

**ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)**

**EXEMPT ORGANIZATIONS ANALYSIS AND RECOMMENDATIONS REGARDING
UNRELATED BUSINESS INCOME TAX COMPLIANCE
OF COLLEGES AND UNIVERSITIES:**

**CONCURRING, DISSENTING, AND
A SIXTH RECOMMENDATION FOR AN ECONOMIC, FINANCIAL, AND
STATISTICAL STUDY OF IRS STATISTICS OF INCOME (“SOP”) AND RELATED
DATA TO INFORM AND GUIDE IRS POLICY AND PRACTICES FOR NONPROFIT’S
UNRELATED BUSINESS INCOME PRACTICES AND UNRELATED BUSINESS
INCOME TAX TO INCLUDE CONSIDERATIONS OF ALTERNATIVE TAX
REGIMES**

**Marty Martin, JD MPA
Martin Law Firm
Raleigh, North Carolina**

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I. Executive Summary

At the end of the ACT's process, an ACT member is left with a choice to accept, concur, or dissent from recommendations contained within its report. Throughout the process ACT members learn from one another, as well as from the IRS. They seek to influence and persuade their fellow members and the IRS on topics and issues upon which reasonable minds may and often will differ based on legal, personal, policy, and professional reasons.

In past years the ACT incorporated members' comments consistent with these three choices. However, this year the members were unable to reach full consensus or accommodation regarding these comments. Therefore, I write to concur, dissent, and offer an additional recommendation to accompany the Exempt Organization's subcommittee's report and recommendations.

As an ACT member we are in agreement for Recommendation 5 (Leverage electronic resources) which I substantively wrote for the report.

As an ACT member and subject to the following comments and recommendation as applicable, I concur in part with the Recommendation 1 (Commerciality and Commensurate) to the extent these inquiries may result in the removal or diminution of these constraints.

As an ACT member I respectfully dissent from the report's Recommendations 2 (Allocations), 3 (Revenue ruling), and 4 (Form 990T) and do not support the adoption of these recommendations in the absence of a substantive financial, economic, and statistical valid analysis of unrelated business income and unrelated business income tax for the reasons expressed herein.

As an ACT member, I make the following additional recommendation:

Using IRS Statistics of Income ("SOI") and other relevant data, the IRS should engage in an economic, financial, and statistical study of IRS Statistics of Income ("SOI") to inform and guide IRS and the U.S. Department of the Treasury's Office of Tax Policy to consider policy and practices for the nonprofit's sectors unrelated business income practices and unrelated business income tax to include considerations of alternative tax regimes.

II. Recommendation

“Policymakers and the public alike have a perception that ‘charity’ means selfless dedication to the public good. When that perception is shaken, a political reaction to stop the unseemly behavior and resolve the cognitive dissonance is likely.”¹

“We have met the enemy and it is us.”
Pogo

ACT Role and Responsibility

The ACT’s responsibility is to “suggest improvements through a yearly final report” to the IRS and to others through its annual public report.² Once they receive the report at the June public meeting, the IRS is free to accept, reject, or modify the recommendations. ACT projects generally are tailored in way that, if it chooses, the IRS may enact ACT recommendations through their administrative and regulatory processes. Through our work ACT members address this country’s senior IRS leadership, the nonprofit sector, and the public on IRS related issues directly and indirectly affected by the tax laws, policies, and procedures. While neither the IRS nor the ACT can change tax law directly, there are issues which suggest a change in the law. In those instances it is appropriate to recommend the IRS study the issue and refer it to the appropriate agencies which seek to affect policy and law. This year’s topic is one which clearly falls within this category.

ACT members are expected to and in fact do ask challenging and provocative questions of the IRS before offering their recommendations privately in the course of our ongoing discussions and publicly through its report. To their credit the IRS leadership and personnel demonstrate remarkable engagement and a healthy and supportive appreciation for these inquiries. They make available personnel and resources to inform the ACT’s inquiries and provide information consistent with the legal constraints under which they operate regarding specific taxpayer information. They encourage and facilitate a healthy dialog among the service and the ACT by which all learn. We share a common goal to improve the IRS, and in turn the nonprofit sector and the public. On occasion we may disagree on the means, but not this underlying goal.

Colleges and University Compliance Project Reports

The IRS Colleges and University Compliance Project reports (collectively, “College and University reports” or “reports”) were sent initially to a “representative sample” of 400 colleges and universities. It appears this representative sample was not selected from a statistically valid

¹Ethan G. Stone, “Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax”, , *Emory Law Journal*, Vol. 54, Number 4, Fall 2005, page 1478. This law review article provides an excellent background and interesting discussion of the adoption of the UBIT statutes.

²“Advisory Committee on Tax Exempt and Government Entities (ACT)”. [http://www.irs.gov/Government-Entities/Advisory-Committee-on-Tax-Exempt-and-Government-Entities-\(ACT\)](http://www.irs.gov/Government-Entities/Advisory-Committee-on-Tax-Exempt-and-Government-Entities-(ACT)), last accessed April 5, 2014.

random sample of the entire population of colleges and universities or from a statistically valid random stratified sample of all colleges and universities. Significantly, this study also did not draw from statistically valid sample or stratified sample from a potential total population of approximately 43,520 UBI returns filed in 2006 by tax exempt organizations³

As such, the interim report considered 400 colleges and universities (.009%) and the final report reviewed only 34 (.0007%) organizations from among the total potential population of 43,520 UBI returns. The reports excluded considerations for all other types of tax exempt organizations engaged in UBI to include a wider range of 501 (c)(3) organizations, as well as, several other types of tax exempt organizations [e.g. (c)(4), (c)(5), (c)(6), (c)(7), and (c)(8) tax exempt organizations] which also report UBI.

The final report looked at only 34 organizations which were specifically selected and targeted for review through a “triage” system.⁴ They were selected from among “those respondents having the greatest potential for compliance issues with respect to UBI or compensation. *** They are not a representative sample of all colleges and universities, and readers should not make assumptions about the UBI and compensation practices of other colleges and universities based on these examination results.”⁵

The College and University study and compliance reports were completed without any input or assistance from the IRS Statistics of Income (“SOI”). Even with their significant statistical limitations, these reports serve a purpose to highlight the need and appropriateness for the IRS and the Office of Tax Policy’s to consider tax and related policy for organizations generating unrelated business income through unrelated business activities.

As one speaker at the 2014 nationally recognized Georgetown Law School continuing legal education conference asked during a panel discussion on UBI and UBIT:

“Given the large number of options for the Service following up on the Colleges and University study—audit all universities, do a similar study for another segment of the EO community, develop audit indicators based on results, etc.—what will the Service do next?”⁶

The College and Universities’ reports envisioned a follow up study. To date no other study has occurred.

³ “SOI Tax Stats - Exempt Organizations' Unrelated Business Income (UBI) Tax Statistics. Number of Returns, Gross UBI, Total Deductions, and Tax Items. 2006 and 2010. <http://www.irs.gov/uac/SOI-Tax-Stats-Exempt-Organizations'-Unrelated-Business-Income-UBI-Tax-Statistics>, last accessed April 27, 2014.

⁴ Judith Kindell, Senior Technical Advisor, EO, IRS. Comments during “Hot UBIT Topics” presentation at “Representing and Managing Tax-Exempt Organizations”, Georgetown Law Continuing Education, Washington, D.C., April 25, 2014.

⁵ IRS, “Colleges and Universities Compliance Project Final Report”, p. 10, http://www.irs.gov/pub/irs-tege/CUCP_FinalRpt_042513.pdf, last accessed April 28, 2014.

⁶ James K. Hasson, Jr., Partner, Sutherland, Asbill & Brennan, LLP. Comments during “Hot UBIT Topics” presentation at “Representing and Managing Tax-Exempt Organizations”, Georgetown Law Continuing Education, Washington, D.C., April 25, 2014. This was the first of two interesting questions at the end of his panel presentation at the Georgetown conference in which he broadly asked about study and inquiry into the area of UBI and UBIT.

Good policy is informed by good data analysis. To date neither the IRS Exempt Organizations (“EO”) nor the Department of the Treasury’s Office of Tax Policy have used the IRS Statistics of Income’s (“SOI”) capabilities to analyze UBI and UBIT in response to these reports. While the ACT’s overall efforts this year may be considered a first pass at this conversation, it is a conversation which needs fuller development before focusing on specific solutions. For that reason the IRS should engage in a significant economic, financial, and statistical valid analysis of SOI and other data to inform and guide IRS policy and practice regarding the nonprofit sector’s UBI and IBIT.

The Question “What If?”

“What if?” can open the space for discussion and serious consideration of alternatives to the “what is” status quo. Asking “What if?” invites and permits inquiry for alternatives to “what is.” The question challenges the underlying and the often unquestioned assumptions which emerge over time to create the corresponding patterns of habit and cultures by which individuals live and organizations work.⁷ It permits and invites others to envision and begin to create alternatives. “What if?” is an invitation to consider a different future.

“What if” also can be an uncomfortable inquiry for those institutions and individuals invested in the “what is” status quo. When confronted by this type of inquiry, there often may be significant resistance seeking to justify or maintain the status quo and at the same time engendering resistance to further inquiry or proposals that question or offer alternatives. When this occurs there are many different rationales and means utilized. Predictably this often may include efforts to censor individuals who question “what is.”⁸ By its very nature, changes in tax law engender

⁷ See generally, Edgar H. Schein, *Organizational Culture and Leadership 4th Edition*, (John Wiley & Sons. San Francisco, California, 2010).

⁸ These comments were excluded from the official published 2014 ACT Report of Recommendations.

The ACT works through its several subcommittees which for all practical purposes work in silos on their respective topics. My Exempt Organization subcommittee colleagues were not substantively prepared or willing to engage in this inquiry though they were present at meetings and calls throughout the year when I raised these questions. As a result, my colleagues did not include these comments and recommendation as part of the overall Exempt Organization subcommittee’s report which they submitted to the IRS for publication. This was surprising given there are four other lawyers on this committee for whom a majority and dissenting court opinions or majority and minority reports in other contexts are a matter of course. Significantly, in previous ACT reports disagreements and dissents among its members have been incorporated in the final ACT report.

Following their actions I submitted an earlier version of these comments in time to accommodate the IRS publication process and deadlines. When informed by IRS personnel during this process they still would not be published, I subsequently wrote directly to the Director, Exempt Organization, then to the TEGE Commissioner, and lastly to the IRS Commissioner seeking their publication. In the end the IRS refused to include them as part of the official 2014 ACT Report of Recommendations.

Because the ACT presents its report in a public hearing, the IRS is required to accept written comments from the public. I submitted these comments through this process. These comments along with the year’s minutes, notes, and the official report then are compiled and ultimately sent to government archives. There will be a very limited opportunity to speak at the public hearing. But at the public meeting’s conclusion, the “official” printed report will be distributed and then published on the IRS website as a PDF file. Irrespective of what may be said or occur at this public meeting in response to this document, the official IRS public report will contain no mention or discussion of

this type of response, particularly in an area of law substantively unchanged for more than six decades. Thoughtful leadership understands, accepts, and seeks to integrate and use a “What if?” inquiry and analysis.

As a different way to frame my inquiry beyond the traditional means used by my colleagues and to generate alternative perspectives and thought in this area of policy and law, I often asked “What if?”

To both the consternation and amusement of my colleagues, I framed the following challenging and, as it turned out, provocative questions:⁹

“What if?” the tax code imposed a flat tax on gross UBI (i.e. no deductions, depreciation or credits) instead of the current tax structure?¹⁰

If so, is this tax regime or another easier, more effective, and more efficient to administer for the IRS, nonprofit and business organizations, and the public while over time increasing capital to the nonprofit sector?¹¹

At the core of this “What if?” inquiry is an underlying broader question which seeks to determine whether there is a better way forward for the IRS, the nonprofit sector, and the public through UBI and UBIT tax and related policies. This is a policy area which has not been substantively considered in more than sixty four years.

Some Tax History

The first corporate income tax statutes were the Wilson Gorham Tariff Act of 1894 and its successor, the Revenue Act of 1909. These statutes provided the earliest statutory references that “established the requirement tax-exempt charitable organizations operate for charitable purposes.” **Significantly, these statutes also imposed a flat 2% tax on corporate income tax**

this dissent, related comments, or recommendation. Yet the report will include my name as a member of the subcommittee and will leave future readers erroneously to believe there was consensus on all recommendations.

⁹ IRS responses varied depending upon an individual’s position, duties, and in some instances when my inquiry occurred during the course of the year. Their responses ranged from a very positive and enthusiastic consideration and engagement to only a single instance of a refusal to respond to these questions. In some instances, as discussed elsewhere in these comments, there simply wasn’t sufficient opportunity to engage in substantive discussions.

¹⁰ See, Robert E. Hall and Alvin Rabushka, *The Flat Tax* (Hoover Institute, Stanford University, 1986), <http://www.hoover.org/publications/books/8329>, last accessed April 5, 2014. See also, J.D. Foster, PhD, “The New Flat Tax: Easy as One, Two, Three” , <http://www.heritage.org/research/reports/2011/12/the-new-flat-tax-easy-as-one-two-three>, last accessed April 20, 2014. There are many other commentators who have written on the concept of a flat tax with variations on different aspects of the overarching concept. A flat tax is generally recognized to be an easy, efficient, and effective tax which helps to increase economic efficiency and productivity. Commentators vary on the rate of a flat tax, but generally agree it can be significantly below the current rate.

¹¹ For example, “What if” there was a flat rate today? Based on SOI’s 2010 UBI statistics released in March 2014, a flat tax rate of less than 4% applied to gross UBI will yield the same amount of UBIT as was paid in 2010 (i.e. “revenue neutral”). While the distribution and amounts paid will vary across those organizations reporting UBI, a flat tax’s wider distribution and/or at a lower tax rate confirms the saying “Many hands make light work.” It may also improve productivity.

rate.¹² (Emphasis added.) From this flat tax rate, the tax rate and code has fluctuated throughout the code's history.¹³

From the adoption of these statutes the slowly emerging nonprofit sector for the first half of the 20th century operated with an understanding that it could engage in business activities. Income derived from these business activities looked to the “destination of income” as the test for whether income was taxable or tax-exempt.¹⁴

In 1950 Congress enacted the UBIT to constrain tax-exempt organizations when they operated through business entities. “Much of the growth in the number of charities in the years after the end of World War II was attributed to the increase in individual income tax rates during and after the war, which led some tax planners, seeking ways to reduce taxes, to manipulate charitable organizations for private purposes.”¹⁵ At that time some of these activities simply did not comport with policymakers' expectations about what nonprofits should do. While Congress imposed the UBIT on these activities, it was clear there were tax promoters who sought to take advantage of the tax code for private gain whose abuses were not addressed directly by this legislation.¹⁶

However, for the legislators who enacted UBIT in 1950,

(t)he UBIT was justified then and has been justified since as a measure to protect taxable businesses from unfair tax-exempt competition and to protect against erosion of the tax base by rapacious charities buying or crushing taxable businesses. Below the surface, however, its primary function has been political symbolism. It deters charities from engaging in activities that do not comport with the policymakers' perceptions of the type of activity subsidized by the charitable exemption.

... In other words, the UBIT protects the symbolic meaning of the exemption, rather than an instrumental policy goal.¹⁷

Since the adoption of these statutory provisions in 1950, competitive business strategy has emerged across many different domains for both for-profit and tax-exempt organizations.

¹² “A History of the Tax-Exempt Sector: A SOI Perspective.” *Statistics of Income Bulletin Winter 2008*. <http://www.irs.gov/pub/irs-soi/tehistory.pdf>, pgs. 2- 3. Last accessed April 2, 2014.

¹³ See, for example, “Federal Corporate Income Tax Rates, Income Years 1909 -2012.” Tax Foundation. <http://taxfoundation.org/article/federal-corporate-income-tax-rates-income-years-1909-2012>. Last accessed April 2, 2014.

¹⁴ See, *Trinidad v Sagrada Orden de Predicadores*, 263 U.S. 763 (1924).

¹⁵ Marion R. Fremont-Smith, *Governing Nonprofit Organizations*, (The Belknap Press of Harvard University Press, Cambridge, Massachusetts, and London, England, 2004), p.60.

¹⁶ See generally, Stone, *supra*. The problems of tax fraud, as well as inurement and private benefit, continue today even for nonprofits to include those which do not engage in UBI. This is an area where statutory and legislative action can address the relevant constraints and penalties on senior managers, board members, and other disqualified persons and entities. In the meantime, federal and state authorities must try to enforce these constraints with increasingly limited resources.

¹⁷ Stone, *supra.*, pg. 1478.

Nonprofits and businesses readily incorporate and adapt strategies and operating methods from one another. University schools of business, government, law, and public policy now explicitly train the next generation for leadership across all three sectors.

These strategies may include sophisticated legal and accounting tax driven strategies. They may provide for competitive advantage by adversely affecting competitor(s) and minimize, if not eliminate, an organization's taxes. Drawing from one example contained within the report, nonprofits, like business corporations, now may use off-shore international foreign blocker corporations to avoid taxes. From the corporation's perspective this may be considered a "good thing." But this tax strategy even for businesses, like others, is coming under scrutiny.¹⁸

Alternatively, these strategies may also be considered a "bad thing."¹⁹ They may generate negative economic externalities which require others to pick up their cost. Thus, legal tax avoidance strategies, as well as those which aren't, result in economic inefficiencies and distortions; increase the cost of compliance by the nonprofit and business organizations; result in inefficient or unnecessary cost of enforcement and regulation by the IRS and other local, state, and federal government entities and lost tax revenue; and, cumulatively, significantly shift the overall tax burden to other taxpayers in the economy.

Changes in the Nonprofit Sector Since 1950

Today's vibrant nonprofit tax-exempt sector engages in diverse business activities through the sale of many services and products; the development and operation of businesses; exploitation of intellectual property; sophisticated investment strategies like the use of off-shore international blocker corporations; and a multitude of other "business-like" activities which largely were unknown and likely unforeseen to legislators who enacted the original UBIT statutes and the subsequent IRS regulations.

Social entrepreneurs and emerging business organizational forms to include emerging legal entities like L3C limited liability companies and benefit or flexible purpose corporations, as well as certification efforts like B Corps, are some examples which now challenge the boundaries between for-profit and nonprofit efforts seeking to address underlying social problems, issues, and challenges. Government is now experimenting with social impact bonds as a means of financing social impact which includes government, business and nonprofit service providers, as well as, business and social investors who may be seeking different returns on their capital by focusing on risk and results through this financing. "What if?" these efforts lead to policies

¹⁸ See for example, Christopher Matthews, "Anatomy of a Tax Cheat: Caterpillar grilled in Senate hearing." *CNN Money*. April 1, 2014, <http://finance.fortune.cnn.com/2014/04/01/caterpillar-tax-avoidance-senate-hearing-shows-how-they-reduce-taxes/>, last accessed April 6, 2014. For states, see, Mark Niquette, "U.S. States Target Corporate Cash Stashed Overseas", *Bloomberg Businessweek*, April 17, 2014, <http://www.businessweek.com/articles/2014-04-17/u-dot-s-dot-states-target-corporate-tax-shelters-overseas#r=nav-fs>, last accessed April 18, 2014.

¹⁹ See for example, Steven Rattner, "End Corporate Taxation", *The New York Times*, May 3, 2014, http://www.nytimes.com/2014/05/03/opinion/end-corporate-taxation.html?_r=0, last accessed May 3, 2014. "But these days, tax avoidance feels like a full-fledged business strategy, with American citizens as the loser." Rattner's op-ed is consistent with the arguments herein. However, these comments were written before his publication and already had been submitted to the IRS as a "final" draft. However, an unexpected editing inquiry from the IRS on May 2, 2014 enabled Rattner's op-ed comments to be incorporated into these comments.

which enable the creation of capital markets for social investors and investment equivalent to the current stock exchanges?

Indeed, the challenge to do social good is developing into a core competitive strategy by which for-profit businesses now may compete directly with nonprofit organizations, as well as other business entities.²⁰ Arguably, “(s)ocial entrepreneurship, which today is rather equally balanced between for-profit and nonprofit businesses, is likely to increasingly gravitate to the latter in the coming decades as the social economy embedded on the Collaborative Commons continues to gain ground on the capitalist marketplace.”²¹

Since the 1980’s generally in response to changing limitations in government and other philanthropic funding mechanisms, nonprofit organizations increasingly have been “forced to focus energy on marketing themselves and their services so that they could compete effectively against rival nonprofits as well as an increasing number of for-profit providers.”²² By compelling them explicitly to move into the marketplace,

(w)e should not force charities to embrace the marketplace and pay their own way, and at the same time leave in place legal doctrines that punish them for doing so. If we as a society are going to force charities and the people they serve to fend for themselves, then we have a moral, if not legal, obligation to get our legal system off their backs.²³

Nonprofits, like any economic or business entity, engage in UBI activities because they seek alternative access to capital in order to enhance and increase their capacity to fulfill their exempt missions which traditional funding constrains despite growing demand for their services.

Whatever the basis in 1950 for the original explicit and implicit rationales for UBIT and, more importantly, now for today’s underlying assumptions about what a nonprofit organization “should” be or do, these assumptions may constrain and often do not comport with today’s reality for many nonprofit organizations and their need for capital to address compelling social problems.²⁴

“Americans rely on nonprofits for food shelter, education, healthcare and other necessities, and everyone has a stake in strengthening this social infrastructure. ... The

²⁰ See, Michael E. Porter and Mark R. Kramer, “Strategy and Society: The Link Between Competitive Advantage and Corporate Social Responsibility”, *Harvard Business Review*, December 2006; “Creating Shared Value”, *Harvard Business Review*, January-February 2011; and “The Competitive Advantage of Corporate Philanthropy”, *Harvard Business Review*, December 2002.

²¹ Jeremy Rifkin, *The Zero Marginal Cost Society*. (Palgrave Macmillan. New York. New York. 2014), p. 266.

²² Thomas Kelley, “Rediscovering Vulgar Charity: A Historical Analysis of America’s Tangled Nonprofit Law.” *Fordham Law Review*, Volume LXXIII Number 6, May 2005, p. 2440.

²³ Kelley, *supra*. 2461.

²⁴ See for example, Dan Pallotta, *Uncharitable: How Restraints on Nonprofits Undermine Their Potential*, (Tufts University Press, Medford, Massachusetts 2008).

struggles nonprofits face are not the short-term result of an economic cycle, they are the results of fundamental flaws in the way we finance social good.”²⁵

Entrepreneurial efforts may enable nonprofits to address or improve upon their ability to fulfill their tax-exempt mission through this source of capital. Indeed, market opportunities may provide a nonprofit with a potential source for opportunity and growth. So long as the source of its revenue is legal and applied to purposes consistent with their exemption, should tax and related policies encourage nonprofits to engage in UBI activities in an effort to meet their social and exempt purposes? If yes, then how can this substantive policy goal be accomplished with minimal cost to the IRS and the sector in tax regulation, compliance, and oversight?

Alternatively, should business organizations, led by today’s emergent social entrepreneurs seeking to do social good considered traditionally within the realm of nonprofits, have corresponding tax policy incentives to increase their social impact and outcomes? “What if” tax policy encouraged more business activity that was less dependent on an individual donor’s choice or government funding as an alternative means of providing capital?²⁶

“Whatever the differences, it is interesting to observe the various ways that the profit-seeking and nonprofit-directed social entrepreneurs are edging closer together, especially among millennials, who are feeling their way toward new business models that combine attributes long associated with each respective domain.”²⁷

Growth and Tax-Exempt Revenues in the Nonprofit Sector

A recent *New York Times* article reported nonprofit organizations grew in numbers by 25% while the number of businesses only grew 1% between 2001 and 2011. Nonprofit organizations comprise approximately 5% of GDP while they provide approximately 10% of the work force.²⁸ A recent Johns Hopkins University study reports that the nonprofit workforce is the third largest in the country trailing only the retail trade and manufacturing industries.

²⁵ “56% of America’s Nonprofits Can’t Meet Demand: Worst Shortfall in 6 Years of Annual Nonprofit Finance Fund Survey”, Nonprofit Finance Fund, <http://nonprofitfinancefund.org/announcements/2014/state-of-the-nonprofit-sector-survey>, last accessed April 14, 2014.

²⁶ See for example, J. Gregory Dees, PhD., “The Meaning of Social Entrepreneurship”, Revised May 30, 2001, Center for the Advancement of Social Entrepreneurship, The Fuqua School of Business, Duke University, http://www.caseatduke.org/documents/dees_sedef.pdf, last accessed March 11, 2014. One early, unexpected, and fun example is Newman’s Own, Inc. which is a “C” corporation founded by actor Paul Newman. Known for his homemade salad dressing, Newman insisted upon “giving it all away.” From its inception the company gave its profits to charity because of Newman’s personal commitment. The company’s marketing slogan is “All Profits to Charity.” See <http://www.newmansown.com/our-stories/>, last accessed April 22, 2014. Robert Forrester, President and CEO of Newman’s Own and the related Newman’s Own Foundation, indicated the company has provided nearly \$410 million since its inception to charity and is gaining market in the highly competitive food industry. Comments during “Social Enterprise and Impact Investing Case Studies” presentation at Georgetown Law Continuing Legal Education program, Washington, D.C., April 23, 2014.

²⁷ Rifkin, *supra.* at page 264.

²⁸ Anna Bernasek, “For Nonprofits A Bigger Share of the Economy”, *New York Times*, March 8, 2014, http://www.nytimes.com/2014/03/09/business/for-nonprofits-a-bigger-share-of-the-economy.html?emc=edit_th_20140309&nl=todaysheadlines&nid=2139773&r=1, last accessed March 9, 2014.

This report noted:

Perhaps the most striking conclusion to emerge from an examination of nonprofit employment trends during the decade of 2000 to 2010 is the persistent dynamism of the nonprofit labor market. Throughout this decade, the nonprofit sector grew steadily, achieving an average annual growth rate of 2.1 percent.... By contrast, the for-profit sector lost jobs over the same time period at an average annual rate of minus 0.6 percent.

What is more, nonprofit employment grew every year between 2000 and 2010 despite two recessions, while for-profit employment contracted in some years and then grew more rapidly in subsequent years. Significantly, the rate of growth of nonprofit jobs outdistanced the rate of growth of for-profit jobs in every year except one, and in that year they were nearly tied.²⁹

In considering the future growth of employment in the nonprofit sector (i.e. the “Commons”), one author noted:

(d)espite the dramatic growth curve in Commons employment, many economists look at it askance, with the rejoinder that the nonprofit sector is not an independent economic force but rather largely dependent on government-procurement contracts and private philanthropy. One could say the same about the enormous government procurements, subsidies, and incentives meted out to the private sector.³⁰

Accompanying the financial growth and success of nonprofit organizations there are emerging questions about tax policy for tax-exempt and related business organizations as evidenced by this report’s initial inquiry.³¹ This question is clearly raised at a local level with the emergence of

²⁹ Lester M. Salamon, S. Wojciech Sokolowski, and Stephanie L. Geller, “Holding the Fort: Nonprofit Employment During a Decade of Turmoil”, Johns Hopkins University, Center for Civil Society Studies, p. 6. http://ccss.jhu.edu/wp-content/uploads/downloads/2012/01/NED_National_2012.pdf, last accessed March 9, 2014.

³⁰ Rifkin, *supra*. pg. 269.

³¹ See, for example, Rick Cohen, “In Weird Twist, Kansas Senate Approves Property Tax Exemption for For-Profit Health Clubs”, *Nonprofit Quarterly*, <https://nonprofitquarterly.org/policysocial-context/24005-in-weird-twist-kansas-senate-approves-property-tax-exemptions-for-for-profit-health-clubs.html>, last accessed April 11, 2014. In this case the Kansas Senate approved a bill which provides a property tax exemption that includes a private health club which competes with the nonprofit YMCA. This provides an interesting counter-point to PILOTS which do directly affect nonprofits. Subsequently, House-Senate committees for the Kansas legislature pulled the health club tax break and rejected tax-exempt status for the for-profit club. See Rick Cohen, “Kansas Rejects Tax-Exempt Status for For-Profit Fitness Clubs, *Nonprofit Quarterly*, <https://www.nonprofitquarterly.org/policysocial-context/24131-kansas-rejects-tax-exempt-status-for-for-profit-fitness-clubs.html>, May 5, 2014, last accessed May 5, 2014. The author noted the implications for similar future tax break and wrote: “Nonprofit leadership organizations have to better explain how nonprofits earning revenues from program services does not violate their nonprofit status and structure.”

“PILOTs” (i.e. payments in lieu of taxes) negotiated between local governments and typically large nonprofits operating in the community.³²

The nonprofit and related business organizations which engage in UBI activities provide a discrete subset of corporate entities which can test the economic, financial, and policy efficacies, efficiencies, and effectiveness of a flat or other corporate income tax to address exempt purposes. What policies might make it easier, more effective, and more efficient for the IRS, nonprofit and related business organizations, and the public? But, more importantly, this “what if” question and analysis bring into focus some of the underlying assumptions for both nonprofit and business entities and ask whether there may be a better way forward in our tax and related policies. This inquiry should begin with a statistically valid analysis of IRS SOI data.

Donations and Program Related Income³³

Business and nonprofit organizations are both economic entities designed for social purposes. Successful organizations and their leadership adapt.

Like businesses, nonprofits require capital to operate. Historically they have sought access to capital through several means which are primarily tax-exempt sources of revenue.

Traditionally, many charities [i.e. 501 (c)(3)] are funded primarily through donors’ gifts reflecting in part the sector’s religious heritage and the origins and traditional concepts of charity, as well as through philanthropic institutions like foundations. Collectively, this funding has remained reasonably constant at approximately 2% of GDP over the past forty years.³⁴ Currently, these “gifts” are tax deductible donations. Today they may also be viewed as an “investment” in a nonprofit’s work by “social investors” who expect a demonstrable social impact and return. “The philanthropic community, now more than ever, has a responsibility to ensure that investments are supporting organizational efforts to generate measurable outcomes

³² See for example, City of Boston “PILOT Program.” <https://www.cityofboston.gov/assessing/PILOTProgram.asp>, last accessed April 11, 2014. See also, “Taxes, Fees, and PILOTS (Payments in lieu of taxes)”, *Council of Nonprofits*, <http://www.councilofnonprofits.org/public-policy/state-policy-issues/taxes-fees-and-pilots>, last accessed April 11, 2014; and Ruth McCambridge, “Princeton University’s ‘Pilot Plus’ Arrangement”, *Nonprofit Quarterly*, <https://nonprofitquarterly.org/policysocial-context/24080-princeton-university-s-pilot-plus-arrangement.html>, last accessed April 25, 2014.

³³ Figures in this section do not include tax-exempt revenue generated by nearly 30 other types of nonprofits which are not (c)(3) charities. These include such diverse organizations as the NCAA, NFL, and PGA sport leagues; business chambers of commerce, labor unions, and professional associations like the bar or CPA associations; social welfare organizations; or country clubs all of which enjoy currently exemption from corporate income tax. Many of these organizations may also engage in UBI activities which may yield significant untaxed revenue while being structured to maintain their tax-exempt income.

³⁴ See, for example, Suzanne Perry, “The Stubborn 2% Giving Rate.” *The Chronicle of Philanthropy*, June, 17, 2013, <https://philanthropy.com/article/The-Stubborn-2-Giving-Rate/139811/>, last accessed March 23, 2014. However, the Urban Institute data suggests it is less than 1.5%. See, “Amount of Charitable Contribution as Percentage of GDP”, Urban Institute. <http://www.urban.org/taxandcharities/Contributions-as-a-Percent-of-GDP.cfm>, last accessed March 23, 2014.

and drive impact.”³⁵ But there are clearly limits to donations as means to fund the demand for exempt purposes given current policies.

The most currently available public SOI data is for tax year 2010.³⁶ In tax year 2010 “charities reported \$344.9 billion from donors and grant makers.”³⁷ Historically, this revenue currently is not subject to corporate income tax which represents a significant loss of potential tax revenue – no doubt a heretical thought. But the charitable deduction is subject to questions for its efficacy, especially in generating resources for those most in need.³⁸ For example, a “what if” inquiry raises directly the question of whether tax and related policies can provide appropriately for the hungry, homeless, sick, a museum, and business or major professional sport leagues through tax-exempt entities?

A second source of tax-exempt revenue is generated from program related income arising from operations pursuant to their exempt purposes. In tax year 2010 “income from program services comprised 72 percent (\$1.1 trillion) of the revenue reported by organizations exempt under IRC section 501 (c)(3).³⁹ This revenue is also largely untaxed as a corporate income tax. But much of this revenue may be generated through “fee for services” purchases by governments seeking to ameliorate and contract for services to address issues through the tax-exempt sector.

Since 1970 only 144 new nonprofits have reached \$50 million in revenue. The two largest sources for these organizations are government dollars and service for fees.⁴⁰ Yet “(t)oday, it’s clear that government funding and traditional philanthropy alone can’t cover the critical work of nonprofits addressing pressing challenges in our communities.”⁴¹ How might policy improve the ability of nonprofits to grow to scale?

While this may be indicative of market-based activities, should it be encouraged and, if so, what policies may enable more nonprofits, as well as business entities, to operate at a scale to address

³⁵ Ben Gose., “Many Groups Seek New Sources of Funds as Economy Recovers, Study Finds”, *The Chronicle of Philanthropy*, April 10, 2014, <http://philanthropy.com/article/Many-Groups-Seek-New-Ways-to/145723/>, last accessed April 19, 2014.

³⁶ This is the most currently available public data available. These figures do not include income from churches and religious entities which are not required to file an IRS Form 990 data.

³⁷ Paul Arnsberger, “Nonprofit Charitable Organizations, 2010”, *Statistics of Income Bulletin, Winter 2014*, pg. 75, <http://www.irs.gov/pub/irs-soi/14eowinbulcharitorg10.pdf>, last accessed March 23, 2014. This report excludes various exempt organizations to include private foundations, churches, exempt organizations with less than \$50,000, and several other categories of exempt organizations including (c)(1), (c)(4) through (c)(6), and (c)(10) through (c)(27).

³⁸ See, for example, “Should the U.S. End the Tax Deduction for Charitable Donations.” *The Wall Street Journal* December 16, 2012, <http://online.wsj.com/news/articles/SB10001424127887324469304578143351470610998>, last accessed April 5, 2014. See also, Doug Donovan, “Senators Seek to Know Why Charitable Deductions Matter”, *The Chronicle of Philanthropy*, June 27, 2013, <https://philanthropy.com/article/Senators-Seek-to-Know-Why/140049/>, last accessed April 7, 2014.

³⁹ See, Arnsberger, supra. at pg. 75.

⁴⁰ William Foster and Gail Fine, “How Nonprofits Get Really Big”, *Stanford Social Innovation Review* Spring 2007, http://www.ssireview.org/articles/entry/how_nonprofits_get_really_big, last accessed April 5, 2014.

⁴¹ See, Nonprofit Finance Fund survey, supra.

and impact growing needs?⁴² If UBI activities represent a growing and significant part of the solution, what policies for nonprofits will encourage the growth and access to other capital needed by them? At the same time, governments will continue to require revenues to address many of these needs as well. What policies will enhance the ease, efficiency, and effectiveness for the IRS in collecting these revenues and a similar ease for organizations required to pay taxes?

Unrelated Business Income and Unrelated Business Income Tax⁴³

In contrast to donation based and program related income, there are two revenue sources derived through UBI which are taxed. Whether initiated by an unexpected opportunity or through deliberate exploitation of a market opportunity arising from their exempt activities, this economic activity provides access to capital generally through some form of market-based activities which is unrelated to the organization's exempt purposes.

The first source is the UBI generated through income producing activities which are unrelated to a nonprofit's exempt purposes. In IRS statistics for the tax year 2010, gross unrelated business income for all exempt organizations was approximately \$10.9 billion dollars.⁴⁴ In the opinion of ACT members and others, this figure likely is significantly underreported across all exempt organizations.

For example, in 2008 the *Chronicle of Philanthropy* stated "of the 91 of the nation's largest charities finds that more than half of the groups list zero or negative taxable income for activities that are unrelated to their core missions."⁴⁵ The IRS College and Universities Compliance Project Final Report demonstrated there was significant UBIT which was owed, but had not been paid by the 34 colleges and universities subjected to an examination. This determination came at a high compliance cost to the IRS which will be difficult to sustain.

At the national 2014 Georgetown Law CLE seminar, one speaker asked:

Given the fact that the study indicated a large number of colleges and universities state that they merely intend to "break even" from their unrelated business activities, has there been any intellectual curiosity at the Service how the obligation to use charitable assets either for charitable programs or for productive investments can be reconciled with a "break even" objective?⁴⁶

⁴² An alternative may be the need to increase government based interventions if effective policies cannot develop more private and/or market based interventions and ,how to reallocate resources among philanthropic, market-based, and government interventions.

⁴³ Figures in this section include UBI from all tax exempt organizations.

⁴⁴ See, "SOI Tax Stats - Exempt Organizations' Unrelated Business Income (UBI) Tax Statistics ("SOI Tax Stats")- Number of Returns, Gross UBI, Total Deductions, and Tax Items, Classified by: Internal Revenue Code Section, Tax Year: 2010", Excel spreadsheet download, <http://www.irs.gov/uac/SOI-Tax-Stats-Exempt-Organizations'-Unrelated-Business-Income-UBI-Tax-Statistics>, last accessed March 23, 2014.

⁴⁵ See for example, Panepento and Williams, supra. In 2008 a sole proprietor generating \$50,000 in taxable business income paid between \$6701.00 and \$8850.00 depending on marital status. IRS 2008 Tax Table, <http://www.irs.gov/pub/irs-prior/i1040tt--2008.pdf>, p.74, last accessed April 20, 2014.

⁴⁶ Hasson, supra.

In tax year 2010 there were 43,184 UBIT returns filed. Approximately 28,716 returns (66%) reported the businesses operated at a deficit; generated “equal” amounts of UBI and deductions (i.e. zero dollars); or had \$1000.00 or less in UBI.⁴⁷ As a result, nearly \$7.0 billion of the \$10.9 billion dollars of gross UBI was not taxed.⁴⁸ Business entities must generate a profit which includes taxable revenue to operate and survive. By contrast, in 2010 an individual operating a business as a sole proprietor which generated \$50,000 in taxable revenue paid in federal income tax between \$6,666.00 and \$8,688.00.⁴⁹

Why do nearly sixty-six percent (66%) of the nonprofits who reported \$1,000 dollars or less of UBI – a figure which is relatively constant for UBI over the years?⁵⁰ Currently, the IRS may wait a period of several years before questioning their methods of operation and apparent lack of profit motive. In the meantime, what are these organizations doing with donor dollars and is it the best use of a donor’s investment? How and why are these organizations apparently being managed in a manner that fails to yield profits which in part should include tax revenues?

If a business wastes its resources on non-results, by and large it loses its own money. In a non-profit institution, though, it’s somebody else’s money-the donors’ money. Service organizations are accountable to donors, accountable for putting the money where the results are, and for performance.⁵¹

If capable of generating a profit which benefits the exempt organization, “what if” asks how might policy encourage these organizations to generate and use profits for exempt purposes?

Alternatively, is current tax policy now eroding the tax base which the original UBIT legislation ostensibly sought to avoid as part of its rationale? After six decades of history these may be questions and issues which will benefit from an IRS SOI analysis guided by computer based financial, economic, and statistical modeling capabilities not available in 1950 and a vibrant and entrepreneurial nonprofit sector not envisioned then.

⁴⁷ See, “Unrelated Business Income Tax Returns: Number of Returns, Gross Unrelated Business Income (UBI), Total Deductions, Unrelated Business Taxable Income (Less Deficit), and Total Tax, by Size of Unrelated Business Taxable Income or Deficits, Tax Year 2010”, <http://www.irs.gov/uac/SOI-Tax-Stats-Exempt-Organizations'-Unrelated-Business-Income-UBI-Tax-Statistics>, last accessed April 19, 2014.

⁴⁸ In 2010 this was the equivalent of approximately \$22.67 in lost tax revenue for every person in the United States. See, “Population Distribution and Change: 2000 to 2010”, U.S. Census Bureau. March 2011, <http://www.census.gov/prod/cen2010/briefs/c2010br-01.pdf>, last accessed April 19, 2014. The 2010 census count reported there were approximately 308.7 million people in the United States.

⁴⁹ See, “2010 Tax Table”, <http://www.irs.gov/pub/irs-prior/i1040tt--2010.pdf>, p. 78, last accessed April 19, 2014. The range in taxes paid is based upon marriage status.

⁵⁰ This is not a new question. See for example, Peter Panepento and Grant Williams, “A Taxing Matter”, *The Chronicle of Philanthropy* January 30, 2008, <http://philanthropy.com/article/A-Taxing-Matter/62766/>, last accessed April 20, 2014. According to this article, “The IRS’ own studies of unrelated business income reporting finds that each year roughly two-thirds of the public charities that generate unrelated business income pay nothing in tax, a trend that dates back to the beginning of its reporting on unrelated-business income in the 1992 tax year.”

⁵¹ Peter Drucker, *Managing the Nonprofit Organization: Principles and Practices*, (HarperCollins Publishers. New York, New York. 1990), p. 139-140.

In 2010 the remaining 14,468 returns reported more than \$3.8 billion dollars which generated approximately \$332.4 million dollars in tax revenue.⁵² These returns likely are derived primarily from very large institutions (e.g. universities and health institutions). For these institutions and activities, questions emerge as to whether and how much of this income is used to benefit the recipients of the exempt purposes for which the exempt organizations operating these businesses were formed?⁵³

Should the inquiry and policy focus on concepts of “insubstantial”, “commerciality”, and “commensurate” concepts or whether and how effectively capital derived from these activities are efficiently and effectively reinvested into an organization’s underlying exempt purposes?⁵⁴

Counter intuitively, a “what if” inquiry might also question whether the relatively low amount of tax revenues might be eliminated in exchange for this foregone tax revenue might provide and leverage this capital to benefit both the nonprofit sector and the economy? If so, how might this effect the IRS EO operations? In a *New York Times* “what if” op-ed, the author argues for changes in the corporate tax code which might include eliminating the corporate income tax. In the author’s opinion doing so will lead to higher stock prices. “Higher stock prices would also help pension funds, foundations and other tax-exempt institutions focused on social betterment. While eliminating corporate taxation would be branded a giveaway, properly engineered reforms would provide a huge uplift to ordinary Americans.”⁵⁵

A second form of UBI is through passive income (e.g. rents, royalties, dividends). This income may be derived through carefully structured ownership of entities engaged in market-based activities and designed to avoid loss of tax exempt status. Significantly, structuring seeks to protect the tax-exempt status of a nonprofit organization from engaging in unrelated activities at a scale which under current law they cannot do directly through the exempt organization without subjecting them to potential loss of exempt status. This may introduce unnecessary complexity and economic inefficiencies. But, “what if” nonprofit management can more efficiently and effectively manage these resources directly?

Alternatively, a nonprofit may engage simply through investment strategies. Investments are tax favored, largely because they comport with the historical and cultural perception that a nonprofit may engage in investment activities.⁵⁶ In tax year 2010 “income from sales of securities and other assets continued to show dramatic gains, increasing from reported losses of \$41.1 billion in

⁵² See, “SOI Tax Stats - Classified by: Size of Unrelated Business Taxable Income or Deficit, Tax Year 2010”, Excel spreadsheet download, <http://www.irs.gov/uac/SOI-Tax-Stats-Exempt-Organizations'-Unrelated-Business-Income-UBI-Tax-Statistics>, last accessed March 23, 2014.

⁵³ See, for example, “Endowments-Under a Tax?” *Harvard Magazine July-August 2008*, <http://harvardmagazine.com/2008/07/endowments-under-a-tax.html>, last accessed April 6, 2014.

⁵⁴ See, for example, Bruce R. Hopkins, *The Law of Tax-Exempt Organizations Eighth Edition*, (John Wiley & Sons, Hoboken, New Jersey, 2003), p. 728: “[T]he federal tax law pertaining to nonprofit organizations is being shaped by a doctrine that rests in part upon untrue premises and that has crept into the law by actions of courts which, consciously or unconsciously, ignored the Internal Revenue Code and the underlying regulations, and developed law with these premises in mind.”

⁵⁵ Rattner, *supra*. Rattner also writes, “A more ambitious, and therefore more politically difficult idea, would be to scrap our unworkable corporate tax system altogether and instead tax shareholders, first by eliminating low tax rates on capital gains and dividends.”

⁵⁶ See, Stone, *supra*.

2008, to gains of \$3.9 billion in 2009 and \$33.9 billion in 2010.⁵⁷ While some portion of this passive income may be subject to taxation, a significant portion may not. Should policy look to increase these investments into meeting social and human service needs? “What if” questions might address how to encourage more of these investments to be used?

The nonprofit sector’s compliance costs will continue to increase. How can these minimized? There is a cost for the IRS to oversee, enforce, and administer tax law related to these organizations as both the level of funding for EO operations and personnel continue to diminish.⁵⁸ How can these costs be minimized? The lost UBIT revenues represent a significant and ongoing loss of tax revenue for federal, state, and local governments for services and benefits which they provide. The loss of this tax revenue shifts the tax burden directly and indirectly to other individual taxpayers in our society. IRS SOI can begin to provide a foundation by which address these inquiries.

Potential Effects on Proposals

The report contains three substantive recommendations which a “What if?” flat tax analysis affects. First, the report recommends formal guidance for indirect cost allocations which are used for accounting purposes and to reduce tax liabilities. These allocations may be eliminated for tax avoidance purposes.⁵⁹

The report recommends a comprehensive revenue ruling to distinguish between taxable and non-taxable revenue. As is, the draft ruling appears to be a “laundry list.” Because of the examples’ specificity this type of ruling invites further additional regulatory action and interpretation. Instead, “what if” the principle was whether gross income (i.e. taxable revenue) is received or generated pursuant to economic activity consistent with or pursuant to an organization’s primary exempt purposes during its tax year. If so, then the income is tax-exempt. If not, then it becomes taxable to the organization at a flat or other tax rate.

Finally, the proposed 990 T form could be reduced to a simple three line calculation and filed electronically:

$$\begin{array}{r} \text{Gross UBI} \\ \times \text{Tax rate} \\ \hline \text{Taxes owed.} \end{array}$$

⁵⁷ Arnsberger, supra. pg. 75.

⁵⁸ See, “Prepared Remarks of Commissioner of Internal Revenue Service John Koskinen Before the National Press Club”, April 2, 2014, <http://www.irs.gov/uac/Newsroom/Prepared-Remarks-of-Commissioner-of-Internal-Revenue-Service-John-Koskinen-before-the-National-Press-Club-2014>, last accessed April 18, 2014. Commission Koskinen’s comments are echoed in a GAO report. See, “Internal Revenue Service: Absorbing Budget Cuts Has Resulted in Significant Staffing Declines and Uneven Performance”, U.S. Government Accountability Office, April 21, 2014, <http://www.gao.gov/assets/670/662681.pdf>, last accessed April 23, 2014.

⁵⁹ Alternatively, this may be an area for which legislation is under consideration and may provide a better approach. See for example, Staff, Joint Committee on Taxation, “Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title V – Tax Exempt Entities”, <https://www.jct.gov/publications.html?func=startdown&id=4558>, last accessed April 27, 2014.

“What if?” a Form 990 T were reduced to this level of simplicity, what is the impact for the IRS? What and how should a tax-exempt organization disclose its non-exempt and taxable activities? For example, publicly traded companies are required to provide information regarding their financial activities.⁶⁰

While a “What if?” analysis doesn’t end regulatory action (no doubt a goal on which many will agree), it permits one to consider alternatives for tax regime which may become easier, more efficient, and more effective for the IRS, the nonprofit organizations, and the public. This process should begin with a financial, economic, and statistical analysis of data affected by each of these proposals.

IRS Discussion

In contrast to most ACT inquiries there was limited information from the IRS for the “what if” inquiry.⁶¹ After several efforts there was a referral to outside websites which, upon searching, had older studies on a flat tax generally, but none focused on UBI or UBIT and its impact on the IRS, nonprofit sector, or public. Indeed, inquiries to the IRS did not yield an IRS study based on SOI UBI data except for the summary public data available which is buried on the IRS SOI’s website.⁶² Most significantly, IRS SOI with its analytic and modeling capabilities was not engaged in the College and Universities compliance project. Yet, this project called for and its findings demonstrate clearly the need for further and substantive analytic study which has not occurred.

Current IRS leadership also was not involved in the original College and Universities’ project and only recently began their new work assignments in EO. During the past year there was significantly less in-person contact and discussion than enjoyed by previous ACT committees because of the significant turnover in EO leadership at all levels.⁶³ With their attention understandably focused on their duties in undertaking new responsibilities, substantive outside inquiries and the IRS reorganization currently underway, in-person meetings were severely

⁶⁰ The proposed 990 T form and worksheets may provide a prototype for consideration, especially if required to be provided in electronic format on an organization’s website or other electronic media. .

⁶¹ For example, there was not a reference to Jael Jackson, “Unrelated Business Income Tax Returns, 2008”, *Statistics of Income Bulletin Winter 2012*, <http://www.irs.gov/pub/irs-soi/12winbul.pdf>, p. 131 et. seq. This article is referenced as footnote 9 in the “Colleges and Universities Compliance Project Final Report.” This article looks at data from 2007 and 2008 during the midst of the economic recession and is already six years out of date. A referral to the Treasury’s Office of Tax Policy was not successful.

⁶² See, “SOI Tax Stats – Exempt Organizations’ Unrelated Business Income (UBI) Tax Statistics”, <http://www.irs.gov/uac/SOI-Tax-Stats-Exempt-Organizations'-Unrelated-Business-Income-UBI-Tax-Statistics>, Excel spreadsheet downloads, last accessed April 19, 2014. See, the report’s recommendation on organizing the IRS website on UBI and UBIT, as well as other, issues.

⁶³ The lack of in-person discussion was an issue for all ACT subcommittees and members, but reflected the reality of what the IRS and the ACT confronted this year. Like the golfer who finds his ball in the rough, both the IRS and the ACT had to play out the year as it was. Significantly, the current EO Director moved from a leadership role outside of EO to begin her duties shortly before the ACT’s scheduled March meeting. She was meeting Washington based staff, as well as the ACT, at this meeting. With a new leadership team in place, limiting the number of in-person meetings hopefully won’t be a substantive issue for next year’s ACT members.

limited.⁶⁴ Monthly phone call conferences IRS leadership kept the ACT apprised of what was occurring, but simply did not permit a fuller inquiry or substantive discussions for a “What if?” discussion. Finally, IRS leadership also recognizes the challenges inherent in these questions. However, given sufficient time and opportunity to probe, a “what if?” inquiry could have been a much richer and more informative discussion than what occurred.⁶⁵

Ironically, it is likely the IRS may benefit from an IRS SOI “what if” analysis for their internal planning and management purposes. In response to several “what if” questions to some IRS personnel, it seemed as if some information systems either did not or could not easily track information in a way that easily addressed alternatives for their capacity, funding, staffing, and structure.⁶⁶ However, during some discussions, several off hand and “back of the envelope” type comments suggest there may be significant advantages.⁶⁷

Scenario planning is a well-established management tool. Given IRS SOI capabilities, running computer models and simulations for a flat and other tax policy could enable the IRS to envision how they might operate at a higher degree efficiency and effectiveness than now may be experienced under the current law. This type of analysis is consistent with the IRS’ Lean Six Sigma analysis used this year to restructure EO’s application processes. Engaging in a substantive data-driven analysis may create opportunities, budget, and planning scenarios to aid the IRS given continuing budgetary and personnel constraints.

IRS Statistics of Income (“SOI”)

The ACT’s realization to consider and use IRS Statistics of Income (SOI) data emerged slowly and very late in our process.⁶⁸ During my tenure ACT members previously have not had a presentation or discussion about SOI’s mission and capabilities. SOI is a valuable resource which the ACT previously has not used.

Significantly, SOI does not work for IRS EO. Instead, it is a headquarters’ function which works for the IRS Commissioner. SOI’s focus is on tax policy analysis. Its main “customers” include the Department of the Treasury’s Office of Tax Policy and Congress’ Joint Committee on Taxation. They work with data, economic, and financial analysis. SOI has the capacity and are used primarily to engage in scenario modeling and simulations which is consistent with a “what if” inquiry and analysis. It is what they do!

⁶⁴ One of only two days scheduled for in-person meetings was converted into telephone conference calls because the Federal government closed because of weather. Most ACT members were already in Washington, D.C. when the announcement of the cancellation occurred. We improvised and met huddled around speaker phones in a hotel bedroom. We note the IRS is not responsible for the weather.

⁶⁵ One colleague suggested this topic might be the basis for a future ACT report. As a returning ACT member, this member will have the ability to initiate this as a topic. If selected, the ACT committee will have the benefit of this recommendation as its starting point. As a soon to be former ACT member, it is a report which I eagerly will look forward to reading.

⁶⁶ This would have been an area for a fuller discussion and understanding.

⁶⁷ A notable, refreshingly honest, and memorable response by an IRS employee came in response to a question about the ease, effectiveness, and efficiency of compliance, examination, and audit reviews under a flat tax. The immediate response was “Like shooting fish in a barrel.”

⁶⁸ Future ACT committees are encouraged to consider SOI resources earlier in their process.

SOI works through the data information contained in the IRS 990 and other forms. A typical SOI data file may have more than 2000 fields of discrete bits of data for analysis. SOI takes the raw data which it receives and analyzes it for purposes of policy with a focus generally on a macro-analysis, but can also drill down in their analysis as well. They have the capacity to answer many different questions and work with large quantities of data.

SOI may “clean” the raw data which originates from the raw Form 990s and 990T data that EO receives and uses. This generally consists of their using a variety of statistical techniques and analysis to sample and weight its data in order to make estimates about the underlying population. This “data cleaning” of the raw data adds value to their analysis. While summary information becomes publicly available, it lags by several years because of filing deadlines and the need to address the data they receive. Significantly, they have access to non-public tax data which they incorporate their analysis.

During our only in-person meeting in mid-March, SOI’s highly engaging and informative presentation was a first and provided ACT members with information about their function and capabilities. SOI clearly has the analytic capacity, expertise, resources, and, most importantly the opportunity and ability to address these questions and draw upon other economic and tax resources which the ACT lacked.

Most importantly, SOI indicated they easily could analyze its data to address “what if” analysis of UBI and UBIT policies to include various tax and economic factors as alternatives. They just haven’t been asked to do so!

Finally, the Department of Treasury’s Office of Tax Policy has a May 1, 2014 deadline for recommendations for their annual work plan. This office is looking for ideas on tax policy from all sources.⁶⁹ This ACT report and recommendations will be presented June 11, 2014. The IRS will have the opportunity to engage an IRS SOI analysis and recommend its findings for consideration the Office of Tax Policy’s 2015 work plan.

Recommendation

UBI and UBIT are at the intersection of the nonprofit and business sectors which have grown and substantively changed since the 1950 legislation. Using a “What if” flat tax inquiry provided me with a powerful and useful framework to think about how the IRS might address UBI and UBIT questions for the benefit of the IRS, nonprofit sector, the public. It was also a provocative inquiry which met with substantial resistance.

The IRS is capable of changing and implementing “What if”, though not always in the exact form envisioned by the ACT.⁷⁰ What might a substantive analysis of this data against the

⁶⁹ Ruth Madrigal, Attorney-Advisor, Office of Tax Policy, U.S. Department of Treasury. Comments during “Update from the Treasury and IRS: What You Need to Know in 2014” presentation at “Representing and Managing Tax-Exempt Organizations”, Georgetown Law Continuing Education, Washington, D.C., April 24, 2014.

⁷⁰ For example, Tammy Ripperda, Exempt Organization Director, discussed the forthcoming Form 1023 EZ which is consistent with the ACT 2012 report recommendations and an ACT specific “what if” question posed during the September 2013 ACT public meeting. Comments during “Update from the Treasury and IRS: What You Need to

framework of a “What if?” flat tax analysis or other tax regime suggest for the 21st century IRS and a rapidly evolving entrepreneurial nonprofit sector whose UBI activities intersect with business organizations?

For me, these were questions and an inquiry which the entire ACT should have considered substantively as part of its work this year and integrated into our report. Doing so will allow the IRS to envision alternative scenarios and opportunities which may affect the IRS, the nonprofit sector, and the public positively. It moves the discussion beyond the report’s more traditional ACT recommendations which tinker at the edges to include an accounting convention, another revenue ruling, and a form as a short term solution. As is often done in the nonprofit sector, working collaboratively with others will provide the IRS, the nonprofit sector, the public, and others with the data, objective analysis, and credibility to find a better way forward.⁷¹ But, it is a substantive conversation and policy analysis which should be informed first by a thoughtful analysis and application of IRS SOI and other relevant data.

At a minimum, the IRS should analyze its own data before adding more regulations and forms in the area of UBI and UBIT with a goal to establish an easier, more efficient, and more effective UBI and UBIT tax policy.

Finally, if an analysis of SOI data on UBI and UBIT results in changes to tax policy, there is no question the IRS will seek to administer them fairly, effectively, and efficiently!

For these reasons, I would add the following recommendation to the ACT report:

Using IRS Statistics of Income (“SOI”) and other relevant data, the IRS should engage in an economic, financial, and statistical study of IRS Statistics of Income (“SOI”) to inform and guide IRS and the U.S. Department of the Treasury’s Office of Tax Policy to consider policy and practices for the nonprofit’s sectors unrelated business income practices and unrelated business income tax to include considerations of alternative tax regimes.

Know in 2014” presentation at “Representing and Managing Tax-Exempt Organizations”, Georgetown Law Continuing Education, Washington, D.C., April 24, 2014.

⁷¹ For example, a collaborative effort might also engage the Treasury’s Office of Tax Policy and the White House’s Office of Social Innovation and Civic Participation and representatives from House and Senate, as well as seek input from academic and bi-partisan think-tank institutions.