

Cato Institute Shares, Tax-Exempt Status Called Into Question

Catherine Dunn March 14, 2012

Is libertarian think tank the Cato Institute entitled to its current tax-exempt status? An unspooling web of legal theories and Cato documents seem likely to draw the Internal Revenue Service into an ongoing dispute about Cato's governance structure and shareholders.

Before it was called the Cato Institute, it was The Charles Koch Foundation, Inc., a nonprofit organized under Kansas law in 1974. According to the foundation's [articles of incorporation \[PDF\]](#), on file with the Kansas Secretary of State, it was "not authorized to issue capital stock." And in 1975, the IRS recognized the nonprofit's federal tax-exempt status, according to two letters from the agency—dated [1982 \[PDF\]](#) and [1994 \[PDF\]](#)—which were obtained by CorpCounsel.com from the Cato Institute.

In 1976, the Charles Koch Foundation was renamed the Cato Institute. In 1977, Cato's [articles of incorporation were amended \[PDF\]](#), such that the organization "shall have authority to issue capital stock." Eventually, the shares of stock came to be held equally by Charles Koch, his brother David Koch, Edward Crane, and William Niskanen, who died in October 2011.

Now, the pivotal portion of shares belonging to the late Niskanen are at the heart of [a lawsuit](#), filed in late February by the [industrialist Charles Koch](#), a Cato co-founder. And as a [very public dispute](#) for control of the institute unfurls between Charles Koch and Crane, Cato's current president, Cato's governance structure and tax-exempt status are also being called into question.

On Friday, the advocacy organization [Common Cause addressed a letter to the IRS \[PDF\]](#), requesting an examination of Cato's 501(c)(3) tax-exempt status. The letter cites what Common Cause believes to be the political motivations of Charles and David Koch, and the potential for the Koch brothers to control the institute (Charles Koch has maintained that his aim is to preserve Cato's original intent, not turn it into a "partisan Republican organization," according to [a statement he released last week](#)). The letter also cites interviews given to [The Washington Post](#) and [Chronicle of Philanthropy](#) by the former director of the IRS's exempt organizations division, Marcus Owens, who describes Cato's governance structure as having a "fatal flaw" that could trigger revocation of its tax-exempt status.

The IRS recognizes shareholders for nonprofit entities can have shareholders when the shareholders are themselves charities, Owens tells CorpCounsel. But if the

shareholders of a nonprofit are individuals, he says, they could potentially sell their shares or take other steps to “maximize their return.”

“That’s the fundamental problem they have,” says Owens, now in private practice with Caplin & Drysdale in Washington, D.C. “It’s inconsistent with the requirement that charities be organized exclusively for charitable purposes.”

The Cato Institute met those requirements when it was originally created in 1974 as The Charles Koch Foundation, says Owens. “Its organizing documents provided all the bells and whistles it needed to meet the organizational test for exemption—as a non-stock, nonprofit corporation,” he says.

Were the IRS to examine and then revoke Cato’s 501(c)(3) status, Cato could be taxed on its income retroactively, and employee retirement accounts could potentially be taxed, as well, according to attorneys interviewed for this story.

As of Tuesday afternoon, it was unclear whether Cato had ever explicitly notified the IRS in writing of the 1977 governance change, which created the capital stock that was issued to Cato’s four shareholders.

Tax-exempt organizations are required to notify the IRS of “changes in organization or operation,” Owens tell CorpCounsel.

A spokesperson for the Cato Institute directed CorpCounsel to [Cato’s 2010 Form 990 filing \[PDF\]](#), which is also available on the institute’s website. That filing does state that Cato “has four shareholders. Each shareholder holds 16 shares, which total 64 shares of the 1,000 shares authorized.”

“The IRS is well aware that Cato has been controlled by four shareholders, each of whom have 25 percent of the shares,” says Khristine Brookes, vice president for communications at Cato. “We are not concerned about losing our tax status based on our current structure.”

But, as of Tuesday evening, Brookes could not say whether or not Cato ever notified the IRS of that change.

CorpCounsel asked Cato Institute if the organization had ever notified the IRS of the 1977 change in the governance structure. In response, Cato Institute provided CorpCounsel with copies of the two letters from the IRS. As of Tuesday evening, Brookes said, “other than our publicly available 990 forms, which also identify our structure as a nonprofit with capital stock, I can provide no further documentation at this time.”

If Cato never notified the IRS explicitly of the change, says Jeffrey Tenenbaum, chair of the nonprofit organization practice at Venable in Washington, D.C., “my presumption is that the IRS has never had or taken the opportunity to scrutinize and evaluate the capital stock structure from an exemption perspective.”

As both Brookes and Wes Edwards, deputy general counsel for Koch Companies Public Sector, have told CorpCounsel, nonprofits organized under Kansas state law can issue

capital stock.

Brookes says: “A shareholder structure for nonprofits is unusual, but not impermissible. No Kansas or federal law precludes a shareholder structure. Nonprofit shareholders elect the board of directors, but shareholders do not have a property right in corporate assets or a financial interest in donations.”

Edwards adds: “Kansas—the state of incorporation of Cato—expressly authorizes nonprofit corporations to have shareholders. The primary reason for providing stock interests to founders of nonprofit entities is quite simple: to help preserve the original intent of the founders of the organization. Many stock-based nonprofit corporations have been created in Kansas over the years. These structures are legally permissible and help safeguard donor intent.”

Cato legal counsel Bruce Hopkins acknowledged in an interview with *The Washington Post* that the structure is “very unusual” and not one that the IRS favors. But he also said the shares are a “strange breed of stock that doesn’t have any economic advantage to it.”

When Cato became a stock corporation in 1977, it created an ownership interest in something other than itself, says Owens. Even though the organization’s articles of incorporation said it would be operated for educational purposes, the assets upon dissolution would go to another charity and there would be no dividends. “The enterprise still had owners, just the way General Motors has owners, and those individuals could sell their ownership interest,” Owens says.

There is a strong likelihood an examination by the IRS could occur, says Tenenbaum. The agency’s enforcement priorities can change, and its interpretation of tax law can evolve. “Public pressure” can also prompt scrutiny by the IRS, says Tenenbaum. Given both the “unusual structure” of Cato and the “high-profile” nature of the lawsuit, “further scrutiny seems almost certain,” he says.