Author: William T. Hutton
Source: University of San Francisco Law Review
Citation: 18 U.S.F.L. Rev. 649 (1984).
Title: Recent Developments in Tax-Exempt Organizations

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ARTICLES

Recent Developments in Tax-Exempt Organizations

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Introduction

Not since 1969, when Congress loosed a kennel of statutory watchdogs to harry the private foundation, has there been a year of such turmoil. Long-simmering issues in bizarre factual trappings forced themselves upon the appellate courts. Foundation managers who once eschewed the risk of investing in common stocks attended seminars on syndication and peddled their buildings and equipment to shelter-hungry investors—a process which raised the “Doing Better By Doing Good” banner over all manner of previously tax-inert properties. And the framers of the Tax Reform Act of 1984 played a prominent, if not entirely predictable part, curbing the traffic in exempt-function properties, and measurably improving the quality of life for the private foundation. From our academic reviewers’ stand we have thus observed an exempt organizations parade of extraordinary vitality. Rare performers have competed for our attention, and we have little confi-
dence that, in rationing discussion of issues presented here, we have not been unduly influenced by the tabloid appeal of certain of this season's featured players: Big Mama Rag and Mother Jones, the National Alliance, and the unforgettable Ecclesiastical Order of the Ism of Am. (One can hardly expect, in any year soon to come, a duplication of this lineup of immortals; still it will be difficult to make do with no more than an errant Scientologist or two and the predictable chorus of Universal Lifers.)

One further caution before we get on with the show. Any "review" of legal developments is a perishable commodity, and even if rushed to market is apt to appear a bit wilted around the edges. Nothing stems the flow of advance sheets, and today's analysis (without pocket parts or quarterly supplements) is tomorrow's historical curiosity, reduced to microfiche. And thus, for current consumption, while the beat goes on . . . .*

I. QUALIFICATION FOR TAX EXEMPTION

Section 501(c) of the Internal Revenue Code confers tax-exempt status on twenty-three separate categories of nonprofit organizations, ranging from churches to black lung trusts. By far the most coveted species of exemption continues to be that granted by section 501(c)(3) to a diverse array of charitable, religious, educational and similarly operated organizations that also qualify to receive tax-deductible, charitable contributions under section 170. These tax benefits are as old as the income tax,¹ but until recently the judiciary had relatively few opportunities to interpret section 501(c)(3). Standards, such as they were, largely were shaped by the Internal Revenue Service, and administrative determinations could not be challenged without a concrete monetary controversy.² It was

* The beat went on even faster than we anticipated. After this article went into production, three of the reviewed cases were reversed, all in favor of the taxpayer. See Bethel Conservative Mennonite Church v. Comm'r, 746 F.2d 388 (7th Cir. 1984) (infra text accompanying notes 69-71); American College of Physicians v. United States, 743 F.2d 1570 (Fed. Cir. 1984); Presbyterian & Reformed Publishing Co. v. Comm'r, 743 F.2d 148 (3d Cir. 1984) (infra text accompanying notes 75-77).

¹ The charitable exemption now found in section 501(c)(3) originated in the Revenue Act of 1894, which exempted from tax "corporations, companies or associations organized and conducted solely for charitable, religious or educational purposes . . ." Revenue Act of 1894, ch. 349, § 34, 28 Stat. 509, 556. Comparable provisions were included in all subsequent revenue acts.

² See, e.g., Bob Jones Univ. v. Simon, 416 U.S. 725 (1974); Commissioner v. "Ameri-
not until the introduction in 1976 of a declaratory judgment procedure, easing the path for organizations seeking judicial review of an adverse IRS determination, that the courts began to have a significant impact on the law of exempt organizations. The number of decisions reported during the period covered by this survey is a testament to the fact that litigation arising under section 501(c)(3) has become a growth industry. Even the Supreme Court entered the fray during its 1982 and 1983 terms. But in keeping with tradition, in the murky world of qualification, these recent decisions raise as many questions as they resolve.

A. Discriminatory Private Schools

Of all the current developments, the Supreme Court’s resolution of the long-simmering controversy over the tax-exempt status of racially discriminatory private schools was the main event. In the companion cases of *Bob Jones University v. United States*4 and *Goldsboro Christian Schools v. United States*,5 the Court held that the Internal Revenue Service properly denied tax-exempt status to two private religious schools with discriminatory policies. The 8-1 decision was a denunciation of the Reagan Administration, which had forced the IRS to shift its position on this sensitive issue.6 But it is hardly the final chapter in a continuing saga.

1. Background

The *Bob Jones/Goldsboro* litigation is a classic study in the legal process which has been chronicled amply elsewhere.7 It will suffice here to briefly review the background of the cases in order to put the Court’s broad and possibly troublesome holding in perspective and move on to the questions that linger.

The modern saga began in 1967, when the IRS announced that

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5. Id.
6. See infra text accompanying notes 24-29.

it would deny tax exemptions to discriminatory private schools that received state aid.\textsuperscript{8} Two years later, parents of black public school children in Mississippi sued to enjoin the IRS from granting exemptions or allowing charitable contributions to any discriminatory school in the state. In the midst of the litigation, the IRS announced that it could no longer justify granting tax-exempt status to discriminatory schools, whether or not they received state aid or were church-related.\textsuperscript{9} The case nonetheless proceeded,\textsuperscript{10} and a three-judge court held in \textit{Green v. Connally}\textsuperscript{11} that racially discriminatory schools did not qualify for tax-exempt status because they violated a sharply defined federal policy against discrimination in education and thus were not common law "charities." To construe the statute otherwise, the court reasoned, would raise serious constitutional problems.\textsuperscript{12}

Following the mandate in \textit{Green}, the IRS issued guidelines aimed at enforcing the policy nationwide, including church-related schools that claimed their discriminatory practices were motivated by sincere religious beliefs.\textsuperscript{13} By 1975, the Service had revoked the exemptions of Bob Jones University, a fundamentalist Christian institution which had a small black enrollment but prohibited interracial dating and marriage, and Goldsboro Christian Schools, which excluded blacks on religious grounds.\textsuperscript{14} As a condition to

\begin{thebibliography}{9}
\bibitem{10} The case had become complicated by the intervention of parents and children who supported or attended private, segregated schools in Mississippi.
\bibitem{14} Bob Jones had 5,000 students, from kindergarten through graduate school. In keeping with its religious belief that the Bible forbids interracial dating and marriage, blacks were completely excluded from the University until 1971. It later relaxed its admissions policies, first accepting applications from blacks married within their race and then unmarried blacks, but the University adhered to a disciplinary rule prohibiting interracial dating.
\end{thebibliography}
achieving exempt status, the IRS required private schools to ade-
quately publicize their nondiscriminatory policies and keep de-
tailed records evidencing compliance with a laundry list of formal-
istic guidelines.¹⁶ No actual minority quotas were imposed, how-
ever, and a school practicing de facto discrimination normally
was able to qualify as long as it met the publicity and paperwork
requirements.¹⁶

By the mid-1970's, it became apparent that the IRS guidelines
were not effectively identifying schools that engaged in de facto
discrimination. Civil rights groups reopened the Green case, which
applied only to Mississippi, and filed a companion suit seeking to
enjoin the IRS from granting exemptions to discriminatory schools
and to force the adoption of stiffer standards on a nationwide ba-
sis.¹⁷ The IRS resisted these actions with the usual procedural de-
fenses, but a sympathetic Carter Administration responded with
stricter new standards, including numerical quotas, to be applied
principally to schools adjudged by a court or agency to be racially
discriminatory as well as to those created or substantially ex-
panded during a time of public school desegregation in the com-
community and having little or no minority enrollment.¹⁸

The standards proposed by the Carter Administration were
greeted by a public outcry,¹⁹ prompting the IRS to retreat to more
flexible guidelines²⁰ and Congress to freeze the appropriations
needed to implement any new enforcement policy.²¹ In the
meantime, the pending injunction suits lurched onward along with
the closely-watched litigation in Bob Jones University and Golds-

and marriage. 103 S. Ct. at 2022-23. Goldsboro Christian Schools completely excluded
blacks until after the Supreme Court's decision. 103 S. Ct. at 2024. See The Supreme Court,


16. Id.

17. See Wright v. Regan, 656 F.2d 820 (D.C. Cir. 1982), aff'd sub. nom. Allen v. Wright,

1978).

on Oversight of the House Comm. on Ways and Means, 96th Cong., 1st Sess., 125 Cong.
Rec. 18808-16 (1979); Private Schools Pounce on IRS Proposal to Deny Exemption Where
Bias is Found, Wall St. J., Nov. 6, 1978, at 13, cols. 1-5.

1979).

"Dornan" and "Ashbrook" amendments).
boro Christian Schools. In 1980, the Fourth Circuit, reversing the district court, held that the IRS had properly revoked the exemption of Bob Jones University. Closely adhering to the rationale of Green, the court interpreted section 501(c)(3) against the background of the law of charitable trusts and held that discriminatory schools were not "charitable" in the common law sense because they violated a sharply defined federal policy.

By early 1982, the stage was set for a dramatic resolution of the issues which had been brewing for over fifteen years. The IRS was buffeted between a hostile public, a mercurial Congress which professed to agree with IRS policy but froze the appropriations needed to enforce it, and a judiciary determined to adhere to the principles forged in Green. But on the eve of the filing date for the Government's brief in Bob Jones, the Treasury announced that it no longer would revoke or deny tax-exempt status to otherwise qualifying organizations on the ground that they did not conform with certain fundamental public policies and that, accordingly, exemptions would be restored to Bob Jones and Goldsboro.

The firestorm of protest which followed is history. The Reagan Administration quickly unveiled proposed legislation to deny tax-exempt status to discriminatory schools, but Congress was uninterested. When the Court of Appeals for the District of Columbia Circuit once again enjoined the Service from restoring exempt status to any racially discriminatory school, the Government withdrew its request to dismiss the pending cases as moot and suggested that the court appoint counsel to support the judg-


23. Id. The same result was reached by the district court in Goldsboro Christian Schools v. United States, 436 F. Supp. 1314 (E.D.N.C. 1977), aff'd per curiam, 644 F.2d 879 (4th Cir. 1981).

24. See Treasury Dept. News Release, [1982] 10 STAND. FED. TAX REP. (CCH) ¶ 6301 (Jan. 8, 1982). The Justice Department thus repudiated the position that it had successfully advanced in several courts, and the Solicitor General requested the Supreme Court to vacate the pending litigation as moot. See 103 S. Ct. at 2025 n.9.


27. Some members of Congress believed the legislation was unnecessary and others complained that the Administration's bill was overly broad, especially as applied to church schools. See Administration's Change in Federal Policy Regarding the Tax Status of Racially Discriminatory Private Schools: Hearing Before the House Comm. on Ways and Means, 97th Cong., 2d Sess. 17-29 (1982).

ments of the Fourth Circuit. The Court invited William T. Coleman, Jr. to brief and argue the case as amicus curiae in support of the judgments below.

2. The Supreme Court’s Opinion

The majority opinion of the Court closely tracked the strong amicus curiae brief filed by Mr. Coleman. The Court went beyond the literal language of section 501(c)(3) and held that it was not enough to be charitable, educational or religious in the narrow sense of those terms in order to qualify for exemption; an organization also must be a common law charity—i.e., it must “serve a public purpose and not be contrary to established public policy.” Recognizing that this standard might be construed too broadly, the Court then sounded a cautionary note: exemption may be denied on public policy grounds only when there is “no doubt” that an organization’s activities are contrary to a “fundamental” public policy. In view of the strong federal policy against racial discrimination in education, the Court had “no doubt” that discriminatory schools were not “charitable.” In a casual rebuff to the constitutional arguments raised by the religious community, the Court went on to hold that denial of exemption did not violate the schools’ right to free exercise of religion under the first amendment because the case involved conduct as well as beliefs, and the governmental interest in eradicating racial discrimination “substantially outweighs” any burden on first amendment rights that might be imposed by denial of tax-exempt status.

By its frequent references to “public policy” and “public benefit” the Court suggested that all section 501(c)(3) organizations must make a positive contribution to the community and not act in a manner “affirmatively at odds with [the] declared position of the whole government . . .” This approach troubled Justice Pow-

29. See 103 S. Ct. at 2025 n.9.
30. 50 U.S.L.W. 3837 (U.S. Apr. 20, 1982).
31. 103 S. Ct. at 2026.
32. Id. at 2029.
33. As evidence of this policy, the Court cited “[a]n unbroken line of cases following Brown v. Board of Education,” congressional civil rights legislation and executive orders over three decades. Id.
34. Id. at 2035.
35. Id. at 2032.
ell, who observed in a concurring opinion that it was unlikely that the widely disparate organizations enjoying tax-exempt status under section 501(c)(3) could conform to a national "public interest" standard.\textsuperscript{38} In emphasizing the role long played by section 501(c)(3) in encouraging diverse viewpoints, Justice Powell commended the Government for its tolerant attitude but rejected the notion that the IRS was capable of deciding which public policies are sufficiently "fundamental" to require denial of tax exemptions.\textsuperscript{37}

3. \textit{The Aftermath of Bob Jones}

The action now shifts back to the enforcement arena, and the IRS once again is forced to grapple with the appropriate standards by which to identify schools that discriminate on the basis of race. This will be no small chore. At this writing, the IRS continues to apply the guidelines adopted in the mid-1970's, which place a premium on publicizing an open admissions policy and keeping careful records.\textsuperscript{38} Consideration of more stringent rules was deferred while the Supreme Court pondered the issues in \textit{Allen v. Wright} and \textit{Wright v. Regan},\textsuperscript{39} the long-pending class actions in which parents of black public school children sought to replace the 1975 guidelines with more stringent standards—primarily numerical quotas—for private schools formed to facilitate "white flight" following a desegregation order.\textsuperscript{40}

The gist of the plaintiffs' complaint in \textit{Wright} was that the IRS has been overly lenient in granting exemptions to schools that

\begin{footnotesize}
36. \textit{Id.} at 2038-2039.

37. \textit{Id.} at 2039 (Powell, J., concurring). Justice Powell nonetheless concurred in the judgment, apparently because he believed Congress had acquiesced in the policy of denying exemptions to discriminatory schools. But he emphasized that it was Congress, not the IRS, which should make determinations of "[t]he contours of public policy." \textit{Id.} In a lengthy dissent, Justice Rehnquist rejected the majority's elevation of "charitable" to the status as a super-factor in section 501(c)(3) and disagreed that Congress had impliedly approved the IRS's policy. \textit{Id.} at 2039-45 (Rehnquist, J., dissenting).

38. \textit{See supra} text accompanying note 16.


40. The D.C. Circuit had held that the plaintiffs, as members of a group subjected to racial discrimination, had standing. \textit{Wright v. Regan}, 656 F.2d 820 (D.C. Cir. 1981). The standards sought by the plaintiffs were virtually identical to those that the IRS attempted to adopt in 1978, but whose implementation Congress blocked with appropriations riders. \textit{See supra} notes 18-21.
\end{footnotesize}
adopted and certified, but failed to implement, a nondiscriminatory policy. In effect, they were seeking to shift the critical question of enforcement from Congress and the IRS to the courts in order to ensure that Bob Jones University was not a hollow victory. Although the plaintiffs did not claim any direct harm from the practices of these discriminatory schools, they alleged injuries as a result of the government subsidy flowing from the tax exemption and the impairment of the ability of their children to attend desegregated public schools.\textsuperscript{41}

In a 5-3 decision, the Supreme Court held that the plaintiffs lacked standing.\textsuperscript{42} It was not enough, in the majority's view, merely to claim unlawful Government conduct; the claim must also be accompanied by a showing of direct personal injury. Although the Court conceded that the claim of impairment to a desegregated education was a concrete and serious injury, it concluded that it was not fairly traceable to the IRS's assertedly illegal administration of section 501(c)(3).\textsuperscript{43} Three Justices dissented, with Justice Brennan bitterly denouncing the Court's use of standing to "slam the courthouse door" against the plaintiff.\textsuperscript{44}

The ramifications of Wright are profound, both as to the constitutional issue of standing (an aspect of the case which is beyond the scope of this article) and as to the ability of aggrieved private citizens to challenge the IRS's administration of section 501(c)(3). The Court once again rebuffed an attempt by interested third parties seeking to influence the IRS's interpretation of the charitable tax exemption and deduction provisions. After Bob Jones University, there is no doubt of the Government's obligation to deny exemptions to discriminatory schools. But it appears unlikely that after Wright the IRS will go beyond the existing enforcement standards which civil rights groups and the Carter Administration found wanting.

Apart from the resolution of Wright, the decision in Bob Jones leaves a number of lingering questions. For example, will a school practicing gender discrimination qualify as "charitable?"\textsuperscript{45}

\textsuperscript{41} Allen v. Wright, 104 S. Ct. 3315 (1984).
\textsuperscript{42} Id.
\textsuperscript{43} Id. at 3336.
\textsuperscript{44} Id. at 3326.
\textsuperscript{45} See, e.g., In re Estate of Wilson, 59 N.Y.2d 461, 465 N.Y.S.2d 900 (1983) (upholding administration of private charitable trust restricting scholarships to males, even though gen-
What about a church that discriminates on the basis of race or an orthodox Jewish school with no minority enrollment? Does a charitable trust that grants scholarships only to Caucasians violate the public policy standard of *Bob Jones*? What about a foundation that makes scholarship awards only to students of minority races? Does the public policy requirement apply to membership organizations which espouse unpopular views?

The answers to these questions await further articulation of the role of “public policy” in interpreting section 501(c)(3). In the short run, it is likely that the IRS will heed the warning of Justice Powell and limit the holding of *Bob Jones* to racial discrimination in education. Indeed, the IRS already has indicated as much by granting tax-exempt status to privately funded and administered scholarship trusts which restrict eligibility to Caucasians or to members of a minority race. In the first ruling, the clear federal policy against racial discrimination in education was balanced by legal principles upholding the validity of private gifts even if made to a racially restricted class of beneficiaries. In both situations, the IRS concluded that the policy of promoting private educational trusts should prevail absent a specific showing that the scholarship grants would actually foster racial discrimination in education. These pronouncements confirm the statement of a leading IRS official that “the Internal Revenue Service had no intention of running wild with the *Bob Jones* case.”

B. *Educational Organizations*

The IRS has long struggled with the standards to be applied to organizations which advocate controversial ideas and seek to qualify for exemption as “educational.” The regulations provide that the term “educational” embraces “instruction of the public on..."
subjects useful to the individual and beneficial to the community” but require an organization seeking “educational” status to present “a sufficiently full and fair exposition of the pertinent facts” as opposed to mere unsupported opinion. But how does one distinguish controversial viewpoints from “unsupported opinion?” What is “opinion” and what is “fact?” Compounding these problems is the Service’s distinction between “educational” organizations, which are subject to the full and fair exposition text, and “advocacy” organizations, which can qualify as “charitable” even if their objective is to advocate social change (fully and fairly?) and mold public opinion.

The Government’s attempt to require educational organizations to become fair-minded commentators was bound to fail. To its credit, the IRS rarely denies exemption simply because an organization is controversial. But in recent years, several organizations which espoused one-sided viewpoints have challenged the constitutionality of the “full and fair exposition” standard. In Big Mama Rag, Inc. v. United States, the District of Columbia Circuit held that the regulations were unconstitutional because: (1) the distinction between “advocacy” and “educational” organizations was unclear; and (2) the full and fair exposition test was unconstitutionally vague.

The D.C. Circuit revisited the quagmire in National Alliance v. United States. National Alliance was a white supremacist organization whose publications took the view that non-whites were inferior, brutal and dangerous, that Jews controlled the media and were harmful to the interests of whites, and that blacks were essentially savages who should be exterminated as soon as possible. The opinion includes sufficient additional illustrations to confirm National Alliance’s status as a hate organization. The district court held that the IRS’s revocation of National Alliance’s exemption was constitutionally flawed and remanded the case “for pro-

51. Id. § 1.501(c)(3)-1(d)(2).
52. 631 F.2d 1030 (D.C. Cir. 1980). Big Mama Rag was a feminist-lesbian organization which declined to publish the views of those with whom it disagreed.
53. Id. at 1039.
54. 710 F.2d 868 (D.C. Cir. 1983).
55. Id. at 871-73.
ceedings consistent with *Big Mama Rag*." On appeal, the IRS proposed a "methodology test" to cure the infirmities of the regulations. That test includes the following criteria: (1) is the presentation of unsupported views a significant portion of the organization's communications? (2) to the extent the organization's views purport to be supported by a factual basis, are they distorted? (3) does the organization make substantial use of particularly inflammatory and disparaging terms based on strong emotion? and (4) is the approach to a subject matter aimed at developing an understanding on the part of the addressees by reflecting consideration of the extent to which they have prior background and training? The D.C. Circuit held that National Alliance's exemption was properly revoked. One would have hoped that the same court which struck down the educational regulations on constitutional grounds might have evaluated the constitutionality of the methodology test. But the court chose to duck that question, recognizing the "inherently general nature of the term 'educational' and the wide range of meanings Congress may have intended to convey." The court simply held that National Alliance was "far outside the range Congress could have intended to subsidize in the public interest by granting tax exemption." In other words, *National Alliance*, like hard core pornography and original sin, was beyond the pale and no more need be said. The court did say more, however, by distinguishing *Big Mama Rag* on the ground that its activities fell "within the range of reasonable interpretation of 'educational' as used in the statute," thus posing a "real risk" that the organization may have been denied exempt status under a constitutionally defective standard.

Perhaps it was too much to expect clarification in this difficult area in a case involving a Nazi hate group. Indeed, quite apart from the proper definition of "educational," it is difficult to imagine how National Alliance could qualify as "charitable" under the public policy standard adopted by the Supreme Court in *Bob Jones*. We thus await a new definition of "educational." The "full and fair exposition" requirement appears to be dead, and it is

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57. 710 F.2d at 874.
58. Id. at 873.
59. Id.
60. Id. at 875.
likely that the IRS will continue to apply the methodology test, liberally granting exemptions to organizations which may express controversial views in a responsible manner even if they do not publish an “op-ed” page. Any less tolerant approach would continue to raise first amendment concerns. But organizations which shock the judicial conscience or engage in illegal acts risk losing their exemption, whether or not the IRS comes up with a constitutional definition of “educational.”

C. Personal Churches

The continuing flurry of cases involving religious tax exemptions confirms that God is not dead, at least insofar as he or she may facilitate tax avoidance. The personal church has become one of the more lamentable vehicles of tax protest. Taxpayers ranging from airline pilots and chiropractors to welders and electricians have piously attempted to shelter normally taxable income by assigning their wages and property to a newly-chartered church which in turn provides lodging and a living allowance to the freshly ordained ministers. The charter is usually obtained from a mail-order ministry which may or may not have obtained tax-exempt status.

The mail-order ministry received a notable blessing in 1974 when a federal district judge upheld the tax-exempt status of the Universal Life Church of Modesto, California. The Church had no dogma other than “to do whatever’s right, to stay within the confines of the law.” But mail-order ministries have been faring quite poorly of late, even if they claim to be affiliates of an exempt parent. Rather than attempting to define religion or questioning religious beliefs, the current approach of the courts is to deny exempt status on the ground that a church is either operated for a


62. See, e.g., Rev. Rul. 75-384, 1975-2 C.B. 204, denying exemption to an organization prompting world peace by blocking traffic and other acts of civil disobedience.

63. For developments involving the tax-exempt status of magazines seeking “educational” status, see infra text accompanying notes 78-82.

64. See generally R. Westin, MIDDLE INCOME TAX PLANNING AND SHELTERS (1982); Note, Mail Order Ministries, the Religious Purpose Exemption and the Constitution, 33 TAX L. REV. 989 (1980).


66. Id. at 772-73.
substantial non-exempt purpose (e.g., to run a business) or is violating the limitation in section 501(c)(3) against inurement of gain to private individuals or shareholders. Particularly instructive is the recent case of The Ecclesiastical Order of the ISM of AM v. Commissioner,67 where the Tax Court denied an exemption to a promoter of religious tax benefits on the ground that it served a substantial non-exempt purpose. The Church had no worship services; rather, its theology was devoted to counseling its local chapters on the tax benefits of religious tax exemptions. The court avoided challenging the sincerity of the Church but nonetheless denied exempt status on the ground that it was “nothing more than a commercial tax service . . . operating under the cover of a professed religious purpose.”68 In so doing, it avoided a confrontation with the first amendment.

Even a church with sincere religious beliefs and regular worship services risks loss of exemption if it engages in substantial nonreligious activities. Thus, the Tax Court upheld the revocation of tax-exempt status for a Mennonite Church because it adopted a medical aid plan for its members.69 Rejecting the Church’s contention that the plan served a religious tenet (coming to the assistance of the needy), the court pointed to the fact that the plan furthered the private interests of the Church’s members.70 It is significant to note that medical insurance was not the primary activity of the organization. But approximately twenty-two percent of all its disbursements were for medical aid, and benefits were not limited to the needy of its members.71

On rare occasions, religious exemptions are denied on the ground that a claimed church is “secular” rather than “religious.” In Church of the Chosen People (Demigod Socko Pantheon) v. United States,72 a federal district court rejected the religious claims of an organization which preached the “gay imperative” as a means of controlling overpopulation. The court held that the Church’s program was “secular” because it did not address fundamental questions regarding the human condition, its beliefs were

68. Id. at 843.
70. Id. at 361.
71. Id. at 361-62.
not comprehensive in nature and were not manifested in "external forms."\textsuperscript{73}

D. Commercial Activities

A recurring qualification issue involves the question whether an organization is engaged in excessive commercial activities which are inconsistent with its exempt purposes. Insubstantial business activities will not be fatal, but an organization risks loss of exemption when it is operated primarily as a commercial enterprise. The regulations provide that an organization's "primary purpose" is to be evaluated on the basis of all the facts and circumstances "including the size and extent of the trade or business and the size or extent of the activities which are in furtherance of one or more exempt purposes."\textsuperscript{74}

Specific cases in this area have always been more illuminating than abstract legal standards, and the recent decision in \textit{Presbyterian & Reformed Publishing Co. v. Commissioner}\textsuperscript{75} is a good illustration. At issue was the tax exemption of the publisher of a religious newspaper known as \textit{Christianity Today}, a Presbyterian journal of unquestioned sincerity operated by a family-run concern which had enjoyed tax-exempt status since 1939. Loss of its tax exemption was the price of the publisher's success. The Tax Court upheld the revocation, pointing to "soaring profits" from book sales, above-cost pricing methods, competition with commercial publishers, payment of substantial royalties to authors, an unwillingness to publish works not expected to recover costs and accumulations of cash to construct a new physical plant.\textsuperscript{76} Although any publisher is bound to have a commercial hue, the court concluded that the tint here was too deep, swallowing up the organization's exempt purposes.\textsuperscript{77} So much for efficiency in the nonprofit

\textsuperscript{73} \textit{Id. But cf.} Holy Spirit Ass'n v. Tax Comm'n, 55 N.Y.2d 512, 435 N.E.2d 662, 450 N.Y.S.2d 292 (1983), upholding the New York property tax exemption of the Unification Church and rejecting any attempt to deny exemption to a church on the ground that it is "political" rather than "religious."

\textsuperscript{74} Treas. Reg. § 1.561(c)(3)-1(e)(1) (1984).

\textsuperscript{75} 79 T.C. 1070 (1982).

\textsuperscript{76} Id. at 1084-87.

\textsuperscript{77} \textit{Id.} For cases upholding the exemption of religious publishers, see Elision Guild, Inc. v. United States, 412 F.2d 121 (1st Cir. 1969) (recurring deficit indicated that religion, not business, was the principal purpose); Pulpit Resource v. Comm'r, 70 T.C. 594 (1978) (organization sold and published "canned sermons" to encourage better preaching; founder re-
sector.

A more widely publicized issue involved the threatened revo-
cation of the exemption of The Foundation for National Progress, the publisher of *Mother Jones.*

*Mother Jones* is well known as an activist liberal journal, available by subscription and on the newsstands. Its typical fare includes articles on topics such as prejudice against women, the plight of American Indians, the human rights of political dissidents, and the evils of the cigarette and automobile industries. Many similar publications, including *Harpers,* *National Geographic* and *Ms.,* enjoy exempt status under section 501(c)(3) even though they are displayed on newsstands along with comparable for-profit magazines.

A recent technical advice memorandum, although not identifying the affected organization, is clearly the Service's capitulation in the *Mother Jones* controversy. According to the ruling, the qualification of a tax-exempt publisher normally turns on whether the distribution of the publication is distinguishable from "ordinary commercial publishing practices." Favorable indicia cited in the ruling were the failure to make a profit, the rejection of advertising from major industries and the distribution of free or reduced rate copies to the poor and elderly. It was assumed that the content and presentation of *Mother Jones* was "educational."

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78. See *Feisty S.F. Magazine Accuses IRS,* San Francisco Chron., Nov. 11, 1982, at 3, cols. 1-5.

79. *See, e.g.,* Rev. Rul. 67-4, 1967-1 C.B. 121, 122, which provides that the publication of printed material is educational "if (1) the content of the publication is educational, (2) the preparation of material follows methods generally accepted as 'educational' in character, (3) the distribution of the materials is necessary or valuable in achieving the organization's educational . . . purposes and (4) the manner . . . of distribution is distinguishable from ordinary commercial practices." Applying these criteria, the IRS granted exempt status in 1982 to *Harper's,* which had been operated as a commercial enterprise for 132 years before this reclassification. See G.C.M. 38845 (May 4, 1982), *reprinted in* 15 *Tax Notes* 651 (1982).


81. *Id.*

82. *Id.*
E. Political Activities

1. Lobbying

An organization does not qualify for exemption under section 501(c)(3) unless “no substantial part” of its activities consists of carrying on propaganda or otherwise attempting to influence legislation.\(^83\) The lobbying limitations have long been attacked on a variety of constitutional grounds, including violation of first amendment speech and associational rights, vagueness and overbreadth, and violation of the equal protection component of the due process clause.\(^84\) Churches have attacked the lobbying limitation as a violation of the religion clauses of the first amendment.\(^85\)

All these arguments were consistently rejected by the courts until the District of Columbia Circuit’s en banc decision in Taxation With Representation v. Regan.\(^86\) Stripped of detail, the essentials of the D.C. Circuit’s long opinion were as follows: (1) although lobbying is protected speech, the limitations in section 501(c)(3) do not abridge the first amendment rights of charitable organizations because the government is never obligated to subsidize first amendment rights; (2) in any event, charities are free to establish separate lobbying affiliates under section 501(c)(4); (3) the alleged discrimination between charities and section 501(c)(19) veterans organizations, which are not subject to any lobbying restrictions (yet remain eligible to receive tax-deductible contributions), must be evaluated under a strict standard of review; (4) there is no governmental interest in giving veterans organizations more freedom to lobby than that given charities; (5) although the appropriate remedy is unclear, it may be preferable to apply the limitations to veterans rather than extend unbridled lobbying privileges to charities.\(^87\) In a remarkable maneuver, the court remanded the case, instructing the district court to convene as a legislature to “cure the


\(^84\) See, e.g., Troyer, supra note 83.

\(^85\) See Schwarz, supra note 7, at 76-80.

\(^86\) 676 F.2d 715 (D.C. Cir. 1982).

\(^87\) Id. at 726-42.
constitutionally invalid operation of section 501(c) after inviting veterans organizations to participate in framing the relief.” 88 Before the legislative session could be convened, the Government appealed and the Supreme Court noted probable jurisdiction.

The constitutional challenges to the lobbying limitations were serious, but the breadth of the District of Columbia Circuit’s opinion virtually guaranteed that it would be reversed. The reversal was nothing short of overwhelming, as the Court held 9-0 that the lobbying limitations violated neither the first nor fifth amendments. 89 Justice Rehnquist’s opinion for the Court emphasized the broad latitude granted to the legislature in the tax area and concluded that there was no violation of first amendment rights because Congress has no obligation to subsidize the lobbying activities of charitable organizations. 90 Also rejecting Taxation With Representation’s fifth amendment challenge, the Court held that the disparate treatment of charities and veterans organizations was not a suspect classification based on the content of speech. Nor was it irrational in view of the congressional concern that tax-exempt organizations not use tax-deductible funds to promote the private political interests of their donors and the long-standing national policy of providing special benefits to veterans. 91

One of the more interesting aspects of this decision is the Court’s unequivocal statement that the tax exemption and charitable deduction are a “form of subsidy that is administered through the tax system” having “much the same effect as a cash grant to the organization of the amount of tax it would have to pay on its income.” 92 This must clearly gratify the proponents of the tax expenditure budget, but it is by no means a unanimous view in the nonprofit community. 93 And if tax exemptions are equivalent to cash grants from the Treasury, one wonders how the religious property tax exemption was able to pass constitutional muster in an earlier opinion of the Court. 94

88. Id. at 744.
90. Id. at 2001.
91. Id. at 2003-04.
92. Id. at 2000.
94. Walz v. Tax Comm’n, 397 U.S. 664 (1970). For that matter, one wonders how Jus-
Although the constitutional debate has ended with a resounding thud, it is likely that *Taxation With Representation* will not significantly affect politically active nonprofit organizations. Since 1976, most section 501(c)(3) organizations may elect to be governed by objective expenditure tests which permit specified expenditures for lobbying and impose gradual sanctions (first an excise tax, then loss of exemption) only for repeated transgressions.95 Under these rules, an organization with a $1,000,000 budget may spend up to $175,000 on overall lobbying, and $43,750 of this amount may be earmarked for grassroots lobbying.96

In addition, the Supreme Court stressed in *Taxation With Representation* that section 501(c)(3) organizations may create section 501(c)(4) affiliates to carry out their lobbying, and the two entities may co-exist and even share officers, directors, office space and common goals without loss of exemption.97 The only restriction is that tax-deductible contributions may not find their way into the lobbying affiliate's bank account. In recent years, it also has become common practice for exempt organizations to create political action committees (PACs) within their lobbying affiliates.98 PACs may solicit funds, endorse candidates and otherwise influence the political process but, of course, they are not eligible to receive tax-deductible contributions.99 The availability of these opportunities prompted Justices Blackmun, Brennan and Marshall to side with the majority in *Taxation With Representation*, but they went on to imply in a concurring opinion that the result might be different if the IRS were to attempt to limit the control exercised by section 501(c)(3) organizations over the lobbying of their section 501(c)(4) siblings.100

96. Id. § 4911(a)-(c).
98. It had once been assumed that section 501(c)(4) social welfare organizations were prohibited from political campaign activity. See, e.g., Treas. Reg. § 1.501(c)(4)-(a)(2)(ii) (1984). The IRS has ruled, however, that there is no such absolute ban as long as the organization remains primarily engaged in activities that promote social welfare. See Rev. Rul. 81-95, 1981-1 C.B. 332. But cf. I.R.C. § 527 (CCH 1984).
100. 103 S. Ct. at 2004-05. See also Troyer & Lauber, *Supreme Court's TWR Decision*
2. Political Campaigning

Section 501(c)(3) also denies exemption to organizations which participate or intervene in political campaigns on behalf of candidates for public office. The IRS has been known to wink at this absolute proscription, especially when it sees a violation by an established religious body. This tolerance has offended pro-abortion rights groups whose exemption is jeopardized by even the slightest hint of electioneering while the exempt status of a leading adversary, the Roman Catholic Church, remains secure notwithstanding the Church's reputed political activities on the abortion question.

Mounting a full-court press, a consortium of twenty-nine individuals and organizations seeking revocation of the Catholic Church's exemption brought suit against the IRS, the U.S. Catholic Conference and the National Conference of Catholic Bishops asserting a variety of constitutional violations resulting from apparent IRS dispensations.\(^{101}\) The Government responded with its typical procedural defenses, arguing principally that the plaintiffs lacked standing and that the suit was barred by the Anti-Injunction Act.\(^{102}\) In a decision with potentially far-reaching implications, the district court held that certain plaintiffs—members of the clergy and an abortion clinic—had standing to bring suit under the establishment clause, and that certain other plaintiffs had standing as voters to contest the alleged infringement of their right to participate in electoral politics, free from governmental interference and on the same terms as the Catholic Church.\(^{103}\) The complaint against the Church defendants was dismissed,\(^{104}\) however, and the remaining parties were ordered to proceed to pretrial discovery.\(^{105}\)

Alarmed by the prospect of protracted discovery and a trial on the merits, the IRS asked the district court to certify the case for

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\(^{102}\) I.R.C. § 7421(a) (CCH 1984).

\(^{103}\) 544 F. Supp. at 477-84. Curiously ignoring the trend of Supreme Court authorities in the area, the court also held that the action was not prohibited by the Anti-Injunction Act, which bars all "suit[s] for the purpose of restraining the assessment or collection of any tax." Id. at 489.

\(^{104}\) Id. at 487.

\(^{105}\) Id. at 491.
an interlocutory appeal on the standing and Anti-Injunction Act questions. The Government’s prayer was denied on the ground that the issues were not suitable for interlocutory appellate review, and the parties once again were instructed to prepare for trial.\textsuperscript{108} Predictions are precarious, but it seems doubtful that the substantive issues in this case ever will go to trial. Furthermore, in view of the Government’s success in \textit{Allen v. Wright},\textsuperscript{107} the plaintiff’s standing to sue very likely will evaporate.

\section*{II. PRIVATE FOUNDATIONS}

The 1969 Tax Reform Act, which dealt in exquisite detail with perceived abuses in the charitable sector, created an entity caste system. The “private foundation,” as first defined in that legislation,\textsuperscript{108} was fettered by operational and investment restrictions of such complexity as nearly to defy comprehension.\textsuperscript{109} Woefully unprepared for the 1969 legislative fray, the private foundation suddenly found itself intensely regulated, and, perhaps even worse, grievously disadvantaged in its quest for the charitable dollar by contribution limitations.\textsuperscript{110} The extinction of the American family foundation seemed all too probable.\textsuperscript{111}

In the years that followed, foundation advisors learned the limits of their new territory, bounded (in the instant argot of the trade) by the threat of self-dealing,\textsuperscript{112} the burden of expenditure responsibility,\textsuperscript{113} the danger of jeopardy investment,\textsuperscript{114} and a dim

\begin{enumerate}
\item 107. See infra text accompanying notes 39-44.
\item 108. I.R.C. § 509 (CCH 1984).
\item 109. I.R.C. §§4940-4948 were enacted as a response to persistent criticism that private foundations too often served private (i.e., their creators’ and managers’) purposes. See \textit{Senate Finance Comm., 89th Cong., 1st Sess., Treasury Dept. Report on Private Foundations} (Comm. Print 1965). That legislation contains absolute proscriptions against self-dealing transactions (§ 4941), maintenance of excessive interests in business enterprises (§ 4943), investments which jeopardize charitable purposes (§ 4944), and various types of expenditures (§ 4945); imposes a tax on investment income (§ 4940); and requires distributions to effectuate charitable purposes based upon the value of the foundation’s investment assets (§ 4942).
\item 110. I.R.C. § 170 was restructured to increase the relative disadvantage of the private foundation in seeking donations. See infra text accompanying notes 150-55.
\item 111. As one commentator remarked: “The bell may well have faintly tolled for the private foundation; it is now to be found only in captivity and there are strong doubts about its ability to reproduce.” Taggart, \textit{The Charitable Deduction}, 26 Tax L. Rev. 63 (1970).
\item 112. I.R.C. § 4941 (CCH 1984).
\item 113. Id. § 4945(d)(4), (h).
\end{enumerate}
awareness of the downward ratchet rule.\textsuperscript{115} Liquidations and mergers were frequently suggested as merciful escapes, but where assets were sufficient to bear the cost of compliance and principal benefactors were content to endure the stigma of "disqualified person" status (a designation tainting their progeny to eternity),\textsuperscript{116} the private foundation muddled along.

Not until 1977, when the section 4940 excise tax on investment income was reduced from 4\% to 2\%, was there any legislative hint that it might be time to reexamine some of the hasty premises upon which the private foundation rules were based. And now, with the Tax Reform Act of 1984—legislation otherwise remarkable mainly for raising revenue in infernally complicated ways—Congress has signaled a new attitude toward the private foundation. Although the developments about to be described hardly portend a return to laissez-faire philanthropy, they appear to indicate that the lawmakers are willing to entertain some healthy second thoughts about the contributions private foundations can make to the commonweal.

\textbf{A. Excise Tax on Investment Income}

Section 4940 has been ingeniously amended to provide an incentive for private foundations to increase the amount of their "qualifying distributions."\textsuperscript{117} Where such distributions equal or exceed average distributions for the five preceding years (measured as a percentage of investment assets) plus 1\% of the net investment income for the current year, the excise tax on net investment income is reduced from 2\% to 1\%.\textsuperscript{118} In effect, then, a foundation which is able to maintain its historical distribution level is given the choice of distributing as additional qualifying distributions half the amount it would otherwise pay as section 4940 tax.

A second form of relief from the excise tax on investment in-

\textsuperscript{114} Id. § 4944.
\textsuperscript{115} Id. § 4943(c)(4)(ii); Treas. Reg. § 53.4943-4(d)(4) (1977).
\textsuperscript{116} I.R.C. § 4946(a) (CCH 1984).
\textsuperscript{117} Such distributions, defined at I.R.C. § 4942(g), satisfy the foundation's minimum-distribution obligation. See infra text accompanying note 123.
\textsuperscript{118} I.R.C. § 4940(e)(1) (CCH 1984). A special rule, § 4940(e)(3)(C) prevents the reduced tax from counting as a qualifying distribution for purposes of computing the "base period" distributions in future years. Without such an adjustment the foundation seeking to make annual use of the new provision would be on a distributions escalator.
come is provided for in section 4940. According to the relevant legislative committee reports, "exempt operating foundations" are supposed to be relieved entirely of the burden of the investment income tax.\textsuperscript{119} The statute as drafted, however, fails to effectuate that intent; it requires not only the section 4942(j)(3) "private operating foundation" definition be satisfied, but also the foundation to have been "publicly supported for at least ten taxable years."\textsuperscript{120} Public support is predictably defined by reference to sections 170(b)(1)(A)(vi) and 509(a)(2), but satisfaction of either of those "public charity" standards would of course relieve the putative operating foundation from the shackles of chapter 42 entirely. Because the legislative history indicates an intent to apply these requirements disjunctively,\textsuperscript{121} thus permitting a newly-formed operating foundation without public support to qualify, a correcting technical amendment would appear to be in order.

\section*{B. Expenditure Responsibility}

Pursuant to section 4945(d)(4) and (h), a private foundation which makes a grant to an organization other than a public charity is required to exercise "expenditure responsibility," which entails pre-grant investigative duties, oversight responsibility, and potentially onerous reporting requirements.\textsuperscript{122} The practical thrust of this requirement has been severely to discourage grants to nonexempt entities and other private foundations, especially private operating foundations.

The intent of the 1984 Act amendments is to lift the expenditure responsibility burden from those making grants to "exempt operating foundations." The expanded class of preferred donees is defined, however, by reference to section 4940(d)(2), which, as discussed above, requires both operating foundation status and a ten-year public-support history. Enhancement of the newly-formed private operating foundation's standing in the grantsmanship


\textsuperscript{121} House Report, supra note 119, at 1466.

\textsuperscript{122} See Treas. Reg. § 53.4945-5(b) (1972).
game, therefore, must await the same statutory repair as will relieve it of the tax on investment income.

C. Distribution Requirements

Among the various goads and prohibitions of chapter 42, none makes a better claim to conceptual soundness than section 4942, which forces private foundations to expend, for their proper charitable purposes, an amount based upon the value of their investment assets. Since 1981 that payout, made by way of “qualifying distributions,” has been set at 5% of the aggregate net fair market value of the foundation’s investment assets, less the investment income tax imposed by section 4940. Qualifying distributions have included administrative expenses, without limitation, provided the administrative function was in pursuit of proper charitable purposes.

1. Grant Administration Expenses

For years beginning after 1984 and before 1991, the statute will limit “grant administrative expenses” to 0.65% of the net assets of the foundation for the current taxable year and the preceding two taxable years, less the aggregate amount of grant administrative expenses paid during those two preceding years and taken into account as qualifying distributions. Any administrative expenses which are allocable to the making of qualified grants, such as travel costs incurred in evaluating grant proposals, will be subject to the statutory ceiling. The new limitation will not apply to administrative expenses incurred directly in the active conduct of a foundation’s program. The House Committee Report also provides comforting assurance that this provision will affect only the calculation of grant administrative expenses as an element of qualifying distributions. Thus, the mere excess of grant administrative expenses over the statutory ceiling will not cause the excess, for example, to constitute unreasonable compensation for purposes

123. I.R.C. § 4942(d), (e) (CCH 1984).
124. I.R.C. § 4942(g)(1)(A), prior to amendment by the 1984 Act.
127. Id.
128. Id. at 1470.
of the section 4941(d) self-dealing provisions, or a taxable expenditure under section 4945(d)(5).

2. Recycling Prior Years’ Distributions

Prior to 1982, a private foundation’s minimum required distributions were based upon the higher of its “minimum investment return” or its “adjusted net income.” In order to preserve their assets, many foundations adopted investment policies favoring low-yield growth stock, so as to limit required distributions to an amount based upon minimum investment return (then, as now, established at 5% of net investment asset value). The statute in effect limited a foundation trustee’s investment alternatives. “Adjusted net income” thus was deleted as an alternative measuring rod for foundation distributions in 1981 to eliminate the trustee’s understandable temptation to make questionable investment choices.

One of the elements of “adjusted net income” was the recovery of amounts taken into account as qualifying distributions in prior years.129 Once adjusted gross income ceased to serve as an alternative measure of the distribution requirement, a foundation was able to make a programmatic loan as a qualifying distribution (for example, a scholarship loan or a low-interest loan to a community development corporation), without any corresponding obligation to increase qualifying distributions for the year in which the loan was repaid. The 1984 Act has corrected this technical deficiency. Henceforth, repayments of loans, amounts received on a sale of assets acquired through qualifying distributions, and amounts set aside for charitable projects but not so applied will increase the amount required to be distributed.130

D. Excess Business Holdings

Several small but salutary changes have been made in the excess business holdings rules of section 4943. Those rules, particularly as they pertain to business interests acquired by gift or bequest and to “grandfathered” interests owned by the foundation on May 26, 1969, have evidently inspired numerous pleas for spe-

130. See id. § 4942(d)(1).
cial relief. The modest changes made by the 1984 Act provide desirable statutory flexibility without seriously eroding the policy of limiting private foundation involvement in business enterprises.

1. Extension in Hardship Cases

Where a foundation receives "an unusually large gift or bequest of diverse business holdings or holdings with complex corporate structures," the IRS may extend the present five-year disposition period by an additional five years.131 Such an extension will only be granted if the foundation establishes that it has made diligent attempts to dispose of the excess holdings within the initial five-year period, and that disposition was not possible other than at a distress sale price. In connection with a request for an extension, the foundation must submit a plan for disposing of the excess holdings both to the Service and to the State Attorney General (or other appropriate State official).

2. Five-Year Reprieve for 95% Controlled Enterprises

The 1969 Act provided for phased divestiture of excess business holdings. The longest "phase one" period was allowed to a private foundation which itself had more than a 95% voting stock interest in an incorporated business enterprise.132 A fifteen-year period, expiring May 26, 1984, was permitted when the foundation and all disqualified persons had more than a 75% voting stock interest.133 At the end of the applicable first phase, the combined holdings of the foundation and disqualified persons must be reduced to 50%, of which no more than 25% may be owned by the foundation.134

In an apparent response to special-interest pleas, the 1984 Act increases the phase-one period from fifteen to twenty years where the private foundation and all disqualified persons had more than a 95% voting stock interest on May 26, 1969.135

131. Id. § 4943(c)(7).
134. Id. § 4943(c)(4)(A)(i), (D)(i).
135. Id. § 4943(c)(4)(B)(i).
3. Relaxation of "Downward Ratchet Rule"

In a similar vein, the beloved "downward ratchet rule" has been suspended in respect of decreases in holdings attributable to issuances of stock (or issuances combined with redemptions), so long as the net percentage decrease does not exceed 2% and the number of shares held by the foundation is not affected.\textsuperscript{136} Under this new provision, if a foundation and its disqualified persons together own 50% of the stock of a corporation, the foundation owning no more than 25% (a permissible ownership configuration during the second phase), an increase in outstanding stock attributable to a sale of treasury stock to a key employee (not a qualified person) will not affect the overall 50% limitation, so long as the combined holdings of the foundation and disqualified persons do not drop below 48%.

E. Disqualified Person Status

Prior to the 1984 amendments, section 507(d)(2) provided that one became a "substantial contributor" by contributing an amount greater than five thousand dollars to the foundation where such contribution exceeded 2% of the foundation's total historical support. Once characterized as a "substantial contributor" the status was permanent. With that designation comes exposure to significant penalties under section 4941 since substantial contributors are also "disqualified persons." Furthermore, a disqualified person whose status as such derived from substantial contributions not only remained so forever, but he conferred the same unwelcome hereditament upon family members including lineal descendants and their spouses.\textsuperscript{137} Such attributed taint obviously holds great potential for mischief as time passes and family trees spread new branches. Moreover, updating the foundation's list of disqualified persons in order to avoid self-dealing transactions may involve considerable time and expense.

That burden has now been lessened. Under section 507(d)(2)(C), a person will no longer be treated as a substantial

\textsuperscript{136} Id. § 4943(c)(4)(A)(ii). The "downward ratchet rule" has the effect, as to grandfathered holdings, of lowering the permitted transitional and permanent percentages of stock which may be held by the foundation and its disqualified persons when such combined ownership actually decreases.

\textsuperscript{137} I.R.C. § 4946(a)(1)(D), (d), prior to amendment by the 1984 Act.
contributor if, for a ten-year period, the contributor or any related person neither makes any contribution to the foundation nor serves as a foundation manager. In addition, the Service must determine that the aggregate contributions made by the contributor and related persons are "insignificant" when compared with the aggregate amount of contributions by "one other person." Putting aside the peculiar comparison of the contributions of the prospective escaper with those of "one other person" (perhaps this reflects a perceived necessity for each private foundation to have at least one continuing substantial contributor), this provision affords the private foundation an opportunity periodically to winnow out its lapsed contributors.

A change to the same effect was made in the definition of "family" under section 4946(d), which formerly applied to lineal descendants and their spouses without limitation. Under the revised statute, the disqualified-person taint persists only through an individual's great grandchildren's generation.

F. Abatement of First-Tier Excise Taxes

Each of the operative provisions of chapter 42 (sections 4941 through 4945) provides a two-tiered sanction—a first-level tax originally intended to serve as an incentive to correction,° and a virtual confiscatory tax imposed in the event of a failure to correct the act or omission giving rise to the initial liability. Under this structure, the private foundation (and, as to certain transgressions, its managers) stand liable for taxes on failure to distribute income, excess business holdings, the making of jeopardy investments, and improper expenditures of various types. For self-

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138. H.R. Rep. No. 91-413, 91st Cong., 1st Sess., reprinted in 1969-3 C.B. 413. The House Report describes the first-level tax as "relatively light." Under the computational formula of § 4941(a)(1), however, this initial tax may seem more than a mild reprimand. In Adams v. Comm'r, 70 T.C. 373 (1978), the assessed first-level tax exceeded $106,000 with respect to transactions valued by the Commissioner at $700,000, even though the participating foundation was not found to have been disadvantaged.

139. Second-level taxes range from a low of 25% of the amount of a jeopardy investment (§ 4944(b)(1)) to 200% of the amount involved in self-dealing and excess business holdings situations (§§ 4941(b)(1), 4943(b)).

140. I.R.C. § 4942(a), (b) (CCH 1984).

141. Id. § 4943(a), (b).

142. Id. § 4944(a), (b).

143. Id. § 4945(a), (b).
dealing transactions, the self-dealer and foundation managers bear the liability.\textsuperscript{144} Prior to amendment, the statute provided the Service no discretion to abate these excise taxes.

Under the 1984 Act, for taxes arising from transactions occurring in 1985 and thereafter, the Service may abate first-tier excise taxes (not including the tax imposed in respect of self-dealing transactions) if the “taxable event was due to reasonable cause and not to willful neglect,” and correction is effected within the appropriate correction period.\textsuperscript{146} The conferral of abatement authority reflects an awareness that innocent transgressions of the private foundation rules commonly occur, and that a rigid penalty is often inappropriate. It is certainly arguable, however, that the most appealing case for equitable consideration can be made on behalf of the “innocent” self-dealer, to whom abatement relief will not be available.\textsuperscript{146}

Assume a knowledgeable disqualified person (DP) who desires to make an immediate sale of a parcel of undeveloped real property, appraised at $100,000, to a private foundation (PF). That sale is tempting to DP, since it may be effected immediately, and at the saving of a 10% broker’s commission. Knowing the transaction to be an act of self-dealing, DP nonetheless sells the property to PF, and then promptly offers to “correct” the act by repurchase—the preferred correction strategy under the regulations.\textsuperscript{147} The foundation, knowing its purchase to have been at a fair price, declines to reconvey. DP can now assert, with considerable force, that he has corrected the act of self-dealing insofar as it is in his power to do so, and thus is liable only for the first-level tax, at 5% of the “amount involved,” a modest “transaction cost” tax of $5,000.

Now compare the self-dealing transaction undertaken in com-

\textsuperscript{144} Id. § 4941(a), (b).
\textsuperscript{145} Id. § 4962.
\textsuperscript{146} The House Report found “no justification” for extending abatement relief to acts of self-dealing, since the “penalty tax” is payable by the self-dealer and not the foundation, and since “commercial transactions between disqualified persons and foundations are generally prohibited.” House Report, supra note 122, at 1472.
\textsuperscript{147} Treas. Reg. § 53.4941(e)-1(c)(3) (1973). The regulations’ preferred correction scenario might be described as “rescission plus expectation,” but it seems to ignore the obvious. The private foundation which has received fair value in a self-dealing transaction will be under no legal compulsion to agree to rescission. Indeed, where the transaction has been to the foundation’s advantage, fiduciary duty would likely compel rejection of the self-dealer’s offer to “correct” through rescission.
plete innocence of section 4941. On the same facts, the blundering disqualified person will of course offer the foundation no opportunity to correct, and thus will become liable for a tax equal to 5% of the amount involved "for each year (or part thereof) in the taxable period." By the time a Service audit uncovers the innocent transgression, the taxable period may include parts of as many as four or five years, and the tax will amount to four or five times that which the devious and knowledgeable self-dealer is required to pay. Given the distinct possibility of such circumstances, limitation of the Service's authority to abate self-dealing transactions seems unfortunate.

G. Charitable Contributions

Perhaps the most positive indication of a mellowing in congressional attitudes toward the private foundation is found in certain amendments to section 170. Following passage of the 1969 Act, nonoperating private foundations were handicapped in competing for charitable gifts (but not bequests) in three respects:

(1) deductible donations were limited to 20% of adjusted gross income;
(2) no carryover of excess contributions was allowed; and
(3) gifts of capital gain property were reduced by 40% of the potential long-term capital gain.

Each of these disadvantages has been ameliorated by the 1984 Act. The overall limitation on allowable private foundation contributions has been raised from 20% to 30%, although contributions of capital gain property remain subject to the 20% ceiling. Both excess contributions of cash and capital gain property may now be carried forward for five years, subject to their respective 30% and 20% limitations during that carryover period. Finally, donations of "qualified appreciated stock" may be made at full fair market value. In order for stock donations so to qualify, market quotations

149. Id. § 4941(e)(1).
152. Id. § 170(e)(1)(B)(ii).
153. Id. § 170(b)(1)(B), (D)(i).
154. Id. § 170(b)(1)(B), (D)(ii).
must be readily available, stock must be capital gain property in the hands of the donor, and the contribution, together with all other contributions of such stock made by any member of the family of the donor, may not exceed in value 10% of the issuing corporation's outstanding stock.\textsuperscript{155}

III. THE UNRELATED BUSINESS INCOME TAX

Nonprofit organizations historically have engaged in a wide range of business and investment activities. Admonished to be less dependent on foundation and government largesse, many nonprofits are undertaking new income-producing activities. This vigorous pursuit of capitalism by the tax-exempt sector recently was described by a promoter of continuing "grantsmanship" education as "the hottest area of nonprofit funding."\textsuperscript{156} The heat has contributed to a host of recent developments involving the unrelated business income tax, a levy imposed annually on an organization's "unrelated business taxable income."\textsuperscript{157}

Three factors must be present before an activity is considered an unrelated trade or business: (1) the activity must be a "trade or business;" (2) it must be "regularly carried on;" and (3) it may not be substantially related to the organization's exempt purposes (aside from the need for funds derived from the activity).\textsuperscript{158} Even if these factors are present, the tax will not be imposed if: (1) substantially all of the work is performed by uncompensated volunteers; (2) the activity consists of selling donated merchandise; or (3) the business is carried on primarily for the convenience of members, students, patients or customers.\textsuperscript{159} Various other specialized exceptions abound.\textsuperscript{160}

It had long been assumed that the primary purpose of the unrelated business tax was to eliminate unfair competition between

\begin{itemize}
\item \textsuperscript{155} Id. § 170(e)(5).
\item \textsuperscript{156} The Grantsmanship Center, Business Ventures for Nonprofits: An Intensive Three-Day Workshop (1983). The brochure goes on to describe "enterprises [ranging] from shoestring businesses to multi-million dollar deals," including "thrift stores and gift stores, restaurants, periodicals and mail-order services, housing and real estate syndication, cable television franchising, and much more."
\item \textsuperscript{157} I.R.C. §§ 511(a), (b), 512(a)(1) (CCH 1984).
\item \textsuperscript{158} Id. § 513(a).
\item \textsuperscript{159} Id. § 513(a)(1)-(3).
\item \textsuperscript{160} See, e.g., id. §§ 513(d)-(f), 512(b).
\end{itemize}
nonprofits and comparable for-profit businesses. Indeed, the regulations state that the primary objective of the tax was "to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete."\footnote{161} Although this theme pervades the legislative history of the tax, a competing theory has developed which suggests that the tax was more of a political decision designed to raise revenue and eliminate a "loophole." The revisionists contend that the presence or absence of competition with for-profits is not determinative; rather, the critical factor is whether the organization has a "profit motive" and operates a business in a competitive, commercial manner.\footnote{162} Recent decisions reveal a clear trend in favor of the "profit motive" rationale. 

The leading case is \textit{Louisiana Credit Union League v. United States},\footnote{163} a tour-de-force conducted by Judge Goldberg of the Fifth Circuit. At issue was the taxability of revenue generated from insurance endorsement, debt collection and data processing activities conducted by a section 501(c)(6) business league for the benefit of its members. The League contended, among other things, that it was not liable for the tax because it was not competing unfairly with taxpaying entities engaged in similar activities.\footnote{164} While acknowledging that Congress had expressed its concern over the dangers of unfair competition, the court concluded that "[t]he presence or absence of competition between a tax-exempt organization and taxable entities engaged in similar activities is not in and of itself determinative of whether a tax-exempt organization's business income should be taxed."\footnote{165} Moreover, it emphasized that there was nothing in the statute requiring a showing of unfair competition and that Congress repeatedly had declined the invitation

\begin{footnotes}

163. 693 F.2d 525 (5th Cir. 1982). \textit{See also} Carolinas Farm & Power Equip. Dealers v. United States, 699 F.2d 167 (4th Cir. 1983).
164. 693 F.2d at 538-39.
165. \textit{Id.} at 541.
\end{footnotes}
to impose such a requirement. 166

Although the unfair competition issue has captured the fancy of the courts, its importance appears to be overstated. The IRS has limited resources and presumably will scrutinize only commercial activities that actually generate a significant net profit. If there is profit potential, one would assume that the activity would be of interest to taxable capitalists. Indeed, with the possible exception of bingo games, which in many states are limited by law to non-profit organizations, it is hard to imagine any potentially successful nonprofit enterprise that does not raise the spectre of unfair competition.

A. Group Insurance and Endorsement Programs

The Louisiana Credit Union League case was one of several controversies involving the taxing of income derived by trade associations from the promotion, endorsement and administration of group insurance programs for their members. Revenues are earned in various forms, principally as commissions for promotional or administrative services or as premium rebates which are turned over to the organizations by its members. Although several older cases had supported the notion that such activities were essentially passive, not rising to the level of a "trade or business," 167 the IRS has scored several notable victories in the flurry of recent litigation.

The stage was set by the Tax Court in Professional Insurance Agents of Michigan v. Commissioner, 168 where the IRS sought to tax the income derived by an association of insurance agents from promotional and administrative services rendered in connection with the sale of malpractice, health, disability and life insurance to the association's members. The court broadly defined "trade or business" as any activity carried on for the production of income from the sale of goods or the performance of services and rejected the association's contention that it was engaged in a primarily pas-

166. Id. The court also noted that on several occasions Congress had enacted special exceptions exempting certain noncompetitive businesses (e.g., horse racing at county fairs; renting display space at trade shows; bingo) from the unrelated business tax. Id. at 539. See I.R.C. § 513(d), (f) (CCH 1984).
168. 78 T.C. 246 (1982), aff'd, 726 F.2d 1097 (6th Cir. 1984).
sive activity. 169 Emphasizing the organization’s “profit motive,” the
court found that its “promotional activities were highly profitable
and generated revenues far in excess of the related expenses.” 170
On appeal, the Sixth Circuit agreed that the existence of a profit
motive was critical, and noted the extensive day-to-day involve-
ment of the association in the lucrative endorsement and adminis-
trative activities. 171 The Fourth 172 and Fifth Circuits 173 similarly
have rejected the “active vs. passive” distinction of earlier cases in
favor of a profit motive standard.

The insurance cases also involve the question whether solicita-
tion, endorsement and administrative activities are substantially
related to the organizations’ exempt purposes. The business
leagues contend that such activities promote the common business
interests of members by providing them with access to low-cost
group insurance. Articulation of standards on the “relatedness”
question is an elusive endeavor. The regulations offer little more
than abstract generalizations, requiring the revenue-producing ac-
tivity to have a “substantial causal relationship” with the exempt
purpose—i.e., the activity must “contribute importantly” to the
accomplishment of the exempt purpose. 174 All the facts and cir-
cumstances control, but particular emphasis is placed on the size
and extent of the activity. 175

In all except one of the recent decisions, the courts have con-
cluded that group insurance programs fail the “relatedness” re-
quirement. The test articulated by the Fifth and Sixth Circuits re-
quires an organization to show that the revenue-producing activity
serves distinctive institutional ends; a tangential relationship, such
as convenience to the membership, is insufficient. 176 And because

169. Id. at 262-63. See also I.R.C. § 513(c), added to the Code in 1969, which provides
that any activity involving the performance of services for the production of income consti-
tutes a “trade or business.”
170. 78 T.C. at 262.
171. 726 F.2d at 1102.
172. Carolinas Farm & Power Equip. Dealers Ass’n v. United States, 699 F.2d 167 (4th
Cir. 1983), holding that a business league received unrelated business income on the rebate
of a percentage of premiums paid under a group accident and health insurance program
administered by the league.
173. Louisiana Credit Union League v. United States, 693 F.2d 525 (5th Cir. 1982).
175. Id. § 1.513-1(d)(3).
176. Professional Ins. Agents of Mich. v. Comm’r, 726 F.2d at 1103; Louisiana Credit
Union League v. United States, 693 F.2d at 534-38.
trade associations are operated to promote the common business interests of their members and to educate the industry, an activity will be substantially related to those exempt purposes only if it benefits the members as a group rather than as individuals.\textsuperscript{177} A similar rationale has been applied to sustain the taxation of revenue derived from a variety of other administrative services provided by trade associations to their members.\textsuperscript{178}

The Government suffered an unusual defeat, however, in a dispute involving the lucrative insurance program of the American Bar Endowment (ABE).\textsuperscript{179} Working with private insurers, the ABE sells group life insurance to its members on the condition that participants assign their premium refunds to the endowment for its charitable and educational projects.\textsuperscript{180} Premiums, though apparently within a competitive range, were set high in order to maximize dividends.\textsuperscript{181}

In a wide-ranging opinion, the Claims Court concluded that the staggering sums raised by the ABE were the product of a successful charitable fund-raising campaign, not a trade or business. Positive factors included the Endowment's unique use of dividends for charitable endeavors, its candor in advising members that the high profit margins were designed for charitable ends, the membership's generous participation in the program, and the fact that the sums retained by the endowment were wholly unrelated to the services provided.\textsuperscript{182} The business league insurance cases discussed above were distinguished on the ground that those associations served "parochial interests" and conducted their activities "in a commercial manner," while the ABE's far more profitable endeavor actually was "procompetitive" because it did not offer insurance at the lowest possible rates.\textsuperscript{183} In a curious turnabout,

\textsuperscript{177} Professional Ins. Agents of Mich. v. Comm'r, 726 F.2d at 1103; Louisiana Credit Union League v. United States, 693 F.2d at 534-38.

\textsuperscript{178} See, e.g., Steamship Trade Ass'n of Baltimore, Inc. v. Comm'r, 81 T.C. 303 (1983) (administrative services benefited members individually rather than industry at large). \textit{But cf.} Kentucky Mun. League v. Comm'r, 81 T.C. 156 (1983) (income earned from tax collection services by \$501(c)(4) league of cities not subject to tax; services promoted effective government and assisted other exempt organizations).


\textsuperscript{180} \textit{Id.} at 405-06. Over 55,000 ABE members participated in the program which generated $5.1 million in dividends in 1979 against $1.5 million in expenses. \textit{Id.} at 406, 410.

\textsuperscript{181} \textit{Id.} at 406-07.

\textsuperscript{182} \textit{Id.} at 409-11.

\textsuperscript{183} \textit{Id.} at 412-14.
however, the court denied a charitable deduction to individual ABE members who claimed that the rebates retained by the Endowment were charitable contributions.\textsuperscript{184}

The decision is an inadvertent tribute to the ABE's fund-raising prowess. It also stands as a consumer protection warning to the participants who, in the court's view, must have known that they were not getting fair value for their premiums unless one assumes they were victims of "an epidemic of irrationality in permitting themselves to be bilked in this manner for almost three decades."\textsuperscript{185} This remark is strangely at variance with the court's finding that the premiums paid by participants were competitive with other insurers, and its denial of a charitable deduction to the individual plaintiffs in the case. Moreover, the court's emphasis on the destination of the profits for charitable purposes is wholly at variance with the genesis of the tax, which was enacted to overturn the "destination of income" test.\textsuperscript{186} Suffice it to conclude that if the case is not reversed on appeal, it likely will be relegated to \textit{sui generis} status.

\section*{B. Advertising and Mailing Lists}

An activity need not be wholly separate from the exempt pursuits of an organization in order to constitute an unrelated trade or business. Under the IRS's "fragmentation" approach, now codified in section 513(c), an activity does not lose its identity as a trade or business merely because it is carried on within a "larger aggregate" of similar activities that may or may not be related to the organization's exempt purposes.\textsuperscript{187} This approach permits the IRS to carve out a profit-seeking activity, such as advertising in an exempt organization's journal, from an admittedly exempt endeavor and subject the net income to tax. The regulations provide that advertising for products of professional interest to members (e.g., law books in a bar association journal) does not constitute a "related" business because it is primarily aimed at stimulating sales.\textsuperscript{188}

\begin{flushleft}
\textsuperscript{184} \textit{Id.} at 414-18.
\textsuperscript{185} \textit{Id.} at 411.
\textsuperscript{186} \textit{See}, e.g., Roche's Beach, Inc. v. Comm'r, 96 F.2d 776 (2d Cir. 1938). The destination of income test was legislatively overturned upon enactment of the unrelated business tax in 1950. \textit{See} I.R.C. § 502(a) (CCH 1984).
\textsuperscript{187} Treas. Reg. § 1.513-1(b) (1984).
\textsuperscript{188} \textit{Id.} § 1.513-1(d)(iv).
\end{flushleft}
In one of the few litigated cases on advertising income, the Claims Court strongly supported the Government's position.\textsuperscript{189} At issue was the revenue derived from the Annals of Internal Medicine, the lead publication of the American College of Physicians. "Stacked" in various portions of this otherwise scholarly journal were advertisements for medical products, principally drugs such as Valium, insulin and Maalox.\textsuperscript{190} Although the court agreed to consider whether the conduct or product of an advertising business related to the organization's exempt purposes, it rejected the American College's contention that the ads in "Annals" performed an educational function. Rather, they were merely the typical "eye catching" commercial fare, many for established products, all designed to serve members in their role as physicians but not as members of the organization.\textsuperscript{191} To avoid the unrelated business tax, the court suggested, an advertising business must be run differently by providing, for example, a comprehensive survey of a particular field or otherwise serving an educational objective.\textsuperscript{192}

In an earlier case, the IRS also was successful in taxing the revenue derived by a veterans organization from the essentially passive activity of renting mailing lists to direct mail advertisers.\textsuperscript{193} The then Court of Claims supported the position in the regulations that distribution of advertising materials to members does not contribute importantly to the exempt purposes of a business league.\textsuperscript{194} Taking the argument into the barter economy, the IRS has ruled that the exchange of mailing lists of potential donors between exempt organizations on a regular basis results in unrelated business income even though no money changes hands.\textsuperscript{195} This position has raised the hackles of the nonprofit community, whose entreaties led to the introduction of legislation to exempt the rental, sale or exchange of mailing lists by nonprofits from the unrelated business

\textsuperscript{189}. American College of Physicians v. United States, 3 Ct. Cl. 531 (1983).
\textsuperscript{190}. Id. at 534 n.4.
\textsuperscript{191}. Id. at 536. To illustrate the point, the court pointed to a regular Annals ad for another publication, Medical Economics, promising the answer to the burning medical question whether "the new Seville [is] worth its $12,479 base price." Id. at 536 n.7.
\textsuperscript{192}. Id. at 535.
\textsuperscript{194}. Id. at 1188-89. See Treas. Reg. § 1.513-1(d)(iv) (1984).
\textsuperscript{195}. Ltr. Rul. 8216009, contradicting the position taken by the IRS in Ltr. Rul. 8101002.
C. Retail Sales: Gift Shops and Mail Orders

The fragmentation approach also has been applied to the growing retail trade of exempt organizations. In a recent Yuletide feature, the New York Times reported: “[W]ith six shopping days until Christmas, some of the busiest cash registers in New York are in the Metropolitan Museum of Art”—an enterprise, along with the museum’s mail order business, which netted $1.8 million in 1982. In auditing gift shops and mail order activities, the IRS scrutinizes each line of merchandise to determine if the items sold bear the requisite nexus to the museum’s exempt purposes. Thus, sales of greeting card reproductions of works in the museum’s collection are related because they stimulate and enhance public awareness in art, but income from the sale of items bearing no relationship to the museum’s cultural mission (e.g., sale of scientific books and city souvenirs by a folk art museum) are considered unrelated.

Several recent letter rulings reveal the IRS’s current attitude toward retail sales. In general, if the primary purpose of the sale is to interpret the museum’s collection and provide a learning experience, the article is related. Thus, sales of art reproductions, learning toys, stuffed animals depicting extinct wildlife and art books are “related” if they can be shown to enhance visitor awareness of art, history, science and culture. But articles which are

197. A provision exempting exchanges and rentals of mailing lists between “Congressionally chartered organizations” (e.g., the Disabled American Veterans) and other nonprofit organizations was added as a floor amendment to the Senate version of the 1984 Act. 130 Cong. Rec. S4537 (April 12, 1984). But the amendment was deleted in the House-Senate conference. H. R. Rep. No. 98-861, 98th Cong., 2d Sess. 1099 (1984).
201. Ltr. Rul. 8303013.
202. Id.
predominantly utilitarian are generally considered unrelated. The following items are currently under attack: period clothing; t-shirts with the museum logo; watches; jewelry; and inexpensive mementos. Mail order campaigns of similar items, however, have been more successful, especially when the organization includes descriptive literature outlining its educational objectives. Thus, the IRS has ruled that a conservation organization operated to preserve wildlife habitats and educate the public on conservation issues was engaged in a related business when it sold various products (stationery, coasters, bar supplies, desk accessories, throw pillow, stuffed animals, emblems and belts), all containing portrayals of endangered wildlife.

To illustrate, one of the more popular subjects at the Metropolitan Museum's gift shop is “William,” an Egyptian hippopotamus dating back to the 13th Dynasty. As part of its educational mission, the museum sells “William” ceramics, pins, key rings, cushions, books and puzzles—but no utilitarian t-shirts. Not surprisingly, the hostile and often inconsistent attitude of the IRS toward items with logos has not escaped the ire of the exempt organization’s tax bar, and we eagerly await the first litigated case.

D. Partnership Income

If an exempt organization is a member of a partnership that regularly carries on a business unrelated to its exempt purposes, the organization’s distributive share of partnership income, less allocable deductions, is includible in unrelated business taxable income. In a case of first impression, the Sixth Circuit has held that an exempt profit-sharing trust was taxable on income from limited partnership interests in several manufacturing businesses. The trust had contended that, as a limited partner, it was essentially a passive investor, without management responsibilities and thus outside the ambit of the tax.

203. Id. See also Ltr. Rul. 8024111.  
204. Ltr. Rul. 8107006.  
205. Salmans, supra note 213.  
207. I.R.C. § 512(c) (CCH 1984).  
209. Id. at 522.
In affirming the Tax Court, the Sixth Circuit found nothing in the legislative history or statutory language to exclude an exempt trust's distributive share of income from an otherwise unrelated business. The court reasoned that if Congress desired to distinguish between general and limited partners, it easily could have done so.\textsuperscript{210} To find otherwise would "encourage unfair competition" by contributing to the creation of "pools of tax-exempt income" because exempt partners would not have to withdraw cash from the partnership to pay their taxes.\textsuperscript{211}

It should be remembered that this holding applies only to income derived from an unrelated business. Otherwise excludable income, such as rentals from real estate that is not "debt-financed," continue to be exempt even if earned by a partnership.\textsuperscript{212} Moreover, exempt organizations that own stock in corporate enterprises are not taxable on their dividend income.\textsuperscript{213}

\textbf{E. Allocation of Deductions}

If an exempt organization engages in an unrelated trade or business, it is taxable on "unrelated business taxable income," which is defined as gross income derived from any unrelated trade or business less allowable deductions for expenses, losses, depreciation, and other items "directly connected" with the carrying on of the business.\textsuperscript{214} The computation is not as mundane as the statute suggests, particularly in situations where expenses may be connected to both an unrelated business and an exempt activity.

Consider, for example, a university fieldhouse used both for exempt purposes (physical education, ice hockey, commencement, etc.) and income-producing commercial events. Expenses directly connected to the commercial revenue are deductible in computing unrelated business taxable income, but what about indirect expenses such as salaries to fieldhouse employees, depreciation, repairs and operating expenditures? The regulations provide, without elaboration, that expenses attributable to these dual use facilities must be allocated between exempt and business uses "on

\textsuperscript{210} Id. at 522-25.
\textsuperscript{211} Id. at 524.
\textsuperscript{212} See I.R.C. §§ 512(b)(3), 514 (CCH 1984).
\textsuperscript{213} Id. § 512(b)(1).
\textsuperscript{214} Id. § 512(a)(1).
a reasonable basis," but reasonable people may differ on the meaning of that flexible standard.

In a significant case of first impression, the Second Circuit has approved an allocation method that should be quite advantageous to exempt organizations with dual-use facilities. At issue were the “variable” and “fixed” expenses of the Rensselaer Polytechnic Institute (RPI) fieldhouse, which generated substantial revenues from commercial ice shows and public ice skating. “Variable” expenses were those which fluctuated in proportion to the actual use of the facility and included salaries, operating expenditures and repairs. “Fixed” expenses, consisting of salaries, repairs and depreciation, did not vary in proportion to the use of the facility and were allocated by RPI in proportion to the relative times of actual rather than total available use of the fieldhouse.

In upholding RPI’s allocation as reasonable, the Second Circuit rejected the Government’s argument that an expense is “directly connected” with an unrelated business activity only if it would not have been incurred in the absence of that activity. The court relied on analogous cases allocating expenses for home offices and vacation homes and reasoned that an allocation based on actual use “sensibly distributes the cost of the facility among the activities that benefit from its use.” In effect, the court concluded that idle time should not be considered in the allocation equation. Judge Mansfield dissented on the ground that, by ignoring idle hours, the majority’s allocation gave organizations credit for time during which the facility was essentially devoted to educa-

216. Rensselaer Polytechnic Inst. v. Comm’r, 732 F.2d 1058 (2d Cir. 1984). The importance of this case was underscored by the fact that amicus briefs were filed on behalf of the American Council on Education, the National Institute of Independent Colleges and Universities and Yale University.
217. A detailed breakdown of all these expenses is included in the Tax Court’s opinion. 79 T.C. at 968-69 (1982). The dispute on appeal was limited to the indirect fixed expenses. 732 F.2d at 1060.
218. Thus, in determining the deductible portion of these expenses, RPI multiplied the total fixed expenses by a fraction whose numerator was the total number of hours that the fieldhouse was used for commercial events, and whose denominator was the total number of hours of overall use. Under the Commissioner’s “available use” allocation, the numerator would remain the same but the denominator would have been the total number of hours in the taxable year, producing a smaller fraction and significantly reducing the available deduction. 732 F.2d at 1060.
219. Id. at 1061-62.
220. Id.
tional purposes. In his view, this gave RPI an unfair advantage over commercial enterprises.\textsuperscript{221}

As nonprofit organizations continue to expand their sources of revenue by engaging in commercial activities, they will find it far more difficult to escape the unrelated business tax. A creative allocation of deductions may be the last line of attack. The issues raised in the \textit{Rensselaer Polytechnic Institute} case are likely to recur, and the Service can be expected to litigate the dual-use allocation issue in other circuits before conceding the point.\textsuperscript{222}

\section*{F. Real Estate}

Rentals from real property generally are not subject to the unrelated business tax even if the property bears no relationship to the organization's exempt purpose.\textsuperscript{223} But if an exempt organization borrows in order to acquire property that is not substantially used for exempt pursuits, all or part of the net rental income will be taxable under the unrelated debt-financed income rules in section 514.\textsuperscript{224} These rules were designed to curb specific abuses, such as bootstrap sales and leasebacks,\textsuperscript{225} but they have much broader application and have become an impediment to exempt organizations that wish to invest in real estate but are unable to do so without financing the acquisition.

In 1978, Congress exempted the real estate rental income of pension and profit-sharing trusts from the debt-financed property rules by providing that indebtedness incurred by a qualified trust in acquiring or improving real property did not constitute an "ac-

\textsuperscript{221} \textit{Id.} at 1063-64.

\textsuperscript{222} The Service refused to give up after losing a comparable allocation issue in the home office deduction area and ultimately secured a reversal. \textit{See} Gino v. Comm'r, 538 F.2d 833 (4th Cir.), \textit{cert. denied}, 429 U.S. 979 (1976) (depreciation of home office, prior to statutory amendment by I.R.C. § 280A, must be made on the basis of total available rather than actual use). \textit{See also} Lewis v. Comm'r, 560 F.2d 973 (9th Cir. 1977).

\textsuperscript{223} I.R.C. § 512(b)(3)(A) (CCH 1984).

\textsuperscript{224} \textit{Id.} § 514. "Debt-financed property" is any property held for the production of income with respect to which there exists an "acquisition indebtedness" at any time during the taxable year. \textit{Id.} § 514(b)(1). "Acquisition indebtedness" is generally defined as any unpaid debt incurred to acquire or improve the property. \textit{Id.} § 514(c). If property is debt-financed, a certain percentage of the income is treated as unrelated business taxable income. Ignoring refinements, the percentage is determined by a fraction whose numerator is the average annual indebtedness connected with the property and whose denominator is the average adjusted basis.

\textsuperscript{225} \textit{See, e.g.}, Commissioner v. Brown, 380 U.S. 563 (1965).
quisition indebtedness” for purposes of section 514.\textsuperscript{226} With the door ajar, educational organizations lobbied for a similar exception, and Congress succumbed in the 1984 Act, extending the exception to educational organizations described in section 170(b)(1)(A)(ii), affiliated support organizations, and tax-exempt title holding companies that meet certain technical requirements.\textsuperscript{227}

The conditions for the expanded exemption are similar to those that still apply to pension trusts. The purchase price must be a fixed amount, and the amount of any indebtedness on the property may not be dependent, in whole or in part, upon the profits derived from the property.\textsuperscript{228} If the real property is held by a partnership, an exempt organization that is a partner may qualify for the exception only if all the partners in the partnership are qualified educational organizations or pension trusts, or each allocation to the partnership is a “qualified allocation.”\textsuperscript{229} For this purpose, the Code incorporates the definition of “qualified allocation” under the newly-enacted rules designed to patrol tax avoidance resulting from the leasing of property by private investors to tax-exempt organizations.\textsuperscript{230} Roughly translated, this means that the exempt organization must be allocated the same percentage share of each item of partnership income, losses and other items that pass through to partners, the share must remain the same during the entire period that the organization is a partner, and the allocation must have “substantial economic effect” under the rules generally applicable to partnership allocations.\textsuperscript{231}

If these technical conditions can be met—and that should not be difficult in a straightforward transaction—the debt-financed income exception will increase the rate of return realized by educational organizations on their real estate investments. The extension

\textsuperscript{226} See I.R.C. § 514(c)(9)(A) (CCH 1983), prior to amendment by the Tax Reform Act of 1984. The exception is subject to several conditions. In general, the purchase price must be a fixed amount, not dependent on profits derived from the property, and the property may not be acquired from or leased back to any “related” party within the rules of section 267. I.R.C. § 514(c)(9)(B) (CCH 1983).


\textsuperscript{228} I.R.C. § 514(b)(9)(B) (CCH 1984).

\textsuperscript{229} Id. § 514(b)(9)(B)(vi).

\textsuperscript{230} Id.

\textsuperscript{231} Id. § 168(j)(9).
of the exception to title holding companies also will be useful to smaller tax-exempt organizations that have been precluded from investing in real estate because of the large capital requirements but which now will be able to pool their resources.

Conclusion

The developments reviewed in this survey are far from routine. After many years of avoiding the fray, the Supreme Court finally has interpreted the requirements for achieving tax-exempt status under section 501(c)(3). In *Bob Jones University*, the Court elevated the term “charitable” to the status of super factor by requiring that section 501(c)(3) organizations serve a public purpose and not be contrary to fundamental public policy, whatever that may be. In *Taxation With Representation*, the Court firmly rejected the constitutional challenges to the lobbying limitations on charitable organizations. In both cases, the Court characterized the exemption and charitable deduction as subsidies, equivalent to cash grants, that require the qualifying beneficiaries to serve a public purpose. It remains to be seen whether these sweeping pronouncements will have an impact on the IRS’s administration of tax-exempt organizations or the many qualification controversies still simmering in the lower courts.

The legislative developments affecting private foundations fell short of the foundation community’s ambitious wish list. But the amendments in the Tax Reform Act of 1984, however small and technical, are at least symbolic. Fifteen years after the orgy of recrimination against foundations in the 1969 Act, Congress cautiously has begun removing some of the tax disincentives to the creation and maintenance of private foundations.

On the unrelated business tax front, the courts have been up to the challenge of the growing number of intriguing new issues. The adoption of a “profit motive” standard for determining the existence of a trade or business is likely to widen the tax collector’s net. Nonprofit organizations seeking to avoid the unrelated business tax must plan more carefully to ensure that their income-producing activities advance their exempt purposes. As the stakes in this area get higher, the day is fast approaching when entertaining controversies involving museum gift shops, merchandise catalogues and t-shirts with logos will move from the one-sided venue of the IRS rulings branch to the courts.
To conclude with a prediction, the centerpiece of the next recent developments survey may become the growing practice of nonprofit organizations to enter into joint ventures with the private sector. Investment partnerships are the wave of the present, with activities ranging from real estate development and genetics research to C.A.T. scanners and theatrical productions. Authorities are sparse at the moment, and one must be content with a growing trickle of letter rulings\textsuperscript{232} and considerable speculation in the trade literature.\textsuperscript{233} By the end of the decade, advisors to nonprofit organizations may have to forego their traditional preoccupation with indefinable terms such as “charitable,” “religious” and “educational” and shift their focus to the pursuit of profit—to accomplish charitable ends, of course—and all its attendant technical minutia.

\textsuperscript{232} See, e.g., G.C.M. 39005 (June 28, 1983), \textit{reprinted in} 20 \textit{Tax Notes} 213 (1983); Ltr. Rul. 8342001; Ltr. Rul. 8338127. The IRS ruled for the first time in these pronouncements that participation by an exempt organization as a general partner in a limited partnership would not \textit{per se} deprive an organization of its exemption provided that the partnership agreement insulates the organization from conflicts of interest and permits it to act solely in furtherance of its exempt purposes.
