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Update on Tax Developments: Exempt Organizations

Milton Cerny, Esquire

UPDATE ON TAX DEVELOPMENTS: EXEMPT ORGANIZATIONS

MILTON CERNY, ESQUIRE*

Thank you very much, Deirdre. When I gave you the outline initially, this was several months ago, and for the last several months many things have been happening in the exempt organization area. In fact, I think you could say that this has been the year of the exempt organization. We've been before the Supreme Court on three different occasions, in the *Bob Jones* case, and *Goldsboro Christian Schools*. We were before the Supreme Court also in *Taxation With Representation*, which is a very important case. For those who haven't read it, I would recommend it to you. And we've also been in court with respect to a standing issue in the *Wright* case, which is in the private school area.

Now, I'm sure that some of these issues have been covered by other speakers. I'd like to just comment on the *Bob Jones* case. There was great concern when that case came down interpreting the law of charity, that the Service would in effect determine what is broad public policy. Let me assure you that the Service is going to be looking to the courts, looking to Congress, and looking to the Executive for direction. IRS is not going to be determining fundamental issues of public policy.

In fact, that decision has been limited basically to racial discrimination in education and also illegal activities. We've only briefed the illegal activities issue in two cases thus far, *Synanon* and in *Scientology*. Both organizations had been engaged in illegal activity. The *Synanon* decision has been handed down. The Court did not make a determination on illegal activity, but rather decided the case on fraud of the court and threw it out. We're awaiting a final decision in *Scientology*.

In addition to those areas, over the past several months we've been

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*Technical Advisor to the Assistant Commissioner for Employee Plans and Exempt Organizations of I.R.S.

heavily involved in legislation. We had three congressional hearings this past year involving private foundations, incomplete returns, and the Church Audit Procedures Act, whose acronym is CAP. So if you hear about that CAP Act, that's what CAP stands for. It is now currently in the Senate version of the Boat Safety Act, which is the Senate 1984 Tax Reform Act.

As far as exempt organizations are concerned, the proposed legislation in 1984 is making minor changes with respect to private foundations. There won't be real significant changes, but merely modifications of existing law. The definitional provisions have been slightly changed as has the disposition of excess business holdings. Many organizations were trying to eliminate the disposition of excess business holdings provision, but Congress seems inclined to making certain modifications agreed to by the Senate and the House; and we don't foresee that the Conference will change that. We should have final legislation this summer or fall.

We had a Senate hearing with respect to the CAP Act procedure. The Service over the years has tried not to trample on any religious rights. We've tried to conduct our audits as reasonably as we possibly can. We've gone even beyond what the statute required in trying to conduct our audits without going to the books and records of the church. We have what we call a two-step pre-examination contact through correspondence where we try to obtain certain information before an examination is conducted.

Questions have been raised by certain religious groups indicating that even these limitations are not strong enough, and that the Service should be more circumspect in its approach to the examination of religious organizations. These groups have suggested certain revisions.

Now the problem, as you can well imagine, is that there is a great variety of religious organizations. There are some organizations who claim to be religious groups but are really sham organizations. The Service for a number of years in the tax protest movement has had a problem with the "mail order ministries." We've been quite successful in litigating these cases against the individual, winning over 60-70 of these cases. The courts have sustained us by holding these organizations to be sham operations.

In fact, as I was looking over some current material, there was a recent case that was decided by the Ninth Circuit. This was a Universal Life Church organization created by a doctor who had invented a soap product. It was called Dr. Bonner's peppermint oil pure castile soap. Dr. Bonner chartered his own church, called the All One Faith and One God State Universal Life Church, and put all of the assets of the business into this church so that he would not be taxed personally on it. He claimed that this soap business was the church's activity and thus it was not taxable to him. The tax court, of course, saw through that, as did the circuit court, and they held that this was taxable income to Dr. Bonner.

This is the kind of problem the Service is facing with these mail order ministry groups. We were concerned when the Church Audit Procedure Act was proposed because we could be somehow hindered in our development of these cases, particularly in our examination of third party sources, etc. The Commissioner and Treasury, while testifying in support of the spirit of the bill, felt that these restrictions could be used by a number of organizations to really handcuff the Service in its examination of these sham-type groups.

There have been a number of meetings on the Church Audit Procedure Act. Several congressional committees have been redrafting the legislation. While it is more restrictive than present law, we hope that we will be able to administer the law so that all parties' rights will be protected.

Another provision that came up involving churches was the Federal Insurance Contributions Act (FICA) exemption with respect to lay employees of churches. As you know, in 1983 Social Security withholding was amended to apply to non-profit organizations exempt under 501(c)(3), which included churches. There were no exceptions. A number of church groups came to Congress who had never withheld these funds before 1984 and asked on religious principles that an exception be made for lay employees of electing churches. So there is a FICA exclusion proposed for the lay employees of a church and specific types of organizations associated with churches. Basically, what it will provide is that these employees will be treated like ministers under the Self Employment Contributions Act (SECA) tax provisions. They will have to pay not only their share of that tax, but also what would be the employer's share of the tax. The churches will be required to submit to the Service a record of the individuals plus the amounts that they earned during the year. Under this proposal, organizations can elect to come under this exception. Once they elect they are required to submit information to the Service. If that information subsequently is not submitted, then that election is terminated, and the organization then must withhold for these employees. So there are two significant aspects here that you should keep in mind and watch as the legislation moves through the Conference Committee.

As you know, the way legislation is put together, the House Ways and Means Committee brings a bill to the House floor with no opportunity for amendments. It's voted on. The Senate Finance Committee, on the other hand, traditionally has permitted member bills to be added to their legislative proposal. The Church Audit Procedure Act and the FICA provisions were part of the Senate bill. There are a whole series of other provisions dealing with leasing and legalized gambling activities, among others. The gambling provision deals with the situation in North Dakota permitting certain games of chance to be exempt from unrelated income tax. The way the proposed statute is written, it really applies just to one

of two states. It's in the House bill not in the Senate bill in this particular case.

I'd like to move on now to another large area that probably doesn't concern you as much. The VEBA area, Volunteer Employment Benefit Associations. We anticipate substantial legislation there. Basically, the problem has been that a lot of employee plan organizations have moved out from defined benefit plans into VEBAs because of the TEFRA limitations on top-heavy plans. We've seen a great influx of these plans being developed for one and two persons. We believe that Congress is going to remedy that situation. There are two different proposals on the House and the Senate side. So, we anticipate legislation there.

As far as unrelated trade or business is concerned, you know that in order to be an unrelated trade or business, an activity must be a business described in Section 162 of the Code. We've been permitted since 1969, really, to look beyond an economic enterprise to fragment an activity to hold it as trade or business. A business must also be regularly carried on and must not be substantially related. There have been some significant court cases decided this past year with respect to several of these issues.

I pointed out in my outline two cases dealing with the concept of passive versus active conduct of business. In the *American Bar Endowment* case, the question came up as to whether experience rebates that the attorneys must turn over to the Bar Association in order to obtain the insurance would be income from an unrelated trade or business. The other question that was before the court was whether these experience rebates could be considered as charitable contributions by the members.

The Court of Claims held in that decision that it wasn't an unrelated trade or business basically because the organization there had pointed out to its members historically that these rebates would be treated as contributions. They produced evidence to show that much of the insurance that is sold is more costly than would be found in the commercial sector, and for this reason the activity should not be a trade or business. The Court went further and said that this is a mutual type organization and thus was providing these benefits to members, and since it was being done for members, it should not be considered a trade or business with the general public.

We of course disagreed with that approach. We've had a problem with this active versus passive concept since we lost a case called *Oklahoma Cattlement*. We have argued that in unrelated trade or business you don't look to see whether there is competition, which is already inherent in the statute, but you have to see whether the activity is being conducted for the promotion of profits. Does this have a profit motivation?

Fortunately, I think, for the Service, we've won a number of cases now in the Fourth, Fifth, and the Sixth Circuits dealing with insurance

activities in which the courts have looked to profit motive and have said that the fact that they may not be in competition with another business is not going to be controlling. But is there a profit motivation to the particular activity? The most recent case has been the *Professional Insurance Agents of Michigan.*

The question of regularity carried on. What does that mean under the statute? As you know since 1950 when the unrelated trade or business came into the statute, we've taxed organizations whose exemption otherwise might have been revoked because it was engaged in a business type of activity. Congress felt that there were certain activities that should be subject to the tax, particularly where other organizations were engaged in this activity as a commercial venture. However, they made certain exceptions to the law, and one of those exceptions was when the organization was not regularly engaged in that business. Several examples in our regulations and our revenue rulings deal with a sandwich stand at a county fair, or the charity ball exception, et cetera. In all of these cases, there are activities that are being conducted for a limited period of time and thus do not correspond to the extended activities that are being conducted by commercial organizations.

This issue came to the fore recently in a case called *Suffolk County Police Benevolent Association.* The cite to that is 77 Tax Court 1311 in which a vaudeville show was being conducted by this police benevolent association at which time they distributed a program book containing advertising. The Service said that this activity should be subject unrelated because of the fact that there was extensive work being done on the program throughout the year and they were dealing with a private fundraiser. The court said no, holding that this exception fits within the charity ball concept, and is not regularly carried on. The Service has acquiesced in that position and of course we'll follow it. However, if we have situations where this type of book is distributed at a particular event and then is sold throughout the year, we would tax that aspect of the program in which it's carried on throughout the whole year.

Substantially related. Of course this is a highly fact-and-circumstances situation. What is substantially related to the tax-exempt purpose of an organization? Probably the prime example here is your gift shop operation in Rev. Rule 69-267. We always have to make this determination. So you can't really make a generalization about it. But basically, you look to see whether it's merely conducted for the purpose of making profits.

Current issues. I mentioned to you the insurance program for members. This had been a very active area. Basically, we're dealing here with trade associations. But there are other groups that provide insurance for their members that are taxable. Now, of course, there are insurance activities of specific organizations that are permitted by the statute. For exam-

ple, we have the fraternal organizations, and labor groups, et cetera. However, in the 501(c)(6) area, which is a business league or trade association, that type of activity is not in furtherance of their purposes, and thus we've held it taxable as we have with 501(c)(3) organizations.

Distribution of premium items to donors. This issue came up in the *Disabled American Veterans* (DAV) case, and the question was whether or not the organization which sent out low-cost, as they called it, items in exchange for a fixed donation, was unrelated to their tax-exempt purpose. And they tried to come in under the exception with respect to low-cost items in 513-1(b) of the regulations, which was put in specifically for organizations that were out fundraising in exchange for which they give token gifts. For example, over the years organizations like the Amvets send out license tags and things of this sort in return for a contribution. These are basically throw-away-type articles of low cost.

In the DAV case, it was a cookbook whose approximate value was the price of the donation. I think they were asking $5.00 for it, and the book may have been valued at $4.50. The court there said this is not a charitable contribution because there is a *quid pro* here, and thus there wasn't a charitable deduction. The other interesting thing about this case, and you ought to keep your eye on it, is that they sold mailing lists. The Service has a position that the sale, exchange, or rental of mailing lists is subject to unrelated trade or business income tax. However, Senator Bentson introduced legislation this past term which would have excluded from the unrelated business income tax the sale or exchange of a mailing list. Recently, in the Senate there was a floor amendment on their tax bill for 1984 that would exclude from the unrelated trade or business income tax the exchange of rental or mailing lists for federally chartered organizations.

Now, it just so happens that the DAV fits into this category and is named in the Committee Reports as the organization to be covered. But there may be other types of federally chartered organizations who rent or exchange mailing lists, and this exclusion could apply to them. Again, it's an area you ought to watch and see what's going to develop.

The Service has been examining hospital laboratory testing and pharmacy sales. Since 1968 we have held in a series of rulings that pharmacy operations by hospitals are related to their exempt function if those pharmacy operations are for the benefit of the patients of that hospital. We've also defined a hospital patient within that covered class. You might want to jot this down if you're not aware of it. It's Rev. Rule 68-370.

Hospitals moved from the pharmacy sale operation into new areas as organizations are searching to find more and more funds to support their activities. There is extensive lab testing activity going on now by hospitals for other hospitals and for doctors in their private practice.

We're taking the same approach with these testing activities. If the testing is done for the patient of the hospital, then the general rule is that that's related. If it's not done for the patient of that particular hospital, then it's going to be unrelated except where the organization can show through facts and circumstances that this testing is necessary for the health of the community. It might be, for example, an organization that has a particular CAT scanner or blood fractionalization testing process that unless that immediate testing was performed could endanger the health of the individual.

In fact, for those of you who get the tax services, there was an interesting decision in an unpublished letter ruling. I hesitate to mention Section 6110 rulings, but you probably all know what I'm talking about. The Service is required to publish its letter rulings and technical advice memorandums. While these are not official positions of the Service, they do reflect the approach that the Service is taking in particular areas. If you have access to the tax services, you might want to jot down this letter ruling. It's 84-17002. It dealt with the situation where a hospital was performing certain testing, lab tests, that were of a specialized nature and required immediate results. In this particular one, they had to have results within fifteen minutes of the time of the test. We held, of course, that because of the emergency need of the health of the community, it was related. There were other tests there that were being performed for doctors in their private practice that didn't meet this immediate public health concept, and we held that those activities would be subject to an unrelated trade or business income tax.

Medical office buildings. I think we've probably issued more rulings in this area in the form of proposed transactions than any other. Basically, I guess there are many reasons for establishing office buildings and also for bifurcating the operations of the hospital through its various departments. We've tried to take a fairly even approach in this area to realize that there are basic purposes that the office building serves in the treatment of the patient and the need for the doctors to be in that immediate area. We generally have held that these activities do not result in unrelated trade or business for the hospital. Again, it's highly fact-and-circumstances approach, and you really have to see what your facts are. The one thing that we are very careful of is to make sure that the charitable organization is benefiting in this activity.

That really leads us into another problem area, and that's partnerships, limited partnership agreements. The Service does not have a *per se* rule against limited partnerships. That's where the tax-exempt organization serves a a general partner in a limited partnership agreement. You have probably seen a number of rulings in which exempt organizations enter into these activities in order to get initial money to build a building or to carry on a tax-exempt activity. The things that we look for in this

area, to assure that charity is really benefitting, is that fair market value is being paid for the land by the limited partner; that if there are any construction loans that those loans be at fair market interest rates.

Partnership agreements are controlled under state law, and the states have a number of restrictions. Basically, under state law these limited partnership agreements require the general partner to be responsible for maximizing the benefits of the limited partner. We try in the development of our rulings to assure that maximum benefits are going to the charitable organization. If there are any requirements in state law in which limited partners' benefits are being served unduly, we will take an adverse position in that case. But again, it's based on what the state law requires. We have laid our general position in this area in a chief counsel memorandum (GCM) that has been published and is open to the general public. It's GCM 39005, and it sets out these parameters.

I briefly discussed with you the issues affecting churches, namely, the Church Procedures Act. Now, another area that I think is significant to you is whether or not an organization is exempt from filing annual returns under § 6033. As you know in 1969, the law was changed so that religious organizations who at one time were exempted from filing the return now in many cases do file because they're not churches, integrated auxiliaries, or inter-church-type organizations.

But built into that law was a commissioner's discretionary authority to relieve other organizations from filing. Reporting, as Congress spelled it out in that 69 legislation, was to provide more information to the Service in order that these areas could more properly be administered. But it did give discretionary authority to the Commissioner to exempt certain organizations from filing.

Now one of the broad categories that we initially exempted were parochial schools. It was felt that there was no need for the Service to obtain this information. They were not really integrated auxiliaries as Congress defined that term, nor were they churches. So the Commissioner exercised discretionary authority, and there is an exception in the regulations for that type of organization.

Subsequent to that we've received a number of other requests to apply this discretionary authority. Two situations have recently come up, one of which is church pension plans in which churches have outstanding rulings holding that these church pension plans are exempt under Section 501(c)(3) of the Code. Now they really don't fit within the concept of an integrated auxiliary or an interchurch organization. The Commissioner has approved, under certain requirements, that this type of organization will be exempt from the filing of the return. He also has approved the authority to apply the exception to organizations which in effect are church pocketbooks. Those are organizations which raise funds basically from their own membership for broad benevolent, charitable and religious

purposes.

If you haven't read it, I call your attention to Notice 84-2. It lays out the parameters for how this will be applied. There are certain percentage tests involved. I would suggest that you may want to seek a ruling on this if you feel that you fit within that particular exception.

Reagan v. Wright. I don't know whether this matter was discussed with you this morning, but it's a very significant case involving the question of standing in the private school area. The Service, as you probably know, has been under a permanent injunction since 1970 enjoining us from issuing tax-exempt rulings to racially discriminatory schools in the state of Mississippi. We then published our revenue ruling in 1971 and have taken that position throughout the United States.

The parents of a number of black children outside of Mississippi sued the Service in 1976, alleging that our standards are not appropriate in that we are not following the mandates of the courts, because we are permitting organizations that were formed or expanded at the time of public school desegregation to racially discriminate. Thus, we are subsidizing in one way or another those schools by tax exemption. We've tried to litigate this issue on the basis of standing in that we feel that the parents of these children have not established that there has been any damage done to a particular student, nor is the remedy that they're suggesting to the Service, stricter requirements, a remedy that would cure the defect that they seek to have cured. Basically, what we're saying is that none of these children that have brought the suit has ever been denied admission to a private school.

Now if the *Wright* parents prevail in this case and the Court finds standing, it would, or course, be contrary to several Supreme Court decisions, including *Eastern Kentucky Welfare Rights Organization* and the *Valley Forge* cases. The Court would have to find standing on the broad issue of racial discrimination.

If that is the case, and the parties prevail on the merits, then the Service of course will have to reexamine its current procedures with Rev. Proc. 75-50 and Rev. Rule 71-447 notwithstanding the *Bob Jones* case. This is because in *Bob Jones* the court there made the decision that the school was racially discriminatory and said that the Service was correct in denying exemptions to racially discriminatory schools; but it didn't tell the Service how it should go about making that determination. So *Wright* is an important case to watch.

But it's an important case not only from the school issue but on standing because what it would mean if these plaintiffs were successful would be that any third party could go into court and challenge the administration of the Service's policies in any particular area. We're now in litigation, as you probably well know, in *Abortion Rights Mobilization* (ARM), in which the parties are contesting our continuation of tax ex-

emption to the Catholic Church. The Catholic Church is no longer a party to that suit, but we are. The district court has held that there is standing in that case based on the appeals court decision in *Wright*. If the *Wright* case is sustained on a broader theory than racial discrimination, it would allow third parties to contest the Service's administration of any area in which claimants cannot establish damages and would mean that we would see a number of these suits filed.

We not only have the *ARM* case currently pending, but we also have another called *Khalof v. Regan*. In that case we have a group fo West Bank Palestinian mayors who are suing the service because it allowed the tax exemption of the United Jewish Appeal and other Jewish groups in violation of public policy by providing tax exemption and permitting contributions to these organizations in support of the political activities of the Jewish community.

The Service is put in a position where you can't win, break even, or even leave the game. We're stuck with litigating these cases. We hope that the court will sustain us on the standing issue.

Probably a very significant case that many of you may now be aware of is the *Lutheran Social Services of Minnesota*. That's an interesting case because it involves the first real test of the Section 6033 regulations application to an organization that was formed by various synods of the Lutheran Church to provide social-welfare-type activities. They also have a chaplaincy activity which we didn't question. Basically, they were providing counseling-type activities. The issue is whether or not this type of organization that was established by the synods but was not under the direct control of any specific synod, engaged in activities of a social welfare nature, would be exempted from the filing of the return. It should be noted that the organization is not a church or interchurch organization, nor was it an integrated auxiliary. Those of you who have been involved in the exempt organizations area for a number of years probably remember the hearings that we had on the 6033 regulations where the Service initially took the position that we look to see whether a purpose is primarily religious. And, of course, we got a great uproar of protest to that position. We then went back, took another look at the committee reports, and we held that activities that are social welfare in nature are not exclusively religious. If you remember, in the committee reports Congress said that men's clubs, women's clubs, mission societies, et cetera, were exclusively religious-type activities and thus come within the phraseology of an integrated auxiliary.

You probably have read Father Whalen's article in *Fordham Law Review*, and I don't need to requote that for you. It's an excellent discussion of how these terms were put together and what Congress had in mind. We for years had a position that an integral organization of a church was part and parcel of that church. The Mormon church tradi-

tionally had auxiliaries of men's and women's organizations. So Congress took our integral test, put it together with the term auxiliary, and now we have an integrated auxiliary concept. The only real direction for its meaning is in the committee reports.

We published our regulations based in part on that and based on the fact that Congress, when it enacted this provision, felt that there was certain information that should be made available to the public. In 1976, after these regulations had been published, a congressional Committee report on charitable lobbying concurred in our correct interpretation that those activities that were delineated as integrated activities was what Congress intended. Other activities such as schools, hospitals, old age homes, et cetera, were not. However, they also said that we would have to look at these other activities to make sure they were not part and parcel of the church. So in the final regulations that were published, there is an example, I believe, of an orphanage that was under the corporate structure of the church that was held to be part of the church activity.

We're probably going to be seeing more litigation in this area. I think in the *Lutheran* case the court made three basic findings. First, they found that the Service was correct in its interpretation of the statutory intent. Second, there was no violation of any constitutional right. Third, the Service's approach, which was contemporaneous with the statute, was a proper interpretation. We don't know whether this case will be appealed. It may very well be.

We have another case pending in another circuit dealing with an orphanage that is operated again by a religious group. And we're going to, I'm sure, have that issue tested. Where this will lead us, I really don't know. I think it's possible, if this court decision is upheld, that we probably will be seeing some movement for legislation in the future.

Now, I'd like to turn to the issue of the prohibition of political activities by 50(c)(3) organizations. When I asked Deirdre and Wil Caron what you would like me to touch on, this topic was suggested; I thought we'd stick basically with the unrelated trade or business.

I approach this subject a little bit like the minister who was telling me about a local church that he had down in southern Virginia. The chairman of the board of trustees came in and said, "Pastor, we really have a problem. Our roof is leaking, and we really need to get it fixed." The minister said, "Well, that's no problem; that's a challenge. Just go out to the congregation, raise the money. And get it done." So he went out, raised the money. The next week he came back and he said, "Really got another one of these problems. The furnace is broken." The minister says, "Well, that's no problem, only another challenge. Just go out to the congregation and raise that money and there's not going to be any problem." So the chairman cam back the third week and he said, "Pastor, we've got a real challenge here. I don't think we're going to be able to pay

your salary this coming month." And the Pastor said, "Boy , you ain't got a challenge, you've got a problem."

As the Service looks at political activities of organizations, I hope that it will be more of a challenge than it will be a problem. Basically, the rules are very well spelled out, and I think that the religious community is aware of those rules. There is a statutory prohibition against engagement in political activities. It was based on a 1954 amendment to the Code. It's usually referred to as the "Johnson Amendment" after President Lyndon Johnson, who as a Senator introduced it on the floor. It refers to *any* political activity. So it's not, as some people usually confuse it with, legislative lobbying. There's a distinct difference. As you know, in the lobbying activities, churches can engage in substantial lobbying activity and be exempt. When we get into the political arena, the law says, "the Church does not participate in or intervene in any political campaign on behalf of any candidate for public office."

Now, this issue has been tested. It was tested initially in the *National Christian Echoes Ministry* case in which there was a combination of both political activities and legislative activities. The Supreme Court, after the Service won that case, was asked on *certiorari* to review it, and refused to do so. In 1976, during the charity lobbying debate, portions of the religious community went to Congress and asked that that case be overturned, and that Congress express its view that it should not be the law of the land. Congress at that time refused to take any position with respect to the case.

The problem, of course, in this whole area is not Service regulations. We've got a Congressional intent here that the Service has to apply. What is political activity? What is the timing of that activity? Is it really political? And basically, who's doing it? These are highly factual situations.

We have a number of revenue rulings in which we've tried to interpret this provision. Rev. Rule 67-71 deals with the organization that goes out and advocates support or rejection of specific candidate. Rev. Ruls. 78-248 and 80-282 basically talk about voter guides, and questionnaires that go out to candidates and provide rules under which those types of questionnaires and voter guides can be exempt (e.g., where you have a narrow issue in which an organization focuses on whether or not that is political activity).

I've cited for you the Federal Election Commission rules on tax-exempt organizations. If you haven't read this, I suggest again that you read it because under those rules partisan politics/campaigning are described with respect to non-profit organizations. It means that 50(c)(3) and 501(c)(4) organizations under the Federal Election law are included as non-profit corporations so they have to be covered. Now what the Federal Elections Commission has done is basically take our Rev. Ruls. 78-248 and 80-282 in applying their standards. In one way this provides some

general uniformity even though there are different thrusts in our two statutes.

Section 527 is a provision that was enacted to permit political organizations to operate under the Code. There had been a question raised whether or not these organizations should file returns in a court case. In order to get it resolved, Congress found that exempt function income for political activity would be permitted under certain conditions. At the same time they realized that 501(c)(4), (5) and (6) organizations had traditionally engaged in political activities, and they permitted them to set aside certain funds exclusively for those political activities. But remember that this does not apply to 501(c)(3) charitable organizations. They were specifically excluded from setting aside any funds for political activities.

But I would like to call your attention again to the *Taxation With Representation* case. Though it dealt with the lobbying issue, it specifically zeroed in on how individual organizations' rights of freedom of speech and expression could be preserved. Justice Rehnquist, writing for the majority of the Court, and the majority was 9-0, held that in that particular instance an organization engaged solely in lobbying activity was not exempt under 501(c)(3) of the Code. The statute was quite clear. Justice Blackmun said there was no infringement of First Amendment rights because traditionally 501(c)(3) organizations and those 501(c)(4) organizations could carry on lobbying activities as the alter ego of the 501(c)(3).

So the Court very carefully in its opinion held that 170 charitable funds cannot be set aside for lobbying activity. If an organization is separately created and separately incorporated or in some way set up as a trust or an unincorporated association, the lobbying activity can be conducted through those organizations without affecting the 501(c)(3) status. As I said, it's very important case, and I think it protects rights of all organizations to speak out on issues.

Significant legal opinions and rulings. I've cited in my outline three instances in which the Service has recently issued some legal opinions involving church organizations. They involve basically the question or whether or not organizations that are established to carry on commercial types of activity in GCH 39003 and GCM 39119 can be exempt from tax.

As you know, since 1952 we've had a feeder provision in the Code that holds in effect that an organization engaged in commercial purchasing or business activity for unrelated tax-exempt organizations is not exempt from tax even though all the profits flow back to the non-profit. We sought legislation to try to deal with these purchasing groups. In 1967, when Section 501(e) came into the Code, Congress indicated that this was the appropriate means for organizations providing hospital supply services, dietetic services, etc., for other hospitals, to be established under the Code and treated as 501(c)(3) organizations. The Supreme Court has

concurred in this. So we've taken a very stringent position with respect to structurally related organizations under Section 502 of the Code. In the first GCM, you have an organization of affiliated organizations that were not structurally related. They were providing liability insurance for member hospitals. We held that that organization was a feeder.

In the next GCM, again we are dealing with a very subjective area in that we're trying to get as much information as we can; what are the facts and circumstances? Here we held that a church newspaper, operated as a church archdiocesan newspaper, was not an integrated auxiliary under Section 6033(a). Now the problem here again is applying the regulations. Was the paper basically or exclusively religious? Or was the paper one that provided a lot of information about the religious community and thus could be charitably advancing education but was not establishing any moral principles or theological pronouncements? This particular paper, as we viewed it, was advancing religion rather than being exclusively religious, and we held that it had to file the return.

That's basically my presentation. I hope we have a few minutes left to — okay. I'm sorry to ramble so. I thought I'd get it all out for you and then you could ask me any questions you'd like. Yes, sir?

MR. WOOD: I'm Bill Wood from Indianapolis. Did I understand you to say that as a general rule medical office buildings owned by hospitals are considered not related business income to the hospitals?

MR. CERNY: I think that's the general approach we're taking. What we're saying is that a lot of these hospitals establish the causal relationship between the hospital building and the hospital; and that they show that doctors otherwise were leaving the area; were not attracted to that particular area; or that the partnership itself was paying reasonable rent for the property; or any loans that were made were based on fair market value principles. So I think that's generally the approach that we've been taking.

MR. WOOD: Well, I have another question.

MR. CERNY: Okay.

MR. WOOD: The American Bar Endowment case, can you go over that again and what the result was?

MR. CERNY: Sure. The American Bar Endowment was a case in which experience rebates were owed to the members. An agreement is entered into with the lawyer who takes that insurance on condition that money will be returned to the Endowment, or will stay with the Endowment. The question that the Court had before it was, were these experience rebates income from a trade or business? In other words, did the Bar Endowment establish a market for a particular insurance and thus was in a trade or business activity? The other question the Court had was since the premiums that were being paid by the individuals were far in excess of what was needed for the insurance, whether or not experience rebates

were charitable contributions. The Court had about five or six weeks of testimony by actuaries and others that presented evidence regarding the activity and found: one, that it was not an unrelated trade or business because it was held out to be a fund raising activity and had traditionally held out to be so; second, it had no commercial counterpart; and third, it was done for the mutual benefit of the members. Thus, it was not a business.

However, they found that the endowment was unable to establish that the premiums that were charged were far in excess of insurance that could have been provided by a commercial carrier. They could establish that fact in New York, but they couldn't establish it in Kansas. So the Court said that the contributions under Section 170 would not be allowed. Now the Service has appealed this case and I'm sure we haven't seen the end of it.

MR: WOOD: Suppose you have a tax-exempt organization that wants to use a part of its assets to go into a joint venture or limited partnership with a proprietary outfit, what cautions would you advise a tax exempt organization to take so that they don't stand in jeopardy of losing their entire tax exemption?

MR. CERNY: Right. That's a good question. We've run across this problem more and more. And I think when I cited you GCM 39005, it's because you've got to be very careful under state law about how those arrangements are made. For example, there may be specific state requirements that require (now we're talking about the exempt organization that's a general partner), in these limited partnership agreements, that they not be required to take on any debts of the limited partnership; that they not be put into a position where they have to maximize the profits of the limited partnership; and that in effect they can carry out their tax-exempt purpose.

Now, let me throw an example at you. There are several current published rulings and technical advice dealing with low-income-housing-type projects that were established where the DOE is the general partner. And they operate under specific HUD guidelines that insure that the exempt organization is carrying out, or can carry out, its tax-exempt function.

The one case that we've lost in this area that's gotten a lot of publicity is the *Plumpstead Theater* case. Some people say that the Service took a rather harsh approach in that area in holding that the limited partnership venture didn't guarantee that limited partners' holdings would not be maximized by the operations at the expense of the nonprofit general partner. And there was nothing in the agreement to preclude that from happening, and thus the Service could not guarantee that charity was really being served.

MR. WOOD: Do you have a cite on that case?

MR. CERNY: Which case is that?

Mr. WOOD: The *Plumpstead* case.

MR. CERNY: The *Plumpstead* case. I don't have one here right with me, but I could run it down for you and pass it on to Deirdre. I think if you read GCM 39005, it does discuss the *Plumpstead* case, and it indicates what approach the Service has taken in this general area.

MS. DESSINGER: Thank you very much, Milt. I think Dave's going to introduce our next speaker. And I think Milt will stay around in the lobby if anyone has any other questions for him.