

Nonprofit Tax Policy— A Game *of* Three- Dimensional Chess

by Tim Delaney

THIS IS THE STORY ABOUT THE ONE THING THAT all charitable nonprofits share—connection to nonprofit tax policy—and how it comes about. This is not the story of sausage making, like the legislative process, but about how nonprofits, networked together, promote their common interests and distinct missions.

The process for developing nonprofit tax policy is not particularly complicated—other than that it gets formed in uncoordinated yet interconnected ways that influence each other, inside a giant, multihub, decentralized system of local, state, and federal governments, spread across the legislative, executive, and judicial branches. To put it another—more “simplified”—way, the formation of nonprofit tax policy is a bit like playing three-dimensional chess, in that tax policy proposals can spread horizontally (from state to state or from one local government to another) and vertically (from federal to state to local and back again) and diagonally (from one branch of government to another).

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To illustrate one of the many challenges that nonprofits face when dealing with nonprofit tax policy, consider the government side of this multi-dimensional chess game. The federal government alone has many thousands of decision makers shaping tax policies affecting nonprofits. These officials are located throughout the legislative, executive, and judicial branches, making uncoordinated choices as they establish, implement, enforce, and interpret elements of those tax policies. It's not only Congress and the president, but also the U.S. Department of the Treasury, including the Internal Revenue Service; the Office of Management and Budget; the U.S. Department of Justice; and dozens of other departments, agencies, and bureaus—interpreted and enforced further by 663 federal district court judges, thirteen circuit courts, and the U.S. Supreme Court. For variety, you can then add similar officials strewn across the fifty states and the District of Columbia, plus nearly ninety thousand local governments (counties, municipalities, school districts, and special districts).

Given the large number of people playing this chess game, it's important to recognize three facts. First, while at times the intent of such officials is

to alter existing tax policy relating to nonprofits, it is also true that they often focus on entirely different objectives without ever considering the impact on nonprofits, which can quickly become unintended collateral damage. The reality that legislation, rules, and court cases affecting nonprofits often aren't labeled "nonprofit tax policy" means that nonprofits must be ever vigilant.

Second, there is not one universal "nonprofit tax policy" about which the chess players are aware; rather, there are large numbers of tax policies that affect nonprofits. Even something as simple as sales taxes (should nonprofits have to pay and/or collect them?) varies widely across the states.

Third, one cannot assume that all nonprofits are of one mind regarding "nonprofit tax policy." With more than 1.4 million 501(c)(3) organizations registered with the IRS, that fact should not be surprising—but it's often forgotten.

Unfavorable tax policies—whether intentional or not—can limit, severely restrict, or even eliminate the ability of nonprofits to advance their missions. Yet no single nonprofit has the capacity to monitor or respond to tax proposals throughout

the country that might harm the work of the sector. That is why staying on top of nonprofit tax policy requires a networked approach.

Tax Policy Is a Power Game

It would be comforting if tax and other public policies were made rationally, based on logic and irrefutable facts. For instance, utilitarians—both classical (Jeremy Bentham, John Stuart Mills) and modern—would have policy makers conduct a cost-benefit analysis to identify what laws (including tax laws) would promote the greatest benefits and do the least harm. Applying this view, calculations could be made on how increasing this element and altering that one on the Rubik's Cube of tax policy should deliver a particular result.

Occasionally, it can work that way. But at the end of the day, tax policy is an exercise of power. Some interest group (a business, industry, unit of government, economic or political class, and the like) simply wants more money. Does it have enough power to alter tax policy? If its desire for more money is strong enough, a political tug-of-war between the status quo and those

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The Cornerstone of Nonprofit Tax Policy

In simplest terms, formal nonprofit tax policy can be traced back more than four hundred years, when Parliament enacted the Charitable Uses Act of 1601.* Before then, certain activities to benefit other people with emotional, spiritual, and material comfort were sometimes deemed worthy of being exempt from taxation. But what got treated as exempt varied, as determined by different ecclesiastical courts, which tended to uphold gifts for pious and charitable purposes, thus reducing the taxes collected while increasing the power of churches. So Parliament stepped in to regulate in a more systematic manner.

Europeans brought that concept, including the Act's preamble, to North America. Even before the United States was established, entities now considered to be nonprofits were treated that way, such as Yale College (1701) and the nation's first lending library (founded by Benjamin Franklin in 1731). Later, state constitutions and statutes exempted charities from taxation. Today, section 501(c)(3) of the federal tax code is based largely on the Charitable Uses Act of 1601.

*Specifically, the preamble to the Charitable Uses Act of 1601 identified the types of items that would not be taxed: "[...] the relief of aged, impotent, and poor people; the maintenance of sick and maimed soldiers and mariners; schools of learning; free schools and scholars in universities; the repair of bridges, ports, havens, causeways, churches, sea banks, and highways; the education and preferment of orphans; the relief, stock, or maintenance of houses of correction; marriages of poor maids; support, aid, and help of young tradesmen, handicraftsmen and persons decayed; the relief or redemption of prisoners or captives; and the aid or ease of any poor inhabitants covering payments of fifteens, setting out of soldiers, and other taxes." (As quoted in Nuzhat Malik, "Defining 'Charity' and 'Charitable Purposes' in the United Kingdom," *International Journal of Not-for-Profit Law* 11, no. 1 [November 2008]: 37.)

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wanting more money will ensue—regardless of whether “more money” in a given case is for the common good or for special interests. It’s about who has sufficient power to win the tug-of-war.

It started that way in 1601, when England’s ruling class—seeing “their” tax revenues and attendant power being taken by religious institutions—exerted power to secure the Charitable Uses Act. It continues through modern times. The federal Tax Cuts and Jobs Act that passed in December 2017 provides three graphic examples of how the exercise of power fueled by desire for more money can override everything else when tax policy is involved.

1. The Republican majorities in the House and Senate developed and passed the most comprehensive rewrite of the federal tax code since 1986, without a single hearing for public input and without a single supporting vote from the Democratic minority in either chamber. (Note: Not the first case of one-sided congressional action. For example, Democrats passed the Affordable Care Act without a Republican voting in support. The point here is not to ascribe blame but to show—with a recent example—that those who hold power can and will bypass procedural fairness and logic to achieve what they want.)
2. Lobbyists for corporate America and the wealthy demanded “more money” for their clients in the form of cuts in corporate and individual income taxes. To slightly counterbalance the revenue the federal government would lose by cutting those taxes, the chair of the House Committee on Ways and Means at the time, Representative Kevin Brady (R-Texas), needed to create or increase taxes on other items. He did that in part by imposing a 21 percent unrelated business *income* tax on nonprofits for their *expenses* providing parking and transit passes to their employees. The concept of imposing an income tax on outflow of expenses is baffling, but the chairman did it because he had the power to get more money for corporations and the wealthy. (He has since agreed—after intense lobbying—that this parking and transit provision should be repealed.¹)

3. The House majority stuck language into its version of the bill regarding an issue that had already been defeated (and was opposed almost universally by charitable nonprofits, houses of worship, and foundations): evisceration of the long-standing Johnson Amendment, which protects nonprofit nonpartisanship. Had they prevailed, partisan elites would have flooded churches and charities with about \$20 billion in dark money—not only to secretly influence elections but also to provide about \$7 billion in tax relief via charitable tax deductions to those making hidden political donations, according to calculations by Congress’s Joint Committee on Taxation. Fortunately, that language did not get through the Senate, so the protections of the Johnson Amendment remain firmly in place.

The lesson of each of these examples is that the power game frequently takes precedence over logic, the ethics of cost-benefit analyses, regular processes, and/or fundamental fairness on matters concerning tax policy issues. This places a heavy burden on the nonprofit sector to be present in tax debates at every level of government and monitor tax proposals in every branch of government. This sounds quite daunting, but coordinated and cross-informed action has proved successful, as can be seen below.

Horizontal Migration of Policy Proposals

Proposals for tax policies affecting nonprofit operations often migrate horizontally, moving from state to state and local government to local government. Sometimes that happens when two jurisdictions share a common border (and perhaps media markets); other times, however, identical proposals appear in noncontiguous jurisdictions.

Proposals Jumping from State to State

In 2011, new governors in Hawai’i and Michigan limited charitable giving incentives in their states because they wanted more money for their priorities.² In Hawai’i, the Democratic governor wanted more money to fill a state budget deficit he inherited, so he called for a cap on the amount

The Math of Charitable Deductions

When tax laws allow people to deduct from their reported income some or all of the amount they gave to charity, those people pay taxes on a lower amount. Consequently, the government receives less revenue via taxes. The reverse is true as well: if policy makers reduce or eliminate the deductibility from reported income of money that taxpayers contributed to charity, then those taxpayers will have higher reportable incomes and pay more in taxes, generating more revenue for the government. The same applies at both the state and federal levels.

of itemized deductions taxpayers could claim, which would also have the effect of limiting deductions for charitable donations. In Michigan, the new Republican governor, wanting more money to replace revenue the state would lose when he cut corporate taxes, targeted three tax credits that had proven successful as incentives for increasing charitable giving in the state.

While their intentions differed, the results were the same: research showed that contributions to charitable organizations fell precipitously in both states. In Hawai'i, the new tax policy brought in almost \$12 million in new revenues for state government to use, but charitable donations dropped by about \$60 million, according to the Hawaii Community Foundation. In Michigan, many people still donated to the work of food banks, homeless shelters, state colleges, and community foundations, yet without the tax credits to incentivize giving more, contributions to support the work of those nonprofits dropped that year by approximately \$50 million.

That's the bad news. The good news followed two years later.

In 2013, the nonprofit community in Hawai'i—led by the Hawai'i Alliance of Nonprofit Organizations—presented evidence to state officials proving that the cap on itemized deductions for charitable giving brought the state only one dollar for every five lost for use in communities.

The data and advocacy helped persuade lawmakers to carve out charitable deductions from the caps, thus reinstating the full incentive for taxpayers to claim itemized charitable deductions.³

Within weeks, a spate of legislative proposals to reduce charitable giving incentives popped up in several more states, including Oregon, Minnesota, Kansas, and North Carolina. That's when the power of a distributed network shines—this time in two important ways. First, information about this type of recurring threat is circulated throughout our networks of state associations of nonprofits and state policy allies, putting everyone on alert to identify similar proposals. While policy people always try to spot potentially harmful legislation, knowing that there's been an outbreak of similar bills sharpens the senses—like with people who live in Tornado Alley: it's one thing to be generally aware, and quite another when the tornado warning gets issued.

Second, the states that first encountered the problematic legislation shared what they saw and heard with the network, allowing each incident to be treated like a focus group or case study. Tapping into lessons learned in both Hawai'i and Michigan, the Nonprofit Association of Oregon identified a particular flaw in the proposal there and, working with nonprofits in that state, defeated legislation that would have included charitable donations in a proposed cap on itemized deductions. Oregon, in turn, added its insights, as did the Minnesota Council of Nonprofits, nonprofits in Kansas, and the North Carolina Center for Nonprofits when they defeated limitation legislation in their states. And as similar legislation has popped up in the years since then, everyone in the network has been able to tap into the experiences of colleagues. There is no cookie-cutter approach; each state association of nonprofits adds its own “accent” to materials, addresses any unique twists, and mobilizes its own networks of contacts and skills. Yet having access to that data bank of peers' insights has proven to be quite valuable (roughly \$50 million of contributions saved annually per state that prevailed) to the work of charitable nonprofits and the individuals and communities they serve.

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The nonprofit community needs such a network to counterbalance the variety of networks of government officials and the intricate networks of the business sector. One way in which tax proposals travel horizontally is through those networks. Government officials attend a variety of national or regional conferences and convenings of their peers, where they exchange ideas and learn about what has been tried elsewhere. These peer groups (such as the Council of State Governments, National Governors Association, National Conference of State Legislatures, National Association of Counties, National League of Cities, and many others) host meetings quarterly or semiannually. Given the rash of attempts by noncontiguous states in 2013 to reduce charitable giving incentives, it's likely that at an event someone shared information about the Hawai'i and Michigan experiments, and people from Oregon, Minnesota, Kansas, and North Carolina heard about the concept and tried to import it to their states.

Tax Ideas That Commonly Spread among Local Governments

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Direct Property Taxes on Charitable Nonprofits. In New Orleans, the mayor called on Louisiana's legislature to amend the state's constitution and allow the city to directly tax the property of charitable nonprofits (but legislators refused, after hearing from the Louisiana Association of Nonprofit Organizations and other nonprofits). Commissioners of Allegheny County, Pennsylvania, voted unanimously to impose a property tax assessment on nonprofits, only to have the county executive veto the tax because it violated the state constitution. Jurisdictions acting less transparently conjured ways to evade state laws that exempted nonprofit property from taxation by inventing approaches

like "bed occupancy taxes" for select categories of nonprofits—that is, imposing a fee for every bed occupied by sick patients in nonprofit hospitals, students attending nonprofit universities, and residents of nonprofit nursing homes.

Many localities determine whether a particular nonprofit-owned property is tax exempt based on its use. For instance, some municipalities push for audits of local "eds and meds" to determine if, and how much of, their property is being used to operate profit-making business endeavors. Similarly, every few years we see a trend of local tax auditors suddenly rejecting long-standing exemptions, which forces individual nonprofits to spend resources to challenge the changed assessment administratively or in court, or nonprofits to respond collectively in different ways.

Payments in Lieu of Taxes. Every state has a law—a constitutional provision, a statute, or both—that exempts charitable property from taxation when used in pursuit of charitable purposes. Those laws are part of the social compact that traces back to 1601. Some municipalities, recognizing that legal limit on their power, have turned to a device called "payments in lieu of taxes," or PILOTs. In their friendly form, PILOT agreements are negotiated between a municipality and certain nonprofits—usually larger institutions with larger footprints, such as universities and hospitals. Common arguments from the host city of the larger nonprofits are that the fates of the city and nonprofit are intertwined, or that the city has to hire extra police or fire services to accommodate the added demands. Larger nonprofits often point to the state laws exempting property, all the added tax revenues that the nonprofit produces as an employer and purchaser of goods, the reduced costs of government that result, the unique community benefits provided by the nonprofits, and the higher property values and tax base attributable to the institutions. After negotiations, an understanding is reached.

Occasionally, situations become more heated, and municipalities demand "voluntary" payments. Some cities have resorted to not

issuing zoning variances or special-event permits, while at least one city has sent simulated property tax bills to dozens of the largest nonprofits demanding “voluntary” payments of up to 25 percent of an imaginary tax liability and then, with all the subtlety of a scarlet letter, publicly posting the names of nonprofits that paid and those that did not.

Here’s another way that a nationwide network of nonprofits provides value. Different state associations of nonprofits noticed pieces to a puzzle that, when put together, revealed a trend: occasionally, a local elected official would make assertions that “More than half the city’s property is tax exempt!” The official would then demand that nonprofits “pay their fair share.” But by having access to multiple data sets provided by the state associations, we were able to discern a pattern: too often, the politicians’ assertions were distorted, a cherry-picking of data. While true in many instances that more than half of a city’s property was exempt from taxation, the vast majority of that property was owned by local governments in the form of streets, schools, parks, airports, and of course, city hall, plus tax-exempt properties owned by the state government (e.g., highways, administrative offices, perhaps state capitol grounds) and the federal government (e.g., post offices, court buildings, maybe military bases, and more). It turned out that in most cases charitable nonprofits owned a comparatively small amount of property. Subsequently, after a few officials in different places were challenged publicly for making the misleading statements, this tactic largely stopped.

Vertical and Diagonal Migration of Policy Proposals

When policy ideas move horizontally, they almost always are made willingly, such as when a city proactively borrows an idea from another city’s experiment, or when a state imports a revenue-generating or cost-cutting idea from another state. But when policy decisions are made vertically between levels of government, they are often reactive in nature, such as states having to react to federal changes. And those vertical migrations are often diagonal as well,

such as a U.S. Supreme Court decision causing state legislatures and executive branches to respond.

Proposals Flowing from Federal to State

The federal government moves like a giant elephant: with each policy step it takes, it shakes everything beneath it. That’s especially true in the tax arena because of the often interlocking nature of tax policy. Recent and upcoming actions by all three branches of the federal government mean that nonprofits must be engaging in tax policy debates happening in the states.

Congress. With the Tax Cuts and Jobs Act of 2017 (TCJA) now in place, it’s tempting to believe that the only things left for nonprofits to do are try to amend it and comply with it. But the 2017 federal tax law pushed a lot of potential problems for nonprofits down to the states, including in the following and other ways:

- *Conformity.* Most states base part of their state income tax law on the federal Internal Revenue Code. Post-TCJA, each state now has a choice: Does it make changes to conform, or should it decouple its laws? Either way, states are reopening their tax codes to make accommodations. Whenever a legislative body starts to make changes to a tax code, there will be new winners and losers—sometimes by design of lawmakers but other times because of error. For example, in 2018, Vermont repealed its charitable deduction and replaced it with a less beneficial and capped tax credit—all in the name of conforming to the new federal tax law. In Kentucky, the legislature amended sales taxes and inadvertently expanded the tax to admissions to nonprofit fundraising events.
- *UBIT on Parking and Transit Benefits.* A specific example of conformity concerns the new 21 percent unrelated business income tax (UBIT) on nonprofits for the expenses they incur providing parking and transit passes to employees. Several states have had laws that automatically conform to federal law and impose parallel state taxes. In New York, for instance, the state tacks a 9 percent tax on

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One of the great hallmarks of the American form of government is federalism. As Supreme Court Justice Louis Brandeis famously observed, states serve as laboratories and can try “novel social and economic experiments without risk to the rest of the country.” That’s true with respect to tax policies, too.

anything on which the federal government imposes UBIT. Last year, state associations of nonprofits in New York and North Carolina sprang into action and secured legislation decoupling their states’ UBIT laws relating to parking benefits to employees.

Executive Branch. The House and Senate majorities inserted a provision in the TCJA that many saw as designed to punish residents of “high-tax states” (which happen to be predominantly Democratic along the two coasts) by capping at \$10,000 the amount taxpayers can deduct for the state and local taxes (SALT) they paid. In response, Connecticut, New Jersey, and New York enacted laws essentially allowing their states’ taxpayers to “work around” the federal limit by making a “charitable contribution” equal to their tax liability to special state-created charitable entities. The workaround laws would enable the taxpayer to claim a state tax credit to cancel most of the state tax liability and also claim a 100 percent tax deduction on federal taxes. The Treasury Department then issued proposed regulations that would prevent the workarounds—and put into question the deductibility of scores of other special tax incentives, such as the North Dakota Endowment Fund Contribution Credit.

Supreme Court. In 2018, the Supreme Court reversed decades of precedence by ruling that states have the power to impose sales taxes on entities with a certain amount of economic activity in their state, even if the entity does not have a physical presence there. (See *South Dakota v. Wayfair*.⁴) By the end of this year, because the decision opens access to roughly \$23 billion in potential new sales tax revenues, every state will have modified its laws—whether by statutes or regulations. Any nonprofit that buys or sells anything over the Internet, now or in the future, has an interest in how this new state tax policy issue created by the Supreme Court gets resolved.

The states have never been of one view as to whether charitable nonprofits should be exempt from sales taxes. The majority view has been that charitable nonprofits are exempt from paying

sales taxes on their purchases. Many states also recognize a related exemption from having to collect, report, and remit sales taxes on items or services they sell. But what will happen to charitable nonprofits selling things online like magazine subscriptions, online marketplaces, ticket sales for events, online auctions, and more? In the past, nonprofits looked to their home state’s laws. But after the fifty states and the District of Columbia all change their laws in response to the *Wayfair* decision, which state’s sales tax laws will control? Might charitable nonprofits in some states continue to enjoy exemptions, while others selling items online suddenly face a multitude of additional taxing jurisdictions (there are more than three hundred in Colorado alone) with endless new registration, calculation, reporting, and payment requirements? As states craft new laws and systems, advocacy opportunities may arise to streamline processes and expand exemptions in your state. Or nonprofits could lose exemptions as powerful interests expand their tax benefits at the expense of nonprofits.

Proposals Jumping from State to Federal

One of the great hallmarks of the American form of government is federalism. As Supreme Court Justice Louis Brandeis famously observed, states serve as laboratories and can try “novel social and economic experiments without risk to the rest of the country.”⁵ That’s true with respect to tax policies, too: When federal officials were proposing to cap or limit deductions that would have reduced charitable giving, we at the National Council of Nonprofits shared with Congress and the White House (as well as with our colleague organizations that focus on the federal level) the insights our network gleaned in 2011 and 2013 about how the states—red, blue, and purple—were finding that capping or eliminating charitable giving incentives significantly undermined financial support for the work of nonprofits. We urged Congress then—as well as when it was preparing for the comprehensive tax reform that surfaced as the Tax Cuts and Jobs Act—to see the initial damage done in Hawai’i and Michigan. We also underscored how fiercely nonprofits responded in their states to protect

the charitable giving incentive against the threats to eliminate, cap, or reduce the various incentives. Fortunately, several in Congress recognized that charitable giving is not a loophole but a lifeline for the communities we all serve.

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The United States has built the largest nonprofit sector in the world, due in part to the fact that federal and state governments have offered favorable tax treatment and charitable giving incentives for a full century. The complex battles over whether these tax laws still make sense in the same way will surely be with us for the next century.

The lessons learned and alliances built show that, for the most part, the nonprofit sector is prepared to engage in these tax policy struggles—living out the wisdom, often attributed to Thomas Jefferson, that “the price of Liberty is eternal vigilance.”

NOTES

1. Naomi Jagoda, “Brady amends his tax package to help nonprofits,” *The Hill*, November 29, 2018, thehill.com/policy/finance/418899-brady-amends-his-tax-package-to-help-nonprofits. (As I write this, the lobbying efforts continue; bipartisan legislation has been introduced in both the House and Senate.)
2. Elaine S. Povich, “Charitable Giving Tied to State Tax Deduction Decisions,” *Stateline*, Pew Charitable Trusts, September 24, 2013, www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2013/09/24/charitable-giving-tied-to-state-tax-deduction-decisions.
3. Ibid.
4. *South Dakota v. Wayfair*, 138 S. Ct. 2080 (2018).
5. *New State Ice Co. v. Liebmann*, 285 U.S. 262 (1932) (Brandeis, J., dissenting).

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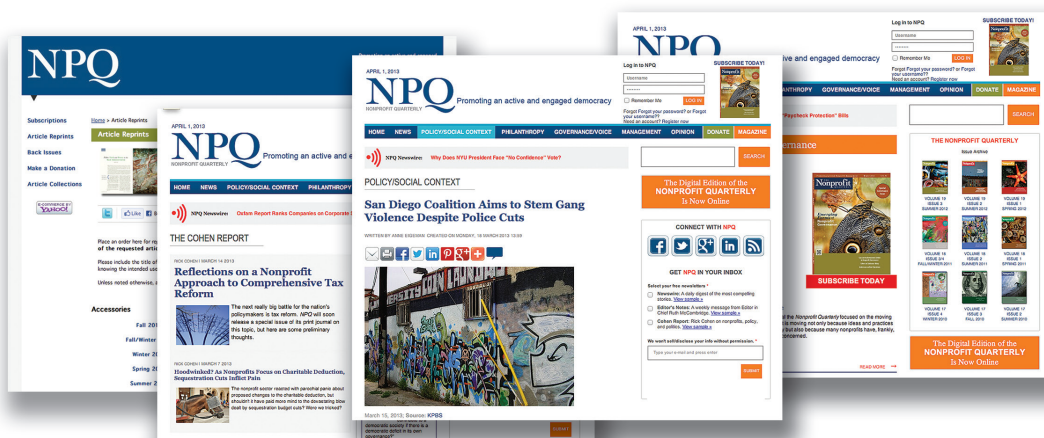
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