

## Written Testimony of Brian Galle<sup>1</sup>

### Before the House Committee on Education and Labor

#### Hearing on *For-Profit College Conversions: Examining Ways to Improve Accountability and Prevent Fraud*

April 20, 2021

Thank you, Chairman Scott, and members of the Committee, for inviting me to speak today, and for holding this hearing. I am here to explain the importance of genuine non-profit status in higher education. As you know, in a number of recent transactions, colleges that were formerly for-profit, or in the statutory terminology, “proprietary” colleges,<sup>2</sup> have claimed that they became non-profit. In my view, a number of these transactions did not genuinely result in a new non-profit, either from a legal or economic perspective. As a result, students at these institutions are left vulnerable to exploitation and other poor outcomes, and all while believing that they are enrolled in a trustworthy, nonprofit, institution. The Education Department should ensure that organizations that have incentives to squeeze their students for profit are regulated that way.

#### **Role of For-Profit Status in Education Department Regulations**

Nonprofit status potentially affects key aspects of the Education Department’s (herein “Education” or “Ed”) regulatory regime for institutions of higher education. The first of these, sometimes called the “90/10” rule, relates to an institution’s sources of revenue. That rule is certainly in effect today, and will be further expanded under recent congressional amendments effective in 2023. The status of another provision, known as the “Gainful Employment” rule, is less certain, and is currently the subject of litigation. Nonprofit status affects an institution’s treatment under both these requirements.

The 90/10 rule effectively bars affected institutions from depending too heavily on federal financial support. If a for-profit institution receives more than 90% of its revenues from sources receiving federal support under Title IV of the Higher Education Act for two consecutive years, that institution loses its eligibility to receive further such funds for at least two years.<sup>3</sup> Title IV includes most of the major federal supports for higher education, including Pell Grants, Federal Work-Study, Direct Loans, and Perkins Loans. For purposes of this calculation, revenues are limited primarily to tuition and fees for essential student services.<sup>4</sup>

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<sup>2</sup> 20 U.S.C. § 1002(a)(1)(A).

<sup>3</sup> 20 U.S.C. 1094(a)(24), d(2).

<sup>4</sup> *Id.* § 1094(d)(1).

In addition, effective in 2023, revenue sources supported by any federal expenditure will fall into the restricted 90% category.<sup>5</sup> In practice, this change prevents schools from using revenues from students receiving aid from the V.A. and U.S. Department of Defense to satisfy their 10% private-source requirement.

The Gainful Employment Rule similarly restricts access to Title IV funding for some for-profit institutions.<sup>6</sup> In broad terms, the Rule requires certain institutions, primarily for-profits, to hit defined metrics for student earnings outcomes, such as the ratio of the graduates' earnings to student debt payments.<sup>7</sup> Institutions that fail to reach these metrics consistently will be suspended from Title IV participation. Institutions must also disclose information about student success, including what the typical graduate earns, their typical debt, and what share of graduates find success in their field.<sup>8</sup>

Beginning in 2017, the Education Department sought repeatedly to delay, and then rescind, the Gainful Employment Rule. The Department delayed implementation of the disclosure requirements three times.<sup>9</sup> In 2019, it sought to rescind the Rule entirely.<sup>10</sup>

The current status of the Gainful Employment Rule is unresolved. Following its issuance, the rescission rule was challenged by teachers, teachers' unions, and the State of California.<sup>11</sup> The District Court denied the Department's motion to dismiss, allowing plaintiffs to proceed on their claim that the Department failed adequately to justify its reversal.<sup>12</sup> That challenge is ongoing.<sup>13</sup> I am unaware of any official statement from incoming Education Department officials regarding whether they intend to continue defending the rescission rule.

## Why For-Profit Status Matters

Given the key role that for-profit status plays in current ED rules, it is worth understanding the ways in which nonprofit organizations differ from the for-profit firms that are more familiar to us from other industries. Technically, a nonprofit organization is one that has voluntarily agreed to be governed by state nonprofit law. Federal law also provides certain benefits, such as tax exemption, to nonprofit organizations that meet federal requirements.<sup>14</sup> But this technical definition only scratches the surface. Why do organization founders choose to be bound by nonprofit law, and how does that choice shape their behavior?

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<sup>5</sup> America Rescue Plan Act of 2021, Pub. L. 117-2, § 2013.

<sup>6</sup> Program Integrity: Gainful Employment, 79 Fed. Reg. 64890 (Oct. 31, 2014).

<sup>7</sup> *Id.* at 64890–91.

<sup>8</sup> *Id.*

<sup>9</sup> *Am. Fed'n of Teachers v Devos*, 484 F. Supp. 3d 731, 739–40 (2020).

<sup>10</sup> Program Integrity: Gainful Employment, 84 Fed. Reg. 31392 (Jul. 1, 2019).

<sup>11</sup> *Am. Fed'n of Teachers*, 484 F. Supp. 3d at 740–41.

<sup>12</sup> *Id.* at 749.

<sup>13</sup> The last-docketed item recorded is an October, 2020 request to file a motion for reconsideration on behalf of Secretary Devos.

<sup>14</sup> *See, e.g.*, I.R.C. § 501(c)(3).

Nonprofit status is about trust. In many markets, buyers cannot easily verify the quality of the products on offer, and cannot know if the firm will exploit their ignorance. Think of an organization that promises that in exchange for a payment of \$1,000, they will vaccinate ten families in Africa against malaria. Purchasers of these vaccination services cannot know whether it actually costs \$1,000 to vaccinate ten families, or instead only \$100. Often, the purchaser cannot even know if the services are delivered at all. Faced with this uncertainty, many customers would refuse to do business with the organization.

Education is a good example. It is difficult for prospective students to know in advance whether the education a school promises will be a good one; scholars would say that going to school is an “experience good” whose value you have to live to assess. Even after graduating, it can be hard to know whether the educator gave you a high-quality experience, unless you are an expert at evaluating pedagogical techniques. You can tell if the dorm was falling down, but you don’t know if the curriculum and professors really prepared you for a career.

Adopting nonprofit status helps to overcome this credibility dilemma. Under state law, a nonprofit cannot pay out profits, but must instead reinvest any excess revenues into its charitable mission. Similarly, under federal tax law, an organization can escape from the corporate income tax if it commits itself not to share its profits with any private party. These commitments help to reassure customers that the organization will not exploit them. If there are investors demanding payment, the organization has reason to take \$1,000 and deliver only \$100 worth of vaccine. But a nonprofit that deprived its customers of \$900 in this way would only be able to spend the \$900 on more vaccine.

Put another way, genuine nonprofit status fundamentally transforms the incentives of an organization’s managers by removing the profit incentive. At a traditional, for-profit business, managers have a legal obligation, known as a fiduciary duty, to maximize the interests of the business’s owners. Turning a profit is almost always one of the central tasks, and some scholars say the only permissible task, for these managers.

To be sure, there are some business owners that want to pursue goals other than profit, but even at these firms there is still pressure on managers to deliver the bottom line. Businesses that could turn a healthy profit but do not will often be bought by investors who see the opportunity to gain from turning around an under-performing asset. Usually the first step the new owner takes is to fire the old managers. Managers therefore have strong personal reasons to heavily emphasize profit, no matter the preferences of the current business owners.

In contrast, state law prohibits (and federal law disincentives) nonprofit managers from considering profit. Again, there is no point in maximizing profit at a nonprofit, since net revenues have to be reinvested in the firm. But state law goes further, holding that managers have a fiduciary duty to uphold and pursue the charitable mission of the organization. The organization of course must break even, and can aim to gather enough resources to expand its mission. But managers must not base decisions on whether their choices will make money, but instead on what best serves the organization’s mission.

Consistent with this theory, numerous studies, across many industries, find that genuine nonprofit status protects consumers, and results in higher-quality services. Compared to nonprofit and public schools, for-profit colleges offer “high costs and low

returns.”<sup>15</sup> Costs exceed benefits for many for-profit enrollees.<sup>16</sup> Graduates earn 11% less, on average, than similar students who go to public schools.<sup>17</sup> Some students would do better to drop out of community college than to transfer to a for-profit college.<sup>18</sup>

There are similar differences in health care. Studies using modern econometric methods find that non-profit nursing homes are higher quality, with fewer bed sores, falls, or other negative outcomes.<sup>19</sup> Although measures of hospital quality are controversial, researchers generally agree that nonprofit hospitals do not mark up costs as aggressively as for-profits, and do a better job of protecting the most vulnerable patients.<sup>20</sup>

Consumers also see better results when the profit motive is weaker at financial services firms. For-profit insurance companies with traditional stock ownership have 20-25% more delayed payments and misconduct than mutual insurers, who like nonprofits cannot distribute profits to investors.<sup>21</sup> Similarly, credit unions, a form of customer-owned mutual bank, behave quite differently from typical commercial banks.<sup>22</sup> Most commercial banks earn large fractions of their banking income through fees and charges that customers could avoid if the customer were highly attentive and able to carefully manage their account usage; overdraft fees and late charges are common examples.<sup>23</sup> Credit unions, in contrast, often advertise that they offer “no hidden fees,” and then in fact deliver on that promise.<sup>24</sup>

For-profits maximize revenue, not quality. For-profit hospice care organizations stretch out patient stays to maximize revenue.<sup>25</sup> For-profit colleges respond to changes in

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<sup>15</sup> Luis Armona et al., “Student Debt and Default: The Role of For-Profit Colleges,” *Federal Reserve Bank of NY Staff Report* No. 811 (Feb. 2020), [https://papers.ssrn.com/Sol3/papers.cfm?abstract\\_id=2958120](https://papers.ssrn.com/Sol3/papers.cfm?abstract_id=2958120).

<sup>16</sup> Stephanie Riegg Cellini & Nicholas Turner, “Gainfully Employed? Assessing the Employment and Earnings of For-Profit College Students Using Administrative Data,” 54 *J. Hum. Resources* 342 (2019).

<sup>17</sup> *Id.*

<sup>18</sup> Vivian Y.T. Liu & Clive Belfield, “The Labor Market Returns to For-Profit Higher Education: Evidence for Transfer Students,” 48 *Community College Review* 133 (2020).

<sup>19</sup> *E.g.*, Lisa A. Ronald et al., “Observational Evidence of For-Profit Delivery and Inferior Nursing Home Care: When Is There Enough Evidence for Policy Change?,” *PLoS Medicine* (Apr. 16, 2016), <https://journals.plos.org/plosmedicine/article?id=10.1371/journal.pmed.1001995>; David C. Grabowski et al., “Effect of nursing home ownership on the quality of post-acute care: An instrumental variables approach,” 32 *J. Health Econ.* 12 (2013); Michael P. Hillmer et al., “Nursing Home Profit Status and Quality of Care: Is There Any Evidence of an Association?,” 62 *Medical Care Research and Review* 139 (2005).

<sup>20</sup> Mark Schlesinger & Bradford H. Gray, “How Nonprofits Matter in American Medicine, and What to Do About It,” *Health Affairs Web Exclusive* (2006), <https://doi.org/10.1377/hlthaff.25.w287>.

<sup>21</sup> Jiang Cheng et al., “The Ownership Complaint Gap: Mutual versus Stock Intermediaries,” 55 *J. Financial & Quantitative Analysis* 1685 (2019).

<sup>22</sup> Ryan Bubb & Alex Kaufman, “Consumer biases and mutual ownership,” 105 *J. Pub. Econ.* 39 (2013).

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> Richard C. Lindrooth & Burton A. Weisbrod, “Do religious nonprofit and for-profit organizations respond differently to financial incentives? The hospice industry,” 26 *J. Health Econ.* 342 (2007).

the generosity of federal student-loan supports by hiking tuition, so that government aid is captured by investors, not students; there is no evidence legitimate non-profits do so.<sup>26</sup> Likewise, for-profit schools, and only for-profit schools, responded to increases in unsubsidized loan caps with tuition hikes.<sup>27</sup>

The evidence is especially stark for one kind of for-profit investor: the private-equity firm. Private equity owners deliver especially high costs and poor outcomes. Following a private-equity acquisition, a college is much more likely to maximize its revenue from government sources, while at the same time seeing drops in graduation rates, loan repayment rates, and job placement.<sup>28</sup> A school that has “converted” but still is in partnership with a for-profit entity is at risk that a private equity firm will acquire its partner, and demand even more aggressive efforts to extract revenue

Why are for-profit firms able to thrive in these industries, when nonprofits deliver higher-quality products? In part, because not all consumers understand that they are vulnerable to being exploited, and so do not recognize that a firm’s nonprofit status is important. For example, one pair of researchers argues that many borrowers do not recognize that banks will employ hidden fees and charges.<sup>29</sup> These are the consumers who prefer commercial banks. Only the relatively smaller group of more sophisticated borrowers recognize that credit unions are the safer option.

### **Students’ Interest in Nonprofit Status of an Institution**

Genuine nonprofit status therefore offers important protections and assurances for students. A traditional nonprofit behaves differently than a school that is incentivized to maximize revenue. Students and their families cannot realistically be expected to carefully review the ownership structure and contracts a school has entered into to verify whether the school has the incentives to deliver a high-quality experience. They can only rely on Ed’s designation that the school is nonprofit.

In addition, the nonprofit triggers in both the 90/10 Rule and the Gainful Employment rule protect important student interests. The 90/10 Rule uses market pressure to incentivize institutions to deliver quality educational services.<sup>30</sup> In effect, the Rule obliges schools to attract some students who must pay out of pocket for tuition and fees.<sup>31</sup> It

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<sup>26</sup> Stephanie Riegg Cellini & Claudia Goldin, “Does Federal Student Aid Raise Tuition? New Evidence on For-Profit Colleges,” 6 *Am. Econ. J: Econ. Pol’y* 174 (2014).

<sup>27</sup> David O. Lucca et al., “Credit Supply and the Rise in College Tuition: Evidence from the Expansion in Federal Student Loan Programs,” 32 *Rev. Fin. Studies* 422, 453 (2019).

<sup>28</sup> Charlie Eaton et al., “When Investor Incentives and Consumer Interests Diverge: Private Equity in Higher Education,” 33 *Rev. Fin. Studies* 4024 (2020).

<sup>29</sup> Bubb & Kaufman, *supra*.

<sup>30</sup> James D. Ward, “Intended and Unintended Consequences of For-Profit College Education: Examining the 90/10 Rule,” 48 *J. Student Fin. Aid* 1, 5 (2019).

<sup>31</sup> Vivien Lee & Adam Looney, “Understanding the 90/10 Rule,” Brookings Institution, Jan. 2019, at 3.

therefore “induce[s] institutions to offer worthwhile programs that provide benefits to students large enough that students are willing to contribute their own funds.”<sup>32</sup>

The Gainful Employment Rule, if applicable, would provide several additional protections for current and prospective students. Most directly, its disclosure provisions would allow students to make more informed decisions about whether to enroll or continue enrollment at a given school. Additionally, by tying the institution’s ongoing financial viability to its graduate’s ability to repay their debts, the Rule incentivizes schools to invest in high-quality programs that prepare graduates to succeed, to mitigate the graduates’ debt levels, or both.

### **For-Profits in Disguise: Recent “Conversion” Transactions**

The GAO Report describes several different ways in which formerly proprietary institutions have attempted to obtain legal recognition as non-profits instead.<sup>33</sup> I believe many of these transactions leave the institutions as non-profits in name only. Although the institution may even succeed in obtaining recognition from the IRS as a charitable organization, as a matter of economic reality, the school and its managers are still strongly motivated to maximize revenue, not student outcomes. The fundamental purpose of the nonprofit form, as I have explained, is to encourage potential customers and supporters to trust that the organization will not divert their money to the benefit of the organization’s insiders. These transactions instead exploit and betray that trust, following a playbook familiar from credit counseling agencies two decades ago.

In my view, many of the new “nonprofit” organizations in these transactions are still essentially for-profit—in the sense that they still prioritize profits, not student outcomes—because they are prisoners of their debts to their for-profit partners. When Everglades College was sold, it owed \$321 million to Art Keiser, its Chancellor. Remington Colleges initially owed \$134 million to its predecessor for-profit. The Center for Excellence in Higher Education, a collection of proprietary institutions, was sold to a non-profit controlled by the proprietary owner for a promissory note with a valuation of \$636 million. Grand Canyon University owes \$800 million to its predecessor and for-profit service provider, now known as GCE.

There is no way for these institutions to behave other than exactly like the for-profit schools they have always been. Debts this massive force them to constantly scramble for dollars at the expense of educational quality. In almost all these deals, a large fraction of the sale price is based on the “intangible” assets of the proprietary institution, which in turn are valued based largely on a multiple of the institution’s historic revenues.<sup>34</sup> Almost by definition, then, the debts can only be sustained if the organization keeps earning profits at

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<sup>32</sup> Ward, *supra*, at 5.

<sup>33</sup> GAO-21-89, *IRS And Education Could Better Address Risks Associated with Some For-Profit College Conversions* (Dec. 2020) (“GAO Report”).

<sup>34</sup> GAO Report at 29.

the same rate it was before the “conversion,” which is to say, it must keep acting as a for-profit would.

A credit agreement and the threat of bankruptcy, which would eliminate an institution’s eligibility to receive federal aid, can leave a newly converted “non-profit” with very little flexibility to prioritize students over revenues. Any flexibility that remains is unlikely to be used because it is the creditor who also controls the institution. Effectively, the former owner can continue to siphon out profits from the “non-profit” institution via the debt obligation. Ed estimated, for instance, that taking debt and service-contract payments into account Grand Canyon University would pay an astonishing 95% of its annual revenue to GCE.<sup>35</sup> Education has recognized that debt arrangements based explicitly on net profit can raise this danger, and for that reason declined to recognize the Center for Excellence in Higher Education as a nonprofit.<sup>36</sup>

More generally, though, every highly-leveraged debt of this kind is in financial reality based on net profits. With relatively few liquid assets relative to the size of its obligations, the school can only pay its debts to the extent that its other operations produce sufficient cash. In other words, the school’s real asset is its ability to continue to draw down federal financial aid benefits in the same aggressive way that it did as a for-profit. As finance experts have long understood, these sorts of arrangement where debt greatly exceeds available hard assets are economically indistinguishable from equity, or profit-based, investment.<sup>37</sup>

Loans aside, there is also a serious danger the non-profit form is not genuine when the new “non-profit” is led by individuals who still stand to profit from its operations. GAO described several of these transactions. GAO Report at 22-23. In most of them, the proprietary institution’s assets are sold to an organization that already has obtained nonprofit status from the IRS, in some cases an organization that was established by the same individuals who are operating the proprietary institution. The for-profit sellers then take over in positions of leadership at the non-profit, and of course are paid for that service. More importantly, the terms of the sale allow for large ongoing payments from the non-profit to the sellers, usually through leases or service contracts.

It is very difficult to be confident that arrangements like that are fair to the nonprofit, its students, or taxpayers who support them. The managers of the new “non-profit” have obvious incentives to manage the organization so that it lines their own pockets. Even if a top manager nominally recuses herself from certain decisions, as some organizations told GAO,<sup>38</sup> her subordinates are perfectly aware that their choices will personally affect her. As nonprofit law has long recognized, a manager who is in a position

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<sup>35</sup> Letter from Michael Frola, Director, Multi-Regional and Foreign Schools Participation Division, U.S. Department of Education, to Brian Mueller, President, Grand Canyon University, at 14 (Nov. 6, 2019).

<sup>36</sup> <https://www2.ed.gov/documents/press-releases/08112016-cio-decision.pdf>

<sup>37</sup> Myron Scholes et al., *Taxes and Business Strategy: A Planning Approach* 355–37 (5<sup>th</sup> ed. 2016).

<sup>38</sup> GAO Report at 24.

to reward board members or subordinates for their loyalty can steer outcomes in her favor even if she doesn't make those decisions herself.<sup>39</sup>

To be sure, not every payment from a nonprofit to its insiders is problematic. Managers can and should be paid a fair wage. What distinguishes these deals is their magnitude, their opacity, and their potential for abuse. Salaries can certainly become excessive, and can affect managers' decisions, as my research has suggested.<sup>40</sup> Still, there is typically only an indirect connection between how a college president runs the organization and her compensation, and her decisions are unlikely to change her pay by more than a few hundred thousand dollars. Raising tuition, aggressive recruiting, and slashing instructional costs will not double her pay. In contrast, these deals involve ongoing payments of millions and tens of millions of dollars to the insiders.

The magnitude of the managers' incentives, and the difficulty of policing them, merits much more careful oversight. It is largely in the hands of the insiders whether to enter into those arrangements, and then to continue them. Ascertaining the fair value of unique assets, such as a campus, is difficult, and so it is hard for any outside party to assess whether the insider is using their influence to extract unwarranted payments. Further compounding this problem, an institution does not need to lease its buildings from its insiders; it can rent somewhere else, buy property, or pursue an on-line business model. Even if the rental payments are not inflated, that fact tells us nothing about whether the organization would have been better served to pursue one of its other alternatives to renting from the insider. It is inherently difficult for an IRS auditor or other regulator to review all the factors that an organization might consider when making these kinds of strategic decisions. This gives self-interested managers a free hand to prioritize their own wealth. Certainly not all will do so. But the greatly heightened risk that they can and will is what justifies close scrutiny.

Indeed, for this reason tax law typically presumes that arrangements of this kind are inherently non-charitable. When a charity puts the daily management of a substantial share of its assets or operations in the hands of for-profit service providers, the charity must retain "control" over the venture.<sup>41</sup> If instead the for-profit interests can determine how the operations are managed, tax law assumes that those operations will not be charitable in nature. If the for-profit's insiders also exert significant influence over the charity, the IRS is likely to conclude the charity does not "control" the venture.<sup>42</sup>

The conversion transactions in fact follow a very similar pattern to the credit counseling agencies that in the early 2000s IRS, and ultimately Congress, concluded were

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<sup>39</sup> Board of Regents of the University of the State of New York, *The Committee to Save Adelphi v. Diamandopoulos* 34 (1997).

<sup>40</sup> Brian Galle & David I. Walker, "Donor Reaction to Salient Disclosures of Nonprofit Executive Pay: A Regression-Discontinuity Approach," 45 *Nonprofit & Voluntary Sector Q.* 787 (2015).

<sup>41</sup> Rev. Rul. 98-15 Sit. 2; see *St. David's Health Care Sys., Inc. v. United States*, 349 F.3d 232, 237 (5<sup>th</sup> Cir. 2003).

<sup>42</sup> Rev. Rul. 98-15 Sit. 2.



not really nonprofits.<sup>43</sup> Credit counseling agencies were organizations that purported to help individuals manage their debts. In fact, their business model was to take payments from large creditors in exchange for extracting more payments from the counseled creditors, usually with the help of very aggressive marketing.<sup>44</sup> Applicable regulations were more demanding for counseling organizations that operated as for-profits. Many therefore attempted to reincorporate as non-profits. The new “non-profit” shared common control with a for-profit entity, and the “non-profit” counseling agency would be obligated to make a stream of interest or lease payments to the for-profit.<sup>45</sup> As IRS Chief Counsel concluded, although these arrangements may have superficially satisfied some of the formal requirements for tax-exempt status, they in fact were not charitable; they existed in order to enrich the for-profit investors, as well as their bank clients.<sup>46</sup> Much of that same analysis could be applied equally to for-profit colleges.

Despite all these evident shortcomings, most of the described transactions appear to have succeeded in obtaining IRS recognition as nonprofits. IRS enforcement actions are confidential.<sup>47</sup> GAO reports that about a third of the transactions it reviewed were audited by the IRS.<sup>48</sup> Most of the organizations described in the GAO report and still in operation today continue to regularly file tax returns, and these documents are public.<sup>49</sup> It thus appears that these organizations remain nonprofits for tax law purposes. I will now explore some possible explanations for this state of affairs.

### **Independent Review by Education is Necessary**

Taken together, the GAO report and the transactions I have described suggest that IRS oversight is not sufficient to safeguard the interests of students or the general public in maintaining the genuinely nonprofit character of supposed nonprofit schools. In part, this shortcoming is due to resource and other institutional limits inside IRS. More fundamentally, though, the legal framework IRS employs isn’t designed to implement Title IV, and fails to further Title IV goals in certain key respects. Relying exclusively on IRS oversight would therefore mean that Ed is failing in its mission.

The GAO carefully and in my view accurately describes many of the procedural limitations at IRS that sharply constrain that agency’s ability to detect and investigate for-profits in disguise. Among other issues, IRS lacks resources to give any meaningful attention to most of the 1.5 million active U.S. charities. This resource crunch has worsened in recent years. For example, on an annual basis, IRS now denies less than 10% the number

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<sup>43</sup> I.R.C. § 501(q); *see* *Profiteering in a Nonprofit Industry: Abusive Practices in Credit Counseling*, Sen. Rep. 109-55 (Apr. 13, 2005); IRS Chief Counsel Advisory 200431023 (July 30, 2004).

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

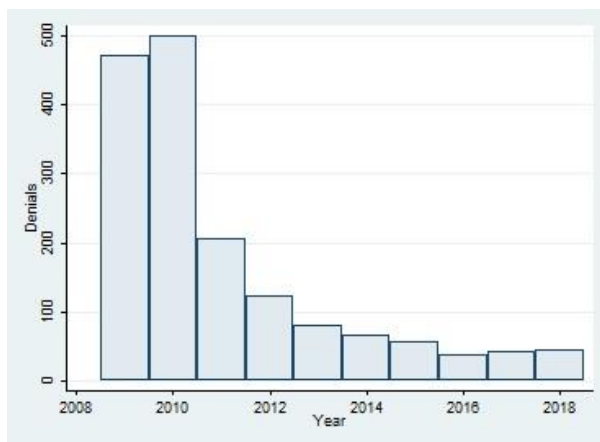
<sup>47</sup> I.R.C. § 6103.

<sup>48</sup> GAO Report, at 35 n. 72.

<sup>49</sup> I.R.C. § 6104.

of applications for tax-exempt status as it did a decade ago, even as total applications are up.<sup>50</sup>

**Figure One: IRS Denials of Applications for Exempt Status**



Source: Author calculations, based on IRS Statistics of Income Data

The current administration is proposing to increase the IRS budget, but that will not solve other key gaps in IRS authority. For example, IRS asks taxpayers to identify transactions with “interested persons” on their tax returns, and defines that term to include “disqualified persons.”<sup>51</sup> But it is left to the taxpayer in the first instance to decide which persons or entities are “disqualified persons.” An organization can therefore take an aggressive position with respect to which transactions even need to be reported. It has been reported, for instance, that Purdue Global did not report Kaplan Education as one of its five largest contractors, despite over \$45 million in contracts between the two organizations.<sup>52</sup>

The uncertain state of tax law also leaves room for institutions to omit key information. For example, if a contractor is in a position to potentially exert significant influence over the conduct of a core operation of the school, but that contractor is not owned by an individual with a formal position of authority at the school, the applicable regulations would call for a complex balancing test to determine whether transactions with the contractor are reportable.<sup>53</sup> IRS is not typically able to second-guess the organization’s position, because without additional information outside the tax return IRS does not even know that the transaction took place. I therefore agree with the GAO report that it is advisable for IRS to ask specifically about conversion transactions.<sup>54</sup>

<sup>50</sup> <https://www.irs.gov/statistics/soi-tax-stats-closures-of-applications-for-tax-exempt-status-irs-data-book-table-12>

<sup>51</sup> IRS Form 990 Schedule L Instructions.

<sup>52</sup> <https://tcf.org/content/commentary/purdue-global-got-irs-stamp-approval/>

<sup>53</sup> Treas. Reg. 53.4958-3(c), (d), (e).

<sup>54</sup> GAO Report at 49.

More fundamentally, resources and improved questions alone will not make IRS an effective monitor of for-profit colleges because that is not the task for which federal tax law, and IRS's regulations implementing it, were designed. As I have described, Title IV requires that Education be able to identify organizations that have a financial incentive to prioritize revenue over student outcomes, and ensure that these organizations are subject to more demanding regulations intended to protect vulnerable students. This is effectively a binary decision: the heightened regulatory standards either apply, or they do not.

For all intents and purposes, IRS does not apply a binary standard to charities it reviews. Instead, when IRS detects a diversion of organizational resources to an impermissible private purpose, IRS imposes a penalty tax on the recipient and potentially the authorizing board members under its "intermediate sanctions" regime.<sup>55</sup> Congress enacted this regime because IRS has been extremely reluctant to revoke an organization's tax-exempt status.<sup>56</sup> The implementing regulations further cement this reluctance, stating that an organization where intermediate sanctions are applied will not typically lose exemption unless the violations were substantial in relation to the overall size of the organization's activities, they happened many times, and the organization failed to correct them.<sup>57</sup>

In some transactions, IRS will not provide any scrutiny at all. Remarkably, IRS guidance entirely exempts "initial contracts" between a charity and a potential insider from penalties even under the intermediate sanctions regime.<sup>58</sup> Regulations expressly state that a management contract between an organization and an outside management company can fall into this exception.<sup>59</sup> Thus, a long-term contract between an educational institution and a for-profit service provider would not result in IRS enforcement, even if that contract provided for payments of essentially all the net revenues of the institution, as long as the parties were following the terms of their initial agreement.

Federal tax law also does not yet fully account for the power that an organization's creditors can exert over the institution. Practically speaking, in many cases a creditor can be as powerful as any officer of the organization, if not more so. If an organization cannot meet its debts, it is only the creditor's forbearance, on conditions negotiated between creditor and the organization, that can prevent the organization from dissolving. While charities usually cannot be forced into an involuntary bankruptcy proceeding, there are many other state-law collection mechanisms that can result in at least partial loss of control over the organization's assets.<sup>60</sup> Even if an organization avoids bankruptcy, failure to pay creditors may foreclose it from further access to affordable credit, effectively

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<sup>55</sup> I.R.C. § 4958.

<sup>56</sup> James J. Fishman et al., *Nonprofit Organizations: Cases and Materials* 417 (5<sup>th</sup> ed. 2015) ("Historically, the Service has invoked the inurement limitation only in the most egregious of insider misconduct. Since the only sanction was the ultimate death sentence...enforcement was lax.").

<sup>57</sup> Treas. Reg. 1.501(c)(3)-1(f)(2)(ii), (iv) Ex. 3.

<sup>58</sup> Treas. Reg. 53.4958-4(a)(3).

<sup>59</sup> Treas. Reg. 53.4958-4(a)(3)(vii) Ex. 7.

<sup>60</sup> American Law Institute, *Restatement of the Law of Charitable Organizations* § 3.05 (Tentative Draft 2017).

shuttering its operations. The charitable institution's managers therefore have very strong incentives to meet their debts or to accede to other concessions demanded by unpaid creditors. This is especially so, of course, in cases such as those I have already described in which the institution's hundreds of millions of dollars in debt exceed by many multiples the value of its liquid assets.

Although creditors could therefore readily qualify as insiders, IRS guidance does not expressly recognize them as such. The intermediate sanction regulations provide that any person or entity that exerts "substantial influence over the affairs of [the] organization" can be treated as an insider for legal purposes.<sup>61</sup> I have not been able to identify, however, any examples in which IRS has treated a person or entity as an insider solely on the basis of their creditor relationship to a charity.<sup>62</sup>

In sum, it is not surprising that IRS has failed to effectively police for-profit colleges in disguise. Tax law is not currently designed to make bright-line distinctions between for-profit and non-profit entities. Even the more limited rules aimed at penalizing excess benefits for insiders have important holes that conversion planners have exploited. Verifying the details of large, complex transactions, investigating the details of the parties' relationships, and ascertaining the true values of assets being transferred are all time and resource intensive tasks, and IRS is an agency in which both of those are in very short supply.

Given the importance of a school's genuine nonprofit status to students and taxpayers, however, Education cannot be content to live with the inadequate review IRS provides. Title IV gives Ed independent authority to distinguish between a "proprietary" institution and one that is a "public or other nonprofit" institution.<sup>63</sup> Nothing in the statute requires Education to accept IRS review (or lack of it) as the final word on that question. Ed has the statutory authority it needs right now, and should independently assess whether educational institutions have powerful motives to maximize revenues at the expense of the student experience.

Both Education and IRS could additionally benefit from more extensive information sharing. It does appear that Education copied IRS on its findings in the Grand Canyon University matter. Formal agreements for sharing of information, expertise, and findings would allow for better coordinated policy. Federal law is currently an obstacle to full coordination. Although tax returns filed by federally-recognized charities are public, IRS takes the position that it is prohibited from sharing other "return information," such as the outcomes or even existence of audit activity.<sup>64</sup> Amending this provision would help

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<sup>61</sup> Treas. Reg. 53.4958-3(a)(1), (e)(2).

<sup>62</sup> Even if creditors are not formally insiders, federal tax law may still prohibit excess benefits to them. A charity may not private an excess private benefit to any party, whether insider or not. [private benefit regs cite] But the law regarding prohibited benefits to parties that are not formally insiders is much less developed, leaving substantial room for creative transactional planning.

<sup>63</sup> 20 U.S.C. § 1001(a)(4), 1002(a)(1)(A).

<sup>64</sup> I.R.C. § 6103(d)(13) permits IRS to share tax-return information with Education for purposes of verifying a student's eligibility for subsidized student loans, but this authority arguably does not include sharing information about the institution the student attends.

Education to more fully understand whether IRS has undertaken enforcement with respect to a conversion transaction, and if not why not.

### **Disclosure is Likely Inadequate to Protect Student and Taxpayer Interests**

It might be argued that Education review is unnecessary because students can rely on public information about school costs and outcomes, and can make their own decisions about whether to attend a converted for-profit school or not. In addition to their substantive requirements, the Gainful Employment regulations may include provisions requiring institutions to report on key cost and outcome measures.<sup>65</sup> Although these disclosure obligations could be useful to some students, they cannot substitute for the 90/10 rule or other components of the Gainful Employment regulations. Education therefore must continue to distinguish carefully between genuine nonprofits and others.

Data disclosures are useful primarily for families with the experience and savvy to find them, interpret them, and use them to compare institutions to each other. Many students in the community that historically have been disproportionately represented at for-profit colleges will struggle with some or all of these tasks. Researchers find, for example, that low-income households, and especially students who are the first in their families to attend college, are rarely able to comparison shop between schools to understand competing financial aid offers.<sup>66</sup> It is likely that many mistake the “sticker” price of tuition for the real price of attending school, not understanding that most schools provide financial aid or access to government-subsidized borrowing.<sup>67</sup>

It is also uncertain whether disclosure requirements are meaningful in an environment with pervasive advertising. Many proprietary schools spend millions of dollars annually on advertising and recruitment.<sup>68</sup> Studies suggest that for-profit recruiters apply a variety of high-pressure sales techniques to enroll students.<sup>69</sup> It is unlikely that students will be attentive to numbers hidden deep in the school’s web site when they are continually exposed to these competing information sources.

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<sup>65</sup> The legal status of the disclosure rules is presently uncertain, with Devos-era changes still potentially subject to challenge.

<sup>66</sup> A helpful overview is Susan M. Dynarski & Judith E. Scott-Clayton, “Complexity and Targeting in Student Financial Aid: A Quantitative Analysis,” 22 *Tax Pol’y & Econ.* 109 (2008); see also Susan M. Dynarski et al., “Closing the Gap: The effect of a targeted, tuition-free promise on college choices of high-achieving, low-income students,” NBER Discussion Paper No. 25349 (2018); Caroline Hoxby & Sarah Turner, “Expanding College Opportunities for High-Achieving, Low-Income Students,” Stanford Institute for Economic Policy Research Discussion Paper 12-014 (2013).

<sup>67</sup> See Celeste K. Carruthers & Jilleah G. Welch, “Not whether, but where? Pell grants and college choice,” 172 *J. Pub. Econ.* 1, 19 (2019).

<sup>68</sup> Alejandro Vazquez-Martinez & Michael Hansen, Brookings Blog, “For-profit colleges drastically outspend competing institutions on advertising” (May 19, 2020), <https://www.brookings.edu/blog/brown-center-chalkboard/2020/05/19/for-profit-colleges-advertising/>; Stephanie Rieg-Cellini & Latika Chaudhary, “Commercials for college? Advertising in higher education,” Brookings Institution Report, <https://www.brookings.edu/research/commercials-for-college-advertising-in-higher-education/> (May 19, 2020).

<sup>69</sup> U.S. Senate, Health, Education, Labor, and Pensions Committee, *For Profit Higher Education: The Failure to Safeguard the Federal Investment and Ensure Student Success* 49–71 (July 30, 2012).

In any event, even if disclosures were effective at informing many students of the poor outcomes at many for-profit institutions, they would still not protect the general interest of taxpayers. Again, proprietary institutions often maximize their government-subsidized revenues, increasing tuition when government subsidies are higher or more widely available. In effect, government is made to pay more for the same education. Subsidized students are relatively insensitive to these changes in price, and so disclosures about cost burdens would not likely affect enrollment decisions. In contrast, the 90/10 rule obliges schools to attract students who indeed are cost sensitive, limiting the schools' ability to hike tuition across the board.

Given these well-documented problems with existing disclosures, it is unrealistic to expect that adding yet more information for aspiring students to comprehend will improve their choices. Ed can and should require simple and uniform information reporting, so that families' task is easier. But that is not enough.

### **Conclusion**

Thank you again for inviting me to testify today. I hope that my perspective on these issues helps the Committee as it thinks about the difficult problem of for-profit colleges.