



Testimony of John M. Palatiello
President, Business Coalition for Fair Competition (BCFC)
Before the House Committee on Ways and Means
"Tax Reform and Charitable Contributions"
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Mr. Chairman, members of the Committee, I am John Palatiello, President of the Business Coalition for Fair Competition, (BCFC), a coalition of private sector firms, large and small, trade associations, think tanks, organizations, and individuals who support the competitive free enterprise system and seek relief from unfair government sponsored competition with private business.

There are thousands of legitimate charitable organizations that do exemplary work in American society. The tax treatment of these charities, and those who donate to them, is not an issue for BCFC.

For us, the issue is non-profit organizations, including charities, which operate in direct and unfair competition with for-profit, tax-paying private businesses.

Private enterprise constitutes the strength of the United States economic system and competitive private enterprises remain the most productive, efficient, and effective sources of goods and services.

However, when the non-profit sector encroaches on private business activities, there are a number of undesirable consequences, which I will discuss in a moment.

Entities organized under various provisions in section 501(c) of the Internal Revenue Code are provided special tax "exempt" treatment were clearly intended to perform activities and provide services otherwise considered "governmental" in nature, not those that are commercially available. A 1954 report by this Committee noted:

"The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds and by the benefits resulting from promotion of the general welfare."

Source: (Unfair Competition: The Profits of Non-profits, James T. Bennett, Thomas H. DiLorenzo, Hamilton Press, 1989, p. 26)

The problem is, this policy has not been adequately codified by Congress or efficiently

1856 Old Reston Avenue, Suite 205, Reston, VA 20190, (703) 787-6665
www.governmentcompetition.org

implemented by the IRS. The situation has become so pervasive that unfair government-sponsored competition has been a top issue at every White House Conference on Small Business.

In 1980, the first White House Conference on Small Business made unfair competition one of its highest-ranked issues. It said, "The Federal Government shall be required by statute to contract out to small business those supplies and services that the private sector can provide. The government should not compete with the private sector by accomplishing these efforts with its own or non-profit personnel and facilities."

In 1986, the second White House Conference made this one of its top three issues. It said, "Government at all levels has failed to protect small business from damaging levels of unfair competition. At the federal, state and local levels, therefore, laws, regulations and policies should ... prohibit direct, government created competition in which government organizations perform commercial services ... New laws at all levels, particularly at the federal level, should require strict government reliance on the private sector for performance of commercial-type functions. When cost comparisons are necessary to accomplish conversion to private sector performance, laws must include provisions for fair and equal cost comparisons. Funds controlled by a government entity must not be used to establish or conduct a commercial activity on U.S. property."

And the 1995 White House Conference again made this a priority issue when its plank read, "Congress should enact legislation that would prohibit government agencies and tax-exempt and anti-trust exempt organizations from engaging in commercial activities in direct competition with small businesses." That was among the top 15 vote getters at the 1995 Conference and was number one among all the procurement-related issues in the final balloting.

Non-profit organizations unfairly compete with private, for-profit businesses by engaging in commercial activities, but not paying taxes.

Billions of dollars in economic activity occurs each year that is untaxed. This results in lost revenue to Federal, as well as state and local government agencies. And it creates an unlevel playing field for the private sector, particularly small business.

Non-profits enjoy a whole host of advantages - chief among them being tax-free status and reduced postal rates - that gives them an unfair advantage in the marketplace. The effect of these special privileges is that governmental policy not only reduces the costs of non-profit organizations, but it also raises the costs of doing business for their for-profit competitors. Profit-seeking firms must pay higher taxes and postal rates to offset the subsidies accorded non-profits. Thus, because of this preferential treatment, competition between non-profits and for-profits is inherently unfair.

Non-profit organizations are provided special tax status under section 501(c) of the Internal Revenue Code. These groups are required to pay an "unrelated business income tax" or UBIT on its commercial or "non-exempt" activities.

The Federal Government first exempted charitable organizations from tax in 1913. In 1950, in response to outrageous examples of unfair competition, Congress changed the tax law by creating the UBIT. Under UBIT, revenues from sources unrelated to the non-profit's tax-exempt purpose are subject to taxation.

Attempts by government to address the problem of unfair competition have been few and far between, and those few measures that have been taken have been largely ineffective. The UBIT which was intended to level the playing field by taxing the revenues of non-profits has, for example, proven difficult if not impossible to enforce. The courts have not been able to give a rigorous and consistent definition of just what constitutes an "unrelated" business activity by a non-profit. And because the UBIT tax was to apply only to "commercial activity which is not significantly related to the purposes for which the non-profit organization was established," enforcement and collection by the IRS has been less than successful. For their part, non-profits have taken an extremely expansive view of what constitutes a related purpose, making the under-reporting or non-reporting of revenues commonplace.

Unfair competition impedes the development of small business by making it hard for them to enter markets and compete. This is significant because two-thirds of all new jobs are created by businesses with fewer than 20 employees. Because commercial enterprises run by non-profits are exempted from taxes and receive other subsidies, taxpaying businesses must bear an extra burden by paying higher taxes than they would otherwise to make up for exemptions enjoyed by their "non-profit" competitors. Unfair competition ends up crowding out of the market precisely those firms which are the principal source of new jobs—ultimately reducing the rate of economic growth.

Unfair non-profit competition takes many forms. It is YMCAs competing with private health clubs; credit unions competing with community banks; rural electric and telephone cooperatives competing with investor-owned utilities; and universities venturing out of the classroom and into hotels, mapping services, and testing laboratories. A few examples follow:

- Credit unions' tax-exemption currently costs the U.S. Treasury \$2 billion annually. By contrast, the more than 6,000 community banks that are the lifeblood of towns across the country contribute \$4 billion annually in taxes that support our nation and those communities;
- A bicycle rental business in Anchorage, Alaska faced competition from a non-profit entity approved by state gaming regulators- a free bike loan program for downtown Anchorage, known as the Earth Bike Program. The program lasted two years and forced other bike rental businesses out of business, and in one case, leave the state;
- A privately owned inn in Fredericksburg, Virginia hosts functions such as banquets and weddings. The University of Mary Washington's Alumni Center not only competes for similar events and opportunities, but it also is building a hotel less than a mile away that will further compete with the hotels, motels and other

lodging destinations that are not tax-exempt. The only reason provided by lost clients for choosing the university was the lower price thanks to the tax differential. University hotels and conference centers are proliferating across the country; and

- A laundry and cleaner in San Antonio, Texas faces competition for its laundry services from a non-profit, Federal tax-exempt Bexar County (government) cooperative entity. The unfair business practice involves, in addition to competing with and eliminating the opportunity for private business services, the co-op going outside its members to provide laundry services to for-profit businesses and hospitals throughout South Texas. It is damaging to a long-time minority owned and operated for-profit business to have to compete in this arena with its taxing entity, Bexar County.

For too many years, the unfair government-sponsored competition issue has not been a top priority for Congress or Administrations of either party. The Small Business Administration's Office conducted a series of hearings and issued a report, "Government Competition: A Threat to Small Business" (March 1980), and "Unfair Competition by Non-profit Organizations With Small Business: An Issue for the 1980s" (June, 1984). The last serious look at non-profits and the UBIT by the Ways and Means Committee was by Congressman J.J. Pickle (D-TX) in 1987-88.

From April 18 through April 25, 1993, the Philadelphia Inquirer presented an exhaustive investigative exposition of the multibillion-dollar world of America's so-called non-profit industries, exposing, in several different contexts, the abuses of their unique tax-exempt status. Certainly, this sweeping indictment by the Philadelphia Inquirer encompasses the world of non-profit sometimes run amok. However, as you, Mr. Chairman, contemplate future oversight hearings and legislation to reform this multibillion-dollar, non-tax-paying competition for many of America's struggling small businesses, you will find valuable factual, albeit dated, information in the Inquirer series.

Source: (Non-profits: America's Growth Industry They're Called Non-profit Businesses, But That Doesn't Mean They Can't Make Money. They Do - Billions Of Dollars. At The Same Time, Their Tax-exemptions Cost Government More Than \$36 Billion A Year," by Gilbert M. Gaul and Neill A. Borowski, The Philadelphia Inquirer April 18, 1993)

Let me give you examples of the revenue loss to the U.S. Treasury, as estimated by the Joint Committee on Taxation. In a December 2010 report prepared for the House Committee on Ways and Means and the Senate Committee on Finance by the staff of the Joint Committee on Taxation, \$16.8 billion in tax revenue in Fiscal Years 2010-2014 is not realized thanks to the following exemptions of where non-profit entities unfairly compete with the private sector:

- Health: Exclusion of interest on State and local government qualified private activity bonds for private non-profit hospital facilities: 2010-2014 Total: \$10.8 Billion

- Financial Institutions: Exemptions of credit union income: 2010-2014 Total: \$2.3 Billion
 - Insurance Companies: Special deduction for Blue Cross and Blue Shield companies: 2010-2014 Total: \$2.1 Billion
 - Community and Regional Development: Eliminate requirement that financial institutions allocate interest expense attributable to tax-exempt interest: 2010-2014 Total: \$1.6 Billion
- Source: ("Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014" Prepared for the House Committee on Ways and Means and the Senate Committee on Finance by the Staff of the Joint Committee on Taxation, December 15, 2010 - JCS-3-10)*

In February 1987, a GAO report found:

- The U.S. Department of Commerce estimates that \$1.2 billion, or 1.3 percent, of the \$91 billion gross national product (GNP) in 1930 could be attributed to non-profit institutions. This share grew to \$131 billion, or 3.3 percent, of the \$3,989 billion GNP by 1985;
 - A 1975 IRS Statistics of Income (SOI) study found that for tax-exempt organizations (religious, schools and colleges, cultural and historical, other instructional, health-related services, scientific research, business and professional, farming and related, mutual organizations, employee or membership benefit, sports-athletic-recreational and social, youth, conservation and environmental, housing, inner city or community, civil rights, litigation and legal aid, legislative and political advocacy, other activities directed to individuals, other activities directed to organizations, other purposes and activities, no activity reported) on average, 39% of their total activity receipts were business receipts; and
 - Complete data do not exist to quantify the nature, extent, and impact of competition between non-profits and the private sector. However, the limited data available indicate that taxable businesses and some tax-exempt organizations are increasingly competing to provide similar services.
- Source: (GAO Briefing Report to the Joint Committee on Taxation; "Tax Policy: Competition Between Taxable Businesses and Tax-Exempt Organizations", February 27, 1987 – GGD-87-40BR)*

In March 1980, a report of the Small Business Administration (SBA) Advocacy Task Force Group on Government Competition with Small Business found:

- The activities of foundations and universities were of particular concern to a number of witnesses;
- In Fiscal Year 1978, the IRS audited approximately 17,000 of the 150,000 required filings by non-profits. Unrelated business income was discovered in 1,800 or 10.6 percent of these 17,000 audited cases. Of the 1,800 audits where unrelated business income was discovered, 46 percent (828 cases) resulted in successful action by IRS to levy additional taxes, and a combined total of \$10 million was recovered. On average, the IRS recovered additional taxes at the

rate of \$12,078 per audited case where unrelated business income was discovered and recovery action succeeded; and

- The small business community's perception of the extent of abuse of the tax system by non-profits strongly suggests that a more extensive review of unrelated business income activities is warranted.

Source: ("Government Competition: A Threat to Small Business" Report of the SBA Advocacy Task Force Group on Government Competition with Small Business, March 1980)

This is a problem that is growing, not diminishing. From 1975 to 1990, the non-profit sector grew by 150 percent, while the gross domestic product grew about 50 percent.

Now, this growth is not a bad thing in itself. It is wonderful that the services non-profits provide are growing. The non-profit organizations have more resources and more assets to serve the people who need their services.

Unfortunately, we have found that for many non-profits, much of their revenue is coming from fees for products and services, not charitable donations. In many cases these fees are from services that duplicate and compete with tax-paying companies, including small businesses in this country. The problem is growing.

None of us are against non-profit organizations. Many of us support museums or YMCAs, the Cancer Society or a university. They do many wonderful things.

We are not suggesting that the Girl Scouts should not be able to sell cookies as a fundraiser. We are not saying the YMCAs should not have programs to help at-risk youth. However, charities and non-profit organizations should not be able to use their tax-exempt status to get tax-free donations, to avoid paying real estate taxes, to avoid paying income taxes on what are essentially 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.

Here are five very specific recommendations.

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 non-profits 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. It is only when we move beyond hidden subsidies and the ineffectual regulations of UBIT that both consumers and producers, and all taxpayers, will be able to enjoy the benefits of even-handed competition. In forming a commercial subsidiary, this would help implement a “commerciality clause”, and thus implement 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 non-profit and, instead, should actually be performed by a tax-paying private sector firm.

Non-profit competition is part of a larger problem of unfair government sponsored and tax-subsidized competition with private enterprise including government (including the insourcing of contracts performed by tax-paying private sector firms out of the private sector for performance by Federal employees), universities, non-profits, prison industries, etc. The Federal government can lower costs and increase revenue by applying the “Yellow Pages’ Test”.

The Federal government employs some 2 million Executive Branch, Non-Postal, Full-time, Permanent Employees. Some 850,000 of those employees – are in jobs that are “commercial” in nature. Only a handful of the 850,000 current commercial positions have been studied to determine whether government employees or private sector workers can perform these activities more effectively. Not only do Federal agencies duplicate private business, but many engage in unfair government competition with the private sector.

In December 2012, BCFC attempted to bridge the impasse in negotiations on the fiscal cliff and sequestration by providing President Obama and Congressional leaders budget savings of \$795 billion by simply utilizing tax-paying private sector firms for commercially available goods and services currently performed by a government or tax-subsidized entity. The federal government can achieve \$795 billion in savings simply by getting out of activities that duplicate or compete with the private sector, which subsidize unfair competition with private, for-profit companies, or by privatizing activities for which there are current or potential private sector providers. This includes:

- Sell Federal lands and other assets, expedite oil and gas production on federal lands and in federal offshore areas, return the National Forest System to profitability by increasing timber sales, and increase coal leasing on federal lands- \$300 Billion
- Privatize the William D. Ford Federal Direct Student Loan Program - \$116 Billion
- Privatize federal power marketing administrations (PMAs) - \$62 Billion
- Pay federal employees at parity with the private sector - \$47 Billion
- Return unspent TARP money - \$44 Billion (as of September 30, 2012)
- Enforce UBIT on commercial activities revenue of non-profits - \$36 Billion

- Auction government-owned wireless spectrum - \$36 Billion
- Privatize Fannie Mae & Freddie Mac - \$30 Billion
- Apply the Yellow Pages test to 850,000 commercial positions in the Federal workforce - \$27 Billion
- End Energy Subsidies - \$20 Billion
- End Federal subsidies and other mandatory support for agriculture – \$15 Billion
- Sell the remaining government owned shares (500,000) of GM (\$25/share) - \$12.5 Billion
- Eliminate Federal Transit subsidies - \$10 Billion
- Eliminate Federal subsidies for High Speed Rail and Amtrak - \$9.6 Billion
- Remove the Pentagon from running grocery stores - \$9.1 Billion
- Privatize the Postal Service - \$7 Billion
- Eliminate the Community Development Block Program - \$6 Billion
- End the tax expenditure exemption of Credit Union income - \$1 Billion
- Privatize the Tennessee Valley Authority - \$1 Billion
- Privatize the National Weather Service - \$1 Billion
- End the Tax Expenditure the special non-profit Blue Cross/Blue Shield organizations over for-profit firms deduction - \$700 Million
- Terminate the Economic Development Administration - \$523 Million
- Terminate the tax break certain non-profit hospital facilities have over for-profit firms - \$500 Million
- Eliminate business subsidies from the National Institute of Standards and Technology - \$500 Million
- Eliminate NeighborWorks America (formerly the Neighborhood Reinvestment Corporation) - \$480 Million
- Eliminate the Hollings Manufacturing Extension Partnership and the Baldrige National Quality Program - \$455 Million
- Eliminate public funding for the Corporation for Public Broadcasting - \$430 Million
- Eliminate the Legal Services Corporation - \$398 Million
- Eliminate the International Trade Administration's trade promotion activities - \$267 Million
- End the tax expenditure tax-exemption of certain insurance companies owned by tax-exempt organizations - \$200 Million
- Eliminate the National Health Service Corps - \$150 Million
- Eliminate the Appalachian Regional Commission - \$73 Million
- Reform the U.S. Army Corps of Engineers (USACE) Laboratory Validation Program - \$1.3 Million

The advantage of using various forms of privatization to avoid the fiscal cliff is three-fold -- (1) tax rates do not need to be raised, thus preventing a strain on economic growth, (2) services would still be available to the populace, the only difference being the user, rather than the general public, will pay to use the service, and prices will be determined by the market, not the artificial whim of government, and (3) the deficit can be reduced while preserving the safety net of critical programs for the neediest Americans. We also

commend to your attention the numerous recommendations of the Reagan Administration's 1988 Privatization Commission that have not been implemented.

Unfair non-profit and governmental competition with the private sector, and small business, is a public policy issue deserving of immediate attention and reform. This hearing will provide an important forum for the private sector to discuss the broader aspects of this issue. I commend your efforts to further explore private sector complaints in this area and advance the debate. The private sector seeks a competitive environment in which all participants play by the same rules.