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the law of tax-exempt organizations

Twelfth Edition

+ website

Bruce R. Hopkins

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The Law of Tax-Exempt Organizations

TWELFTH EDITION

BRUCE R. HOPKINS

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About the Author

BRUCE R. HOPKINS is the principal in the Bruce R. Hopkins Law Firm, LLC, Kansas City, Missouri. He concentrates in his practice on the representation of private foundations and other categories of tax-exempt organizations. His practice ranges over the entirety of law matters involving exempt organizations, with emphasis on the formation of nonprofit organizations, acquisition of recognition of tax-exempt status for them, the private inurement and private benefit doctrines, governance, the intermediate sanctions rules, legislative and political campaign activities issues, public charity and private foundation rules, unrelated business planning, use of exempt and for-profit subsidiaries, joint venture planning, tax shelter involvement, review of annual information returns, Internet communications developments, the law of charitable giving, and fundraising law issues.

Mr. Hopkins served as Chair of the Committee on Exempt Organizations, Tax Section, American Bar Association; Chair, Section of Taxation, National Association of College and University Attorneys; and President, Planned Giving Study Group of Greater Washington, D.C.

Mr. Hopkins is the series editor of Wiley's Nonprofit Law, Finance, and Management Series. In addition to being co-author of *The Tax Law of Private Foundations, Fifth Edition*, he is the author of *The Law of Tax-Exempt Organizations, Eleventh Edition*; *The Planning Guide for the Law of Tax-Exempt Organizations: Strategies and Commentaries*; *Bruce R. Hopkins' Nonprofit Law Library* (e-book); *Tax-Exempt Organizations and Constitutional Law: Nonprofit Law as Shaped by the U.S. Supreme Court; Bruce R. Hopkins' Nonprofit Law Dictionary*; *IRS Audits of Tax-Exempt Organizations: Policies, Practices, and Procedures*; *The Tax Law of Charitable Giving, Fifth Edition*; *The Tax Law of Associations*; *The Tax Law of Unrelated Business for Nonprofit Organizations*; *The Nonprofits' Guide to Internet Communications Law*; *The Law of Intermediate Sanctions: A Guide for Nonprofits*; *Starting and Managing a Nonprofit Organization: A Legal Guide, Sixth Edition*; *Nonprofit Law Made Easy*; *Charitable Giving Law Made Easy*; *Private Foundation Law Made Easy*; 650 *Essential Nonprofit Law Questions Answered*; *The First Legal Answer Book for Fund-Raisers*; *The Second Legal Answer Book for Fund-Raisers*; *The Legal Answer Book for Nonprofit Organizations*; and *The Second Legal Answer Book for Nonprofit Organizations.* He is the co-author, with Thomas K. Hyatt, of *The Law of Tax-Exempt Healthcare Organizations, Fourth Edition*; with Alicia M. Beck, of *The Law of Fundraising, Fifth Edition*; with David O. Middlebrook, of *Nonprofit Law for Religious Organizations: Essential Questions & Answers*; with Douglas K. Anning, Virginia C. Gross, and Thomas J. Schenkelberg, of *The New Form 990: Law, Policy and Preparation*; also with Ms. Gross, of *Nonprofit Governance: Law, Practices & Trends*; and with Ms. Gross and Mr. Schenkelberg, of *Nonprofit Law for Colleges and Universities: Essential Questions and Answers for Officers, Directors, and Advisors.* He also writes *Bruce R. Hopkins' Nonprofit Counsel*, a monthly newsletter, published by John Wiley & Sons.

ABOUT THE AUTHOR

Mr. Hopkins maintains a website providing information about the law of tax-exempt organizations, at www.brucerhopkinslaw.com (click on nonprofit law center). Material posted on this site includes a current developments outline concerning this aspect of the law, discussions of his books, and various indexes for his newsletter.

Mr. Hopkins received the 2007 Outstanding Nonprofit Lawyer Award (Vanguard Lifetime Achievement Award) from the American Bar Association, Section of Business Law, Committee on Nonprofit Corporations. He is listed in *The Best Lawyers in America*, Nonprofit Organizations/Charities Law.

Mr. Hopkins is the Professor from Practice at the University of Kansas School of Law, where he teaches courses on the law of tax-exempt organizations.

Mr. Hopkins earned his JD and LLM degrees at the George Washington University, his SJD at the University of Kansas, and his BA at the University of Michigan. He is a member of the bars of the District of Columbia and the state of Missouri.

Preface

One of the major highlights of my life is writing books, published by John Wiley & Sons, about the tax law applicable to nonprofit organizations. I began doing this in the early 1970s and have not stopped. I authored or coauthored 40 books during these years; more await. *The Law of Tax-Exempt Organizations*, however, remains special, inasmuch as it is the first book I wrote. I find it extraordinary that the book is now in its twelfth edition, covering developments in the federal law of tax-exempt organizations for the period ending in the fall of 2018.

By the time this edition is available, the book will have been in print for nearly 45 years. Sometimes, I shudder, thinking of the thousands of hours that underlie this and my other writing projects. Certainly the field of tax-exempt organizations law has been dynamic, volatile at times; the fact that this book is now in its twelfth edition is testament to the complexity of the subject matter and its astonishing and steady growth. In fact, the number of books in the Wiley Nonprofit Law, Finance, and Management Series, and the wonderful range of that material, evidences the explosiveness of the nonprofit sector over recent decades.

Most of the law reflected in this book did not exist 45 years ago. Tax exemption was introduced, constitutionally, in 1913, and the unrelated business income rules arrived in 1950. A considerable portion of the statutory law of exempt organizations is the product of enactment of the Tax Reform Act of 1969. (I am asked, from time to time, how I ended up practicing law in the realm of exempt organizations. I began practicing late in 1968. I got caught up in the writing and interpreting of the law Congress passed a few months later, and have just kept on going.)

This body of statutory law has been significantly expanded by many major and minor tax acts. In recent years, the field has been enlarged by the Pension Protection Act of 2006, the Patient Protection and Affordable Care Act, the Tax Increase Prevention Act of 2014, and the Protecting Americans from Tax Hikes (PATH) Act of 2015.

The most recent significant change reflected in this twelfth edition is assimilation of the new law brought about by enactment of what is informally known as the Tax Cuts and Jobs Act. The principal elements of this new body of law in the exempt organizations context is the "bucketing" rule now in place for computation of unrelated business taxable income, inclusion as unrelated business items of the value of certain types of fringe benefits, taxation of some colleges' and universities' endowment income, and taxation of the "excess" compensation of certain exempt organizations' executives. The Department of the Treasury and the IRS are just beginning to issue guidance as to these and other additions and changes to the law.[1]

[1] An article summarizing the various law additions and changes wrought by this legislation is available at Hopkins, "The Tax Cuts and Jobs Act Brings New Law for Tax-Exempt Organizations," 29 *Tax'n of Exempts* (No. 5) 3 (March/April 2018).

Another law area that is festering at this time is the matter of donor-advised funds. These funds are currently the subject of intense criticism. Treasury and the IRS are working on proposed regulations, which are anticipated to range over topics beyond the scope of the donor-advised funds statutory law provisions.

But the federal tax law affecting exempt organizations is by no means confined to statutes. Like other areas of the federal tax law, the field is heavily informed by Treasury Department regulations, Internal Revenue Service revenue rulings and revenue procedures, and opinions from various federal (and, occasionally, state) courts. The world of exempt organizations is also dramatically affected by IRS private determinations, usually in the form of private letter rulings and technical advice memoranda.

The past decade or so alone bears witness to an immense augmentation of the federal tax law of tax-exempt organizations. Developments in the health care, higher education, private foundations, and association fields, just to name a few, have been awesome to watch and challenging to chronicle. Other notable expansions of this law have occurred and are occurring in the realms of private inurement and private benefit, legislative and political campaign activities, applications for recognition of exemption and annual information returns, the use of limited liability companies and subsidiaries, supporting organizations, the commerciality doctrine, and the unrelated business rules.

Still other notable bodies of law include the intermediate sanctions rules, disclosure and document distribution requirements, exempt organizations and insurance, mergers and other reorganizations, tax shelter penalties, and fundraising regulation.

The IRS's Tax Exempt and Government Entities (TE/GE) Division has resumed issuance of annual work plans. The IRS has issued other interesting publications (summarized or referenced herein), including a memorandum from Rulings and Agreements concerning toughening of the processing time followed in connection with applications for recognition of exemption, a memorandum from the TE/GE Division regarding the use of one or more political activities referral committees, a notice pertaining to mission-related investing by private foundations, and a revenue procedure setting forth (in delightful detail) the process private foundations are to follow in securing equivalency determinations in connection with grants to foreign charities.

The streamlined application for recognition process, utilizing Form 1023-EZ, has been, I think, operating fairly well. The IRS continues to be battered by criticism of this application, much of it leveled by the National Taxpayer Advocate (noted herein). The IRS has responded to that criticism by adding to the application a required activity description and additional questions on gross receipts, assets thresholds, and public charity/private foundation classification. Thus, the streamlined application will be less streamlined. The IRS noted, perhaps dryly, in its fiscal year 2018 work plan, that "as a result of these changes, EO expects the average processing time for a Form 1023-EZ to increase."

The IRS continues to issue dozens of private letter rulings, some reflecting its positions on application of the commerciality doctrine (some of them questionable), the private inurement and private benefit doctrines, absence of a requisite charitable class, housing organizations, the lessening-burdens-of-government principle, qualification for exemption (mostly the lack thereof) for social welfare

organizations and business leagues, the conduit rules in connection with foreign grantmaking, and applications of the unrelated business rules. Rulings on matters of governance have noticeably slowed; the IRS's policies in connection with regulation of nonprofit governance continue to be, in the view from here, incorrect.

An issue has come to the fore, which is the matter of "conversion" from for-profit status to nonprofit, tax-exempt status. The IRS's ruling position seems to have evolved to the point that, once an enterprise has been formed as a for-profit entity, the commerciality and private inurement doctrines prevent it from ever being reconstituted as an exempt organization. That is certainly not the law. This issue was bizarrely highlighted when a small group of uninformed U.S. senators wrote to the IRS and the Department of Education asserting that conversions of for-profit schools to exempt schools are resulting in "sham nonprofits" and constitute fraud and tax evasion. In a surprise, this issue popped up in the 2018 work plan. It will be interesting to see how this matter will be treated.

Many notable court cases have been decided (again, all summarized herein), resulting in opinions concerning the necessary attributes of an entity qualifying as an *organization*, preliminary to considerations as to whether it is tax-exempt; the concept of a *corporation*, which generally subsumes the concept of a *nonprofit corporation*; the strict scrutiny test to apply in evaluating race-based affirmative action programs in the public higher education context; the lawfulness of the contraceptive mandate and its religious exceptions as applied to nonreligious tax-exempt entities; application of the strict scrutiny test in the free speech context; application of free speech principles in the realm of processing of applications for recognition of exemption; and articulation of a "historic principle of respect for the autonomy of genuine religions."

The Tax Cuts and Jobs Act was enacted near the close of 2017 year, bringing several new and revised rules concerning the law of tax-exempt organizations, all of which are summarized in this edition.

Two recent developments affecting tax-exempt organizations are of note. One development is the new country-by-country reporting regime and its impact on tax-exempt organizations. The regulations that detail this reporting requirement were issued in final form in July 2016; the principal statutory authority for this reporting is IRC § 6038. The other development is the import for exempt organizations of the new audit regime for partnerships; this body of law was created by the Bipartisan Budget Act of 2015 and revised by the PATH Act of 2015. Regulations have been issued, effective January 1, 2018. The concern is that exempt organizations in partnerships with for-profit partners may have tax penalties allocated to them by reason of the new taxes on partnerships, giving rise to unwarranted private benefit.

Also, there is this matter of executive orders issued from the Trump White House. One order placed a regulatory freeze on departments and agencies of the federal government, including the Department of the Treasury. Another order required agencies to revoke existing rules for every new one proposed. Still another is designed to eliminate regulations that are outdated or unnecessary. A report issued by Treasury on October 2, 2017, recommended actions to eliminate or mitigate the "burdens imposed on taxpayers" by eight sets of regulations. An executive order of direct relevance in the exempt organizations setting is the one pertaining to "free speech and religious liberty" (summarized herein).

One of the great stars of this show, of course, is the revamped Form 990. Despite its size and complexity (and some overreaching), this return is a work of art. For the larger tax-exempt organizations, proper preparation of this return is a mighty feat. But that is not the stuff of law development, although the return preparation entails considerable lawyering. Form 990 is no mere government form; the issuance of the redesigned return, and its accompanying schedules and instructions, was akin to publication of a mammoth set of regulations. Much new "law" is embedded in this document. In the context of nonprofit law, there has never been anything like it. Touted by its designers as a vehicle for acquiring information and promoting transparency, the real story is the enormous impact this return has been having, and continues to have, in shaping the behavior of the leaders, managers, and representatives (including lawyers and accountants) of exempt organizations, particularly in terms of development of policies, procedures, protocols, and other forms of governance practices.

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This book evolved out of materials developed for the course on the law of tax-exempt organizations that I taught for 19 years at the George Washington University School of Law, in Washington, D.C., beginning in 1973. It reflects hundreds of questions asked by law students and seminar and conference attendees over the years. It has been shaped further by the inquiries of clients and colleagues.

I have tried to provide a summary of the law of tax-exempt organizations, one that is sufficiently general to present the subject in all of its marvelous expanse and peculiarity, yet with enough particularity to give the reader the specifics when needed. Thus, the book has been written in as nontechnical a manner as I can muster, yet with footnotes and other sources (including the online material) that lead to more detailed information.

It is hoped that lawyers, managers, accountants, directors and officers, fundraising executives, and students of the field can use this book to learn particular aspects of the subject matter or refresh their minds about a rule.

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I struggle to keep this book to a single volume. This book would be much thicker but for some tightening of the writing and jettisoning of various sections. For example, I removed most of the material concerning private foundations law and incorporated it into *The Tax Law of Private Foundations*, now in its fifth edition (2018). Further trimming occurred when four other books were published – *The Tax Law of Unrelated Business for Nonprofit Organizations* (2005), *The Tax Law of Associations* (2006), *The New Form 990: Law, Policy, and Preparation* (2009); and *Nonprofit Governance: Law, Practices, and Trends* (2009). These topics are nonetheless reflected in the book (in Chapters 12, 24, 25, 14, 28, and 5, respectively).

There have been other instances of tightening of this nature. I am the author or coauthor of books on charitable giving, fundraising regulation, intermediate sanctions, Internet communications, and health law. These efforts, too, have helped curb the girth of the book. Nonetheless, there is not enough space herein for a detailed analysis of cases, rulings, and the like. I provide such analysis, however, in my monthly newsletter, *Bruce R. Hopkins' Nonprofit Counsel*, which is in its 36th year. The newsletter includes references to this book for additional reading and

background information. The newsletter is a stand-alone publication; at the same time, for those with the book, it also serves as a monthly update.

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Clichés about a book such as this abound. "Labor of love" and "work in progress" are two of them. The most important one of all, however, must be said: There have been many individuals with me on this journey who have helped enormously, doing much to nurture the book over the years, especially my friends and colleagues at John Wiley & Sons. Most notable in the past have been Walter Maythem, Dick Lynch, Jeffrey Brown, Marla Bobowick, Martha Cooley, Robin Goldstein, and Susan McDermott.

My thanks go to my senior editor, Brian T. Neill, my development editor, Vicki Adang, and my production editor, Abirami Srikandan, for their assistance and support in connection with creation of this edition of the book.

Bruce R. Hopkins
2019

About the Online Resources

The Law of Tax-Exempt Organizations, Twelfth Edition is complemented by a number of online resources.

For a list of all Wiley books by Bruce R. Hopkins, please visit www.wiley.com/go/hopkins.

Also, please visit www.wiley.com/go/hopkinstaxexempt to download various appendices and tables in PDF format to use alongside this Twelfth Edition.

The appendices are:

- Appendix A - Sources of Tax-Exempt Organizations Law
- Appendix B - Internal Revenue Code Sections
- Appendix C - 76 Categories of Tax-Exempt Organizations

The tables are:

- Table of Cases
- Table of IRS Revenue Rulings
- Table of IRS Revenue Procedures
- Table of IRS Private Determinations Cited in Text
- Table of IRS Private Letter Rulings, Technical Advice Memoranda, and General Counsel Memoranda
- Table of Cases Discussed in *Bruce R. Hopkins' Nonprofit Counsel*
- Table of IRS Private Determinations Discussed in *Bruce R. Hopkins' Nonprofit Counsel*

Book Citations

Throughout this book, 14 books by the author (in some instances as coauthor), all published by John Wiley & Sons, are referenced as follows:

1. *IRS Audits of Tax-Exempt Organizations: Policies, Practices, and Procedures* (2008): cited as *IRS Audits*
2. *The Law of Fundraising*, Fifth Edition (2014): cited as *Fundraising*
3. *The Law of Intermediate Sanctions: A Guide for Nonprofits* (2003): cited as *Intermediate Sanctions*
4. *The Law of Tax-Exempt Healthcare Organizations, Fourth Edition* (2014): cited as *Healthcare Organizations*
5. *The New Form 990: Law, Policy, and Preparation* (2009): cited as *New Form 990*
6. *Nonprofit Governance: Law, Practices and Trends* (2009): cited as *Nonprofit Governance*
7. *The Nonprofits' Guide to Internet Communications Law* (2003): cited as *Internet Communications*
8. *Planning Guide for the Law of Tax-Exempt Organizations: Strategies and Commentaries* (2004): cited as *Planning Guide*
9. *Private Foundations: Tax Law and Compliance, Fourth Edition* (2014): cited as *Private Foundations*
10. *Starting and Managing a Nonprofit Organization: A Legal Guide, Sixth Edition* (2013): cited as *Starting and Managing*
11. *The Tax Law of Associations* (2006): cited as *Associations*
12. *The Tax Law of Charitable Giving, Fifth Edition* (2014): cited as *Charitable Giving*
13. *The Tax Law of Unrelated Business for Nonprofit Organizations* (2005): cited as *Unrelated Business*
14. *Tax-Exempt Organizations and Constitutional Law: Nonprofit Law as Shaped by the U.S. Supreme Court* (2012): cited as *Constitutional Law.*

The second, fourth, ninth, and twelfth of these books are annually supplemented.

Updates on all of the foregoing subjects (plus *The Law of Tax-Exempt Organizations*) are available in *Bruce R. Hopkins' Nonprofit Counsel*, the author's monthly newsletter, also published by John Wiley & Sons.

PART ONE

Introduction to the Law of Tax-Exempt Organizations

CHAPTER ONE

Definition of and Rationales for Tax-Exempt Organizations

Nearly all federal and state law pertains, directly or indirectly, to tax-exempt organizations; there are few areas of law that have no bearing whatsoever on these entities. The fields of federal law that directly apply to exempt organizations include tax exemption and charitable giving requirements, and the laws concerning antitrust, contracts, education, employee benefits, the environment, estate planning, health care, housing, labor, political campaigns, the postal system, securities, and fundraising for charitable and political purposes. The aspects of state law concerning exempt organizations are much the same as the federal ones, along with laws pertaining to the formation and operation of corporations and trusts, insurance, real estate, and charitable solicitation acts. Both levels of government have much constitutional and administrative law directly applicable to exempt organizations. A vast array of other civil and criminal laws likewise applies. The principal focus of this book is the federal tax law as it applies to nonprofit organizations.

§ 1.1 DEFINITION OF *NONPROFIT ORGANIZATION*

A tax-exempt organization is a unique entity; among its features is the fact that it is (with few exceptions) a nonprofit organization. Most of the laws that pertain to the concept and creation of a nonprofit organization originate at the state level, while most laws concerning tax exemption are generated at the federal level. Although almost every nonprofit entity is incorporated or otherwise formed under state law, a few nonprofit organizations are chartered by federal statute. The nonprofit

organizations that are the chief focus from a federal tax law standpoint are corporations, trusts, and unincorporated associations. There may also, however, be use of limited liability companies in this regard.

A nonprofit organization is not necessarily a tax-exempt organization. To be exempt, a nonprofit organization must meet certain criteria. As noted, most of these criteria are established under federal law. State law, however, may embody additional criteria; those rules can differ in relation to the tax from which exemption is sought (such as taxes on income, sales of goods or services, use of property, tangible personal property, intangible personal property, or real property).[1] Thus, nonprofit organizations can be taxable entities, under both federal and state law.[2]

(a) *Nonprofit Organization* Defined

The term *nonprofit organization* does not refer to an organization that is prohibited by law from earning a *profit* (that is, an excess of earnings over expenses). In fact, it is quite common for nonprofit organizations to generate profits. Rather, the definition of nonprofit organization essentially relates to requirements as to what must be done with the profits earned or otherwise received.

The legal concept of a nonprofit organization is best understood through a comparison with a *for-profit* organization. The essential difference between nonprofit and for-profit organizations is reflected in the private inurement doctrine.[3] Nonetheless, the characteristics of the two categories of organizations are often identical, in that both mandate a legal form,[4] one or more directors or trustees, and usually officers; both of these types of entities can have employees (and thus pay compensation), face essentially the same expenses, make investments, enter into contracts, sue and be sued, produce goods and/or services, and, as noted, generate profits.[5]

A fundamental distinction between the two entities is that the for-profit organization has owners who hold the equity in the enterprise, such as stockholders of a corporation. The for-profit organization is operated for the benefit of its owners; the profits of the business undertaking are passed through to them, such as by the payment of dividends on shares of stock. That is what is meant by the term *for-profit* organization: It is one that is designed to generate a profit for its owners. The transfer of the profits from the organization to its owners is the inurement of net earnings to them in their private capacity.

[1]In establishing its criteria for tax exemption, however, a state may not develop rules that are discriminatory to the extent that they unconstitutionally burden interstate commerce (Camps Newfound/Owatonna, Inc. v. Town of Harrison, et al., 520 U.S. 564 (1997)). See *Constitutional Law*, Chapter 3.

[2]An illustration of the use of a taxable nonprofit corporation is in IRS Private Letter Ruling (Priv. Ltr. Rul.) 201722004.

[3]See Chapter 20.

[4]See § 4.1.

[5]The word *nonprofit* should not be confused with the term *not-for-profit* (although it often is). The former describes a type of organization; the latter describes a type of activity. For example, in the federal income tax setting, expenses associated with a not-for-profit activity (namely, one conducted without the requisite profit motive) are not deductible as business expenses (IRC § 183).

By contrast, a nonprofit organization generally is not permitted to distribute its profits (net earnings) to those who control it (such as directors and officers).[6] (A nonprofit organization rarely has owners.[7]) Simply stated, a nonprofit organization is an entity that cannot lawfully engage in private inurement. Consequently, the private inurement doctrine is the substantive defining characteristic that distinguishes nonprofit organizations from for-profit organizations for purposes of the federal tax law.

In addition to the prohibition on private inurement, several state nonprofit corporation acts require the nonprofit entity to devote its profits to ends that are beneficial to society or the public, such as purposes that are classified as agricultural, arts promotion, athletic, beneficial, benevolent, cemetery, charitable, civic, cultural, debt management, educational, eleemosynary, fire control, fraternal, health promotion, horticultural, literary, musical, mutual improvement, natural resources protection, patriotic, political, professional, religious, research, scientific, and/or social.[8]

(b) Nonprofit Sector

Essential to an understanding of the nonprofit organization is appreciation of the concept of the *nonprofit sector* of society. This sector of society has been termed, among other titles, the *independent sector*, the *third sector*, the *voluntary sector*, and the *philanthropic sector.*

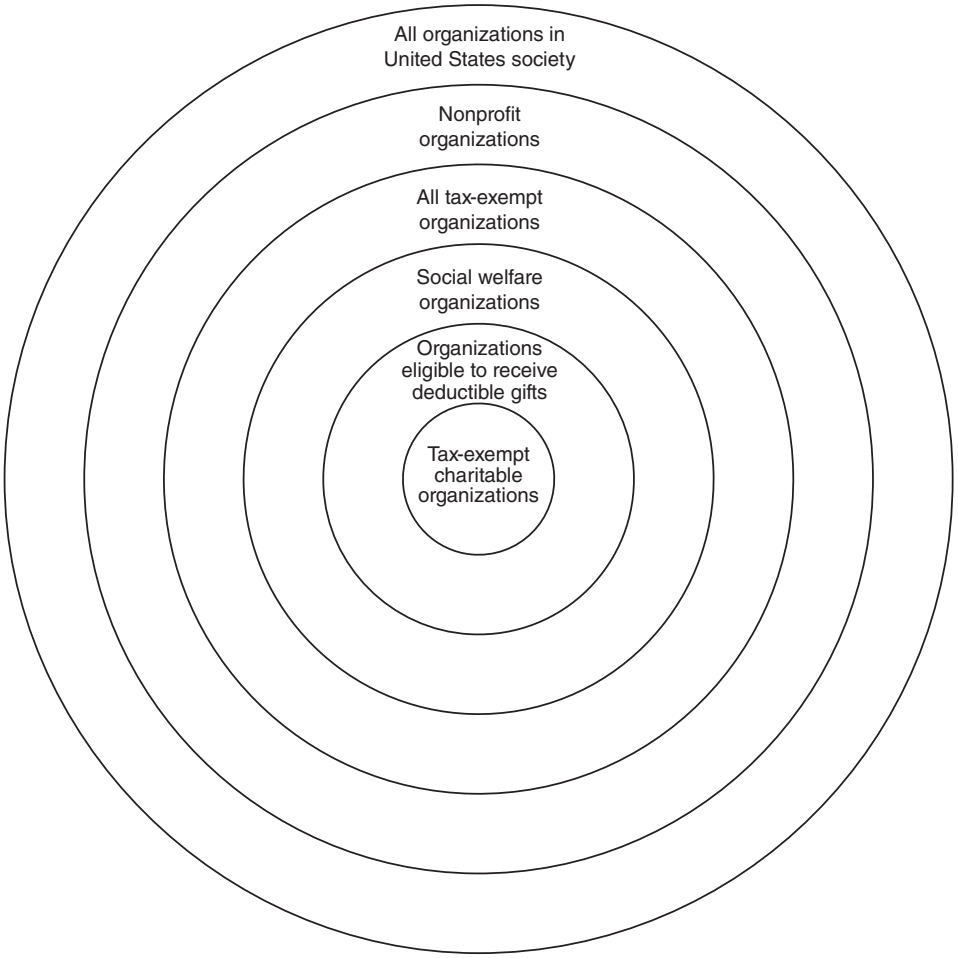
A tenet of political philosophy is that a democratic state—or, as it is sometimes termed, civil society—has three sectors. These sectors contain institutions and organizations that are governmental, for-profit, and nonprofit in nature. Thus, in the United States, the governmental sector includes the branches, departments, agencies, and bureaus of the federal, state, and local governments; the class of for-profit entities comprises the business, trade, professional, and commercial segment of society; and nonprofit entities constitute the balance of this society. The nonprofit sector is seen as being essential to the maintenance of freedom for individuals and a bulwark against the excesses of the other two sectors, particularly the governmental sector.

[6]The U.S. Supreme Court wrote that a "nonprofit entity is ordinarily understood to differ from a for-profit corporation principally because it 'is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees'" (Camps Newfound/Owatonna, Inc. v. Town of Harrison, et al., 520 U.S. 564, 585 (1997)). Other discussions by the Court concerning nonprofit organizations are in Burwell v. Hobby Lobby Stores, Inc., 134 S. Ct. 2751, 2768–2772 (2014), and Corporation of the Presiding Bishop of the Church of Jesus Christ of Latter-Day Saints v. Amos, 483 U.S. 327, 344–346 (1987) (concurring opinion).

[7]A few states allow nonprofit organizations to issue stock. This is done as an ownership (and control) mechanism only; this type of stock does not carry with it any rights to earnings (such as dividends). Ownership of this type of stock does not preclude federal tax exemption, although the IRS occasionally rules to the contrary (e.g., Priv. Ltr. Rul. 201835009).

[8]Use of the word *corporation* in the law context usually means both nonprofit and for-profit corporations (e.g., Medical College of Wisconsin Affiliated Hosps., Inc. v. United States, 854 F.3d 930 (7th Cir. 2017); United States v. Detroit Medical Center, 833 F.3d 671 (6th Cir. 2016); Maimonides Medical Center v. United States, 809 F.3d 85 (2nd Cir. 2015); Charleston Area Med. Center v. United States, 2018 BL 271879 (Ct. Fed. Cl., July 31, 2018); and Wichita Center for Graduate Medical Education v. United States, 2017 BL 438284 (D. Kan., Dec. 7, 2017).

There are subsets within the nonprofit sector. Tax-exempt organizations represent a subset of nonprofit organizations. Organizations that are eligible to attract deductible charitable gifts, charitable organizations (using the broad definition[9]), and other types of exempt organizations are subsets of exempt organizations. Charitable organizations (in the narrow, technical sense of that term) are subsets of charitable organizations (as defined in the broader sense).[10] These elements of the nonprofit sector may be portrayed as a series of concentric circles (see diagram).



[9]This broad definition carries with it connotation of *philanthropy*. The term *philanthropic* was added to the federal tax law when the concept of the *philanthropic business* was enacted (see § 12.4(c), text accompanied by note 299).

[10]The complexity of the federal tax law is such that the charitable sector (using the term in its broadest sense) is also divided into two segments: charitable organizations that are considered *private* (private foundations) and charitable organizations that are considered *public* (all charitable organizations other than those that are considered private); these nonprivate charities are frequently referred to as *public charities*. See Chapter 12.

§ 1.2 DEFINITION OF *TAX-EXEMPT* ORGANIZATION

The term *tax-exempt organization* is somewhat of a fabrication, in that nonprofit organizations are rarely excused from being subject to all taxes, including the federal income tax. There are, of course, other applicable federal taxes, such as excise and employment taxes; there are categories of exemptions from them. At the state level, there are exemptions associated with income, sales, use, excise, and property taxes.

The income tax that is potentially applicable to nearly all tax-exempt organizations is the tax on income derived from an unrelated trade or business.[11] Exempt entities can be taxed for engaging in political activities;[12] public charities are subject to tax in the case of substantial efforts to influence legislation[13] or participation in political campaign activities;[14] business leagues may elect to pay a proxy tax;[15] donor-advised funds are subject to taxes;[16] and some exempt organizations, such as social clubs and political organizations, are taxable on their investment income.[17] Private foundations are caught up in a variety of excise taxes.[18]

This anomaly of a tax-exempt organization being an entity that is subject to various taxes is addressed in the Internal Revenue Code. There it is written that an organization that is exempt from tax[19] shall nonetheless be subject to certain taxes but, notwithstanding that tax exposure, "shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes."[20] The Internal Revenue Service (IRS) advanced the argument that an organization, having paid tax on unrelated business income for some of its years, should not be considered a tax-exempt organization for a federal tax law purpose,[21] but that argument was rejected by a court as being inconsistent with the purpose of the quoted statute.[22]

There is no entitlement in a nonprofit organization to tax exemption; there is no entity that has some inherent right to exempt status. The existence of tax

[11]See Chapters 24, 25.
[12]See §§ 17.5, 17.6, 23.4.
[13]See §§ 22.3(d)(iii), 22.4.
[14]See § 23.3.
[15]See §§ 22.6(c), 23.7.
[16]See § 11.8(b).
[17]See §§ 15.5, 17.5.
[18]See § 12.4.
[19]By reason of IRC § 501(a).
[20]IRC § 501(b). Also, IRC § 527(a), second sentence; IRC § 528(a), second sentence; IRC § 529A(a), second sentence.
[21]IRC § 4980(c)(1)(A).
[22]Research Corp. v. Comm'r, 138 T.C. 192 (2012). This argument would cause an otherwise tax-exempt organization to cease being an exempt organization once it had to pay some income tax, even if the tax exposure was due to transferee liability (e.g., Salus Mundi Found., Transferee v. Comm'r, 103 T.C.M. 1289 (2012), *vac'd and rem'd sub nom.* Diebold Found., Inc. v. Comm'r, 736 F.3d 172 (2nd Cir. 2013), *rev'd and rem'd*, 776 F.3d 1010 (9th Cir. 2014), 112 T.C.M. 227 (2016) (two private foundations held liable for income taxes as transferees of a transferee)).

A court held that the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation are exempt, by broad construction of a statute, from all state and local taxes, other than real estate taxes (Montgomery County, Maryland v. Federal Nat'l Mortgage Ass'n, 740 F.3d 914. (4th Cir. 2014)). Likewise, Delaware County, Pennsylvania v. Federal Housing Finance Agency, 2013 WL 1234221 (E.D. Pa. 2013), *aff'd*, 747 F.3d 215 (3rd Cir. 2014).

exemption and the determination of entities that have it are essentially at the whim of the legislature involved. Thus, the IRS wrote that "[e]xemption from federal income taxation is not a right; it is a matter of legislative grace that is strictly construed."[23] There is no constitutional law principle mandating tax exemption.[24]

There are several illustrations of this point. Congress granted tax-exempt status to certain mutual organizations—albeit with the stricture that to qualify for the exemption, an organization must have been organized before September 1, 1957.[25] A challenge to this law by an otherwise qualified organization formed in 1962 failed, with the U.S. Supreme Court holding that Congress did not act in an arbitrary and unconstitutional manner in declining to extend the exemption beyond the particular year.[26]

For years, organizations like Blue Cross and Blue Shield entities were tax-exempt;[27] Congress, however, determined that these organizations had evolved to be essentially no different from commercial health insurance providers and thus generally legislated this exemption out of existence.[28] (Later Congress realized that it had gone too far in this regard and restored exemption for some providers of insurance that function as charitable risk pools.[29]) Congress allowed the exempt status for group legal services organizations[30] to expire without ceremony in 1992; it also created a category of exemption for state-sponsored workers' compensation reinsurance organizations, with the stipulation that they be established before June 1, 1996.[31] Indeed, in 1982, Congress established exemption for a certain type of veterans' organization, with one of the criteria being that the entity was established before 1880.[32]

There is a main statutory list of tax-exempt organizations[33] to or from which Congress periodically adds or deletes categories of organizations. Occasionally, Congress extends the list of organizations that are exempt as charitable entities.[34] Otherwise, it may create a new provision describing the particular exemption criteria.[35]

[23]Priv. Ltr. Rul. 200830028.

[24]Nonetheless, see *supra* note 1 and § 1.7. Also, *Constitutional Law*, Chapter 1.

[25]IRC § 501(c)(14)(B).

[26]Maryland Sav.-Share Ins. Corp. v. United States, 400 U.S. 4 (1970).

[27]By reason of IRC § 501(c)(4).

[28]See § 28.14(b).

[29]See § 11.6.

[30]See former IRC § 501(c)(20).

[31]See § 19.5.

[32]See § 19.11(b).

[33]IRC § 501(c).

[34]IRC §§ 501(e), 501(f), 501(k), 501(m), 501(n).

[35]IRC §§ 521, 526–529A. The staff of the Joint Committee on Taxation and the Department of the Treasury measure the economic value (revenue "losses") of various tax preferences, such as tax deductions, credits, and exclusions (termed *tax expenditures*). The income tax charitable contribution deduction has traditionally been the sixth- or seventh-largest tax expenditure; the ones that are greater than it include the net exclusions for pension plan contributions and earnings, the exclusion from gross income of employer contributions for health insurance premiums and health care, the deductibility of mortgage interest on personal residences, the reduced rates of tax on long-term capital gains, and the deduction for state and local governments' income and personal property taxes.

§ 1.3 TAX-EXEMPT ORGANIZATIONS LAW PHILOSOPHY

The definition in the law of the term *nonprofit organization* and the concept of the nonprofit sector as critical to the creation and functioning of a civil society do not distinguish nonprofit organizations that are tax-exempt from those that are not. This is because the tax aspect of nonprofit organizations is not relevant to either subject. Indeed, rather than defining either the term *nonprofit organization* or its societal role, the federal tax law principles respecting tax exemption of these entities reflect and flow out of the essence of these subjects.

This is somewhat unusual; many provisions of the federal tax laws are based on some form of rationale that is inherent in tax policy. The law of tax-exempt organizations, however, has little to do with any underlying tax policy. Rather, this aspect of the tax law is grounded in a body of thought rather distant from tax policy: political philosophy as to the proper construct of a democratic society.

This raises, then, the matter of the rationale for the eligibility of nonprofit organizations for tax-exempt status. That is, what is the fundamental characteristic that enables a nonprofit organization to qualify as an exempt organization? In fact, there is no single qualifying feature; the most common one is, as noted, the doctrine of private inurement. This circumstance mirrors the fact that the present-day statutory exemption rules are not the product of a carefully formulated plan. Rather, they are a hodgepodge of statutory law that has evolved over more than 100 years, as various Congresses have deleted from (infrequently) and added to (frequently) the roster of exempt entities, causing it to grow substantially over the decades.

There are six basic rationales underlying qualification for tax-exempt status for nonprofit organizations. On a simplistic plane, a nonprofit entity is exempt because Congress wrote a provision in the Internal Revenue Code according exemption to it. Thus, some organizations are exempt for no more engaging reason than that Congress said so. Certainly, there is no grand philosophical construct buttressing this type of exemption.

Some of the federal income tax exemptions were enacted in the spirit of being merely declaratory of, or furthering, then-existing law. The House Committee on Ways and Means, in legislating a forerunner to the provision that exempts certain voluntary employees' beneficiary associations,[36] commented that "these associations are common today [1928] and it appears desirable to provide specifically for their exemption from ordinary corporation tax."[37] The exemption for nonprofit cemetery companies[38] was enacted to parallel then-existing state and local property tax exemptions. The exemption for farmers' cooperatives[39]

[36]See § 18.3.

[37]H. Rep. No. 72, 78th Cong., 1st Sess. 17 (1928).

[38]See § 19.6.

[39]The staff of Congress's Joint Committee on Taxation estimated that, for the federal government's fiscal years 2017–2021, the tax expenditure for the income tax charitable contribution deduction is $261.1 billion (the eighth-largest) (JCX-34-18).

Tax exemption for qualified nonprofit organizations is not considered a tax expenditure. There are two rationales for this approach. One is that exempt status is not a tax expenditure because the nonbusiness activities of these organizations, such as charities, generally must predominate and their unrelated business activities are subject to tax. The exemption of certain nonprofit cooperative business organizations, including trade and business associations, is not treated as a tax expenditure because

is an element of the federal government's policy of supporting agriculture. The provision exempting certain U.S. corporate instrumentalities from tax[40] was deemed declaratory of the exemption simultaneously provided by the particular enabling statute.[41] The provision according exemption to multiparent title-holding corporations was derived from the IRS's refusal to recognize exempt status for title-holding corporations serving more than one unrelated parent entity.[42] The exemptions for certain workers' compensation reinsurance organizations[43] and for state-sponsored qualified tuition plans[44] were created to avoid having their exemption rested on the view that these entities are instrumentalities of states.[45]

Tax exemption for categories of nonprofit organizations can arise as a by-product of enactment of other legislation. In these instances, exemption is granted to facilitate accomplishment of the purpose of another legislative end. Thus, exempt status was approved for funds underlying employee benefit programs.[46] Other examples include exemption for professional football leagues (and thus other sports leagues) that emanated out of the merger of the National Football League and the American Football League,[47] and for state-sponsored providers of health care to the needy and for certain insurance issuers, which were required to accommodate the goals of Congress in creating health care delivery legislation.[48]

There is a pure tax rationale for a few tax-exempt organizations. The exemption for social clubs, homeowners' associations, and political organizations is reflective of this rationale.[49]

The fourth rationale for tax-exempt status is a policy one—not tax policy, but policy with regard to less essential elements of the structure of a civil society. This is why, for example, exempt status has been granted to fraternal organizations,[50] title-holding companies,[51] and qualified tuition plans.[52]

the tax benefits are available to any entity that chooses to organize itself and operate in the required manner to avoid the entity-level tax.

Under the new Joint Committee on Taxation staff approach, however, tax exemption for credit unions (see § 19.7) is treated as a tax subsidy, in the subcategory of *business synthetic spending*. Also, exceptions to the rules for the taxation of unrelated business income (see Chapter 25) are business synthetic spending tax subsidies.

[40]See § 19.1.

[41]H. Rep. No. 704, 73rd Cong., 2nd Sess. 21–25 (1934). This policy has changed, however (see § 19.1, text accompanying note 1).

[42]See § 19.2(b).

[43]See § 19.16(b).

[44]See § 19.17(a).

[45]See § 19.19.

[46]See Chapter 18.

[47]See § 19.20.

[48]See §§ 19.16(a), 19.18.

[49]See § 1.5.

[50]See § 19.4.

[51]See § 19.2.

[52]See § 19.19.

The fifth rationale for tax-exempt status is one that rests solidly on a philosophical principle. Yet there are degrees of scale here; some principles are less grandiose than others. Thus, there are nonprofit organizations that are exempt because their objectives are of direct importance to a significant segment of society and indirectly of consequence to all society. Within this frame lies the rationale for exemption for entities such as labor organizations,[53] trade and business associations,[54] and veterans' organizations.[55]

The sixth rationale for tax-exempt status for nonprofit organizations is predicated on the view that exemption is required to facilitate achievement of an end of significance to the entirety of society. Most organizations that are generally thought of as *charitable* in nature[56] are entities that are meaningful to the structure and functioning of society in the United States. At least to some degree, this rationale embraces social welfare organizations.[57] This rationale may be termed the *political philosophy* rationale.

§ 1.4 POLITICAL PHILOSOPHY RATIONALE

The policy rationale for tax exemption, particularly for charitable organizations, is, as noted, one involving political philosophy rather than tax policy. The key concept underlying this philosophy is the pluralism of institutions, which is a function of competition and tension between various institutions within the three sectors of society. In this context, the competition is between the nonprofit and the governmental sectors. This element is particularly critical in the United States, the history of which originates in distrust of government. (Where the issue is unrelated business income taxation, the matter is one of competition between the nonprofit and for-profit sectors.) Here, the nonprofit sector serves as an alternative to the governmental sector as a means for addressing society's problems.

One of the greatest proponents of pluralism is John Stuart Mill. He wrote in *On Liberty*, published in 1859:

> In many cases, though individuals may not do the particular thing so well, on the average, as officers of government, it is nevertheless desirable that it should be done by them, rather than by the government, as a means to their own mental education—a mode of strengthening their active faculties, exercising their judgment, and giving them a familiar knowledge of the subjects with which they are thus left to deal. This is a principal, though not the sole, recommendation of … the conduct of industrial and philanthropic enterprises by voluntary associations.

[53]See § 16.1.

[54]See Chapter 14.

[55]See § 19.11.

[56]These are the charitable, educational, religious, scientific, and like organizations referenced in IRC § 501(c)(3).

[57]See Chapter 13. Tax exemption for social welfare organizations originated in 1913; the promotion of social welfare is one of the definitions of the term *charitable* for federal tax purposes (see § 7.11).

Following a discussion of the importance of "individuality of development, and diversity of modes of action," Mill continued:

> Government operations tend to be everywhere alike. With individuals and voluntary associations, on the contrary, there are varied experiments, and endless diversity of experience. What the State can usefully do is to make itself a central depository, and active circulator and diffuser, of the experience resulting from many trials. Its business is to enable each experimentalist to benefit by the experiments of others, instead of tolerating no experiments but its own.

This conflict among the sectors—a sorting out of the appropriate role of governments and nonprofit organizations—is, in a healthy society, a never-ending process, ebbing and flowing with the politics of the day.

Probably the greatest commentator on the impulse and tendency in the United States to utilize nonprofit organizations is Alexis de Tocqueville. Writing in 1835, he observed in *Democracy in America*:

> Feelings and opinions are recruited, the heart is enlarged, and the human mind is developed only by the reciprocal influence of men upon one another. I have shown that these influences are almost null in democratic countries; they must therefore be artificially created, and this can only be accomplished by associations.

Tocqueville's classic formulation on this subject came in his portrayal of the use by Americans of "public associations" as a critical element of societal structure:

> Americans of all ages, all conditions, and all dispositions constantly form associations. They have not only commercial and manufacturing companies, in which all take part, but associations of a thousand other kinds, religious, moral, serious, futile, general or restricted, enormous or diminutive. The Americans make associations to give entertainments, to found seminaries, to build inns, to construct churches, to diffuse books, to send missionaries to the antipodes; in this manner they found hospitals, prisons, and schools. If it is proposed to inculcate some truth or to foster some feeling by the encouragement of a great example, they form a society. Wherever at the head of some new undertaking you see the government in France, or a man of rank in England, in the United States you will be sure to find an association.

This was the political philosophical climate concerning nonprofit organizations in place when Congress, toward the close of the nineteenth century, began considering enactment of an income tax. Although courts would subsequently articulate policy rationales for tax exemption, one of the failures of American jurisprudence is that the Supreme Court and the lower courts have never fully articulated this political philosophical doctrine.[58]

Contemporary Congresses legislate by writing far more intricate statutes than their forebears, and in doing so usually leave in their wake rich deposits in the form

[58]See *Constitutional Law* §§ 1.5–1.7.

of extensive legislative histories. Thus, it is far easier to ascertain what a recent Congress meant when creating law than is the case with respect to an enactment well over 100 years ago.

At the time a constitutional income tax was coming into existence (the first enacted in 1913),[59] Congress legislated in spare language and rarely embellished on its statutory handiwork with legislative histories. Therefore, there is no contemporary record in the form of legislative history of what members of Congress had in mind when they first started creating categories of tax-exempt organizations. Congress, it is generally assumed, saw itself doing what other legislative bodies have done over the centuries. That is, the political philosophical policy considerations pertaining to nonprofit organizations at that time were such that taxation of these entities—considering their contributions to the well-being and functioning of society—was unthinkable.

Thus, in the process of writing the Revenue Act of 1913, Congress viewed tax exemption for charitable organizations as the only way to consistently correlate tax policy with political theory on the point, and saw exemption of charities in the federal tax statutes as an extension of comparable practice throughout the whole of history. No legislative history expands on the point. Presumably, Congress believed that these organizations ought not be taxed and found the proposition sufficiently obvious so that extensive explanation of its actions was not necessary.

Some clues in this regard are found in the definition of *charitable activities* in the income tax regulations,[60] which are considered to be reflective of congressional intent. The regulations refer to purposes such as relief of the poor, advancement of education and science, erection and maintenance of public buildings, and lessening the burdens of government. These definitions of charitable undertakings have an obvious derivation in the Preamble to the Statute of Charitable Uses,[61] written in England in 1601. Reference is there made to certain charitable purposes:

> … some for relief of aged, impotent and poor people, some for maintenance of sick and maimed soldiers and mariners, schools of learning, free schools, and scholars in universities, some for repair of bridges, ports, havens, causeways, churches, sea banks and highways, some for education and preferment of orphans, some for or towards relief, stock or maintenance for houses of correction, some for marriages of poor maids, some for supportation, aid and help of young tradesmen, handicraftsmen and persons decayed, and others for relief of redemption of prisoners or captives …

As this indicates, a subset of this political philosophical doctrine implies that tax exemption for charitable organizations derives from the concept that they

[59]In 1894, Congress imposed a tax on corporate income. This was the first time Congress was required to define the appropriate subjects of tax exemption (inasmuch as prior tax schemes specified the entities subject to taxation). The Tariff Act of 1894 provided exemption for nonprofit charitable, religious, and educational organizations; fraternal beneficiary societies; certain mutual savings banks; and certain mutual insurance companies. The 1894 legislation succumbed to a constitutional law challenge (Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895), overruled on other grounds, State of S.C. v. Baker, 485 U.S. 505 (1988)), the Sixteenth Amendment was subsequently ratified, and the Revenue Act of 1913 was enacted.

[60]Income Tax Regulations (Reg.) § 1.501(c)(3)–1(d)(2).

[61]Stat. 43 Eliz. i, ch. 4.

perform functions that, in the absence of these organizations, government would have to perform. This view leads to the conclusion that government is willing to forgo the tax revenues it would otherwise receive in return for the public interest services rendered by charitable organizations. This rationale is, of course, inapplicable in the case of many religious organizations.[62]

Since the founding of the United States and during the colonial period, tax exemption—particularly with respect to religious organizations—was common. Churches were uniformly spared taxation. This practice has been sustained throughout the history of the nation—not only at the federal level but also at the state and local levels of government, which grant property tax exemptions, as an example.

The U.S. Supreme Court concluded, soon after enactment of the income tax, that the foregoing rationalization was the basis for the federal tax exemption for charitable entities (although in doing so it reflected a degree of uncertainty in the strength of its reasoning, undoubtedly based on the paucity of legislative history). In 1924, the Court stated that "[e]vidently the exemption is made in recognition of the benefit which the public derives from corporate activities of the class named, and is intended to aid them when [they are] not conducted for private gain."[63] Nearly 50 years later, in upholding the constitutionality of the federal income tax exemption for religious organizations, the Court observed that the "State has an affirmative policy that considers these groups as beneficial and stabilizing influences in community life and finds this classification [tax exemption] useful, desirable, and in the public interest."[64] Subsequently, the Court wrote that, for most categories of nonprofit organizations, "exemption from federal income tax is intended to encourage the provision of services that are deemed socially beneficial."[65]

Other courts have taken up this theme. A federal court of appeals wrote that the "reason underlying the [tax] exemption granted" to charitable organizations "is that the exempted taxpayer performs a public service."[66] This court continued:

> The common element of charitable purposes within the meaning of the … [federal tax law] is the relief of the public of a burden which otherwise belongs to it. Charitable purposes are those which benefit the community by relieving it pro tanto from an obligation which it owes to the objects of the charity as members of the community.[67]

This federal appellate court subsequently observed, as respects tax exemption for charitable organizations, that one "stated reason for a deduction or exemption of this kind is that the favored entity performs a public service and benefits the public or relieves it of a burden which otherwise belongs to it."[68] Another federal court opined that the justification of the charitable contribution

[62]See § 10.1.

[63]Trinidad v. Sagrada Orden de Predicadores de la Provincia del Santisimo Rosario de Filipinas, 263 U.S. 578, 581 (1924).

[64]Walz v. Tax Comm'n of City of New York, 397 U.S. 664, 673 (1970).

[65]Portland Golf Club v. Comm'r, 497 U.S. 154, 161 (1990).

[66]Duffy v. Birmingham, 190 F.2d 738, 740 (8th Cir. 1951).

[67]*Id*.

[68]St. Louis Union Trust Co. v. United States, 374 F.2d 427, 432 (8th Cir. 1967).

deduction was "historically … that by doing so, the Government relieves itself of the burden of meeting public needs which in the absence of charitable activity would fall on the shoulders of the Government."[69]

Only one federal court has fully articulated this political philosophical doctrine, noting that the "very purpose" of the charitable contribution deduction is "rooted in helping institutions because they serve the public good."[70] The doctrine was explained as follows:

> [A]s to private philanthropy, the promotion of a healthy pluralism is often viewed as a prime social benefit of general significance. In other words, society can be seen as benefiting not only from the application of private wealth to specific purposes in the public interest but also from the variety of choices made by individual philanthropists as to which activities to subsidize. This decentralized choice-making is arguably more efficient and responsive to public needs than the cumbersome and less flexible allocation process of government administration.[71]

Occasionally, Congress issues a pronouncement on this subject. One of these rare instances occurred in 1939, when the report of the House Committee on Ways and Means, part of the legislative history of the Revenue Act of 1938, stated:

> The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.[72]

The doctrine is also referenced from time to time in testimony before a congressional committee. For example, the Secretary of the Treasury testified before the House Committee on Ways and Means in 1973, observing:

> These organizations [which he termed "voluntary charities, which depend heavily on gifts and bequests"] are an important influence for diversity and a bulwark against over-reliance on big government. The tax privileges extended to these institutions were purged of abuse in 1969 and we believe the existing deductions of charitable gifts and bequests are an appropriate way to encourage those institutions. We believe the public accepts them as fair.[73]

The literature on this subject is extensive. The contemporary versions of it are traceable to 1975, when the public policy rationale was reexamined and reaffirmed by the Commission on Private Philanthropy and Public Needs.[74] Here, the concept of *philanthropy* enters, with the view that charitable organizations, maintained by tax exemption and nurtured by the ability to attract deductible contributions,

[69]McGlotten v. Connally, 338 F. Supp. 448, 456 (D.D.C. 1972).

[70]Green v. Connally, 330 F. Supp. 1150, 1162 (D.D.C. 1971), *aff'd sub nom*. Coit v. Green, 404 U.S. 997 (1971).

[71]*Id*., 330 F. Supp. at 1162.

[72]H. Rep. No. 1860, 75th Cong., 3d Sess. 19 (1939).

[73]Department of the Treasury, "Proposals for Tax Change," Apr. 30, 1973.

[74]*Giving in America: Toward a Stronger Voluntary Sector*, Report of the Commission on Private Philanthropy and Public Needs 9–10 (1975).

reflect the American philosophy that not all policy making and problem solving should be reposed in the governmental sector.

Consequently, it is error to regard tax exemption (and, where appropriate, the charitable contribution deduction) as anything other than a reflection of this larger political philosophical construct. Congress is not merely "giving" eligible nonprofit organizations "benefits"; the exemption from income taxation (or charitable deduction) is not a "loophole," a "preference," or a "subsidy"—it is not really an "indirect appropriation."[75] Rather, the various provisions of the federal and state tax exemption system exist as a reflection of the affirmative policy of American government to refrain from inhibiting by taxation the beneficial activities of qualified tax-exempt organizations acting in community and other public interests.

Regrettably, however, the tax law is not evolving in conformity with this political philosophical framework; long-term political philosophical principles are being sacrificed to short-term views as to practical economical realities. This is reflected in the U.S. Supreme Court's confusion in thinking; the Court has been correct on some occasions as to the rationale for tax exemption for nonprofit organizations,[76] yet in its fear of misuse of exemptions, such as to promote racial discrimination,[77] or in furtherance of unconstitutional ends, such as government promotion of religion,[78] it has on other occasions trimmed the political philosophical construction. Thus, for example, in striking down a state sales tax exemption solely for the sale of religious publications, the Court wrote that it is "difficult to view" this "narrow exemption as anything but state sponsorship of religious belief."[79]

From a constitutional law perspective, it may have been appropriate for the Court to use the word *sponsorship* in that setting. Certainly it would have been preferable, not to mention more accurate, for the Court to have confined this characterization to that word. Unfortunately, the Court found it necessary to amplify this point by observing that "[e]very tax exemption constitutes a subsidy that affects nonqualifying taxpayers."[80] While this "subsidy" is accurate terminology from the standpoint of the pure economics of the matter,[81] it misconstrues and

[75]Cf. *supra* note 35.

[76]See text accompanied by *supra* notes 63–65.

[77]E.g., Bob Jones Univ. v. United States, 461 U.S. 574 (1983).

[78]Texas Monthly, Inc. v. Bullock, 489 U.S. 1 (1989).

[79]*Id*. at 15.

[80]*Id*. at 14. The lower courts, not surprisingly, follow the Supreme Court's occasional view that tax exemption is a government-provided subsidy (e.g., American Civil Liberties Union Found. of Louisiana v. Crawford, 2002 WL 461649 (E.D. La. 2002)) (where the court enjoined application of three state statutes providing tax exemptions only for religious organizations) *rev'd* (on another issue), American Civil Liberties Union Found. of Louisiana v. Bridges, 334 F.3d 416 (5th Cir. 2003).

Actually, the matter is somewhat worse. The Supreme Court, in addition to asserting that these tax exemptions are subsidies, also regarded nonexempted taxpayers as "indirect and vicarious donors" (Bob Jones Univ. v. United States, 461 U.S. 574, 591 (1983), quoted in Texas Monthly, Inc. v. Bullock, 489 U.S. 1, 14 (1989)). Persons who are required to pay a tax because they do not qualify for an exemption, however, are hardly "donors," indirect or otherwise; characterization of such persons as "donors" is wholly inconsistent with the Court's jurisprudence on that subject (e.g., Comm'r v. Duberstein, 363 U.S. 278, 285 (1960), where the Court stated that a *gift* is a transfer of money or property motivated by "detached or disinterested generosity"). In general, *Charitable Giving* § 3.1.

[81]Usually, every tax exemption, deduction, credit, or other preference accorded to certain persons causes other persons to pay more tax; that almost always is an inevitable outcome when a tax base is narrowed (see *supra* note 35).

distorts the larger (and far more important) political philosophical rationalization for tax exemption for nonprofit organizations. The policy underlying this tax exemption simply reflects the nature of the way U.S. society is structured. Inasmuch as it is not the government's money to begin with, the governmental sector and those who fund it should not be seen as "subsidizing" the nonprofit sector.[82]

§ 1.5 INHERENT TAX RATIONALE

Aside from considerations of public policy, an inherent tax theory for tax exemption exists. The essence of this rationale is that the receipt of what otherwise might be deemed income by an exempt organization is not a *taxable event*, in that the organization is merely a convenience or means to an end, a vehicle by which each of those participating in the enterprise may receive and expend money in much the same way as they would if the money was expended by them individually.

This rationale chiefly underlies the tax exemption for certain social clubs, which enable individuals to pool their resources for the purpose of provision of recreation and pleasure more effectively than can be done on an individual basis.[83] This tax rationale was summarized by a federal court as follows:

> Congress has determined that in a situation where individuals have banded together to provide recreational facilities on a mutual basis, it would be conceptually erroneous to impose a tax on the organization as a separate entity. The funds exempted are received only from the members and any "profit" which results from overcharging for the use of the facilities still belongs to the same members. No income of the sort usually taxed has been generated; the money has simply been shifted from one pocket to another, both within the same pair of pants.[84]

This rationale is likewise reflected in congressional committee reports.[85] It was invoked by Congress when enacting the tax exemption for homeowners' associations.[86] Thus, the Senate Finance Committee observed that, "[s]ince homeowners' associations generally allow individual homeowners to act together in order to maintain and improve the area in which they live, the committee believes it is not appropriate to tax the revenues of an association of homeowners who act together if an individual homeowner acting alone would not be taxed on the same activity."[87] This rationale, however, operates only where "public" money is not unduly utilized for private gain.[88]

The inherent tax theory also serves as the rationale for the tax exemption for political organizations.[89] Thus, the legislative history underlying this exemption

[82]E.g., Arizona Christian School Tuition Organization v. Winn, 131 S. Ct. 1436, 1447 (2011). See *Constitutional Law* §1.12.
[83]See Chapter 15.
[84]McGlotten v. Connally, 338 F. Supp. 448, 458 (D.D.C. 1972).
[85]H. Rep. No. 91-413, 91st Cong., 1st Sess. 48 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 71 (1969).
[86]See § 19.14.
[87]S. Rep. No. 938, 94th Cong., 2d Sess. 394 (1976).
[88]West Side Tennis Club v. Comm'r, 111 F.2d 6 (2nd Cir. 1940), *cert. den.*, 311 U.S. 674 (1940).
[89]See Chapter 17.

stated that these organizations should be treated as exempt organizations, inasmuch as "political activity (including the financing of political activity) as such is not a trade or a business which is appropriately subject to tax."[90]

§ 1.6 OTHER RATIONALES AND REASONS FOR EXEMPT ORGANIZATIONS

There are, as noted,[91] rationales for exempting organizations from federal income tax other than the political philosophy rationale[92] and the inherent tax rationale.[93]

One of these rationales, less lofty than that accorded charitable and social welfare organizations, is extended as justification for the exemption of trade associations and other forms of business leagues.[94] These entities function to promote the welfare of a segment of society: the business, industrial, and professional community. An element of the philosophy supporting this type of exemption is that a healthy business climate advances the public welfare. The exemption for labor unions and other labor organizations rests on a comparable rationale.

The tax exemption for fraternal beneficiary organizations also depends, at least in part, on this concept. A study of the insurance practices of large fraternal societies by the U.S. Department of the Treasury[95] concluded that this rationale is inapplicable with respect to the insurance programs of these entities because the "provision of life insurance and other benefits is generally not considered a good or service with significant external benefits" to society generally. This report added, however, that "tax exemption for these goods and services [insurance and like benefits] may be justified in order to encourage" the charitable activities conducted by these organizations. The inherent tax rationale[96] "may" provide a basis for exemption for "certain" of these societies' services, according to the report. Further, the report observed that "[i]nsurance is not a type of product for which consumers may lack access to information on the appropriate quantity or quality that they need."

Other federal tax exemption provisions may be traced to an effort to achieve a particular objective. These provisions tend to be of more recent vintage, testimony to the fact of a more complex Internal Revenue Code. For example, exemption for veterans' organizations[97] was enacted to create a category of organizations entitled to use a particular exemption from the unrelated business income tax,[98] and exemption for homeowners' associations[99] came about because of a shift in the policy of the Internal Revenue Service[100] regarding the scope of exemption provided

[90]S. Rep. No. 1357, 93rd Cong., 2nd Sess. 26 (1974).
[91]See § 1.3.
[92]See § 1.4.
[93]See § 1.5.
[94]See Chapter 14.
[95]Report to the "Congress on Fraternal Benefit Societies," U.S. Department of the Treasury, January 15, 1993.
[96]See § 1.3.
[97]See § 19.11(a).
[98]See § 25.3, text accompanied by note 199.
[99]See § 19.14.
[100]Hereinafter IRS or agency.

for social welfare organizations. The exemption for college and university investment vehicles was the result of Congress's effort to salvage the exempt status of a common investment fund in the face of a determination by the IRS to the contrary.[101] As is so often the case with respect to the tax law generally, a particular exemption provision can arise as the result of case law, or to clarify it; this was the origin of statutes granting exemption to cooperative hospital service organizations,[102] charitable risk pools,[103] child care organizations,[104] public safety testing entities,[105] and prepaid tuition programs.[106]

§ 1.7 FREEDOM OF ASSOCIATION DOCTRINE

Tax exemption for nonprofit membership organizations may be viewed as a manifestation of the constitutionally protected right of association accorded the members of these organizations. There are two types of *freedoms of association.* One type—termed the *freedom of intimate association*—is the traditional type of protected association derived from the right of personal liberty. The other type—the *freedom of expressive association*—is a function of the right of free speech protected by the First Amendment to the U.S. Constitution.

By application of the doctrine of freedom of intimate association, the formation and preservation of certain types of highly personal relationships are afforded a substantial measure of sanctuary from interference by government.[107] These personal bonds are considered to foster diversity and advance personal liberty.[108] In assessing the extent of constraints on the authority of government to interfere with this freedom, a court must make a determination of where the objective characteristics of the relationship, which is created where an individual enters into a particular association, are located on a spectrum from the most intimate to the most attenuated of personal relationships.[109] Relevant factors include size, purpose, policies, selectivity, and congeniality.[110]

The freedom to engage in group effort is guaranteed under the doctrine of freedom of expressive association[111] and is viewed as a way of advancing political, social, economic, educational, religious, and cultural ends.[112] Government,

[101] See § 11.5.
[102] See § 11.4
[103] See § 11.6.
[104] See § 8.8.
[105] See § 11.3.
[106] See § 19.17.
[107] Pierce v. Society of Sisters, 268 U.S. 510 (1925); Meyer v. Nebraska, 262 U.S. 390 (1923).
[108] Zablocki v. Redhail, 434 U.S. 374 (1978); Quilloin v. Walcott, 434 U.S. 246 (1978); Smith v. Organization of Foster Families, 431 U.S. 494 (1977); Carey v. Population Servs. Int'l, 431 U.S. 678 (1977); Moore v. East Cleveland, 431 U.S. 494 (1977); Cleveland Bd. of Educ. v. LaFleur, 414 U.S. 632 (1974); Wisconsin v. Yoder, 406 U.S. 205 (1973); Stanley v. Illinois, 405 U.S. 645 (1972); Stanley v. Georgia, 394 U.S. 557 (1969); Griswold v. Connecticut, 381 U.S. 479 (1965); Olmstead v. United States, 277 U.S. 438 (1928).
[109] Runyon v. McCrary, 427 U.S. 160 (1976).
[110] Roberts v. United States Jaycees, 468 U.S. 609 (1984).
[111] Rent Control Coalition for Fair Hous. v. Berkeley, 454 U.S. 290 (1981).
[112] NAACP v. Claiborne Hardware Co., 458 U.S. 886 (1982); Larson v. Valente, 456 U.S. 228 (1982); In re Primus, 436 U.S. 412 (1978).

however, has the ability to infringe on this right where compelling state interests, unrelated to the suppression of ideas and not achievable through means significantly less restrictive of associational freedoms, are served.[113]

These two associational freedoms were the subject of a U.S. Supreme Court analysis concerning the scope of a nonprofit organization's right to exclude women from its voting membership.[114] The Court concluded that the governmental interest in eradicating gender-based discrimination is superior to the associational rights of the organization's male members.[115]

The Court held that an organization had a constitutional right, under the First Amendment, to exclude gay individuals from leadership positions because of their sexual orientation, overruled this opinion.[116] Application of the state's antidiscrimination law was found to be a "severe intrusion" on the organization's rights to freedom of expressive association.[117] The Court's review of the record resulted in a finding that there was a sufficient basis to conclude that the organization does "not want to promote homosexual conduct as a legitimate form of behavior."[118] The Court wrote: "The forced inclusion of an unwanted person in a group infringes the group's freedom of expressive association if the presence of that person affects in a significant way the group's ability to advocate public or private viewpoints."[119]

[113]Brown v. Socialist Workers '74 Campaign Comm., 459 U.S. 87 (1982); Democratic Party v. Wisconsin, 450 U.S. 107 (1981); Buckley v. Valeo, 424 U.S. 1 (1976); Cousins v. Wigoda, 419 U.S. 477 (1975); American Party v. White, 415 U.S. 767 (1974); NAACP v. Button, 371 U.S. 415 (1963); Shelton v. Tucker, 364 U.S. 486 (1960); NAACP v. Alabama, 347 U.S. 449 (1958).

[114]Roberts v. United States Jaycees, 468 U.S. 609 (1984).

[115]*Id*. at 622–629.

[116]Boy Scouts of Amer. et al. v. Dale, 530 U.S. 640 (2000).

[117]*Id*. at 659.

[118]*Id*. at 651.

[119]*Id*. at 648. In general, *Constitutional Law* § 1.9.

CHAPTER TWO

Overview of Nonprofit Sector and Tax-Exempt Organizations

The nonprofit sector in the United States and the federal tax law with respect to it have a common feature: enormous and incessant growth. As to the sector, this expansion is reflected in all the principal indicators, such as the number of organizations, the sector's asset base, the amount of charitable giving and granting, its annual expenditures, its share of the gross domestic product, and the size of its workforce. There is, however, this direct correlation: As the nonprofit sector expands, so too does the body of federal and state law regulating it. No end to either of these expansions is in sight.[1]

Over the years, there have been many efforts to analyze and portray the nonprofit sector. One of the first of these significant undertakings, utilizing statistics, conducted jointly by the Survey Research Center at the University of Michigan and the U.S. Census Bureau, was published in 1975 as part of the findings of the Commission on Private Philanthropy and Public Needs, informally known as the Filer Commission.[2] The data compiled for the Commission's use were for 1973. Contemporary charitable giving statistics are explored below, but one striking basis of comparison cannot be resisted at this point: Charitable giving in the United States in the year the first edition of this book was published—1975—was $28.56 billion, whereas for 2017 the amount of charitable giving was an estimated $410.02 billion (the first time annual giving in the United States exceeded $400 billion).[3]

Research of the nature developed for the Filer Commission spawned recurring statistical portraits of the sector. One of the most comprehensive of these

[1]The "rapid growth of the nonprofit sector in the last half century has led to greatly increased attention from the media, scholars, the government, and the public" (O'Neill, *Nonprofit Nation: A New Look at the Third America* 34 (Jossey-Bass, 2002) (*Nonprofit Nation*)).

[2]*Giving in America: Toward a Stronger Voluntary Sector*, Report of the Commission on Private Philanthropy and Public Needs (1975).

[3]See text accompanied by *infra* note 65.

analyses is that provided in a periodic almanac published by the Urban Institute.[4] Others include a fascinating portrait of the "third America"[5] and the annual survey of charitable giving published by the Giving USA Foundation.[6] The IRS's Statistics of Income Division collects data on tax-exempt organizations.[7] Further, various subsets of the nonprofit sector are the subject of specific portrayals.[8]

The nonprofit sector in the United States is not uniformly labeled; it goes by many names. In addition to *nonprofit*,[9] adjectives used include *tax-exempt*, *nongovernmental*, *independent*, and *voluntary.* In its most expansive definition, the nonprofit sector comprises all tax-exempt organizations and some entities that cannot qualify for exemption. The Independent Sector coalition defined the *independent sector* as all charitable[10] and social welfare organizations.[11]

As Independent Sector defined the sector, it comprises "many, varied" organizations, such as "religious organizations, private colleges and schools, foundations, hospitals, day-care centers, environmental organizations, museums, symphony orchestras, youth organizations, advocacy groups, and neighborhood organizations, to name a few." This analysis continued: "What is common among them all is their mission to serve a public purpose, their voluntary and self-governing nature, and their exclusion from being able to distribute profits to stockholders."[12]

§ 2.1 PROFILE OF NONPROFIT SECTOR

Any assessment of any consequence of the contours of the nonprofit sector includes a discussion of the number of organizations in the sector. Yet it is "surprisingly difficult to answer the seemingly simple question, How many nonprofit organizations are there in the United States?"[13] The simple answer is: There

[4]The most recent version of this almanac is Roeger, Blackwood, and Pettijohn, *The Nonprofit Almanac 2012* (Washington, DC: Urban Institute Press, 2012) (*Nonprofit Almanac*).

[5]*Nonprofit Nation*.

[6]These annual publications are titled *Giving USA*.

[7]The IRS publishes various editions of the *Statistics of Income Bulletins*.

[8]E.g., *Yearbook of American and Canadian Churches* (Nat'l Council of the Churches of Christ in the United States of America, various editions); *Foundation Giving: Yearbook of Facts and Figures on Private, Corporate and Community Foundations* (The Foundation Center, various editions); *Foundation Management Report* (Council on Foundations, various editions). The American Hospital Association publishes statistics concerning hospitals; the National Center for Education Statistics publishes data on independent colleges and universities; and the American Society of Association Executives publishes information concerning the nation's trade, business, and professional associations. There are several other analyses of this nature.

[9]Indeed, there is no uniformity as to this term (see § 1.1(b)).

[10]That is, organizations that are tax-exempt pursuant to IRC § 501(a) because they are described in IRC § 501(c)(3) (see Part Three).

[11]That is, organizations that are tax-exempt pursuant to IRC § 501(a) because they are described in IRC § 501(c)(4) (see Chapter 13). This definition of the independent sector is in the 2002 edition of the *Nonprofit Almanac* 7–8. Today, the *Nonprofit Almanac* does not attempt a definition of the sector but instead surveys the "nonprofit landscape" (*Nonprofit Almanac* at 3–5).

[12]*Nonprofit Almanac* at 3.

[13]*Nonprofit Nation* at 8.

are "several million" nonprofit organizations, although "no one really knows how many."[14]

In an understatement, the observation was made that "[m]easuring the number of organizations in the independent sector is a complex activity, largely because of the diversity of its components."[15] There are several reasons for this. One reason is that churches (of which there are an estimated 350,000[16]) are not required to file annual information returns with the IRS,[17] so that data concerning them is difficult to amass. Also, hundreds of organizations are under a group exemption[18] and thus not separately identified. Further, smaller nonprofit organizations need not seek recognition of tax exemption from the IRS.[19] Small organizations are not required to file annual information returns with the IRS but are required to electronically submit a notice as to their existence.[20]

One source of data in this regard is the IRS, which maintains a "master file" regarding tax-exempt organizations. This file contains a list of organizations that have requested recognition of tax exemption[21] or that have filed annual information returns.[22] On the basis of these compilations, the number of exempt organizations known to and interacting with the IRS is over 2 million. The most recent analysis posited the population of U.S. exempt organizations (as of 2012) at 2.3 million entities.[23] Of these organizations, 1.63 million were recognized as exempt by the IRS, and 1.08 million of them were charitable organizations.[24] An estimated 274,000 of these charitable organizations filed annual information returns.[25]

Because a "price cannot be placed on the output of most nonprofit organizations," their percentage of the gross domestic product is difficult to assess; the conventional estimate is that it is about 5 percent.[26] The federal government relies on charitable organizations to deliver services; in 2012, government agencies paid an estimated $137 billion to exempt organizations for services.[27] When the measure is in terms of wages and salaries paid, the percentage arises to

[14]*Id*. at 1.

[15]*Id*. at 8. The point was articulated more forcefully (albeit less elegantly) in the fifth edition of this almanac, where it was stated that "[c]ounting the number of institutions in the independent sector is a challenge" (Hodgkinson & Weitzman, *Nonprofit Almanac: Dimensions of the Independent Sector* 25 (Jossey-Bass, 1996)).

[16]*Nonprofit Almanac* at 139. The term *church* includes analogous religious congregations, such as temples and mosques. See § 10.3(a).

[17]See § 28.2(b)(i).

[18]See § 26.9.

[19]These are organizations that normally do not generate more than $5,000 in revenue. See § 26.2(b).

[20]See § 28.3. The IRS has not published any data resulting from this notification requirement.

[21]See § 3.2.

[22]See § 28.2.

[23]Government Accountability Office, Report to the Ranking Member, Committee on Homeland Security and Governmental Affairs, U.S. Senate (GAO-15-164 (Dec. 2014)) (*GAO Report*) at 8.

[24]*GAO Report* at 8–9.

[25]*Id*. at 9.

[26]McKeever and Pettijohn, *The Nonprofit Sector in Brief 2014* (Urban Institute, Oct. 2014); Sherlock and Gravelle, *An Overview of the Nonprofit and Charitable Sector* (Congressional Research Service (CRS-R40919 (2009)).

[27]Pettijohn, Boris, De Vita, and Fyffe, *Nonprofit-Government Contracts and Grants: Findings from the 2013 National Survey* (Urban Institute, 2013).

approximately 8 percent.[28] Other ways to measure the size of the sector are its revenue (about $1,006.7 billion),[29] its outlays (about $915.2 billion),[30] and its paid employment (12.9 million).[31] Most of the sector's revenue is in the form of fees for services provided, followed by contributions and grants.[32] As to outlays, the funds are expended by the organizations (88.7 percent), granted (8 percent), or invested or used as a buffer for cash flow (3.3 percent).[33]

The number of public charities is said to be 876,164.[34] Public charities had $1.1 trillion in expenses and $2 trillion in total assets.[35]

The breakdown as to these tax-exempt organizations[36] shows that approximately one-half of them (984,386) are charitable organizations.[37] As to other categories of exempt organizations, there are about 100 instrumentalities of the United States,[38] 5,850 single-parent title-holding companies,[39] 1,133 title-holding companies for multiple beneficiaries,[40] 116,890 social welfare organizations,[41] 56,819 labor and agricultural organizations,[42] 71,878 business leagues (including associations),[43] 56,369 social clubs,[44] 63,818 fraternal beneficiary societies,[45] 20,944 domestic fraternal beneficiary societies,[46] 10,088 voluntary employees' beneficiary societies,[47] 14 teachers' retirement funds,[48] 5,901 benevolent or mutual associations,[49] 9,808 cemetery companies,[50] 3,565 credit unions,[51] 1,646 mutual insurance companies,[52] 16 crop operations finance corporations,[53] 300 supplemental unemployment benefit trusts,[54] 35,113 veterans' organizations,[55] 28 black

[28] *Nonprofit Almanac* at 10.
[29] *Id*. at 115.
[30] *Id*.
[31] *Id*. at 18, 27.
[32] *Id*. at 115. Fees for services and goods were estimated to be 70.3 percent of the total; contributions and nongovernment grants were said to be 12.3 percent of the total (*id*. at 143–144).
[33] *Id*. at 121.
[34] *Id*. at 140.
[35] *Id*. at 141.
[36] *Id*. at 2–3.
[37] That is, organizations described in IRC § 501(c)(3). See Part Three.
[38] That is, organizations described in IRC § 501(c)(1). See § 19.1.
[39] That is, organizations described in IRC § 501(c)(2). See § 19.2(a).
[40] That is, organizations described in IRC § 501(c)(25). See § 19.2(b).
[41] That is, organizations described in IRC § 501(c)(4). See Chapter 13.
[42] That is, organizations described in IRC § 501(c)(5). See Chapter 16.
[43] That is, organizations described in IRC § 501(c)(6). See Chapter 14.
[44] That is, organizations described in IRC § 501(c)(7). See Chapter 15.
[45] That is, organizations described in IRC § 501(c)(8). See § 19.4(a).
[46] That is, organizations described in IRC § 501(c)(10). See § 19.4(b).
[47] That is, organizations described in IRC § 501(c)(9). See § 18.3.
[48] That is, organizations described in IRC § 501(c)(11). See § 18.7.
[49] That is, organizations described in IRC § 501(c)(12). See § 19.5.
[50] That is, organizations described in IRC § 501(c)(13). See 19.6.
[51] That is, organizations described in IRC § 501(c)(14). See § 19.7.
[52] That is, organizations described in IRC § 501(c)(15). See § 19.9.
[53] That is, organizations described in IRC § 501(c)(16). See § 19.10.
[54] That is, organizations described in IRC § 501(c)(17). See § 18.4.
[55] That is, organizations described in IRC § 501(c)(19). See § 19.11(a).

lung benefits trusts,[56] 10 organizations providing medical insurance for those difficult to insure,[57] 12 state-formed workers' compensation organizations,[58] 160 religious and apostolic organizations,[59] 18 cooperative hospital service organizations,[60] 1 cooperative service organization of educational institutions,[61] 1,400 farmers' cooperatives,[62] 13,000 political organizations,[63] and 127,000 homeowners' associations.[64]

Charitable giving in the United States in 2017 is estimated to have totaled $410.02 billion.[65] Giving by individuals in 2017 amounted to an estimated $286.65 billion; this level of giving constituted 70 percent of all charitable giving for the year. Grantmaking by private foundations is an estimated $66.9 billion (16 percent of total funding). Gifts in the form of charitable bequests in 2017 are estimated to be $35.7 billion (9 percent of total giving). Gifts from corporations in 2017 totaled $20.77 billion (5 percent of total giving for that year).

Contributions to religious organizations in 2017 totaled $127.37 billion (31 percent of all giving that year). Gifts to educational organizations amounted to $58.9 billion (15 percent); to human service entities, $50.06 billion (12 percent); to foundations, $45.89 billion (11 percent); to health care institutions, $38.22 billion (10 percent); to public-society benefit organizations, $29.59 billion (7 percent); to international affairs entities, $22.97 billion (6 percent); to arts, culture, and humanities entities, $19.51 billion (5 percent); and to environment and animals groups, $11.83 billion (3 percent).

Here are some other perspectives on the nonprofit sector; it:

- Accounts for 5 to 10 percent of the nation's economy.
- Accounts for 8 percent of the nation's noninstitutional civilian employees.
- Has more civilian employees than the federal government and the 50 state governments combined.

[56]That is, organizations described in IRC § 501(c)(21). See § 18.5.

[57]That is, organizations described in IRC § 501(c)(26). See § 19.15.

[58]That is, organizations described in IRC § 501(c)(27). See § 19.16.

[59]That is, organizations described in IRC § 501(d). See §§ 10.7, 10.8.

[60]That is, organizations described in IRC § 501(e). See § 11.4.

[61]That is, organizations described in IRC § 501(f). See § 11.5.

[62]That is, organizations described in IRC § 521. See § 19.12.

[63]That is, organizations described in IRC § 527. See Chapter 17.

[64]That is, organizations described in IRC § 528. See § 19.14. In connection with a posting in the *Federal Register*, August 22, 2018, the IRS estimated that, as of the federal government's fiscal year 2018, there are 1,288,700 tax-exempt organizations in the United States, with that number broken down by category of Form 990 series filings: Form 990 (322,900), Form 990-PF (113,100), Form 990-EZ (252,900), and Form 990-N (599,800) (see § 28.2(a))

A court had occasion to observe that "[t]rying to understand the various exempt organization provisions of the Internal Revenue Code is as difficult as capturing a drop of mercury under your thumb" (Weingarden v. Comm'r, 86 T.C. 669, 675 (1986), *rev'd* (on other grounds), 825 F.2d 1027 (6th Cir. 1987)). The federal tax law recognizes about 80 categories of tax-exempt organizations (see Appendix B (online)).

[65]These data are from *Giving USA 2018: The Annual Report on Philanthropy for the Year 2017*, published by the Giving USA Foundation, and researched and written by the Indiana University Lilly Family School of Philanthropy.

- Employs more people than any of these industries: agriculture, mining, construction, transportation, communications, and other public utilities; and finance, insurance, and real estate.
- Generates revenue that exceeds the gross domestic product of all but six foreign countries: China, France, Germany, Italy, Japan, and the United Kingdom.[66]

§ 2.2 ORGANIZATION OF IRS

Among the departments of the United States government is the Department of the Treasury, which is headed by the Secretary of the Treasury. One of the functions of the Treasury Department is assessment and collection of federal income and other taxes.[67] The Secretary is authorized to conduct examinations,[68] serve summonses,[69] and undertake what is necessary for "detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws or conniving at the same."[70] This tax assessment and collection function has largely been assigned to the IRS, which is an agency (or bureau) of the Department of the Treasury.[71]

The Department of the Treasury formulates the nation's tax policies, including those pertaining to tax-exempt organizations.[72] This policy formulation is the direct responsibility of the Assistant Treasury Secretary for Tax Policy.

(a) IRS in General

The mission of the IRS is to "provide America's taxpayers with top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all."[73] One of the functions of this agency is to administer and enforce the law of tax-exempt organizations. The mission and functions of the IRS have been substantially influenced by a massive restructuring of the agency, in part due to the mandates of legislation[74] and in part to initiatives undertaken by the agency as the result of a plan of reorganization that was implemented beginning in 1998.[75]

The IRS is headquartered in Washington, D.C.; its operations there are housed in its National Office. An Internal Revenue Service Oversight Board is

[66] *Nonprofit Nation* at 12.

[67] IRC § 7601(a), which provides that the Secretary of the Treasury "shall, to the extent he deems it practicable, cause officers or employees of the Treasury Department to proceed, from time to time, through each internal revenue district [authorized by IRC § 7621] and inquire after and concerning all persons therein who may be liable to pay any internal revenue tax, and all persons owning or having the care and management of any objects with respect to which any tax is imposed."

[68] IRC § 7602. See § 27.6.

[69] IRC § 7603.

[70] IRC § 7623.

[71] Reg. § 601.101(a).

[72] IRC § 7801(a)(1).

[73] IRS website.

[74] Internal Revenue Service Restructuring and Reform Act of 1998, 112 Stat. 685 (Pub. L. No. 105–206, 105th Cong., 2d Sess. (1998)) (for purposes of this section, Act).

[75] See *infra* note 82.

responsible for overseeing the agency in its administration, conduct, direction, and supervision of the execution and application of the nation's internal revenue laws.[76] A function of this board is to recommend to the President candidates for the position of Commissioner of Internal Revenue.[77] The Commissioner, who need not be a tax lawyer or accountant but must have a "demonstrated ability in management," serves one or more five-year terms.[78] The Commissioner is charged with administering, managing, conducting, directing, and supervising the execution and application of the internal revenue laws.[79]

Within the Treasury Department is the office of General Counsel for the Department of the Treasury.[80] This general counsel, who is appointed by the President, is the chief law officer of the Department. Among the associate chief counsels is the Associate Chief Counsel (Employee Benefits and Exempt Organizations). One of the functions of this Associate Chief Counsel's office is to develop policy and strategy in the field of the law of tax-exempt organizations.

Congress in 1998 directed the Commissioner of Internal Revenue to reorganize the IRS in a way that substantially altered the then-existing structure (which was based on regional divisions) by restructuring the agency into units serving groups of taxpayers[81] with similar needs.[82] Consequently, the IRS is organized into four operating divisions; this structure is reflected in the IRS's regional offices. These divisions are the Large and Mid-Size Business, the Small Business/Self-Employed, the Tax Exempt and Government Entities, and the Wage and Investment Divisions.

This reorganization of the IRS, in the form of a four-division structure, resulted in delegation to each division of the responsibility for developing procedures and establishing priorities for servicing its customers. In the words of a Treasury Inspector General for Tax Administration report, this organizational methodology "enabled each division to establish end-to-end accountability for its respective customer base."[83] This report, however, also stated that this "fragmented approach" to IRS operations is a "weakness" that frustrates the accomplishments intended by the creation of "IRS-wide" programs, one of which is the National Fraud Program.[84]

(b) Tax Exempt and Government Entities Division

The first of these four divisions—the Tax Exempt and Government Entities (TE/GE) Division—was established on December 5, 1999.[85] Within the TE/GE

[76]IRC §§ 7802(a), (c)(1)(A).

[77]IRC § 7802(d)(3)(A).

[78]IRC § 7803(a)(1).

[79]IRC § 7803(a)(2)(A). Also Reg. § 601.101(a) (providing that the Commissioner has "general superintendence of the assessment and collection of all taxes imposed by any law providing national revenue").

[80]IRC § 7801(b)(1).

[81]A *taxpayer* is a person subject to any internal revenue tax (IRC § 7701(a)(14)); this term includes a tax-exempt organization.

[82]Act § 1001(a)(3). This approach was a reinforcement of a plan announced by the Commissioner of Internal Revenue on January 28, 1998.

[83]TIGTA, "A Corporate Approach Is Needed to Provide for a More Effective Tax-Exempt Fraud Program," at 2 (no. 2009-10-096, July 6, 2009).

[84]*Id*.

[85]IRS News Release IR-1999-101.

Division is the Exempt Organizations (EO) Division, which develops policy concerning and administers the law of tax-exempt organizations. The director of the Exempt Organizations Division, who reports to the Commissioner of the TE/GE Division, is responsible for planning, managing, and executing nationwide IRS activities in the realm of exempt organizations. This director also supervises and is responsible for the programs of the offices of Customer Education and Outreach, Rulings and Agreements, Examinations, and Exempt Organizations Electronic Initiatives.

The Customer Education and Outreach office develops the nationwide education and outreach programs of the IRS for tax-exempt organizations. Revenue agents, tax law specialists, and other support personnel staff this office, initiating and delivering programs and products designed to assist exempt organizations understand their tax law responsibilities. These programs are intended to improve compliance with the federal tax law by exempt organizations. This office's efforts result in workshops and other presentations by the IRS, publications and forms, Web-based programs, marketing and other communications programs, and support for programs of the Examinations office.[86]

The Rulings and Agreements office is the function that is primarily responsible for up-front, customer-initiated activities such as determination applications, taxpayer assistance, and assistance to other Division offices.[87] This office includes EO Technical and EO Determinations, the latter being the function that is primarily responsible for processing initial applications for recognition of tax-exempt status. It includes the main Determinations office located in Cincinnati, Ohio, and other field offices. Applications are generally processed in the centralized Determinations office in Cincinnati.[88] The IRS's lawyers in the field are part of the Office of Division Counsel (TE/GE); those in the Office of Associate Chief Counsel (TE/GE) are part of EO Technical.[89]

The Examinations office focuses on tax-exempt organizations examination programs and compliance checks. Its support functions include Examination Planning and Programs, Classification, Mandatory Review, Special Review, and Examinations Special Support. An Exempt Organizations Compliance Unit addresses instances of exempt organizations' compliance with the tax law by conducting compliance checks. Another component of this office is the Data Analysis Unit, which uses various databases and other information to investigate emerging trends in exempt organizations' operations, in an effort to select subjects for examination in the exempt organizations area. A Review of Operations unit engages in follow-up reviews of tax-exempt organizations. The Compliance Strategies Critical Initiative coordinates the Division's strategic planning, monitors progress of critical initiatives, and analyzes the results of these projects.

The Electronic Initiatives office manages and coordinates the development and deployment of new automation efforts to support evolving and expanding

[86]This office has initiated an academic program initiative for the purpose of collaborating with academic institutions that offer degrees related to the nonprofit sector, to promote education as to the law of tax-exempt organizations. IRS Announcement (Ann.) 2009-26, 2009-14 I.R.B. 755.

[87]IRS Revenue Procedure (Rev. Proc.) 2018-5, 2018-1 I.R.B. 233 § 1.01(2). See §§ 3.2, 26.1.

[88]*Id*. § 1.01(3). The IRS's lawyers in the field are part of the Office of Division Counsel (TE/GE). Those in the Office of Associate Chief Counsel (TE/GE) are part of EO Technical.

[89]Ann. 2014-34, 2014-51 I.R.B. 949.

IRS administration and enforcement expectations, with the objective of balancing customer satisfaction, employee satisfaction, and business results. The projects of this office include implementation of the agency's annual information returns electronic filing program,[90] development of an interactive Web-based application for recognition of exemption to be filed by charitable organizations,[91] and support of the operations of the Data Analysis Unit.

Also within the TE/GE Division are the Employee Plans and Government Entities functions. Within the latter are the Federal, State, and Local Governments; Indian Tribal Governments; and Tax Exempt Bonds offices.

The IRS has a National Fraud Program, which entails the coordination of the establishment of IRS-wide fraud strategies, policies, and procedures to enhance enforcement of the federal tax law. This program, which is within the Small Business/Self-Employed Division, facilitates coordination for all IRS divisions to identify and develop fraud cases. The Treasury Inspector General for Tax Administration criticized the TE/GE Division for ineffectiveness in implementing its share of the fraud program and caused the Division to implement a more centralized approach to fraud cases across the five offices in the Division.

§ 2.3 EO DIVISION'S REPORTS AND WORK PLANS

The Exempt Organizations Division annually publishes a report summarizing its accomplishments for the fiscal year just concluded and a work plan inventorying its forthcoming projects. In recent years, these reports have become long on management matters and production of online technical products and short on new initiatives involving the law of tax-exempt organizations. Nonetheless, these documents are required reading for exempt organizations practitioners.[92]

[90]See § 28.4.

[91]See § 26.2(a).

[92]These reports and work plans are summarized in the supplements accompanying this book.

PART TWO

Fundamentals of the Law of Tax-Exempt Organizations

CHAPTER THREE

Tax Exemption: Source and Recognition

As subsequent chapters indicate, there are many categories of tax-exempt organizations. Accordingly, the advantages and disadvantages of tax exemption will differ, depending on the particular category.

§ 3.1 SOURCE OF TAX EXEMPTION

Section 61(a) of the Internal Revenue Code provides that "[e]xcept as otherwise provided in this subtitle [Subtitle A—income taxes], gross income means all income from whatever source derived," including items such as interest, dividends, compensation for services, and receipts derived from business. The Code provides for a variety of deductions, exclusions, and exemptions in computing taxable income. Many of these are contained in Internal Revenue Code Subtitle A, Subchapter B, entitled "Computation of taxable income." Of pertinence in the tax-exempt organizations context, however, is the body of exemption provisions contained in Subtitle A, Subchapter F, captioned "Exempt organizations."

Exemption from federal income taxation is derived from a specific provision to that end in the Internal Revenue Code. A federal tax exemption is a privilege (a matter of legislative grace), not an entitlement,[1] and—being an exception to the norm of taxation—is often strictly construed.[2] (The same principle applies with

[1] As discussed, however, the federal tax exemption for many nonprofit organizations (such as charitable ones) is a reflection of the heritage and societal structure of the United States (see § 1.3).

[2] E.g., Knights of Columbus Bldg. Ass'n of Stamford, Conn., Inc. v. United States, 88-1 U.S.T.C. ¶ 9336 (D. Conn. 1988) ("A tax exemption is a benefit conferred by the legislature in its discretion. Because there is no entitlement to an exemption absent allowance by the legislature, the exemption provisions are strictly construed"); Mercantile Bank & Trust Co. v. United States, 441 F.2d 364 (8th Cir. 1971) ("Special benefits to taxpayers, such as tax exemption status, do not turn upon general equitable considerations but are matters of legislative grace" (at 366)). Also Conference of Major Religious Superiors of Women, Inc. v. District of Columbia, 348 F.2d 783 (D.C. Cir. 1965); American Automobile Ass'n v. Comm'r, 19 T.C. 1146 (1953); Associated Indus. of Cleveland v. Comm'r, 7 T.C. 1449 (1946); Bingler v. Johnson, 394 U.S. 741 (1969), and authorities cited therein.

respect to tax deductions and tax exclusions.[3,4]) This type of exemption must be by enactment of Congress and will not be granted by implication.[5] Two related tax precepts are that a person requesting exemption must demonstrate compliance with the requirements set forth in the statute that grants the exemption,[6] and the party claiming the exemption bears the burden of proof of eligibility for the exemption.[7] Thus, a court wrote that the federal tax statutory law "generally consists of narrowly defined categories of exemption" and is "replete with rigid requirements which a putatively exempt organization must demonstrate it meets."[8] The IRS and the courts are alert for efforts to gain a tax exemption where the underlying motive is the purpose of "confounding tax collection."[9]

Nonetheless, provisions according tax exemption for charitable organizations are usually liberally construed. Thus, a court wrote that the "judiciary will liberally construe, and rightfully so, provisions giving exemptions for charitable, religious, and educational purposes."[10] Another court said that "in view of the fact that bequests for public purposes operate in aid of good government and perform by private means what ultimately would fall upon the public, exemption from taxation is not so much a matter of grace or favor as rather an act of justice."[11] Similarly, the exemption of income devoted to charity by means of the charitable contribution deductions has been held to not be narrowly construed.[12] These provisions respecting income destined for charity are accorded favorable construction, since they are "begotten from motives of public policy"[13] and any ambiguity therein has been traditionally resolved against taxation.[14]

The provision in the Internal Revenue Code that is the general source of the federal income tax exemption is IRC § 501(a),[15] which states that an "organization

[3]Deputy v. Du Pont, 308 U.S. 488 (1940); White v. United States, 305 U.S. 281 (1938). In a case involving tax deductions claimed by a trust, the court wrote that the deductions "must fit into a statutory category of deductibility, else the trustees must carry out their fiduciary duty at the expense of the trust, rather than the public fisc" (Alfred I. duPont Testamentary Trust v. Comm'r, 514 F.2d 917, 922 (5th Cir. 1975)).

[4]E.g., Estate of Levine v. Comm'r, 526 F.2d 717 (2d Cir. 1975) (where the court was prompted to observe that "[o]ne suspects that because the Internal Revenue Code … piles exceptions upon exclusions, it invites efforts to outwit the tax collector" (at 717)).

[5]E.g., Mescalero Apache Tribe v. Jones, 411 U.S. 145 (1973).

[6]E.g., Christian Echoes Nat'l Ministry v. United States, 470 F.2d 849 (10th Cir. 1972), *cert. den.*, 414 U.S. 864 (1973); Parker v. Comm'r, 365 F.2d 792 (8th Cir. 1966), *cert. den.*, 385 U.S. 1026 (1967).

[7]E.g., United States v. Olympic Radio & Television, Inc., 349 U.S. 232 (155); Bubbling Well Church of Universal Love v. Comm'r, 670 F.2d 104 (9th Cir. 1981); Senior Citizens Stores, Inc. v. United States, 602 F.2d 711 (5th Cir. 1979); Kenner v. Comm'r, 318 F.2d 632 (7th Cir. 1963).

[8]Knights of Columbus Bldg. Ass'n of Stamford, Conn., Inc. v. United States, 88-1 U.S.T.C. ¶ 9336 (D. Conn. 1988).

[9]Granzow v. Comm'r, 739 F.2d 265, 268–269 (7th Cir. 1984).

[10]American Inst. for Economic Research, Inc. v. United States, 302 F.2d 934, 937 (Ct. Cl. 1962), *cert. den.*, 372 U.S. 976 (1963), *reh'g den.*, 373 U.S. 954 (1963).

[11]Harrison v. Barker Annuity Fund, 90 F.2d 286, 288 (7th Cir. 1937). The court also said that the "courts quite generally have extended liberal construction to statutes furthering the encouragement of bequests for purposes which tend toward the public good, without reference to personal or selfish motives" (*id.*).

[12]SICO Found. v. United States, 295 F.2d 924, 930, note 19 (Ct. Cl. 1962), and cases cited therein.

[13]Helvering v. Bliss, 293 U.S. 144, 151 (1934).

[14]C. F. Mueller Co. v. Comm'r, 190 F.2d 210 (3rd Cir. 1951).

[15]Also IRC §§ 521, 526–529.

described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle [Subtitle A—income taxes] unless such exemption is denied under section 501 or 503."

The U.S. Supreme Court characterized IRC § 501(a) as the "linchpin of the statutory benefit [exemption] system."[16] The Court summarized the exemption provided by IRC § 501(a) as extending "advantageous treatment to several types of nonprofit corporations [and trusts and unincorporated associations], including exemption of their income from taxation and [for those that are also eligible charitable donees] deductibility by benefactors of the amounts of their donations."[17]

Most categories of tax exemption are manifested in the list of them that comprises IRC § 501(c). Yet, references to exemption are found elsewhere in the Internal Revenue Code, namely, IRC §§ 501(d), 521, 526–529A, and 664.[18]

An organization that seeks to obtain tax-exempt status, therefore, bears the burden of proving that it satisfies all the requirements of the exemption statute involved.[19]

§ 3.2 *RECOGNITION* OF TAX EXEMPTION

An organization's tax-exempt status may be *recognized* by the IRS; indeed, the law may mandate this recognition. Recognition of tax exemption is a function of the IRS, which it accomplishes, where the organization qualifies for exemption, by making a written determination[20] that the entity constitutes an exempt organization. (The role of the IRS in recognizing the exempt status of organizations is part of its general function of evaluating the tax status of organizations.[21]) Recognition of exempt status, however, must be contrasted with *eligibility* for exempt status. Congress, not the IRS, is responsible for *granting* exempt status.[22] Thus, if an organization qualifies for exemption pursuant to the federal tax law, it is exempt—although the law may require a procedural step, such as filing for recognition of exemption by or providing a notice to the IRS.

(a) General Rules

As a general rule, recognition of tax exemption by the IRS is not required in connection with most categories of exempt organizations. (The IRS informally refers to

[16]Simon v. Eastern Ky. Welfare Rights Org., 426 U.S. 26, 29, note 1 (1976).

[17]*Id.*, at 28.

[18]Indeed, the list is even longer, in that individual retirement accounts (IRC §§ 408, 408A), domestic international sales corporations (IRC § 991), employee stock ownership plans and related employee stock ownership trusts (e.g., Val Lanes Recreation Center Corp. v. Comm'r, T.C. Memo. 2018-92 (2018)), and Coverdell education savings accounts (IRC § 530) are tax-exempt organizations. For an interplay between some of these provisions, see Benenson v. Comm'r, 887 F.3d 511 (1st Cir. 2018).

[19]E.g., Harding Hosp., Inc. v. United States, 505 F.2d 1068, 1071 (6th Cir. 1974); Haswell v. United States, 500 F.2d 1133, 1140 (Ct. Cl. 1974).

[20]See § 26.1(c).

[21]Reg. §§ 601.201(a)(1), 601.201(d)(1).

[22]As a court stated, a "tax exemption is a benefit conferred by the legislature at its discretion" (Knights of Columbus Building Ass'n of Stamford, Connecticut v. United States, 88-1 U.S.T.C. ¶ 9338 (D. Conn. 1988). This court added that the federal statutory law "generally consists of narrowly defined categories of exemption" and is "replete with rigid requirements which a putatively exempt organization must demonstrate it meets" (*id.*).

these types of entities as *self-declarers*.) Frequently there is confusion on this point, because there is no rule of statutory law that affirmatively so provides. Rather, this conclusion has to be reached by implication, as a matter of statutory construction, in that the federal tax law requires certain types of organizations to secure recognition of exemption to be exempt; thus, the other types of entities need not make the filing.[23] That is, in order for an organization to be exempt as a charitable entity (with exceptions), a credit counseling organization that desires exemption as a social welfare entity, a nonprofit health insurance issuer, or an employee benefit entity, it must file an application for recognition of exemption with the IRS and receive a favorable determination.[24] Nonetheless, an organization that is not obligated to seek recognition of exemption may voluntarily do so.[25]

(By contrast, for an organization to be regarded as a tax-exempt social welfare entity,[26] it must give notice to the IRS.[27] The same is the case with respect to exempt political organizations.[28])

There is little formal evidence of this distinction in the law between organizations that are required to file for recognition of tax exemption and those that do not have to file. The distinction is somewhat reflected in an IRS revenue ruling,[29] which is predicated on the rule that an organization that desires tax exemption as a charitable entity from the outset of its existence must file for recognition of exemption within a threshold period; if it does so, the recognition of exemption is effective as of the date the entity was formed (that is, the recognition is retroactive).[30] The point of this ruling is that an organization that qualifies for exemption both as a charitable entity and as a social welfare entity,[31] and that filed for recognition of exemption after expiration of this threshold period and thus cannot qualify as a charitable entity from its beginning, can qualify as an exempt social welfare entity during the period starting with the date of its formation and ending on the date the exempt charitable entity status commences—the underlying concept being that social welfare organizations are not required to file for recognition of exemption to be exempt. This ruling is somewhat confusing and misleading, however, in that it states that an organization in this circumstance "may" file an application for recognition of exemption as a social welfare organization during the initial period, implying to some that it *must* file an application. In fact, an organization of this nature (that is, an entity that is not a charity credit counseling/social welfare organization, nonprofit health insurance issuer, or employee benefit fund) can achieve the same result without filing for recognition of social welfare organization status merely by operating as such an organization.

[23]The IRS's procedures state that an organization seeking recognition of tax-exempt status must file the appropriate application (Rev. Proc. 2018-5, 2018-1 I.R.B. 235 § 4.01, 4.02) but are silent on the point that recognition of exemption is not always required.

[24]IRC §§ 508(a), 501(q)(3), 501(c)(29)(B)(i), 505(c), respectively. See §§ 26.2, 26.4, 26.7, 26.5, respectively.

[25]This is done, for example, to obtain government confirmation of tax-exempt status.

[26]See Chapter 13.

[27]IRC § 506. See § 26.13.

[28]IRC § 527(i). See Chapter 17 and § 26.11.

[29]IRS Revenue Ruling (Rev. Rul.) 80-108, 1980-1 C.B. 119.

[30]See § 26.2.

[31]See Chapter 13.

This dichotomy is also reflected in the application for recognition of exemption filed by organizations seeking tax exemption as charitable entities.[32] If the applicant organization is submitting the application more than 27 months after the end of the month in which it was formed,[33] it may be eligible for exemption only from the date the application was sent to the IRS.[34] Nonetheless, the IRS observes that the organization may be eligible for exemption as a social welfare organization from the date of its formation to the postmark date of the application. A box on the application is to be checked if the organization wants the IRS to regard the submission as a request for exemption as a social welfare organization during this initial period. Then the IRS requires the organization to attach page 1 of the application that is filed by social welfare organizations.[35] Once again, this is somewhat misleading, because the applicant organization could qualify as an exempt social welfare organization during the interim period without making any submission to the IRS—because social welfare organizations (like most other categories of exempt entities) do not have to file for recognition of exemption with the IRS to be exempt.

Subject only to the authority of the IRS to revoke a determination letter or ruling for good cause (a material change in the facts or a revision of law), an organization, the tax exemption of which has been recognized by the IRS, can rely on that determination as long as there are no substantial changes in the entity's character, purposes, or methods of operation.[36] Should one of these changes occur, the organization is expected to notify the IRS to accord the agency the opportunity to reevaluate the entity's exempt status.

(b) Concept of *Recognition*

Thus, rather than *grant* tax-exempt status, the IRS's function is to *recognize* exempt status (assuming the organization so qualifies). The concept of *recognition* is based on the fact that the tax exemption exists before the IRS commences its review of the applicant organization. The IRS thereafter recognized the fact of exemption, by agreeing with the applicant that it is an exempt entity, as manifested by the issuance of a favorable determination letter.[37]

This distinction is reflected in the IRS's instructions that accompany Form 1023. It is there stated that, in connection with the categories of entities that are "eligible" for tax-exempt status, "[o]rganizations organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals are *eligible* to file Form 1023 to obtain *recognition* of exemption from federal income tax under section 501(c)(3)

[32]See § 26.2.

[33]Form 1023, Part VII, question 2.

[34]Form 1023, Schedule E, question 8.

[35]Form 1024.

[36]Reg. § 1.501(a)-1(a)(2).

[37]The Department of the Treasury and the IRS occasionally use the word *establish* as a synonym for *recognize* (e.g., Reg. § 1.501(a)-1(a)(2)). Sometimes the two words are used interchangeably in the same document (e.g., Rev. Proc. 2018-15, 2018-9 I.R.B. 379).

of the Internal Revenue Code."[38] In explaining that certain organizations are not required to file this application to be tax-exempt (such as churches[39]), the IRS stated that "these organizations may choose to file Form 1023 in order to receive a determination letter that *recognizes* their section 501(c)(3) status."[40]

This distinction is also reflected in a publication the IRS prepared on the subject of tax exemption. This document, the IRS stated, "explains the procedures [an applicant organization] must follow to obtain an appropriate determination letter *recognizing* [the] organization's exemption."[41] The IRS added: "To *qualify* for exemption under the Code, [the] organization must be organized for one or more of the purposes specifically designated in the Code."[42] In other words, if an organization satisfies the requirements of the federal tax law for exemption, it qualifies for exemption, but it may have to have that qualification recognized by the IRS to actually achieve exemption.

§ 3.3 RECOGNITION OF PUBLIC CHARITY, PRIVATE FOUNDATION STATUS

The IRS expanded this concept of *recognition* to include recognition of changes in public charity status;[43] although an organization is not required to obtain a determination letter[44] to qualify for a new public charity classification, in order for the IRS's records to recognize a change in public charity status[45] an organization must obtain a new determination of this status.[46] Likewise, a private foundation[47] may qualify as a private operating foundation[48] without an IRS determination letter, but the IRS will not recognize the status in its records without a determination.[49] An organization claiming to be an exempt operating foundation[50] must obtain an IRS determination letter recognizing that status to be exempt from the tax on its net investment income.[51]

[38]IRS Instructions for Form 1023 (revised December 2017) 1 (emphasis added).
[39]See § 26.2(b).
[40]IRS Instructions for Form 1023 (revised December 2017) 1 (emphasis added).
[41]IRS, "Tax-Exempt Status for Your Organization," Pub. 557 (revised January 2018) 2 (emphasis added).
[42]*Id.* (emphasis added).
[43]See § 12.3.
[44]See § 26.1, text accompanied by notes 9–11.
[45]The possible changes are summarized in Rev. Proc. 2018-5, 2018-1 I.R.B. 235 § 7.
[46]*Id*. § 7.04(1).
[47]See § 12.1(a).
[48]See § 12.1(b).
[49]Rev. Proc. 2018-5, 2018-1 I.R.B. 235 §7.04(4).
[50]See § 12.1(c).
[51]Rev. Proc. 2018-5, 2018-1 I.R.B. 235 § 7.04(4). These determinations of change of status may be requested by the filing of Form 8940. *Id*. §§ 4.02(5), 7.02.

CHAPTER FOUR

Organizational, Operational, and Related Tests and Doctrines

The federal tax law mandates adherence to certain general organizational and operational requirements as a condition of tax exemption. These requirements are the most pronounced with respect to charitable organizations.[1]

[1]That is, organizations described in IRC § 501(c)(3) and tax-exempt by reason of IRC § 501(a).

§ 4.1 FORMS OF TAX-EXEMPT ORGANIZATIONS

Generally, the Internal Revenue Code does not prescribe a specific organizational form for entities to qualify for tax exemption.

(a) General Rules

Basically, a tax-exempt organization will be a nonprofit corporation, trust (*inter vivos* or testamentary), or unincorporated association.[2] Exempt charitable and social welfare organizations may be formed as limited liability companies,[3] although the IRS has suggested that this form of entity may be inappropriate for exempt social clubs.[4] Some provisions of the Code, however, mandate, in whole or in part, the corporate form,[5] and other Code provisions (particularly in the employee plan context) mandate the trust form for exempt organizations.[6] Throughout the categories of exempt organizations are additional terms such as *clubs*, *associations*, *societies*, *foundations*, *leagues*, *companies*, *boards*, *orders*, *posts*, and *units*, which are not terms referencing legal forms. For tax purposes, an organization may be deemed a corporation even though it is not formally incorporated.[7]

The federal tax provision that describes charitable organizations provides that an organization described in that provision must be a corporation, community chest, fund, or foundation; only the first of these terms has any efficacy in law. An unincorporated association or trust can qualify under this provision, presumably as a fund or foundation or perhaps, as noted, as a corporation.[8] A partnership cannot, however, be tax-exempt as a charitable organization.[9]

[2]Rev. Proc. 82-2, 1982-1 C.B. 367. In the context of religious organizations (see Chapter 10), state law may recognize the *corporation sole*, which is an entity "composed of a series of natural persons who, one after another, hold the office of the religious leader of the particular religious organization" (In re Catholic Bishop of Spokane, 329 B.R. 304 (U.S. Bankr. Ct. E.D. Wash. 2005), *rev'd, in part, on other grounds*, 364 B.R. 81 (E.D. Wash. 2006)). Also in this context, entities can be established in dubious forms, such as *ministerial trusts* (e.g., United States v. Hovind, 2009-1 U.S.T.C. ¶ 50,143 (11th Cir. 2008)), which can be or edge close to being fraudulent tax schemes (e.g., United States v. Stoll, 2005 WL 1763617 (W.D. Wash. June 27, 2005)) or *personal ministries* (see § 10.2(c)).

[3]See § 4.3(e).

[4]Priv. Ltr. Rul. 200450041.

[5]IRC §§ 501(c)(1), 501(c)(2), 501(c)(3), 501(c)(14), 501(c)(16). Thus, for example, in determining that an organization did not qualify for tax exemption by reason of IRC § 501(c)(16), one reason given by the IRS was that the state involved had suspended the organization's corporate status (Priv. Ltr. Rul. 201333014).

[6]IRC §§ 501(c)(17), 501(c)(18), 501(c)(19), 501(c)(20), 401(a).

[7]IRC § 7701(a)(3). See § 4.1(b). The IRS ruled that a tax-exempt organization that had its corporate status irrevocably terminated by a state because of failure to file state annual reports, yet continued to operate, was deemed to have elected to be classified as an association taxable as a corporation pursuant to the check-the-box rules (Priv. Ltr. Rul. 200607027).

[8]Fifth-Third Union Trust Co. v. Comm'r, 56 F.2d 767 (6th Cir. 1932).

[9]Emerson Inst. v. United States, 356 F.2d 824 (D.C. Cir. 1966), *cert. den.*, 385 U.S. 822 (1966). In one opinion, a court, in deciding that an organization could not qualify for tax-exempt status because of its role as a general partner in a limited partnership (see § 31.1(a)), placed emphasis on the fact that the partnerships involved "are admittedly for-profit entities" and that none of these partnerships is "intended to be nonprofit" (Housing Pioneers, Inc. v. Comm'r, 65 T.C.M. 2191, 2195 (1993)); however, the law does not provide for an entity such as a nonprofit partnership.

An organization already exempt from federal taxation may establish a separate fund or like entity that is itself an exempt organization.[10] The attributes of this type of fund include a separate category of exemption (e.g., an educational research and scholarship fund established by a bar association),[11] a separate governing body, and separate books and accounts.[12] A mere bank deposit cannot, however, amount to a requisite fund.[13]

For purposes of the rules concerning charitable organizations, an organization tax-exempt by reason of those rules may be a unit of government[14] or a foreign organization,[15] or may conduct all or part of its activities in foreign countries.[16]

The formalities of organization of an entity may have a bearing on the tax exemption. This is the case not only in connection with the sufficiency of the governing instruments,[17] but also, and more fundamentally, with regard to whether there is a separate organization in the first instance. An individual may perform worthwhile activities, such as providing financial assistance to needy students, but will receive no tax benefits from his or her beneficence unless he or she establishes and funds a qualified organization that in turn renders the charitable works, such as scholarship grants. One court observed, in the process of denying a charitable contribution deduction, that the federal tax law makes no provision for a charitable deduction in the context of personal ventures, however praiseworthy in character. The court noted that "[t]here is no evidence of such enterprise being a corporation, community chest, fund, or foundation and little information, if any, as to its organization or activities."[18] Assuming the organization is not operated to benefit private interests, its tax exemption will not be endangered because its creator serves as the sole trustee and exercises complete control,[19] although state law may limit or preclude close control.

A "formless aggregation of individuals" cannot be tax-exempt as a charitable entity.[20] At a minimum, the entity—to be exempt—must have an organizing instrument, some governing rules, and regularly chosen officers.[21] These rules have been amply illustrated in the cases concerning so-called personal churches.[22]

Among the nontax factors to be considered in selecting an organizational form are legal liabilities in relation to the individuals involved (the corporate form

[10]See Chapter 29.

[11]American Bar Ass'n v. United States, 84-1 U.S.T.C. ¶ 9179 (N.D. Ill. 1984); Rev. Rul. 58-293, 1958-1 C.B. 146.

[12]Rev. Rul. 54-243, 1954-1 C.B. 92.

[13]E.g., Pusch v. Comm'r, 39 T.C.M. 838 (1980).

[14]Rev. Rul. 60-384, 1960-2 C.B. 172.

[15]Rev. Rul. 66-177, 1966-1 C.B. 132.

[16]Rev. Rul. 71-460, 1971-2 C.B. 231.

[17]Cone v. McGinnes, 63-2 U.S.T.C. ¶ 9551 (E.D. Pa. 1963). See § 4.2.

[18]Hewitt v. Comm'r, 16 T.C.M. 468, 471 (1957). Also, Doty, Jr. v. Comm'r, 6 T.C. 587 (1974); Walker v. Comm'r, 37 T.C.M. 1851 (1978).

[19]Rev. Rul. 66-219, 1966-2 C.B. 208.

[20]IRS Exempt Organizations Handbook (IRM 7751) §§ 315.1, 315.2(3), 315.4(2).

[21]E.g., George v. Comm'r, 110 T.C.M. 190 (2015); Kessler v. Comm'r, 87 T.C. 1285 (1986); Trippe v. Comm'r, 9 T.C.M. 622 (1950). Cf. Morey v. Riddell, 205 F. Supp. 918 (S.D. Cal. 1962). A claim that it is unconstitutional not to permit individuals to be tax-exempt was dismissed (Fields v. United States, Civ. No. 96-317 (D.D.C. 1998)).

[22]E.g., United States v. Jeffries, 88-2 U.S.T.C. ¶ 9459 (7th Cir. 1988). In general, see § 10.2(c).

can limit certain personal liabilities), local law requirements, necessities of governing instruments, local annual reporting requirements, organizational expenses, and any membership requirements.[23] Federal law other than the tax laws may also have a bearing on the choice, such as the organization's comparable status under the postal laws.[24]

(b) Check-the-Box Regulations

In general, the classification of an entity as a particular type of organization can have significant federal tax consequences. Although this is an issue principally for for-profit entities, there are some ramifications in this area for tax-exempt organizations.

(i) Basic Rules. In the for-profit context, classification of this nature can be problematic for unincorporated business organizations. (That is, this issue does not pertain to entities that are formed as corporations.) Under old law, an unincorporated entity was classified as a trust or an association, depending on certain characteristics. If an entity was determined to be an association, it was then classified as a corporation or partnership for tax purposes, according to criteria as to limited liability, centralized management, continuity of life, and free transferability of member interests.[25]

The IRS decided to simplify the entity classification process and did so by means of regulations that generally took effect in 1997. These rules are known as the *check-the-box* regulations.[26] Basically, under these rules, an organization is either a trust[27] or a *business entity.*[28] A business entity with two or more members is classified for federal tax purposes as a corporation or a partnership. A business entity with only one owner either is classified as a corporation or is disregarded. When an entity is disregarded, its activities are treated as those of the owner, in

[23] A separate form (even the corporate form), however, is not always respected. For example, courts find charitable organizations to be the "alter ego" of their founders or others in close control and operating proximity, so that IRS levies against the organizations for their income and assets to satisfy the individuals' tax obligations are upheld (e.g., Towe Antique Ford Found. v. Internal Revenue Serv., 999 F.2d 1387 (9th Cir. 1993); United States v. Kitsos, 770 F. Supp. 1230 (N.D. Ill. 1991), *aff'd*, 968 F.2d 1219 (7th Cir. 1992); Zahra Spiritual Trust v. United States, 910 F.2d 240 (5th Cir. 1990); Loving Savior Church v. United States, 556 F. Supp. 688 (D.S.D. 1983), *aff'd*, 728 F.2d 1085 (8th Cir. 1984); United States v. Hovind, 2009 WL 2369340 (N.D. Fl., July 29, 2009); Faith Missionary Baptist Church v. Internal Revenue Serv., 174 B.R. 454 (U.S. Bankr. Ct. E.D. Tex. 1994); Church of Hakeem v. United States, 79-2 U.S.T.C. ¶ 9651 (N.D. Cal. 1979)).

[24] 39 C.F.R. Part 132 (second class), Part 134 (third class).

[25] Prior Reg. § 301.7701-2.

[26] This name is derived from the simple way in which entity classification is made: by checking the appropriate box on Form 8832 (Reg. § 301.7701-3(c)(1)). A federal district court held that these regulations are lawful as a valid exercise of a government agency's rulemaking authority (Littriello v. United States, 2005-1 U.S.T.C. ¶ 50,385 (W.D. Ky. 2005), *aff'd*, 484 F.3d 372 (6th Cir. 2007), *cert. den.*, 552 U.S. 1186 (2008).

[27] A *trust* essentially is a nonbusiness entity; it is an arrangement created by a will or lifetime instrument by which trustees take title to property for the purpose of protecting or conserving it for designated beneficiaries (Reg. § 301.7701-4(a)).

[28] Reg. § 301.7701-2(a).

the manner of a sole proprietorship.[29] A *corporation* includes a business entity organized under a federal or state statute, an *association*, or a business entity owned by a state or political subdivision of a state.[30]

A business entity that is not classified as a corporation is an *eligible entity.* An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation)[31] or a partnership. An eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner.[32] If there is no election, an eligible entity with two or more members is a partnership, and an eligible entity with a single member is disregarded as an entity separate from its owner.[33] Thus, an eligible entity is required to act affirmatively only when it desires classification as a corporation.

(ii) Exempt Organization Rules. There is a *deemed election* in the tax-exempt organization's context. That is, an eligible entity that has been determined to be, or claims to be, exempt from federal income taxation[34] is treated as having made the election to be classified as an association.[35] As noted, this in turn causes the exempt entity to be regarded as a corporation.[36]

Some organizations are tax-exempt because of a relationship to a state or a political subdivision of a state.[37] When a state or political subdivision conducts an enterprise through a separate entity, the entity may be exempt from federal income tax,[38] or its income may be excluded from federal income tax.[39] Generally, if income is earned by an enterprise that is an integral part of a state or political subdivision of a state, that income is not taxable. In determining whether an enterprise is an integral part of a state, it is necessary to consider all the facts and circumstances, including the state's degree of control over the enterprise and the state's financial commitment to the enterprise.

These distinctions are reflected in the check-the-box regulations. A business entity can be recognized as a distinct entity when it is wholly owned by a state or a political subdivision of a state; it then is classified as a corporation.[40] Yet an entity formed under local law is not always recognized as a separate entity for federal tax purposes. The regulations specify that an "organization" wholly owned by a state is not recognized as a separate entity for federal tax purposes if it is an "integral part of the State."[41]

[29] *Id*. Also Reg. § 301.7701-2(c).
[30] Reg. § 301.7701-2(b). An organization wholly owned by a state is not recognized as a separate entity for these purposes if it is an integral part of a state (Reg. § 301.7701-1(a)(3)).
[31] Reg. § 301.7701-2(b)(2).
[32] Reg. § 301.7701-3(a).
[33] Reg. § 301.7701-3(b)(1).
[34] That is, exempt from tax by reason of IRC § 501(a).
[35] Reg. § 301.7701-3(c)(1)(v)(A).
[36] See text accompanied by *supra* note 30.
[37] See, e.g., §§ 7.15, 19.21.
[38] That is, exempt from tax by reason of IRC § 501(a).
[39] IRC § 115.
[40] Reg. § 301.7701-2(b)(6).
[41] Reg. § 301.7701-1(a)(3).

Another instance of an interrelationship between the law of tax-exempt organizations and the check-the-box regulations is the matter of formation by exempt charitable organizations of single-member limited liability companies (LLCs) for various purposes. Under a default rule,[42] these LLCs are disregarded for federal income tax purposes; these entities are known as *disregarded LLCs*.[43]

The IRS contemplated whether a single-member LLC can qualify for tax-exempt status.[44] In the case of an LLC owned wholly by a charitable organization, the issue was whether the LLC, like its owner,[45] is obligated to file an application for recognition of tax-exempt status. The IRS decided that a disregarded LLC is regarded as a branch or division of its member owner.[46] Thus, separate recognition of tax exemption for these LLCs is not required (or available).[47] The IRS subsequently addressed the matter of the tax-exempt status of LLCs that have more than one tax-exempt member.[48]

§ 4.2 GOVERNING INSTRUMENTS

An organization must have governing instruments to qualify for tax exemption, if only to satisfy the appropriate organizational test. This is particularly the case for charitable organizations, for which the federal tax law imposes specific organizational requirements.[49] These rules are more stringent if the charitable organization is a private foundation[50] or a supporting organization.[51]

If the corporate form is used, the governing instruments will be articles of incorporation and bylaws.[52] An unincorporated organization will have articles of

[42]See text accompanied by *supra* note 33.

[43]Many interesting IRS rulings concerning the use of disregarded LLCs by charitable organizations are emerging. As an illustration, the IRS ruled that a charitable organization may transfer parcels of contributed real property to separate LLCs—for the purpose of sheltering other properties from legal liability that may be caused by the gifted property—yet report the gift properties on its annual information return as if it owned them directly (Priv. Ltr. Rul. 200134025). See § 32.4.

[44]An LLC is not taxable; that is, it is treated, for federal income tax purposes, as a partnership (IRC § 701). The issue, however, is whether an LLC can qualify for tax-exempt status under IRC § 501.

[45]See § 26.2.

[46]Ann. 99-102, 1999-43 I.R.B. 545.

[47]E.g., Priv. Ltr. Rul. 200134025. Caution must be exercised in this context because of state law. Some states do not recognize the concept of the disregarded LLC. There can be issues as to the availability of income, sales, use, and/or property taxation where an LLC is involved.

For many years, the IRS has had before it the question as to whether a contribution of money or property directly to a disregarded LLC, where the sole member is a tax-exempt charitable (IRC § 501(c)(3)) organization, is deductible as a charitable contribution. Given other applications of this body of law by the IRS, the answer to the question assuredly is yes. The IRS, however, stated that a private foundation may make a grant for charitable purposes to a disregarded LLC, where the member is an unrelated public charity, and properly treat the transfer as a qualifying distribution, without the need to exercise expenditure responsibility (see § 12.4(b)) (INFO 2010-0052).

[48]See § 4.3(e).

[49]See § 4.3.

[50]IRC § 508(e). See § 12.1(g).

[51]See § 12.3(c).

[52]Reg. § 1.501(c)(3)-1(b)(2).

organization, perhaps in the form of a constitution, and, undoubtedly, also bylaws. If a trust, the basic document will be a declaration of trust or trust agreement. If an LLC, the organizing document will be an operating agreement.

The articles of organization should contain provisions stating the organization's purposes; whether there will be members and, if so, their qualifications and classes; the initial board of directors or trustee(s); the registered agent and incorporators (if a corporation); the dissolution or liquidation procedure; and the required language referencing the appropriate tax law (federal and state) requirements and prohibitions. If the organization is a corporation, particular attention should be given to the appropriate state nonprofit corporation statute, which will contain requirements that may supersede the provisions of the articles of incorporation and bylaws or may apply where the governing instruments are silent.

The bylaws may also contain the provisions of the articles of organization and, in addition, should contain provisions amplifying or stating the purposes of the organization, the terms and conditions of membership (if any), the manner of selection and duties of the directors or trustees and the officers, the voting requirements, the procedure for forming committees, the accounting period, any indemnification provisions, the appropriate tax provisions, and the procedure for amendment of the bylaws.

§ 4.3 ORGANIZATIONAL TEST

An organization, to be tax-exempt as a charitable entity, must be both organized and operated exclusively for one or more of the permissible exempt purposes. This requirement has given rise to an *organizational test* and an *operational test*[53] for charitable organizations. If an organization fails to meet either the organizational test or the operational test, it cannot qualify for exemption from federal income taxation as a charitable entity.[54] The federal tax regulations barely provide for an organizational test for other categories of exempt organizations. Yet this test is inherent in each category of exemption. For example, the IRS referenced an organizational test for exempt social clubs.[55]

An organization is organized exclusively for one or more tax-exempt, charitable purposes only if its articles of organization limit its purposes to one or more exempt purposes[56] and do not expressly empower it to engage, other than as an insubstantial part of its activities, in activities that in themselves are not in furtherance of one or more exempt purposes.[57]

The fact that an organization's organizational documents are not properly executed can be viewed by the IRS as a violation of the organizational test.[58]

[53]See § 4.5.
[54]Reg. § 1.501(c)(3)-1(a); Levy Family Tribe Found. v. Comm'r, 69 T.C. 615, 618 (1978).
[55]Priv. Ltr. Rul. 200450041. See Chapter 15.
[56]See Reg. § 1.501(c)(3)-1(d).
[57]Reg. § 1.501(c)(3)-1(b)(1)(i).
[58]E.g., Priv. Ltr. Rul. 200508019.

(a) Statement of Purposes

In meeting the organizational test, a charitable organization's purposes, as stated in its articles of organization, may be as broad as, or more specific than, the particular exempt purposes, such as religious, charitable, or educational ends. Therefore, an organization that, by the terms of its articles of organization, is formed for "literary and scientific purposes within the meaning of section 501(c)(3) of the Internal Revenue Code" shall, if it otherwise meets the requirements of the organizational test, be considered to have met the test. Similarly, articles of organization stating that the organization is created solely to "receive contributions and pay them over to organizations which are described in section 501(c)(3) and exempt from taxation under section 501(a) of the Internal Revenue Code" are sufficient for purposes of the organizational test. If the articles of organization state that the organization is formed for "charitable purposes," the articles ordinarily will be adequate for purposes of the organizational test.[59]

Articles of organization of charitable entities may not authorize the carrying on of nonexempt activities (unless they are insubstantial), even though the organization is, by the terms of its articles, created for a purpose that is no broader than the specified charitable purposes.[60] Thus, an organization that is empowered by its articles to "engage in a manufacturing business" or to "engage in the operation of a social club" does not meet the organizational test, regardless of the fact that its articles of organization may state that the organization is created for "charitable purposes within the meaning of section 501(c)(3) of the Internal Revenue Code."[61]

In no case will an organization be considered to be organized exclusively for one or more tax-exempt charitable purposes if, by the terms of its articles of organization, the purposes for which the organization is created are broader than the specified charitable purposes. The fact that the actual operations of the organization have been exclusively in furtherance of one or more exempt purposes is not sufficient to permit the organization to meet the organizational test. An organization wishing to qualify as a charitable entity should not provide in its articles of organization that it has all of the powers accorded under the particular state's nonprofit corporation act, since those powers are likely to be broader than those allowable under federal tax law.[62] Similarly, an organization will not meet the organizational test as a result of statements or other evidence that its members intend to operate only in furtherance of one or more exempt purposes.[63]

An organization is not considered organized exclusively for one or more exempt charitable purposes if its articles of organization expressly authorize it to (1) devote more than an insubstantial part of its activities to attempting to influence legislation by propaganda or otherwise;[64] (2) directly or indirectly participate in,

[59]Reg. § 1.501(c)(3)-1(b)(1)(ii).

[60]Rev. Rul. 69-279, 1969-1 C.B. 152; Rev. Rul. 69-256, 1969-1 C.B. 151.

[61]Reg. § 1.501(c)(3)-1(b)(iii). Also Interneighborhood Housing Corp. v. Comm'r, 45 T.C.M. 115 (1982); Santa Cruz Bldg. Ass'n v. United States, 411 F. Supp. 871 (E.D. Mo. 1976).

[62]E.g., IRS General Counsel Memorandum (Gen. Couns. Mem.) 39633.

[63]Reg. § 1.501(c)(3)-1(b)(1)(iv).

[64]An organization organized and operated to reform, repeal, and decriminalize laws meant to protect children from sexual abuse and sexual predators failed to achieve tax-exempt status as a charitable entity in part because its articles of incorporation mandated substantial legislative activity (Mysteryboy Incorporation v. Comm'r, 99 T.C.M. 1057 (2010)). See Chapter 22.

or intervene in (including the publishing or distributing of statements), any political campaign on behalf of or in opposition to any candidate for public office;[65] or (3) have objectives and engage in activities that characterize it as an *action* organization.[66] The organizational test is not violated, however, where an organization's articles empower it to make the expenditure test election (relating to expenditures for legislative activities[67]) and, only if it so elects, to make direct lobbying or grassroots lobbying expenditures that are not in excess of the ceiling amounts prescribed by that test.[68] The organizational test, however, does not require that references be made in the organizational document to the prohibitions on private inurement, substantial private benefit, substantial lobbying, and political campaign activities.

The organizational test requires that the articles of organization limit the purposes of the entity to one or more exempt purposes. Exempt purposes are described in the statute,[69] and include purposes such as charitable, educational, religious, and scientific. These purposes are also enumerated in the tax regulations in explication of the term *charitable*,[70] and include purposes such as advancement of religion, lessening the burdens of government, and promotion of social welfare. There is no requirement in the law that the statement of purposes, when exempt purposes are referenced, expressly refer to IRC § 501(c)(3).

There are many other permissible functions of a charitable organization that are not formally recognized as exempt purposes in the Code or the regulations that nonetheless have been recognized as exempt functions (generically) in IRS revenue rulings and court decisions (and thus satisfy the operational test).[71] Purposes of this nature include promotion of health, promotion of the arts, operation of a school, and protection of the environment. Inasmuch as functions of this nature are not exempt functions (as technically defined), they cannot stand alone in a statement of purposes. That is, for the organizational test to be satisfied, one of two statements must be in the articles of organization: (1) If the document contains a purpose that is not an exempt purpose, it should expressly limit the organization's purposes to those described in IRC § 501(c)(3), or (2) if the document contains a purpose that is not an exempt purpose, and that purpose is not contrary to exempt purposes, the document should include a "notwithstanding" clause.[72]

An overly broad statement of purposes cannot be cured by a provision stating that the organization's activities will be confined to those described in IRC § 501(c)(3). Again, this is because activities are considered in connection with the operational test, while the organizational test is concerned with purposes.

[65]See Chapter 23.

[66]Reg. § 1.501(c)(3)-1(b)(3). See § 4.5(d).

[67]See § 22.3(d)(iv).

[68]Reg. § 1.501(c)(3)-1(b)(3).

[69]IRC § 501(c)(3).

[70]Reg. § 1.501(c)(3)-1(d)(2). See Chapter 7.

[71]See § 4.5.

[72]This provision may read as follows: "Notwithstanding other language (or provisions) in the creating document, the purposes will be limited exclusively to exempt purposes within the meaning of IRC [§] 501(c)(3)." This is from Ardoin, "Organizational Test—IRC 501(c)(3)," prepared as part of the IRS's continuing professional education text for the government's fiscal year 2004.

Also, despite the rules of law governing charitable entities, there is nothing in the organizational test that requires reference to the private inurement doctrine,[73] limitation on attempts to influence legislation,[74] or the prohibition on political campaign activities in the articles of organization.[75]

It is the view of one court, however, that the organizational test entails a "purely … factual inquiry" and that it is not required to "myopically consider *only*" articles of incorporation or another creating document; in the case, an organization was found to qualify as a charitable organization meeting the organizational test because of suitable language in its bylaws.[76]

The law of the state in which an organization is created is controlling in construing the terms of its articles of organization.[77] An organization that contends that the terms have, under state law, a different meaning from their generally accepted meaning must establish the special meaning by clear and convincing reference to relevant court decisions, opinions of the state attorney general, or other evidence of applicable state law.[78]

An organization that would be classified as a private foundation[79] if it were recognized as a charitable entity does not satisfy the organizational test by virtue of having complied with the special governing instrument provisions applicable only to private foundations.[80] In so ruling, the IRS considered a case where an organization's articles of incorporation lacked the requisite provision requiring the distribution of its assets for charitable purposes on dissolution. The state law under which the organization operates had not been construed to assure dedication of assets to charitable purposes,[81] although the state had a statute that mandates reference to the various private foundation rules in the foundation's articles of incorporation on all private foundations formed in the state.[82] The IRS reasoned that a private foundation is a charitable organization, yet an organization cannot be so classified where its governing instrument fails to include a dissolution clause, and the special governing instrument provisions apply only to private foundations. Also, the IRS reviewed the legislative history of the private foundation rules, which makes it clear that these rules comprise requirements that are in addition to the general tax exemption requirements.[83]

(b) Dissolution Requirements

An organization is not organized exclusively for one or more tax-exempt charitable purposes unless its assets are dedicated to an exempt purpose.[84] An organization's

[73]See Chapter 20.
[74]See Chapter 22.
[75]See Chapter 23.
[76]Colorado State Chiropractic Soc'y v. Comm'r, 93 T.C. 487, 495 (1989) (emphasis in original).
[77]Estate of Sharf v. Comm'r, 38 T.C. 15 (1962), *aff'd*, 316 F.2d 625 (7th Cir. 1963); Holden Hosp. Corp. v. Southern Ill. Hosp. Corp., 174 N.E. 2d 793 (Ill. 1961).
[78]Reg. § 1.501(c)(3)-1(b)(5).
[79]See Chapter 12.
[80]IRC § 508(e). See § 12.1(g).
[81]See text accompanied by *supra* note 78.
[82]Rev. Rul. 75-38, 1975-1 C.B. 161.
[83]Rev. Rul. 85-160, 1985-2 C.B. 162.
[84]Reg. § 1.501(c)(3)-1(b)(4).

assets will be considered dedicated to an exempt purpose, for example, if, on dissolution, the assets would, by reason of a provision in the organization's articles of organization or by operation of law, be distributed for one or more exempt purposes, or to the federal government, or to a state or local government, for a public purpose or would be distributed by a court to another organization to be used in a manner that in the judgment of the court will best accomplish the general purposes for which the dissolved organization was organized.[85] A charitable organization does not, however, meet the organizational test if its articles of organization or the law of the state in which it was created provide that its assets would, on dissolution, be distributed to its members or shareholders.[86] Consequently, exemption as a charitable organization will be denied where, on dissolution of the organization, its assets would revert to the individual founders rather than to one or more qualifying charities.[87] Likewise, the IRS will likely revoke a charitable organization's exemption for removal of a dissolution clause, with the revocation retroactive to the date the clause was deleted.[88] A charitable organization's assets may, on dissolution, be transferred for charitable purposes without necessarily being transferred to a charitable organization.[89]

The dedication-of-assets requirement contemplates that, notwithstanding the dissolution of a charitable entity, the assets will continue to be devoted to a charitable purpose (albeit a substituted one). Under the *cy pres* rule, a state court, in the exercise of its equity power, may modify the purpose of a charitable trust or place the funds of a charitable corporation in a new entity.[90] Organizations that are organized for both tax-exempt and nonexempt purposes fail to satisfy the organizational test.[91]

The IRS published guidelines for identification of states and circumstances where an express dissolution clause for charitable organizations is not required. Basically, these guidelines are a function of the type of organization that is involved. For example, the IRS has determined that the *cy pres* doctrine in any jurisdiction is insufficient to prevent an *inter vivos* charitable trust or an unincorporated association from failing, and thus that an adequate dissolution clause is essential for satisfaction of the organizational test. By contrast, the law of several states applies the *cy pres* doctrine to testamentary charitable trusts and the law

[85] *Id.* The IRS incorrectly ruled that an organization violated the organizational test because, on dissolution, its assets would be distributed to a "specific organization" (assuming that organization was a charitable entity) (Priv. Ltr. Rul. 201738012).

[86] Reg. § 1.501(c)(3)-1(b)(4). E.g., Chief Steward of the Ecumenical Temples & Worldwide Peace Movement & His Successors v. Comm'r, 49 T.C.M. 640 (1985). Cf. Bethel Conservative Mennonite Church v. Comm'r, 746 F.2d 388 (7th Cir. 1984).

[87] Church of Nature in Man v. Comm'r, 49 T.C.M. 1393 (1985); Stephenson v. Comm'r, 79 T.C. 995 (1982); Truth Tabernacle v. Comm'r, 41 T.C.M. 1405 (1981); Calvin K. of Oakknoll v. Comm'r, 69 T.C. 770 (1978), *aff'd*, 603 F.2d 211 (2d Cir. 1979); General Conference of the Free Church of Am. v. Comm'r, 71 T.C. 920 (1979).

[88] E.g., Priv. Ltr. Rul. 200842047.

[89] Gen. Couns. Mem. 37126, clarifying Gen. Couns. Mem. 33207. Moreover, the absence of a dissolution clause has been held to not be fatal to IRC § 501(c)(3) status, in Universal Church of Scientific Truth, Inc. v. United States, 74-1 U.S.T.C. ¶ 9360 (N.D. Ala. 1973).

[90] E.g., Davis v. United States, 201 F. Supp. 92 (S.D. Ohio 1961).

[91] Rev. Rul. 69-256, 1969-1 C.B. 151; 1969-1 C.B. 152.

of a few states applies the doctrine to nonprofit charitable corporations.[92] Consequently, from the standpoint of the IRS, an organization in a jurisdiction where the *cy pres* doctrine is inapplicable must have an express, qualifying distribution or liquidation clause to satisfy the organizational test.[93]

Most other categories of tax-exempt organizations are not subject to federal tax law dissolution requirements. Consequently, there is almost no law on the subject outside the charitable context. In one instance, however, an organization was denied recognition of exemption as a social welfare entity because it was not promoting the common good and general welfare of a community,[94] with the IRS citing the organization's dissolution clause, which left its assets to its members, as "further illustrat[ing]" that it was not serving a "wider community."[95] In another instance, the IRS approved dissolution of an exempt labor organization[96] by transfer of all or substantially all of its assets to another exempt labor organization having similar purposes, noting that relevant state laws were complied with, permission of a state attorney general was not required, and no compensation was paid to any director or officer of either organization in connection with the dissolution.[97] The dissolution rule in the exempt voluntary employees' beneficiary association[98] setting provides that prohibited inurement does not occur if amounts distributed to members are determined on the basis of objective and reasonable standards that do not result in unequal payments to officers, shareholders, or highly compensated employees.[99] The IRS applied this rule in connection with dissolution of an exempt teachers' retirement fund[100] where the fund's plan of dissolution, involving transfers to its members, appeared to be in accordance with the "plain and ordinary" meaning of the teachers' retirement fund rules and the VEBA regulation, so that private inurement did not occur in connection with the distribution, and the exemption of the fund would not be imperiled.[101]

(c) Mission Statements

As part of the redesign of Form 990,[102] the IRS is placing considerable emphasis on mission statements, particularly those of public charities. Thus, the return

[92]Rev. Proc. 82-2, 1982-1 C.B. 367.

[93]The IRS will accept the following phraseology of a dissolution clause: "Upon the dissolution of [this organization], assets shall be distributed for one or more exempt purposes within the meaning of section 501(c)(3) of the Internal Revenue Code, or corresponding section of any future Federal tax code, or shall be distributed to the Federal government, or to a state or local government, for a public purpose" (Rev. Proc. 82-2, 1982-1 C.B. 367 § 3.05). An organization that was tax-exempt (IRC § 501(a)) during any of its last five tax years preceding its liquidation, dissolution, termination, or substantial contraction may be required to disclose the development to the IRS (IRC § 6043(b)).

[94]See § 13.2(a).

[95]Priv. Ltr. Rul. 201736027.

[96]See § 16.1.

[97]Priv. Ltr. Rul. 201136027.

[98]See § 18.3.

[99]Reg. § 1.501(c)(9)-4(d).

[100]See § 18.7.

[101]Priv. Ltr. Rul. 201149032.

[102]See § 28.3.

requests, in two instances, a description of the filing organization's *mission.*[103] An organization may thus have a mission statement in addition to a statement of purposes. A mission statement should not, of course, be inconsistent with the purposes statement.[104]

(d) Board Composition

The IRS has developed a policy, predicated on the private benefit doctrine,[105] that an organization, particularly one striving to qualify as a public charity, cannot qualify for tax-exempt status if it has a small board or a board wholly or principally composed of related individuals.[106] Traditionally, of course, this has been solely a matter of state law; most states require a governing board consisting of at least three persons.

The optimum size of a governing board of a nonprofit organization depends on many factors, including the type of organization involved, the nature and size of the organization's constituency, the manner in which the directors are selected, and the role and effectiveness of an executive committee (if any).[107] In some instances, particularly in connection with trusts, an institutional trustee may be involved.

(e) Rules for Limited Liability Companies

The IRS concluded that an LLC[108] with two or more members that are charitable or governmental entities[109] can qualify for tax exemption as a charitable organization itself, if it satisfies 12 conditions.[110] They are:

1. The LLC's organizational documents must include a specific statement limiting its activities to one or more exempt (charitable) purposes.
2. The organizational language must specify that the LLC is operated exclusively to further the charitable purposes of its members.
3. The organizational language must require that the LLC's members be charitable organizations, governmental units, or wholly owned instrumentalities of a state or political subdivision of a state.
4. The organizational language must prohibit any direct or indirect transfer of any membership interest in the LLC to a transferee other than a charitable organization, governmental unit, or instrumentality.

[103]Form 990, Part I, line 1 (with an option to report *most significant activities*), Part III, line 1 (if the mission statement has been approved by the board).
[104]See *New Form 990*, §§ 1.6(a), 2.1(d), 2.2(a).
[105]See § 20.12.
[106]See § 5.4.
[107]See *Governance* § 1.3(b).
[108]See §§ 4.1(b), 32.5–32.7.
[109]A single-member LLC generally is a disregarded entity for tax purposes (see § 4.1(b)(ii)).
[110]These elements are stated in the IRS's exempt organizations continuing professional education technical instruction text for fiscal year 2001.

5. The organizational language must state that the LLC, interests in the LLC (other than a membership interest), or its assets may only be availed of or transferred to, directly or indirectly, any nonmember (other than a charitable organization, governmental unit, or instrumentality) in exchange for fair market value.
6. The organizational language must guarantee that, on dissolution of the LLC, the assets devoted to the LLC's charitable purposes will continue to be devoted to charitable purposes.
7. The organizational language must require that any amendments to the LLC's articles of organization and operating agreement be consistent with the general organizational test applicable to charitable organizations.
8. The organizational language must prohibit the LLC from merging with, or converting into, a for-profit entity.
9. The organizational language must require that the LLC not distribute any assets to members who cease to be charitable organizations, governmental units, or instrumentalities.
10. The organizational language must contain an acceptable contingency plan in the event one or more members cease at any time to be a charitable organization, a governmental unit, or an instrumentality.
11. The organizational language must state that the LLC's exempt members will "expeditiously and vigorously" enforce all of their rights in the LLC and will pursue all legal and equitable remedies to protect their interests in the LLC.
12. The LLC must represent that all its organizing document provisions are consistent with state LLC laws, and are enforceable at law and in equity.

Because of conflict and confusion among the states as to the role of LLC articles of organization and operating agreements, the IRS is requiring that both documents separately comply with the first 11 of these conditions. The last one is met in a separate written statement from the organization.

An LLC that meets each of these 12 conditions can also qualify as a tax-exempt social welfare organization,[111] if it otherwise meets the requirements for that category of tax exemption. The IRS has yet to establish its position as to whether an LLC can qualify as any other type of exempt organization. The IRS appears to be of the view that a social club, to be exempt,[112] cannot be structured as a limited liability company, because the members, rather than the club itself, directly control the entity's assets.[113]

[111] See Chapter 13.
[112] See Chapter 15.
[113] Priv. Ltr. Rul. 200450041.

§ 4.4 PRIMARY PURPOSE TEST

A basic concept of the law of tax-exempt organizations is the *primary purpose rule.* The rule is one of the fundamental bases for determination of the appropriate category of tax exemption (if any) for an organization. The principle is formally explicated, by use of the word *exclusively*,[114] in the context of exempt charitable organizations,[115] exempt social welfare organizations,[116] exempt cemetery companies,[117] exempt health care coverage organizations,[118] and exempt workers' compensation coverage organizations,[119] and by use of the word *substantially* in the case of exempt social clubs.[120] The terms *exclusive* and *substantial* are generally subsumed, in this context, in the word *primary.*[121] This principle of the federal tax law is generally applicable to all categories of exempt organizations.[122]

Consequently, the definition of the word *exclusively*, in the law of tax-exempt organizations, is different from the meaning normally associated with the word. As one court nicely stated, the term *exclusively* "in this statutory context is a term of art and does not mean 'solely.'"[123] The law could not reasonably be interpreted in any other way. That is, if *exclusively* truly meant exclusively (as in solely), there would not be an opportunity for the conduct of unrelated business activity. Since that interpretation would render the entire law of unrelated business income taxation[124] meaningless, the interpretation would not be reasonable. Consequently, by treating the word *exclusively* as if it meant *primarily*, the law accommodates the coexistence of some unrelated activities with related ones.

In a rule frequently honored in its breach, the primary purpose test looks to an organization's purposes rather than its activities.[125] The focus should not be on an organization's primary activities as the test of tax exemption but on whether the activities accomplish one or more tax-exempt purposes.[126] This is why, for example, an organization may engage in nonexempt or profit-making activities and nonetheless qualify for exemption.[127]

[114]See § 4.6.

[115]See Chapter 7.

[116]See Chapter 13.

[117]See § 19.6.

[118]See § 19.15.

[119]See § 19.16.

[120]See Chapter 15.

[121]E.g., Reg. §§ 1.501(c)(3)-1(a)(1), 1.501(c)(3)-1(c)(1).

[122]E.g., Orange County Agric. Soc'y, Inc. v. Comm'r, 55 T.C.M. 1602 (1988), *aff'd*, 893 F.2d 647 (2d Cir. 1990).

[123]New Dynamics Found. v. United States, 2006-1 U.S.T.C. ¶ 50,286 (U.S. Ct. Fed. Cl. 2006). Also, Easter House v. United States, 12 Ct. Cl. 476, 483 (1987), *aff'd*, 846 F.2d 78 (Fed. Cir. 1988), *cert. den.*, 488 U.S. 907 (1988).

[124]See Chapters 24, 25.

[125]Reg. § 1.501(c)(3)-1(c)(1).

[126]Aid to Artisans, Inc. v. Comm'r, 71 T.C. 202 (1978).

[127]Nonetheless, the courts occasionally stretch this criterion, as illustrated by the decision denying tax-exempt status to a scholarship fund, for violation of the primary purpose test, because its fundraising activities were conducted in a cocktail lounge and attracted customers to the lounge (P.L.L. Scholarship Fund v. Comm'r, 82 T.C. 196 (1984); also KJ's Fund Raisers, Inc. v. Comm'r, 74 T.C.M. 669 (1997), *aff'd*, 166 F.3d 1200 (2d Cir. 1998)). Cf. Hope Charitable Found. v. Ridell, 61-1 U.S.T.C. ¶ 9437 (S.D. Cal. 1961).

The general rule, as stated by the U.S. Supreme Court in the context of charitable organizations, is that the "presence of a single … [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly … [exempt] purposes."[128] A federal court of appeals held that nonexempt activity will not result in loss or denial of exemption where it is "only incidental and less than substantial" and that a "slight and comparatively unimportant deviation from the narrow furrow of tax approved activity is not fatal."[129] In the words of the IRS, the rules applicable to charitable organizations in general have been "construed as requiring all the resources of the organization [other than an insubstantial part] to be applied to the pursuit of one or more of the exempt purposes therein specified."[130] Consequently, the existence of one or more authentic exempt purposes of an organization will not be productive of tax exemption as a charitable (or other) entity if a substantial nonexempt purpose is present in its operations.[131]

There is no formal definition of the term *insubstantial* in this setting. Thus, application of the primary purpose test entails an issue of fact to be determined under the facts and circumstances of each case.[132] A court opinion suggested that, where a function represents less than 10 percent of total efforts, the primary purpose test will not be applied to prevent exemption.[133] Another court opinion stated that an organization that received approximately one-third of its revenue from an unrelated business could not qualify for tax-exempt status, in that the level of nonexempt activity "exceed[ed] the benchmark of insubstantiality."[134] Yet the IRS allowed a charitable organization to remain exempt where it derived two-thirds of its income from unrelated businesses, inasmuch as the net income from these businesses was used to further exempt purposes.[135]

In application of the primary purpose rule, a court concluded that a police benevolent association could not qualify for tax exemption as a charitable organization because the payment of retirement benefits to its members was a substantial nonexempt activity.[136] This approach was again followed by the court in a case holding that a religious organization was ineligible for exemption because a substantial portion of its receipts was expended for the nonexempt function of

[128]Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279, 283 (1945). Also Universal Church of Jesus Christ, Inc. v. Comm'r, 55 T.C.M. 143 (1988).

[129]St. Louis Union Trust Co. v. United States, 374 F.2d 427, 431–432 (8th Cir. 1967). Also Seasongood v. Comm'r, 227 F.2d 907, 910 (6th Cir. 1955).

[130]Rev. Rul. 77-366, 1977-2 C.B. 192.

[131]Stevens Bros. Found. v. Comm'r, 324 F.2d 633 (8th Cir. 1963), *cert. den*., 376 U.S. 969 (1964); Scripture Press Found. v. United States, 285 F.2d 800, 806 (Ct. Cl. 1961), *cert. den*., 368 U.S. 985 (1962); Fides Publishers Ass'n v. United States, 263 F. Supp. 924, 935 (N.D. Ind. 1967); Edgar v. Comm'r, 56 T.C. 717, 755 (1971); The Media Sports League, Inc. v. Comm'r, 52 T.C.M. 1093 (1986).

[132]E.g., Kentucky Bar Found. v. Comm'r, 78 T.C. 921 (1982).

[133]World Family Corp. v. Comm'r, 81 T.C. 958 (1983).

[134]Orange County Agric. Soc'y, Inc. v. Comm'r, 55 T.C.M. 1602, 1604 (1988), *aff'd*, 893 F.2d 647 (2d Cir. 1990).

[135]IRS Technical Advice Memorandum (Tech. Adv. Mem.) 200021056.

[136]Policemen's Benevolent Ass'n of Westchester County, Inc. v. Comm'r, 42 T.C.M. 1750 (1981). Also, Police Benevolent Ass'n of Richmond, Va. v. United States, 87-1 U.S.T.C. ¶ 9238 (E.D. Va. 1987).

medical care of its members.[137] The second of these two holdings was reversed, however, with the appellate court holding that the medical aid plan was carried out in furtherance of the church's religious doctrines and therefore advanced an exempt purpose.[138]

The primary purpose test was applied by a court denying tax-exempt status as a religious entity to an organization that operated a mountain lodge as a retreat facility.[139] By contrast, an organization formed to construct, and sell or lease, housing at a religious retreat facility owned and operated by a church was held to be tax-exempt as a charitable entity because the predominant use of the housing units was inextricably tied to the religious activities of the church.[140]

The primary purpose test was invoked to deny tax exemption as a charitable entity to an organization formed to provide a service by means of which public and private libraries, commercial organizations, and other entities centrally pay license fees for the photocopying of certain copyrighted publications, with a court finding that the "potential for a substantial private profit was the driving force" behind the organization and its operations.[141] Thereafter, in application of this test, the same court found that a scholarship fund established pursuant to a collective bargaining agreement was not entitled to exemption, in part because the class of individuals served was "too restricted" to confer the requisite public benefit.[142] This test was applied by another court to preclude exempt status as charitable entities to two cemetery associations because their activities included the sale of burial plots and maintenance of the cemetery.[143]

As another example, the retail sale of goods and services normally is a nonexempt business activity. This is the case, for example, when a tax-exempt museum is selling souvenir items relating to the city in which the museum is located.[144] Yet an organization with the primary purpose of providing assistance to needy women to enable them to earn income was held to be exempt as a charitable entity because it operated a market for the cooking and needlework of this category of women, who were not otherwise able to support themselves and their families.[145] Likewise, an organization that operated a consignment shop as a place where "industrious and meritorious" women could sell articles and foodstuffs prepared by them was held to be exempt.[146] By contrast, an organization was denied exempt status as a

[137] Bethel Conservative Mennonite Church v. Comm'r, 80 T.C. 352 (1983).

[138] Bethel Conservative Mennonite Church v. Comm'r, 746 F.2d 388 (7th Cir. 1984). This approach, however, is not always followed. For example, a grantmaking organization (that would not have been a private foundation) was denied exemption by application of the primary purpose test because it failed to provide grant criteria (Church in Boston v. Comm'r, 71 T.C. 102 (1978)). Cf. IRC § 4945(d) (see § 12.4(e)). The primary purpose test can intersect with the commerciality doctrine (see § 4.9) (e.g., Federation Pharmacy Servs., Inc. v. Comm'r, 72 T.C. 687 (1979), *aff'd*, 625 F.2d 804 (8th Cir. 1980)).

[139] The Schoger Found. v. Comm'r, 76 T.C. 380 (1981).

[140] Junaluska Assembly Housing, Inc. v. Comm'r, 86 T.C. 1114 (1986).

[141] Copyright Clearance Center, Inc. v. Comm'r, 79 T.C. 793, 807, 808 (1982).

[142] Local Union 712, I.B.E.W. Scholarship Trust Fund v. Comm'r, 45 T.C.M. 675, 678 (1983). See § 6.3(a).

[143] Smith v. United States, 84-2 U.S.T.C. ¶ 13,595 (W.D. Mo. 1984).

[144] Rev. Rul. 73-105, 1973-1 C.B. 264.

[145] Rev. Rul. 68-167, 1968-1 C.B. 255.

[146] Tech. Adv. Mem. 200021056.

social club in part because the IRS concluded that its "purposes and operations are primarily of a business [nonexempt] nature."[147]

In addition to being applied to allow or deny tax-exempt status, the primary purpose test can be utilized to determine the appropriate category of exemption. For example, when an organization promotes and sponsors recreational and amateur sports, with an emphasis on training and education, the organization may qualify as an exempt charitable and/or educational entity.[148] By contrast, if the principal purpose of an organization is advancement of the social and recreational interests of the players, the organization cannot be an exempt charitable or educational entity;[149] it may, however, qualify as an exempt social club.[150] Likewise, the IRS ruled that an organization that conducts festivals to promote Mexican American culture, including *folklórico* dancers and a beauty contest, cannot qualify as an exempt charitable entity but can constitute an exempt social welfare organization.[151] Similarly, the IRS converted an organization's exempt status from that of a veterans' organization to that of a social club.[152] Also, the IRS denied recognition of exemption as a charitable organization in part because the entity was functioning essentially as a professional society.[153]

In addition, the IRS ruled that (1) an organization formed to promote soccer was ineligible for exemption as a charitable or educational organization because its primary purpose was the promotion of recreational sports for adults;[154] (2) an organization established to "spread the gospel of Jesus Christ through professionally run fishing tournaments" did not qualify as an exempt religious entity because its primary purpose was socializing;[155] (3) an organization could not be tax-exempt on the basis of operating a religious camp, because its primary activities were fishing and socializing;[156] (4) an organization formed as an "Italian culture club" did not constitute a charitable or educational entity, in that it was more akin to a fraternal organization;[157] (5) an organization whose primary purpose was enjoyment of the art of riding motorcycles with members could not qualify as an exempt social welfare entity, because social activities were its substantial function;[158] and (6) an organization that sought exempt status as a charitable and educational organization could not qualify for the exemption because its activities were conducted exclusively for recreational and/or social purposes.[159]

[147]Priv. Ltr. Rul. 200450041. Similarly, an organization with the primary purpose of fostering networking between vendors and prospective clients within the legal profession was held to not qualify as an exempt social club (Priv. Ltr. Rul. 200906057).

[148]E.g., Hutchinson Baseball Enters., Inc. v. Comm'r, 73 T.C. 144 (1979), *aff'd*, 696 F.2d 757 (10th Cir. 1982). See §§ 7.16(c), 8.4.

[149]E.g., Wayne Baseball, Inc. v. Comm'r, 78 T.C.M. 437 (1999).

[150]See Chapter 15.

[151]Priv. Ltr. Rul. 200621023. See Chapter 13.

[152]Priv. Ltr. Rul. 201103062. See § 19.11(a), Chapter 13.

[153]Priv. Ltr. Rul. 201143020. See § 14.1(e).

[154]Priv. Ltr. Rul. 200849018.

[155]Priv. Ltr. Rul. 200851040.

[156]Priv. Ltr. Rul. 200905028.

[157]Priv. Ltr. Rul. 200905029.

[158]Priv. Ltr. Rul. 200909072.

[159]Priv. Ltr. Rul. 200930049.

The primary purpose of an organization is not taken into account only when determining whether it qualifies for tax-exempt status. This purpose can also be a critical factor in application of the unrelated business rules.[160]

§ 4.5 OPERATIONAL TEST

The operational test, as its name indicates, is concerned with how an organization functions in relation to the applicable requirements for tax-exempt status. Thus, in a generic sense, every type of exempt organization is subject to an operational test.

(a) Basic Rules

An organization, to qualify as a charitable entity, is regarded as operated exclusively for one or more tax-exempt purposes only if it engages primarily in activities that accomplish one or more of its exempt purposes.[161] The IRS observed that, to satisfy this *operational test*, the organization's "resources must be devoted to purposes that qualify as exclusively charitable within the meaning of section 501(c)(3) of the Code and the applicable regulations."[162] An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.[163] An organization is not considered as operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.[164] An organization can be substantially dominated by its founder without, for that reason alone, failing to satisfy the operational test.[165] A court concluded, however, that an organization cannot qualify for tax exemption where one individual controls all aspects of the organization's operations and "is not checked" by any governing body.[166]

An organization may meet the federal tax law requirements for charitable entities even though it operates a trade or business as a substantial part of its activities.[167] If the organization has as its primary purpose the carrying on of a trade or business, however, it may not be tax-exempt.[168] The core issue is whether the

[160]See Chapters 24, 25.

[161]Reg. § 1.501(c)(3)-1(c)(1).

[162]Rev. Rul. 72-369, 1972-2 C.B. 245.

[163]Reg. § 1.501(c)(3)-1(c)(1). In one instance, the operational test was found to be unmet because the organization involved, which was organized for the study and promotion of the philately of the Central American republics, operated a mail bid stamps sales service for its members as a substantial activity (Society of Costa Rica Collectors v. Comm'r, 49 T.C.M. 304 (1984)). An organization that is inactive for a significant period of time is likely to have its exempt status revoked by the IRS by application of the operational test (e.g., Priv. Ltr. Rul. 200631028).

[164]Reg. §§ 1.501(c)(3)-1(c)(2), 1.501(a)-1(c). Also Wildt's Motorsport Advancement Crusade, Bill v. Comm'r, 56 T.C.M. 1401 (1989); Athenagoras I Christian Union of the World, Inc. v. Comm'r, 55 T.C.M. 781 (1988); Levy Family Tribe Found. v. Comm'r, 69 T.C. 615 (1978). See Chapter 20.

[165]E.g., The Church of the Visible Intelligence That Governs the Universe v. United States, 83-2 U.S.T.C. ¶ 9726 (Cl. Ct. 1983).

[166]Chief Steward of the Ecumenical Temples & Worldwide Peace Movement & His Successors v. Comm'r, 49 T.C.M. 640, 643 (1985).

[167]E.g., Rev. Rul. 64-182, 1964-1 (Part 1) C.B. 186.

[168]Reg. § 1.501(c)(3)-1(e)(1).