

**SUMMARY OF COMMENTS OF THE SECTION OF TAXATION  
OF THE DISTRICT OF COLUMBIA BAR  
REGARDING TITLE III OF D.C. ACT 10-225,  
IMPOSING A SPECIAL PUBLIC SAFETY FEE**

- Although it is called a Public Safety Fee and is based on "District gross receipts", the fee is fundamentally a tax on income and should not be imposed on organizations exempt from income-based taxes.
- Imposition of the fee on exempt organizations is not in the District's best interests. Other jurisdictions do not impose fees or taxes of this magnitude on exempt organizations, and it will be viewed as burdensome by exempt organizations. While the one-time fee is not sufficient alone to lead organizations to leave the District, it is one factor that contributes to an unfavorable climate in the District.
- Contributions, grants and other gifts are not treated as income for tax purposes and should not be treated as gross receipts.
- Gross receipts taxes typically apply to proceeds from the sale of goods or services. Although tax exempt organizations have program service revenue from their activities (e.g., admission fees to a museum), the only sales proceeds they have in a business sense is unrelated business income. Gross unrelated business income should be used for determining gross receipts of exempt organizations.
- The statute does not define the term "from sources within the District". The District used the standard payroll-property-receipts apportionment method for the franchise tax, and exempt organizations use this method for reporting unrelated business income. If this method is used for the Public Safety Fee and gross receipts of exempt organizations is defined as gross unrelated business income, exempt organizations could easily comply. If the definition of gross receipts is broader, a simple method such as payroll should be adopted to maximize ease of administration.

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The views expressed herein represent only those of the Section of Taxation of the District of Columbia Bar and not those of the D.C. Bar or of its Board of Governors.

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\* The principal drafter of these comments is Suzanne Ross McDowell, Chair of the Exempt Organizations Committee, assisted by Catherine E. Livingston, a member of the Section of Taxation. Helpful comments were received from Joseph Rieser, the Chair of the newly formed State and Local Taxes Committee of the Section of Taxation.

**COMMENTS OF THE SECTION OF TAXATION  
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These comments are offered in connection with the District of Columbia's new Special Public Safety Fee. The Council of the District of Columbia and the Mayor enacted the fee on April 14, 1994 as Title III of D.C. Act 10-225. It appears that when the period of Congressional review expires, the fee will become law. At present, the Department of Finance and Revenue is actively engaged in the process of drafting regulations and designing forms to be used in implementing the fee. Personnel in the Department have indicated that they would welcome input from members of the Bar. These comments were prepared by members of the Steering Committee and of the Exempt Organizations Committee of the Section of Taxation.

The District's new Special Public Safety Fee is a one-time fee imposed on individuals or entities that are subject either to the District's franchise tax or to its Unemployment Compensation Act. The size of the fee is determined according to a sliding scale that is based on the feepayer's "District gross receipts" for its last fiscal year ending before July 15, 1994. The smallest fee (\$25) applies if gross receipts were less than \$200,000. The largest fee (\$8,400) applies if gross receipts exceeded \$15 million. There are five fee levels in between. The term "District gross receipts" is defined as "all income, derived from any activity whatsoever from sources within the District, whether compensated in the District or not, prior to the deduction of any expense whatsoever connected with the production of such income."

The new statute raises a number of concerns as set forth below. First, organizations that are exempt from District income taxation should not be subject to a fee that is essentially an income tax. Second, tax-exempt organizations face particularly acute problems in determining their District gross receipts that should be given special consideration when devising a system for implementing the Special Public Safety Fee.

I. Objections to Imposing the Tax on Otherwise Tax-Exempt Organizations

Because application of the public safety fee is tied to the application of the Unemployment Compensation Act, nonprofit organizations that have employees performing services in the District are generally subject to the public safety fee even if they are exempt from the franchise tax under D.C. Code § 47-

1802.1.<sup>1</sup> This result is inconsistent with the general principles for granting tax exemption to charities and other organizations that benefit the public.

A. Disguised Income Tax

Although it is called a "public safety fee" and although it is based on "District gross receipts," the fee is fundamentally a tax on income. The statute defines District gross receipts as "all income from any activity whatsoever from sources within the District. . . ." Further, use of the revenue from the fee is not restricted to public safety but rather, like an income or franchise tax, can be used for any governmental purposes. Organizations that are exempt from the franchise tax should not be subject to an income tax by another name.

Exempt organizations generally fall into two groups. "Public benefit" organizations are exempt from income-based taxes because their activities lessen the burdens of government and provide a benefit to the general public. One of the principal scholars on the subject, Boris Bittker, has written that charitable organizations are exempt from tax not as a matter of legislative grace but because their earnings are not considered income under prevailing tax definitions. Their revenues are not the product of activities intended to generate profit. Furthermore, their resources are permanently dedicated to charitable purposes, meaning that they do not have the kind of dominion and control over their funds that are ordinarily associated with ownership of income. It should also be noted that very few of these organizations have income in excess of their expenses. Thus, the public safety fee would take money from vital social services and other activities currently administered by the nonprofit community.

"Mutual benefit" organizations are comprised of individuals or entities who pool their resources to achieve some common goal. Members of these organizations, be they individuals or businesses, are subject to tax individually. The policy behind income-based taxes has deemed it inappropriate to tax members again when they join together for some common purpose other than the business purpose of creating profits.

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<sup>1</sup> The Unemployment Compensation Act also applies to employers that have employees who are District residents and who perform services outside the District but not in states where the office controlling their activities is located. D.C. Code § 46-101(2)(B). The Act contains an exemption for churches and some religious organizations. See D.C. Code § 46-101(2)(A)(iv).

In sum, these organizations are not generally viewed as appropriate objects of taxation. Imposing the public safety fee on tax-exempt organizations undermines the coherence of the District's income tax system and, as discussed below, leads to very difficult questions of implementation.

#### B. Detrimental to the District's Interests

At current levels, the public safety fee will be modest for organizations with low levels of District gross receipts. Nevertheless, it will be a factor influencing considerations by tax-exempt organizations whether to relocate their offices outside the District. The economic well-being of the tax-exempt sector is lagging a few years behind that of the economy as a whole, and any additional fee is seen as burdensome.

Tax-exempt organizations with \$1 million or more in "District gross receipts" will be paying far more in District public safety fees than they typically pay in registration or filing fees in other states. They certainly will be paying more than they pay in income-based taxes elsewhere since they are generally exempt from tax in other jurisdictions. Therefore, although the fee may appear to be small when compared to the receipts of these organizations, it will seem large to them and could provoke strong adverse reactions.

Although tax-exempt organizations do not pay taxes in the District, they provide valuable benefits to District residents. Moreover, they contribute to the District's economy by providing employment, renting office space, and purchasing goods and services. Many of them also incur higher costs to operate in the District than they would incur if they located in neighboring jurisdictions. It is in the District's interest to treat such organizations in a manner comparable to the treatment other jurisdictions would accord them.

#### II. Problems in Determining Fee for Exempt Organizations

All feepayers will have difficulty understanding what the statute means to treat as District gross receipts, but the problems will be particularly acute for organizations that are exempt from the District's franchise tax and from federal income tax. Their revenues are not comparable to business receipts, and they have had no reason to apportion their revenues among the various jurisdictions in which they operate. Consequently, with the exception of their unrelated business income, they have no measure which can be readily borrowed for purposes of determining the level of their public safety fee.

A. What are "District Gross Receipts"?

The definition of District gross receipts given in the new statute is unclear. Gross receipts cannot be the same as "gross income" under IRC § 61 since that definition was used in an earlier version of the legislation and rejected. That distinction is reinforced by the difference between the definition of District gross receipts and the definition of "gross income" given in D.C. Code § 47-1803.2 -- defined as that which is captured by the IRC § 61 definition of income with certain modifications. However, the statute does say that gross receipts are a type of income.

Receipts of tax-exempt organizations generally fall into one of the following five categories: (1) contributions, gifts and grants; (2) membership dues; (3) program service revenue; (4) investment income; and (5) unrelated business income. The first four categories are reported on Form 990, the federal information return; the fifth category is reported on Form 990-T, the federal unrelated business income tax return.

Receipts in the nature of gifts-- charitable contributions from individuals and businesses, and grants from private foundations and governments-- are generally excluded from any tax-related definition of income. By definition, such contributions are amounts given in return for inadequate consideration, i.e. gifts. See e.g., IRC § 102. The fact that a charitable organization may depend heavily, or even exclusively, on gifts to support its activities does not transform them into income for tax purposes. Thus, any measure of an exempt organization's gross receipts should exclude charitable contributions, grants and other gifts.

As noted above, members of a mutual benefit type exempt organization are typically individually subject to tax on their income and, if located in the District, individually subject to the Public Safety Fee. When they pay dues to an organization, they are simply pooling their resources to do collectively what they could do individually. They are not engaged in an income-producing activity when they pay dues and, accordingly, membership dues should not be considered gross receipts for purposes of the Public Safety Fee.

The third category of receipts, program service revenue (e.g., museum admission fees), is also not an appropriate subject for a gross receipts tax. When other jurisdictions tax "gross receipts," they typically tax proceeds from sales of goods and services. The same is true of the "receipts" factor that is usually incorporated into the standard payroll-property-receipts formula used to apportion income among states. In fact, the D.C. Code refers to this factor as "sales." D.C. Code § 47-1810.2(g). Tax-exempt organizations do not have income from sales of goods

or services in the conventional sense. They may generate program service revenue to cover the costs of providing goods and services. These goods and services, however, are provided to benefit the general public, not to generate a profit. Receipts from such goods and services are not treated as "income" for franchise tax purposes and should not be treated as gross receipts.

The treatment of investment income is more problematic. For the policy reasons summarized above, such income is not subject to the District franchise tax or the federal income tax and should not be subject to any income-based tax. Such income does, however, arise from an activity undertaken for the purpose of generating income. In that sense, it is distinguishable from the first three categories of income which arise from activities undertaken to achieve directly the organization's exempt purpose. Regardless of the general decision on investment income, gross proceeds from the sales of securities and other investments should not be included in gross receipts. Sales are often made at a loss and many portfolios turn over several times during a year, a fact that could result in multiple taxation of the same funds.

Gross unrelated business income is the only category of income that clearly gives rise to "gross receipts" for tax purposes. Such income, by definition, is derived from business activities that do not contribute importantly to accomplishment of an organization's exempt purposes and are undertaken for purposes of earning a profit.

#### B. What is Income "From Sources within the District"?

The source question has great legal significance. According to the Supreme Court's decision in Complete Auto Transit v. Brady, 430 U.S. 274 (1977), a gross receipts tax that affects income generated in interstate commerce must be apportioned in order to comply with the Constitution's Commerce Clause. Unfortunately, the statute fails to specify how gross receipts should be apportioned or allocated where a feepayer generates receipts both within and without the District. The Council may have assumed that the apportionment and allocation rules used for the franchise tax would be borrowed for the purpose of calculating District gross receipts, but if that was their intent, it is not expressed in the statute. Any number of other source rules would be equally plausible. For example, income from sources within the District could refer to income generated by activities performed in the District or it could refer to income transferred from payors located in the District. Or, apportionment could be based on a simple measure such as payroll.

The standard payroll-property-receipts method used for the franchise tax would be very difficult for exempt organizations to

use, unless the fee was imposed only on gross income from unrelated business activities. As explained above, since other activities of exempt organizations do not produce "receipts" in the usual sense, they have not had any reason to apportion receipts from such activities. Moreover, they have not had any reason to keep their books and records in a manner that will enable them to apportion their receipts. On the other hand, exempt organizations do apportion their unrelated business income in order to calculate their franchise tax. See D.C. Code § 47-1802.1. The District would achieve ease of administration and high levels of compliance with the new public safety fee by basing it on information that is already available for exempt organizations-- the unrelated business income that they have already calculated, apportioned and reported to the District.

### III. Suggestion for Accommodating These Concerns

If organizations that are exempt from federal income tax and District franchise tax are to be subject to the Special Public Safety Fee at all, their gross receipts for this purpose should be limited to and measured by their unrelated business income. The District gross receipts of tax-exempt organizations should be determined according to a simple formula, either a measure based on an easily ascertainable factor like payroll or the standard apportionment formula used for franchise tax purposes. See D.C. Code § 47-1810.2. Since gross income from unrelated business activities will already have been reported on federal form 990-T and already apportioned for purposes of the District's franchise tax, it will be easy for tax-exempt organizations to identify the level of their gross receipts and the associated Public Safety Fee. Moreover, such an approach would not conflict with core principles of income taxation which do not treat charitable contributions or other revenues derived from exempt activities as income.