Citizens League Report

# Cut Tax Exemptions, Boost Equity and Accountability

Prepared by
**Tax Exempt Committee**
**Allen Olson, Chair**
**Craig Olson, Vice-Chair**

**Approved by the Citizens League Board of Directors**
**October 20, 1988**

Citizens League
708 South Third Street
Suite 500
Minneapolis, MN 55415
338-0791

**TABLE OF CONTENTS**

## LIST OF TABLES

## SUMMARY

Minnesota's policy of exempting government and nonprofit organizations from most taxes should be changed. It unfairly raises taxes on those who do pay, sends the wrong economic signals to both those who pay and those who don't, and ignores the fact that the nonprofit and for-profit sectors are beginning to look more and more alike.

The Legislature should:

* Apply the sales tax to purchases made by all governments and nonprofit organizations, but provide a two-year transition period to assist organizations in the adjustment.

* Require government agencies and nonprofit organizations that are exempt from property taxes to pay fees for property-related services provided by local governments.

* Tax the income of nonprofit organizations from those business activities that are unrelated to the exempt purpose of the organization.

However, the Legislature should still exempt basic activities of government and nonprofit organizations from state income taxes.

The Legislature should expand incentives, through income tax credits, for individual contributions to nonprofit organizations.

All money collected by government as a result of extending the sales tax to government and nonprofit purchases, from taxing income of unrelated businesses of nonprofits, and from imposing fees for property-related services should be used to reduce tax burdens.

<u>The sales tax exemptions</u> on purchases of nonprofit organizations and government should be removed because:

* Not all nonprofit organizations or governments receive the exemption.
* The exemption has the effect of making all taxpayers contribute to the nonprofit organization or a taxing jurisdiction, even though the organization or taxing jurisdiction may serve only the interests of its members or residents.
* The exemption gives a nonprofit organization an advantage over a for-profit or other nonprofit organizations engaged in the same or similar activities.
* Any exemption narrows the tax base, which means the tax rate must be higher in order to bring in the same amount of money.
* The exemption may encourage formation of nonprofit organizations for the sole purpose of avoiding the tax.
* Purchases of nonprofits enjoying the exemption are not audited by the Department of Revenue to determine whether they fit the requirements. The law makes merchants responsible for enforcement.

* There is no accountability because effective and regular review of exemptions do not exist.
* By removing part of the cost of a purchase, the exemptions distort decision-making in nonprofits and governments.
* Ending the exemption would bring in an estimated $36 million from nonprofits and $47 million from government in 1989.

<u>Owners of tax-exempt property</u> should pay a fee for property-related services received from government because:

* Ownership of property brings with it a demand for services, including roads, fire and police protection. Since all property requires and benefits from property-related services, all property owners, including governments and nonprofit organizations, should share in the cost of providing these services.
* Property exempt from taxes may serve an area much wider than the taxing jurisdiction in which it is located, but taxpayers within that jurisdiction pay most of the cost of the exemption.
* Some organizations providing the same or similar services as those enjoying property tax exemptions are unable to enjoy the benefit of property tax exemptions.
* There is no accountability because effective review of exemptions does not exist.

Property exempt from taxes should pay a fee based on the value of services received rather than be subjected to the property tax, because the system of taxing property on its "highest and best use" would ignore the public good delivered by the exempt organizations and governments.

<u>Income from unrelated business activities</u> of nonprofits and governments should be taxed because:

* Failure to tax puts competitors at a disadvantage.
* Imposing a tax will send an important message to nonprofit organizations--engaging in unrelated business is a move away from the organization's purpose and toward profit-making status.
* Imposing the tax will bring in between $300,000 and $400,000 a year in Minnesota.

## INTRODUCTION

This Citizens League study is partly a result of the 1987 Legislative debate about whether to extend sales taxes to a variety of organizations and to services. The proposals considered by the Legislature were primarily motivated by the need to hold or lower tax rates and raise revenue.

Our study took a different look at the issues surrounding tax exemptions. We evaluated the nature and role of the two types of organizations receiving tax exemptions, governments and nonprofits, in the context of all organizations. We focused on how state tax policy should promote the goals of accountability, equity, and economic efficiency. Our findings and recommendations are not intended to create revenue windfalls for state and local governments.

Concerns about tax exemptions are not limited to Minnesota. Other states are also reviewing and making changes to tax exemptions. A few have changed their definition of charity, or limited the availability of tax exemptions. At the federal level, the Subcommittee on Oversight of the House Ways and Means Committee is examining current "unrelated business income" tax policy, because small business owners allege unfair competition from nonprofit organizations.

# FINDINGS

## I. GENERAL

### A. History of Nonprofit Organizations

1. **Private voluntary and charitable organizations have existed for hundreds of years and so has support for them.**

Charitable organizations existed for centuries before any government considered what their role should be. Prior to the 17th century, charitable causes were directly connected with religion. Later, charitable purposes became more secular and included providing health care, building and maintaining roads and bridges, education, and assisting the poor. [1]

Individuals have always contributed to the causes of these organizations, through gifts and bequests. [2]

2. **With the passage of the Statute of Charitable Uses, government defined specific purposes as charitable.**

In 1601, the English Parliament passed the Statute of Charitable Uses. One purpose of the statute was to define charitable purposes.

As enumerated in the statute, charitable purposes include:

> relief of aged, impotent, and poor people...maintenance of sick maimed soldiers and mariners, schools of learning, free schools, and scholars in universities...repair of bridges, ports, havens, causeways, churches, sea-banks, and highways... education and preferment of orphans...towards relief, stock, or maintenance for houses of correction...for marriages of poor maids...for supportation, aid, and help of young, tradesmen, handicraftsmen, and persons decayed...for relief or redemption of prisoners or captives...for aid or ease of any poor inhabitants concerning payments of fifteens, setting out of soldiers, and other taxes.

While charitable purposes are specifically enumerated in the Statute, a history of the period shows the intent of the Statute was not all inclusive. [3] The concepts of public benefit and relief of poverty were, however, concluded to be the keys of the Statute. [4]

3. **American charitable organizations followed the purposes and traditions of English charities.**

American charities, begun by early settlers, followed English precedents. American historians find church-affiliated organizations developed to provide a large variety of social services, including health, adoption, foster care, counseling, and care of the poor, while other organizations concentrated on the development of educational institutions. [5]

Alexis de Tocqueville, in his book Democracy in America, was fascinated by the tendency of Americans "of all ages, all stations in life, and all types of dispositions" to form associations..."religious, moral, serious, futile, very general and very limited, immensely large and very minute." De Tocqueville concluded the American tendency to form organizations to meet common needs, rather than wait for government to do so, to be a unique aspect of our democracy.

After the American Revolution, lawyers and legislators began to "draw on English legal and organizational precedents (including the Statute of Charitable Uses)..." for the purposes of incorporating different types of organizations. [6]

Early "grants of incorporations were delegations of power from the state to groups of individuals for the performance of public tasks...legislators made the grants selectively to groups of individuals, who...were viewed more as public stewards than as private profiteers..." [7]

## B. Characteristics of Current Tax-Exempt Organizations

Two types of organizations are exempt from some or all state taxes--nonprofits and governments. Nonprofits and governments share some important characteristics and yet are different. For example, both government and nonprofits attempt to produce "public" goods. But governments are elected, while nonprofits form voluntarily. Nonprofits and governments often work together, as in the financing and provision of social services.

This section illustrates the characteristics of tax-exempt organizations. Some similarities and differences are also discussed.

1. **Number of Nonprofit Organizations and Governments**

Nonprofit organizations represent a large and growing sector of the economy. By the Internal Revenue Service's count, the number of nonprofit organizations has grown from 309,000 in 1967, to 887,000 in 1985 (not including governmental units.) [8]

All nonprofits are exempt from the federal income tax. Some are also eligible to receive tax-exempt contributions. These organizations are designated as 501(c)(3) organizations, referring to the relevant section of the Internal Revenue Code. In 1969, 501(c)(3) organizations numbered 138,000. That number grew to 366,000 in 1985. 501(c)(3) organizations also represent a growing portion of all nonprofit organizations, from approximately 34 percent in 1976 to 41 percent in 1985. (See Appendix A.)

The number of active nonprofit organizations in Minnesota is unknown. While more than 38,000 nonprofits are registered with the Minnesota Secretary of State, Minnesota nonprofit corporations are not required to notify state officials at the time the organization dissolves or becomes inactive. The <u>1988-89 Minnesota Nonprofit Directory</u>, published by the Council on Nonprofits, lists 1,507 nonprofit organizations in the state.

While we do not know the number of active Minnesota nonprofit organizations, we know two other facts. First, the growth rate of Minnesota nonprofit organizations is slowing, as evidenced by a smaller number of incorporations. According to state officials, the number of applications for nonprofit corporations fell from 1,526 in 1983 to 1,271 in 1987. [9] Second, most nonprofits in the metropolitan area have formed since 1960. A recent study found "three out of four local nonprofits were formed after 1960, and half after 1970." [10]

Thousands of governmental units exist in Minnesota. In addition to state government, there are 87 counties, 855 cities, 1,802 townships, 435 school districts, and hundreds of other small taxing jurisdictions, such as the Metropolitan Council, hospital districts, fire districts, planning districts, and watershed districts.

## 2. <u>Nonprofit and Government Assets</u>

Nationally, the percent of U.S. assets owned by nonprofits and governments remained virtually unchanged from 1952 to 1975, slightly over 13 percent. Changes occurred, however, in the respective shares of different types of organizations. The federal government's share dropped significantly (from 7.5 percent to 3.9 percent), state/local government's share increased significantly (from 5.6 percent to 8.5 percent), and nonprofit organizations' share increased slightly (from 1.5 percent to 1.8 percent). (See Appendix A.)

Total assets of all Minnesota nonprofits are unknown, although assets for some types of nonprofits are known. For example, Minnesota's 500 foundations hold approximately $2.25 billion in assets. [11]

One type of asset is property. The value of nonprofit and government property increased 40 percent between 1980 and 1986, from $16 billion to $22.6 billion. The value of property owned by different types of exempt organizations is noted in the following table.

Table 1.

**Market Value of Tax-Exempt Property in Minnesota** [12]

| | |
|---|---|
| K-12 Schools | $ 5,980,122,402 |
| Colleges and Universities* | 2,175,500,016 |
| Public Burying Grounds | 135,683,294 |
| Church Property* | 2,662,435,947 |
| Hospitals | 2,005,442,770 |
| Charitable Organizations | 849,226,839 |
| Forests | 994,290,535 |
| Indian Reservations* | 139,354,600 |
| Public Property | 7,652,118,495 |
| TOTAL | $22,594,174,898 |

(*indicates constitutionally-exempt property)

Source: 1986 Exempt Property Values, Local Government Aids and Analysis Division, Minnesota Department of Revenue.

While the value of exempt property is large and growing, it does not match the increase in the value of taxable property which grew 88 percent, from $66.5 billion in 1980 to $123.2 billion in 1986.

3. **Employment**

National estimates of employees of nonprofit organizations vary from 4.95 million to 10.3 million paid workers. [13] If voluntary labor is included, an additional 5.7 to 6.7 million full-time equivalent workers can be added to the total number of persons employed by nonprofits. [14]

We do not know the total number of persons employed by nonprofit organizations in Minnesota. But the number of Minnesota state and local government employees increased from 232,776 in 1978 to 242,746 in 1986. [15]

4. **Revenue**

The vast majority of government revenue is raised by taxation. However, government also raises money from fees for services, licenses, fines, and sales of products.

Nonprofit organizations raise money through voluntary private contributions, sale of services or products, or public grants, or contracts for services.

Today, the degree to which nonprofits rely on contributions, gifts, and grants varies widely, depending on the type of nonprofit. Because only some nonprofits are eligible to receive tax-deductible contributions, the variances are not surprising.

A recent study found the portion of revenues received from contributions, gifts and grants varies from 1 percent to 97 percent among nonprofit organizations, as shown in Table 2.

Table 2.

**Contributions, Gifts and Grants as a Percent of Nonprofit Organization Revenues, 1974-1977, by Industry***

| Industry | Donations as % of Revenues |
|---|---|
| Litigation and legal aid | 97 |
| Civil Rights | 65 |
| Inner City and Community Development | 51 |
| Conservation and environment | 46 |
| Welfare | 43 |
| Advocacy | 40 |
| Instruction and training | 37 |
| Housing | 31 |
| Culture | 27 |
| Legislative and political action | 18 |
| Education | 18 |
| Employee or membership benefit | 15 |
| Scientific research | 14 |
| Health | 8 |
| Farming | 7 |
| Business and professions | 5 |
| Sports, athletic, and social clubs | 4 |
| Mutual associations | 1 |

*Data compiled from IRS form 990 tapes. Organizations were classified by the first activity code listed on the tax form by the organization.

Source: The Nonprofit Economy, Burton Weisbrod, 1988.

Nonprofit organizations eligible to receive tax-deductible contributions also receive a majority of their revenues from sources other than contributions. [16] Only religious organizations (most of whom do not file Form 990 returns with the I.R.S.) continue to rely heavily on private contributions for revenues. [17]

Nationally, more than $87 billion was donated to organizations in 1986. Donors and donees are listed in Table 3.

Table 3.

**United States Philanthropy, 1986**
(In Billions of Dollars)

| Donor Type | Amount Given |
|---|---|
| Individuals | $71.7 |
| Foundations | 5.2 |
| Corporations | 4.5 |
| Charitable Bequests | 5.8 |
| TOTAL | $87.2 |

| Recipient | Amount Received |
|---|---|
| Religion | $40.9 |
| Health | 12.3 |
| Education | 12.7 |
| Human Services | 9.1 |
| Arts/Culture/Humanities | 5.8 |
| Public/Social Benefits | 2.4 |
| Other | 4.0 |
| TOTAL | $87.2 |

Source: Statistical Abstract of the United States, 1988, U.S. Department of Commerce, Bureau of the Census.

The federal government is also a large funder of nonprofit organizations. Direct federal support (through grants or contracts) was estimated at $40.3 billion in 1980. [18] Direct state and local government support was estimated to add an additional $8-10 billion. [19]

Some Minnesota nonprofit activities are financed by government. A recent survey of nonprofit organizations in the Twin Cities found that government provided 40 percent of revenues in 1981. [20]

Twin Cities nonprofits receiving 40 percent of their revenues from the government provide services often used by the poor, including social services, employment and training services, legal services, housing, or advocacy. [21] Other revenues for these nonprofits include fees for service (31 percent) and private giving (22 percent.) [22]

The amount of direct government support is attributable, in part, to changes in public policy. As government adopted social policies, it consciously turned to nonprofit organizations for assistance in implementation of the policies.

5. **Tax-exempt organizations are diverse.**

Nonprofit organizations have a variety of missions. Still, most nonprofits can be grouped into one of these four categories (as defined by the federal courts or IRS regulations):

a. Religious Organizations--assisting others in their beliefs including, but not limited to, the belief in God, associated with most religions;

b. Education Organizations--engaging in training or instruction in which subject matter, useful to the individual and beneficial to the community, is presented in a sufficiently objective manner to enable the recipient to evaluate it and come to an independent judgment;

c. Scientific Organizations--carrying on research in the public interest, the results of which either are available to the public on a nondiscriminatory basis or otherwise benefit the public;

d. Charitable Organizations--engaging in activities that:

   i. meet a recognized need of the community that would not otherwise be met through the functioning of the commercial market;
   ii. serve the public interest as distinguished from a private or "selfish" interests;
   iii. are consistent with law and public policy.

   Additionally, charitable organizations must fulfill their purposes with means reasonably related to the needs they are addressing. [23]

Governmental units are not considered nonprofit by the IRS. Nevertheless, government shares many of the characteristics common in other nonprofits and would pass the legal test imposed by the IRS. One distinguishing characteristic of government is that it serves primarily majority interests--whereas nonprofits can, and do, serve minority interests.

6. **Nonprofits and governments are distinguishable from for-profit organizations.**

Nonprofit organizations share many of the characteristics found in the for-profit sector. For example, the same type of services may be available through both organizations (e.g., travel services, day care services, nursing home services), or the same type of product may be sold by different organizations (e.g., personal computer sales by private businesses and universities.)

Although nonprofit and for-profit organizations sometimes provide similar services or products, there are distinguishing characteristics between the two organizations.

a. The clientele may be different--A recent study found for-profit and nonprofit organizations "catering to different subsets of consumers." [24] For example, consumers unable to judge the quality of a service or product are more likely to purchase from nonprofits. [25]

b. Government and nonprofits produce public goods and services--Government produces the types and amounts of public goods desired by the majority of citizens, while nonprofit organizations provide public goods that supplement government offerings or are desired by a minority of citizens.

c. Nonprofits lack the profit incentive--Nonprofit organizations operate under a "nondistribution constraint." [26] The nondistribution constraint "prohibits the distribution of residual earnings to individuals who exercise control over the firm, such as officers, directors, or members. Nonprofits are not prohibited from earning profits; rather, they must simply devote any surplus to financing future services or distribute the surplus to noncontrolling persons." [27]

d. Financing mechanisms are different--Governments levy taxes to finance their operations, and some nonprofits raise revenue through contributions.

7. **<u>Information about nonprofit organizations is not gathered by or for the public.</u>**

Most of what we know about nonprofit organizations is the result of private research. Even then, information is usually general in nature.

Some of the missing information includes:

a. the number of active nonprofits in the state;
b. how, and the extent to which, nonprofit organizations fulfill their mission;
c. the sources of revenue and the financial condition of many nonprofit organizations;

d. the percentage of the state's economy attributable to activities of nonprofit organizations;
e. the extent to which nonprofit organizations offer services also provided by the for-profit sector; and
f. the number of nonprofits owning property in the state.

# II. THE SYSTEM OF TAX EXEMPTIONS

## A. Four types of tax exemptions are available to Minnesota nonprofit organizations and governments. However, not all nonprofits or governments qualify for the exemptions.

Minnesota nonprofit organizations may be exempt from four types of state and local taxes: (1) Income, (2) Unrelated Business Income, (3) Sales, and (4) Property.

1. Income tax exemptions are available to nonprofit organizations registered under Section 501 of the Internal Revenue Code. Many types of organizations are found within Section 501 including religious, educational, charitable, research, community, labor and business associations, veteran organizations, credit unions, hospitals, health insurers, and other fraternal or mutual associations. (For a complete list of categories of organizations exempt from Minnesota's corporate income tax see Appendix B.) Governments are also exempt from payment of income taxes.

2. Unrelated Business Income tax exemptions are also available to all Minnesota nonprofits registered under Section 501 of the Federal Tax Code. If not exempt, the tax would apply to income generated by activities that are substantially unrelated to the organizations' tax-exempt goals. The federal government and most other states tax a nonprofit's or government's unrelated income.

   Recently, some nonprofit organizations have come under criticism because of royalty earnings. These organizations are allowing for-profit organizations to use their name in their business. The nonprofit, in turn, receives a fee. Because the organization does not produce the product, unrelated business income taxes would not apply. Whether the unrelated business income tax should apply to this type of passive income is a current debate.

3. Sales tax exemptions are available to a much smaller subset of Minnesota nonprofit organizations when compared to income or unrelated business income tax exemptions. Sales tax exemptions are granted to any "corporation, society, association, foundation, or institutional organization operated exclusively for charitable, religious, or educational purposes, if the property is to be used in the performance of charitable, religious, or educational functions." [28]

   Examples of Minnesota organizations enjoying exemption from the sales tax include: churches, hospitals, public and private schools, foundations, and nonprofit arts and music organizations. Examples of nonprofits not exempt from sales taxes include: organizations attempting to influence legislation or participating in political campaigns, fraternal or beneficial societies, clubs organized and operated for pleasure, recreation, or other similar purposes, and volunteer benefit associations.

Approximately 5,000 Minnesota nonprofit organizations are currently exempt from sales tax. From 1984 to 1987, the State Department of Revenue received an average of 601 applications for sales tax exemptions per year. The number of applications approved and the percentage of applications approved during those years has declined, as illustrated in Table 4. The decline is due in part to stricter review of applications.

Table 4.

Applications for Sales Tax Exemptions

| Year | # of apps. | # approved | % approved | # rejected | % rejected |
|---|---|---|---|---|---|
| 1984 | 610 | 478 | 79.5 | 61 | 10.0 |
| 1985 | 625 | 409 | 64.5 | 31 | 5.0 |
| 1986 | 604 | 352 | 58.3 | 33 | 5.5 |
| 1987 | 566 | 299 | 52.8 | 50 | 8.8 |

(Totals are not 100% because of withdrawal of applications or approval/rejection occurring in a different year than application)

Source: Minnesota Department of Revenue

Most states exempt purchases by nonprofits from the sales tax. Nineteen states do not exempt sales to nonprofit organizations. Nine states do not exempt all sales to state and local government from taxation. (See Appendix C.)

4. <u>Property tax exemptions</u> are granted in two ways. First, the Minnesota Constitution exempts churches, academies, colleges, universities, public burying grounds, and Indian reservations. Second, state statutes provide property tax exemptions for elementary and secondary schools, hospitals, charitable institutions, federal and state forests, parks and wildlife refuges, and public property used for public purposes.

The Minnesota Supreme Court ruled that six factors will determine whether the property of an organization can qualify for exemption. The factors are:

a. whether the stated purpose of the organization is to be helpful to others without immediate expectation of material reward;
b. whether the entity is supported by donations and gifts, in whole or in part;

c. whether the recipients of the charity are required to pay for services, in whole or in part (it is, however, acceptable to charge fees for services);
d. whether income from gifts produces a profit to the institution (but reasonable reserves are acceptable);
e. whether beneficiaries of charity are restricted or unrestricted, and if restricted, whether the class of persons to whom the benefits are available is one having a reasonable relationship to the charitable objectives; and
f. whether dividends are made available to private interests. [29]

Property tax exemptions are not available to all nonprofits. In addition, nonprofits that do not own property, but rent instead, cannot benefit from property tax exemptions.

**B. <u>Governments in Minnesota do not receive hundreds of millions of dollars in revenue every year because of tax exemptions granted to organizations. The cost increases every year.</u>**

During 1987, Minnesota governments did not collect $540.4 million in taxes because of organizational exemptions. The State Department of Revenue estimates the amount of foregone tax revenues will grow to almost $861.4 million in 1989. The large growth is primarily attributable to large estimated increases in the assessed market value of exempt property.

Governments are the largest beneficiaries of exemptions from state sales and property taxes, as illustrated in Table 5.

Table 5.

**Fiscal Impact of Sales and Property Tax Exemptions** [12]

| Tax Type<br>Exempt Organization | Year<br>1987 | <br>1989 |
|---|---|---|
| Sales | | |
| State Government | Unknown | NA* |
| Local Governments | $ 43,100,000 | $ 47,500,000 |
| Nonprofits | 29,600,000 | 36,400,000 |
| Property | | |
| Elem/Sec. School | 171,900,000 | 256,900,000 |
| Public Burying Grounds | 4,000,000 | 5,700,000 |
| Hospitals | 52,000,000 | 88,000,000 |
| Charitable Institutions | 20,400,000 | 34,100,000 |
| Government Parks/Refuges | 32,100,000 | 46,100,000 |
| Other Public (Gov.) Property | 187,300,000 | 346,700,000 |
| TOTAL | $540,400,000 | $861,400,000 |

*Purchases of state government are no longer exempt.
Source: Tax Expenditure Budget for the State of Minnesota Fiscal Years 1986 - 1989, Minnesota Department of Revenue, January 1987

We also reviewed the fiscal impact of exemptions from other taxes.

1. Income--Estimates of the amount of foregone revenues due to exemptions from corporate income tax do not exist. The State Department of Revenue believes "applying the concept of taxable income to many nonprofits would be problematical," since many of these organizations budget to meet expenses and needs, not to produce a profit or surplus of other kinds. [30]

2. Unrelated Business Income--Estimates of foregone state revenues due to exempting unrelated business income are $300,000 in 1987 and $400,000 in 1989. [31]

3. Property--The cost of property tax exemptions is not fully known because no estimates are available for the taxes that would be payable by constitutionally-exempt property. The value of constitutionally-exempt property, however, is estimated to be $4.9 billion.

**C. In absolute dollars, governments and some types of nonprofit organizations benefit most from sales and property tax exemptions. However, when compared with total spending, the effect of sales tax exemptions is almost equal among organizations.**

Many Minnesota nonprofit organizations are exempt from sales and property taxes. However, most of the cost of tax exemptions is attributable to government. Hospitals are the largest type of nonprofit benefitting from sales tax exemptions.

1. Sales--The exempt purchases of nonprofit hospitals and local governments (including counties, cities, towns, school districts, and special taxing jurisdictions) account for over 70.6 percent of all sales tax expenditures. Estimates for 1988 indicate that hospitals and local governments will receive $55.2 million of the $78.1 million cost of sales tax exemptions. The Department of Revenue estimates nonprofit hospitals account for $9.9 million and local governments for $45.3 million. Nonprofit hospitals, however, estimate the impact at $16.5 million annually. [32]

   As a percentage of total spending, most nonprofit organizations benefit almost equally from sales tax exemptions, as illustrated in Table 6.

Table 6.

**Estimated Fiscal Impact of Removing Sales Tax Exemptions for Different Types of Nonprofits**

| Nonprofit Type | 6% Sales Tax* FY 1988 | FY 1989 | Tax as % of total spending |
|---|---|---|---|
| Char./Some Educ. | $6.4 | $ 6.7 | 0.6% |
| Nonprofit Hospital | 9.9 | 10.3 | 0.6 |
| Private, Nonreligious Elem./Sec. Educ. | .1 | .1 | 0.3 |
| Prvt. Foundations | .1 | .1 | 0.6 |
| Religious | 6.0 | 6.3 | 0.6 |
| Rel. Elem./Sec. | .8 | .8 | 0.3 |
| Sr. Citizens | .004 | .004 | 1.8 |
| Post Secon. Educ. | 2.1 | 2.0 | 0.3 |
| TOTAL | $25.304 | $26.304 | 0.5% |

*In millions

Source: Minnesota Department of Revenue, Sept. 1986

2. Property--Government and K-12 education account for 77.6 percent of the cost of property tax exemptions. Hospitals are a distant third, accounting for 11.3 percent of the cost of property tax exemptions. All estimates for 1988 are found in Table 7 below.

Table 7.

**Share of Cost of Property Tax Exemptions**

| Property type | 1988 fiscal year impact | % of total |
|---|---|---|
| Government | $325,900,000 | 44.6% |
| Elem/Sec. Schools | 241,500.000 | 33.0 |
| Hospitals | 82,700,000 | 11.3 |
| Gov. Parks.Refuges | 43,400,000 | 6.0 |
| Charitable Insti. | 32,100,000 | 4.4 |
| Public Burying Grounds | 5,400,000 | .7 |
| TOTAL | $731,000,000 | 100.0% |

Source: Tax Expenditure Budget, 1987

**D. Property exempt from taxation is not spread evenly across all areas of the state.**

1. Some jurisdictions have large percentages of exempt property.

   Estimates of the percentage of property values exempt from taxation are not available for all counties or cities in Minnesota. In 1987, at least 12 Minnesota counties have over 25 percent of the total market value of property exempt from taxation. Within those 12 counties, 97 cities have over 25 percent of the total market value of property exempt from taxation. [33] (See Appendix D.)

2. In some jurisdictions the exempt property benefits all taxpayers in the state, but taxpayers in those jurisdictions bear a larger burden for services provided to the exempt property.

   Some state facilities are located within a jurisdiction (e.g., state hospital in Faribault). While the state provides support to all local governments through local government aids, the extent to which local governments are compensated for large percentages of exempt property is unclear. As a result, local property taxpayers in jurisdictions with large amounts of exempt property may be paying the costs of property-related services needed by exempt property benefitting all Minnesotans. The same may be true for county property located within a city.

**E. The use of tax exemptions as public support for nonprofit organizations and government produces public benefits and public concerns.**

1. Public Benefits

   a. Tax exemptions are inexpensive to administer.

      Because tax exemptions are not periodically reviewed, benefits accrue without legislative involvement. Legislators are thus free to work on other issues. Support through tax exemptions is also less expensive than support through direct funding, because no money changes hands. Those distributing state funds save the time and expense involved in other distributions of state support.

   b. Tax exemptions are a reliable and stable source of public support.

      As government and organizations grow, so will the value of the exemptions received. Because tax exemptions are not periodically reviewed, they provide a stable source of support.

c. Tax exemptions partially relieve nonprofit organizations and government of the obligation to raise revenues directly.

As the amount of revenue needed to operate is reduced, so too is the need to raise funds directly. Nonprofits can use more of their resources to accomplish their missions.

2. Public Concerns

a. Tax exemptions bypass traditional government processes preceding the expenditures of public money.

After granting a tax exemption, the state Legislature no longer is required to evaluate the results of those tax exemptions when it meets. As a result, the costs/ benefits/burdens of tax exemptions are rarely discussed publicly.

b. No accountability for the use of tax exemptions exist.

The lack of public review of tax exemptions granted to organizations is a loss of accountability by legislators to voters. If legislators do not act, voters are unable to fully evaluate their performance.

Accountability is also a concern with sales tax exemptions. Records of purchases exempt from the sales tax are kept by retailers. Clerks record a tax-exempt number at the time of sale. It is difficult for retail clerks to know whether the item being purchased will be used by the organization or government in furtherance of its mission.

c. The cost of tax exemptions bears no necessary relationship to the value of the services that various nonprofit organizations provide to the community.

The cost of tax exemptions may far exceed the benefits conferred on the general public in some segments of the nonprofit sector. Often cited examples include hospital and arts organizations, where direct public benefits may exceed the costs of tax exemptions.

d. Tax exemptions are inequitable among nonprofits and between nonprofits and for-profits.

As previously mentioned, some nonprofits benefit more from tax-exempt policies than other similar nonprofits. For example, a nonprofit providing health care services and owning property would have its purchases exempt from the sales tax and its property exempt from the property tax. Another nonprofit providing similar services to a similar clientele, but renting, instead of owning property, would only be exempt from the sales tax purchases.

If a for-profit and nonprofit organization also operate in the same area (e.g., day care, nursing homes), only the nonprofit will be eligible to apply for exemptions.

e. <u>Unfair competition may be occurring.</u>

Governments and private organizations are concerned about the fairness competition between nonprofit and for-profit organizations. One study concluded that the availability of state property, sales, and income tax-exemptions "has a significant effect in enhancing the market share of nonprofit firms vis-a-vis their proprietary competitors." [34]

Minnesota conducted hearings on unfair competition during the late summer and early fall of 1988 to better understand the extent of competition between nonprofits, for-profits, and governments.

## F. Tax exemptions have many effects.

When government exempts an organization or product from taxation several effects follow:

1. <u>Tax rates are higher</u>--Exemptions narrow the tax base. Narrowing of the base means that rates must be higher in order to collect similar amounts of revenue.

Minnesota exempts certain items and organizations from the sales tax. The cost of tax exemptions on certain items (e.g., food, clothing) is much larger than the cost of exemptions granted to organizations. But when combined, exemptions from sales taxes equal almost as much as sales taxes collected. In 1986, $1.218 billion in exemptions were granted to organizations and products, while state government collected $1.360 billion. In 1987, state government exempted $1.298 billion and collected $1.470 billion. [35] An additional $25.5 million in 1986, and $24.7 million in 1987 were partially exempt from sales taxes. [36] (See Appendix E for more specific information.)

Estimates of the cost to local governments of property tax exemptions are $731 million in 1988, and $777.5 million in 1989. An analysis of the effects of broadening the property tax base to include statutorily-exempt property found that a seven percent rate reduction across all classes of property would be possible. [37]

2. <u>Not all taxpayers benefit from tax exemptions</u>--Lost revenue to state or local governments, because of tax exemptions, means that every taxpayer supports all the activities of organizations receiving tax exemptions. Some nonprofits represent only the interests of their members. While all taxpayers support the organization, only the members of the organization may benefit from the tax exemption (e.g., alumni organizations).

   Although all taxpayers may not benefit from the appropriations made by governments, government officials regularly review appropriations. Governments do not regularly review tax exemptions.

3. <u>All taxpayers may benefit, but fewer taxpayers may finance the benefits</u>--Some tax exemptions, like those for state government, benefit all taxpayers. However, with the property tax exemptions, residents living where exempt property is located pay a higher share of the cost of providing property-related services to exempt property.

4. <u>The overall efficiency of the economy may be affected</u>--If an organization makes decisions without considering the full cost of those decisions, efficiency may be affected. For example, if a nonprofit organization had to pay property taxes, the amount of that tax would be considered when a decision about where to locate was being made. Similarly, consumption by nonprofits might decrease if sales taxes were applied to purchases.

   Economic studies find that the prices of goods and services will affect the behavior of producers and consumers. When governments and nonprofits face the same prices as for-profits, economic efficiency is enhanced. Because nonprofit organizations and government have been exempt from taxes for many years, little anecdotal evidence exists to show how their organizational behavior would be affected without exemptions.

   Minnesota state government, however, lost its sales tax exemption recently. State officials express concern about the paperwork associated with paying sales tax. But the same officials note that loss of the sales tax caused the state to "look closer for better deals...occasionally buy cheaper products (for office supplies)...(or make) fewer purchases of big ticket items...(while) product specifications...have not been lowered or changed." [38]

5. <u>Government and nonprofit organizations are benefitted</u>--Tax exemptions confer benefits on government and nonprofit organizations. Without exception, these organizations view the benefits as public support for their organizations for which they are very grateful.

Nonprofit representatives argue that extension of taxes to their organizations will result in fewer services and/or fewer nonprofits.

G. **The federal government and other states are examining tax-exempt policies.**

1. Federal government--The Subcommittee on Oversight of the House Ways and Means Committee heard testimony from representatives of hundreds of nonprofit organizations and businesses for a week, during the summer of 1987. "Unfair competition" was alleged by small business owners.

   As a result of the hearings, Congress is considering minor changes to current "unrelated business" definitions to curb abuse in specific areas.

2. Other states--Like the federal government, several state governments are examining or recently examined their tax-exempt policies. A few have actually made changes.

   a. Examining Changes--The Wisconsin Legislature received a recommendation from its Audit Bureau to clarify the definitions of "benevolent" and "educational" organizations during 1987.

      Oregon's Department of Revenue is considering changing exemption regulations to make it more difficult to qualify. The Oregon Department of Revenue recently denied property tax exemption to the YMCA, in Portland, after finding that "the organization is not operated in a charitable manner because of their policies to serve only a small segment of the community, their pricing structure, and the minimal element of giving." [39]

      Pennsylvania Legislators received recommendations that would prohibit nonprofit competition with commercial enterprise, regulate the transfer of funds among affiliated groups that include nonprofits, and establish strict administrative oversight of nonprofit corporations.

   b. Changes made--After county tax assessors in Kansas began challenging and denying property tax exemption to a variety of organizations, the Kansas Legislature amended its exemption statute to clarify that charging fees would not, in and of itself, cause loss of property tax exemptions.

      South Dakota's Legislature adopted restrictive criteria for tax exemptions in 1986. To qualify for tax exemptions, nonprofit organizations must devote resources to "relief of the poor, distressed, or underpriviledged." Additionally, the organizations must receive a majority of their income from donations, public funds, membership fees, or program fees generated solely to cover operating expenses. Organizations must offer services without regard to ability to pay, and they must be designated as 501(c)(3) by the I.R.S.

Some Utah hospitals recently lost their property tax exemptions because of a finding that too little charity care was being provided. As a response, the hospitals losing their property tax exemption recently opened a health care clinic providing free health care.

# CONCLUSIONS

I. **The lines between government, nonprofit, and for-profit organizations have blurred. But the extent and consequences of the blurring are not well known.**

Governments and nonprofits have adapted to changing environments. But to what extent has pressure to lower tax rates (on governments) and earn revenues (on nonprofits) caused either to engage in activities also provided by tax paying organizations? What are the implications for the state's economy as a whole? Are some services/products more efficiently provided by certain types of organizations? We have many questions, but few answers. We should know more.

II. **Nevertheless, important distinctions between government, nonprofit, and for-profit organizations remain.**

Unlike for-profit organizations, governments and nonprofit organizations are prohibited from distributing excess revenues to persons exercising control of the organization.

Government produces the types and amounts of public goods desired by the majority of its citizens (or their representatives). Government is the only kind of organization that raises most of its revenue by levying taxes, rather than selling a service or product. And governments are elected.

Some nonprofits provide public goods that supplement government offerings. Other nonprofits provide public goods desired by a minority of citizens, producing services or products government is unwilling or unable to provide (e.g., advocacy for minority groups and religion). Nonprofit organizations form voluntarily, providing an important tool for individual participation in community life, necessary in a democratic society.

III. **Exemptions from taxation do not in any way affect the opportunity for individuals to associate voluntarily.**

Voluntary associations existed for many years before exemptions from income, unrelated business income, and sales taxes. Many voluntary organizations not enjoying exemptions from taxation exist today. Tax exemptions, therefore, do not affect the ability or opportunity for individuals to associate voluntarily.

IV. **Nonprofits and governments deserve public support.**

Government and nonprofits serve Minnesotans well. These organizations provide many economic, social, and political benefits to the state. Tax policy should recognize this important role.

V. **Some public support in the form of tax exemption is desirable.**

Through exemption from taxation, the special role of governments and nonprofits in our society is recognized.

Tax exemptions do more, too. They:

A. Provide incentives for organizations to fill gaps left by commercial markets;
B. Promote diversity; and
C. Recognize the special nature of some property assets of nonprofit organizations.

VI. **Less public support to governments and nonprofits should be provided through tax exemptions because tax exemptions have several disadvantages. Tax exemptions are inequitable, unaccountable, and may negatively affect the overall efficiency of the economy.**

A. Equity--

Income tax exemptions are available only to groups organized as nonprofits. Many nonprofits are engaged in activities that are also found in the for-profit sector (e.g., day care, health care, nursing homes, education). Even if the mission, clientele, and fees charged are similar in both types of organizations, only the nonprofit organization will be eligible for exemption from income taxation.

Sales tax exemptions are not available to all nonprofits. Nor are they available to for-profit organizations providing similar services to a similar clientele as nonprofits.

Property tax exemptions are enjoyed only by some nonprofits owning property. Many nonprofit organizations pay property taxes through rent, or they do not pass the legal test necessary to take advantage of property tax exemptions.

The property tax is partly used to provide local services to property owners. Some of the services are property-related, including street construction, maintenance and repair, and police and fire protection. While all property owners benefit from these local services, those with tax exemptions escape the costs.

Those costs are borne partly by all state taxpayers (through local government aids and school aids) and partly by the taxpayers in a given jurisdiction (through local property taxes). When the facility benefits the entire state (state prison or university) it is unfair to require local taxpayers to subsidize the property-related services needed by the exempt appropriation. Conversely, when the property benefits only a few invididuals or community (e.g., membership organizations) it is unfair for all taxpayers in the state to subsidize.

B. Accountability--

No effective review of tax exemptions occurs by elected officials. Lack of periodic review of tax exemptions by elected officials results in a loss of accountability to voters and taxpayers. As long as legislators do not review tax-exempt policies, voters will not be able to evaluate their performance fully.

Tax exemptions are subject to abuse. While state law exempts only purchases made to fulfill charitable nonprofits' mission, the Department of Revenue does not audit nonprofit organizations' purchases to determine their appropriateness or to discourage abuse. Instead, the state makes retailers responsible for enforcing the law, because they must determine whether to question if the purchase is related to the charitable mission of the purchasing organization.

Because of the inter-related nature of Minnesota's system of state and local finance, property tax exemptions in any one taxing jurisdiction have unforeseen, as well as unknown financial consequences for taxpayers. While state policy determines eligibility for exemption from property taxes, administration is left up to local officials. When property tax exemptions are granted by a community, the consequences of that decision are partly paid for by all Minnesota taxpayers. Formulas used by state government to determine the level of school aids and local government aids consider the property tax base of the community. In most cases, if the property tax base is smaller (because of exemptions), the local government will receive more aid from the state.

C. Efficiency--

Organizations enjoying tax exemptions are able to make decisions without considering the full cost of those decisions. Decision-making is distorted.

Distortions in decision-making may result in inefficient use of resources--Would nonprofit organizations own as much property if there were no exemptions from property taxes? Would the location of exempt property be the same? Would organizations purchase the same quantity/quality of taxable items if there were no sales tax exemptions?

**VII. Public support to governments should rely more on taxation. Public support for nonprofit organizations should rely more on incentives for individual contributions.**

Unlike other nonprofit organizations, governments have the ability to finance their operations through taxation. When doing so, equity between governments and accountability to voters is enhanced. Less reliance on tax exemptions should also result in better decision-making by governments.

Indirect support for nonprofit organizations in the form of voluntary contributions has none of the disadvantages associated with tax exemptions. Voluntary contributions are equitable, because they are currently available to all nonprofit organizations and some governments. Voluntary contributions are publicly accountable, because they allow individuals to evaluate their support at regular intervals. And voluntary contributions enhance efficiency, because they encourage organizations to satisfy the demands of donors for service provision and operation at minimal costs.

It is more fair and more efficient to support nonprofit organizations through individual giving decisions on merits rather than sustaining a system that grants public support through broad, undiscriminating exemptions.

## VIII. **Public support should not be limited to certain types of nonprofit organizations through establishment of more limited criteria.**

A few states have limited the availability of tax exemptions to certain types of organizations. We believe that individuals, not government, should decide which organizations deserve their support. We also believe that charity should continue to be an evolving concept. New criteria may result in less flexibility, and therefore, opportunity for organizations to adapt to changing needs.

## RECOMMENDATIONS

The following recommendations are intended to (a) recognize the special role of governments and nonprofit organizations in our society and (b) make tax policy more equitable, accountable and enhancing of the overall state economy.

I. <u>The Minnesota Legislature should:</u>

A. **<u>Continue to exempt government and nonprofit organizations from state income taxes.</u>**

By exempting Minnesota governments and nonprofits from the payment of income taxes, the state conforms with federal tax policy. Movement away from conformity would pose a significant administrative burden on state tax enforcement and on nonprofit organizations. The potential yield is small, since most experts agree that nonprofit organizations rarely accumulate significant revenue surpluses that might be subject to taxation.

Governments and nonprofit organizations have enjoyed exemption from Minnesota state income taxes as long as the tax has existed. State policy should continue to recognize organizations electing not to make "profits" their goal through exemption from state income taxes.

B. **<u>Tax the unrelated business income of nonprofit organizations.</u>**

Continuing to exempt the unrelated business income of nonprofits is not justifiable. Given increasing concern and information about nonprofit and government involvement in activities also provided by tax-paying organizations, state policy should ensure equal tax treatment, not exacerbate unfair competition. By taxing unrelated business, state government will send an important message--as the organization shifts away from its mission to unrelated business, so too will the taxable status of the activity.

C. **<u>Continue to exempt government and nonprofit organizations from payment of property taxes. The state Legislature should require that all exempt property pay a fee for property-related services provided by local governments.</u>**

While we are concerned about the equity, efficiency, and effects of property tax exemptions, we recognize that the responsibilities of governments and some nonprofits require ownership of property in order to fulfill their mission. State policy should recognize this by continuing to exempt these properties from payment of the property tax.

Ownership of property brings with it a demand for services. Someone must provide access to and protection for the property. Most of these services are provided by local governments. Because all property requires and benefits from property-related services, all property owners, including governments and nonprofits, should share in the cost of providing those services.

The costs of providing property-related services are currently included in the local property tax. As a result, the value of property being assessed plays an important part in the amount of property tax paid for these services.

Our recommendation, however, would have <u>all</u> property pay a share of the costs. Because the state Constitution does not allow imposition of property taxes against certain types of properties, the current system charging for property-related services cannot be used.

The system to determine fees should be set by statute. Administration should occur at the county or city level. The system should set fees based on:

1. the cost of property-related services within a jurisdiction;
2. the amount of land involved;
3. the size and type of structures; and
4. the way in which the property as a whole is used.

The system should allow abatement of the fee for local property services to the extent the organization provides some of the property services normally provided by local governments (e.g., higher education institutions providing some of their own police services.)

Without doubt, there will be costs and concerns with setting up the new system to determine fees. In the event the Legislature finds a new system unfeasible, it should allow assessment of fees on all statutorily exempt property using the current system of property valuation and applying appropriate mill rates for property-related services.

D. **<u>Require government and nonprofit organizations to pay sales taxes on their purchases but provide a transition period to assist organizations in adjusting to the change.</u>**

Eliminating sales tax exemptions produces more equity between different organizations. No longer will distinctions be made because of the identity of the purchaser. Without organizational exemptions, accountability is enhanced because taxpayers and persons who support nonprofits will know what is being spent for taxable purchases.

Requiring payment of sales taxes should also enhance efficiency, because all governments and nonprofits will make purchasing decisions based on the true costs of those decisions.

Elimination of sales tax exemptions will affect organizations differently. A transition period, lasting a few years, should be provided to assist organizations in adjusting to and planning for the loss of sales tax exemptions.

II. **<u>To provide additional opportunities for fundraising to nonprofit organizations, the federal and state governments should provide additional incentives for individual contributions.</u>**

Loss of sales and unrelated business income tax exemptions and imposition of service fees for property-related services will cause many nonprofits to seek additional support. It seems only reasonable for national and state policy to expand incentives for individual contributions to nonprofit organizations. These incentives should take the form of income tax credits.

III. **<u>As tax-exempt policy changes and tax bases are broadened, new revenues should be used to decrease tax burdens to the extent possible.</u>**

It is not the intent of these recommendations to provide windfalls for governments. Although the fiscal impact is unclear, we expect requiring payment of fees for property-related services to result in additional revenues for local governments. Requiring local governments to pay sales taxes will also increase the need for new revenues. The bottom line will vary from one community to another, local governments should, to the extent possible, use new revenues to provide property tax relief.

Extension of sales taxes to nonprofit and government organizations should net state government approximately $100 million annually. Like local governments, state government should use new sales tax revenue to lower sales tax burdens.

IV. **<u>The legislative auditor should evaluate the effects of extending taxes to nonprofit organizations after they have been in place for at least two years.</u>**

Changes in tax-exempt policies are likely to affect the way in which both local governments and nonprofit organizations are able to perform their functions. The legislative auditor should evalute the effects of changed tax-exempt policies and report to the Legislature.

E. <u>**The Legislature should charge a state agency with responsibility for collecting and analyzing information about the state's nonprofit sector.**</u>

Minnesota's nonprofit organizations play a major role in the state's economy. But we know very little about them. A statistical program should be developed to gather data about the sector, including: its size, activities, products, sources of revenue, and interactions with for-profit organizations.

## NOTES

1. Research Papers, The Commission on Private Philanthropy and Public Needs, Vol. IV. -- Taxes, Department of the Treasury, 1977.

2. Ibid.

3. History of the Law of Charity, 1532-1827, Gareth Jones, London: Cambridge University Press, 1969.

4. Ibid.

5. The Nonprofit Sector, Walter Powell, Editor, Yale University Press, 1987.

6. Ibid.

7. Ibid.

8. The Nonprofit Economy, Burton Weisbrod, Harvard University Press, 1988.

9. Information provided by the Secretary of State's Office, July 21, 1988.

10. "Nonprofits in the Twin Cities, Expectations and Realities," Barbara Lukermann, Cura Reporter, Vol. XVII, No. 4, October 1987.

11. Testimony to the Committee by Jacqueline Reis, Executive Director, Minnesota Council on Foundations, February 23, 1988.

12. The Minnesota Department of Revenue defines the categories listed in the following manner:

    Elementary and Seconday Schools--K - 12 public and private (including religious) schools
    Colleges and Universities--Public and private (including religious) colleges and universities
    Public Burying Grounds--All cemeteries except Indian Burial Grounds or church-owned cemeteries
    Church Property--church-owned cemeteries, sanctuaries, parsonages, and other non-educational (school) buildings
    Hospitals--public and private hospitals
    Forests--state and federal forest land
    Indian Reservations--land owned by an Indian tribe or individual tribe member and not leased, loaned, or used by outside interest
    Public Property--federal, state, county, city, special taxing jurisdiction-owned buildings, and county and municipal parks
    Charitable Organizations--all other exempt property (e.g., fine and dramatic arts, emergency centers, community centers, food banks)

13. The Nonprofit Economy.

14. Ibid.

15. "Average Covered Employment and Wages by Economic Region for Calendar Years 1978-86," Minnesota Department of Jobs and Training.

16. The Nonprofit Economy.

17. "The Nonprofit Sector and the Rise of Third-Party Government: The Scope, Character and Consequences of Government Support for Nonprofit Organizations," Lester M. Salamon, The Urban Institute, May 1983.

18. Ibid.

19. Ibid.

20. "Nonprofits in the Twin Cities, Expectations and Realities."

21. Ibid.

22. Ibid.

23. Research Papers, The Commission on Private Philanthropy, Vol. IV--Taxes.

24. The Nonprofit Economy.

25. Ibid.

26. The Nonprofit Sector.

27. Ibid.

28. Minnesota Statute, Section 297A.25, Subdivision 1(p).

29. Minnesota Supreme Court, Northstar Search Institute v. Hennepin County, 1975.

30. "Tax Expenditure Budget for the State of Minnesota, Fiscal Years 1986-1989," Minnesota Department of Revenue, January 1987.

31. Ibid.

32. Testimony by Scott Anderson, representing the Minnesota Hospital Association and the Council of Hospital Corporations, to the Citizens League, Wednesday, February 23, 1988.

33. From "Taxable and Exempt Market Values for Cities in Selected Counties," Minnesota Department of Revenue, March 16, 1987.

34. "Nonprofit Enterprise in the Performing Arts," Henry Hansmann, The Bell Journal of Economics, Vol. 2, Pages 341-361, 1981.

35. "Tax Expenditure Budget" and "Minnesota Tax Handbook", Minnesota Department of Revenue.

36. "Tax Expenditure Budget."

37. Simulation done by the Minnesota House of Representatives Research Department, Spring, 1987.

38. Information provided by the Minnesota Department of Revenue, February 1988.

39. Ruling of the Oregon Department of Revenue, November 16, 1987.

# APPENDIX A

## Table 1

**Number of Nonprofits* (Nationally)**

| Year | Total | 501(c)(3) | % of Total |
|---|---|---|---|
| 1976 | 763 | 260 | 34.07% |
| 1977 | 790 | 276 | 34.93% |
| 1978 | 810 | 294 | 36.29% |
| 1979 | 825 | 304 | 36.84% |
| 1980 | 846 | 320 | 37.82% |
| 1981 | 851 | 328 | 38.54% |
| 1982 | 841 | 323 | 38.40% |
| 1983 | 845 | 336 | 39.76% |
| 1984 | 871 | 353 | 40.52% |
| 1985 | 887 | 366 | 41.26% |

*In thousands

Source: The Nonprofit Economy, Burton Weisbrod, Harvard University Press, 1988.

## Table 2

**Percent of all U.S. assets owned by government and nonprofit organizations, 1953 and 1975.**

| Year | Government: Federal | Government: State/Local | Nonprofit | Total |
|---|---|---|---|---|
| 1953 | 7.5 | 5.6 | 1.5 | 13.1 |
| 1975 | 3.9 | 8.5 | 1.8 | 12.4 |

Source: The Nonprofit Economy, Burton Weisbrod, Harvard University Press, 1988.

## APPENDIX B

| IRC, Sec. | Type of Organization |
|---|---|
| 501(c)(1) | Federal corporations created by federal law to act as instrumentalities of the United States. Example: Federal Deposit Insurance Corporation. |
| 501(c)(2) | Title-holding corporations for exempt organizations, necessary because certain states prohibit tax exempt organizations from holding property. |
| 501(c)(3) | Religious, educational, charitable, scientific, and literary organizations testing for public safety, fostering certain national or international amateur sports competition, or prevention of cruelty to children or animals. This classification also includes private foundations. |
| 501(c)(4) | Civic leagues, social welfare organizations, and local associations of employees which promote community welfare or contribute earnings to charitable, educational, or recreational purposes. |
| 501(c)(5) | Labor, agricultural, and horticultural organizations which seek to improve working conditions, products, or efficiency through education or instruction. |
| 501(c)(6) | Business leagues, chambers of commerce, real estate boards, and other similar organizations which seek to improve the common business of their members. |
| 501(c)(7) | Clubs organized for the pleasure, recreation, or social activities of their members. |
| 501(c)(8) | Fraternal beneficiary societies and associations. These organizations operate under the lodge system and provide life, sickness, and/or accident benefits to their members. |
| 501(c)(9) | Voluntary employee benefit associations (including federal employee voluntary benefit associations formerly covered by Section 501(c)(10). These organizations provide for payment of life, sickness, accident, or other benefits to members. |
| 501(c)(10) | Domestic fraternal societies and associations. These organizations are similar to 501(c)(8) organizations but do not provide life, sickness, or accident payments to their members. |
| 501(c)(11) | Teachers' retirement fund associations. These are organizations of a purely local character which provide for payment of retirement benefits. |

| | |
|---|---|
| 501(c)(12) | Benevolent life insurance associations, mutual ditch or irrigation companies, and mutual or cooperative telephone companies among others. |
| 501(c)(13) | Cemetery companies owned by and operated exclusively for the benefit of their members. |
| 501(c)(14) | State chartered credit unions and mutual reserve funds. These organizations provide banking services to their members. |
| 501(c)(15) | Mutual insurance companies or associations which provide insurance to members at cost. (Tax exempt status is limited to organizations with annual gross incomes of $150,000 or less). |
| 501(c)(16) | Cooperative organizations which finance crop operations in conjunction with activities of a marketing or purchasing association. |
| 501(c)(17) | Supplemental unemployment benefit trusts. |
| 501(c)(18) | Employee funded pension trusts (founded prior to June 25, 1959). |
| 501(c)(19) | Recognized posts or organizations of war veterans. |
| 501(c)(20) | Trusts to provide for prepaid legal services for employees. |
| 501(c)(21) | Black lung disease trusts. |
| 501(c)(22) | Withdrawal liability payment funds. These organizations provide funds to meet the liability of employers withdrawing from a multi-employer pension fund. |
| 501(c)(23) | Associations of past or present members of the Armed Forces, founded before 1880. |
| 501(d) | Religious and apostolic associations. These organizations provide a common treasury of the regular business activities of a communal religious group. |
| 501(e) | Cooperative hospital associations providing the following services for two or more exempt hospitals: data processing, purchasing, laboratory testing, printing, communications, records center, and personnel services. |
| 501(f) | Cooperative educational service organizations. These perform collective investment services for educational organizations. |
| 521 (a) | Farmers cooperative associations. These organizations perform cooperative purchasing and marketing of agricultural products. |

11-10-87

## APPENDIX C

## TRANSACTIONS—PART III

T = taxable E = exempt

| STATE | SALES TO NONPROFIT ORGANIZATIONS(1) | SALES TO FEDERAL GOVERNMENT AND ITS AGENCIES, (32) | SALES TO STATE, ITS SUBDIVISIONS & AGENCIES | SALES OF COMPUTER (SOFTWARE) (89) | WITHDRAWAL FROM OWN STOCK (45) | SALES OF WRAPPERS AND CONTAINERS |
|---|---|---|---|---|---|---|
| Ala. | T(67) | E | E(37) | T(96) | T | E(49) |
| Ariz. | T(34,73) | E(35) | T(65) | T(104) | T | E(49) |
| Ark. | T(14,67) | E(16) | T(43) | T | T | T(51) |
| Calif. | T(74) | E(18,66) | T | T(96) | T(59) | E(55,69) |
| Colo. | E | E | E | T(90) | T(59) | E(48,64) |
| Conn. | E(1,6) | E | E(5) | T | T | E(69) |
| D.C. | E(5) | E | E(77) | T(90) | T(59) | E(49,50) |
| Fla. | E | E | E(71) | T(96) | T(3) | E(49,50) |
| Ga. | T(7,28) | E | E | T(91) | T | E(49) |
| Haw. | T | E(4) | T | T | T(3) | T |
| Idaho | T(14,67) | E | E | T | T | T(69) |
| Ill. | E | E | E | E(89) | E(59) | E(76) |
| Ind. | E | E | E(27) | T(92) | T | E(55,81) |
| Iowa | T(67) | E | E(42,78) | T(89,93) | T | E(44) |
| Kan. | T(28) | E | E(33,39) | T | T | E(49) |
| Ky. | E(8) | E | E(27) | T | T | E(55,80) |
| La. | T(67) | E | E(19) | T(94) | T(75) | E(48-50,52) |
| Me. | T(67,68) | E(85) | E(85) | T | T(59) | E(41,44,55) |
| Md. | E | E(16) | E | T(94) | T | E(72,79) |
| Mass. | E(8) | E | E | T(95) | T | E(69,80) |
| Mich. | E | E(15) | E(24) | T(96) | T | E(12,48-50,54) |
| Minn. | E(86) | E(86) | E(77) | T(106) | T | T(49,82) |
| Miss. | E(28,67) | E(23) | E(15) | T | T | E(41) |
| Mo. | E | E | E | T(89,96) | T | T(48,63) |
| Neb. | E | E | E | T(98) | T | E(69,81) |
| Nev. | E | E(18) | E | T | T | E(69,81) |
| N.J. | E(11) | E | E | T(99) | E(59) | E(49) |
| N.M. | E(8) | E(87) | E(38) | T | E(59) | E(49) |
| N.Y. | E(11) | E | E | T(99) | E(59) | E(5,21) |
| N.C. | T(46) | E(26) | T(46,56) | T(100) | E(59) | E(22) |
| N.D. | T(40,67) | E | E(77) | T(96) | T | E |
| Ohio | E(10) | E | E | T(101) | T | E(44) |

T = taxable E = exempt

| STATE | SALES TO NONPROFIT ORGANIZA-TIONS(1) | SALES TO FEDERAL GOVERNMENT AND ITS AGENCIES, (32) | SALES TO STATE, ITS SUBDI-VISIONS & AGENCIES | SALES OF COMPUTER (SOFTWARE) (89) | WITH-DRAWAL FROM OWN STOCK (45) | SALES OF WRAPPERS AND CON-TAINERS |
|---|---|---|---|---|---|---|
| Okla. | T(67) | E(88) | E | T | T | E(49,57,88) |
| Pa. | E(83) | E | E | aT(96) | T | E(22,49) |
| R.I. | E | E | E | T(102) | T | E(69,80) |
| S.C. | T(73) | E(48) | T(73) | T | T | E(22) |
| S.D. | T(14) | E | E(36) | T | T(59) | E(44) |
| Tenn. | E | E(23) | E | T(103) | T | E |
| Tex. | E | E | E | T | T | E(69,80) |
| Utah | E | E | E(25) | T(96) | T | E(49,81) |
| Vt. | E(8) | E | E | T(96) | T | E(41,48) |
| Va. | T(28,47,73) | E | E | T(94) | T | E(44,48) |
| Wash. (Sales-use) | T(58,67) | E(29) | T(2,53) | (104) | T(59) | E(30) |
| (Bus. & Occup.) | T(67) | T | T | T | E | E |
| W.Va.—GST(17) | T(17) | T(17) | T(17) | T(17) | T(17) | T(17) |
| —CRST(17) | E(8) | E(31) | E(31,70) | T(107) | T | E(60) |
| Wis. | E | E | E | T(96) | T | E |
| Wyo. | E(47,84) | E | E | T(105) | T | E(48,49,51) |

FOOTNOTES to chart ¶255: (1) Refers to sales to charitable, religious, educational, etc., orgs. for use exclusively for charitable, etc., exempt purposes.

(2) Exemption allowed for receipts reimbursed by US for flood control.

(3) No specific provision; probable status shown.

(4) Sales of liquor, tobacco and other tangible personalty by sellers licensed under respective liquor, tobacco and gross income tax laws. Sales to Natl. Banks are taxable.

(5) Buyer must have exemption certificate; vendor must meet record keeping requirements; institution must be located in D.C., carry on activities to substantial extent in D.C., which result in substantial benefit to D.C. citizens; and property or services bought are for use consumption in operating institution or honoring institution or members.

(6) Sales of food products to nonprofit schools are exempt.

(7) Religious papers for org. benefit are exempt.

(8) Applies only to those orgs. exempt under IRC §501(c)(3) (Ky., Mass., Vt.). In W.Va., such Fed orgs. are among those exempted.

(9) Restricted to orgs. providing a public benefit.

(10) Exemption also applies to orgs. providing specified services to hospitals and charities; state headquarters of veterans' org.; animal adoption society; community arts center; performing arts; educational TV-radio (Ohio).

(11) Sales to UN are also exempt.

(12) Taxable if consumer pays separate charge for container.

(13) State purchased textbooks, library books for public schools are exempt.

(14) Exempts sales to nonprofit educational institutions (public only in Ark.) and hospitals.

(15) Order must be on prescribed form; paid directly by govt.

(16) Statute exempts transactions if Fed constitution prohibits taxing.

FOOTNOTES to chart ¶255—continued:

(17) GST refers to "Gross Sales Tax" or the business and occupation tax is repealed 7-1-87 except for certain utility cos. CRST refers to "Consumers Retail Sales Tax."

(18) Sales taxable if made to U.S. corporate agencies and instrumentalities, not wholly owned by U.S. Sales to Selective Service officials or local draft bds. exempt. In Calif. exemption doesn't apply to rentals.

(19) Purchases by—La., depts. & agencies state boards-commissions, school boards, parish and municipalities, parish hospital service & law enforcement dists., waterworks dists., public housing authorities are state tax-exempt. Capital mass transit equipment exempt.

(20) Specifies IRC exempt org. and other such furnishing exempt certificate.

(21) Container with contents for ultimate consumer, exempt; includes permanent labels, name plates for shipping.

(22) Exempt if part of sale, delivery to customer.

(23) If sale made and billed directly to U.S. or agency and paid for directly by U.S.

(24) If sale ordered on prescribed govt. order form.

(25) Agencies must be performing essential governmental function.

(26) Agencies must be owned and controlled by govt.

(27) Sales exempt if used to perform governmental functions.

(28) Sales to nonprofit schools and hospitals are exempt. In Va. also exempt are sales to adult or nursing homes, state historical societies (specified items) and specified others.

(29) Regulation exempts if govt. agency operates for benefit of public.

(30) Taxable if in litter-producing category.

(31) Sales to govt. and agencies for distribution in public welfare or relief work.

(32) Kern-Limerick (1954) 347 U.S. 110, 74 SCt 403 is paramount Fed law, exempting from use tax and from consumer's sales taxes.

(33) Sales to state, its departments and institutions, for use in governmental capacity.

(34) Exempt: sales to nonprofit hospital, nursing-residential care institutions.

(35) Direct sales by instate manufacturers, assemblers or repairers to U.S. exempt. Sellers for manufacturers etc. making Fed sales pay tax less 50% deduction. Also exempt if items for development of certain Fed research projects (Ariz.).

(36) Proof may be required as to payment of sale with government funds.

(37) Counties and incorporated municipalities.

(38) Agencies not specifically mentioned in law or regulations.

(39) Unless buyer engaged in business subject to sales tax.

(40) Exempts sales to nursing homes. And hospitals in N.D.

(41) Non-returnables when sold to manufacturers and wholesalers.

(42) Except sales of goods used to operate municipally owned public utilities.

(43) Exempt items are specified.

(44) Exempt if (a) sold to mfrs., fabricators or processors as raw materials per S. Dak. law and used or consumed by mfr.; or (b) sold to retailer using same to hold other taxable personalty.

(45) If exempt from sales tax, probably subject to existing use tax. (See (59) below).

(46) Refund of tax on personalty and building material available to certain buyers.

(47) Sales to churches are exempt.

(48) Sales to U.S. are exempt except charges for transmission of voice or messages.

(49) If container is returnable (except food and soft drinks containers), sale is taxable.

(50) Taxable if sold to person rendering non-taxable service. In Fla., if one-time use.

(51) Sales to manufacturers for shipping own product are exempt, including processors & compounders in Wyo.

(52) Sales to wholesalers for making single wholesale delivery are taxable.

(53) Sales of one political subdivision to another are exempt.

(54) Includes sales to wholesalers and others for making deliveries.

(55) Returnable containers sold with contents or resold for filling.

(56) Refund of tax on materials for buildings owned or leased by counties, cities and towns. Sales to Dept. Transp. are exempt. (NC).

(57) Sales to persons having no sales tax permit are taxable.

FOOTNOTES to chart ¶255—continued:

(58) Sales to schools are exempt.

(59) Taxable under use tax.

(60) Containers exempt if returnable and billed separately.

(61) Tax is on retailer so most sales to US are taxed.

(62) If original use substantial, later sale isn't one for resale.

(63) Reusable containers transferred in retail sales are exempt if refundable deposit required; note (64) also applies (Mo.).

(64) Exempt: containers and other disposables furnished free with taxable food, meals or beverages (Colo., Mo.).

(65) State hospitals are exempt.

(66) Nat'l banks are use tax-exempt.

(67) Specified groups exempt.

(68) Except sales to hospitals, medical research centers, schools and churches.

(69) Nonreturnable containers when sold without contents, returnable (except nonrefillable beverage in Conn.) containers when sold with contents and containers sold with nontaxable contents are exempt.

(70) Sales to Vol. fire dept. and public service districts are exempt.

(71) Sales of machinery, equipment, parts, etc., used to produce electricity to subdivision are taxable.

(72) Taxable if sold to person rendering nontaxable service.

(73) Exempts proceeds of sales of textbooks used in schools. In Ariz., exemption applies only to books required by state U or community college.

(74) Exempt if for resale.

(75) Exempt if self-propelled farm equipment or earth movers ($3000 cot (min.)) withdrawn for rental (sales promotion).

(76) Exempt if purchased for resale along with contents.

(77) Other states-territories exempt if reciprocal. Minn. and localities; Minn. doesn't require reciprocity.

(78) Applies to purchases used for public purposes.

(79) Exempt under use tax if purchased by purely public charity.

(80) Returnable and nonreturnable exempt if sold to sellers for filling and sale.

(81) Taxable if sold to final user or consumer.

(82) Exempt if for use by farm or mfrs; also, for shipping household goods outstate.

(83) Taxable are items becoming permanent part of realty but items for routine maintenance-repair are exempt.

(84) Sales to charities are exempt.

(85) Taxable if title held or taken as finance security (Me.).

(86) Taxable if bldg. materials bought by contractor as part of lump-sum or like contract with guaranteed max. price for labor-materials.

(87) Taxable if items for metropolitan dev. project.

(88) Exempts if sale of oil drums to nonretailer of such items. Also exempt are sales to persons appointed or contracted by U.S. agencies/instrumentalities if U.S. takes immediate ownership-possession.

(89) Chart covers only sales of computer software. Sales of computer hardware is generally taxable unless specifically exempted from tax as in Illinois (if used to generate exempt machinery); Iowa (if used directly-primarily in processing or in R&D of new products or processes); Mich. (if used in CAD or certain industrial processing system). Exemption for manufacturing machinery-equipment is charted at ¶254.

(90) Exempt if program's preparation or selection needs analysis (D.C.) or it needs adaptation (by vendor) for use in a specific output device (Colo.).

(91) Exempt if software written in customer's business place (Ga.).

(92) Exempt if specifically designed for buyer (Ind.).

(93) Exempt if used directly-primarily in processing or in R&D of new products or processes (mfg., purifying, combining materials, meat packing) (Iowa).

(94) Exempt if software custom-designed for one person's exclusive use (Ida., La., Md., Minn.; Va.).

(95) Exempt if custom program is readable by humans (Mass.).

**FOOTNOTES to chart ¶255—continued:**

(96) Exempt if customized written program (Ala., Calif., Fla., Mich., Mo., N.D., Pa., Utah, Vt., Wis.)

(97) Taxable if program is the information-directions dictating computer's function and if sold without adaptation to customer's requirements.

(98) Tax also applies to charges for coding, punching or otherwise producing software (Neb.).

(99) Software is exempt intangible if preparation-selection need analysis; or program needs adaptation by vendor in a specific environment (N.J.; N.Y.).

(100) Software is exempt unless program remains in or placed on computers to operate equipment (N.C.).

(101) Tax applies to ADP and computer services if true object is buyer's receipt of such services (not merely incidental) rather than receipt of personal-professional services (Ohio).

(102) Exempt if custom software (incl incidental services) created specifically for one user and prepared to that user's special order (R.I.).

(103) But fabrication of software for own use isn't taxable "use" (Tenn.).

(104) Exempt if program is tangible evidence of professional (Wash.) or technological service (Ariz.).

(105) Tax applies to sale of computer software needed for basic operation of hardware (Wyo.).

(106) Exempt if master program used to make copies for sale or lease; note (94) also applies (Minn.).

(107) Exempt if sale of EDP services and related software (W.Va.).

Source: All States Tax Guide, Prentice Hall Information Services, 1987

## APPENDIX D

Selected Minnesota Counties and Cities with over
25 Percent of Property Market Value Exempt

| County | City | % of Market Value Exempt |
|---|---|---|
| Anoka | | |
| | Anoka | 29.11% |
| | Coon Rapids | 30.46% |
| | Hilltop | 51.10% |
| | St. Francis | 25.94% |
| Becker | | 28.87% |
| | Audubon | 39.40% |
| | Callaway | 27.82% |
| | Detroit Lakes | 27.08% |
| | Frazee | 39.57% |
| | Lake Park | 30.04% |
| | Ogema | 27.50% |
| | Wolf Lake | 29.13% |
| Big Stone | | 34.50% |
| | Beardsley | 40.42% |
| | Clinton | 34.36% |
| | Graceville | 51.59% |
| | Odessa | 30.31% |
| | Ortonville | 29.53% |
| Brown | | |
| | Comfrey | 46.13% |
| Carver | | |
| | Mayer | 28.79% |
| | Norwood | 36.58% |
| Clay | | 34.47% |
| | Barnesville | 27.17% |
| | Georgetown | 28.05% |
| | Hawley | 29.81% |
| | Hitterdal | 33.93% |
| | Moorehead | 36.48% |
| | Ulen | 28.23% |
| Cottonwood | | 29.27% |
| | Mountain Lake | 34.46% |
| | Westbrook | 26.91% |
| | Windows | 28.87% |
| Dakota | | |
| | Farmington | 31.32% |
| | Hastings | 30.79% |
| | Northfield | 65.88% |
| | New Trier | 34.42% |
| | Rosemount | 28.83% |

Selected Minnesota Counties and Cities with over
25 Percent of Property Market Value Exempt

(Continued)

| County | City | % of Market Value Exempt |
|---|---|---|
| Fillmore | | |
| | Harmony | 30.54% |
| | Mabel | 28.15% |
| | Peterson | 35.22% |
| | Preston | 26.85% |
| | Spring Valley | 30.20% |
| | Wykoff | 30.12% |
| Hennepin | | |
| | Osseo | 36.34% |
| | Richfield | 42.65% |
| | Robbinsdale | 31.35% |
| | Rockford | 55.02% |
| Itasca | | 41.60% |
| | Bigfork | 59.21% |
| | Bovey | 55.86% |
| | Coleraine | 46.47% |
| | Deer River | 60.29% |
| | Effie | 36.41% |
| | Grand Rapids | 40.41% |
| | Keewatin | 30.27% |
| | Marble | 30.69% |
| | Nashwauk | 42.78% |
| | Squaw Lake | 68.83% |
| | Warba | 40.24% |
| Koochiching | | 33.19% |
| | Big Falls | 27.81% |
| | International Falls | 36.26% |
| | Littlefork | 50.15% |
| | Northome | 70.74% |
| Le Sueur | | 25.18% |
| | Cleveland | 30.58% |
| | Kilkenny | 37.94% |
| | Le Center | 37.43% |
| | Le Sueur | 26.26% |
| | Waterville | 25.77% |
| Mower | | |
| | Adams | 26.75% |
| | Elkton | 40.89% |
| | Grand Meadow | 29.57% |
| | Lyle | 37.38% |
| | Leroy | 25.24% |
| | Rose Creek | 29.53% |

Selected Minnesota Counties and Cities with over
25 Percent of Property Market Value Exempt

(Continued)

| County | City | % of Market Value Exempt |
|---|---|---|
| Ottertail | | 31.13% |
| | Fergus Falls | 37.19% |
| | New York Mills | 36.61% |
| | Parkers Prairie | 30.38% |
| | Underwood | 47.42% |
| Ramsey | | |
| | Arden Hills | 41.66% |
| | Falcon Heights | 51.16% |
| Redwood | | 27.35% |
| | Belview | 46.71% |
| | Lucan | 33.17% |
| | Milroy | 35.61% |
| | Morgan | 39.08% |
| | Redwood Falls | 26.53% |
| | Seaforth | 28.73% |
| | Wabasso | 36.68% |
| Rice | | 35.03% |
| | Faribault | 29.11% |
| | Morristown | 30.07% |
| Swift | | |
| | Appleton | 27.34% |
| | Murdock | 30.35% |
| Traverse | | 43.55% |
| | Browns Valley | 43.44% |
| | Dumont | 26.98% |
| | Tinton | 46.84% |
| | Wheaton | 44.56% |
| Washington | | |
| | Bayport | 44.89% |
| | Lakeland Shore | 32.90% |
| | Mahtomedi | 26.81% |
| Wilkin | | 30.81% |
| | Breckenridge | 32.53% |
| | Campbell | 30.40% |
| | Rothsay | 28.89% |
| Winona | | |
| | Winona | 28.96% |

Where county percentage does not appear, it is less than 25%.

## Minority Report #1

We reject the recommendation that the purchases of nonprofit entities and local governments be subject to the sales tax, even with a transition period. Major flaws in support of this recommendation exist.

<u>It is not sound public policy to extend taxes first and analyze the effects at a later date.</u> Throughout the report, uncertainty about the effect of this recommendation abounds. For example, the majority recommends a review by the Legislative Auditor of the effects of extending taxes to nonprofits (and presumably local governments.) It also recommends a state agency gather and analyze information on the nonprofit sector.

<u>There was no demonstration of abuses in the sales tax area or that administration of the sales tax exemption is being tightened.</u> That calls into question two of the key "findings" for the majority recommendation. The only case of abuse cited was in the case of a building, said to be Galtier Plaza or Landmark Center in St. Paul, or City Center in Minneapolis. We also heard varying versions of what happened in this instance. This hardly constitutes firm evidence of widespread abuse. The evidence that applications are scrutinized more closely is anecdotal, from staff discussion with Department of Revenue personnel, and is not borne out by records showing the proportion of applicants rejected.

<u>The majority recommendation ignores testimony throughout the first three months of meetings that imposing a sales tax would endanger the services of nonprofits.</u> For example, the Wilder Foundation estimates a sales tax would cost $660,000 annually and would result in increased fees to the elderly or reduced services. The United Way of Minneapolis estimates that a sales tax on its 108 agencies would increase its expenses by $2.5 million. According to data from arts groups, arts organizations with budgets over $700,000 would have to pay 51 percent of their grants from the state Arts Board in sales taxes. Organizations with annual budgets less than $700,000 would pay 30 percent of their state grants in sales taxes. YMCAs in the state estimate the sales tax would increase their costs by $500,000.

<u>The stability and predictability of sales tax revenue--one of the principal objectives of proposals to "broaden the base" of sales taxes--is not enhanced by this proposal.</u> The state estimates it would raise revenue of about $78 million (1988) from a sales tax on nonprofit entities and local governments. That is the equivalent of about one-half of one percent in current sales tax revenue. A principal objective of critics of the current sales tax system, is to improve the stability of sales tax revenue. The stability added by this proposal is negligible. The potential harm is great.

There is no reliable evidence that additional tax deductions or credits would make up for lost sales tax dollars. There is mixed evidence on the question of whether charitable giving has increased or decreased since personal income tax rates were reduced (an action which economic theorists predicted would reduce giving.) The majority acknowledges the uncertainty of this recommendation by recommending a review of the effects.

Uncertainty about whether the state legislature would, or should, provide an income tax credit which is not in conformity with federal tax law also exists. Doing so would be contrary to recent legislative efforts to move toward conformity with the federal tax code. The majority report rightly cites conformity as a benefit from taxing UBI. The recommendation to provide an income tax credit would have the opposite effect.

Extending the sales tax to purchases by local government (including school districts, cities, counties, towns and special districts) would create another loop in an already overly complex state-local system. There are more than 4,000 units of local government. The state does not need additional controls (beyond those already in place) on local spending. The fundamental control on local spending decisions is voters' ability to elect--or reject--candidates for office. It is a far more powerful control than creating another financial loop.

In its property tax report of two years ago, the Citizens League came down on the side of simplifying the state-local fiscal system, making it more understandable. The majority recommendation would have exactly the opposite effect. [Editor's note: The 1987 Citizens League Property Tax report recommended simplifying the system by reducing the number of property classes to one and eliminating all property tax exemptions.]

We put a high value on pluralism as reflected in nonprofits. The majority prefers governmental review, recommends the possibility of governmental grants through state boards and commissions if nonprofits fall on hard times through paying the sales tax. In fact, the majority report prefers judgments made by a legislative majority.

All nonprofits--whether "mainstream" or minority--are worthy of support until they have abused or not qualified for exemptions. The neediest nonprofits--those serving the least recognized clients, taking on the least popular tasks, or nonprofits in their formative years, are generally those with less sophisticated ability to raise funds. And the necessity to raise additional funds (to compensate for paying sales taxes) would divert these nonprofits from their mission.

The failure to make any distinction among nonprofit organizations is a fundamental flaw in the report. Any legitimate distinctions among nonprofits should be identified prior to making changes in tax policy.

Recommendation

<u>The legislature should study the current criteria for nonprofit/sales tax exempt status, to determine whether or not they are adequate, and to make changes as appropriate.</u> New law should provide that the exempt status of nonprofit entities would sunset periodically, so that reapplication is required to validate an organization's eligibility. This would permit periodic review of the current activities of the organization.

Respectfully submitted,

Carol Kelleher
Hugh McLeod
Florence Myslajek
Carl Reuss
Phyllis Thornley
Constance Waterous

**Minority Report #2**

The report's recommendation on the property tax exemption is disappointing. It fails to provide a credible rationale for not ending the exemption or modifying it substantially. And, it falls short of the kind of full discussion of the policy aspects of this issue that the topic requires.

While the sales-tax exemption is recommended to end (with a transition period), the property tax exemption is preserved. A "fee for property-related services provided by local governments" is the only change recommended.

The only rationale offered for not ending the tax exemption on statutorily-exempt property is: "that the responsibilities of governments and some nonprofits require ownership of property in order to fulfill their missions."

This is not sufficient rationale for preserving the "statutory" property tax exemption, for several reasons:

--it does not explain the difference from the approach recommended on sales taxes, since governments and most nonprofits must buy (or sell) goods and services to fulfill their mission;

--it does not examine sufficiently the questions hinted at in the rationale itself: Is the balance between property owned and mission performed appropriate or reasonable? Does the exemption confer benefits that are not necessary to performance of the mission? Can the burdens of property ownership, legitimately required to fulfill missions, be borne in other ways that are more efficient, equitable, and responsible?;

--it gives the appearance of resisting change based on an inadequately examined fear of working hardship on particular kinds of nonprofit organizations;

--it does not frame a response to most of the problems identified with tax exemption: (a) lack of review of "cost versus benefit" for each recipient; (b) lack of legislative accountability for exemption "expenditures"; (c) inequitable distribution among members of the public of the burdens created or benefits conferred by exemption; and (d) distortions in resource allocation, operating decision-making and overall performance potentially created by exemption;

--it results in a "fee for service" recommendation that is vague; uncertain in its effects on constitutionally-exempt property; and an incomplete solution that is more likely to prolong than end this debate; and

--it cuts off careful examination of how to structure revisions to tax treatment of statutorily exempt property that could capture the major benefits of ending the exemption while avoiding undesirable hardships; for example, continuing to exempt the first X dollars of property could minimize hardships on property-owning social service nonprofits; similarly, a staged phase-in, with review "check points" could trigger relief for recognized hardships based on the emergence of explicit criteria for relief.

Recommendation

<u>The Legislature should end property-tax exemptions.</u>

Important public policy gains can be achieved by ending property tax exemptions:

--beneficiaries of arts, public lands, professional associations, hospitals, and other selectively-used goods or services should pay a fairer share of their real costs;

--governments and nonprofits themselves should take a closer look at the relationship between property ownership and service delivery; the result should be better decision-making by each; and

--in recognition of the need, in some cases, to augment public support or private contributions to "deserving" nonprofits, a system of decision-making would evolve with more transparency and more explicit criteria for public support and, in the case of private charitable giving, more individual influence in allocating resouces to the nonprofit sector.

Respectfully submitted,

Robbin Johnson
Pat Davies
Wayne Carlson

## Minority Report #3

What has differentiated American society from others, including Western industrial countries, is the degree of voluntary participation of its citizens. This participation has been encouraged by government in recognition of the important role that pluralism plays in our society. Income and other tax exemptions were specifically designed to encourage the growth of the spirit of volunteerism. Many of the most important advances in health, welfare, and the arts have resulted from demonstration programs that were initiated by private organizations. Changes in tax exemption could threaten the existing structure of these organizations, and would strike at the basic composition of American society.

The majority report recommends that the State Legislature impose three taxes on nonprofits: 1) a tax on unrelated business income; 2) a fee for property-related services; and 3) sales taxes. While it is easy to rationalize that such changes are fair, it is irresponsible to recommend such legislation without giving thought to the impact it would have on the institutions concerned. No measure of such impact are included in the League's report. It is impossible to present an overall analysis for all nonprofit organizations, but I have taken the liberty of trying to determine what such impact will have on a few.

### Impact of Majority Recommendations

**Unrelated Business Income**--There is a growing trend for nonprofit organizations to develop business activities not directly related to their missions or goals. A tax on the income derived from such activities is thoroughly defensible.

**Sales Tax**

Wilder Foundation--As an operating foundation, Wilder operates programs for people who are economically deprived. Its major areas of interest are in child welfare and services to the elderly. These include intermediate and long-term care of the elderly, care of emotionally disturbed children, day care, and the provision of housing for low and moderate income persons. The Wilder Foundation estimates that the imposition of a sales tax would result in a tax increase of $660,000, and would result in increased fees to the elderly or reduction in services. Since 40% of its clients come from county referrals, it would be necessary to ask the county for more money. The private sector could not build the low-income housing provided by Wilder.

United Way--The United Way of Minneapolis estimates that a sales tax imposed on its 108 agencies would increase the expenses of those agencies by $2,536,808. A proportionate increase would also be assessed against the agencies of the St. Paul United Way. These increases would amount to more than both United Ways could expect to raise in new or additional money in their forthcoming campaigns. It is not an exciting prospect to ask corporations and individuals to increase their gifts in order that the agencies pay sales tax.

**YMCA's**--The YMCA's in Minnesota indicated that the imposition of a sales tax would increase their costs by $500,000 and would account for one-fifth of all their contributed dollars.

**Arts Groups**--If a sales tax is adopted, it would mean that much of the aid received by arts organizations from the State Arts Board would be negated. Data provided by arts groups indicate that those organizations with budgets over $700,000 would have to pay 51% of their state grants in sales tax payments. Organizations with annual budgets less than $700,000 would have to return 30% of their State grants in sale taxes. What is accomplished by this approach?

**Fees for Property-Related Services**

One of the difficulties in determining the impact of fee for property-related services is that no information has been made available as to the method of valuing the property, or giving the percentage of mill rate that would be applied. Under these circumstances, it is impossible to measure accurately the effect a property tax would have on hospitals, social service agencies, health agencies, settlements and arts organizations. What is known is that many of these nonprofit groups are having a very difficult time in balancing budgets. The imposition of fees would merely add to their burden, and in some cases, make it impossible for the organization to continue to serve the public. Once a tax base has been established, government has a habit of constantly expanding it.

The hospital industry, in particular, is in a state of crisis, and the imposition of a property tax would result in increases in insurance premiumns for policyowners and an increase in Medicaid payments by the counties. Some rural hospitals might have to close. Fees for service on hospitals could amount to $7.5 million. Total operating margins for all 158 hospitals last year was only $36 million. Thirty-nine percent of Minnesota hospitals had operating deficits.

## Contributions by Nonprofits

The draft report also fails to give specific information about the direct and indirect contributions of nonprofit organizations to government. Examples include:

Private High Schools-- Education provided through private high schools in Minnsota amounts to $46 million per year. These schools receive no grants from the State, and they educate over 14,000 students.

Private Colleges--The 17 private colleges in Minnesota create 24,000 jobs and have an impact on Minnesota's economy of nearly $2 billion per year. While students in private colleges pay 65% of their tuition, students at public colleges provide only about 35%, the balance coming from the State. Private colleges receive only 2% of their income from state grants. Of all families with children attending private colleges, 63% have two wage earners, 58% earn less than $36,000, 20% earn less than $18,000. Contrary to popular belief, private education is not for the elite. Private colleges and universities educate over 30,000 students and account for the highest percentage of merit scholars. Seventy-five percent of private college students receive some kind of financial assistance. If private high schools and colleges did not exist, the students would have to be educated in state colleges, at an enormous increase in cost.

<u>Hospitals</u> -- Hospitals provided over $19 million of free care in 1984. Additionally, hospitals provided over $53 million of subsidized care (the difference between established fees for procedures and the amount paid by government for the services) to patients eligible for Medicaid. $38 million was provided by hospitals as a subsidy to Medicare patients where fees are discounted by the federal government. $46 million was absorbed by hospitals for patients who were unable or unwilling to pay for care.

## Conclusions

1. The imposition of a tax on unrelated business income is justifiable.

2. Fees for property-related services and sales taxes will greatly increase the cost of operating nonprofit organizations. Some organizations may cease to exist.

3. Since some of the services offered by nonprofits are paid for by government, it will be necessary for the nonprofit sector to ask local and state governments for additional funds to compensate for the cost of new taxes and fees. Therefore, any additional income to the state and local governments will tend to be offset by the increase request for funding, if the funding is granted.

4. Exemption from property taxes is a way the local community indicates its support for the provision of essential health, welfare, and educational services, and the contribution these services make to the community and to the quality of life.

5. Imposition of sales taxes and fees for property-related services will necessitate increases in government expenditures, disallowing any reduction is tax burdens recommended by the majority.

6. Many nonprofit organizations receive no state assistance. Imposition of taxes would fall heaviest on organizations not receiving state grants.

7. Present public policy shifts more responsibility from government to the private sector. The imposition of taxes will make shifting more difficult at a time when federal grants are being reduced.

## Recommendations

1. The Legislature should impose taxes on the unrelated business income of nonprofit organizations.

2. Sales tax exemptions should be maintained, but sunset periodically.

3. Fees for property-related services should be rejected.

Respectfully submitted,

William Smith

## WORK OF THE COMMITTEE

**Charge to the Committee:**

The committee worked in response to the following charge from the Citizens League Board of Directors:

**Eligibility for Tax-Exempt Status**

Many types of entities, including charitable, religious, and educational groups and units of government are exempt from paying state and local sales, income, and property taxes.

Controversy is growing in the state Legislature over how to define an organization that should be eligible for tax exemption. For example, should entities be allowed to retain their tax exemption if they produce services or products in direct competition with taxpaying entities? If non-profit entities lose their exemptions but units of government retain theirs, are units of government given unfair advantage in delivering services?

The 1987 Legislature considered, but did not pass, proposals to extend property and sales taxes to a broad array of tax-exempt groups. Ultimately, the only major change in exemptions was to extend the sales tax to purchases of state government.

The committee's broad assignment: to decide what types of organizations should be eligible for exemption from some or all local and state taxes, in light of the public purposes that should be served by such exemptions. The assignment should encompass all types of governmental and nonprofit entities, including nonprofits that receive much of their funding from government.

The committee should examine:

--The cost of existing exemptions and the return to the public for granting the exemptions.
--How tax burdens would shift among individuals and groups of various incomes if exemptions were removed.
--Whether entities that offer services without charge would be more seriously affected by removal of exemptions than those entities that are reimbursed for services rendered.
--The impact on for-profit competitors when nonprofits or governmental entities are favored through exemptions.
--The adequacy and clarity of the definitions of exempt entities, including the use of such terms as "nonprofit."
--The role of the tax-exempt sector in introducing innovation in public services.

If the committee believes the charge is too broad, it may limit its inquiry, for example, to sales taxes.

**Committee Membership:**

Under the leadership of Allen Olson, chair, and Craig Olson, vice-chair, 28 Citizens League members participated actively in the deliberations of the committee. They are:

Wayne Carlson**
Pat Cragoe
Pat Davies**
Shannon Evans
Lloyd Graven
Charles Hartfiel
John Heintz
Curt Hubbard
David Hunt
Robbin Johnson**
Carol Kelleher*
John Klein
A. Scheffer Lang
Patricia Leary
Mary Ann McCoy
Hugh McLeod, III*
Robert Michelet
Florence Myslayek*
Ann O'Loughlin
Joan Peters
Carl Reuss*
Erika Sitz
Rick Smith
William Smith***
Michael Stutzer
Tom Swain
Phyllis Thornley*
Constance Waterous*

* Dissented from the committee recommendation to abolish sales tax exemptions. (See minority report #1, page 51.)

** Dissented from the committee recommendations to require only payments for property-related services. (See Minority Report #2, page 55.)

*** Dissented from the committee recommendations to abolish sales tax exemptions and require payments for property-related services. (See minority report #3, page 57.)

**Committee Meetings/Resource Speakers:**

The committee met for the first time on January 13, 1988 and concluded its work on September 21, 1988. A total of 32 meetings were held. As a part of the study process, the committee heard from the following resource speakers:

Scott Anderson, Chief Executive Officer, North Memorial Medical Center, and Chairman of the Board, Council of Hospital Corporations
Dave Bernier, City of Minneapolis Assessor
Leslie Blicker, Executive Director, Community Clinic Consortium
Marcia Bystrom, Head, Minnesota Delegation to the White House Conference on Small Business
Jim Carufel, Vice President, KTCA TV
Ann Cheney, Minnesota Orchestra Administration
Maybeth Christenson, Director, Congressman Frenzel's Minnesota Office
Glenn Dorfman, Minnesota Association of Relators
Johnelle Foley, Executive Director, Minnesota Association of Public Teaching Hospitals
David Galligan, Administrative Director, Walker Art Center
Sam Grabarski, Executive Director, Minnesota State Arts Board
Phil Griffin, Physicians Health Plan of Minnesota

Monsignor James Habiger, Minnesota Catholic Conference
Dennis Hamilton, Minnesota Public Radio
John Harris, Attorney, Faegre and Benson
Michael Hatch, Commissioner, Minnesota Department of Commerce
Rick Heydinger, Vice President, External Relations, University of Minnesota, Minneapolis Campus
John Humke, Director of Stewardship, Nature Conservancy
John James, Commissioner, Minnesota Department of Revenue
Jim Johnson, AMADOR Corporation
Tom Keegan, Minnesota Public Radio
Peg LaBore, Director, Family Tree Clinic
Byron Laher, United Way of Minneapolis
Patricia Lynch, Vice President, Minneapolis YMCA
Tom Mahowald, MedCenters Health Plan
Jim McCarthy, Board of Trustees Member, Mixed Blood Theatre
Brian Osberg, Group Health, Inc.
Larry Osnes, President, Minnesota Private College Council
Roger Peterson, Association of Metropolitan Municipalities
Jon Pratt, Executive Director, Minnesota Council on Nonprofits
Jacqueline Reis, Executive Director, Minnesota Council on Foundations
Dottie Rietow, member, Metropolitan Council
Pete Rode, Research Director, Urban Coalition
John Roth, President, Minnesota Citizens for the Arts
Joe Selvaggio, Executive Director, Project for Pride in Living
Michael Stutzer, committee member, Senior Economist, Federal Reserve Bank
Tom Triplett, Commissioner, Minnesota Department of Finance
Richard Ward, Ramsey County Assessor
Lois Wattman, Blue Cross/Blue Shield of Minnesota
Burton Weisbrod, Economist, University of Wisconsin, Madison

Detailed minutes were kept of each committee meeting. A limited number of copies of the committee's minutes and background materials are available from the League office.

## Assistance to the Committee

Citizens League staff assistance to the committee was provided by Marina Lyon, Dawn Westerman, and Joann Latulippe.