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Organization Trends

When Nonprofits Compete with Businesses

Leveling an unfair playing field

By Neil Maghami

Summary: *Congress is seriously considering changes to the complicated rules that govern the way nonprofits may operate income-generating businesses. While reform won't be simple, this is an area that cries out for greater fairness in the way nonprofits and for-profits are treated under our tax laws.*

Law professor Thomas A. Kelley III says the law should be changed so charities that rely on income-generating commercial businesses to support their work no longer have to contort themselves around rules regarding whether or not those businesses are related to charities' primary purposes.

Tax reform is a perennial topic in Congress, but this year proposals that touch the world of philanthropy and nonprofit activism have been in the spotlight. Plans are afoot to fine-tune various kinds of government-granted tax-exemptions that nonprofits and foundations enjoy. Ahead of its Feb. 14, 2013 hearings on this subject, the House of Representatives' Ways and Means Committee declared that it wanted to hear "from the charitable community before considering any proposals as part of comprehensive tax reform that might impact their ability to obtain the resources they need to fulfill their missions."

A funny thing happened at the hearings. Among the more than 40 speakers testifying was John Palatiello, president of the Business Coalition for Fair Competition based in Reston, Virginia. He dared to make an observation that likely stunned some of his fellow speakers. While praising nonprofits and charities for the "exemplary" work they do throughout the nation, he also drew attention to the problem of "non-profit organizations unfairly compet[ing] with private, for-profit businesses by engaging in commercial activities, but not paying taxes." This results, he said, in an "unlevel playing field for the private sector, particularly small business."

The tax code isn't the sort of topic that usually stimulates passionate discussion, but Palatiello's testimony has helped renew interest in capturing the revenue foregone

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by the U.S. Treasury because nonprofits are generally exempted from paying taxes. (The current tax-exemption rules could be costing the Treasury almost $40 billion, by one estimate.) The specific problem Palatiello zeroes in on, which we will explore in this issue of *Organization Trends*, is how the inconsistent application of existing tax exemption rules allows groups that are immune to the burdens of taxation to compete directly with tax-paying private businesses.

The Problem of Unfair Competition

For years, Congress has discussed the need for better reporting and higher quality data on "the nature, extent and impact of competition between" the non-profit and for-profit sectors, as the Government Accountability Office (GAO) put it in a tax policy report titled, "Competition Between Taxable Businesses and Tax-Exempt Organizations."

This study noted that "IRS officials recognize that better data are needed on the nature and extent of tax-exempt organizations' activities and have initiatives planned or underway to develop better data." The GAO report where these quotes appear was released way back in 1987, in the days when Rep. Dan Rostenkowski (D-Ill.) and Sen. Lloyd Bentsen (D-Texas) led the congressional Joint Committee on Taxation. Both men are now deceased.

The concerns broached by John Palatiello in his testimony are not new, but in a society that prides itself on a sense of fairness, they remain important. Some critics say Palatiello's argument that tax law unfairly creates an un-level playing field between nonprofits and the private sector must mean he opposes the annual Girl Scout cookie sales drive.

In an interview for this article, *Organization Trends* asked Palatiello directly what he thought of that criticism. He laughed, replying that "charitable groups and nonprofits carry out a lot of important activities—all worthwhile and altruistic. That's why they have special treatment under the tax law, such as tax deductibility for the donations made to them by private individuals. But when nonprofits veer from these core activities, and get involved in commercial activities, there are laws that are supposed to apply."

"So we are certainly not suggesting that the Girl Scouts should not be able to sell cookies to raise funds. They are buying the cookies from someone else and re-selling the cookies—they are not selling items in competition with the private sector. Nor are we saying the YMCAs should not offer programs to help at-risk youth, for example," he continued.

"At the same time, charities and non-profit organizations should not be able to carry out commercial activities while using their tax-exempt status to get tax-free donations, avoid paying real estate taxes, and avoid paying income taxes on those commercial activities. These tax-subsidized entities should not be making the same kind of profits on activities that are virtually identical to those of a for-profit, tax-paying business."

"At present, I believe there's evidence that we appear to have an enforcement problem [when it comes to some tax-exempt groups undertaking commercial activities]."

Indeed, Palatiello's February statement seems to have struck a chord with the committee. In a May 6, 2013 report by Congress's Joint Taxation Committee that lists suggestions received for reform to the tax code, mention is made of "the problem of unfair competition between for profit companies and nonprofit organizations conducting an unrelated for profit activity." The same report also makes reference to the concept of "base erosion," which is the idea that the persistence of lucrative tax loopholes can cause a reduction in the overall tax base leading to higher taxes on for-profit companies to make up the difference.

Probably the most egregious and most powerful serial abuser of the non-profit tax exemption is the crony-capitalist, big government lobby AARP. Formerly known as the American Association of Retired Persons, the politically formidable AARP describes itself as a "nonprofit, nonpartisan organization with a membership that helps people 50-plus have independence, choice and control in ways that are beneficial and affordable to them and society as a whole."

What the AARP never admits in public is that it's a mammoth money-making enterprise, with $1.57 billion in assets and revenue of $1.18 billion in 2010, according to its tax returns. The bulk of its riches derives not from membership dues, but from its business agreements with insurance companies and endorsements. Obamacare-boosting AARP gets much of its revenue from selling supplemental Medicare insurance provided by UnitedHealthcare, an insurance company that explains in its promotional materials that it "pays a royalty fee to AARP for use of the AARP intellectual property." AARP income from contracts with UnitedHealthcare jumped from $284 million in 2007 to $427 million in 2009, and then to $670

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million in 2010—a 136% increase in just three years.

The billions of dollars generated by AARP's money-making operations, as well as the extravagant salaries that this mother of all fat-cat advocacy groups pays its executives, are so noteworthy that members of Congress have asked the IRS to review AARP's 501(c)(4) tax-exempt status. (For more on AARP abuses, see *Foundation Watch*, May 2012.)

The Connection Between Macaroni and Nonprofit Tax Law

The issues of tax base erosion and competition between nonprofits and private companies have been around for some time. Palatiello points to a case involving the Mueller Macaroni Co., New York University Law School, and the IRS, as well as a policy innovation known as the "unrelated business income tax." It's worth briefly exploring the story.

Founded in 1867 (and known today as Mueller's Pasta), in 1946 the Mueller Macaroni Co. suffered a tragedy when its owner died. The company had more than 500 employees. An entrepreneur named H.T. Sorg saw an opportunity as the company approached an important management transition. He approached NYU's law school with the idea that it would purchase control of Mueller, so that the profits created by this successful business could support the law school. The idea was received favorably, and in 1947 the purchase was completed.

As an educational institution, the law school was already tax-exempt, and it went to court and successfully argued to have its exemption extended to the pasta company. To quote a legal analysis of the resulting situation, Mueller therefore "did not pay a tax on its profits, thereby enjoying a higher after-tax profit margin than other rival macaroni companies." The university was delighted to have this source of revenue to fund scholarships, new buildings, and so on. In the eyes of some observers, however, this exemption gave the company an advantage over its competitors, perhaps even an unfair one.

In 1950, Uncle Sam's tax men struck back and overturned the exemption. The government claimed in court that while the law school was tax-exempt by virtue of its clear educational mission, this exemption should not extend to the manufacturing and sale of noodles, a product completely unrelated to the law school's educational mission. On appeal, the law school scored a victory of its own after arguing that, in fact, it was consistent with existing law for its tax exemption to extend to Mueller.

The novelty of the case attracted wider attention, including a hearing that year by the House of Representatives' Ways and Means Committee. One member of the committee warned (perhaps slightly tongue-in-cheek) that unless action was taken, "Eventually all the noodles produced in this country will be produced by corporations held or created by universities . . . and there will be no revenue to the Federal Treasury from this industry. That is our concern." The comment may have been in semi-jest, but the loophole was no laughing matter.

Academics who study the evolution of U.S. tax law around this issue go back to the decision by Congress in 1950 to impose an "unrelated business income tax." This so-called UBIT allows for the taxation of businesses operated by nonprofits, the profits from which were unrelated to the nonprofits' official tax-exempt mission.

UBIT has evolved over time. A nonprofit will not automatically lose its tax-exempt status for collecting a portion of its income through an unrelated business. Rather, the IRS will scrutinize what proportion of its total income derives from sources unrelated to its tax-exempt purpose, and whether the activity producing that unrelated income "contributes importantly to the tax exempt purposes of the organization" (according to nonprofit law specialists Hurwit & Associates) and take action as necessary.

Complexity and More Complexity

The application of these rules can become very complicated. To quote one example cited by Hurwit, imagine a nonprofit folk art museum that sells books on folk art in its museum shop. At the time of its tax filings, it declares (correctly) the resulting profits to be income related to its tax-exempt mission of preserving works of folk art. But if the same museum were to sell books on astronomy in the same museum shop, this income would be unrelated to its main tax-exempt purpose, and therefore taxable.

The health club industry presents another example of how problematic these rules can become. The Boston-based International Health, Racquet & Sportsclub Association (IHRSA) has long argued that nonprofit organizations offering the use of exercise rooms and fitness equipment to paid members "should pay taxes on revenue generated from their fitness facilities when the majority of individuals being served are not in a truly charitable class."

IHRAS isn't shy about competition "as long as the playing field is level and the game fair." From their perspective, "tax exemption is a powerful tool that tax-exempts use to compete directly with taxpaying businesses for identical customers." Hence their long-standing support for "better reporting and disclosure on what tax-exempt organizations are actually doing and collecting." With clearer "legal principles relating to charitable institutions that may be applied within an analysis of whether a particular tax-exempt fitness center is eligible for a tax-exemption," the IRS will have an easier time enforcing admittedly sophisticated rules, according to IHRSA.

Ending automatic renewal of an organization's tax-exempt status is another IHRSA-backed idea: "As an organization evolves over time, it should have to prove on a regular basis that its efforts are directed at the underprivileged, not the well-to-do."

Another UBIT option that IHRSA supports is to allow IRS officials more leeway to tax just those activities of a tax-exempt group "that are generating business income" and unrelated to its primary mission, while leaving the rest of its mission-driven activities and operations untaxed.

In his February testimony on the unintended consequences resulting from the lack of enforcement around rules related to tax exemptions, Palatiello argued that it's time to re-think certain aspects of UBIT. He highlighted five suggestions in particular:

1. The Department of the Treasury should be required to provide an annual public estimate of revenues lost through avoidance of UBIT.

2. The Treasury Department should provide an official public estimate of potential new revenues to the Treasury if the UBIT law were expanded to require all commercial operations of non-profits to pay their fair share of taxes.

3. The law should be modified or new legislation introduced that lets the Treasury Department collect taxes that insures that all commercial activities of nonprofits are taxable. The IRS has only one option today – that is to revoke an organization's charter to do business. They simply can't administer the law the way it is.

4. There should be standards, oversight and transparency into the actual extent of assistance to charity and needy cases by non-profit and tax-exempt entities.

5. Non-profits entering a commercial undertaking should be required to form a for-profit subsidiary that must obey all the same laws and regulations that apply to for-profit enterprises.

Palatiello provocatively illustrated his final point by drawing on what he called the "Yellow Pages" test: "If an activity is available from a private sector company found in the Yellow Pages, that activity should not be a responsibility of a nonprofit and, instead, should actually be performed by a tax-paying private sector firm."

Confusing Tax Code Is Not Nonprofits' Fault

One school of thought argues that further efforts to massage the tax code and its treatment of unrelated business income flowing to nonprofits are pointless, and that larger-scale change is required.

Thomas A. Kelley III, a University of North Carolina at Chapel Hill law professor, is sympathetic to those leaders in the nonprofit sector who find the debate over unrelated business income perplexing. In a 2005 article on various aspects of U.S. nonprofit law (including UBIT), Kelley notes that this complex, confusing situation is not the fault of nonprofits and charities; rather, it "has deep historical roots in the Anglo-American legal tradition." On the one hand, he says, charities are expected to provide aid to those in need; but they are also expected to "efficiently [produce] socially beneficial results that will lighten the burdens on our government."

Kelley argues for updating the legal architecture around charities that rely on income-generating commercial businesses to support their work, so that they no longer have to contort themselves around rules regarding whether or not those businesses are related to charities' primary purposes. Rather, there would be a special category of charity that would be subject to a simple "operational test [of whether] the profits generated by their enterprises were in fact going to serve the poor." If a charity wants to "embrace entrepreneurial solutions to pay [its own] way," Kelley writes, then they should be allowed to do so, and the relevant laws should be updated so that these rules can be applied precisely and consistently. Kelley says this is the only fair solution to the problem, and that the government has "a moral, if not legal, obligation to get our legal system off [the] backs" of charities.

2013: The Year of Tax Exemption

As we've seen, the issue of how much revenue the U.S. Treasury fails to capture by allowing various kinds of organizations to operate on a tax-exempt basis has come up repeatedly in Washington, D.C. policy discussions this year. In April, for example, the IRS released a report summarizing a multi-year examination of the college and university sector, which enjoys tax-exempt status.

The project began in 2008. The final report notes that just under 10 percent of the 400 randomly selected colleges and universities examined were found to have compliance issues, including their unrelated business income. The colleges and universities compliance project includes examinations of how those institutions report income and expenses related to such business activities as "sports management agreements, facility rentals, arenas, food service, golf courses, hotels, recreation centers and programs, parking lots, commercial research, and bookstores"—that is, revenue-generating activities unrelated to these institutions' educational mission.

In July, Diana Furchtgott-Roth, a senior fellow at the Manhattan Institute for Policy Research, wrote about the issue of tax-exempt worker centers (designated as 501(c)(3) tax-exempt organizations) that hold "demonstrations and [engage in] lobbying" to push a political agenda—"activities that are inconsistent with 501(c)(3) status." She writes that more than 200 of these centers exist across the country, and she suggests they have been misclassified by being allowed to operate as 501(c)(3)s, which exempts them from regulations requiring financial transparency to which labor unions, for example, are subject. The federal and state governments could be missing out on nearly $85 million annually because of this misclassification, Furchtgott-Roth believes. She suggests the National Labor Relations

Board needs to step in to help correct the situation. (For more on worker centers, see the Sept. 2013 *Labor Watch*.)

On Sept. 9, Bloomberg News noted that even the tax-exempt status of professional sporting juggernauts like the NFL, PGA, and National Hockey League are under congressional scrutiny. Sen. Tom Coburn (R-Okla.), for example, has taken to Twitter to question whether the 501(c)(6) designation held by these groups should continue. Coburn has been vocal on this issue for some time. In 2012, he wrote:

> Major professional sports leagues should no longer be eligible for general federal tax exemption. Removing them from federal nonprofit status may also benefit states and localities, which lose out on much needed revenue. For example, the NFL may have lived every taxpayer's dream at this year's Super Bowl in Indianapolis. According to the *Indianapolis Business Journal*, "Hotels and restaurants [did not tax] National Football League employees.… The NFL [used] its tax-exempt status as a 501(c)(6) to avoid paying taxes, in addition to fuel, auto rental and admissions taxes."
>
> Hardworking taxpayers should not be forced to provide funding to offset tax giveaways to lucrative major professional sports teams and leagues. Based on publicly available information about the NFL and NHL alone, barring major leagues from using the non-profit status may generate at least $91 million of federal revenue every year.

There has also been a slew of stories about how "left-wing nonprofits such as ACORN's successor groups are flouting federal law by spending tax-exempt funds for partisan political activities, using 'fiscal sponsorship' to shift those funds through a shell game of various activist groups," in the words of Capital Research Center president Terrence Scanlon. While there is much more to be said on this topic, it would be outside the intended scope of this article. We will observe only that these allegations of abuse merit immediate attention from the relevant authorities.

Conclusion

In a 1999 article for the Capital Research Center, Patrick Reilly welcomed the idea that nonprofit leaders might embrace for-profit activities, "as long as a nonprofit's primary private activity continues to warrant tax-exemption." Like John Palatiello, he also warned about the danger of "self-identified nonprofits that engage in business practices [that] may lead to unfair competition with legitimate businesses." (See "Nonprofits in a For-Profit World," *Organization Trends*, July 1999.)

Reilly also warned against the heavy hand of "intrusive government regulations" as a solution to the problem. And in that admonition, Reilly made a point Congress should keep in mind in its current deliberations. It would benefit neither the nonprofit sector, nor the for-profit sector, if the lines between the two became practically invisible by wanton non-enforcement of the relevant tax rules. At the same time, drawing an unduly rigid line between the two through regulation would risk inviting an unwelcome level of government intrusion into and surveillance of nonprofit groups' activities.

There's no need for a costly witch hunt or for a repeat of the unprecedented war that federal tax officials have been waging against Tea Party groups over their tax-exempt status.

In that respect, John Palatiello's five recommendations represent a middle course between these two extremes. Palatiello has identified some interesting ways to make the tax code fairer to both nonprofits and for-profits. That was not a topic that most of his co-presenters at the Feb. 14 congressional hearings wanted to explore. The status quo appears to be just fine, from their perspective.

The Ways and Means Committee displayed an admirable degree of open-mindedness by inviting Palatiello to testify. Assuming the committee maintains this open-mindedness, it will surely give his five suggestions full and fair consideration as it prepares to make further proposals regarding changes to the tax code.

Neil Maghami is a freelance writer and frequent contributor to CRC publications.

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BrieflyNoted

Operatives of the disgraced radical group **ACORN** continue to advise the **Obama** administration and guide its far-left policies years after the group filed for bankruptcy. Good-government group **Judicial Watch** discovered through Freedom of Information Act (FoIA) requests that former **ACORN Housing** official **Bruce Dorpalen**, now head of the **National Housing Resource Center**, has been meeting with and advising senior Obama administration officials on housing policy, the Breitbart News website reports. ACORN Housing legally changed its name in 2010 to **Affordable Housing Centers of America** (AHCOA) and then closed its doors for good last year.

"How is it, after the scandals of ACORN and its contribution to the housing crash, that this organization's former leadership is still able to guide federal housing policy?" asked Judicial Watch president **Tom Fitton**. The Housing Resource Center's office is in the same space used for years by ACORN's Philadelphia headquarters.

Thanks to a separate FoIA request, Judicial Watch discovered that educational materials the Obama administration uses on the military characterize conservative organizations as "hate groups" and Tea Party supporters as potentially dangerous extremists. The 133 pages of lesson plans and PowerPoint slides released by the **Air Force** came from a 2013 Defense Department diversity training center "student guide" entitled "Extremism." It is "striking that some of the language in this new document echoes" language the IRS used to target conservative and Tea Party nonprofits for heightened levels of scrutiny, Fitton said.

Funding for clinical cancer trials and other life-saving research under the **National Institutes of Health** was suspended during last month's partial federal government shutdown, but taxpayer funds kept flowing to TV's Cookie Monster, Fox News reports. On the first day of the fiscal standoff, the U.S. Treasury handed over $445 million to the **Corporation for Public Broadcasting**, thereby funding "PBS Newshour," **NPR**, and "Sesame Street." **Media Research Center**'s director of media analysis, **Tim Graham**, observed that in the weeks leading up to the shutdown, **PBS** hosted two "very friendly" interviews with President Obama.

Despite the shutdown, the Obama administration last month allowed its radical allies who support immigration amnesty to hold a large rally on the National Mall in Washington, D.C., even though the administration had closed the Mall to the general public at the time. The "Camino Americano: March for Immigration Reform" event featured Democratic politicians and was co-sponsored by **CASA de Maryland**, **Center for Community Change**, **SEIU**, **AFL-CIO**, and **AeroMexico** airlines.

The **Council on American-Islamic Relations** (CAIR), reportedly a front group for Egypt's **Muslim Brotherhood**, conceals donations from Islamist governments overseas by maintaining a complex web of shell organizations, according to the Daily Caller news website. A shady social welfare and lobbying organization recognized under 501(c)(4) of the federal tax code, CAIR has reportedly been "washing" millions of dollars from oil-rich nations without disclosing the donations to the U.S. government, as the law requires. For example, court documents indicate the group, which has ties to the terrorist groups **Hamas** and **al-Qaeda**, has recently received $405,000 from the government of **Qatar**, $199,980 from the **Kingdom Holding Company of Saudi Arabia**, and $219,563 from the U.S. embassy of the **United Arab Emirates**.