GEORGETOWN LAW

Brian Galle
Professor of Law

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Dr. Arthur Keiser, Ph. D.
Chairman
National Advisory Committee on Institutional Quality and Integrity
U.S. Department of Education, Office of Postsecondary Education
400 Maryland Ave. SW, Room 6W250
Washington, DC 20202

Mr. Frank H. Wu, J.D.
Vice Chairman
National Advisory Committee on Institutional Quality and Integrity
U.S. Department of Education, Office of Postsecondary Education
400 Maryland Ave. SW, Room 6W250
Washington, DC 20202

Dear Dr. Keiser and Mr. Wu:

Please accept these written comments regarding NACIQI's consideration of "Oversight of For-Profit Institutions' Conversions to Non-Profit Entities," currently scheduled for discussion at the Committee's meeting of May 22-24, 2018. By way of brief biographical introduction, I am a Professor of Law at the Georgetown University Law Center, where I teach courses on Nonprofit Organizations and Federal Income Taxation, among others. Previously I served as an attorney at the U.S. Department of Justice, Tax Division, Criminal Appeals and Tax Enforcement Policy Section. These comments are offered in my personal capacity and do not represent the views of Georgetown or anyone other than the author.

I write to urge the Committee to protect the public's interest in genuine non-profit educational institutions. In particular, the Committee should take steps to oblige the relevant accreditation authorities to scrutinize conversions of currently for-profit institutions into putative non-profits, and to decline to accredit institutions that

600 New Jersey Avenue, NW Washington, DC 20001-2075
PHONE 202-662-4039 FAX 202-662-4030
brian.galle@georgetown.edu

inaccurately purport to operate as non-profits. Further, the Committee should require that accreditors engage in continuing scrutiny of non-profit or public educational institutions with extensive contractual or other financial relationships with profit-seeking firms, in order to ensure that organizations that hold themselves out as charitable or public in fact are operated without regard for profit.

As the Committee is aware, the past year has seen several large for-profit institutions of higher education convert or announce plans to convert to non-profit status. As part of the plan of conversion, each of these institutions will enter into a complex web of financial and other ties with a for-profit successor of the former for-profit educational institution. In addition, Purdue University, a state institution that also has applied for and been granted federal tax exemption as a charitable organization, is engaged in a significant joint venture with the former Kaplan Education. For reasons that I will detail, these conversions and cooperative agreements raise serious concerns for students and other stakeholders of the respective institutions, as well as for taxpayers generally.

Non-Profit Status

First, let me briefly explain non-profit status from a legal perspective. State law makes an organization either for-profit, non-profit, or some other intermediate status, such as a "public benefit corporation." Each status carries with it a distinct set of obligations and entitlements, and the individuals in control of a business entity may choose which to elect. An organization that opts into non-profit status is thereafter prohibited from distributing any portion of its profits to its members, contributors, or insiders. State attorneys general have the power to enforce this restriction against the organization, and in most states, non-profits must register with the A.G.'s office and provide regular updates about the organization's activities and finances. Non-profit legal form is often required to claim certain state benefits, such as exemption from property or sales taxes.

In addition, federal tax law offers important financial supports for organizations that engage in charitable, educational, religious, or certain other activities benefiting the general public. Section 501(c)(3) of the Tax Code exempts qualifying entities from the corporate income tax, and makes them eligible to receive tax-deductible contributions. Organizations must apply for recognition, and file annual tax returns showing their continuing eligibility; churches and certain other religious institutions are exempt from these requirements. Some public institutions—those the IRS describes as an "arm of the State"—also may obtain the benefits of § 501(c)(3) without formally qualifying under that provision.

Crucially, to obtain and keep § 501(c)(3) status, an organization must show that it is organized and operated so that "no part of [its] net earnings…inures to the benefit of any private shareholder or individual." Tax lawyers refer to this rule as the prohibition on "private inurement." In practice, an organization that pays out only a small portion of its profits can typically still retain its tax exemption. However, another provision, § 4958 of the

Tax Code, imposes excise taxes on individuals and entities that receive these profit distributions, as well as on the charity managers who willfully authorize them.

NACIQI's Interest in Assuring Genuine Non-Profit Status

In short, non-profit status is a kind of public trust. As the Yale Law School professor Henry Hansmann explains it, the pledge not to distribute profit is a commitment the organization makes to dedicate itself to its public goals, not the personal enrichment of its investors or managers.[1] Organizations choose to bind themselves to the non-profit form because they deliver a good or service whose quality is hard for consumers to determine for themselves. By promising not to pay out profits, the organization is assuring its customers that it will not stint on quality in order to enrich its investors. Research has shown that consumers expect that nonprofits will not behave the way profit-maximizing firms would. For instance, consumers accurately recognize that non-profit community banks will not impose the hidden fees and charges on credit-card customers that are common elsewhere in the banking industry.[2]

Governments, too, rely on the non-profit pledge as a way of ensuring that public money is dedicated to public purposes, not private bank accounts. Again, federal and state tax benefits are conditional on non-profit status. More recently, as you know, ED regulations tie eligibility for federal higher-ed loan subsidies to the non-profit status of the institution where a student is enrolled. That regulation assumes—until very recently appropriately, in my view—that non-profit institutions will prioritize their educational mission over cash flows. Indeed, because state law imposes a fiduciary duty on the managers of a for-profit firm to protect the interests of their investors, a for-profit institution may well be prohibited by law from turning away tuition-paying students, even where those students have no reasonable prospects for job success. In contrast, law requires nonprofit insiders to act in the "best interests of the nonprofit," Model Nonprofit Corporation Act (3d) §8.30, not the interests of investors or any other person.

An organization's representation that it holds non-profit status, then, directly implicates important concerns within the regulatory authority of the Education Department, regional accreditors, and this Committee. Genuine non-profit status safeguards federal tax dollars committed to student loan programs from the pressures that profit-seeking may create. Further, students and other stakeholders—such as instructional staff or research funders—may rely on the representation that an organization is a non-profit in choosing which institution to attend, which employer to work for, or which institutions to support or partner with.

Recent Transactions Implicating NACIQI's Oversight Authority

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[1] Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980).

[2] Ryan Bubb & Alex Kaufman, *Consumer Biases and Mutual Ownership*, 105 J. PUB. ECON. 39 (2013).

Based on the documents I have reviewed, several of the new or proposed "non-profit" institutions of higher education are not non-profit in any meaningful legal sense. These transactions fail to uphold the public's trust in the non-profit form, and place taxpayer funds at unnecessary risk.

For purposes of illustration, I will focus on the recent reorganization of Grand Canyon University ("GCU"). In preparation for this testimony, I have reviewed a set of documents filed by GCU in support of its application for tax-exempt status, as well as disclosures it filed in compliance with federal securities laws.

According to these documents, GCU will split off its real estate and "academic-related" assets to reform as a non-profit college. The remaining piece of the old firm will then contract with the college to provide "recruiting, counseling, human resources and marketing" services; the form 8K GCU files with the Securities and Exchange Commission also mentions "financial aid." In exchange, the for-profit partner will take between a fifty and sixty percent share of the tuition, fees, room, and board revenue earned by the college (securities filings report sixty percent, while the application with the IRS reports fifty percent of gross revenue). GCU claims in its securities filings that this split is "comparable to other services agreements currently in the marketplace."

In order to effect the split, the new non-profit GCU will purchase most the educational-related assets of old GCU for $800 million. To finance this purchase, it will take out a balloon (i.e., interest-only) loan from the for-profit GCU, paying an interest rate of about 6%. In order to escape from the service agreement granting the for-profit a fifty to sixty percent share of revenues, non-profit GCU must first pay off its entire $800m loan balance, and in addition must pay a termination fee of one year's service fees on top.

As a practical matter, non-profit GCU is wholly dependent on and indentured to for-profit GCU. It will be exceedingly difficult for the non-profit to make annual $48 million debt-service payments when its free cash flows are limited to the residual earnings it retains after turning over fifty percent of gross revenue from most sources to the for-profit. The combination of these contractual arrangements will put extreme financial pressure on the non-profit to maximize revenues.

But for-profit GCU's control over the non-profit is not limited to these financial pressures. In addition, again according to securities filings, "[nonprofit] GCU would be governed by a board of trustees comprised of the persons who currently serve on the institutional board of trustees of [for-profit] GCU." It appears from the tax exemption application that other officers and directors of the two institutions would overlap as well. Non-profit GCU will be dependent on the for-profit for essential services, such as student recruitment.

Under these facts, there is no reason to believe that the new GCU will behave as a non-profit organization. It is financially and practically beholden to a for-profit partner. It is operated by a group of individuals who serve two masters, and who presumably are well compensated by for-profit GCU's investors for serving the interests of those investors.

Federal tax law should prevent GCU from obtaining non-profit status. Again, tax law prohibits "private inurement" from a charity to its insiders. When a charity engages in what amounts to a joint venture with a for-profit firm, existing private inurement rules require that the agreement satisfy what is sometimes known as the "control test." The control test derives from an IRS guidance document, Revenue Ruling 98-15, as well as a series of federal appellate decisions upholding and applying the revenue ruling. The ruling is unfortunately typical of IRS guidance in its reliance on a long list of factors, or "facts and circumstances," without clear statements about which factors are the most important.

Still, GCU's proposal fails the control test. To be sure, one central factor in the test is whether the venture agreement provides for "reasonable compensation," and GCU has been careful to state that both the $800m sale price and the 60/40 division of revenues are based on market comparables. GCU will still be an educational institution. But there are no assurances that the new organization will prioritize its charitable mission over profit. Under the control test, overlapping boards between the for-profit and nonprofit are a serious red flag. So, too, is the inability of the nonprofit to escape its management agreement. And, as in the situation ruled impermissible in the revenue ruling, for-profit GCU will "have broad discretion over [nonprofit]'s activities and assets that may not always be under the [nonprofit] board's supervision." Nor are those activities peripheral to the college's mission—certainly recruitment and financial aid are central components of how a college builds its student community.

Even if the arrangement isn't considered as a joint venture, it would still violate the more general prohibition on private inurement. Private inurement rules govern not only those with current positions of power, but also those who within the past five years held such a position, so for-profit GCU certainly fits that description. The private inurement rules don't outright forbid incentive pay, but profit-sharing or other contracts that would incentivize managers to favor revenue over nonprofit mission are disfavored. A manager that earns fifty to sixty percent of revenues has obvious incentives to maximize them. Even the nonprofit's officers would have powerful incentives to ensure enough cash flow to service the massive $800m loan, forcing them to constantly scramble for dollars at the expense of educational quality. A finding of private inurement might not outright prohibit nonprofit status, but it would trigger penalty taxes under § 4958 that would make conversion economically infeasible.

Despite the clarity of federal tax law on these facts, it is my understanding that GCU's application for tax-exempt status was recently granted. It is worth noting in this regard that the Tax-Exempt and Governmental Entities unit of the IRS has dramatically reduced its reported enforcement activity in the wake of congressional hearings into possible political bias in that unit. According to IRS data, from 2009 to 2016, the share of new applications for nonprofit status rejected by the Service plummeted by more than 90%.

NACIQI should ensure that regional accreditors do not assume that IRS scrutiny is adequate to safeguard the public's interest in genuine non-profit status. Even aside from its current enforcement crisis, the IRS is not tasked with protecting the integrity of the federal student loan system. IRS does not directly account for facts that would suggest the goals of the gainful employment rule could be undermined by an institution's ties to related for-profit firms. Further, IRS developed and has historically applied the control test to hospitals; its failure to apply that test to GCU's application may reflect a reticence to expend scarce resources in extending (and potentially litigating) its application to colleges and universities. The Committee should not depend on the IRS's choices about how to allocate its own enforcement resources in carrying out NACIQI's mission.

Further, the fact that an entity was granted tax-exempt status is no guarantee it will keep it. Again, 501(c)(3) organizations other than churches must file annual tax returns showing that they are in fact operated as a qualifying organization. IRS remains free at any time to determine that GCU or any other former for-profit college is delivering excess private inurement, and to seek appropriate excise taxes or revocation of the organization's tax exemption. Revocation may result in liability for unpaid back taxes.

Obviously, serious tax enforcement actions such as these would represent a major threat to the continuing viability of an educational program, with concomitant threats to the well-being of enrolled and even former students. Excise taxes for uncorrected distributions of excess profit can be as high as 200% of the excess amounts distributed. Accreditors should give serious consideration to whether a putative "non-profit" school may face legal risks of a kind and scale that differ dramatically from those of other non-profit institutions.

Another recent transaction illustrates yet another serious gap in the protections tax law offers to higher education stakeholders. As has been widely reported, Purdue University in Indiana recently entered into a highly detailed partnership with Kaplan University. Among other provisions, Kaplan will provide distance learning services to Purdue students, including by operating a free-standing, on-line only law school. As with the GCU arrangement, my review of the Purdue-Kaplan documents suggests that the arrangement would raise significant questions of excess private inurement.

Purdue's status as a state institution complicates the tax law analysis, however. As described earlier, under IRS rulings dating to the early part of the last century, state institutions can be exempt from the federal corporate income tax and eligible for deductible contributions even without formally attaining § 501(c)(3) status. Some such organizations apply for formal recognition in order to be listed in the IRS "Business Master File" of entities eligible to receive contributions, although the IRS also makes available an official letter declaring an entity to be exempt as a governmental institution. Purdue appears to have obtained recognition as a 501(c)(3) in 2000. But state institutions do not need to file tax returns, and Purdue evidently has not done so. Further, IRS regulations implementing § 4958 exclude state institutions from being subject to excise taxes for private inurement, even though the statutory basis for that exclusion is uncertain. In my view, Purdue at a minimum could be subject to revocation of its 501(c)(3) status due to excess private inurement, but that proposition is not currently clearly established in IRS guidance.

Therefore, NACIQI should ensure that state institutions entering into partnerships or other complex business arrangement with for-profit entities are subject to close accreditor scrutiny. These deals, like outright conversions to for-profit status, may potentially undermine public trust in public institutions, jeopardize federal taxpayer supports, and weaken the protections of the gainful employment rule. Federal tax law applicable to public entities is sufficiently unsettled that IRS cannot at this time be expected to serve as a meaningful check on possible profit-seeking.

Thank you for taking the time to consider these remarks. I am happy to answer any follow-up questions from you, your fellow committee members, or staff.

Respectfully submitted,

Brian Galle
Professor of Law
Georgetown University Law Center