PUBLIC CHARITY ORGANIZATIONAL ISSUES, UNRELATED BUSINESS INCOME TAX, AND THE REVISED FORM 990

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

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PUBLIC CHARITY ORGANIZATIONAL ISSUES, UNRELATED BUSINESS INCOME TAX, AND THE REVISED FORM 990

WEDNESDAY, JULY 25, 2012

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

The Subcommittee met, pursuant to call, at 9:30 a.m., in room 1100, Longworth House Office Building, Hon. Charles Boustany (Chairman of the Subcommittee) presiding.

[The advisory of the hearing follows:]

HEARING ADVISORY

Boustany Announces Hearing on Public Charity Organizational Issues, Unrelated Business Income Tax, and the Revised Form 990

Wednesday, July 25, 2012

Congressman Charles W. Boustany Jr., MD (R–LA), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold the second in its series of hearings on tax-exempt organizations, this time examining the revised Form 990, reasons for the increasing organizational complexity of public charities, including unrelated business income tax issues, and their effect on transparency and tax compliance. **The hearing will take place on Wednesday, July, 25, 2012, in room 1100 of the Longworth House Office Building, beginning at 9:30 A.M.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. 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. A list of invited witnesses will follow.

BACKGROUND:

Over the last two decades, public charities have grown increasingly more complex in their organizational structures and operations. Contributing to the complexity is the prevalence of profit-generating arms and investment activities within the tax-exempt organizational structure. Tax-exempt organizations are governed by a variety of rules to ensure compliance with Federal tax law and limit abuses, including rules that subject business income from for-profit activities to income tax (the unrelated business income tax, "UBIT"), unless explicitly exempted. These issues, among others, may affect how a public charity chooses to organize and operate.

To address increased complexity and to promote greater transparency and compliance within the sector generally, the Internal Revenue Service ("IRS") released a redesigned Form 990, *Return of Organization Exempt from Income Tax*, in 2008. The principal goal behind the redesigned Form 990 was to facilitate improved IRS compliance efforts. The Form was also intended to provide all interested parties with a clearer picture of a tax-exempt organization's activities, including those that further its exempt purpose and related party transactions. In an October 6, 2011 letter to the IRS, Chairman Boustany sought to assess whether the goals for the newly redesigned Form 990 have been achieved, the challenges the IRS faces with respect to compliance areas such as UBIT, and how the information required on the new form is being used. The hearing will, in part, follow up on this inquiry.

In addition to the importance of continuing oversight by this Subcommittee of the IRS and the tax-exempt sector, the Committee is working on comprehensive tax reform. Thus, the hearing will also provide an opportunity to discuss how current issues for public charities may inform the Committee's ongoing tax reform efforts.

In announcing this hearing, Chairman Boustany said, **"Given the size and scale of the operations of public charities, which in 2008 had over $2.5 trillion in assets, it is critical that the Subcommittee continue its review of the tax-exempt sector. Indeed, over the last two decades, the organizational structures of public charities have become increasingly complex, creating compliance and transparency issues. This hearing is an excellent opportunity for the Subcommittee to hear from the IRS and experts in the tax-exempt community. Their insight will allow the Subcommittee to better understand what is driving organizational complexity, and to learn about the new compliance efforts by the IRS and the UBIT rules."**

FOCUS OF THE HEARING:

The hearing will focus on organizational and compliance issues related to public charities, including the increased complexity of public charity organizational structures, the rules governing profit-generating activities giving rise to unrelated business income tax, and whether the newly redesigned Form 990 is promoting increased compliance and transparency.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit written comments 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 "Hearings." Select 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 online instructions, submit all requested information. ATTACH your submission as a Word document, in compliance with the formatting requirements listed below, **by the close of business on Wednesday, July 25, 2012**. 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) 225–3625 or (202) 225–2610.

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 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.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://www.waysandmeans.house.gov/*.

Chairman BOUSTANY. Welcome to this morning's hearing on public charities. This hearing is second in a series of hearings exploring tax-exempt issues and IRS compliance efforts. The focus of today's hearing is on 501(c)(3) public charities, the largest category of tax exempt organizations.

In particular, for public charities, we are focused on transparency, compliance efforts, organizational complexity and commercial activities. Over the past several decades, public charities have become increasingly complex organizations. While universities and hospitals are notable examples of this, complexity has not been limited to these types of organizations. A number of factors have driven this trend, including the Federal tax law itself and the expansion of the types of exempt and commercial activities that public charities engage in.

About a decade ago, there was a growing recognition that the Form 990, the Federal return used by most tax-exempt organizations, was not collecting the kind of information needed by the IRS or the public to understand the activities of this increasingly complex sector. To ensure a greater level of transparency across the sector, the IRS substantially redesigned the Form 990, rearranging how information is reported and expanding the breadth of information requested to draw out critical issues, such as related party transactions, governance and commercial activities.

We will discuss today how the Form 990 was changed, whether those changes have promoted compliance and transparency. Today we have two panels that will help the Subcommittee explore public charity compliance issues, such as the redesigned Form 990 sector transparency, organizational complexity and commercial activities. This exercise also will provide important information to the Subcommittee as it begins to look to the future and think about changes that will help tax-exempt organizations work most effectively to meet their goals. Now I am pleased to yield to my friend and colleague, the Ranking Member of the Subcommittee, Mr. Lewis, for purposes of an opening statement.

Mr. LEWIS. Thank you, Mr. Chairman, for yielding.

This is the Subcommittee's second hearing on tax-exempt organizations in this Congress. Today we will examine public charities and their complex structures.

Public charities serve as an important role in our society. They often fill the gap between what the government can provide and Americans' basic needs. These charities feed our hungry, care for our sick and preserve our culture and the arts.

As public charities become larger and more complex, I am concerned that they may be engaging in activities that are not part of their charitable mission. Some may be using for-profit subsidies to engage in business that is not related to their charitable mission. Some may be used in related organizations to engage in certain activity indirectly that they could not engage in directly.

As we move toward tax reform, we should consider whether these rules are working as intended. I look forward to hearing from our witnesses today about these issues. I would like to learn more about how the Internal Revenue Service oversees nearly 2 million tax-exempt organizations with a budget of about $100 million and about 860 employees.

I also look forward to hearing how the new Form 990 helps both the agents and the public oversee the activities of charitable organizations. And Mr. Chairman, I yield back my time. And thank you very much again for holding this hearing.

Chairman BOUSTANY. Thank you Mr. Lewis.

Chairman BOUSTANY. And next—I would like to say, first of all, we have two very distinguished panels today, who will be excellent witnesses as we delve into these issues. Today's witnesses have extensive experience studying or working with tax-exempt organizations, and their experience will certainly be very, very helpful as we examine the current state of the tax-exempt sector. Our first panel will be Deputy Commissioner Steven Miller.

The Committee has received your formal statement, Mr. Miller. And as deputy commissioner for services and enforcement, we know that you are dealing directly with all these issues, the complexity of it, and so we are very eager to hear your testimony and to follow up with questions.

So, Mr. Miller, you may proceed.

STATEMENT OF STEVEN T. MILLER, DEPUTY COMMISSIONER FOR SERVICES AND ENFORCEMENT, INTERNAL REVENUE SERVICE, WASHINGTON, DC.

Mr. MILLER. Thank you.

Good morning, Chairman Boustany, Ranking Member Lewis, Members of the Subcommittee. My name, as indicated, is Steve Miller, Deputy Commissioner at the IRS.

At the request of the Subcommittee, my testimony this morning will offer an overview of one segment of the tax-exempt community, specifically the 501(c)(3) charitable sector, and our role in regulating that community. Let me begin with some observations.

First, the charitable sector deserves to be commended for its vital role in our society. Second, on the whole, we believe the charitable sector is or tries to be compliant with the Internal Revenue Code. Finally, the sector is incredibly diverse in size and function, ranging from store-front soup kitchens to large complex hospital systems. This means our approach in regulation has to be flexible.

Currently there are more than 1 million section 501(c)(3) organizations. In the tax-exempt area, almost more than in any other area we cover, we serve more as a regulator and less as a revenue authority. In light of this, we have a balanced program which ensures that congressional intent is honored and that the public confidence in the integrity of the charitable sector is maintained. Our program is carried out, as Mr. Lewis says, by around 860 employees.

Our approach in regulation is comprised of education, the determination letter process, Form 990 filing and a robust examination and review program.

Let me touch on a couple of these. In our Determination Letter Program, which is in many respects a continuation of our educational efforts, we review the intended operations of organizations seeking exempt status. We receive more than 50,000 applications a year for charitable status. Our specialists review them and, where appropriate, work individually with the applicant to ensure the organization understands and meets the requirements of the Code.

Most exempt organizations also have an annual filing requirement and must file one of the Form 990 series returns. The Form 990 is a unique and essential part of our regulatory process. It is an information return made widely available to the public. We and other stakeholders use the information to review the operations of the organization. The 990 is also utilized by nearly 40 states to satisfy at least a part of their filing requirements. Given our limited resources, the Form 990 is particularly important. It allows the public to review, rate, compare and otherwise make their own decisions about organizations. Thus it promotes transparency and accountability.

There has been much discussion of the Form 990 revision which we began in 2004. The basic format and content of the form had remained essentially the same since 1979, while the community had grown dramatically in size, variety and complexity. After two drafts were released to the public over several years and after hundreds of comments were received and acted upon, we made the form effective with a generous transition rule beginning with tax year 2008. The process continues as the law changes and as we continue discussions with stakeholders.

The last aspect of our work I will mention is our robust and multi-faceted post-filing compliance program. We constantly seek more efficient and effective ways to conduct examinations or other reviews. And we continuously refine our selection criteria to help apply compliance resources where they are most needed.

I will wind up by talking about some of our challenges. First, given the size, breadth and growth of the sector we have a great deal of ground to cover with the available resources we have. Secondly, this is a difficult area to regulate. That is because the law deals most often in general principles and not specifics. The lines are not bright. While this leaves a great deal of flexibility for organizations and how they operate, it also makes it harder to judge where noncompliance begins or to give the organizations the certainty that they need to operate within clear lines. Third, with some key exceptions, the current law gives us limited options when we find noncompliance. We are often left with the question of whether to revoke an organization's tax exemption. Revocation is a draconian step, one that may not be proportionate in any given case.

Finally, the IRS role may at times not match the public's expectations. For example, it is difficult for the IRS to assess the quality of an organization's performance or measure its comparative worth. Thus it may be difficult for us to take action with respect to an organization that the public believes is not spending sufficiently on charity or is not doing a preferred type of charitable work. An example, the IRS cannot differentiate between an organization that gives out candy to flood victims versus one that distributes food or clothing. The IRS is neither equipped nor is it our role to make such determinations. The best we can do is make all the facts available for others to see and make their own decisions. That concludes my comments. Thanks for the opportunity to testify.

Chairman BOUSTANY. Thank you, Mr. Miller.

[The prepared statement of Mr. Miller follows:]

TESTIMONY OF STEVEN T. MILLER
DEPUTY COMMISSIONER SERVICES & ENFORCEMENT
INTERNAL REVENUE SERVICE
BEFORE THE OVERSIGHT SUBCOMMITTEE
HOUSE WAYS AND MEANS COMMITTEE
ON THE OVERSIGHT OF TAX-EXEMPT ORGANIZATIONS
JULY 25, 2012

Good morning Chairman Boustany, Ranking Member Lewis, and Members of the Oversight Subcommittee. Thank you for the opportunity to appear this morning. My name is Steven T. Miller, and I am the Deputy Commissioner for Services & Enforcement for the Internal Revenue Service (IRS).

Exempt Organizations is an office within Tax Exempt and Government Entities (TE/GE), one of four operating divisions created after the enactment of the IRS Restructuring and Reorganization Act of 1998 (RRA). Its responsibilities include charities and other tax-exempt organizations.

At the request of the Subcommittee, my testimony this morning will offer an overview of one segment of the tax-exempt community, specifically section 501(c)(3) organizations and our role in regulating that community. I will highlight the general law that applies to these organizations and the key administrative processes we employ in our work with this sector.

Let me begin with two observations. First, the charitable sector deserves to be commended for the vital work it does throughout America, and indeed throughout the world. Second, on the whole, we believe the charitable sector is, or tries to be, compliant with the Internal Revenue Code.

<u>Demographics of the Tax-Exempt Community</u>

Internal Revenue Code section 501(c)(3) describes a subset of the entire tax-exempt sector. Section 501(c)(3) organizations include those organized and operated exclusively for religious, charitable, scientific, educational, and other specified exempt purposes. They are eligible to receive tax-deductible contributions, and they are subject to certain operating restrictions.

Currently, there are more than one million section 501(c)(3) organizations. This includes public charities and private foundations. In tax year 2009, section 501(c)(3) public charities held assets valued at approximately $2.7 trillion, and had annual revenues of nearly $1.5 trillion. Private foundations held assets valued over $500 billion, and had annual revenues of $ 52 billion. These numbers do not include churches because they generally have no registration or filing requirements.

General Law Governing Section 501(c)(3) Organizations

The Internal Revenue Code specifies certain types of organizations that are exempt from federal income tax.[1] The most common are charitable, religious and educational organizations, civic associations, labor organizations, business leagues, social clubs, fraternal organizations, and veterans' organizations.[2]

Not all non-profit organizations are tax-exempt under federal law.[3] To be tax-exempt, the organization generally must meet specific requirements of the Code, such as being described in a paragraph of section 501(c) of the Code.[4]

With limited exceptions, section 501(c)(3) organizations must apply to be recognized as tax-exempt.[5] They do this by filing a Form 1023, *Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, with the IRS.[6] Churches and certain church-related organizations, very small organizations, and certain other organizations do not need to apply for tax-exempt status under section 501(c)(3).[7]

We consistently receive about 60,000 applications for tax-exempt status each year. Most are requesting status under section 501(c)(3).

If the IRS approves an application, we issue a "ruling letter" or a "determination letter."[8]

Contributions to section 501(c)(3) organizations are generally deductible on the donor's federal income tax return, if the donor chooses to itemize deductions.[9] Contributions to most other types of tax-exempt organizations do not qualify for a charitable contribution deduction.[10]

Section 501(c)(3) organizations are the largest category of exempt organizations. These organizations are organized and operated exclusively for religious, charitable, scientific, educational, or other specified purposes and no part of their net earnings may inure to the benefit of any private shareholder or individual, no substantial part of their activities may be carrying on propaganda, or otherwise attempting to influence legislation (except in certain circumstances), and which do not participate in, or intervene in, any political campaign on behalf of (or in

[1] IRC § 501(a); Treas. Reg. § 1.501(a).
[2] IRC § 501(c); Treas. Reg. §§ 1.501(c)(3)-1 through 1.501(c)(21)-1.
[3] Treas. Reg. § 1.501(a)-1(a)(2).
[4] Treas. Reg. § 1.501(a)-1(a)(1).
[5] Treas. Reg. §§ 1.501(a)-1(a)(3); 1.508-1.
[6] Id.
[7] IRC § 508(c)(1); Treas. Reg. § 1.508-1(a)(3).
[8] Treas. Reg. § 1.501(a)-1(a) (2); Treas. Reg. § 301.6104(a)-1.
[9] IRC § 170; Treas. Reg. § 1.170-2.
[10] But see IRC § 170(c)(3), (4), (5).

opposition to) any candidate for public office.[11] The regulations divide this statutory language into two requirements. To qualify for exemption under section 501(c)(3), the organization must be:

- *Organized*, and
- *Operated* exclusively for one or more exempt purposes.[12]

The organizational requirement is that a section 501(c)(3)'s organizing documents (articles of incorporation, trust documents, articles of association, etc.) must:

- Limit its purpose or purposes to those described in section 501(c)(3),[13]
- Not expressly empower the organization to carry on, otherwise than as an insubstantial part of its activities, activities which are not in furtherance of one or more exempt purposes,[14] and
- Dedicate its assets to exempt purposes, for example by ensuring that upon dissolution its assets will be distributed to another charitable organization or government entity.[15]

The operational requirement is that a section 501(c)(3) organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of the exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is in furtherance of a non-exempt purpose.[16]

In addition, a section 501(c)(3) organization cannot:

- Participate in political campaigns on behalf of, or in opposition to, any candidate for public office,[17]
- Perform lobbying activities as a substantial part of its overall activities,[18]
- Allow its earnings to inure to the benefit of any private shareholder or individual,[19]
- Operate for the benefit of private interests, such as those of its founder, the founder's family, its shareholders, or persons controlled by such interests,[20] or
- Operate for the primary purpose of conducting a trade or business that is not related to its exempt purpose.[21]

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[11] IRC § 501(c)(3)
[12] Treas. Reg. § 1.501(c)(3)-1(a).
[13] Treas. Reg. § 1.501(c)(3)-1(b) (1).
[14] Id.
[15] Treas. Reg. § 1.501(c)(3)-1(b)(4).
[16] Treas. Reg. § 1.501(c)(3)-1(c)(1).
[17] IRC § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(b)(3) (ii); § 1.501(c)(3)-1(c)(3).
[18] IRC § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(b)(3) (i); § 1.501(c)(3)-1(c)(3).
[19] IRC § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(c)(2).
[20] Treas. Reg. § 1.501(c)(3)-1(d) (1) (ii).
[21] Treas. Reg. § 1.501(c)(3)-1(e).

The most common types of section 501(c)(3) organizations are charitable, educational, or religious.

The term "charitable" is used in section 501(c)(3) in its generally accepted legal sense. While the regulations and other sources list charitable purposes, other purposes may also fall within the broad definition of "charitable" as developed by judicial decisions.[22] "Charitable purposes" may include the following purposes identified in the regulations:[23]

- Relief of the poor, the distressed, or the underprivileged,
- Advancement of religion,
- Advancement of education or science,
- Building or maintaining public buildings, monuments, or works,
- Lessening the burdens of government,
- Reducing neighborhood tensions,
- Helping eliminate prejudice and discrimination,
- Defending human and civil rights, and
- Combating community deterioration and juvenile delinquency.

An educational organization is one involved in:[24]

- The instruction or training of the individual for the purpose of improving or developing his capabilities, or
- The instruction of the public on subjects useful to the individual and beneficial to the community.

Religious organizations include churches and other organizations organized and operated exclusively for religious purposes.

<u>Public Charity or Private Foundation</u>
Every organization that qualifies as tax-exempt under section 501(c)(3) is classified as either a *public charity* or a *private foundation*. Under Section 508, organizations (other than churches, certain educational organizations, and certain trusts) are automatically classified as private foundations, unless they can meet the criteria for being a public charity listed in Section 509(a).[25] Whether a section 501(c)(3) organization is classified as a public charity or private foundation is important because different tax rules apply to each. For example, the deductibility of contributions to a private foundation is more limited than the deductibility of contributions to a public charity.[26] In addition, private foundations

[22] Treas. Reg. § 1.501(c)(3)-1(d)(2).
[23] Id.
[24] Treas. Reg. § 1.501(c)(3)-1(d)(3) (i).
[25] Treas. Reg. §§ 1.508-1(b); 1.509(a)-1; 1.509(a)-2.
[26] Treas. Reg. § 1.170-2.

are subject to stricter federal regulation and may be subject to excise taxes not imposed on public charities.[27]

One common distinction between public charities and private foundations lies in their sources of financial support.[28] A public charity typically has a broad base of public support, whereas a private foundation generally is supported by just a few individuals, such as members of a family.[29]

To be classified as a public charity, either because it performs specific types of activities identified in the Code (e.g. churches, schools, hospitals, etc.) or because of its public support, an organization must meet one of the tests set out in the Code and accompanying regulations.[30]

Common organizations meeting the definition of public charity under Section 509(a) include:

- Churches,
- Schools,
- Organizations that provide medical or hospital care,
- Organizations that receive a substantial part of their support in the form of contributions from publicly supported organizations, governmental units and/or from the general public, and
- Organizations that normally receive not more that one-third of their support from gross investment income and after-tax unrelated business income, and more than one-third of their support from gifts, grants, contributions, or membership fees and gross receipts from activities related to their exempt functions.

Role of the IRS

Congress has established in the tax law certain requirements that organizations must meet to be entitled to the privilege of tax exemption. It is the IRS's responsibility to administer those requirements.

The IRS has a balanced program for regulating the charitable sector. Within the IRS, the Tax Exempt and Government Entities division (TE/GE) has the responsibility to administer and enforce these requirements. Doing so accomplishes a number of important public purposes. It ensures that Congressional intent is honored. It helps maintain public confidence in the integrity of the charitable sector. And it prevents the erosion of the tax base by identifying and stopping those who misuse the privilege of tax-exempt status.

The IRS approaches this responsibility with a program that emphasizes both service and enforcement. The program is carried out by the 868 employees of

[27] Chapter 42 of the Code [i.e., IRC §§ 4940-4946].
[28] IRC § 509(a)(2); Treas. Reg. § 1.509(a)-3.
[29] Treas. Reg. §§ 1.509(a)-1; 1.509(a)-3.
[30] IRC §§ 170(b)(1)(A)(vi) and 509(a)(2); Treas. Reg. §§ 1.170A-9; 1.509(a)-2; and 1.509(a)-3.

TE/GE's Exempt Organization function (EO). EO's efforts in this area fall into four categories: determinations or rulings on applications for tax exemption, public education and outreach, guidance, and post-filing compliance.

Application for Tax-Exemption
TE/GE's application program for organizations seeking exempt status is particularly important. In this program, prospective exempt organizations submit information to the IRS about their purpose and structure. Determination specialists review the applications and, where appropriate, work individually with the applicant organization to help them understand the requirements for tax exemption and any necessary changes. Unless the organization is later selected for examination, the determination process is often the only time the IRS is in direct contact with the organization.

The application process therefore represents an important opportunity for the IRS. It is the time when the IRS has the chance to insure that the charity is organized as required by law, that the organization is operating properly, and that the IRS has the information it needs about the organization. The determination letter process also presents an important educational opportunity for the applicant to learn of its responsibilities and filing obligations as a tax-exempt organization.

Most organizations seeking recognition of exemption from federal income tax must use specific application forms prescribed by the IRS. Primarily, these are Form 1023, *Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code*, and Form 1024, *Application for Recognition under Section 501(a)*.

Customer Education & Outreach
TE/GE conducts an active education and outreach program for the charitable sector. This effort is designed to keep exempt organizations compliant by keeping them alert to the requirements of the law and by giving them the opportunity to have their questions answered.

We also accomplish this through a balanced program that provides both "online" educational materials that are available 24/7, as well as "real time" events such as workshops, seminars, on-line webinars, speeches, and phone forums.

Our "online" effort involves extensive use of electronic media. A free e-mail newsletter, *EO Update*, reaches over 188,000 subscribers (up 23 percent from FY2010). Our numerous publications and other materials are increasingly distributed online. And the EO website (www.irs.gov/charities) plays an important and growing role as a resource for tax-exempt organizations. EO's homepage had 2 million visits in the first five months of calendar 2012 – a monthly average of 335,000 visits.

The web site includes web-based information tools called "Life Cycles." Each Life Cycle provides practical information about each of five stages organizations typically go through during their existence: starting the organization; applying for tax-exempt status; filing required returns and other documents; maintaining the organization; and terminating the organization. We provide Life Cycles not only for public charities and private foundations, but also for other tax-exempt organizations such as social welfare organizations, labor organizations, agricultural and horticultural organizations such as farm bureaus, and trade associations and other business leagues. Another popular tool we offer is StayExempt.org, a web-based version of our day-long workshop for small and mid-size exempt organizations.

The exempt organizations community is using these tools. In the year ended June 30, 2012, for example, we recorded more than 119,000 visits to the public charity life cycle site, over 50,000 visits to the private foundation life cycle site; and over 142,000 visits to StayExempt.org.

We provide education and outreach to exempt organizations through "real time" events such as workshops, seminars, online webinars, speeches, and phone forums. In FY 2011, we reached 41,252 customers through our real time events – a 28 percent increase over FY 2010. We conducted 30 day-long workshops, held at different colleges and universities, for small and medium size section 501(c)(3) organizations.

In addition to providing general education about the responsibilities of tax-exempt organizations, advising charities about changes in the tax law helps them stay compliant. For example, the Pension Protection Act of 2006 requires automatic revocation of exempt status of organizations that fail to file a Form 990-series return for three consecutive years. We conducted extensive outreach on this issue, and launched SelectCheck, a searchable online database to help the tax-exempt community and the public track organizations' tax-exempt status.

Post-Filing Compliance

While we provide an upfront evaluation of a charity's exempt status and support exempt organizations with customer education and outreach, we also must have a process to review these organizations as they operate. We therefore maintain a robust and multi-faceted post-filing compliance program. We are organized and staffed in a way that allows us to respond flexibly to different types of non-compliance in different areas. We constantly seek more efficient and effective ways to conduct examinations, and continuously refine our selection criteria to help us apply compliance resources where they are most needed.

IRS Exempt Organizations agents conduct reviews of exempt organizations in various ways:

- "Review of Operations Office" reviews: The Review of Operations Office (ROO) carries out its post-filing compliance work without needing to contact taxpayers. A ROO review is not an examination; the ROO looks at an organization's Form 990, website, and other publicly available information to see what it is doing and whether it continues to be organized and operated for tax-exempt purposes. The ROO looks at a random sample of new organizations after they have operated for a year or two, and also follows up with older organizations that we have examined and with whom we have entered into a closing agreement to resolve compliance issues. If it appears from a ROO review that an organization may not be compliant, the organization is referred for examination. Separately, the ROO conducts the statutorily mandated community benefit reviews of tax-exempt hospitals.

- Compliance checks: In a compliance check, we contact taxpayers by letter when we discover an error on a taxpayer's return or wish to obtain further information or clarification. A compliance check is an efficient and effective way to maintain a compliance presence without an examination. We also use compliance check questionnaires to study a specific part of the tax-exempt community or specific cross-sector practices.

- Examinations: Examinations, also known as audits, are authorized under Section 7602 of the Code. For exempt organizations, an examination determines an organization's continued qualification for tax-exempt status. We conduct two different types of examinations: correspondence and field.

    - Correspondence examination: In a correspondence examination, the examiner conducts the audit through correspondence with the organization's officers or representatives. These audits are often limited in scope, focusing on only one or two items on a return. On occasion, if the issues become complex or if the organization does not respond to correspondence efforts, the IRS may require representatives from the organization to bring their records to an IRS office. We may also convert a correspondence examination into a field examination.

    - Field examination: In a field examination, the examiner conducts the audit at the organization's place of business. Generally, these exams are the most comprehensive. There are two distinct types of Exempt Organizations field examinations:

        1. Under the Exempt Organizations Team Examination Program, examinations are conducted by a team of IRS specialists. The IRS typically uses team examinations for the largest exempt organizations.

2. Under the Exempt Organizations General Program, an examination is usually performed by an individual revenue agent.

The post-filing compliance program is aimed at detecting and deterring noncompliant behavior. We have strengthened this program by broadening our approach and shifting resources into it. In FY 2003, we had 394 examinations full time equivalents (FTE) and closed 5,754 returns. In FY 2011, we had 531 examinations FTE, and through a combination of enforcement projects and traditional examinations, closed 11,699 returns, more than doubling the 2003 figure. We also completed 3,194 compliance checks. We are strengthening the program by using results from completed examinations, new data from the redesigned 990, our studies of customer segments, and the application of research techniques to distinguish between those who are willfully noncompliant and those who make errors while attempting to follow the rules. We then apply our examination resources accordingly.

Reporting Requirements

Most exempt organizations must file one of the Form 990-series returns – the 990, 990-EZ, 990-N, or the 990-PF.[31] There are certain exceptions, such as for churches and their related organizations.[32]

Form 990. For tax year 2010 and beyond, an organization that is not a private foundation must file Form 990 if it does not meet the criteria for filing the Form 990-EZ or Form 990-N.

Form 990-EZ. An organization that is not a private foundation with annual gross receipts of less than $200,000, and total assets less than $500,000 for the tax year may file Form 990-EZ instead of Form 990. Form 990-EZ is a shorter and simpler version of Form 990.

Form 990-N. Organizations that are not private foundations with annual gross receipts that are normally $50,000 or less may file Form 990-N instead of filing Form 990 or Form 990-EZ. The Form 990-N, also referred to as the "e-Postcard," is filed electronically. Filing is very simple and requires no specialized computer equipment or software. The Form 990-N asks for:

- The employer identification number (EIN),
- Tax year,
- Legal name and mailing address,
- Any other names the organization uses,
- Name and address of a principal officer,

[31] IRC § 6033.
[32] IRC § 6033(a)(3).

- Website address, if the organization has one,
- Confirmation that the organization's annual gross receipts are normally at or below the threshold, and
- If applicable, a statement that the organization is going out of business.

Form 990-PF. Private foundations must file the Form 990-PF.

Organizations with $10 million or more in total assets that file at least 250 returns during the calendar year (including income, excise, employment tax, and information returns) are required to file Form 990 electronically.

Organizations that are required to file a Form 990-series must file Form 990, 990-EZ, or the 990-N by the 15^{th} day of the fifth month after their tax year ends. For example, May 15 would be the due date for an organization with a December 31 year-end. Organizations exempt under section 501(c) with gross income of $1,000 or more from a regularly conducted unrelated trade or business also file the Form 990 –T, *Exempt Organization Business Income Tax Return.*

The Form 990-series returns are unique and useful for four key reasons. First, the Form 990, Form 990-EZ and Form 990-N are information returns, not tax returns. The primary reason tax-exempt organizations file a return is to provide information on their programs and activities. We use this information to verify the organization is operating in accordance with its stated tax-exempt purpose and is not violating rules and regulations governing tax-exempt status.

Second, tax-exempt organizations are required to make their returns widely available for public inspection. Organizations must allow the public to inspect the Forms 990, 990-EZ, 990-N, and 990-PF they have filed with the IRS for their three most recent tax years. Exempt organizations are also required to provide copies of these returns when requested, or make them available on the Internet. They are also available from the IRS.

Third, exempt organization returns are used as multi-jurisdictional forms; nearly 40 states require exempt organizations to file some or all parts of a Form 990-series return to satisfy the states' filing requirements.

Finally, these information returns promote transparency and accountability, which strengthens the relationship that an exempt organization has with its stakeholders and funders.

Form 990 Redesign

The Form 990, *Return of Organization Exempt from Income Tax*, is a key element of our compliance program. The IRS undertook a comprehensive redesign of Form 990 that was effective beginning with tax year 2008.

We began redesigning the Form 990 in 2004. The basic format and content of the form had remained essentially the same since 1979, while the community of tax-exempt organizations had grown dramatically in size, variety, and complexity. The prior Form 990, with its emphasis primarily on revenues and expenses, assets and liabilities, had grown outdated. It was primarily a series of yes/no checkboxes and numbers, but did not provide an accurate portrait of what an exempt organization was actually doing. Nor did it reflect the full scope, activities, or dynamics of modern, sometimes multi-leveled tax-exempt organizations. The form needed to be updated to meet the needs of the IRS and the public to understand the activities of tax-exempt organizations, and to confirm that these organizations were continuing to operate consistently with their tax-exempt purposes.

In redesigning the Form, the IRS followed three guiding principles:

- Promote compliance with the tax law,
- Promote transparency, and
- Minimize burden (where consistent with the first two principles).

The redesign was a comprehensive, collaborative effort in which the IRS sought and received extensive input from the public. We met with nonprofit associations, state charity regulators, public interest groups, policymakers, and various representatives of the tax-exempt community. We redesigned the Form 990 based on input from both our own internal stakeholders (e.g., our Examinations and Submission Processing functions) and these external groups.

Once we developed a draft redesigned form, we released it to the public, including the exempt sector, and asked for comment. To help all filers become familiar with the Form, we released two drafts of the 2008 Form 990, and a draft of the instructions, in the year and a half before we published the final Form. We accompanied these drafts with educational resources showing how the Form had changed, and including tips for completing it. Over the course of a year and a half, we held seminars and provided speakers for interested parties. We explained the new format (a core form and schedules), what we were asking for and why, and we solicited comments. We wanted to know from affected organizations and practitioners whether the draft form's questions were relevant, reasonable, and feasible to answer.

We met with stakeholders, who had provided comments to make sure we understood them, and we had conversations about what we – and they – were trying to accomplish. Where recommended revisions furthered our goals of transparency, compliance, and/or minimizing taxpayer burden, we revised the form. We considered every comment that was submitted, and made many further changes based on them. The final Form 990 took effect in the 2008 tax year. The redesign is evolving, and we continue to receive comments from the sector and to refine the form.

We recognized that the transition from the old to the new Form 990 would change the way some organizations capture and track data needed to complete the form. To give small and mid-sized organizations with fewer legal, accounting, and administrative resources more time to adapt to the redesigned form, we provided transition relief. We implemented a three-year phase-in period, raising the asset and gross receipts thresholds for Form 990 filing by ten-fold for tax year 2008 (from $100,000 in gross receipts and $250,000 in assets to $1 million and $2.5 million, respectively), by five-fold for tax year 2009 ($500,000 and $1.25 million), and ending at $200,000 and $500,000 for tax years 2010 and later. The transition allowed hundreds of thousands of smaller and mid-sized organizations that would have been required to file the Form 990 for tax years 2008 and 2009 to file the shorter Form 990-EZ for one or both of those years. This transition period also gave organizations time to progressively enable their internal systems to respond to the new requirements.

We have posted on our website, IRS.gov/eo, many audio, visual, and written tools to assist filers in understanding and completing the Form 990 and its schedules. We also speak at conferences, seminars, and webinars throughout the year to reach thousands of representatives of tax-exempt organizations and answer their questions about Form 990 preparation. We continue to accept comments through the IRS Form 990 comment mailbox.

In short, the redesign of the Form 990 remains an ongoing and continuing process that will continue as the IRS monitors levels of compliance, shareholder needs, and changes to the law.

Conclusion

I have provided you with descriptions of the general law applicable of section 501(c)(3) organizations, and of the key elements of our regulatory and education and outreach programs.

We look forward to continuing our work with this Subcommittee, with the Congress, and with all parts of the charitable sector and its leaders as it continues to evolve and change. We will work to insure that the public remains confident that its contributions of time, effort, and money, are used for charitable purposes.

Thank you again for the opportunity to be here this morning and for your interest in this subject. I will be happy to answer your questions.

Chairman BOUSTANY. I failed to mention earlier that your full testimony will be made part of the record.

You very succinctly outlined a number of challenges, both with some of the generalities of a law that create problems, as well as the rapidly growing nature of this sector, both in terms of size and complexity. The revision of the Form 990 was a multi-year process involving comments from hundreds of stakeholders. Clearly, it was a very important initiative of the IRS and the taxpayers. Can you describe the compliance issues that gave rise specifically to the revision of Form 990? Can you outline some of those?

Mr. MILLER. Certainly, Chairman.

In talking about how we dealt with the 990, as I mentioned in my testimony and is in my written testimony in more detail, we had not modified the form in any realistic way since 1979. In 1979, organizations were much simpler, they were much smaller. There was great diversity still, but it was a very different world. As it is in the corporate world, the world of nonprofits truly has changed over time. We did not have a good enough vision into things, such as compensation, things such as related organizations. What did the entire organization look like, in fact. We did not have a great deal of information on the largest of the organizations, colleges and universities, hospitals.

So there were several areas that we did not have sufficient information really to regulate in and that as we revised the form decided to try to——

Chairman BOUSTANY. So these were some of the areas that were targeted from a compliance standpoint?

Mr. MILLER. These were areas that we saw huge amounts of resources in the sector dedicated to, and we did not have a good enough vision into what was happening there.

Chairman BOUSTANY. With regard to the Form 990, are you satisfied with the progress, the type of information coming in, and from an administrative standpoint, has it been something that has worked both ways? In other words, you are able to collate this data and use it effectively?

Mr. MILLER. So I think it has been a success. I also think it is an ongoing effort. I absolutely don't want anyone to come away from this thinking that we are done, that we haven't—what we did—I will do it in three parts.

First, was it necessary? I think it absolutely was, and I don't think you will get any argument about that.

Second, did we engage in an extensive discussion with the industry? Absolutely did. It started in 2004 for a 2008 return, put out two drafts, significantly modified the second draft specifically for the comments that were made. So I think if you talk to folks they will say, yes, it was a participatory process. Are we done? Is there too much burden on some of it? Probably, is the answer to that, unfortunately. It has got to be a living document, and we need to talk to folks and look at what they are saying in terms of have we gotten it right. Because I think we have, but by no means is the discussion over.

Chairman BOUSTANY. Thank you. Now I would like to pivot to a different issue and look at some of the compliance challenges with regard to unrelated business income tax. The unrelated business income tax rules are an ongoing source of confusion and certainly a challenge from a compliance standpoint. Can you describe for the Committee the types of compliance challenges the IRS faces in enforcing UBIT and how the redesigned Form 990 addresses some of those concerns?

Mr. MILLER. So this is probably less about the redesign than it is about a general rules here. We have several problems and issues in addressing the Form 990–T, which is actually the form that gets used here. There are three generalized requirements for what is unrelated, and it starts with is it regularly carried on? Is it a trade or business? These are things that we sort of can deal with. The third one, is it substantially related? And that is a remarkably difficult and soft sort of issue to deal with. Is it related to have a gift shop sell postcards of things that are in the museum that is attached to it? These are the sorts of issues that we actually have to parse through in dealing with that particular issue. Other issues also exist in the area. A key issue is exactly what expenses are taken against the unrelated business income, especially where there are indirect expenses being taken. Those are things that are very hard I think for the taxpayer to do and very hard for us to do as well. So those would be the two things that are mainly our issue: What is substantially related, and how do you deal with expenses, in particular indirect expenses?

Chairman BOUSTANY. Is there any move on the part of IRS to start looking at revising some of those regulations, looking at those definitions and the complexity there?

Mr. MILLER. I think it would be good if we had the resources to do that. I don't think that right now we are looking at that. It is not at the top of our list of things that we can get to, to be honest with you.

Chairman BOUSTANY. From your standpoint, do you think—is there anything Congress needs to do from a legislative standpoint to provide more clarity with regard to some of those areas that are murky?

Mr. MILLER. I am more than happy for us to talk to staff on that issue. I don't know of anything off the top of my head. As I said, substantially related is just a very difficult, difficult concept.

Chairman BOUSTANY. Right. And I know there is a multi-step process as you work through the Form 990 and sort of working through your entire compliance process. How does the IRS determine whether an audit related to UBIT is warranted?

Mr. MILLER. So we will be looking at the Form 990 itself to see what an organization is doing. And then we receive about 40,000 to 50,000 Form 990–Ts. And that is where a particular organization will outline all of the necessary information that it has done in order to calculate whether it owes unrelated business income tax. We will be looking at both of those in order to make that determination.

Chairman BOUSTANY. Were there any particular red flags that an auditor would—you know, that would prompt an auditor to take a closer look at a public charity, for instance?

Mr. MILLER. I don't off the top of my head know what a red flag would be in this area, and I am not sure I would throw it out for public discussion.

Chairman BOUSTANY. I understand. All right. Thank you. That is all I have.

Mr. Lewis, you are recognized for questions.

Mr. LEWIS. Thank you, Mr. Chairman.

Mr. Miller, thank you for being here today, and again welcome.

I must tell you that I am deeply concerned about the IRS' ability to oversee about 2 million tax-exempt organizations when your budget has been cut. Public charities alone have over $2.5 trillion in assets and $1.5 trillion in revenue each year. I understand that the funding and number of employees for the exempt organization division have been cut this year. Are you trying to do more or the same with less? Could you explain to the Committee?

Mr. MILLER. Certainly, Mr. Lewis. Across the service, we have had to face decisionmaking with respect to a declining budget over the last couple of years. Probably at its height, in recent years, the exempt organizations division had about 950 people, 940, 950 people. We are down to about 860. We will be down from there by the end of this year.

We are trying to maintain current levels as best we can, but it has been a challenge. Now we are getting smarter, I hope, with the types of things that we do, and we have efficiencies that we are doing. But it is a challenge, as it is across the service.

Mr. LEWIS. Could you tell me how many tax-exempt organizations exist?

Mr. MILLER. We have—I think the latest data that I have publicly available is about 1.85 or something like that million organizations, 1.3 of which are 501(c)(3) organizations. Now, those are somewhat dated numbers, but that is roughly right.

Mr. LEWIS. Now you have less money, right, you have less money?

Mr. MILLER. We do.

Mr. LEWIS. Less resources, fewer employees to monitor and oversee the sector. Given the IRS budget constraints, how does the IRS oversee this sector—or do you think you are doing the best possible job with less money and less employees? Is something falling through the cracks? Are we missing something?

Mr. MILLER. Mr. Lewis, I would be obviously remiss if I didn't take you up on the opportunity to ask for more resources, which we could certainly use.

Do I believe we are missing something? I don't believe so. I believe we have to be efficient in the way we do business. But we certainly could use more resources. This sort of toggles back, Mr. Chairman, to your discussion of the Form 990. We have always been somewhat understaffed in this area. That has not changed. We are a little more understaffed than we were. We have always relied upon the transparency of the annual reporting to leverage other folks taking a look, finding problems, coming to us with the problems. That has always been a help to us and an essential part of our regulatory regime in the exempt organizations area.

Mr. LEWIS. Thank you very much, Mr. Commissioner.

Thank you, Mr. Chairman.

Chairman BOUSTANY. I thank the gentleman. Lest anybody thinks this is quite as simple as just simply improving resource allocation, I think we also have to mention the complexity of tax law. And in the spirit of moving forward with the tax reform, I am hopeful that our Full Committee in a bipartisan way will be able to move forward with the tax reform to lend greater clarity to the Tax Code, but also simplicity that will make compliance easier. With that, I will yield to Ms. Jenkins.

Ms. JENKINS. Thank you, Mr. Chairman, and thank you for holding this hearing.

Thank you for being here Mr. Miller. What is the process for an organization that applies to be a public charity? I am aware that you submit a Form 1024 and that begins the application on a review process. But what are the specific steps an applicant can expect.

Mr. MILLER. So, actually, if you are talking about a public charity it would be a Form 1023 that has to be filed by all, with the exception of very small organizations and churches and church affiliates. But an organization would prepare the Form 1023, which basically outlines its prospective operations. What are its budgets going to be? What are its activities likely to be? Who is going to run the organization? What are they going to be paid? All of these things so that we can take a look to see whether they meet the requirements. Those are filed with us in Cincinnati, Ohio; Covington, Kentucky, and are reviewed in our Cincinnati office by specialists. Some are very easy. If they are small organizations, they don't get a very detailed look. We look, we say, okay, this seems right. Some may be very simple but are being done by folks who don't really have experience. Those may take a little longer because we will work to have them understand exactly what their obligations are and what their rights and responsibilities are as a tax-exempt organization. Some come in and they are doing things that either are close to the line, impermissible, unclear as to which of those two that they might be and those may take a longer time still, and they will be referred to specialists in Cincinnati and elsewhere that will take a look to justify it and see whether or not the organization qualifies as a public charity.

Ms. JENKINS. Okay. Has the revision of the Form 990 led the IRS to approach the application process any differently?

Mr. MILLER. I don't believe so. I will say that our advisory Committee, which is a batch of specialists outside of the IRS, has come back and said, what you have done with the 990, you probably should do with the 1023. And so at some point, we probably will take a good hard look. We did redesign the 1023 in advance of the 990. It is probably time to take another look at it.

Ms. JENKINS. Okay. Once an organization is approved as a public charity, can you explain how the IRS ensures that the organization remains in compliance and how do you ensure that the organization continues to engage in activities that further its exempt purpose?

Mr. MILLER. So the primary way of our doing that would be through the Form 990, through the annual filing requirement of the organization. And I mention there is a series of possible forms. The very smallest organizations, which have less than $50,000 in receipts in a year, they are filing a postcard with us, an electronic postcard, with like six items as to, okay, how do we contact you and where are you. It is sort of a fact of filing so that we can maintain our records in an intelligent fashion. There is also a 990–EZ which is a shorter form of the 990, which if you have less than $200,000 in gross receipts or half a million in assets, you will be filing that with us on an annual basis. And then there is the Form 990 that was the subject of the large scale redesign for larger organizations. And that really is the way we can take a look at these organizations across the country and see whether they are meeting the requirements.

Ms. JENKINS. Okay. Thank you.

Mr. Chairman, I yield back.

Chairman BOUSTANY. Thank you.

The chair now recognizes Mr. Kind for 5 minutes.

Mr. KIND. Thank you, Mr. Chairman, and thanks for holding this hearing today. I think it is very important because it is such a fast moving area of IRS jurisdiction and oversight that I think it is incumbent on the Committee to pay a little more attention to. I appreciate your willingness to do so.

Mr. Miller, almost 2 million tax-exempt organizations; obviously, Representative Lewis expressed concern about funding and resources and personnel in order to deal with such large numbers, and now we are starting to see a lot of tax-exempt organizations engaging in blatant political activities. I mean, how much is the IRS capable of reviewing these type of activities to make sure that these organizations are complying with the law, they are meeting their charitable purposes and that, given the plethora of other tax-exempt organizations that you have to keep an eye on as well?

Mr. MILLER. Well, we do maintain, and again, we are talking about public charities here, we do maintain a process by which we take a look at organizations that are either referred to us or come up in the papers as having done these sorts of political activities in the 501(c)(3) area. Those referrals, that information, will make its way to our Dallas office, which is the examination function, where a team of three individual careerists will take a look and determine, is there enough here to start an audit or not? So we do maintain a program in that area.

Mr. KIND. A lot of the casework that I see, I don't know if my colleagues share this observation, but it is dealing with smaller charitable organizations back home trying to obtain tax-exempt status and helping them navigate, make sure they are legally compliant and doing everything that they need to do. Given the lack of resources that Mr. Lewis just pointed out, are you still able to provide sufficient service for the smaller charitable organizations and helping them comply with the law and everything that they need to do?

Mr. MILLER. So we are trying, is I think a fair answer to that question. Could we do more? Absolutely. We are trying by putting more of our work on our Web site so that organizations can reach out. I would like to do more small, small organization conferences. Right now, that is not really the most efficient use of the resources that we have. But our Web work is good. We have also begun to partner with local educational institutions, universities and such, to try to have them take the lift and bring small organizations together so that we can get our word out that way as well. So we are trying.

Mr. KIND. Also, the redesigned 990 now has a new schedule R. Why was that necessary and how does that help you perform your functions?

Mr. MILLER. So the R, unless I am mistaken, is the related entity schedule. And that was essential we think because we needed to see—we needed to have a window into what the entire organization looks like. A hospital system is more than an individual corporation. A college and university is more than the very college or university itself. It is an endowment. There are numerous things around that organization that we sort of needed to take a look at. I will say it is probably one of the areas that we should be talking to people about. Is it too much information or too many people having to do that?

It is worth the discussion. It is one of the areas that we are beginning to hear maybe there is burden there that we can alleviate. But the concept is essential because the largest organizations, you need a complete window into what the organization looks like, what the web of organizations is.

Mr. KIND. All right. Great. Thank you.

Thank you, Mr. Chairman.

Chairman BOUSTANY. Thank you, Mr. Kind.

Before I go to Mr. Marchant, I have a quick question I would like to ask you, Mr. Miller, in follow-up to Ms. Jenkins' questioning. And that is, can you comment on whether the thresholds make sense with regard to the different forms? I mean, or should that be revised?

Mr. MILLER. So I am open to the discussion.

It was placed there basically in conjunction with the discussion with the States who are using these numbers as well, but it is one of the things we ought to talk about. So originally, there was no filing requirement for organizations with $25,000 or less in gross receipts. The Pension Protection Act of 2006 modified that and said, no, everybody has to file. We moved that group up to $50,000. And we also modified the other numbers a bit as well to try to provide some relief from what we knew was going to be a somewhat more burdensome 990. We are open to the discussion as to whether those thresholds are correct.

Chairman BOUSTANY. Fair enough.

Mr. Marchant, you are recognized.

Mr. MARCHANT. Thank you, Mr. Chairman.

In my discussion this morning, I would like to focus on some of the smaller local groups that are claiming tax-exempt status. And these are groups that are unapologetically politically involved. I mean, in fact, they were formed around that idea. What would a small group in a suburban town that might have 60 to 80 Members, what is the most likely organizational tool that they would file in order to be tax exempt?

Mr. MILLER. Are these organizations coming in as 501(c)(3)s, or would they be coming in as 501(c)(4)s?

Mr. MARCHANT. I think that is my question. What would be the most efficient as far as compliance goes?

Mr. MILLER. So if they are really doing politics, Congressman, they really can't be a charitable organization under the Internal Revenue Code.

Mr. MARCHANT. So would they be a tax-exempt organization?

Mr. MILLER. So they could be one of a couple of things. They are permitted to have some politics in their business if they are a 501(c)(3) social welfare organization, although they need to primarily be engaged in other than politics. They can do some work if they are a labor union to qualify that way or as a trade association. Those are also able to do some politics.

But really, if all they are going to be doing is politics, then they probably should be a political organization, that we would describe under section 527, a PAC.

Mr. MARCHANT. And so if they don't file for the 527 PAC designation, many of these groups are now contacting our offices. I can speak for myself. I have been contacted by several of the groups in my district. And they feel like they are being harassed. I don't have any evidence that that is the case. But they feel like they have been harassed and feel like the IRS is threatening them with some kind of action or audit. What kind of a letter or action is taking place at this time that you are aware of?

Mr. MILLER. So if we are talking about social welfare organizations, (c)(4)s, 501(c)(4)s, then we did receive quite a few. We received an uptick, an increase in the number of (c)(4) organizations that were advocacy organizations, they were advocating on various things, which is a fine thing for a 501(c)(4) to do. It is politics that isn't really considered to be appropriate 501(c)(4) behavior past a certain threshold because they can do politics. And what is politics also, Congressman, is, you know, it may not be what you and I would think of politics as; it is politics under the Internal Revenue Code, which is really campaign intervention. It is endorsing or arguing against a particular candidate for public office, that is politics.

So you know I am aware that there is an uptick of organizations that came into us for exemption. So it was the determination letter process, not the examination process.

I am aware that some 200 501(c)(4) applications fell into this category. We did group those organizations together to ensure consistency, to ensure quality. We continue to work those cases.

My understanding, Congressman, is something over 50 of the 200 have received exemption already, more will. But many of these organizations fall into the category that I was talking about with Congresswoman Jenkins, where they are very small organizations and they are not quite sure what the rules are, and so we are working with them to ensure that they understand what the rules are. It is my hope that some of the noise that we heard earlier this year has abated as we continue to work through these cases.

Mr. MARCHANT. Yes, we have had many constituents call, and there is a lot of blog activity. There is a lot of activity on the Internet talking about potential legal fees in the hundreds of thousands of dollars in fines in this group. So what is the potential if a group crosses over the line from being advocacy, advocating certain policy, over into the endorsement, the campaign endorsement realm?

Mr. MILLER. So if they are coming in for application to be recognized as a social welfare organization, and they don't receive that recognition, then they would just not be a tax-exempt organization.

Mr. MARCHANT. So what about organizations that have already received the recognition but somewhere along the way have shifted their emphasis to where—is there an audit process?

Mr. MILLER. There would be an audit process to determine what was their primary activity. Was their primary activity good 501(c)(4) work, societal benefit, community benefit, social welfare or something else. And the something else could include much more than politics. It is just non—and so if we found that they were not primarily engaged in social welfare activities, we would revoke their exemption or work with them, as we do oftentimes, to move forward in an improved way.

There also would be under the tax rules some possible tax based on the lesser of net investment income that they had or the political expenditure itself under the Code.

Mr. MARCHANT. Thank you, Mr. Chairman.

Chairman BOUSTANY. Thank you.

I thank the gentleman. Mr. Becerra, you are recognized for 5 minutes.

Mr. BECERRA. Thank you, Mr. Chairman.

Mr. Miller thank you for being here. Is there a section on Form 990 that requires a social welfare organization to document what portions of that organization's activity or portions of those activities are devoted to political activity specifically?

Mr. MILLER. Yes, sir, I believe there is.

Mr. BECERRA. And does the IRS have a bright line in terms of how much of that 501(c)(4)'s activities can be spent as political expenditures?

Mr. MILLER. We do not have a bright line, no.

Mr. BECERRA. Does the IRS plan to try to provide better guidance to 501(c)(4)s as to at what point that bright line is crossed?

Mr. MILLER. So we have received obviously some inquiries, both from your colleagues and from others in the community, to look at the area. I don't think we have made a decision as to whether to do guidance one way or another, but we have agreed to take a look and have that discussion.

Mr. BECERRA. So for any organization that is looking to stay within the law and also wants to engage in some aspect of political activity, what guidance would IRS give that organization?

Mr. MILLER. Well, they ought to get professional help, obviously, because this is not a——

Mr. BECERRA. We know they need professional help.

Mr. MILLER. We will move on from that.

So the general rule, as I was mentioning to Mr. Marchant, the rule is that a 501(c)(4) organization must be primarily engaged in activities that further and promote community benefit, social welfare. We have been asked to primarily test a bright line, and we don't believe it is. It is not a qualitative test—or rather it is a qualitative test versus quantitative. We would be looking at things like expenditures. We would be looking at things like staff time, including volunteer time. We would be looking at what dollars are being devoted to this activity, what dollars are being derived from this activity, what sorts of assets are being dedicated to this outside of fixed assets, what kind of building and equipment. All of those things would come into sort of the conversation. And that guidance is sort of out there in terms of both court cases and revenue rulings to give people sort of a guide way to make that determination on their own.

Mr. BECERRA. Now, what about this whole notion that social welfare should be the principal purpose of the activities of some of these 501(c)s, (c)(4)s, (c)(3)s and so forth, and the fact that it seems like some of these 501(c)(4)s are stretching what might be considered social welfare to the point where it is blurred and it looks nothing like a social welfare activity that most Americans would reasonably think can be applied to that term.

Mr. MILLER. So, again, the general rule would be a 501(c)(4) organization can do campaign work, but it must be primarily engaged in social welfare activities, and it can't operate for the private benefit of a select group.

To your point, first, there is no bright line, and we would take a look at organizations that were involved in politics.

Secondly, this is an area obviously that for us is somewhat difficult, because for a 501(c)(4) organization, when I talk about how do you calculate out the primarily test, you look at the entire year. So the fact that an organization is doing something today might be relevant to the inquiry, but it is not the end of the inquiry. The inquiry is, what are your activities for the year? What did you do, and how much of it did you do? So it is almost always going to have to be after the year is up that we have sufficient information in a 501(c)(4) context to make a determination as to whether there is a problem or not.

Mr. BECERRA. And do you have the resources and staff to try to monitor and oversee all the different 501(c)(4)s and how they apply that social welfare test?

Mr. MILLER. We could always use more resources. I believe we have sufficient resources if we decide to place them in the places we need to place them, is sort of the answer there, Congressman.

Mr. BECERRA. I will try to decipher that answer. Thank you very much.

I yield back Mr. Chairman.

Chairman BOUSTANY. I thank the gentleman.

This hearing is really intended to focus on the public charities and the (c)(3)s. I know the activities with (c)(4)s is an issue, and it is something we will get to down the line. But right now with this hearing, I wanted to keep the focus on the (c)(3) organizations and the complexities with regard to organizational structure, UBIT, and some of the vagaries that attend those issues and the problems that arise as a result. So I appreciate the gentleman's questioning, but hopefully, we will keep it to the public charities.

Mr. Reed.

Mr. REED. Well, thank you, Mr. Chairman.

I was going to continue on that line of questioning, but I will back off to another day.

But I am interested at some point in time if you could, Mr. Miller, get to my office, you referenced three careerists who make these decisions on political activity or not. I would like to know who they are, how they are appointed, what their tenure is and what the process is that they use to adjudicate whether or not it is a political activity. Do you mind doing that for me?

Mr. MILLER. As to the names, I will have to see about that one. Mr. Reed, these are careerists, these are lower graded folks who are managers, group managers at some point, and they cycle in and out. It is not only a—it is not one single three person.

What we have tried to do in the area is make sure that one individual at the service can't start an examination that is a politically charged type of examination.

Mr. REED. But if I understand your testimony, there are three individuals that are kind of the sounding board.

Mr. MILLER. There is a referring committee that as a normal course of its business and under established procedures of the Internal Revenue Service receive referrals, evaluate the referrals.

Mr. REED. That is what I would like to get to. I am new here, so how you operate and what the background is.

Mr. MILLER. I would be glad to walk you through the referral process.

Mr. REED. I really do appreciate that. It is more of an educational exercise for me and making sure that we are aware of it and getting up to speed on it.

But I do want to challenge you on one thing, Mr. Miller—and I appreciate the work you do. I totally appreciate what the IRS is under and the burden that the IRS faces with managing the whole tax issue and revenue job mission that you have for America.

But many witnesses come up here and they state a conclusion to us, and you have stated it again today. You have stated that you are understaffed. And my colleagues on the other side have raised that issue repeatedly. I want to know from you as a deputy commissioner, a leader of a large organization, how do you determine that conclusion? Are there metrics? I mean, is your goal then—and then also the flip side of that, what is fully staffed? I can't imagine you are advocating to have 2 million IRS employees added to monitor one for one each of the organizations. So obviously to illustrate my point, I am taking it to the extreme.

So I want to understand what allows you to state that conclusion to us as Members of Congress that you are understaffed? What is not getting done that should be getting done? And what is your definition of fully staffed?

Mr. MILLER. So I will start with what I don't have. I don't have a definition of fully staffed. Congress determines what our full staffing is. Are we understaffed? We have enough people to do the job we need to do. Could we use more? Absolutely, Mr. Reed. The way I would like, and it is not only staffing, right, it is IT money as well, I would like, I would very much like, especially for small organizations but for all organizations, to modernize the way they fill out an application form, to sort of have a 1023 that is online that they can fill out easily with help along the way, not unlike the tax software that we all sort of use; what does this mean, and there will be information right there for them to pull down and get that information. I would love to be able to build that system. And I would like to be able to say to you that I have better and more robust number of examinations that I am doing relative to the 1.3 million organizations that are out there.

So my metrics are difficult, but my metrics would be how many people contacted my various education sites; how fast did I do my work for people, customer satisfaction again; how many people was I able to touch in a compliance fashion to try to influence future behavior by the whole of the group and not just the people that I touched; and am I doing enough of those? And I would say that it is close, Mr. Reed, it is close on that one. But those are the sorts of metrics we would look at.

Mr. REED. And I appreciate that. So my takeaway is that essentially, from your testimony and just correct me if I am misunderstanding it, is that right now staffing resources, making do, you would like to have more, you would love to have more, I believe is your testimony, which I can appreciate, but you are making the best of what you have and you seem to be hitting the targets of the metrics of doing your job. And so is that a clear understanding of your testimony?

Mr. MILLER. So the last bit of it I would say we are getting to the point where I think it is taking us a little too long to get to determination letter requests. I think we may not be doing everything we need to do in the educational area. And we are getting to the point where I would worry about our coverage rate in the exam area. But I am not going to quibble with the discussion. That is roughly right.

Mr. REED. Okay. Thank you. I appreciate that, Mr. Miller.

I appreciate the candor. With that, I yield back.

Chairman BOUSTANY. Thank you, Mr. Reed.

Mr. McDermott, you are recognized for questions.

Mr. MCDERMOTT. Mr. Chairman, I appreciate that you wanted to be on (c)(3)s, but some of my colleagues have gone down another alley. And I see—first of all, I want to ask a question.

Chairman BOUSTANY. Mr. McDermott, you don't have to make the same mistake.

Mr. MCDERMOTT. I think emulation is the high pride of authorship. One of the things that is raised here is, are you doing your job? You didn't mention audits. You sort of obliquely did, that is to get people to you know sort of do what ought to be done in the future. But if you don't have a lot of people, you just don't audit people. That is the place where you make cuts, right?

Mr. MILLER. That and in the determination letter process. There is education, there is——

Mr. MCDERMOTT. You can't avoid that. If they call in asking questions, you got to answer them, right?

Mr. MILLER. Well, I would like to reach out more. I would like to have people available to reach out to these folks rather than wait for the questions.

And the determination letter process is a customer-driven process. You will come in to me with a 1023 or a 1024. I have to work that case. How fast I work it will depend on how many folks I have. And as the folks dwindle, that will suffer as well. So it is more than just exam, but exam clearly is part of that.

Mr. MCDERMOTT. And if you have these targets and something pops up to be audited, do you audit 100 percent of those people whose names come up along because of what something in their account?

Mr. MILLER. We never did, and we never will audit everybody who comes onto our radar screen. We have to make intelligent decisions about how far we can go based on resources and other topics.

Mr. MCDERMOTT. Do you get back money when you audit?

Mr. MILLER. So we do get back some money. As I indicated in my oral testimony, Congressman, we regulate here more than derive revenue from the sector. We seek to protect the investment that the U.S. Government has made in the tax-exempt sector. Mr. Lewis spoke about the amount of revenues. Mr. Lewis spoke about the amount of resources, the $2.5 trillion in assets that sit out there. We are there to sort of ensure not that we take more of that $2.5 trillion, but that it is being utilized within congressional intent.

Mr. MCDERMOTT. When people fight back against you, I walked in here and the discussion was about the Tea Party and the Richmond Tea Party, and I am looking at the letter that you have and these questions—provide a resume for each Member of your governing body, and provide copies for all your newsletters, provide promotional literature developed by your activist committee, provide a list and description of specific events. What is unreasonable about those questions? They say you are being unreasonable in asking for these. Do you think those are unreasonable questions?

Mr. MILLER. So I am not going to speak to the specifics of any given case because I can't.

Mr. MCDERMOTT. Right.

Mr. MILLER. We ask questions. And in the cases that we talked about, we asked a series of questions. We also went back afterwards and said, by the way, if these questions are too much for you, let's talk. And that is what we did in this case.

Mr. MCDERMOTT. So these questions, this is kind of a standard letter here I have, which you send out to anybody you audit—or you are questioning their exemption, is that correct?

Mr. MILLER. So I don't know the letter that you are looking at, Congressman, so I can't say. But we don't send out a standard letter to everyone in any event.

Mr. MCDERMOTT. It is from the IRS, dated 9–17–2010. And it is to this organization, and dear sir or madam. So it sounds like it is a kind of a standard letter.

Mr. MILLER. It might have been standardized to a group of cases, sir, but I can't really speak to this.

Mr. MCDERMOTT. If they call in and say, this is too burdensome for us, we can't do it, do you then talk to them orally. Well, how do you do that? Get them into the office or over the phone?

Mr. MILLER. So these are almost always going to be over the phone because our folks generally are going to be in Cincinnati, and a lot of organizations aren't and don't have the ability to either hire somebody to wander over to Cincinnati or come themselves to Cincinnati. These are almost always a review of paper and additional letters that go out, like the one you are talking about, and responses and a discussion on the phone in conference of right if we are going in a particular direction. But these are more office audits than they are sort of a field audit.

Mr. MCDERMOTT. And from that, you make a determination as to whether they are doing social activities?

Mr. MILLER. Whatever the particular requirements are——

Mr. MCDERMOTT. Under a (c)(3).

Mr. MILLER. So under (c)(3), it would be, are they charitable, and do they have a charitable purpose? Under (c)(4), we would be looking at what they are doing, and does that promote social welfare? Different requirements for different code sections.

Mr. MCDERMOTT. And is the standard for promoting social welfare—my time is up. I would like to see the standard. If you would send us the standard you use for determining social welfare.

Mr. MILLER. Surely. We can do that, sir.

Mr. MCDERMOTT. Thank you.

Chairman BOUSTANY. I thank the gentleman.

Mr. Paulsen.

Mr. PAULSEN. Thank you, Mr. Chairman.

And thank you, Commissioner, for being here. I want to ask a question on a slightly different subject as well because we have heard a great deal from the IRS about a realtime tax system. And there have been a number of public meetings that have taken place on this issue. And many are concerned that this type of a filing system could lead to a very burdensome reporting component, similar to what we saw in the 1099 debate that took place not too long ago. And I think this would be a nightmare for American companies, for businesses, whether you are small or large, and the IRS is going to now make this realtime system work. If you are going to make this realtime system work, I am sure you are going to want to have all the data earlier to collect information than is required today, you are probably going to want to have more 1099 data. Just looking at what has been discussed today, it seems that compressing the report and timeline and potentially increasing the reporting requirements would make an already onerous process even more onerous or more burdensome.

And I sent a letter not too long ago, I think the Chairman followed up and sent a letter as well to Commissioner Schulman, about the realtime taxes a few months ago. I haven't heard back. But can you help get a response to that in particular in looking at that, and do you have some comments on the realtime tax?

Mr. MILLER. So we will certainly look at getting a letter back to you all. On realtime, let me just say a couple of things. First, we are very far away from making any decisions that would move up or even draw a picture of what this might look like. But the conversation—we can't be scared of the conversation, because the concept of our having and the taxpayer having the information available earlier, we can't shy away from that conversation because it is an important area. And in a perfect world, all that information would be available. It would be available for us to make a decision around whether the refund was a good refund or a bad refund going out. And it would allow us to go back and say up front, by the way, you know, we have information that indicates you should have X here versus X minus Y here, do you want to work through that and finalize a return?

But what I would say, again Congressman, is we are very far away from any sort of decision as to what exactly this would look like. What we are doing at this point is building scenarios as to what this might look like for a given taxpayer? We will then engage the public again and throughout this entire process, which will be a multiyear process.

Mr. PAULSEN. So you say you are far away; you are building scenarios. Do you believe that the creation of such a system under it is authorized right now under the IRS charter?

Mr. MILLER. It depends what the system looks like. If we were moving the filing date, no, it wouldn't be. That is a legally set date. Certainly there would be discussions with the Hill before we move forward with anything that even remotely touched on those issues.

Mr. PAULSEN. So you believe you need to have congressional authorization for those types of changes?

Mr. MILLER. For some of the changes, absolutely.

I also want to say, you know, and there has been concern about this, this is not in order to send out pre-filed returns, that is not really what we are talking about here. And I know there has been concern by some in the industry that this is a stalking horse for that. It simply isn't.

Mr. PAULSEN. Do you have any sort of estimates on what the cost would be, because given that we are talking about I had heard some conversation and testimony about resources and employees and staff and how—the intention—to be—to pay for that or what the cost would be on a realtime system for preparing for that as well?

Mr. MILLER. So absent a blueprint of what it would look like, we have no way of doing a cost estimate at this point, sir.

Mr. PAULSEN. Thank you, Mr. Chairman.

I yield back.

Chairman BOUSTANY. Thank you, Mr. Paulsen.

That concludes our questioning, Mr. Miller, and we thank you for coming before the Committee once again, and I look forward to future visits, and this Subcommittee particularly looks forward to working with you going forward to resolve some of these issues.

Mr. MILLER. Thank you.

Chairman BOUSTANY. I would like to call up the next panel. Next we have four witnesses on our second panel, all distinguished witnesses who will lend some clarity to this debate. We will hear from Eve Borenstein.

Ms. Borenstein is a partner with Borenstein and McVeigh Law Office in Minneapolis, Minnesota, and is known as the queen of the 990.

So we welcome you.

Second, we welcome Mr. Thomas Hyatt. Mr. Hyatt is a partner with SNR Denton here in Washington and is chair of SNR Denton's health care practice focusing on tax-exempt organizations.

Sir, welcome.

Thirdly, Mr. John Colombo.

Mr. Colombo is the Albert E. Jenner, Jr., Professor at the University of Illinois, College of Law, in Champaign, Illinois. And Mr. Colombo has written extensively on tax-exempt organizations.

Mr. Colombo, thank you for being here today.

And finally, we will hear from Donald Tobin. Mr. Tobin is associate dean for faculty and the Frank E. and Virginia H. Bazler Designated Professor in Business Law at the Ohio State University's Moritz College of Law in Columbus, Ohio. Mr. Tobin is an expert on campaign finance law and previously worked on the Joint Economic Committee.

Mr. Tobin, welcome.

You will each have 5 minutes to given us your oral testimony. Keep in mind that your full written statements will be made part of the formal record, and so I ask you to keep your oral comments to 5 minutes so we can get to questions.

Ms. Borenstein, we will begin with you.

STATEMENT OF EVE BORENSTEIN, BORENSTEIN AND MCVEIGH LAW OFFICE LLC, MINNEAPOLIS, MINNESOTA

Ms. BORENSTEIN. Thank you Chairman Boustany, Ranking Member Lewis, Members of the Committee.

I thank you for inviting me to testify today. I do not elaborate in my written submission as to why I believe that the redesigned Form 990 for the most part makes the right asks of those who are afforded tax exemption.

There are four points I want to offer in that regard now. One, because the filing is appropriately not just numbers, organizations must be proactive and collect from internal sources the various information the form seeks, as well as prepare written narratives. Accordingly, the amount of resources and time that filers expend in favor of preparation has undoubtedly increased. This is not a bad thing; it is just a fact.

Two, the information the form provides the IRS is more thorough and descriptive than before, allowing the agency to more effectively apply its resources toward improved enforcement and education.

Three, the fact that the filing is widely available makes filers transparent in ways they never were before, which is huge. The public relations power of that transparency leverages the IRS's limited resources as the reading audience brings their own potential "enforcement" forward.

And four, while the new form does have a sharp learning curve, which has burdened the sector, filers are starting to master the form, and I am certain further improvement will be evidenced over the next few years, particularly if the IRS can help.

It is this last point that generates the recommendations I make in my written testimony. As to charges leveled of being overly burdensome, the new form makes multiple asks that its predecessor did not and imposes new architecture for the form—a core form with 15 subject schedules tailored to the individual topics that the IRS seeks information upon, not all of which are in play for most filers.

But as a result, the form's instructions comprise a new playbook for filers and those who assist them. The need to master this new regime has clearly shocked many filers, but many of those had not properly understood or appreciated the form's complexity in the years prior to the redesign. Indeed, many filers have misperceived the prior form as only a financial statement report to the IRS belonging solely to the domain of the organization's accountants.

The new form is clearly a full information return for exempt entities that extends well beyond financial results. It cannot be wholesale handed off to auditors or paid preparers. Completion requires meaningful participation by the filer, whose staff or leadership must now provide firsthand data on the group's output and operations, including information that resides outside of the finance staff.

The understanding by groups of all sizes that this is the case and that they must have a preparer (either internal and/or external) who is committed to mastering more of the new form's learning curve each year has been evidenced as we have moved from the form's filing season in 2009 to today.

Ms. BORENSTEIN. In the recommendations section of my written testimony, I make five specific suggestions and note that comments on overlapping burdens of two schedules should be opened. I urge this Committee and the tax press to read each of those six points not as signs of the redesign's failure or overreach but as lessons from the field.

In that spirit, I want to offer three realities that need to be taken into account before we start assigning final grades to the Redesigned Form and its results to date. First, the IRS should not change the form now, midstream, but instead focus on the few areas where it is clear that burden could be decreased and take advantage of the opportunity to better the form by getting those areas right. As set out in my recommendation, the first one, this is particularly urgent with respect to helping organizations and users of the form understand that the IRS's semantics and reporting requirements are not necessarily value-laden, especially in regards to reporting insider transactions and counting directors as "independent" or not.

Second, we should not conflate the fact that reporting organizations will be burdened by the resources required to complete this annual filing—that is a cost of exemption—with the fact that many organizations do not and will not have access to an accountant or other professional who is qualified to assist in preparing this filing. It is appropriate to keep the preparation challenge situated with filers at all times, regardless of whether they have access to competent paid or pro bono professionals.

And third, the Redesigned Form does a great job of using the form's transparency factor and the certainty of public access by funders, whistleblowers, competitors, reporters, et cetera. The form sets out affirmative reporting responsibilities that I have seen promote far greater compliance and appreciation of tax mandates and charitable precepts than ever before. This is notably evident in the management of compensation and certain other governance arenas, as well as in portions of the form's most complicated schedule, the Schedule L, where filers are to disclose intersections with insiders. That disclosure responsibility has, as it should, generated valuable self-reflection by reporting organizations as to the motives and results obtained from such opportunities.

I can talk about the 990 for hours at a time, but I see my time is up. I look forward to answering any questions you may have. Thank you.

Chairman BOUSTANY. Thank you, Ms. Borenstein.

[The prepared statement of Ms. Borenstein follows:]

TESTIMONY OF EVE BORENSTEIN
PARTNER, BORENSTEIN AND MCVEIGH LAW OFFICE LLC
PRINCIPAL, EVE ROSE BORENSTEIN, LLC

BEFORE THE SUBCOMMITTEE ON OVERSIGHT
HOUSE WAYS AND MEANS COMMITTEE
UNITED STATES CONGRESS
JULY 25, 2012

IN REGARDS TO OPERATIONS AND OVERSIGHT OF TAX-EXEMPT ORGANIZATIONS

Chairman Boustany, Ranking Member Lewis, and members of the Subcommittee, I am honored to provide testimony as to the design and efficacy of the chief tool by which oversight of the operations, activities and finances of most tax-exempt organizations is prosecuted: the IRS Form 990, annual return of organizations exempt from income tax under Internal Revenue Code Section 501(c).[1]

My remarks today will focus on three areas. First, my experience in preparing Form 990, advising clients about the form, and teaching practitioners and organizational staff about the Form 990 for over 20 years, including most recently over that period which witnessed the revolutionary Form 990 redesign implemented for 2008 and later tax years. Second, those reporting areas for which the Form's 2008 redesign requires additional or new information not previously required. Third, those areas of the Form which I believe require further improvement and redesign in order to provide greater clarity and reduce compliance burden.

There is no doubt that the Redesigned Form 990 is a major improvement over the form's prior version. In my experience, the Form's new structure is both easier to follow and has resulted in filers providing more accurate versions of their activities. Filed Forms 990 now include much broader contextual data (mission, narration of changes in programming, explanation of changes in fiscal resources from the prior year or of new policies, etc.) than that which was available via pre-2008 Forms.[2] It is widely-admitted, albeit sometimes grudgingly,

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[1] My remarks do not address the Form 990-EZ (short form for many smaller exempt organizations), the Form 990-T (the annual return to report and pay the unrelated business income tax), or the Form 990-PF (the annual return for private foundations) none of which have been redesigned.

[2] The baseline Form, called the "Core Form" consists of twelve pages filled out by all filers along with a Schedule of blank lines, the Schedule O, where filers narrate additional information called for by the Core Form. A sample Core Form and common Schedule O annotated with tips and explanations that I use in my teaching may be accessed at:
http://taxexempt.ehclients.com/images/uploads/990_ERB_sample_core_form_2011_and_O_final.pdf_(locked)_.pdf

that the addition of a full page Part[3] on Governance, where filers must address various aspects of their management structure, has been extremely successful in focusing attention upon basic "good governance" precepts and highlighted Board and manager's responsibilities.

One of the advantages of the Form is that by providing all regulators – the IRS, the States, and the 'court of public opinion' – more complete information both on the Core Form and through some key Schedules, filers are cognizant of the Form's importance not only from a tax-administration perspective but from a public relations perspective. It is clear that one of the three goals of the Redesign, "to take advantage of the Form's transparency aspects," has borne fruit and given credence to the notion that "sunshine is the best antiseptic." I believe that the lay-out of the Redesigned 990 and the additional substantive data requested in the ancillary Schedules allows the IRS to more efficiently and effectively "hone in" on filers' activities and study specific sub-sectors, analyze trends, and more appropriately allocate their limited resources to educational efforts and compliance programs.

I. Expertise/Experience with the Form 990

For my entire professional career, my legal practice has focused on advising and representing small and mid-size exempt organizations. My clientele does not include hospital systems, higher education systems (aside from 990 reviews), or other types of the largest exempt organizations (again, aside from 990 reviews or specific engagements related to IRS controversies). As a result, my experience has been with the size and type of organization that comprises the vast majority of organizations filing the Form 990.

I first began to practice tax law in 1985 when I joined the tax department of a Big 8 accounting firm after law school. There, I was assigned to Form 990 preparation, an assignment I had requested. For tax years begun in 1985, the Form 990 was five pages, supplemented by an additional Schedule for 501(c)(3) organizations which added three pages. At that time, the Form's questions focused on virtually every federal income tax mandate to which the exempt sector was subject.

Incremental changes to the Form took place over the next several years. As the Form changed, so did my professional opportunities. I opened my own firm and began to represent tax-exempt organizations exclusively, on both exemption qualification and tax planning, and on IRS examinations of filed 990s. The 1989 Form added a Part requiring filers to 'self-audit/report' the basis by which their revenue streams were or were not subject to the unrelated business income tax. That addition was made after the IRS expressed concern that the Form provided no

[3] To save space, I have placed the names of Parts and Titles in footnotes. Part VI of the Core Form is titled, *Governance, Management, and Disclosure*.

windows into those activities of filers that were generating non-contribution revenues (such revenues then potentially being subject to reach of the unrelated business income tax). The expansion created new demand for continuing professional education on the Form, and I ended up being asked to design and teach a 990 course for my home state CPA Society, which was later recommended by the Minnesota CPA Society to other State Societies. Over the course of 1991-1996, my self-authored/instructed whole day 990 continuing professional education (CPE) course was provided to more than 1,200 participants, by 12 State CPA Societies.

In the latter half of the 1990s, the increasing complexity of the Form and its accompanying Instructions grew as if on steroids, which increased my teaching opportunities. The number of State Societies that offered my 990 day class grew to 20. The most frequent critique of my all-day course at that time was that it was too short and really should be a two day course. In 2000, in response to demand from non-preparers seeking instruction on the Form, I developed a "half day" version of a 990 class for "real people." 990 educational presentations were increasingly sought by State nonprofit associations and by CPA Societies sponsoring conferences for nonprofits. All of that attention was directly related to the Form's unwieldy growth in complexity.

By 2007, the Form was a total of nine pages, with the additional Schedule required of 501(c)(3) organizations adding seven more pages. It was widely regarded -- by the filing sector, by public users, by paid preparers, and by the IRS -- as a "disastrous monster" that was staggering under its own weight, lacking any coherent design, and suffering from Instructions that could barely earn that title. The Form had been amended piecemeal over time, mostly at the request of Congress, in order to access more nuanced and relevant information from reporting organizations. By the time of the 2007 Form's release, it was clear that it was time to redesign the Form.

During 2007 and 2008, the IRS ramped up its efforts to redesign the Form and requested public comments to advance the Form's redesign. As someone whose experience with the Form had been informed by the many practical questions participants raised in my 990 classes (by that point more than 2,500 professionals had taken the 8-credit CPE 990 class from me) and by the nearly 20 years of practice representing organizations of all sizes before the IRS on audit examination, I eagerly participated in that comment process. I believe that my affinity for assisting small and medium organizations on understanding compliance mandates, including Form 990 preparation challenges, informed my approach. I participated via task forces from both the American Bar Association and the American Institute of Certified Public Accountants, and also provided personal comments to the IRS on their proposals for the Redesign. Ultimately, I played a part in providing close to 600 pages of the approximately 3000 pages of comments the IRS received.

I have continued to provide comments to the IRS on the Redesigned Form and its instructions to the present day. I continue to teach on the Form. I now offer two all day courses (the second day being an "advanced" Schedules class). I do not address the reporting mandates faced by nonprofit hospital facilities, leaving that specialty topic to the health care specialists. My course participants increasingly come directly from the exempt sector as more medium-sized entities choose to self-prepare their 990 filing.

In all venues of my work with the "Redesigned 990" – via comments to the IRS, teaching preparers, educating readers, and reviewing prepared Forms pre-filing for clients – my goal has always been to make the form and instructions more understandable so that the filing's precepts are understood by those preparing a form for filing or accessing a form that has been filed. Promoting consistent and appropriate inputs on the Form not only enhances the credibility and stature of the exempt sector but allows those who regulate the sector to keep up with changing trends and tailor enforcement efforts accordingly.

II. The "Opportunity" Seized by the Redesigned 990 – Expanded and More Tailored Disclosures in Key Arenas Relevant Not Just to IRS but to Multiple Stakeholders

The Redesigned Form, if filled out properly by an exempt organization, captures far more specific and appropriate information in twelve arenas of operations and administration than did its predecessor. As a result, preparation of the Redesigned Form requires more labor than the prior form. However, that result occurs not just because of the new information sought, but because the Form requires *disclosures on multiple non-financial realms.* Those demands exist in spite of the fact that the Redesigned Form 990's structure (a Core Form that all filers complete, with narrowly tailored-to-subject Schedules that apply in specific circumstances) implies that each Part or Schedule square with a "one size fits all" approach. Individual filer's answers and inputs are not going to be "uniform" with those of other filers unless their circumstances are exactly the same.[4] Trends and similarities will certainly cut across sub-sectors,[5] but each filer must approach its own circumstances not only in devising the appropriate answer, but in many cases designing a narrative response.

The Redesigned Form 990 asks the filer to report on virtually all aspects of the exempt organization's enterprise – what the filer's programs achieved during the year, what managers (and certain other employees) and fiduciaries were in place, what those managers and fiduciaries

[4] For example, all filers who have an executive committee empowered to act with delegated power of the Board would presumably identify that fact and explain the composition of individuals residing thereupon in responding to Line 1a of the Governance Part of the Form.
[5] For example, most private schools and colleges will have some directors who are not in the count of "independent directors" because they have children attending the institution who were the recipients of financial aid or merit awards paid out during the tax year.

were paid, what governance and internal policies were in place by the end of the year, the existence of insider transactions, the type and total amount of grants or assistance provided to individuals, information on non-cash contributions received, results from larger fundraising activities or events, number of volunteers engaged (this is optional), narration of lobbying activities or detail of lobbying dollars disbursed for those under the lobbying election (this only for 501(c)(3)s), and dollar amounts of revenues garnered in conducting the organization's three largest (and then all other) programs (this only for 501(c)(3)s and (c)(4)s.) This requires filers to access *their* facts and *cull internal information* from multiple sources – staff on the program side of the organization, administrative/operations officers, and those who keep the organization's financial recordkeeping.

The twelve new arenas of expanded reporting required by the Redesigned 990 are largely related to operational imperatives that the public expects to be met by the exempt sector. Each of these arenas is listed below, separated into new areas and expanded areas of information reporting.

Eight *Completely New* Arenas

1. **Updating** the organization's ongoing **exemption application record** -- accomplished in the "Program Service Accomplishment" Part of the 990 Core Form, Part III, via three questions:
   - Inquiring whether the organization is undertaking any activity not previously reported to the IRS upon an exemption application and/or prior-filed 990s
   - Inquiring whether the organization has ceased any activities it previously reported to the IRS or has significantly changed how it conducts any previously reported activities
   - Requiring recitation of the organization's Board-approved mission statement

2. Focusing attention on **the authority and management practices** that are in place as a result of the inherent and ultimate authority **exercised by the exempt filer's governing Board** -- accomplished by (Core Form) Part VI[6] and Part XII[7] which ask questions that previously were absent from the Form concerning:
   - Board composition
   - Board's delegation of authority
   - Accountability to members if members exist (and denoting rights reserved to those members)

[6] Part VI is titled, *Governance, Management, and Disclosure.*
[7] Part XII is titled, *Financial Statements and Reporting.*

- Policies and procedures in place with respect to management practices overall in conflict of interest scenarios
- Whether standard basic practices are employed in setting executives' compensation – also asked of in Schedule J, Part I[8]
- Attention paid by the Board to review of the 990 filed with the IRS
- How the organization makes public inspection of its 990 available as well as whether chartering and key governance documents (including audited financial statements) are available to the public

3. Providing information on each "related organization" (parent/subsidiary/brother-sister corporations, supporting/supported organizations, certain partnerships and trusts) – accomplished via Schedule R regarding related organizations

4. Providing information on **arenas of operation regulated by the States** – accomplished via the following Schedules:
   - Schedule G[9], Part I – addressing use of "professional fundraisers" and requiring organizations to certify they have met registration/reporting responsibilities in jurisdictions where professional fundraiser solicitation has occurred
   - Schedule G, Part III – addressing compliance of gaming operations with State (and local) law mandates
   - Schedule N[10] – addresses "substantial contraction" and dissolution, merger, and termination of the organization

5. Providing details on types of non-cash (colloquially referred to as **"property") contributions**, including method of valuation – accomplished via Schedule M[11]

6. Providing information on **political (i.e., support or opposition of candidates for elective office) activities** undertaken – accomplished via Schedule C[12], Part I

7. Providing information on **financial and other undertakings outside of U.S. borders** – accomplished via Schedule F[13]

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[8] Schedule J is titled, *Compensation Information*; Part II of the Schedule provides input on the same managers reported upon (Core) Form Part VII.
[9] Schedule G is titled, *Supplemental Information Regarding Fundraising or Gaming Activities.*
[10] Schedule N is titled, *Liquidation, Termination, Dissolution, or Significant Disposition of Assets.*
[11] Schedule M is titled, *Noncash Contributions.*
[12] Schedule C is titled, *Political Campaign and Lobbying Activities*
[13] Schedule F is titled, *Statement of Activities Outside the U.S.*

8. Providing information on **tax-exempt bond issuances** – accomplished via Schedule K[14]

Four NOW EXPANDED Arenas of Inquiry (numbering continuing from above)

9. Requiring due diligence (i.e., reasonable efforts) to ascertain if parties who are themselves 'insiders' or who are connected to 'insiders' received grants or assistance from the organization or had business transactions with the organization *and then* disclosing basic parameters of such intersections – accomplished via Schedule L, Parts III and IV[15]

10. Reporting more revenue sourcing detail on potential types of unrelated business income tax-susceptible revenue – accomplished via (Core Form) Part III (solely for 501(c)(3)s and 501(c)(4)s), joint venture focus overall and specifically including Schedule R, Part VI and Schedule R, Part II column identifying 512(b)(13) controlled entities, and Schedule G, Part III

11. Compensation to managers (Board members, Officers, "Key Employees," and the five highest compensated employees whose taxable income is at six figures or greater) is now reported using a consistent period and methodology (and details compensation paid by the filer and its related organizations) at (Core) Form Part VII Section A and Schedule J Part II

12. Consistent definitions for identifying "in charge" employees and Officers (current and former) that are subject to reporting at (Core) Form Part VII Section A and Schedule J Part II

III. How Well has the Opportunity Been Realized (i.e., How Complete/Accurate are Prepared Returns)?

Informing the answer here is the fact that the Form 990 is not a tax return. It is an annual information return. The difference between the functions of those two types of return is huge! In the Redesigned Form 990, there are only three pages of the (Core) Form that exclusively present financial statement data. The remaining nine pages, while in some places requiring numeric input, speak almost exclusively to topics that are either specific to exempt organization tax mandates or specific to programs and activities. In other words, the information is not likely to be in the knowledge base of an organization's outside auditor or tax consultant. While these

[14] Schedule K is titled, *Supplemental Information on Tax-Exempt Bonds.*
[15] Schedule L is titled, *Transactions with Interested Persons;* Part III is titled, *Grants or Assistance Benefitting Interested Persons*, and Part IV is titled, *Business Transactions Involving Interested Persons.*

nine pages of the Core Form (and almost all the ancillary Schedules) do require numeric input, the numbers sought are typically to be culled not in line with generally-accepted accounting principles (GAAP). A truism for those of us who work with CPAs is that a non-profit auditor is almost always not an exempt organizations tax person and in many firms it is the case that "never the twain shall meet."

Proper completion of the Redesigned 990 has required a steep learning curve. Filers have only recently begun to master the Form.

Preparers and users of the Form have found, for the most part, that the Form's instructions are useful and relatively 'plain English'. However, there is no denying that multiple areas of the Form have introduced new and/or complex concepts so that in total a steep learning curve exists. Not surprisingly, the pace by which the filing community has moved ahead in advancing on that learning curve has been slow. Indeed, in my judgment, it is only with the fourth filing season of the Redesign now in hand that palpable mastery and accurate completion of the new Form is being widely evidenced.

Self-preparers have had a much easier time in adjusting to the new Form than has the paid preparer community. Their learning curve progress has been advanced by the fact that in most cases the staff that does internal preparation actually reads the instructions. (My first teaching tip on the Redesigned Form is to "read the instructions.") Furthermore, they can apply what they find in the instructions based on their firsthand knowledge of their own organization. The availability in the last decade of software for such self-preparers from the National Center of Charitable Statistics (via the ***efile.form990.org*** website) has also advanced the ability of exempt organizations to do their own returns – that software ("desktop 990") is not expensive (it is practically free to small and medium organizations), allows the user to "pop up" the instruction for each entry point of the filing, save their work, have fail-safe error recognition, and ultimately e-file the return.

The generally slower advance on the learning curve by the professional "paid preparer" community is not surprising to me, as the quality of work by that community pre-Redesign was often impeded by several challenges, including:

- many CPA firms do exempt organization audit and tax work as a courtesy to their for-profit clients and do not have tax professionals in house who are adequately trained in exempt organizations tax mandates; the incentive to build out such expertise in smaller CPA firms and in firms in most non-metropolitan areas is lacking for multiple reasons (i.e., the nonprofit world has limited desire and ability to pay for what the work would cost; it is expensive to train staff on these mandates or work with associated experts to get the prepared returns properly reviewed; and little incentive exists to commit to training when the firm is at risk of losing the individuals trained who may have more remunerative fields to ply).

- the longstanding misperception that a corporate tax preparer, or an auditor who knows the organization's financial statements, can easily and accurately complete a Form 990
- the reality that those serving multiple clients on tight deadlines will need to coordinate access to and input of data from the filer, then must interpret the Form's instructions in the context of that data (ignoring results that may have arisen from other fact scenarios), and then await review and further input from the filer before making the return final

And finally, regardless of whether an organization's preparer – internal or external – may be qualified to assist in or perform the actual 990 preparation, three other factors have slowed progress on the Redesigned 990's learning curve over the course of the first two to three years of the new Form's existence:

a. the opaqueness of the pre-Redesigned Form's instructions led to an understandable initial resistance by most preparers to pick up and read all the Redesigned Form's instructions. The instructions packet is of daunting length, but there really are 'only' 34 substantive instruction pages pertaining to the 12 pages of the Core Form, and most of the ancillary Schedules have instructions running 3-5 pages. The Core Form instructions include a very valuable Glossary in which common terms are set out clearly and succinctly.
b. a good old fashioned "this can't be" negative reaction to some of the Redesigned Form's demands fueled a lot of resistance . . . . My personal experience with that carping is that oftentimes people spend more time whining than they would expend in properly learning the application that fits their (or their client's) situation.
c. the propensity of folks to not read the instructions fully when they do read them. . . . In teaching CPAs I always get a big laugh when I tell people NOT to stop reading when they get the answer they want.

Ultimately, in my experience, the reporting organizations themselves have become more willing to tackle the Form's requirements. This is in great part due to increasing public awareness of the Form and the information that it provides. Many filers are being challenged by readers of their 990 filings (particularly funding sources) who note that data is missing or inconsistent. This is in line with the intent of the Redesign, which is to have the Form not only foster compliance by providing information to the regulatory community but by taking advantage of the Form's transparency aspects.

IV. Where Can The Form Be Improved?

There are five *wishes* that almost all preparers (and those advising preparers) of the new 990 have. My address of these subjects, and recommendations in each arena, should not be interpreted as my belief that the five arenas in which those wishes vest (with one exception) are inappropriate for or otherwise unworthy topics of disclosure. My point is simply that the IRS could do a more efficient and effective and less burdensome job of getting information from the Schedule L, the Schedule F, the Core Form's Governance Part VI, and overall from small organizations. At the end of this section I also make some observations on Schedule R's reporting on transactions with "related organizations" and suggest the IRS seek comments as to how some of the Schedule L and R complexity can be attenuated to the end of reducing burden.

Additional IRS Education on "Semantics" and Reporting Implications

There is a need for education of the reporting community as to the meaning of key semantics the Form employs. There is also a need to foster an understanding that the IRS definitions for the Form are not necessarily the same used by others for other purposes, and that in many instances what appears to be negative reporting on the Form does not mean that the organization is doing anything improper. A classic example of this is the insider transactions reporting on Schedule L, which requires an organization to disclose many transactions which are common-place, even though the transaction may be advantageous to the organization. Reporting organizations and preparers are concerned that their reporting of Board members (Trustees or Directors) who are NOT "*independent*," or that their reporting that some of their Board members, Officers, or Key Employees are related to each other by "*business relationships*" or "*family relationships*," means that the involved individuals lack competence and appropriate capacity to serve the filer. Filers are similarly anxious if they must report having undertaken business transactions with firms or parties who are connected to their Board members, Officers, or Key Employees, upon Schedule L, Part IV, especially when the existence of such transactions is commonplace and commercially reasonable. Indeed, transactions are reportable upon Schedule L, Part IV regardless of whether they offer extreme advantage to the organization or afford the filer of opportunities that would not otherwise be available. Nonetheless, many organizations are fearful that the mere requirement to report the existence of such transactions on the Form 990 means that the transaction is improper, and that the involved individual should step down, a result that would deprive the organization of a valuable employee or Board member.

It would be beneficial to the sector for the IRS to address this problem by providing educational materials explaining that the only obligation (from an exemption qualification perspective) that a filer has in disclosing the existence of non-*independent* directors, managers with "*family*" or "*business*" *relationships*, or Schedule L, Part IV *reportable business transactions* is to ensure that those insiders (or those connected to them) are not being privately benefited from their influence over the organization. The disclosures are there to focus attention on governors' responsibility to protect the filer from uneven exchanges to the organization's detriment and to ensure that transactions outside of the filer's best interests are not undertaken. Practitioners attempt to communicate this point, but the voice that should speak on this subject so that the message is delivered uniformly and with authority is that of the IRS. This is an area where additional IRS educational outreach, rather than revision of the form, would do much to solve the problem.

Simplify Schedule L

For the vast majority of organizations, Schedule L is the most difficult of all the Schedules that Form 990 filers must complete. The difficulties start with the significant burden in reviewing the circumstances that, if in place, would trigger the Schedule's application. Filers must self-assess if they have:

- if a 501(c)(3) or (c)(4) organization, engaged in a Code Section 4958 *excess benefit transaction* in the current year or have discovered such a transaction from a prior year that was not previously reported upon the Form 990. Such transactions are those that are undertaken with *disqualified* persons that unfairly benefit such persons.
- a loan on the balance sheet to or from a manager listed on the Core Form Part VII Section A or to or from a Code Section 4958 *disqualified* person
- grants or assistance provided to a pool of interested persons that includes managers listed on the Core Form Part VI Section A *other than five highest compensated employees*, family members of the preceding, grant selection committee members and their family members, contributors appearing on Form 990's Schedule B, and in some instances those contributors' employees
- business transactions with the same pool of managers reached by the preceding bullet, or their family members, or certain entities connected to any of those parties by control (in the case of nonprofit corporations, but this is attenuated when the other entity is 501(c)(3)), ownership (in the case of other than nonprofit corporations) or management involved by those individuals (in the case of business or investment entities) *and those transactions are above certain thresholds*

It would be beneficial to the sector if the Schedule L definitions were simplified. The fact that experts such as myself have spent tens of hours (if not a hundred or more) to be well-versed in the instructions for just two of the Schedule L's Parts (those in the final two bullet points preceding) reflects how difficult it is to have the sector become conversant with the parameters at play. The instructions require filers to make "reasonable efforts" to inquire of their managers if they are aware if they, their family members, or other entities with whom they or their family members are connected are getting grants or assistance from the filer, or have engaged in business transactions with the filer. As a result, filers must convey the instructions' parameters to numerous insider parties in order to properly conduct a "reasonable effort" inquiry of managers. Either the IRS should attempt to simplify the present definitions for Schedule L's Parts III and IV, or it should provide flow-chart materials or similar tools in the Instructions to help demonstrate the numerous and complex reporting relationships encompassed in these Parts.

Allow Most Small Organizations to File a Form 990-EZ that Captures the Broader Information Sought by the 990's Core Form But Does Not Require Full Completion of All the Redesigned 990's Schedules

The Redesigned 990 overly burdens small charities and small non-501(c)(3) exempt organizations. In my experience, reporting organizations whose budget is on average under $1,000,000 of revenue per year are not able to self-prepare the Form and are unlikely to have access to paid or volunteer professional preparers who are well-versed in the Form's intricacies. The present threshold at which the Form 990 is required (and the Form 990-EZ may not be used) for most filers: gross receipts for the year less than $200,000 and gross assets at year end of less than $500,000 – should be altered. To more closely tailor the reporting burden to the size of the these organizations, my recommendation would be to allow exempt organizations with gross receipts for the year less than $1,000,000 and gross assets at year end of less than $3,000,000 to file a Form 990-EZ, modified in key ways, in lieu of the 990. Many will argue that this would exclude too many organizations from the full blown reporting of the Form 990, but I believe the response to that would be to utilize the Form 990 Core Form for most of these filers and modify the reach and extent to which the full Form's ancillary Schedules are required. The full blown Form 990 is too comprehensive for most of the sector's small organizations.

Eliminate or Streamline Schedule F, Statement of Activities Outside the United States

One of the most significant changes made by the redesigned form was the additional reporting pertaining to foreign activities and investments. Although many exempt organizations do not engage in foreign activities and thus are not subject to this additional reporting, for the many that do engage in relatively small amounts of foreign activity, the Schedule F reporting is daunting. For organizations with significant foreign activities it is not only difficult but extremely burdensome due to having undergone numerous reporting changes yielding evolving instructions and new learning curves each year.

The rules for determining when an organization is required to complete Schedule F have been altered significantly several times over the four filing years that the Redesigned Form 990 has been in place, requiring preparers each year to reacquaint themselves with new reporting triggers that lead to the Schedule's employ. In addition, the Schedule has for the last two years asked if filers are responsible to report to the IRS upon any of six additional IRS Forms involving ownership in or transfers with foreign entities. The complexity of those tax Forms is well beyond the purview of most exempt organizations professionals, indeed of most tax professionals overall. Furthermore, as investment vehicles grow in complexity across the commercial sector, it is not uncommon for exempt organizations to have their reserves or endowment funds partially placed in investment partnerships that have some interests in foreign corporations.

In my experience, organizations of all size are struggling with both the "triggers" to the Schedule F (which determine when the schedule must be completed) and how to complete its Parts when they do apply. By way of example, it is not uncommon for U.S. groups working on issues that reach across the border to Canada to spend hours of preparation time detailing the expenses and receipts (for example from materials carried to meetings in Canada for which a charge is made) of work of theirs undertaken in our neighbor's borders (assuming the total of same is $10,000). Similarly, secondary schools who conduct student field trips in which a border crossing occurs find that their 990 reporting costs are exponentially higher in years in which such programming occurs versus those in which it does not.

This is one arena of reporting in which the benefits of the reported information do not presently outweigh the burden of compiling and gathering the information. The information collected by the IRS on Schedule F is unlikely to be of assistance to the IRS or other federal agencies with respect to combatting terrorism and/or promoting exempt organizations tax compliance. Its completion is not only a burden but a disincentive for organizations to conduct programming or participate in activities with connection to non-U.S. jurisdictions. For all the aforementioned reasons, this Schedule should be eliminated or its scope substantially reduced.

Eliminate the Statement of Functional Expenses

In the course of the public's participation on the redesign of the Form 990, one of the most common complaints regarding the Form's burden was the requirement that 501(c)(3) and 501(c)(4) organizations report expenses by both type or class of expenditure, and also by *function*. However, the Redesigned Form did not alter that requirement and it, like its precedessor, requires these organizations to report each class of expense they incur allocated between "program services," "management and general," and "fundraising." The chorus of valid comments against this requirement that came in during the redesign process highlighted that the information captured by such "functionalization" was ill-documented, unbelievably subjective, and all-too-often geared to the desire to appease donors or meet aspirational criteria employed by charity watch-dog groups. Aside from the charity watch-dog groups (who themselves have come around to the position I now assert), there was virtual unanimity that this requirement should be struck from the Redesigned Form.

In the course of finalizing the Redesigned Form, the IRS bowed to the requests of State regulators and did not remove the columns by which functionalized expenses are reported. The States' concern was that many 501(c)(3) and some 501(c)(4) organizations who solicit in their jurisdictions are subject to State law reporting requirements, which typically include the responsibility to report total fundraising expenses or fundraising and management expenses versus program expenses. Filers who complete the Form 990 (but not the 990-EZ) have this data "readily available" from their completed Form, but those who do not complete the Form 990 typically must be provided an additional sheet by the State to complete. A point perhaps overlooked by the States in seeking the retention of the 990's functionalized expense reporting is that the Redesigned Form provides more detail on professional fundraisers and fundraising events and activities (including expenses incurred) than reflected on the predecessor form.

Given the lack of benefit to the IRS of requiring this information from all 501(c)(3) and 501(c)(4) filers, the burden it places on the filing sector to either have contemporaneous documentation systems in place or to undertake laborious post-year end processes, and the growing understanding that such reporting brings little value to the table, it is appropriate for the IRS to no longer require this information.

Regarding the Schedule R, One Aspect of Schedule L Reporting, and The Complexity of these Two Schedules' Definitions

Large complex institutions have repeatedly (and validly) opined a further wish – that reporting on Schedule R of transactions undertaken with "related organizations" be made mechanically simpler. That concern rarely vests with small and medium size organizations. An overall observation I would make with respect to Schedule R reporting of related organizations transactions that affects all filers is that in the instance where a "related organization" is also an "interested person" for purposes of reporting business transactions on Schedule L, unnecessary duplication results. One way the IRS could encourage compliance and reduce burden in getting disclosure of such transactions is to except from Schedule L Part IV's definition of "interested persons," all "related organizations." Alternatively, the reporting thresholds between the two Schedules could be synchronized.

There is no doubt that a public interest is served (and compliance promoted) by having filers detail transactions undertaken with parties who are connected to their insiders. In my recommendations I note that the IRS should provide education of the sector to emphasize that reporting of such transactions does not imply that the transaction is "bad." I have further recommended that the IRS simplify the Schedule L definitions or provide materials that guide preparers through their parameters. To access preparers' experience as we approach the close of the fourth filing season of the Redesigned 990, I would suggest that the IRS seek public comments as to what burden-reducing improvements could be made in seeking the valid data now sought by both Schedules L and R.

V. Conclusion

In the few short years of its employ, the Redesigned Form 990 has brought a better "form" to reporting organizations for their completion and the public and regulators' use. For the most part, the data sought on the reconfigured form promotes greater transparency and much more fully-fleshed out and relevant information on filing organizations. That has led to individual organizations having an increased appreciation of exempt organization compliance points, particularly related to management and governance overall. It has also led to the IRS (and other regulatory agencies) having better access to specific information that Congress has required by statute or policymakers have encouraged as being relevant to activities and trends that the IRS (and/or Congress) wishes to explore.

The "cost" to the filing sector of the Form's redesign has been a steep learning curve and the need for filing organizations to be more participatory in the completion of the filing. Over the course of the first several filing seasons, it has become apparent that many organizations can prepare the bulk of the filing themselves and successfully file a complete and accurate return. Based on my experience, it is likely to take several more years for the sector to have widely mastered the learning curve, adequately planned for the increased burden of the filing as a cost of exemption, and fully realized that gaps in the paid professional community may require them to move to self-preparation and/or utilization of more experienced professionals on a consultative basis.

The Redesigned Form has achieved much of what it was intended to do. However, further improvements could and should be made to reduce unnecessary burden in a few areas and tailor the reporting to the size of the reporting organization. I believe that the five specific recommendations made above, along with the suggestion that the IRS seek comments on ways to minimize Schedule L and Schedule R burden, would address most of these concerns and improve the Form 990 even more.

Chairman BOUSTANY. Mr. Hyatt, you have 5 minutes.

STATEMENT OF THOMAS K. HYATT, PARTNER, SNR DENTON, WASHINGTON, DC.

Mr. HYATT. Thank you, Mr. Chairman.

Chairman Boustany, Ranking Member Lewis, and Members of the Subcommittee, I really appreciate the opportunity to testify before you this morning. I have been invited to testify as to the current state of complexity in the organization and operation of nonprofit tax-exempt public charities. As has been reported to this Committee, there are some 1.6 million tax exempt organizations known to the IRS, give or take different sources of data. Over 60 percent of these are 501(c)3 public charities.

Now while many nonprofit organizations are small organizations, small staffs, small budgets, we usually are most familiar with the large institutional nonprofits, those with regional and national reach. According to the IRS, large hospitals and universities dominate the financial activity of the nonprofit charitable sector. In fact, by their stats, 9 of the 10 largest nonprofit organizations by assets were hospitals or university-affiliated organizations. It is this class of organizations that I describe today.

Certainly, there can be no denying that these large nonprofit public charities are more complex in their structures and in their operations than they were say 40 years ago. Today, it is not uncommon to have multiple business entities operating within an integrated system. They may have a central parent organization charged with strategic oversight of the system; brother-sister companies subsidiaries and subsidiaries of subsidiaries. These entities may include nonprofit corporations, taxable for-profit corporations, nonprofit taxable corporation, limited liability companies, limited and general partnerships and joint ventures.

Most institutions understand the cost as well as the benefit of operating multiple corporations and they try to err on the side of keeping it simple. Still, some organization charts appear to be designed by engineers rather than business planners and would make Rube Goldberg proud.

In addition to directly owned and operated business entities there has been a substantial increase in the use of joint ventures by nonprofits to achieve their goals. The IRS over time has determined that joint ventures between public charities and for-profit businesses in many different forms are consistent with public charity status if they are properly structured and properly operated.

There are many reasons for the increased complexity of the corporate organizational structures in the modern nonprofit sector, often acting in concert. In my statement, I have provided an overview of the key factors as I see them. They include protection from liability, operation in highly regulated fields, restrictions imposed on public institutions, restrictions imposed by overseers, chapter-based organizations, improved governance, and Federal tax-exempt organization law compliance.

While corporate complexity is a reality in the institutional side of the nonprofit sector, in my view, this is not a problem that requires a change in the law to resolve. Rather, it is an environment that both invites and deserves continuing scrutiny and transparency to ensure that these public charities are acting in accordance with their tax-exempt purposes and with applicable law.

There are already important checks and balances in place to ensure that a complex corporate structure does not impede achievement of charitable goals and legal compliance. At the State level, this is primarily accomplished through the State Attorney General. In recent years, State Attorneys General have been extremely active in overseeing the activities of nonprofit organizations within their State. The IRS plays an important oversight role both towards enforcement of the Internal Revenue Code's tax exemption requirements and implementation of the Form 990 with an increasing focus on transparency and accountability.

DCMN BURREL

It should also be noted that the IRS has undertaken a considerable effort in the last few years to learn more about this large institution segment of the nonprofit sector through a series of what are called compliance checks. The IRS in 2006 conducted a compliance check of hospitals and health systems, and in 2008 a compliance check on colleges and universities.

When a change in the law is warranted, Congress has not hesitated to step in. For example, one type of public charity, the supporting organization, was being used for private benefit in ways that the Congress never intended in the Internal Revenue Code. Through the Pension Protection Act of 2006, Congress largely eliminated this type of abuse, including through the expansion of the IRS' intermediate sanctions penalties authority.

With that, I will close my oral statement. I, again, appreciate this opportunity and would welcome any questions you might have.

Chairman BOUSTANY. Thank you, Mr. Hyatt.

[The prepared statement of Mr. Hyatt follows:]

U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

HEARING BEFORE THE SUBCOMMITTEE ON OVERSIGHT

OPERATIONS AND OVERSIGHT OF TAX-EXEMPT ORGANIZATIONS

Testimony of Thomas K. Hyatt

Increased Complexity of Public Charity Organizational Structures

July 25, 2012

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Chairman Boustany, Ranking Member Lewis, and Members of the Subcommittee on Oversight, I greatly appreciate this opportunity to testify before you today on the topic of the increased complexity of public charity organizational structures. I am a partner in the law firm of SNR Denton, resident in the Washington DC office, where I head our health law practice group. I have been practicing law for 30 years, focusing on legal and policy issues relevant to nonprofit organizations. I currently serve as Chair of the Board of Directors of Maryland Nonprofits, a statewide nonprofit public charity that strengthens, educates, and engages other nonprofits so that they can successfully achieve their missions. I also serve on the Board of Directors of Appalachian Regional Healthcare, a 10-hospital nonprofit rural health system serving indigent communities in eastern Kentucky and southern West Virginia. In addition, I am a Senior Fellow for Public Policy for the Association of Governing Boards of Universities and Colleges. I am the co-author of the legal text, *The Law of Tax-Exempt Healthcare Organizations*, now in its Third Edition.

I. Complexity in the Organization and Operation of Public Charities

I have been invited today to testify as to the current state of complexity in the organization and operation of nonprofit, tax-exempt public charities. As has been reported previously to this committee, there are some 1.6 million tax-exempt organizations known to the Internal Revenue Service.[1] Over 60% of these are 501(c)(3) public charities. In 2010, public charities received over $1.51 trillion in total revenues and incurred $1.45 trillion in total expenses. They were charged with the stewardship of over $2.7 trillion in total assets. Nonprofit organizations paid 9.2% of all wages and salaries in this country in 2010 and accounted for 5.5% of GDP. While many nonprofits are local organizations with small staffs and small budgets, we are usually most familiar with large institutional nonprofit organizations and those with regional and national reach. According to the Internal Revenue Service, large hospitals and universities dominate the financial activity of the nonprofit charitable sector; nine of the ten largest nonprofit organizations by assets were hospitals or university-affiliated organizations.[2] It is this class of organizations that I describe today.

There can be no denying that these large nonprofit public charities are more complex in their structures and operations than they were, say, 40 years ago. Today it is not uncommon to have multiple business entities operating within an integrated system. They may have a central parent organization charged with strategic oversight of the system; brother-sister companies; subsidiaries; and subsidiaries of subsidiaries. These

[1] National Center for Charitable Statistics, Urban Institute, NCCS Core Files 2010, http://nccs.urban.org/statistics/quickfacts.cfm.

[2] IRS Statistics of Income, Charities and Other Tax-Exempt Organizations, http://www.irs.gov/pub/irs-soi/11esgiftsnap.pdf.

entities may include nonprofit corporations, taxable for-profit corporations, nonprofit taxable corporations, limited liability companies, limited and general partnerships, and joint ventures. Most institutions understand the cost as well as the benefit of operating multiple corporations and try to err on the side of keeping it simple. Still, some organization charts appear to have been designed by engineers rather than business planners, and would make Rube Goldberg proud.

II. Joint Ventures

In addition to directly owned and operated business entities, there has been a substantial increase in the use of joint ventures by nonprofits to achieve their goals over the last 30 years. A joint venture is generally defined as a business enterprise that is undertaken by two or more persons in which the parties share profits and losses. Prior to that time, the IRS had taken the position that public charities could not enter into limited partnership-type joint ventures with for-profit taxable corporations consistent with their tax-exempt status. However, the United States Tax Court overruled that position in 1980 and the IRS has over time determined that joint ventures between public charities and for-profit businesses in many different forms are consistent with public charity status if properly structured and operated. The IRS has approved both whole-entity joint ventures and ancillary joint ventures as long as the joint venture participation is serving a charitable purpose; the joint venture permits the tax-exempt organization to operate exclusively in furtherance of its tax exempt purposes; and undue control is not vested in private parties.[3]

Joint ventures are an important form of business operation for nonprofit public charities for three primary reasons: 1) they provide the exempt organization with access to sources of capital that they are unable to generate themselves; 2) they provide the exempt organization with access to expertise from parties who have experience in the relevant area; or 3) they provide access for the exempt organization to a service area which may otherwise have high economic or logistical barriers to entry.

III. The Need for Complex Structures

There are many reasons for the increased complexity of corporate organizational structures in the modern nonprofit sector, often acting in concert. The following is an overview of the key factors now promoting complexity in the operation of nonprofit public charities.

[3] See Rev. Rul. 98-15, 1998-1 C.B. 718; Rev. Rul. 2004-51, 2004-1 C.B. 974.

a) Protection from Liability. One factor is the erosion over the last 70 years of the doctrine of charitable immunity which provided protection from liability for nonprofit public charities. As a result, nonprofit organizations now rely upon the limited liability of the corporate form for protection of their assets and operations.

b) Operation in Highly Regulated Fields. It is not unusual even today to find some large institutional charities operating out of a single nonprofit corporation, using an often complex internal organizational structure to oversee different groups and service lines. However, it is now more common for public charities to use multiple business entities to facilitate operation in highly regulated fields, such as healthcare. Because hospital operating companies are state-licensed entities, they are subject to numerous legal restrictions which can impede their ability to undertake such important tasks as expanding operations, raising capital, protecting assets from lawsuits, and growing investments. Since the late 1970s, most hospitals have expanded beyond their single hospital operating corporation structure into a multi-corporate entity system. A common healthcare system organization chart might include a parent holding corporation with various subsidiaries including hospitals, home health agencies, cancer treatment centers, laboratories, management service organizations, and physician clinics.

Multi-corporate systems also enable healthcare providers to facilitate compliance with sometimes conflicting regulatory schemes. Medicare and Medicaid reimbursement requirements, Medicare and Medicaid fraud and abuse requirements, and tax-exempt organization requirements imposed by Congress, Health and Human Services, and the Internal Revenue Service sometimes dictate that separate corporations be established to ensure compliance.

Colleges and universities also typically employ multi-level organizational structures to optimize the operation and governance of multiple colleges, schools, campuses, and service lines. Healthcare provision and academic pursuits merge in the medical school/academic medical center which can create an especially complex structure involving separate incorporation of departments and faculty practices in order to maximize federal reimbursement and to more effectively manage operations.

c) Restrictions Imposed on Public Institutions. Public institutions, such as colleges and universities, frequently establish one or more related, nonpublic charitable foundations. These foundations enable these public institutions to accomplish projects in furtherance of their mission that would not otherwise be possible because of state restrictions imposed upon public assets. For example, these foundations may establish and grow endowments which fund needed campus improvements, fund research and faculty development, provide real estate development, and enhance bond issuance.

d) Restrictions Imposed by Overseers. Some nonprofit organizations, particularly in the higher education space, are subject to requirements imposed by one or more accrediting organizations which ensure that these nonprofits are providing services in accordance with agreed upon quality standards and best practices. These accreditation requirements may provide an incentive to organizations to separately incorporate various activities to maintain accreditation.

e) Chapter-Based Organizations. Multiple and sometimes quite complex corporate structures are also found in chapter-based organizations which have a regional or national network. These organizations may receive recognition of their tax-exempt status from the Internal Revenue Service through a group ruling procedure under which the national organization oversees and ensures the continuing compliance of the individual chapters with IRS requirements, or each chapter may be separately recognized as tax-exempt. Such well-known chapter based organizations as the YMCA, Girl Scouts of America, Boys & Girls Club of America, Audubon Society, Elks Club and Little League Baseball have multiple corporations carrying on the mission of the national organization in many states and often with several corporations in the same state. They are usually bound together by chapter agreements, bylaws, and a common vision.

f) Improved Governance. Another important factor promoting a multi-corporate system is the ability to more effectively govern far-ranging services by having separate boards of directors focusing on the discrete tasks of a specific corporation rather than using one large board responsible for all matters. This enables directors to serve on boards that can best utilize their expertise.

g) Federal Tax-Exempt Organization Law Compliance. Related nonprofit organizations are commonly used to ensure compliance with applicable federal tax law, most notably the restrictions on charitable organizations with respect to lobbying and political campaign activity. Thus, it is common for a charitable organization to have a related social welfare organization which can carry on unlimited amounts of lobbying and is permitted to have some level of political campaign activity, such as by operating a political action committee.

IV. Is Corporate Complexity in the Nonprofit Sector a Problem?

While corporate complexity is a reality in the institutional side of the nonprofit sector, in my view this is not a problem which requires a change in the law to resolve. Rather, it is an environment which both invites and deserves continuing scrutiny and transparency to ensure that public charities are acting in accordance with their tax-exempt purposes and with applicable law.

There are already important checks and balances in play to ensure that a complex corporate structure does not impede achievement of charitable goals and legal compliance. At the state level, this is primarily accomplished by the oversight of the state attorney general. In recent years, state attorneys general have been extremely active in overseeing the activities of nonprofit organizations within their state. It is not unusual for a state attorney general to become involved at the level of overseeing membership on the board of directors, governance practices, compensation of senior leadership, transparency of operation, investment of endowments, and expenditures in furtherance of charitable purposes. State attorneys general are effective watchdogs that have a primary responsibility with respect to the operation of charities within their states and have sought to expand their jurisdiction in this area with legislatures and courts.

The Internal Revenue Service plays an important oversight role through its enforcement of the Internal Revenue Code's tax exemption requirements and its implementation of the annual information return filed by most tax-exempt organizations, the Form 990, with an increasing focus on transparency and accountability. The Form 990, now more than ever, requires transparency with respect to corporate structure and relatedness. For example, Schedule R of Form 990 requires disclosure of related organizations and unrelated partnerships of a tax-exempt organization, including transactions with related organizations. Schedule H, which pertains to hospitals, requires full disclosure of management companies and joint ventures that the hospital is participating in, including ownership by physicians and members of the board of directors. The transparency created through these schedules, albeit at the cost of a greater filing preparation burden, sheds light on complex structures that will facilitate oversight and action by legislators, regulators, courts, donors and funders, the media, and the public at large. Transparency also helps to ensure that legal compliance is maintained, including preserving the separateness of corporations and the observance of corporate formalities so that appropriate activities under one area of the law do not become improper activities under another area of the law because of aggregated operation.

It also should be noted that the IRS has undertaken a considerable effort in the last few years to learn more about the large institution segment of the nonprofit sector through a series of what it calls "compliance checks." These checks involve gathering large amounts of data about all aspects of the institutions' operation, reporting their findings to the public, and acting on their findings through their continuing examination and enforcement activities. The IRS conducted a compliance check on hospitals and health systems in 2006, with a final report issued in 2009, and one on colleges and universities in 2008, with an interim report in 2010.

The Internal Revenue Service and the courts have also played an important role in ensuring that corporate complexity does not lead to an impermissible transition from nonprofit tax-exempt activity into commercial activity. Under a legal principle known as the commerciality doctrine, the IRS would not recognize tax-exempt status, or could revoke exemption, for an organization that has a substantial non-exempt purpose and operates primarily in a commercial fashion. While most organizations would have commercial activity addressed under the unrelated business income rules which are being discussed at this hearing, enforcement of the commerciality doctrine ensures that unrelated business activity does not reflect the primary purpose of a complex organization or system and, ideally, ensures that you can tell the difference between a nonprofit, charitable organization's provision of a service and the same provision of service by a for-profit enterprise.

A potential adverse consequence of a complex corporate structure is an increased possibility that a member of the board of directors may have an conflict of interest as to a transaction involving a related corporate entity. This situation requires continued vigilance by these organizations with respect to ongoing disclosure of conflicts and compliance with the organization's conflict of interest policy and applicable state law. This is squarely within the fiduciary duty of care and loyalty responsibilities of any director of a public charity, enforceable by both federal and state regulators.

Governance of multi-corporate public charities is also improving thanks to the continuing work of such organizations as the Association of Governing Boards of Universities and Colleges, Maryland Nonprofits Standards for Excellence Institute, BoardSource, Independent Sector, Commonfund Institute, and others to ensure that best practices are being developed, shared, and implemented.

When a change in the law is warranted, Congress has not hesitated to step in. For example, one type of public charity, the supporting organization, has in recent history been used in ways and for purposes other than those intended by the Internal Revenue Code. The complicated statutory provisions for public charities lent themselves to significant abuse by organizations and individuals other than the charity which was supposedly being supported. The Pension Protection Act of 2006 largely eliminated the possibility of continuing this type of abuse, including through the expansion of the IRS's intermediate sanctions penalties authority.

V. Conclusion

On balance, corporate complexity is a necessary consequence of the efforts of large public charities to operate effectively and with economic sustainability in the modern nonprofit sector, and their need to comply with multiple federal and state regulatory schemes and third party standards in their operations. Important and largely effective checks and balances, as well as the oversight of the nonprofit sector itself, are present to keep this level of complexity from becoming a problem under the law. Nevertheless, continued emphasis on transparency regarding these structures is critical and continued scrutiny is warranted.

Thank you for the opportunity to testify today and I would welcome any questions that you may have.

Chairman BOUSTANY. Mr. Colombo, you have 5 minutes.

STATEMENT OF JOHN COLOMBO, ALBERT E. JENNER, JR., PROFESSOR, UNIVERSITY OF ILLINOIS COLLEGE OF LAW, CHAMPAIGN, ILLINOIS

Mr. COLOMBO. Mr. Chairman, Mr. Ranking Member, and Members of the Committee, thank you for the opportunity to speak today about commercial activity by charities.

Over the past 20 years or so we have seen a steady expansion of commercial activity by charities. In most cases, commercial activity provides badly needed revenue to expand charitable outputs. But the legal issues surrounding commercial activity are complex and I think hopelessly confused.

When a charity engages in commercial activity, it raises two main issues. The first is whether the charity loses tax exemption as a result. If the charity does not lose tax exemption, then the second issue arises: Whether the commercial activity nevertheless should be taxed as though it were a freestanding corporate business. This latter issue is the providence of the unrelated business income tax.

Underlying these issues is a third issue: Does it matter what kind of business container the commercial activity is conducted in; that is, does it matter whether the business is conducted directly by the charity versus in a separate corporation or via a partnership with a for-profit enterprise. Under current law, each of these containers can have different tax consequences for the charity.

With respect to the effect of commercial activity on exempt status, the main policy issue is straightforward: How much, if any, commercial activity may a charity undertake without impairing exemption. Unfortunately, the existing legal precedent and Treasury regulations are of little help in resolving this issue. The regulations and precedent are clear that some amount of commercial activity is permitted, but beyond that we don't know much.

One part of the regulations, for example, suggest that charities cannot engage in more than an insubstantial amount of such activity, while another part of the same regulation states that a charity can operate a commercial business as a substantial part of its activities as long as that business is not its primary purpose and the business is in furtherance of its exempt purpose. But concepts such as substantial and in furtherance of are left undefined.

Think of it this way. Suppose I incorporate a charity to operate a soup kitchen. Everyone would agree that, properly operated, this organization is tax exempt under 501(c)(3). But now suppose that I decide that to expand my revenue base I am going to can my soup and sell it to the public. Is that okay? Does it depend on the size of my soup business versus the size of my soup kitchen relief efforts? If so, how is that measured, by gross expenditures, gross revenues, net revenues, number of people working in each activity, all of the above? Does it matter how much profit I have and how that profit is used? Does it matter whether my soup business is in a separate corporate container or is operated as a joint venture with a commercial soup company? What if I don't operate a soup kitchen directly but use profits from my commercial activity to make grants to other soup kitchens.

The UBIT has a similar set of problems. The UBIT was designed to tax certain commercial activities by charities but not all of them.

The main test for applying the UBIT is whether a businesses substantially related to accomplishing the charity's exempt purpose. If so, it is not taxed. If not, it is. In addition, there are specific exemptions for certain kinds of activities—activities run completely by volunteers, for example, or activities such as a cafeteria run for the convenience of employees or patrons.

Like the commerciality limitation, the UBIT also suffers from a lack of theoretical consistency and practical definition. Though the classic rationale for the enactment of the UBIT was to avoid unfair competition, the test for taxation doesn't depend on whether a charity is competing fairly or unfairly with the private market, but rather whether the business is substantially related to the organization's charitable purpose.

We know that substantially related involves more than just providing revenue for charitable purposes. But beyond that, the test for relatedness is murky, at best. To go back to my previous example, is my selling soup substantially related to my charitable purpose of providing a soup kitchen for the poor? If a symphony orchestra sells its recordings through commercial channels, is that substantially related? What if it has a gift shop and sells CDs by popular rock bands? Can it sell musical instruments, too? How about an upscale stereo system? How about art? After all, Modest Mussorgsky wrote a very famous musical composition called "Pictures at an Exhibition." So maybe art is substantially related to music.

These questions go to the heart of what we want our charitable sector to look like, and in my written testimony I have provided both a structure of how we might analyze those issues as well as some suggestions on possible reforms. But whether you agree with my suggestions or not, it is time for us to reconsider these issues from a policy perspective and provide clarity to charities regarding these activities.

Thank you.

Chairman BOUSTANY. Thank you, Mr. Colombo.

[The prepared statement of Mr. Colombo follows:]

Testimony of John D. Colombo*
House Committee on Ways and Means, Subcommittee on Oversight
July 25, 2012

I. Introduction

In a 2002 article, Stephanie Strom of the New York Times reported that in the previous year, the Metropolitan Museum of Art had revenues of $96.6 million from its shops, restaurants and parking garage, almost three times the revenue generated by admissions and membership fees.[1] That same year, the Yale School of Management announced that it had secured grants totaling $4.5 million from the Pew Charitable Trusts and the Goldman Sachs Foundation to establish a program to help charities develop business plans for entering commercial markets.[2] A 2003 article in Forbes reported on the wide-ranging business activities of "megachurches";[3] a 2001 article in the Wall Street Journal struck a similar note, commenting on how churches across the country were opening restaurants, Starbucks franchises and private gyms.[4] Even the academic world has noticed the trend: in 1998, economist Burton Weisbrod and several of his colleagues published an entire book about the growing commercial activities of charities,[5] and the Urban Institute Press published another book on the subject is in 2009.[6]

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* Albert E. Jenner, Jr. Professor of Law, University of Illinois. This written testimony is largely copied from my article *Reforming Internal Revenue Code Provisions on Commercial Activity by Charities*, 76 FORDHAM L. REV. 667 (2007).

[1] Stephanie Strom, *Nonprofit Groups Reach for Profits on the Side*, New York Times, March 17, 2002.

[2] *Yale School of Management Receives Twin Grants Totaling $4.5 Million from the Goldman Sachs Foundation and the Pew Charitable Trusts to Foster Business Growth Among Nonprofit Organizations*, SOM NEWS, Feb. 8, 2002.

[3] "World Changers Ministries, for instance, operates a music studio, publishing house, computer graphic design suite and owns its own record label. The Potter's House also has a record label as well as a daily talk show, a prison satellite network that broadcasts in 260 prisons and a twice-a-week Webcast. New Birth Missionary Baptist Church has a chief operating officer and a special effects 3-D Web site that offers videos-on-demand. It publishes a magazine and holds Cashflow 101 Game Nights. And Lakewood Church, which recently leased the Compaq Center, former home of the NBA's Houston Rockets, has a four-record deal and spends $12 million annually on television airtime." Luisa Kroll, *MegaChurces, Megabusinesses*, available at http://www.forbes.com/2003/09/17/cz_lk_0917megachurch.html.

[4] Elizabeth Bernstein, *Holy Frappucino!*, WALL ST. J., Aug. 31, 2001 at W1.

[5] TO PROFIT OR NOT TO PROFIT (Burton Weisbrod ed., 1998).

[6] Joseph J. Cordes and Eugene Steurle, NONPROFITS AND BUSINESS (Urban Institute Press 2009).

Charities are not just conducting more commercial activities themselves, however. It is increasingly common to find charities engaged in a variety of economic activities through for-profit subsidiaries, joint-venture partnerships and contractual arrangements. The health care sector is perhaps the most visible in its use of complex structures, but they are also found in education and other traditionally-charitable activities.[7]

Commercial activity by charities, therefore, seems to be an entrenched and growing phenomenon. Yet the income tax rules surrounding commercial activity are confused and contradictory, based on regulations issued in 1959 that no longer serve either tax policy or the exempt organizations community.

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[7] One of the more famous recent cases illustrating a complex structure was Geisinger Health Plan v. Comm'r, 100 T.C. 394 (1993). As explained by the Tax Court:

> Petitioner [GHP] owned and operated a health maintenance organization (HMO) under the Pennsylvania Health Maintenance Organization Act, Pa. Stat. Ann. tit. 40, secs. 1551-1567 (Supp. 1991). Petitioner was one of nine related organizations. The eight other organizations, referred to collectively as the Geisinger system and described below, were the Geisinger Foundation (the foundation), Geisinger Medical Center (GMC), Geisinger Clinic (the clinic), Geisinger Wyoming Valley Medical Center (GWV), Marworth, Geisinger System Services (GSS), and two professional liability trusts. Each of these eight entities was recognized by the Internal Revenue Service as an exempt organization described in sections 170(b)(1)(A)(iii), 501(c)(3), and 509(a)(1).
>
> ....
>
> The foundation controlled petitioner and the other entities in the Geisinger system, as well as three for-profit corporations. The foundation had the power, under the articles of incorporation and bylaws of petitioner, GMC, GWV, GSS, the clinic, and Marworth, to appoint the corporate members of those entities, who in turn elected their respective boards of directors. The foundation's board of directors was composed of civic and business leaders who were representative of the general public in northeastern and north-central Pennsylvania and were public-spirited citizens. The foundation raised funds for the Geisinger system's numerous charitable purposes and activities.

Id. at 395-96.

Although a large percentage of complex structures come from the health care sector, they exist in other sectors as well. See, e.g., Priv. Ltr. Rul. 95- 06-046 (Nov. 17, 1994) (ruling on a case in which a business league exempt under section 501(c)(6) established first- and second-tier subsidiaries to construct and operate a golf course); Gen. Couns. Mem. 39,776 (Jan. 4, 1989) (analyzing a situation in which an exempt university controlled a section 501(f) organization that in turn controlled a taxable subsidiary). *See generally* FRANCES R. HILL & DOUGLAS M. MANCINO, FEDERAL AND STATE TAXATION OF EXEMPT ORGANIZATIONS, chapter 27 (2006) (discussing exempt organizations' use of complex structures of related exempt and taxable entities); James J. McGovern, *The Use of Taxable Subsidiary Corporations by Public Charities – A Tax Policy Issue for 1988*, 38 TAX NOTES 1125 (1988) (discussing use of taxable subsidiaries by exempt organizations).

II. The Current Tax Rules[8]

Federal tax rules regarding commercial activity involve two main issues and two subsidiary ones.[9] The first main issue is whether the activity jeopardizes the charity's tax exemption under Section 501(c)(3) of the Internal Revenue Code ("Code"). Commentators have referred to this first issue as the "commerciality doctrine" or "commerciality limitation" on exempt status.[10] The second main issue is whether, if commercial activity does not jeopardize exemption, it nevertheless should be taxed. This issue is covered by the Unrelated Business Income Tax (UBIT) in sections 511-514 of the Code that has been with us since 1950.

To illustrate these main issues, suppose that I start a charity whose purpose is to run a soup kitchen for the homeless. The revenue for this charity comes exclusively from donations. Provided that this organization complies with other requirements of exemption, there is no question it qualifies as an exempt charity under 501(c)(3), with both a primary purpose and activity dedicated to relief of the poor. Now suppose that I decide that I could expand my soup kitchen operation if I had more revenue. So I finance the acquisition of a small manufacturing facility to manufacture and can chicken soup that I then sell through commercial channels with the intent of using the profits generated to expand my soup kitchen operation. Two questions arise: does the "commercial" soup manufacturing/sales operation cause my organization to lose its exempt status? If not, must I nevertheless pay tax on the profits from the soup sales?

The two subsidiary issues are (1) whether commercial activity undertaken by entities related to a charity (e.g., a subsidiary of a charitable parent, a sibling for-profit corporation or a partnership in which a charity is a partner) will be "imputed" to the exempt entity for purposes of determining their tax-exempt status and (2) how the IRS uses the "private benefit" doctrine to police economic transactions with for-profit entities or individuals outside the charitable class. This part of the article describes the current doctrine applicable to each of these issues. Returning to my soup hypothetical, suppose that instead of the charitable organization operating the soup manufacturing, it does so through a controlled

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[8] Parts of this section are copied or adapted from John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487, 491 (2002) (hereafter *Commercial Activity*) and John D. Colombo, *Regulating Commercial Activity by Exempt Charities: Resurrecting the Commensurate-in-Scope Doctrine*, 39 EXEMPT ORG. TAX REV. 341 (2003) (hereafter *Commensurate-in-Scope*).

[9] See generally, Colombo, *Commercial Activity*, *supra* note 8, at 491 (2002); JAMES J. FISHMAN AND STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS 567-72 (4th ed. 2010).

[10] Colombo, *Commercial Activity*, *supra* note 7, at 491; FISHMAN AND SCHWARZ, *supra* note 7, at 572; BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 99-114 (10th ed. 2011).

for-profit subsidiary. Does this change the analysis? What if instead my charity enters into a partnership with a commercial soup manufacturer to market a line of Colombo's Soup Kitchen soups? Unfortunately, the answers to all these questions are extremely difficult under existing law.

A. The Commerciality Limitation vs. the UBIT

Though Section 501(c)(3) states that an organization will qualify for exemption only if it is "organized and operated *exclusively*" for a charitable purpose, the statute has almost never been interpreted literally. As early as 1924, the Supreme Court held that a religious order would not lose exemption because of its limited sales of wine and chocolate.[11] Over time, this and subsequent cases established what was known as the "destination of income" test for exemption: an organization could engage in unlimited amounts of commercial activity as long as the revenues from that activity were used for charitable purposes.[12] Even organizations whose only activity was running a commercial business was exempt if it paid over its revenues to a charity.[13]

The destination of income test was overruled by Congress (at least in part) in 1950, when it passed the unrelated business income tax and prohibited exemption for "feeder" organizations.[14] These laws made revenues from commercial activities that were unrelated to charitable purposes taxable, and also prohibited exemption for the entity whose sole activity was operating a commercial business, even if the revenues were paid over to charity.[15] But Congress said nothing in the UBIT and related legislation about whether commercial activity by an organization that otherwise had a bona-fide charitable purpose should affect exemption. One could argue, in fact, that the adoption of the UBIT was an implicit blessing for charities to engage significant amounts of commercial

[11] Trinidad v. Sagrada Orden de Predicadores de la Provincia del Santissimo Rosario de Filipinas, 263 U.S. 578 (1924).

[12] Colombo, *Commercial Activity*, *supra* note 8, at 498-99; FISHMAN & SCHWARZ, *supra* note 9, at 570-72; HOPKINS, *supra* note 10, at 103-104; HILL AND MANCINO, *supra* note 7, ¶ 21.01 at page 21-4.

[13] *E.g.*, C.F. Mueller Co. v. Commissioner, 190 F.2d 120 (3d Cir. 1951) (Corporation that made macaroni exempt because revenues were paid to New York University's law school).

[14] I.R.C. §§ 502, 511-514. A "feeder" is an entity that operates a commercial business but is obligated to pay the net revenues of that business over to an exempt charity. *See* FISHMAN AND SCHWARZ, *supra* note 9, at 588-589.

[15] Colombo, *Commercial Activity*, *supra* note 8, at 500; FISHMAN & SCHWARZ, *supra* note 9, at 570-572; HOPKINS, *supra* note 10, at 103-104; HILL AND MANCINO, *supra* note 7, at ¶ 27.04.

activity, since unrelated activity now would be taxed and related activity (presumably) was not viewed as a problem.[16]

The final regulations adopted by the IRS in 1959, however, are confusing. The UBIT uses a "relatedness" test for determining taxability. Under the UBIT, commercial activity is taxable if it is not "substantially related" to the organization's exempt purpose.[17] According to the regulations implementing the UBIT, an activity is "substantially related" if "the principal purpose of such trade or business is to further (other than through the production of income) the purpose for which the organization is granted exemption."[18] The key phrase in this regulation is the parenthetical "other than through the production of income." That is, it is clear from the UBIT regulations that a commercial activity whose purpose is simply to provide a revenue stream for charitable activities is not "related" and therefore is taxable. Instead, "relatedness" is a functional concept focused on how the underlying nature of the commercial activity integrates with the exempt entity's charitable purpose, not on where the revenues from the commercial activity end up. But these regulations say nothing about whether commercial activity, related or unrelated, should affect exempt status.

With respect to the exempt status issue, Regulations §1.501(c)(3)-1(b)(1)(i) states that an exempt charity's organizational document (e.g., articles of incorporation or trust agreement) may not empower it to "engage, other than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes."[19] A couple of paragraphs later, the regulations warn that an organization will fail to qualify for exemption "if more than an insubstantial part of its activities is not in furtherance of an exempt purpose."[20] But an even later part of the regulations (1.501(c)(3)-1(e)) states that

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[16] Indeed, Professor Ethan Stone has argued that the UBIT was largely a "border patrol" measure (a phrase first used by Professor John Simon in describing the various tax rules applicable to exempt organizations) designed to keep charities from wandering too far from traditional "good works" that defined the charitable sector. Ethan Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 EMORY L.J. 1475 (2005). Stone's analysis supports the proposition that "related" business activity should have no bearing on exempt status, and that Congress believed it adequately responded to the "threat" of unrelated activity by taxing it, rather than revoking exemption because of it. The counter-argument here is that if Congress really did view the UBIT as mostly a "border-patrol" measure, then perhaps excessive "unrelated" business should cause loss of exemption due to inappropriate border-crossing.

[17] I.R.C. § 513(a). For a more extensive discussion of the UBIT rules, see HILL AND MANCINO, *supra* note 7 at chapter 22; HOPKINS, *supra* note 10 at chapter 23

[18] Treas. Reg. § 1.513-2(a)(4).

[19] Treas. Reg. §1.501(c)(3)-1(b)(1)(i).

[20] Treas. Reg. §1.501(c)(3)-1(c)(1).

an organization may qualify for exemption even if "it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business . . . ."[21] It appears from these regulations, therefore, that the two key concepts in determining the effect of commercial activity on exempt status (as opposed to whether the commercial activity is taxable under the UBIT) is when an activity is "substantial" and when an activity can be said to be "in furtherance of" an exempt purpose. The regulations, particularly Regulations §1.501(c)(3)-1(e), seem to say that unrelated business activities that are "in furtherance of" can be substantial without endangering exempt status; activities that are not "in furtherance of," however, must be insubstantial in order to retain exemption.

The regulations, therefore, seem to set forth a fairly straightforward linear analysis regarding the effect of commercial activity on exempt status. This three-step analysis is as follows. First, one must identify the organization's charitable purpose (if any). Second, one must analyze whether a particular noncharitable activity (e.g., a commercial activity) is "substantial" in comparison to other activities of the organization in question. Third, if the commercial activity is substantial, then one must analyze whether that substantial commercial activity is "in furtherance of" the organization's charitable purpose.

The problem is that the regulations under 501(c)(3) do not tell us anything about when a commercial activity is "substantial" or when it is or is not considered "in furtherance of" an exempt purpose. With respect to the former issue, a number of questions arise. Is "substantial" measured quantitatively or qualitatively? If the former, what quantitative measures are relevant, and are they measured absolutely or relative to charitable activity? If absolute, how much activity is "substantial"? If relative, do we compare the gross expenditures on the commercial activity vs. the charitable activities? Gross revenues for each? Number of employees (or volunteers) in each activity? The amount of time spent by the employees/volunteers on each activity? The regulations say nothing about this.[22]

[21] Treas. Reg. §1.501(c)(3)-1(e).

[22] Case law is equally useless. The closest we have to a definition of "substantial" is a case that dealt with the concept under the lobbying limitation ("no substantial part" of an exempt organization's activities may be lobbying). In *Christian Echoes National Ministry, Inc. v. United States*, 470 F.2d 849 (10th Cir. 1973) the court refused to measure "substantiality" by a mathematical test: "A percentage test to determine whether the activities were substantial obscures the complexity of balancing the organization's activities in relation to its objectives and circumstances." This interpretation of "substantial" (admittedly for a different purpose – lobbying, rather than commercial activity) suggests that the question of substantiality is dependent on how important the activity in question is to the other charitable activities carried on (if any). Quantitative measures might inform "importance" of course, but would not be determinative.

With respect to the interpretation of "in furtherance of," the regulations and case law are also completely silent. One possible interpretation of the regulations is that "in furtherance of" is equivalent to "substantially related" under the UBIT. Or put the opposite way, one might conclude that any "unrelated" activity under the UBIT is *not* "in furtherance of," and any "substantial" amount of unrelated commercial activity therefore creates exemption problems.[23] Certainly, one cannot see "related" activity as creating exemption problems; if an activity is related for UBIT purposes, then by definition it must functionally advance the organization's exempt purpose, and hence must be viewed as being "in furtherance of" that purpose. But the contrary proposition (that "unrelated" activity automatically is *not* "in furtherance of") is not necessarily true. In fact, if this proposition were correct, then the statement in Regulations § 1.501(c)(3)-1(e) quoted above that an organization may operate a business as long as the "primary purpose" is not carrying on an unrelated business makes no sense. If *any* "unrelated" business were viewed as *not* being "in furtherance of," then any unrelated business that was "substantial" would cause an organization to lose exempt status. A "substantial" business is presumably well short of one that is a "primary purpose"; therefore, the reference in Regulations § 1.501(c)(3)-1(e) to an organization losing exemption when an unrelated business becomes its primary purpose would be completely meaningless, because any "substantial" unrelated business would cause loss of exemption even if that business was not the "primary purpose."

The only sensible harmonization of these regulations, therefore, is that in enacting the UBIT, Congress did not intend to alter the "destination of income" test for the purpose of granting exemption to an entity in the first instance.[24] That is, unrelated business activity is taxed, but if the proceeds are used to support charitable activities, the organization in question is still entitled to an exemption (for its other income). It is only when the operation of the unrelated business becomes the entity's "primary purpose" that it loses exempt status, because at that point (obviously) the entity's "primary purpose" is no longer charitable. Put another way, "in furtherance of" has two meanings: commercial activity may be "in furtherance of" an exempt purpose by being functionally related to that purpose (for example, the music school of an exempt university puts on concerts for which it charges admission fees) *or* by being a source of revenue to expand charitable outputs.

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[23] See Jessica Pena & Alexander L.T. Reid, *A Call for Reform of the Operational Test for Unrelated Commercial Activity in Charities*, 76 N.Y.U. L. REV. 1855, 1864 (2001).

[24] *See* Ellen P. Aprill, *Lessons from the UBIT Debate*, 45 TAX NOTES 1105, 1107 (1989).

Early interpretations of the regulations by the IRS seemed to support the notion that even substantial unrelated business activity would not endanger exempt status as long as the revenues from that activity (which, of course, would be taxable under the UBIT) were used for charitable purposes. In Rev. Rul. 64-182,[25] the IRS considered a case in which an exempt organization derived its revenues largely from renting space in a commercial office building; the revenues were used to make grants to other charitable entities. Concluding that the rental activity was "unrelated" for purposes of the UBIT, the Service nevertheless ruled that the organization was entitled to retain its exempt status as an organization described under section 501(c)(3) because it was carrying on a charitable program "commensurate in scope" with its financial resources.[26]

The background to the 1964 revenue ruling, however, is more revealing than the ruling itself in interpreting the "commensurate-in-scope" language. Prior to approving the 1964 revenue ruling, the General Counsel's office referred the issue in the proposed ruling to the Exempt Organizations Council for analysis. The Council's analysis, attached to General Counsel's Memorandum 32689,[27] contained two primary conclusions. First, "the amount of expenditures of an organization for charitable purposes must be taken into consideration in equating business activities with charitable activities" under the primary purpose test of reg. section 1.501(c)(3)-1(c). Second, if after considering such expenditures, "an organization is shown in fact to be carrying on a real and substantial charitable program reasonably commensurate in financial scope with its financial resources and its income from its business activities and other sources," then the organization would be considered as having a charitable primary purpose.[28] According to the Council's analysis, the primary purpose test "becomes a test of whether there is a real, bona fide or genuine charitable purpose . . . and not a mathematical measuring of business purpose as opposed to charitable purpose."[29] Or in other words, (1) "primary purpose" cannot be determined by a mathematical comparison of size based upon number of employees, space utilized, or similar factors – there is no specific mathematical limit on unrelated business activities and (2) the dedication of net revenues from an unrelated business to charitable purposes is a necessary part of the analysis of the effects of unrelated business activity on tax exemption, and such dedication itself is evidence that an organization's "primary purpose" is charitable. On the other hand, the Council indicated that when the operation of a substantial unrelated business did not result in cross-subsidization, the organization was no longer being operated primarily

[25] Rev. Rul. 64-182, 1964-2 C.B. 186.

[26] *Id.*

[27] Gen. Couns. Mem. 39862, 1963 WL 62497 (IRS GCM) (Oct. 9, 1963).

[28] *Id.*

[29] *Id.*

for charitable purposes.[30] By implication, the Council's analysis seemed to be that dedication of revenues from commercial activity to charitable activities was "in furtherance of" a charitable purpose.

A later General Counsel's Memorandum further illuminated the "commensurate in scope" idea. This memo provides perhaps the best analysis of the doctrine and related issues of any IRS document. Reaffirming the original view of the Exempt Organizations Council that there were no "bright line" tests in determining whether unrelated business activity was consistent with exempt status, the memo stated,

> [A]side from express statutory limitations on business activity, such as section 502 and the newly enacted provisions relating to private foundations, there is no quantitative limitation on the "amount" of unrelated business an organization may engage in under section 501(c)(3), other than that implicit in the fundamental requirement of charity law that charity properties must be administered exclusively in the beneficial interest of the charitable purpose to which the property is dedicated.
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> . . .
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> [F]or some time now it has been increasingly apparent that our earlier approach to the problem of permissibility or nonpermissibility of business activities of charities has been based on a misconception that somehow in the enactment of the provisions for exemptions of charities from income tax, Congress intended an implied restriction on the extent of their engagement in business activities. In the years past, the Service sought by ruling and by litigation to deny the right of charities to engage in business, insisting that somewhere, somehow in the enactment of the exemption provisions Congress must have intended to limit the classification of exempt charities to those charities not engaging to any substantial extent in commercial endeavors.
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> Exhaustive research of legislative history from the earliest enactment of the charitable provisions of our income tax laws fails to provide support for such proposition. To the contrary, the evidence is clear that the first provision for exemption of charities from imposition of tax under the Corporation Excise Tax of 1909,

[30] As summarized by the Counsel's office in GCM 34682, 1971 IRS GCM LEXIS 38 (Nov. 17, 1971) "the Council's supporting Appendix also indicated that, aside from the 'primary purpose' requirement of the regulations, the better logic in cases in which the business activity does not in fact provide any significant funds for charitable use is that the organization is not being operated exclusively for charitable purposes."

> from which the present income tax exemption provisions derive, was accompanied not by any intention to limit exemption to charities not engaged in business, but an intention to assure exemption of certain charities that were engaged in business.[31]

The memo also addressed the issue regarding what should happen in cases in which the operation of an unrelated business either produced no profit to subsidize charitable activities or in which the profit was purposely reinvested to grow the unrelated business, as opposed to dedicated to expanding charitable outputs. As to the former case, the memo agreed with the original position of the Council that "the better logic in cases in which the business activity does not in fact provide any significant funds for charitable use is that the organization is not being operated exclusively for charitable purposes."[32] With respect to the latter case, the memo observed,

> We think that if an organization devotes its resources to business use which produces a reasonable return on the investment, but refuses to apply any significant part of its profits or resources to any charitable program and the condition prevailed for an unwarranted long time, a prima facie case could be made out that the organization is not administering its properties exclusively in the beneficial interest of charity since it is neither accomplishing any short range or any long range charitable purpose in respect to the beneficial use of its properties.[33]

The memo cautioned, however, that each such case would need to be resolved on its particular facts and circumstances.

Despite what seems to be the clear linear analysis mandated by the regulations, the IRS and courts seem to universally ignore this analysis (particularly the "in furtherance of" question) in analyzing cases. Instead, the IRS litigating positions and case law seems largely to concentrate on whether a particular activity has a "commercial hue" and if so, whether it is "substantial." Positive answers to these questions generally lead to loss of tax exemption, though even here the analysis is variable. No one seems interested in asking the "in furtherance of" question that is clearly posed in the regulations. The result has been a legal morass.

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[31] Gen. Couns. Mem. 34682, 1971 IRS GCM LEXIS 38, *26-*29 (Nov. 17, 1971).

[32] Id. at *18.

[33] Id. at *23-24.

For example, in *Scripture Press Foundation v. U.S.*,[34] the taxpayer, Scripture Press, was formed primarily to improve the quality of teaching texts for protestant Sunday schools.[35] Soon the company found itself highly successful in preparing and selling a variety of religious literature, accumulating over $1.6 million in surplus earnings by 1957.[36] As a result, the IRS revoked exempt status for the organization, claiming that it in effect was nothing more than a for-profit publisher and hence no longer was operated primarily for charitable purposes. The Claims Court agreed with the Service, noting that Scripture Press priced its products similarly to for-profit competitors and amassed significant profits.[37] Though it had an educational program aimed at promoting and expanding Sunday School instruction, the court found that expenditures on educational activities were "unaccountably small" in comparison to the surplus that Scripture Press accumulated annually.[38] Accordingly, the court concluded that Scripture Press was not operated "primarily" for charitable purposes.[39] Subsequently, the Tax Court and federal district courts upheld the IRS's revocation of exemption in a number of other publishing cases.[40]

As a result of *Scripture Press* and subsequent cases, by the early 1980's the Tax Court had developed the view that an organization that conducted a significant activity with a "commercial hue" risked losing exempt status. Factors which painted an activity with this impermissible "hue" included the presence of substantial overall profits; using commercial pricing methods with substantial net profit margins and competing with for-profit firms in the same sector.[41] In 1991, the Seventh Circuit in *Living Faith v. Commissioner* adopted this basic analysis in the context of an organization affiliated with the Seventh-day Adventist Church

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[34] 285 F.2d 800 (Ct. Cl. 1961), cert. denied, 368 U.S. 985 (1962).

[35] *Id.* at 803.

[36] *Id.* at 804.

[37] *Id.* at 804-05.

[38] *Id.*

[39] *Id.* at 806.

[40] Fides Publishers Ass'n v. United States, 263 F. Supp. 924 (N.D. Ind. 1967); Elisian Guild, Inc. v. United States, 292 F. Supp. 219 (D. Mass. 1968), *rev'd*, 412 F2d 121, 125 (1st Cir. 1969); Incorporated Trustees of Gospel Worker Society v. United States, 510 F. Supp. 374, 381 (D.D.C. 1981), *aff'd*, 672 F2d 894 (D.C. Cir. 1981); Presbyterian & Reformed Publishing Co. v. Comm'r, 70 T.C. 1070 (1982), rev'd 743 F.2d 148 (3d Cir.1984).

[41] Presbyterian & Reformed Publishing v. Commissioner, 70 T.C. 1070, 1083, aff'd, 743 F.2d 148 (3d Cir. 1982).

that operated vegetarian restaurants and health food stores, ostensibly to advance church doctrine relating to diet.[42] In reviewing a Tax Court opinion denying exempt status to the organization, the Seventh Circuit identified several factors leading to a conclusion that the organization violated the commerciality doctrine. These included (1) direct competition with commercial firms, including similar locations (in shopping centers) and similar hours of operation; (2) a pricing structure designed to produce a profit; (3) extensive advertising and use of commercial advertising materials; and (4) a lack in the record of any showing of donations to the organization or significant "relief of the poor."[43]

This analysis, however, is not consistent with the IRS's own regulations. Take *Scripture Press* itself. The proper analysis of this case should have been to ask first whether Scripture Press had a charitable purpose. Given that its stated purpose was to advance religion via religious publishing, it clearly had a religious charitable purpose per Section 501(c)(3). Next, we would ask whether its commercial activities in pursuing that purpose (publishing religious books) were substantial; the clear answer is this case is yes, given that this was essentially all the organization did. We would then follow with the third, critical question completely ignored in the *Scripture Press* litigation, which is whether the publishing activity was "in furtherance of" the religious charitable purpose. I cannot see how one could conclude that religious publishing is not "in furtherance of" a religious purpose – in fact, one could make an extremely strong argument that religious publishing is "substantially related" under the UBIT, given the centrality of the publishing activity to achieving the charitable purpose of advancing or proselytizing religion. In other words, in analyzing *Scripture Press*, the IRS ignored its own regulations, and the courts followed like children to the pied piper.

On the other side of the ledger, in 1984 the Third Circuit reversed the revocation of exempt status for a religious publisher in *Presbyterian & Reformed*

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[42] Living Faith, Inc. v. Commissioner, 950 F.2d 365, 367 (7th Cir. 1991) ("According to its articles of incorporation, Living Faith was established for the purpose of keeping with the doctrines of the Seventh-day Adventist Church. . . . Good health, according to Seventh-day Adventists, promotes virtuous conduct, and is furthered by a vegetarian diet and abstention from tobacco, alcohol, and caffeine.")

[43] *Id.* at 373-75. An even more recent case (decided literally weeks ago) is Asmark Institute, Inc. v. Commissioner, No. 11-1553 (6th Cir. 2012). In this case, the Sixth Circuit used a "commercial hue" analysis to conclude that an organization which provided consulting services to farms and agribusinesses on a fee-for-service basis was not an exempt charity under 501(c)(3). The court's one-page analysis of the commercial activity issue (on page 10 of the slip opinion) completely ignores the three-step analysis set forth above. While I suspect the result in the case is correct, it would be nice if courts and the IRS would occasionally engage in some actual reading of the law – particularly when the law is the IRS's own regulations!

Publishing v. Commissioner,[44] a case substantially similar to *Scripture Press*. The taxpayer in *Presbyterian & Reformed Publishing* was a highly profitable nondenominational religious publisher that priced its products at market. Though the Tax Court upheld an IRS revocation of exempt status on the ground of impermissible commercial hue based primarily on the large profits generated by the taxpayer's publishing business,[45] the Third Circuit reversed, noting that "success in terms of audience reached and influence exerted, in and of itself, should not jeopardize the tax-exempt status of organizations that remain true to their stated goals."[46] A charitable organization, according to the Third Circuit, should be able to make money to expand its audience and influence, and doing so does not make the organization any less charitable.

Similarly, the Tax Court itself approved exemption in several "resale shop" cases - situations in which a nonprofit enterprise primarily operated a business selling crafts produced by a particular group. In the late 1970's, for example, the Tax Court approved exemption for an organization that imported, purchased and sold artist's crafts,[47] an organization that purchased and sold products manufactured by blind individuals,[48] and an organization that operated two public art galleries.[49] A Federal appellate court also reversed a lower court ruling upholding a revocation of exemption on commerciality grounds when the taxpayer, a publishing company, showed that it had no "operational profits."[50]

Even the IRS itself has approved charities engaging in activities with decidedly commercial hues - for example, hospitals and educational organizations can operate health clubs that charge fees similar to for-profit competitors without

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[44] 743 F.2d 148 (3d Cir. 1984)

[45] 79 T.C. 1070 (1982).

[46] *Id.* at 158.

[47] Aid to Artisans, Inc. v. Comm'r, 71 T.C. 202 (1978). The organization claimed that its charitable purposes were (1) "helping disadvantaged artisans in poverty stricken countries to subsist and to preserve their craft; and (2) furnishing services to tax-exempt museums by providing museum stores with representative handicrafts from disadvantaged countries." *Id.* at 209.

[48] Industrial Aid for the Blind v. Comm'r 73 T.C. 96 (1979). The charitable purpose was to provide employment for the blind and thus came within the regulations' statement that a charitable purpose includes "relief of the poor and distressed or underprivileged." Id. at 100-101. *See* Treas. Reg. 1.501(c)(3)-1(d).

[49] Goldsboro Art League v. Comm'r, 75 T.C. 337 (1980).

[50] Elisian Guild, Inc. v. United States, 412 F.2d 121, 125 (1st Cir. 1969).

endangering exempt status, although the income from these activities may in part be subject to taxation under the UBIT.[51] Some recent private rulings, moreover, have reverted to commensurate-in-scope analysis, approving exemption for an organization that published textbooks for religious schools, even though revenues from the publishing business counted for over half of the organization's total revenues and enjoyed 75% profit margins; [52] for an organization that helped developmentally disabled children, despite receiving 98% of its gross income from bingo games;[53] and for an organization formed to give financial assistance to needy women that produced 66% of its revenues from the operations of a gift shop and tea room.[54] Nevertheless, the IRS has continued to push the

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[51] *See generally*, Virginia Richardson, Roderick Darling and Marvin Friedlander, *Health Clubs* in INTERNAL REVENUE SERVICE, EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION (CPE) TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 2002 (2001) (operation of health club by university or hospital generally does not affect exempt status; income from memberships sold to general public – as opposed to students and faculty or patients and staff – generally taxable under UBIT).

[52] Tech. Adv. Mem. 9636001, 1996 PLR LEXIS 1026 (January 4, 1996). The organization started its publishing activities to supply its own schools with textbooks, but soon expanded to provide religious-oriented textbooks to schools worldwide. Revenues from the publishing business constituted over half the total gross revenues of the organization, and its profit margins were as high as 75%, though expenditures on the publishing business were less than half the organization's total expenditures. Finding that the publishing activities were virtually indistinguishable from those of a commercial religious publisher and that they were not "substantially related" to the educational activity of operating its own religious schools, the Service concluded that the profits of the activity were subject to the UBIT. At the same time, however, the Service concluded that the obviously-substantial nature of the publishing business did not endanger the taxpayer's exempt status because "there is no evidence that any of the funds generated by [the publishing business] were not properly used to further the organization's education purposes in some manner." *Id.* at *25. Accordingly the taxpayer was entitled to exemption "because it is carrying on an exempt program commensurate in scope with its financial resources." *Id.* at *25-26.

[53] Tech. Adv. Mem. 9711003 (Nov. 8, 1995) reprinted in 16 Exempt Org. Tax Rev. 626 (1997). *See* D. Benson Tesdhal, *Letter Ruling Alert: IRS Applies Liberal Primary Purpose and Commensurate Tests*, 16 EXEMPT ORG. TAX REV. 617 (1997). The organization represented that 50% of its time and resources were dedicated to bingo games, although over 95% of its gross income was used for bingo operations; expenditures on charitable activities ranged from about 1.5% to 3.5% during the years in question. Nevertheless, the IRS summarily dismissed the notion that this organization had any "commensurate" problems, noting that for 30 years the organization had been assisting developmentally disabled children and spent over 40% of its time and resources doing so. Accordingly, the commensurate-in-scope test "would not be applicable since the Association has a substantial charitable program in addition to its fundraising activities." *Id.* at 628. In the ruling, the IRS noted that although income from bingo games was specifically excluded from the UBIT in I.R.C. Section 513(f), that exclusion "was not intended to result in exemption for organizations whose primary activity is the conduct of bingo. Bingo remains an activity unrelated to exempt purposes and alone cannot support exemption . . ."). *Id.* at 627.

[54] Priv. Ltr. Rul. 200021056, 2000 PRL LEXIS 562 at *33 (Feb. 8, 2000). The Service in this ruling reasoned that an unrelated business that is used as a "fundraiser" for an overall charitable

"commercial hue" test in litigation,[55] and several recent applications for exempt status have been rejected by the IRS on grounds that the organization's activities were no different from commercial enterprises.[56]

In short, the Treasury Regulations, IRS interpretations and litigating positions, and court cases all seem to be inconsistent in judging when commercial activity should result in loss of exempt status. In particular, neither the IRS nor the courts have analyzed consistently the main issue raised by the regulations: when (unrelated) commercial activity will be considered "in furtherance of" an exempt purpose as opposed to simply "primarily" operating an unrelated business.

B. Complex Structures

The conflict between "relatedness" and "in furtherance of" is not the only inconsistency in the commercial activity realm. IRS positions on how complex structures affect exempt status are also conflicting. In general, the IRS adheres to the view that corporate entities "stand on their own" for tax exemption purposes – that is, the activities (charitable or commercial) of one corporate entity will not be imputed to a related entity for either good (obtaining exempt status) or ill (revoking exemption). This "separate corporate identity" rule is a long-standing feature of corporate tax law, where treating an entity as a bona-fide, separate business container is necessary to protect the corporate tax base.[57] When it

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purpose was operated "in furtherance of" a charitable purpose and did not constitute a substantial nonexempt purpose. *Id.* ("One way in which a trade or business may be in furtherance of exempt purposes is to raise money for the exempt purposes of the organization, notwithstanding that the actual trade or business activity may be taxable under sections 511 through 513.") Similarly, in Field Service Advice memo 199910007 (Nov. 24, 1998); 1998 FSA LEXIS 15, the Service concluded that an organization operating a sports tournament whose net proceeds were turned over to another charity met the commensurate-in-scope requirement. For additional analysis of the checkered history of the commensurate-in-scope test, see Evelyn Brody, *A Taxing Time for Bishop Estate: What is the I.R.S. Role in Charity Governance?*, 21 U. HAW. L. REV. 537, 575-76 (1999).

[55] *E.g.*, Airlie Foundation v. I.R.S., 283 F. Supp. 2d 58 (D.D.C. 2003) (organization that rented conference facilities to other charities and helped with conference logistics not exempt because its activities were conducted in a commercial manner). The most recent example is

[56] E.g., Priv. Ltr. Rul. 200704041, 2006 PLR LEXIS 2448 (Oct. 30, 2006) (organization that provided down payment assistance to HUD-qualified home buyers not exempt; "The manner in which you operate your down payment assistance program indicates that you facilitate the sales of homes in a manner that is indistinguishable from an ordinary trade or business."); Priv. Ltr. Rul. 200651037, 2006 PLR LEXIS 2020 (Sept. 28, 2006) (organization formed to sell items for individuals and transfer proceeds to charity of individual's choice was performing services as agent for donor "which are characteristic of a trade or business and ordinarily carried on by for-profit commercial businesses.").

[57] Moline Properties v. Commissioner, 319 U.S. 436 (1943). In *Moline Properties*, the taxpayer argued that a corporation which sold certain real estate should be disregarded, and the proceeds of sale taxed directly to the corporation's sole shareholder. The Supreme Court ruled that the tax system must respect the separate identity of a corporation formed for a valid business reasons, thus

comes to joint ventures conducted in a partnership form (or in a limited liability company taxed as a partnership), however, the IRS position is that the partner is deemed to be in the same trade or business as the partnership – that is, the partner is deemed to be conducting directly the business of the partnership.[58] This "aggregate" view of partnerships is also a long-standing rule of general tax law.

In one sense, therefore, the IRS has been perfectly consistent in adopting for tax exemption the same rules that apply in general tax law regarding the "separate-ness" of entities. In a larger sense, however, these rules mean that the effects of a particular business activity on exemption and the potential that such activity will be taxed can be dramatically altered by the form of the "container" in which the business is conducted. For example, under current rules, an exempt entity could sit at the top of an extensive for-profit corporate business pyramid, and the corporate isolation rule would mean that the exempt parent would be essentially immune from claims that the overall activities of the "group" were not charitable.[59] By comparison, a charity that operated a substantial business

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protecting the integrity of the corporate income tax. In General Counsel's Memorandum 39326 (Jan. 17, 1985), the IRS applied the *Moline Properties* doctrine in assessing the exempt status of a nonprofit parent that owned a for-profit subsidiary, concluding that the subsidiary's activities would not be imputed to the nonprofit parent. *See generally*, Colombo, *Commercial Activity*, *supra* note 8, at 515. For an extended discussion of the *Moline Properties* doctrine in the context of tax exemption, see HILL AND MANCINO, *supra* note 7, at ¶ 27.02.

A subsidiary corporation of an exempt parent can sometimes claim tax exemption as an "integral part" of the parent's exempt activities. In general, the IRS position is that the "integral part" test is available only to "captive" subsidiaries that perform services exclusively for the exempt parent, such as a subsidiary that generates electrical power for its parent. Treas. Reg. § 1.502-1(b). For general discussions of the integral part doctrine, see John D. Colombo, *The IHC Cases: A Catch-22 for Integral Part Doctrine, A Requiem for Rev. Rul. 69-545*, 34 EXEMPT ORG. TAX REV. 401 (2001); HILL AND MANCINO, *supra* note 7 at ¶ 27.04.

[58] See, e.g., Rev. Rul. 98-15, 1998-1 C.B. 718, 720-721.

[59] One private ruling issued in 2004 suggests (in the mode of the "commensurate in scope" doctrine discussed above) that an exempt parent must somehow use revenues or assets of its for-profit subsidiaries to further its charitable purpose, or else it may run afoul of the primary purpose test. In TAM 200437040, the IRS examined whether large accumulations of value in a for-profit subsidiary of an exempt church would result in loss of exempt status. While the IRS ruled that it would not under the particular facts presented, its analysis suggests an ongoing obligation for an exempt parent to use revenues/assets from a for-profit subsidiary to expand charitable outputs, a la the commensurate in scope doctrine. In this private ruling the IRS stated:

> In post-audit years, it appears that the subsidiary grew rapidly -- perhaps beyond X's expectations. It is now worth several times X's investment in the subsidiary, although it apparently had not earned an operating profit through * * *. This growth presents a continuing obligation on X to translate this valuable asset into funds, and use those funds for the expansion of its charitable religious activities. For example, X may have to give consideration to selling some of the subsidiary's assets, or selling a portion of the stock of the subsidiary, to an unrelated party. The proceeds of such transactions must be used to fund or expand X's charitable or religious activities. The subsidiary should give highest

enterprise via a partnership would place its exempt status at risk under the current version of the commerciality doctrine described above.[60] At the same time, an exempt organization that isolated a particular business activity in a corporate container for regulatory or liability reasons would lose any possibility of arguing that the business was "related" to the exempt organization's charitable purpose, since the parent's charitable activities could not be attributed "downstream" to the subsidiary corporation.[61] At one time, even the Treasury itself questioned the wisdom of these rules,[62] although there are no current legislative proposals to change them.

C. Private Benefit

The final issue that comes up repeatedly in the commercial-activity sphere is the private benefit doctrine. Even trying to summarize the private benefit doctrine is hazardous, but from a variety of IRS rulings and litigated cases, one might conclude that private benefit is a benefit (usually economic) that flows to some person or entity outside the charitable class as a result of serving the charitable

> priority to repaying X's investment loans once it begins generating cash flow or earnings and profits, so that these funds can be used for X's charitable or religious activities. X cannot be allowed to focus its energies on expanding its subsidiary's commercial business and assets, and neglect to translate that financial success into specific, definite and feasible plans for the expansion of its charitable religious activities. . . .
>
> The fact that the assets are being accumulated in a for-profit company under the formal legal control of X does not excuse X from using such assets for charitable religious purposes.

Tech. Adv. Mem. 200437040, 2004 PLR LEXIS 612, *25-*26 (June 7, 2004).

[60] See text at notes 19-56, *supra*.

[61] For example, we know from recent case law that a contract-model health maintenance organization (HMO) will find it difficult to obtain exemption under 501(c)(3) if the HMO business is in a separate corporation. See, e.g., IHC Health Plans v. Comm'r, 325 F.3d 1188 (10th Cir. 2003). It is not clear, however, whether revenues from an HMO that was operated as a "division" of a nonprofit corporation that operated an exempt acute-care hospital would be taxable or not; one could certainly argue that such revenues are "substantially related" to the hospital's exempt purpose of providing health care for the general benefit of the community, although some older IRS rulings suggest that if a hospital receives revenues from persons other than hospital patients, such revenues would be "unrelated." See, e.g., Gen. Couns. Mem. 39830 (Aug. 30, 1990) (suggesting that an HMO might be considered an unrelated business in the hands of a hospital corporation since the HMO provides services to persons not patients of the hospital).

[62] As part of hearings on the UBIT in the late 1980's (hereafter, "the Pickle hearings") the Oversight Subcommittee of the House Ways and Means Committee circulated a draft report that recommended aggregating the activities of a parent nonprofit and any 80%-owned subsidiary for purposes of applying the "primary purpose" test of exemption. *See generally*, HILL AND MANCINO, *supra* note 7, ¶27.03[4]; Aprill, *supra* note 24, at 1106; Evelyn Brody, *Business Activities of Nonprofit Organizations: Legal Boundary Problems in* CORDES AND STEURLE, *supra* note 6.

class. Whether such a benefit creates exemption problems is judged on a balancing test. The best statement we have from the IRS regarding the doctrine comes from a 1987 General Counsel's Memorandum, which stated:

> An organization is not described in section 501(c)(3) if it serves a private interest more than incidentally. . .
>
> A private benefit is considered incidental only if it is incidental in both a qualitative and a quantitative sense. In order to be incidental in a qualitative sense, the benefit must be a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by benefiting certain private individuals. . . . To be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity.[63]

Although the IRS has used the private benefit doctrine in a wide variety of contexts, it has been a particular fixture of IRS analysis of commercial transactions undertaken by exempt charities with for-profit entities or individual investors. Thus the IRS has applied the concept to partnerships between hospitals and doctors;[64] low-income housing partnerships with private investors;[65] "down-payment assistance" programs in which a charity acts as an intermediary between a real estate developer and a potential charitable client[66] and similar transactions.[67] Because of the breadth of the doctrine as currently applied by the IRS, any significant economic transaction between an exempt charity and a non-exempt entity or individual outside the charitable class is subject to private benefit attack, and the balancing approach means that the line between permitted and problematic private benefit is unclear.[68]

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[63] Gen. Couns. Mem 39598 (Jan. 23, 1987).

[64] *E.g.*, Gen. Couns. Mem. 39862, 1991 IRS GCM LEXIS 39 (Nov. 22, 1991).

[65] *See, e.g.*, Jerry O. Allen and Alan D. Duffy, *Solving the Low-Income Tax Credit Housing Partnership Dilemma*, 49 EXEMPT ORG. TAX REV. 319 (2005); J. Christine Harris, *Tax-Exemption And Low-Income Housing Ventures: Irreconcilable Differences?* 47 EXEMPT ORG. TAX REV. 329 (2005); J. Christine Harris, *Tax Law Professors Say Recent Joint Venture Ruling Doesn't Break Ground In Housing*, 47 EXEMPT ORG. TAX REV. 21 (2005); Michael I. Sanders and Celia A. Roady, *EO Practitioners Suggest Way To Expedite Exemptions For Low-Income Housing Orgs.*, 37 EXEMPT ORG. TAX REV. 127 (2002).

[66] *E.g.*, Rev. Rul. 2006-27, 2006-21 I.R.B. 915.

[67] *See generally*, John D. Colombo, *In Search of Private Benefit*, 58 FLA. L. REV. 1063 (2006).

[68] In 2004, the IRS did clarify that certain "ancillary" partnerships between an exempt charity and a for-profit company would not create private benefit problems, though the ruling is largely devoid of analysis and leaves open as many questions as it answers. Rev. Rul. 2004-51, 2004-22 I.R.B. 974. *See generally*, Colombo, *supra* note 66, at 1077-79; J. Christine Harris, *Tax Law Professors*

III. Making Tax Law Coherent

A. A Taxonomy of Commercial Activity and the Policy Objectives of Regulating It

Part II. above recounts the inconsistent positions the IRS and courts have taken with respect to whether commercial activity should affect exempt status. In order to get a handle on the issues involved and how best to revise federal tax law on this front, it may be helpful to think about how different kinds of commercial activity impact policy objectives relating to such activity.

In some prior writing, I identified several policy concerns with charities conducting commercial activities. Those concerns are (1) avoiding unfair competition between exempt and for-profit entities, (2) limiting erosion of the corporate tax base by having charitable organizations buy taxable activities that become non-taxable in the charity's hands, (3) limiting the extent to which the attention of management is "diverted" from charitable activities into running for-profit businesses, (4) promoting economic efficiency, (5) guarding against "over-subsidizing" charitable activities by letting charities "self-subsidize" through the acquisition of commercial businesses and (6) limiting the business risk exposure of charitable assets that might accompany running a business from the same "container" (corporation or trust) that houses charitable assets.[69] Some of these policy concerns are more significant than others. For example, economists have almost uniformly rejected the notion that charities engage in unfair competition, at least if that phrase is limited to predatory pricing techniques or inappropriately using exempt revenues to subsidize commercial activity.[70] Similarly, exposing charitable assets to business risk can best be handled through insurance and proper diversification; tax law should have little to say about this policy issue.[71] On the other hand, protecting the corporate tax base, limiting managerial diversion, promoting economic efficiency and limiting possible over-subsidization of charitable activities (which could be viewed as simply a subset of promoting economic efficiency) do seem to be significant concerns.

Say Recent Joint Venture Ruling Doesn't Break Ground In Housing, 47 EXEMPT ORG. TAX REV. 21 (2005).

[69] Colombo, *Commercial Activity*, *supra* note 8, at 529-546.

[70] *Id.* at 530. *See also*, Michael S. Knoll, *The UBIT: Leveling and Uneven Playing Field or Tilting a Level One*, 76 FORDHAM L. REV. 857 (2007) (questioning whether there is *any* economic advantage to a nonprofit engaging in a commercial business.

[71] *Id.* at 544-46.

Commercial activity also has its benefits, however. The obvious benefit is that it permits charitable organizations to expand (or maintain) their outputs in an environment in which the availability of direct government grants may be shrinking and competition for both the available government money and private donations is increasing exponentially along with the sheer numbers of exempt charities.[72] In some cases, moreover, commercial activity may permit a charity to earn a return on capital investments made primarily for charitable purposes, but which by their nature may be under-utilized for purely charitable outputs. Thus a conclusion that commercial activity by exempt charities is uniformly "bad" is not correct.

Instead, it may be useful to try to categorize the kinds of commercial activities charities engage in and analyze whether the concerns with commercial activity outweigh the potential benefits. In general, one can separate commercial activity into five categories:

- *Category 1*: commercial activity that is also the primary exempt activity;
- *Category 2*: commercial activity that is functionally related to the organization's exempt purpose (e.g., "substantially related" activity under the UBIT);
- *Category 3*: "unrelated" commercial activity that exploits excess capacity;
- *Category 4*: "unrelated" commercial activity that does not exploit excess capacity but the revenues from the activity are directed to charitable outputs, and
- *Category 5*: "unrelated" commercial activity that becomes "empire building" for its own sake.[73]

Scripture Press, discussed above, is a classic example of a Category 1 case, because religious publishing was the taxpayer's only activity. Other examples exist, however. There is little doubt that a nonprofit hospital, selling health care services for a fee at prices virtually identical to for-profit hospitals in similar markets is engaged in commercial activity that is also its primary activity; in this case, however, the specific commercial activity has been approved (under the correct ancillary conditions)[74] as a primary charitable activity. Low-income housing partnerships are another example of a charitable organization engaging in

[72] *See* Burton A. Weisbrod, *The nonprofit mission and its financing: Growing links between nonprofits and the rest of the economy*, in TO PROFIT OR NOT TO PROFIT, *supra* note 5, at 1, 2-7.

[73] *See* Colombo, *Commercial Activity*, *supra* note 8, at 525-529. The "empire building" concern is what led Treasury to propose an aggregation rule for determining if a particular nonprofit had a "primary" charitable purpose in the Pickle hearings in the late 1980's. See note 62, *supra*; Brody, *supra* note 62, at 32.

[74] *See, e.g.*, IHC Health Plans, Inc. v. Comm'r, 325 F.3d 1188 (2003); John D. Colombo, *The Failure of Community Benefit*, 15 HEALTH MATRIX 29, 30-37 (2005).

a commercial enterprise (building and renting housing) as its primary charitable activity. In these cases, therefore, the key question is whether the activity undertaken by the nonprofit will be considered charitable in itself. If so, there is nothing more to discuss; if not, then the organization presumably falls into the category of Treasury Regulations 1.501(c)(3)-1(e)(1) of operating an "unrelated" business as its primary purpose, and thus fails the tests for exemption.[75]

Categories 2-5 involve inherently different circumstances. In each of these categories, the charity has a substantial charitable activity of some kind that exists alongside the commercial activity. In Category 2, the commercial activity is one that is functionally related to the charity's exempt purpose – activity which would be "substantially related" under the current UBIT. Such related activities may be a concern for tax-base erosion, but little else. Since the activities are functionally related to the exempt purpose they bear little risk of managerial diversion (after all, management is engaging in these activities as an integral part of their exempt activities). Moreover, as Professor Henry Hansmann has noted, these activities raise few, if any, economic efficiency problems since one would assume these activities involve some kind of economies of scope (e.g., the capital asset has already been purchased or employees are already trained to do these activities).[76]

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[75] This category is one where confusion over the difference between charitable purpose and charitable activities is most problematic. One might argue, for example, that a nonprofit pharmacy has a charitable purpose to promote health; *see, e.g.*, Rev. Rul. 69-545, 1969-2 Cum. Bull. 117 (promotion of health for the general benefit of the community is a charitable purpose). If none of its activities can be classified as charitable, however, then it seems obvious that its *primary* purpose is not charitable but something else. *See, e.g.*, Federation Pharmacy Services v. Comm'r, 625 F.2d 804 (8th Cir. 1980) (nonprofit pharmacy not exempt because activity of selling drugs at cost to elderly and poor is a commercial activity, not a charitable one; pharmacy not eligible for exemption). Similarly, this conflation of charitable purpose and charitable activities can explain the different results in the *Scripture Press* and *Presyhyterian and Reformed Publishing Cases* discussed above. In *Scripture Press*, the Claims Court appeared to view religious publishing as not being a charitable activity, at least when conducted with a "commercial hue," despite the fact that publishing religious texts would seem to functionally advance a charitable purpose of promoting religion. In contrast, the Third Circuit in *Presbyterian and Reformed Publishing* clearly did view religious publishing as a charitable activity that promoted a religious purpose.

In PLR 200818023 (released Feb. 6, 2008), the IRS came as close as it has in 40 years to properly analyzing the effect of commercial activity on exempt status. In this ruling, the Service analyzed the case of an organization primarily selling certain types of securities for a fee to facilitate estate planning, with about .5% (one half of one percent) of the fees going to charity. The IRS concluded that the security sales were inherently commercial, and that the .5% of revenues going to charity did not pass muster under the "commensurate in scope" doctrine. This in turn meant that the taxpayer's "primary purpose" was operating an unrelated business, because the securities sale activity was not "in furtherance of" a charitable purpose. The ruling created something of a stir among charities after the then-head of TE/GE, Mike Miller, opined that the commensurate test might be used to regulate how charities were using their resources.

[76] Henry Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605, 626-28 (1989).

For example, one would expect that the music school that puts on concerts by by for-profit groups already has personnel experienced in concert planning and execution. There may be some risk of undue "self-subsidization" by charities if these related activities are financially successful, but given that these activities are by definition a functional part of the charitable program, the chances of these activities becoming serious money-makers likely are small.

In Category 3, charities undertake "unrelated" commercial activities because they have excess capacity from capital investments made for charitable purposes. The classic example here is a university that rents its stadium facilities to a professional football team for the summer or that leases unused supercomputer time to for-profit research groups.[77] Commercial activities falling within this category also should not raise exemption problems. In this kind of case, we should positively encourage charities to avoid letting assets simply lie fallow. Doing so is a waste of invested capital. There may be some concern that we not encourage charities to consciously "over-invest" in capital facilities or in employees simply to use them in commercial businesses, but to the extent that investments are made at a level necessary to conduct charitable activities, earning a profit through maximum utilization of that investment would seem to be a desirable and efficient outcome. Moreover, if the capital investment is made in the first instance to pursue charitable activities, there is little reason to think that there is much risk to the corporate tax base (since the activities for which the investment was made likely would not have been undertaken by the private market). Managerial diversion also would be limited, because if the capital assets used in the commercial activity were primarily meant for charitable purposes, any commercial activity by definition will be subordinate to commercial use. For example, the empty athletic stadium is only available to rent when the university's teams are not using it – generally, this means the summer only. Ditto for the unused supercomputer time – commercial use will by necessity be subordinate to academic use.

In Category 4, charities undertake commercial activities that do not exploit economies of scope, but generate returns above the market rate on stocks and bonds that in turn will be used to expand charitable outputs. The church that opens a Starbucks franchise probably has no significant economies of scope to exploit in that activity, but may (in some cases correctly) conclude that investing in the Starbucks will produce a rate of return significantly higher than a diversified portfolio of stocks and bonds. There may be programmatic reasons as well: luring former church-goers back to Sunday services with the promise of good coffee, or trying to expand the number of patrons of the local museum by having after-hours cocktail parties.

[77] *See* Hansmann, *supra* note 76, at 627, 628.

These Category 4 activities raise mixed issues. On the one hand, it seems that we should not impede the ability of charities to develop alternative resources to expand charitable outputs. Other commentators have noted the modern pressures on funding sources for charities;[78] if investing wisely in certain commercial activities produces a premium rate of return for charities to expand charitable outputs, that seems as though it would be a generally good thing. Engaging in these activities, therefore, likely should not affect exempt status as long as the revenues from the commercial activity are used to subsidize charitable outputs. Yet there are some countervailing concerns. Unlike category 2 or 3 activities, those in category 4 are far more likely to result in managerial diversion, since the commercial activity is not subordinate to any charitable use of the underlying assets. The church that runs a Starbucks to supplement the collection plate will almost certainly need to invest significant managerial time in running the Starbucks. Category 4 activities also raise questions of protecting the corporate tax base, economic efficiency and over-subsidization, particularly if these activities are not subjected to the general corporate income tax. If these activities are not taxed, charities can earn a premium rate of return on them simply because they can avoid the corporate-level tax, not because managerial or other efficiencies produce a premium rate of return.[79] Thus, failing to tax these activities would encourage charities to invest money in direct commercial activities even if such activities would be "worse" investments on an after-tax basis than a diversified portfolio. This incentive would in turn result in more such activities undertaken by charities, withdrawing those assets from the corporate tax base (the tax-base protection issue), and would result in charities essentially "self-subsidizing" their operations even if doing so resulted in an oversupply of the particular charitable good or service that the commercial activity was subsidizing. The proper policy response to category 4 activities, therefore, would seem to be to tax them, but not have them affect underlying exempt status.

Finally, in Category 5, charities become involved in commercial activities that take on a life of their own, where revenues are largely reinvested in the activity itself, instead of being used to subsidize expanding charitable outputs. In a 2004 Technical Advice Memorandum dealing with an exempt church that owned a for-profit subsidiary, the IRS raised precisely these empire building concerns, cautioning the exempt parent that it "cannot be allowed to focus its energies on expanding its subsidiary's commercial business and assets, and neglect to

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[78] See Weisbrod, *supra* note 72.

[79] Corporations pay entity-level tax on their earnings at a maximum rate of 35%, whereas proprietorships and partnerships (or LLC's that choose to be taxed as partnerships) pay no entity-level tax. That means that in theory, a corporation must earn a higher pre-tax return on equity to compete with other investments in the market on an after-tax basis. If a charity could acquire a corporate business and avoid the corporate-level tax, it would be able to capture this higher pre-tax rate of return for itself simply as a result of the ownership change.

translate that financial success into specific, definite and feasible plans for the expansion of its charitable religious activities."[80] One might argue that Division I college basketball and football programs may also present these problems, at least in individual cases. Recent headlines such as Alabama's hiring of Nick Saban for $32 million over eight years[81] surely make one wonder whether Alabama is rationally seeking to maximize football revenues to subsidize other charitable (e.g., educational) outputs, or whether running a successful Division I football program has simply become an end unto itself. In these cases, management of the charity may need a forceful reminder of its underlying mission – and there is no more forceful reminder than the threat of losing tax exemption.[82]

B. Suggested Reforms

The above analysis suggests some reforms that may be worthy of consideration. First, the problem with Category 1 cases is really a problem with defining appropriate charitable activities, not a problem of the relationship between charitable activities and commercial ones. What is necessary here is that the IRS adopt a consistent approach to analyzing Category 1 cases. Perhaps that consistent approach could be something along the following lines: if an organization's sole activity (ignoring *de minimis* activities) is one that is commercial, exemption will be denied. One can imagine that the "commercial hue" test adopted by the courts would have a place in this analysis as a method of determining whether the sole activity is a commercial one or not.

Of course, this approach would create a few problems with some existing organizations. If publishing religious texts in a manner similar to commercial publishers is not charitable, then one wonders why operating a hospital in a manner similar to for-profit hospitals justifies exemption. I certainly have no problem with the IRS taking the position that no commercial activity can support exemption standing alone[83] (e.g., apart from cases in which the commercial revenues are used to support some other charitable activities), but if that is going to be approach, it needs to be applied consistently.

[80] Tech. Adv. Mem. 200437040, 2004 PLR LEXIS 612, *25-*26 (June 7, 2004).

[81] *See*, Jodi Upton, *Saban's contract could bring congressional inquiry*, USA Today, *available at* http://www.usatoday.com/sports/college/football/sec/2007-01-03-saban-contract_x.htm

[82] Of course, if one believes that big-time college football and basketball programs are themselves charitable activities, then this example is really a Category 1 case, not a Category 5 case. An issue that arises with the analysis in the text is exactly how one distinguishes between a "commercial" activity and a "charitable" activity that produces revenue. For a discussion of this issue, see text at notes 91-92, *infra*.

[83] I have in the past suggested that tax exemption is appropriate only in cases of combined market failure and government failure; if a "charity" is engaged in an activity that is simply participating in a private market, there is no market failure and no need for exemption. *See generally*, JOHN D. COLOMBO AND MARK A. HALL, THE CHARITABLE TAX EXEMPTION (1995).

Catgories 2, 3, 4, and 5, on the other hand, all presuppose that the organization in question has *some* charitable activities apart from its commercial activity. Of these, only Category 5 activity should result in loss of tax exemption. These "empire building" cases present the greatest threat of managerial diversion and of nonprofits becoming for-profits in disguise. Accordingly, exemption should be at risk only in cases in which the commercial activity is not functionally related to the organization's exempt purpose *and* revenues from commercial activity are not used to substantially cross-subsidize charitable outputs. Put another way, the IRS needs to make clear that the key concept in the regulations on this issue – the "in furtherance of" concept – can mean *either* that the activity is functionally related to an exempt purpose (e.g., "substantially related" as defined in the UBIT) or else that the activity provides revenues to subsidize other charitable outputs (in effect, a retention for exemption purposes of the "destination of income" test). As noted below, this approach is completely consistent with taxing commercial revenues under the current or an expanded UBIT; the "in furtherance of" concept relates only to exempt status.

A second suggested reform, therefore, is for either Congress or the IRS to formally resurrect the 1964 version of the commensurate in scope doctrine; that is, either an amendment to Section 501 or new regulations or a new Revenue Ruling that makes clear that as long as revenues from commercial activities are being used to conduct a substantial charitable program, the activity will be considered "in furtherance of" an exempt purpose and the organization's tax exempt status is not at risk. One possible refinement to the commensurate in scope test would be to provide a safe-harbor provision for exactly how much subsidy a commercial business must provide to charitable activities to avoid exemption issues. I have previously suggested that one might use the short-term or mid-term Applicable Federal Rate as a safe-harbor rate of return for this purpose – for example, if the short-term AFR is 4%, then a charity would know that if a commercial activity provided at least a 4% return used to subsidize charitable activities, the commensurate-in-scope test would be met automatically, and no exemption issues would arise from operating this commercial activity.[84]

A third reform would be to jettison the relatedness test for the UBIT and impose tax on all commercial activities by charities, whether related or not.[85]

[84] Colombo, *Commensurate-in-Scope*, *supra* note 8, at 351.

[85] This proposal is not new. The idea of replacing the "substantially related" test with a "commerciality" test stretches back at least to the Pickle hearings by the Oversight Subcommittee of the House Ways and Means Committee in the late 1980's. Brody, *supra* note 62, at 32-34. *See also*, James Bennett and Gabriel Rudney, *A Commerciality Test to Resolve the Commercial Nonprofit Issue*, 36 TAX NOTES 1095 (1987). The proposed rationale for this reform at the time, however, was to prevent "unfair competition" by nonprofit charities, which to the small business

There are several reasons for this approach. First, the analysis in Part III.A. indicates that while commercial activity in categories 2, 3 and 4 should not affect exemption, such activities (particularly those in category 4) do present some significant risks to the corporate tax base, of managerial diversion, and of economic inefficiency and excessive self-subsidization. Taxing all commercial activities obviously would more completely protect the corporate tax base than the current system, since no commercial activity (even if it is "related") would escape taxation. Second, taxing all commercial activity would promote economic efficiency, because charities could not earn a premium rate of return on a particular activity simply by avoiding the income tax that would otherwise be due. Under this proposed system, a charity presumably would choose to invest in a direct commercial activity only if the after-tax rate of return it could earn would be greater than the market rate on a diversified portfolio of investment assets – that is, the charity would have to make a decision that it could earn a premium rate of return by efficient operation of the commercial enterprise, and not just by avoiding taxes.[86] It is likely, therefore, that if all commercial activity were taxed, charities would concentrate on commercial activities for which they enjoy some economies of scope with respect to either capital investments or employees or which had some other kind of synergy with their charitable programs, which in turn would also help curb empire-building tendencies and avoid managerial diversion issues.[87] Finally, this approach would actually simplify the law – we would no longer rely on tortured interpretations of the phrase "substantially related" to determine if a commercial activity is taxable or not; and if all such activities are taxable, the "container" used to conduct them would be irrelevant.

The fourth potential reform follows from the second and third. If commercial activity is essentially unlimited provided that it is used by the exempt organization as a source of funding for charitable outputs and if all commercial activity is

community, really meant "any competition." As noted in the text, several other policy concerns present better rationales for taking this step.

[86] See Hansmann, *supra* note 76, at 627. Taxing all commercial activity also should satisfy Susan Rose-Ackerman's concern that the current system distorts economic activity by encouraging nonprofits to invest more in related than unrelated activity. Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 Stan. L. Rev. 1017, 1038 (1982). Rose-Ackerman suggested getting rid of the UBIT because of this distortion, but subjecting all commercial activity to tax should also eliminate this problem.

[87] Making all commercial activities subject to taxation, rather than just "unrelated" activities, might also reduce the ability of charities to "game the system" by allocating costs from charitable and related businesses to "unrelated businesses," thereby reducing (often eliminating) any tax liability for unrelated activities. *See, e.g.*, Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 TENN. L. REV. 687, 733 (1999); Joseph J. Cordes & Burton A. Weisbrod, *Differential Taxation of Nonprofits and the Commercialization of Nonprofit Revenues*, *in* TO PROFIT OR NOT TO PROFIT, *supra* note 5, at 97-100; Robert J. Yetman, *Tax-Motivated Expense Allocations by Nonprofit Organizations*, 76 ACCT. REV. 297 (2001).

taxed, then there is no tax reason to distinguish between the activities of different pieces of a complex enterprise for tax exemption purposes. That is, whether a specific nonprofit within a related group of organizations meets the "primary purpose" test for exemption should be tested based upon the aggregate activities of a complex group, not on an entity-by-entity basis.[88] Either the group as a whole would have a "primary" charitable purpose (and operating commercial businesses to fund this primary purpose would be perfectly OK under my proposals) or it does not. Exemption should follow this group analysis, and not rest upon arbitrary distinctions regarding the kind of economic container in which specific activities are carried out. Note, however, that if the first and second reforms suggested above are adopted, then the IRS should give exempt status rather freely: any nonprofit organization that can make a credible claim to a bona-fide, substantial charitable purpose should be granted exemption, since all of the commercial activities of that organization would be subject to taxation in any event.[89]

Finally, the IRS desperately needs to better-define the role of the private benefit doctrine in policing exempt organizations, particularly in the realm of revenue-generating activities carried on in partnership with for-profit organizations or private investors. These transactions often are used to expand charitable outputs or as revenue-generators for exempt activities, and therefore should not automatically be subject to private benefit attack. I have recently suggested that private benefit should be used by the IRS to guard against transactions in which charities arguably "waste" charitable resources, primarily in transactions in which a charity "outsources" core services or enters into long-term contracts with for-profit entities than confer a competitive advantage on the for-profit.[90] Limiting private benefit in this manner would make clear that economic transactions with for-profit entities that enhance a charity's ability to serve its charitable class (a feature of many partnership transactions that the IRS has viewed dimly in the past) are not exemption problems.

The reforms suggested here, however, are dependent on a final issue: being able to distinguish revenue-producing charitable activities from commercial ones. If a nonprofit theater sells tickets to the public, is the ticket revenue from a

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[88] Once again, this proposal is not new and harkens back to the Pickle hearings of the late 1980's. The Treasury proposal at that time suggested aggregation for 80%-owned subsidiaries; see note 62, *supra*. I have suggested a far broader test of aggregation based upon the "supporting organization" tests in I.R.C. § 509(a)(3). Colombo, *Commercial Activity*, *supra* note 8, at 565.

[89] I do not mean to suggest here that for-profit entities in a complex structure would somehow be converted for tax purposes to nonprofit status. Rather, I mean only that any nonprofit organizations in a complex structure would be tested for its "primary purpose" based upon the activities of the group as a whole, and not on their individual activities.

[90] John D. Colombo, *In Search of Private Benefit*, 58 Fla. L. Rev. 1064, 1088-1090 (2006).

"commercial activity"? How about sales of drinks and food to theater patrons? For the answer, we should turn back to the main policy issues surrounding commercial activity, including protecting the corporate tax base, managerial diversion and economic efficiency. In particular, it seems that if these are the main problems with charities engaging in commercial activity, then an activity should not be labeled "commercial" unless it is competing with substantially similar for-profit goods or services. An activity that would not be conducted in the for-profit market is not a worry for the corporate tax base, because no tax would be collected on that activity in any event. Nor would such an activity seem to be a managerial diversion concern – in fact, it seems that nonprofits should be providing exactly those services not part of the for-profit market. Finally, if the for-profit market can't or won't produce a particular good or service, then by definition there is no more efficient way to produce it than through the government or the nonprofit sector, and if the government won't do it, that leaves only the nonprofit sector. Thus whether the theater's ticket sales are a "commercial activity" or not should depend on whether the theater is producing the same kinds of plays as for-profit theaters and hence is competing in the for-profit theater market. Food and drink sales, on the other hand, are easy to classify as "commercial" since all sorts of for-profit restaurants, vending machine companies and so forth are in that same business.[91] For cases in the middle, the "commercial hue" analysis developed by the courts and the IRS (but inappropriately applied to the decision to grant exemption)[92] might be a good starting point for analyzing whether a particular activity is, in fact, a "commercial" one.

IV. Summary

As a policy matter, how the law regulates commercial activity by charities goes to the very heart of what the charitable sector will look like in the future.

[91] Of course, as with all other legal tests, there will be inevitable disagreement at the edges. For example, are Division I college football and basketball "commercial" under this test? They certainly produce substantial revenues for their schools, but whether they compete with "substantially similar" for-profit goods and services (e.g., professional for-profit sports) is an open question. The Supreme Court, for example, has suggested in the antitrust context that NCAA football does not compete with professional football. *See* N.C.A.A. v. Board of Regents, 468 U.S. 85, 101-102 (1984). Tax law would not necessarily have to adopt precedents from antitrust law for this purpose. Particularly in light of the policy concerns of managerial diversion and economic efficiency, one could argue that the test for what is a commercial activity in the tax exemption world should be somewhat broader than what the courts may find to be competing products in the antitrust field. Viewing markets and competing goods narrowly in antitrust law generally has the effect of protecting competition, which is the purpose of antitrust law. Drawing similar narrow lines in exemption law does not similarly advance the policy concerns noted above with commercial activity by charities.

[92] See text at notes 41-43, *supra*.

Unfortunately, the current provisions of the I.R.C. regarding commercial activity by charities and the IRS's and courts' interpretations of those provisions have created needless confusion and uncertainty, particularly regarding the effects of commercial activity on exempt status. While I have suggested some possible reforms above, even if one disagrees with the suggestions, it is certainly time for Congress to undertake a comprehensive review of these rules and enact provisions that embody a clear rationale with clear lines demarking appropriate and inappropriate activities.

Chairman BOUSTANY. Mr. Tobin, you have 5 minutes.

STATEMENT OF DONALD TOBIN, ASSOCIATE DEAN FOR FACULTY AND THE FRANK E. AND VIRGINIA H. BAZLER DESIGNATED PROFESSOR IN BUSINESS LAW, THE OHIO STATE UNIVERSITY MORITZ COLLEGE OF LAW, COLUMBUS, OHIO

Mr. TOBIN. Thank you, Mr. Chairman.

Chairman Boustany, Ranking Member Lewis, and Members of the Committee, thank you for the invitation to testify today.

Charities are not just using affiliated entities in the for-profit context. They are also affiliating with other tax exempt organizations, mainly social welfare organizations and political organizations. I want to give you just a brief explanation of how these organizations interact.

Public charities are exempt from tax under 501(c)(3) and donations to the charity are deductible by the donor. Public charities are not allowed to intervene in a political campaign and can only engage in an insubstantial amount of lobbying. Social welfare organizations are organized under section 501(c)(4) and must be operated exclusively for the promotion of social welfare, according to the statute. Although the statute uses the term "exclusively," Treasury regulations allow social welfare organizations to intervene in political campaigns as long as the organizations' primary purpose is social welfare. Amounts spent by organizations on political campaign-related activities are not considered a social welfare function. The income of social welfare organizations is tax exempt but donations are not tax deductible.

Then we have political organizations, which are exempt under section 527 and are primarily involved in influencing elections. Contributions to 527 organizations are not deductible and political organizations are required to disclose contributions and expenditures.

Public charities are allowed to create affiliates in order to engage in these different types of activities and the Form 990, Schedule R is important in helping the IRS and others understand the various activities that tax-exempt organizations are engaged in and their various associations. It also helps ensure that the important policy goals of each section is honored.

First, we have the subsidy that is received by public charities because the donors get to deduct their donations and we want to make sure that isn't transferred improperly to a (c)(4) or a 527 political organization.

Second, there needs to be a continued outlet for constitutionally protected speech, and the affiliated entity helps ensure that continued outlet exists. The congressional goal of having disclosure of amounts spent on political activity shouldn't be obfuscated.

Now when operated correctly, affiliated entities support these policy goals. Affiliations between public charities and social welfare organizations help cordon off the subsidy to public charities while allowing organizations to lobby and engage in other activities with non-subsidized dollars.

So first we want to look at the restrictions that are on public charities because they are very important. The restriction on lobbying and political campaigning by 501(c)(3) public charities is essential for maintaining the special role that charities play in our National life. Providing public charities with a subsidy to lobby and intervene in political campaigns would put that special status at risk.

The restrictions on lobbying and political intervention for public charities ensure that tax deductible donations are not used to promote political campaigns. It requires organizations that wish to engage in lobbying or political activity to be on the same footing as other citizens. Absent a ban on such activities, public charities could easily be used as a tax-subsidized vehicle for political campaigns.

Now these affiliated entities can be formed in very different ways. You can have a public charity with a social welfare organization, which in turn has a political organization. You can have a social welfare organization with an affiliated public charity and an affiliated political organization. And you can have loosely affiliated entities who aren't actually organizationally connected but have an affiliation. The key is that the public charity is not allowed to subsidize the activities of the other organizations. We have had problems in this area in how we deal with them.

The first is that this area is incredibly complicated. The rules on affiliated entities are very complex. The second is we have had very aggressive assignment of tasks between affiliated entities that may be inconsistent with our policy goals. Third, the IRS has limited resources to enforce, and when it does, it is often accused of enforcing on political grounds. Finally, the results of investigations by the IRS are not made public so it is hard to know what standards are being applied.

I have some suggestions for the future. We could examine the possibility of creating a public complaint and resolution process. We could consider allowing the results of audits of exempt organizations to be made public. We could streamline the rules regarding associated entities to reduce some of these regulatory burdens. And we could create disclosure provisions that are consistent, or near so, among tax exempt organizations.

I very much appreciate your invitation for me to be here today, and I am happy to answer any questions you might have.

[The prepared statement of Mr. Tobin follows:]

STATEMENT OF PROFESSOR DONALD B. TOBIN
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BEFORE

THE COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT

ON

INCREASED COMPLEXITY OF PUBLIC CHARITIES

Chairman Boustany, Ranking Member Lewis, and members of the Committee:

Thank you for the invitation to testify today on the increased complexity of public charities organized under §501(c)(3) as it relates to affiliated tax-exempt organizations such as §501(c)(4) social welfare organizations and §527 political organizations. Public charities are no longer just the local soup kitchen, nursery school, or local college. Public charities have expanded their activities both in the United States and abroad. They have sought more sophisticated ways to participate in the public sphere and looked at creative ways to both increase their impact and their revenues. To accomplish these tasks, public charities have turned to increasingly complex organizational structures including for-profit subsidiaries, joint ventures with for-profit entities, and affiliated organizations.

The complex organizational structure has not been limited to affiliations with for-profit entities. Public charities are also increasingly using complex arrangements with other tax-exempt organizations to increase the charity's involvement in certain political activities, including lobbying and campaign advocacy. In addition, other tax-exempt organizations involved in lobbying or campaign advocacy are using complex arrangements so that they can maximize the benefits of tax deductible contributions while still engaging in lobbying or election advocacy. Specifically, a public charity may set up a §501(c)(4) social welfare organization to engage in unrestricted lobbying, and the social welfare organization may set up a segregated fund under §527, which governs political organizations, to engage in electioneering activities. The affiliated or controlled entities will not result in the loss of public charity status as long as the public charity does not subsidize, either monetarily or through other types of support, the social welfare organization or its affiliated political organization (or segregated account). Ensuring that a public charity does not subsidize other tax-organizations requires a complicated organizational structure and tremendous effort.

These arrangements not only increase complexity for the entities involved, but they also increase complexity in the tax code, as further regulations and provisions are necessary to ensure that tax subsidies available to public charities are not used to subsidize lobbying and political campaign activity. Today I am going to discuss the current restrictions public charities face with regard to lobbying and intervention in political campaigns, how organizations set up affiliated organizations to engage in the prohibited activities, and some of the problems that have currently arisen with the current statutory scheme and the interaction between public charities, social welfare organizations, and political organizations.

A. Activities of Public Charities (§ 501(c)(3) organizations)

Public charities are organized under §501(c)(3) of the Code. Public charities, including religious organizations, are treated more favorably than other tax-exempt organizations. Public charities are the organizations that most people identify as tax-exempt organizations. They educate our children, promote important public causes, and help the needy. Because these organizations have a charitable purpose, Congress has provided that they are exempt from taxation. More importantly, however, unlike other tax-exempt organizations, Congress has specifically provided that donations to public charities are deductible by the donor. From a tax perspective, we think of public charities as receiving a double benefit. Their income is not taxed, and donations to the organizations are deductible.

Since other tax-exempt organizations do not receive a subsidy in the form of tax deductible contributions, Congress both restricted the activities a public charity can engage in and put in place anti-abuse provisions to ensure that the benefits of being a public charity were not shifted to other exempt organizations. As a condition of receiving this favorable tax status, Congress has limited the activities of public charities to ones it deems charitable. For example, §501(c)(3) prohibits public charities from intervening in a campaign for or against a candidate for public office, and from engaging in more than an insubstantial amount of lobbying.

Congress has long sought to limit the tax subsidy available to organizations engaged in lobbying and campaign activities. While other tax-exempt organizations may engage in lobbying without limit and substantial political activity, contributions to those organizations are not deductible by the donor. Similarly, in most cases, Congress has prohibited business entities from deducting lobbying expenses or political campaign contributions as ordinary and necessary business expenses. The hope is that all entities will be on a level playing field. Organizations can engage in lobbying and political campaign activities, but they cannot receive a tax subsidy in the form of either a tax deduction or the receipt of tax deductible contributions.

1. Intervention in Political Campaigns

Although a public charity may not intervene in political campaigns, they may engage in voter-education drives, discuss issues, educate citizens, lobby to a small degree, and invite candidates to speak as long as the invitations are issued on a non-partisan basis. When organizations engage in such activities, they need to be sure that the activities do not rise to the level of intervention in a political campaign. The IRS has developed a facts and circumstances test to determine whether an organization's activity is intervention in a political campaign. In Revenue Rule 2007-41, the Service provides an explanation of the facts and circumstances test, and provides examples of the application of the test.

With regard to determining whether communication is issue related or is prohibited intervention in a political campaign, the IRS warns:

> Section 501(c)(3) organizations must avoid any issue advocacy that functions as political campaign intervention. Even if a statement does not expressly tell an audience to vote for or against a specific candidate, an organization delivering the statement is at risk of violating the political campaign intervention prohibition if there is any message favoring or opposing a candidate. . . . All the facts and circumstances need to be considered to determine if the advocacy is political campaign intervention. (See IRS FS-2006-17).

The IRS has explained that in applying the facts and circumstances test, the key factors the IRS examines are whether the statement: 1) identifies candidates; 2) expresses approval or disapproval for a candidate's positions and/or actions; 3) is delivered close in time to the election; 4) makes reference to voting or an election; 5) distinguishes candidates on particular issues; 6) is part of an ongoing series of communications by the organization independent of an election; 7) is timed to coincide with a non-electoral event such as a scheduled vote on legislation by a legislator who is also a candidate. In applying these factors, the IRS seems particularly concerned about communication that is biased, partisan, or clearly designed to influence votes in an election, and about communication that is close in time to an election.

The distinction between issue advocacy and political campaign intervention is particularly important in the context of affiliated entities because the definition of political intervention under §501(c)(3) also guides the determination whether something is political intervention under both §501(c)(4) social welfare organizations and §527 political organizations. The common definition is important because it is the Service's regulations and interpretations about political intervention under §§ 501(c)(3), 501(c)(4) and 527 that control here, not the Federal Election Commission's.

Since the ban on intervening in an election is absolute, public charities interested in intervening in elections associate with other tax-exempt organizations that are allowed to do so. This association allows the public charity to maintain its tax-exempt status and have an outlet to engage in election advocacy.

2. Lobbying

Public charities are also allowed to engage in only an insubstantial amount of lobbying. The Code provides that no substantial part of a public charity's activities may be "carrying on propaganda, or otherwise attempting, to influence legislation." Once again, the idea is to put the lobbying activities of all organizations on equal footing and to ensure that the subsidy provided to public charities is not used to subsidize lobbying activities.

Public charities were concerned that the "no substantial part" test was vague and left them wondering how much lobbying was allowed. Congress responded to this criticism by passing §501(h), which, by reference to §4911 sets specific dollar amounts for lobbying, calculated on a sliding scale based on an organization's exempt purpose expenditures – referred to as the expenditure test. The maximum dollar amount is set at one million. The public charity must make a §501(h) election for it to apply, but once a public charity makes the election, it has more certainty regarding whether its lobbying expenditures are permissible. If the organization exceeds the amounts set out in §4911, it will be subject to a tax on the excess expenditures. The §501(h) election is not available to churches. Treasury Regulations provide further guidance, including examples, of both direct and grass roots lobbying.

If an organization wishes to engage in more than an insubstantial amount of lobbying or more lobbying than is allowed under the expenditure test, the public charity may create an associated social welfare organization under §501(c)(4) that may engage in lobbying as its primary purpose. Contributions to the social welfare organization will not be deductible by the payor and the public charity must be careful to ensure that it does not improperly subsidize the social welfare organization.

B. Social Welfare Organizations (§501(c)(4) Organizations)

Section 501(c)(4) organizations are social welfare organizations or civic leagues. Section 501(c)(4) defines social welfare organizations as "[c]ivic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare." Although §501(c)(4) provides that an organization must be organized "exclusively for promotion of social welfare," the Treasury regulations provide for more flexibility than those relevant to public charities. Specifically, Treasury regulations allow social welfare organizations to intervene in political campaigns as long as the organization's primary activity is social welfare. Although the regulations do not define "primary," it is certainly less than the statutory term "exclusively." The regulations do, however, indicate that in order to qualify as a social welfare organization, the organization must be primarily engaged in promoting the "common good and general welfare" of the community.

In determining whether an organization is primarily engaged in social welfare, amounts spent by the organization on political campaign related activities are not considered a social welfare function. (See Treas. Reg. 1.501(c)(4)-1). (For purposes of brevity, I have not discussed §501(c)(5) labor unions, and §501(c)(6) business leagues. Similar rules apply to those organizations, and while they can engage in political activity, it cannot be their primary purpose). Lobbying, however, is considered a social welfare activity, and a social welfare organization may engage in an unlimited amount of lobbying so long as the lobbying is related to its exempt purpose. Tax exempt organizations that wish to discuss issues, educate the public, lobby, or engage in other social welfare functions may organize as social welfare organizations and may then intervene in an election for or against a candidate as long as social welfare continues to be the organizations' primary function.

Although the income of a social welfare organization is tax-exempt, donations to a social welfare organization are not deductible by the donor. In addition, if a social welfare organization has investment income, that investment income is taxable dollar for dollar to the extent the organization has spent funds to intervene in a political campaign. (See §527(f)). For example, a social welfare organization with $3,000 in investment income and $2,000 in political expenditures will find $2,000 of its investment income subject to taxation.

A social welfare organization may create a separate segregated fund under §527 to engage in political campaign activities. If the social welfare organization creates a segregated fund, the segregated fund is treated as a §527 political organization, and amounts in the segregated fund are not subject to §527(f).

Finally, there is an outstanding issue whether contributions to social welfare organizations are subject to gift tax. The Code clearly does not exempt such organizations from gift tax, and IRS guidance clearly indicates that contributions to social welfare organizations are subject to gift tax. The IRS recently indicated, however, that it is reviewing the need for additional guidance in this area, and that it will not "use resources to pursue examinations on this issue" while it is reviewing its guidance.

Thus, a public charity that wishes to engage in substantial lobbying activities can create an affiliated social welfare organization to engage in lobbying and even a limited amount of political campaign advocacy. The lobbying and campaign activity of the social welfare organization will not impact the validity of the public charity as long as the public charity does not subsidize the political activities of the social welfare organization. If the public charity subsidizes the lobbying activity of the social welfare organization, the amount of the subsidy will be counted as lobbying by the public charity.

C. Political Organizations (§527 Organizations)

Section 527 provides tax-exempt status for political organizations that have as their primary purpose influencing elections. Political organizations are exempt from tax on their "exempt function income," which is defined as contributions, membership dues, and proceeds from political fundraisers. They are, however, subject to tax on investment income or on other income that is not exempt function income. Contributions to political organizations are also statutorily exempt from the gift tax.

In 2000, as part of Public Law 106-230, Congress amended §527 and added disclosure requirements to §527. Under the disclosure provisions in §527, most political organizations are now required to disclose the sources of contributions in excess of $200 and the organization's expenditures in excess of $500. If a political organization fails to disclose its contributions or expenditures, the nondisclosed amount is subject to tax at the highest marginal rate. The disclosure provisions were only added to §527, and other exempt organizations, including social welfare organizations, are not currently subject to disclosure through the tax code. (They may be subject to disclosure under election law).

Prior to the amendments to §527, the major tax regulatory difference between the various tax-exempt organizations (other than §501(c)(3) organizations) was the purpose of the organization. There was very little advantage to using one entity over another as a vehicle for political activity so entity planning or entity manipulation based on tax considerations was almost non-existent. In fact, prior to 2001, organizations often preferred to be political organizations rather than social welfare ones because no disclosure was required and the gift tax exemption was explicit. The IRS's taxpayer-friendly rulings broadly defined exempt function income, thus allowing organizations to organize as political organizations.

Under existing law, however, organizations that do not want to disclose contributions and expenditures have an incentive to try to qualify as another type of tax-exempt organization. This increases complexity in two ways. First, it encourages legitimate organizations to bifurcate their activities and create separate social welfare and political organizations (or create a §501(c)(4) with a segregated account) and assign as much of the activity as possible to the social welfare organization. In many cases, absent the disclosure provisions in §527, the organizations would have just organized as political organizations since most of their activities would qualify as exempt function income under §527.

More problematic is the fact that by having disclosure provisions only in §527, aggressive organizations have been seeking to avoid §527 status, and thus avoid disclosure, by claiming status as a social welfare organization. It appears that some entities are arguing that their communication is not intervention in a political campaign but instead issue advocacy, which they claim is a social welfare function. The problem is that in making this assertion, the organizations appear to be using the election law definition for express advocacy, which is relatively strict and has been interpreted by many courts to require some type of words of action, like "vote for" or "vote against." Intervention in a political campaign for purposes of tax-exempt status is based on a facts and circumstances test and does not require magic words. The facts and circumstances test is clearly broader than the election law definition and encompasses communication that is not express advocacy but is designed to influence an election of a candidate for public office.

In many cases, the organizations claiming to be social welfare organizations are better suited as political organizations, and would have likely organized as political organizations absent the disclosure provisions. Since the public does not have access to the financial records of these organizations, it is impossible to tell if they really meet the definition of a social welfare organization. (If the primary purpose of the organization is social welfare as opposed to campaign intervention). The lack of information creates significant enforcement burdens for the IRS, and increases the likelihood that congressional intent with regard to the disclosure of amounts spent to intervene in political campaigns is not being respected.

However, §527 appears to have been written in a way that makes inclusion into its regulatory regime mandatory. If §527 status were not mandatory, organizations could avoid the disclosure provisions either by not filing as a §527 organization or by choosing a different tax-exempt form even though the organizations were the type of organization covered by the statute. As a result, even if an organization claims it is a social welfare organization, if its primary purpose is intervention in a political campaign it is subject to the disclosure provisions in §527.

D. The Political Intervention Ban and Lobbying Restriction are Constitutional

The Supreme Court upheld the constitutionality of the lobbying restriction contained in §501(c)(3) in *Regan v. Taxation with Representation of Washington* (*TWR*), 461 U.S. 540 (1983). Specifically, the Court recognized that Congress could constitutionally condition the granting of §501(c)(3) status on an organization's willingness to accept limitations on certain activities protected under the First Amendment. *TWR* involved an organization that sought §501(c)(3) status even though the organization acknowledged that a major component of its activities would consist of attempting to influence legislation, but argued the lobbying restriction violated its First Amendment rights. The Court rejected TWR's claim and held that TWR was seeking not just the right to lobby, but was also seeking a subsidy in the form of tax benefits for its lobbying activities. The Court stressed that "[b]oth tax exemptions and tax-deductibility are a form of subsidy that is administered through the tax system." The Court recognized that Congress had the right to refuse to "pay for lobbying out of public monies."

In reaching its decision, the Court appeared to find it very important that TWR had an alternative outlet to exercise is First Amendment rights. In fact, Justice Blackmun in his concurring opinion found an alternative outlet for the organization to engage in lobbying to be essential. (See *TWR*, 461 U.S. at 552-554). Specifically, the Court noted that TWR's original structure consisting of two separate organizations--a public charity that was mainly involved in educational activities and a social welfare organization that was involved in influencing elections--allowed TWR to lobby. Under this structure, the public charity would receive tax-deductible donations while the social welfare organization would not.

The constitutional analysis in *TWR* similarly applies to the political campaign ban provision in §501(c)(3). As the Court recognized in *TWR*, an organization is not entitled to preferential tax treatment, and Congress can condition tax-exempt status under §501(c)(3) on an organizations willingness to meet the regulatory requirements of the statute. Section 501(c)(3) status is not a right. The political campaign ban is constitutional because just as in *TWR*, a public charity can create a social welfare affiliate that can engage in lobbying and the social welfare organization can create a segregated account under §527 to engage in political activity. Thus the allowance of affiliated organizations in the tax-exempt context may be necessary to maintain the constitutionality of the current statutory bans on lobbying and political intervention.

In addition, it is important to recognize that in the tax-exempt context the restrictions I have discussed -- lobbying, political campaign ban, and disclosure -- are not complete prohibitions on the activity in question. They are restrictions within the regulatory regime, and act more as basketing provisions for different activities. Thus, charitable activities are placed in the §501(c)(3) basket, social welfare and lobbying in the §501(c)(4) basket, and political in the §527 basket. The restrictions thus operate to protect the fisc and sort activities to their relevant home. The provisions do not operate as an absolute bar to the activity.

E. Importance of Lobbying and Political Campaign Intervention Ban

The restrictions in §501(c)(3) on lobbying and political campaign activities are essential for maintaining the special role public charities play in our national life. Public charities are seen as filling a special need in our society; helping feed the hungry, educating our children, expanding our cultural knowledge, and generally promoting societal well-being. Tax policies that favor these organizations and further empower them are generally seen as positive and do not appear harmful to our democratic system of governance. But providing public charities with a subsidy to lobby and intervene in political campaigns harms both public charities in general and our democratic process.

First, allowing public charities to intervene in political campaigns and to engage in a substantial amount of lobbying will change the character of these organizations. They will no longer be altruistic, charitable, and educational type organizations. Instead, they will be seen as similar to other political organizations and any justification for favored tax status will disappear.

Second, the fact that these organizations are respected and are often engaged in activities designed to promote societal well-being makes them particularly effective in manipulating those who depend upon them. This influence and dependence by others makes political intervention and significant lobbying by public charities particularly inappropriate.

The restrictions on lobbying and political intervention ensure that tax-deductible donations, which as the Supreme Court recognized are subsidies from the public fisc, are not used to promote political beliefs. It requires organizations that wish to engage in lobbying or political activities to be on the same footing as other citizens.

In addition, we have seen a tremendous amount of entity manipulation with regard to tax-exempt organizations' involvement in political campaign activities. There is already significant risk that tax deductible donations are being used as a means of supporting political campaign activity. Absent a ban on such activities, public charities could easily be used as a tax subsidized vehicle for political campaigns, and public charities could replace social welfare organizations as the campaign vehicle of choice for independent groups.

F. Affiliated and Related Organizations in the Tax-Exempt Context

As previously discussed, public charities are allowed to affiliate with other tax-exempt entities. In some cases, the public charity is the "lead" organization and in others the public charity is a subsidiary or a controlled corporation of another entity. As the Court recognized in *TWR*, a public charity may have a connected social welfare organization, and the social welfare organization may engage in lobbying and other activities. In addition, the public charity may make grants to the social welfare organization. These funds, however, must be used to further the exempt purpose of the public charity, and if they are used for lobbying, the amount will count as lobbying by the public charity.

Public charities are not allowed to form a connected political organization. (See S. Rep. No. 93-1374 and Reg. 1.527-6(g)). They can, however, form a social welfare organization, which can in turn, create a segregated fund under §527. The idea is that the social welfare organization is a separate entity and thus has the same rights as other social welfare organizations, including the right to create a separate segregated fund. In this situation, the parent public charity needs to be careful that it in no way subsidizes the social welfare organization's political activities. The IRS recommends that the public charity exercise sufficient control over any funds to ensure that the funds are not used for political purposes.

The IRS has provided guidance when a public charity has too much control over a political organization. It notes that the public charity cannot have the right to appoint the board of the political organization, cannot subsidize the political organization by providing any assets or funds for its creation or operation. Assets include money, facilities, personnel, and property, including mailing lists. If the organizations share personnel, space, or equipment, there must be a reasonable allocation of the expenses among the various entities.

Another possibility for organizations wishing to have a public charity, social welfare organization, and affiliated political organization is to organize with a parent social welfare organization. The parent organization can then create two separate subsidiaries, one a public charity and the other a political organization. Once again, the organization must ensure that the public charity does not subsidize the political organization.

There are also possibilities for more informal associations between tax-exempt organizations. In some situations, there may be a loose affiliation among organizations where the organizations share common directors and a common goal. The IRS will generally respect such an arrangement as long as the public charity is not improperly subsidizing one of the informal associated entities.

Finally, individuals who are directors of a public charity may in their individual capacities form a political organization. In this situation, the facts and circumstances determine whether the public charity is controlling the political organization or whether the board members are doing so in their personal capacity.

G. Problems with Affiliated Entities and Thoughts for the Future

There are three main underlying policies that need to be protected when exempt organizations are allowed to create affiliated entities. They are ensuring that: 1) the subsidy received by public charities is not improperly transferred to other exempt entities, 2) there is a continued outlet for constitutionally protected speech, and 3) the congressional goal of having disclosure of amounts spent on political intervention is not obfuscated.

When operated correctly, affiliated entities support these policy goals. Affiliations between public charities and social welfare organizations help cordon off the subsidy to public charities while allowing organizations to lobby and engage in other activities with non-subsidized dollars. Moreover, the ability to create affiliated §527 political organizations allow organizations to separate out funds spent on political advocacy and ensure contributions and expenditures of political intervention are disclosed.

In order to provide clarity regarding the interaction of affiliated entities, the IRS modified Form 990, to require tax-exempt organizations to disclose their affiliations with other organizations, both exempt and non-exempt. (See Schedule R to Form 990). The disclosures on Form 990 help ensure that affiliations between various tax-exempt organizations are known and understood. This type of disclosure is a step in the right direction for ensuring that affiliated entities are being used to support the policy goals surrounding tax-exempt organizations.

One of the main problems in this area is the required time, energy and expertise to create and police the activities of affiliated organizations. As should be clear form this testimony, the law surrounding affiliated entities, and the regulations necessary to ensure the different entities are operated properly, is very complicated, and these types of arrangements can generally only be achieved by sophisticated parties.

The second main problem in this area is that parties have been very aggressive in what activities they assign to different affiliated organizations. Although parts of these organizations'

Form 990s are made available to the public, the Form 990s provide little insight into the assertions by the tax-exempt organization regarding the character of their activities. If the tax-exempt organization asserts that its activities are social welfare, the Form 990 does not provide sufficient information to help determine whether the tax-exempt organization assertion is correct. In addition, while the Form 990 requires organizations to disclose donors over $5,000, this part of the Form 990 is not disclosed to the public. The best check on whether organizations are acting consistent with their exempt purpose is an audit by the IRS. But audits are rare and unpopular, and the IRS does not appear to have the staffing to conduct major audits in this area.

Organizations therefore have an incentive to organize affiliated entities in a way to maximize the subsidy they receive by claiming the activities they engage in are charitable, and by transferring as much of their activity as possible to the public charity. Organizations also have an incentive to avoid the disclosure provisions under §527 by claiming their activities are social welfare or education instead of intervention in a political campaign. It appears that some entities are arguing that their communication is not intervention in a political campaign but instead issue advocacy, which they claim is a social welfare function. The problem is that in making this assertion, the organizations appear to be using the election law definition for express advocacy and not the definition in the tax code defining intervention in a political campaign.

There are also serious enforcement problems in the tax-exempt area with regard to affiliated entities, lobbying and intervention in political campaigns. The IRS does not have the resources to engage in large scale audits in the exempt organization area. When the IRS attempts enforcement in this area, it is often accused of being politically motivated in its audit decision. In addition, although third parties can make complaints to the IRS regarding excessive lobbying or campaign intervention, the IRS's decision whether to audit an organization and the results of that audit are protected taxpayer information and are not made public unless the organization chooses to do so. We are thus left with no clear knowledge of what organizations are audited and the results from such audits. In addition, there is no mechanism to trace third-party complaints or to see whether a third-party complaint has been acted upon.

Congress should examine the possibility of creating a public complaint and resolution process when exempt-organizations are accused of violating their exempt status, and should create a non-partisan process within the IRS for these complaints to be resolved. Congress might also consider allowing the results of audits of exempt organizations to be made public. Once there is more confidence that exempt organizations and their affiliates are engaging in activities consistent with their exempt purpose, Congress could examine ways to streamline the rules regarding associated entities to reduce the burden on tax-exempt organizations seeking to create affiliated entities. Congress could also seek to create disclosure provisions that are consistent, or near so, among tax-exempt organizations thereby disincentivizing organizations from using social welfare organizations as a means of avoiding the disclosure provisions contained in §527.

Public charities and their affiliated entities play a very important role in our national life. We are at a crossroads, however, where aggressive use of associate entities may be weakening support for public charities. In light of the history of good work of public charities, this would be an unfortunate result.

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Chairman BOUSTANY. I want to thank all of you for really excellent testimony, both written and oral. We really appreciate what you have brought to the committee.

Right now I want to start by looking at these complex interactions between UBIT rules, complex organizational structures, and reporting requirements. It is my understanding that passive income, such as royalties and interest, is exempted from UBIT.

So I would like to ask Ms. Borenstein, Mr. Hyatt, Professor Colombo several questions about what appears to be a relatively simple issue, but clearly is not.

First, Mr. Hyatt, this Committee has been told that often such income is generated in subsidiary organizations instead of the parent organization to protect the exempt status of the parent. Oftentimes, joint ventures are formed. So explain how this type of income can arise for a public charity.

Mr. HYATT. Certainly, Mr. Chairman. Obviously, the fundamental purpose of a charitable organization is tax exempt. That doesn't mean that it can't entertain or carry on some level of commercial activity. When it does so, the unrelated business income rules apply. And back in the fifties when Congress first looked at this the idea was to have a level playing field. So if you have some level of unrelated activity, perhaps you run a hotel to help families that are visiting your hospital or your campus, for example, there may be a legitimate reason to run that business enterprise as a part of your charity. But if you are starting to operate it in a commercial fashion and one that looks to the layman like something a for-profit concern would operate, you can do that as long as you pay taxes on that income.

At some point, however, there is a line that you cross. It is, as has been discussed by the panel, a facts and circumstances line. It is not a bright line test. But at some point that line is crossed where it becomes too commercial in nature. And if you were to continue it and if it represents what the law calls a substantial non-exempt purpose, you could lose your tax exempt status. That would then cause the organization to say the best way to protect our exemption and continue to carry on this activity is to spin it off into a separate corporation, a taxable subsidiary, for example, that we would control, and that taxable subsidiary might generate interest, royalties, annuities, et cetera, up to the parent as passive income.

Chairman BOUSTANY. Thank you.

Mr. Colombo, you went at great length in your written testimony, which I read, about these regulations and some of the conflicts, the definitional issues that have come up. Clearly, I think we are going to have to work to provide more clarity there. I know passive income is generally exempt from taxation under UBIT rules. Just briefly, why does this exception for passive income exist?

Mr. COLOMBO. Well, I think that the answer to that has always been that passive income was consistent with the notion of charitable expenditures and funding charities. You would get money in, if you needed it you would spend it. If you didn't need it, you would invest it in a diversified portfolio and put it in the bank and then you would use your earnings off of that. Endowments have always been a feature of the charitable sector. And I think we have always viewed the notion of passive investing as being particularly consistent with charitable expenditures and charitable operations in a way that we have not viewed the direct operation of a commercial enterprise as being necessarily consistent.

Chairman BOUSTANY. Thank you.

Ms. Borenstein, if a public charity does have passive income and it is generated through a subsidiary or involves a related party transaction, how is that income reported on the new Form 990?

Ms. BORENSTEIN. Well, one of the points to make is that excess capacity is what generates passive income. We have excess cash or extra office space, our budget is under stress a little bit and now we want to rent out some offices at the end of the hallway to other entities. If we turn our building for liability purposes over to a for-profit corporation or another nonprofit corporation, that we have control over it, we are going to report that other entity as a related organization. And because of the 512(b)(13) rules—which I am sure everyone loves the complexity of that number even having to be cited—it is a loophole closer in the Code that requires payments of these types of passive, otherwise not subject to UBIT streams to be reached by UBIT, and thus so rents from real property paid by a controlled organization have to be reported on the 990. This was an addition from the Pension Protection Act of 2006 requiring such receipts to be reported on the 990. And so now the Schedule R not only gives detail of who are my related organizations but requires me to denote dollar amounts of all transactions that have passive streams from my related organizations that I control, as well as denote any other transactions, once they are large enough, by type and potentially amount.

Chairman BOUSTANY. Thank you. Professor Colombo, in your written testimony as well as oral testimony you discuss commerciality, the commerciality doctrine. Commercial activities of public charities and tax exempt organizations in general have been an issue raised by Members of this Committee several times over the past year-and-a-half. And as you note, the policy question is how much if any commercial activity may a charity undertake without impairing its exempt status.

Could you elaborate? The regulation seems very, very confusing. We need more guidance on this.

Mr. COLOMBO. Well, it is very confusing and I think that is why we need to have a policy discussion about where we want charities to go with respect to commercial activities. I am actually not opposed to charities being involved in commercial activities. I would probably do so in a manner that, first of all, I would tax all commercial activities. I would probably get rid of the related versus unrelated distinction.

And second, I think maybe the more important piece would be that I would make sure that charities have to demonstrate to us that the commercial activity is enhancing their charitable outputs; that that is better for them in some way than simply investing in a diversified portfolio. If it is not, if they can't show that, then my response to them would be: Well, then why are you doing this? Go invest your money in a diversified portfolio and use the earnings to do your charitable activities.

So I do believe the law is very, very difficult in this particular area and that I think there is an underlying policy question that I think Congress should engage.

Chairman BOUSTANY. Well, I think Ms. Borenstein raised this issue of excess capacity and more efficient use of resources. I think in your testimony you talked about empire building, on the opposite side of the scale. If all commercial activity were taxed and we got rid of this distinction, would that ease the compliance burden for the IRS?

Mr. COLOMBO. Well, I think it would ease the burden in the sense that they would not be required to deal with this very difficult, as Mr. Miller pointed out, very difficult test of related versus unrelated. Now pieces of the compliance, however, are not going to go away. The issue of how you allocate expenditures, particularly how you allocate overhead and that kind of thing, are always going to be with us, no matter what, when you have a differentiation between charitable activities on one side and taxable activities on the other. But it certainly would get us out of the business of scratching our heads and figuring out whether selling rock CDs is related or unrelated.

Chairman BOUSTANY. I see. Of course, you went at great length in analyzing commercial activities by charities and showing it is not a really easy task. And to make sense out of the area, in your written testimony you talked about five categories. And the first categories were commercial activity by a charity is also a primary exempt activity. A prime example of this type of charity is a nonprofit hospital, for instance.

Explain in more detail this particular category of commercial activity and how it applies to nonprofit hospitals.

Mr. COLOMBO. Well, the question in my category 1, there are certain charities which I would say do nothing except conduct a commercial activity. I think the publishing cases are another example, where you have a religious publisher for example. The question right now is: Does that commercial activity further a charitable purpose? Well, in some cases, we have said so, right? So in the case of nonprofit hospitals, they sell services for a fee. There is not any question that that is what they do. But we have said that under certain ancillary rules and circumstances that that in effect will be a charitable activity.

We have had a lot of litigation over religious publishers. And so my sense of that one is we need to figure out what that policy rule is and apply it consistently across all sectors of our charitable operation. I am not sure why you wouldn't say publishing religious text is as much furthering a religious purpose as selling hospital services is furthering a health care purpose.

Chairman BOUSTANY. Thank you.

Finally, Mr. Hyatt, the last thing I would like you to do for us is if you would be so kind as to come up and use this white board we have set up to draw what I will call a simple complex structure for public charity and briefly explain the different elements.

Mr. HYATT. I would be happy to, Mr. Chairman, if the committee will indulge me in any lack of artistic ability I might have in doing so.

Chairman BOUSTANY. We won't criticize your artistic ability.

Mr. HYATT. Simple. A hospital, a college or university. Not unusual still today to find a single hospital operating corporation running the full enterprises of a hospital or university. However, I expect if you were to look at the internal organizational chart of that organization, you would see the Rube Goldberg scheme. There are a lot of far-flung enterprises, services being provided, primarily charitable, some taxable, that they pay unrelated business income tax on, but it is certainly possible to run it through a single operating corporation.

If you wanted to have a multi-corporate system for some of the reasons I mentioned in my statement to deal with competing reimbursement and regulatory schemes, to improve the governance by division of labor, by helping others get into the mix, to really focus on the knitting of particular activities, or perhaps to put out, as I mentioned a moment ago, a commercial activity that might threaten your exemption if it really took off, you might very well look at this type of corporation structure.

Externally, this is a pretty common structure for large institutional public charities today. So what would this box become then in that complex structure? This would now be what is commonly called a parent holding corporation or a parent entity. You would see this primarily in health care systems, less so in private universities. You would see it in public universities, where there is a flagship overseer and then the individual colleges and campuses. But commonly a parent corporation has its own board of trustees, it is a 501(c)(3) public charity as well, and its job is to do the strategic thinking here. If each of these boards focuses on their own activities, someone has got to see what do we do in concert. Are we all pulling in one direction. That is what this board would commonly do.

So, again, this is a public charity, the parent corporation. This public charity here might be the primary organization in the system. It is a hospital, it is a college campus, it is school of medicine or a school of law. It is a separately contained organization that carries on that primary activity. You might have a separate or distinct activity here that is also a public charity focusing on a distinct activity. If you are a hospital system, this might be a home health agency or a cancer treatment center or laboratory. If you are a college or university, this might be an alumni association. It might be an investment management company to manage your endowment to grow revenues and funds for decreasing the cost of tuition and improving faculty, et cetera.

This might be yet another public charity or it might be a taxable corporation. It might be a credit union for your employees, for example. Or, it may be some new technology that you are developing that you want to be able to license and use the revenues to support your mission. It may or may not be a public charity or a taxable enterprise.

If you are a hospital system over here, this, again, would typically still be a public charity. It could be a physician group that you now employ. It has now become quite common. The pendulum has come all the way back for hospital systems to employ doctors directly to provide services. So now increasingly the IRS is seeing, again, applications for tax exempt status by physician groups, whereas they used to be solo practitioners and private practitioners in that area.

Then you might also see joint ventures between for-profit entities, public charities through a joint venture entity. The limited liability corporation, or LLC, is probably the most common vehicle for joint ventures today. It could still be a taxable corporation. It could even be another tax exempt organization. But commonly you are doing that for one of three reasons. You are trying to get access to capital that you wouldn't otherwise be able to obtain. You are trying to get access to expertise. That for-profit enterprise knows a lot about this business. You need to get them to help you manage that so you can do it more effectively. Or, you are trying to get access to a neighborhood, an area market where it is difficult because of barriers to entry economically to get in, logistically to get in, so you get the help of others to run that joint venture.

So as you can imagine, this is the basic form of complex. There can certainly be a lot more boxes under it. The key there—and I think this is where the Service has done a good job and can continue to do a good job—is transparency. And keep in mind that the Form 990 is a public record document. And the IRS, while it is the regulator, is but one constituency for that document. Because it is public record, you can see it online on guidestar.org, look at these 990s of organizations. You want to make sure that regulators, donors, funders, staffs, patients, Members of Congress understand what each of these boxes are and it is very clearly reported and transparent. And I think that is where we can continue to see progress in that direction.

Chairman BOUSTANY. Thank you very much, Mr. Hyatt. That is a very helpful description to get the committee focused on some of the complexities of these organizations.

With that, I am happy to yield to the ranking member, Mr. Lewis.

Mr. LEWIS. Thank you very much, Mr. Chairman.

I want to thank each of you for being here, for your testimony. Thank you so much.

Professor Tobin, since you have been so quiet and you haven't had an opportunity to respond, is there anything that you want to say, to just get it off your chest? You have been waiting so patiently.

Mr. TOBIN. I think on UBIT and associated entities my colleagues have done quite well. So I am happy to answer your questions regarding the tax exempt entities and the way that they affiliate.

Mr. LEWIS. Professor Tobin, Schedule R of the new Form 990 asks for information about organizations related to a public charity. This includes for-profit subsidiaries and affiliated tax exempt organizations. Why is this information so important and so necessary for the IRS and the public to know?

Mr. TOBIN. So in the tax exempt situation it is very, very important, and that is because the public charities get a significant subsidy from the public. Donations to public charities are deductible by donors. And we see these organizations as special, as ones that serve some type of government function. When they affiliate with other organizations there is a serious risk that that subsidy that we provide to them gets pushed off to those other affiliates. And what we really want to make sure of is that public charities are doing public charity work and that these other organizations are doing what they are designed to do. So if they are lobbying, if they are engaged in political campaigns, we want to make sure that is not being done by the public charity. It is separated off. And the Form 990, without it, it is very hard to figure out who the different affiliated organizations are and what role they are playing.

So the Form 990, Schedule R serves a very important public function of letting us know who those organizations are and what they are doing.

Mr. LEWIS. Could you really elaborate and make it simple and plain to this Member? Are there activities that an affiliated tax-exempt organization may engage in that a public charity may not?

Mr. TOBIN. Sure. So public charities are only allowed to engage in an insubstantial amount of lobbying. And there is section 501(h), which helps determine how much that is. So a (c)(3), a public charity, can engage in some little amount of lobbying, but not a lot. And the idea here is they are doing their normal functions and they may doing some little thing that may be considered lobbying, and we want to let them do that. But if they are going to be a lobbying organization, they are supposed to be a 501(c)(4) organization, a social welfare organization. Because lobbying is considered a social welfare function.

So it is perfectly fine for a 501(c)(4) to be a lobbying organization, and a (c)(3) can form a 501(c)(4). And it happens all the time.

Now a charity, a public charity, is not allowed to engage in a political campaign for or against a candidate for public office, 501(c)(3) makes that very clear. We do not want the subsidy that goes to public charities to be going into campaign organizations. So a 501(c)(3) is prohibited from engaging in political activity. They should do that through an affiliated (c)(4). Actually, they are not allowed to create an affiliated 527, but they are allowed to create an affiliated (c)(4), which is allowed to create an affiliated 527. So that is how they get that done.

Mr. LEWIS. In your testimony, you noted that there are serious enforcement problems. Some big issues. I know the chairman and others do not want us to move into this political climate that we are in right now, but it seems like each time we pick up the newspaper, hear something on television or the radio, that there are real problems out there.

Do you think the IRS is having a major problem in enforcment with limited resources, limited staff? Who is watching? Who is policing?

Mr. TOBIN. This interrelated affiliation is a mess. And it is a mess for a lot of reasons that are the faults of a lot of us and a lot of reasons that are not anyone's fault. The IRS is not set up to be a campaign watchdog. They are not good at it and it doesn't serve their primary purpose. And so when they are placed in the position of having to get involved in these kind of political debates, it is very difficult for them to make these kind of determinations. But in addition, we have seen really, really aggressive pushing by organizations and what they claim their activities are. So the more aggressive organizations push, the more it creates problems for the IRS in enforcement. If we talk about a public charity not being allowed to intervene in a political campaign, and the public charity starts doing it but claims they are not from some weird definition, it creates this enforcement burden on the IRS; have the engaged, have they not.

We have seen in the social welfare context where the definition that organizations seem to be using appears to be the election law definition, not the Tax Code definition. So you have a whole set of (c)(4) social welfare organizations who in my view are absolutely 527s. Now who is supposed to police that, right? If a social welfare organization says this political campaign activity is social welfare, who comes in and checks that? And the answer is it has got to be the IRS. And it is just very difficult for them to do that.

Mr. LEWIS. Thank you. I notice my time has expired. And the chairman has been so liberal here. Thank you very much. Thank you, Mr. Chairman.

Chairman BOUSTANY. Thank you.

Ms. Jenkins, you are recognized.

Ms. JENKINS. Thank you, Mr. Chairman. Thank you all for being here.

Ms. Borenstein, in your testimony you discuss the extensive changes to the Form 990 and note that some problems still exist. Can you talk more about what challenges still exist for tax exempt organizations, preparers, and the IRS, and also maybe what recommendations might solve them?

Ms. BORENSTEIN. Yes. At basic ground level the difficulty with the form vests in a couple of places that have been vexing to preparers. Again, I stress that there is many people who are doing a good job preparing their own form, especially when filing organizations do them on their own.

My first suggestion is that the IRS should do more educational efforts to explain that some of the terminology used is not inherently value-laden as we are finding a fear in the exempt sector: "That I should not have a board member whose company is providing us a good deal because then I have one less independent director and there is something inherently wrong with that director's capacity to serve,"—which is certainly not the case. Folks like myself can say that as much as we want. Hearing it directly from the IRS would be helpful. So I am asking for more educational outreach on the part of the Service to express that they are just asking the question, rather than saying there is anything inherently bad about disclosure of favorable transactions with insiders.

The Schedule L, colloquially we refer to it as "lose your mind." The Schedule L has four separate parts. One deals with a statutory regime regarding excess benefit transactions that there is to ensure public charities cannot be taken advantage of unfairly by people who have been in substantial influence at any point in the last 5 years. You turn someone in if that has been the case. So one part of the Schedule L filers have a definition of and disclosure asking "has that happened with a certain group of people?" Another part asks, "are there loans outstanding at year end with a different group of certain people?" A third part asks, "have there been grants or assistance provided to yet another group of certain people?" And then finally, one last part asks, "are there business transactions with certain people?"

I have strongly recommended that the IRS create some sort of educational materials or flow chart in the instructions to the end of simplifying the definitions, trying to make them easier to handle. Standalone they all make sense as bright lines in the sand, but paired together their combined weight creates a very daunting task for the sector.

Past there: The Schedule F. I think there is much concern about the utility of the information being provided to the IRS about activities outside the borders of the United and widespread evidence that the info asks are burdensome (and potentially of questionable value). So I am recommending that that schedule be either extremely streamlined or eliminated.

And then there was a vestigial part of the old 990 that I think there was huge agreement had very value to the IRS. It is there at the behest of States and requires groups to functionalize their expenses between program and fundraising and management. There was an old-school belief that I would give a dollar to a charity first who was going to spend 90 cents of that dollar on program, but I know that I might want to give a group a dollar who is going to spend only 60 cents on program because that is where they are in their lifecycle and they need to build up management or need to put some efforts into fundraising, et cetera. That part/statement that has groups functionalize expenses should not be on the form. It is subjective. It doesn't work, and it continues longstanding mythology in favor of giving money to groups who say more dollars are going to program.

And then finally, it is clear that in spite of my saying groups can do their own Form 990, that small organizations can't. They are being very burdened. We had a transition period in which small organizations did not have to file the full redesigned 990 for a period of years. That finally ratcheted down to gross receipts of $200,000 as the level at which one must fill out the Form 990, or gross receipts at any level but owning assets of more than a half million dollars (requires the whole 990). I am suggesting that those thresholds rise back to the first transition year of a million dollars of gross receipts or perhaps on average a million dollars of gross revenues a year or having assets of $3 million. We have amateur athletic associations who have built a hockey and sports facility arena. They own $3 million worth of real estate. Well, $3 million might be the point at which they are filling out the full 990. But if they own a million dollars or $2 million worth of real estate, I and many others think they are still a small organization if their budget is less than a million dollars a year. On top of those increased thresholds by which groups could still fill out the Form 990–EZ, I am suggesting that the IRS come up with a third way to find ways in which that Form can be bettered in order to let more small organizations fill out a less comprehensive form. In sum total, that was my last recommendation.

Ms. JENKINS. Thank you.

Mr. Chairman, I yield back.

Chairman BOUSTANY. Thank you.

Mr. Becerra.

Mr. BECERRA. Mr. Chairman, thank you. Thank you all for your testimony. Each of you has to some degree focused some of your testimony on the growing complexity in this area and also the need for more transparency, a greater degree of disclosure, and so forth. I know that Mr. Miller put the best light or best face he could on the capacities of the IRS to try to oversee the numerous organizations that are now popping up under the tax-exempt structure, but it seems like what we are doing is losing ground every day on the ability to seek transparency and reduce the complexity. And so we thank you for your guidance and some of your ideas of how to try to make that better.

I think, Mr. Tobin, you have also suggested some ways to try to enhance the ability for us to pursue the bad apples, those who make the rest of the nonprofit world look bad because they have done things that don't conform with what we consider to be good mode of procedure for a nonprofit, the kind of things that we think of when we think of that charitable hospital or the cancer society or those organizations that are out there to do good for a lot of Americans.

Can you tell us a little bit with more detail from what you say in your written testimony about how we can go about enforcing some compliance in the tax-exempt area where, for example, we deal with lobbying, political campaigning, and other activities that seem to go beyond what we typically think of the work of a charitable or a not-for-profit entity?

Mr. TOBIN. So one of the problems in this area is that we have put the IRS in charge of policing and we haven't really given them the tools that we would normally give an agency that is required to police in this way. For example, the Federal Election Commission, you can make a complaint to the Federal Election Commission. But the IRS, it runs, it does its audits. You don't complain that your neighbor has not been audited and have them all of a sudden audit your neighbor. There are whistleblower statutes. But for the most part the IRS does their audit and then they keep it all secret, because that is what they are supposed to do. They are not supposed to disclose my tax return to anyone else, and we expect that kind of privacy.

Well, that is happening in the tax exempt area, and I think there is a real question whether we need it to happen in the tax exempt area. Tax exempt organizations are public charities. They are public organizations. They are receiving this public subsidy. So I think that there are ways in which we can have a public complaint process, where the public are looking at what is going on, they find that there is a problem. Right now they can send a letter to the IRS, but they don't have any idea what is going to happen. There is no requirement the IRS look at it. There is certainly no requirement that the IRS tell you what happened in that process. And they can't, in most cases.

And so I advocate that you have a public complaint process that you set up and that we have some transparency in that process because I think both sides of the aisle—in my history, I have been a professor for 11 years, and before that have at DOJ for 4 years, and then I was a judge, and I was on the Hill for 7 years, so there is a good 20 years of this stuff—and both sides of the aisle, when these things happen, you want to have some certainty that it is not political and that it very objective. My experience is the IRS handles this in an objective way. And the more we can be transparent in that, the better.

Mr. BECERRA. Are there any existing complaint processes that we could use to guide us in how you would form such a complaint process?

Mr. TOBIN. It is nice when you are a professor and somebody asks you about something you wrote, you just have to remember what you said. But I did an article on that in Georgetown's Law Review on the process. And I think having a panel of nonpartisan, of career service employees that could rotate through so that you weren't doing something like the FEC, where you had three and three, which creates a possibility for deadlock, where you had transparency in the decisionmaking process so that you could have some sense of what was actually happening, is the best way to go forward.

Mr. BECERRA. Thank you. Thank you all for your testimony.

Yield back, Mr. Chairman.

Chairman BOUSTANY. I thank the gentleman.

Mr. Marchant.

Mr. MARCHANT. Professor Colombo, it is easy to imagine an instance where a tax exempt organization would participate in a soup kitchen kind of scenario and then everybody liked the soup and so started canning the soup and then selling it and made that. But can you describe in better detail how one analyzes a for-profit activity and at what point the activity jeopardizes their tax exempt status?

Mr. COLOMBO. Well, I think in my world a commercial activity is one that competes in the private market with products and services available widely in the private market. So I will use my example of selling soup. I don't know whether selling soup is related or unrelated to operating a soup kitchen, but I am quite certain that it is a commercial activity. It competes in the private market with other soup makers.

How about tuition charged by a private school? Well, that one I would say is not a commercial activity because we have not yet reached the point where educational services are widely available in the private market. There are a couple. There is the University of Phoenix. But we are not there yet. So my view about that one is that tuition charged is not.

So I would look to the private market and I would say that if what the charity is doing is selling a good or service that is widely available in the private market, that is a commercial activity.

Where would I draw the line? I actually wouldn't draw the line. I would say to charities, You can engage in as much commercial activity as you want, provided that all of it is taxed and that you show us that that commercial activity is generating revenue that is expanding your charitable outputs. If it is not doing that, then why are you doing it? Do something else. Go sell your business and invest it in a diversified portfolio and use the money from the portfolio to operate the soup kitchen rather than selling soup. You may not be good at selling soup.

Mr. MARCHANT. So in my State and many States are now experiencing expiration leasing income on the land that they own. So that someone comes to a local university, simple, that first box up there. They have never really even thought about getting out of that box. And all of a sudden they discovered oil and gas on their campus or a piece of land that they have always considered to be their campus. That income, is it clearly not taxable?

Mr. COLOMBO. I think under current law it is pretty clearly a royalty, if that is the way that it is structured. I come from southern Illinois. We have oil and gas in southern Illinois, too, but I forget how the oil and gas leasing is done in that situation. But I think it is pretty clear that it would be passive income either as rental income from real estate or as a royalty arrangement.

Mr. MARCHANT. If they chose not to lease the royalty out and chose to drill, actually hire a rig and start drilling and producing their gas and oil, is that——

Mr. COLOMBO. In my world, that is a commercial activity. Now you are Shell Oil.

Mr. MARCHANT. And then, in your opinion, you would have an unrelated——

Mr. COLOMBO. Yes.

Mr. MARCHANT. Ms. Borenstein.

Ms. BORENSTEIN. If it were a school and you were teaching your students how to do that drilling and operate a business, you would be able to, under the current UBIT regime, talk about a substantial relationship to the conduct or accomplishment of your exempt purpose.

Mr. MARCHANT. Mr. Tobin, would you feel like that that fell outside the actual participation in the drilling and becoming the consumer, not just the royalty owner?

Mr. TOBIN. I agree with both examples. In the first example I think if you actually engaged in the commercial activity and you became the driller, it would be much more problematic. If you were able to make it part of your teaching process, then it would be less. We are talking about a hypothetical here, but it would be less problematic.

Mr. MARCHANT. Thank you, Mr. Chairman.

Chairman BOUSTANY. Thank you, Mr. Marchant.

Mr. Paulsen.

Mr. PAULSEN. Thank you, Mr. Chairman. As you know, one of the issues that has come up at prior hearings actually deals with our learning about tax exempts and the ability of exempt entities to enter into partnerships, whether it is with another exempt entity or with a for-profit entity. Can you just explain maybe, Mr. Hyatt, in a little bit greater detail how a public charity would actually enter into a partnership or a joint venture with another organization and what are the specific issues in particular that have to be dealt with to ensure that an exempt organization actually remains exempt?

Mr. HYATT. Certainly. Thank you, Mr. Paulsen. Joint ventures are really one of the areas of substantial corporate growth certainly in the last 20 years, since about the late seventies or early eighties, for the reasons I described. Typically, what would happen is the exempt organization would look to this outside for-profit party, look for a way of sharing mutual abilities and enter into a joint venture through a limited or general partnership. A limited liability company, as I say, is the most common model these days.

If you look back historically prior to about 1980, the IRS took the position that you couldn't as a public charity engage in limited partnership joint ventures, for example, that it was too much of sharing of your activities with the for-profit side and that was inconsistent with the tax exempt status. The Tax Court overruled that position. The IRS subsequently pulled back from that line and over the years has come up with a series of guidance that approved certain structures for entering into joint ventures.

The essence of it is no matter how you do it, no matter how you structure that joint venture, your participation in it has to further a charitable purpose and you have to ensure that you haven't unduly ceded control over the organization to for-profit parties.

So if you look back into the 1980s, for example, we were starting to see hospitals cede the entire operation of the hospital to a joint venture with a for-profit party, what is sometimes called a whole hospital joint venture. The IRS took a look at that and used a fact pattern that is not uncommon in these sorts of situations in a revenue ruling, the good situation and the bad situation. And in essence, they said as long as you ensure that you haven't unduly conceded control to the for-profit parties, as long as you are doing this for a legitimate charitable purpose, perhaps you are, as many hospitals are, particularly academic medical centers, struggling to make ends meet, this is the way to remain as a charitable entity, you got a legitimate reason for doing that, and as long as you are not improperly benefiting private parties under IRS rules, that is an acceptable way to go. But if you ceded so much control to the for-profit party that they in effect are really operating the charity now, it no longer continues to qualify as a charity and the IRS has indicated we would take that away.

Another version of that is what is sometimes called an ancillary joint venture. The example in the most recent revenue ruling by the IRS in this circumstance was a college or university that wanted to do distance learning. They wanted to ensure that teachers in the summertime could come and take courses without actually having to be on campus. They said there are for-profit companies out there who can do a better job at figuring out what cameras to choose, how to get the mikes set up, what halls should we rent, how do we go about doing that. What we do very well is figuring out what our curriculum is, who our best teachers are, what the standards are for passing that test.

So we will approve that kind of ancillary joint venture as long as you haven't ceded control over to this for-profit party and the for-profit party is dealing with the business aspects, the charity continues to deal with the charity aspects of it. If you break it up in that fashion, otherwise share risks and rewards, have shared governance of that organization, in the IRS's view back in 2004, that is a legitimate way to do an ancillary joint venture as well for a public charity.

Mr. PAULSEN. That is helpful. Thank you. Let me just dovetail into something real quick, Ms. Borenstein, if I can ask you a question. Because in your testimony you noted that the changes have occurred for the Form 990 and entirely new information now is required and existing requirements have changed substantially. What were the deficiencies of the old Form 990 and what particular concerns actually prompted all these substantial changes with 990

Ms. BORENSTEIN. Well, where should we start? I mean, the director of the exempt organization division referred to the prior iteration of the Form 990 as a disaster, and it was perhaps the one time that the entire exempt organization community completely agreed with the IRS.

The old form was built out very, very poorly. Questions were asked as the topic du jour rose through hearings in this august body and through law changes. There was no rhyme or reason to how it was structured. And as I earlier stated, it was perceived as a financial statement because you largely saw numbers, but there were questions all over the place that said attach a schedule, and you had to read the instructions to know what to attach in the schedule. The software providers for 990 preparation all had a different inclination as to what the schedules should provide. You couldn't find the data. You would go to Guide Star and find a 300-page return, and be endlessly searching for the list of directors, officers and key employees, or other common attachments without so much as a clue where that information was going to be.

It was widely understood that it was time to start over, which is why the IRS, starting in 2005 and 2006, went through what I thought was a very thoughtful process of engaging the entire sector to say if we have to ask questions about who you are and what you are doing and why you continue to be an exempt entity in terms of qualifying, "what would you want to see us put on the form?" And there was a fair amount of back and forth. The IRS proposals I am sure included items that they were ready to negotiate on, and they did jettison some completely. They took a lot of suggestions. The architecture of the form was agreed to for the most part by the sector. The instructions are relatively plain English. They worked very, very hard on that. They continue to make corrections each year, resulting in improvements to the form. But again, the notion is that we want an environment of transparency and accountability, particularly for public charities. And so to annually report on the sum total of who they are, under whose watch are things being performed, what compensation is being paid particularly to those in charge—a full view—is what the new 990 affords. The old 990 attempted to ask a lot of that information but only someone like myself understood those questions.

Mr. PAULSEN. Thank you, Mr. Chairman.

Chairman BOUSTANY. Thank you.

And Ms. Borenstein, just in follow up on what Mr. Paulsen asked, in your testimony, you had discussion of eight completely new areas on the revised Form 990. For example, any information required on authority and management practices, related parties on Schedule R is one example. Explain what specific information is now required there. How the IRS or other interested parties may use that information to examine the organization. And how have these requirements prompted public charities to make changes for compliance purposes?

Ms. BORENSTEIN. Well, I am sorry, Mr. Chairman, are you asking about the Schedule R?

Chairman BOUSTANY. Yes.

Ms. BORENSTEIN. I think the chief imperative behind the Schedule R was to afford a view into the linkages between the filing organization and organizations over which control existed in one direction or the other. Also, in addition to noting where the linkages are, it gives the opportunity for the IRS and the public—the court of public opinion in my eyes is the third regulatory body to the States and the IRS—to see answers to the IRS' asking the right questions, depending on whether the related organization is for profit and taxable versus exempt or a partnership—in each of those instances, there is different contextual information asked of. So you and I as readers of the return see who those entities are with much more detail than that afforded by the prior 990.

One of the things I don't note in my testimony that is important to understand that the Schedule R serves to inform the compensation picture, too. The very important people, the in-charge people for the filer, for these individuals the Schedule R triggers visibility for what compensation they are paid by, and what hours they are providing to, the filer's "related organizations." In the good old days, before the current 990, if I had a complex organization that was comprised of a (c)(3) with a related (c)(4), I would not know from reading the 990 of either if an important person for the (c)(3) was also being compensated by or providing services to the (c)(4) or vice versa. I would have had to read both returns together but now it is in one place on each organization's return.

Chairman BOUSTANY. Okay. Thank you. That was very helpful.

And finally, Professor Colombo, in your testimony, after discussing the many problems with the commerciality doctrine compliance IRS enforcement, you provide several suggestions for reform. And I want to just focus on two of those options you had laid out. First is to return to the commensurate in scope doctrine. Explain to me in more detail what that proposal is and how it would actually work.

Mr. COLOMBO. Well, this is actually part of this question of how much commercial activity should a charity engage in. In 1964, actually, the Internal Revenue Service took a look at this problem and wrote a ruling and basically said that you could engage in—there was no limit on the amount of commercial activity you could engage in as long as your charitable activities were commensurate in scope with your investment in commercial activity.

So this was the IRS's check on making sure that the commercial activity was providing resources to the charitable side as opposed to just becoming, as I point out, empire building.

I would resurrect that test. I probably would resurrect it. The IRS has sort of let it lie, and then they resurrected it in other areas, and now I am not exactly sure anymore what——

Chairman BOUSTANY. It is inconsistent.

Mr. COLOMBO. Yeah. I don't know what it means anymore. I am not sure they know what it means anymore, frankly. So I would resurrect it for its original purpose.

I might even add some kind of safe harbor rule, that if you earn a rate of return that is equal to the current Federal rate, medium-term Federal rate or something like that, that you then redeploy on the charitable side, you are okay, it is fine, you go and you can engage in as much commercial activity as you want. So that is the piece of it that I refer to as resurrecting the commensurate in scope doctrine.

Chairman BOUSTANY. Okay.

And finally, second is to no longer use the relatedness test for UBIT and impose tax on all commercial activities by charities. You kind of talked a little bit about that in our previous back and forth.

How would that work? Would it make oversight easier? And what kind of impact would this have on the tax-exempt sector overall?

Mr. COLOMBO. Well, I think, first of all, if you just tell charities that all of your commercial activities are taxable—you could actually I think do it either way, tell them they are all taxable or tell them they are all not taxable; I think that it happens to be not a good idea to tell them that they are all not taxable—hen again, you eliminate this, as Mr. Miller pointed out, very difficult to enforce line between what is related and unrelated.

Now, there is still a definitional question, no doubt about that, there is a definitional question about what is commercial. But my own view about that one is that is a pretty easy definitional line to meet, certainly much easier in my view than related or unrelated. I am not sure at the end of the day that that will have much effect on charities other than giving them clarity that they can engage in commercial activities. It will not cause them to lose their tax exemption. They can then set up the corporate structure or the business structure that makes sense from a business perspective as opposed to worrying about, well, do I have to drop this thing into a corporate container because if I don't, then someone from the IRS might come along and say, well, that affects your tax exemption. No. You know, let them make those decisions based upon issues that are not tax issues, that are issues of business issues. So my own view is that that would in fact simplify oversight. How much? I don't know. But I think the system we have got, sort of anywhere is up.

Chairman BOUSTANY. Thank you.

Mr. Lewis, do you have any follow up.

Mr. LEWIS. No, Mr. Chairman.

Chairman BOUSTANY. Mr. Paulsen is gone.

Well, that concludes our hearing. Thank you very much. Your testimony was very, very helpful to us. Keep in mind that members may have some additional questions that may come up, and they would submit those to you directly for answers. Both questions and answers will be made part of the official record. And with that, I will now conclude the hearing.

[Whereupon, at 11:38 a.m., the Subcommittee was adjourned.]

[Submissions for the Record follow:]

American Bankers Association

July 25, 2012

Statement for the Record

On behalf of the

American Bankers Association

before the

Oversight Subcommittee

of the

Committee on Ways and Means

United States House of Representatives

American Bankers Association

Statement for the Record
On behalf of the
American Bankers Association
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of the
Committee on Ways and Means
United States House of Representatives
July 25, 2012

Chairman Boustany, Ranking Member Lewis and members of the Subcommittee, the American Bankers Association (ABA) appreciates the opportunity to submit a statement for the record for this hearing on tax-exempt organizations' compliance with unrelated business income tax (UBIT). ABA represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its two million employees.

Over the last two decades, tax exempt organizations of all types have grown increasingly more complex in their organizational structures and operations. Contributing to this complexity is the prevalence of profit-generating arms within the tax-exempt organizational structure. We commend the Subcommittee for holding this oversight hearing with regard to tax-exempt organizations' compliance with Federal tax law, including rules that subject business income from for-profit activities to UBIT and the disclosure of information about sources of income and expenditure on the Form 990.

Just like other tax exempt institutions, all credit unions should be subject to UBIT on income earned from activities outside of the scope of their tax-exempt purpose. Currently, only state credit unions are subject to UBIT; federal credit unions should also be required to comply. Similarly, state credit unions are required to disclose information about income and expenditures, such as executive compensation and charitable donations, on IRS Form 990. Federal credit unions should also be required to comply.

Credit unions were originally created for the purpose of promoting thrift and providing credit to members of the credit union and were granted their tax exemption to serve people of modest means.

However, many of these credit unions have now morphed from serving "people of small means" to become full service, financially sophisticated institutions that compete head-to-head with local taxpaying banks. In many cases, these morphed credit unions offer products and services that are outside of their tax-exempt purpose and should be subject to UBIT, just like what is applied to other tax-exempt entities.

Our statement will make several points:

- Credit unions are becoming increasingly complex organizations, virtually indistinguishable from taxpaying banks.
- Federal Credit Unions Should Disclose Activities on Form 990
- Activities outside of the scope of the credit union tax-exempt purpose should be subject to UBIT.
- Federal credit unions should be subject to UBIT, just like state chartered credit unions.

We will discuss these items in detail below.

I. Credit Unions Are Becoming Increasingly Complex

Many of today's credit unions are a far cry from the small, traditional credit unions that served distinct groups of "people of small means," which Congress sought to assist when it provided tax subsidies to credit unions in the 1930s. Today, the credit union industry has surpassed the $1 trillion asset threshold and will soon hold more assets than the savings association industry.

There are now 194 credit unions that have more ***than $1 billion in assets*** each; these credit unions hold 50.3 percent of all credit union assets but represent only 2.8 percent of the total number of credit unions. These 194 large credit unions are larger than 91 percent of all banks. For consumers, credit unions are indistinguishable from taxpaying community banks. Indeed, these credit unions compete for the same loans as their community bank counterparts, but pay no taxes. Credit unions were not intended to be simply tax exempt banks.

Moreover, many credit unions are exhibiting increased organizational complexity, including operating for-profit affiliates known as credit union service organizations (CUSOs). According to the National Credit Union Administration, approximately 33 percent of all credit unions reported using CUSO services in 2010.

These for-profit affiliates can be wholly or jointly owned. Many are organized as limited liability companies. Limited liability companies are pass-through entities, where the shareholders pay the taxes on the profits of the company. However, since credit unions are tax exempt, ***the earnings of CUSOs structured as LLCs go untaxed***. Additionally, CUSOs have the authority to offer products and services that credit unions cannot offer and CUSO's can serve nonmembers. National Credit Union Administration regulations only require that the majority of a CUSOs business must come from credit unions or credit union members.

Alaska USA Federal Credit Union in Anchorage, Alaska is illustrative of this growing complexity. The credit union owns a mortgage company, insurance agency, trust company, and title agency and ***pays no UBIT on income earned from these activities***.

II. Federal Credit Unions Should Disclose Activities on Form 990

As credit unions become more complex, it is important to increase credit union transparency. Credit unions should be required to reveal information about sources of income and expenditures, such as executive compensation and charitable donations. Most tax-exempt organizations, including universities and hospitals, must disclose the compensation of senior officials to the Internal Revenue Service on the Form 990—a form that has become an important tool for determining the transparency and accountability of tax-exempt organizations. By publicly disclosing this information, the Form 990 fosters good corporate governance as it attempts to ensure that the tax expenditure is being appropriately employed.

State-chartered credit unions are already required to file a Form 990, but federal credit unions are not. Since federal credit unions are cooperatives, the member-owners have a right to know the total compensation paid to senior officials. For example, if Public Service Credit Union of Denver had been a federal credit union (rather than state-chartered), information regarding the $9.8 million base compensation of its CEO and President would not have been disclosed. His 2010 pay package was almost 20 times the average for comparable sized credit unions according to press reports.

Federal credit unions should be required to file Form 990 information just like state-chartered credit unions and most other tax-exempt institutions. Expanding the public's opportunities to review executive salaries would promote improved corporate governance and greater credit union accountability. It would inform Congress, taxpayers, and credit union members about whether this valuable tax subsidy is going towards the credit union mission or is subsidizing credit union management.

III. Numerous Credit Union Products and Services Should Qualify for UBIT

ABA believes that income derived from non-members and from activities unrelated to the credit union's tax-exempt purpose should be subject to taxation. In general, a tax exempt organization is subject to UBIT if income is derived from an activity that is (1) a trade or business, (2) regularly carried on, and (3) not substantially related to the exempt purposes of the organization. An activity is related to the exempt purpose only where the conduct of the activity has a causal relationship to the achievement of the exempt purpose.

Today, credit unions and their subsidiaries offer numerous financial products and services that are not substantially related to their tax-exempt purpose and should be subject to UBIT.

Consider the following examples:

- La Capitol FCU in 2004 built a new six-story building in downtown Baton Rouge. The credit union occupied 30,000 feet of the 80,000 square-foot development and leased out the rest. The income from the 50,000 square feet of leased out office space ***should be taxed***.
- Another credit union, First FAA FCU located in Los Angeles, leased its unused portion of its office at above-market rates to the "CSI: Miami" production company. Space on the main floor of the building is set up to look like a police interrogation room. The income from the "CSI: Miami" set ***should be taxed***.
- Forum Credit Union in Indianapolis operates a conference and events center. It can be used for special occasions like weddings or corporate events. If you want to rent the entire facility during the weekend for a corporate event, the price would be $1,700 plus $4 per person. The income from the convention center rentals ***should be taxed***.

- Lake Michigan Credit Union in Grand Rapids, Michigan operates an auto dealership, called Lake Michigan Auto Center. The credit union also operates a car wash. It is hard to fathom what a car dealership and a car wash has to do with a credit union's tax-exempt purpose. The income from the Lake Michigan Auto Center ***should be taxed***.

- Many credit unions are surcharging nonmembers for using their automatic teller machines. The income from the ***nonmember fees should be taxed***.
- A number of the largest credit unions are now offering real estate brokerage services. Digital Credit Union of Marlborough, Massachusetts offers real estate brokerage services through its DCU Realty affiliate. The income from the real estate brokerage ***should be taxed***.

Furthermore, UBIT should also be applied to a credit union when it purchases or participates in a business loan to nonmembers. Since the first quarter of 2004, the NCUA has collected information on the number and the dollar volume of nonmember business loan purchases and participations. According to NCUA, 820 credit unions held $6.4 billion in nonmember business loan purchases and participations at the end of the first quarter of 2012. ABA believes this activity is outside the scope of a credit union's tax-exempt purpose and ***should be taxed***.

IV. UBIT Should Be Extended to Federal Credit Unions

Currently, state-chartered credit unions must pay UBIT. However, federally-chartered credit unions are statutorily exempted from paying UBIT. In fact, the tax exemption for federal credit unions is so broad that these organizations are excluded from all forms of federal and state taxation, other than state property taxes.[1] This statutory exemption from UBIT is no longer warranted. The only significant difference between state and federal credit unions is that federal credit unions are chartered by a federal agency, the National Credit Union Administration, while state-chartered credit unions are chartered by state regulators.

Tax policy should not differ between federal and state credit unions that offer virtually the same business services and compete for the same customers. The same competitive pressures between taxable businesses and tax-exempt organizations that motivated Congress to enact the unrelated business income tax also exists between federal credit unions and the nation's community banks. Disparity in the application of UBIT between state and federal credit unions also creates the potential for tax arbitrage and creates an incentive for credit unions to obtain federal charters.

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[1] "The federal credit unions organized hereunder, their property, their franchises, capital, reserves, surpluses, and other funds. and their income shall be exempt from all taxation now or hereafter imposed by the United States or by any state, territorial, or local taxing authority; except that any real property and any tangible personal property of such federal credit unions shall be subject to federal, state, territorial, and local taxation to the same extent as other similar property is taxed..." (12 U.S.C. 1768).

ABA encourages the Committee to examine repealing the federal credit union UBIT exemption. There is no public policy reason to exempt federal credit unions from UBIT, especially when the activities have no connection with their tax-exempt purpose.

Conclusion

As credit unions become more complex and expand the breadth of their product and service offerings beyond their tax-exempt purpose, ABA believes that it is incumbent on Congress to limit the growth of this tax exemption. A starting point for limiting the expansion would be to subject all credit unions to UBIT and to narrowly define the scope of activities that are related to the tax-exempt purpose of credit unions.

Also, as we stated in our May 16, 2012 Statement for the Record, ABA encourages the Committee to hold a hearing specifically on credit unions as tax-exempt entities. Credit unions represent a significant tax expenditure. Since 2001 they have enjoyed the privilege of not paying an estimated $20.5 billion in federal corporate income taxes. The size and taxpayer contribution conferred certainly make them worthy of careful Congressional investigation to ensure that their tax exemption is being used as Congress intended.

Center for Fiscal Equity

Comments for the Record

House Ways and Means Committee
Subcommittee on Oversight

Hearing on Public Charity Organizational Issues, Unrelated Business Income Tax, and the Revised Form 990
July 25, 2012, 9:30 AM
1100 Longworth House Office Building

By Michael G. Bindner
Center for Fiscal Equity

Chairman Boustany and Ranking Member Lewis, thank you for the opportunity to submit comments for the record on these issues. We will leave it to others to examine how the current system is working and confine our comments to how our tax reform program would impact these questions. As you know, the Center for Fiscal Equity has a four part proposal for long term tax and health care reform. The key elements are

- A Value Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure every American pays something.
- Personal income surtaxes on joint and widowed filers with net annual incomes of $100,000 and single filers earning $50,000 per year to fund net interest payments, debt retirement and overseas and strategic military spending and other international spending, with graduated rates between 5% and 25% in either 5% or 10% increments. Heirs would also pay taxes on distributions from estates, but not the assets themselves, with distributions from sales to a qualified ESOP continuing to be exempt.
- Employee contributions to Old Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive.
- A VAT-like Net Business Receipts Tax (NBRT), which is essentially a subtraction VAT with additional tax expenditures for family support, health care and the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.

We agree that charity has become big business and needs to be taxed accordingly where appropriate. We also agree that charitable organizations deserve special treatment in any tax reform.

Charities that have commercial operations will be subject to a VAT, like any other commercial company, at least to the extent of such commercial operations. This is essential to provide visibility to their customers as to taxes imposed by the entire supply chain, unless sales to charities are also made VAT exempt. As this would turn every business into some form of charitable organization overnight, this would not be advisable. Fiscal conservatism should not be synonymous with empowering tax evasion schemes. The degree to which this needs mention shows the extent to which it has become so.

Whether non-commercial operations are subject to a VAT depends on the extent they are used to fund entitlement spending and payroll taxes versus discretionary government spending. For example, if Social Security or Medicare were to become VAT funded, replacing the payroll tax, than charitable organizations must continue to fund these operations, as they will benefit the employees of these organizations. If, however, entitlement services are funded through our proposed VAT-like NBRT, then there is an argument to leave the non-commercial activities of these entities VAT-exempt and we would urge you to do so.

Political organizations and committees would pay VAT on their payroll and their purchases would not be VAT exempt.

Transferring tax exemption to the VAT will also soften the blow should the charitable contribution be eliminated from flatter individual income surtax rates. The rationale for cancelling such an exemption is that if everyone uses the exemption, it will simply require that the tax rates be set higher to yield the same income. The Center is agnostic as to which option is best, as this depends on how entitlements are funded, although contributions to political organizations should certainly not be tax exempt after reform.

Charitable organization employees will continue to pay the employee contribution to Old Age and Survivors Insurance, assuming it is not subsumed into the NBRT.

Charitable organizations will pay the NBRT because their employees will benefit from the programs funded by this levy or from offsets to it. For example, Catholic Charities employees might designate the Catholic school system as an alternative provider to public schools, which would allow Catholic Charities agencies to take a credit on this levy, which would otherwise be paid against their total value added. Likewise, employees would be paid the same child tax credit as commercial employees – again as an offset to NBRT levies. Health and higher education credits proposed for other enterprises would also be available to charitable organizations, as well as any other applicable credits. Note that because certain payroll and personal income taxes will be eliminated, the gross pay of charitable employees will decline in like manner to those of their commercial counterparts.

On the issue of disclosure, payments of various taxes may or may not be listed on the Revised Form 990, although doing so would serve the function to donors of offering receipt visibility for the VAT. The total amount of NBRT paid may or may not be included, as well as the total amount of credits taken. We are agnostic as to whether the credits taken should be itemized, as privacy concerns should be dealt with in deciding whether to do so on a public form.

Finally, this schema is as applicable to governmental organizations as it is to charitable organizations, with modifications. State governments would be the federal NBRT, while federal organizations would pay the state NBRT, both on the same basis relating to value added through payroll. These organizations would not pay NBRT to themselves, however their personnel systems should contain a similar range of benefits. This schema provides a better explanation of how a FairTax might work on these levels, while also providing a rationale for adjusting government employee salaries and providing for non-governmental performance of services through the same type of alternative NBRT programs.

Thank you again for the opportunity to present our comments. We are always available to discuss them further with members, staff and the general public.

Contact Sheet

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Hearing on Public Charity Organizational Issues, Unrelated Business Income Tax, and the Revised Form 990
July 25, 2012, 9:30 AM

All submissions must include a list of all clients, persons and/or organizations on whose behalf the witness appears:

This testimony is not submitted on behalf of any client, person or organization other than the Center itself, which is so far unfunded by any donations.

Economic Research Institute

Testimony for

Subcommittee on Oversight of the Committee on Ways and Means

Hearing on Public Charity Organizational Issues,
Unrelated Business Income Tax, and the Revised Form 990

July 25, 2012

Whither Form 990 E-filing -- or Is It Wither?

Submitted by Linda M. Lampkin, Research Director

ERI Economic Research Institute (www.erieri.com)

Congress can take a simple action that would:

- Improve the efficiency of IRS form processing;
- Help target IRS compliance resources;
- Promote high quality data on the nonprofit sector; and
- Increase the transparency of nonprofit data for all users.

Minimal funding is required and the Exempt Organization division of the IRS could refocus its resources from processing paper and creating databases to research, education, and compliance.

The action is to enable universal electronic filing of Form 990. All that is required is simple legislation that amends the Internal Revenue Code to permit lowering the number of returns that trigger the requirement to file electronically from 250 to five filed per year.

Background

The Form 990 now serves as the major public source of information about an organization's finances, governance, operations, and programs for federal and state regulators, the public, the media and nonprofit watchdog groups, foundations and donors, and even nonprofit clients and customers. Supported by nonprofit sector groups such as Independent Sector[1], e-filing actually promotes accurate Forms 990 as the preparation software detects incomplete and potentially inaccurate information *before* returns are filed. It also allows the IRS to provide immediate feedback to organizations about incomplete returns and those with obvious inaccuracies.

The IRS currently requires larger organizations --with assets of more than $10 million -- to e-file if they filed more than 250 returns (including W-2s and other returns). Private foundations that file at least 250 returns are also required to e-file Form 990-PF, regardless of total assets. And of course, the 5-question Form 990-N postcard is available only electronically, and must be e-filed by the very smallest organizations in the sector. The vast majority of the nonprofits are not required to e-file – software is used to prepare their returns, then they are printed and mailed to the IRS, where they are scanned and turned into images for distribution, a time consuming and expensive process that does not result in data usable for research.

When the IRS attempted to meet the demand for clearer and more accurate information about nonprofit organizations by redesigning the annual information return they file, a basic assumption was that all or most returns would be filed electronically in the future. And in fact, the public, nonprofit organizations and the government will not fully benefit from the improvements to the Form 990 until most nonprofit organizations are required to file their returns electronically.

Current Form 990 E-filing and Future Projections

The IRS expects that about 741,000 Forms 990, 990-EZ, and 990-PF were filed for 2011. Of these, about 13% were filed electronically with the IRS.[2] Another 480,000 organizations will file the electronic post card, the 990-N – these are the very smallest nonprofits with less than $50,000 in annual revenues.

While the IRS tries to manage its ever increasing work of processing data by encouraging (and requiring where possible) e-filing of returns, the expectations are discouraging for the nonprofit sector. The number of Forms 990, 990-EZ, and 990-PF filed in 2018 is projected to increase by about 14% from 2011. The percentage e-filing rises also, but only to 38% in 2018, not nearly the level for individual tax returns (84% in 2018), or corporation returns (55% in 2018). The table below, derived from the IRS Statistics of Income figures, breaks out the estimates by type of return.

[1] see https://www.independentsector.org/efiling_form_990?s=Form%2099

[2] see Projections of Federal Tax Return Filings: Calendar Years 2011–2018 by Brett Collins at http://www.irs.gov/pub/irs-soi/12rswinbulreturnfilings.pdf.

Type of Return	Estimated 2011	Projected 2018
990, 990-EZs, 990-PF	**741,200**	**842,600**
990, EZ, PF e-filed	203,100	321,500
% of all e-filed	***27%***	***38%***
Total Form 990	401,700	448,100
990, e-filed	113,900	175,500
% of 990s e-filed	***28%***	***39%***
Total Form 990-EZ	222,500	264,500
990-EZ, e-filed	73,600	114,200
% of 990-EZs e-filed	***33%***	***43%***
Total Form 990-PF	117,000	130,000
990-PF, e-filed	15,600	31,800
% of 990-PFs e-filed	***13%***	***24%***

Currently, about 77% of all individual income tax returns are e-filed, projected to rise to 84% in 2018. When e-filing reaches these levels, the processing of the data is less of a burden for the IRS.

The impediment to requiring e-filing for Forms 990 is a provision in federal legislation from 30 years ago designed to reduce filing burdens for smaller entities, not just nonprofits. However, with the dramatic change in how computers are used from the 1980s to the present, e-filing for all organizations is not a burden and is generally supported in the nonprofit sector. As shown above, the smaller nonprofits that can use Form 990-EZ have the highest percentage of e-filings! And of course, the very small nonprofits that must file the postcard Form 990-N can only e-file.

Advantages of E-Filing

Forms 990 are often the primary document providing information about an organization's finances, governance, operations, and programs for federal regulators, the public, and many state charity officials. Many returns filed include inaccurate or incomplete data and the Internal

Revenue Service currently uses a costly, labor-intensive, manual process to review the submitted forms. If there are errors or omissions detected, the IRS then sends a notice to the filing organization, usually requiring an amended return which can add considerable time before the complete, correct information is available to the public and regulators.

E-filing actually prevents many of the most common problems with Forms 990 as the software ensures that the numbers add up and all required blanks are filled before the file can be transmitted. This means that incomplete and potentially inaccurate information is fixed before a return reaches the IRS.

The redesign of Form 990 restructured questions and the presentation of financial and other information assuming that most returns will be filed in the future by electronic means. Most returns are now prepared using software but then printed and mailed to the IRS. So the data are in electronic format initially, then converted to paper, and then converted back to electronic data by the IRS and by all the users of the data – state regulators, foundations, donors, media, watchdog groups, companies and consultants providing services to the nonprofit sector, etc. And even the IRS is projecting only a minimal amount of e-filing in the future, seemingly resigned to the current situation of lack of authority to require electronic filing by entities filing fewer than 250 returns during the year.

As a result, most organizations will continue to submit paper tax returns, thus depriving the IRS and the public of the most efficient and effective means of disclosure. Legislative action in needed to require organizations that file at least five tax forms to file their informational returns electronically.

Role of ERI Economic Research Institute

ERI Economic Research Institute was founded in 1987 to provide compensation, benefits, and human resource research for private and public organizations in the form of published reports and software database products. Our research database software subscriptions are available to management, analysts and consultants and are widely used (over 10,000 corporate and consulting subscribers, affecting pay practices in over 100,000 organizations). Subscribers include corporate compensation, relocation, human resources, and other professionals, as well as independent consultants and counselors, and US and Canadian public sector administrators (including military, law enforcement, city/county, state/provincial, and federal government pay administrators and regulators).

One of ERI's primary products is the Nonprofit Comparables Assessor™ & Tax-Exempt Survey or **CA**, a desktop program that converts the compensation data reported to the IRS on Forms 990, 990-EZ, and 990-PF into infinite combinations of reports and analyses, based on characteristics chosen by the user. ERI makes a basic version of the **CA** available at no cost – this provides information that can be used by the vast majority of nonprofits to benchmark their executive salaries and ensure that they are paying "reasonable" compensation in accordance with IRS regulations (see www.erieri.com for more information and to download the demo version). The enhanced versions provide more precise and detailed data and are used by larger nonprofits, compensation consultants, and government charity regulators at the federal and state levels. In fact, the compliance officers of the EO division of IRS represent our largest group of customers, along with the charity regulators in a number of states.

The interactive graphs and screens present data on compensation reported on all Forms 990 since 1998, the year that the images of the forms were first made available by the IRS. Since the IRS provides only images, not data files, the data for the **CA** must be entered into a database from the images. ERI now purchases digitized data from GuideStar and has its own supplemental digitizing operation for smaller organizations, foundations and those missing from leased GuideStar data. This is a very costly, time-consuming process that is fraught with potential for errors.

A requirement for e-filing of Form 990 would allow the IRS to do its work far more efficiently and permit the IRS to provide data – in fact, greatly improved data in a usable format -- to those that provide services to the sector, including ERI. The improved reporting and database format would enable ERI to create a much more accurate and timely product for use by the sector.

Conclusion

Making this necessary legislative change to require organizations to e-file should be a priority for all those interested in the nonprofit sector. Because of the limited resources of the division of the IRS in charge of the nonprofit filings, the forms were deemed to be public, thus allowing all stakeholders -- the media, watchdog groups, funders, etc. – to be part of the enforcement process. But when there is a long delay in providing these public documents and they are in a format that is difficult to use, the purpose of making them public is not met. Making e-filing a requirement would allow the IRS to use its resources more effectively and encourage the creation of a system to disseminate the data in a usable format in a timely fashion.

Everything is in place to implement a change in the requirement for Form 990 e-filing – support of the IRS, support of the nonprofit sector, infrastructure within the IRS and software available and currently in use within the filing community. The enabling legislation needed to make the change is not partisan and would yield improved data in a format that would allow regulators to efficiently regulate nonprofits and allow all stakeholders to benefit from the Form 990 revision process.

Just do it.

Elizabeth Boris, Thomas Pollak, Charles McLean and Jeffrey Falkenstein

Comments Submitted to

The Subcommittee on Oversight of the Committee on Ways and Means
United States House of Representatives

Hearing on Public Charity Organization Issues, Unrelated Business Income Tax,
and the Revised Form 990

July 25, 2012

by
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Congress can take key steps to improve the transparency and accountability of the nonprofit sector, without creating a burden on nonprofits, by requiring that the Internal Revenue Service immediately implement electronic filing of all Form 990, 990-EZ, and 990-PF returns by Tax Year 2013.

Electronic filing has been required of smaller organizations since implementation of the Pension Protection Act of 2006. All in all, this has proved a major success. Approximately 300,000 dead organizations have been removed from the IRS rolls as a result and we now have a much clearer picture of the nonprofit sector.

Voluntary electronic filing of Form 990s began in 2004 – yet the IRS does not provide timely public access to the raw data from these returns because it is obligated to treat electronically filed returns the same as paper returns.

There are clear efficiency gains for the federal government, nonprofit watchdog and transparency groups like GuideStar and the Foundation Center, state governments' charity monitoring divisions, and ordinary nonprofit organizations if electronic filing were to be required. The IRS would then be able to make all data available electronically. This, in turn, would save watchdog and transparency organizations and state governments millions of dollars each year.

At the same time, donors and nonprofit organizations would have easy access to more timely and accurate information for making important decisions about giving, program effectiveness, and executive compensation.

In short, this is a win-win proposition for individuals, nonprofit organizations, and government.

The primary barrier to achieving this more transparent and accountable world is a tiny, mid-1980s provision in the tax code -- IRC sec. 6011(e)(2) -- that was intended to protect small businesses from being required to submit employment data to the IRS on massive reels of magnetic tape. This provision has long outlived its usefulness and, therefore, the IRS should be mandated to require electronic filing from all tax-exempt organizations. Once this is in place, it should move expeditiously to make all data from electronically filed returns available.

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The views expressed in this statement are those of the authors and should not be attributed to the Urban Institute, GuideStar, the Foundation Center, their trustees, their directors, or their funders.