DEVELOPMENT OF THE FEDERAL TAX TREATMENT OF CHARITIES

A PRELUDE TO THE TAX REFORM ACT OF 1969

KENNETH LILES*

CYNTHIA BLUM†

To understand the present and forecast for the future of federal tax treatment of charitable organizations, it is not sufficient to study the changes made by the Tax Reform Act of 1969. To place those changes in proper perspective, it is helpful to trace the development of the prior tax treatment of charities from the beginning of our federal income, gift and estate tax laws. The following article attempts to meet this need by studying the prior history of the charitable exemption, deduction and the unrelated business tax, as a prelude to other articles in this symposium that cover changes made by the 1969 Act.

I

HISTORY OF CHARITABLE EXEMPTION

A. Early History

For as long as we have had federal income tax laws, our charitable institutions have been exempted from tax thereunder. The first federal income tax exemption for charitable organizations appeared in the Act of 1894.¹ A year later, the Act of 1894 was declared unconstitutional by the United States Supreme Court in *Pollock v. Farmers' Loan and Trust Company*.²

In 1903, Congress granted a federal charter of incorporation, including a provision for a self-perpetuating board of trustees and exemption from federal taxation, to the Rockefeller-funded General Education Board, in accordance with an established congressional habit of granting charters to educational organizations.³ Similarly, a federal charter was granted by Congress to the Carnegie Institute of Washington in 1904 and to the Carnegie Foundation

* Partner, Sutherland, Asbill & Brennan, Washington, D.C. and Atlanta, Ga.

† Law Clerk, Sutherland, Asbill & Brennan, Washington, D.C.

1. Act of August 15, 1894, ch. 349, 28 Stat. 553.

2. 158 U.S. 601 (1895).

3. J. LANKFORD, CONGRESS AND THE FOUNDATIONS IN THE TWENTIETH CENTURY 9 (1964).

for the Advancement of Teaching in 1906.⁴ However, a growing congressional hostility to large private foundations was evidenced by the Rockefeller Foundation's unsuccessful attempt between 1910 and 1913 to obtain a federal charter including tax exemption (a state charter was acquired instead from the State of New York in 1913).⁵

The Corporate Excise Act of 1909⁶ imposed a "special excise tax with respect to the carrying on or doing business" by "every corporation, joint stock company, or association, organized for profit and having a capital stock represented by shares," (amounting to one per cent of net income over \$5,000);⁷ but the statute exempted from tax, among other organizations,⁸

[A]ny corporation or association organized and operated exclusively for religious, charitable, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual.

Already in the 1909 Act the present phrase, "organized and operated exclusively," appears, and it is here that the "private inurement" language originated.⁹ The *Congressional Record*, containing the debates concerning this statute, shows that some senators believed that the nonprofit charities would not have been subject to the corporate excise tax anyway;¹⁰ but the view that a specific exemption was necessary prevailed.¹¹

The Revenue Act of 1913,¹² enacted after the ratification of the sixteenth amendment, contained an exemption provision for charitable organizations which followed the language of the 1909 exemption, except that it added "scientific" (after the word "charitable") as an exempt purpose.¹³ The sponsor of this addition felt that it required no elaborate justification.¹⁴

B. Walsh Commission Report

Hostility toward large private foundations was evidenced again in 1916 with the publication of the *Walsh Commission Report*.¹⁵ This commission,

4. *Id.* at 10-11.

5. *Id.* at 11-19.

6. Ch. 6, 36 Stat. 11.

7. *Id.* § 38.

8. *Id.*

9. *Id.* In the present provision, there is a minor variation of "net income," instead of "net earnings."

10. 44 CONG. REC. 4148-51 (1909); W. SMITH & C. CHIECHI, PRIVATE FOUNDATIONS BEFORE AND AFTER THE TAX REFORM ACT OF 1969, at 11 (1974).

11. 44 CONG. REC. 4151 (1909); W. SMITH & C. CHIECHI, *supra* note 10, at 11.

12. Ch. 16, 38 Stat. 114.

13. Ch. 16, § 11G(a), 38 Stat. 114.

14. 50 CONG. REC. 1305-06 (1913).

15. COMMISSION ON INDUSTRIAL RELATIONS, FINAL REPORT AND TESTIMONY ON INDUSTRIAL RELATIONS, S. DOC. NO. 415, 64th Cong., 1st Sess. (1916) [hereinafter cited as WALSH REPORT].

created by Congress in 1912,¹⁶ included in its mandated study of industrial relations an inquiry into the role of private foundations in the "Concentration of Wealth and Influence" felt by the Commission's majority to have reached dangerous proportions.¹⁷ According to the Commission's report:¹⁸

The domination by the men in whose hands the final control of a large part of American industry rests is not limited to their employees, but is being rapidly extended to control the education and "social service" of the Nation.

This control is being extended largely through the creation of enormous privately managed funds for indefinite purposes, hereinafter designated "foundations," by the endowment of colleges and universities, by the creation of funds for the pensioning of teachers, by contributions to private charities, as well as through controlling or influencing the public press.

The *Walsh Report* begrudged the foundations their exemption, but believed its elimination to be impracticable:¹⁹

The funds of these foundations are exempt from taxation, yet during the lives of the founders are subject to their dictation for any purpose other than commercial profit.

....

As regards the "foundations" created for unlimited general purposes and endowed with enormous resources, their ultimate possibilities are so grave a menace, not only as regards their own activities and influence but also the benumbing effect which they have on private citizens and public bodies, that if they could be clearly differentiated from other forms of voluntary altruistic effort it would be desirable to recommend their abolition. It is not possible, however, at this time to devise any clear-cut definition upon which they can be differentiated.

Instead, the report recommended that all incorporated nonprofit making organizations, chartered to be broad-functioned and having funds in excess of one million dollars, be required to obtain a federal charter, which would provide: (1) a "definite limitation" on the amount of allowable funds, (2) "definite and exact specifications" of the organization's "powers and functions," (3) "specific provision against the accumulation of funds by the compounding of unexpended income and against the expenditure in any one year of more than 10 per cent of the principal," (4) "rigid inspection" as to "investment and expenditure of funds," (5) "open reports" to government officials, and (6) provision against performing work not specifically authorized in the charter, without unanimous approval of its board and notification of Congress.²⁰ The *Walsh Report* also recommended that Congress make a thorough study of large foundations²¹ and recommended an increase in the federal gov-

16. Act of August 23, 1912, ch. 351, 37 Stat. 415.

17. WALSH REPORT 80-86.

18. WALSH REPORT 81.

19. WALSH REPORT 81, 85.

20. WALSH REPORT 85.

21. *Id.*

ernment's expenditures for education and social service as a means of "counteracting the influence of the foundations."²² However, these recommendations were not acted upon then. As described by Lankford,²³ hostility against foundations waned, as the attention of Congress and the foundations turned to the war; the Rockefeller Foundation dropped its controversial investigation into labor conditions²⁴ and Belgian relief received a large portion of its 1915 expenditures.²⁵

The basic charitable exemption provision gradually advanced toward its present state²⁶ with the passage of the Revenue Acts of 1918, 1921, and 1934. The Revenue Act of 1918 added to the exempt purposes "the prevention of cruelty to children or animals."²⁷ The Revenue Act of 1921 added "literary" to the exempt purposes and added categories of organizations eligible for the exemption "corporations, companies, or associations" in the Act of 1894,²⁸ "corporation or association" in the Corporate Excise Act of 1909²⁹ and in the Revenue Act of 1913,³⁰ and "corporations" only in the Revenue Act of 1918,³¹ so as to include, as in present section 501(c)(3), "[c]orporations, and any community chest, fund, or foundation."³²

C. Legislative Activities

The Revenue Act of 1934 added the requirement that "no substantial part of the activities" of the organization "be carrying on propaganda, or otherwise attempting, to influence legislation."³³ This new provision originated as an amendment, proposed in the Senate by Senator Harrison, which read: "and no substantial part of the activities of which is participation in partisan politics or is carrying on propaganda, or otherwise attempting to influence legislation."³⁴ The rationale of the amendment is not explained in the Senate report,³⁵ but its sponsor said to the Senate:³⁶

I may say to the Senate the attention of the Senate committee was called to the fact that there are certain organizations which are receiving contributions in order to influence legislation and carry on propaganda. The committee

22. WALSH REPORT 86.

23. J. LANKFORD, *supra* note 3, at 32.

24. *Id.* at 27.

25. *Id.* at 32.

26. INT. REV. CODE OF 1954, § 501(c)(3).

27. Ch. 18, § 231(6), 40 Stat. 1057.

28. Ch. 349, § 32, 28 Stat. 509.

29. Ch. 6, § 38, 36 Stat. 11.

30. Ch. 16, § 11G(a), 38 Stat. 114.

31. Ch. 18, § 231(b), 40 Stat. 1057.

32. Ch. 136, § 231(6), 42 Stat. 227.

33. Ch. 277, §§ 101(6), 23(o)(2), 48 Stat. 680.

34. H.R. REP. NO. 7835, 73d Cong., 2d Sess. (1934).

35. 21 THE TAX LAWYER 968 (1968).

36. 78 CONG. REC. 5959 (1934).

thought that there ought to be an amendment which would stop that, so that is why we have put this amendment in the bill . . .

The House accepted the amendment, after striking the phrase, "participating in partisan politics."³⁷ This action was explained in the House, "[w]e were afraid this prohibition was too broad, and we succeeded in getting the Senate conferees to eliminate organizations, a substantial part of the activities of which was participation in partisan politics."³⁸ It has been suggested that the primary focus of the proponents of the 1934 legislation was aimed at a particular organization (the National Economy League), was not well conceived, and showed no awareness of prior case law on the subject.³⁹

However, the concept of restricting legislative activities of charitable organizations had originated long before 1934; the Treasury had incorporated the principle, with particular reference to "controversial" and "partisan" activities with respect to "educational organizations," into its Regulations in 1919.⁴⁰ The Regulation stated: "But associations formed to disseminate controversial or partisan propaganda are not educational within the meaning of the statute."⁴¹

The Board of Tax Appeals had applied a restriction on the carrying on of controversial political activity by charitable organizations in cases during the 1920's.⁴² In *Slee v. Commissioner*,⁴³ the Court of Appeals for the Second Circuit had affirmed the decision of the Board of Tax Appeals holding that gifts made by a taxpayer to the American Birth Control League could not be deducted from income. On the one hand, Judge Learned Hand explained that the League was "organized for charitable purposes," in that it operated a non-profit clinic offering birth control advice to married women. However, the League's purposes were not, he thought, "exclusively charitable, educational, or scientific" in that its charter declared the purpose of effecting the repeal of anti-birth control statutes:⁴⁴

This raises the only question which seems to us important, which is, whether the League is also agitating for the repeal of laws preventing birth control. . . . Political agitation as such is outside the statute, however innocent the aim, though it adds nothing to dub it "propaganda," a polemical word used to decry the publicity of the other side. Controversies of that sort must

37. H.R. REP. NO. 1385 (Conferences Rep.), 73d Cong., 2d Sess. 17 (1934).

38. 78 CONG. REC. 7831 (1934).

39. Troyer, *Charities, Law-Making, and the Constitution: The Validity of the Restrictions on Influencing Legislation*, 31 N.Y.U. INSTITUTE ON FED. TAXATION 1415, 1421 (1973).

40. Clark, *The Limitation on Political Activities: A Discordant Note in the Law of Charities*, 46 VA. L. REV. 439, 446 (1960).

41. Treas. Reg. 45, art. 517, T.D. 2831, 21 TREAS. DEC. INT. REV. 285 (1920), quoted in Clark, *supra* note 40, at 446.

42. Clark, *supra* note 40, at 446. Clark cites Herbert E. Fales, 9 B.T.A. 828 (1927) and Sophie G. Coxe, 5 B.T.A. 261 (1926), *acquiescing* VI-1 CUM. BULL. 2 (1927).

43. 42 F.2d 184 (2d Cir. 1930).

44. 42 F.2d at 185.

be conducted without public subvention; the Treasury stands aside from them.

Nor, explained Hand, did the League's legislative activity fit within the protected category of work "to relieve itself of the restraints of law in order to better conduct its charity."⁴⁵

Nevertheless, there are many charitable, literary and scientific ventures that as an incident to their success require changes in the law. A charity may need a special charter allowing it to receive larger gifts than the general laws allow. It would be strained to say that for this reason it became less exclusively charitable, though much might have to be done to convince legislators. . . .

We cannot say that the Board was without warrant in concluding that this aspect of the League's work was not confined solely to relieving its hospital work from legal obstacles.

Alongside this restriction on legislative activity by a charitable organization, there had developed the principle that "lobbying" expenses were not deductible as "ordinary and necessary" business expenses.⁴⁶ This principle, established first by the Treasury, was later endorsed by the United States Supreme Court in *Textile Mills Security Corporation v. Commissioner*,⁴⁷ and again in the companion cases of *Cammarano v. United States* and *Strauss v. Commissioner*.⁴⁸

The congressional restriction on the legislative activities of charitable organizations, first appearing in the 1934 statute, received interpretation by the Court of Appeals of the Sixth Circuit in the case of *Seasongood v. Commissioner*.⁴⁹ The court of appeals held that the taxpayer's contribution to the Hamilton County Good Government League was deductible as a charitable contribution, rejecting the Tax Court's view that the League had overstepped the statute's "lobbying" limitation. First, the court's spokesman gave a narrow interpretation of the statutory terms "propaganda" and "attempting to influence legislation," to exclude the unselfish efforts of the League to promote good laws for better government:⁵⁰

It is my view that, as used in the statute, the term [propaganda] connotes public address with selfish or ulterior purpose and characterized by the coloring or distortion of facts. . . .

45. *Id.* The reasoning of *Slee* has been severely criticized; see Troyer, *supra* note 39, at 1423-25.

46. T.D. 2137, 17 TREAS. DEC. INT. REV. 48, 57-58 (1915).

47. 314 U.S. 326 (1941).

48. 358 U.S. 498 (1959).

49. 227 F.2d 907 (6th Cir. 1955).

50. 227 F.2d at 911, 912. See also *Dulles v. Johnson*, 273 F.2d 362 (2d Cir. 1959) which, in holding a local bar association to be a charitable organization, reasoned that efforts to promote good government and judicial reform legislation did not preclude exemption. Cf. *League of Women Voters v. United States*, 180 F. Supp. 379 (Ct. Cl. 1960). The Internal Revenue Service does not distinguish between "good" and "bad" legislation. For definition of "legislation," see EXEMPT ORGANIZATIONS HANDBOOK, INTERNAL REVENUE MANUAL 671-56, § 763 (1972).

So, here, the method of influencing legislation must be considered and there is nothing in the findings of fact that either challenges the validity, the good faith purpose, or any untoward result in the communications addressed by the League either to its members, public opinion generally, or to legislative or administrative officers. Nothing in the record indicates lobbying, influence peddling or illegal or unethical pressures upon legislators. Little is disclosed other than letters to the Governor and an appearance before a legislative committee.

The court's spokesman then said that even if "propaganda" were to be given a wider meaning, it was the court's conclusion that the League's "political" activities were not "substantial" since the testimony showed that less than five per cent of the time and effort of the League was devoted to legislative activity.⁵¹

A few years later, the Treasury's own interpretation of the statute appeared in the Regulations.⁵² The Regulations state that an organization is not "operated exclusively" for exempt purposes if it is an "action" organization.⁵³ The Regulations then define an "action" organization as an organization (1) which, as a substantial part of its activities, either "contacts, or urges the public to contact," legislators to support or oppose legislation or "advocates the adoption or rejection of legislation," (2) or which "participates or intervenes, directly or indirectly, in any political campaign on behalf of or in opposition to any candidate," (3) or whose "main or primary objective . . . may be attained only by legislation" and it "advocates or campaigns" therefore "as distinguished from engaging in nonpartisan analysis, study, or research and making the results thereof available to the public."⁵⁴ The Regulations also define "educational" as including: "The instruction of the public on subjects useful to the individual and beneficial to the community."⁵⁵ Moreover, the Regulations state that: "An organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion. . . ."⁵⁶

Later,⁵⁷ the Service interpreted the Regulations with commendable enlightenment to conclude that an exempt university was not engaged in prohibited legislative activity if, at the request of a legislative committee, a representative testified as an expert witness on pending legislation affecting the organization, since the university did not initiate the action and it was unlikely that Congress intended to deny itself access to the expert's testimony.

51. The IRS refuses to accept the reasoning of *Seasongood* as to how activities are to be measured and what amount is substantial. For definition of "substantial," see *id.* § 764.

52. Treas. Reg. § 1.501(c)(3)-1(c)(3) & § 1.501(c)(3)-1(d)(3) (1959).

53. Treas. Reg. § 1.501(c)(3)-1(c)(3)(i) (1959).

54. Treas. Reg. § 1.501(c)(3)-1(c)(3)(ii),(iii),(iv) (1959).

55. Treas. Reg. § 1.501(c)(3)-1(d)(3)(i)(b) (1959).

56. Treas. Reg. § 1.501(c)(3)-1(d)(3)(i) (1959).

57. 1970-2 CUM. BULL. 111.

Only three years after the United States Supreme Court handed down its *Cammarano* decision that lobbying expenditures were not deductible as business expenditures, Congress effectively limited that decision's future application by enacting in the Revenue Act of 1962⁵⁸ a new provision, Code section 162(e), allowing taxpayers to deduct business expenses for communicating directly with legislative bodies. (In the case of legislation "of direct interest to the taxpayer," expenditures incurred "in direct connection with" (1) "appearances before" or communications with legislative committees or legislators, or (2) "communication of information between the taxpayer and an organization of which he is a member" are deductible; however, deductions for amounts incurred "for participation in . . . any political campaign on behalf of any candidate" or "in connection with any attempt to influence the general public . . . with respect to legislative matters, elections, or referendums" are expressly denied.)

Thereafter, in 1968, the Committee on Exempt Organizations of the American Bar Association's Section of Taxation recommended, and the ABA later adopted this position, that the Internal Revenue Code:⁵⁹

[B]e amended to permit organizations which are exempt from taxation under section 501(c)(3) . . . to engage in direct legislative activity with respect to matters of direct interest without losing their tax exempt status and without loss of tax deductions for contributions made to such organizations.

The ABA proposal would extend the lobbying privilege to charitable organizations similar in scope to that allowed business organizations,⁶⁰ and so would continue to prohibit attempts to "influence the general public," or so-called grass-roots lobbying. "Legislation of direct interest" to the organization would include legislation directly affecting its exemption or the deduction of contributions to it, and also, in the case of "publicly-supported" organizations, legislation directly affecting its exempt purposes.⁶¹ Subsequent efforts of public charities to obtain remedial legislation in a compromise form have thus far failed.⁶²

D. Information Returns; Prohibited Transactions and Unreasonable Accumulations

The Revenue Act of 1943 first imposed the requirement of filing an annual information return on exempt charitable organizations; however, it excepted from this requirement religious organizations, educational organiza-

58. Pub. L. No. 87-834, § 3, 76 Stat. 960.

59. 21 TAX LAWYER 967 (1968).

60. INT. REV. CODE OF 1954, § 162(e).

61. 21 TAX LAWYER 868 (1968).

62. For summary of later developments on the congressional front, see Geske, *Direct Lobbying Activities of Public Charities*, 26 TAX LAWYER 305 (1973); 120 CONG. REC. 10,175-76 (daily ed. Oct. 8, 1974).

tions normally maintaining a regular faculty and student body, and also "publicly supported" charitable organizations.⁶³ The House Report explained that the new requirement stemmed from concern that certain exempt organizations were directly competing with taxpaying businesses and expressed desire to gather, from the new returns, sufficient information for remedial action.⁶⁴

The Revenue Act of 1950⁶⁵ imposed a series of further restrictions on the exemption of charitable organizations. The Act provided for the denial of exemption to charitable organizations engaging in certain "prohibited transactions" or "unreasonable accumulations of income"; once again, as with reference to the 1943 annual information return requirement, Congress excepted from these restrictions religious organizations, educational organizations with regular faculty and student body, "publicly-supported" charities, and here, additionally, certain medical organizations.

In the House version of the bill, five categories of self-dealing transactions between donors and their trusts or foundations were categorically prohibited: loans to the donors, payment of more than reasonable compensation, provision of services to the donor on a preferential basis, purchase of securities or other property from the donor, or sale of a substantial part of the organization's property to the donor.⁶⁶ The Senate Finance Committee, however, modified the House version to prohibit these categories of self-dealing transactions only when not carried on at "arm's length."⁶⁷ It explained: "Your committee is in sympathy with the goals sought by the above provisions of the House bill but believes they would be unduly harsh in their application."⁶⁸ Thus, in the final version,⁶⁹ loans to the donor were prohibited only if made "without adequate security and a reasonable rate of interest" and sales of property to or from the donor were subject to an "adequate consideration" test. The final version also included a general prohibition, added by the Senate committee, of transactions resulting in a "substantial diversion" of the organization's funds to the donor or related parties.

The House bill also would have imposed a tax, with certain exceptions, on "accumulated investment income," *i.e.*, "income not paid out on or before the 15th day of the third month following the close of the taxable year in which the income is received."⁷⁰ The House Ways and Means Committee explained its position thus:⁷¹

63. Revenue Act of 1943, ch. 63, § 117, 58 Stat. 21.

64. H.R. REP. NO. 871, 78th Cong., 1st Sess. 24-25 (1943).

65. Ch. 994, §§ 301-22, 64 Stat. 906.

66. H.R. REP. NO. 2319, 81st Cong., 2d Sess. 42 (1950).

67. S. REP. NO. 2375, 81st Cong., 2d Sess. 36-37 (1950).

68. *Id.* at 37.

69. INT. REV. CODE OF 1939, § 3813; INT. REV. CODE OF 1954, § 502 [INT. REV. CODE OF 1939 and INT. REV. CODE OF 1954 are hereinafter cited respectively as 1939 CODE and 1954 CODE].

70. H.R. REP. NO. 2319, *supra* note 66, at 40.

71. *Id.*

Your committee's studies have revealed that in a number of cases charitable, etc., organizations have obtained the concessions granted under existing law without distributing a substantial portion of their current income for exempt purposes. In some of these cases the time when charity can expect to benefit appears extremely remote. In the opinion of your committee the tax-exemption privileges with respect to investment income should be restricted to that portion of the income which those organizations demonstrate that they are using to fulfill their charitable, etc., purposes by actual distribution to charity as the income is received by them.

The Senate Finance Committee once again rejected the House proposal as being too harsh.⁷²

Your committee has rejected this accumulations tax and substituted for it the requirement that information disclosing the extent of accumulations must be made available to the public. Your committee does not question the contention that some organizations are abusing their tax-exempt privilege by undesirable accumulations of income. However, witnesses before, and statements presented to, your committee brought out quite clearly that the measure passed by the House was too inflexible and as a result would seriously injure many worth-while educational and charitable projects.

The information requirement, said the Senate Report, would accomplish the dual purpose of "encourage[ing] distributions" and of "reveal[ing] the extent of the accumulations problem."⁷³

The Senate provision requiring an expanded annual information return (to include gross income, expenses, disbursements for exempt purposes out of income and principal, prior aggregate accumulations, and balance sheet) was adopted.⁷⁴ In lieu of the House-proposed tax on investment accumulations the Conference Committee substituted (without any explanation) a new provision denying the exemption to certain categories of charities (the same ones covered by the "prohibited transactions" provision, *i.e.*, in general, private foundations) in the event that the charity's accumulations from the taxable year or prior years are (1) "unreasonable in amount or duration" in order to carry out its exempt purposes, or (2) "are used to a substantial degree" for non-exempt purposes, or (3) "are invested" so "as to jeopardize the carrying out" of its exempt purpose.⁷⁵

E. 1950-1969

The period beginning after the passage of the Revenue Act of 1950 and extending up to the passage of the Tax Reform Act of 1969 did not bring a great deal of change to the basic provisions in the tax statute affording tax

72. S. REP. NO. 2375, *supra* note 67, at 34.

73. *Id.* at 34-35.

74. 1939 CODE § 153(a) (now 1954 CODE § 6033(b)).

75. 1939 CODE § 3814 (reenacted as 1954 CODE § 504 until its repeal by the Tax Reform Act of 1969, Pub. L. No. 91-172, § 101(j)(15), 83 Stat. 487).

exemption to charitable organizations. The Internal Revenue Code of 1954⁷⁶ did add "testing for public safety" to the exempt purposes listed in section 501(c)(3); this addition originated in the Senate Finance Committee.⁷⁷

An amendment introduced by then Senator Lyndon Johnson on the Senate floor added to the exemption provision the requirement that a charitable organization not engage in political activity; that is, not "participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office."⁷⁸ The reason for this addition was not explained.⁷⁹

The period between the passage of the Revenue Act of 1950 and the Tax Reform Act of 1969 did, however, bring a series of governmental investigations of one particular class of charitable organizations, namely private foundations.⁸⁰

F. Cox Committee

The Select Committee to Investigate Foundations and other Organizations, known as the Cox Committee, was created by a House resolution in 1952 and:⁸¹

[D]irected to conduct a full and complete investigation and study of educational and philanthropic foundations and other comparable organizations which are exempt from Federal income taxation to determine which such foundations and organizations are using their resources for purposes other than the purposes for which they were established, and especially to determine which such foundations . . . are using their resources for un-American and subversive activities or for purposes not in the interest or tradition of the United States. . . .

On the central issue of whether foundations had been "infiltrated by communists" or had disbursed funds to "subversive individuals and organizations," the Cox Committee Report concluded:⁸²

The foundations, for the most part, have made no secret of their mistakes, and have stated frankly that in recent years they have recognized the increasing need to be constantly alert to avoid giving unintended aid to subversives.

The Committee believes that on balance the record of the foundations is good. It believes that there was infiltration and that judgments were made which, in the light of hindsight, were mistakes, but it also believes that many of these mistakes were made without the knowledge of facts which, while later

76. Ch. 736, 68A Stat. 1.

77. S. REP. NO. 1622, 83d Cong., 2d Sess. 67 (1954).

78. 1954 CODE § 501(c)(3); Clark, *supra* note 40, at 445 n. 29.

79. 100 CONG. REC. 9604 (1954); Clark, *supra* note 40, at 445 n. 29.

80. For a discussion of these investigations, see M. FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT 358-80 (1965).

81. H.R. RES. 561, 82d Cong., 2d Sess., 98 CONG. REC. 3489 (1952).

82. SELECT COMM. TO INVESTIGATE FOUNDATIONS, FINAL REPORT, H.R. REP. NO. 2514, 82d Cong., 2d Sess. 8 (1953).

obtainable, could not have been readily ascertained at the time decisions were taken.

The Cox Committee declined to consider the issues of the use of foundations for family control of corporations and as devices for "tax avoidance and tax evasion," but did consider these issues "of sufficient importance to warrant inquiry by the Ways and Means Committee."⁸³ The Cox Committee's report did, however, recommend that "[p]ublic accounting . . . be required of all foundations," and included a proposed amendment of the tax statute, adding to the items required on the annual information return.⁸⁴

G. Reece Committee

In July of 1953, the House created another committee, the Special Committee to Investigate Tax-Exempt Foundations and Comparable Organizations, known as the Reece Committee, to conduct a study of foundations; this committee was directed to focus once again on whether foundations were using funds for "subversive activities" and also to focus on the use of funds for "political purposes; propaganda, or attempts to influence legislation."⁸⁵

In the "Summary of Committee Findings" the majority of the Reece Committee painted a picture of a tremendously powerful "interlock" of foundations, exerting their influence in dangerous ways.⁸⁶

[T]here is such a concentration of foundation power in the United States, operating in the social sciences and education. It consists basically of a group of major foundations, representing a gigantic aggregate of capital and income. . . .

. . . .
A professional class of administrators of foundations funds has emerged. . . . It has already come to exercise a very extensive, practical control over most research in the social sciences, much of our educational process, and a good part of government administration in these and related fields. . . .

. . . .
Associated with the excessive support of the empirical method, the concentration of power has tended to support the dangerous "cultural lag" theory and to promote "moral relativity", to the detriment of our basic moral, religious, and governmental principles.

. . . .
[T]he concentration has shown a distinct tendency to favor political opinions to the left. These foundations and their intermediaries engage extensively in political activity, not in the form of direct support of political candidates or political parties, but in the conscious promotion of carefully calculated political concepts

83. *Id.* at 13.

84. *Id.* at 13-15.

85. H.R. RES. 217, 83d Cong., 1st Sess., 99 CONG. REC. 10015 (1953).

86. SPECIAL COMM. TO INVESTIGATE TAX-EXEMPT FOUNDATIONS, REPORT ON TAX-EXEMPT FOUNDATIONS, H.R. REP. NO. 2681, 83d Cong., 2d Sess. 17-19 (1954).

With several tragically outstanding exceptions . . . foundations have not directly supported organizations which, in turn, operated to support Communism. However, some of the larger foundations have directly supported "subversion" in the true meaning of that term, namely, the process of undermining some of our vitally protected concepts and principles.

At the conclusion of its report, which elaborated on this description of foundations placed in the summary of findings, the majority made several recommendations:⁸⁷ (1) IRS's manpower be increased to "more closely watch foundation activity,"⁸⁸ (2) foundations be limited to an existence of ten to twenty-five years,⁸⁹ (3) the "accumulations" rules be changed to require that foundations distribute all of each year's income, including capital gains, within two or three years,⁹⁰ (4) restrictions be placed on "corporation-created foundations,"⁹¹ (5) the Ways and Means Committee "consider the advisability of denying tax exemption to any foundation which holds more than five or ten per cent of its capital in the securities of one enterprise,"⁹² (6) the wording of the tax statute be changed to provide for "the complete exclusion of political activity, leaving it to the courts to apply the maxim of *de minimis non curat lex*,"⁹³ and (7) the area of lobbying by foundations be investigated.⁹⁴

In the 1960's two further governmental studies of private foundations were made: one by Congressman Wright Patman, as Chairman of the Select Committee on Small Business of the House of Representatives, and another by the Treasury.

H. Patman Committee

After carrying out a "preliminary survey" with requests for information sent to over 500 foundations, Congressman Patman submitted to his Committee an Interim Report in 1962.⁹⁵ The Report began by stating that "[t]here is a pressing need for an immediate moratorium on the granting of tax exemptions to foundations."⁹⁶ The reasons cited in support were (1) the "laxness" of the IRS, (2) "violations of law and Treasury Regulations by far too many" of the foundations surveyed, (3) loss of enormous amounts of tax revenue, (4) the "rapidly increasing concentration of economic power in foun-

87. *Id.* at 212-22.

88. *Id.* at 213-14.

89. *Id.* at 214.

90. *Id.* at 214-15.

91. *Id.* at 215.

92. *Id.* at 217.

93. *Id.* at 219.

94. *Id.* at 220.

95. M. FREMONT-SMITH, *supra* note 80, at 365.

96. SELECT COMM. ON SMALL BUSINESS, 87TH CONG., 2D SESS., CHAIRMAN'S REPORT, TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY I (Comm. Print 1962).

dations,” and (5) the competitive threat to small business posed by “foundation-controlled enterprises.”⁹⁷ The report closed with a series of seventeen recommendations,⁹⁸ including: a twenty-five year limit on a foundation’s life; a prohibition on foundations’ “engaging in business directly or indirectly,” owning more than three per cent of a corporation’s stock, or voting stock, or engaging in commercial money lending or borrowing; the taxing as “unrelated business income” of profits “from trading or speculating in securities, as distinguished from passive investment”; and the inclusion of contributions, of capital gains and of “amounts unreasonably accumulated in corporations controlled by a foundation” in computing the foundation’s accumulation of income. Congressman Patman also made suggestions in the area of the deduction for charitable contributions; he proposed that a taxpayer not be allowed to deduct contributions to a foundation he controls until the “foundation actually uses the money for charity,” and that contributions of property be valued at the lower of cost or value. In the area of tax administration, Patman proposed closer review of applications for exemption, greater disclosure on foundations’ tax returns including business activities, political activities, and advertising, and revocation of exemption for insufficient reporting.

In 1963, Congressman Patman issued the second installment of his report, which related to the business dealings of various foundations controlled by industrialist David G. Baird,⁹⁹ and in 1964 he issued a third installment relating to the estate of Alfred Dupont and its affiliate, the Nemours Foundation.¹⁰⁰

I. Treasury Report on Private Foundations

Upon the request in 1964 of the Senate Finance Committee and the House Ways and Means Committee, the Treasury Department undertook a study of private foundations, surveying approximately 1,300 foundations, before submitting its report in 1965.¹⁰¹ Early in the report, the Treasury stated its conclusion that “prompt and effective action to end the specific abuses extant among foundations is preferable to a general limitation upon foundation lives.”¹⁰² The body of the report was devoted primarily to six major problems. In the first area, self-dealing, Treasury suggested that the “arms-length” standard of the 1950 Revenue Act was ineffective to prevent abuses and recommended “legislative rules patterned on the total prohibitions of the 1950

97. *Id.*

98. *Id.* at 133-35.

99. M. FREMONT-SMITH, *supra* note 80, at 370.

100. *Id.* at 370-71.

101. *Id.* at 374-75.

102. SENATE COMM. ON FINANCE, 89TH CONG., 1ST SESS., TREASURY DEP’T REPORT ON PRIVATE FOUNDATIONS 5 (Comm. Print 1965).

House bill.”¹⁰³ Treasury also asserted that the “indefinite” standards of the “accumulation of income” provisions of the 1950 Revenue Act had been ineffective to deal with the problem of delay in benefits to charity; it recommended instead that private foundations be required to expend an amount “equal either to actual foundation net income or to a fixed percentage of foundation asset value, whichever is greater” for “active charitable operations . . . on a reasonably current basis.”¹⁰⁴ Treasury further recommended that, after a reasonable transition period, no foundation be permitted to own “either directly or through stock holdings, 20 percent or more of a business unrelated to . . . [its] charitable activities.”¹⁰⁵ In the area of “family use of foundations to control corporate and other property,” Treasury recommended that:¹⁰⁶

[W]here the donor and related parties maintain control of a business or other property after the contribution of an interest in it to a private foundation, no income tax deduction would be permitted for the gift until (a) the foundation disposes of the contributed asset, (b) the foundation devotes the property to active charitable operations, or (c) donor control over the business or property terminates.

As to the problem of “financial transactions unrelated to charitable functions,” Treasury’s recommendations included a prohibition on all borrowing by foundations for investment purposes, a prohibition on foundations’ engaging in “trading activities and speculative practices,” and a limitation of foundation loans to types “clearly necessary, safe, and appropriate for charitable fiduciaries.”¹⁰⁷ In the sixth problem area, “broadening of foundation management,” the Treasury proposed that donors and related parties not be allowed to constitute over 25 per cent of the foundation’s governing body after the first twenty-five years of the foundation’s existence.¹⁰⁸

J. Definition of “Charitable”

The term “charitable” used by Congress in the federal income tax exemption provisions (including present section 501(c)(3)) has never been given any statutory definition by Congress. In Regulations 111, the following brief elaboration appeared:¹⁰⁹

Corporations organized and operated exclusively for charitable purposes comprise, in general, organizations for the relief of the poor. The fact that a

103. *Id.* at 6.

104. *Id.* at 6-7.

105. *Id.* at 7.

106. *Id.* at 8.

107. *Id.* at 9.

108. *Id.* at 9.

109. Treas. Reg. 111, § 29.101(6)-(1) (1943). This passage remained unchanged when § 29.101(6)-(1) was amended by T.D. 5924, 1952-2 CUM. BULL. 181 & T.D. 5928, 1952-2 CUM. BULL. 100.

corporation established for the relief of indigent persons may receive voluntary contributions from the persons intended to be relieved will not necessarily deprive it of exemption.

Thus the Treasury at this point defined charity in the narrow, popular sense of aid to the poor and suffering.

In a 1958 article entitled "What is a Charitable Organization," Herman T. Reiling, then Assistant Chief Counsel of the IRS, argued that Congress had used the term in the statute "in its generally accepted legal sense," which was "broad and comprehensive."¹¹⁰ Reiling cautioned against restricting "charitable" to its popular meaning of aid to the poor and suffering, thus omitting from consideration public works, such as public recreational facilities.¹¹¹

The following year, the Treasury published Regulation section 1.501(c)(3)-1,¹¹² which included a definition of "charitable." Following the view advocated by Reiling, the new Regulation stated that "charitable" was meant by Congress in its "generally accepted legal sense." After noting that the term was not intended to be limited by the listing of the other descriptive terms ("religious," "literary," "educational," and "scientific,") in section 501(c)(3), nor by the definitions of charity in the case-law, the Regulation listed the various aspects of charity traditionally considered part of its legal meaning and then modernized the definition by adding its own new category. The Regulation reads:¹¹³

Charitable defined.—The term "charitable" is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of "charity" as developed by judicial decisions. Such term includes: Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

Like Reiling, the Treasury considered it to be a requirement of exemption that an organization "serve[s] a public rather than a private interest."¹¹⁴

Experience to date demonstrates that the definition of "charity" in the current Treasury Regulations is proving broad enough to accommodate developments of the term to satisfy changing needs of our society. Three examples will show how well this expanded definition has worked in practice, namely, with "hospitals," "private schools," and "public interest law firms."

110. Reiling, *What is a Charitable Organization*, 44 A.B.A.J. 525, 526-27 (1958).

111. *Id.* at 528.

112. 1959-2 CUM. BULL. 139.

113. Treas. Reg. § 1.501(c)(3)-1(d)(2) (1959).

114. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (1959).

(The question of whether, or under what circumstances, a hospital can qualify as a "charitable" organization is discussed in another article in this volume.)

The issue of eligibility of segregated private schools for exemption provided a tough test for the broad definition of charity in the 1959 Regulation. After suspending action on exemption applications filed by apparently segregated private schools since October 15, 1965, the Service announced on August 2, 1967 that a school's racially discriminatory policy would be a basis for denying exemption only where "State action for constitutional purposes" was found.¹¹⁵

This IRS policy was challenged in a class action, in which plaintiffs, black parents of students attending Mississippi public schools, sought to enjoin the Service from according tax-exempt status and deductibility of contributions to Mississippi private schools practicing discrimination against black students. About six months after the granting of a preliminary injunction on January 12, 1970,¹¹⁶ the IRS announced in two July news releases¹¹⁷ that it could "no longer legally justify allowing tax-exempt status" or eligibility to receive tax-deductible contributions "to private schools which practice racial discrimination."¹¹⁸

The rationale for the Service's new position is more fully explained in Revenue Ruling 71-447,¹¹⁹ which stated that a school seeking to qualify as an "educational" organization must be a "common law" charity;¹²⁰ that according to common law concepts a charitable trust, educational or otherwise, must not have a purpose which is illegal or contrary to public policy; and that due to the federal public policy against racial discrimination in education, private segregated schools cannot meet this common-law test, under section 501(c)(3).

On June 30, 1971, the district court granted plaintiffs declaratory relief¹²¹ (a declaration that only private schools with a "racially non-discriminatory policy as to students" could qualify under sections 501(c)(3) and 170(a)-(c)), and a permanent injunction enjoining the Commissioner from approving applications for tax-exempt status or for deductibility of contributions as to Mississippi private schools, unless the schools had made a showing of a racially nondiscriminatory policy, under certain specified procedures, stricter than those required by the Service in its July news releases.¹²²

115. 7 CCH 1967 STAND. FED. TAX REP. ¶ 6734.

116. *Green v. Kennedy*, 309 F. Supp. 1127 (D.D.C. 1970).

117. IRS News Releases (July 10, 1970), No. 1052 (July 19, 1970), 7 CCH 1970 STAND. FED. TAX REP. ¶¶ 6790, 6814.

118. IRS News Release (July 10, 1970), 7 CCH 1970 STAND. FED. TAX REP. ¶ 6790.

119. 1971-2 CUM. BULL. 230.

120. See also testimony of Randolph W. Thrower, Commissioner of Internal Revenue, in *Hearings on S. Res. 359 Before the Senate Select Comm. on Equal Educational Opportunity*, 91st Cong., 2d Sess. 1995 (1970).

121. *Green v. Connally*, 330 F. Supp. 1150 (D.D.C. 1971).

122. The IRS thereafter published Rev. Proc. 72-54, 1972-2 CUM. BULL. 834, providing pri-

In supporting its interpretation of the Code, the court first stated that there was "at least a grave doubt whether an educational organization that practices racial discrimination can qualify as a charitable trust under general trust law." It noted that charitable trusts must satisfy society's changing conception of "benefit to the community," and it also noted the increasing tendency of courts to view racial restrictions in charitable trusts as "against public policy."¹²³ The court, however, chose not to apply a "common law approach"¹²⁴ in interpreting the Code, but instead based its interpretation on the "Federal public policy against support for racial segregation of schools."¹²⁵

Another interesting area of controversy over the definition of "charitable" involved eligibility of a "public interest law firm" for tax exemption and receipt of charitable contributions. The controversy was set in motion on October 9, 1970 when the Service announced in a news release that it had "temporarily suspended" the issuance of tax-exemption rulings to "public interest law firms," pending a "study" of the issue.¹²⁶ The Service cited as a problem the "lack of standards or controls" applicable to a litigant's claim to be "acting in the public interest." This news release precipitated a stream of protest in the newspapers, and within a few days, on October 14, 1970, the members of the Senate Subcommittee on Employment, Manpower, and Poverty sent a letter to Commissioner Randolph W. Thrower objecting to the IRS action.¹²⁷

The Commissioner soon responded to such criticism by the publication on November 12, 1970 of guidelines under which the Service would issue advance rulings to public interest law firms (pending amendment of the Regulation defining "charitable" to "clarify the treatment" of such firms).¹²⁸ The news release explained that special guidelines for public interest law firms were necessary because there was no "clear set of precedents" recognizing as charitable the legal representation of the "interests of a majority of the public, as distinguished from legal representation for a disadvantaged minority, such as the poor, the victims of racial discrimination, or those denied human and civil rights either in criminal or civil matters." (These latter categories all appear in the 1959 Regulation's definition of "charitable.")

vate schools with guidelines for "adequately" publicizing their racially nondiscriminatory policies. On February 18, 1975, the IRS published in the *Federal Register* (40 Fed. Reg. 6991) a proposed Revenue Procedure intended to establish "more specific guidelines" and also recordkeeping requirements for determining whether private schools have racially nondiscriminatory policies. 40 Fed. Reg. at 6992; 9 CCH 1970 STAND. FED. TAX REP. ¶ 6398. Announcement 75-20, 1975 INT. REV. BULL. No. 10, at 62, invited comments on the proposed Procedure. The Procedure, somewhat modified, was issued in final form as Rev. Proc. 75-50, 1975 INT. REV. BULL. No. 49, at 46.

123. 330 F. Supp. at 1159-60.

124. 330 F. Supp. at 1161.

125. *Id.*

126. IRS News Release No. 1069 (Oct. 9, 1970), 7 CCH 1970 STAND. FED. TAX REP. ¶ 6937E.

127. Garrett, *Federal Tax Limitations on Political Activities of Public Interest and Educational Organizations*, 59 GEO. L.J. 561, 575-76 (1971).

128. IRS News Release No. 1078 (Nov. 12, 1970), 7 CCH 1970 STAND. FED. TAX REP. ¶ 6943G; Rev. Proc. 39, 1971-2 CUM. BULL. 575.

Guideline number one contained the central requirement of litigation serving "a broad public interest":¹²⁹

The engagement of the organization in litigation can reasonably be said to be in representation of a broad public interest rather than a private interest. The litigation is designed to present a position on behalf of the public at large on matters of public interest. Typical of such litigation may be class actions in the public interest, suits for injunction against action by government or private interests broadly affecting the public, similar representation before administrative boards and agencies, test suits where the private interest is small, and the like.

In furtherance of this first requirement, the Guidelines called for an explanation of how the firm's cases "would benefit the public generally" to be included in the firm's annual information return, and also required that the firm's policy and program decisions be the "responsibility" of a board "representative of the public interest." The Guidelines left the public interest law firms in uncertainty as to permissible fees, stating only that the firms must not accept fees "except in accordance with procedures approved by I.R.S."

The recent slackening off of foundation grants to public interest law firms has increased the urgency of the "fee" issue for such firms.¹³⁰ While refusing to permit the charging or acceptance of fees from clients,¹³¹ the IRS has recently ruled that public interest firms may accept attorneys' fees, from opposing parties, awarded by a court or administrative agency or provided in a settlement agreement approved by such a tribunal. Such fees may, however, defray no more than 50 per cent of the firm's total costs of legal functions, calculated over a five-year period.¹³² Meanwhile legislation under which judges could award legal fees to successful "public interest" plaintiffs from general Treasury funds has been sponsored in the Senate by California Democrat John V. Tunney.¹³³

II

HISTORY OF CHARITABLE DEDUCTION

A. Early History

The first provision in the income tax law for a deduction by individuals of contributions to charitable organizations appeared in the War Revenue Act of

129. *Id.*

130. Kuttner, *I.R.S. Has Liberalized Rules on Public Interest Law Fees*, Washington Post, December 26, 1974, at C-13.

131. Rev. Rul. 75-75, 1975 INT. REV. BULL. No. 10, at 9; see Kuttner, *supra* note 130.

132. Rev. Rul. 75-76, 1975 INT. REV. BULL. No. 10, at 9; Rev. Proc. 75-13, 1975 INT. REV. BULL. No. 10, at 46; 28 TAX LAWYER 410-11 (1975); see Kuttner, *supra* note 130. In its most recent ruling regarding fees, the IRS held that a public interest law firm may not retain a private attorney under an arrangement that if a court awards attorneys' fees the organization will be reimbursed for the amount it paid to the private attorney and the private attorney will keep any excess. Rev. Rul. 76-5, 1976 INT. REV. BULL. No. 1, at 12.

133. See Kuttner, *supra* note 130.

1917.¹³⁴ This new provision read as follows:¹³⁵

Contributions or gifts actually made within the year to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals, no part of the net income of which inures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayer's taxable net income as computed without the benefit of this subparagraph. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury.

Such a deduction was touted by its supporters as necessary for the preservation of charitable institutions in wartime.¹³⁶ Indeed, an attempt to include such a deduction in the Revenue Act of 1913 had been unsuccessful.¹³⁷

It is interesting to note that from the beginning the charitable deduction has been a self contained provision rather than being tied-in by cross reference to the charitable exemption provision. Thus, these provisions have never been necessarily coextensive. For example, an organization organized and operated exclusively for "testing for public safety" qualifies for charitable exemption;¹³⁸ however, it is not eligible to receive deductible charitable contributions.¹³⁹

The Revenue Act of 1918¹⁴⁰ brought a couple of changes to the charitable deduction provision. First, the phrase "contributions or gifts actually made within the year" was modified to read "contributions or gifts made within the taxable year." Also added was a special restriction on contributions by nonresident aliens limiting the deduction to gifts to "*domestic* corporations."¹⁴¹ The Revenue Act of 1918 also enacted for the first time an estate tax deduction for bequests to charitable organizations.¹⁴²

The Revenue Act of 1921¹⁴³ modified both the charitable deduction and the charitable exemption provisions to include "literary" among the charitable purposes and to expand the categories of organizations eligible for exemption and for deductible contributions to include, as well as corporations, any

134. Ch. 63, § 1201(2), 40 Stat. 300.

135. Act of 1917, ch. 63, Title XII, § 1201(2), 40 Stat. 300.

136. J. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF THE FEDERAL INCOME TAX LAWS 1938-1861, at 944-45 (1938); 55 CONG. REC. 6728-29 (1971). Senator Hollis, the amendment's sponsor, explained that the heavy war taxes would absorb the surplus funds of the wealthy, which were ordinarily contributed to charities. In addition, many colleges would be losing their students to the military. 55 CONG. REC. 6728 (1971).

137. J. SEIDMAN, *supra* note 136, at 945.

138. 1954 CODE § 501(c)(3).

139. 1954 CODE § 170(c).

140. Ch. 18, 40 Stat. 1057.

141. Ch. 18, § 214(a)(11), 40 Stat. 1057 (emphasis added).

142. Ch. 18, § 403(a)(3), 40 Stat. 1057.

143. Ch. 136, 42 Stat. 227.

"community chest, fund, or foundation."¹⁴⁴ Also modified was the special restriction on deductions by nonresident aliens to allow only gifts "made to domestic corporations, or to community chests, funds, or foundations, created in the United States."

In the Revenue Act of 1924, Senate amendments accounted for two changes in the charitable deduction provision.¹⁴⁵ The category of eligible charitable organizations was expanded to include a "trust." And the so-called "unlimited deduction" was enacted to remedy the plight of an heiress-nun, who had taken a vow of poverty.¹⁴⁶ This new exception to the 15 per cent limitation on charitable deductions was allowed a taxpayer whose charitable contributions in the taxable year and in *each* of the *ten* preceding years exceeded 90 per cent of net income for that year.¹⁴⁷ The Senate Report states that the "provision is designed substantially to free from income taxation one who is habitually contributing to benevolent organizations amounts equalling virtually his entire income."¹⁴⁸

The first federal gift tax, also enacted in the Revenue Act of 1924, provided a deduction for charitable contributions.¹⁴⁹ In 1926 the gift tax was repealed, but when reenacted in the Revenue Act of 1932,¹⁵⁰ it continued a deduction for charitable gifts. In 1928 the "unlimited deduction" was modified to include not only charitable contributions, but also the "amount of income, war-profits, or excess-profits taxes paid during such year," in the "90% of net income" measurement.¹⁵¹

The Revenue Act of 1934¹⁵² imposed the so-called "lobbying restriction" upon charitable organizations, as a condition of eligibility to receive deductible contributions and as a condition of the exemption. (See Part I for further history of this provision.)

B. Deduction for Corporations

Corporations first obtained the privilege of taking deductions for charitable contributions in the Revenue Act of 1935.¹⁵³ The deduction of corporations was limited (then as now) to five per cent of the corporation's income.

144. Ch. 136, §§ 214(a)(11), 231(6), 42 Stat. 227.

145. H.R. REP. NO. 844 (Conference Comm.), 68th Cong., 1st Sess. 18 (1924).

146. Revenue Act of 1924, ch. 234, § 214(a)(10), 43 Stat. 253; Baker, *The Tax Treatment of Charitable Contribution Deductions Under the Tax Reform Act of 1969*, TWENTIETH ANNUAL TULANE TAX INSTITUTE 327, 330 (1971).

147. Ch. 234, § 214(a)(10), 43 Stat. 253.

148. S. REP. NO. 398, 68th Cong., 1st Sess. 24 (1924).

149. Ch. 234, § 321(a)(2), 43 Stat. 243.

150. Ch. 209, 47 Stat. 169.

151. Revenue Act of 1928, ch. 852, § 120, 45 Stat. 791.

152. Ch. 277, §§ 23(o)(2), 101(6), 48 Stat. 680.

153. Ch. 829, 49 Stat. 1014.

The deduction was only allowed for contributions to a “domestic corporation, or domestic trust, or domestic community chest, fund, or foundation,” and there was the following parenthetical further limitation: “(but in the case of contributions or gifts to a trust, chest, fund, or foundation, only if such contributions or gifts are to be used within the United States exclusively for such purposes).”¹⁵⁴

The House Ways and Means Committee apparently had rejected a provision for such a deduction. The minority report complained of this omission in that time of depression.¹⁵⁵

We deem it a mistake not to have provided an exemption from the corporation income tax on gifts made by corporations to community chests and other charities. It is the announced policy of the administration to throw the burden of caring for unemployables back on the States and local communities. When this occurs there are two ways they can be provided for. One is by direct taxation on the people of the local communities through taxation of homes, farms, and other real estate; the other is through private charity. If corporations are public spirited enough to make contributions to charities, we believe their contributions for such purposes should be exempt from taxation exactly as is done in the case of individuals.

The bill apparently left the House with such a provision. The Senate accepted this new deduction privilege and added “or the prevention of cruelty to children” to the allowable purposes of the eligible organizations; and the House agreed to this addition.¹⁵⁶

C. “Foreign-Charity” Restriction

In the Revenue Act of 1938,¹⁵⁷ Congress restricted the charitable deduction of individuals to include only contributions to “domestic” organizations, thus bringing the individual deduction further (though not entirely) into line with the corporate deduction, in this regard. The House Report explained this new limited restriction as follows:¹⁵⁸

The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare. The United States derives no such benefit from gifts to foreign institutions, and the proposed limitation is consistent with the above theory. If the recipient, however, is a domestic organization the fact that some portion of its funds is used in other

154. Revenue Act of 1935, ch. 829, § 102(c), 49 Stat. 1014. This restriction does not apply in case the charity is a corporation; *see* Rev. Rul. 80, 1969-1 CUM. BULL. 65. This is certainly a trap for the unwary.

155. H.R. REP. NO. 1681, 74th Cong., 1st Sess. 20 (1935).

156. S. REP. NO. 1240, 74th Cong., 1st Sess. 6-7 (1935); H.R. REP. NO. 1885 (Conference Comm.), 74th Cong., 1st Sess. 6-7 (1935).

157. Revenue Act of 1938, ch. 289, 52 Stat. 447.

158. H.R. REP. NO. 1860, 75th Cong., 3d Sess. 19-20 (1938).

countries for charitable and other purposes (such as missionary and educational purposes) will not affect the deductibility of the gift.

The 1938 Act also provided a clearer timing rule for the charitable deduction by changing the old language, "contributions or gifts made within the taxable year," to the phrase "contributions or gifts payment of which is made within the taxable year."¹⁵⁹ The House Report explains that confusion had arisen, especially as to the time when an accrual basis taxpayer could deduct an as-yet-unpaid charitable pledge, and that this confusion was "aggravated" by the uncertain and diverse state law as to the liability of a subscriber to a charitable fund.¹⁶⁰

In addition, the House version of the 1938 Act proposed that, in the case of a contribution made in property other than money, the allowable deduction should be equal only to the adjusted basis of the property in the taxpayer's hands, or to its fair market value, whichever was *lower*. (Under the administrative rule then in force, the donor could deduct the property's value at the time of the gift.)¹⁶¹ The House Report explained the reason for this proposal as follows: "There is no justification in principle for the allowance of a deduction for the amount of unrealized appreciation which has never been included in taxable income"¹⁶² This House provision, however, was rejected by the Senate. The Senate Report explained that the bill's potential chilling effect on contributions of appreciated property was feared:¹⁶³

Representations were made to the committee by officials of educational and charitable institutions that the effect of such a provision would be to discourage the making of charitable gifts in kind. The committee believes that charitable gifts generally ought to be encouraged and so has eliminated this provision of the House bill.

In the Revenue Act of 1939,¹⁶⁴ the organizations eligible to receive deductible contributions from individuals or corporations was expanded from "domestic" organizations to include organizations "created or organized in, or under the laws of, any *possession* of the United States."¹⁶⁵ The phraseology of the provisions was also modified, so that under section 23(o)(2), the provision for charitable deductions by individuals now read:¹⁶⁶

A corporation, trust, or community chest, fund or foundation, created or organized in the United States or in any possession thereof, or under the law

159. Ch. 289, § 23(o), 52 Stat. 447.

160. H.R. REP. NO. 1860, 75th Cong., 3d Sess. 19 (1938).

161. Treas. Reg. 111, § 29.23(o)-(1), I.T. 3910, 1948-1 CUM. BULL. 15; Treas. Reg. 118, § 39.23(o)-1, Rev. Rul. 138, 1955-1 CUM. BULL. 223.

162. H.R. REP. NO. 1860, 75th Cong., 3d Sess. 19-20 (1938).

163. S. REP. NO. 1567, 75th Cong., 3d Sess. 14 (1938).

164. Ch. 247, § 224(a) (modifying 1939 CODE § 23(o)(2)) and § 224(b) (modifying 1939 CODE § 23(q)), 53 Stat. 862.

165. S. REP. NO. 648, 76th Cong., 1st Sess. 8 (1939) (emphasis added).

166. Ch. 247, § 224(a), 53 Stat. 862 (now 1954 CODE § 170(c)(2)(A)).

of the United States or of any State or territory or of any possession of the United States

(The deduction for corporations also was modified by allowing contributions "used within the United States or any of its possessions.")¹⁶⁷

Two revenue rulings issued by the IRS in the 1960's provided guidelines for determining the deductibility of contributions to a domestic organization which then transmits the funds to a foreign charity. The Service noted that the foreign-charity restriction would be undermined if contributions "inevitably committed to go to a foreign organization were held to be deductible solely because . . . they came to rest momentarily in a . . . domestic organization."¹⁶⁸ And it warned that a domestic organization receiving contributions would be deemed "only nominally the donee"¹⁶⁹ in cases where it transmitted the funds to a foreign charity either (1) as the creature of the foreign charity, (2) by requirement of its charter, or (3) merely by agreement, if it represented, during its solicitations, that the contributions would go to the foreign charity. Amplification of the earlier ruling, however, stated that the mere solicitation by a domestic organization of funds for specific projects of a foreign charity would not preclude the deductibility of contributions, so long as the domestic organization's charter required that such solicitation be (1) preceded by board approval of the planned project grants and (2) conditioned on the domestic charity's retention of control as to use of the funds, including the right to cancel the project grants.¹⁷⁰

In contrast to the income tax provision, the charitable deduction provision of the estate tax statute applicable to estates of citizens or residents¹⁷¹ contains no comparable language disallowing contributions to foreign charities or for foreign use. The Treasury Regulation explicitly states that the deduction is "not limited . . . to transfers to domestic corporations or associations, or to trustees for use within the United States."¹⁷² Moreover, the IRS has ruled, very recently, that a charitable bequest to a foreign government or political subdivision is deductible under section 2055 so long as its use is limited to exclusively charitable purposes within the meaning of sections 2055(a)(2) and 2055(a)(3).¹⁷³

Similarly, the gift tax statute places no "foreign-charity" or "foreign-use" restriction on its charitable deduction, in the case of gifts by citizens or

167. Ch. 247, § 224(b), 53 Stat. 862 (now § contained in last sentence of 1954 CODE § 170(c)(2)) (emphasis added).

168. Rev. Rul. 252, 1963-2 CUM. BULL. 101, 104.

169. *Id.*

170. Rev. Rul. 79, 1966-1 CUM. BULL. 48. *See* Rev. Rul. 75-65, 1975 INT. REV. BULL. NO. 9, at 5.

171. 1954 CODE § 2055.

172. Treas. Reg. § 20.2055-1(a) (1958).

173. Rev. Rul. 74-523, 1974 INT. REV. BULL. NO. 43, at 29.

residents.¹⁷⁴ This absence of restriction in the case of citizen or resident donors is made explicit in Regulations section 25.2522(a)-1(a).

However, Congress has imposed such "foreign-use, foreign-charity" restrictions in the case of estates of nonresident aliens and in the case of nonresident alien donors, though the restrictions do not entirely parallel the income tax restrictions. The charitable contributions of nonresident alien decedents or donors are only deductible when made to (1) "a domestic corporation" or (2) "a trust, or community chest, fund or foundation" (in the case of the gift tax) or a "trustee or trustees, or a fraternal society" (in the case of the estate tax), if the contribution is "to be used within the United States" exclusively for charitable purposes.¹⁷⁵

D. 1940-1954

The Individual Income Tax Act of 1944 brought a change in the computation of an individual's charitable deduction.¹⁷⁶ Before passage of this act, a deduction was allowed up to "15 per centum of the taxpayer's net income as computed without the benefit of this subsection or of subsection (x)."¹⁷⁷ As amended, the statute allowed a deduction up to "15 per centum of the taxpayer's adjusted gross income."¹⁷⁸ The new provision was explained in the House Report as follows: "This has the effect of increasing the allowance for charitable contributions, and will enable the taxpayer to compute his charitable deduction without having to determine his net income."¹⁷⁹

In 1949, amendments to the Internal Revenue Code of 1939¹⁸⁰ liberalized the rules with respect to the time of payment for corporations seeking to make deductible charitable contributions. Under the new provision, an accrual-basis corporation was allowed if it filed the proper election, until the fifteenth day after the end of its taxable year for payment of a charitable contribution, authorized by its board during the year.¹⁸¹ The House Report explained that the provision would aid corporations which "intended to make the maximum charitable contributions allowable as deductions" but which have had "difficulty in determining before the end of the taxable year what

174. However, contributions to war veterans' organizations are only deductible if such organizations "are organized in the United States or any of its possessions." 1954 CODE § 2522(a)(4).

175. 1954 CODE §§ 2106(a)(2)(A)(ii),(iii) (estate tax), 2522(b)(2),(3) (gift tax). As noted earlier, the Revenue Act of 1918 restricted the income tax charitable deduction for nonresident aliens to gifts made to "domestic corporations." *Id.* § 214(a)(11).

176. Ch. 210, 58 Stat. 231.

177. 1939 CODE § 23(o), as last amended by the Revenue Act of 1942, ch. 619, 56 Stat. 798, § 127(c) to include the phrase "or of subsection (x)." Subsection 23(x) related to "medical, dental etc. expenses."

178. Individual Income Tax Act of 1944, ch. 210, § 8(b), 58 Stat. 231.

179. H.R. REP. NO. 1365, 78th Cong., 2d Sess. 2 (1944).

180. Act of October 25, 1949, ch. 720, 63 Stat. 891.

181. *Id.* § 3(a).

constitutes 5 percent of their net income.”¹⁸²

In 1952, Congress raised the ceiling on deductions by individuals for charitable contributions from 15 to 20 per cent of adjusted gross income.¹⁸³ In explaining this provision (which originated as an amendment in the Senate Finance Committee), the Senate Report expressed particular concern for the financial “plight” of colleges and educational institutions, in words that by now have a familiar ring:¹⁸⁴

Your committee is of the opinion that by increasing the 15-percent limit to 20-percent, much-needed relief will be given to colleges, hospitals, and other organizations who are becoming more and more dependent upon private contributors to enable them to balance their budgets and carry on their programs. The plight in which many of our educational institutions find themselves at the present time is due to the fact that their endowment income is inadequate to meet rising costs. It is only through supplemental gifts by the alumni or other persons interested in the cause of education that they are able to continue their programs. Many of the smaller colleges whose alumni have not sufficient means to make adequate contributions are able to continue their existence only through gifts or contributions *received by* [sic] one or two prominent families in their community. Your committee believes that it is to the best interest of the community to encourage private contributions to these institutions and it is believed that this amendment will provide some assistance in this respect.

E. Internal Revenue Code of 1954

With the enactment of the Internal Revenue Code of 1954, the ceiling on an individual's deductions for charitable contributions was raised once again, but only as to a limited and select group of charities (thus introducing discrimination as to the type of charitable organization being supported). In addition to the “20% percent” allowance already provided in 1952, the taxpayer was now granted an extra 10% per cent allowance for charitable contributions to any of three specific types of charitable organizations:¹⁸⁵

- 1) “a church or a convention or association of churches,”
- 2) “an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on; or”
- 3) “a hospital referred to in Sec. 503(b)(5).”

The latter two categories were defined by reference to then section 503(b), which exempted these and certain other categories of charitable organizations from the “prohibited transactions” provisions.¹⁸⁶

182. H.R. REP. NO. 920, 81st Cong., 1st Sess. 3 (1949).

183. Act of July 8, 1952, ch. 588, § 4(a), 66 Stat. 442.

184. S. REP. NO. 1584, 82d Cong., 2d Sess. 2 (1952).

185. 1954 CODE § 170(b)(1)(A)(i),(ii),(iii).

186. Before the amendment of 1954 CODE § 503(a)(1) and the repeal of former 1954 CODE § 503(b)(e), there was an explicit statutory linkage between the charitable deduction and the

The reasons for allowing an extra ten per cent of deductions for contributions to these three categories of charitable organizations is but scantily explained in the Committee Reports, which only state: "This amendment by your committee is designed to aid these institutions in obtaining the additional funds they need, in view of their rising costs and the relatively low rate of return they are receiving on endowment funds."¹⁸⁷

The Internal Revenue Code of 1954 relaxed the test of eligibility for the "unlimited charitable deduction."¹⁸⁸ The statute's former requirement that charitable contributions plus income tax total 90 per cent of the individual's income in each of the last 10 years was considered "unduly strict" by the Ways and Means Committee.¹⁸⁹ The House Committee's bill provided that the 90 per cent test need be met only in 9 of the last 10 years; and under the Senate provision, enacted into law, meeting the 90 per cent test in 8 of the last 10 years was deemed sufficient.¹⁹⁰

The 1954 Code also introduced a new "carryover" provision for corporate charitable contributions.¹⁹¹ This "carryover" provision originated in the Senate, and then was modified by the House to limit the carryover period to the two succeeding taxable years.¹⁹² The Revenue Act of 1964 increased the corporate carryover period from two to five years, and, in addition, provided a new five-year carryover period for individuals.¹⁹³ The 1964 House Report explained that the increased carryover period for corporations was intended to aid corporations which have varying yearly income, but which nevertheless commit themselves to stable yearly contributions to local charities.¹⁹⁴ The new carryover provision for individuals was added by the Senate Committee, which saw "no reason" to permit corporations a carryover "while individuals are in effect compelled to waste their contributions in excess of the specified limitation." A "more important" reason for the provision, in the Senate Committee's view, was to eliminate the need for a donor of a large gift to "carefully divide" it into annual parts.¹⁹⁵

"prohibited transaction" provision. Former § 503(e) disallowed charitable deductions for contributions to organizations that lost their exemption by having engaged in "prohibited transactions." There was, however, no similar linkage between the charitable deduction and § 504 (repealed by the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487), so that the charitable deduction was not disallowed, if the recipient organization lost its exemption solely by reason of "unreasonable accumulations."

187. See H.R. REP. NO. 1337, 83d Cong., 2d Sess. 25 (1954) and, with minor variation, S. REP. NO. 1622, 83d Cong., 2d Sess. 29 (1954).

188. 1954 CODE § 170(b)(1)(C).

189. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 26 (1954).

190. S. REP. NO. 1622, 83d Cong., 2d Sess. 30 (1954).

191. 1954 CODE § 170(b)(2), last sentence.

192. H.R. REP. NO. 2543 (Conference Rep.), 83d Cong., 2d Sess. 29 (1954).

193. Revenue Act of 1964, Pub. L. No. 88-272, §§ 209(c)(1) (adding 1954 CODE § 170(b)(5) for individuals), 209(a)(1) (amending 1954 CODE § 170(b)(2) for corporations), 78 Stat. 19.

194. H.R. REP. NO. 749, 88th Cong., 1st Sess. 54 (1963).

195. S. REP. NO. 830, 88th Cong., 2d Sess. 61 (1964). Such division of the gift, noted the

F. 1954-1964

Various additions were made to section 170 of the 1954 Code in the ten years following the Code's enactment. In 1958 a subsection, "Reduction for certain interest," was added,¹⁹⁶ reducing the charitable deduction by the amount of interest paid by the donor on a liability to which the donated property is subject. In 1960 a provision allowing a deduction for amounts paid by a taxpayer to support a full-time student in his household under a written agreement between the taxpayer and a charitable organization was enacted.¹⁹⁷ And in 1962, Congress enacted a provision reducing the deduction for a charitable contribution of depreciable property by the amount that would be subject to recapture on sale as ordinary income under section 1245;¹⁹⁸ in 1964¹⁹⁹ and 1966,²⁰⁰ this provision was extended to disallow amounts subject to recapture under section 1250 (depreciable real property) and under section 617 (mining exploration expenditure deductions). The Revenue Act of 1964 enacted a provision denying a charitable deduction for a gift of a future interest in tangible personal property until all interests in and rights to actual possession or enjoyment of the property, on the part of the donor or related parties, have expired.²⁰¹ This provision was aimed particularly at taxpayers who donated future interests in art objects to museums, and took an immediate charitable deduction, although no change in the actual use of the art object had yet occurred.²⁰²

The ten years following the enactment of the 1954 Code also witnessed a gradual expansion by Congress of the categories of organizations (listed in section 170(b)(1)(A)) eligible to receive the extra ten per cent of an individual's charitable contributions. In 1956²⁰³ "medical research organizations directly engaged in continuous active conduct of medical research in conjunction with a hospital" were added to this favored class of charities (al-

Report, is troublesome not only for the donor, but also for the donee-charity, which might receive unusable and unsalable undivided interests in a property, in each of a series of years, before finally achieving full ownership.

196. Technical Amendments Act of 1958, Pub. L. No. 85-866, § 12(a), 72 Stat. 1606, added § 170(b)(4) to the 1954 Code. This provision was redesignated § 170(f)(5) by the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.

197. Former § 170(d), redesignated (h) by the 1969 Act. Act of September 14, 1960, Pub. L. No. 86-779, § 7(a)(2), 74 Stat. 998.

198. Revenue Act of 1962, Pub. L. No. 87-834, § 13(d), 76 Stat. 960.

199. Revenue Act of 1964, Pub. L. No. 88-272, § 231(b), 78 Stat. 19.

200. Act of September 12, 1966, Pub. L. No. 89-570, § 1(b)(1), 80 Stat. 759.

201. Pub. L. No. 88-272, § 209(e), 78 Stat. 19, enacting a new 1954 Code § 170(f).

202. H.R. REP. No. 749, 88th Cong., 1st Sess. 55 (1963); S. REP. No. 830, 88th Cong., 2d Sess. 64-65 (1964). The House bill provided an exception (from the general rule denying an immediate deduction) in cases where the only reservation in the gift was the retention of a life interest by the donor; the Senate Finance Committee, however, deleted this exception, explaining that the exception would gobble up the rule.

203. Pub. L. No. 1022, § 1, Act of August 7, 1956, ch. 1031, 70 Stat. 1117, amending 1954 Code § 170(b)(1)(A)(iii).

ready including hospitals). The new provision required the recipient organization to commit itself to use the gift within a statutorily specified period, to "insure," as the House Report explained, that the gift is "actually devoted to medical research."²⁰⁴ In 1962, a provision (originating in the Senate Finance Committee) added state university endowment funds to the preferred charities of section 170(b)(1)(A). These endowment funds were created as vehicles for indirect contributions to state universities in states where direct contributions are subject to legal restrictions. Whereas endowment funds for private colleges could qualify for the extra ten per cent deduction, as being a part of the "educational organization" itself, the endowment funds for state universities are corporations separate from their schools and cannot qualify under the heading of "educational organization."²⁰⁵ Therefore, the Senate committee explained, the new category of state university endowment funds was added to section 170(b)(1)(A), so that these state funds would be "placed on the same footing with private institutions."²⁰⁶

G. Publicly Supported Organizations

The Revenue Act of 1964 added to the list of organizations eligible to receive the extra ten per cent of an individual's charitable contributions two new categories of 1) government units, and 2) so-called "publicly supported" organizations,²⁰⁷ defined by Congress as follows:²⁰⁸

[A]n organization referred to in subsection (c)(2) which normally receives a substantial part of its support (exclusive of income received in the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a)), from a government unit referred to in subsection (c)(1) or from direct or indirect contributions from the general public.

The late President Kennedy's 1963 Tax Message to Congress explained that his proposed extension of the extra ten per cent deduction to charitable organizations²⁰⁹

which are publicly supported and controlled . . . will prove advantageous to the advancement of highly desirable activities in our communities, such as symphony orchestras and the work of community chests and cultural centers.

This provision, the House Report further explained, was intended to produce "greater uniformity in the availability" of the extra ten per cent deduction,

204. H.R. REP. NO. 2887, 84th Cong., 2d Sess. 2 (1956).

205. S. REP. NO. 2109, 87th Cong., 2d Sess. 6 (1962).

206. *Id.*

207. Revenue Act of 1964, Pub. L. No. 88-272, § 209(a), 78 Stat. 19, adding § 170(b)(1)(A)(v),(vi) to the 1954 CODE.

208. *Id.*

209. *Hearings on the Tax Recommendations of the President Before the House Comm. on Ways and Means*, 88th Cong., 1st Sess., pt. 1, at 18 (1963).

rectifying, in particular, the ineligibility of "many cultural and educational organizations and major charitable organizations."²¹⁰ The "public support" requirement was intended to preclude the eligibility of private foundations which, the committee believed, "frequently do not make contributions to the operating philanthropic organizations for extended periods of time and in the meanwhile use the funds for investments"; this extension of the extra ten per cent deduction thus was "intended to encourage immediately spendable receipts of contributions for charitable organizations."²¹¹ The 1964 Act imposed another disadvantage on private foundations; section 170 was amended to disallow the unlimited charitable deduction with respect to contributions to a private foundation.²¹² A supposed tendency of private foundations to be slow in funnelling contributions to active charitable uses was cited once again by the Senate Finance Committee in explanation.²¹³

H. 1966 Treasury Regulations

The statutory definition of a "publicly-supported" organization clearly required additional implementation by the Treasury; and on December 21, 1964 the IRS issued TIR-667 (the basis for Revenue Ruling 66-100)²¹⁴ to provide temporary rules pending the issuance of Regulations. Under TIR-667, an organization met a "mechanical test" for qualification as a publicly-supported organization if 33 1/3 per cent of its "total support" for three out of the last four taxable years came from a government unit or from contributions made directly or indirectly by the general public. The IRS defined "support" to include not only contributions but also "investment income" and also net income from related or unrelated business activities (unless excluded by the statute as income realized from the performance of the organization's tax-exempt purpose). The IRS also provided that contributions by any individual, trust, or corporation could not be included in "public support" for a taxable year to the extent they exceeded one per cent of the organization's "total support" for that year. Revenue Ruling 66-100 stated in conclusion that, apart from the mechanical test, an organization might be shown to be

210. H.R. REP. NO. 749, 88th Cong., 1st Sess. 53 (1963).

211. *Id.*

212. Revenue Act of 1964, Pub. L. No. 87-272, § 209(b), 78 Stat. 19, inserting new subsection 170(g). The provision as enacted allowed the unlimited deduction for contributions to any organization eligible to receive the extra 10 per cent deduction, and also to any charitable organization devoting substantially more than half of its assets and income directly to the active conduct of charitable activities.

213. S. REP. NO. 830, 88th Cong., 2d Sess. 59-60 (1964). In apparent conformity with this rationale, Congress also allowed the unlimited deduction in the case of a contribution to an organization which within three years funnelled at least 50 per cent of the amount of the contribution and all of its net income for the period to active charitable activities or to other organizations qualified with respect to the unlimited deduction.

214. 1966-1 CUM. BULL. 51.

publicly-supported "on the basis of all the facts and circumstances."²¹⁵ However, absent any further guidelines, the IRS refused to issue rulings on such a basis.

It was the apparent intention of Congress that this new provision of the 1964 Act extend the benefit of the extra ten per cent deduction to museums, libraries, and similar organizations. Such organizations were repeatedly mentioned as intended beneficiaries of the new provision throughout consideration of the bill in Congress. Secretary of the Treasury Dillon, in his statement accompanying President Kennedy's 1963 Tax Message, included "community chests, museums, symphony orchestras, etc.," among organizations to be covered by the proposed legislation;²¹⁶ the technical implementation accompanying the Tax Message listed "museums, libraries, civic centers, symphony orchestras, and similar organizations" as beneficiaries of the proposals.²¹⁷ Furthermore, the technical explanation in the House Report stated that the new provision would apply to:²¹⁸

[N]ational charitable organizations which normally receive a substantial part of their financial support from a wide segment of the general public, and also to contributions to museums, libraries, civic centers, symphony orchestras, and similar organizations which normally derive a substantial part of their financial support from a representative number of persons in the communities where their activities are centered.

Encouraged by such statements surrounding the provision's enactment, some museums and similar organizations were disappointed to find that they had difficulty in qualifying under the mechanical test. Heavy endowments and large contributions by single individuals were serious obstacles to qualification, in view of the Treasury's inclusion of investment income in total support and its one per cent limitation on gifts by a single individual or organization, in measuring "public support." Subsequent efforts by museums and similar organizations to convince the Treasury to liberalize its definition of "publicly-supported" organizations bore good fruit in the Treasury's formulation of proposed Regulations issued in 1965,²¹⁹ and of final Regulations, issued in 1966.²²⁰

In the proposed Regulations, TIR-667's mechanical test was liberalized only to a small extent. In a relatively neutral change, the proposed Regulations made a four year aggregate period the basis for applying the "33 1/3% of total support" test (formerly applied on a "3 out of 4 year" basis) and for

215. Rev. Rul. 100, 1966-1 CUM. BULL. 51, 54.

216. *Hearings on the Tax Recommendations of the President Before the House Comm. on Ways and Means*, *supra* note 209, at 46.

217. *Id.* at 100.

218. H.R. REP. NO. 749, 88th Cong., 1st Sess. A48 (1963).

219. 30 Fed. Reg. 14158 (1965).

220. T.D. 6900, 1966-2 CUM. BULL. 72.

applying the "excess over 1%" test.²²¹ The proposed Regulations provided some relief to museums and similar organizations by excluding capital gains and related business income from "total support."²²² Also, the proposed Regulations clarified the definition of government support.²²³

The articulation of the "facts and circumstances" test in the proposed Regulations did, however, greatly improve chances of qualifying as "publicly-supported" organizations. The proposed Regulations stated that in applying this test "no single factor" would be "conclusive."²²⁴ The Regulations did, however, list four factors that would "indicate" that an organization was public-supported:²²⁵

- 1) "The organization is constituted so as to receive contributions, directly or indirectly, from a wide segment of the public." This factor can be met by showing either (a) receipt of contributions from a number of persons in its community; or (b) an organizational structure and method of operation under which it makes bona fide solicitations for broad based support, or, in the case of a new organization, under which it is required to make such solicitations; or (c) receipt of support from community chests; or (d) its possession of a substantial number of dues-paying members.
- 2) "The organization has a governing body . . . comprised of public officials, of individuals chosen by public officials . . . , etc., as distinguished from individuals selected by a limited number of donors" or related parties. An example relating to an art museum indicated that the "etc." would include "representative citizens" of the community.
- 3) The organization "is required to" and does make regularly available to the public its financial reports.
- 4) The organization, if of a "type which generally holds open to the public its buildings . . . or performances . . . actually follows such practice."

After the publication of the proposed Regulations, museums and similar organizations urged further clarification and modification of these rules. The final Regulations issued in 1966 retained the mechanical test without change; the efforts of the museums and others, however, were rewarded by liberalization and clarification of the facts and circumstances test. The final Regulations made explicit provision for flexibility in the application of the facts and circumstances test, offering aid in particular to newly-created and to specialized organizations. In determining the weight and relevancy of the various "facts," the nature and age of the organization were to be considered;²²⁶ and in determining what constitutes "a representative number of persons," for purposes of measuring "public support," the "type of organization" and whether it was devoted to a "specialized field" of limited appeal were to be

221. Proposed Treas. Reg. § 1.170-2(b)(5)(iii)(b), 30 Fed. Reg. 14160 (1965).

222. Proposed Treas. Reg. § 1.170-2(b)(5)(ii)(b)(1),(2), 30 Fed. Reg. 14160 (1965).

223. Proposed Treas. Reg. § 1.170-2(b)(5)(ii)(c), 30 Fed. Reg. 14160 (1965).

224. Proposed Treas. Reg. § 1.170-2(b)(5)(iii)(c)(2), 30 Fed. Reg. 14160 (1965).

225. Proposed Treas. Reg. § 170-2(b)(5)(iii)(c)(2)(i)-(iv), 30 Fed. Reg. 14160-61 (1965).

226. Final Treas. Reg. § 1.170-2(b)(5)(iii)(c)(2) (1966).

considered.²²⁷ The final Regulations also made it clear that the organization's governing body could consist not only of public officials and their designates, but also of "citizens broadly representative of the interests and views of the public."²²⁸ Under the final Regulations, the actual, annual "bona fide dissemination" of financial information to the public was sufficient, except in the case of a new organization which only must be "constituted so as to require such reporting."²²⁹ The final Regulations made two other important changes in the facts and circumstances test. While listing the same four factors as the proposed Regulations, they stated that "the most important consideration" is the first of the factors, "the organization's source of support."²³⁰ The final Regulations also provided that "under no circumstances" could an "organization which normally receives substantially all of its contributions . . . from the members of a single family or from a few individuals" be deemed "publicly-supported."²³¹ The efforts of the museums in particular bore fruit in clarifying and liberalizing changes in example (3) of the Regulations, dealing specifically with an art museum.²³²

The definition of a "publicly-supported organization" in section 170(b)(1)(A) of the statute and in the Regulations thereunder must be viewed in the light of the definition's prior use in other parts of the Code. The category of "publicly-supported" organizations made its first appearance in the tax law when the Revenue Act of 1943 established an information return requirement for tax-exempt charitable organizations but excepted from this new requirement religious organizations, certain educational organizations, and "publicly-supported" organizations.²³³ The Revenue Act of 1950 exempted these same three categories of charities (and two other categories) from its new "prohibited transactions" and "unreasonable accumulation" provisions.²³⁴ This exception for "publicly-supported" organizations, appearing in section 3813(a)(3) of the 1939 Code and later in 1954 Code section 503(b)(3) (repealed by the Tax Reform act of 1969), is phrased in language identical, in all relevant respects, to the language in section 170(b)(1)(A)(vi). (Such borrowing

227. Final Treas. Reg. § 1.170-2(b)(5)(iii)(c)(3) (1966).

228. Final Treas. Reg. § 1.170-2(b)(5)(iii)(c)(4)(i) (1966).

229. Final Treas. Reg. § 1.170-2(b)(5)(iii)(c)(4)(ii) (1966).

230. Final Treas. Reg. § 1.170-2(b)(5)(iii)(c)(3) (1966).

231. Final Treas. Reg. § 1.170-2(b)(5)(iii)(c)(2) (1966).

232. Final Treas. Reg. § 1.170-2(b)(5)(iii)(c)(5) Example (3).

233. Revenue Act of 1943, ch. 63, 1939 CODE § 117, 58 Stat. 21, adding § 54(f) to the 1939 CODE. Section 54(f) became § 6033 of the 1954 CODE. Sections 6033(a)(3) and 54(f)(3) excepted charitable organizations "supported, in whole or in part, by funds contributed by the United States or any State or political subdivision thereof, or . . . primarily supported by contributions of the general public." The Tax Reform Act of 1969, Pub. L. No. 91-172, § 101(d)(1), transported this phrase to § 6033(a)(2)(c)(iii), and limited this exception to organizations with \$5,000 or less in annual gross receipts.

234. Revenue Act of 1950, ch. 994, § 331, 64 Stat. 906, adding §§ 3813, 3814 to the 1939 CODE.

from prior legislative definitions appears to be a favorite legislative drafting technique of the writers of our tax laws. Its soundness, however, can be questioned, since it is based on an assumption called "Foof" (Faith of our Fathers), *i.e.*, on the assumption that whoever drafted the prior legislation knew what he was doing and that a definition which may have been all right in one context is appropriate for that different purpose. For example, it may legitimately be questioned whether source of funds (*i.e.*, from public contributions) rather than control of their use is an appropriate way of distinguishing whether a museum or library should be treated as a public organization rather than as a private foundation.)

Thus the Treasury, in formulating Regulations under section 170, had to consider the danger that an excessively liberal definition of "publicly-supported" organizations might allow private foundations to qualify, not only under section 170(b)(1)(A)(vi), but also under sections 503(b)(3) and 6033(a)(3). This consideration may have led the Treasury to formulate a rather strict mechanical test. On the other hand, desiring to implement the congressional intent in the 1964 Revenue Act of encouraging contributions to truly publicly-supported organizations, the Treasury also provided a more flexible and liberal "facts and circumstances" test, as a basis for the IRS to examine the credentials of each organization.

With the passage of the 1969 Tax Reform Act the definition of a "publicly-supported organization" took on greater significance. First, the percentage limit on an individual's charitable deduction was raised, so that gifts to the favored section 170(b)(1)(A) organizations could total 50 per cent of the taxpayer's contribution base. And second, Congress imposed a series of new restrictions on one class of section 501(c)(3) organizations, *i.e.*, the private foundation; and, in defining a private foundation in section 509(a)(1), Congress excluded the class of organizations described in section 170(b)(1)(A)(i)-(vi). (This was the class eligible for the extra 10 per cent deduction before the 1969 Act, and eligible for the 50 per cent deduction under the 1969 Act.)

The repeated references in the legislative history to this class of organizations (*i.e.*, those described in section 170(b)(1)(A)(i)-(vi)) as being essentially the same as in prior law,²³⁵ and Congress's exclusion of this class from the new "private foundation" category would seem to have amounted to tacit congressional approval of the 1966 Treasury Regulations clarifying the boundaries of this class. Thus, the Treasury's formulation of a flexible "facts and circumstances" test in these Regulations (offering to organizations failing under the "mechanical" test an alternative method of qualification as a publicly-supported organization under section 170(b)(1)(A)(vi)) would seem to

235. See, *e.g.*, H.R. REP. NO. 413, 91st Cong., 1st Sess. 41 (1969); S. REP. NO. 552, 91st Cong., 1st Sess. 57 (1969).

have been endorsed by Congress. Despite this rather clear indication that Congress approved the final 1966 Regulations, the Treasury adamantly insisted on making significant restrictive changes in the definition of a "publicly-supported" organization in a new Regulation section 1.170A-9(e), filed with the Office of the Federal Register on December 29, 1972.²³⁶

I. 1972 Treasury Regulation

The new Regulation placed a significant obstacle to qualification as "publicly-supported" in the way of museums and similar organizations, by adding a new mechanical element to the "facts and circumstances" test. Under the new Regulation an organization failing the "33 1/3 percent-of-support" test, must, in any event, pass a "10 percent-of-support" floor test in order to be eligible to be considered under the "facts and circumstances" test.²³⁷ Under the 1972 Regulation, two threshold requirements, (1) the "10 percent-of-support" limitation²³⁸ and (2) a requirement that the organization be "so organized and operated as to attract new and additional public or governmental support on a continuous basis,"²³⁹ must be met, before a flexible weighing of "all pertinent facts and circumstances" can be undertaken. The 1972 Regulation did, however, give some recognition to the plight of heavily-endowed organizations in describing one of the pertinent factors, the "percentage of support received . . . from public or governmental sources."²⁴⁰ The Regulation stated that where an organization received a "high percentage of its total support from investment income on its endowment funds," it will nevertheless satisfy this factor, if the "endowment funds were originally contributed by a governmental unit or by the general public." (This concession, however, will afford little solace to a heavily-endowed organization, which fails the initial "10% of support" test; see Example (2).)²⁴¹ The new Regulations, moreover, did offer some relief for organizations receiving large gifts from a single source. In measuring "public support," for purposes of the "33 1/3%" or the new "10%" rule, the 1972 Regulation included contributions by a single individual or corporation up to two per cent (rather than one per cent) of the organization's total support.²⁴² The 1972 Regulation also allowed an organization to exclude certain "unusual grants" given by "disinterested parties" from

236. T.D. 7242, 1973-1 CUM. BULL. 118.

237. Treas. Reg. § 1.170A-9(e)(3) (1973).

238. Treas. Reg. § 1.170A-9(e)(3)(i) (1973).

239. Treas. Reg. § 1.170A-9(e)(3)(ii) (1973). The theory seems to be that, if an organization is dependent upon continued public support, it will be more apt to be responsive to the wishes of the public than if it already is adequately endowed.

240. Treas. Reg. § 1.170A-9(e)(3)(iii) (1973).

241. Treas. Reg. § 1.170A-9(e)(9) Example (2) (1973).

242. Treas. Reg. § 1.170A-9(e)(6)(i) (1973).

both "total support" and "public support" in applying the "33 1/3%" and "10%" tests.²⁴³

Nevertheless, these new Regulations threaten serious consequences for a heavily endowed museum or similar organization. If the organization fails the initial "10% of support" test, and thus does not qualify as a section 170(b)(1)(A)(vi) organization, it probably will fall into the "private foundation" category and thus be subjected to the four per cent excise tax on its investment income, even though it qualifies as an "operating foundation" under section 4942(j)(3). If a museum, due to a heavy endowment, fails to qualify for the exception to private foundation status in section 509(a)(1) (the exception for section 170(b)(1)(A)(i)-(vi) organizations), it most likely also will fail to qualify for the exception in section 509(a)(2), which is available only to organizations whose "gross investment income" does not exceed one-third of support. Clearly, remedial legislation is needed to remove this discrimination against museums and similar cultural organizations which serve the public as faithfully as do the colleges and hospitals.²⁴⁴

III

HISTORY OF UNRELATED BUSINESS TAX

A. Early History

The tax on unrelated business income of charitable organizations was first enacted in the Revenue Act of 1950. However, much earlier the business activities of charitable organizations engaged the attention of Congress, the courts and the Service.

As already noted, the inclusion of an exemption provision for charitable organizations in the Corporate Excise Act of 1909 was deemed to be superfluous by some senators, in that the tax was by its terms only applicable to a "corporation . . . organized for profit."²⁴⁵ Senator Bacon, who considered a specific exemption provision to be essential, cited the example of the Methodist Book Concern, "a very large printing establishment," which, he said, "is organized for profit, but it is not organized for individual profit. It is organized to make a profit to extend religious work and to extend benevolent work, charitable work, and educational work."²⁴⁶

243. Treas. Reg. § 1.170A-9(e)(6)(ii) (1973).

244. See testimony of Kyran M. McGrath, Director of American Association of Museums, and testimony of Rollin van N. Hadley, Director of Isabella Stewart Gardner Museum, for the Association of Art Museum Directors, *Hearings on The Role of Private Foundations Before the Subcomm. on Foundations of the Senate Finance Comm.*, 93d Cong., 2d Sess. 29, 99 (1974).

245. 44 CONG. REC. 4148-51 (1909) (emphasis added); W. SMITH & C. CHIECHI, *supra* note 10, at 11. For a detailed analysis of the congressional debate, see Eliasberg, *Charity and Commerce: Section 501(c)(3)—How Much Unrelated Business Activity?*, 21 TAX. L. REV. 53, 55-58 (1965).

246. 44 CONG. REC. 4151 (1909); quoted in Eliasberg, *supra* note 245, at 56 & n. 16.

One particular type of profit-making, the earning of a profit by "holding title to property," was formally recognized as compatible with exemption in the Revenue Act of 1916, which specifically exempted from tax those organizations organized for the exclusive purpose of earning such a profit and turning it over to an exempt organization.²⁴⁷

A strict stand against an exempt organization's engaging in business activities was taken by the Service in its Regulations²⁴⁸ accompanying the Revenue Act of 1918 and in O.D. 953,²⁴⁹ both published in 1921. The Regulations stated that a religious corporation owning and working a large amount of farm land and manufacturing and selling clothing for profit would not qualify for exemption, even though its property was held in common and no individual profit was made by its members.²⁵⁰ In O.D. 953, the Service declared that an organization "which owns property in excess of its needs and carries on industrial pursuits distinct from its exempt activities is not exempt from taxation."²⁵¹

The validity of the Service's non-permissive attitude toward commercial activities of exempt organizations was soon subjected to the scrutiny of the United States Supreme Court in *Trinidad v. Sagrada Orden De Predicadores*.²⁵² There the Court upheld the tax exemption of a religious corporation with far eastern missions which derived most of its income in the form of rents, dividends, and interest from its large properties in the Philippines and the rest, a "relatively small" amount, from alms for mass, occasional sales of its stock, and sales of wine, chocolate, etc. supplied for use in its churches, missions, and parsonages. As to the investment income, the Court deemed it to be "common knowledge" that the charitable activities of exempt corporations "are largely carried on with income received from properties dedicated to their pursuit."²⁵³ The Court noted that this investment income was devoted exclusively to exempt purposes (in fact, the members of this ancient religious order had taken vows of poverty). It concluded that in earning such income, the organization was "adhering to and advancing those purposes, and not stepping aside from them or engaging in a business pursuit."²⁵⁴ As to the wine and chocolates, the Court noted that there was no "selling to the public or in competition with others," but that, rather, the articles were supplied for

247. Revenue Act of 1916, ch. 463, § 11(a) Twelve, 39 Stat. 767. This provision now appears in 1954 CODE § 501(c)(2). See Eliasberg, *supra* note 245, at 58-59.

248. Treas. Reg. 45, art. 517 (1919).

249. 4 CUM. BULL. 261 (1921).

250. Treas. Reg. 45, art. 517 (1919), quoted in Eliasberg, *supra* note 245, at 60.

251. 4 CUM. BULL. 261 (1921), quoted in Eliasberg, *supra* note 245, at 60. Eliasberg points out, at 60 n.31, that the Service had taken a more indulgent view of an exempt organization's commercial activities only a year earlier in 2 CUM. BULL. 209 (1920).

252. 263 U.S. 578 (1924).

253. 263 U.S. at 581.

254. 263 U.S. at 582.

use within the organization, some “for strictly religious use and the others for uses which are purely incidental” to the organization’s work.²⁵⁵ In the course of its opinion, the Court also offered a much broader rationale for its decision, making two broad observations about the exemption clause itself:²⁵⁶

First, it recognizes that a corporation may be organized and operated exclusively for religious, charitable, scientific, or educational purposes, and yet have a net income. Next, it says nothing about the *source* of the income, but makes the *destination* the ultimate test of exemption.

This ultimate “destination of income” theory, *i.e.*, that the carrying on of business activities would not disqualify a charitable organization from exempt status if the profits so earned were devoted solely to its charitable purposes, was cited by the Board of Tax Appeals, as the basis for two decisions in which it upheld an organization’s tax exemption: *Unity School of Christianity*²⁵⁷ (operation of inn and farm and publication of books and periodicals), and *Sand Springs Home*²⁵⁸ (carrying on of several business activities, in course of which the organization “trade[d] with the general public and compete[d] with other corporations and individuals engaged in similar businesses”).²⁵⁹ In *Roche’s Beach v. Commissioner*,²⁶⁰ the court of appeals endorsed the “destination of income” test, citing *Trinidad*, *Sand Springs*, and *Unity School*, in deciding that a corporation operating a bathing beach and rental business for the benefit of a charitable foundation was still entitled to exemption.

In 1942, the Treasury Department made its first proposal for levying a tax on the unrelated business income of tax-exempt organizations.²⁶¹ In testimony before the House Ways and Means Committee, Treasury representatives said that many exempt organizations had “so far departed from the purpose of the exemption as to engage in trades and business completely unrelated to their exempt activities.”²⁶² The House Report accompanying the Revenue Act of 1943²⁶³ acknowledged that “many” tax-exempt organizations were “directly competing with” tax-paying businesses and that this increasingly “widespread” practice was “affording a loophole for tax evasion and avoidance.” The committee, however, lacking “sufficient data to act intelligently,” decided to “con-

255. *Id.*

256. 263 U.S. at 581 (emphasis added).

257. CCH DEC. 1435, 4 B.T.A. 61 (1926), *acquiescing*.

258. CCH DEC. 2180, 6 B.T.A. 198 (1927).

259. Weithorn & Liles, *Unrelated Business Income Tax: Changes Affecting Journal Advertising Revenues*, 45 TAXES 791, 792 (1967).

260. 96 F.2d 776 (2d Cir. 1938).

261. Weithorn & Liles, *supra* note 259, at 792-93.

262. *Hearings on Revenue Revision Before the House Comm. on Ways and Means*, 77th Cong., 2d Sess. 89 (1942), quoted in Weithorn & Liles, *supra* note 259, at 793. As noted by Weithorn and Liles, the legislative proposal was essentially the same as the 1950 enactment; however, the phrase “necessarily incident to” was used instead of “substantially related,” and the amount of the exclusion was 5,000 dollars rather than 1,000 dollars as enacted in 1950.

263. Revenue Act of 1943, ch. 63, 58 Stat. 21.

tinue the present tax exemption," but at the same time impose an information return requirement on exempt organizations²⁶⁴ (with certain select categories exempted from the requirement).²⁶⁵ The House Committee promised to "make a thorough study" of the data so obtained "with a view to closing this existing loophole and requiring payment of tax, and the protection of legitimate companies against this unfair competitive situation."²⁶⁶

B. Revenue Act of 1950

In 1950, the Treasury renewed its proposal for taxing the unrelated business income of charitable and educational organizations.²⁶⁷ In his statement before the House Ways and Means Committee, Secretary of the Treasury Snyder noted that "[s]ome colleges and other institutions are engaging in a wide variety of business undertakings, including the production of such items as automobile parts, chinaware, and food products, and the operation of theaters, oil wells, and cotton gins."²⁶⁸ The Treasury had unsuccessfully argued in *Trinidad* and subsequent cases that the carrying on of substantial unrelated business activities should disqualify a charitable organization from exemption. Now it made the more practical suggestion that "if such [unrelated business] activities are conducted by the exempt organization itself, the exemption of the organization would not be disturbed, but such business income would be segregated and subjected to tax."²⁶⁹ However, in a case such as *Roche's Beach*, where a business organization itself conducted no exempt activities but instead fed its business profits to a separate charitable organization, the Treasury recommended that "the entire income" of the "feeder" be taxed.²⁷⁰

These unrelated commercial activities of charitable and educational organizations referred to by Secretary Snyder were seen as embodying a double threat:

1. A narrowing of the revenue base, and
2. an unfair competitive edge for exempt organizations over taxpayers carrying on the same commercial activities.

264. H.R. REP. NO. 871, 78th Cong., 1st Sess. 24 (1943).

265. The House bill exempting religious organizations, educational organizations maintaining a regular faculty, curriculum and student body, and publicly-supported charitable organizations was amended by the Senate to include publicly-supported societies for the prevention of cruelty to children or animals and certain other non-"charitable" exempt organizations. See S. REP. NO. 627, 78th Cong., 1st Sess. 21 (1943) and Revenue Act of 1943, ch. 63, § 117(f), 58 Stat. 21.

266. H.R. REP. NO. 871, *supra* note 264, at 24-25.

267. *Hearings on Revenue Revision of 1950 Before the House Comm. on Ways and Means*, 81st Cong., 2d Sess. 19, 165 (1950).

268. *Id.* at 19.

269. *Id.* at 165.

270. *Id.* at 165.

These two threats were interrelated in that exempt organization competition would tend to drive taxpayers out of business, thus narrowing the tax base.

In his 1950 tax message to Congress, President Truman included exempt organization "unrelated business activities" in the category of "loopholes" which should be closed both as a matter of tax equity and also to offset the loss of revenues anticipated from his proposed reduction of excise taxes.²⁷¹ However, it was the "unfair competitive advantage" over taxpaying businesses, which was most often cited as the reason for the new tax. In his 1950 tax message, President Truman noted that the exemption privilege had been "misused" by some educational organizations "to gain competitive advantage over private enterprise."²⁷² The House Report explicitly cited such competition as its chief concern:²⁷³

The problem at which the tax on unrelated business income is directed here is primarily that of unfair competition. The tax-free status of these Section 101 [now Section 501(c)] organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes.

The most notorious example cited of such "unrelated business activities" was the acquisition of the Mueller Spaghetti Company with borrowed funds by a tax-exempt corporation established to feed the profits of the business, after acquisition debt payments, to the New York University Law School.²⁷⁴ The tax-exempt status of this particular feeder corporation was being considered by the courts, at the time Congress was considering Treasury's proposals.²⁷⁵ Other well-publicized examples of such "unrelated business activities" included the purchase and leaseback of most of the land and buildings of Allied Stores Corporation, a department store chain, by Union College of Schenectady,²⁷⁶ and the running of Willow Run Airport by the University

271. *Id.* at 3-4. See also Statement of Leonard J. Calhoun, Counsel, National Tax Equality Association, in *Hearings on Revenue Revision Before the House Comm. on Ways and Means*, 80th Cong., 1st Sess. 3412 (1947), where Mr. Calhoun states that the purchase of businesses by exempt educational institutions has "reduced the tax base."

272. *Hearings on Revenue Revision of 1950*, *supra* note 267, at 4.

273. H.R. REP. NO. 2319, 81st Cong., 2d Sess. 36-37 (1950).

274. *Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951), *rev'g* 14 T.C. 922 (1950); Statement of Leonard J. Calhoun, *supra* note 271, at 3410-11. Mr Calhoun described this and other acquisitions of manufacturing concerns and real estate by educational institutions; see also testimony of John Gerdes on behalf of New York University describing the Mueller acquisition, three similar acquisitions, and other prospective acquisitions for New York University's benefit. *Id.* at 3535.

275. 190 F.2d at 120. The Tax Court denied tax-exempt status to the feeder corporation, distinguishing *Trinidad* where the corporation seeking exemption itself engaged in charitable activities, and declining to follow *Roche's Beach*. The Court of Appeals for the Third Circuit, acting after the passage of the 1950 Revenue Act, upheld the feeder's exempt status for 1947 under the law then in force, relying on *Roche's Beach*.

276. Statement of Leonard J. Calhoun, *supra* note 271, at 3411. Myers, *Taxing the Colleges*, 38 CORNELL L.Q. 368, 374-75 (1953).

of Michigan.²⁷⁷

In the Revenue Act of 1950,²⁷⁸ Congress enacted provisions intended to counteract the corollary dangers of unfair competition and resulting revenue loss seen as stemming from the business activities of tax-exempt organizations. A two-fold attack was launched against the perceived abuses. First, tax exemption was denied to the "feeder" organization; the statute provided that an "organization operated for the primary purpose of carrying on a trade or business for profit" could not claim tax-exempt status "on the ground that all of its profits are payable" to an exempt organization.²⁷⁹ This provision met the immediate problem presented by the *Mueller* case. However, it was apparent to Congress that imposition of the tax on the "feeder" alone would merely result in the transfer of business activities from the feeder to its exempt parent.²⁸⁰ Therefore, Congress added a second prong to the attack, a tax on the unrelated business income of "charitable, etc." organizations (except for churches or conventions or association of churches).²⁸¹ The intended limited scope of this direct attack on a charitable organization's business activities is made clear in the House Report,²⁸² and even more emphatically in the Senate Report:²⁸³

In neither the House bill nor your committee's bill does this provision deny the exemption where the organizations are carrying on unrelated active business enterprises, nor require that they dispose of such businesses. Both provisions merely impose the same tax on income derived from an unrelated trade or business as is borne by their competitors. In fact it is not intended that the tax imposed on unrelated business income will have any effect on the tax-exempt status of any organization.

Furthermore, Congress placed two important restrictions on the business income subject to the tax: first, the income must be from a business "regularly carried on by" the organization;²⁸⁴ and second, the income must be from an "unrelated trade or business," *i.e.*, a business "not substantially related" to the performance of the organization's exempt purposes "aside from the need of such organization for income."²⁸⁵ In addition, a \$1,000 specific exemption

277. *Id.* at 376. This raised the constitutional question of unrelated business activity by state related institutions.

278. Revenue Act of 1950, ch. 994, 64 Stat. 906.

279. Revenue Act of 1950, ch. 994, § 301(b), 64 Stat. 906, amending 1939 CODE § 101 (now 1954 CODE § 502).

280. H.R. REP. NO. 2319, *supra* note 66, at 37; S. REP. NO. 2375, *supra* note 67, at 29.

281. Revenue Act of 1950, ch. 994, § 301(a), 64 Stat. 906, adding 1939 CODE §§ 421-24 (now 1954 CODE §§ 511-15).

282. H.R. REP. NO. 2319, *supra* note 66, at 37.

283. S. REP. NO. 2375, *supra* note 67, at 29.

284. 1939 CODE § 422(a) (now 1954 CODE § 512(a)(1)); H.R. REP. NO. 2319, *supra* note 66, at 37; S. REP. NO. 2375, *supra* note 67, at 37, 106.

285. 1939 CODE § 422(b) (now 1954 CODE § 513(a)); H.R. REP. NO. 2319, *supra* note 66, at 37; S. REP. NO. 2375, *supra* note 67, at 29, 107. The Technical Explanation in the *Senate Report*, *id.* at

was provided, which was intended to dispose of small cases where the unrelated business income was "incidental."²⁸⁶ Also excluded from the term "unrelated business income" were dividends, interest, royalties, rents (except certain debt-financed "leaseback income") and capital gains and losses. The Senate Report's explanation for this exclusion was that such "passive" investment income was "not likely to result in serious competition for taxable businesses having similar income" and that such income has "long been recognized as a proper source of revenue for educational and charitable organizations."²⁸⁷

C. Leaseback Transactions

A related abuse which Congress sought to correct in the Revenue Act of 1950 was a "bootstrap" transaction in which the exempt organization purchased rental real estate with borrowed funds and then leased the property, often back to the vendor, using the tax-free rental income to pay off the debt.²⁸⁸ What Congress found particularly objectionable in such transactions was the fact that the exempt organization need not commit any of its own funds toward the purchase of the property. Thus, instead of seeking an "adequate rate of return" on investment of "its own funds," the exempt organization was "obviously trading on its exemption."²⁸⁹ Moreover, since such purchases of property were "not in any way limited" by the amount of the exempt organization's own funds, it was feared that such organizations might "in the not too distant future . . . own the great bulk of the commercial and industrial real estate in the country."²⁹⁰ Finally, Congress felt that an exempt organization engaging in such a transaction probably had "in effect sold part of its exemption," in that it might have offered the vendor better terms (either a higher purchase price or lower "leaseback" rental) than a tax-paying vendor could afford to offer; and this abuse, Congress felt, was particularly "likely to occur" when the exempt vendor need not invest any of its own resources in the purchase.²⁹¹ In response to this problem, the new legislation provided that if an exempt organization leased out under a lease of over five years real property²⁹² acquired or improved with borrowed funds, a certain

107, notes that "[I]f a trade or business is regularly carried on, it is still not subject to the . . . tax unless such business is unrelated within the meaning of section 422(b)."

286. 1939 CODE § 421(c) (now 1954 CODE § 512(b)(12)).

287. 1939 CODE § 422(a)(1)-(5); S. REP. NO. 2375, *supra* note 67, at 30-31.

288. S. REP. NO. 2375, *supra* note 67, at 31; *Hearings on Revenue Revision of 1950*, *supra* note 267, at 19.

289. S. REP. NO. 2375, *supra* note 67, at 31.

290. *Id.*

291. *Id.* at 31-32.

292. Real property was defined for these purposes to include "personal property of the lessor leased by it to the lessee of its real estate if the lease of such personal property is made under, or in connection with, the lease of such real estate." 1939 CODE § 423(c).

percentage of the resulting rental income would be included in its gross unrelated business income; this percentage was the fraction consisting of the outstanding indebtedness as numerator and the "adjusted basis" of the property as denominator.²⁹³

When the Revenue Code of 1954 was enacted by Congress, for the most part only changes of arrangement and minor changes in phraseology, but not changes of substance, were made in the "unrelated business tax" and feeder provisions.²⁹⁴ However, one obvious loophole in the "leaseback" provision was closed. The 1950 provisions had applied only to leases for a term of more than five years (and the lease term was to include periods for which a renewal option could be exercised). Congress in 1954, noting that the tax was being avoided by "continuous renewals of leases for less than 5 years,"²⁹⁵ extended the provisions so that the tax applied in the sixth and succeeding years of a business tenant's occupancy of the property, even though the lease was only for a term of five years or less.²⁹⁶

Even after the tightening of the "business lease" provision (then section 514) in 1954, there remained an important exclusion from its coverage—the short term lease of five years or less.²⁹⁷ Thus "bootstrap" transactions, now tailored to fit within this statutory exception, continued to flourish, and the Service, in an attempt to render such transactions less profitable, launched challenges against the favorable tax treatment claimed by each participant (the seller, the lessee, and the exempt purchaser).²⁹⁸ In *Commissioner v. Brown*,²⁹⁹ the Service sought to deny capital gains treatment to the seller in a "bootstrap" transaction. In that case, the exempt organization-purchaser received 80 per cent of the operating profits of the acquired lumber business from the lessee-operating company and then turned over 90 per cent of such payments to the sellers in reduction of its acquisition debt. The Supreme Court held that the seller was entitled to capital gains treatment, rejecting the Service's argument that, due to the absence of risk-shifting from seller to

293. 1939 CODE § 423; S. REP. NO. 2375, *supra* note 67, at 32.

294. The "feeder" provision now appeared in 1954 CODE § 502 and the "unrelated business tax" provisions appeared in 1954 CODE §§ 511-15.

295. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 51 (1954).

296. 1954 CODE § 514(a)(2)(B).

297. *Commissioner v. Brown*, 380 U.S. 563, 565-66 (1965); H.R. REP. NO. 413, 91st Cong., 1st Sess., pt. 1, at 44-45 (1969); S. REP. NO. 522, 91st Cong., 1st Sess. 62 (1969).

298. Cooper, *Trends in the Taxation of Unrelated Business Activity*, 29 N.Y.U. INSTITUTE ON FED. TAXATION, 1999, 2005-06 (1971). See also Rev. Rul. 420, 1954 CUM. BULL. 128, advising participants in bootstrap transactions that the exempt organization might lose its exemption, that it would be taxed on the rental income, and that the seller would be denied capital gains treatment. For a list of cases where the IRS followed the approach of challenging the lessee's deduction of rental payments, see University Hill Foundation v. Commissioner, 446 F.2d 701, 703 n. 1 (1971). One of these cases, Warren Brekke, 40 T.C. 789 (1963), on remand 25 CCH TAX CT. MEM. 1063 (1966), is described in Cooper, *supra* at 2005.

299. 380 U.S. 563 (1965).

buyer, there was no "sale." In closing, the Court described the Service's approach as "a clear case of 'overkill' if aimed at preventing the involvement of tax-exempt entities in the purchase and operation of business enterprises."³⁰⁰ The Court noted that Congress, having considered the problems of exempt organizations' purchasing businesses and paying for property out of the future earnings of the purchased property, had "responded, if at all, with precise provisions of narrow application." Thus, the Court concluded, the framing of any further rules in this area was the province of Congress.

In *University Hill Foundation v. Commissioner*,³⁰¹ the Service sought to deny tax exemption to a foundation which had engaged in twenty-one "bootstrap" purchases of businesses and paid over all its profits to Loyola University, on the ground that it was not "operated exclusively" for exempt purposes. The Tax Court, however, upheld the foundation's claim to exemption. That court did not find "active, direct participation" by the foundation in the leased-out businesses; it rejected the Service's argument that the leases were, in reality, joint ventures. And it held that the foundation could not be taxed as a section 502 "feeder" as it fell within that section's proviso specifically excluding from its definition of trade or business the "rental by an organization of its real property (including personal property leased with real property)." Similarly, it held that the foundation's rental income was not subject to the unrelated business tax in view of section 512(b)(3)'s exclusion, from unrelated business taxable income, of rent. On appeal, the Ninth Circuit upheld the commissioner's determination. It found that the foundation was a "used-business dealer" and thus "engaged in commercial business for profit."³⁰² The rental proviso in the section 502 feeder provision, it held, was not intended to preserve the tax exemption of organizations trading on their exemption by regularly engaging in bootstrap transactions.

This unexpected judicial support for the Service's long struggle against the bootstrap transaction was preceded and overshadowed by its victory in Congress in 1969. The Tax Reform Act of 1969, passed while the Tax Court's *University Hill* decision was still on appeal,³⁰³ replaced the narrow "business lease" provision with a new section 514, "Unrelated Debt-Financed Income," offering a much more comprehensive solution to the "bootstrap transaction" problem. Under this sweeping new provision, an exempt organization receiving *any* income from "debt-financed" property, unrelated in use to its exempt function, would be subjected to the unrelated business tax on the same proportion of that income as the outstanding acquisition indebtedness bears to the

300. 380 U.S. at 579.

301. 51 T.C. 548, *rev'd*, 446 F.2d 701 (9th Cir. 1971).

302. 446 F.2d 701, 705 (9th Cir. 1971).

303. Both the Senate and House Reports discussed the *Clay Brown* case and the Tax Court's decision in *University Hill* in explaining the need for the new provision. H.R. REP. NO. 413, 91st Cong., 1st Sess., pt. 1, at 45-46 (1969); S. REP. NO. 552, 91st Cong., 1st Sess. 63 (1969).

property's adjusted basis. The term "debt-financed property" is very broadly defined to include (with certain modifications) "any property which is held to produce income and with respect to which there is an acquisition indebtedness . . . at any time during the taxable year."³⁰⁴

D. Treasury Regulations

After Congress enacted the unrelated business tax, controversy arose as to the intended scope of the tax. The Regulations contemporaneously adopted by the Treasury in 1952 (under the 1939 Code)³⁰⁵ and readopted later, without major substantive changes, in 1958 (under the 1954 Code)³⁰⁶ set forth three elements required for the imposition of the unrelated business tax and furnished definitions of these elements. First, there must be a "trade or business," and this term, stated the Regulations, "has the same meaning as it has in section 162."³⁰⁷ Second, the trade or business must be "regularly carried on by the organization," *i.e.*, "conducted with sufficient consistency to indicate a continuing purpose of the organization to derive some of its income from such activity." "An activity," noted the Regulations, "may be regularly carried on even though its performance is infrequent or seasonal."³⁰⁸ Third, the business must not be "substantially related" to the performance of the organization's exempt function. A business, stated the Regulations, is "substantially related," if its "principal purpose . . . is to further" the organization's exempt purposes.³⁰⁹

The IRS, however, perceiving a "need for a more complete and detailed explanation of the statute," carried out a "major study" of the statute's intended application,³¹⁰ which culminated in the publication of new proposed Regulations on April 14, 1967 and the filing of new final Regulations on December 11, 1967.³¹¹ These new Regulations redefined the terms "unrelated trade or business" and "unrelated business taxable income." One apparent target of these changes was the approximately \$100 million gross annual advertising revenues of journals published by nonprofit organizations.³¹² The

304. 1954 CODE § 514(b)(1).

305. T.D. 5928, 1952-2 CUM. BULL. 181.

306. T.D. 6301, 1958-2 CUM. BULL. 197. *See especially* former Treas. Reg. § 1.512(a)-1 and former Treas. Reg. § 1.513-1 both added by T.D. 6301, 1958-2 CUM. BULL. 197. Both Regulations were amended by T.D. 6939, 1968-1 CUM. BULL. 274; former Treas. Reg. § 1.512(a)-1 (1958) was redesignated Treas. Reg. § 1.512(a)-2, "[d]efinition applicable to taxable years beginning before Dec. 13, 1967" and former Treas. Reg. § 1.513-1 (1958) was redesignated Treas. Reg. § 1.513-2, "[d]efinition of unrelated trade or business applicable to taxable years beginning before Dec. 13, 1967."

307. Present Treas. Reg. § 1.513-2(a)(1).

308. Present Treas. Reg. § 1.513-2(a)(2),(3).

309. Present Treas. Reg. § 1.513-2(a)(2),(4).

310. T.I.R. No. 899 (April 14, 1967), 7 CCH 1967 STAND. FED. TAX REP. ¶ 6557 announcing completion of the study and publication of proposed Regulations.

311. T.D. 6939, 1968-1 CUM. BULL. 274.

312. Weithorn & Liles, *supra* note 259, at 791. The journals apparently affected included

not insignificant competition, in the area of advertising revenues, that the exempt journals could offer to non-exempt journals seemed to weigh heavily in the Treasury's decision to attempt to declare these revenues subject to tax.

In T.I.R. 899, announcing the completion of its study, the Treasury declared that the basic purpose of the 1950 unrelated business tax provisions was "to remove the unfair competitive advantage which tax immunity would confer upon exempt organization business." It noted, at a later point in the information release, that its study had confirmed the assertion of taxpayer groups that a "number of exempt organizations conduct active and competitive advertising businesses in association with their publications." In attempting to tax such advertising revenues, the proposed Regulations, in the Service's self-serving view, were "[c]arrying out the fundamental policy objective of the unrelated business tax and applying the statutory standards."³¹³

The new Regulations, by way of text and examples, made it explicit that the solicitation and publication of advertising by "exempt organization" journals constituted a "trade or business" (Regulation section 1.513-1(b)) which was "unrelated" to the organization's exempt purposes (Regulation section 1.513-1(b)(4)(iv) Examples (6) and (7)), and the Regulations also offered rules by which exempt organizations deriving journal advertising revenues could compute allowable deductions to arrive at "unrelated business taxable income" (Regulation section 1.512(a)-(1)(d)(2) and (e) Example (2)).

Under the 1958 Regulations the term "trade or business" had been construed as referring to an *entire*, unfragmented economic unit or enterprise.³¹⁴ The new Regulations, on the other hand, explicitly defined the term as including "any *activity* carried on for the production of income." The Regulations specifically stated that the term "is not limited to integrated aggregates of assets, activities and good will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code."³¹⁵ The purpose and significance of this new definition for exempt journal advertising revenues is not left for the gentle reader's speculation. The Regulations categorically state:³¹⁶

Nation's Business, published by the Chamber of Commerce of the United States with an estimated four million dollars gross annual advertising revenues, *Journal of the American Medical Association* with an estimated ten million dollars gross annual advertising revenues, and *National Geographic* published by the National Geographic Society with an estimated six million dollars gross annual advertising revenues.

313. T.I.R. No. 899, *supra* note 310.

314. Weithorn & Liles, *supra* note 259, at 798. See also Cooper, *Trends in the Taxation of Unrelated Business Activity*, 29 INSTITUTE ON FED. TAXATION, N.Y.U. PROCEEDINGS 1999, 2007 (1971). Cooper notes that the 1958 Regulations used examples, drawn from the 1950 Committee Reports, (see Treas. Reg. § 1.513-2(a)(4), "[d]efinition of unrelated trade or business applicable to taxable years beginning before Dec. 13, 1967") which appeared to refer only to entire enterprises as the potential objects of the tax.

315. Treas. Reg. § 1.513-1(b) (1967) (emphasis added).

316. Treas. Reg. § 1.513-1(b) (1967).

Similarly, activities of soliciting, selling, and publishing commercial advertising do not lose identity as trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization.

Some critics have argued that this new definition of "trade or business" is inconsistent with congressional intent.³¹⁷ The 1950 Senate Finance Committee Report had flatly stated that the "term 'trade or business' has the same meaning as it has elsewhere in the Code, as, for example, in Sec. 23(a)(1) [now Code section 162]."³¹⁸ Also, the 1950 statute refers to "any trade or business" without using the term "activities." Moreover, the statute as enacted should be contrasted with a bill introduced by Representative Mason of the House Ways and Means Committee in 1949 but not enacted;³¹⁹ that bill would have subjected to tax "all business income," defined to include income from "any activity of a kind which is recognized as an ordinary trade or business activity."³²⁰ In addition, the examples of trades and businesses offered in the 1950 Senate Report, *i.e.*, a tire business, a wheat farm, a *university press*,³²¹ clearly conform to the definition of "trade or business" as a single economic unit, rather than as an "activity." The wording of the statute, which defines unrelated business taxable income as "gross income . . . from *any* unrelated trade or business," less allowable deductions, also indicates Congress's intent to reach only *a* trade or business, which is unrelated, but not unrelated business activities carried on by an exempt organization in conjunction with the performance of its exempt purposes.³²²

317. Weithorn & Liles, *supra* note 259, at 798-800. See also Moore, *Current Problems of Exempt Organizations*, 24 TAX L. REV. 469, 475-76 (1968).

318. S. REP. NO. 2375, 81st Cong., 2d Sess. 106 (1950).

319. H.R. REP. NO. 5064, 81st Cong., 1st Sess. (1949). This point is made by Moore, *supra* note 317, at 476. See also Weithorn & Liles, *supra* note 259, at 795.

320. See H.R. REP. NO. 5064, 81st Cong., 1st Sess. (1949), quoted by Weithorn & Liles *id.*

321. S. REP. NO. 2375, 81st Cong., 2d Sess. 29, 107 (1950). Weithorn & Liles, *supra* note 259, at 800. As noted, the Report states that "[I]ncomes from a university press would be exempt in the ordinary case since it would be derived from an activity that is 'substantially related' to the purpose of the university." S. REP. NO. 2375, *supra* at 29. Congress, if it considered at all the presence of advertising in such presses, certainly expressed no intention that advertising revenues be taxed.

322. Weithorn & Liles, *supra* note 259, at 799; 1954 CODE § 512(a)(1) (emphasis added). In *Massachusetts Medical Soc'y v. United States*, 35 Am. Fed. Tax. R.2d 75-963 (D. Mass. 1974), *aff'd*, 75-1 U.S. Tax Cas. ¶ 9392 (1st Cir. 1975), involving the applicability of the unrelated business tax to the advertising revenues of a medical journal, District Judge Skinner ruled that "[t]he conversion by the Treasury of the concept of 'trade or business' in Section 513 of the Internal Revenue Code into the notion of an isolated 'activity' in Reg. [§] is unwarranted." He pointed to the arguments presented in Moore, *supra* note 317. He also noted that "Congress felt obliged to change the statute in order to reach the result sought to be achieved by the regulation for years beginning after Dec. 31, 1969." 35 Am. Fed. Tax. R.2d 75-963. The Court of Claims agrees with the reasoning of the First Circuit in *Massachusetts Medical Society v. United States*, and reaches the same result in *American College of Physicians v. United States*, No. 100-74 (Ct. Cl., Feb. 18, 1976).

The new Regulations' definition of "regularly carried on"³²³ shows the same strong emphasis on the "competitiveness" of the exempt organization as was noted in T.I.R. 899. In Regulation section 1.513-1(c)(1), the Treasury reiterated that the purpose of the tax is to "place exempt organization business activities upon the same tax basis as the non-exempt business endeavors with which they compete." In determining whether an exempt organization's "intermittent" business activities should be classified as "regularly carried on," the manner of their conduct must, therefore, "be compared with the manner in which commercial activities are normally pursued by non-exempt organizations."³²⁴ Thus, intermittent activities carried on "without the competitive and promotional efforts typical of commercial endeavors," (and here the Treasury favorably offers the example of advertising in programs for sports events or music performances) are not deemed to be "regularly carried on."³²⁵

The final element required for imposition of the tax, *i.e.*, that the trade or business not be "substantially related" to the organization's exempt purposes, has also been redefined in the new Regulations.³²⁶ The old test, requiring that the business's "principal purpose" be to further exempt purposes was replaced by a new test requiring that "the production or distribution of the goods or the performance of the services . . . must contribute importantly to the accomplishment" of the exempt purposes.³²⁷

The Treasury dubiously declared this new test more liberal than the old one.³²⁸ However, whereas advertising revenues of an exempt organization's "related" journal were not taxed under the old test, such advertising revenues, under the new test, are deemed "unrelated" and therefore subject to tax. Moreover, as specified by the examples in the new Regulations,³²⁹ *all* such advertising is deemed unrelated, whether it be "general consumer advertising" or advertising limited to "products which are within the general area of professional interest" of the organization's members.³³⁰ Albeit, it could be cogently argued that this second category of advertising (*e.g.*, advertising of drugs in a medical association's journal) "contributes importantly" to the exempt purpose of educating members as to products meeting their professional needs, Treasury's example flatly rejects this argument, stating that the "publication of advertising designed and selected in the manner of ordinary

323. Treas. Reg. § 1.513-1(c) (1967).

324. Treas. Reg. § 1.513-1(c)(2)(ii) (1967).

325. *Id.*

326. Treas. Reg. § 1.513-1(d) (1967).

327. Treas. Reg. § 1.513-1(d)(2) (1967).

328. T.I.R. No. 899, *supra* note 310. The change was described as one of "several important liberalizations."

329. Treas. Reg. § 1.513-1(d)(4)(iv) Examples (6),(7) (1967).

330. *Id.*

commercial advertising" cannot be classified as educational.³³¹ In so reasoning, the Treasury mistakenly looks to the purpose of the advertisers rather than that of the exempt organization publisher.

The statutory definition of "unrelated business taxable income," as the gross income from any unrelated trade or business *less* the expenses "directly connected with the carrying on of such trade or business," posed a real dilemma for the Treasury. On the one hand, Treasury had declared the goal of putting the competing business activities of exempt and non-exempt organizations on an equal basis; however, this statutory definition of unrelated business taxable income, taken in conjunction with Treasury's new definition of "trade or business" to include an activity, such as advertising, would seem logically to require that an exempt journal be taxed on its advertising revenues with deductions allowed only for *advertising* expenses, even though the journal as a whole was operating at an overall loss. Treasury chose a pragmatic solution; it chose to uphold its goal of an "equal tax basis" even though it involved stretching the scope of the statutory term "directly connected" expenses. Thus, under the new Regulations (section 1.512(a)-1(d)(2) Example (2)) an exempt organization publishing a journal whose editorial content is deemed "related" to its exempt purposes, nevertheless may apply the expenses (in excess of subscription revenues) attributable to this exempt editorial activity *against* the "unrelated" non-exempt advertising revenues; under the Regulations' "equal tax basis" approach, such "exempt activity" expenses are deemed to be "directly connected" with the carrying on of the non-exempt advertising business, because such editorial expenses are "costs generally incurred by taxable organizations publishing journals with advertising." (Example (2)). So much for the logic of the Treasury's position!

E. Congressional Response

The publication of the new Regulations in December of 1967 provoked congressional interest in the issue of advertising revenues, or rather the battle shifted to the Hill. The issue was considered twice by Congress in 1968, but no legislation resulted.³³² An exemption from tax for advertising revenues of exempt journals passed the Senate, but failed to survive the Conference.³³³ Later in the year the full Senate rejected a one year postponement of the Regulations' effective date, which had been approved by the Senate Finance Committee.³³⁴

On reconsidering the continuing issue the next year, Congress finally enacted a provision in the Tax Reform Act of 1969 which endorsed the

331. Treas. Reg. § 1.513-1(d)(4)(iv) Example (7) (1967).

332. Moore, *supra* note 317, at 477.

333. *Id.*

334. *Id.*

Treasury's redefinition of "trade or business" for purposes of the unrelated business tax. Newly enacted section 513(c), entitled "Advertising, Etc. Activities," defined "trade or business" for purposes of the unrelated business tax as "any activity which is carried on for the production of income from the sale of goods or the performance of services"; the new provision further stated:³³⁵

For purposes of the preceding sentence, an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, *or may not*, be related to the exempt purposes of the organization.

As the title of this new provision indicates, Congress was concerned primarily with advertising revenues of exempt organization journals. The new statutory provision, however, would seem to deal only with the definition of "trade or business," and to leave unaffected the definition of "unrelated." Thus, exempt organizations can still argue, with respect to advertisements in their related journals, that certain kinds of advertising (*e.g.*, advertising of products relating to the professional interests of the exempt organization's members), are "related" to the organization's exempt purposes.³³⁶

CONCLUSION

The prior history related above speaks pretty well for itself. Each reader is free to interpret it and read into it what he will. However, some conclusions may be safely drawn: From the very beginning of our federal income tax laws, charities have been exempted from tax; in addition, from very early dates both individuals and corporations have been encouraged to support charities through allowance of tax deductions for charitable contributions,

335. 1954 CODE § 513(c) (emphasis added).

336. A somewhat similar issue, which the IRS has not yet resolved, is whether the unrelated business tax should be imposed upon income received by exempt organizations from supplier exhibits at their conventions. IRS might attempt to assimilate this case to its treatment of advertising revenues, on the theory that the ultimate purpose of the *suppliers* is to sell their products. On the other hand, IRS might focus more properly on the principal purpose of the *association* in holding the suppliers' show, namely to educate its members as to available products. An appropriate analogy could be found in the definition of membership income in § 277 (added by the 1969 Tax Reform Act, Pub. L. No. 91-172, 83 Stat. 487) to include income from institutes and trade shows which are "primarily for the education of members." In fact, one well might argue that, in the area of journal advertising also, the IRS should have put heavier emphasis on the exempt organizations' purposes, rather than on the purpose of the advertiser.

[Note: After this article went to press, the IRS published a series of five Revenue Rulings dealing with the treatment of income from the rental of display space to exhibitors at exempt organization sponsored trade shows. See Rev. Ruls. 75-516 - 75-520, 1975 INT. REV. BULL. No. 48, at 18-23. Generally, the Rulings focus on the "potential informational value" of the exhibits and, primarily, the presence or absence of selling and order-taking as determining whether the space rental income is unrelated business income.

Similarly, after this article went to press, the Treasury adopted amendments to the Regulations dealing with the advertising income of exempt organizations. See T.D. 7392, 1976 INT. REV. BULL. No. 3, at 7. The text and prior footnotes refer to the Regulations prior to this amendment.]

which have been unlimited in the case of the gift and estate taxes, and which over the years have been generously increased and made more liberal as far as the income tax deduction is concerned. One does not have to be an economist to appreciate what this tax encouragement has meant to the development of private philanthropy in this country. Our record of achievement in this regard is unique in the world and one of which all taxpayers can be justly proud. Moreover, when tax abuses inevitably appeared, attempts were made to deal with them carefully, in a limited way designed to eliminate the abuses without harming private charity. Here again, the record preceding the Tax Reform Act of 1969 was not a mean achievement. Having come this far and having achieved so much under a tax system which encourages private philanthropy, it would be a disaster if we were at this late date to decide to junk the present system in favor of some untried scheme of direct government subsidy or operation of all charity.