



# DAILY REPORT FOR EXECUTIVES



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## REPORT

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### Grassley Seeks Estimate of Nonprofit Tax Exemption, Putting Organizations on Edge

**L**awmakers looking to bring in new revenue during tax reform talks have focused on scrutinizing the hundreds of tax expenditures contained in the Internal Revenue Code but Sen. Charles Grassley (R-Iowa) would first like Congress to calculate the cost of the nonprofit tax exemption, which currently is not considered an expenditure.

Grassley has long used his perch as a senior member of the Senate Finance Committee to examine nonprofit organizations—particularly hospitals and universities—and their tax-exempt status. Speaking during a March 1 hearing on tax reform, Grassley noted that Congress has not tackled major issues related to charities in more than 40 years.

does not want to investigate this specific case, he thinks the underlying issue needs to be addressed.

“Let me be clear . . . I am not referring to those charities that are on the ground feeding the hungry, sheltering the homeless,” Grassley said. “I’m talking about those charities which there may be no discernible difference between commercial, for-profit entities.”

#### Watchdog of Charitable Groups

Grassley has been the self-appointed watchdog of charities since 2004, repeatedly using the threat of reform legislation to spur the sector into his preferred method of effecting change, namely self policing.

Beginning with the biggest charities in 2004, he forced the sector to come up with a host of guiding principles that address legal issues, governance, financial oversight, and other issues of accountability. Through the years he has taken on the American Red Cross, the Smithsonian Institution, the Nature Conservancy, and American University, focusing more recently on tax-exempt hospitals, university endowments, religious organizations, and tax-exempt bonds.

Virtually no charitable scandal escaped his notice while he was Finance Committee chairman, leading the exempt sector to breathe a sigh of relief when he was forced to step aside from the ranking membership this year because of term limits. His questioning of whether fee-for-service organizations should be included in tax expenditures gave the first indication that, even in his role as a senior member on the tax-writing panel, his interest in the charitable world has not waned.

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**The charitable sector “is an area that is often neglected in the discussion of tax reform.”**

SEN. CHARLES GRASSLEY

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The charitable sector “is an area that is often neglected in the discussion of tax reform,” he said. But since the last examination of charitable organizations, Grassley said the sector has seen tremendous growth, particularly in the fee-for-service segment, with software companies and consulting firms joining hospitals and universities among the ranks of exempt organizations.

In a lawsuit filed by California-based for-profit company SkyRiver Technology Solutions, SkyRiver says it believes OCLC, an Ohio-based nonprofit provider of similar library software services, has created a monopoly, is manipulating the market, is not providing reduced-fee services, and is doing all of this while enjoying a subsidy paid for by taxpayers. While Grassley

#### Seeking Clarity, Not Change in Tax Status

Grassley’s ongoing examination of the nonprofit sector makes many organizations nervous. But he has

made it clear he is not trying to take away their tax exemptions—rather he wants to see whether the services they provide are worth the revenue the government loses from their status.

Part of Grassley's concern, his staff said, is that for-profit companies that provide similar services and programs as nonprofits worry about their ability to compete, a cry echoed by SkyRiver. Some are operating more like businesses and not relying on donations—instead the majority of their revenue comes from charging for services, staff said.

What Grassley ultimately is asking, staff said, is if an entity is going to charge fees for what it is doing, what then distinguishes the nonprofit from the for-profit? Examples cited included sliding-scale fees or a charitable objective in which for-profit entities would have no interest.

Nonprofit hospitals have long been a target of Grassley's inquiries. Since 1969, hospitals have relied on an Internal Revenue Service community benefit standard that allows them to qualify for tax exemption by providing health screenings, medical research, and softer forms of community benefit. Guidance from IRS has been largely nonexistent in this area.

Grassley was successful in adding provisions to the 2010 health care law (Pub. L. No. 111-148) requiring nonprofit hospitals to prove to IRS that they are providing a charitable service to the community in order to keep their tax exemptions (56 DTR G-1, 3/25/10), as well as adding credit counseling organization reforms to the Pension Protection Act of 2006 (Pub. L. No. 109-280). However, his staff said, Grassley wants a look at the entire tax-exempt sector, because there could be other entities that once were clearly nonprofits but that now operate under a core mission that would no longer win tax-favored status.

Rep. Pat Tiberi (R-Ohio), chairman of the House Ways and Means Select Revenue Measures Subcommittee, said he supports examining the sector, but does not want it to become a "witch hunt."

Rather, he said in a March 10 interview, a "legitimate" issue to look at is what nonprofits are doing and whether they are doing it properly under the auspices of the law and the tax code. "Let's not punish all because of the actions of one," said Tiberi, whose congressional district is home to OCLC.

## **Software Company's Dispute Serves as Example**

Arthur Shartsis, outside counsel for SkyRiver, the for-profit provider of online library cataloging services, supports what Grassley would like to do and thinks the government should go further, with IRS examining the charitable sector to see if some entities that fall under the not-for-profit banner should be shifted to the corporate tax regime.

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**"This is a revenue source that Congress needs to pay more attention to . . . , we don't know how many entities are out there whose status was granted for whatever reason way back when and has simply been renewed on an ongoing basis."**

JERRY HALEVA  
SERGEANT MAJOR ASSOCIATES

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At the heart of the dispute between SkyRiver and OCLC is SkyRiver's contention that OCLC has unfairly used its nonprofit status—granted more than 40 years ago—to morph from a cooperative of libraries to a worldwide conglomerate that is acquiring for-profit businesses and monopolizing the library services sector. Additionally, SkyRiver has filed an antitrust lawsuit in Ohio charging that OCLC is monopolizing the market through anti-competitive and exclusionary practices. In December 2010, OCLC filed a motion to dismiss the suit.

As Shartsis describes it, when SkyRiver was formed 18 months ago to create a smaller library cataloging service that would appeal to cash-strapped universities cutting their library budgets, OCLC intimidated schools purchasing those services by raising their fees for access to OCLC's WorldCat interlibrary lending tools.

This was a "clearly anti-competitive thing and intended to signal to the library community that if you so much as dare go to SkyRiver, your access to the ILL would be destroyed with this punitive pricing," Shartsis said in a March 8 interview. "This is the poster child issue of 'what is a charitable organization?' What deserves the subsidy of the United States taxpayer, and does a company which is doing overseas business being subsidized by the United States taxpayer, doing profitable domestic business, and then in turn abusing public institutions, qualify as a tax-free operation?"

OCLC strongly disagrees with SkyRiver's assessment of its business operations, saying there is plenty of evidence to demonstrate that it is still operating within the confines of the tax-exempt regime.

"Since 1967, OCLC has operated as a nonprofit, membership, computer library service and research organization dedicated to furthering access to the world's information and reducing the rate of rise of library costs," OCLC President and Chief Executive Officer Jay Jordan said in a statement provided to BNA. "To do that, we provide an infrastructure and services that benefit library users and libraries, and engage in a variety of programs and activities that benefit the library community and information seekers at large. Every decision made by our board and management is informed by those public purposes for the advancement of libraries."

Jordan called OCLC a "unique organization" in size, scope, and purpose and said it operates at "essentially break-even, using our resources to fund operations and research and development with revenues generated by services provided to member libraries."

In defending the organization's not-for-profit status, he went further, saying that consistent with OCLC's public purpose, it pursues projects for the benefit of libraries and their users, and provides programs that promote libraries and increase their "visibility and viability within their communities."

Finally, Jordan said OCLC's goals "complement those of the libraries and other knowledge institutions we serve—to advance research and education, to organize and preserve knowledge, and pass it on to future generations."

## Congress or IRS to Weigh In?

Shartsis said he does not think Congress needs to change any laws relating to nonprofits. Instead, he thinks IRS should put some energy into examining them.

"There is enough law [that] if the IRS examined OCLC under their legal guidelines I think they would be compelled to conclude that OCLC, for most or all of its activities, doesn't meet the charitable requirements. It's just a commercial enterprise," he said.

Jerry Haleva, who owns Sergeant Major Associates, a consulting firm that represents SkyRiver, said that given the nation's economic realities, IRS should be more aggressive at investigating the nonprofit sector.

"This is a revenue source that Congress needs to pay more attention to because although we've identified one, we don't know how many entities are out there whose status was granted for whatever reason way back when and has simply been renewed on an ongoing basis," Haleva told BNA.

Tiberi disagreed, however, saying he is concerned about the "over-zealousness of the thought of IRS enforcement going after nonprofits just because somebody makes a charge." Congress, he said, would have an obligation to use its oversight capabilities to examine the situation.

## More Information on Benefit's Value

The Joint Committee on Taxation annually releases a list of tax expenditures in the tax code but the tax exemption for nonprofits is not considered a tax expenditure; Grassley is curious about whether it is worthwhile to get a handle on that figure.

"What Sen. Grassley is suggesting is something that has been a background issue for a while," said Roger Colvinaux, a Catholic University law school professor and former counsel with JCT.

Having more information about the value of that benefit could lead to an honest assessment of the extent to which charitable organizations are supported by the tax system, so that when members have to decide where to cut back, they have a better picture of everything that is on the table, Colvinaux said.

Not knowing could be a disadvantage to some charities that do not make much money, because it leaves them open to the argument that they are being supported by tax exemption but the return from the benefit might be questionable, he said.

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JONATHAN TALISMAN  
CAPITOL TAX PARTNERS

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The tax expenditure analysis could show that the value of the tax exemption is not significant, Colvinaux said. It could be that a hospital or other charity might not have much, if any, taxable income because it might operate at a loss, or some of its income might be a non-taxable gift, if the charitable contribution deduction is still around.

"It might not necessarily lead you to say let's start taxing hospitals," he said. "On the other hand, if the number is big enough, it could lead you to say there could be some tax savings here, or ask the question of what public benefit is received in return for tax benefits."

## Call to Examine Whole Code

Jonathan Talisman, who served in the Treasury Department during President Clinton's second term and now is a partner at Capitol Tax Partners, testified at the March 1 tax reform hearing that the entire code should be examined, not just items considered expenditures.

"I actually think the definition of tax expenditure in driving the tax policy and reform is a little bit of a problem. I think you should examine all of these issues, but not necessarily because they're called a tax expenditure," Talisman said.

The point, he said, is to make sure the system is operating as intended. "And if we think that we are getting benefits from providing tax-exempt status to these charities because they're providing social benefits, then that is something that should be OK. And whether it's labeled a tax expenditure or not ultimately shouldn't matter."

Lawmakers examining all of the tax code provisions related to the exempt sector would come across other measures with which these organizations must comply, such as the unrelated business income tax rules that already subject exempt organizations to taxation of business income, Colvinaux noted.

"UBIT is trying to level the playing field between your nonprofit that is doing a taxable business and a for-profit," he said.

If a nonprofit receives tax exemption on its business activities and it is competing with a for-profit that does not get the same tax exemption, then the tax exemption of the nonprofit should be viewed as a tax expenditure, Colvinaux said.

He said it is important to remember that not-for-profit does not mean the organization cannot make

money. "What it means is that the organization is not making money for the benefit of shareholders, it's making money for the benefit of its cause," he said.

### Calculation Makes Some 'Squirm'

Hospitals and universities already are starting to squirm at the possibility of such a tax expenditure calculation.

"If we treat net fees for services charged by tax-exempts as tax expenditures, we will be making an enormous change to our understanding of tax exemption as part of the basic structure of the tax system, as well as face a host of issues," Ellen Aprill, a tax law professor at Loyola University, told BNA March 10.

Aprill questioned if the fee was less than the cost, as is likely to be the case for universities, whether there would be no net revenue once costs were allocated to the income.

"The issue of how costs would be allocated would be crucial," she said. "We already see that in the case of UBIT, tax-exempt organizations seem to make very little money in such endeavors, even though they are undertaken to raise revenue, and such is likely to be the case because of the currently generous rules regarding allocation of costs." These issues would be heightened further should exemption become a tax expenditure, she said.

Hospitals also questioned how the computation would be made, asking if the change would be applied only to the extent of revenue paid to them by virtue of participation in the Medicare and Medicaid programs.

Tax code Section 501(c)(3) organizations already are required to pay federal tax on any income that is unrelated business income; their remaining revenues are derived from, and inextricably connected to, their pursuit of charitable missions, they said. Including them in tax expenditures would be a sea change, they said.

### Putting a Dollar Figure on Tax Exemptions

Edward Kleinbard, who served as chief of staff at JCT from 2007 to 2009, said once Grassley makes a formal request, the tax-estimating committee has no choice but to comply. It might take time, he noted, but it can be accomplished.

The keys to the calculation, Kleinbard said, will be how good IRS data are, along with economic studies, dissertations, and information from trade associations.

"JCT uses all of those kinds of resources and more to try to get an accurate picture of how large the sector is and estimate the profitability of the constituent enterprises," Kleinbard said in a March 8 interview.

Noting that JCT gets thousands of revenue requests each year, Kleinbard said that without talking to JCT's economists and knowing how solid the data are, he could not estimate how long it would take to create the revenue estimate.

Part of coming up with a figure, Kleinbard said, would involve figuring out how profitable the entity would be if it was no longer subject to the tax-exempt regime and therefore availed itself of the credits and deductions of the corporate tax regime. "I don't know the IRS data on tax-exempts well enough to know whether you can deduce anything on profitability from that . . . in the end, it can be done," Kleinbard said.

"The Finance Committee is focused on tax reform. For an intellectually honest debate, it makes sense to get a handle on foregone revenue just as much as we understand incoming revenue," Grassley said in a March 11 statement to BNA. Since JCT "historically hasn't included tax exemption as a tax expenditure, there's a real lack of understanding in that area," he added.

Grassley's former senior chief counsel, Dean Zerbe, said Grassley is asking a fair question. "No one should be afraid of the facts. If you're afraid of the facts and justifying your position, there's something wrong with you," he said.

The first organizations on the list for consideration as a tax expenditure should be hospitals and universities, because those are the entities receiving tax-exempt status that are also providing services for fees, Zerbe, now national managing director for alliantgroup, told BNA.

"When you look at the federal government and overall expenditures, the two massive areas of expenditures in terms of the tax code and raw dollars are higher education and health care," he said.

Zerbe said he thinks the dollar value of the charitable exemption will be eye-popping.

"I don't think members of Congress understand the enormity of the benefit," he said. "It's billions of dollars on the table out there."

BY HEATHER M. ROTHMAN AND DIANE FREDA