



INDEPENDENT  
SECTOR

## House Ways and Means Committee Hearing Focuses on Tax-Exempt Sector Hearing is First in a Series on This Topic

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The House Ways and Means Committee on April 20 held the first in a series of hearings focusing on tax-exempt organizations. This hearing represented a broad overview of this area of the law and was designed, according to Committee Chairman Bill Thomas (R-CA), to establish a foundation and broadly examine the concepts, theories and tax policies pertaining to the tax exempt organizations.

Unlike a similar examination of the tax-exempt sector launched by the Senate Finance Committee, the House panel's hearing did not focus on any specific proposed changes in the rules governing tax-exempt organizations. Chairman Thomas reiterated that the committee is not rushing through any particular reforms in order to create revenue raisers. Furthermore, he stated the committee will hold additional hearings on the tax-exempt sector that will provide more focus on theory and practice of tax exempt entities.

Below is a synopsis of the Ways and Means Committee hearing. All the testimony presented to the Committee can be obtained on the Committee's website [Hearing on an Overview of the Tax-Exempt Sector](#).

The witnesses who testified before the Ways and Means Committee were:

- ◆ The Honorable David M. Walker, Comptroller General, U.S. Government Accountability Office
- ◆ George Yin, Chief of Staff, Joint Committee on Taxation
- ◆ Douglas Holtz-Eakin, Ph.D., Director, Congressional Budget Office
- ◆ John Colombo, Professor, University of Illinois College of Law, Urbana-Champaign, Illinois
- ◆ Frances R. Hill, Professor, University of Miami School of Law, Miami, Florida
- ◆ The Honorable Sheldon S. Cohen, Partner, Morgan, Lewis and Bockius, and Commissioner, Internal Revenue Service, 1965-1969
- ◆ Bruce Hopkins, Attorney, Polsinelli Shalton Welte Suelthaus, P.C., Kansas City, Missouri

**GAO Comptroller General David M. Walker** suggested that it may be time for a comprehensive reexamination of the tax-exempt sector, and raised the following specific issues that may merit such a re-examination.

- ◆ Should the criteria for granting exempt status be reconsidered and do we need as many types of tax-exempt entities?

- ◆ Do we need to modify the model used in overseeing tax-exempt entities to ensure that the tax- exempt purpose is met and that fraud is deterred?
- ◆ What governance standards should apply to the tax-exempt sector, and should particular types of exempt entities have more specific standards?
- ◆ Are the activities of tax-exempt organizations sufficiently transparent to support oversight by the public, media, and governmental agencies?
- ◆ Beyond revoking tax-exempt status and various currently available intermediate sanctions, do we need more intermediate sanctions to deter abuse and enhance accountability while minimizing any damage to those served by the exempt entity?
- ◆ Should certain federal audit and internal control requirements apply to tax-exempt entities, if so, how should the requirements vary according to entities' various characteristics?
- ◆ Is there sufficient transparency over the total compensation package and its justification for executives and other officials at tax-exempt entities?
- ◆ What should be the allowable "lobbying and political" activities in which different types of tax-exempt entities can engage and how should such activities be reported?
- ◆ What are the differences between nonprofit and for-profit entities that perform similar activities? Do these entities provide sufficiently different services to justify their exemption?

In response to the Committee's request, Walker presented in his testimony some general observations about the current state of the tax-exempt sector. Specifically, he cited, the 501(c) tax-exempt sector has grown steadily in reported assets, revenues, and expenses. Between 1998 and 2002 (the most recent year of available data), their reported assets grew 15 percent to more than \$2.5 trillion. Accordingly, the tax-exempt sector comprises a significant part of the nation's economy and workforce. Spending in the tax-exempt sector appears to be about one-tenth of our economy and the paid exempt workforce appears to be comparable in size to some of the largest sectors of the U.S. civilian workforce, such as food and lodging. The sector's significance in the economy might be greater, he noted, because the asset, revenue, and expense data are likely understated. For example, the data do not include all tax-exempt entities under section 501(c) because not all entities are required to file, such as religious entities, and some entities do not file required Form 990.

According to Walker, good governance and transparency are essential elements to ensure that tax-exempt entities operate with integrity and effectiveness in carrying out their missions. Governance facilitates well-run operations that dissuade abusive behavior. Transparency sheds light on entities' practices, which enhances incentives for ethical, efficient, and effective operations and facilitates oversight by the public and others. With recent concerns about abuses within the tax-exempt sector, renewed attention is being given to improving governance practices and expanding and increasing the transparency of the sector's operations.

Walker pointed out that staffing trends and insufficient data have contributed to the challenge of IRS executing its oversight role. The IRS has begun to increase staffing during 2005, which results in 467 FTE to examine the compliance of about a half million section 501(c) entities that file Forms 990. IRS does not know, however, the extent to which these entities comply. Recognizing this, IRS started efforts in 2002 to obtain compliance data for various segments of

the exempt sector but had to suspend most of these efforts to use those resources on higher priorities such as pursuing known types of noncompliance, Walker said. For example, IRS has ongoing special compliance initiatives dealing with critical issues such as excessive compensation and abusive tax transactions involving exempt entities. IRS is also seeking ways to access and better analyze existing data at IRS or elsewhere on exempt entities.

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

**JCT Staff Director George Yin** provided an overview of the size and growth of the tax exempt sector. He discussed the various reasons why organizations have been granted tax-exempt status and gave an overview of some of the common tax laws that feature tax exempt organizations. His testimony also summarized the requirements for exempt status as a charitable organization and reviewed various issues relating to tax exempt organizations.

**CBO Director Douglas Holtz-Eakin's** testimony addressed several issues of tax policy, budgetary and economic issues that arise from entities whose revenues come primarily from selling goods and services that are in direct competition with traditional for-profit organizations and whose income is exempt from federal corporate and individual income taxes. He refers to these business entities as "the untaxed business sector" and outlined three types of the entities: 1) certain for profit institutions - such as nonprofit hospitals that are engaged in business activity and research development partnerships; 2) cooperatives, including credit unions, that differ from other businesses because their clients are their owners; and 3) business enterprises of state and local governments, such as municipally owned utilities that operate on a fee-for-service structure.

According to his testimony, CBO's analysis led to several conclusions, including:

- ◆ The ownership structure of untaxed business entities differs significantly than the conventional for-profit companies because there are no separate claimants that obtain the residual profits, such as stakeholders for example. He points out that the lack of "owners" in the usual sense is what primarily determines how any attempt to tax such entities will affect federal revenues and the economy.
- ◆ Due to the absence of owners and/or claimants, managers of these entities have different incentives from the managers of privately owned businesses. The profit motives a different, for example, instead of returning the profits to the owners, the mangers of the untaxed business entities have incentives to lower prices, increase costs, or increase retained earnings.

- ◆ These entities may not generate as much revenue as initially anticipated because taxation would bolster incentives to reduce or eliminate the entities tax liabilities by using any surplus to reduce prices or increase costs.

**John Colombo's** testimony outlined the rationale that, when looking at exemptions, there are first, charitable organizations and then everything else. He testified that, in general, tax exemption for charities is tied to a concept of improving general public welfare while, for non-charities, the rationale tends to be much more entity-specific. He testified that one of the core problems with tax exemption for charities has been that exemption "just happened" without a much thought as to why the government hands out such tax exemption. As a result, there is this vague notion that exemption is granted to charities because they are beneficial to society, but there hasn't been a specifically articulated rationale that concretely defines what "good behavior" or benefits to society should be awarded the exemption. He concluded that any reform of the rules for tax exemption should include some thought on the overall system for granting tax exemption, particularly for charitable entities, and should consider the possibility of using donations as the core rationale.

**Frances Hill** focused her testimony on the development of a "public benefit framework" that should guide both the process of granting exemptions and the subsequent administration of oversight of the rules that govern exempt organizations. "As exempt entities engage in an ever-broadening range of activities and as the exempt sector grows larger, more dynamic and more diverse, this is an appropriate time to consider the reasons for the exemption and the relationships between these fundamental rationales and current law," she said. According to Hill, "Exempt entities should always operate to provide a public benefit to the beneficiaries they have been organized to serve. Exempt entities should never be treated as the private domain of managers or board members or substantial contributors who treat either the tangible or intangible resources of the exempt organization as something to be used for personal benefit. The challenge is to reconcile useful change with these foundational principles."

**Former IRS Commissioner, Sheldon Cohen**, discussed some of the types of groups exempt under Section 501(c) and raised the point that exempt organizations have been added to the code piecemeal of time. It is time, he said, for Congress to determine whether these exempt organizations still serve their intended purpose. Cohen also raised the question he of whether organizations should be required to apply to the IRS for recognition of their exempt status, which currently is only required of Section 501(c)(3) organizations. Other organizations, he noted, are nonetheless required to file an annual information return, Form 990, but only if they have gross receipts over \$25,000 a year. In practice, the IRS tends to request that any organization filing a Form 990 submit an application for recognition of tax exemption. But because organizations that have gross receipts of less than \$25,000 a year are not required to file Form 990, small organizations may escape the IRS' notice completely or for a long time, he said.

Other issues that he recommended Congress may want to consider included whether the code should be amended to implement penalties against insiders who deal unfairly with all Section 501(c) organizations, rather than the limited current private inurement sanctions that are applicable only to the 501(c)(3) and (c)(4) organizations.

Finally, Cohen pointed to scarce IRS resources and said the question of whether the IRS is devoting enough attention and resources to auditing these organizations depends on budgetary constraints and the need for enforcement in other areas.

**Bruce Hopkins** outlined in his testimony several proposals for the committee to consider, including:

- ◆ Create law spelling out the specific criteria (i.e., what is charitable, educational or scientific) for tax-exempt status.
- ◆ Develop law outlining an organizational test for at least the principal categories of tax-exempt organizations.
- ◆ Spell out the elements of the private inurement doctrine, including the criteria for determining the reasonableness of compensation, lending arrangements, rental arrangements, and sales transactions.
- ◆ Codify a version of the private benefit doctrine, in the process clarifying whether the doctrine applies to tax-exempt organizations other than charitable entities.
- ◆ Amplify the political activities rules, both for charitable entities and other forms of tax-exempt organizations, particularly Section 501(c)(4) social welfare organizations, Section 501(c)(5) labor organizations, and Section 501(c)(6) associations (business leagues).
- ◆ Codify a version of the commerciality doctrine, in the process clarifying whether the doctrine applies to tax-exempt organizations other than charitable entities.
- ◆ Enact rules concerning the use of for-profit subsidiaries by tax-exempt organizations.
- ◆ Enact rules concerning the involvement of tax-exempt organizations in partnerships and other joint ventures.
- ◆ Develop statutory law concerning exempt organizations' use of the Internet, such as for advocacy, unrelated business, and fundraising purposes.
- ◆ Consider, in the context of reporting and disclosure, proposals for a five-year review filing with the IRS, an annual notice requirement for small organizations, and certification as to compliance with the unrelated business rules for large exempt organizations.
- ◆ Consider enactment of federal law corporate governance principles.
- ◆ Consider changes to the law concerning charitable fundraising.

It is likely that both the House Ways and Means Committee and the Senate Finance Committee will continue to examine the rules governing tax-exempt organizations, and legislative changes are possible.