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Tax Exempt Organizations: Winds of Change

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I. Introduction and Scope:

A. This outline will consider two issues affecting nonprofit organizations. The main focus will be on tax and compliance rules affecting I.R.C. § 501(c)(3) entities.

1. The first issue involves tax deductions for transfers of property or money to charities when some benefit is received in return by the transferor — the so-called quid-pro-quo issue.

2. The second issue involves the tax rules affecting competition between nonprofit and for-profit entities, i.e., the Code's treatment of "unrelated business income" under I.R.C. §§ 511-15.

B. Only federal income tax issues are considered.

C. The outline is designed only to organize discussion. It is not detailed, much less comprehensive.

II. Deductions for Property Transfers to Charities:

A. This part of the outline exclusively considers the tax deductibility of transfers of property or money to a charity when the donor receives something in return. Because it is limited to the quid-pro-quo issue, it contains no discussion of any of the many other current and interesting issues swirling around charitable deductions.

B. The ground rules: Rev. Rul. 67-246, 1967-2 C.B. 104 —

> "[W]here consideration . . . is received in connection with payments by patrons . . . , the presumption is that the payments are not gifts. In such case, . . . the burden is on the taxpayer to establish that the amount paid is not the purchase price of the privileges or benefits and that part of the payment, in fact, does qualify as a gift."

C. One instance in which the ground rules were applied: Rev. Rul. 86-63, 1986-1 C.B. 6 (preferred seats at football games, resulting from donations to university, are a substantial benefit, so no charitable deduction permitted); I.R.C. § 170(m), added by § 6001(a) of the Technical and Miscellaneous Revenue Act of 1988 (80% deduction permitted in such cases).

D. The ground rules re-emphasized: Pub. 1391 (June 1988); Assistant Commissioner Brauer's interview, Sept. 22, 1988, published by BNA together with Questions and Answers prepared by members of the ABA Tax Section's Exempt Organizations Committee.

E. Hernandez v. Commissioner, ___ U.S. ___ , 109 S. Ct. 2136 (1989), reh. denied, ___ U.S. ___, 110 S. Ct. 16 (1989): payments to the Church of Scientology for "auditing" and "training" services held not deductible.

1. The Service had stipulated that the Church of Scientology was a religious organization eligible to receive tax-deductible contributions. (Subsequently, the Service changed its view on this point, and courts have tended to side with it in holding the Church of Scientology *not* to be tax exempt. See, e.g., Church of Scientology of California, 83 T.C. 381 (1984), aff'd, 823 F.2d 1310 (9th Cir. 1987), cert. denied, 486 U.S. 1015 (1988). The Supreme Court knew of and referred to these developments. See n. 4 to the opinion.)

2. The Supreme Court majority in Hernandez comprised Justice Marshall (the author of the opinion) and Justices Rehnquist, White, Blackmun, and Stevens. Justices O'Connor and Scalia dissented. Justices Brennan and Kennedy did not participate.

3. The Hernandez decision resolved a deep split on the issue among the Circuit Courts of Appeal, in which the 1st, 4th, 9th, and 10th Circuits had held the payments *not* to be deductible (the position adopted by the Supreme Court), but the 2d, 6th, and 8th Circuits had allowed deductions.

4. The Scientology tax-deduction litigation had begun in the late '70s. See, e.g., Rev. Rul. 78-189, 1978-1 C.B. 68, denying deductibility for payments to the Church of Scientology for "auditing" and other services. It is far from over: over 1,000 cases involving the Hernandez issue had been grouped by the Service into a "Project." Virtually all taxpayers had entered into stipulations to be bound by the Supreme Court decision, so — in most instances — these are being resolved by recomputations and the entry of decisions. An undetermined number of these cases, however, involve issues left open by the Hernandez Court, so more litigated decisions are likely.

5. The Supreme Court not only reaffirmed the general rule of nondeductibility in quid-pro-quo situations, but rejected various constitutional claims that the general rule should not apply in the case of payments to a church for religious benefits.

F. Three Technical Advice Memoranda:

1. TAM 8832003 (May 6, 1988): even providing incorrect information about the proper amount of a deduction will not produce sanctions.

2. TAM 8909004 (Dec. 2, 1988): further audit activities directed as to the organization considered in LTR 8832003.
3. TAM 9027003 (March 21, 1990): I.R.C. §§ 6700 and 6701 penalties may apply, and "continued misrepresentations regarding tax matters could raise questions as to whether public purposes are still being served by continued exemption."

G. Safe harbors for de minimis amounts: Rev. Proc. 90-12, 1990-8 I.R.B. 20.

H. The ongoing compliance program, the Program Study Checksheet — Phase II, and audits of donors. As of early August, 1990, 26 audits have produced referrals for further IRS action, and 900 individual donors have been targeted for audit.

III. Competition Between Nonprofit and For-Profit Organizations:[1]

A. Ancient History:

1. From the earliest days of this century — even prior to the adoption of a general income tax in 1913 — the tax law has provided an exemption for certain entities "organized and operated exclusively for religious, charitable, or educational purposes, no part of the profit of which inures to the benefit of any private stockholder or individual." Corporate Excise Tax Act of 1909, § 38, 36 Stat. 112 (1909) (emphasis added). These words, with additions not here relevant, have been carried forward without substantial change into the current Code. I.R.C. § 501(c)(3).

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1. Much of the following is adapted from an earlier outline by the author, prepared for a New York University Conference, sponsored by the Center for Entrepreneurial Studies, held on November 15-16, 1988.

2. In a landmark opinion, the Supreme Court interpreted virtually identical language, from the Act of October 3, 1913, as affording tax exemption to a religious organization, even though it earned just less than three percent of its income from the sale, to its own members, of chocolate, wine, and other articles. Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578 (1924). Thus, it has long been clear that the word, "exclusively," is not to be given a rigidly literal meaning. The Trinidad opinion is interesting for two reasons:

   a. It is often cited as the genesis of the so-called "destination" test for tax exemption. That test held that an organization could qualify for tax exemption so long as the ultimate destination, or use, of its income was for the prescribed religious, charitable, etc., purposes, regardless of the source of the income. The relevant language in the opinion, however, is mere dictum. The Court said the Act "says nothing about the source of the income, but makes the destination the ultimate test of exemption." 263 U.S. at 581.

   b. It may be that the "relatedness" notion stems from an ambiguity in the Court's discussion of the sale transactions:

      > "The articles are merely bought and supplied for use within the plaintiff's own organization and agencies — some of them for strictly religious use, and the others for uses which are *purely incidental* to the work which the plaintiff is carrying on." 263 U.S. at 582 (emphasis added).

It is not clear from the context which of two possible meanings to put on the emphasized words:

(1) Do they mean that the sales were incidental in the sense of being trivial or unimportant?

(2) Or do they mean that the sales were incidental in the sense of being related to the exempt activities of the taxpayer?

Both meanings are proper dictionary understandings of the word, "incidental." Thus, WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY (G. & C. Merriam 1981) defines "incidental" either as (1) "unimportant" or "nonessential" or "minor," or as (2) "appertaining to" or "associated or naturally related" to. The 1901 edition of the OXFORD ENGLISH DICTIONARY defines it either as (1) "accessory or subordinate" but of "no essential part," or as (2) "relating or pertinent." (It treats the latter, however, as obsolete.) Either interpretation would be correct on the facts of the case; neither seems compelled.

3. From 1924 on, the courts, applying the destination test, permitted tax-exempt organizations to engage in a growing variety of substantial business activities.

4. In 1942, the "relatedness" concept — but <u>not</u> that word for it — emerged in the legislative process for the first time. Randolph Paul, then Tax Adviser to the Secretary of the Treasury, testified about the problem of tax-exempt entities engaging in businesses.

He identified two concerns: loss of tax revenue and unfair competition with for-profit enterprises. He continued:

> "It is therefore suggested that such corporations be taxed on income derived from a trade or business *not necessarily incident to* their exempt activities." 1 Revenue Revision of 1942: Hearings Before the House Committee on Ways and Means, 77th Cong., 2d Sess. 89 (1942) (emphasis added).

It is clear that Mr. Paul was using the emphasized phrase in the second sense, i.e., as connoting relatedness, not triviality: immediately above the quoted language, he had referred to exempt corporations which "engage in trades and business *completely unrelated to* their exempt activities." (emphasis added). Note that the perceived abuses — loss of revenue and unfair competition — would have been more cleanly addressed by taxing all income from competitive businesses, whether or not such businesses were related to the exempt activities of the organization. The choice of the relatedness test, rather than a competitiveness test, is nowhere discussed.

5. The courts continued to broaden the scope of permitted business activities. Perhaps the most celebrated case involved the famous — and still revered — N.Y.U. Law School's macaroni factory. There, a wholly-owned "feeder" subsidiary of the school was granted tax exemption. C.F. Mueller Co. v. Commissioner, 14 T.C. 922 (1950), rev'd, 190 F.2d 120 (3d Cir. 1951). Although the 3d Circuit decision was handed down in 1951, the litigation involved the 1947 taxable year, and the facts of the litigation were well known to members of Congress during the 1950 debates. See, e.g., Repre-

sentative Dingell's reference to the risk that "all the noodles produced in this country will be produced by corporations held or created by universities . . . ." Revenue Revision of 1950: Hearings Before the House Committee on Ways and Means, 81st Cong., 2d Sess. 579-80 (1950).

6. Although the 1942 Hearings did not produce legislation which taxed unrelated business income, they formed the basis for the Treasury's 1950 recommendation of a similar tax. Secretary John W. Snyder and Tax Legislative Counsel Vance Kirby both suggested a tax on "unrelated" business activities of exempt organizations. 1 Revenue Revision of 1950: Hearings Before the House Committee on Ways and Means, 81st Cong., 2d Sess. 19 (statement of Secretary Snyder); Id. at 165 (testimony of Tax Legislative Counsel Vance Kirby). Mr. Kirby, acknowledging that the genesis of the 1950 proposal was the earlier testimony of Randolph Paul, said, "A similar proposal was presented to the committee in 1942 . . . ." Ibid. The testimony is interesting both for what it condones and what it condemns:

   a. Passive income received by exempt entities is clearly approved for tax-free status; the only reason enunciated is that such receipts are "the traditional sources of income of these institutions . . . ." Ibid.

   b. Active business income is clearly targeted for taxation, but only if unrelated to the institution's exempt activities. Mr. Kirby made this explicit, when he testified:

"Moreover, only business income which is not incident or related to the exempt purpose would be taxed. For example, a university bookstore may continue to sell textbooks to students, an agricultural college may run a wheat farm in connection with its educational program, a social club may sell food to its members, without affecting its tax exempt status. All of these activities would continue to be exempt from tax. Only the unrelated business would be taxed — the spark-plug or chinaware factory run by a university." Id. at 166.

The resulting legislation adopted the relatedness test, which continues in I.R.C. § 513(a) to the present date. Revenue Act of 1950, Pub. L. No. 814, § 301(a), defining "unrelated business net income." The principal problem addressed by the Act was "that of unfair competition." H. Rep. No. 2319, 81st Cong., 2d Sess. 36 (1950); S. Rep. No. 2375, 81st Cong., 2d Sess. 28 (1950). Accord, Treas. Reg. § 1.513-1(b); S. Rep. No. 94-938, 94th Cong., 2d Sess. 601 (1976). Less, but some, attention was paid to the UBIT's revenue-raising potential. See, e.g., H. Rep. No. 2319, 81st Cong., 2d Sess. 1-3 (1950).

7. Although Congress has tinkered with the UBIT since 1950, its most significant revisiting of the area took place in 1969. The Tax Reform Act of 1969 enacted five major, and several other less important, changes to the reach of the UBIT:

   a. It extended the reach of the UBIT to almost all exempt organizations, albeit with a deferred effective date for churches and church affiliates. I.R.C. § 511(a)(2)(A).

b. It adopted the so-called fragmentation rule, under which parts of an activity could be subject to the UBIT, even if the overall business was not (as in the case of advertising income of an otherwise exempt magazine). I.R.C. § 513(c).

c. It imposed tax on the passive investment income of, and otherwise modified the definition of UBIT for, certain social clubs, voluntary employees' beneficiary associations, and selected other entities. I.R.C. § 512(a)(3).

d. Responding to the Service's loss in United States v. Clay Brown, 380 U.S. 563 (1965), it imposed the UBIT on debt-financed income of certain types. I.R.C. § 514.

e. It imposed the UBIT on interest, rents, and royalties received from controlled organizations. I.R.C. § 512(b)(13).

8. Subsequent legislative developments, prior to the 1987 hearings described below, have been less significant even if not inconsequential. They are not discussed here.

B. More recent events:

1. Beginning in the early '80s, and spearheaded by the Office of the Chief Counsel for Advocacy of the Small Business Administration, concerns began to be expressed about growing competition between nonprofit and for-profit enterprises. The dialogue was heated and intense, as were the lobbying pressures generated by both sides.

2. On September 12, 1986, Chairman Rostenkowski of the House Ways and Means Committee issued a press release calling for the Oversight Subcommittee:

> "to conduct a comprehensive review of the Federal tax treatment of commercial and other income-producing activities of organizations that have tax-exempt status under section 501 of the Internal Revenue Code." Press Release #25, reprinted in 1 Hearings Before the Subcommittee on Oversight of the Committee on Ways and Means, House of Representatives, Unrelated Business Income Tax, 100th Cong., 1st Sess. 2-4 (Serial 100-26 1987).

3. The Oversight Subcommittee of the House Ways and Means Committee held five days of hearings from June 22 through June 30, 1987. They have been reprinted in three parts.

4. In late March 1988, Chairman J.J. Pickle of the Oversight Subcommittee issued a press release containing a number of "discussion options regarding the unrelated business income tax . . . ." Press Release #16, reprinted in Subcommittee on Oversight of the Committee on Ways and Means, U.S. House of Representatives, Written Comments on Discussion Options Relating to the Unrelated Business Income Tax, 100th Cong., 2d Sess. III-VI (Comm. Print, WMCP:100-30 1988). A very considerable volume of comments was submitted, filling 960 printed pages. The Subcommittee held a further public hearing on May 9, 1988, at which Assistant Secretary for Tax Policy O. Donaldson Chapoton, among others, testified.

5. On May 19, 24, and 25, 1988, and again in early June 1988, the Oversight Subcommittee met in closed sessions to discuss the

options referred to above. The members were unable to agree. No firm decisions were made, no final legislative language was drafted, and no definitive committee report was issued. A *draft* report, however, was circulated to members of the Oversight Subcommittee on June 23, 1988.[2] It remains, in some sense, under consideration, no further formal committee action having been taken since then.

6. On September 7, 1989, the chairmen and ranking minority members of both the House Ways and Means Committee and its Oversight Subcommittee wrote to Assistant Secretary of the Treasury Kenneth Gideon about the UBIT. The letter read, in part:

> "We view the final resolution for improvements in the unrelated business income tax rules to be a priority matter for this Committee. Recognizing that the pending draft report and recommendations were developed in consultation with the prior Administration, we request the official position of the current Administration on the proposed recommendations contained in the draft report as well as any other proposal or modification to a recommendation you would like for us to consider. This will enable the Subcommittee and full Committee to move forward to reform the UBIT laws."

On September 21, 1989, Assistant Secretary Gideon replied, confirming that "[t]he Treasury Department and the Internal Revenue Service share your desire to move this project forward in the near

2. The draft report is reprinted in HIGHLIGHTS & DOCUMENTS 3027-48 (June 24, 1988). For a helpful description and analysis, see Troyer, Changing UBIT: Congress in the Workshop, 41 TAX NOTES 1221 (Dec. 12, 1988). See also Spitzer, Reform of the UBIT: An Open Letter to Congress, 43 TAX NOTES 195 (Apr. 10, 1989).

future." His letter referred to the then-pending IRS "taxpayer compliance measurement program for tax-exempt organizations" due to be completed in 1990, suggesting that it "should provide important new data on compliance in this area."

7. There was no further activity on UBIT reform in 1989, but the signs strongly suggest that the issue will be on the legislative agenda for future years. Both the Chief of Staff of the Joint Committee on Taxation and the Chief Counsel for the House Ways and Means Committee have so stated.