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AN OVERVIEW OF THE TAX STATUS OF EXEMPT ORGANIZATIONS

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Twelve years ago, Randolph Thrower, the former Commissioner of the Internal Revenue Service (IRS), embarked upon the uncharted course of administering a racially nondiscriminatory policy for private schools, and was faced with the complex Tax Reform Act of 1969¹ which established new rules for private foundations. He mused one day that if the Internal Revenue Service (IRS) had access to the Oracle of Delphi, it would pose this question: "What do you see ahead for the IRS in the field of exempt organizations?" The Oracle's short and cryptic response, would no doubt be "Trouble." With her traditional penchant for ambiguity, the Oracle was not clear in explaining for whom trouble was foreseen. Thus, each was left to interpret this for himself.

Upon reflection, it appears that she was about as accurate as today's weather forecasters. The administration of the racially nondiscriminatory policy for private schools has proved and continues to be a problem for the IRS. The statute regarding private foundations, on the other hand, has worked well, and many of the actual and perceived problems about private foundations that troubled Congress at that time have been corrected.

If one were to ask for the sage wisdom of that Oracle again, would he receive the same ambiguous reply? "Trouble" certainly looms on the horizon in a number of areas but there are also signs of hope. In the private school area the good news is that the Supreme Court has agreed to hear the appeal in *Bob Jones*² and *Goldsboro*³ and, it is hoped, will clarify the interpretation of the law in this area. On the administrative side the IRS

¹ I.R.C. §§ 4940-4948 (1980).

² *Bob Jones Univ. v. United States*, 639 F.2d 147 (4th Cir. 1980), *aff'd*, 103 S. Ct. 2017 (1983).

³ *Goldsboro Christian Schools, Inc. v. United States*, 644 F.2d 879 (4th Cir.), *aff'd*, 103 S. Ct. 2017 (1983).

has developed a new form 990 and 990PF for 1981, a uniform report that will also be used by thirty-three states for reporting purposes. The resulting elimination of wasteful duplication and paperwork will save exempt organizations an estimated \$125 million per year. This is an outstanding example of how state, federal and voluntary organizations can work together in the development of a reporting system that serves the needs of all parties in the simplest way possible.

That is the good news. The bad news, depending upon your perspective, is that difficult problems lay ahead in challenges to the IRS' authority to determine whether certain educational and lobbying organizations are tax exempt under sections 501(a) and 501(c)(3).⁴ The Court of Appeals for the District of Columbia Circuit has rendered two opinions that establish constitutional limitations on the Service's authority to administer the tax law. The first case involved the denial of exemption under section 501(c)(3) to Big Mama Rag, Inc. which published only profeminist articles in its newspaper and other literature.⁵ The Service found that Big Mama Rag's publications failed to meet the "full and fair" exposition test of regulation 1.501(c)(3)-1(d)(3).⁶ The district court upheld the constitutionality of the regulations.⁷ On appeal, however, the circuit court reversed, and declared regulation 1.501(c)(3)-1(d) unconstitutional as being violative of the first amendment.⁸ The Government decided not to appeal further, but chose instead to litigate the point in a parallel case, *National Alliance v. United States*.⁹ National Alliance published a monthly newspaper and bulletin devoted to racist material.¹⁰ The IRS denied 501(c)(3) exemption because the organization did not meet the "full and fair" ex-

⁴ Under section 501(a), organizations listed under section 501(c) are exempt from taxation. Section 501(c)(3) describes such organizations as:

[c]orporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes . . . or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation . . . and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

I.R.C. § 501(c)(3) (1980).

⁵ *Big Mama Rag, Inc. v. United States*, 494 F. Supp. 473, 475 (D.D.C. 1979), *rev'd*, 631 F.2d 1030, 1034-35 (D.C. Cir. 1980).

⁶ 494 F. Supp. at 477; *see* Treas. Reg. § 1.501(c)(3)-1(d)(3) (1959).

⁷ 494 F. Supp. at 480-81.

⁸ *Big Mama Rag, Inc. v. United States*, 631 F.2d 1030, 1034-35 (D.C. Cir. 1980), *rev'g* 494 F. Supp. 473 (D.D.C. 1979).

⁹ 48 A.F.T.R.2d (P-H) ¶ 81-5029, at 81-5138 (D.D.C. 1981).

¹⁰ *Id.* at 81-5140.

position test.¹¹ In a declaratory judgment, the district court, without reaching a decision on whether the organization qualified for exemption, followed the *Big Mama Rag* precedent and remanded the case to the IRS for further proceedings.¹² The Government has appealed this decision based on the educational methodology approach it has used for the past 20 years in applying the "full and fair" exposition test.

The other significant case involved an educational lobbying organization, Taxation with Representation (Taxation), that applied for exemption under section 501(c)(3) of the Code. In a seven-to-three decision, the District of Columbia Circuit Court held that the Internal Revenue Code's restriction on lobbying by charitable and educational groups "fail[ed] to meet the constitutional standard," and reversed a district court decision upholding 501(c)(3)'s restrictions on substantial lobbying by charities, educational organizations, and churches.¹³ The court remanded the case to the district court with directions to devise a remedy that would cure the constitutionally invalid operation of section 501(c)(3).¹⁴ Under current law, charities cannot engage in "substantial" lobbying, unlike veterans organizations which can lobby freely despite their tax-exempt status. Prior to this decision, the Service had won a series of cases holding that the lobbying limitation in section 501(c)(3) does not abridge first amendment rights.¹⁵ The appeals court agreed that Taxation had no compelling claims based solely on the first amendment since section 501(c)(3) limitations do not directly abridge its rights of free speech.¹⁶ The court held, however, that the differing tax treatment of tax-exempt lobbying groups receiving deductible contributions, such as veterans and fraternal groups, involves unequal levels of government subsidy of first amendment rights.¹⁷ The court could find no substantial reason to justify the discriminatory treatment of Taxation's activities, and held that such treatment constituted a denial of equal protection.¹⁸

In remanding the case to the district court, it was suggested that either all 501(c)(3) organizations be allowed to lobby or that the district court permit veterans organizations to participate in framing the relief.¹⁹ Interim remedies suggested by the court were that the Service could pro-

¹¹ *Id.* at 81-5139 to -5140.

¹² *Id.* at 81-5142.

¹³ *Taxation with Representation v. Regan*, 676 F.2d 715, 745 (D.C. Cir. 1982).

¹⁴ *Id.*

¹⁵ See *Taxation with Representation v. United States*, 585 F.2d 1219, 1223 (4th Cir. 1978); *Haswell v. United States*, 500 F.2d 1133, 1148-49 (Ct. Cl. 1974); *Christian Echoes Nat'l Ministry, Inc. v. United States*, 470 F.2d 849, 857 (10th Cir.), *cert. denied*, 414 U.S. 864 (1973).

¹⁶ 676 F.2d at 724.

¹⁷ See *id.* at 731.

¹⁸ *Id.* at 740.

¹⁹ *Id.* at 742-45.

vide more restrictive regulations governing lobbying activities of veterans organizations, or provide more diligent enforcement of existing lobbying regulations.²⁰ The Government has asked for a stay of the court's mandate, and has filed a direct appeal to the Supreme Court pursuant to federal statute.²¹

It is submitted that the court erred in its determination that the classification adopted by Congress in section 501(c) is subject to strict judicial scrutiny and thereby unconstitutional unless that classification serves a substantial governmental interest. The discussion in the Government's supplemental brief for the en banc rehearing makes clear that in the area of taxation, legislatures possess the greatest freedom in classification, and that, in the absence of invidious discrimination or substantial infringement of a fundamental right, a tax classification may not be disturbed if it is rationally related to the achievement of a legitimate governmental purpose.²²

As the dissenting opinion in the *Taxation* case rightfully indicates, exemption under 501(c)(3) is based upon the theory that the Government is compensated for the loss of revenue by its relief from the financial burden that would otherwise have to be met by appropriations from other public funds and by the benefits resulting from the promotion of the general welfare.²³ Thus, the Government has conferred tax benefits on those organizations seeking taxpayer support in order to encourage particular kinds of activity in the public interest and has imposed the lobbying restriction as a means to ensure that the benefit is issued directly to further the purposes Congress sought to encourage.

Accordingly, it can be argued that Congress is free to determine the conditions under which veterans groups may be worthy of certain benefits, while other groups with charitable or educational purposes may not be. When Congress determines that two organizations serve significantly different purposes or present significantly different regulatory problems, the Constitution does not require it to afford them identical treatment.²⁴ The litigation in these areas is significant because, unlike ordinary attempts to reverse individual IRS determinations, the cases have sought by judicial action to establish blanket exemptions for two whole classes of organizations presently ineligible to qualify for exemption under the stat-

²⁰ *Id.* at 744.

²¹ The United States has filed a direct appeal to the Supreme Court pursuant to 28 U.S.C. § 1252 (1976).

²² See *Western & S. Life Ins. Co. v. State Bd. of Equalization*, 451 U.S. 648, 656-57 (1981); *Kahn v. Shevin*, 416 U.S. 351, 355-56 (1974); *San Antonio Indep. School Dist. v. Rodriguez*, 411 U.S. 1, 50-51, 54-55 (1973).

²³ 676 F.2d at 752 (MacKinnon, J., dissenting).

²⁴ See *Kahn v. Shevin*, 416 U.S. 351, 355 (1974); *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356, 359 (1973).

ute and regulations.

Two other recently decided cases are also important. In *Suffolk County Patrolman's Benevolent Association, Inc. v. Commissioner*,²⁵ a test as to what constitutes "regularly carried on" for the purpose of unrelated trade or business was finally established. In *Suffolk County*, the organization conducted an annual vaudeville show and in conjunction published and distributed a program guide containing extensive paid advertising solicited by a commercial promoter.²⁶ The promoter's solicitation covered a 2-to-4-month period and employed a significant number of professional solicitors.²⁷ The court held that since the distribution was made during an annual event and "for only a few weeks," it was not "regularly carried on."²⁸ The IRS will not appeal this decision but will continue to defend those cases in which prolonged commercially oriented advertising solicitations or separate distributions evidence an autonomous program independent of the event.

The other recent case involves a hospital's sale of pharmaceuticals to the private patients of its staff doctors.²⁹ The court held that these sales did not result in unrelated business income because the service was necessary to attract doctors to the rural community. The court distinguished Revenue Ruling 68-375, which holds that hospital pharmacy sales to the general public are an unrelated trade or business.³⁰ Due to the unique facts in this case, the IRS also will not appeal this decision.

The final area that has caused the IRS great concern and has shaken public confidence in the tax system involves the use of "mail order" churches as a tax-protesting device to decrease or eliminate federal income tax liability. This is not only an IRS concern but should be a major concern to all bona fide religious groups when organizations of this nature abuse the tax system for private benefit. These organizations are typically established by an individual who has purchased his minister's credentials and church charter by mail from an organization that may not itself be exempt from tax. The individual then "establishes" his own church, takes a vow of poverty and assigns all of his assets and income to the church. The IRS has taken a strict approach in interpreting the standards for qualification and has denied a number of these sham churches. The Service has also attacked the income tax deductions claimed by these individuals as contributions and has disallowed excessive wages and parsonage allowances. Even though the Service has an effective enforcement

²⁵ 77 T.C. 1314 (1981).

²⁶ *Id.* at 1316-17.

²⁷ *Id.* at 1317-18.

²⁸ *Id.* at 1320.

²⁹ *Hi-Plains Hosp. v. United States*, 670 F.2d 528, 530 (5th Cir. 1982).

³⁰ *Id.* at 531; Rev. Rul. 68-375, 1968-2 C.B. 245.

program and has won over forty cases that it has litigated in this area, there remains a widely held perception that organizations of this nature enjoy tax-exempt status while the public carries an ever increasing tax burden.

Action has been taken by several states using restraining orders to prevent these organizations from selling mail order certificates. In an important decision, *People v. Life Science Church*,³¹ the Supreme Court of the State of New York held that the organization was permanently enjoined from selling church kits and ordered restitution to the purchasers exceeding \$16 million.³² This case was brought under the state consumer fraud statute and the promoters were fined for both civil and criminal contempt.³³ A number of states with similar statutes are looking to this decision to protect their citizens from these pyramid schemes. This is not a first amendment issue of free exercise or establishment of religion. Rather, it is a basic issue of legal compliance with the tax laws.

³¹ 113 Misc. 2d 952, 450 N.Y.S.2d 664 (Sup. Ct. N.Y. County 1982).

³² *Id.* at 970-71, 450 N.Y.S.2d at 676-77.

³³ *Id.* at 969-70, 450 N.Y.S.2d at 676.