CHARITIES AND FEDERAL TAXES: ISSUES FOR ANALYSIS*

by

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November 1989

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Any comprehensive analysis of charities and the law must consider tax issues, for in the United States, the tax law is the principal way in which the federal government interacts with charities, both to support by exemption and gift deductibility, and to regulate by conditions on qualification for such support. Overwhelmingly, the most important federal support for charities comes from their exemption from income taxation and the favorable tax treatment of living and deceased donors, and the federal tax system also includes -- though not to so great a degree now as formerly -- other provisions intended to favor charities. In addition, virtually all federal regulatory standards for charities are also embedded in Title 26.

This paper, written from the perspective of a practitioner, identifies a number of specific issues, some relatively technical and immediate, some rather more long-term in nature, that should be included in a comprehensive agenda for research on legal issues affecting charities.

1. Rationale And Utility Of Exemption. The very fact that federal tax rules applicable charities serve several purposes means that they lack a single, unifying theme or objective. The rationale for the most basic tax rule applicable to charity -- exemption of current income from tax -- is implicit, rather than explicit. A modern legal analysis of charity requires a fresh look at the rationale for exemption. Exemption could plausibly be said to serve a host of purposes. A central goal of exemption is to identify those organizations that perform public services and to make resources available for those services by foregoing normal taxes.

Under current conditions, however, exemption is important less for current tax savings on income than as the threshold test for eligibility for other benefits -- especially deductibility of contributions.[1] For grantmaking foundations, and a small

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1. For all practical purposes, in this country status as a federal section 501(c)(3) organization is both a necessary and sufficient condition of being a charity. With federal exemption under section 501(c)(3) come a variety of other, consequential benefits outside the tax system -- at least a presumptive claim to local property and sales tax exemptions and access to lower postage rates. In addition, some federal programs prefer "c-3's" as grantees.

number of operating institutions with substantial endowments, relief of current income taxation remains the critical effect of exemption. But the great bulk of operating charities — including many of the wealthiest — show, over any period of time, no net income — at least if, consistent with normal tax principles for measuring income, current gifts are left out of account. Thus, exemption from federal income tax does not in itself produce significantly different economic results than would be obtained by treating such charities as "in the business" of providing charitable services, with concomitant deductions of current costs and capital allowances -- especially if the normal rule that gifts are not income were applied.

Perhaps because exemption is, as a practical matter, conferred largely on entities that would have no taxable income in any event, treating as a business expense the cost of their basic function for society, it is sometimes argued that the true purpose of the exemption is administrative simplicity. This purpose is plausible in both a limited and a more expansive sense of the virtues of administrative simplicity.

— Where detailed computation is likely to produce no revenue, there is a strong societal efficiency in foregoing the analysis — particularly in a context where so many of the entities are small, understaffed and underfunded anyway.

— Second, and more profoundly, exemption can be said to reflect a judgement in favor of autonomy for private institutions that produce socially and economically valuable services, but not, to any significant extent, economic gain. For one important special class of charities, churches, it is sometimes suggested that tax exemption (and abjuring direct tax support) is, if not constitutionally required, at least a very convenient and efficient way of enforcing separation of church and state. The same rationale, arguably, supports exemption of privately controlled public service entities that have only a pragmatic, not a constitutional, claim to noninterference by government.

The exemption of charities has not, of course, been complete since the enactment of the unrelated business income tax in 1950, and the excise tax on private foundation investment income in 1969. Pressures to extend the UBI tax -- and

indeed, to tax investment income more broadly – may call into question the concept of exemption itself.

Compared to other institutional taxpayers, the unique element of the UBI tax is that it bifurcates a taxpayer's economic existence. In one domain — the "unrelated" — receipts are taxable but costs deductible; in the other — the "related" — income is not included so deductions are irrelevant, but costs in this domain generally cannot offset income in the other domain. Historically, the basis of the division was between income derived from activities "related" to charitable purposes, in the latter class, and, in the former class, "unrelated" activities.

However, in recent years, pressure has increased to define various sorts of receipts by charitable entities — including many hitherto thought integrally connected with their core functions (including passive investment income) — as subject to the tax on "unrelated" income. The tendency of this approach will be to segregate the charity's profitable "lines" from its losers, and, by applying the general rule that "related" costs cannot offset "unrelated" income, to tax the full apparent net of the winners, with no allowance for the costs of the losers. Carried very far, this trend could produce a situation in which an operating charity would be subject to higher taxes as an "exempt" than as a regular business — assuming, of course, that its core charitable activity would qualify as a business for tax purposes.

An issue for research, therefore, is these pressures on exemption, and the consequences of any scheme that would not make exemption from normal income taxes the cornerstone of federal tax policy vis-a-vis operating charities.

2. Contribution/Deduction Rules. As a tax subsidy, the charitable contribution deduction is far more important than exemption for operating charities — and at least as important for endowed foundations. Conceptually, the basis for the deduction is presumably that gifts to charity are fully dedicated by the donor to the public purposes advanced by charitable services, and therefore should not be subject to tax to support other public purposes advanced by governmental expenditures. Less conceptual, but probably more compelling for legislators, donors, and donees, is the argument that the contribution deduction is an appropriate incentive to devoting

wealth and income to "good," non-personal purposes that are in society's view certainly better than personal consumption or passing wealth to the next generation and, in many cases, better than the equivalent services being supported by taxes.

Viewed as an incentive system, however, the current deduction regime is imperfectly balanced. Most of the population does not itemize, and so feel no tax incentive for charitable gifts. Gifts of different kinds of property are treated quite differently in terms of the amount declared deductible. To some degree as well, the degree of tax incentive varies according to the character of the donee institution, with gifts to private foundations significantly less favorably treated than gifts to other charities. Bequests at death are not subject to the principle, strongly reflected in the income tax law by percentage limits and inclusion in the AMT base of the appreciation element of gifts of property, that charitable gifts should not eliminate all tax liability.

An important issue for research is improving our understanding of these incentive effects of federal tax benefits to philanthropic generosity. Somewhat similarly, the differing charitable contribution rules impact different sorts of gifts very differently, and constitute an implicit policy of differential support whose implications — and acceptability — would be illuminated by analysis.

3. Private Inurement; Herein Of Insiders And Compensation. Legally critical to tax benefit of charity has been irrevocably foregoing the potential personal rewards of ownership of property held by the charity. This principle, reflected in the ban on "private inurement" has always been subject to the rule that a charity can pay "reasonable compensation."

Historically, there has probably been a societal expectation that those who chose to work in the charitable sector will accept lower levels of compensation than those who work in the business world. However, beyond a general standard that compensation must be "reasonable," this expectation has not been embodied in the tax law.

Most salaries paid by charities still lag well behind those normally paid by for-profit business, but the patterns of compensation, especially for senior managers, who may have incentive arrangements, may well become a focus of public attention —

and of Congressional concern.[2] Such concerns seem likely to confuse widely publicized (and already illegal) abuse cases — particularly in the little-monitored religious fields — with pay in a number of areas, e.g., health care, in which charities must, to attract talent, pay fully competitive salaries that are very high by the standard of average income in the country. The fact that many charities pay their senior management substantially more than Congress has been able to find the courage to pay itself and senior federal officials can be expected to add to the temptation to criticize management salaries.

Historically, compensation issues have been a source of tax controversy for charities only where insiders appear to be abusing their position, so that an issue of "private inurement" arises. Under current law, charities — like other taxpayers -- can properly pay "reasonable compensation." An issue for research is that of standards for determining the content of the notion of "reasonable compensation" in the charity context.

4. Scope Of Activities Eligible For Exemption: What Is A Section 501(c)(3) Purpose? History and tradition play a central role in exemption; an important reason the core types of charities — churches, schools, hospitals, museums, and the like — are now exempt is that they always have been. Even historically, the scope of "charity" has been a broad and evolving one, but there have been disputes over granting qualification to groups involved in activities that depart from standard charitable programs; newer types of groups have successfully assimilated themselves to exempt treatment on the basis of public services analogous to traditional ones, specific new social functions, and, in some cases, clout or fashionability without broad agreement on the overarching principle of an evolving concept of charity based on public service through private groups.

Sometimes the recognition of qualification has come at the administrative level;

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2. The new rules for public inspection of information returns, which include reports of management compensation, can be expected to focus more attention on the issue of compensation for executives of section 501(c)(3) organizations.

sometimes from the Congress. The result has been a considerable degree of inconsistency in qualification, particularly at the boundary between serving an interest that is specific, but still deemed "public" in character and serving an interest that is deemed too narrow, though having a public interest. The IRS' long-standing resistance to granting section 501(c)(3) status to groups that set professional standards is but one example.

In addition to the lack of a systematic set of rules for determining what types of organizations qualify for exemption under the existing standard, which focuses on the inherent character of the benefits provided, there have been proposals for a new, more economically oriented, standard. One view of exemption is that it should be reserved for activities that not only serve a social purpose, but that the market will not provide in anything like the necessary amount, and that require a continuing subsidy — not only from the state in the form of exemption, but from the public in the form of contributions. It is a necessary corollary of this view that the list of exemption-qualifying activities must be periodically reviewed to disqualify — with appropriate transition rules — those activities that no longer need such subvention, because they have become actually or potentially self-sustaining.

It was clearly some such concept that underlay the decision to terminate the exemption of Blue Cross/Blue Shield in 1986. High on the list for exclusion if the principle were generalized would be most exempt hospitals. However, the principle itself is flawed by failure to recognize the differences in motivation, values, community involvement, and accountability that come with a non-profit, charitable mission.

An issue for research is the merits and content of such a standard of exemption — and what would be irretrievably lost were it adopted.

5. <u>Accumulation Of Wealth And Economic Power In A Particular Sort Of Exempt Organization — Pension Funds — And Its Effects On Rules For Charities</u>. Pension funds — whose exemption also rests on section 501(a) — control a large, and probably increasing, segment of the wealth of the country. The share controlled by section 501(c)(3) entities pales by comparison, but the association of the two may produce changes in rules that, while arguably appropriate for pensions, are not for

charities.

The recent Congressional inquiry into investments by "exempts" LBOs suggests that, increasingly, the investment practices of "exempts" will be an issue in the public policy debate — with proposals to curtail perceived abuses by limiting the investments of tax exempts or subjecting the income from such investments to taxation. The notion that tax exemption entails legally-imposed limits on investment choice is hardly unprecedented. Indeed it has only been in recent decades that traditional "legal lists" for charitable trusts have gradually been abolished, and sections 4943 and 4944 — which find pension analogues — embody modern versions of the concept.

Discussions of new limits pose issues, not only of the potential effects of particular limits, but of the problem of accountability and of the continuing appropriateness of linking investment-related limits on pension funds and on charities, given the different nature of the entities and their social functions.

6. Convergence Of Other Tax Rules For Charities To Those For Other Taxpayers: Pensions, Payroll Taxes, Tax Exempt Bonds. Before the last few years, the tax laws contained significant special preferences to charities, such as more flexible pension rules and exemptions from generally applied payroll taxes. While some such rules survive, the trend in recent years has been to assimilate charities to the same tax regime as other entities. The significance and appropriateness of this change is an appropriate subject of future analysis.

7. The Private Foundation/Public Charity Distinction. Since 1969, federal tax treatment of charities has depended heavily on whether the charity is classified as a "private foundation" or a "public charity." Special rules that apply only to private foundations deal with self-dealing, minimum charitable distributions, permitted ownership of single businesses, risky investments, legislative advocacy, and grant administration and supervision — and the investment income of private foundations is subject to a low-rate excise tax. Further, gifts to private foundations are treated less generously than gifts to public charities. These private foundation rules are by no means unworkable but they are substantially more restrictive — and more complicated to obey — than those governing other charities.

At the extremes, such as traditional schools and churches and groups with broad community support, the organizations that are exempt from the private foundation rules differ sharply from the single-donor dominated endowments that are. But at the margin, the distinctions and their rationale can be unclear. Why, for example are "schools", "hospitals" and "churches" automatically exempt, based on the character of their work, while museums, social service agencies, research institutes, and arts organizations must show public support. The complex "section 509(a)(3)" -- funds dedicated to support of a particular public charity (or even non-charity exempt organization) — may be less publicly accountable than the typical public charity. Issues for research include the rationale for the public/private distinction and the appropriateness of continuing so sharp a regulatory distinction based on the classification.

8. Role Of Charities In The Public Policy Debate. A development of relatively recent origin is the emergence of the issue-oriented section 501(c)(3) organizations as a principal instrument for the formulation and articulation of public policy positions, and, indeed, as a key player in the policy debate. Paralleling social changes, the tax law has, in general, been encouraging to the growth of organizations whose principal purpose is neither academic research nor direct services in any traditional sense, but shaping public policy — groups concerned with civil rights, the environment, foreign policy, economic organization, and the like. Initially heavily "liberal" in outlook, the conservative side of the spectrum is now vigorously participating.

Scarcely a serious perspective or position now lacks its own more or less well funded think tank, complete with researchers, litigators, lobbyists, and spokespersons. Use of the tax system to encourage such groups — by making contributions tax-deductible — has resulted in a livening and deepening of public debate. So far, the IRS has been commendably non-partisan — and, more important, broadly tolerant — in carrying out its tasks in this area. However, the memory of Nixon's "enemy list," coupled with the Supreme Court's bland treatment of tax arrangements for charities as subsidies that can be granted or withheld largely at will, potentially expose the

system to manipulation. The field therefore presents both policy and constitutional issues for research.

9. IRS As Charity Commission. Under current arrangements, the United States has, in practical effect, a national Charities Commissioner buried within the structure of the Internal Revenue Service. The essentially regulatory functions of the IRS with respect to exempt organizations are quite different from the revenue tasks that are the central focus of that agency. Especially given close to a century of tradition — not to mention considerations of federalism and respect for the dedication of IRS exempt organizations specialists — there is much to be said for leaving the institutional arrangements as they are, but there are clearly possible alternative structures.

10. UBIT Issues. The pendency of proposals for a major restructuring of the unrelated business income tax makes it premature to propose topics of research in this area, but clearly there will be many. If the tax becomes more significant because more types of income are subject to it, issues inherent even in the current regime will attain more significance. First, there are important issues of the purpose of the tax. In fact enacted primarily with a view to curbing unfair competition by ordinary businesses runs through a charity with taxing firms, the tax has gradually expanded, and, with that expansion and proposals for more, have come assertions that the historical purpose is too narrow. The rules on debt-financed income and on passive income from subsidiaries, for example, serve a "fair competition" goal only in the most general sense. Some recent proposals for extending the tax treat its purpose, not as insuring equal tax treatment of charities' unrelated businesses, but as deterring the establishment of such businesses altogether.

11. Issue Of Transition Into And Out Of Exempt Status. A surprising number of section 501(c)(3) organizations have a taxable past and may find themselves voluntarily or involuntarily in a taxable future. The consequences of loss of exemption — whether by IRS action or voluntary surrender of the status — are surprisingly vague, being partly a product of state-law limits (imposed in large part by the federal tax laws as a condition of exemption) and partly of direct tax rules.

12. Constitutional Issues. Finally, tax rules affecting exempt organizations present constitutional issues to a degree practically unknown nowadays in other tax areas. Several significant judicial decisions in recent years[3] have raised a range of potential future issues, including the constitutional status of religious exemptions[4] (including the problems presented by IRS efforts to define a "church," and IRS discretion in enforcing restrictions on organizations active on controversial issues.[5] Complex potential church-state issues are presented by such long-standing federal tax provisions as the rules for reporting and auditing of church returns and the parsonage exemption.

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3. These include Bob Jones, TWR, ARM, and Big Mama Rag.

4. Compare Walz' holding, in effect, that since tax exemption is not a subsidy, church exemptions are consistent with the Establishment Clause with TWR's holding that since gift deductibility is a subsidy, Congress can condition its availability of foregoing First Amendment rights to petition Congress.

5. This is the issue presented in the ARM litigation.