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## The Exemption of Nonprofit Organizations from Federal Income Taxation\*

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# Exemption of Nonprofit Organizations

## Introduction

The practice of exempting charitable and religious organizations, mutual benefit groups, and a variety of other nonprofit associations from federal income taxation has persisted, with surprising consistency despite minor variations in coverage, for many years. With roots reaching back to the British Statute of Charitable Uses of 1601 and to early state constitutional provisions,<sup>1</sup> most of today's exemptions from income taxation date from the Revenue Act of 1894<sup>2</sup> and were re-enacted in the corporation income tax of 1909<sup>3</sup> and the Revenue Act of 1913.<sup>4</sup> But neither upon their initial enactment nor during the ensuing decades have these exemptions elicited more than cursory legislative explanation, save for matters of technical detail. Commentators have been almost equally silent.<sup>5</sup> These decades of benign neglect may have reflected a conviction that the wisdom of tax exemption was self-evident, that the basic policy was politically invulnerable to change, or that taxation in this area would bring in little revenue. But there have been several departures from this legislative tolerance in recent years.<sup>6</sup> This change in attitude, in our view, amply warrants a re-examination of a policy long accepted almost without question.

Although it is common practice (as in the title of this article) to refer to the tax exemption enjoyed by "nonprofit organizations," the Internal Revenue Code<sup>7</sup> exempts a wider range of groups than the

1. See generally Reiling, *Federal Taxation: What Is a Charitable Organization?*, 44 A.B.A.J. 525, 526 (1958); 50 CONG. REC. 1306 (1913) (discussion of state constitutional exemptions of scientific and benevolent organizations from property taxation).

2. Act of Aug. 27, 1894, ch. 349, § 32, 28 Stat. 556. There was an earlier recognition of exemption for "literary, scientific, or other charitable institutions" by the Internal Revenue Service. G. BOUTWELL, A MANUAL OF THE DIRECT AND EXCISE TAX SYSTEM OF THE UNITED STATES 275 (1863).

3. Act of Aug. 9, 1909, ch. 6, § 38, 36 Stat. 112.

4. Act of Oct. 3, 1913, ch. 16, § 2(G), 38 Stat. 172.

5. See generally Stone, *Federal Tax Support of Charities and Other Exempt Organizations: The Need for a National Policy*, 1968 U. SO. CAL. TAX INST. 27, 28-30 & nn.3-7 (contains extensive bibliographies and is one of the few articles to concern itself with basic issues rather than details).

6. The imposition of a tax on the unrelated business income of many charities by the Revenue Act of 1950, 64 Stat. 906, see pp. 320-22 *infra*, was the first of these inroads. It was followed by the special tax and other constraints imposed in 1969 on private foundations, INT. REV. CODE OF 1954, §§ 4940-4948, see p. 326 *infra*, and the imposition in 1975 of a tax on political organizations, INT. REV. CODE OF 1954, § 527, see pp. 328-29 *infra*.

7. Current provisions of the Internal Revenue Code, 26 U.S.C., will hereinafter be cited by section number only.

“nonprofit” label implies. The best known exempt organizations—charitable institutions, schools, colleges, churches and the like—serve the interests of society in a broad sense, ordinarily without economic benefit to their organizers or benefactors. But many other exempt organizations (such as chambers of commerce, consumer cooperative societies, and labor unions) are operated primarily for the economic benefit of their members; they are “nonprofit” groups only in the limited sense that they do not engage in business with the general public for the benefit of investors.<sup>8</sup> Moreover, there are differences in tax treatment under the Code within the broad category of “exempt organizations.” A few are exempt regardless of the nature of their income; others lose their exempt status on receiving income from proscribed sources; most are taxed on their “unrelated business income” and some on “passive” investment income as well; some but not all lose their exemption if they engage in specified political activity; some qualify only if they were organized before a specific date; and there are numerous other distinctions among the many subspecies of exempt organizations listed in § 501(c) and other sections of the Code.

In the early days of the federal income tax, however, all nonprofit organizations were lumped together and exempted from tax as though fungible members of an undifferentiated mass. Congress enunciated no developed theory for this practice. But in a groping way the few lawmakers who commented on the issue suggested that an income tax could appropriately be imposed only on activities conducted for profit, and that crucial statutory notions like “net income” and “business expenses” do not ring true when applied to nonprofit organizations. The Revenue Act of 1894 imposed a two percent corporate tax on “net profits or income above actual operating and business expenses . . . of all . . . corporations, companies, or associations doing business for profit . . . .”<sup>9</sup> Perhaps because the distinction between profitmaking corporations and nonprofit institutions was thought obvious, Congress devoted little discussion to a separate section of the Act exempting various charitable, religious, educational, and fraternal benefit organizations from income taxation. The most extensive recorded debate was provoked by the exemption of mutual life insurance companies, which was successfully defended on the ground that these

8. See note 15 *infra*.

9. See note 2 *supra*.

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companies are not “conducted as a business for gain,” and are therefore inappropriate subjects for income taxation.<sup>10</sup>

Shortly after ratification of the Sixteenth Amendment, Representative Cordell Hull, author of the Revenue Act of 1913, argued in Congress against an explicit expansion of its exemption clauses to embrace “benevolent” and “scientific” organizations, on the ground that the statutory reference to “net income” automatically excluded all nonprofit organizations:

Mr. Chairman, I simply desire to say . . . that this bill contains the usual language exempting all corporations of the different kinds mentioned and indicated in the exemption clause. Of course any kind of society or corporation that is not doing business for profit and not acquiring profit would not come within the meaning of the taxing clause of paragraph G [taxing the “entire net income” of every corporation, joint-stock company or association]. So I see no occasion whatever for undertaking to particularize . . . I think the better way is to follow the exemption clause that has been well defined and understood heretofore without any particular objection.<sup>11</sup>

In administering the new law, however, the Treasury was inclined to treat the particularized list of exempt organizations as exclusive rather than to interpret the statutory reference to “net income” as conferring blanket exemption on all nonprofit organizations. Congress responded by expanding the exemption clauses when enacting the Revenue Act of 1916.<sup>12</sup> Although in subsequent years nonprofit organizations that could not bring themselves within an explicit exemption did not ordinarily claim that they were implicitly exempted by the statutory references to “income,” there are occasional echoes of this broader rationale for exempting such groups. The tax status of political parties, for example, was not prescribed by statute until 1975, but they had not previously filed tax returns, in part no doubt be-

10. 26 CONG. REC. 6623 (1894) (remarks of Sen. Hill). The same rationale was applied to exemptions from the excise tax on corporations imposed by the Revenue Act of 1909. *See* 44 CONG. REC. 393 (1909) (remarks of Sen. Aldrich, Finance Committee Chairman, who proposed the corporate excise tax).

11. 50 CONG. REC. 1306 (1913). *See also* 44 CONG. REC. 3937-39 (1909) (fraternal beneficiary societies and building and loan (“homestead”) associations implicitly exempted if not operated for profit).

12. H.R. REP. NO. 64-922, 64th Cong., 1st Sess. 4 (1916):

It was deemed advisable to specifically extend the exemption to other corporations similar to those enumerated in the present law as exempt from tax in view of the fact that the experience of the Treasury Department has been that the securing of returns from them has been a source of expense and annoyance and has resulted in the collection of either no tax or an amount which is practically negligible.

cause the concept of "income" seemed ill-adapted to their objectives, receipts, and activities.<sup>13</sup>

It is not surprising that the early legislative history of the tax exemption reveals no systematic analysis. The focus of Congress was (indeed, still is) on profitmaking organizations, investors, and wage earners, not on charities, churches, fraternal societies, labor unions, and other nonprofit groups which could be, at most, marginal targets for the tax collector. No wonder it was not thought necessary or worthwhile to disentangle the various, sometimes inconsistent, strains of thought in the legislative discussion of the tax exemption of nonprofit organizations. At different times and in different contexts, Congress has rested income tax exemption on a number of distinct rationales: a lack of fit between the concept of "income" and the objectives of nonprofit organizations; their meager potential as sources of revenue; the nuisance of recordkeeping for groups that often operate informally and rely heavily on voluntary services; and the praiseworthy benevolent spirit animating such groups.

In retrospect, however, we are struck not so much by the rudimentary state of the early analysis, though rudimentary it surely was, as by the legislative perception, however groping, that nonprofit organizations are not suitable targets for an income tax. In our view, for reasons that will be developed at some length in this article, this was a sound judgment deserving more attention and respect than it has received from tax scholars. Moreover, we believe that it is sounder both in theory and as a basis for legislative action than the competing view that statutory exemptions for nonprofit organizations constitute loopholes in a "normal" tax structure or special privileges requiring affirmative justification.<sup>14</sup>

13. See note 70 *infra*.

14. Using language that is strikingly similar to recent discussions of "tax expenditures," a 1958 comment on the tax exemption of charitable institutions asserted that the exemption "differs only in method from a disbursement of government funds" and can be justified only "when the public interest is served in much the same manner as when public funds are properly expended." Reiling, *supra* note 1, at 595. For the concept of tax expenditures, see OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSES, BUDGET OF THE UNITED STATES 1976, at 101-17 (1975); Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969); Surrey & Hellmuth, *The Tax Expenditure Budget—Response to Professor Bittker*, 22 NAT'L TAX J. 528 (1969); Bittker, *The Tax Expenditure Budget—A Reply to Professors Surrey & Hellmuth*, 22 NAT'L TAX J. 538 (1969). The exemption of credit unions is listed as a tax expenditure in the 1976 Budget, OFFICE OF MANAGEMENT AND BUDGET, *supra* at 108 (Table F-1), but other nonprofit organizations are not included. It is not clear whether they are omitted because the amounts involved are too small to be significant or cannot be estimated with reasonable accuracy, or because, as argued in this article, the exemptions can properly be

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The major shortcoming in the early legislative attitude toward nonprofit organizations, in our opinion, was a failure to give effect to the distinction alluded to earlier in this article between "public service" and "mutual benefit" organizations.<sup>15</sup> To foreshadow our conclusions, we will argue that nonprofit organizations engaged in "public service" activities, broadly conceived, should be wholly exempted from income taxation, because they do not realize "income" in the ordinary sense of that term and because, even if they did, there is no satisfactory way to fit the tax rate to the ability of the beneficiaries to pay. The principal types of organizations, all of which currently enjoy some form of tax exemption, that we would place in the public service category, are the following:

1. Charitable organizations
2. Educational institutions
3. Scientific organizations
4. Social welfare organizations
5. Churches and other religious organizations
6. Political parties<sup>16</sup>

regarded as routine aspects of the income tax structure rather than as digressions from an as yet undefined comprehensive tax base.

For a systematic examination of the tax treatment of entities, see Klein, *Income Taxation and Legal Entities*, 20 U.C.L.A. L. REV. 13 (1972).

15. For these labels, and for other insights, we are indebted to an unpublished manuscript by Professor George Cooper (on file with *Yale Law Journal*) proposing a revision of existing law to accord different tax treatment to these two categories of organizations.

In using the distinction, we do not mean to deny that the benefactors of public service organizations may derive "psychic" income from their benevolence, or conversely that members of labor unions, chambers of commerce, and consumer cooperatives may believe that their organizations confer benefits on the public while assisting their memberships. Nor are we oblivious to the possibility that persons active in both categories of organizations, when examined under the microscope of psychoanalysis or the telescope of economic theory, may be found to be motivated by their own psychological or economic objectives. (The same may be true of members of the House Appropriations Committee, George Meany, Ralph Nader, and other worthy citizens; but the Internal Revenue Code taxes them only on their salaries, not on any bonuses in the form of psychic income.) Since at either of these levels of analysis, the issues canvassed in the article pale into insignificance, we are content with the more mundane assumption that there is an operationally useful distinction between public service and mutual benefit organizations.

16. We discuss briefly the tax treatment of political parties, *see* pp. 303-04 *supra*; pp. 328-30 *infra*, but the role of money in American politics has many tax ramifications which we have, reluctantly, chosen to pass over in silence. An adequate examination of these issues would plunge us into sociopolitical and constitutional problems tangential to our main themes, including analysis of such overarching nontax issues as the Federal Corrupt Practices Act, 18 U.S.C. §§ 591, 597, 599, 610 (Supp. IV 1974), and its recent partial invalidation in *Buckley v. Valeo*, 96 S. Ct. 612 (1976). The longstanding refusal by the Treasury Regulations to allow taxpayers to deduct profit-related lobbying expenses as business expenses under § 162 (summarized in *Cammarano v. United States*, 358 U.S. 498, 503 n.6 (1959), and superseded in 1962 by the enactment of § 162(e)), the denial of tax exemptions to § 501(c)(3) organizations engaging

By contrast with these public service organizations for which complete exemption seems suitable, "mutual benefit" organizations are best viewed, in our opinion, as conduits through which the members pursue their own ends. The activities of such an organization should be imputed to its members as though there were no intervening entity. On this theory, the organization as such would not be taxed, but the members would be taxed if and to the extent that the group activities, when imputed to them, generated income for them.<sup>17</sup> Current law confers some form of tax exemption on a bewildering array of mutual benefit organizations.<sup>18</sup> We shall discuss the following, which appear to be the most important within this broad category:

1. Social clubs
2. Consumer cooperatives and similar organizations
3. Labor unions
4. Trade associations

In this article we are concerned with the income tax exemption accorded to both public service and mutual benefit organizations on their own receipts, not with the right of benefactors to take income, gift, or estate tax deductions for their gifts and bequests to nonprofit organizations. Because these quite separate issues are often confused, however, it is important to note that contributions can be deducted by the donor if the recipient is a charitable, educational or religious organization, and that there is also a recently enacted token deduction

in any of a wide range of political activities, and the denial by § 271 of bad debt deductions for loans to political parties can all be regarded as efforts to free the political process from the influence of wealth, or, from another perspective, as lopsided interventions by government imposing disabilities on some groups and types of political activity but not on others. See generally Boehm, *Taxes and Politics*, 22 TAX L. REV. 369 (1967); Clark, *The Limitation on Political Activities: A Discordant Note in the Law of Charities*, 46 VA. L. REV. 439 (1960); Fogel, *To the I.R.S., 'Tis Better to Give than to Lobby*, 61 A.B.A.J. 960 (1975); Troyer, *Charities, Law-Making, and the Constitution: The Validity of the Restrictions on Influencing Legislation*, N.Y.U. 31ST INST. ON FED. TAX 1415 (1973).

17. The imputation of income to the members of mutual benefit societies entails deferring the tax until the benefits are actually received, while not taxing the societies themselves. This treatment can be compared with that accorded "deferral organizations," such as teachers' retirement fund associations (§ 501(c)(11)) and funds for the payment of supplemental unemployment benefits (§ 501(c)(17)). Both organizations are exempted from tax by § 501(a). The beneficiary of retirement fund payments, however, is taxed upon receipt of those payments to the extent that they exceed his contributions. § 72. The recipient of unemployment benefits from a private fund is taxed in the same way. Rev. Rul. 59-5, 1959-1 CUM. BULL. 12.

18. But some nonprofit mutual benefit societies are taxed. One example is the American Automobile Association, discussed p. 350 *infra*, which is denied exempt status as a social club because its activities do not involve the requisite "social contacts" between members and does not qualify for any other exemption. See also Rev. Rul. 70-32, 1970-1 CUM. BULL. 132, denying exemption to a flying club, apparently because the nature of the sport precluded "significant commingling of members."



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or credit for certain political contributions.<sup>19</sup> Payments to other types of nonprofit organizations do not entitle the donor to a deduction, unless the payment (union dues, for example) qualifies as a "business expense" within the meaning of § 162 of the Internal Revenue Code.<sup>20</sup>

### I. The Tax Status of "Public Service" Organizations

#### A. *Measuring the "Income" of Public Service Organizations*

Though differing in form and in the boundaries of their permissible activity, all exempt organizations engaged in public service activities share one common feature: if they were deprived of their exempt status and treated as taxable entities,<sup>21</sup> computing their "net income" would be a conceptually difficult, if not self-contradictory task. From its inception, the federal income tax has been imposed not on gross receipts or gross income, but on an adjusted net amount—roughly speaking, gross income less business expenses. As a guide in computing "net" or "taxable" income, an extensive body of legal and accounting principles derived from business and financial practice has been developed. But these principles rest on the premise that the organization seeks to maximize its profit, and hence are not a satisfactory way of measuring the success of organizations that reject this basic premise.<sup>22</sup> When the familiar methods of income measure-

19. Section 41 allows a maximum credit for political contributions in a taxable year of \$25 (\$50 for a joint return under § 6013). Alternatively, under § 218, the taxpayer may deduct up to \$100 (\$200 on a joint return). Pub. L. No. 93-625, §§ 11(a), (d), 12(a), (b), 88 Stat. 2108 (1975).

20. Dues and assessments paid by members of labor unions are deductible under § 162 as business expenses, Rev. Rul. 72-463, 1972-2 CUM. BULL. 93, but not if the employee elects the standard deduction. See §§ 62(2), 63(b); p. 354 *infra*. Similarly, payments to pension funds which are required as a condition of union membership are deductible. Rev. Rul. 54-190, 1954-1 CUM. BULL. 46. At the other end of the employment spectrum, corporations and occasionally businessmen may be able to deduct dues paid to social and other clubs if they can demonstrate that these memberships are maintained for "business purposes" only. See § 274; George Durgom, 33 CCH Tax. Ct. Mem. 276 (1974); Anthony Quinn, 33 CCH Tax. Ct. Mem. 310 (1974). See also § 170(c)(3) and (4), allowing charitable deductions for contributions to veterans' posts and, under certain conditions, to fraternal orders.

21. For present purposes, it does not matter whether the organization is treated as a corporation or as a trust in computing the amount of the hypothetical tax; we are concerned here only with the threshold problem of measuring its "income." Even if it were treated as a partnership, the organization's tax status would raise similar issues, since its "income" (or loss) would then have to be computed in order to allocate an appropriate amount to each "partner." See Sanden, *What to Do About the Loss of Exemption: Effect Upon the Organization and Its Members*, N.Y.U. 24TH INST. ON FED. TAX. 167 (1966).

22. The accounting profession has had to develop special procedures for analyzing the financial affairs of exempt organizations since "[t]he concept of profit accountability typically present in private business is not pertinent to most nonprofit entities." E.

ment prescribed by the Internal Revenue Code, the accounting profession, or administrative practice are applied to nonprofit organizations, these methods must be stretched to, or beyond, the breaking point.

This result can be readily illustrated by a simple example.<sup>23</sup> Assume that a charitable organization's receipts and disbursements for the year are as follows:

<i>Receipts:</i>	(thousands)
1. Interest from endowment	\$100
2. Membership dues	25
3. Gifts and bequests	75
4. Total receipts	<u>\$200</u>
 <i>Disbursements:</i>	
5. Salaries of staff	\$ 25
6. Medical welfare program for indigent persons	125
7. Total disbursements	<u>\$150</u>
 <i>Net:</i>	
8. Receipts less Disbursements (line 4 minus line 7)	<u>\$ 50</u>

The first step in computing this organization's hypothetical taxable income is to take account of its endowment income (line 1), but nothing else is this simple. Should the dues paid by its members (line 2) be treated as gifts to the organization and excluded from gross income under § 102, which provides that gifts and bequests are not taxable? Or are dues the functional equivalent of business income because the organization has obtained them by advertising its activities, promising to apply the funds to its announced charitable purposes, and allowing the members to participate in its affairs in the manner specified by its charter and by-laws? Similarly, do the gifts and bequests

HENKE, ACCOUNTING FOR NONPROFIT ORGANIZATIONS 9 (1966). See also M. GROSS, FINANCIAL AND ACCOUNTING GUIDE FOR NONPROFIT ORGANIZATIONS 13-14 (1972):

In oversimplified terms, it might be said that the ultimate objective of a commercial organization is to realize net profit for its stockholders through the performance of some service wanted by other people, whereas the ultimate objective of a nonprofit organization is to meet some socially desirable need of the community or its members.

So long as the nonprofit organization has sufficient resources to carry out its objectives, there is no real need or justification for "making a profit" or having a surplus.

For an application of these principles to a specific area, see AMERICAN HOSPITAL ASSOCIATION, CHART OF ACCOUNTS FOR HOSPITALS (1973).

23. The example and discussion are based on Bittker, *Churches, Taxes and the Constitution*, 78 YALE L.J. 1285, 1298-99 (1969). The senior author apologizes to his faithful readers, if any, for the partial overlap.

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(line 3) qualify for exclusion from the organization's gross income under § 102, or should that provision be restricted to gifts and bequests received by individuals in a personal context, and not applied to amounts received by an organization as a result of its systematic solicitation of contributions? To the extent that dues, gifts, and bequests are used to increase the organization's endowment, should they be treated as contributions to capital, excluded from gross income under § 118?

At a more fundamental level, in view of the organization's duty to use contributions for its charitable purposes, should it be regarded as a mere conduit through which the funds move from the donor to the ultimate recipients, without creating any tax consequences for the intermediary?<sup>24</sup> If an individual puts funds into a separate bank account to be used by him for charitable purposes, the deposit itself (as distinguished from interest thereon) could hardly be regarded as creating income. Should the dues and contributions received by a charitable organization be seen as a series of such individual deposits, which do not become taxable income simply because they are jointly administered by, or for, the benefactors? Or should the organization be treated as having a life of its own, separate from its contributors, and thus as having "income" when it collects funds that will be disbursed in a significantly different manner, given the natural evolution of bureaucracies, from the way the individuals would have spent their own funds if acting independently?

Once these puzzles in the definition of the organization's gross income have been solved, we must then decide which expenses may be deducted to arrive at net income. Do staff salaries (line 5) constitute "ordinary and necessary business expenses" under § 162, when paid by an organization that does not seek profits? Individuals who engage in such benevolent activities as giving money to needy relatives, acquaintances, or beggars cannot deduct their contributions, let alone any expenses for travel, advice, or bookkeeping incurred in distributing their largesse, no matter how extensive and systematic their generosity may be.<sup>25</sup> Is this the proper analogy in deciding

24. See Edward F. Webber, 21 T.C. 742 (1954), *aff'd sub nom.* Webber v. Commissioner, 219 F.2d 834 (10th Cir. 1955) (contributions to a radio preacher that were earmarked by donors for foreign missionaries held not income to taxpayer, who served as a conduit, and had no right to retain the donations).

25. Under § 170(c), gifts qualify as deductible charitable contributions only if the recipient is a corporation, trust, foundation, or similar organization. For denial of the deduction when the recipient lacked the proper institutional status, see DeJong v. Commissioner, 309 F.2d 373 (9th Cir. 1962); Chester D. Tripp, 32 P-H Tax Ct. Mem. ¶ 63,244 (1963); Rev. Rul. 58-303, 1958-1 CUM. BULL. 61.

whether a charity can deduct its expenses, or should it instead be treated as an enterprise whose "business" is benevolence? The answer to these questions will bear on the proper classification of the medical and welfare program (line 6). If the salaries paid to the organization's staff are deductible business expenses because the charity's "business" is charity, then the funds given by it to the indigent should also be treated as business expenses.

The Internal Revenue Service has persistently asserted, with substantial success in the litigated cases, that expenditures not motivated by the desire for profit cannot be deducted as business expenses under § 162. For example, the taxpayer is allowed to offset any receipts generated by his "hobbies" against his related expenditures, but cannot deduct the loss if expenditures exceed receipts.<sup>26</sup> If applied to nonprofit organizations, this interpretation of § 162 would lead to a bizarre result, which can be illustrated by a simple example. Assume two retirement homes for the poor, each of which is operated by a nonprofit (but nonexempt) corporation and has 100 guests whose maintenance costs \$3,000 per year each. If the first home operates at the breakeven point because it charges each guest \$3,000 annually, it will, like the hobby farmer operating a breakeven farm, have neither income nor loss. If the second home has an endowment of \$3 million, producing \$300,000 interest per year, and is hence able to open its doors to guests who cannot afford to pay at all, it will have \$300,000

26. § 183 enacted in 1969, Pub. L. No. 91-172, 83 Stat. 571; § 183(e) added by amendment in 1971, Pub. L. No. 92-178, 85 Stat. 525. See Oshins, *Proposed Regulations Provide New Rules for the Hobby Loss Game*, 35 J. TAX 214 (1971). For a further discussion of this question, see *Iowa State Univ. of Science & Technology v. United States*, 500 F.2d 508, 521-22 (Ct. Cl. 1974) (cases cited therein). In *Estate of Leslie E. Johnson*, 56 T.C. 944, 948 (1971), the Tax Court assumed that a nonprofit institution has no "income" under current law if it operates at an economic loss: "As a practical matter a university's exemption from taxation is generally no more than an amnesty from filing returns since generally the costs of operation exceed its income." This assumption is belied by *Iowa State*. (By a curious coincidence, *Johnson's Estate* involved an employee of the very same university.) Compare *Anaheim Union Water Co. v. Commissioner*, 321 F.2d 253 (9th Cir. 1963) (a nonexempt corporation organized to supply water to its shareholders without profit used income from collateral activities to reduce water charges to below its cost, and was permitted to deduct water expenses from its collateral income, as well as from the water income), with *Chicago & W.I.R.R. v. Commissioner*, 303 F.2d 786 (7th Cir.), *vacated on other grounds*, 310 F.2d 380 (7th Cir. 1962) (contra).

Section 277, enacted in 1969, allows nonexempt membership corporations to deduct expenses of providing goods and services to members from income attributable to such activities, but not from income attributable to unrelated activities or investments; until its enactment, there was very little authority on the computation of income in the case of genuinely nonprofit organizations (as distinguished from those conducted for personal gain) which for some reason fail to qualify for tax exemption. For the uncertain status of political parties before the enactment of § 527 in 1974, see S. REP. NO. 93-1357, 93d Cong., 2d Sess. pt. J (1974).

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of gross income<sup>27</sup> but no deductible expenditures, because its maintenance charges do not arise in a profit-seeking venture.<sup>28</sup> It will, therefore, be subject to a corporate tax of \$138,500 (at current rates), or more than 45 percent of its gross income, even though its guests are wholly indigent, while the other institution, whose guests may have been better off to begin with, will have no taxes to pay.<sup>29</sup>

At first blush, the comparison may seem incomplete, since the personal tax status of the paying guests of the first institution has not been taken into account. Is the tax on the free institution simply a substitute for the income taxes paid by the paying guests of the first institution on their personal income, so that their \$3,000 annual fees are after-tax amounts, while the expenditures of the free institution are also after-tax amounts? The trouble with this effort to reconcile the two cases is that the paying guests may be below the taxable income level, or derive their \$3,000 fees from exempt social security benefits, gifts from members of their families, or other exempt sources. And even if their income had been fully taxed, their effective rate would not have been comparable to the 45 percent tax imposed on the free institution (and hence indirectly on its guests) unless they came from the upper reaches of the income ladder—\$75,000 or above. Moreover, this way of analyzing the two cases suggests that the endowment income of the free institution should be imputed to the guests it supports, and this in turn implies that if they are below, or even substantially above, the poverty level, they are being grossly overtaxed.

In an effort to avoid this unpalatable dilemma, it might be argued that the concept of “business expenses” should be enlarged, by statutory amendment if necessary, to permit nonprofit institutions to deduct all amounts expended to advance their charitable or other nonprofit objectives. This would achieve substantially the same result as

27. Even though its clientele is limited to indigent guests, the organization might fail to qualify for exemption under § 501(c)(3) or § 501(c)(4) (as construed in *Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii)* (1959)) because of a nonqualified organizational status, *see* note 25 *supra*, because it engaged in political activities, or for other reasons. *See* note 130 *infra*.

28. *See* *Del Ray Fraternity, Inc.*, P-H TAX CT. REP. & MEM. DEC. (Tax Ct. Mem.) ¶ 75,206 (June 26, 1975) (nonexempt nonprofit organization may not deduct scholarships as business expenses). The discussion in the text is concerned solely with expenses incurred in maintaining nonpaying guests; the organization would be allowed to deduct the cost of collecting its income, safeguarding its endowment, and similar activities related to its income-producing property.

29. The illustration in the text is inspired by *Eden Hall Farm v. United States*, 389 F. Supp. 858 (W.D. Pa. 1975), where the Internal Revenue Service sought to tax the gross income—except for deductions not here relevant—of a nonprofit organization operating a vacation home on a no-fee basis. *Cf.* *People's Educ. Camp Soc'y, Inc. v. Commissioner*, 331 F.2d 923 (2d Cir.), *cert. denied*, 379 U.S. 839 (1964) (vacation resort operated by taxable, but nonprofit, organization; taxed on net profits, not its gross receipts).

tax exemption, save for amounts earned in one year and either accumulated for future expenditure or spent on buildings and equipment. Since these accumulations and capital outlays are irrevocably dedicated to the institution's nonprofit objectives, however, we do not regard this alternative mode of computing a nonprofit organization's income as very appealing; nor can we see that it has any economic or social advantages over a regime of complete exemption.

If, as we believe, any attempt to treat charitable activity as a "business" is self-contradictory, can the income of a charitable organization be computed by treating its disbursements as charitable contributions, to be deducted under the rules applicable to other philanthropically inclined taxpayers? Although this approach seems more promising at the outset as a method of computing income than the § 162 route just examined, it proves on further analysis hardly more satisfactory.

To begin with, if the charity must rely on the current statutory provision (§ 170) for its right to deduct charitable contributions, it would encounter the obstacle that § 170 permits contributions to be deducted only if they are channeled *by the taxpayer claiming the deduction* through a nonprofit organization.<sup>30</sup> Natural persons and business organizations cannot deduct charitable contributions made directly to needy individuals; and since philanthropic organizations are themselves tax-exempt, there has heretofore been no need to allow them to deduct such benefactions. If they had to rely on § 170, and it could be twisted to allow a deduction for direct grants to needy persons when paid by a charitable organization, another obstacle is encountered: taxpayers are allowed to deduct charitable contributions only up to specified percentages of their adjusted gross or taxable income—five percent, in the case of corporations.<sup>31</sup> If charitable organizations were subject to these percentage restrictions, they would no doubt consistently report higher profit margins on their gross receipts than the nation's most successful business corporations. A charity with \$100,000 of income, for example, could deduct only \$5,000 of charitable contributions if the five percent limit of § 170(c) applied, leaving 95 percent of its income as taxable "profit" even if the entire amount was spent to advance its eleemosynary objectives. Yet removal of the percentage limit for charities would mean that charities using all of their receipts for charitable purposes would be "unprofitable" as judged

30. See note 25 *supra*.

31. § 170(b)(2). For an attempted application of this percentage restriction to a nonprofit organization by the Internal Revenue Service, see *Eden Hall Farm v. United States*, 389 F. Supp. 858 (W.D. Pa. 1975). The Service's computation became moot when the court held that the organization was exempt under § 501(c)(4).

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by Internal Revenue Code standards, while, conversely, those making the smallest current contributions would be the most "profitable," even though the retained funds were allocated for charitable expenditures in the immediate future.

Perhaps this curiously inverted standard of success might be avoided by still another modification of customary standards of income measurement. Existing law permits taxpayers to deduct charitable contributions only in the year of payment; promises do not ordinarily generate deductions until the obligation is discharged by an actual payment.<sup>32</sup> This insistence on "payment" reflects the fact that impulsive taxpayers may promise more than they will deliver, and then consume their income rather than use it to pay their charitable pledges. A similar skepticism underlies the fact that taxpayers engaged in business are rarely allowed to deduct reserves for future business expenses, such as the estimated cost of complying with a three-year guarantee of products sold in the current year.<sup>33</sup> However unavoidable the expenditures may seem, circumstances may change and the anticipated liabilities not materialize, in which event the reserves will inure to the benefit of the shareholders or partners of the enterprise.

By contrast, however, a charitable institution's income is, at the very moment of receipt, *irrevocably* dedicated to nonprofit purposes, with no possibility of reversion to the donor, directors, or other controlling persons. For this reason, it would be logical to allow a deduction *at that moment* in computing the organization's income.<sup>34</sup> The charity might thus be regarded as an accrual taxpayer whose entire income is immediately committed to expenses related to its altruistic functions. If this suggestion were to be adopted, of course, the deduction would always offset the charity's retained income, leaving nothing to be taxed. Tax immunity would then have been achieved, but by a more roundabout route than the straightforward exemption of current law.

So far, we have not complicated the problem of measuring a nonprofit organization's income by assuming any expenditures for non-

32. See § 170(a)(1), permitting contributions to be deducted only in the year when "payment" is made, subject to the limited exception of § 170(a)(2) (accrual basis corporations may deduct contributions in the year when they are authorized by the board of directors, if payment is made within the first 75 days of the following taxable year).

33. See B. BITTKER & L. STONE, *FEDERAL INCOME, ESTATE AND GIFT TAXATION* 839-40 (4th ed. 1972).

34. Cf. § 642(c)(1) (trusts and estates allowed an unlimited charitable deduction for amounts distributed or permanently set aside for charitable purposes). For the 1969 revision of this provision, see *Tax Section Recommendation No. 1975-3*, 28 *TAX LAW* 1037, 1038 (1975).

deductible capital outlays, but the effect of such investments must be examined. If the Church of the Gospel spends all of its receipts to support missionaries who live in tents, does it have less "net income" than the Church of the Adoration, which uses some of its receipts to construct a basilica (with an estimated useful life of 50 years) and to purchase a reliquary whose useful life cannot be predicted, at least not by the secular engineering methods with which the Internal Revenue Service is conversant? If both churches were ordinary business enterprises, the former could deduct all of its expenses currently, and hence would have no net income, while the latter would have to report income currently, because it could neither deduct nor depreciate the cost of the reliquary and could depreciate only a small fraction of the cost of the basilica. No doubt a church with reliquaries and buildings is "rich" in certain senses; Savonarola might denounce its possessions as an affront to the Almighty and Sotheby's could sell them on the auction block. But in the more modest framework of an income tax system, much can be said for treating both churches alike, even if equality is not compelled by the establishment clause of the First Amendment.

Depending, then, on the answers to these riddles, and depending also on such statutory clarification as might be forthcoming, the "net income" or "loss" of our hypothetical charity is one of a dozen different amounts. By itself, this possibility, though exasperating, is not unprecedented; "income" is a vaguer concept than the layman imagines. But our excursion has taken us through several unusually murky caverns, leaving—in our view—no escape from the conclusion that the very concept of "taxable income" for charitable or other public service organizations is an exotic subject more suited to academic speculation than to practical administration.<sup>35</sup>

#### B. *The Appropriate Tax Rate for Public Service Organizations*

If despite these conceptual difficulties a satisfactory measure of the income of a charitable organization can be found, or if the difficulties are simply overridden by legislative fiat in favor of an arbitrary formula, we then face the problem of prescribing a suitable tax rate. This should not be plucked from the sky, nor should the rates prescribed for other taxpayers be applied to public service organizations unless

35. When Congress has explicitly decided to tax the income of nonprofit organizations, it has avoided the task of prescribing rules to compute their overall income and has instead taxed only such restricted and specifically defined amounts as their unrelated business income, or certain investment income. See pp. 316-27 *infra*.



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their circumstances are comparable. Contemporary tax theorists would want a rate schedule that was consonant with either the "benefit" or the "ability to pay" theories of taxation.<sup>36</sup> Though vague and malleable, these efforts to match the burden with the taxpayer's circumstances are less arbitrary than any alternative standard.

Ideally, since the economic burden of the tax will fall on the organization's ultimate beneficiaries (unless the tax prompts the benefactors to increase their gifts), the organization's income should be imputed to these recipients so it can be taxed at each one's personal tax rate. The difficulty with this approach, of course, is that the identity of the beneficiaries will rarely be known when the income is received by the organization; in this respect, they resemble the beneficiaries of a "sprinkling" trust.<sup>37</sup> Recognizing that the beneficiaries of a charitable organization are usually too widely dispersed to allow an accurate imputation of the association's income, Congress might tax the entity itself, as a surrogate for its beneficiaries, at the estimated average rate at which the income would be taxed to the individuals if an imputation were feasible. As an alternative, Congress might conclude that justice would be better served by foregoing any tax on the entity's income, lest the estimated rate be higher than an accurate imputation would have produced. This decision would draw strength from the fact that an average rate, even if low, is bound to overtax the most needy beneficiaries of most philanthropic organizations.

The fact that recipients of gifts, whether they benefit from personal generosity or institutional philanthropy, are allowed by § 102 of the Internal Revenue Code to exclude these receipts from their gross income provides independent support for a decision to exempt charitable

36. See, e.g., R. MUSGRAVE & P. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 192-204 (1973).

37. The Code contains elaborate provisions for taxing the income of trusts which do not regularly distribute all current income to beneficiaries. See §§ 665-669. The statutory scheme seeks to tax the income allocable to each beneficiary as if current income were entirely distributed every year. Each year the beneficiary is taxed on the current income distributed to him, while the trustee pays the tax on the undistributed income. The beneficiary and trustee pay at independent rates consonant with their separate taxable incomes.

In years when the trust distributes more than the current distributable income, the excess, called "accumulation distribution," is allocated to the earliest preceding year in which the trust did not distribute all of its current income. (The allocation for each preceding year is limited to that year's undistributed income.) This excess, together with the proportionate amount of taxes actually paid by the trust in that preceding year, is deemed to have been distributed to the beneficiary as income in that year. The beneficiary is then taxed at the rate at which he would have been taxed had the income actually been distributed to him; if necessary, he receives a credit for the amount of taxes already paid by the trust on that income. The beneficiary is thus, albeit belatedly, taxed according to his ability to pay.

organizations. Since direct gifts from the original donor to the ultimate recipients would be excluded from their gross income, it would not be inappropriate to allow the same amount to pass untaxed through the organization, viewing it as a conduit to convey gifts from donors to their beneficiaries, rather than as an entity with independent tax-paying ability.<sup>38</sup> Moreover, the benefits of a vast range of government services are received tax-free by citizens; this state of affairs has long been accepted as unavoidable, because it is simply not feasible to measure and impute the value of these benefits to the recipients in order to tax each person at an appropriate marginal rate.<sup>39</sup> The largesse of public service organizations is not much different, and this analogy argues for exempting their income from taxation, thus allowing their resources to pass intact to the beneficiaries.

### C. *The Legislative Retreat from Complete Tax Exemption*

Whether for the reasons just canvassed, or because of a more general attitude of benevolence toward charitable and other public service organizations, Congress for many years granted them a complete exemption from income taxation. This statutory immunity was partly withdrawn by Congress in 1950, however, and there have since been several other legislative retreats. We turn now to these statutory limitations on the unqualified exemption that prevailed from 1913 to 1950.<sup>40</sup>

#### 1. *The Tax on "Unrelated Business Income"*

In granting tax exemption to corporations "organized and operated *exclusively* for religious, charitable . . . or educational purposes," Congress clearly did not intend to disqualify nonprofit organizations that receive dividends and interest on their endowments. They are not organized and operated for the "purpose" of collecting income from

38. To be sure, Congress has chosen to distinguish between gifts to organized charities and gifts to individuals by allowing donors to deduct the former, but not the latter, as charitable contributions under § 170. But this distinction has its own rationale; see note 25 *supra*. The "conduit" theory advanced above would not embrace the income generated by the contributions while they were in the possession of the charity (*i.e.*, interest and dividends on its endowment): § 102 exempts gifts, but not the income earned thereafter on donated property.

39. See Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 935-38 (1967), reprinted in B. BITTKER *et al.*, *A COMPREHENSIVE INCOME TAX BASE? A DEBATE* 11-14 (1968).

40. In describing the 1913-1950 statutory exemption as "unqualified," we do not, of course, mean to disregard the loss of immunity that could be incurred by violating such statutory conditions as the prohibitions on legislative activities and on the inurement of the organization's earnings to private benefit.

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their investments, any more than they are organized and operated for the purpose of soliciting and collecting dues and contributions. Their investment income, like their other receipts, is collected for the purpose of supporting their exempt activities and hence is a means rather than an end. The same can be said of the profit derived by charities from the active conduct of a business, as was recognized in the major early litigated cases rejecting the Internal Revenue Service's attempt to tax their business profits.<sup>41</sup> As one court pointed out, if for some unforeseen reason a nonprofit organization could no longer serve the exempt functions for which it was created, "it would have no cause to continue in existence" even though its business activities were profitable.<sup>42</sup> Like dividends, interest, membership dues, and contributions, business profits are sought by such an organization not for their own sake, but only as a way of financing the organization's ultimate (and exempt) purposes.

The 1913-1950 status of so-called "feeder" corporations, which engage in investment and business activities for the sole benefit of an affiliated charitable organization, was more problematical. Since their profits go exclusively to the parent, the courts might have accorded them a kind of "piggyback" exemption, even though they do not carry out exempt functions directly; it would not have distorted the statutory language to hold that a feeder corporation was "organized and operated exclusively" for exempt purposes, given the fact that its profits were irrevocably dedicated to its parent's needs. At a time when the Supreme Court's "destination of income" test enjoyed its full vitality,<sup>43</sup> this view would seem to have been compelling. Moreover, if business or investment activities do not create tax liability when conducted directly by a charitable organization, there is little reason to treat them differently if the charity chooses to segregate them in a separate organization, in order to protect its endowment against tort liabilities or for other valid nontax reasons.

This spirit evidently animated the enactment in 1916 of what is now § 501(c)(2), exempting:

41. *See* *Trinidad v. Sagrada Orden De Predicadores De La Provincia Del Santismo Rosario De Filipinas*, 263 U.S. 578 (1924) (religious mission that earned income from rents, interest, dividends, and sales of wine and chocolate was exempt from income tax). The Court's "destination of income" test was applied even in cases where the business activities were more substantial. *See* *Unity School of Christianity*, 4 B.T.A. 61, 68 (1926) (holding exempt a religious corporation's earnings from publications and an inn); *San Springs Home*, 6 B.T.A. 198, 214 (1927) (income from such enterprises as a greenhouse, a cotton gin, and an electric generating plant).

42. *Unity School of Christianity*, 4 B.T.A. 61, 69 (1926).

43. *See* note 41 *supra*.

Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt under this section.

Because this provision embraces only title-holding feeder corporations, however, it inevitably created uncertainty about the tax status of subsidiaries vested by their parent organizations with broader investment and business functions. But in 1938, the Court of Appeals for the Second Circuit held, in a decision that quickly became a leading case, that the statutory exemption of title-holding feeder corporations was not exhaustive, and that other feeder corporations could qualify for exemption if their profits were dedicated to charitable purposes:

No reason is apparent to us why Congress should wish to deny exemption to a corporation organized and operated exclusively to feed a charitable purpose when it undoubtedly grants it if the corporation itself administers the charity.<sup>44</sup>

The principle established by this decision lasted until 1950, when Congress intervened to impose a tax on the so-called "unrelated business income" of charitable organizations and certain other nonprofit institutions.<sup>45</sup> This dramatic change was brought about by several widely publicized acquisitions of nationwide businesses by exempt organizations through feeder corporations, which thereafter claimed tax exemption for the previously taxable business profits. The most celebrated instance was the purchase of a large macaroni company by a

44. *Roche's Beach, Inc. v. Commissioner*, 96 F.2d 776, 779 (2d Cir. 1938) (Judge L. Hand dissented, arguing that the statutory exemption for titleholding corporations preempted the field). This decision did not deprive the statutory predecessor of § 501(c)(2) of a function; the Code (in § 501(c)) describes many exempt organizations by labels (e.g., "civic leagues," "chambers of commerce," and "fraternal beneficiary societies") that cannot be applied to their feeder corporations, with the result that the latter could claim exemption only if embraced by § 501(c)(2). By contrast, § 501(c)(3) refers to corporations "organized and operated exclusively for religious, charitable . . . or educational purposes," a description that is broad enough to embrace their feeder organizations without reference to § 501(c)(2).

After *Roche's Beach*, charitable organizations and their feeder corporations were entitled to tax exemption, regardless of the source of their income, except in unusual instances—primarily where business activities so far dwarfed the exempt functions that the "exclusively for religious, charitable . . . or educational purposes" requirement was violated. See, e.g., *Lichter Foundation, Inc. v. Welch*, 247 F.2d 431 (6th Cir. 1957); *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951); *Willingham v. Home Oil Mill*, 181 F.2d 9 (5th Cir. 1950). But see *University Hill Foundation v. Commissioner*, 446 F.2d 701, 702-04 (9th Cir. 1971). Nonprofit organizations not falling within § 501(c)(3) could not avail themselves of the principle of *Roche's Beach* unless their "feeder" corporations came within the narrow standards of § 501(c)(2). See *University Hill Foundation v. Commissioner*, *supra* at 702-08.

45. See Latchman, *Charitable Organizations and Federal Taxation*, 3 W. RES. L. REV. 99 (1951); Comment, *Colleges, Charities and the Revenue Act of 1950*, 60 YALE L.J. 851 (1951).

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feeder corporation organized for the benefit of New York University's law school. This acquisition, it was alleged, might lead to a monopoly in pasta products because, being tax-exempt, the feeder corporation could sell its merchandise for less, or use its tax-free profits to expand more rapidly, than its taxable competitors.

These predictions of unfair competition were rarely subjected to close analysis, and we know of no empirical examination of the results of such acquisitions.<sup>46</sup> In particular, it was never made clear why the price level that had maximized both the pretax and after-tax profits of the enterprise before the change of ownership would not continue to maximize its profits thereafter.<sup>47</sup> Equally mysterious was the unarticulated but widely accepted assumption that charities would compete unfairly with their taxable rivals in "active" manufacturing and mercantile pursuits, but not in "passive" investment areas. No one suggested, for example, that charities would lend their endowment funds or rent their real estate for less than the going rate, and thus drive private investors in these areas out of business; it was assumed, rather, that "passive" investments by charities were no threat to taxable enterprise.<sup>48</sup> Nor was there any discussion of the possibility that, if charities increased their ownership of active business enterprises, they would correspondingly reduce their ownership of marketable securities and other passive investments and, hence, compete less vigorously with taxable investors for these assets.

Moreover, the labels "active" and "passive" were accepted as though they denoted self-defining and clear-cut compartments, although in fact the spectrum of profit-oriented activity is not readily bisected. The owner of multi-unit residential real estate, for example, has many

46. For anecdotal material, see Mansfield, *Some Aspects of Taxation of Business Income of Exempt Organizations*, in 3 TAX REVISION COMPENDIUM 2067 (House Comm. on Ways & Means 1959); Sugarman, *Business Income of Exempt Organizations*, in *id.* at 2115. See generally Ely, *Federal Taxation of Income of States & Political Subdivisions*, in *id.* at 2091; Dunham, *Business Activities of Exempt Scientific Research Organizations*, in *id.* at 2127; Gilpin, *Business Income of Exempt Organizations—Tax Equalization—Electric Utility Service Organizations*, in *id.* at 2077; Harris, *Tax Exempt Organizations*, in *id.* at 2101.

47. At least in the short run, no reason for a change in pricing policies is apparent; and the long run results of shifting a business from taxable to tax-exempt status are hard to predict except on an unrealistic assumption of perfect competition in a state of equilibrium. See Comment, *Colleges, Charities, and the Revenue Act of 1950*, 60 YALE L.J. 851, 876 (1951); Klein, *supra* note 14, at 61-66.

48. But see Break & Pechman, *Relationship Between the Corporation and Individual Income Taxes*, 28 NAT'L TAX J. 341, 344 (1975), proposing that the tax on the unrelated business income of charitable organizations be extended to their investment income; though recognizing that this would reduce their ability to finance their activities, the authors say nothing about the relation of the proposed tax to the charitable beneficiaries' ability to pay, evidently because they view the tax as a method of subjecting the charitable institution itself to a "market test of the value of its activities."

options, including (1) leasing the entire project to an operator for an amount unrelated to the latter's profits, (2) leasing it to an operator for a percentage of the gross or net profits, (3) leasing the units to separate tenants on long term leases, or (4) renting the units as hotel accommodations to transients. The first of these arrangements is a "passive" investment; the fourth is an "active" business; the other two are less easily characterized. But all entail competition with private owners of similar property, and it is hard to see why the charity would be a more ruthless competitor, cut rents more severely, or expand more rapidly with its tax-free profits in one situation than in the others. When the 1950 legislation was proposed, there was some fear that the acquisition of taxable business enterprises by tax-free feeder corporations would narrow the federal tax base, but this danger seems, in retrospect, overstated if not wholly erroneous. This is because the sellers of the business would presumably reinvest the proceeds of the sale in new enterprises, marketable securities, rental real estate, etc., which would produce a taxable yield to restore the status quo ante. The charitable organization purchasing the enterprise, for its part, would shift its investment from assets producing tax-free dividends, interest, and rent to equally tax-free business profits.<sup>49</sup>

Still another aspect of the alleged competitive threat posed by charities was virtually disregarded in the 1950 debate: whether the trustees of nonprofit organizations would prove to be as energetic in the management of their enterprises, or as shrewd in selecting managers to act for them, as private entrepreneurs. An objective observer might have predicted that the business practices of charity-owned enterprises would be characterized more by caution than boldness.<sup>50</sup>

Whether the fear of "unfair competition" was rooted in reality or in fantasy, it carried the day. In 1950, Congress imposed the regular corporate tax on the "unrelated business income" of most charitable organizations and a number of other nonprofit groups, whether the income accrues directly to the exempt parent or to a subsidiary feeder corporation.<sup>51</sup> As expanded in 1969,<sup>52</sup> these provisions reach:

49. If the charitable organization borrowed funds to effect the acquisition, the lender would receive, and be taxed on, the same amount of interest that it would have received from advancing the same funds to a taxable borrower.

50. We know of no effort to examine post-acquisition history of businesses purchased by charitable organizations.

51. "The problem at which the tax on unrelated business income is directed is primarily that of unfair competition." S. REP. NO. 2375, 81st Cong., 2d Sess. 28-29 (1950), reprinted in 1950-2 CUM. BULL. 483, 504. For the history of the 1950 legislation, see *Veteran's Foundation v. United States*, 281 F.2d 912, 913-14 (10th Cir. 1960), and *United States v. Community Servs.*, 189 F.2d 421, 425-27 (4th Cir. 1951).

52. There were several statutory changes in the provisions on unrelated business income between 1950 and 1969. See Pub. L. No. 85-367, 72 Stat. 80 (1958); Pub. L. No.

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[T]he gross income derived by any [exempt] organization from any unrelated trade or business [as defined] regularly carried on by it, less the deductions allowed by [Chapter I, Subtitle A, of the Internal Revenue Code] which are directly connected with the carrying on of such trade or business . . . .<sup>53</sup>

An “unrelated trade or business” is

any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis of its [tax] exemption . . . .<sup>54</sup>

There are—as always in the Internal Revenue Code—numerous qualifications, conditions, and exceptions to the general rules just described.<sup>55</sup> And it should be noted that the organization’s exempt status is not lost or directly affected by the receipt of unrelated business income; the statutory remedy is limited to taxing that income.

The 1950 legislation did not withdraw the traditional exemption of “passive” income:

Dividends, interest, royalties, most rents, capital gains and losses, and similar items are excluded from the base of the tax on unrelated income because your committee believes that they are “passive” in character and are not likely to result in serious competition for taxable businesses having similar income. Moreover,

86-667, 74 Stat. 534 (1960); Pub. L. No. 88-380, 78 Stat. 333 (1964); Pub. L. No. 89-352, 80 Stat. 4 (1966); Pub. L. No. 89-809, 80 Stat. 1588 (1966).

53. § 512(a)(1).

54. § 513(a). See *Iowa State Univ. of Science & Technology v. United States*, 500 F.2d 508 (Ct. Cl. 1974) (university’s TV station constitutes an unrelated trade or business). See also § 513(c), enacted in 1969 to provide statutory support for a previously issued Treasury regulation requiring income from advertising to be treated as unrelated business income even though it appears in a periodical whose editorial content advances the organization’s exempt function; S. REP. NO. 91-552, 91st Cong., 1st Sess. 75 (1969); Lehrfeld, *The Unfairness Doctrine: Commercial Advertising Profits as Unrelated Business Income*, 23 TAX LAW. 349, 365 (1970). In 1976, the pre-1969 regulations were invalidated by *American College of Physicians v. United States*, 37 Am. Fed. Tax R.2d 76-806 (Ct. Cl. 1976).

55. Among the more important items *not* taxed as “unrelated business income” are income from dividends, interest, annuities, royalties, capital gains and losses, rents from real property (but not when received from an 80 percent controlled company or from investments which are debt-financed), and a \$1000 specific deduction. § 512(b). In addition, an “unrelated trade or business” does not include activities in which substantially all the work is performed by unpaid volunteers. § 513(a). See Note, *The Macaroni Monopoly: The Developing Concept of Unrelated Business Income of Exempt Organizations*, 81 HARV. L. REV. 1280 (1968). For problems in separating “related” from “unrelated” business income, see Kannry, *How Hospitals Can Minimize Their Potential Exposure to the Unrelated Business Income Tax*, 43 J. TAX. 166 (1975).

[income-producing investments] of these types have long been recognized as a proper source of revenue for educational and charitable organizations and trusts.<sup>56</sup>

But income from certain leases of debt-financed property was denied the status of exempt "passive" income and taxed as unrelated business income by the 1950 legislation,<sup>57</sup> which was expanded in 1969 to embrace a broader range of debt-financed acquisitions,<sup>58</sup> primarily on the theory that the exempt organization may be "trading on its exemption" by borrowing to acquire such property and using tax-free income to pay off the debt. According to the 1950 committee reports, these "bootstrap" transactions, if not checked, created a danger that "exempt organizations in the not too distant future may own the great bulk of the commercial and industrial real estate in the country."<sup>59</sup>

On analysis, however, these assertions are less persuasive than the rhetoric in which they were wrapped. To begin with, unlike an Oriental levitator, a charity cannot lift itself by its tax-exempt bootstraps if it borrows funds at eight percent to acquire assets that will yield

56. S. REP. No. 2375, 81st Cong., 2d Sess. 30-31 (1950), reprinted in 1950-2 CUM. BULL. 483, 506.

57. Revenue Act of 1950, ch. 944, § 422, 64 Stat. 948-50.

58. The expansion of § 514 was prompted by the decision in *Commissioner v. Brown*, 380 U.S. 563 (1965), in which petitioner sold all the stock in a closely held company to a charity for \$5,000 down (paid with company assets) and a \$1,300,000 non-interest bearing note which was to be paid off with future company income that could be earned tax-free by the charity. The Supreme Court upheld capital gains treatment for petitioners' gain, despite the Commissioner's argument that petitioner was using the charity's tax exempt status to convert the company's future business income, normally taxable at ordinary income rates, into capital gains. Section 514 was expanded, in the wake of *Brown*, on the recommendation of the Treasury and the Staff of the Joint Committee on Internal Revenue. See *Hearings Before the House Ways and Means Comm. on H.R. 15942 and H.R. 15943*, 89th Cong., 2d Sess. (1966); Cooper, *Trends in the Taxation of Unrelated Business Activity*, N.Y.U. 29TH INST. ON FED. TAX. 1999 (1971).

59. See note 56 *supra*. This is not the place for a disquisition on the law of property, or for a full examination of the Pickwickian sense in which charities "owned" the property involved in the kind of nonrecourse debt-financed transaction which was the subject of the *Brown* case. Suffice it to say that the proper image is not that of a proud freeholder, surveying his bountiful acres and lordling it over his cowering tenants. Throughout the entire term of the contract, the charity was an "owner" in name only of a debt-ridden business, bound hand and foot to the mortgage on the one hand and the business operator on the other; its "ownership" consisted of the right to a small spread (if it was earned at all) between the business's receipts and its payments, plus a reversion so far in the future that its discounted value was ordinarily close to zero. These observations suggest, in turn, the validity of Lanning's conclusion that:

The central bootstrap issue is the tax characterization of the transfer of the business . . . . [B]ootstrap owners appear to be receiving a steady flow of business profits, as entrepreneurs rather than as creditors.

Lanning, *Tax Erosion and the "Bootstrap Sale" of a Business-I*, 108 U. PA. L. REV. 623, 692-93 (1960). This implies in its own turn that the appropriate remedy would have been denial of capital gain treatment to the "sellers" by legislation, after the Supreme Court refused to take this action in the *Brown* case.



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only eight percent. The cash flow will wash out, leaving no residue with which to pay off the acquisition debt. Thus, the transaction does not resemble the maneuver that is forbidden by § 265(2) (the deduction of interest paid on debt used to acquire tax-exempt state and municipal bonds), which, in the absence of statutory constraints, would enable the taxpayer to make money by a “wash” transaction, or even by one that produced an economic loss if the tax saving exceeded the difference between the interest paid by him and the interest received.

To profit from an investment financed with borrowed funds, an exempt organization must be able to borrow at a lower rate than it will receive from the new investment. But if we assume that the charity borrows solely on the security of the investment and provides no new management services—the only possible transaction in which the charity contributes “nothing but its tax exemption” (clearly the extreme form of the transactions reached by the 1950-1969 amendments)—it is not easy to grasp why it would be able to borrow at a more favorable rate than the yield on the assets to be acquired. More concretely, why should a lender advance funds on an eight percent nonrecourse basis to enable the charity to buy assets paying nine percent, when the lender could get the nine percent yield, with the same security, by lending to the original owner or by buying the assets itself.<sup>60</sup>

Of course, if the charity had other assets and pledged its general credit, the transaction would reduce the lender’s risk by increasing the pool of assets subject to the debt; and hence an eight percent loan to enable the charity to purchase assets yielding nine percent would be commercially comprehensible. But the evil to be cured by § 514 was a bootstrap transaction, not one in which the charity serves the economic function of assuming a genuine risk.

The model “evil” would be a situation in which funds to acquire a nine percent investment could be borrowed at eight percent by either the charity or its taxable competitor (the lender being ignorant of the opportunity to get nine percent by investing directly), in which the charity’s taxable competitor loses out because its income tax on the one percent spread would make it impossible for it to pay off the debt as fast as the charity. If *this* is the paradigm case for which the remedy of § 514 was prescribed, however, the charity’s unfair advan-

60. If the charity’s trustees know something about the target company that others do not, their willingness to put this information at the charity’s disposal means that the charity is not trading on its tax exemption, but is benefiting from the charitable impulses of its trustees. This is hardly an “abuse” calling for legislative action (unless the information was acquired improperly), nor is it the announced target of § 514.

tage turns out to be rather slight. By devoting the entire one percent spread to retirement of the purchase money mortgage, the charity could amortize the debt in 28 years; its taxable competitor, whose identical one percent gross spread would be reduced by taxes (assuming a 50 percent rate) to 0.5 percent,<sup>61</sup> would need 36 years to pay off the same debt. Assuming a two percent spread—which of course increases the likelihood that the lender would by-pass both the charity and its competitor and invest on its own behalf in the assets yielding the higher return—the amortization periods would be 20 1/2 years for the charity and 28 years for its taxable rival.

Finally, the larger the spread between the yield from the business assets and the interest that must be paid for the nonrecourse borrowed funds, the more likely it is that a number of charities will compete for the “deal.” As the Government pointed out in its brief in *Commissioner v. Brown* (an unsuccessful assault on the seller’s claim to capital gain treatment on a debt-financed sale of business assets to a charity):

[T]here are an almost unlimited number of possible tax-exempt buyers and it requires, indeed, only a certificate of incorporation for [the seller] to create one of his own.<sup>62</sup>

Given this plenitude of potential exempt competitors, a charity cannot demand too large a share of the hypothesized spread without inducing the seller to seek out a more accommodating charity. This, in turn, means (1) that the lion’s share of the spread will probably gravitate to the seller (whose reinvestment of this amount will generate taxable profits to replace the now exempt profits of the transferred business, as pointed out earlier), and (2) that the charity will not be able to cut the prices charged for the products of the business without jeopardizing the flow of profits needed to keep abreast of its obligations to the seller on the one hand and to the lender, on the other. To some extent, of course, this model of an auction in which an infinite number of charities bid against each other for an attractive target business must be qualified by noting that the owners of other businesses may be simultaneously seeking out the same charities and offering to sell their enterprises for less. We do not claim to know exactly how this clash of financial interests will be resolved in the market place; but the mere fact that, so far as our research has disclosed, there has been

61. By using accelerated depreciation and similar tax privileges, the taxable owner may in fact have more than a 0.5 percent after-tax spread available to pay off the loan.

62. Brief for Petitioner at 35, *Commissioner v. Brown*, 380 U.S. 563 (1965). See note 58 *supra*.

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no detailed examination of the subject by tax economists is melancholy evidence of the gap between scholarship in the tax field and legislative action.<sup>63</sup>

But even if the fear of unfair competition between taxable and tax-free enterprises was exaggerated, as we believe, it might be thought that taxing the unrelated business income of exempt organizations was justified on a narrower ground, *viz.*, avoidance of an unwarranted double exemption—one for the feeder corporation when the business profits are earned, and a second for the exempt organization for the dividends it receives from the feeder.

On analysis, however, this fear turns out to be a chimera. To begin with, the profits of an unrelated business are taxed under the 1950 and 1969 rules even when it is conducted by the exempt organization in its own right and where there was never more than one exemption at stake. By withdrawing that exemption, Congress demonstrated that it was concerned not with “double exemptions” arising as a matter of form from an exempt organization’s use of a subsidiary, but with the status of the business profits themselves. This is made doubly clear by the fact that if the feeder corporation engages solely in investment activities or in a business related to the exempt organization’s functions, both the feeder and the organization itself are entitled to exemptions even under the 1950-1969 amendments. The second exemption (for dividends received by the exempt organization from its subsidiary) is less a reflection of congressional benevolence than a device to avoid unwarranted taxation when income passes through a purely formal corporate veil to the real party in interest. It is comparable to the right of an ordinary business corporation to deduct either 85 percent or 100 percent of dividends received from other domestic corporations, or to disregard intercorporate dividends entirely by filing a consolidated return.

There remains a final point regarding the taxation of unrelated business income. By reducing the amount that the exempt organization can apply to its charitable or other purposes, the tax necessarily burdens the beneficiaries of these activities, and their ability to pay ought to be considered in deciding whether and to what extent to impose the tax. Yet it was evidently never suggested during the 1950

63. Since the 1950 legislation did not curtail the right of nonprofit organizations to purchase real estate with their own funds and use the tax-free rents thus generated to expand their holdings, it would be interesting to know whether rich exempt organizations, in the ensuing quarter-century, have significantly increased their percentage ownership of the nation’s real estate. If they did, given the recent collapse of real estate values, they must regret the failure of Congress to impose the same constraints on self-financed as on debt-financed acquisitions of rental real estate!

and 1969 debates that the tax on the unrelated business income of charitable organizations reflected the ability to pay of those affected by it. Almost certainly, we believe, it did not, and thus made the income tax more regressive.<sup>64</sup>

## 2. *The Investment Income and Capital Gains of Private Foundations*

Still another step in the retreat from the 1913-1950 policy of complete exemption for charitable and other public welfare organizations was taken in 1969, when Congress imposed an "excise tax" of four percent on the "net investment income" of private foundations.<sup>65</sup> The rationale for this tax is unclear. The House Committee on Ways and Means proposed a 7.5 percent tax on investment income, in order to require foundations to share the cost of the government services they receive and to offset the cost of IRS audits.<sup>66</sup> The Senate balked at a tax which implies "a beginning in the removal of income tax exemption," and instead proposed a "user charge" to defray the cost of audits, to be based on a percentage of noncharitable assets.<sup>67</sup> The conference committee compromised on a four percent tax, without explicitly choosing either a "sharing the cost of government" or an "audit fee" rationale.<sup>68</sup>

Viewed as a method of financing the costs of government by taxing "all of those able to pay," as proposed by the House, the tax is open to two objections: (1) there is no reason to believe that the rate is

64. See note 48 *supra*.

65. § 4940. For the meaning of the term "private foundation," see pp. 326-27 *infra*. "Net investment income" consists of (1) gross investment income (primarily "passive" income which is not already taxed as unrelated business income under § 511), plus (2) capital gains (determined by reference to a December 31, 1969 basis), less (3) capital losses (but only to the extent of gains realized), (4) ordinary and necessary expenses incurred in the management of these income-producing assets, and (5) certain depreciation and depletion allowances. § 4940. No deduction is allowed for expenses of the foundation's eleemosynary activities. Treas. Reg. § 53.4940-1(e) (1972).

66. H. REP. NO. 91-413, 91st Cong., 1st Sess. 4 (1969), reprinted in 1969-3 CUM. BULL. 200, 213.

67. S. REP. NO. 91-552, 91st Cong., 1st Sess. 27 (1969), reprinted in 1969-3 CUM. BULL. 423, 442.

68. Simple arithmetic suggests that the Senate's views prevailed. The Senate proposed a tax of one-fifth of one percent of noncharitable assets. *Id.* If the familiar assumption is made that charities earn a five percent return on investments, a four percent tax on investment income (disregarding capital gains and allowable deductions) is equivalent to the Senate's proposed rate of tax.

In practice, the revenue derived from the § 4940 tax has not been specifically allocated to audit functions by the Internal Revenue Service; and the revenue generated apparently far exceeds the estimated cost of foundation audits. Commission on Private Philanthropy and Public Needs, *Philanthropy and the Federal Tax System*, 1973, at 29 (unpublished manuscript, on file with *Yale Law Journal*).

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appropriately related to the economic status of the beneficiaries of foundation assistance (who, directly or indirectly, will presumably bear the burden of the tax); and (2) there is no reason to believe that these persons have a greater ability to pay taxes than those who benefit from the activities of charitable organizations that are exempt from the tax, such as churches, schools, hospitals, and publicly supported foundations. Indeed, the ultimate beneficiaries of both types of organizations are ordinarily the same, since private foundations make most of their grants to charitable organizations themselves exempt from the new tax. To this extent, the tax imposes an economic burden on the ultimate beneficiaries if income reaches them by one route rather than another.

If the tax is viewed not as a method of imposing the general costs of government on persons according to their ability to pay but as an "audit fee," its status is somewhat more complicated. All nonprofit organizations are subject to statutory restrictions whose enforcement entails some supervising and auditing by the Government. No reason was given by the congressional committees for requiring private foundations, but not other organizations, to reimburse the Government for these enforcement expenses. It is dubious to assume, without evidence, that private foundations are inherently given to greater abuses and therefore require more expensive audit, than other nonprofit groups.<sup>69</sup> Nor is there any justification for requiring charitable foundations to pay audit costs while nonprofit groups operated for the mutual benefit of their members (such as social clubs, labor unions, and business leagues) are audited at public expense.

The "excise tax" on private foundations illustrates the ambiguities inherent in any effort to reach deeper into the pockets of the nonprofit world. Like a tax on the manufacture of cigarettes or the sale of firearms, it is levied on events that have no relationship to the economic status of the person who must bear its burden. Because it was launched as an "audit fee," the 1969 assault on the tax exemption of private foundations was perhaps more palatable to Congress than an explicit excise tax on the receipt of philanthropic grants would have been. But the economic result of the tax was no different. The tax as enacted is almost surely regressive, and undeniably creates inequalities among otherwise similar exempt organizations. The tax base—net investment income—is computed by deducting a limited number of expenses and losses from a limited category of gross income; the resulting amount bears little resemblance to the "net income" that

69. See pp. 341-42 *infra*.

is the normal target of federal income taxation. These deficiencies in the 1969 legislation are consistent with and, in a sense, confirm our theory that nonprofit organizations simply do not realize "income" in the normal sense. Congress was thus forced to define the tax base for private foundations in a mechanical—and largely arbitrary—way.

The remedy of Procrustes for the guest who does not fit his allotted bed is no more attractive today than in ancient Greece.

### 3. *The 1975 Tax on "Political Organization Taxable Income"*

In the wake of Watergate, Congress was impelled in 1975 to clarify the uncertain tax status of the national political parties, which had never been granted a statutory tax exemption but had never filed tax returns. To use the more delicate language of the Senate Finance Committee:

Historically, the Internal Revenue Service has not generally required the filing of income tax returns by political organizations.<sup>70</sup>

Congress also wished to resolve a number of other tax issues growing out of political activity, including the applicability of the federal gift tax to political contributions, the treatment of unexpended political funds, and the donation of property which had appreciated since its acquisition by the donor. The result was a network of interrelated statutory provisions.<sup>71</sup>

70. S. REP. No. 93-1357, 93d Cong., 2d Sess. 25 (1974). See pp. 303-04 *supra*. One exception, a blatantly discriminatory episode in the Internal Revenue Service's history, is described as follows by the Committee:

However, it appears that the Government took a contrary public position on at least one occasion, in attempting to sustain an asserted income tax deficiency against the Communist Party. In that case (*Communist Party of the U.S.A. v. Commissioner*, 373 F.2d 682 (CAD.C., 1967)), the Court of Appeals stated that "the Government now assures us that all political parties, including petitioner are taxable associations under the statute. That may be, but the Tax Court did not so rule; and petitioner is entitled to an adjudication in that court of its contention that the statute is not to be construed because the Commissioner and his predecessors have never so construed it." [Footnote omitted.] The case was remanded to the Tax Court, but the Government conceded virtually all of the asserted tax, and so the Tax Court never ruled on this question. The committee is not aware of any other instances in which the Internal Revenue Service has attempted to require a political party, as such, to file a Federal income tax return or to pay a Federal income tax.

S. REP. No. 93-1357, *supra* at 26 n.1.

The Government's "assurance" referred to by the court is puzzling; one can hardly assume that the Service was unaware of the nonfiling practice of political parties.

71. See note 16 *supra*; Boehm, *Taxes and Politics*, 22 TAX L. REV. 369 (1967); Bruce, *Taxing of Political Organizations, Candidates, Contributors*, 62 A.B.A.J. 123 (1976); Kaplan, *Taxation and Political Campaigns: Interface Resolved*, 53 TAXES 340 (1975); Streng, *The Federal Tax Treatment of Political Contributions and Political Organizations*, 29 TAX LAW. 139 (1975).

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The 1975 provisions relating to the tax status of political organizations themselves were summarized by the Senate Finance Committee as follows:

In general, the committee's bill provides that political organizations are to be treated as tax-exempt organizations, since political activity (including the financing of political activity) as such is not a trade or business which is appropriately subject to tax. However, where assets are not currently used by a political organization for political activities, but are invested for use at a later date, the income from the investment (less direct expenses incurred in earning that income) is to be subject to tax.<sup>72</sup>

Although the details need not detain us, the tax base for political groups is not investment income by itself, but a statutory construct bearing the label "political organization taxable income."<sup>73</sup> The computation of this amount starts with the organization's gross income (excluding "exempt function income"—primarily contributions, dues, and the proceeds of fund raising events), from which the direct expenses of producing the gross income are deducted. As is true of the excise tax on private foundations, no allowance is granted for the expenses of discharging the taxpayer's exempt—and hence primary—functions, nor can the political group deduct any of its general administrative expenses or take the dividends received deduction allowed to other corporations.<sup>74</sup>

The defects of the 1969 excise tax on private foundations are repeated in the 1975 tax on political organizations:<sup>75</sup> the tax base is simply an aggregation of items that does not measure the improvement during the taxable year in anyone's economic status and the rate is equally unrelated to anyone's ability to pay. But the legislation should not really be judged by normal "tax" standards. It is, rather, a manifestation of discontent with the role of money in the political process; and whether the punishment fits the crime can only be decided in an inquiry with a totally different scope from the one that we have set for ourselves.

We very much fear, however, that the 1969 and 1975 inroads on the tax exemption of nonprofit institutions just detailed will soon give

72. See note 70 *supra*; S. REP. NO. 93-1357, 93d Cong., 2d Sess. 25, 26 (1974).

73. § 527.

74. Regardless of their formal structure, all political organizations are subject to the corporate tax rate. § 527(b)(1).

75. Note the prescient observation of Labovitz: "[T]he 4 percent tax on investment income of private foundations is a bad [idea] that threatens to be carried further." Labovitz, *1969 Tax Reforms Reconsidered*, in *THE FUTURE OF FOUNDATIONS* 101, 108 (F. Heimann ed. 1973).

rise to allegations that those who have escaped these limitations have benefited from "loopholes" that must be closed in order to re-establish the "integrity" of the federal income tax system. The rhetoric to support such a proposal, however specious, is at hand;<sup>76</sup> it would be child's play to write the speeches. Only a strong sense of history will serve to remind us that withdrawal from an unjustified venture—domestic or foreign—is sometimes better than proceeding through the tunnel and bombing everything in sight.

## II. The Tax Status of Public Service Organizations— Some Specific Problems

Now that we have analyzed the taxation of public service organizations in general terms, it remains for us to review their tax status in detail and to apply the broad principles we have derived to specific classes of organizations.

### A. Charitable Organizations

Charitable organizations have been exempt from federal income taxes since 1894,<sup>77</sup> but Congress has never seen fit to provide a statutory definition of the term "charitable." The Treasury has not attempted to fill this vacuum, preferring instead to refer in the Regulations to the term's "generally accepted legal sense," and to "the broad outlines of 'charity' as developed by judicial decisions."<sup>78</sup> By way of illustration, the current Regulations go on to say:

[Charity] includes: Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.<sup>79</sup>

The Regulations, as well as most of the judicial decisions whose definitions they incorporate by reference,<sup>80</sup> echo the British Statute of

76. See generally Bittker, *Income Tax "Loopholes" and Political Rhetoric*, 71 MICH. L. REV. 1099 (1973).

77. See note 2 *supra*.

78. Treas. Reg. § 1.501(c)(3)-1(d)(2) (1959).

79. *Id.*

80. A much quoted summary of the scope of a "charity" appears in an 1891 British case:

"Charity" in its legal sense comprises four principal divisions: trusts for the relief



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Charitable Uses (1601).<sup>81</sup> The language in the Regulations has been modernized, but the spirit is unchanged.

As interpreted in applying § 501(c), "charitable" overlaps—indeed is virtually interchangeable with—the terms "eleemosynary," "philanthropic," and "benevolent." Despite the vagueness of the term and the divergent activities which it embraces,<sup>82</sup> the unadorned reference to "charitable purposes" in § 501(c)(3) has created only minor problems of interpretation for tax planners, administrators, and the courts.<sup>83</sup> In any event, it is not likely that a detailed statutory defi-

of poverty; trusts for the advancement of education; trusts for the advancement of religion; and trusts for other purposes beneficial to the community, not falling under any of the preceding heads.

Commissioners for Special Purpose of Income Tax v. Pemsel, [1891] A.C. 531, 583.

81. The Statute of Charitable Uses, 43 Eliz. I, c. 4 (1601), outlined the scope of charitable purposes in its preamble, which included expenditures for:

Releife of aged impotent and poore people, some for Maintenance of sicke and maymed Souldiers and Marriners, Schooles of Learninge, Free Schooles and Schollers in Uni<sup>u</sup>sities, some for Repaire of Bridges Portes Havens Causwaies Churches Seabankes and Highewaies, some for Educa<sup>o</sup>n and p<sup>r</sup>ferments of Orphans, some for or towardes Releife Stocke or Maintenance for Howses of Correc<sup>o</sup>n, some for Mariages of poore Maides, some for Supporta<sup>o</sup>n Ayde and Helpe of younge Tradesmen, Handicraftesmen and p<sup>r</sup>sons decayed, and others for releife or redemption of Prisoners or Captives, and for aide or ease of any poore Inhabitant<sup>r</sup> con<sup>o</sup>nninge paymente of Fifteenes, settinge out of Souldiers and other Taxes . . . .

For a suggestion that this language was copied from William Langland's *The Vision of Piers the Plowman*, see Moe, "The Vision of Piers the Plowman" and the Law of Foundations, 102 PROCEEDINGS OF THE AM. PHIL. Soc'y 371 (1958).

The modern definition of "charity" in the Regulations, while no longer explicitly embracing "releife or redemption of Prisoners or Captives . . . ." was construed to allow deduction of gifts to ransom the Bay of Pigs prisoners.

82. See *Ould v. Washington Hosp. for Foundlings*, 95 U.S. 303, 311 (1877):

A charitable use, where neither law nor public policy forbids, may be applied to almost any thing that tends to promote the well-doing and well-being of social man.

See also *Kain v. Gibboney*, 101 U.S. 362, 365 (1879) (charity is "a gift for a public use"); IV A. SCOTT, THE LAW OF TRUSTS § 368, at 2855 (3d ed. 1967).

83. The most notable recent issue is whether a segregated institution can qualify as "charitable." To the effect that a racially discriminatory private school cannot qualify, see *Green v. Connally*, 330 F. Supp. 1150, 1156 (D.D.C.), *aff'd per curiam sub nom. Coit v. Green*, 404 U.S. 997 (1971). During this litigation, the Treasury issued a revenue ruling which relied on both federal public policy and the common law definition of "charity" to deny exemption to a private school "not having a racially nondiscriminatory policy as to students." Rev. Rul. 71-447, 1971-2 CUM. BULL. 230. See also Rev. Rul. 75-231, 1975 INT. REV. BULL. No. 25, at 12 (private church-affiliated schools not maintaining a racially nondiscriminatory policy do not qualify as "charitable" even if racial exclusion is dictated by religious conviction). See generally *Bob Jones Univ. v. Simon*, 416 U.S. 725, 748-49 (1974); Bitker & Kaufman, *Taxes and Civil Rights: "Constitutionalizing" the Internal Revenue Code*, 82 YALE L.J. 51 (1972).

Another currently troublesome issue is whether the term "charitable" includes organizations that charge for their services and thereby either exclude persons who cannot pay or absorb clients who might otherwise be served by taxable competitors. See *Eastern Ky. Welfare Rights Organization v. Simon*, 506 F.2d 1278 (D.C. Cir.), *rehearing en banc denied*, 506 F.2d 1292 (D.C. Cir. 1974), *cert. granted*, 421 U.S. 975 (1975) (hospital need not provide free or below-cost service to qualify as "charitable"); Rev. Rul. 74-587, 1974-2 CUM. BULL. 162 (nonprofit organization making loans to ghetto businesses held exempt under § 501(c)(3) because of beneficial effect on community conditions, even though bor-

dition would eliminate these residual problems of distinguishing between "charitable" and "noncharitable" purposes, save by an unending process of amending the Code to settle every boundary dispute as it arises.

Assuming, then, a large central core of meaning for the term "charitable purposes" despite its ambiguity at the edges, should such organizations be exempt from income taxation? The answer (and the reason) was so self-evident to President Eliot of Harvard University when he was called upon, in 1874, to comment on a proposal to revoke Massachusetts's exemption laws that he responded with an arrogance that has plagued the cause of tax exemption for charities ever since:

It is at once apparent that this objection [to tax exemption] is both illogical and mean; illogical, because if churches, colleges and hospitals subserve the highest public ends, there is no reason for making them contribute to the inferior public charges; and mean, because it deliberately proposes to use the benevolent affections of the best part of the community as a means of getting out of them a very disproportionate share of the taxes.<sup>84</sup>

Less smug advocates of the exemption often offer a defense of tax exemption that is more modest than, and diametrically opposed to President Eliot's—that most of the services supplied by private charities, if diminished in scale by taxation, would have to be replaced at government expenses. By itself, however, this assertion—even if factually accurate—does not supply an affirmative reason for preserving charities as an alternative; it establishes merely that both routes, private and public, will take us to the same destination. The missing link in the chain of reasoning is usually supplied by the claim that private charitable organizations can discharge these quasi-governmental functions with more imagination, diversity, flexibility, speed, and economy than is usually displayed by public agencies.<sup>85</sup>

Lacking a method for measuring these appealing but elusive virtues, one must perforce rely on intuition in comparing the achievements of private charities with those of government, when they are perform-

rowers might not themselves qualify for charitable assistance); Rev. Ruls. 75-75 & 75-76, 1975 INT. REV. BULL. No. 10, at 8, 9 (public interest law firm may accept fees awarded or approved by court or administrative agency, but not regular fees from clients even if rates are below those of private firms).

84. C. Eliot, *The Exemption from Taxation, 1874* (paper delivered to the Commissioners of the Commonwealth of Massachusetts), reprinted in CHARLES W. ELIOT, *THE MAN AND HIS BELIEFS* 667, 675 (W. Nielson ed. 1926).

85. For an eloquent statement of the values served by charitable and other nonprofit institutions, see Stone, *supra* note 5, at 39-40. See also HOUSE COMM. ON WAYS AND MEANS, 89TH CONG., 1ST SESS., TREASURY DEPT' REPORT ON PRIVATE FOUNDATIONS 12-14 (Comm. Print 1965); H. REP. No. 1860, 75th Cong., 3d Sess. 19-20 (1938).

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ing similar functions. In our view, private institutions are characterized by the advantages claimed for them, and also provide a standard against which to measure the achievements of competing government agencies. But this is not the place to seek to convert those who are skeptical on this point, let alone those of a contrary persuasion.

In any event, it is our thesis that tax exemption for charitable organizations need not rest on these value judgments because it is independently and firmly grounded on the basic presuppositions of income taxation: neither the "net income" concept nor the "ability to pay" rationale for income taxation can be satisfactorily applied to charitable organizations.<sup>86</sup> If our analysis and conclusions are well founded, the exemption of these organizations from income tax is not a preference or a special favor,<sup>87</sup> requiring affirmative justification, but an organic acknowledgment of the appropriate boundaries of the income tax itself.

### B. *Educational Institutions*

Sections 501(c)(3) lists "educational purposes" as a basis for tax exemption, but this is probably an unnecessary bit of specification. Since the enactment of the Statute of Charitable Uses (1601), the statutory term "charitable" has ordinarily been interpreted to include educational purposes and institutions.<sup>88</sup> The Treasury Regulations expand on the statutory term "educational purposes" as follows:

The term "educational", as cited in section 501(c)(3) relates to—

- (a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or
- (b) The instruction of the public on subjects useful to the individual and beneficial to the community.<sup>89</sup>

In keeping with this definition, the Regulations go on to state that the term "educational" embraces not only schools and colleges, but also public discussion groups, instructional programs transmitted by radio and television, museums, symphony orchestras, and similar organizations. Like other § 501(c)(3) organizations, an educational institution forfeits its tax exemption if a "substantial part of [its] activities . . . is carrying on propaganda, or otherwise attempting, to influence legislation" or if it participates or intervenes in "any political campaign

86. See pp. 307-16 *supra*.

87. See note 14 *supra*; Bittker & Kaufman, *supra* note 83.

88. The inability of segregated schools to qualify as "charitable," see note 83 *supra*, implies that the "educational" exemption is not independent of the "charitable" exemption.

89. Treas. Reg. § 1.501(c)(3)-1(d)(3)(i) (1959).

on behalf of any candidate for public office." The impact of this restriction is outside the scope of this article,<sup>90</sup> but it should be noted here that the statutory distinction between permissible "educational" and forbidden "propaganda" activities is not easily applied. Moreover, in an elaboration containing an apparently independent constraint, the Regulations provide:

An organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion.<sup>91</sup>

The rationale for exempting educational institutions from income taxes is substantially the same as that for exempting other charitable organizations. The principal difference, which is one of degree rather than of kind, is that the students who attend exempt schools and colleges and the patrons of museums, galleries, and orchestras probably come from higher income classes than most of the beneficiaries of other charitable organizations. Though this does not make it any easier to compute the "net income" of educational organizations, it weakens one argument in favor of exempting many other nonprofit organizations—that the burden of a tax would fall largely on persons at the bottom of the income ladder.

We do not mean to imply, however, that students are the only beneficiaries of the money spent by schools and colleges or that art galleries and symphony orchestras are merely the playthings of the rich. Only a philistine would doubt that these institutions provide benefits, directly and indirectly, to an indefinably wide audience over the entire income spectrum.<sup>92</sup> In his famous comment on the law of charities, Lord MacNaughten asserted that activities are no less charitable in

90. See note 16 *supra*.

91. Treas. Reg. § 1.501(c)(3)-1(d)(3)(i) (1959). This distinction is reminiscent of an ancient but still unresolved debate in an area of private law—whether trusts to promote dogmatic, sectarian, political or subversive propaganda are protected by the Statute of Charitable Uses or its latter day statutory offspring. See, e.g., IV A. SCOTT, *supra* note 82, § 370.4, at 2875-76; 15 AM. JUR. 2d *Charities* § 68, at 76-77 (1964); 2 RESTATEMENT (SECOND) TRUSTS § 370, at 252 (comment g); *id.* § 374, at 261 (comment e).

92. There is little risk, in today's America, that "education" will become the exclusive province of effete intellectual snobs. See *Mobile Arts & Sports Ass'n v. United States*, 148 F. Supp. 311, 316 (S.D. Ala. 1957), stating that:

The halftime shows put on [at football games] by the famed Rangerettes of Kilgore College, Kilgore, Texas, and the Dixie Darlings of Mississippi Southern College, Hattiesburg, Mississippi, provide entertainment with a flavoring of art, dancing and music, and undoubtedly have some educational and publicity value.

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the eye of the law because incidentally they benefit the rich as well as the poor, as indeed every charity must do either directly or indirectly.<sup>93</sup> Moreover, it is precisely in the area of education, including the arts, that private institutions are especially well suited to serve as independent centers of power and influence in our society, fostering innovation and diversity with a dedication that government agencies can seldom muster or sustain. This separate rationale for tax exemption applies particularly to educational institutions.

### C. *Scientific Organizations*

Like educational institutions, organizations which fulfill "scientific purposes" might have been brought under the aegis of the exemption for "charitable purposes" even if not explicitly listed in § 501(c)(3).<sup>94</sup> Congress did not leave the issue to the courts, however, and scientific organizations have been included in the exempt category since 1913.<sup>95</sup>

The justification for exempting charitable organizations applies equally to scientific organizations, given the statutory disqualification of those whose net earnings inure to the benefit of private shareholders or individuals and the requirement in the Regulations that the organization must serve "a public rather than a private interest." If anything, the choice of a proper tax rate, were the exemption to be repealed, would be even more difficult for most scientific organizations than for other public service institutions, since the class of "beneficiaries" who would bear the economic burden of such a tax might be as broad as the nation, and embrace future generations as well as all living persons. To be sure, some individuals and corporations are able to profit currently from the research or other activities of exempt scientific organizations; but they will be taxed on their income as it arises (and on a "gross" basis since they will not be allowed to deduct or amortize any part of the exempt organization's expenses in developing the ideas or innovations used in the income-producing business). If the exempt organization's research is open to commercial exploitation on an equal basis by all comers, the fact that their income will be taxed provides adequate assurance that the exemption

93. *Commissioners for Special Purpose of Income Tax v. Pemsel*, [1891] A.C. 531, 583. See also note 83 *supra*, regarding the status of "charitable" organizations which charge for their services and thereby exclude indigent clients.

94. But see *In re Association of the Bar v. Lewisohn*, 34 N.Y.2d 143, 313 N.E.2d 30, 356 N.Y.S.2d 555 (1974) ("scientific" organizations not included in N.Y. statute granting tax exemption to "charitable" and "educational" institutions). See also Brief for Respondents in *id.* at 12.

95. Compare Revenue Act of 1913, ch. 16, § 2(G), 38 Stat. 172, with Revenue Act of 1909, ch. 6, § 38, 36 Stat. 113.

will not permit private interests to escape their fair share of the national tax burden.

D. "Public" and "Private" Charities—"Private Foundations"

Since 1950, Congress has distinguished for a variety of purposes between charitable organizations that, roughly speaking, are financed or patronized by the public and those that are not.<sup>96</sup> The evolution of this distinction between "public" and "private" charities (to use non-statutory, but roughly descriptive labels), which by now has become extremely intricate, began in 1950, when the Internal Revenue Code was amended to deny tax exemption to charities that engaged in "prohibited transactions" (specified acts benefiting substantial contributors) or whose undistributed income was unreasonably accumulated, used to a substantial degree for nonexempt purposes, or invested in a manner jeopardizing the exempt purposes. Without offering any explicit rationale for doing so, Congress excepted churches, schools and colleges, hospitals, and certain publicly supported organizations from these rules. By asserting that the new self-dealing rules were applicable to organizations which are manipulated to the private advantage of their substantial donors, the 1950 committee reports implied that charitable organizations subjected to these rules were more prone to this type of abuse than those exempted. At the same time, however, this suggestion was watered down by the comment that "similar criteria" might be used to determine whether other charitable organizations "are operated exclusively for exempt purposes."<sup>97</sup>

Thus, the 1950 legislation—which planted the seeds of today's full-grown statutory distinctions between private foundations and other charitable organizations—was based on a vague impression that foundations were somewhat more susceptible than other organizations to the abuses diagnosed by Congress, not on a firm conviction that disease was rampant in one group and unknown to the other. But since the new rules were replete with such words as "reasonable," "adequate," and "substantial," the legislation was hardly more than a congressional instruction to the Internal Revenue Service to be especially alert to

96. For a more extended examination of the issues surveyed at pp. 336-42 *infra*, see BITTKER, *Should Foundations Be Third-Class Charities?*, in *THE FUTURE OF FOUNDATIONS* 132 (F. Heimann ed. 1973). There is a detailed examination of the legislative history of the distinction between public and private charities in L. WILLIAMS & D. MOOREHEAD, *AN ANALYSIS OF THE FEDERAL TAX DISTINCTIONS BETWEEN PUBLIC AND PRIVATE CHARITABLE ORGANIZATIONS* (Commission on Private Philanthropy and Public Needs (Filer Commission) 1975).

97. S. REP. NO. 2375, 81st Cong., 2d Sess. 123-24 (1950), *reprinted in* 1950-2 CUM. BULL. 483, 571.

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the possibility of misfeasance or nonfeasance by private foundations, while not overlooking similar behavior by other charitable organizations. Thus, it probably added little to the longstanding and overarching requirements, applied by § 501(c)(3) to all charitable organizations, that they must be “organized and operated exclusively” for the exempt purposes specified in the statute and must not allow any part of their net earnings to inure to the benefit of any private shareholder or individual.<sup>98</sup>

The process of distinguishing among charitable organizations, begun by Congress on this modest scale in 1950, was accelerated in subsequent years. In 1954, when the ceiling on an individual taxpayer’s deduction for charitable contributions was raised from 20 percent of adjusted gross income to 30 percent, the extra 10 percent allowance could be used only if the donee was a church, school, or hospital. The announced reason for raising the ceiling on gifts to these institutions was “to aid [them] in obtaining the additional funds they need, in view of their rising costs and the relatively low rate of return they are receiving on endowment funds.”<sup>99</sup> It is difficult to believe that other operating charities were not feeling the same pinch; and in 1964, Congress acknowledged this by enlarging the charmed circle to include “publicly or governmentally supported” charities.<sup>100</sup>

Charitable organizations qualifying for the extra 10 percent allowance were also favored by two other provisions of the 1964 legislation: contributions to them in excess of the donor’s percentage ceiling qualified for the newly enacted carryover of excess contributions of § 170(b)(5) (now § 170(d)); and the unlimited charitable deduction of § 170(g) was amended to favor contributions to these donees.

The 1954 and 1964 legislation seems to embody two distinctions, resting on different rationales. The first is between “operating” and “nonoperating” charities, based on the premise that those in the former category need special assistance in maintaining their activities at

98. See, e.g., *Founding Church of Scientology v. United States*, 412 F.2d 1197 (Ct. Cl. 1969), *cert. denied*, 397 U.S. 1009 (1970) (exemption denied to a church organization where earnings inured to benefit of founder and his family in form of salaries, rentals, reimbursements, and loans); *Kenner v. Commissioner*, 318 F.2d 632 (7th Cir. 1963), *aff’g* 20 CCH Tax Ct. Mem. 185 (1961) (exemption denied to a hospital owned and controlled by one doctor, who commingled his funds with hospital’s funds in one account and used hospital funds for his personal expenses); *Horace Heidt Foundation v. United States*, 170 F. Supp. 634 (Ct. Cl. 1959) (exemption denied to an organization formed to help aspiring entertainers, where the organization was operated in part to maintain popularity of founder’s radio show and to reduce his expenses through employment of such entertainers).

99. S. REP. NO. 1622, 83d Cong., 2d Sess. 8-9 (1954).

100. S. REP. NO. 830, 88th Cong., 2d Sess. 58-59 (1964), *reprinted in* 1964-1 CUM. BULL. 505, 562-63.

accustomed levels (or expanding them) in the face of increased costs and low yields on their endowments. Presumably it was thought that nonoperating charities (especially foundations which make grants) have fewer on-going commitments and hence can retrench or postpone their undertakings more easily. The second distinction is between public and private charities, evidently resting on a judgment that publicly supported charities satisfy more pressing social needs than private charities, or that public support amounts to an informal referendum conferring an endorsement on some charities to the exclusion of others.

These separate rationales coincide in the case of many charitable organizations. Hospitals, for example, are often supported by the public and are burdened with continuing commitments that are not easily scaled down; family foundations, conversely, are usually free to retrench when income is low, and often lack explicit public endorsement in the form of contributions from a widespread body of benefactors. But there are other cases in which the rationales conflict: some privately supported charities engage in day-to-day operations comparable to those of publicly supported charities, and they may even have a regular public patronage; conversely, some publicly supported charities are grant-making institutions. Churches, schools and colleges, and hospitals, it should be noted, were favored by the 1950-1964 legislation whether publicly supported or not; the nature of their activities, not the source of their support, put them into the charmed circle.

Foundations engaged in making grants rather than in such "operating" activities as education, hospital care, and aid to the indigent drew a sustained barrage of congressional criticism during the 1960's. A much-publicized 1962 report to the House Select Committee on Small Business, by its Chairman, Congressman Wright Patman, set out certain instances of misuse of funds and violations of law or Treasury regulations by private foundations. The report also charged that private foundations put the income from large amounts of capital beyond the reach of taxation, operated businesses at a competitive advantage vis-à-vis small businesses, enjoyed increasingly excessive economic power, and lightened the tax burden of the rich.<sup>101</sup>

Whether well founded or not,<sup>102</sup> these charges gained sufficient currency to culminate in 1969 in the imposition of a series of complex restrictions on some nonprofit organizations, buttressed by a variety of penalty taxes, in addition to the excise tax on their investment in-

101. CHAIRMAN, HOUSE SELECT COMM. ON SMALL BUSINESS, 87TH CONG., 1ST SESS., TAX EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY (Comm. Print 1962).

102. See Bittker, *supra* note 96.



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come discussed earlier in this article.<sup>103</sup> Some of these restrictions and taxes were wholly new; others were stricter versions of earlier measures. The prime target was the "private foundation," defined by § 509 as all § 501(c)(3) organizations except: (1) churches, schools, colleges, and hospitals; (2) "publicly supported" charities, as described in § 170(b)(1)(A); (3) "publicly patronized" charities normally receiving more than one-third of their income from gifts, dues, service charges, etc., and less than one-third from investments; and (4) a few other groups of less general significance. Moreover, some distinctions were drawn by the 1969 legislation among the residual group of "private foundations," with some being treated a bit more leniently than their fellow culprits.<sup>104</sup>

Stripped of detail, the 1969 rules provide:

1. *Self-dealing.* Section 4941 imposes an absolute prohibition on almost every conceivable transaction between a private foundation and a "disqualified person" (broadly defined by § 4946 to include substantial contributors, trustees and officers of the foundation, members of their families, their business associates, and other related persons), enforced by a graduated set of penalties on the disqualified person and on any foundation manager who knowingly participated in the forbidden act.

2. *Excess business holdings.* Section 4943 imposes a tax of five percent of the value of a private foundation's "excess business holdings in a business enterprise," defined to mean, ordinarily, stock in excess of an amount equal to 20 percent of the voting stock of a business corporation minus the stock owned by disqualified persons. The foundation is allowed a period of five to 20 years to dispose of excess stock, depending on when the stock was acquired and on certain other factors. An additional tax of 200 percent is imposed if the foundation persists in retaining the stock after the prescribed correction period. The announced reasons for this limitation were that concentrated charitable ownership of stock might enable the corporation to compete unfairly with other corporations, whose shareholders are taxed on their dividends, and could also lead foundation managers to neglect their charitable obligations in order to focus on business operations.

3. *Risky investments.* Section 4944, replacing an earlier restriction,

103. See p. 326 *supra*.

104. The details are outlined in a table by Sugarman, *A Tax-Treatment Table for Charitable Organizations Under the Tax Reform Act of 1969*, PRAC. LAW., Mar. 10, 1970, at 85. This graphic display of the statutory distinctions drawn by the 1969 legislation suggests that its draftsmen could have given lessons to the most talented of theological hairsplitters.

imposes a tax on any private foundation investing its funds "in such a manner as to jeopardize the carrying out of any of its exempt purposes," and a similar tax on any foundation manager guilty of "knowing" participation in such risky investing. The legislative reports do not explain why this tax is imposed on private foundations but not on other charitable organizations, nor do they offer any evidence that foundations have been more prone than other nonprofit organizations to jeopardize their exempt functions by risky investments.

4. *Failure to distribute income.* Section 4942 imposes a 15 percent tax on the undistributed income of private nonoperating foundations—roughly speaking, on their actual income or a specified percentage of the value of their investment assets,<sup>105</sup> whichever is higher, less their qualifying distributions for the year, and further reduced by amounts set aside for specified projects with the approval of the Treasury and by "excess" distributions carried over from prior years.<sup>106</sup> A second tax, at the rate of 100 percent, is imposed if a failure to distribute the requisite amount is not remedied within a prescribed correction period, and there is a third level of penalties for more flagrant violations.

The legislative reports on this provision do not explain why a mandatory payout rule should be imposed on private foundations but not on other charitable organizations.<sup>107</sup> The distinction presumably rests on an implicit assumption that the budgets of schools and colleges, hospitals, and other "operating" charities compel them to use their income currently and to avoid nonproductive investments, except when the prospect of overriding future needs dictates the accumulation of reserves; but there seems to be no hard evidence to support this speculation.

5. *Disfavored grants and other expenditures.* Section 4945 imposes a 10 percent tax on a private foundation's "taxable expenditures," defined as amounts paid or incurred for: (a) specified political activities; (b) grants to individuals, unless awarded on an objective basis

105. Under § 4942(e)(3), the Secretary of the Treasury may alter the percentage, according to changes in the rate of return generally available in financial markets.

106. For the status of indefinite accumulations under prior law, see *Eric Endowment v. United States*, 316 F.2d 151 (3d Cir. 1963); *Stevens Bros. Foundation, Inc. v. Commissioner*, 324 F.2d 633, 640 (8th Cir. 1963) (accumulation of income served no "definite functional objective"; exemption therefore revoked); *Samuel Friedland Foundation v. United States*, 144 F. Supp. 74 (D.N.J. 1956) (accumulation of income up to the level necessary to construct a medical research building held reasonable). Before 1969 the relevant statutory provisions were: INT. REV. CODE OF 1939, ch. 38, § 3814, 61 Stat. 958 (1950) (later INT. REV. CODE OF 1954, § 504, Act of Aug. 16, 1954, ch. 736, 68A Stat. 168, repealed by Act of Dec. 30, 1969, Pub. L. No. 91-173, Tit. I, § 101(j)(15), 83 Stat. 527).

107. See p. 336 *supra*.

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(under a procedure approved in advance by the Treasury) as a scholarship, fellowship, prize to a person selected from the general public, or grant to achieve a specific intellectual or artistic objective; and (c) grants to other private foundations (and certain other groups), unless the granting foundation assumes "expenditure responsibility" by supervising spending under the grant and reporting on the expenditures to the Internal Revenue Service. The initial 10 percent tax on taxable expenditures is buttressed by a tax on foundation managers for willful violations, and by second and third level penalties if corrective action is not taken within a prescribed period.

These restrictions reflect a miscellany of congressional objections to the programs of a few foundations, including the financing of voter registration activities and certain travel and study grants to some members of President Kennedy's administration pending their relocation in other posts after his assassination. Given this background, a search for a principled justification for these statutory constraints, or for their imposition on private foundations and not on other exempt organizations, is not likely to be fruitful. A realistic assessment, rather, compels the conclusion that the general form of § 4945 only thinly disguises its specific origin in a handful of grievances.<sup>108</sup>

It is common knowledge that preachers sometimes divert church funds to personal ends, that the nonprofit facade of a school or college can mask a proprietary operation, that some hospitals serve primarily to enrich their physician-entrepreneurs, and that some publicly supported charities allow most of their contributions to be siphoned off by grasping fundraisers. It is equally clear, however, that these instances did not—and should not—impel Congress to extend to the vast body of charitable organizations the labyrinth of statutory restrictions,

108. Indeed, the elaborate skein of rules imposed on private foundations in 1969 was based—despite the abundance of congressional hearings and Treasury investigations—on little more than isolated instances of actual, alleged, or suspected misconduct by a few foundations, coupled with a plethora of suggestions that these cases were typical and that existing law "could" or "might" or "probably would" lead to abuses. Even more conjectural was the unarticulated premise that foundations were more likely to succumb to temptation than other charitable organizations. If the need to justify a distinction between private foundations and other charities rose to the conscious level, it was probably satisfied by contrasting the sins of the most errant foundations with the reputations of the most scrupulous religious, educational, and publicly supported charities.

Tax scholars have called attention to special purpose tax legislation designed to aid a handful of taxpayers (or even a single individual) cloaked in the language of generally applicable legislation. Cary, *Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws*, 68 HARV. L. REV. 745 (1955); Surrey, *The Congress and the Tax Lobbyist—How Special Tax Provisions Get Enacted*, 70 HARV. L. REV. 1145 (1975). A parallel study of the punitive tax legislation in the Tax Reform Act of 1969 would be equally valuable, and it might suggest to a post-Viet Nam and post-Watergate generation of observers that the label "tax reform" can be exploited as readily as "national security."

navigable only by lawyers and accountants and guarded by penalties far exceeding the civil penalties for deliberate tax fraud, which were prescribed in 1969 for private foundations.

One wonders, therefore, whether it is quixotic to seek an explanation for the "third-class" status of private foundations, as we have done, in the congressional announcements that accompanied the legislation. Perhaps it would be more realistic to attribute these restrictions to skepticism or distrust of the very characteristics that are often extolled as the virtues of the private foundation—its capacity to experiment because it is usually free of permanent commitments and is controlled by trustees answerable primarily to their own sense of responsibility.<sup>109</sup> Private organizations displaying independence, flexibility, and originality are bound to tread on toes, and when the toes belong to public officials, an adverse legislative reaction should not come as a surprise.

This kind of backlash is encouraged—and, indeed, legitimated—by the theory that the recipients of tax exemption enjoy the privilege of spending "government money." At a recent conference on the contemporary role of foundations, they were urged to take advantage of "their independence, their diversity, their freedom to pick their own objectives and tasks, their resources, their ability to take the long view, their immunity from pressure" in order to support projects "that are profoundly critical, root and branch, of public policy and behavior." But if foundations are, in truth, spending public money, it is fatuous to expect Congress to tolerate expenditures devoted for causes that challenge the established order.<sup>110</sup>

### E. *Religious Organizations*

Religious organizations share with charitable and educational organizations the distinction of having enjoyed tax exemption consistently since the Revenue Act of 1894. Their exemptions (and the deductions allowed contributors by § 170) raise an extremely wide range of issues—from custom and practicality to constitutionality, and ultimately, teleology. Setting to one side the encumbrances of history<sup>111</sup> and the concerns of the theologian, we wish to determine how religious institutions fare under the theory expounded above<sup>112</sup> that nonprofit

109. See HOUSE COMM. ON WAYS AND MEANS, 89TH CONG., 1ST SESS., TREASURY DEP'T REPORT ON PRIVATE FOUNDATIONS; 12-13 (Comm. Print 1965). Bittker, *supra* note 96, at 160-61.

110. Address by David R. Hunter, 26th Annual Conference, Council on Foundations, Chicago, Apr. 22, 1975.

111. See *Walz v. Tax Comm'n*, 397 U.S. 664, 676-78, 681-86 (1970) (New York statute exempting realty used for religious purposes from property tax is not an unconstitutional sponsorship of religion).

112. See pp. 305-06 *supra*.

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organizations should not be viewed as independent taxpaying entities generating "income," and should be taxed, if at all, only as proxies for their contributors or members.<sup>113</sup>

Thorstein Veblen likened churches to business enterprises engaged in the sale of promises and expectations:

Of such sacred sales-publicity concerns operating as certified agents for this marketing of supernatural intangibles, the Census of 1916 enumerates 202 chain-store organizations, comprising a total of 203,432 retail establishments occupied exclusively with the sale of such publicity to the ultimate consumers; of whom there is one born every minute, and who are said to be carried on the books of these retailers to the number of 41,926,854. It has been confidently estimated, on the ground of these data, that the effectual number of paying customers will be approximately 90,000,000; regard being had to the very appreciable floating clientèle and the great number of effectual consumers attached to and associated with the customers of record.<sup>114</sup>

Viewed in this light, a church would realize profit or loss, depending on whether its receipts exceeded its current expenses and depreciation on its plant and equipment.

Another way of describing churches, less entertaining than Veblen's but more congenial to the American public, is that they are voluntary associations of their members to conduct activities that are no more profit-oriented than the pooling of resources by a group of friends or neighbors to establish a cooperative nursery school. If this analysis is accepted, the contributions and dues paid by the church's members would not be embraced even by an expansive definition of income. As for dividends, interest, and other receipts from the church's endowment funds, if they are classified as gross income for the group (which is how the comparable investment income of the individual members would be treated), it would then be necessary to decide wheth-

113. Some of the views set out here are advanced in greater detail in Bittker, *supra* note 23.

114. T. VEBLÉN, *ABSENTEE OWNERSHIP AND BUSINESS ENTERPRISE IN RECENT TIMES* 323-24 (1923). Like other § 501(c)(3) organizations, churches are subject to the rule that no income may inure to private individuals. By virtue of this requirement, "it is necessary for an organization to establish that it is not organized or operated for the benefit of . . . the creator or his family . . ." Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (1959). In *Founding Church of Scientology v. United States*, 412 F.2d 1197 (Ct. Cl. 1969), *cert. denied*, 397 U.S. 1009 (1970), the Court of Claims upheld the Commissioner's denial of exemption to a church which enriched its earthly founder in an unusual fashion. The church derived over 90 percent of its income from the sale, under contract, of "spiritual processing" whereby "detrimental aberrations" were monitored by a device measuring changes in the electrical resistance within the communicant's body. The founder, who had invented the device, received royalties, and was paid a salary set at 10 percent of the church's gross receipts.

er the church's operating expenses are deductible expenses, an issue examined earlier in this article.<sup>115</sup>

If, resolving all debatable issues against the churches, we were to include that their activities can produce "income" which should be taxed to the organization or its members, we would then reach the knotty problem of an appropriate tax rate. Do members derive benefits from their church's activities that ought to be included in their income but are excluded because of practical difficulties in making the imputation? In a secular society, the initial response to this question is likely to be: "The church belongs to its parishioners and they are the ones who benefit from its activities." If this response is accepted, the church's income should be imputed to its parishioners; but if inappropriate imputation is not feasible—should more be allocated to pious members than to lax ones?—the next best device would be to tax the church, at a rate designed, if possible, to yield about the same amount of income as an imputation to individuals. This could hardly be done church-by-church, even though a regime of divergent tax rates would better reflect the ability to pay of each church's average member than a flat national figure. The only conceivable tax schedule, therefore, and perhaps the only constitutional one, would be a flat rate that would overtax churches with poor members while undertaxing those catering to the rich.

Another view of religious activity, however, is that its benefits are not intended for, or even primarily received by, its communicants, who should instead be viewed as missionaries to a world that stands in need, albeit unwittingly, of their work.<sup>116</sup> Their claim to serve the public interest, with little or no benefit to themselves, may be received skeptically by the outsider, but is it less persuasive than the same claim when advanced by contributors to the Red Cross, members of the American Civil Liberties Union, or backers of the Socialist Party? If secular nonprofit organizations are exempt from income tax for the reasons canvassed earlier in this article, despite the psychic income that their activities confer on their members,<sup>117</sup> can a nation whose Constitution guarantees religious freedom properly deny the

115. See pp. 309-14 *supra*.

116. This alternative view of religious activity may be more suited to evangelical groups than to those that do not seek to convert nonbelievers, but under the Constitution, all churches must be treated alike.

If the church uses investment income (as distinguished from dues) to provide secular education or similar services to its members, of course, the most appropriate treatment would be an imputation of the income thus used to those receiving the benefits. See pp. 349-51 *infra*.

117. See note 15 *supra*.

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same exempt status to religious organizations on the theory that they are more tinctured by self-interest than secular organizations?

A final issue is the effect of the establishment clause of the First Amendment on the tax exemption accorded to religious institutions. If nonprofit organizations do not have "income" in the ordinary sense, as we have argued, their exemption from income taxation is not properly classified as "government aid" raising an establishment clause problem; it is, rather, a normal or even inevitable corollary of the economic and philosophical foundation on which the income tax itself rests. Even if this theory of income taxation is rejected, and the exemption of churches is regarded as government assistance to them,<sup>118</sup> it may be permissible under the establishment clause so long as churches are not singled out for special treatment but are, rather, incidental beneficiaries of a rule applied impartially to a wide range of other nonprofit institutions.<sup>119</sup> Indeed, taxing churches while exempting the secular organizations that compete with them in the marketplace of ideas for the hearts and minds of man might collide with the free exercise clause of the First Amendment.<sup>120</sup>

### F. Social Welfare Organizations

Nonprofit organizations "operated exclusively for the promotion of social welfare" are exempted from income taxation by Section 501(c)(4).<sup>121</sup> The regulations flesh out the term "social welfare" by stating that:

118. The exemption of churches is not listed as a "tax expenditure" in the 1976 federal budget. See OFFICE OF MANAGEMENT AND BUDGET, *supra* note 14, at 108-09. See generally note 14 *supra*.

119. For a detailed examination of the establishment clause issue, see *Walz v. Tax Comm'n*, 397 U.S. 664 (1970); Bittker, *supra* note 23.

120. Cf. *United States v. Seeger*, 380 U.S. 163 (1965), and *Welsh v. United States*, 398 U.S. 333 (1970), involving the scope of the exemption from the draft granted by Congress to persons conscientiously opposed to participation in war in any form by reason of "religious training and belief." The draft exemption was held to embrace a number of conscientious objectors whose convictions were not based on orthodox religious grounds. The cases were concerned at one level with the intended scope of the legislation, but the opinions are replete with both implicit and explicit references to the establishment clause, leading to the conclusion that a statutory distinction between "religious" and "secular" objections to war might be unconstitutional.

121. The statutory phrase is "[c]ivic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare . . ." To the effect that the introductory adjective "civic" does not confine the exemption to municipal or community-sponsored groups, see *Peoples Educ. Camp Soc'y, Inc. v. Commissioner*, 331 F.2d 923, 929-30 (2d Cir. 1964). But see *Commissioner v. Lake Forest, Inc.*, 305 F.2d 814 (4th Cir. 1962) (holding that a cooperative nonprofit corporation organized to purchase and own a housing project in which its members resided did not promote "social welfare" because the benefits did not inure to the public at large). But cf. *Eden Hall Farm v. United States*, 389 F. Supp. 858 (W.D. Pa. 1975) (vacation home for "working girls and women" endowed by the executive of a business corporation qualifies under § 501(c)(4)

An organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated primarily for the purpose of bringing about civic betterments and social improvements.<sup>122</sup>

As defined, "social welfare" is similar to "charitable purposes" as that term is used in § 501(c)(3),<sup>123</sup> and there is a substantial degree of overlapping between the two provisions.<sup>124</sup> The two statutory provisions are saved from complete redundancy, however, by the exclusion of "action organizations" from § 501(c)(3).<sup>125</sup> Thus, a nonprofit organization can qualify under § 501(c)(4) even though it has forfeited its § 501(c)(3) exemption by such "action organization" activities as attempting to influence legislation by propaganda, by pursuing objectives that can be attained only by the enactment of legislation, or by campaigning for the attainment of its objectives rather than engaging in nonpartisan analysis and making the results of its research available to the public.<sup>126</sup>

This "action organization" distinction between § 501(c)(3) and § 501(c)(4) organizations is a creature of the Treasury Regulations, with no explicit sanction in either the statute or its legislative history, but it is not easy to find other criteria separating the two categories.<sup>127</sup>

even though 80 percent of occupancy was by employees of the corporation and remaining 20 percent by their invited guests and others). *See also* *Erie Endowment v. United States*, 316 F.2d 151 (3d Cir. 1963).

Section 501(c)(4) also embraces a limited class of local employee associations devoting their net earnings to charitable, educational or recreational purposes. *See* *Treas. Reg. § 1.501(c)(4)-1(b)* (1959).

122. *Treas. Reg. § 1.501(c)(4)-1(a)(2)(i)* (1959).

123. *See Amdur, Tax Exemption of Social Welfare Organizations*, 45 *TAXES* 292 (1967); *Hopkins, The Social Welfare Organization under the Internal Revenue Code*, *PRAC. LAW.*, Oct. 1971, at 15.

124. Indeed, the term "charitable" is defined by *Treas. Reg. § 1.501(c)(3)-1(d)(2)* to include the "promotion of social welfare" by charitable or similar activities. *But see* *Rev. Rul. 57-493, 1957-2 CUM. BULL. 314*, ruling that a nonprofit corporation organized to construct and lease a stadium to a school district, the title to which would eventually vest in the district, was not a § 501(c)(3) organization, but qualified under § 501(c)(4); and that contributions to it could be deducted under § 170(c)(1) (gifts to governments and political subdivisions, if for exclusively public purposes).

125. *Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii)* (1959). For another distinction between § 501(c)(3) and § 501(c)(4) organizations, see note 127 *infra*.

126. *But see* note 130 *infra*.

127. *But see* *Erie Endowment v. United States*, 316 F.2d 151 (3d Cir. 1963), where a nonprofit corporation whose income was eventually to be spent for charitable purposes was denied a § 501(c)(3) exemption because the trustees were obligated to accumulate income in a manner held to be unreasonable under the now repealed § 504. When the organization then sought an exemption under § 501(c)(4), the court held that it was not "a community movement designed to accomplish community ends" as required by § 501(c)(4), because it was created and dominated by one man. (These aspects of its



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The principal operational difference is that donors may deduct contributions to § 501(c)(3) organizations, but not those to § 501(c)(4) organizations.<sup>128</sup> When the sole issue is the exemption of the organization's own income, however, it does not matter whether it is classified as a "charitable" or a "social welfare" organization; both are exempt, except for their unrelated business income. Thus, a charitable organization that is expelled from § 501(c)(3) for advocating the adoption or rejection of legislation will ordinarily be entitled to an exemption under § 501(c)(4), though contributions to it will no longer be deductible by the donors.<sup>129</sup> Looking solely to the statute, one might draw the same inference about a charitable organization that participated in a political campaign, an activity that is explicitly forbidden by § 501(c)(3) but not by § 501(c)(4). But the Regulations state that this activity does not constitute "the promotion of social welfare," and the Internal Revenue Service has taken the position that *any* campaign activity is a bar to exemption.<sup>130</sup>

The tax exemption accorded to social welfare organizations rests on substantially the same grounds as the exemption of charitable organizations. Since their objectives largely overlap, it would be as difficult to measure the "income" of the one as of the other, and since the beneficiaries of both are unidentifiable members of the public at large, there would be equal difficulty in prescribing an appropriate tax rate even if the income of either could be satisfactorily defined and computed. Finally, the policy reasons canvassed

organization and operation would not have been a barrier to an exemption under § 501(c)(3) if its other conditions had been met.) Had *Erie Endowments* gone the other way, the statutory denial by the now repealed § 504 and its statutory predecessor (§ 3814 of the 1939 Code, applicable to taxable years 1951-1969) of a § 501(c)(3) exemption to charitable organizations that unreasonably accumulated income would have served, in practice, only to prevent contributors from deducting their gifts to such organizations; the organizations themselves would have continued to be tax-exempt by virtue of § 501(c)(4).

Former § 504 and its statutory predecessor also denied tax exempt status to § 501(c)(3) organizations if they engaged in prohibited business transactions with certain related persons, and they were taxed on unrelated business income. § 501(c)(4) organizations were not subject to these disabilities.

128. § 170(c). *But see* Rev. Rul. 57-493, 1957-2 CUM. BULL. 314. When a contribution to a § 501(c)(4) organization can qualify as a business expense, however, the amount of the donor's deduction is not restricted by § 162(b); to this limited extent, § 501(c)(4) organizations may be better off than § 501(c)(3) organizations.

129. *But see* Rev. Rul. 57-494, 1957-2 CUM. BULL. 315, asserting that an organization cannot qualify under § 501(c)(4) if it falls within § 501(c)(9)'s purview (certain employee groups), but does not meet all of its requirements. Some of the impetus for this position may have been reduced in 1969 when § 501(c)(4) organizations were subjected to the unrelated business income tax, thus eliminating one comparative advantage of classification as a social welfare organization. *See also* *Erie Endowment v. United States*, 316 F.2d 151 (3d Cir. 1963).

130. Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii) (1959). For the status of political organizations, see pp. 328-30 *supra*.

earlier<sup>131</sup> are equally applicable to § 501(c)(4) organizations. Indeed, since current law permits social welfare groups to seek the enactment or repeal of legislation, they may be even more effective than charitable organizations as independent centers of power in a bureaucratized society.

### III. Mutual Benefit Organizations

In general terms, mutual benefit organizations are operated to provide goods and services to their members at cost. Any excess of gross revenues over costs may appear to violate this purpose, but since they do not endeavor to generate profits from membership patronage, a year-end surplus could be viewed as an overcharge which, if promptly refunded to the members, should not be classified as "income." This is in fact how patronage refunds by consumers' cooperative societies are treated, reflecting the fact that the society would have had nothing resembling "income" if it had reduced its prices in order to avoid a year-end surplus.<sup>132</sup> And since actual price reductions would have prevented the society from having any income, one might favor the same tax-free result if the "overcharges" are retained by the mutual society to benefit the members in future years by permitting charges to be reduced or facilities to be expanded without additional cost. Alternatively—but with the same nontaxable result—a mutual society's "profit" from membership patronage might be regarded as a deposit or capital contribution<sup>133</sup> by the members to finance future activities or facili-

131. See p. 332 *supra*.

132. §§ 1381-1388. Farmers' cooperatives and similar groups for the joint marketing of their members' products seem to be a special case, but can be subjected to a similar analysis. For each member, the spread between the cost of raising his crop and the price received by the marketing coop can be appropriately regarded as income, whether it is distributed to him or retained, with his consent, to expand the cooperative's facilities or reduce its expenses in future years. The organization as such is best viewed as a conduit, which would realize nothing resembling "income" if it could accurately predict and deduct its expenses from the amounts remitted to its members, and borrow from them any amounts needed to acquire or construct buildings, equipment, and other facilities. Alternatively, the organization could be viewed—with similar tax consequences—as a partnership, the results of whose operation should be imputed to its members. See also note 140 *infra*; Logan, *Federal Income Taxation of Farmers' and Other Cooperatives*, 44 TEXAS L. REV. 250 & 1269 (1965, 1966); Klein, *supra* note 14, at 31-34.

For a similar analysis of mutual insurance companies, disentangling the customer, creditor, and shareholder aspects of the policyholder's relationship to the company, see Clark, *The Federal Income Taxation of Financial Intermediaries*, 84 YALE L.J. 1603, 1657-63 (1975).

133. *But see* Edison Club, P-H TAX CT. REP. & MEM. DEC. (Tax Ct. Mem.) ¶ 75,019 (1975), *aff'd per curiam sub nom.* Edison Club v. Commissioner, 76-1 U.S. Tax Cas. ¶ 9186 (2d Cir., Dec. 8, 1975) (rejecting the argument that unexpended amounts paid by members as "dues" or "assessments" are excludable from taxable income as capital contributions under § 118).

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ties. If the members of a commune estimate their expenses for food at \$500 per person and pay this amount in advance to their purchasing agent, one would not expect the group, as an entity, to realize income if the cost turned out to be only \$450 per person, even if the excess was retained for the commune's future needs rather than refunded to the members. To classify the excess as income would be tantamount to taxing the members because they were astute shoppers or because they performed unpaid services for the society.

Much could be said for a comprehensive statutory rule embodying the foregoing rationale, but—as is often true of the Internal Revenue Code—Congress has preferred piecemeal legislation to broad generalizations. Similarly, Congress did not prescribe a set of across-the-board rules governing the investment income, profit-oriented activities and transactions with nonmembers, of mutual benefit organizations, but instead established many divergent taxing systems, which turn on such variables as the organization's size, function, history, and occupational or geographic characteristics. The most important categories of mutual benefit organizations are discussed hereafter.

### A. *Social Clubs*

Clubs organized and operated exclusively “for pleasure, recreation, and other nonprofitable purposes” have been exempt since 1916.<sup>134</sup> As originally enacted, the exemption was denied if any part of the club's net earnings inured to the benefit of any “private shareholder or member.” In 1924, the word “member” was excised from this restriction,<sup>135</sup> and the door was opened to two substantial tax advantages: the build-up of a tax-free endowment, and the exemption from tax of profits derived from dealings with nonmembers.

First, the members of a social club could build up its capital with their initiation fees and dues, immunizing the income generated by these contributions from tax, even though it served to reduce the club's charges to its members in later years. Of course, if the dues and fees

134. See generally Moffett, *The Problem of Section 501(c)(7) Organizations*, 54 TAXES 4 (1976).

135. The cases and rulings continue to refer to benefits which inure to “members” but they can be construed as saying no more than such benefits are a sign that the club in question is not operated *exclusively* for “pleasure, recreation, and other non-profitable purposes.” Thus, Rev. Rul. 70-32, 1970-1 CUM. BULL. 132, denied tax exempt status under § 501(c)(7) to a flying club whose sole activity was “rendering flying services to its members,” and in which there was “no significant commingling of its members.” Cf. Rev. Rul. 74-30, 1974-1 CUM. BULL. 137, granting tax exempt status to a flying club where there was “constant person-to-person association among the members.” Rev. Rul. 70-32 was distinguished by the fact that in that case “the club was operated primarily as a service to members, rather than for the pleasure and recreation of members.” See also *Spokane Motorcycle Club v. United States*, 222 F. Supp. 151 (E.D. Wash. 1963).

were invested in such assets as a golf course or a clubhouse, the use of the exempt organization to acquire these properties would not result in a tax savings for the members, because if the members invested in recreational or social property individually or as joint tenants rather than through a "conduit" organization, their ownership and use of these facilities would not itself create taxable income. But if the club converted the contributions into income-producing endowment, it got an exemption that was not available to the members as individuals. In effect, therefore, they could earmark part of their own income-producing capital to be used, free of income taxes, to pay for their pleasure or recreation.<sup>136</sup> Second, social clubs enjoyed an even more dramatic advantage in that profits generated by their transactions with nonmembers were also exempt from tax, despite use of these profits to reduce the fees paid by members or to provide better facilities without cost to them.

Before 1969, when this state of affairs was drastically altered by legislation, the courts intervened from time to time to limit the scope of these tax advantages. Although the adjective "social" is a label rather than an operative statutory phrase, the statutory term "club," in conjunction with the Code's references to "pleasure" and "recreation," was held to require "some sort of commingling of members," with the result that groups like automobile clubs serving a mutual interest without social contact among the members were held not to qualify.<sup>137</sup> The courts found another restraint in the statutory requirement that a club be operated exclusively for "nonprofitable purposes," which was interpreted to disqualify clubs with excessive amounts of income from nonmembership patronage or separate business activities.<sup>138</sup> Even if a social club avoided these pitfalls, however, the Tax Reform Act of 1969 substantially reduced its tax advantages by expanding the

136. A nonexempt club might attempt to achieve the same result, by using endowment or business income to reduce its charges to members for their use of its social facilities, and deducting the maintenance expenses under § 162, in a manner reminiscent of the incorporated country estates and yachts that gave rise to § 543(a)(6) of the personal holding company provisions. See B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS ¶ 8.22, at 8-44, ¶ 8.20, at 8-34 (3d ed. 1971). This gambit has been ended by the enactment of § 277 in 1969; for its relation to pre-1969 law, see *Adirondack League Club*, 55 T.C. 796 (1971), *aff'd per curiam*, 458 F.2d 506 (2d Cir. 1972) (deductions for social facilities allowed only to the extent of income from members).

137. *Automobile Club v. Commissioner*, 353 U.S. 180 (1957); *Keystone Auto. Club v. Commissioner*, 181 F.2d 402 (3d Cir. 1950); *Chattanooga Auto. Club v. Commissioner*, 182 F.2d 551 (6th Cir. 1950). See also note 135 *supra*; §§ 277, 456(c); S. REP. NO. 91-552, 91st Cong., 1st Sess. 74 (1969), *reprinted in* 1969-3 CUM. BULL. 423, 471-72.

138. *United States v. Fort Worth Club*, 345 F.2d 52, *modified on other grounds*, 348 F.2d 891, (5th Cir. 1965). See also *Pittsburgh Press Club v. United States*, 388 F. Supp. 1269 (W.D. Pa. 1975).

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reach of the tax on "unrelated business taxable income." With minor exceptions, a social club's income from investments and from non-member patronage is now taxable.<sup>139</sup>

As a consequence of the 1969 changes, the major significance of a social club's exemption at present is that it is not taxed on "profits" arising from goods, facilities, and services furnished to members and their dependents and guests. This residual tax advantage is minimal, if the club is regarded as a true association of its members, since any profit from one year's operations will at most be used to reduce membership charges in another year. A relentless search for income in this context, of course, would disclose that some members derive an economic advantage from expenditures by their fellow members. Thus, if the club's sole charge is an annual membership fee, those who use the club's facilities frequently are subsidized by the other members, just as a trencherman benefits from splitting a restaurant bill equally after dining with a group of abstemious friends. But if the friends' overpayment is subjected to analysis, it qualifies as a tax-free gift to the person paying less than his true share of the bill. Perhaps the benefits accruing to a member of a social club who pays less than his share of its costs, at the expense of members paying more than their share, can also be characterized as a gift, even though the bonds of affection among the members are more attenuated than is customary in the case of most gifts.

### B. Consumers' Cooperatives and Similar Organizations

The Internal Revenue Code contains a single set of rules to govern the tax treatment of two quite different types of cooperative societies—consumers' cooperatives, organized primarily to supply food and other household goods to their members; and marketing cooperatives, organized by farmers, dairymen, and other producers to market their agricultural products. The far greater economic importance of marketing cooperatives, coupled with a risk that agricultural profits may slip untaxed through a statutory crevice between the cooperative and its members, has given rise to elaborate provisions to ensure that all income will be reported by one or the other of these potential taxpayers.<sup>140</sup> The tax status of consumers' cooperatives emerges almost as an afterthought from the same network of rules.

139. § 512(a)(3). See Rev. Proc. 71-17, 1971-1 CUM. BULL. 683, prescribing audit guidelines to determine the amount of a social club's nonmembership receipts, as a prelude to deciding whether its tax exemption has been forfeited and, if not, its tax under § 512(a)(3); Horn, *Unrelated Business Income of Social Clubs*, 49 TAXES 738 (1971).

140. §§ 1381-1388. See note 132 *supra*. The "exemption" conferred by § 521 on many of these marketing cooperatives is something of a misnomer; they are treated much like

Under the basic statutory scheme, as applied to consumers' cooperatives, the organization enjoys no explicit tax exemption; but it is allowed to exclude patronage dividends from its taxable income. These distributions are not taxed to the members, on the theory that they represent belated reductions in the cost of household goods.<sup>141</sup> The net effect is that the organization is taxed in full on income from business with nonmembers; it is taxed on transactions with its members only to the extent that overcharges are not refunded, and it can reduce its taxable income from membership transactions by either charging less or refunding more. Earnings from membership patronage retained by the organization to provide working capital or expand its facilities, however, are subject to tax, even though, as suggested earlier, they might be appropriately exempted on the ground that they represent savings by the members to reduce their future living expenses.<sup>142</sup>

Although they perform substantially the same functions as consumers' cooperatives, various other organizations are granted blanket tax exemption (save for their unrelated business income) by the Internal Revenue Code. This miscellaneous group of exempt organizations includes:

1. Fraternal lodges and employee associations providing life, sickness, accident, or other benefits to members and dependents.<sup>143</sup>
2. Local life insurance associations, and mutual irrigation, telephone, and similar companies, if at least 85 percent of their income is paid by members to defray expenses and losses.<sup>144</sup>
3. Cemetery companies operated for the benefit of their members, or not for profit.<sup>145</sup>

conduits through which the members sell their goods, patronage dividends being excluded from the organization's income but taxed to the members. Because the basic statutory principle is "conduit" treatment rather than true tax exemption, these cooperatives are comparable to trusts and Subchapter S corporations, and the statutory rules effectuating this basic policy are outside the scope of this article. See generally A.C. PICOU, *ESSAYS IN APPLIED ECONOMICS* ch. XIII (2d ed. 1924) (Income Tax and Co-operative Societies); I. PACKEL, *THE ORGANIZATION AND OPERATION OF COOPERATIVES* (4th ed. 1970).

141. Note that the member is not taxed on the patronage refund even if the society lost money on its sales to him and is able to distribute a dividend only because it made money on transactions with other members. Compare the treatment of members of a social club, discussed *supra*.

142. See note 132 *supra*.

143. §§ 501(c)(8) (fraternal beneficiary societies), 501(c)(9) (voluntary employees' beneficiary associations).

See also § 501(c)(10) (added in 1969 to provide an exemption for the Masons and similar groups); S. REP. NO. 91-552, 91st Cong., 1st Sess. 71-73 (1969), reprinted in 1969-3 CUM. BULL. 423, 470.

144. § 501(c)(12).

145. § 501(c)(13). See *John D. Rockefeller Family Cemetery Corp.*, 63 T.C. 355 (1974) (family nonprofit cemetery corporation qualifies for exemption; no requirement that it be open to the public).

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4. Credit unions.<sup>146</sup>
5. Insurance companies (primarily fire and casualty companies), whose premiums and investment income do not exceed \$150,000.<sup>147</sup>

Profits accruing to these organizations from membership patronage, which is probably the sole or dominant source of their income in most cases, qualify for exemption under the rationale outlined above for exclusion of the patronage dividends of cooperatives. Income from investment or nonmembership patronage, however, would not be immune from tax under this conduit rationale, and the statutory exemption of income from these sources probably reflects benign neglect more than thoughtful attention.<sup>148</sup>

### C. Labor Unions

Section 501(c)(5) exempts "labor organizations" in unqualified language, carrying forward a provision of the Revenue Act of 1913.<sup>149</sup> The Regulations state that the organization's net earnings must not inure to the benefit of any member, a restriction of doubtful validity

146. § 501(c)(14)(A).

147. § 501(c)(15).

148. In addition to consumer cooperatives, agricultural and horticultural organizations have been consistently included in the statutory list of exempt organizations since 1913. Although the statute does not describe these organizations further, the Regulations state that their objectives must be "the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations" and that they must not allow their net earnings to inure to the benefit of their members. Treas. Reg. § 1.501(c)(5)-1(a) (1958).

Given these limitations, organizations qualifying under § 501(c)(5) have much in common with business leagues, exempt under § 501(c)(6), and with social welfare organizations, exempt under § 501(c)(4). *But see* Consumer Farmer Milk Coop., Inc. v. Commissioner, 186 F.2d 68 (2d Cir. 1950), *cert. denied*, 341 U.S. 931 (1951) (farmer's cooperative not exempt under predecessor of § 501(c)(4)); *cf.* Scofield v. Rio Farms, Inc., 205 F.2d 68 (5th Cir. 1953) (corporation aiding low income farmers exempt as a social welfare organization).

Since the agricultural and horticultural organizations qualifying under § 501(c)(5) would probably otherwise meet the tests of § 501(c)(6) or, in some instances, § 501(c)(4), their inclusion in § 501(c)(5) seems a harmless bit of statutory specificity. There is, however, no reason why agriculture and horticulture should be signaled out for special mention in the Code, which makes no mention of other occupational areas.

Farmers' cooperatives, whether engaged in purchasing supplies and equipment for their members or in marketing their produce, are subject to special rules. *See* p. 351 *supra*. Hence the organizations qualifying under § 501(c)(5) are probably of minor importance. The few published rulings refer to the sponsorship of county fairs, improvement of livestock, and soil testing as appropriate objectives of these organizations. *See* Campbell v. Big Spring Cowboy Reunion, 210 F.2d 143 (5th Cir. 1954); East Tenn. Artificial Breeders Ass'n v. United States, 12 Am. Fed. Tax R.2d 5848 (E.D. Tenn. 1963); Rev. Rul. 66-179, 1966-1 CUM. BULL. 139; Rev. Rul. 56-245, 1956-1 CUM. BULL. 204; Rev. Rul. 55-230, 1955-1 CUM. BULL. 71; Rev. Rul. 54-282, 1954-2 CUM. BULL. 126 (1939 Code).

149. *See* Albert & Hansell, *The Tax Status of the Modern Labor Union*, 111 U. PA. L. REV. 137 (1962).

unless loosely construed, since the statutory provision must have been intended, and has been consistently interpreted, to exempt labor unions engaged in collective bargaining on behalf of their members.<sup>150</sup> The prohibition is also virtually retracted by another part of the Regulations themselves, conditioning the exemption on the organization's dedication to "the betterment of the conditions" of its membership.<sup>151</sup> Moreover, the Internal Revenue Service has ruled that unions do not lose their exemption by paying sickness, death, accident, or other benefits to members. In revoking an earlier ruling to the contrary, the Service said that "labor organizations were exempted for the very reason that they operated, in part, as mutual benefit organizations providing [such] benefits to their members."<sup>152</sup>

Approached ab initio, the exemption of labor unions is best examined in the context of the principles governing business expenses. Dues paid by a union member are deductible as ordinary and necessary business expenses under § 162 because the organization serves as his collective bargaining agent in a profit-seeking endeavor and in otherwise seeking to improve his conditions of employment.<sup>153</sup> If the dues are not immediately spent by the union, but are invested and retained for future contingencies (in a strike fund, for example), the member's share of the union's investment income might be imputed back to him. But then the member should be allowed an offsetting deduction when the income so imputed is later spent by the organization on his behalf, because he could deduct similar expenditures from his own private (and taxable) investment income.

As in the case of business leagues,<sup>154</sup> exempting the organization's accumulated income is the equivalent of currently imputing its income to its members but allowing them to deduct these amounts when they are ultimately used by the union, except that the time value of the money slips past the tax collector. Alternatively, if the union's accumulated income permits dues to be reduced in future years (or activities to be expanded without additional cost to the member-

150. Treas. Reg. § 1.501(c)(5)-1(a)(1) (1958). See Rev. Rul. 73-411, 1973-2 CUM. BULL. 180, to the effect that in employing "popular names in describing [exempt] organizations . . . such as 'labor organizations' . . . Congress is presumed to have had reference to organizations as they actually exist and are commonly known."

151. Treas. Reg. § 1.501(c)(5)-1(a)(2) (1958).

152. Rev. Rul. 62-17, 1962-1 CUM. BULL. 87, revoking Rev. Rul. 58-143, 1958-1 CUM. BULL. 239.

153. See note 20 *supra*. If the dues are spent by the union on activities that would not generate deductions for the members if financed directly by them (rather than for activities advancing their occupational interests), the case for a § 162 deduction is pro tanto weakened. Cf. Treas. Reg. § 1.162-20(c)(3) (1965), amended by T.D. 6996, 1969-1 CUM. BULL. 88.

154. See pp. 356-57 *infra*.



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ship), the fact that the members will deduct a smaller amount for dues in these years than if they paid in full for the union's activities will compensate the Treasury, albeit belatedly, for the revenue lost by exempting the union's income when realized—again, except for the time value of the money.<sup>155</sup>

### D. *Business Leagues*

Since 1913, business leagues, chambers of commerce, and boards of trade have been exempt from income taxation if not organized for profit and if their net earnings do not inure to the benefit of any private shareholder or individual. Real estate boards were added to the statutory list in 1928 and professional football leagues in 1966.<sup>156</sup> Trade associations are the most common instances of exempt "business leagues," along with professional groups like the American Bar Association and the American Medical Association.

For most qualifying organizations, the statutory prohibitions of § 501(c)(6) against a profit orientation and the inurement of net earnings to private benefit must be loosely interpreted, as was no doubt intended by Congress from the outset. Strictly construed, these limits would close the door to organizations serving the business interests of an industry, since these activities inure to the benefit of their profit-motivated members. Such a construction would confine § 501(c)(6) to organizations not in need of its protection—those devoted to the general welfare of society, which qualify for exemption as charitable or social welfare organizations under § 501(c)(3) or (4). The statutory prohibitions of § 501(c)(6), therefore, have not been interpreted to preclude the commonly understood objectives of chambers of commerce and similar organizations.

As summarized by the Regulations, the activities of a business league

should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons. An organization whose purpose is to engage in a regular business of a kind ordinarily carried on for profit, even though the business is con-

155. *But see* note 153 *supra*. Since the membership's composition changes over time, the group to whom the union's investment income would be imputed is not identical with the group that will benefit from future lower dues. As pointed out earlier (p. 350 *supra*), there is a similar disparity in the case of social clubs.

156. § 501(c)(6). The 1966 committee reports do not disclose why baseball was not given the same treatment as football. If the House Committee on Un-American Activities were still on the warpath, surely it would want to investigate this disparagement of our national sport.

ducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a business league.<sup>157</sup>

In administration, the interpretative problems under § 501(c)(6) have primarily concerned the boundary between business leagues and taxable joint business ventures. Although § 501(c)(6) does not by any means impose a high standard of altruism, it has been held to exclude organizations created by business competitors to coordinate or centralize their advertising or purchasing activities, engage in research for their exclusive benefit, furnish credit reports and collect delinquent accounts, or otherwise advance their special business interests; § 501(c)(6) does require some showing of benefit to the public.<sup>158</sup> Less frequently, it is necessary to decide whether a business league's devotion to the public interest so outweighs its service to its membership as to justify classification as a charitable or educational organization.<sup>159</sup> Charitable status is ordinarily of minor importance, however, since tax exemption as a business league is usually as satisfactory as exemption under § 501(c)(3). To be sure, the latter status permits gifts to be deducted by the donors as charitable contributions, but this is no more (and, occasionally, less) advantageous than deducting them as

157. Treas. Reg. § 1.501(c)(6)-1 (1958). For the exclusion of associations engaged in a business of a type ordinarily carried on for profit, see *Credit Bureau of Greater New York, Inc. v. Commissioner*, 162 F.2d 7 (2d Cir. 1947). See also note 160 *infra*.

The major current interpretative issues arising under § 501(c)(6) are: (1) whether accrediting organizations belong under § 501(c)(6) or § 501(c)(3); (2) whether the provision of low cost life insurance to the members of a business league at a profit generates unrelated business income for the organization; (3) whether organizations of merchants in a shopping center to centralize their advertising qualify under § 501(c)(6); (4) whether the protection and promotion of an industry trademark is consistent with § 501(c)(6) status; and (5) the proper treatment of income from trade shows and publications sponsored by a business league. See Donald C. Alexander, Commissioner of Internal Revenue, Remarks before American Society of Association Executives, New Orleans, La., Aug. 29, 1973; *American Plywood Ass'n v. United States*, 267 F. Supp. 830 (W.D. Wash. 1967) (quality control and trademark promotional activities, although they may not be exempt activities per se, are consistent with § 501(c)(6) exemption if "incidental" to a main purpose which justifies exemption); Rev. Rul. 75-516, 1975 INT. REV. BULL. No. 48, at 18 (exempt organization's rental of display space at convention qualifies on the basis of the informational value of exhibits and a "no sales or order-taking" clause in the rental agreements); Rev. Rul. 73-411, 1973-2 CUM. BULL. 180 (shopping center merchants' association to promote membership's business interests does not qualify).

158. See *Medical Diagnostic Ass'n*, 42 B.T.A. 610, 616-17 (1940); *Glass Container Indus. Research Corp. v. United States*, 70-1 U.S. Tax. Cas. ¶ 9214 (W.D. Pa. 1970). For a broad reading of the public benefit test, see *Pepsi-Cola Bottlers' Ass'n, Inc. v. United States*, 369 F.2d 250 (7th Cir. 1966), *not acquiesced in*, Rev. Rul. 68-182, 68-1 CUM. BULL. 263.

159. See, e.g., Rev. Rul. 74-146, 1974-1 CUM. BULL. 129 (organization which accredits schools, including a small number of proprietary schools, is exempt under § 501(c)(3)); Rev. Rul. 68-373, 1968-2 CUM. BULL. 206 (nonprofit organization engaged in testing drugs for pharmaceutical companies; held, not exempt under § 501(c)(3)).

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business expenses under § 162.<sup>160</sup> While charitable status would be preferred to a § 501(c)(6) exemption if gifts are sought from exempt foundations or other nonmember donors, a business league could obtain deductible contributions by organizing an affiliated entity devoted solely to its charitable objectives. An example is the American Bar Association's American Bar Endowment.

Once it is recognized that § 501(c)(6) organizations ordinarily serve the business objectives of their members, the justification for their statutory exemption is exposed as rickety. There would be no great difficulty in applying familiar principles of income computation to their activities, nor in fixing an appropriate level of taxation for an organization whose membership is composed of corporations whose income is taxed predominantly at a fixed rate. On the other hand, the exercise would, to a large degree, be self-defeating. First, their charges to members would no doubt be increased to offset the tax, and the additional amounts would be deductible by the members as business expenses; their own taxes would thus be reduced by about one-half of the taxes paid by the organization. Second, as a more drastic response, the organization could operate at or near its breakeven point, generating little or no income to be taxed, and increasing its charges to its members when necessary.

Viewed as an alternative to hypothetical charges that could be deducted by its members, a business league's tax exemption, which covers its investment income, is not without a plausible rationale. The principal residual objection to the § 501(c)(6) exemption is that if large reserves are currently being accumulated by the organization against nebulous and distant future needs, its members are able to delay income tax liability—and thus save the time value of the deferred taxes—by taking immediate deductions for the league's future business expenditures and by excluding from income the organization's endowment income.

### Conclusion

The exemption of nonprofit organizations from federal income taxation is neither a special privilege nor a hidden subsidy. Rather, it reflects the application of established principles of income taxation

160. See note 128 *supra*. But see *Underwriters' Laboratories, Inc. v. Commissioner*, 135 F.2d 371 (7th Cir. 1943), involving an association organized by fire insurance companies to test electrical products for safety, which was excluded both from § 501(c)(6) (because it conducted a regular business) and § 501(c)(3) (because it was not a charitable, scientific or educational organization, the only categories embraced by § 501(c)(3) for the taxable years before the court); in 1954, organizations of this type were given § 501(c)(3) status by an amendment covering "testing for public safety."

to organizations which, unlike the typical business corporation, do not seek profit.

In these pages we have distinguished between public service organizations—institutions which channel the largesse of some individuals in the interest of others—and mutual benefit organizations, whose main purpose is to allow individuals to pool their income in order to spend it more efficiently. Public service organizations do not produce income which can easily be assimilated to the “profit” produced by a business for the benefit of investors. Even if this inherent unsuitability of an income tax were disregarded by imposing an arbitrary concept of “income” on their financial activities, the burden of the tax would not reflect the ability to pay of the individual beneficiaries.

The activities of mutual benefit organizations that consist simply in the members' doing together what they could do separately without income tax consequences (such as buying food or operating social facilities) are not fit objects of taxation. But such organizations may also do business with nonmembers or invest in assets which produce income inuring to the benefit of their members. There is no reason to permit income of these types, which would be neither excludable nor deductible from taxable income in the hands of an individual, to escape taxation when acquired under the umbrella of an organization. Frequently, however, the investment income of mutual benefit organizations would not be taxed if it were imputed to (or realized in the first instance by) the group's members, because it is used to defray expenses which the individuals would be entitled to deduct. One example is the investment income of a labor union, used to pay expenses serving the occupational interests of its members; another is a trade association's investment income, used for business expenses or to reduce the members' dues and assessments. In both cases, if the investment income were imputed to (or realized by) the members, they would be entitled to offsetting deductions under § 162. This is why to tax such income would be in effect to penalize taxpayers for doing together what they could do separately without being taxed. In sum, mutual benefit organizations should be taxed only to the extent of their investment income if such income would not be immune from tax in the hands of their members, or to the extent they do business with nonmembers in a way that produces something akin to “profit.”