(4) the aggregate of the agency's debt management plan services (measured by time, resources, effort expended by the agency, and any other factors prescribed**

**by the Secretary) during the four-year period that includes the agency's current taxable year and the immediately preceding three taxable years does not exceed 10 percent of the agency's total activities during such four-year period;".**

On page 336, the report also refers to an IRS counsel memorandum released in July of 2004. This memorandum also suggested a 10% limit on debt management plan (DMP) activities and is the likely source for the Joint Committee on Taxation's proposed provision. It states that, "**The 10-percent limit applicable to charitable and educational organizations comports with the traditional levels of such activity before the dramatic growth in the industry.**" While this may or may not have been true far in the past, the statement completely ignores the fact that even 15 years ago consumers did not have the broad access to credit or carry the large levels of indebtedness that have become common today. The fact is that consumer debt, and the stresses that accompany it, have grown much faster than the credit counseling industry. As a result, the number of consumers for whom a DMP is an appropriate alternative to filing bankruptcy has grown so large that no agency could limit DMPs to 10% of total activities and even begin to meet the needs of consumers. Further, the thrust of the newly enacted bankruptcy reform bill is at complete odds with this unrealistic ceiling. That new law will send at least 1.5 million additional consumers through the doors of approved credit counseling agencies on an annual basis, and some significant percentage is expected to opt for entering into a DMP as an alternative to bankruptcy. How can Department of Justice-approved counseling agencies fulfill their role and recommend a DMP where it appears to be the suitable course for a given consumer if that recommendation risks jeopardizing the agency's tax-exempt status?

AICCCA believes that, if enacted, this provision would eliminate all non-profit credit counseling agencies without exception. Even though legitimate credit counseling agencies typically enroll in debt management plans only between 10% and 25% of those they counsel, those who are enrolled must receive continuing support as they repay their debts over a three-to-five-year period. Many of these support activities are mandated by current state laws that have compelled all reputable credit counseling agencies to devote an ever-increasing portion of their activities to DMP support. This means that a large part of any agency's activities involve continuing efforts (education, re-budgeting, re-counseling, monthly payment processing) to assist consumers that are in the process of repaying their debts under structured plans. While credit counseling and education are the primary activities of any legitimate credit counseling agency, activities necessary to support those who qualify for debt management plans will always constitute far more than 10% of an agency's work, especially given current levels of consumer indebtedness. This JCT proposal is unnecessary, unrealistic, and at total odds with state regulation and the new bankruptcy reform bill. The level of resources devoted to DMP support can and does vary significantly between legitimate counseling agencies. AICCCA strongly recommends that this inflexible and misguided JCT recommendation be rejected in favor of flexible oversight of an agency's activities to assure that they meet all applicable standards and serve the best interests of clients.

There are other JCT recommendations that are also cause for serious concern. For example, also on page 336, the report refers to the IRS memorandum suggestion that income from DMP activity could be considered unrelated business income in some cases and therefore taxable. However the report makes no proposal of its own on this subject and relies on present law to determine this issue. As this issue was decided by the federal district court in the 1976 *Consumer Credit Counseling Service of Alabama* decision, the AICCCA concurs that reliance on present law is appropriate. This income flows from activity that is an integral part of a non-profit's overall mission. Credit counseling agencies should not be asked to operate under the threat that a judicial decision on which they have relied for more than a quarter century may be reversed by regulatory fiat or ill-considered legislation.

Finally, while projected revenue raising should not be the primary focus of any proposed reform of the tax treatment of credit counseling agencies, AICCCA would note that the JCT's estimate for increased revenue flowing from full adoption of its credit counseling recommendations is both minor and unrealistic. JCT projects that adoption would generate \$100 million over a ten year period, or only \$10 million a year. Even this modest figure is wildly optimistic, as adoption of the ten percent DMP activity limit would cause credit counseling agencies to lose their tax-exempt status and become ineligible to provide services in most states, or to participate in the pre-bankruptcy counseling program established by the new reform bill. They would thus be forced to cease their operations, and defunct entities generate no tax revenues.

Federal Regulation

The AICCCA trusts that the Congress will consider carefully any legislation designed to regulate the credit counseling industry. Whatever Congress does, it must recognize that the Tax Code is not an efficient mechanism for direct regulation of activities. Once a credit counseling agency has met and maintains reasonable criteria for tax-exempt status, any further regulation of its activities should be done directly. And, before taking such a step, Congress must recognize that counseling agencies already operate in a complex federal and state regulatory environment.

Well-meaning but poorly conceived attempts to protect citizens from headline-grabbing abuses have had an opposite and unanticipated effect in many states. For example, Maryland has passed a law with such high bonding requirements that most legitimate small-to-medium-sized agencies cannot comply with it. Unfortunately, Kansas and New York have passed similar laws. In contrast, Georgia enacted a law that does not require high bonding levels but that nonetheless protects its citizens by requiring appropriate insurance coverage that is within the financial reach of responsible credit counseling agencies.

In another area of ongoing debate, Virginia recently passed a provision that allows for-profit credit counseling firms to serve their citizens. AICCCA believes that the credit counseling sector should remain non-profit, and observes that the profit motive was clearly at the heart of all of the recent abuses of rogue agencies that received wide media coverage. If the JCT's ill-advised DMP activity limit were adopted it would drive legitimate non-profit agencies out of business and leave the credit counseling function wide open to participants for whom profit maximization is the primary goal.

AICCCA is gratified that no direct federal regulation of credit counseling, beyond the EOUST standards for pre-bankruptcy counseling eligibility, are being contemplated at this time. If a federal regulation statute were enacted, it would impose yet another layer of rules on an industry that is struggling to support consumers who are in serious need of unbiased advice and expertise. The counseling industry is also in the process of preparing for its considerable responsibilities under the new bankruptcy reform law. If new regulation is to be imposed it would be far more preferable for the states to enact the uniform law that is undergoing final NCCUSL review and approval.

Conclusion

The abuses that have been the focus of the many hearings and investigations into the credit counseling industry over the past several years—and which have caused complaints and lawsuits, generated many new state laws, and fed unending negative press coverage—are the result of a relatively few maverick agencies. The AICCCA believes that appropriate IRS oversight and the enforcement of existing law are in the process of proving their ability to protect consumers from those abuses that have occurred. In addition, both the AICCCA and the National Foundation for Credit Counseling have long-established and rigorous consumer protection standards that accredited member agencies must meet and maintain.

If the members of the Ways and Means Committee decide that new tax legislation that affects credit counseling is worthy of consideration, the AICCCA stands ready to provide any assistance or insight that is requested. Our members are dedicated to serving the best interests of consumers in need of counseling and personal finance education nationwide. As you go forward, we ask you to differentiate between credit counseling agencies and the great number of other types of tax-exempt entities. We also implore you to refrain from adopting ill-conceived and unrealistic requirements for agencies to qualify for and retain tax-exempt status that could undermine their ability to survive and serve the financial assistance needs of millions of Americans in economic distress.

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Central Arkansas Area Agency on Aging, Inc.  
North Little Rock, AR 72119  
May 2, 2005

The Honorable Bill Thomas  
U.S. House of Representatives  
2208 Rayburn House Office Building  
Washington, DC 20515

Dear Congressman Thomas:

I am writing to urge you to protect the charitable sector from unnecessary and overly burdensome regulations such as those presented by the Senate Finance Committee, particularly those proposals that would modify the tax rules regarding non-cash charitable contributions (known as "in-kind" contributions).

The new proposals include recommendations to completely eliminate or substantially modify deductions for in-kind contributions. Many charities heavily rely upon non-cash donations, and there is no legitimate reason to attack this lifeline. [Please insert a sentence or two here about how your organization relies on in-kind gifts.]

Changing the in-kind contribution rules would unfairly compel charities to divert valuable time and resources to new valuation compliance schemes. The inability of the Internal Revenue Service to address improper donor behavior should not result in penalties for charities and the communities and populations which they serve. Significant revision of the in-kind contribution rules would greatly diminish my organization's ability to provide altruistic services.

Furthermore, these proposals are not based on any credible evidence of widespread abuse. In fact, empirical data indicates that there is NOT widespread abuse among the charitable sector and that proposals are unnecessary. Reports collected by the FBI, the Federal Trade Commission, State Attorneys General and even watchdog groups like the Better Business Bureau show that reports of charity fraud are less than 1 percent of all complaints of *fraud*. This is consistent with every single year's annual findings in the annual report on *Fraud in the United States* published by the FTC.

It appears that many of the suggestions are driven by a desire to raise federal revenues from the charitable sector. Such an effort is completely inconsistent with the notion of tax-exempt status, and I hope you will strongly oppose such proposals.

The Senate Finance Committee's proposals to alter the non-cash charitable gift incentives come at a precarious time for charities. Americans are a generous people, but many charities are still recovering from the past several years when charitable giving has been flat and even decreased for many organizations.

At the same time, we understand that your committee seeks to gather information on the size, scope and impact on the economy of the nonprofit sector; the need for congressional oversight; IRS oversight of the sector; and what the IRS is doing to improve compliance by the sector with the law. These are laudable objectives. We are interested in assisting the committee in identifying appropriate areas for further study as well as criteria and standards to better define and outline the sector and its players.

Again, I urge you to oppose changes to the in-kind contribution rules as well as any unreasonable and burdensome legislation that would harm the charitable sector. I very much appreciate your support.

Thank you for your consideration.

Sincerely,

Ann C. Leek  
*Vice President, Development*

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#### **Statement of Gary Kohn, Credit Union National Association**

Credit unions are exempt from federal and most state taxes because—unlike many other insured financial institutions—credit unions are member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors and because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means.

Congress itself came to the above conclusion just seven years ago, when it passed the Credit Union Membership Access Act (PL 105-219). Since 1998, nothing has changed in the structure and focus of credit unions.

The Credit Union National Association (CUNA), and the 86 million members of the credit unions in the United States, urges you to leave the tax status of credit unions unchanged, recognizing that the tax exemption is sound public policy, based on the following:

- The original justification for the tax exemption still holds;
- Credit unions serve those of modest means at reasonable costs;
- Over 86 million credit union members receive substantial benefits;
- The tax exemption ensures the cooperative alternative is available;
- Credit unions of all sizes benefit their members; and,
- There is no evidence of market disruption from the tax exemption.

The following pages detail each of these six points:

Original justification for the credit union tax exemption still holds

Since inception, the credit unions tax exemption has had absolutely nothing to do with either field of membership restrictions or the extent to which credit union service offerings were limited. Rather, the original reason for the tax exemption was based solely on the cooperative structure of credit unions. The U.S. Treasury Department underlined this fact in its most recent comprehensive report on credit unions outlining the rationale for the tax exemption for federal credit unions:

Two reasons were given for granting this exemption (in 1937): (1) that taxing credit unions on their shares, much as banks are taxed on their capital shares, "places a disproportionate and excessive burden on the credit unions" because credit union shares function as deposits; and (2) that "credit unions are mutual or cooperative organizations operated entirely by and for their members . . ." Thus, the tax exemption was based primarily on the organizational form of credit unions . . . (Quotes within this excerpt are from H.R. REP. NO. 1579, 75th Cong., 1st Sess. P. 2.)<sup>1</sup>

Similarly, the rationale for the tax exemption for state chartered credit unions hinges on their cooperative structure. In a 1991 report, the GAO found:

Under current law, state credit unions are exempt from tax under Internal Revenue Code section 501(c)(14)(A). This section states that credit unions that are (1) operating on a nonprofit basis, (2) organized without capital stock, and (3) operating for mutual purposes can qualify for exemption.<sup>2</sup>

Today, credit unions continue to operate as democratically controlled mutual institutions, serving their members on a non-profit basis. Rather than distributing net income among stockholders (as do banks), the bulk of it is returned to members in lower loan rates and fees, or higher yields on savings. The balance is retained by the credit union to comply with statutorily mandated net worth requirements that protect the federal share insurance fund and the taxpayer from loss. These retained earnings are not accumulated for the benefit of management or stockholders. They exist only for the benefit of members in the future by providing for the stability of the credit union.

As indicated at the outset, Congress recently reaffirmed the tax treatment of credit unions in the findings to the Credit Union Membership Access Act of 1998. Specifically, the findings read:

The Congress finds the following: . . .

(4) Credit unions, unlike many other participants in the financial services market, are exempt from Federal and most State taxes because they are member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors and because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means.<sup>3</sup>

By way of contrast, mutual savings banks lost their tax exemption because they competed with taxed institutions AND because they engaged in widespread proxy voting schemes and were not democratically controlled (voting was based on the size of each member's deposit not on the basis of one-member-one-vote as is the case with credit unions). The U.S. Treasury underlined this fact in its recent comprehensive report on credit unions. The report states: "In 1951, however, Congress removed the thrift tax exemption because these institutions had evolved into commercial bank competitors, and had lost their "mutuality," in the sense that the institutions' borrowers and depositors were not necessarily the same individuals.

The significance of the credit union tax exemption is well understood by public officials. Last year, both President Bush and Senator Kerry wrote letters affirming their appreciation for the important service that credit unions provide to their 86 million members, and indicating their support for the continuation of credit unions' tax exemption. Their support was added to that of a number of members of Congress, including: Senate Banking Committee Chairman Richard Shelby, House Majority Leader Tom DeLay; House Majority Whip Roy Blunt; House Minority Whip Steny Hoyer; and nearly 200 other members of Congress.

<sup>1</sup> U.S. Department of the Treasury "Comparing Credit Unions and Other Depository Institutions", January 2001. Page 28.

<sup>2</sup> GAO, July 1991. Page 292.

<sup>3</sup> Pub. L. No. 105-219. August 7, 1998.

Credit unions serve those of modest means at reasonable costs

A recently published study found that: "Households that use a bank only have higher median incomes than those who use a credit union only" and "Among households that use both a bank and a credit union, those that use a bank primarily have higher median incomes than those that use a credit union primarily."<sup>4</sup>

A significant way credit unions provide value to America's working class and modest income consumers is through the pricing of their services. Numerous studies and reports show that credit unions charge fewer and lower fees than do banks for the same kinds of services.<sup>5</sup> In particular, minimum balances to avoid fees are typically much lower at credit unions than at banks. Lower rates on loans, especially on used cars and small loans are another way credit unions serve those of modest means. Credit unions also serve America's low and moderate-income households with member business loans. The Treasury reported in 1999 that 45% of credit union member business loans were to borrowers with household incomes below \$50,000.<sup>6</sup> In addition, Home Mortgage Disclosure Act (HMDA) data consistently shows that low income or minority applicants are significantly more likely to have their loans approved at a credit union than at any other type of lender.

Throughout most of their history, credit unions have actually been hamstrung in their efforts to serve members of modest means because field of membership rules generally restricted eligibility to occupational groups. Four years ago, the National Credit Union Administration adopted an expedited program known as Access Across America to permit federal credit unions to add underserved areas to their fields of membership. Since the beginning of 2001, over 92 million potential members from underserved areas have been added to credit union fields of membership. Credit unions acknowledge it will take some time to reach out to and serve members in these communities. However, in the three years ending December 2003, credit unions that added such underserved areas experienced membership growth over three times that of other credit unions (17.4% vs. 5.2% over the three year period.)

86 million CU members receive substantial benefits

Credit unions provide substantial, tangible benefits to members that far exceed the amount of the tax exemption. These benefits are realized in the form of lower fees, lower loan rates, and higher yields on savings. CUNA has estimated that these benefits total over \$6 billion a year.<sup>7</sup> That is the additional amount that credit union members would pay if they were to conduct all the business they do at banks instead of credit unions. That is about four times the roughly \$1.5 billion that credit unions would pay in federal income tax.

The tax exemption is leveraged as it is for the benefit of credit union members because of the cooperative structure of credit unions. When comparing banks to credit unions, the amount that banks pay in dividends to stockholders is more significant than is the tax exemption. Further, credit unions either do not compensate directors (as is the case with federal credit unions), or (in the case of state-chartered credit unions) generally compensate only the board Treasurer or reimburse incidental expenses incurred by other directors. The savings realized in not compensating all directors are then passed on to members. Finally, credit unions ratios for expenses and loan losses compare very favorably to similarly sized banks.

Tax exemption keeps the cooperative alternative available, and supports safety and soundness

Credit union regulation, which is much more restrictive than that for other financial institutions, includes: limits on who the credit union can serve, limits on business lending, lack of access to capital markets, higher capital requirements than other depository institutions, etc. The tax exemption is the incentive that encourages credit union CEOs and boards to continue to operate as credit unions rather than shedding those restrictions by converting to a bank charter. Such conversions would only limit the range of choices available to America's consumers, especially those of modest means.

<sup>4</sup> Jinkook Lee and William Kelly, *Who Uses Credit Unions*, Third ed. Filene Research Institute, 2004. Page 15.

<sup>5</sup> 2004-2005 Credit Union Fees Survey, Credit Union National Association. Big Banks, Big Fees 2001, US Public Interest Research Group. New Jersey Department of Banking and Insurance, various surveys. The Money Talks Personal Finance Advice website at [www.moneytalks.org](http://www.moneytalks.org).

<sup>6</sup> US Department of the Treasury. *Credit Union Member Business Lending*. January 2001.

<sup>7</sup> The Benefits of Credit Union Membership. CUNA Research and Policy Analysis White Paper, 2004.

Because the tax exemption is an important part of the reason credit unions remain cooperatives, it serves to protect taxpayers from losses to the share insurance fund. There are two important connections between the stability of NCUSIF and credit unions' tax exemption. First, the primary buffer for a deposit insurance system is the capital or net worth maintained in insured institutions. Because credit unions have no access to capital markets, their only source of capital is the retention of earnings. A tax on net income would thus disincent credit unions from retaining earnings, weakening protection for NCUSIF. In fact, the cost to the taxpayer of FSLIC's losses far exceeded the total taxes paid by FSLIC insured institutions prior to FSLIC's failure.

Second, as cooperatives credit unions have a systemic inclination to avoid risky activities. In their 1996 study of the National Credit Union Share Insurance Fund, Edward Kane and Robert Hendershott show that the cooperative structure of credit unions presents credit union decision makers with incentives that are strikingly different from those faced by a for-profit financial institution, making it less feasible for credit union managers to benefit from high-risk strategies.<sup>8</sup> This is an especially useful trait for federally insured depository institutions.

#### Large credit unions stand out in providing credit union benefits

There is no relation between the size of an institution and the absence or presence of reasons to justify the tax exemption. Members of large credit unions relate to the institutions to which they belong in exactly the same way as do members of smaller credit unions. Regardless of the size of the credit union, each credit union member has one equal vote, and thus an equal say, in the direction of the credit union.

Large credit unions are democratically controlled, not-for-profit cooperatives in every way that are smaller credit unions. The boards of directors of large credit unions are composed of volunteers just as they are at small credit unions. A large credit union may be more likely to offer a broader array of services, and to be a greater presence in a local market. But neither activity makes it less a cooperative than a smaller credit union. No one suggests that as soon as the congregation of a church, synagogue or mosque exceeds a certain size, it should no longer be tax exempt. Likewise, it would be ludicrous to say the American Heart Association should lose its tax exemption simply because of its size while a small local charity should not.

Because of their size and efficiency, large credit unions are often more able to provide the benefits of the cooperative to members, such as lower loan rates and fees and higher dividend rates. Larger credit unions are also more able to offer special programs benefiting low- and moderate-income households. In a survey conducted in 2002, when asked how many of up to 18 services geared to low/moderate income households were offered, only 6% of credit unions with assets below \$20 million offered at least half of the services. Fully 42% of credit unions with assets over \$500 million offered that many of the services. Large credit unions are also more likely than small credit unions to participate in outreach activities to attract low/moderate income members, and to have added underserved areas to their fields of membership under NCUA's Access Across America program.<sup>9</sup>

#### No evidence of market disruptions from credit union tax exemption

There is no evidence that the credit union tax exemption adversely affects banks or thrifts; other financial institutions continue to thrive in the presence of credit unions. In fact, the FDIC recently reported that banks recorded record profits for the fourth year in a row.<sup>10</sup> Aggregate bank return on assets (ROA) has exceeded 1% for the past 12 years, averaging 1.23%. And credit unions are only growing marginally faster than banks. In the decade ending in 2004, total banking institution assets grew at a compound annual rate of 7.25% compared to 8.4% for credit unions. Credit unions now account for 6.2% of the combined assets of all depository institutions. At the growth rates of the past decade, it will take until the year 2053 for the credit union share to climb to just 10%. And, although more credit unions have become interested in recent years in business lending to their members, credit unions as a whole hold a very small portion of the market: Less than 1% of the business loan market in the U.S.

The health of the banking industry over the past decade has not been confined to just large banks. In a 2003 conference, Federal Reserve Gov. Mark Olson said: "The year that just ended was one of record profits for the industry as a whole, and

<sup>8</sup>Edward Kane and Robert Hendershott, *The Federal Deposit Insurance Fund that Didn't Put a Bite on U.S. Taxpayers* *Journal of Banking and Finance*, 20(September, 1996), pp.1305-1327.

<sup>9</sup>2003 Serving Members of Modest Means Survey Report. CUNA.

<sup>10</sup>Federal Deposit Insurance Corporation, *Quarterly Banking Profile*, Fourth Quarter 2004.

for community banks in particular" and "Community banking has a long history of strength and success and a bright future. The past year was a good one for community banks. Once again the vitality and adaptability of the community banking franchise were amply demonstrated."<sup>11</sup> Two Federal Reserve economists have recently described the strong performance of the nation's smaller banks. They found that "small banks have grown considerably more rapidly than large banks and have tended to meet or exceed them in some measures of profitability."<sup>12</sup>

As Federal Deposit Insurance Corp. Chairman Donald E. Powell told the convention of the Independent Community Bankers of America March 12, "In the banking business, times are surely good."

Summary.

America's credit unions continue in their long tradition of providing members affordable financial services driven by their cooperative, not-for-profit structure. As a result, 86 million members receive significant benefits from their credit unions even while the rest of the financial services industry thrives. The public policy rationale for the credit union tax exemption is just as valid today as it was at credit unions' inception.

The Credit Union National Association—the nation's largest credit union trade association representing 90 percent of the nation's 9,000 credit unions—is pleased to offer these comments and suggestions to the Ways and Means Committee as it conducts its overview of the tax-exempt sector. We look forward to working with the Chairman, Members and staff of the committee as it continues its overview, and stand ready to answer any questions or expand on or otherwise further explain our remarks.

Fair Housing Center  
Toledo, OH 43624  
April 26, 2005

The Honorable Bill Thomas  
U.S. House of Representatives  
2208 Rayburn House Office Building  
5Washington, DC 20515

Dear Congressman Thomas:

I am writing to urge you to protect the charitable sector from unnecessary and overly burdensome regulations such as those presented by the Senate Finance Committee, particularly those proposals that would modify the tax rules regarding non-cash charitable contributions (known as "in-kind" contributions).

The new proposals include recommendations to completely eliminate or substantially modify deductions for in-kind contributions. Many charities heavily rely upon non-cash donations, and there is no legitimate reason to attack this lifeline. [Please insert a sentence or two here about how your organization relies on in-kind gifts.]

Changing the in-kind contribution rules would unfairly compel charities to divert valuable time and resources to new valuation compliance schemes. The inability of the Internal Revenue Service to address improper donor behavior should not result in penalties for charities and the communities and populations which they serve. Significant revision of the in-kind contribution rules would greatly diminish my organization's ability to provide altruistic services.

Furthermore, these proposals are not based on any credible evidence of widespread abuse. In fact, empirical data indicates that there is NOT widespread abuse among the charitable sector and that proposals are unnecessary. Reports collected by the FBI, the Federal Trade Commission, State Attorneys General and even watchdog groups like the Better Business Bureau show that reports of charity fraud are less than 1 percent of all complaints of *fraud*. This is consistent with every single year's annual findings in the annual report on *Fraud in the United States* published by the FTC.

It appears that many of the suggestions are driven by a desire to raise federal revenues from the charitable sector. Such an effort is completely inconsistent with the notion of tax-exempt status, and I hope you will strongly oppose such proposals.

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<sup>11</sup> Comments before the 2003 Chicago Federal Reserve Bank Conference: Whither the Community Bank?

<sup>12</sup> William F. Bassett and Thomas F. Brady. *The Economic Performance of Small Banks, 1985-2000*. Federal Reserve Bulletin, November 2001.

The Senate Finance Committee's proposals to alter the non-cash charitable gift incentives come at a precarious time for charities. Americans are a generous people, but many charities are still recovering from the past several years when charitable giving has been flat and even decreased for many organizations.

At the same time, we understand that your committee seeks to gather information on the size, scope and impact on the economy of the nonprofit sector; the need for congressional oversight; IRS oversight of the sector; and what the IRS is doing to improve compliance by the sector with the law. These are laudable objectives. We are interested in assisting the committee in identifying appropriate areas for further study as well as criteria and standards to better define and outline the sector and its players.

Again, I urge you to oppose changes to the in-kind contribution rules as well as any unreasonable and burdensome legislation that would harm the charitable sector. I very much appreciate your support.

Thank you for your consideration.

Sincerely,

Michael P. Marsh, CFRE  
*Vice President, Development and Public Relations*

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International Community Association  
San Diego, 92121  
May 5, 2005

Chairman Bill Thomas  
Committee on Ways & Means  
U.S. House of Representatives  
1102 Longworth House Office Building  
Washington D.C. 20515

On behalf of the International Community Foundation (ICF) and our Board of Governors, I am calling attention to the fact that the Senate Finance Committee staff had recommended that no grants from donor advised funds to foreign organizations be permitted unless the foreign organization is on a list specifically approved by the IRS. Here, ICF concurs with your Panel's recommendation that no special rules be created specific to international grants through donor advised funds.

ICF believes that an approved IRS list of foreign nonprofits will be difficult and costly to effectively administer. Without clear multi-lingual guidelines on how a foreign nonprofit can get listed, otherwise worthy groups could be precluded from receiving support leading to a potential chilling effect in overseas grantmaking by U.S. public charities at a time when there is a need for expanded goodwill initiatives originating from our country overseas. Yet, according to USA Giving, in 2002 international giving amounted to less than 1.9% of total charitable gifts. Of this amount, less than \$843 million in grants were made to overseas nonprofits.

It is the opinion of ICF that so long as public charities engaged in international giving through donor advised funds provide full public accountability and disclosure, ensure good governance and undertake the proper due diligence and controls with their overseas grantmaking (including pre-grant evaluations, site visits and follow up reporting), the current IRS requirements are more than satisfactory. As your report recommends, to the extent that current law does not provide adequate safeguards against potential abuses in overseas grantmaking, such abuses can be specifically targeted through rules applicable to all charities.

If your Panel has specific questions about ICF's views on your full report or would like additional clarification on our foundation's position specific to proposed changes in rules for grants to foreign grantees, we would welcome the opportunity to speak to you in person.

Sincerely,

Richard Kiy  
*President & CEO*

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**Statement of John McCarthy, International Health, Racquet & Sports Club Association**

This is in response to your request for statements at the April 20 Committee hearing regarding an Overview of the Tax-Exempt Sector. IHRSA is the business

association representing the nation's 6,000 private fitness club entrepreneurs. Our members employ more than 100,000 workers and provide a needed service to our communities and clients, all the more important given a new awareness of the public health and economic costs of obesity and poor physical condition.

IHRSA members are largely small businesses, and are proud of their ability to compete and provide service demanded by our clients. However, it is clear that for many of our members their, major competitors are operating under a different set of competitive factors due to tax competition. When tax exempt facilities provide adult fitness services, they are clearly competing in a commercial arena with tax-paying small-businesses. We want to be clear. There is plenty of room for competition, and we salute those exempt providers who truly serve their entire community across geographic, age and income categories. But we clearly see the inadequacy of the current tax exempt legal, reporting and enforcement structure. It does not assure that such competition from tax exempt providers is fair or consistent with their exempt purposes. A tax exemption is a privilege, not a right, and does not include a license to compete in commercial markets.

IHRSA regularly meets with state tax and Internal Revenue Service officials on these issues. Their response, particularly in recent years, has been consistent—they are highly sympathetic with our concerns but are hard pressed to address the situation due to limited enforcement resources and guidelines.

IHRSA congratulates the Ways and Means Committee for its review of the basic policy issues behind tax exemption. Whatever the original justification of some of our largest exempt organizations, it cannot be denied that in the current hyper-competitive business environment, the distinctions between the services offered by certain exempt organizations and our fully taxed proprietary small business members are barely noticeable. As appears to be the case in some other service sectors, tax-exempt providers of adult fitness services too often appear to be, in the phrase of the Congressional Budget Office's statement at this hearing, simply part of "the untaxed business sector."

IHRSA strongly endorses your call for additional Ways and Means Committee hearings to look into basic issues underlying the rationale for tax exemptions. The law today, largely unchanged in several generations, may not be adequate to appropriately treat, to use a charitable term, the clearly very mixed commercial and public activities pursued by highly competitive exempt organizations.

In addition to hearings looking into fundamental issues regarding the rationale for tax exemption, we would like to suggest the Ways and Means Committee take three actions, which would advance progress on this difficult issue.

1. The Committee should hold oversight hearings focused on unfair competition by tax exempt organizations with commercial businesses, and particularly in the provision of adult fitness services.
2. The Committee should encourage the IRS to immediately adjust 990 reporting forms to elicit more specific information about the actual use by all elements of the local community of exempt organizations' adult fitness services.
3. The Committee should support enhanced enforcement capability for IRS and a prioritization of commercial competition problems.

IHRSA stands ready to support the Committee in these efforts and appreciates your interest in these key tax issues.

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#### Statement of Barbara R. Levy

As a member of the Association of Fundraising Professionals and a thirty plus year fundraiser, I am alarmed at the proposal to eliminate the deduction of non-cash contributions to charity. For so many charities, this proposal would slash income drastically. It has the potential of causing some charitable organizations to close their doors. Congress has done enough to make life difficult for the not-for-profit sector, please don't make this "the last straw."

Instead, Congress should support every aspect of the non profit sector as they are fulfilling the services that many governments offer their citizens. With education budgets and medical coverage being slashed, let's give our tax paying citizens an opportunity to help themselves and their communities through charitable acts.

Let the IRS scrutinize tax returns a bit more carefully and collectively help the nation and the taxpayers.

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**Statement of Brad Thaler, The National Association of Federal Credit Unions**

***Introduction***

Chairman Thomas, Ranking Member Rangel and Members of the Committee, the National Association of Federal Credit Unions (NAFCU), the only national trade association that exclusively represents the interests of our nation's federal credit unions, appreciates this opportunity to submit comments for the record of today's hearing which is an overview of the tax-exempt sector. NAFCU represents approximately 800 federal credit unions—financial cooperatives from across the nation—that collectively hold approximately 66 percent of total federal credit union assets and serve the financial needs of approximately 26 million individual credit union members.

The universe of tax-exempt entities is very large; there are over 1.8 million federal income tax-exempt organizations, not including churches and religious organizations, under § 501(c) of the Internal Revenue Code. Credit unions constitute a very small portion of that universe of federal income tax exempt organizations. In fact, our nation's approximately 9,000 credit unions account for merely one-half of one percent of all federal income tax-exempt organizations. Yet while small in number, credit unions play an important role in directly serving their members, and ultimately in indirectly benefiting the American public since studies have shown that the presence of credit unions benefits not only credit union members but all Americans who use federally-insured depository institutions.

NAFCU would like to take this opportunity to emphasize this point to the members of the Committee: the credit union federal income tax exemption benefits not just credit unions and their members, but all who have savings in any regulated depository institution. Credit union critics have erroneously claimed that some credit unions today are no different than banks and thus should forfeit their federal income tax exempt status. Such claims simply do not stand up to close scrutiny. While credit unions—like all financial service providers—have evolved and grown over the years to meet the changing financial services needs of their members, the basic structure, philosophy and guiding principles of credit unions remain the same today as when the federal income tax exemption was granted to credit unions in 1937. Congress reaffirmed this fact just seven years ago, when as part of Section 4 of the "Findings" contained in the *Credit Union Membership Access Act* (P.L. 105-219) Congress declared that:

"Credit unions, unlike many other participants in the financial services market, are exempt from Federal and most State taxes because they are member-owned, democratically operated, not-for-profit organizations generally managed by volunteer boards of directors and because they have the specific mission of meeting the credit and savings needs of consumers, especially persons of modest means."

As part of that legislation, the Treasury Department was asked to examine credit unions and their role in the financial services marketplace, including "the potential effects of the application of Federal laws, including Federal tax laws, on credit unions in the same manner as those laws are applied to other federally insured financial institutions." The Treasury Report (*Comparing Credit Unions with Other Depository Institutions*, U.S. Department of Treasury, January 2001) found that credit unions were, indeed, serving their purpose and that there was no reason—or recommendation—to remove the federal income tax exemption from credit unions. This position was supported by then candidate and now President George W. Bush in 2000, when he stated ". . . as part of my overall commitment to lower taxes and provide more opportunities for working Americans, I support continuing the tax-exempt status of credit unions". During the 2004 campaign, President George W. Bush reiterated that position when he noted that "I support strongly the tax-exempt status of credit unions and will continue to highlight the important contributions that credit unions make to our financial system." Treasury Secretary John Snow recently told a credit union audience "We oppose this talk of taxation of you and your industry—it's a truism I think in economics, you always get less of anything you tax. Well, we don't want to get less of what you do." Reflecting the bipartisan nature of this issue, in also supporting the credit union federal income tax exemption, 2004 Democratic presidential nominee John Kerry wrote to NAFCU that ". . . I want you to know that I will continue to support America's credit unions and oppose any efforts to change the existing tax-exempt status of credit unions."

***Bankers Myths vs. The Credit Union Reality***

Some critics of credit unions would have you believe that credit unions pay no taxes at all. That is false. Credit unions still pay many taxes and fees, among them payroll and property taxes, but Congress has determined that federal income tax-

ation of member-owned shares in a credit union would put a “disproportionate and excessive” burden on credit unions due to their nature.

Other critics of credit unions would have you believe that credit unions are growing bigger and bigger and really are no different than banks, which pay corporate income taxes. Again, that is false. The defining characteristics of a credit union, no matter what the size, remain the same today as they did in 1937: credit unions are not-for-profit cooperatives that serve defined fields of membership, generally have volunteer boards of directors and cannot issue capital stock. They are restricted in where they can invest their members’ deposits and are subject to stringent capital requirements. A credit union’s shareholders are its members (and each member has one vote, regardless of the amount on deposit), while a bank has stockholders.

While credit unions have grown, like all financial institutions, over the years, they are quite tiny when compared to banks. Federally insured credit unions had \$647 billion in assets as of December 31, 2004, while FDIC-insured institutions held over \$10.1 trillion in assets, and last year Federal Deposit Insurance Corporation (FDIC)-insured institutions grew by an amount exceeding the *total* assets of all credit unions combined. The world’s largest credit union, with just over \$22.9 billion in assets, is dwarfed by the nation’s largest bank with over \$967 billion in assets. Although banks claim there is “competition” from credit unions, banks continue to see record profits quarter after quarter. According to Federal Reserve Board statistics, the credit union share of total household assets is extremely small, just 1.4 percent as of December 31, 2004 (the same percentage of household assets that credit unions had in December of 1980). Banks, on the other hand, accounted for 18.7 percent of household assets as of December 31, 2004.

Furthermore, while banks continue to attack the credit union federal income tax exemption, the number of banks that pay no corporate federal income tax at the corporate level continues to rise through increases in the number of banks organized as Subchapter S corporations and through the utilization of other tax avoidance measures. According to NAFCU’s analysis of FDIC call report data, *as of December 31, 2004, nearly 20% of all FDIC-insured institutions paid no federal corporate income tax*. These 1,771 FDIC-insured institutions not only account for nearly 20% of all FDIC-insured institutions; they collectively hold over \$286 billion in total assets, or more than 44% of the total assets of all federally-insured credit unions combined. Of these 1,771 FDIC-insured institutions that paid no corporate federal income tax, 693 of them (ranging in size up to \$18.4 billion) were not Subchapter S corporations.

#### ***The Credit Union Income Tax Exemption Benefits Everyone***

Consumer advocates have also recognized and supported the federal income tax exemption of credit unions. In the fall of 2003 the Consumer Federation of American (CFA) examined the federal income tax status of credit unions and reaffirmed these points in a study entitled “Credit Unions in a 21st Century Financial Marketplace”. In the study CFA concluded, among other things, that:

- The benefits that credit unions deliver to the public far exceed the costs, as measured by the tax exemption, through lower cost services and paying higher interest rates; and,
- The value of tax breaks enjoyed by banks is “far greater, in absolute and relative terms, than the value of the credit union tax exemption.”

Furthermore, even bankers have admitted that credit unions’ influence in the market has led them to better serve their customers. An article in the January 31, 2005 issue of the *American Banker* newspaper entitled “Feeling Heat from Deposit Competition” reported that “Zions Bancorp [of Salt Lake City, Utah] was one of the many large regional banks that while making record profits for the 4th quarter of 2004 and for the calendar year, gave in to deposit pricing pressure in the fourth quarter [of 2004].” The article continued: “Zions said pressure from other banks and specifically credit unions in Utah prompted it to raise rates on money market accounts by 20 basis points late in the fourth quarter.”

A September 2004 report and analysis by Robert M. Feinberg, Professor of Economics at American University, entitled “An Analysis of the Benefits of Credit Unions to Bank Loan Customers” found that “the presence of a substantial credit union presence in local consumer lending markets has a significant impact on U.S. bank loan customers, saving them at least \$1.73 billion per year in interest payments.” A January 2005 study by Robert J. Tokle, Professor of Economics at Idaho State University, entitled “An Estimate of the Influence of Credit Unions on Bank CD and Money Market Deposits in the U.S.” estimated that *bank* customers benefit to the tune of \$2.0 to \$2.5 billion annually in just interest on deposits due to the presence of credit unions. The credit union federal income tax exemption, therefore, does not just benefit credit unions and their members, but each and every American who uses a federally-insured depository institution.

The loss of the federal tax exemption would seriously threaten the fundamental nature of not-for-profit credit unions and significantly change the role that they play in the consumer financial services marketplace. Almost all federally insured credit unions must build their capital reserves through retained earnings, and all are prohibited from accessing the open capital markets by law. As noted by former NCUA Chairman Dennis Dollar in a letter to The Honorable Sheryl Allen (a member of the Utah State House of Representatives) regarding potential safety and soundness implications from the taxation of credit unions in that state: ". . . it is certain that any resulting net worth considerations that might arise (from taxation) could indeed become a significant issue . . . [as a result of] credit unions having their retained earnings negatively impacted [by taxation]." Furthermore, because of their structure, any taxes imposed on credit unions would be passed directly to their members in the form of lower savings rates, higher borrowing rates and/or higher fees—in essence a tax increase on America's 85 million credit union members. Finally, credit unions boards and management would be driven to make decisions in a manner similar to banks, with the end result being a decision-making process driven by tax considerations or other issues rather than what is in the best interest of members. As a result, a very unfortunate consequence could be a shift in orientation to profit-motivated interests, instead of providing low-cost financial services to member-owners.

#### **Conclusion**

In summary, the basic structure, philosophy and guiding principles for credit unions, large and small, remains the same today as it was in 1937; i.e., they continue to be member-owned, democratically-controlled, not-for-profit organizations generally managed by volunteer boards of directors with the mission of meeting the credit and savings needs of consumers, especially persons of modest means. Thus, we believe there is more than ample justification for continuing the federal income tax exemption for all credit unions, regardless of size, charter type, field of membership or services offered.

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#### **Statement of Mary Martha Fortney, National Association of State Credit Union Supervisors**

The National Association of State Credit Union Supervisors (NASCUS) is a professional association representing the forty-eight (48) state and territorial regulatory agencies that supervise the nation's more than 4,000 state-chartered credit unions. NASCUS has been committed to enhancing state credit union supervision and advocating for a safe and sound state credit union system since its inception in 1965. NASCUS is the sole organization dedicated exclusively to the promotion of the dual chartering system and advancing the autonomy and expertise of state credit union regulatory agencies. NASCUS appreciates the opportunity to provide a submission for the record to the House Committee on Ways and Means Hearing on *An Overview of the Tax-Exempt Sector*.

NASCUS understands and respects that it is not the position of state regulators to set tax policy. Tax policy is rightfully a concern for our elected officials, both state and federal. NASCUS does believe, however, that our elected officials must have access to accurate information to develop sound public policy.

#### **State and Federally Chartered Credit Union Taxation Explained**

NASCUS wants to clarify the tax treatment of state-chartered and federally chartered credit unions. Under our current tax system, state-chartered credit unions are taxed differently than federal credit unions. Section 501(c)(1) of the Internal Revenue Code grants federal credit unions their tax exemption, while state credit unions are exempted under Section 501(c)(14).

In his written testimony, the Honorable Sheldon Cohen, Partner, Morgan, Lewis and Bockius, and Commissioner, Internal Revenue Services from 1965—1969, distinguishes the difference between Section 501(c)(1) and Section 501(c)(14) of the Internal Revenue Code, noting that credit unions receive their tax exemption under one of these sections. He explains that a Section 501(c)(1) designation exempts federal instrumentalities from federal taxes and notes that a Section 501(c)(1) designation is preferable for credit unions because the IRS has taken an audit position that Section 501(c)(1) entities are tax exempt. State-chartered credit unions are taxed according to state law and do not enjoy the totally exempt status as their likewise non-profit federally chartered credit unions.

***Current tax policy threatens the credit union dual chartering system***

As the association representing state credit union regulators, our concern with federal tax policy is that state and federal charters are treated fairly, so an unintended tax advantage is not provided for either state or federally chartered credit unions in our nation's tax policy.

Together, the Federal Credit Union Act, the Internal Revenue Code and case law grant federal credit unions a broad tax exemption as instrumentalities of the federal government. State credit unions are provided a federal exemption under Section 501 (c)(14) of the Internal Revenue Code and various state statutes mandate when and whether state-chartered credit unions are taxed.

As Mr. Cohen references in his testimony, for tax purposes, it is preferable for credit unions to be designated as Section 501 (c)(1) organizations. NASCUS does not want the tax burden on any credit unions increased. But treating credit unions differently for tax purposes solely based on their charter is simply wrong, and continues to threaten the dual chartering system we so highly value in America.

***NASCUS Advocates Fairness in the Tax System***

NASCUS does not advocate any new taxes for credit unions—whether they are state or federally chartered. However, they should receive the same tax treatment; both state and federally chartered credit unions should be tax-exempt.

NASCUS does not believe that it was ever the intent of Congress to benefit, via preferential tax treatment, one charter over another charter for like institutions. Congress recognized the cooperative nature of credit unions and approved their tax-exempt status in 1934 when it voted to approve the Federal Credit Union Act. President Roosevelt signed the Act and it became law. Congress has never wavered in its position that credit unions should be tax exempt. Further, President Bush's Administration has publicly acknowledged its support of credit unions' tax-exempt status.

NASCUS supports equal treatment of the state and federal credit union charter regarding federal tax policy. State credit unions should be granted the same tax exemptions as their federal counterparts. State and federal credit unions provide the same due solely to their choice of charter.

NASCUS is pleased to have the opportunity to submit written testimony to the House Ways and Means Committee regarding the *Overview of the Tax-Exempt Sector* Hearing. We appreciate your time studying our concerns; we are available for dialogue or to answer questions.

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**Statement of Rick Cohen and Jeff Krehely, National Committee for Responsive Philanthropy**

**“Reforming the United States Philanthropic Sector”**

The National Committee for Responsive Philanthropy (NCRP) has long advocated for significantly improving philanthropic accountability and responsiveness and the means for providing necessary government oversight and enforcement. It is insufficient to call for stronger oversight and enforcement of the standards of philanthropic accountability if the standards are inadequate or completely missing. This statement outlines the elements of philanthropic accountability that should be the basis for both public policy and foundation self-regulation to create a truly responsive and accountable philanthropic sector.

For several years, the media have regularly uncovered and reported on egregious instances of abuse and mismanagement in the nation's private foundations and other tax-exempt institutions. Leaders of the nonprofit and philanthropic sectors' leaders have responded to these scandals and the resulting increased public scrutiny in a very defensive and self-interested fashion. Often, self-regulation is the suggested remedy to these ethical and illegal ills. In other cases, the suggested solutions to these problems involve minor mechanical changes to current oversight efforts. Based on NCRP's perspective—as well as the sheer size and diverse scope of the nonprofit and philanthropic sectors—such a response is wholly inadequate and would do little to clean up current abuses, prevent future abuses, or restore public faith in the sectors.

It is time to recommend comprehensive reforms to bring new standards of public and private accountability to the approximately 70,000 private foundations that control \$500 billion in philanthropic assets in the United States today.<sup>1</sup> Independent research estimates that at least 45 percent of those \$500 billion belong to the Amer-

trol \$500 billion in philanthropic assets in the United States today.<sup>1</sup> Independent research estimates that at least 45 percent of those \$500 billion belong to the American public, having been accumulated thanks to various tax breaks that foundations receive at their inception and throughout their institutional lives.<sup>2</sup>

Speaking of the American people, public trust in the nation's charities and foundations is at historically low levels. They have read the news stories about scandals in philanthropy, and they have concluded what most of the media and many lawmakers—but only a few leaders of philanthropy—have as well: It's time for change. The current laws and regulations pertaining to foundations were established more than 30 years ago, when the philanthropic sector was much smaller, both in numbers and dollars. In the last ten years alone, the number of foundations has doubled and their assets have more than tripled.

The U.S. Congress has a responsibility and obligation to pass new, better laws to regulate private philanthropy. Because foundations wield so much financial power and influence over their grantee organizations—which know foundations the best—calls for reform will not be coming from the nonprofit sector. And the public has no say in who sits on foundation boards of directors, so there are no outside share—or stakeholders to bring foundations into line. The government, therefore, must step in and take action. No other entity has the authority, integrity, or courage to do so.

This statement will provide concrete suggestions for reform of the nation's philanthropic sector. Foundation leaders will be unhappy with many of them, but this statement was crafted not to please the philanthropic elite, but to bring a sense of democratic and fair governance and oversight to billions of dollars that are not living up to their legal mandates or ethical obligations.

The suggestions are organized into three broad areas:

- Maximizing foundation accountability and transparency
- Maximizing foundation support for nonprofits
- Maximizing foundation support for justice and democracy

These suggestions were drafted based on NCRP's observation of and research on current deficiencies among the nation's foundations, as well as comments from our organizational members and board of directors.

It is an honor and privilege to offer this statement to the United States House of Representatives Ways and Means Committee. They are offered in the hopes of aiding the Committee's efforts to bring about a new era of reform and transparency for the United States philanthropic sector.

#### **Maximizing Foundation Accountability and Transparency**

- *Use the foundation excise tax:* Reduce and consolidate the private foundation investment excise tax to 1% of investment income and devote the bulk of the tax payment to IRS and state government oversight of nonprofits and foundations—as the foundation excise tax was originally intended to be used when first enacted. The remainder can and should be used to supplement government oversight through grants for nonprofit activities such as research and data collection on the nonprofit sector, nonprofit accountability standard setting, and special investigations.

NCRP's legislative proposal for making the foundation excise tax a tool for a more accountable philanthropic sector includes the following:

1. Reduce the foundation tax to a simplified, consolidated 1 percent of private foundation investment income, but require that the money that foundations "save" from the tax reduction go to nonprofit organizations in the form of grants—as opposed to being used by foundations to increase foundation executives' salaries, foundation trustees' compensation, and other expenses.
2. Dedicate 20 percent of the remaining excise tax to more than double the budget of the Tax Exempt/Government Entities division of the Internal Revenue Service from its current budget of less than \$60 million to approximately \$130 million, enabling it to more effectively oversee and audit private foundations, public grantmaking foundations, donor advised funds, and other philanthropic grantmaking mechanisms, as well as nonprofits in general, to weed out the more than a few bad apples currently undermining the accountability of philanthropy and charity.

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<sup>1</sup> Significantly more organizations, perhaps as many as 100,000, are counted as private foundations with the IRS, but we estimate that a third or so are actually public charities that failed to meet their public support test.

<sup>2</sup> Mark Dowie. *American Foundations: An Investigative History*. Cambridge: MIT Press, 2002.

3. Dedicate 40 percent of the remaining excise tax to create a fund of \$140 million, which the Commissioner of the Internal Revenue Service (IRS) can use to supplement the charity investigative and oversight arms of state attorneys-general offices.
4. Allocate 15 percent (or approximately \$50 million) of the remaining excise tax for the IRS Commissioner to grant to nonprofit organizations whose research, ratings, and evaluation efforts complement and augment the oversight functions of federal and state agencies.
5. Use another 15 percent of the excise tax for the generation of IRS statistics on the finances of foundations and charities comparable with the research IRS generates on other sectors of the economy.
6. Reserve the remainder of the excise tax revenues to support special initiatives of the Tax Exempt/Governmental Enterprises division of IRS and for additional research and data collection and dissemination.

The private foundation excise tax, originally set at 4 percent of foundation investment income when enacted in 1969, was intended to pay for IRS costs of overseeing tax-exempt organizations. Had the reduction of the foundation excise tax been enacted to start in 2004, \$144 million would have been potentially freed up for grantmaking in the first year and nearly \$200 million in the second year.

Oversight and enforcement of the nonprofit sector has changed since 1969, when Congress last implemented broad changes to rules pertaining to nonprofits and foundations. The responsibility is no longer just that of the Internal Revenue Service's Tax Exempt Division, but also the charity oversight offices of states attorneys-general, few of which were on the radar screen 35 years ago; their on-the-ground roles in monitoring foundations and nonprofits overall should be supported by the excise tax whose primary purpose was meant to bolster foundation and nonprofit accountability.

Bolstering philanthropic oversight is crucial, given the explosive growth in the number of private foundations, plus other kinds of grantmaking charities, while IRS audits of foundations plunged from 1,200 in 1990 to less than 200 in 1999 and considerably less today.

- *Improve IRS forms 990PF and 990:* The 990 needs to be radically overhauled to reveal important information about foundations (and public charities) for necessary review and oversight; foundations and nonprofits should be able to e-file; and there should be significant penalties for foundations that do not file their 990PFs on a timely basis. All publicly disclosed data should be available in a free, publicly accessible and searchable format.

Some of the recommendations below—such as disclosure of insider relationships between foundations and outside vendors providing services for hire—can be implemented through changes to the IRS Forms 990PF and 990. Institutions filing these forms should also be regularly required to state ***in specific terms*** how their grantmaking and/or programmatic activities further their tax-exempt purposes.

- *Increase disclosure of corporate philanthropy:* The bulk of corporate giving to nonprofits is not disclosed to the public due to the privacy of corporate tax returns and the unwillingness of the SEC to demand disclosure. The recent trajectory of corporate abuses including philanthropic misbehavior makes the need for enhanced disclosure clear.

Corporations undoubtedly have a variety of motives for giving to charity. Tax breaks, positive publicity, and a genuine concern for the public good could all encourage a company to donate its money, time, products, or services to charity. In more sinister cases, corporate charitable gifts could also be used as bribes to encourage corporate directors to overlook financial improprieties, as in the case of Enron.

Corporations receive significant tax breaks for their giving—the money that they donate is in a sense “public,” since it is actually lost tax revenue for the government and the general public. Further, whether or not it is a motivation for giving, being seen as a good corporate citizen undoubtedly helps a company’s bottom-line. For example, in 1999 Philip Morris spent \$75 million on charitable contributions, and \$100 million to publicize these donations.<sup>3</sup> Corporate philanthropy, then, can be viewed in many cases as government subsidized advertising for for-profit corporations. Further, there is evidence that corporate philanthropy is being used to per-

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<sup>3</sup> Michael E. Porter and Mark R. Kramer. “The Competitive Advantage of Corporate Philanthropy.” *Harvard Business Review*, 2002.

petrate and perpetuate scandals in corporate America—to the eventual detriment of shareholders, nonprofits, and citizens alike.

For these reasons, NCRP recommends that the SEC adopt disclosure requirements for all corporate philanthropic donations—in-kind or cash, through a foundation or directly from the corporation. The amount donated, as well as the recipient of the funds, needs to be made public through paper and electronic means on an annual basis. Such a policy would help restore some faith in corporate America, as well as the recipients of its charity. It would also allow researchers and advocates to understand a significant piece of US private giving and work to make it more fair and responsive to the country's neediest and most disadvantaged citizens.

- *Disclose grantmaking by public charities:* Private foundations are not the only charitable grantmakers. While some public charities such as community foundations routinely and completely disclose their grantmaking, the grantmaking disclosure performance of public charities overall is spotty. The public deserves to know who receives how much of charitable grantmaking whether from public or private charities.

Current IRS regulations for both public charities and private foundations require the public disclosure—on IRS Form 990 or 990-PF—of grantees (including the organization's name and full contact information), specific purposes of grants made, and potential conflicts of interest. Based on our use of literally thousands of these documents for various research projects, only one foundation comes to mind that follows these requirements. More often than not, the only information offered is the name of the grantee organization and the grant amount. Contact information, a specific (or even general) description of how the money will be used, and conflict of interest information are rarely, if ever, provided.

- *Disclose the grantmaking from donor-advised funds:* Donor-advised funds (DAFs) are increasing rapidly, but there is virtually no disclosure of their grantmaking, much less oversight of their philanthropic probity. At a minimum, a comprehensive regime of DAF disclosure should be established.

In 2003 alone, nearly 70,000 new DAFs were established, according to the *Chronicle of Philanthropy*.<sup>4</sup> A private financial adviser has set up a website ([www.donoradvisedfunds.com](http://www.donoradvisedfunds.com)) to educate potential clients why they should set up DAFs instead of private foundations. According to this website: "Starting a private foundation can involve substantial start up costs and administrative expenses, such as the yearly filing of a Form 990-PF. But one of the most important differences is that Donor Advised Funds receive more favorable tax treatment than a private foundation. Donor Advised Funds allow donors to take a federal income tax deduction up to 50% of adjusted gross income (AGI) for cash contributions and up to 30% of adjusted gross income (AGI) for appreciated securities; versus 30% of AGI for cash contributions and 20% of AGI for appreciated securities for a private foundation. Donor Advised Funds also offer the ability to recommend grants anonymously, if desired."

Another perk, this site points out, is that donors get all of these tax breaks, but do not have to make grants to any charitable organizations anytime soon—while the funds continue to grow. But it is recommended, however, that a DAF make a minimum grant contribution of \$250 annually.

If donors want to continue to receive significant tax breaks for "giving" through DAFs, then they must be held accountable in radically new ways. At a minimum, DAFs should have the same disclosure requirements that public charities and private foundations have, and they should be required to pay out at least 6 percent of their financial holdings annually to charities.

- *Disclose all insider relationships with foundation vendors:* Foundations only list a small number of their outside vendors providing accounting, investment, consulting, and other services, without any obligation to identify which are related to foundation trustees or officers. Disclosure of vendors should include all firms with business relationships with foundation insiders, piercing the "doing business as" shield some insider vendors currently hide behind.

Stronger definitions of and restrictions against foundation trustee self-dealing also should be implemented, especially a standard that eliminates the practice of investing foundation assets through foundation trustees' firms or funds. The Bielfeldt Foundation, in Peoria, Illinois, paid nearly millions of dollars to three members of the Bielfeldt family for investment services. The foundation's assets were invested

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<sup>4</sup> Leah Kerkman and Nicole Lewis. "Donor Funds Are on the Rise Again." *The Chronicle of Philanthropy*, May 27, 2004.

in risky commodities futures trading, resulting in a 64 percent loss in value in just two years. These types of services should be outsourced on a competitive basis to companies that are qualified to invest what are largely public dollars.

- *Don't count foundation CEO and staff salaries in foundation payout:* NCRP continues to advocate that foundation salaries and other foundation administrative expenses should be removed from calculations of qualifying distributions (payout). Removing administrative costs from foundation payout—while maintaining or increasing the required foundation payout rate—will result in more grant dollars going to nonprofits and provide funders with incentive to be more efficient when spending money on themselves as opposed to their grantees. NCRP does not advocate that there should be specific limits or caps on the salaries of foundation executive directors or staff, but that foundation trustees should review executives' salaries very carefully and include in their calculations pensions, stock options, and other perks. In addition, foundations should disclose the total compensation paid—including benefits, severance packages, and other payments—to senior staff members.

According to NCRP analyses of IRS data on private foundations, in 2000 \$2.5 billion in foundation administrative expenses were included in their payout calculations. On average, throughout the 1990s, each year nearly half of these payout-related administrative expenses—44 percent—was used for foundation executive, board of trustee, and staff salaries and related benefits. As a matter of principle, foundations should not be allowed to count a \$1 million severance package to an outgoing CEO as the legal and financial equivalent of a \$1 million grant to a nonprofit organization. Foundations receive tax breaks in exchange for their charitable purpose, which is to get their assets into the hands of nonprofit organizations. The constitution of foundation payout should reflect this legal reality.

- *Limit foundation trustees' compensation:* In nearly all cases, foundation trustees should not be compensated for their board service. If trustee compensation is deemed necessary, NCRP calls for limiting compensation or fees for foundation trustees (not including reimbursement for reasonable travel and incidental expenses) to no more than \$8,000 per year from all sources (i.e., not only fees, but also compensation through contracts for services such as legal, accounting, and investment functions). Like salaries and other administrative costs, foundation trustee fees should be removed from foundations' qualifying distributions.

If a public charity paid its board members, most foundations would probably not even consider it for a grant. Ideally, all board service in the nonprofit sector should be thought of as volunteer work, not as a highly paid part-time job. And many board positions are highly paid. A study from the Center for Effective Philanthropy, for example, found that the median hourly compensation rate of foundation board trustees in its research sample was \$324.<sup>5</sup>

Ideally these rates should be reduced to a maximum of \$8,000 per trustee per year, and such payments should not count toward a foundation's annual grants payout.

- *Promote foundation diversity:* Despite some progress, the diversity of the philanthropic sector still needs improvement. Racial, ethnic, gender, and class diversity should be addressed and increased, particularly among private foundation board members who are still overwhelmingly white, male, and upper class. Information on the diversity of foundation board members, senior staff members, professional staff, and other staff should be publicly disclosed.

A semi-regular survey from the Council on Foundations tracks the racial and gender diversity of foundation board members. In 1982, 77 percent of all foundation board members in the survey were men. By 2002, some erosion of the gender divide occurred, but not much, with men representing 65 percent of all foundation board members. Similarly, in 1982, 96 percent of all board members in the survey were white, which fell to 89 percent in 2002.

Because foundations are using largely public dollars and many claim to serve minority and other disenfranchised populations, it makes sense that foundation staff and board members should reflect the citizens of the United States—or, at the very least, the communities the foundations strive to serve—in racial, gender, ethnic, and class terms.

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<sup>5</sup>The Center for Effective Philanthropy. *Effective Governance: The CEO Viewpoint*. 2004.

### **Maximizing Foundation Support for Nonprofits**

- *Emphasize core operating support grantmaking:* NCRP maintains that at least half of foundation grant dollars should be in the form of core operating support or flexible grants as opposed to restrictive, program—or project-specific grants. NCRP's research indicates that giving nonprofits flexible, unrestricted grant support leads to stronger organizations, better support for the communities they serve, and improved relationships between grantors and grantees. Unlike foundations, nonprofits cannot simply give themselves grants to cover their core administrative costs. Additionally, in program or project support, the full cost of nonprofits' reasonable related administrative or "indirect" expenditures should be included in the foundations' grants.
- *Increase foundation grants payout:* NCRP reaffirms its longstanding position that private foundation spending, or payout, should be a minimum of 6 percent annually, with all administrative and operating expenses excluded from the payout and qualifying distributions calculations.

Right now, private foundations are required to pay out 5 percent of their assets each year. Again, this 5 percent currently includes foundation overhead expenses, as well as grants to nonprofit organizations and program related investments. Many foundations pay out exactly 5 percent each year, effectively turning the 5 percent floor into a 5 percent ceiling. IRS data show that smaller foundations tend to exceed the 5 percent minimum much more frequently than larger foundations; smaller foundations also tend to have little—and in some cases, no—overhead costs.

Interestingly, the foundations with the most overhead costs tend to also have the lowest payout rates, even when taking overhead costs into consideration. For example, the IRS analyzed the payout rates of the 50 largest foundations from 1985–1997, and found that only thirteen actually met or exceeded 5 percent. The other 37 foundations fall short of this legal requirement, sometimes by more than one full percentage point. Looking at the ratio of grants to assets, only four of these top 50 foundations met or exceeded 5 percent in 1997.

Many foundation leaders oppose increasing the foundation payout rate because they claim that any rate above the current 5 percent increases their minimum spending requirement to a level that is not sustainable, effectively drawing down foundation assets to nothing.

Most research on payout and returns on investments do not, however, substantiate the claims that these individuals have made. For example:

- Research that the Council on Foundations commissioned shows that foundations could have maintained a 6.5 percent payout rate from 1950 to 1998 and would have still increased their assets by 24 percent.
- A study conducted at Harvard University on the investment returns of 200 of the nation's largest foundations found that they earned an average return of 7.62 percent, while paying out an average of only 4.97 percent.
- US Bancorp's Piper Jaffrey who presented at a recent meeting of Northern California Grantmakers found that an investment portfolio made up of 70 percent equity stocks and 30 percent government bonds earned nearly an inflation-adjusted 8 percent return from January 1980 through December 2002.
- Lincoln Investment Planning, Inc. reports that the S&P 500 earned an average annual return of 10.2 percent from 1926 through December 2002. Investments in small stock companies yielded an average return of 12.2 percent for the same period.

Further, IRS data show that many foundations annually receive new infusions of money beyond returns on investments, including new contributions from individuals and profits from real estate holdings. Assuming that the only source of revenue for foundations is returns on investments simply does not reflect the reality of the philanthropic sector. And considering that the foundation sector has more than quadrupled in size over the past 25 to 30 years, it is mathematically impossible that a one or two percent increase in foundation payout would drain foundation assets and bankrupt the sector.

*Establish foundation-comparable donor-advised fund payout requirements:* There is currently no payout minimum for donor-advised funds. There should be a minimum grants payout from donor-advised funds, established at a 6% level comparable to the payout rate that should be required of foundations. Considering the substantial tax breaks that DAFs receive—and their recent proliferation—they must be required to provide some minimal return to society, as everyone is impacted by the lost tax revenue from these charitable vehicles.

- *Promote philanthropic support for social equity:* Foundations need to better address the needs of disadvantaged and disenfranchised populations—and the

nonprofits that serve them. Toward that end, there should be more foundation grantmaking devoted to social justice organizing and advocacy, significantly higher proportions of grantmaking devoted to racial/ethnic minorities, low-income populations, immigrant populations, the disabled, gay/lesbian/bisexual/transgender communities, and a willingness to make grants to smaller organizations as opposed to the current propensity of many foundations to make only a few large grants to a small number of large nonprofit recipients.

In 2002, civil rights and social action nonprofit organizations received only 1.7 percent of all foundation grant dollars. Minority populations in general are underserved by foundations. Grants designated for African Americans/Blacks amounted to only 1.9 percent of all grant dollars in 2002; for Hispanics/Latinos the figure was 1.1 percent; for the disabled, 2.9 percent; the homeless, 1 percent; single parents 0.1 percent; and gays and lesbians, 0.1 percent. These are the groups of people who have been hardest hit by discrimination in society, and they are entitled to receiving a greater share of philanthropic dollars.<sup>6</sup>

Despite the fact that the overwhelming majority of nonprofit organizations in the United States are financially small institutions, nearly half of all foundation grant dollars was given out in grants that were larger than \$1 million in 2002. Only 18 percent of all grant dollars were given through grants that were smaller than \$100,000. These data suggest that foundations are not supporting the countless small, community-based organizations that the nation's most disadvantaged communities and populations depend on for critical human services and political representation.

- *Maintain and support small foundations:* While some very small foundations may very well be economically impractical, NCRP does not believe that small foundations are any less accountable or probative than large foundations, and in many cases, because of their smallness and localism, they are more responsive to disadvantaged constituencies than others. Therefore, NCRP calls for maintaining and working with small foundations—and resisting calls for establishing and raising arbitrary minimum capitalization levels for foundations.

The scandals and abuses in foundations that have been reported in the press are not exclusive to small foundations. Foundations in all parts of the country and of all sizes have been engaged in illegal and/or unethical behaviors, according to these press accounts and the foundations' IRS filings. It is irresponsible to pass blame for the recent foundation scandals from the entire foundation sector to just one segment of the sector, as some nonprofit and foundation leaders are attempting to do. Doing so is inaccurate, irresponsible, and unethical.

#### **Maximizing Foundation Support for Justice and Democracy**

- *Encourage democratic participation:* Foundations should be encouraged to support nonprofit public policy advocacy, community organizing, nonpartisan voter registration drives, and civic engagement. It is perfectly legal for them to do so, and these activities do more to advance a broad public interest agenda than most service organizations and programs that foundations currently support.
- *Foundation investment activism:* Foundations invest hundreds of billions in corporate shares, giving them the opportunity of voting their proxies on critical matters of corporate governance, corporate accountability, and other corporate policies. The failure of foundations to take these affirmative steps with proxy actions results in missed opportunities for social change. NCRP encourages foundations to use their powers as shareholders to promote social change. Unfortunately, the majority of foundations do not take advantage of this position of power that they currently hold.
- *Promote mission-based investing:* It makes social and economic sense for foundations to devote part of their investments to mission-based investment options such as community loan funds, equity funds, and other charitable instruments. Mission-based investing should be a standard component of a foundation accountability regime.
- *Prevent portfolio concentrations:* Foundations should not invest more than a very small proportion of their investments in any one particular corporation, as the law currently calls for, they should desist in asking for exceptions to that standard, and those foundations that have received approval to circumvent this standard should return to the philanthropic norm of preventing such investment concentrations.

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<sup>6</sup>The Foundation Center. *Foundation Giving Trends*, 2004.

The experience of the David and Lucille Packard Foundation is a great example why foundations should avoid such concentrations. The majority of the foundation's investments was held in Hewlett-Packard company stock. The economic boom of the 1990s—fueled in large part by the technology sector—boosted the foundation's assets to around \$10 billion. Following the economic downturn in 2001—which hit the technological sector especially hard—the foundation's assets shrank by \$8.3 billion, forcing Packard to eliminate entire grantmaking program areas and lay off staff members.

#### **Conclusion**

Current regulations, laws, and oversight are clearly not working. The drumbeat of scandalous stories in the nation's newspapers will not stop anytime soon. But it is not the responsibility of the media to police the philanthropic sector. Responsibility rests with the government, at both the state and federal level. Not only do the current laws and regulations need to be actually enforced, but stronger and more relevant laws and regulations are needed to reflect the current realities that both foundations and the charities that they support face.

NCRP was created nearly 30 years ago, which was the last time the U.S. Congress took an active interest in holding foundations more accountable to their grantees and the general public. We are encouraged that the House Ways and Means Committee is returning to these very important issues, and look forward to an ongoing dialogue that we hope will strengthen philanthropy so that it can better serve the people and communities who need it the most, as well as remain true to the U.S. citizens who bear the brunt of tax breaks that support the philanthropic sector.

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#### **Statement of Paul Hazen, National Cooperative Business Association**

The National Cooperative Business Association appreciates the opportunity to submit testimony about cooperatives and their tax treatment. This is a critical issue for cooperatives, their members and the communities in which they operate. NCBA is the nation's only national organization representing cooperatives across all sectors of our economy—including agriculture, childcare, electricity, finance, food retailing and distribution, healthcare, housing, insurance, purchasing and shared services, telecommunications and many others.

Cooperative taxation principles and specific provisions of the Internal Revenue Code reflect the member-owned and governed structure of cooperatives. Generally, cooperatives themselves do not have taxable income because they pass through that income to their members in the form of patronage refunds. Members pay tax on the patronage refunds they receive. Though cooperatives may not be taxed on income and business derived from their patrons, they typically do pay taxes on non-patron income.

Co-ops operate as not-for-profit businesses in that they return any profits they earn to their members based on the amount of business the members do with the co-op. Some cooperatives are organized under section 501(c) of the Internal Revenue Code and are entitled to a tax-exemption if they meet certain criteria, e.g., operate on an at-cost basis. While these exemptions address different types of cooperatives, they are based on the same tax principles applied to other types of cooperatives. Cooperatives that file under section 501(c), however, are subject to restrictions not applied to other cooperatives.

How successful a cooperative is either in terms of size or meeting the needs of its members should not be a measure of whether and how it is taxed. Cooperatives may be Fortune 500 companies or they may be small, community-based businesses. But regardless of the size or the success of the cooperative, the structure remains the same. They are member-owned and member-controlled. And the tax principles and provisions that apply to them appropriately reflect that structure.

#### **Cooperatives—A Business Structure that Promotes Ownership and Accountability**

Cooperatives are a vital part of the economy. An estimated more than 40,000 co-ops in this country are, by definition, businesses that are owned and democratically controlled by their members. These are the people who buy the goods or services the cooperative provides, rather than outside investors. Cooperatives serve some 120 million members by providing them with agricultural processing and marketing services, childcare, education, healthcare, affordable housing, financial services, group purchasing, food and other consumer goods, electricity and telecommuni-

cations services, among many others. Cooperatives and their members generate millions of dollars in economic activity, creating jobs, wealth, and opportunity.

Cooperatives return surplus revenues—that is, income over expenses and investment—to members proportionate to their use of the cooperative, not proportionate to their “investment” or ownership share. Co-ops are motivated, not by profit, but by service to their members. Their goal is to meet their members’ needs for affordable and high-quality goods or services. For this reason, outside capital investment is often hard to attract. Co-op equity consists largely or solely of member equity.

Cooperatives’ member-owned and member-governed structure also promotes accountability and trust among consumers. A national survey commissioned by cooperative organizations together with the Consumer Federation of America found that consumers trust the cooperative structure more than the investor-owned structure.

Cooperatives fall into four categories:

- **Producer-owned cooperative**—These cooperatives are owned by farmers or craftsmen who form a co-op to jointly market, process or produce a similar product. There are 1,600 farmer—or rancher-owned marketing or processing cooperatives in the United States. New generation cooperatives—small co-ops that specialize in value-added agricultural processing—are becoming more popular.
- **Consumer-owned cooperatives**—The largest co-op category, these cooperatives are owned by the consumers who buy the businesses’ goods or services. They include food co-ops, rural electric and telecommunications cooperatives, credit unions, housing co-ops, parent-owned childcare co-ops, and consumer-owned HMOs.
- **Purchasing and shared services**—These cooperatives are owned by individuals or small businesses that buy goods or services as a group to lower costs. As more and more small businesses see purchasing co-ops as the key to their survival, this segment of the co-op community is growing. NCBA estimates that, nationwide, more than 50,000 independent businesses are members of purchasing co-ops. The nation’s 1,600 farm supply and service co-ops fall into this category, since they are effectively purchasing co-ops for farmers and ranchers.
- **Worker-owned cooperatives**—These cooperatives are owned and controlled by their employees. They are similar to companies with Employee Stock Ownership Plans, known as ESOPs. However, in a worker cooperative, the employees benefit from the profitability of the company earlier than ESOP employees. Members of worker-owned co-ops receive annual taxable dividends on the company’s earnings, rather than waiting for retirement to cash in their stock.

The cooperative structure lends itself to addressing economic challenges facing America today, especially in rural areas. Municipalities are using cooperatives to provide needed services at lower costs. Communities are using the cooperative model to provide affordable housing that allows seniors to age in place. Cooperatives are also addressing soaring health care costs and other services for seniors. Cooperatives also help retain the wealth and purchasing power of communities. Instead of being drained away from communities by outside interests, money is put back into local economies by co-op member-owners. Studies show that the patronage refunds play a significant role in the economy of the communities in which they operate. These refunds can be critical to maintaining the vitality or revitalizing communities, particularly in rural America.

#### **Cooperative Taxation Reflects Unique Structure of Co-ops**

Cooperative taxation, though addressed under different provisions of the Internal Revenue Code, generally follows the same basic tax principles regardless of the type of cooperative. The principles reflect the common member-owned and member-governed cooperative structure.

Unlike investors, members join a cooperative to benefit from the goods and services it offers, not to make a substantial return on their investment. Farmers join an agricultural co-op to benefit from the leverage the group has in negotiating a price for their crop or the premium enjoyed through the co-op’s product branding. Small businesses join a purchasing co-op to reduce their costs or to reach otherwise inaccessible markets, such as international markets.

Following is a general description of the tax principles common to all types of cooperatives.

**Single Tax Principle: Surplus Member Revenues Not Taxable:** Cooperatives do not pay income tax for surplus revenues generated by member business and distributed to or used in the service of members. For some cooperatives, surplus revenues from member business are returned to members as patronage refunds at the end of the year. Refunds can be either cash or equity held by the co-op and allocated to individual members. The co-op deducts these refunds from its tax liability, cre-

ating a single tax treatment of those revenues at the patron level. Patronage refunds effectively constitute patron “overcharges” or “underpayments” returned to members at the end of the year.

**Treatment of Non-Member Revenues:** Cooperatives pay corporate income tax on non-member surplus revenues. This is the same tax treatment as any other type of corporation. Some co-ops, such as credit unions, serve only members. As a result, they have insignificant or no non-member income. IRS rulings and case law have upheld interpretations of “member business” that allow some non-member revenue to be treated as member revenue and therefore not taxable at the cooperative level. Generally, any income derived from activities for which the principle purpose is serving members is not taxable.

Some cooperatives have no surplus revenues from member business to return to their members. Essentially these cooperatives attempt to operate as close to cost as possible. That is, they offer “refunds” in advance, discounts at the point of purchase, discounts negotiated in advance from suppliers, lower fees, better interest rates on savings, or lower interest rates on loans.

**Tax Treatment of Patronage Refunds:** Co-ops with surplus member revenue may return those surpluses to patrons in the form of cash or retained equity in the cooperative, or both. In some cases, patrons pay tax on the refund they receive. Patronage refunds arising from personal expenses, such as electricity for the home, groceries and other consumer goods, and interest refunds, are not taxable at the individual level.

#### **Tax Code Provisions Embody Cooperative Taxation Principles**

Cooperatives are covered under several sections of the Internal Revenue Code. Subchapter T, section 1381–1388, provides single tax treatment of surplus member revenue, or pass-through treatment, for businesses that operate on a “cooperative basis.” Members are taxed on any surplus returned in the form of patronage refunds. Cooperatives filing under Subchapter T include agricultural and other producer cooperatives, purchasing cooperatives, some banks within the Farm Credit System, worker cooperatives, and some types of consumer cooperatives, such as housing and food co-ops.

Under section 521, certain types of farmer cooperatives are allowed to pass through earnings from non-patron income sources to their patrons. Refunds are taxable at the patron level. To qualify for filing under this section, these co-ops must meet thresholds for member versus non-member business and other criteria.

Some cooperatives file under Section 501(c), which provides six different types of exemptions. These include service cooperatives serving non-profit hospitals, credit unions and educational service cooperatives. While each exemption has its own history, all are based on member ownership and a purpose of serving their members. For example, public law states that “credit unions . . . are exempt from federal and most state taxes because they are member-owned, democratically operated, not-for-profit organizations . . .” PL 105–219, August 7, 1998.

- Under section 501, member revenue is generally exempt from taxation if the conditions of the exemption are met. These requirements are in addition to those imposed on other cooperative businesses.
- Section 501(c)(1) provides tax exemption for “federal instrumentalities” that are cooperative organizations, such as banks for cooperatives. Some Farm Credit Associations receive tax treatment under this section.
- Section 501(c)(3) provides tax exemption for co-ops, such as student housing cooperatives, that operate for charitable or educational purposes.
- Section 501(c)(12) provides tax exemption for rural utility cooperatives—providing electricity, telecommunications, or water—so long as 85 percent of the income comes from members and is for the sole purpose of meeting losses and expenses (i.e., operation at-cost). This is a requirement Subchapter T cooperatives do not face.
- Section 501(c)(14) provides tax exemption for credit unions. It requires them to operate “without profit” and “without capital stock,” requirements Subchapter T cooperatives do not face. Credit unions generally cannot serve non-members, a restriction not imposed on Subchapter T co-ops.
- Section 501(e) provides tax exemption for service cooperatives serving non-profit hospitals. Like other tax-exempt cooperatives, these cooperatives face additional operational restrictions.
- Section 501(f) provides tax exemption for educational service cooperatives.

Some cooperatives covered by 501(c) are exempt from federal income tax on non-member revenue under certain thresholds, generally related to whether most of the co-op’s income is for its exempt purpose. This results from the additional statutory

or regulatory requirements specific to these cooperatives and does not constitute preferential treatment. Generally, this is consistent with the concept of a "purpose" test applied to non-member revenue for non-501(c) cooperatives—that is, the non-member income that is not taxable meets the primary member service purpose of the cooperative.

### Conclusion

Co-ops are member-owned and member-run businesses that return any profits they earn to their members based on their patronage with the co-op. This model of business is more accountable and instills more confidence than companies owned by shareholders in search of unrealistic returns. At a time of rising deficits, cooperatives are poised to meet economic challenges such as high health care costs, a growing aging population and senior housing in rural America.

From large agricultural co-ops to the local food co-op, all cooperatives are owned and governed by their members. The tax treatment cooperatives receive reflects their member-owned and member-controlled structure. NCBA urges the committee to retain that treatment.

Thank you for opportunity to provide testimony. We would be pleased to discuss the tax treatment of cooperatives further with the committee.

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Ohio Hospital Association  
Columbus, OH  
May 2, 2005

The Honorable Bill Thomas  
Chair, U.S. House Ways and Means Committee  
Washington, DC 20515

Dear Chairman Thomas:

On behalf of the Ohio Hospital Association (OHA), we thank you for the opportunity to submit comments for the record regarding the hearing held April 20, 2005, on the Tax-Exempt Sector.

OHA is the oldest state hospital association in the nation, representing more than 170 acute-care hospitals and 40 health systems across Ohio. Our governing Board of Trustees is comprised of representatives from the whole gamut of providers in Ohio—from large, urban teaching facilities to small, rural hospitals, and from every corner of the state. Each of our members is dedicated to providing its community with the highest quality health care service all day, every day. The majority of these hospitals are not-for-profit, 501(c) (3) organizations.

Our members earn their tax-exempt status through a wide range of services that benefit the community. Ohio hospitals annually provide more than half a billion dollars in charitable services to the elderly, uninsured, and indigent for which they receive no reimbursement. They help educate patients on whether they qualify for discounts and public health coverage. Hospitals care for everyone who comes through their doors, regardless of ability to pay.

However, the immense amount of charity care hospitals provide is only part of the story. Our hospitals provide hands-on training for the next generation of nurses, technicians, pharmacists, and physicians. They conduct blood drives, wellness and health diagnosis fairs, vaccination events, and mobile screening services for cancer and other life-threatening diseases, saving thousands of lives and health care dollars each year. They help local and state government prepare for natural and man-made disasters. Hospitals provide everything from community education about health risks, diet, and exercise, to basic items like bandages, thermometers and pedometers. In short, hospitals' vital contributions to society cannot be measured in dollars alone.

Just like churches, universities, and other organizations, hospitals receive considerable financial relief by way of their tax-exempt status. And like churches, universities, and other organizations, hospitals provide such a diverse and high-level of service to their community that they more than earn their keep. Moreover, the savings achieved by tax-exempt status are re-invested in the community, stretching the value of the government's dollar. While short-term government revenues might increase if hospitals did not receive 501(c) (3) status, the long-term loss of access to health care and of economic development would outweigh the small gains.

Like all of our nation's laws and regulations, those regarding the tax-exempt sector deserve periodic review and occasional improvement. As the Congress continues its evaluation of this sector, we look forward to working with you to ensure the gov-

ernment's resources are being used wisely and that our fellow citizens continue to receive the high-quality health care they deserve.

Sincerely,

James R. Castle  
President and CEO

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Phoenix Children's Hospital Foundation  
Phoenix, AZ 85006  
April 26, 2005

The Honorable Bill Thomas  
U.S. House of Representatives  
2208 Rayburn House Office Building  
Washington, DC 20515

Dear Congressman Thomas:

I am writing to urge you to protect the charitable sector from unnecessary and overly burdensome regulations such as those presented by the Senate Finance Committee, particularly those proposals that would modify the tax rules regarding non-cash charitable contributions (known as "in-kind" contributions).

The new proposals include recommendations to completely eliminate or substantially modify deductions for in-kind contributions. Many charities heavily rely upon non-cash donations, and there is no legitimate reason to attack this lifeline. In particular, gifts of real estate have been tremendously beneficial to Phoenix Children's Hospital. In the past two years, gifts of real estate have generated over \$800,000 in revenue for Phoenix Children's Hospital. These dollars were used to provide charitable healthcare to children whose families had no means to pay. Our donors were motivated to donate real estate by the resulting charitable tax deduction. Their property was fairly appraised at the time it was donated resulting in their desired and fair tax deduction.

Changing the in-kind contribution rules would unfairly compel charities to divert valuable time and resources to new valuation compliance schemes. The inability of the Internal Revenue Service to address improper donor behavior should not result in penalties for charities and the communities and populations which they serve. Significant revision of the in-kind contribution rules would greatly diminish my organization's ability to provide altruistic services.

Furthermore, these proposals are not based on any credible evidence of widespread abuse. In fact, empirical data indicates that there is NOT widespread abuse among the charitable sector and that proposals are unnecessary. Reports collected by the FBI, the Federal Trade Commission, State Attorneys General and even watchdog groups like the Better Business Bureau show that reports of charity fraud are less than 1 percent of all complaints of *fraud*. This is consistent with every single year's annual findings in the annual report on *Fraud in the United States* published by the FTC.

It appears that many of the suggestions are driven by a desire to raise federal revenues from the charitable sector. Such an effort is completely inconsistent with the notion of tax-exempt status, and I hope you will strongly oppose such proposals. The tax-exempt sector provides an array of services to the public and advocates for under served populations, including children, minorities, women and the elderly. We fight disease, domestic violence, pollution and crime while promoting education, literacy and family values. Without the tax-exempt sector, there would be an enormous burden on the federal government to provide these services. Please ensure the stability of this sector by opposing these new, unnecessary regulations.

The Senate Finance Committee's proposals to alter the non-cash charitable gift incentives come at a precarious time for charities. Americans are a generous people, but many charities are still recovering from the past several years when charitable giving has been flat and even decreased for many organizations.

At the same time, we understand that your committee seeks to gather information on the size, scope and impact on the economy of the nonprofit sector; the need for congressional oversight; IRS oversight of the sector; and what the IRS is doing to improve compliance by the sector with the law. These are laudable objectives. We are interested in assisting the committee in identifying appropriate areas for further study as well as criteria and standards to better define and outline the sector and its players.

Again, I urge you to oppose changes to the in-kind contribution rules as well as any unreasonable and burdensome legislation that would harm the charitable sector. I very much appreciate your support.

Thank you for your consideration.  
Sincerely,

Heidi A. DroegeMueller  
*Director of Major Gifts*

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Read "Write" Adult Literacy Program  
Moriarty, NM 87035  
May 4, 2005

The Honorable Bill Thomas  
U.S. House of Representatives  
2208 Rayburn House Office Building  
Washington, DC 20515

Dear Congressman Thomas:

I am writing to urge you to protect the charitable sector from unnecessary and overly burdensome regulations such as those presented by the Senate Finance Committee, particularly those proposals that would modify the tax rules regarding non-cash charitable contributions (known as "in-kind" contributions).

The new proposals include recommendations to completely eliminate or substantially modify deductions for in-kind contributions. Many charities heavily rely upon non-cash donations, and there is no legitimate reason to attack this lifeline. Twenty-three (23%) of Torrance County reads below a first grade level. The need for our literacy program is apparent. At least 45% of our annual budget is in-kind contributions. This consists largely of donated space and volunteer hours. Our volunteer tutors donate over 2,500 hours per year to help adults learn to read, write, and comprehend English. In-kind space for our office is donated by the Moriarty Community Library which values up to \$10,000. Neither the tutors nor the Library receive any benefit other than the success of the students and our program. Without our in-kind donations the program would not exist.

Changing the in-kind contribution rules would unfairly compel charities to divert valuable time and resources to new valuation compliance schemes. The inability of the Internal Revenue Service to address improper donor behavior should not result in penalties for charities and the communities and populations which they serve. Significant revision of the in-kind contribution rules would greatly diminish my organization's ability to provide altruistic services.

Furthermore, these proposals are not based on any credible evidence of widespread abuse. In fact, empirical data indicates that there is NOT widespread abuse among the charitable sector and that proposals are unnecessary. Reports collected by the FBI, the Federal Trade Commission, State Attorneys General and even watchdog groups like the Better Business Bureau show that reports of charity fraud are less than 1 % of all complaints of *fraud*. This is consistent with every single year's annual finding in the annual report on *Fraud in the United States* published by the FTC.

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At the same, we understand that your committee seeks to gather information on the size, scope and impact on the economy of the nonprofit sector; the need for congressional oversight; IRS oversight of the sector; and what the IRS is doing to improve compliance by the sector with the law. These are laudable objectives. We are interested in assisting the committee in identifying appropriate areas for further study as well as criteria and standards to better define and outline the sector and its players.

Again, I urge you to oppose changes to the in-kind contributions rules as well as any unreasonable and burdensome legislation that would harm the charitable sector. I very much appreciate your support.

Thank you for your consideration.  
Sincerely,

Tina J. Cates-Ortega,  
President

Betty Miller,  
Program Director

**Statement of Steven M. Rose, Walpole, Massachusetts**

**The public charity reforms proposed by the JCT do not go far enough. The problems need to be solved for decades to come. Please consider the following 6 proposals:**

**1. Compensation Speed Limits:** Please enact firm numerical “speed limits” on public charity insider compensation. Legally require only “government sector compensation comparisons” for public charity compensation. *The JCT proposals for compensation limits are not quantitative enough and will just further burden our limited Government resources to interpret and police.* Firm numerical speed limits on insider compensation (along with fines for breaking and/or evading the speed limits) will be much more efficient and will maximize the amount of money applied to each charities’ exempt purpose, as opposed to enriching well connected insiders and their advisors. **Public charity insiders have developed schemes to evade and defeat the current intermediate sanctions regime and they will do the same under a new regime if speed limits are not clearly posted.** Just like Government public service, one should not be working at a public charity in order to “get rich,” this only sullies and conflicts with the charitable purpose. This is all about finding the most efficient way to limit greed and increase accountability.

**2. Report ALL Compensation and Fee Arrangements and Amounts Paid:** Public charity compensation and fee reporting should be greatly expanded to report to the public ALL compensation and fees directly and indirectly paid by public charities. Public charities are “taxpayer subsidized organizations” and like the Government all compensation and fee information and arrangements should be disclosed for the public to see. This encourages public charity integrity and transparency. Hiding most of the compensation and fee picture from public view does not serve the public interest, it serves special insider interests and allows for undisclosed “special” or “patronage” like arrangements to run rampant among insiders, outside of Public and Government view. More *comprehensive* Public disclosure of compensation and fee arrangements and amounts paid is very important to help determine whether individuals connected to public charities are overpaid at ALL LEVELS of the public charity.

**3. Directly Connect Each Donor’s Charitable Contribution to Public Charity Information:** Most donors are unaware of and/or don’t know where to find information on the public charity they are contributing their hard earned money to, and many public charity insiders would like it to stay that way. That’s unfair and should definitely change. When soliciting money and after receiving any charitable contribution, the public charity should be required to inform each donor of a web site where the donor may review the public charity’s detailed and fully disclosed returns, related entity returns and audited financial statements. This would be like giving the investor (contributor) an opportunity to look at the financial prospectus and other fully disclosed financial information filed with the SEC before they invest (contribute). *A simple and decent provision that would connect the contributor to the charity’s financial information will help immeasurably toward making sure that public charity insiders and their advisors are continually reminded that they are accountable to the Public for the money they receive.*

**4. U.S. Government Posting of Public Charity Filings on the Internet:** The U.S. Government should establish and maintain a web site, much like the SEC, for promptly posting all public charity filings and disclosures so the Public can readily review them in order to make important evaluations about how a particular charity is using its money. The U.S. Government should charge each public charity a small fee according to the size of the charity for this very important public service.

**5. A Visible and Welcome Place to Report Public Charity Abuse:** Public charity reform should include a formal mechanism and place for the public to confidently report complaints and concerns about charity abuse. **The current avenue for raising concerns about possible terrorist involvement, financial corruption and other abuse of public charities, is an uncertain and difficult route**

**to take.** Congress needs to enact laws that clear all roadblocks and welcome concerns about the conduct of public charities. Please consider the establishment of an "Exempt Organization Commission," modeled after the SEC. Please also review Massachusetts Attorney General Reilly's "Act to Promote the Financial Integrity of Public Charities, Section 3, Audit Committees; Procedures for Submission of Complaints and Concerns" (see [www.bostonbar.org/sc/bl/docmat0304.htm](http://www.bostonbar.org/sc/bl/docmat0304.htm) for a copy). The U.S. Government should enact similar procedures to promote integrity.

**6. Conflict of Interest Provisions:** Please consider enacting strict conflict of interest provisions modeled after state "conflict of interest" laws, especially for large public charities. Conflict of interest laws help to insure the integrity of state and local government. They can be applied as well to insure the integrity of public charities, which exist, like the government, to serve the public interest. Firm and clear conflict of interest provisions that prohibit self-dealing among insiders are crucial to public charity reform. The Massachusetts conflict of interest laws can be viewed at: [www.mass.gov/ethics/](http://www.mass.gov/ethics/). Conflict of interest "red flags" were raised last summer and this prompted Massachusetts Governor Romney to veto a provision that would have increased secrecy with public pensions funds and he said (July 4, 2004 Boston Globe): "*Given our history in Massachusetts of abuse and potential self-dealings, we're very concerned about confidentiality provisions as they relate to investments of billions of dollars of public pension funds.*" *No question about it, these very same concerns apply to the significant amounts of public charity money being "secretly" managed by public charity insiders with "No Public Accountability or Transparency."* *We need more public charity openness as opposed to secrecy (confidentiality); secrecy serves the self-indulgent monetary interests of insiders, and is a recipe for corruption.*

The more quantitative and exact the rules are, the less likely they will be subject to "evasive interpretation" by money hungry insiders and their public charity paid advisors. *Clear rules that require minimal time and money to understand and comply with and will greatly lessen the burden on the Government and public charities.* This objective will help public charities spend much more of their time and money on fulfilling the charitable purpose. I hope members of Congress will listen to the often under-represented concerns of people who are Not public charity insiders when writing new rules needed to safeguard our nation's charitable assets, *for decades to come.*

I've tried to limit my comments to 2 pages. However, since November of 2002, I've submitted a great deal of information about charity abuse to Senators Grassley and Baucus. Unfortunately, I know, first hand, how really bad the abuse is. It's disheartening. So much depends on the integrity of our country. Like you, I want to do all that I can to help fix what I know is broken. Please feel free to contact me, if you would like more information. **Thank you for your public service.**

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San Diego County Veterinary Medical Association  
San Diego CA 92120  
April 18, 2005

The Honorable Bill Thomas  
Chairman, Committee on Ways and Means  
United States House of Representatives  
1100 Longworth House Office Building  
Washington, DC 20515

Dear Representative Thomas:

Concerns surrounding unfair business competition by tax-exempt organizations continues among the tax paying small business community nationally. Although currently not a direct problem for the veterinary industry in San Diego County, we have concerns that this activity may soon be attempted here as it is done in other communities nationwide. Our perspective is proactive rather than reactive at this time.

In some communities throughout the U.S., societies for the prevention of cruelty to animals and like organizations have begun to expand their services beyond their charitable mission. In an attempt to generate revenue for their organization they are providing inherently commercial, veterinary medical services to the general public without regard for their charitable need or financial ability to pay.

Hearing testimony transcripts from a California legislative panel, as well as a recent Internal Revenue Service Panel would indicate that most of these business ac-

tivities by tax-exempt organizations go unreported to the IRS pursuant to the Unrelated Business Income Tax (UBIT) reporting requirement. Criteria that provide examples of what "unrelated business income" activities are, are absent with the exception of "animal boarding" referenced as "unrelated" to a charitable mission. A solitary example in itself may encourage an absence of income activity reporting.

The many other veterinary medical services that are provided by these charities to the general public without regard to charitable need apparently go unreported by most. In contrast, veterinarians operating small business hospitals and clinics are taxed fully and at several levels.

I am the President of this local veterinary association representing 650 members and I appreciate the opportunity to make you aware of our concerns, which we feel are representative of the almost 100,000 veterinarians nationally. In the March 1, 2005 *Panel on the Nonprofit Sector Interim Report* presented to the Senate Finance Committee we could not find UBIT reporting on their current agenda for providing recommendations for "strengthening the accountability of charities and foundations" but assume this issue will be addressed in their final report. We hope that you will direct and support efforts to define and enforce appropriate regulations, enhanced example guidelines, and oversight. Doing so will show fair support for a substantial small business sector as well as increase the taxable revenue paid to the governmental coffers.

We commend philanthropic and charitable organizations for the distinctive role they play in our society. Animal assistance organizations have a significant and vital charitable role in serving the plight of abandoned and abused animals. Some also provide subsidies for medical services to a needs-based population. Veterinarians commend and support that compassionate mission and many lend their own services to these organizations and provide pro bono contributions to the community on many levels on a regular basis. The practice of veterinary medicine, both clinically and from its operational perspective, fairly belongs in the established and well-regulated small business arena. Taxation exemption should not be allowed when provided to the general public by a "charity".

Keith Hilinski  
President

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#### Statement of Peter V. Berns, Standards for Excellence Institute

On behalf of the Standards of Excellence Institute we appreciate the opportunity to submit comments as the Ways and Means Committee undertakes a broad review of issues concerning the tax-exempt, nonprofit sector in the United States.

The Standards for Excellence Institute is a national initiative that promotes a comprehensive system of nonprofit sector self-regulation. Originated in Maryland, it now includes active programs in six other states with outreach to groups anywhere in the nation. The Institute couples a strong ethics and accountability code—*Standards for Excellence*—with the resources needed to achieve the highest standards in governance, management and operations. The program provides educational resource packets, clinics and person to person technical help to assist groups interested in understanding and implementing the individual standards. There is also a voluntary system of certification, based on an extensive peer review process, leading to the award of a "Seal of Excellence", which is subject to periodic re-certification. The program was cited as a model in the Finance Committee's discussion paper last year.

A careful review of the tax-exempt nonprofit community will clearly find some examples of abusive practices, excessive compensation, and areas such as tax shelters and credit counseling that demand examination and corrective action by the Congress and regulators at the federal and state level. What is less clear is how many of these problems require new laws or regulations rather than more effective enforcement of existing rules. It appears that many of these practices are already illegal, and there is uniform support from the nonprofit sector for more rigorous enforcement by the Internal Revenue Service, and a need for more resources for that purpose. We strongly support the work and recommendations of the Panel on the Nonprofit Sector convened by Independent Sector on these issues.

A careful review will also find that the nonprofit sector is extremely diverse, and that "one size fits all" reforms could be a terrible mistake. Simply put, the level of regulation and reporting appropriate and necessary for large national organizations may present an impossible burden for groups that have small staffs, limited re-

sources, and may rely completely on volunteers in serving the community. These make up the vast majority of tax-exempt organizations across the country.

From years of providing assistance to hundreds of organizations, and from our experience implementing the Standards for Excellence program, we have come to understand that better management and accountability cannot be assured simply by new laws and law enforcement.

Adoption of new stringent regulations, new reporting requirements, and new accreditation programs for nonprofits will not change two essential facts. First, tens of millions of well-intended individuals are involved in the management and operation of the nations' charities, and many already know they should be doing more in terms of management, but simply lack the time and resources. Second, for the most part, nonprofits' compliance with legal requirements or with voluntary standards of 'best practice' is essentially self-enforced.

Our research and experience have shown that nonprofit board and staff leaders have high expectations for themselves and their organizations, that unfortunately often exceed the level of performance they are able to achieve with the time and resources available to them.

Any effective program to broadly improve the governance, management and accountability of nonprofit organizations must address the obstacles that prevent them from improving these areas within their organizations.

First, there must be an accessible, user friendly and clear statement of standards that provides guidance and sets high expectations for how nonprofits are governed, managed and operated.

A second significant problem is that we have under-invested in the infrastructure of nonprofit organizations and the nonprofit sector. Facing increasing demands for services they provide, with limited staff and resources to perform core mission activities, few can afford the time, effort and expense that is required to improve their governance and management practices. In fact, most of the incentives at present encourage nonprofits to spend as little as possible on their management and administration.

We need to make clear that it's OK, in fact that it is expected, for board and staff leaders to pay attention to internal organizational health and to invest in building well run, responsibly governed, sustainable nonprofits. And we need to make resources available to support them as they endeavor to do so.

A further major obstacle is that there are limited financial resources available to support those of us who are trying to help the helpers. The assistance that is currently available from state associations of nonprofits, local management support organizations, as well as national groups, is limited by our reliance on members' dues, fees, and already stretched thin philanthropic support.

Improvement and expansion of programs such as the Standards for Excellence, and of training and information to promote basic legal compliance, will require more than is foreseeable from these sources.

This is a logical area for partnership between government and the nonprofit sector. Nonprofit organizations deliver many vital government funded programs and services, and provide programs and services to citizens where government efforts are limited or non-existent.

Just as it made sense years ago to develop federal and state programs to support the development and growth of small businesses, it makes sense now for both federal and state governments to invest in strengthening the capacity of nonprofits to serve the community.

The national version of the *Standards for Excellence* is available on the web at [http://www.standardsforexcellenceinstitute.org/public/html/explore\\_b.html](http://www.standardsforexcellenceinstitute.org/public/html/explore_b.html).

Appended to these comments is additional information on the Standards for Excellence Institute and its national programs.

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The Standards for Excellence Institute is a national initiative to promote the highest standards of ethics and accountability in nonprofit governance, management and operations, and to facilitate adherence to those standards by all nonprofit organizations. The Institute uses as a vehicle the Standards for Excellence program, a system of nonprofit sector self-regulation originated by the Maryland Association of Nonprofit Organizations and now replicated by nonprofit associations in Ohio, Pennsylvania, Georgia, Louisiana, North Carolina and Illinois.

The Standards for Excellence program has been developed to strengthen nonprofit organizations' ability to act ethically and accountably in their management and governance, therefore enhancing the public's trust in the nonprofit sector. The program promotes widespread application of a comprehensive system of self-regulation in the nonprofit sector—the first of its kind in the United States.

The *Standards for Excellence: An Ethics and Accountability Code for the Nonprofit Sector (Standards, Standards for Excellence)* is the centerpiece of the program. The *Standards* are based on the fundamental values of honesty, integrity, fairness, respect, trust, compassion, responsibility and accountability, and provide a guideline for how nonprofit organizations should act to be ethical and accountable in their program operations, governance, human resources, financial management and fund-raising.

**Standards for Excellence set a high benchmark**, exceeding the minimum legal requirements by establishing a new standard to quantify how well managed and responsibly governed nonprofit should operate.

The Standards cover eight areas of nonprofit governance and operations:

- Mission and Program
- Governing Board
- Conflict of Interest
- Human Resources
- Financial and Legal Accountability
- Openness
- Fundraising
- Public Affairs and Public Policy

The *Standards* cover a broad range of topics such as: how many times each year an organization's board of directors should meet, what subjects should be covered in an organization's personnel policies, and when audited financial statements should be prepared. The *Standards* also encourage organizations to have procedures in place to evaluate their programs and require board member, staff and volunteers to disclose any conflicts of interest.

### **Standards**

The Standards for Excellence Institute works with its affiliates to implement the *Standards* in their organizations in a number of ways. The Institute provides affiliates with extensive written educational materials detailing best practices, outlining model policies, and providing user-friendly samples. Specialized training seminars are available on a range of topics that are pertinent to implementing the *Standards* in your organization. Ongoing one-on-one technical assistance is also accessible, allowing your organization to personally contact the Institute to address any questions that might emerge during the implementation process.

### **Putting The Standards for Excellence Program to Work**

If you are a nonprofit organization you can . . .

- Set a new benchmark for your organization by implementing the *Standards for Excellence: An Ethics and Accountability Code for the Nonprofit Sector*, with the support of your Board of Directors and Staff;
- Show a copy of the Standards for Excellence Introductory Video to your Board of Directors and Staff; or
- Apply for the Seal of Excellence through the Standards for Excellence voluntary certification program (Now available in Maryland, Ohio, Pennsylvania, and Louisiana).

If you are a foundation or a grantmaker you can . . .

- Distribute copies of the *Standards for Excellence: An Ethics and Accountability Code for the Nonprofit Sector* to the nonprofits in your area as a blueprint for well managed, responsible governed organizations.
- Encourage and/or underwrite the organizations you support to use the Standards for Excellence as a tool for strengthening operations.
- License the Standards for Excellence Program and launch a full-scale Standards program in your region.
- Support the Standards for Excellence programs operating in your region.
- Sponsor a Standards for Excellence Institute training for nonprofits or grantees in your region.

If you are an association you can . . .

- Purchase copies of the *Standards for Excellence: An Ethics and Accountability Code for the Nonprofit Sector* to distribute to nonprofits in your area as a blueprint for well managed, responsible governed organizations.
- Contract with the Standards for Excellence Institute to provide training for nonprofits or grantees in your region.

- Apply for the Seal of Excellence through the Standards for Excellence voluntary certification program (Now available in Maryland, Ohio, and Pennsylvania). Soon to be available in additional states and jurisdictions.
- Become a supporter of the Standards for Excellence program by partnering with current or potential Standards replication partners.

Affiliation to the Standards for Excellence Institute provides your organization and/or you, as an individual, access to a wealth of knowledge and support that will enable you to abide by the highest level of standards set forth by the nonprofit sector.

Affiliate packages are available for:

*Nonprofit Organization*—501(c)(3), 501(c)(4), or 501(c)(6)

*Individual Associates*—not employed by a nonprofit

*Foundations / Federated Funding Agencies / Grantmaking Organizations*

*Full Time Students*

Affiliate Benefits include:

- Discounts on purchases of Standards booklets
- Access to the Standards Educational Resource packages and permission to make additional copies of the materials
- Contacting Standards For Excellence Institute's expert staff through telephone technical assistance
- Access to information from our comprehensive nonprofit management library
- Participation in online forums with other members
- Discounts on customized Standards training programs

Fees are determined by the type of membership and are based on a sliding scale. To receive more information about membership please refer to [www.standardsforexcellenceinstitute.org](http://www.standardsforexcellenceinstitute.org)

