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INTEGRATION OF THE NOT-FOR-PROFIT CORPORATION LAW AND SECTION 501(c)(3) OF THE INTERNAL REVENUE CODE

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Impelled by a desire to consolidate and lend flexibility to an area of law previously in a state of dislocation, the New York State Legislature enacted the Not-For-Profit Corporation Law (N-PCL) on May 26, 1969, effective September 1, 1970.¹ A profound impact upon the state's "nonprofit" corporate law² was created by the major changes and innovations of the new act. The N-PCL provides one basic not-for-profit corporation statute to which subsidiary corporate statutes may be bridged.³ Additionally, important revisions are made concerning judicial and administrative supervision, corporate finance, and membership.⁴

The mere thought of a "nonprofit" corporation, and now the not-for-profit corporation, concomitantly gives rise to visions of tax advantage under the Internal Revenue Code of 1954 (IRC). Indeed, such an exemption is available to the typical charitable organization, *i.e.*, one "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the

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¹ Law of May 26, 1969, ch. 1066, § 3, [1969] N.Y. Laws 1940.

² Although the term "nonprofit" corporation has been commonly used to describe the structure to be considered, the legislature took great pains to emphasize a distinction between the "nonprofit" and the "not-for-profit" corporation. The former connotes a corporation whose business makes no profit because it is not allowed to do so; the latter indicates a corporate organization whose main purpose is not to make a profit, although it may do so within the confines of the N-PCL. It was hoped that this would avoid unnecessary confusion. See Joint Leg. Comm., Explanatory Memorandum No. 1 on the N-PCL (Jan. 13, 1969), in N.Y. Consolidated Laws, Not-For-Profit Corporation Law ix (McKinney 1970) [hereinafter N.Y. N-PCL].

³ *E.g.*, N.Y. Educ. L. (McKinney 1953); N.Y. RELIG. CORP. L. (McKinney 1952); N.Y. BENEV. ORDERS L. (McKinney 1951). However, the new law does not apply to corporations formed under these special not-for-profit statutes. N.Y. N-PCL § 103(a). Apparently, banks, insurance companies, cooperatives, and some other types of corporations, are also excluded from the purview of the N-PCL. See *id.* § 301(5), (7). Of course the legislature, in its wisdom, may subject these corporations to the N-PCL, which is sufficiently flexible to accommodate them. See Explanatory Memorandum No. 1, in N.Y. N-PCL at x. Similarly, new special statutes may be promulgated, utilizing the N-PCL as the general frame of reference.

⁴ Under prior law, the not-for-profit corporate mandates were scattered throughout the Membership Corporations Law, the General Corporations Law and the various special statutes previously referred to. The Membership Corporations Law was repealed by the N-PCL. Law of May 26, 1969, ch. 1066, § 2, [1969] N.Y. Laws 1940.

prevention of cruelty to children or animals"⁶ so long as no shareholder or individual derives a monetary benefit from the organization's business. Moreover, the corporation's activities may not extend to propaganda, legislative lobbying, or political campaigning.⁶

Traditional construction of income tax exemption sections has been strict and narrow. However, liberality prevails when a charity is involved and the requisite 501(c)(3) purpose is present.⁷ This less stringent standard does not provide an automatic exemption for a charity, since qualification for and continuation of the exemption may depend upon the satisfaction of state requirements for the charitable mantle. For our purposes, the mandates of the N-PCL will be the focal point. The complexity of both the federal and the state laws makes integration a formidable task and coerces encounters with perplexing conceptual and structural problems. Nonetheless, such an analysis is of considerable practical importance to the attorney or student who may be faced one day with the vagaries of the N-PCL and the IRC in unison.

N-PCL FORMATION VERSUS IRC QUALIFICATION

The N-PCL's Categorization Process

The initial integration endeavor occurs in the organization of a corporation within the N-PCL format so that it will qualify for tax-exempt status under the IRC. In the first instance, under the New York law, the corporation cannot be formed for pecuniary profit or financial gain but must be one established exclusively for a purpose authorized by the N-PCL.⁸ Additionally, the corporate assets, income or profits, may not be distributed to or inure to the benefit of the members, directors, or officers of the corporation except as permitted in the N-PCL.⁹ Within the confines of this two-pronged test, there are four categories of permissible nonpecuniary purposes for which a not-for-profit corporation may be organized.¹⁰ The distinctions between categories revolve around the business or nonbusiness purpose of the corporation and the scope of the resulting benefit to society. Thus, a Type A corporation is illustrated by the typical nonbusiness membership organization whose predominant characteristic is activity by or for its

⁶ INT. REV. CODE § 501(c)(3) (1954) [hereinafter IRC].

⁶ *Id.* This prohibition includes publishing or distributing statements for any candidate.

⁷ *See, e.g., Helvering v. Bliss*, 293 U.S. 144 (1934); *Coastal Club, Inc. v. Commissioner*, 43 T.C. 783 (1965), *aff'd per curiam*, 368 F.2d 231 (5th Cir. 1966).

⁸ N.Y. N-PCL § 102(5) & (10).

⁹ *Id.*

¹⁰ *Id.* § 201(b).

members.¹¹ Section 201 contains a nonexclusive list of permissible Type *A* nonpecuniary purposes, including "civic, patriotic, political, social, fraternal, athletic, agricultural, horticultural, animal husbandry, and for a professional, commercial, industrial, trade or service association."¹² The Type *B* organization is confined to the following nonbusiness purposes: "charitable, educational, religious, scientific, literary, cultural or for the prevention of cruelty to children or animals."¹³ The beneficiary of a Type *B* enterprise is society or some segment of it rather than the organization's members as in Type *A*.¹⁴ The Type *C* category permits incorporation for "any lawful business purpose to achieve a lawful public or quasi-public objective."¹⁵ Since this type is within the double-edged definition previously noted, the major reason for the corporation's existence must be for something other than a pecuniary purpose, *i.e.*, its principal objective cannot be to earn money, although it may have a business purpose and in fact make money.¹⁶ The final category, Type *D*, is referred to by the Joint Legislative Committee as an "adapter clause."¹⁷ It is a "catchall" provision covering any purpose not listed (business or nonbusiness) which is permissible for corporate formation under the mandates of some other New York corporation statute. This provision will allow the bridging-over process from subsidiary corporate laws.¹⁸

Tax Exemption for Charitable Organizations Under the IRC

In sharp contrast to these carefully drawn N-PCL categories is the relevant definitional provision of the Code which is not specifically structured upon either the benefit or business purpose criteria.¹⁹ Rather, section 501(c) details a list of eighteen subsections, each exempting organizations created for desirable purposes.

From a statutory terminology perspective, it might appear that the N-PCL organizational and IRC exemption purpose provisions intermesh quite easily. For example, the Type *B* corporation appears to be a rough equivalent to the organization contemplated by IRC section 501(c)(3). Both sections restrict qualifying corporate purposes to educational, scientific, cultural, or prevention of cruelty to children or ani-

¹¹ See Explanatory Memorandum No. 1, in N.Y. N-PCL at xi.

¹² N.Y. N-PCL § 201(b).

¹³ *Id.*

¹⁴ See Explanatory Memorandum No. 1, in N.Y. N-PCL at xi.

¹⁵ N.Y. N-PCL § 201(b).

¹⁶ See Explanatory Memorandum No. 1, in N.Y. N-PCL at xi.

¹⁷ *Id.* at xii.

¹⁸ N.Y. N-PCL § 201(b); see also note 3 and accompanying text *supra*.

¹⁹ IRC § 501(c); see also Treas. Reg. §§ 1.501(c)(2)-1-1.501(e)-1.

mals.²⁰ Similarly, N-PCL Type A seems to extend to most of the remaining 501(c) subsections of the Code.²¹ These statutory structures expose material variations, however, when examined in light of the qualification requirements for the tax exemption, particularly under section 501(c)(3).

Most organizations attempt to qualify under 501(c)(3) because it not only bestows tax-exempt status upon the organization, but also confers the status of an organization to which tax deductible contributions can be made.²² Only 501(c)(3) organizations are entitled to a listing in the Treasury Department's *Blue Book*.²³ Since it is virtually impossible to obtain contributions without such a listing, most organizations eagerly attempt to achieve and maintain such a position.²⁴

The Organizational Test of 501(c)(3)

Almost all tax-exempt organizations are required in a general way to meet a so-called "operational test" in order to maintain their preferred status.²⁵ In addition, however, those corporations seeking the 501(c)(3) exemption must, at the time of their incorporation, meet a special organizational test provided by the IRC and illuminated by Treasury Regulations.²⁶ The regulations dealing with this special requirement state that in order to satisfy the test, the articles of incorpora-

²⁰ Although IRC § 501(c)(3) also encompasses religious organizations, the N-PCL does not do so. See N.Y. N-PCL § 103(a).

²¹ Civic, patriotic, and in some limited circumstances, political corporations may qualify under IRC § 501(c)(4); agricultural, horticultural, and animal husbandry corporations, under IRC § 501(c)(5); professional, commercial, industrial, trade or service corporations, under IRC § 501(c)(6); and social and fraternal corporations, under IRC § 501(c)(8) or (10). Although, by virtue of N-PCL § 301(5) & (7), banks, cooperatives, and insurance companies are beyond the ambit of the N-PCL, under certain conditions they may be exempt from taxation due to IRC § 501(c)(1), (12) & (15). However, for our purposes, this latter exemption is not relevant. Similarly, the exemptions of 501(c)(17) & (18) regarding trusts are also obviously inapplicable.

²² See IRC §§ 170(c)(2)(income), 2055(a)(2)(estate), 2522(a)(2)(gift). Under § 170(b)(1)(A), a contributor may deduct his contribution to the extent of 50 percent of his adjusted gross income. This limitation, however, applies exclusively to 501(c)(3) organizations. Other qualifying charitable contributions are deductible only to the extent of 20 percent of adjusted gross income. See IRC § 170(b)(1)(B). Moreover, 501(c)(3) organizations are granted mailing rate reductions and sales tax exemption privileges which are ordinarily unavailable to other kinds of exempt organizations.

²³ U.S. DEP'T OF TREASURY, PUB. NO. 78, CUMULATIVE LIST OF ORGANIZATIONS DESCRIBED IN SECTION 170(b) OF THE INTERNAL REVENUE CODE OF 1954 (revised Dec. 31, 1968).

²⁴ See Parker, *Relations with the Internal Revenue Service; Exemption Application, Rulings, and Audits*, in NINTH BIENNIAL CONFERENCE ON CHARITABLE FOUNDATIONS 223-24 (1969).

²⁵ See notes 61-76 and accompanying text *infra*.

²⁶ The organizational test applies only to § 501(c)(3) organizations seeking an exemption determination after July 26, 1959. Corporations exempted under subsections of § 501(c) other than (3) are not subject to the organizational test. All exempt corporations are, however, subject to the operational test, discussed at pp. 458-60 *infra*.

tion must limit the corporation's purposes to one or more of those listed as exempt in 501(c)(3), and may not expressly sanction more than an insubstantial amount of activity which is not in furtherance of one or more of the exempt purposes, or engage in activity which constitutes "attempting to influence legislation."²⁷

The structural importance of N-PCL section 201 reveals itself upon further examination of the mode of compliance with the first organizational test requirement, *i.e.*, limiting the corporation's purposes in the articles of incorporation exclusively to one or more of the specified exempt purposes of 501(c)(3).²⁸ The Treasury Regulations provide that in determining whether a corporation's purposes are exempt, the law of the state in which a corporation is organized controls the construction of the terms of the corporation's articles.²⁹ Any corporation contending that the meaning of such terms is different under state law than their widely acknowledged meaning "must establish such special meaning by clear and convincing reference to relevant court decisions, opinions of the State attorney-general, or other evidence of applicable State law."³⁰

In applying this general rule of construction, a close reading of the N-PCL reveals that its seemingly happy marriage with the IRC has instead created a troubled relationship. This outcome results from legislative intentment, the presumptive and binding type status of the N-PCL, and the judicial and administrative gloss covering IRC section 501(c).

For example, the Joint Legislative Committee charged with the responsibility for drafting the N-PCL, premised the 201 purpose provisions partly upon membership and scope-of-benefit considerations. As previously noted, from this vantage, it was intended that the Type *A* organization cover the usual kind of nonbusiness membership corporation wherein "activities by or for members are the predominant aspect"; whereas Type *B* was designed primarily to "benefit a broad class of society or society in general."³¹ But, section 201 itself is silent regarding

²⁷ Treas. Reg. §§ 1.501(c)(3)-1(b)(1)(a), 1.501(c)(3)-1(b)(1)(i)(b), & 1.501(c)(3)-1(b)(3)(ii).

²⁸ *Id.*

²⁹ *Id.* § 1.501(c)(3)-1(b)(5).

³⁰ *Id.*

³¹ Explanatory Memorandum No. 1, in N.Y. N-PCL at xi. Although not specifically mentioned in the explanatory memoranda, there was an important reason for this characterization of corporate purposes. Previously, all corporations organized under the Membership Corporations Law were subject to supreme court approval or supervision regarding organization, merger, consolidation, and dissolution. *See* N.Y. MEMBERSHIP CORP. L. §§ 10, 50 & 55 (McKinney 1941). The committee apparently believed that the approval and supervisory requirements in many instances were purposeless and unnecessarily time-consuming. Thus, the N-PCL retains the procedures for Type *B* and *C* corporations, but

the scope-of-benefit criterion; perhaps the committee's memorandum should not be accepted as binding evidence of legislative intent. By implication, however, there appears to be strong legislative support for the committee's views within article 14 of the N-PCL. The memorandum, in considering that article, indicates an intention that it be merely a consolidation without change in either form or substance of the prior Membership Corporations Law articles which dealt with special types of membership corporations.³² Nevertheless, article 14 contains statutory additions which could in several instances have an important effect under the regulations relating to the 501(c)(3) tax exemption. In particular, every section of article 14 pertaining to a special not-for-profit corporation now contains a subsection which specifically categorizes the corporation for organization and operation purposes as Type *A*, *B*, or *C*.

An inspection of the categorizations unearths applications by the legislature of the scope-of-benefit criterion would produce rather arbitrary effects. Potentially, the most damaging example of such an application in article 14 is N-PCL section 1404, which deals with Christian associations.³³ Section 1404(b) designates a Christian association to be a Type *A* corporation for organizational purposes. By contrast, federal income tax and New York real property tax exemptions³⁴ have historically been interpreted as applying to Christian associations on the premise that such corporations are organized exclusively for educational and charitable purposes.³⁵ No apparent logic, other than the scope-of-benefit standard, exists for treating such organizations differently under the N-PCL.

As a result, Christian organizations have been put in a difficult position vis-à-vis continuance of their federal income tax exemption under IRC section 501(c)(3). Under the "state law control" regulation³⁶ it must be demonstrated that N-PCL Type *B* purposes are not the only ones which will qualify under the 501(c)(3) tax exemption. Additionally, it must be shown that the Type *A* purposes relied upon for the exemption have a meaning different from their generally accepted meaning and that such meaning includes a section 501(c)(3) purpose.

not for the Type *A* organization. Unfortunately, this deletion of judicial control may prove to be an unwise, costly decision.

³² Explanatory Memorandum No. 1, in N.Y. N-PCL at xxvii. See also N.Y. MEMBERSHIP CORP. L. arts. 9-19 (McKinney 1941).

³³ N.Y. N-PCL § 1404.

³⁴ IRC § 501(c)(3); N.Y. REAL PROP. TAX L. § 420 (McKinney 1960).

³⁵ Cf. G. P. Douglas, 1 B.T.A. 372, *acquiesced in*, IV-1 CUM. BULL. 2 (1925); *In re Syracuse Y.M.C.A.*, 126 Misc. 431, 213 N.Y.S. 35 (Sup. Ct. Onondaga County 1925).

³⁶ See note 29 and accompanying text *supra*.

A possible but complicated resolution of the problem presents itself in several further interrelationships of N-PCL section 201 and article 14. In two other sections of article 14, the N-PCL also runs counter to the exemption designations of IRC section 501(c). Cemetery and fire corporations are designated as Type *B*,³⁷ whereas for the federal income tax exemption they are exempted under subsections other than 501(c)(3).³⁸ Inclusion of such corporations in the Type *B* category for organizational purposes raises several inferences with respect to the legislative intention behind the definitional limits of N-PCL section 201. First, placement of cemetery and fire corporations within Type *B* evinces a legislative intent that broader conceptual limits be adopted in construing the Type *B* charitable, educational, scientific, literary, and cultural purpose terminology rather than the generally accepted meaning standard of IRC section 501(c)(3).³⁹ Second, if the broad Type *B* conceptual limits and scope-of-benefit standard is indeed the legislature's intention, a further inference regarding the definitional limits of the Type *A* designation should follow; *i.e.*, the statute, although delineating some Type *A* organizational purposes, does not limit Type *A* corporations to such purposes. Thus, a Type *A* corporation, due to the scope of its benefits to society, might also be organized and limited exclusively for purposes set out in section 501(c)(3). In fact, N-PCL section 201(b) provides that a Type *A* corporation may be formed for any lawful nonbusiness purpose including, but not limited to the purposes enumerated. Moreover, where a section 501(c)(3) purpose exists and its scope of benefit is broad enough, N-PCL section 201(c) relegates the corporation to Type *B* status.⁴⁰ Consequently, one subpart of the Type *A* classification must of necessity include corporations whose purposes are structured in such a manner as to qualify them under 501(c)(3) for the tax exemption, but are still too narrow for Type *B*

³⁷ N.Y. N-PCL §§ 1401 & 1402.

³⁸ IRC § 501(c)(13) (cemetery corporations). In Rev. Rul. 66-221, 1966-2 Cum. Bull. 222, the IRS ruled that an organization operating a volunteer fire department was entitled to exemption under section 501(c)(4) as an organization operated exclusively for the promotion of social welfare.

³⁹ Such reasoning strikes an ominous note for all Type *B* corporate foundations. Although a corporation organized as Type *B* would ordinarily qualify under the 501(c)(3) exemption rules, such status does not guarantee a *carte blanche* exemption.

⁴⁰ N.Y. N-PCL § 201(c) provides as follows:

If a corporation is formed for purposes which are within both type A and type B . . . , it shall be considered a type B corporation. If a corporation has among its purposes any purpose which is within type C, such corporation shall be considered a type C corporation. A type D corporation shall be considered a type B corporation . . . unless provided to the contrary in [another] corporate law authorizing formation under this chapter of the type D corporation.

inclusion.⁴¹ On the other hand, a section 501(c)(3) corporation that attempts to avoid the smite of the new private foundation provisions⁴² by seeking a Type *A* classification should be aware that no safe harbor exists there.

It is unfortunate that the confusing N-PCL section 201 terminology and its vague legislative underpinnings necessitate the undertaking of this detailed analysis. Similarly, the resulting predicament is scarcely a good start for Christian associations on the road toward satisfaction of the clear and convincing standard of the state law control regulation. Faced with the usual dim prospect for immediate clarifying legislation, it would seem appropriate for the New York Attorney General to issue, as soon as practicable, an opinion setting out essential interpretative guidelines for federal tax exemption purposes.

The Type C Labyrinth: Business Versus Nonbusiness Activity

The remaining guidepost used in structuring the type limits of N-PCL section 201, *i.e.*, business versus nonbusiness purpose, also raises several interesting interpretative problems when an attempt is made to reconcile such purpose with the 501(c)(3) exemption provisions. The question is embodied in the Type *C* organization. This category comprises not-for-profit corporations formed for any lawful business purpose—a rather broad genre. Fixing its outer boundaries is not simple and the Joint Committee's memoranda are of only limited usefulness for this task. The pertinent memorandum declares that Type *C* covers the corporation which has, among its purposes, one which is usually carried on for profit. Nonetheless, the Type *C* category is expressly limited to corporations formed principally for some purpose other than a money-making enterprise.⁴³ In short, the memorandum appears merely to restate the outer conceptual limits of a not-for-profit corporation, leaving the Type *C* corporation broad discretion in detailing its organizational structure for tax exemption purposes. However, these broad boundaries are unsatisfactory since it is necessary to delineate narrow

⁴¹ Examples of such corporations would be the employee relief and annuity associations. See G.C.M. No. 19028, 1937-2 CUM. BULL. 125.

⁴² IRC §§ 507-09 & 4940-48, recently added by the Tax Reform Act of 1969.

⁴³ Explanatory Memorandum No. 1, in N.Y. N-PCL at xi. The policy behind the provision is explained as follows:

This provision . . . fills a gap in the existing law which accommodates a business corporation for profit under the Business Corporation Law, a non-business purpose not for profit under the Membership Corporations Law, but makes no provision for the business activity formed for a not-for-profit purpose, that is, other than to make money.

categories of business activity in order to fit within the limits of section 501(c)(3).

Indeed, the organizational test regulations coerce a narrowing of the not-for-profit boundaries of business operations for Type C corporations. For example, the second organizational requirement, dealing with the limiting of activity which is not in furtherance of the exempt purposes, is particularly relevant.⁴⁴ In order to qualify under 501(c)(3), the Treasury Regulations require that the articles of incorporation of a Type C corporation not empower it, other than insubstantially, to engage in business activities which do not further one or more exempt purposes, even though its corporate articles restrict it to 501(c)(3) purposes. Thus, the Internal Revenue Service takes the extreme position that a corporation empowered by its articles to engage in a manufacturing business does not meet the organizational test, notwithstanding the fact that its articles also state that its creation was for 501(c)(3) charitable purposes.⁴⁵

This limitation of substantial business activity not in furtherance of corporate purpose results in a triangular structure of N-PCL corporations conducting business operations. The first category contains the 501(c)(3) corporation whose articles empower it to engage in only an insubstantial amount of business activities. This form of not-for-profit corporation should still find itself most comfortable in either the Type A or B classification depending upon the scope of its benefit. Secondly, the outer limits of 501(c)(3) also pertain to a Type C corporation when substantial general business activity in furtherance of one or more exempt purposes is authorized by its articles.⁴⁶ For example, nursing homes and religious publishing corporations might fall within the Type C provisions while concomitantly qualifying for 501(c)(3) exempt status.⁴⁷ Finally, there is nothing to prevent Type C corporations from qualifying for tax-exempt status under other subsections of section 501(c). Indeed, N-PCL section 1411 provides a specific example, the local development corporation, which is classed as a Type C corporation.⁴⁸ For tax purposes, these corporations have been recognized as

⁴⁴ See note 27 and accompanying text *supra*.

⁴⁵ Treas. Reg. §§ 1.501(c)(3)-1(b)(1)(iii) & 1.501(c)(3)-1(c)(1).

⁴⁶ In line with this observation, a district court has held that the power of an organization to engage in general business activity is not fatal to exemption under the organizational test if the power is so limited that it can only be exercised to further the tax-exempt purpose of the organization. See *Lewis v. United States*, 189 F. Supp. 950 (D. Wyo. 1961).

⁴⁷ Cf. Rev. Rul. 68-26, 1968-1 CUM. BULL. 272; Rev. Rul. 56-185, 1956-1 CUM. BULL. 202.

⁴⁸ N.Y. N-PCL § 1411(b).

exempt under section 501(c)(4) as organized exclusively for the promotion of the general welfare.⁴⁹

It is worthwhile, at this point, to touch briefly upon the organizational area question of authorized political activity versus tax-exempt status.⁵⁰ N-PCL section 201 gives little direction to not-for-profit corporations in the political activity area. Type *A* specifically includes within its scope not-for-profit corporations with political purposes. Also, it appears that under the N-PCL any not-for-profit corporation, regardless of its purpose, may be empowered to engage without restriction in political activity which is in furtherance of its exempt purposes. On the other hand, a corporation seeking a 501(c)(3) tax exemption must tread very lightly in this area. The Treasury Regulations deny exempt status to a corporation whose articles expressly empower it to devote more than an insubstantial part of its activities in an attempt to influence legislation or participation in any political campaign.⁵¹ However, if a not-for-profit corporation seeks merely to influence legislation and not to participate in political campaigns, it may still, under certain circumstances, qualify for exemption under 501(c)(4) as an organization organized and operated exclusively for the promotion of social welfare.⁵²

Corporate Dissolution and the Tax Exemption

An important final consideration concerns the organizational test requirement that the assets of a 501(c)(3) corporation be dedicated to an exempt purpose and subsequent dissolution of the entity. This dedication will continue if upon dissolution the corporate assets are required to be distributed by the corporation for other 501(c)(3) purposes or for public purposes, either under the terms of the corporate articles or by operation of law. In the event of judicial dissolution, the court must be authorized to distribute the assets to another corporation

⁴⁹ Under limited circumstances, a contributor to such a corporation may even receive a deduction for his contribution. Thus, the Internal Revenue Service has held that contributions to an Area Redevelopment Act corporation may be deducted under section 162 of the Code, if they bear a direct relationship to the donor's business and are made with a reasonable expectation of financial return commensurate with the investment. Rev. Rul. 64-187, 1964-1 CUM. BULL. 354; see also *Garden Homes Co. v. Commissioner*, 64 F.2d 593 (7th Cir. 1933).

⁵⁰ For a detailed historical development of the effect of political activity upon the tax-exempt status, see Note, *Political Activity and Tax Exempt Organizations Before and After the Tax Reform Act of 1969*, 38 GEO. WASH. L. REV. 1114 (1970).

⁵¹ Treas. Reg. § 1.501(c)(3)-1(b)(3). This area again points up the need for careful drafting of corporate articles. All not-for-profit corporations seeking 501(c)(3) status, especially Type *A* corporations with political purposes, must limit their purposes to those expressly exempted. A general statement in the articles that the corporation is formed for Type *A*, *B*, or *C* purposes will deal a death blow for the 501(c)(3) exemption and probably for the other 501(c) exemptions as well.

⁵² See Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii); Rev. Rul. 68-656, 1968-2 CUM. BULL. 216.

for use in such a manner as in the court's discretion "will best accomplish the general purposes for which the dissolved organization was organized."⁵³

The implications of the dedication test meet varied reactions under the N-PCL, depending upon the type of corporation under consideration. Thus, depending on type classification, not-for-profit corporations may be required to alter their corporate articles to gain or retain 501(c)(3) status. The law provides a choice of two dissolution methods, judicial and nonjudicial.⁵⁴ However, due to a method of cross-referencing,⁵⁵ only one procedure for the distribution of assets after dissolution is prescribed for not-for-profit corporations.⁵⁶ Section 1005 provides different distribution procedural requirements depending upon the kind of purpose for which the assets were used. If the assets were held either for Type B purposes or were of the *cy pres* kind, *i.e.*, "legally required to be used for a particular purpose," distribution must be to "organizations engaged in activities substantially similar to those of the dissolved corporation." All other assets are distributed according to the plan of distribution or directly to the members of the corporation if the corporate articles prescribe such rights.⁵⁷

The interrelation of the N-PCL distribution section and the dedication requirement of the Treasury Regulations breed the following conclusion: inasmuch as the N-PCL required-use standard for distribution purposes is more restrictive than that of the Treasury Regulation,⁵⁸ those 501(c)(3) corporations classed as Type B clearly need not insert a restrictive distribution requirement in their corporate articles.⁵⁹ Additionally, Type A and C corporations of necessity fall within the purview of the N-PCL distribution section when they meet the organizational

⁵³ Treas. Reg. § 1.501(c)(3)-1(b)(4).

⁵⁴ N.Y. N-PCL arts. 10 & 11.

⁵⁵ *Id.* § 1115.

⁵⁶ *Id.* § 1005.

⁵⁷ *Id.* § 1005(a)(3)(A) & (B).

⁵⁸ Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii) requires that corporate assets be distributed for one or more of the 501(c)(3) purposes. The mandate of N-PCL § 1005(a)(3)(A) is obviously stricter since it not only limits asset distribution to organizations with 501(c)(3) purposes, but also requires that they be engaged in activities which are substantially similar to those of the defunct corporation. Consequently, the N-PCL section easily satisfies the dedication of asset requirement.

⁵⁹ As a practical matter, all existing New York corporations qualified under § 501(c)(3) (with the exception of those listed in N-PCL article 14) have a restrictive dissolution requirement in their corporate articles, due to the lack of prior qualifying statutory limitations. Thus, N-PCL § 1005(a)(3)(A) is primarily of benefit to new Type B corporations. However, even here it may be wise to include the restrictive clause, since in its absence the IRS requires a brief on applicable state law to accompany the application for exemption.

test's "exclusive purpose" requirement⁶⁰ in their corporate articles, since this will qualify them as *cy pres* types for section 1005 purposes.

THE CODE OPERATIONAL TEST AND THE NOT-FOR-PROFIT CORPORATION

In addition to compliance with the IRC organizational test just considered, successful utilization of the not-for-profit format on a continuing tax-exempt basis requires satisfaction of the 501(c)(3) operational test, which is extensively set out in the Treasury Regulations.⁶¹ The regulations contain three fundamental requirements which must be met if an organization is to be regarded as operated exclusively for one or more exempt purposes. First, the corporation must engage primarily in activities which accomplish one or more 501(c)(3) exempt purposes;⁶² second, corporate earnings must not benefit wholly or partially the private shareholders or other individuals;⁶³ and third, the corporation must not fall under the definition of an "action" corporation, *i.e.*, one which engages in certain political activities.⁶⁴

The first operational test requirement regarding activities accomplishing exempt purposes, has a counterpart in N-PCL section 204 which limits the conduct of profitable activities to the extent that they support the corporation's other lawful activities then in progress.⁶⁵ Illustrative of a permissible activity carried on for pecuniary profit or financial gain is an investment program that results in a profit which is thrown back into the organization's pocket for application to its major business, *i.e.*, in support of its not-for-profit activities. However, investment activity solely for the sake of investment and profit is obviously not within the spirit of the law and thus not permitted.⁶⁶ Consequently, profitable activity, investment or business, related or unrelated, may be conducted by a not-for-profit corporation as long as the profits are dedicated to the support of the section 201 corporate purposes actually being conducted. In essence, section 204 does little

⁶⁰ See note 27 and accompanying text *supra*.

⁶¹ Treas. Reg. § 1.501(c)(3)-1(c).

⁶² *Id.* § 1.501(c)(3)-1(c)(1); *cf.* IRC § 501(c)(4); Treas. Reg. § 1.501(c)(4)-1.

⁶³ Treas. Reg. § 1.501(c)(3)-1(c)(2); *cf. id.* §§ 1.501(c)(4)-1(b) & 1.501(c)(5)-1(a)(1).

⁶⁴ *Id.* § 1.501(c)(3)-1(c)(3). An "action" organization is defined as any organization which: (1) as a substantial part of its activities, attempts to influence legislation by direct or "grassroots" lobbying; (2) electioneers in a campaign for public office; or (3) has a primary objective which may be attained only by legislation or defeat of proposed legislation and campaigns for that objective. It should be noted that while an "action" organization as described in (1) and (3) above may not be exempt under 501(c)(3), it may still qualify for an exemption under section 501(c)(4) as a social welfare organization. However, since charitable contribution deductions are not allowed, a 501(c)(4) classification makes fund raising more difficult.

⁶⁵ N.Y. N-PCL § 204.

⁶⁶ See Explanatory Memorandum No. 1, in N.Y. N-PCL at xii.

to limit the actual conduct of a business activity by a not-for-profit corporation, restricting only the ultimate destination of the profits earned.

For New York not-for-profit corporations qualifying under IRC section 501(c)(3), destination of profits is an issue of secondary importance, because under the operational test the type of profit-making activity and its purpose is controlling for the continuation of the tax exemption. Although there are few Code restrictions on investment activity,⁶⁷ where a 501(c)(3) corporation operates a trade or business as a substantial part of its activities, such operations must (1) be "in furtherance of the organization's exempt purpose" and (2) not be "operated for the primary purpose of carrying on an unrelated trade or business."⁶⁸ Consequently, it would seem that a not-for-profit corporation may conduct investment activities with application of only N-PCL section 204, whereas trade or business activity requires sequential conformance with, first, the IRC operational test, and, second, the section 204 limitations.

The second operational test requirement, dealing with interested beneficiaries, is less difficult to integrate with the N-PCL since the provisions are almost identical. However, the N-PCL's scope of application is narrower, providing that a not-for-profit corporation may not "pay dividends or distribute any part of its income or profit to its members, directors, or officers."⁶⁹ By contrast, the operational test prohibits inurement of any part of the net earnings to the benefit of private shareholders or individuals, a class which includes any person having a personal or private interest in the activities of the corporation.⁷⁰ The IRC definition is, of course, broader than the N-PCL phrase, "members, directors, or officers" and, in addition, contemplates persons such as a donor, an incorporator or his family, and a person controlled by such private interests.⁷¹

The scope of the operational test should instill a note of caution in a corporation contemplating use of the liberalized corporate financing techniques under the N-PCL.⁷² For example, exemption has been

⁶⁷ Investment activities of an exempt organization are not necessarily a separate type of activity, *i.e.*, trade or business, but may be purely incidental to, and promotional of the organization's exempt purposes. Therefore, they are not objectionable as an application of funds for a nonexempt purpose. *See Samuel Friedland Foundation v. United States*, 144 F. Supp. 74 (D.N.J. 1956).

⁶⁸ Treas. Reg. § 1.501(c)(3)-1(e)(1); *see also* IRC § 513.

⁶⁹ N.Y. N-PCL § 515(a); *see also id.* § 508.

⁷⁰ Treas. Reg. § 1.501(a)-1(c).

⁷¹ *See* I.R.S. Doc. No. 5551, at 5 (1964).

⁷² N.Y. N-PCL art. 5.

denied where an organization intended to reimburse the founder for expenses incurred by him prior to its formation.⁷³ A similar result was reached where a foundation purchased assets of a speculative nature from its founder.⁷⁴ Thus, a section 501(c)(3) not-for-profit corporation which upon formation issues subventions, in the nature of debt,⁷⁵ or bonds to its donors should structure these instruments in such a manner as to avoid any inference that they were issued in consideration of prior expenses paid by such donors or that they are for the purchase of speculative business assets. The same principle is, of course, relevant to such transactions with other private shareholders or individuals.

The last operational test requirement, *i.e.*, prohibition of "action" organization activities, is identical to its organizational test counterpart and, as stated in prior discussion, has no complement in the N-PCL.⁷⁶

CONCLUSION

The N-PCL structure was guided by the legislative determination to make flexible and rejuvenate the regulation of not-for-profit corporations. These corporations, when applying for tax-exempt status under IRC section 501(c)(3) or operating within that subsection subsequent to qualification, will soon realize that many of the benefits bestowed by the N-PCL are more illusory than real.

For tax exemption qualification purposes, the enactment of the N-PCL has in some instances created confusion and consternation vis-à-vis satisfaction of the 501(c)(3) organizational tests due to its unfortunate use of terminology in the categorization of differing types of not-for-profit corporations. An authoritative interpretation is essential for ultimate clarification of the N-PCL definitional subsections. Regarding other organizational and operational requirements for section 501(c)(3) purposes, the comparable N-PCL provisions either add nothing or are more restrictive than their IRC counterparts. Thus, although the N-PCL has procedurally simplified the formation and regulation of not-for-profit corporations, from a tax viewpoint the N-PCL is a difficult statute at best, and more often than not, a trap for the unwary.

⁷³ Rev. Rul. 55-610, 1955-2 CUM. BULL. 262.

⁷⁴ *Randall Foundation, Inc. v. Riddell*, 244 F.2d 803 (9th Cir. 1957).

⁷⁵ See N.Y. N-PCL § 504. The subvention is a new concept in long-term corporate financing.

It resembles a capital contribution in that it does not create a debt of the corporation, and may therefore constitute a subsidy of indefinite duration. However, the subvention may become an obligation of the corporation, so that it is returnable upon the accomplishment of its purpose or upon the happening of an event, according to the terms agreed upon by the subventor and the corporation.

Explanatory Memorandum No. 1, in N.Y. N-PCL at xv.

⁷⁶ See note 51 and accompanying text *supra*.