NONPROFIT QUARTERLY

Koch Challenge to Cato Raises Questions about Tax-exempt Status

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THURSDAY, 15 MARCH 2012 12:36

Cato the Younger, the namesake of the Cato Institute, was a politician and statesman from the late Roman republic known for his stoicism, his moral integrity, and his stubbornness. The Cato Institute may need to draw on similar qualities, *Corporate Counsel*'s Catherine Dunn writes, to deal with the litigation it faces from the Koch brothers (who own the libertarian think tank), as well as the possible vulnerability it might face with the IRS concerning its tax-exempt status.

The Cato Institute was originally incorporated in Kansas in 1974 as the Charles Koch Foundation. In its original articles of incorporation, it wasn't authorized to issue capital stock. When it was renamed the Cato Institute in 1976, the articles of incorporation were amended to allow for capital stock. As we have pointed out in earlier coverage, the shares were divided equally among one of the Koch brothers, Cato founder Edward Crane, William Niskanen, and a fourth person. Now there are four shareholders, each with 16 shares—the two Koch brothers, Crane, and Niskanen's wife, who inherited her husband's shares at his death last October.

The Koch brothers are challenging the legality of that inheritance, arguing that the shares in Cato aren't really like shares of ownership in a private corporation and cannot be inherited or awarded, but must be returned to the corporation (Cato) or sold to the remaining shareholders (at $1 per share). If that happens, it would give the two Koch brothers a controlling interest in Cato, which they believe has not been particularly effective under Crane's leadership.

Can a nonprofit issue stock? And is nonprofit stock different than for-profit stock? Suggesting that the Koch brothers' argument is simply politically motivated, Common Cause has just requested an IRS review of Cato's 501(c)(3) status. Common Cause cites a comment by former IRS official Marcus Owens, who used to run the tax exemption division of the Service; Owens said that Cato's stock-based governing structure might be a "fatal flaw" jeopardizing the think tank's 501(c)(3) status retroactively.

According to Dunn, Owens says that the IRS allows for shareholders when the shareholders are nonprofit entities themselves. If the shareholders are individuals, they could somehow sell or use their shares to "maximize their return," which is inconsistent with public charity status. It is possible that Cato never officially informed the IRS of its shift to a shareholder form of governance, which also could jeopardize the Institute's tax status. Koch lawyers say that the capital stock structure was devised "to help preserve the original intent of the founders of the organization" and is not uncommon among Kansas nonprofits. Countering Owens, Cato's legal counsel, Bruce Hopkins, argues that, while unusual, the Cato stock, which is restricted to $1 per share, "doesn't have any economic advantage to it."

It's hard to imagine that the IRS will be able to sidestep this controversy. Even though Kansas apparently allows for individual ownership of nonprofit stock, does the IRS feel the same? Was the IRS ever officially notified of the shift to a capital stock structure? Are the actions of the Koch brothers—trying to exercise stock control in order to wrest influence from Crane—comparable to the use of nonprofit stock for individual benefit? Will the somnolent IRS, understaffed and stressing about its impending role in health insurance reform, be able to take on an investigation of the nation's foremost libertarian think tank?

It could be that Crane may have to adopt some of Cato the Younger's philosophy and, unlike an anti-government libertarian, let the IRS do its job. He might be well served by Cato's words: "The first virtue is to restrain the tongue; he approaches nearest to the gods who knows how to be silent, even though he is in the right."—Rick Cohen