

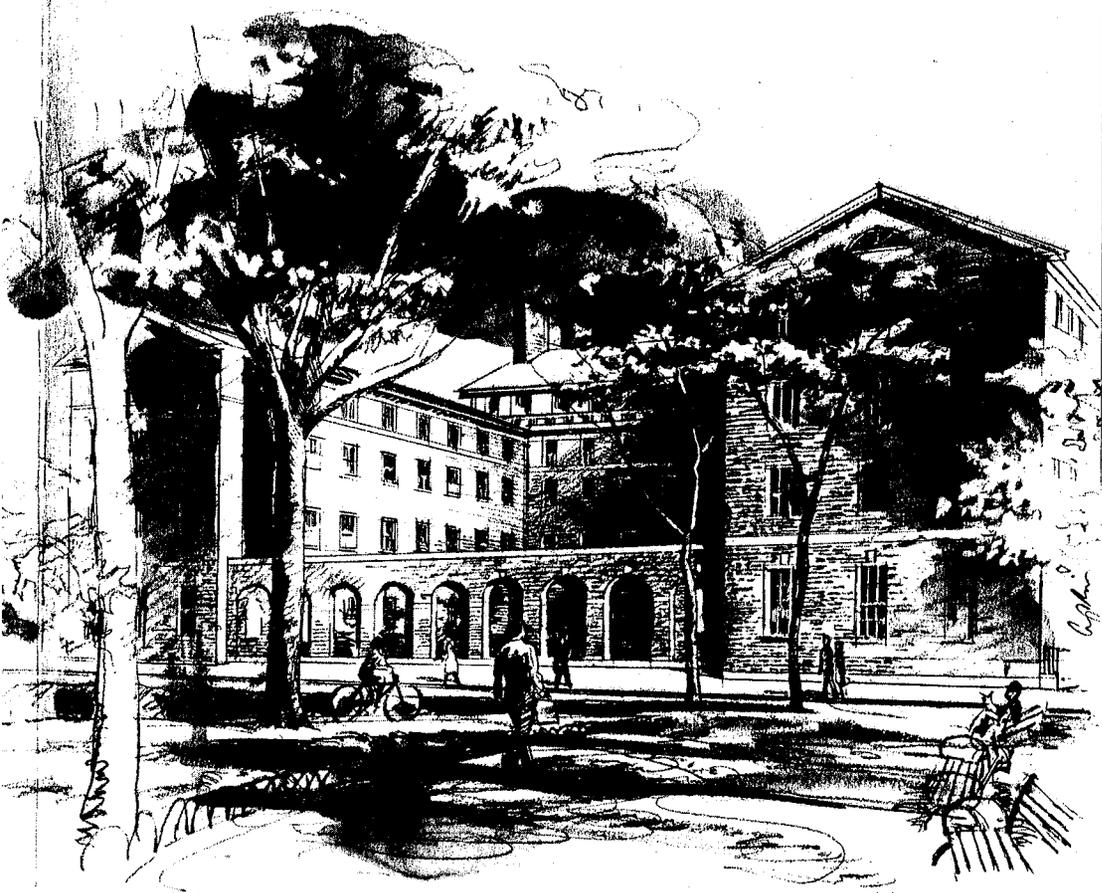
New York University  
School of Law

3

TOPICS IN PHILANTHROPY

Privileges & Exemptions Enjoyed By Nonprofit  
Organizations: A Catalog and Some Thoughts on  
Nonprofit Policymaking

The Program on  
Philanthropy and the Law



**Privileges & Exemptions Enjoyed  
By Nonprofit Organizations:**

**A Catalog And Some Thoughts  
On Nonprofit Policymaking\***

**Bazil Facchina  
Evan Showell  
Jan E. Stone**

---

\* Copyright © 1993, New York University. All rights reserved.

## TABLE OF CONTENTS

I) Introduction .....	1
II) Catalog Of Privileges And Exemptions .....	8
A) Special Treatment Under The Tax Laws .....	8
1) Federal Income Tax Exemptions .....	8
2) Federal Income Tax Deductions for Contributions .....	23
a) Limitations on the Amount Deductible by Individuals and Corporations .....	26
b) Federal Charitable Deductions for Income of Estates and Trusts .....	30
3) Income Tax-Exempt Government Bonds .....	32
4) Income Tax-Deferred Retirement and Compensation Plans .....	33
5) State Income Tax Exemptions .....	34
6) Federal Estate Tax Charitable Deduction .....	34
7) State Inheritance and Succession Taxes .....	36
8) Federal Tax Deduction for Taxable Inter-Vivos Gifts .....	36
9) Unemployment Insurance Tax .....	37
10) Social Security Tax .....	40
11) Federal Excise Taxes .....	43
12) Exemptions Afforded from Taxes Generally Imposed by State Law .....	44
a) Sales and Use Tax Exemptions .....	44
b) Property Tax Exemptions .....	45
B) Antitrust Law Exemptions .....	47
1) Price Discrimination .....	48
2) Unfair Competition .....	50
3) Business of Insurance Exemption .....	51
4) State Action Antitrust Exemption .....	53
5) Restraint of Trade — Sherman Antitrust Act .....	55
6) Miscellaneous Federal Antitrust Law Exemptions .....	63
7) State-Level Antitrust Enforcement Activities .....	64
C) Securities Regulation Exemptions .....	64
1) Securities Act of 1933 .....	66
2) Investment Company Act of 1940 .....	68
3) Miscellaneous Federal Securities Law Exemptions .....	68
4) Exemptions under State Securities Laws .....	69

D) Federal Involuntary Bankruptcy Exemption For Nonprofits .....	71
E) Preferred Postal Rates: Special Second And Third Class Nonprofit Postal Rates .....	72
1) Cooperative Mailings .....	78
2) Advertising .....	79
F) Labor Regulation .....	80
1) Federal Wage and Hour Laws .....	80
2) Federal Collective Bargaining Laws .....	82
3) Federal Anti-Discrimination Laws .....	85
4) State Workers' Compensation Acts .....	86
G) Copyright Law .....	87
1) "Fair Use" .....	87
2) Performance or Display of Protected Works .....	88
3) Nonprofit Broadcasters .....	90
H) Exemption for Nonprofits from Federal and State Criminal Liability .....	92
1) Federal Conflict of Interest and Lobbying .....	92
2) Federal Antibribery Law .....	93
3) Gambling-Related Criminal Law Exemptions .....	93
I) Miscellaneous State Law Provisions Immunizing Nonprofits From Civil Liability Under Certain Circumstances .....	96
J) Government Assistance Programs .....	98
K) Surplus Government Property .....	99
L) Financial Reporting And Accounting Standards .....	101
1) Nonprofit Accounting Concepts .....	101
2) Setting Accounting Standards for the Nonprofit Sector .....	102
3) Current Developments .....	103
4) Trends in Nonprofit Accounting .....	106
III) Conclusion: Better Methods To Oversee The Benefits Accorded Nonprofits .....	106
A) Problems Facing the Nonprofit Sector .....	106
B) Proposals for a Modified Regulatory System .....	112

## D) Introduction<sup>1</sup>

This article has two purposes. The first and principal purpose is to catalog and describe the privileges and benefits accorded nonprofit organizations by federal, state, and local governments and thereby increase the awareness of these benefits among those concerned about nonprofit issues. The second purpose grows out of the catalog which shows the diffusion in the present system of authority for overseeing these privileges and benefits and regulating nonprofits. This article therefore questions the wisdom of regulating nonprofits on an *ad hoc* basis, as is presently the case, and seeks to stimulate thinking about whether alternatives to the present regulatory system should be considered.

Organizations considered "nonprofit" because they satisfy various requirements defining "nonprofit" status,<sup>2</sup> are entitled to a panoply of exemptions and privileges under federal, state, and local law, which relieve nonprofits of many governmental burdens placed on ordinary citizens. While exemptions and benefits have been granted to favored entities literally for millennia,<sup>3</sup> seldom have they

---

1 Mr. Facchina (B.S.B.A., Boston University; J.D., University of Virginia; LL.M., (Taxation) New York University) is a member of the District of Columbia and Massachusetts Bars. Mr. Showell (B.A., University of Chicago; J.D., New York University) is a member of Anderson Kill Olick & Oshinsky, P.C. in New York, New York. Ms. Stone (B.A., University of Pennsylvania; M.S., Columbia University; J.D., New York University) is an associate attorney at McDermott, Will & Emery in Chicago, Illinois. The authors wish to express their special thanks to Professor Harvey P. Dale, Director, Program on Philanthropy and the Law, New York University School of Law, for first proposing this topic and for his guidance and insight in directing the authors' efforts. The authors also wish to thank Professor Richard H. Levenson of the Program for his editorial assistance. Additionally, the authors thank Sandra K. Agan and Carol J. Petitmaire for their invaluable assistance and technical expertise.

It is the authors' hope that their survey of pertinent law over a wide range will be useful to practitioners in the field of philanthropy and the law, and that this survey of a decentralized regulatory system will encourage discussion on whether greater centralization is desirable.

2 This status is generally determined for particular purposes under bodies of law governing specific areas; however, two principal systems of legislation have become the basis for defining the characteristics of these entities, the federal Internal Revenue Code (Title 26 of the United States Code) and state corporation laws.

3 See C. Belknap, *The Federal Income Tax Exemption of Charitable Organizations: Its History and Underlying Policy*, in COMMISSION ON PRIVATE PHILANTHROPY AND

been employed to greater effect than in the United States. A large and vital private nonprofit sector,<sup>4</sup> reflecting many of the singular features of American society,<sup>5</sup> has developed partly because of the benefits afforded to entities independent of the government. Nonprofits serve every sector of society and constitute an important national resource, often accepting new challenges and responding to emerging needs.

However, as one commentator has perceptively noted, this tradition of granting exemptions has grown subtly, "leaving no trace of its origin,"<sup>6</sup> because the governments bestowing these exemptions and privileges have seldom articulated motivating reasons. Several justifications have been advanced. The oldest and most common explanation is that exemptions were granted to aid the work of nonprofits, which benefitted the public at large<sup>7</sup> and

---

PUBLIC NEEDS [hereinafter "FILER COMMISSION"], DEPARTMENT OF THE TREASURY, IV RESEARCH PAPERS [hereinafter "RESEARCH PAPERS"], TAXES 2025, 2026-31 (1977); E. FISCH, D. FREED & E. SCHACHTER, CHARITIES AND CHARITABLE FOUNDATIONS 7-34 (1974) (historical development of charities); A. BALK, THE FREE LIST 20-28 (1971) (discussing exemptions afforded religious and secular institutions from ancient to modern times); M. FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT 11-48 (1965) (historical development of foundations); P. ADLER, TAX EXEMPTIONS ON REAL ESTATE: AN INCREASING MENACE 1-81 (1922) (origin and historical development of charitable tax exemptions). See also *Genesis* 47:26 (priests of Egypt exempted from law requiring 20% of crops be turned over to Pharaoh); *Ezra* 7:24 (priests of Israel not subject to tax).

4 See, e.g., V. HODGKINSON, M. WEITZMAN, C. TOPPE, & S. NOGA, NONPROFIT ALMANAC, 1992-93: DIMENSIONS OF THE INDEPENDENT SECTOR (4th ed. 1992). In 1990, the "independent sector" (organizations qualifying as tax-exempt under §§ 501(c)(3) and (4) of the Internal Revenue Code) comprised 983,000 organizations, with income of \$289 billion, 6.2% of the national income, and 10.4% of total national employment. These percentages have increased significantly since 1977. *Id.* at 4-5, 15-18.

5 See D. BOORSTIN, HIDDEN HISTORY 193-209 (1987); W. WELLFORD & J. GALLAGHER, UNFAIR COMPETITION? THE CHALLENGE TO CHARITABLE TAX EXEMPTION 2 (1988) (noting de Tocqueville's observation that Americans banded together to undertake privately tasks that in Europe would be left to government); Belknap, *supra* note 3, at 2036-39 (American preference for addressing problems through private, rather than governmental, action); L. Stone, *Federal Tax Support of Charities and Other Exempt Organizations: The Need for a National Policy* 1968 So. Cal. Tax Inst. 27, 39. See also 55 Cong. Rec. 550 (1918) (statement of Sen. Penrose) (private support of education in the United States is unique).

6 P. ADLER, *supra* note 3, at 73.

7 See *Bob Jones Univ. v. United States*, 461 U.S. 574, 587-90 (1983); *Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518, 637 (1819); B. HOPKINS, THE LAW OF

replaced services the government would have been obliged to provide in their absence.<sup>8</sup> Other rationales based on the nature of nonprofits have been suggested;<sup>9</sup> however, no one rationale can fully explain all of the special favors extended to nonprofits.

Whatever their basis, the range and diversity of these exemptions have expanded tremendously in the twentieth century. When government's role in society was more limited than it is today,

---

TAX-EXEMPT ORGANIZATIONS 7-13 (5th ed. 1987); Belknap, *supra* note 3, at 2031-35; J. Martin, *General Theory of Tax Exemption*, in TAX POLICY LEAGUE, TAX EXEMPTIONS 3, 18 (1939); L. Killough, *Exemptions to Educational, Philanthropic and Religious Organizations*, in TAX EXEMPTIONS, *supra* at 23, 31-32. The modern economist would say that these organizations produce "positive externalities," i.e., the benefits generated by their activities extend beyond the persons immediately involved in them.

8 See H.R. REP. NO. 1860, 75TH CONG., 3RD SESS., 1938; *McGlotten v. Connally*, 338 F. Supp. 448, 456 (D.D.C. 1972); B. HOPKINS, *supra* note 7, at 5; REPORT OF THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, GIVING IN AMERICA: TOWARD A STRONGER VOLUNTARY SECTOR 103 (1975) (the "FILER COMMISSION REPORT"); Killough, *supra* note 7, at 28-31.

A variation on this rationale is that exempt organizations form an auxiliary to government, supplementing and assisting it in the discharge of its functions. For instance, in *Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 519, 647, Chief Justice Marshall wrote that special consideration was extended to private philanthropic institutions because they "do not fill the place that would otherwise be occupied by government, but that which would otherwise remain vacant." Others contended that these organizations helped to foster the conditions in which orderly society could flourish in ways which the government could not. See, e.g., *Trustees of the First Methodist Episcopal Church v. City of Atlanta*, 76 Ga. 181, 193 (1886) (exemption granted to churches because their moral teaching helped check anti-social behavior and aided government in maintaining order), cited in P. ADLER, *supra* note 3, at 2.

9 Commentators have postulated that private nonprofits are favored because they operate more efficiently than governments. See H. Hansmann, *The Role of the Nonprofit Enterprise*, 89 YALE L.J. 835, 895 (1980); Belknap, *supra* note 3, at 2035-36. Professor Hansmann has also theorized that the nonprofit structure exists to remedy "contract failure" problems arising where donors cannot verify that their contributions are put to good use; the various legal constraints on nonprofits, such as prohibitions on private inurement and heightened fiduciary responsibilities, help assure the public that the nonprofits will act responsibly. Hansmann, *supra*. He has also argued that exemptions are given to assist nonprofits with capital formation. Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 72-74 (1981). B. Bittker and G. Rahdert, in *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299 (1976), have espoused the view that nonprofits are tax-exempt because of the inapplicability to them of standard tax concepts, which were developed for profit-oriented activities and entities.

nonprofits benefitted principally from tax exemptions.<sup>10</sup> With the demise of *laissez-faire* governance in this century, governments reached into new spheres of activity. As new regulatory systems emerged, their effect on nonprofits had to be considered and accommodations made to avoid burdening nonprofits' work or diverting resources from their valued activities. Consequently, a growing number of nonprofit privileges and benefits have been a function of expanding government — itself a product of an increasingly complex society.

Exemptions, therefore, increased as a secondary consequence of government expansion. The accretion has been impressive, resulting in accommodations between the state and nonprofits in nearly every sphere of government regulation. For example, nonprofits, notably charities, may enjoy exemption from income, sales, property, excise, and payroll taxes imposed by all levels of government. Contributions to certain nonprofits enjoy preferred income, estate, inheritance, and gift tax treatment. Nonprofits may receive the proceeds of debt instruments paying tax-exempt interest and may be exempted from certain registration and disclosure requirements in securities issuances. Exemptions in trade regulation laws enable nonprofits to purchase goods on terms not available to others; the law also shields them from Federal Trade Commission scrutiny. Nonprofits are also exempt from certain labor regulations concerning both collective bargaining and workers' compensation. They may benefit from preferred postal rates and are eligible to receive government funds for a wide variety of purposes. The bankruptcy, copyright, civil rights, and criminal laws also afford special consideration to certain nonprofits, permitting them to engage in conduct prohibited to others.

The proliferation of exemptions has progressed to the point where those concerned with managing nonprofits may not realize their extent; furthermore, to the authors' knowledge, a comprehensive survey of this field and a summary of the major exemptions in different areas has not previously been undertaken. Consequently, a principal purpose of this article is to catalog and describe the privileges and exemptions accorded nonprofit organizations, especially those classed as "charitable" by federal, state, and local governments. By doing so, the authors hope to increase awareness

<sup>10</sup> See Belknap, *supra* note 3, at 2027-31.

of the extent of these benefits and to provide a focus for the current debate concerning the appropriateness and effectiveness of many of them.<sup>11</sup>

This cataloging inevitably leads to a second purpose of this article: to examine the present system for regulating the exemptions identified herein. These exemptions typically were created on an *ad hoc* basis. Generally, in crafting a system of regulation, legislatures have carved out exemptions for certain nonprofit or charitable organizations or types of activities, based upon certain beliefs or theories, not always clearly articulated, concerning the role of nonprofits in society and their relationship to government. Legislatures have left the administration of those regulations to the agency charged with implementation of the overall statutory scheme. Consequently, authority over nonprofits has come to be diffused among many governmental entities. However, little attention has been devoted to whether the current system for managing nonprofits, if it can be called a system at all, is the best that can be devised.

The wide array of benefits for nonprofits may figure significantly in an organization's decision to seek income tax exemption.<sup>12</sup> Furthermore, an exempt designation in one field of law, such as taxation, is frequently a qualifying criterion for benefits conferred in other areas. Consequently, nonprofits may seek exemption under one scheme of regulation for reasons unrelated to

<sup>11</sup> The authors note that this catalog, while extensive, is by no means exhaustive. For instance, no discussion of charitable tort immunity has been attempted, although vestiges of the doctrine may survive in the law of several states. The authors have endeavored, however, to identify and include the most significant and valuable exemptions accorded nonprofits by government.

<sup>12</sup> Various non-tax benefits and privileges can come with the nonprofit or tax-exempt designation, as other sections of this article demonstrate. The availability of these benefits has influenced at least one Congress to extend tax-exempt status to a particular type of organization. Noting the advantages accruing to agricultural organizations and finding no reason to deny these benefits to commercial fishing organizations, it enacted I.R.C. § 501(g) as part of the Tax Reform Act of 1976, which permitted commercial fishing entities to be designated I.R.C. § 501(c)(5) agricultural organizations. This action overturned a prior IRS ruling (Rev. Rul. 75-287, 1975-2 C.B. 212) holding that such entities did not qualify for the I.R.C. § 501(c)(5) classification. See S. REP. NO. 938, 94th Cong., 2d Sess. 420 (1976), reprinted in 1976-3 C.B. 49, 458.

either the regulatory scheme or the organization's primary purpose.<sup>13</sup>

The existence of so many points of contact between nonprofits and government multiplies sources of potential friction in the relationship of the two sectors. Even when the special treatment accorded nonprofits has been confined to the more traditional areas, such as tax exemption, tensions between government and the exempt sector have arisen.<sup>14</sup>

Current conditions indicate that the potential for conflict will not abate, and probably will intensify. The economic importance of the nonprofit sector has grown at a significantly increased rate.<sup>15</sup> Nonprofits are increasingly undertaking new activities<sup>16</sup> and

<sup>13</sup> See *Baltimore Regional Joint Bd. Health & Welfare Fund v. Commissioner*, 69 T.C. 554 (1978) (tax exemption sought by organization in order to qualify for Department of Agriculture child nutrition programs), discussed in B. HOPKINS, *supra* note 7, at 33.

<sup>14</sup> Beginning in the late 19th century, commentators and legislators began to examine critically the various exemptions enjoyed by nonprofits. Initially, property tax exemptions came under fire. See A. BALK, *supra* note 3; TAX POLICY LEAGUE, *TAX EXEMPTIONS*, *supra* note 7; P. ADLER, *supra* note 3. Subsequently, the benefits nonprofits derived from federal income tax relief became a fertile field for study. See *infra* authorities cited in notes 69, 74.

Indeed, the practice of questioning exemptions for charities stretches back to the Middle Ages. Beginning in 1215, the rulers of England, concerned about the growing wealth and power of the Catholic Church, passed a succession of progressively more stringent mortmain statutes, designed to prevent transfers of land to the Church without royal consent, see E. FISCH, D. FREED, & E. SCHACHTER, *supra* note 3, at 12-14; Belknap, *supra* note 3, at 2027. Despite these restraints, the Church's holdings encompassed between one-third and one-half of the realm by the time of Henry VIII's break with the Papacy in the 1530's. See W. Orton, "Endowments and Foundations" in *Encyclopedia of the Social Sciences*, 531 (1931) (cited in Persons, Osborne, & Feldman, *Criteria for Exemption under 501(c)(3)*, in IV RESEARCH PAPERS 1909, 1916 (1977); M. FREMONT-SMITH, *supra* note 3, at 17-23; See P. ADLER, *supra* note 3, at 8-9. Similarly, levies and taxes upon Church lands grew over time, until Henry VIII confiscated them outright. Belknap, *supra* note 3, at 2027; P. ADLER, *supra* note 3, at 21-46.

<sup>15</sup> See generally, V. HODGKINSON, M. WEITZMAN, C. TOPPE, S. NOGA, 1992-1993 NONPROFIT ALMANAC: DIMENSIONS OF THE INDEPENDENT SECTOR.

<sup>16</sup> For instance, in the 1980's, government funding reductions impelled the nonprofit sector to increase its level of participation in the nation's economic life, whether by soliciting contributions or by engaging in income-producing activities. See W. WELLFORD & J. GALLAGHER, *supra* note 5; J. Simon, *The Tax Treatment of Nonprofit Organizations: A Review of Federal and State Policies*, in THE NONPROFIT SECTOR 67, 91 (W. Powell ed. 1987).

adopting new methods of operation which warrant a reexamination of their societal role and the attributes of nonprofit status.<sup>17</sup>

The wide range of government-bestowed privileges for nonprofits, pressures on lawmakers and regulators by other interest groups, and the decentralized system of agencies currently employed to regulate specific aspects of the relationship between nonprofits and government — each with its own mandate — ensure fertile ground for controversy and conflict. Changing conditions in both the nonprofit sector and government warrant reexamining the administration of the benefits afforded nonprofits. Indeed, the increased pressures on nonprofits resulting from decreased government funding may suggest the need for closer monitoring of nonprofits to ensure that nonprofits are legitimately pursuing the public good in a manner that inspires public confidence, especially in light of recent problems, such as the William Aramony-United Way Scandal<sup>18</sup>. Some method should be devised to minimize the potential for abuse and to heighten cooperation, thereby forging a more constructive relationship between these two sectors, which both seek to advance the public welfare.

It is beyond the scope of this article to propose definitive answers to such multifaceted questions; however, the authors will suggest the dimensions of opportunities and hazards to the unified regulation of nonprofits.

<sup>17</sup> See generally THE FUTURE OF THE NONPROFIT SECTOR (Virginia A. Hodgkinson & Richard W. Lyman, eds. 1989).

<sup>18</sup> See Kathleen Teltsch, *United Way Awaits Inquiry on Its President's Practices*, N.Y. TIMES, Feb. 24, 1992, at A12; Felicity Barringer, *United Way Head is Forced Out in a Furor over his Lavish Style*, N.Y. TIMES, Feb. 28, 1992, at A1; Felicity Barringer, *United Way Head Tries to Restore Trust*, N.Y. TIMES, Mar. 7, 1992, at A8; William Celis III, *Leaders Say Charity May Be Dismantled*, N.Y. TIMES, Mar. 23, 1992, at A10; Carla Rivera, *United Way Scandal Puts Charities Under Scrutiny*, L.A. TIMES, Mar. 30, 1992, at A1; Deborah Sontag, *Affiliates Feeling Pinch of United Way Scandal*, N.Y. TIMES, Apr. 22, 1992, at A1; Felicity Barringer, *Justice Department Seeks Records of United Way and Its Companies*, N.Y. TIMES, May 28, 1992, at A16.

## II) Catalog Of Privileges And Exemptions: Description Of Preferences Granted Charities By Federal, State And Local Governments

### A) Special Treatment Under The Tax Laws

#### 1) Federal Income Tax Exemptions

Although several sections of the Internal Revenue Code of 1986, as amended (the "Code"), provide income tax exemptions for various types of entities,<sup>19</sup> Section 501(a)<sup>20</sup> contains the basic nonprofit exemption. The Supreme Court has justly called this Section the "linchpin of the statutory benefit system."<sup>21</sup> This Section confers exemption on certain classes of organizations, leaving their definition and enumeration to other provisions of the Code, primarily Section 501(c).<sup>22</sup> The federal income tax exemption is not

<sup>19</sup> See discussion *infra* at notes 20-68 and accompanying text. Examples of such entities include: instrumentalities of the Federal Government described in 26 U.S.C. (Internal Revenue Code ("I.R.C." or "Code")) § 501(c)(1); states and their political subdivisions exempt under I.R.C. § 115; foreign governments and certain of their instrumentalities within the terms of I.R.C. § 892; and foreign persons exempted from tax on U.S. source income either under provisions of the Code, such as I.R.C. §§ 871(h) and 881(c) (portfolio interest), and §§ 871(i)(2)(A) and 881(d) (interest paid on U.S. bank accounts), or by treaty. Also, insurance companies are not taxed on that portion of their receipts representing liabilities to depositors and policyholders. See, e.g., I.R.C. § 807. Because this article will focus on private nonprofit organizations, certain inhabitants of the tax-exempt universe, such as those just mentioned, will not be discussed here.

<sup>20</sup> All references are to the Internal Revenue Code of 1986, unless otherwise noted.

<sup>21</sup> *Simon v. Eastern Ky. Welfare Rights Org.*, 426 U.S. 26, 29, n.1 (1976). See generally, Hopkins, *The Law of Tax-Exempt Organizations*, *supra* note 7, at 58; Bittker & Rahdert, *supra* note 9.

I.R.C. § 7802(b) provides that administration of the Code provisions relating to I.R.C. § 501(a) exempt organizations is the responsibility of the Assistant Commissioner for Employee Plans and Exempt Organizations of the Internal Revenue Service ("IRS"), whose budget is funded through the investment income excise tax imposed by I.R.C. § 4940.

I.R.C. § 501(a) also provides the tax exemption for retirement trusts described in I.R.C. § 401(a); however, discussion of these "tax-exempt entities" is beyond the scope of this article.

<sup>22</sup> While exemption is primarily a question of statutory law, certain common law principles can also govern whether an organization may qualify as tax-

complete, however, and nonprofits are taxed in various situations.<sup>23</sup>

The definitional tests in the Code divide tax-exempt organizations into several broad categories. The benefits conferred and restrictions imposed on each category differ in several important respects. The two basic types of exempt organizations are "charitable" nonprofits, described in Section 501(c)(3), and "non-charitable" nonprofits, described in all other exemption provisions.<sup>24</sup>

Generally, a "non-charitable" entity is exempted because it is considered an inappropriate subject of taxation. Most entities in this class are "mutual benefit" organizations,<sup>25</sup> organized to promote the interests of their members; as these organizations are formed to pursue individual benefits collectively, receipts from members represent a sharing of expenses, and are not "income" as understood

---

exempt. The Supreme Court has held that the IRS may deny exemption to organizations which otherwise meet the statutory criteria if they do not provide a public benefit and their purposes violate clear and fundamental public policy. *Bob Jones Univ. v. United States*, 461 U.S. 574, 595-99 (1983) (upholding Rev. Rul. 71-447, 1971-2 C.B. 230, which denied I.R.C. § 501(c)(3) exempt status to racially discriminatory schools, and holding no First Amendment violation occurs in denying tax exemption, even where discrimination is religiously motivated). See also M. Galston, *Public Policy Constraints on Charitable Organizations*, 3 VA. TAX REV. 291 (1984); J. Simon, *The Tax-Exempt Status of Racially Discriminatory Schools*, 36 TAX L. REV. 477 (1981). The public policy test can be invoked to deny tax exemption in a variety of situations not involving racial discrimination in education. See *Church of Scientology v. Commissioner*, 83 T.C. 381 (1984), *aff'd on other grounds*, 823 F.2d 1310 (9th Cir. 1987), *cert. denied*, 486 U.S. 1015 (1988) (exemption revoked due to purposeful criminal behavior); *Synanon Church v. United States*, 820 F.2d 421 (D.C. Cir. 1987) (same); Rev. Rul. 75-384, 1975-2 C.B. 204 (exemption denied organization encouraging civil disobedience); Gen. Couns. Mem. 39,800 (June 20, 1989) (considering whether funding public school classes discussing the Bible violates Establishment Clause.)

<sup>23</sup> See, e.g., *infra* notes 78-91, and accompanying text (private foundation excise tax provisions); notes 92-103, and accompanying text (unrelated business income tax).

<sup>24</sup> Professor Simon has constructed a "federal tax taxonomy" describing the various types of organizations qualified for tax exemption. He has separated these entities into four principal categories: (1) so-called non-charitable nonprofits, many of which are described in I.R.C. § 501(c)(4) through (21), and within I.R.C. § 501(c)(3), (2) publicly supported charities, (3) private operating foundations, and (4) private non-operating, or grant-making, foundations. See Simon, *supra* note 16, at 68-72. This article's discussion of the types of tax-exempt organizations will generally follow Simon's outline.

<sup>25</sup> This term was coined by Bittker & Rahdert, *supra* note 9.

by the tax law.<sup>26</sup> However, this rationale is inapplicable to other income received by these organizations, which is often taxed as it would be in the hands of a non-exempt entity.<sup>27</sup> An additional ground for exempting some nonprofits from federal income tax may have been a legislative judgment that these particular nonprofits were not engaged in business for private gain, which the tax was designed to reach.<sup>28</sup>

"Noncharitable" nonprofits include civic leagues,<sup>29</sup> labor or agricultural organizations,<sup>30</sup> business leagues and chambers of commerce,<sup>31</sup> social clubs,<sup>32</sup> fraternal societies,<sup>33</sup> certain nonprofits providing insurance, retirement, disability, or unemployment benefits to members,<sup>34</sup> cemetery companies,<sup>35</sup>

26 In the case of a mutual benefit organization, the association is generally not viewed as an entity separate from its members for tax purposes. Cf. 26 Cong. Rec. 6622 (1894) (remarks of Sen. Hill) (taxation of mutual savings banks as entities separate from their depositors improper). Another way of presenting the argument for exemption is through analogy: since an individual engaging in these activities would not be taxed, it is considered inappropriate to tax groups doing the same thing. See *McGlotten v. Connally*, 338 F. Supp. 448, 458 (D.D.C. 1972), citing H.R. REP. NO. 413, 91st Cong., 1st Sess., 48 (1969), reprinted in 1969 U.S. CODE CONG. & ADMIN. NEWS 1645; S. REP. NO. 552, 91st Cong., 1st Sess., 199 (1969), reprinted in 69 U.S. CODE CONG. & ADMIN. NEWS 1645. See also R. Desiderio & S. Taylor, PLANNING TAX-EXEMPT ORGANIZATIONS § 4.03 at 4-16 through 4-18 (1989). Exemptions for mutual organizations were once broader than is currently the case. For instance, mutual savings banks were tax exempt until 1951. Internal Revenue Code of 1939 § 101(2), repealed by Revenue Act of 1951 § 313(a), 65 Stat. 452, 490.

27 See, e.g., I.R.C. § 512(a)(3).

28 See Bittker and Rahdert, *supra* note 9.

29 I.R.C. § 501(c)(4). The exemption is denied if selling commercial-type insurance comprises a substantial portion of an organization's activities. I.R.C. § 501(m).

30 I.R.C. § 501(c)(5). I.R.C. § 501(g) lists certain activities, such as catching fish, deemed "agricultural" for purposes of the exemption.

31 I.R.C. § 501(c)(6).

32 I.R.C. § 501(c)(7). Exemption is denied under I.R.C. § 501(i) to clubs discriminating based on race, color or religion; however, the religious discrimination prohibition is relaxed where a club is religious in nature. I.R.C. § 501(i)(1), (2).

33 I.R.C. § 501(c)(10).

34 I.R.C. § 501(c)(8),(9),(11),(12),(15),(17),(18),(21),(22),(23),(24).

mutual credit unions,<sup>36</sup> crop financing associations,<sup>37</sup> and trusts to provide legal services to members of an organization pursuant to a Code Section 120 plan.<sup>38</sup> Other sections of Subchapter F exempt similar noncharitable nonprofits undertaking individual action in collective form. Sometimes, the exemption is partial, applying only to income from performance of the organizations' exempt functions.<sup>39</sup> Some noncharitable nonprofits are taxed on income received from other sources.<sup>40</sup> Section 521 exempts farmers' marketing or purchasing cooperatives from income tax, provided the association distributes all profits to its members, who are taxed upon them. Undistributed profits are taxed to the cooperative at corporate rates.<sup>41</sup> Section 526 exempts shipowners' protection and indemnity associations from taxation on receipts from members, if private inurement is absent; however, income from other sources is taxed.<sup>42</sup> Section 527 exempts political organizations whose primary purpose is to accept contributions and make expenditures in political campaigns.<sup>43</sup> Section 528 exempts homeowners' associations that elect under this section from taxation on dues or assessments paid by members, but subjects other income to a 30% tax.<sup>44</sup>

35 I.R.C. § 501(c)(13).

36 I.R.C. § 501(c)(14).

37 I.R.C. § 501(c)(16).

38 I.R.C. § 501(c)(20).

39 For § 501(c)(7) social clubs, only the income received from members is not taxed, apparently because associations merely receive and expend such funds as agents on behalf of members.

40 Only the expenses of producing this income are deductible against it. See I.R.C. §§ 526; 527(c)(1)(B); 528(d)(1)(B).

41 See B. HOPKINS, *supra* note 7, at 396-404; see J. McGovern, *The Exemption Provisions of SubChapter F*, 29 TAX LAW. 523, 544 (1976).

42 See B. HOPKINS, *supra* note 7, at 404; McGovern, *supra* note 41, at 545-46. The funds of these organizations indemnify shipowners against losses not generally covered by marine insurance.

43 Such organizations are not taxable on contribution income, but are taxed on income from other sources. I.R.C. § 527(b),(c). See also B. HOPKINS, *supra* note 7, at 404-409.

44 Exempt associations are those which maintain condominiums or other residential real estate owned by its members. See B. HOPKINS, *supra* note 7, at

An organization may also be exempted from income tax on the ground that it is properly disregarded for income tax purposes. For example, Code Section 501(c)(2) exempts corporations holding title to real property and remitting the entire net income therefrom to an exempt organization.<sup>45</sup> Code Section 501(c)(2) is an example of the general common law rule of federal taxation that a corporation passively holding title to real property is not the proper taxpayer for the income of such property;<sup>46</sup> the exemption, however, may well antedate the first judicial statement of the principle which it exemplifies.<sup>47</sup>

"Noncharitable nonprofits" are not granted many of the privileges usually accorded charities, the most favored members of the nonprofit sector, since their activities focus on advancing the interests of their members, rather than those of the general public. For instance, donations to nearly all noncharitable nonprofits are not tax-deductible to the donor.<sup>48</sup> Furthermore, such noncharitable nonprofits are not exempt from unemployment (FUTA) taxes as are

409-11.

45 I.R.C. § 501(c)(2), (c)(25). This provision may have been enacted in order to assist nonprofits whose ability to own property was restricted under state law and to facilitate property ownership by unincorporated associations. See McGovern, *supra* note 41, at 528.

46 Generally, corporations that are mere passive holders of title to property are ignored for tax purposes and are treated as conduits through which the income passes to the person actually controlling the property. See *Bollinger v. Commissioner*, 485 U.S. 340 (1988); *Paymer v. Commissioner*, 150 F.2d 334 (2d Cir. 1945). Section 501(c)(2) reinforces this common law rule, removing any danger that tax-exempt entities will be penalized simply on the basis of a technical difference in the form of ownership. Since the income is probably subject to the unrelated business income tax, the rule protects the tax-exempt entity from double taxation on the income by eliminating taxation to the corporation. Moreover, the provision may well extend the common law rules, shielding the corporation from taxation even if it is not entirely passive.

47 The predecessor of § 501(c)(2) was first enacted as part of the Revenue Act of 1916. See Revenue Act, ch. 463, § 11(a)(12), 39 Stat. 756, 757 (1916).

48 Individuals are allowed charitable contribution deductions only for gifts to veterans' organizations, fraternal orders (if the donation must be used for charitable purposes), and cemetery companies. See I.R.C. § 170(c)(3)-(5). However, in some instances, a member may deduct a payment to one of these entities as an ordinary business expense. See I.R.C. § 162; Treas. Reg. § 1.162-6 (1991) (professional association dues and fees).

Section 501(c)(3) entities,<sup>49</sup> nor may they elect out of paying Social Security (FICA) taxes, as may charities that are churches and church-controlled organizations.<sup>50</sup> However, noncharitable nonprofits are not subject to many of the regulations imposed by the Code on Section 501(c)(3) entities, and they have greater freedom to engage in political activities limited or prohibited to charities.<sup>51</sup>

The organizations described in Code Section 501(c)(3) comprise the second major class of nonprofits recognized by the tax law.<sup>52</sup> Originally, qualified organizations were limited to those engaged in "charitable" activities; however, a process of legislative accretion has gradually extended charitable nonprofit status to other organizations deemed to serve worthy public ends.<sup>53</sup> Express exemption<sup>54</sup> of charitable entities has been a feature of income tax law since enactment of the first modern version of the tax in 1894.<sup>55</sup> The

49 Organizations exempted under I.R.C. § 501(a), but not described in I.R.C. § 501(c)(3), must pay FUTA taxes with respect to any employee receiving over \$50 in remuneration in a calendar quarter. I.R.C. § 3306(c)(10)(A).

50 I.R.C. § 3121(a).

51 See Simon, *supra* note 16, at 70-71, Table 5.1 C, D (Ring I).

52 See generally Persons, Osborn, & Feldman, *Criteria for Exemption under Section 501(c)(3)*, in RESEARCH PAPERS, TAXES, *supra* note 3, at 1909, 1925-32.

53 See *id.* at 1924-25, 1977-80.

54 An income tax to finance the Civil War was in force between 1861 and 1870, but its levies applied only to the income of certain enumerated types of corporations, and so did not affect nonprofit corporations. See Belknap, *supra* note 3, at 2025 & n.2; McGovern, *supra* note 41, at 525 (prior to 1894, revenue laws, both income and excise, specifically enumerated persons and articles subject to taxation, so exemption existed by reason of statutory omission). With the 1894 Act, all income save that specifically exempted was taxed, so express exemption became necessary.

55 See Act of Aug. 27, 1894, ch. 349, § 32, 28 Stat. 509, 556-57. The 1894 Act was ruled unconstitutional by the Supreme Court in *Pollock v. Farmers' Loan and Trust Co.*, 157 U.S. 429 (1895), on other grounds. The *Pollock* decision led to the passage of the Sixteenth Amendment to the Constitution, which expressly conferred on Congress the authority to levy the income tax. Subsequently, a substantially similar exemption was included in the corporate income excise tax enacted as part of the Payne-Aldrich Tariff Act of 1909, ch. 6, § 38, 36 Stat. 11, 112, which was Congress' next effort to levy an income tax prior to the passage of the Sixteenth Amendment. This tax passed constitutional muster in *Flint v. Stone Tracy Co.*, 220 U.S. 108 (1911). Exemption language was incorporated in each new revenue enactment. See Belknap, *supra* note 3 (history of I.R.C. § 501(c)(3), also provides texts of statutory language exempting charities from 1909 through

courts, mindful of the public policy reasons underlying the creation of this exemption, have held that the exemption is to be construed broadly to effectuate its purposes.<sup>56</sup>

Code Section 501(c)(3) exempts entities created for religious,<sup>57</sup> charitable,<sup>58</sup> scientific, testing for public safety,<sup>59</sup> literary, or educational purposes,<sup>60</sup> or to foster amateur athletic competition,<sup>61</sup> or for the prevention of cruelty to children or animals.

Charitable organizations must satisfy various Internal Revenue Code tests to qualify for the exemption. Code Section 501(c)(3) requires an organization to be "organized and operated exclusively" for exempt purposes. Where a non-exempt purpose forms more than an insubstantial objective of an organization or where operations of a non-exempt nature comprise a substantial part of its activities, the

1950).

<sup>56</sup> See *Helvering v. Bliss*, 293 U.S. 144 (1934). See also Note, *Sales and the Tax-Exempt Organization: Federation Pharmacy Services, Inc. v. Commissioner*, 44 ALBANY L. REV. 661, 662-63 n.6 (1980) (collecting cases).

<sup>57</sup> An additional exemption is provided for religious or apostolic organizations, usually religious communities in which property is held in common and which engage in businesses to support themselves, otherwise taxable as corporations. I.R.C. § 501(d). In order to qualify for the exemption, the members must be taxed individually on their pro rata shares of the organization's income. See McGovern, *supra* note 41, at 542. Religious organizations enjoy other benefits not available even to other I.R.C. § 501(c)(3) organizations. For instance, "ministers of the gospel" are allowed to exclude from their income the rental value of their parsonages. I.R.C. § 107.

<sup>58</sup> A cooperative hospital service organization exclusively controlled by and serving hospitals is deemed tax-exempt under this provision. I.R.C. § 501(e).

<sup>59</sup> This provision was added by the 1954 Code to reverse *Underwriters' Laboratories v. Commissioner*, 135 F.2d 371 (7th Cir.), cert. denied, 320 U.S. 756 (1943), which denied exemption to this organization on the grounds that it was neither "scientific" nor "charitable." See S. REP. NO. 1622, 83rd Cong. 2d Sess., 310 (1954).

<sup>60</sup> I.R.C. § 501(f) extends exempt treatment to cooperative service organizations managing the endowments of exempt educational institutions; § 501(k) provides that a child care organization can qualify as an educational organization.

<sup>61</sup> The exemption is available only if no part of the organization's activities include the provision of athletic supplies or equipment. I.R.C. § 501(j) provides an exception to this requirement for certain organizations. This is the most recently created exemption, added by the Tax Reform Act of 1976, Pub. L. No. 94-455, § 1313(a), 90 Stat. 1520, 1730.

organization fails to satisfy this definitional requirement and is not entitled to an exemption.<sup>62</sup>

This definitional provision further provides that none of the net earnings of such organizations may "inure to the benefit of any private shareholder or individual."<sup>63</sup> This requirement has been imposed since the 1894 Act and incorporates the common law test which required an "absolute divorce from gain to those controlling ownership" to determine whether a corporation was charitable.<sup>64</sup> In order to pass this test, an organization may not function for the private benefit of an individual or select group, but must benefit a charitable class or the public at large.<sup>65</sup>

This Code Section also limits the degree to which Code Section 501(c)(3) exempt organizations may engage in political activities. Except for public charities, which may engage in limited lobbying under an elective safe harbor or under a vague common law test,<sup>66</sup>

<sup>62</sup> Treas. Reg. § 1.501(c)(3)-1(b), (c), (e) (1990). This position has been endorsed by the courts. See, e.g., *Better Business Bureau v. United States*, 326 U.S. 279, 283 (1945); *Colorado State Chiropractic Soc'y v. Commissioner*, 93 T.C. 487 (1989) (term "exclusively" as used in the statute means "substantially"). See also *Federation Pharmacy Servs. v. Commissioner*, 72 T.C. 687 (1979), *aff'd*, 625 F.2d 804 (8th Cir. 1980) noted in Note, *supra* note 56.

<sup>63</sup> See B. HOPKINS, *supra* note 7, at 239-64.

<sup>64</sup> See E. FISCH, D. FREED & E. SCHACHTER, *supra* note 3, at 309 (quoting *Riverview Hosp. v. City of Tomahawk*, 243 Wis. 581, 11 N.W.2d 188 (Wis. 1943)). The prohibition of private inurement has been a distinguishing feature of charitable corporations since the earliest period of American law. See, e.g., *Hearns v. Waterbury Hosp.*, 66 Conn. 98, 33 A. 595 (Conn. 1895); *McDonald v. Massachusetts Gen. Hosp.*, 120 Mass. 432 (1876); *Gooch v. Association for the Relief of Aged Indigent Females*, 109 Mass. 558 (1872); *American Asylum v. Phoenix Bank*, 4 Conn. 172, 10 Am. Dec. 112 (1822). The statutory prohibitions against using the assets or income of a charitable corporation for private gain probably were derived from standard provisions included in charters granted by legislatures or the Crown, which restricted the use of the property of a charitable corporation to the purposes for which it was created. See, e.g., *Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 519, 640-42 (1819) (provisions of charter granted Dartmouth College by George III).

For a recent statement of prohibitions against "private inurement" and "private benefit", see *American Campaign Academy v. Commissioner*, 92 T.C. 1053 (1989).

<sup>65</sup> *American Campaign Academy*, 92 T.C. at 1067-1079.

<sup>66</sup> These limits are described in I.R.C. § 501(h). See also I.R.C. §§ 4911, 4912 (excise taxes imposed for violation of lobbying restrictions). The common law test was used in *Christian Echoes National Ministry, Inc. v. United States*, 470 F.2d 849 (10th Cir. 1972).

these entities may not propagandize or attempt to influence legislation as a significant part of their activities.<sup>67</sup> Intervention in campaigns for public office, either in support of or in opposition to a particular candidate, was prohibited in 1954.<sup>68</sup>

Starting in 1943,<sup>69</sup> Congress began to segment the Section 501(c)(3) category by distinguishing between institutions on the basis of the source of their support and the type of activities in which they engaged. Entities deriving the bulk of their support from a limited circle of donors, subsequently called "private foundations," were by stages treated less favorably by subsequent revenue legislation.<sup>70</sup> Certain types of religious, educational, and medical Section 501(c)(3)

<sup>67</sup> This restriction was imposed in 1934 and was aimed at a particular organization which had drawn the ire of Congress. B. HOPKINS, *supra* note 7, at 265.

<sup>68</sup> This provision was added at the behest of then-Senator Lyndon B. Johnson, who believed that a private foundation had worked against his bid for office. See B. HOPKINS, *supra* note 7, at 281. See also I.R.C. § 4955 (excise tax on expenditures in violation of this provision).

<sup>69</sup> The Revenue Act of 1943, ch. 63, § 117, 58 Stat. 21, 36-37 (1944), required tax-exempt organizations possessing the general characteristics of a private foundation, as subsequently described in § 509(a) of the Tax Reform Act of 1969, Pub. L. No. 91-172, § 101(a), 83 Stat. 487, 496-98, to file certain information returns. The basic types of organizations exempted from this requirement were also exempted from subsequent legislation designed to deal with the perceived abuses of private foundations. However, private foundations had been the subject of scrutiny since the earliest days of the income tax. The first large foundations, established by great industrialists such as Rockefeller and Carnegie, initially excited populist suspicion because of their great wealth, as well as the vagueness and breadth of their aims and powers. R. Bremner, *Private Philanthropy and Public Needs: Historical Perspective*, in FILER COMMISSION, DEPARTMENT OF THE TREASURY I RESEARCH PAPERS, HISTORY, TRENDS, AND CURRENT MAGNITUDES 89, 102-03 (1977) (sponsored by the Commission on Private Philanthropy and Public Needs); M. FREMONT-SMITH, *supra* note 3, at 50-51 (discussion of opposition to federal charter of Rockefeller Foundation). See also COMMISSION ON INDUSTRIAL RELATIONS, FINAL REPORT AND TESTIMONY SUBMITTED TO CONGRESS, S. DOC. NO. 415, 64th Cong., 1st Sess. 80-86 (1916) (the "Walsh Commission" report), which viewed foundations as a means used by the very wealthy to achieve control of the nation's "social services" and to influence national policy in their favor.

<sup>70</sup> The Revenue Act of 1950, ch. 994, § 331, 64 Stat. 906, 957-58 (codified at I.R.C. § 503 (1954)), prohibited private foundations from dealing with certain related parties at less than arm's length. The Act also prohibited excess accumulations of income by these organizations. Revenue Act of 1950, ch. 994, § 331, 64 Stat. at 958-59, (codified at I.R.C. § 504 (1954)), repealed by Tax Reform Act of 1969, § 101(j)(15), 83 Stat. at 527. These provisions were supplanted by the excise tax rules of the 1969 Act; only § 503 survives, with very limited application. Tax Reform Act of 1969, § 101(j)(7), 83 Stat. at 527 (codified at I.R.C. § 503 (1986)).

organizations, as well as other Section 501(c)(3) entities deriving a "substantial" portion of their support from contributions from the general public or governmental bodies, which became known as "public charities," were exempted from these restrictions.<sup>71</sup> Donors to private foundations were also treated less favorably than those to public charities.<sup>72</sup> This additional regulation was intended to combat perceived abuses by certain foundations which confined their activities to grantmaking rather than active charity, although the actual extent of misconduct by such foundations has been the subject of controversy.<sup>73</sup>

In 1969, Congress, responding to decades of hearings, investigations, and studies,<sup>74</sup> enacted far-reaching legislation

<sup>71</sup> 64 Stat. at 957.

<sup>72</sup> In the 1954 codification of the internal revenue laws, Congress increased the percentage of income which an individual donor could contribute to charities and receive an income tax deduction therefor; however, donations to organizations not within this exempted class of public charities were not eligible for this increased charitable contribution deduction percentage. Internal Revenue Code of 1954, ch. 1, § 170(b)(1)(A), 68A Stat. 58 (allowing increased deduction limitation only to religious orders, churches, conventions of churches, educational organizations, and hospitals). In 1964, Congress extended the benefits of these increased limitations to organizations deriving a substantial portion of their support either from governments or contributions by the public. Revenue Act of 1964, Pub. L. No. 88-272, § 209(a), 78 Stat. 19, 43. The 1964 Act also reduced the availability of the "unlimited" charitable deduction, which was then allowed to individuals who customarily gave over 90% of their income to charity, to contributions to private foundations that did not conduct active charitable programs. Revenue Act of 1964, § 209(b), 78 Stat. at 43-45. Finally, a five-year carryover of annual contributions in excess of the deduction limit was provided only for the religious, educational, health care, and publicly supported institutions enumerated in I.R.C. § 170(b)(1)(A). Revenue Act of 1964 § 209(c)(1), 78 Stat. at 46. See generally Williams and Moorehead, *An Analysis of the Federal Tax Distinctions between Public and Private Charitable Organizations*, in RESEARCH PAPERS, TAXES, *supra* note 3, at 2099, 2100-03.

<sup>73</sup> See Bittker, *Should Foundations be Third Class Charities?*, in THE FUTURE OF FOUNDATIONS 132, 159-60 (J.G. Heimann, ed. 1973), quoted in Williams & Moorehead, *supra* note 72, at 2120-21 (suggesting that suspicion of abuse was not well grounded).

<sup>74</sup> Beginning in the 1950's, Congress took an intense interest in private foundations, which resulted in an impressive array of material dealing with a variety of issues connected with them. See FOUNDATIONS, PRIVATE GIVING AND PUBLIC POLICY, REPORT AND RECOMMENDATIONS OF THE COMMISSION ON FOUNDATIONS AND PRIVATE PHILANTHROPY, (1970) (the "Peterson Commission" report); Senate Committee on Finance and House Committee on Ways and Means, 89th Cong., 1st Sess. *Treasury Department Report on Private Foundations* (Comm. Print 1965);

governing private foundations, and formally accomplished the bifurcation of Code Section 501(c)(3) organizations into public and private classes. It defined a "private foundation" as any Section 501(c)(3) organization which is not a church, an educational organization of certain types, a hospital, a state university endowment fund, a governmental unit, an organization which receives a substantial part of its support from government or public contributions, a "support organization" for public charities, or a public safety testing organization.<sup>75</sup> Organizations that are not private foundations under this test are commonly called "public charities"<sup>76</sup> and are free from a complex web of restrictions. Put differently, public charities are the only class of nonprofit which has not suffered a reduction of the benefits formerly accorded all Code 501(c)(3) organizations.<sup>77</sup>

---

Select Committee on Small Business, *Tax-Exempt Foundations and Charitable Trusts: Their Impact on our Economy*, (First Installment) 87th Cong., 2nd Sess. (Comm. Print 1962); — (Second Installment) 88th Cong., 1st Sess. (Comm. Print 1963); — (Third Installment) 88th Cong., 2nd Sess. (Comm. Print 1964); — (Fourth Installment) 89th Cong., 2nd Sess. (Comm. Print 1966); — (Fifth Installment) 90th Cong., 1st Sess. (Comm. Print 1967); — (Sixth Installment) 90th Cong., 2nd Sess. (Comm. Print 1968); — (Seventh Installment) 91st Cong., 1st Sess. (Comm. Print 1969) (the Patman investigations); *Final Report of the Select Committee to Investigate Foundations and Other Organizations*, H. R. REP. NO. 2514, 82nd Cong., 2d Sess. (1952) (the "Cox Commission," investigating Communist and other subversive influences on foundations); *Report of the Special Committee to Investigate Tax-Exempt Foundations and Charitable Organizations*, H. R. REP. NO. 2681, 83rd Cong., 1st Sess. (the "Reece Commission," which did the same); House Special Committee to Investigate Tax-Exempt Foundations, 83rd Cong., 2nd Sess. *Tax-Exempt Foundations, Staff Reports No.1 through 4* (Comm. Print 1954).

<sup>75</sup> Tax Reform Act of 1969, § 101(a), 83 Stat. at 496-97 (codified at I.R.C. § 509(a) (1986)). Section 509 provided the first formal definition of a "private foundation," essentially incorporating the types of organizations subject to the exemption disqualification rules of the Revenue Act of 1950.

<sup>76</sup> Federal, state and local governments are also public charities. I.R.C. § 170(b)(1)(A)(v).

<sup>77</sup> See Simon, *supra* note 16, at 69-72. For instance, individual donors are entitled to deduct contributions to them of up to 50% of their "contribution base" (a modified form of adjusted gross income) (I.R.C. § 170(b)(1)(F)) for the year (I.R.C. § 170(b)(1)(A)) and may carry excess deductions forward to future years. I.R.C. § 170(d)(1)(A) (*see infra* note 123 and accompanying text). These organizations are also exempt from the regulatory excise tax provisions imposed on private foundations by the 1969 Act. See *infra* notes 78-83 and accompanying text. However, excise taxes on excessive political activity can be imposed on them under I.R.C. §§ 4911 (excess lobbying expenditures on public charities making a § 501(h) election for the year) and 4912 (excise tax on lobbying

Several consequences flow from private foundation status. In addition to the donor contribution deduction limitations,<sup>78</sup> private foundations must comply with rules created by the 1969 Act which were designed to remedy perceived potential abuses and which are enforced by excise taxes, rather than revocation of exempt status. First of all, "self dealing," defined as transactions between a foundation and certain related parties such as major donors or controlling persons, is expressly and comprehensively prohibited.<sup>79</sup> Private foundations are also required to distribute a certain amount of funds each year, calculated as a percentage of the value of their assets.<sup>80</sup> They may not hold more than a certain level of proprietary interest in a business enterprise,<sup>81</sup> or make speculative or other investments deemed to jeopardize the organization's exempt purpose.<sup>82</sup> Additionally, certain enumerated expenditures considered not in furtherance of the organization's purpose are forbidden.<sup>83</sup>

These rules are enforced through excise taxes levied on the foundation or, in some cases, upon its management, determined as a percentage of the value of the funds or other property involved in the prohibited transaction. An excise tax used to fund the operations of the Internal Revenue Service's (the "Service") exempt organiza-

---

expenditures causing a loss of exempt status by a public charity). All I.R.C. § 501(c)(3) organizations are subject to the political expenditure excise tax, which is imposed on their intervention in campaigns for public office in violation of the exemption condition in I.R.C. § 501(c)(3). I.R.C. § 4955.

<sup>78</sup> See *supra* note 72 and *infra* notes 104-137 and accompanying text.

<sup>79</sup> I.R.C. § 4941. The arm's length standard of the 1950 legislation, see *supra* note 70, was abandoned in favor of a flat rule.

<sup>80</sup> I.R.C. § 4942.

<sup>81</sup> I.R.C. § 4943.

<sup>82</sup> I.R.C. § 4944.

<sup>83</sup> I.R.C. § 4945. Among those "taxable expenditures" enumerated by the statute are payments with respect to which the organization does not exercise "expenditure responsibility;" I.R.C. § 4945(d)(4),(h); however, private foundations need not exercise such responsibility with respect to public charities (organizations described in I.R.C. § 509(a)(1)-(3)) or exempt operating foundations, defined in I.R.C. § 4940(d)(2). See also I.R.C. § 4955, *supra* note 77 (all private foundations subject to political expenditure excise tax).

tions regulatory bureaucracy<sup>84</sup> is also imposed upon the investment income of private foundations.<sup>85</sup>

Congress recognized that the test for a private foundation provided in Code Section 509(a) was overinclusive, and that it was inappropriate to impose all of the excise tax rules, especially the minimum distribution requirements, on non-grantmaking institutions. Consequently, the 1969 Act created a new subclass of private foundations called "private operating foundations."<sup>86</sup> These are organizations that (a) directly expend substantially all of their adjusted net income or minimum investment return on active charitable programs<sup>87</sup> and that (b) either (i) devote over one half of their assets to such activities,<sup>88</sup> (ii) expend a certain minimum portion of their assets directly for active charitable functions, or (iii) receive substantially all of their support from the public or certain unrelated exempt organizations.<sup>89</sup> The principal advantages of private operating foundation status are exemption from the minimum distribution requirements of the excise tax rules<sup>90</sup> and eligibility of donations by individuals for the higher ceiling for charitable deductions: 50% of the donor's modified adjusted net income.<sup>91</sup>

Congress has narrowed the tax exemptions of Code Section 501(c) organizations in another significant way. Responding to reports that nonprofits were taking undue advantage of favorable

<sup>84</sup> I.R.C. § 7802(b).

<sup>85</sup> I.R.C. § 4940. A special class of private foundations, "exempt operating foundations", are relieved of liability for this tax. I.R.C. § 4940(d). The tax may also be reduced if a private foundation meets certain tests. I.R.C. § 4940(e).

<sup>86</sup> Tax Reform Act of 1969, § 101(b), 83 Stat. at 506-07 (codified at I.R.C. § 4942(j)(3) (1986)).

<sup>87</sup> I.R.C. § 4942(j)(3)(A). I.R.C. §§ 4942(f) and (g) define "minimum investment return" and "adjusted net income", respectively.

<sup>88</sup> I.R.C. § 4942(j)(3)(B)(i).

<sup>89</sup> I.R.C. § 4942(j)(3)(B)(ii)-(iii). See generally B. HOPKINS, *supra* note 7, at 478-86.

<sup>90</sup> I.R.C. § 4942(a)(1).

<sup>91</sup> I.R.C. § 170(b)(1)(A)(vii). See Simon, *supra* note 16, at 70-71 Table 5.1 for a fuller comparison of the treatment of private operating and nonoperating foundations under federal tax law. See also notes 124 and 125 *infra* for a description of the 50% ceiling.

court decisions<sup>92</sup> by operating businesses in competition with taxable firms to raise funds, Congress enacted the unrelated business income tax ("UBIT") as part of the Revenue Act of 1950.<sup>93</sup>

This Act, which has broad application,<sup>94</sup> changed the tax

<sup>92</sup> In 1924, the Supreme Court ruled that an exempt organization would not lose its status simply because it derived revenue from commercial businesses operated by it, provided that such income was dedicated to the exempt purposes of the organization and did not inure to the benefit of any private person. *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578, 581 (1924). This decision formed the basis for the "destination of income" test, under which courts permitted exempt organizations to engage in a wide variety of active business activities, often in competition with nonexempt concerns. See *Roche's Beach, Inc. v. Commissioner*, 96 F.2d 776 (2d Cir. 1938) (bathing beach business); *Sand Springs Home v. Commissioner*, 6 B.T.A. 198 (1927) (cotton gin, greenhouse, oil and gas, electricity generating and other businesses). Indeed, the doctrine was extended to include for-profit corporations owned by exempt organizations. See *C.F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951) (although handed down after passage of the 1950 Act, the decision involved the 1947 tax year). For a discussion of this test and its acceptance by the courts see R. DESIDERIO & S. TAYLOR, *supra* note 26, at § 34.02.03.

<sup>93</sup> Revenue Act of 1950, ch. 994, § 301, 64 Stat. 906, 947-53. See generally R. DESIDERIO & S. TAYLOR, *supra* note 26, at ch. 34. This legislation effected a repudiation of the "destination of income" test first announced in *Sagrada Orden*, which, in Congress' view, conferred an unfair competitive advantage on exempt organizations and threatened to erode the tax base by causing exempt businesses to supplant taxable ones. See S. REP. NO. 2375, 81st Cong., 2d Sess., 28-290 (1950) (expressing, *inter alia*, concern based on the *Mueller* case, involving a macaroni manufacturing company controlled by New York University School of Law, that a "noodle monopoly" controlled by exempt institutions would result if they were not taxed).

The 1950 law constituted a significant victory for the Treasury, which had long disagreed with the "destination" test. See W. WELLFORD & J. GALLAGHER, *supra* note 5, at 79-83. It first proposed a tax of this type, to be levied on income derived by nonprofit institutions from businesses unrelated to their exempt activities, in 1942. See 1 Revenue Revision of 1942: Hearings Before the House Committee on Ways and Means, 77th Cong., 2d Sess. 89 (1942) (testimony of Randolph Paul, Adviser to the Secretary of the Treasury). The 1950 legislation grew out of this suggestion. See testimony of Vance Kirby, Tax Legislative Counsel, 1 Revenue Revision of 1950: *Hearings Before the House Committee on Ways and Means*, 81st Cong., 2nd Sess. 165 (1950) (hereinafter "1950 Hearings").

<sup>94</sup> All § 501(c) organizations can be liable for UBIT. I.R.C. § 501(b). Colleges and universities that are government agencies or instrumentalities are likewise subject to this tax. I.R.C. § 511(a)(2)(B). Governmental corporations exempt under I.R.C. § 501(c)(1) are not subject to the unrelated business income tax. I.R.C. § 511(a)(2)(A). Other organizations are exempted because other Code sections control their taxable status. Section 501(d) apostolic organizations are not subject to UBIT, but either their members are taxed directly on the income or else the corporation pays the tax on undistributed income. Similarly, organizations

treatment of nonprofits in two principal ways. First, it subjected to taxation the income of so-called "feeder organizations," i.e., separate for-profit entities either controlled by or required to pay all of their net income to exempt organizations.<sup>95</sup> Secondly, nonprofits themselves were subject to the corporate tax rate on businesses regularly carried on by them directly<sup>96</sup> which were not substantially related to their exempt purposes.<sup>97</sup>

This tax is levied, generally at corporate rates,<sup>98</sup> upon the net income of these unrelated for-profit trades or businesses operated by or for the benefit of nonprofits.<sup>99</sup> The tax falls on the net income of businesses "regularly carried on" by the organization.<sup>100</sup> The tax is not levied on businesses furthering the organization's exempt purpose.<sup>101</sup> The statute also provides exceptions for certain other

---

exempt under §§ 521, 526, 527, and 528 are not liable for the UBIT because the sections creating their exemption provide for the taxation of certain of their income.

<sup>95</sup> I.R.C. § 502.

<sup>96</sup> Entities doing business through a partnership are also subject to the UBIT. I.R.C. § 512(c); Treas. Reg. § 1.512(c)-1 (1990).

<sup>97</sup> I.R.C. §§ 511(a), 513(a). The legislative history of the 1950 Act makes clear that the tax was not intended to reach activities "incident or related to" an organization's exempt purpose. See *1950 Hearings, supra* note 93, at 166. However, under the so-called "fragmentation rule," a portion of an activity can be subject to the UBIT, even if the overall enterprise is not. See I.R.C. § 513(c); *American College of Physicians v. United States*, 475 U.S. 834 (1986).

Even if the UBIT provisions are complied with, operation of such a business can still jeopardize exempt status. The Service has held that, where operation of a profit-making business is a substantial purpose of the organization, that organization fails to meet the 501(c)(3) "organized and operated exclusively" for exempt purposes test, and so is not tax-exempt at all. Treas. Reg. § 1.501(c)(3)-1(b), -(c), -(e) (1990).

<sup>98</sup> I.R.C. § 511(a)(1). Charitable trusts are taxed at individual rates. I.R.C. § 511(b).

<sup>99</sup> I.R.C. §§ 511, 512.

<sup>100</sup> I.R.C. § 512(a)(1). The undertaking must be characterized by frequent and continuous, rather than sporadic or isolated, activity in order to come within the ambit of the tax. See B. HOPKINS, *supra* note 7, at 717-19. See also *United States v. American Bar Endowment*, 477 U.S. 105 (1986); *Suffolk County Patrolmen's Benevolent Ass'n v. Commissioner*, 77 T.C. 1314, *acq. in result*, 1984-1 C.B. 2 (1981).

<sup>101</sup> I.R.C. § 513(a). See e.g., Rev. Rul. 76-33, 1976-1 C.B. 169; Rev. Rul. 79-472, 1979-2 C.B. 208; Rev. Rul. 73-104, 1973-1 C.B. 263.

income-generating activities that might otherwise be treated as unrelated.<sup>102</sup> Similarly, investment or other "passive" income is not subject to the UBIT.<sup>103</sup>

## 2) Federal Income Tax Deductions for Contributions

The charitable deduction is a significant federal statutory benefit afforded nonprofits.<sup>104</sup> The deduction reduces the after-tax cost of the contribution to the donor, thus encouraging such transfers. In 1986, the total charitable deductions claimed on individual income tax returns amounted to \$67,094,000,000; this was the final year the deduction was allowed for non-itemizers, whose total claimed charitable deductions amounted to \$13,278,000,000.<sup>105</sup> In 1987, the deduction claimed on individual income tax returns equalled \$49,260,909,000.<sup>106</sup> Contribution deductions claimed by

---

<sup>102</sup> See I.R.C. §§ 513(a)(1) (businesses carried on with donated services); (2) (businesses carried on for the convenience of members or users of organization's services); (3) (sales of donated merchandise); 513(d) (trade fairs, shows, and exhibitions); 513(e) (cooperative hospital service organizations); 513(f) (bingo games); 513(g) (pole rentals by cooperative electric or telephone company); 513(h) (distribution of certain articles incident to fund-raising and sales of mailing lists).

<sup>103</sup> I.R.C. § 512(b)(1). The 1950 law did not disturb the exempt status of this income, which was viewed as the "traditional" source of revenue for nonprofit institutions. See *1950 Hearings, supra* note 93, at 165. However, certain types of passive income can be subject to the UBIT. Under I.R.C. § 512(b)(13), interest, rents, and royalties received from controlled organizations are taxable. Investment or other income from certain kinds of debt-financed real property which is unrelated to an organization's exempt purpose is taxed as unrelated business income. I.R.C. § 514; B. HOPKINS, *supra* note 7, at 794-806. If the recipient is a private foundation, investment income is subject to the excise tax imposed by I.R.C. § 4940.

<sup>104</sup> The deduction is also one of the oldest. Individuals have been allowed contribution deductions since enactment of the War Revenue Act of 1917, ch. 63, § 1201(2), 40 Stat. 300, 330. This deduction was initially designed to prevent a drop in public support of charities which might result from the great increase in taxes imposed to finance World War I; it was believed that the government otherwise might have to make up the drop in public support, which could be accomplished only through even greater taxation. See Wallace & Fisher, *The Charitable Deduction under Section 170 of the Internal Revenue Code*, in RESEARCH PAPERS, TAXES, *supra* note 3, at 2131.

<sup>105</sup> See Hostetter & Bates, *Individual Income Tax Returns, Preliminary 1987*, 8 STATISTICS OF INCOME BULLETIN, Spring 1989 at 5, 10 at Table H, col. 2.

<sup>106</sup> *Id.* at 24, Table 1, col. 58.

corporations in 1985 equalled \$4,471,736,000.<sup>107</sup> Due to its potential to cost the Treasury substantial revenue, however, the deduction has become highly regulated.

The Internal Revenue Code does not allow a deduction for all transfers which might be termed "charitable" or which would objectively be considered philanthropic or in aid of a public purpose; rather, the deduction is permitted only for gratuitous transfers to a specified class of organizations.<sup>108</sup> For individuals and corporations, it is limited to a specified percentage of income.<sup>109</sup> Only donations to statutorily eligible organizations qualify.<sup>110</sup> Donations to individuals, groups that are not formally organized, or groups that do not meet the organizational or operational tests of subsection 170(c) are ineligible for the charitable deduction.<sup>111</sup>

Generally, contributions to the following organizations may be deductible:<sup>112</sup> (1) the United States, and states, territories, or political subdivisions thereof,<sup>113</sup> (2) charitable organizations

<sup>107</sup> See *Selected Historical Data*, 8 STATISTICS OF INCOME BULLETIN, Spring 1989 at 92, 107 at Table 13, col. 6.

<sup>108</sup> For instance, a gift for the relief of a particular individual, even though motivated by charitable aims, would not qualify for the deduction. See J.W. COLLITON, CHARITABLE GIFTS (1980), § 2.05; R. STEPHENS, G. MAXFIELD, S. LIND & D. CALFEE, Federal Estate and Gift Taxation (6th ed. 1991) [hereinafter STEPHENS & MAXFIELD] ¶ 5.05 [1].

<sup>109</sup> I.R.C. § 170(b)(1) (individual limitations); I.R.C. § 170(b)(2) (corporate limitation). See *infra* notes 122-137 and accompanying text. Contributions made by partnerships are limited based on the limits applicable to the partners. I.R.C. § 702(a)(4); Treas. Reg. 1.703-1(a)(2)(iv).

<sup>110</sup> The Internal Revenue Service identifies eligible recipients in IRS Publication 78, Cumulative List of Organizations.

<sup>111</sup> See 8 J. MERTENS, THE LAW OF FEDERAL INCOME TAX [hereinafter MERTENS] §§ 31.01, .06, .07 (1989); 4 J. RABKIN & M. JOHNSON [hereinafter RABKIN & JOHNSON], FEDERAL INCOME, GIFT, AND ESTATE TAXATION § 59.04A(1) (1991).

<sup>112</sup> While I.R.C. § 170(c) does not expressly incorporate a citation to the § 501 exemption provision applicable to the type of organization described in each subdivision, the language of each provision generally tracks that of the relevant I.R.C. § 501(c) subsection. If a contribution is made to an organization not described in I.R.C. § 170(c), it may be possible to secure a deduction under I.R.C. § 162, as in the case of a payment to a I.R.C. § 501(c)(6) business league.

<sup>113</sup> I.R.C. § 170(c)(1).

formed for purposes listed in Code Section 501(c)(3),<sup>114</sup> (3) veteran's associations,<sup>115</sup> (4) lodges or fraternal orders provided that the contributions are from individuals and are to be used exclusively for charitable purposes,<sup>116</sup> and (5) cemetery companies.<sup>117</sup>

To qualify for the deduction, a donation must meet certain other tests. The contribution must consist of property; no deduction is allowed for services, although deduction of out-of-pocket expenses connected with such services is permitted.<sup>118</sup> An expenditure must not benefit the donor personally; rather, the contribution must be a gift.<sup>119</sup> A partial deduction is allowed to the extent the contribution exceeds the value of any goods or services received

<sup>114</sup> I.R.C. § 170(c)(2); however, no deduction is available for organizations testing for public safety. Furthermore, the organization must be organized under the law of the United States, a state, the District of Columbia, or any possession of the United States in order for a donation to qualify for the deduction. A gift by a corporation is deductible if it is to be used within the United States. I.R.C. § 170(c)(2).

<sup>115</sup> I.R.C. § 170(c)(3). The parallel exemption provision for such an organization is I.R.C. § 501(c)(19); however, because the deduction and exemption sections were drafted separately, the former provides that associations of "war veterans" are eligible donees, while the latter provides an exemption for associations of "past or present members of the Armed Forces of the United States."

<sup>116</sup> I.R.C. § 170(c)(4). The parallel exemption provision is I.R.C. § 501(c)(10).

<sup>117</sup> I.R.C. § 170(c)(5). The parallel exemption provision is I.R.C. § 501(c)(13).

<sup>118</sup> Treas. Reg. § 1.170A-1(g) (1991); *Grant v. Commissioner*, 84 T.C. 809 (1985), *aff'd* 800 F.2d 260 (4th Cir. 1986); Rev. Rul. 84-61, 1984-1 C.B. 39. See also MERTENS, *supra* note 111, at §§ 31.42, 31.43 (1989); Bennett, *Treatment of Volunteer Services and Related Expenses under the Internal Revenue Code*, in IV RESEARCH PAPERS, TAXES, *supra* note 3, at 2287.

<sup>119</sup> See *Hernandez v. Commissioner*, 490 U.S. 680 (1989) (charitable deduction denied on payments for physical/spiritual examinations (known as "auditing" services) rendered for religious purposes to church members). *United States v. American Bar Endowment*, 477 U.S. 105 (1986) (deduction denied for apparently involuntary contribution of insurance policy dividends to exempt organization); *Winters v. Commissioner*, 468 F.2d 778 (2nd Cir. 1972) (deduction denied for donations that are effectively tuition payments to schools). Furthermore, no deduction is allowable for contributing to exempt organizations for the benefit of a particular individual. *Cooper v. Commissioner*, 264 F.2d 889 (4th Cir. 1959). *But see*, I.R.C. § 170(c), (g) (allowing deduction of payment to certain educational organizations which benefit donor's child). See also MERTENS, *supra* note 111, at § 31.01; RABKIN & JOHNSON, *supra* note 111, at § 59.04 and cases cited therein.

from the donee.<sup>120</sup> Contributions to organizations whose purposes violate public policy are denied the deduction.<sup>121</sup>

a) Limitations on the Amount Deductible by Individuals and Corporations

Since the inception of the charitable deduction, Congress has limited the amount that individual and corporate taxpayers may deduct in a tax year.<sup>122</sup> The Code generally limits the annual charitable contribution deduction allowed a corporation to 10% of its taxable income.<sup>123</sup> The percentage limitations currently applicable

<sup>120</sup> See RABKIN & JOHNSON, *supra* note 111, at § 59.04(2). A charity may, however, provide token gifts to donors without affecting the deductibility of the full amount of the contribution. Rev. Proc. 90-12, 1990-1 C.B. at 71. Moreover, Congress has provided that contributions to tax-exempt institutions of higher education which enable the donor to purchase tickets to athletic events held by the institution are deductible to the extent of 80% of such a donation. I.R.C. § 170 (m).

<sup>121</sup> See *Bob Jones Univ. v. United States*, 461 U.S. 574, 595-96 (1983); *Green v. Connally*, 330 F. Supp. 1150 (D.D.C.) (three judge court) *aff'd per curiam sub. nom. Coit v. Green*, 404 U.S. 997 (1971); Rev. Rul. 71-447, 1971-2 C.B. 230.

<sup>122</sup> In the debates over the original deduction, enacted as part of the Second (War) Revenue Act of 1917, ch. 63 § 1201(2), 40 Stat. 300, 330, which imposed stiff rates on income in order to pay for American participation in World War I, a senator stated, "I should not favor allowing any man to deduct all of his contributions to these objects from his income tax return, but if we limit it to [15] percent of his income we cannot be doing much harm to the Public Treasury." 55 CONG. REC. 6728 (1917) (remarks of Senator Hollis) *quoted in* Wallace & Fisher, *supra* note 104, at 2145.

However, the Code formerly provided an unlimited deduction for individuals who regularly contributed over 90% of their income to charity, but this deduction was phased out between 1970 and 1974 under the Tax Reform Act of 1969. Tax Reform Act of 1969, § 201(a), 83 Stat. at 551.

<sup>123</sup> I.R.C. § 170(b)(2). I.R.C. § 170(d)(2) allows, with some restrictions, a five-year carryover of excess contributions. However, § 502 "feeder organizations", which are required to turn over their entire net income to an exempt organization, are not eligible to claim any charitable deduction with respect to such payments. See RABKIN & JOHNSON, *supra* note 111, at § 59.04A(1).

Until 1936, corporations were not able to claim a deduction for charitable contributions as such; this was initially allowed by the Revenue Act of 1935, ch. 829, § 102(c), 49 Stat. 1014, 1016, but the deduction was limited to 5 percent of income. Prior to this, a business expense deduction under the predecessor of I.R.C. § 162 was allowed for "donations which legitimately represent a consideration for a benefit flowing directly to the corporation as an incident of its

to individual contributions are varied and interrelate in a complex manner. In 1969, Congress established the present deduction limit of 50 percent of the taxpayer's contribution base (modified adjusted gross income).<sup>124</sup> Within that overall limit, additional percentage restrictions have been imposed, based on the identity of the donee, or the form of the gift, and on donations of property that would produce capital gain if sold.<sup>125</sup> Where a donation fails to qualify for the 50% contribution limit, contribution deductions are limited to either 30 or 20 percent of the donor's income.<sup>126</sup>

business." Regulations 74, Article 262. See also Regulations 62, Art. 562 (1921 Act). The 1935 enactment was prompted by the emerging view that corporations were invested with a social service, as well as profit-making, function in society. See Baker & Shillingburg, *Corporate Charitable Contributions*, FILER COMMISSION, DEPARTMENT OF THE TREASURY, III RESEARCH PAPERS, SPECIAL BEHAVIORAL STUDIES, FOUNDATIONS, AND CORPORATIONS 1853, 1854 (1977).

Currently, I.R.C. § 162(b) disallows deduction of amounts under § 162(a) where the contribution would be allowed under § 170 but for the percentage or other limitations of that section.

<sup>124</sup> I.R.C. § 170(b)(1). "Contribution base" is defined as the taxpayer's adjusted gross income computed without regard to net operating loss carrybacks. I.R.C. § 170(b)(1)(F).

<sup>125</sup> I.R.C. § 170(b)(1); Treas. Reg. § 1.170A-8 (1991). The 50 percent limit applies to donations to organizations described in § 170(b)(1)(A), which generally include nonprofits that undertake active programs in furtherance of their purposes or derive a substantial portion of their support from the public; these organizations, consequently, are frequently referred to as "50% organizations." A further restriction is provided where capital gain property, not subject to I.R.C. § 170(e)(1)(B), is donated to a 50% organization; the deduction on account of contributions of such property may not exceed 30% of the taxpayer's modified adjusted gross income or contribution base. I.R.C. § 170(b)(1)(C)(i).

<sup>126</sup> The actual limit is the lesser of 30 percent of income or the excess of 50 percent of the contribution base (essentially adjusted gross income) over the percentage of such contributions to 50% organizations. I.R.C. § 170(b)(1)(B). The 30-percent limit also applies to donations made "for the use of" § 170(b)(1)(A) organizations, such as donations of income interests in property. See *id.*; Wallace and Fisher, *supra* note 104 at 2145-46. Generally, the term "for the use of" has been taken to mean "in trust for." See *Davis v. United States*, 495 U.S. 472 (1990); *Rockefeller v. Commissioner*, 676 F.2d 35 (2d Cir. 1982); Rev. Rul. 84-61, 1984-1 C.B. 40.

I.R.C. § 170(b)(1)(D) provides that contribution deductions attributable to capital gain property to private nonoperating foundations, or charities not considered to be publicly supported, cannot exceed the lesser of 20% of income for the year or the excess of 30% of the base over the amount of I.R.C. § 170(b)(1)(C) contributions for the year. See MERTENS, *supra* note 111, at § 31.19. Contributions in excess of the percentage limitations may be carried over for five

Generally, the deduction equals either the amount of money or the fair market value of the property contributed.<sup>127</sup> However, this rule has afforded donors the opportunity to manipulate contributions and achieve tax savings in what Congress perceived to be an abusive manner. Prior to 1969, it frequently was pointed out that a donor often was better off donating property to charity and taking the deduction than selling the property and paying tax on the proceeds.<sup>128</sup>

In 1938, Congress considered limiting the deduction to the lesser of adjusted basis or fair market value of the property at the time of the gift, but rejected the idea because it would unduly discourage such gifts.<sup>129</sup> Subsequently, except for denying charitable deductions for amounts which would constitute ordinary income under the recapture rules if the property were sold at fair market value at the date of the contribution,<sup>130</sup> Congress did not deal with the appreciated property problem until the Tax Reform Act of 1969, when it significantly expanded restrictions on deductions of the full fair market value of contributions of appreciated property.<sup>131</sup> Certain specialized exceptions are provided for corporate taxpayers to encourage certain transfers favored by Congress.<sup>132</sup>

---

subsequent years. I.R.C. § 170(b)(1), (d)(1).

<sup>127</sup> See Treas. Reg. § 1.170A-1(c) (1991).

<sup>128</sup> See S. REP. NO. 552, 91st Cong., 1st Sess. 80 (1969) (cited in RABKIN & JOHNSON, *supra* note 111, at 59.05A); H. REP. NO. 413, Part 1, 91st Cong., 1st Sess. 53 (1969).

<sup>129</sup> See H.R. REP. NO. 1860, 75th Cong., 3d Sess. 20 (1938) (arguing against allowing deduction of unrealized gain) cited in Wallace & Fisher, *supra* note 104, at 2140 & n.44; S. REP. NO. 1567, 75th Cong., 3d Sess. 14 (1938) (allowing deduction of full value advances policy of encouraging gifts to charity), cited in Wallace & Fisher, *supra* note 104, at 2140 & n.45.

<sup>130</sup> See Wallace & Fisher, *supra* note 104, at 2140.

<sup>131</sup> I.R.C. § 170(e). For instance, under § 170(e)(1)(A), the amount of the deduction will be reduced by any ordinary income or short term capital gain that would have been realized by the taxpayer had the property been sold at fair market value at the time of the contribution.

<sup>132</sup> C corporations (see I.R.C. § 1361) are allowed a deduction for contributions of inventory property given to operating or publicly supported charities for use in caring for the ill, the needy, and infants. I.R.C. § 170(e)(3); RABKIN & JOHNSON, *supra* note 111, at 59.05A(4); MERTENS, *supra* note 111, at § 31.75. Most corporations are also allowed an enhanced deduction for the contribution of scientific

The deduction for property that would produce long term capital gain if sold is also restricted, using a combination of limitations determined as a percentage of income and reductions in the deduction available for particular gifts, which are determined according to the identity of the donee as well as the character of the property transferred. While a full deduction generally is allowed for the value of most capital gain property donated to publicly-supported charities, an individual taxpayer may not deduct more than 30% of his contribution base on account of such gifts.<sup>133</sup>

In certain situations, the deduction is limited to the adjusted basis of the donated property. A taxpayer may elect to disregard the 30% limitation and apply the 50% limit if he reduces the deduction claimed on account of the donation to its adjusted basis; however, the election applies to all capital gain property donated during the year.<sup>134</sup> Where tangible personal property unrelated to a donee's exempt purpose is transferred to any exempt organization, the deduction is essentially limited to the taxpayer's adjusted basis in the property; if, however, the donation consists of property related to the exempt organization's function, deduction of the appreciated value of the gift is allowed.<sup>135</sup> The deduction is also reduced for donations of capital gain property to a private nonoperating foundation,<sup>136</sup> except that a fair market value deduction is generally permitted for publicly traded appreciated stock which is capital gain property in the donor's hands.<sup>137</sup>

---

equipment to institutions of higher education, provided they have manufactured the property in question and it constitutes inventory in their hands. See I.R.C. § 170(e)(4). The deduction in both instances equals the donor's basis in the property plus one-half of the unrealized appreciation, not exceeding twice the basis of the property. I.R.C. § 170(e)(3)(B).

<sup>133</sup> I.R.C. § 170(b)(1)(C). Excess deductions are carried over to the five succeeding tax years. I.R.C. § 170(b)(1)(C)(ii).

<sup>134</sup> I.R.C. § 170(b)(1)(C)(iii).

<sup>135</sup> I.R.C. § 170(e)(1)(B)(i); Treas. Reg. § 1.170A-4(b)(3)(1991).

<sup>136</sup> I.R.C. § 170(e)(1)(B)(ii).

<sup>137</sup> I.R.C. § 170(e)(5) (full value deduction not available where donor's contributions aggregate more than 10% of the value of all the corporation's stock). These limits also apply to appreciated property transfers by corporations.

### b) Federal Charitable Deductions for Income of Estates and Trusts

The Code allows a trust or estate an unlimited deduction from income for all amounts paid, pursuant to its governing instrument, to eligible organizations<sup>138</sup> during its tax year.<sup>139</sup> Deductions also may be claimed on account of amounts set aside for payment to qualified organizations; estates are allowed an unlimited set-aside deduction, but trusts are only allowed a deduction if the contribution actually is paid by the end of the year succeeding the year in which it is so set aside.<sup>140</sup>

<sup>138</sup> These are organizations described in I.R.C. § 170(c) without regard to § 170(c)(2)(A), meaning that an entity need not be organized under United States law in order for the contribution to qualify for deduction.

<sup>139</sup> I.R.C. § 642(c)(1). It may also elect to treat contributions as having been made in the prior year. *Id.*

Estates and trusts have been allowed an income tax deduction for charitable contributions since the enactment of the War Revenue Act of 1917, which limited it to 15 percent of net income; at that time, the taxable income of trusts and estates was determined in the same manner as that of individuals, and so the deduction was permitted these entities when Congress allowed individuals to claim it. *See War Income Tax, ch. 63, § 1201(2)(a), 40 Stat. 300, 330 (1917); Revenue Act of 1916, ch. 463, §§ 1(c), 2(b), 8(a)-(c), 39 Stat. 756, 757, 757-58, 761, 762.* However, under the Revenue Act of 1918, this deduction was expanded to encompass "any part of the gross income which, pursuant to the will or deed creating the trust, is during the taxable year paid or permanently set aside" for certain enumerated types of corporations, which generally corresponded to those eligible for exemption from the income tax under the predecessor to I.R.C. § 501(c)(3). *See Revenue Act of 1918, ch. 18, § 219(b), 41 Stat. 1057, 1071 (1919).*

<sup>140</sup> Estates are allowed an unlimited deduction for amounts set aside for the organizations and purposes described in I.R.C. § 170(c). I.R.C. § 642(c)(2). However, the scope of the deduction allowed trusts was narrowed somewhat by the Tax Reform Act of 1969, which eliminated the deduction for amounts set aside for, but not paid to, I.R.C. § 170(c) donees in the tax year, unless the subsequent year election is made; a grandfather clause was provided for certain pre-October 9, 1969 trusts. *See Tax Reform Act of 1969, Pub. L. No. 91-172, § 201(b), 83 Stat. 487, 558.* This change was made to impose a current distribution requirement on trusts making charitable contributions similar to the one placed on private foundations, essentially by threatening imposition of the regular income tax rather than through the use of an excise tax. *See S. REP. NO. 552, 91st Cong., 1st Sess. 84-85.* The restriction was also imposed to eliminate an inconsistency with the charitable remainder trust rules created by the Act. *See id.*

Special rules also apply to split-interest gifts in trust where a charitable contribution deduction is sought for the value of the gift.<sup>141</sup> A grantor may desire to create a charitable income or remainder interest in a trust corpus along with other, noncharitable interests in the property. Prior to the Tax Reform Act of 1969, considerable leeway was given with regard to which interests qualified for the deduction, as well as to the valuation of such interests. However, the 1969 Act established definite qualifying interest and valuation rules.

Deduction for a charitable remainder interest is now allowed only if the noncharitable income interest is limited to a fixed dollar payout or certain percentage of the value of the assets of the trust.<sup>142</sup> The income tax deduction allowed is the fair market value of the remainder interest.<sup>143</sup> The remainder interest is valued according to Treasury actuarial tables.<sup>144</sup> A gift of a charitable income interest in trust, with a noncharitable remainderman, must also provide for annual distribution of a definite annuity amount or percentage of trust assets for the gift to qualify for the charitable deduction under the income, gift, and estate taxes.<sup>145</sup> To receive an income tax deduction for the charitable interest when created, the donor must remain subject to tax on the income of the trust as it is earned.<sup>146</sup> The income tax deduction allowed is the value of the interest on the date of contribution, valued according to Treasury tables.<sup>147</sup>

<sup>141</sup> *See Kurz & Robinson, Explanation and Analysis of Split-Interest Gifts to Charity, in RESEARCH PAPERS, TAXES, supra note 3, at 2221.*

<sup>142</sup> *See I.R.C. §§ 170(f)(2)(A), 644(d).*

<sup>143</sup> *Treas. Reg. § 1.170A-6(b)(2) (1991).*

<sup>144</sup> *Treas. Reg. §§ 1.664-2(c), -2(d); 1.664-4 (1991).* Similar rules apply to the determination of the gift and estate tax deductions allowable on account of such transfers. *I.R.C. §§ 2055(e)(2)(A), 2522(c).*

<sup>145</sup> *See I.R.C. §§ 170(f)(2)(B), 2055(e)(2)(B), 2522(c).*

<sup>146</sup> *I.R.C. § 170(f)(2)(B); Treas. Reg. § 1.170A-6(c) (1991).*

<sup>147</sup> *Treas. Reg. § 1.170A-6(c)(3) (1991).*

### 3) Income Tax-Exempt Government Bonds

The Internal Revenue Code allows nonprofits to raise capital through tax-exempt bond issues, thus lowering the interest costs associated with borrowing. Code Section 145 allows state and local governments to issue bonds paying interest exempt from federal income tax on behalf of organizations described in Code Section 501(c)(3), provided that 95% of the net proceeds are used by the organization or a governmental unit.<sup>148</sup> Furthermore, all property purchased with bond proceeds must be owned exclusively by the exempt organization or governmental unit,<sup>149</sup> and the proceeds must be used to further the organization's exempt purpose and not in an unrelated trade or business.<sup>150</sup> Generally, bond proceeds may not be used to finance residential rental property for family units.<sup>151</sup> Only \$150,000,000 of these bonds may be outstanding with respect to any non-hospital exempt organization at any one time.<sup>152</sup> Hospital bonds<sup>153</sup> are not subject to this limitation; furthermore, any hospital bonds outstanding are not counted toward an organization's non-hospital bond limit.<sup>154</sup> The Tax Reform Act of 1986 significantly revised the rules affecting this form of financing, reducing somewhat its attractiveness and imposing several qualification requirements as a condition of exemption.<sup>155</sup>

148 I.R.C. § 145(a)(1). See generally JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 1183-88.

149 I.R.C. § 145(a)(1).

150 See JOINT COMMITTEE ON TAXATION, *supra* note 148, at 1184.

151 I.R.C. § 145(d).

152 I.R.C. § 145(b).

153 Defined as an issue 95% or more of the proceeds of which are used with respect to a hospital. I.R.C. § 145(c).

154 See JOINT COMMITTEE ON TAXATION, *supra* note 148, at 1185, 1188.

155 See Zimmerman, *Effect of Tax Reform Act of 1986 upon Tax-Exempt Bond Financing for the Health Care Industry*, 18 LOY. U. CHI. L.J. 887, 905-20 (1987); Bates, *Bond Financing for Governments and 501(c)(3)s Newly Restricted*, 66 J. TAX'N 160 (1987).

### 4) Income Tax-Deferred Retirement and Compensation Plans

While a nonprofit may create and maintain the same type of qualified pension or profit sharing plan as a for-profit employer, the Code affords exempt organizations other methods of providing tax-favored deferred compensation to employees. These provisions afford nonprofit employers greater flexibility in structuring employee compensation. Section 403(b) of the Code provides special treatment for contributions to tax sheltered annuities. Section 501(c)(3) organizations<sup>156</sup> or state educational organizations<sup>157</sup> can purchase these annuities.

Deferred compensation plans complying with Code Section 457 may be set up by any organization exempt from tax under subtitle A of the Code.<sup>158</sup> Section 457 effectively caps the amount of compensation which can be deferred by an employee of a charitable organization pursuant to an agreement between the employee and the organization.<sup>159</sup> A Section 457 plan is an unfunded deferred compensation plan;<sup>160</sup> consequently, it is not subject to the usual qualification rules imposed on tax-deferred retirement plans.

156 Non-church purchasers must buy annuities under a plan subject to I.R.C. § 401(a) nondiscrimination and I.R.C. § 410(b) minimum participation requirements. I.R.C. § 403(b)(1)(D). Churches (as defined in § 3121(w)(3)(A) & (B), see I.R.C. § 403(b)(12)(B)) are not subject to non-discrimination rules.

157 Defined at I.R.C. § 170(b)(1)(A)(ii).

158 I.R.C. § 457(e)(1)(B) (this category includes organizations exempted from the income tax, such as those listed in I.R.C. § 501(c)). This was a change made by the 1986 Act; previously, these plans were available only to states. Church plans are not eligible for I.R.C. § 457 treatment. I.R.C. § 457(e)(13).

159 I.R.C. § 457 provides that, where it applies, it is the only mechanism through which inclusion of compensation for services in an employee's income may be deferred after it is earned.

160 Such plans are commonly referred to as "rabbi trusts." They are called "unfunded" because assets in the plan remain subject to the claims of the employer's creditors (I.R.C. § 457(b)) unlike the assets in an I.R.C. § 401(a) trust, which cannot be diverted to another use before all benefit liabilities of the plan are satisfied. I.R.C. § 401(a)(2).

### 5) State Income Tax Exemptions

All states imposing a corporate income tax provide exemptions for charitable organizations.<sup>161</sup> However, the exact language of the exemption varies. In some states, the exemption is tied expressly to qualification as an entity exempt from federal income tax under Code Section 501(c)(3). In others, the federal tax statute is not explicitly referred to in the state act, but the exempt categories mirror federal law. Some state laws provide that income tax is only imposed on corporations operated for profit, thus excluding nonprofits.<sup>162</sup> Most states impose the unrelated business income tax on nonprofits provided under federal law.<sup>163</sup>

### 6) Federal Estate Tax Charitable Deduction

The Internal Revenue Code allows an unlimited deduction for the value of property includable in an estate transferred to certain enumerated charities.<sup>164</sup> To qualify, the contribution must be made

<sup>161</sup> W. WELLFORD & J. GALLAGHER, *supra* note 5, at 121-22.

<sup>162</sup> *Id.*

<sup>163</sup> *Id.*

<sup>164</sup> I.R.C. § 2055. The charitable deduction became a feature of the tax on legacies and estates in the early part of the twentieth century. At various times in the eighteenth and nineteenth centuries, levies were imposed upon legacies, with the tax paid by the recipients of the decedent's property, as a wartime revenue-raising device. See Act of July 6, 1797, ch. 11, 1 Stat. 527, *repealed by* Act of June 30, 1802, ch. 17, 2 Stat. 148 (Revolutionary War stamp duty on legacies); Act of July 1, 1862, ch. 119, § 111, 12 Stat. 432, 485, *repealed by* Act of July 14, 1870, ch. 225 § 1, 16 Stat. 256 (Civil War tax on legacies); Act of June 13, 1898 (War Revenue Law of 1898), ch. 448, § 29, 30 Stat. 464, *repealed by* Act of April 12, 1902, ch. 500, § 7, 32 Stat. 96, 97 (Spanish-American War tax on legacies).

No exemption for charitable bequests was provided in the Revolutionary, Civil, or Spanish-American War taxes as originally enacted, but Congress afforded charitable bequests some relief under the latter two laws subsequent to their passage. In the 1870 law repealing the 1862 Civil War tax, Congress provided that taxes imposed upon bequests "for public use, of a literary, educational, or charitable character," but which were unpaid at the date of repeal, were not to be collected. Act of July 14, 1870, ch. 255, § 27, 16 Stat. at 269. Congress moved more swiftly and granted broader relief under the Spanish-American War tax. In 1901, Congress corrected what it termed an "oversight" (H.R. REP. NO. 2016, 56th Cong. 2d Sess. 7) in the 1898 legislation by prospectively exempting all legacies "for uses of a religious, literary, charitable, or educational character, or for encouragement of art, or legacies or bequests to

to a corporation, association, society, or trust, and not to an individual.<sup>165</sup> Donations to Section 501(c)(3) organizations generally qualify, but the statutory language of Code Section 2055(a)(2) does not parallel that of Section 501(c)(3).<sup>166</sup> Bequests to fraternal orders are also deductible, provided that they are applied exclusively for charitable purposes.<sup>167</sup> Contributions to Congressionally-chartered veterans' organizations also are eligible for the deduction.<sup>168</sup>

---

societies for the prevention of cruelty to children" from the tax. Act of March 2, 1901, ch. 806, § 29, 31 Stat. 938, 947. After the 1898 war tax was repealed in 1902, Congress ordered that all taxes collected on bequests of the type exempted under the 1901 amendment be refunded by the Treasury. Act of June 27, 1902, ch. 1160, 32 Stat. 406. The refund was justified in the following passage from the Committee Report:

In a word, these institutions embrace the whole domain of the charities of the country. It is inconceivable that it was ever intended by Congress to levy this enormous tax upon legacies for such uses and, in effect, to put a hand in the contribution boxes of the country. The vindication of our national character calls for the refunding of the moneys thus taken.

H.R. REP. NO. 1702, 57th Cong., 1st Sess. 1902, *quoted in* Myers, *Estate Tax Deduction for Charitable Benefits: Proposed Limitations*, in RESEARCH PAPERS, TAXES, *supra* note 3, at 2299 (1977).

The modern form of the estate tax, that is, a levy upon the transfer of the decedent's estate, rather than upon the property received by his heirs and devisees, dates from the time of the First World War. See Revenue Act of 1916, ch. 463, § 200, 39 Stat. 756, 777. Again, no deduction for charitable bequests was provided; this was remedied in 1918, when the predecessor of today's deduction was created. See Revenue Act of 1918, ch. 18, § 403(a)(3), (b)(3), 40 Stat. 1057, 1098-99. Although the estate tax did not fall directly on charitable donees, as had the imposition created by the 1898 statute, since it was paid by the estate rather than by the recipient of the decedent's property, the deduction was deemed desirable in order to encourage private support of eleemosynary institutions, which was described as an important and distinctive characteristic of American civilization. See 57 Cong. Rec. 550 (1918) (statement of Sen. Penrose).

<sup>165</sup> See STEPHENS & MAXFIELD, *supra* note 108, at ¶ 5.05[1].

<sup>166</sup> For instance, organizations testing for public safety are not included in the class of eligible donees, while institutions for the encouragement of art are included, although not expressly mentioned in I.R.C. § 501(c)(3). Such an organization may, however, qualify for exemption as a "charitable" entity under I.R.C. § 501(c)(3).

<sup>167</sup> I.R.C. § 2055(a)(3). This class of organizations generally corresponds to that described in I.R.C. § 501(c)(10), and the proviso restricting the use of such gifts is also found in I.R.C. § 170(c)(4).

<sup>168</sup> I.R.C. § 2055(a)(4). The related sections under the income tax law in this area are I.R.C. §§ 501(c)(19) and 170(c)(3).

## 7) State Inheritance and Succession Taxes

Following the federal Tax Reform Act of 1976, most states modified their inheritance taxes so that a tax is imposed only to the extent that a credit on account of such tax will be allowable against the federal estate tax. These provisions allow the state to claim a portion of the tax that would otherwise be payable to the federal government. This results in an indirect charitable deduction, since the deduction allowed for such contributions under the federal tax results in a reduction of the federal tax payable, and thus a reduction of any possible state tax liability. States imposing traditional legacy and succession taxes, however, generally have not taxed charitable beneficiaries, since these taxes fall on the legatee.

## 8) Federal Tax Deduction for Taxable Inter-Vivos Gifts

The Internal Revenue Code allows taxpayers to deduct gifts to certain enumerated organizations in computing the amount of taxable gifts made in a tax year.<sup>169</sup> As with income and estate tax deductions, the gifts must be made to organizations, and not to individuals.<sup>170</sup> The classes of eligible recipients are generally the same as those enumerated under Code Sections 170(c) and 2055(a), with minor variations in the descriptive language.<sup>171</sup> An unlimited deduction is allowed against gifts made. However, eligibility of a gift for the deduction depends on the character of the donee, i.e., whether it is within the classes enumerated in the statute or whether it has engaged in prohibited activities depriving it of exempt status

<sup>169</sup> I.R.C. § 2522. The charitable deduction was incorporated in the 1924 law, which created the gift tax. See Revenue Act of 1924, ch. 234, §§ 321(a)(2), (b)(1), 43 Stat. 253, 314, 315. The original exemption provided a deduction for three of the four classes of eligible donees enumerated under the present law. War veterans' associations were added to the list in 1932, Revenue Act of 1932, ch. 209, § 505(a)(2)(D), 47 Stat. 169, 248, providing a deduction to parallel the one available under the income tax law. Interestingly, a charitable deduction for bequests to these organizations was not provided under the estate tax at that time.

<sup>170</sup> See I.R.C. § 2522(a); *Bolton v. Commissioner*, 1 T.C. 717 (1943).

<sup>171</sup> These include the United States; any State or political subdivision (I.R.C. § 2522(a)(1)); I.R.C. § 501(c)(3) organizations (I.R.C. § 2522(a)(2)); I.R.C. § 501(c)(10) fraternal societies (I.R.C. § 2522(a)(3)); and I.R.C. § 501(c)(19) veterans' organizations (I.R.C. § 2522(a)(4)).

under Code Section 501(c)(3), and whether the gift is in the proper form.<sup>172</sup>

## 9) Unemployment Insurance Tax

Charitable organizations exempt from the income tax were exempted from the first unemployment insurance tax, which formed part of the Social Security Act of 1935.<sup>173</sup> In 1970, an exemption

<sup>172</sup> An example of this latter requirement occurs when a split interest in property is conveyed to charity; the interest must constitute either a qualified charitable lead or remainder trust under applicable Code provisions in order to obtain the benefit of the deduction. See I.R.C. § 2522(c).

<sup>173</sup> See Social Security Act of 1935, ch. 531, § 907(c)(7), 49 Stat. 620, 643. See H.R. REP. NO. 615, 74th Cong., 1st Sess. at 37 (1935); S. REP. NO. 628, 74th Cong., 1st Sess. at 49 (1935). Exemption was preserved in the Federal Unemployment Tax Act of 1939, ch. 2, § 1607(c)(7), 53 Stat. 183, 187, and in subsequent versions of the law. I.R.C. §§ 3301-11. While the legislative history of the 1935 provision does nothing more than paraphrase the statutory language, both the House and Senate Reports provide a brief explanation of an identical exemption from the Social Security Tax provided under § 811(b)(8) of the same Act. H.R. REP. NO. 615, 74th Cong., 1st Sess. at 33; S. REP. NO. 628, 74th Cong., 1st Sess. at 45. Both these reports make clear that the "destination of income" test, discussed *supra* note 92, was to be applied in determining whether services were rendered to an exempt organization. For instance, a person employed in a profit-making activity carried on by an exempt organization to generate income used in furtherance of its exempt purpose was considered an employee of the exempt entity for purposes of the exemption.

The regulations promulgated under these provisions provide that the general test for exemption is the character of the organization for which the services are performed. The nature of the services is immaterial. See Regulations 90, Art. 206(7) (1936). To qualify, an organization must be operated exclusively for an exempt purpose, and none of its net earnings may inure to the benefit of any private individual. However, in an apparent allusion to the *Trinidad* case, discussed *supra* note 92, the regulation provides that a religious organization that manufactures articles for sale to the public at a profit is not entitled to the exemption provided by the Act because it is not operated exclusively for an exempt purpose, even if no private inurement occurs. Consequently, in applying the statute, it appears that the Treasury did not take the expansive "destination of income" view that Congress adopted in the legislative history. The Service's view of the "exclusive operation" test became the law upon the enactment of the UBIT, which rejected the "destination of income" standard. Thus, an organization would not be an I.R.C. § 501(a) exempt entity if a substantial purpose of the organization was the operation of profit-making businesses unrelated to the exempt purpose. See B. HOPKINS, *supra* note 7, at 225-38.

After the passage of the UBIT in the Revenue Act of 1950, 64 Stat. 906, the "destination" test was no longer used to determine whether an organization was exempt from income tax. See *Sico Found. v. United States*, 295 F.2d 924 (Ct. Cl.

for non-501(c)(3) nonprofits was repealed.<sup>174</sup> The Code currently exempts employment services rendered to Section 501(c)(3) exempt organizations from the federal unemployment payroll tax.<sup>175</sup>

In 1970, however, Congress required the states to extend unemployment insurance protection to employees of these institutions, giving nonprofits the option of either reimbursing the states for the actual expense of paying benefits to their laid-off workers or of paying the regular state unemployment insurance payroll tax.<sup>176</sup> Church employees, ministers, and members of religious orders performing duties required by such orders were exempted from the requirements of this Act.<sup>177</sup>

Administrative and judicial applications of the exemption have turned on two factors: the services must be performed by a common

1961). Consequently, since only I.R.C. § 501(c)(3) exempt organizations are entitled to the I.R.C. § 3306(c)(8) exemption, the I.R.C. § 3306(c)(8) eligibility determination is made on the basis of tests normally applied to determine whether an entity is exempt from the income tax under I.R.C. § 501(c)(3). Rev. Proc. 57-29, 1957-2 C.B. 1099. However, the Service, in determining the scope of the exemption, does not rely on the concept of "unrelated trade or business" in determining which services rendered to an organization found to be exempt under § 501(c)(3) are exempt from FUTA.

174 I.R.C. § 3306(c)(10)(A) requires organizations exempt under I.R.C. § 501(a), other than I.R.C. § 501(c)(3) organizations, to pay the quarterly FUTA tax for each employee whose remuneration exceeds \$50 in the calendar quarter. See generally, Note, *Preferential Treatment of Charities Under the Unemployment Insurance Laws*, 94 YALE L.J. 1472 (1985).

175 I.R.C. § 3306(c)(8). This subsection provides that service performed in the employ of an organization exempt from tax under I.R.C. § 501(c)(3) is not considered "employment" for FUTA purposes, thus relieving it of liability for the federal tax. Exemption extends to all employees of the charity, including those engaged in unrelated business activities, notwithstanding the UBIT principle embodied in the income tax law. Cf. *St. Martin Evangelical Lutheran Church v. South Dakota*, 451 U.S. 772 (1981); *Alabama v. Marshall*, 626 F.2d 366, 369 (5th Cir. 1980), cert. denied sub nom. *Donovan v. Alabama*, 452 U.S. 905 (1981) (construing church exemption of I.R.C. § 3309(b)(1) to extend to all employees of the church).

176 Employment Security Amendments of 1970, Pub. L. No. 91-373, § 104, 84 Stat. 695, 697-99 (amending I.R.C. §§ 3303(e), (f), 3304(a)(6), 3309). Congress advanced two reasons for setting up the optional prepayment/reimbursement system in 1970. First, it did not wish to change the tax-exempt status of I.R.C. § 501(c)(3) organizations, S. REP. NO. 752, 91st Cong., 2d Sess., reprinted in 1970 U.S. CODE CONG. & ADMIN. NEWS 3606, 3618, and, second, it did not wish to have nonprofits fund the compensation costs of for-profit entities. *Id.*

177 I.R.C. § 3309(b)(1), (2). See generally Note, *supra* note 174, at 1477-79.

law employee,<sup>178</sup> and the employer must be a member of the class entitled to the exemption.<sup>179</sup>

A similar entity-level approach has been taken with the exemption afforded churches under Code Section 3309(b). In 1981, the Supreme Court ruled that services performed by employees of church-run secondary and elementary schools were exempted from the unemployment insurance system established by the Employment Security Amendments of 1970, because those employees were employed by a church that was exempt under Code Section 3309(b)(1).<sup>180</sup> The Court reached this conclusion despite Congress' 1976 repeal of an exemption, formerly provided by Code Section

178 This status is determined under the usual common law tests. See Treas. Reg. § 31.3121(d)-1(c).

179 In Rev. Rul. 56-188, 1956-1 C.B. 485, construing the FICA exemption formerly accorded I.R.C. § 501(c)(3) organizations under I.R.C. § 3121(b)(8)(B), the Service held that the exemption applied to such organizations as a whole, rather than to their component parts or activities, and that, consequently, services performed by employees of an I.R.C. § 501(c)(3) organization in connection with its unrelated income-producing activities were not subject to the employment tax.

This position has been consistently applied in subsequent rulings concerning FUTA; if it is shown that a person is an employee of an I.R.C. § 501(c)(3) organization under the common law tests used to determine whether such a relationship exists for purposes of the Code, wages paid for such services will not be subject to FUTA. This seems to be the case irrespective of the type of services rendered by the employee. See, e.g., Rev. Rul. 65-165, 1965-1 C.B. 446 (handicapped workers in sheltered workshop); PLR 8821072, 1988 PLR LEXIS 594 (3/1/88)(instructors hired by I.R.C. § 501(c)(3) organization to teach in local businesses pursuant to contract between exempt organization and businesses); PLR 8732053 (5/13/87) (data processing consultant to I.R.C. § 501(c)(3) organization); PLR 8204075 (10/28/81) (computer technician employed by I.R.C. § 501(c)(3) organization); PLR 7302289210A (2/28/73) (day care workers under control and direction of I.R.C. § 501(c)(3) organization); PLR 610411760A (4/1/61) (construction supervisor engaged by church to oversee building project). If, however, an employee is not directly controlled by an I.R.C. § 501(c)(3) organization, but rather by some other entity, such as a non-exempt partnership between an I.R.C. § 501(c)(3) organization and a profit-making business, the I.R.C. § 3306(c)(8) exemption is not available. Rev. Rul. 54-369, 1954-2 C.B. 369; PLR 7611111880A (11/11/76).

180 *St. Martin Evangelical Lutheran Church v. South Dakota*, 451 U.S. 772 (1981). The Court reasoned that since the schools were not separate legal entities from the church and were owned, supported, and controlled by the church, persons working in the schools were employees of the church, and so were covered by the I.R.C. § 3309(b)(1) exemption. *Id.* at 784-85.

3309(b)(3), for schools that were not institutions of higher education.<sup>181</sup>

Exempt organizations benefit from the payroll tax exemption through lower labor costs, as an employer's tax payments often exceed the benefits received by its laid-off employees. Under the present system, Code Section 501(c)(3) organizations need pay only the equivalent of the former employees' unemployment compensation. These employers do not subsidize other businesses which lay off many workers, and a nonprofit's liability for unemployment compensation is largely under the nonprofit's control.<sup>182</sup> Furthermore, permitting nonprofit employers to reimburse states for unemployment benefits provided their workers, instead of pre-paying them, allows nonprofits a timing advantage not available to other employers.<sup>183</sup>

### 10) Social Security Tax

Prior to 1983, organizations defined in Code Section 501(c)(3) were exempted from Social Security taxes,<sup>184</sup> but they could waive

<sup>181</sup> See Unemployment Compensation Amendments of 1976, Pub. L. No. 94-566, § 115(b)(1), 90 Stat. 2667, 2670. The Court concluded that this action did not diminish the scope of the exemption allowed under I.R.C. § 3309(b)(1), and that the exemption extended to any person shown to be an employee of a church under the usual common law tests. *St. Martin Evangelical Lutheran Church*, 451 U.S. at 785-88.

<sup>182</sup> A 1985 Yale Law Journal note estimated that the value of the § 3306(c)(8) exemption to I.R.C. § 501(c)(3) organizations was approximately \$290 million dollars. Note, *supra* note 174, at 1478 n.33. The amount of the tax paid to the federal government, after allowance of the credit for payments of tax to state unemployment insurance funds, generally covers the administrative costs of the program. *Id.* at 1478. A 1984 Labor Department report estimated that the unemployment compensation system expended \$40 million per year in administrative costs on account of nonprofit participation, which was borne by employers subject to the tax. OFFICE OF THE INSPECTOR GENERAL, U.S. DEP'T OF LABOR, IMPROVEMENTS ARE NEEDED IN THE UNEMPLOYMENT INSURANCE REIMBURSABLE EMPLOYER SYSTEM 28 (1984).

<sup>183</sup> Note, *supra* note 174, at 1478 n.35. Investment income losses to state insurance funds attributable to this payment method have been estimated to have amounted to \$37 million in 1982. *Id.* (citing 1984 DEPARTMENT OF LABOR AUDIT REPORT at 1, 3, 11-12).

<sup>184</sup> I.R.C. § 3121(b)(8)(B), repealed by Social Security Amendments Act of 1983, Pub. L. No. 98-21, § 102, 97 Stat. 65, 70-71. The original Social Security Act exempted I.R.C. § 501(c)(3) organizations from liability for the old age employ-

exemption and elect to pay the tax, thus allowing their workers to participate in the system.<sup>185</sup> This exemption was abolished by the

---

ment tax. See Social Security Act of 1935, ch. 531, § 811(b)(8), 49 Stat. 620, 639. Consequently, wages earned in the employment of a nonprofit did not count toward the calculation of the employee's old age benefits. See Social Security Act of 1935, ch. 531, § 210(b)(7), 49 Stat. 620, 625; H.R. REP. NO. 615, 74th Cong., 1st Sess. 22; S. REP. NO. 628, 74th Cong., 1st Sess., 9, 33. According to the legislative history, this exemption extended to all employment services rendered to the nonprofit, provided the income generated by the activity was devoted to the exempt purposes of the organization. See H. REP. NO. 615, 74th Cong., 1st Sess. at 33; S. REP. NO. 628, 74th Cong., 1st Sess. at 45. Both the House and Senate Reports describe the scope of the Social Security Tax exemption in the following terms:

Services performed in the employ of religious, charitable, scientific, literary or educational institutions, no part of the net earnings of which inures to the benefit of any private shareholder or individual, are also exempt from the tax imposed by this title. For the purpose of determining whether such an organization is exempt, the use to which the income is applied is the ultimate test of the exemption rather than the source from which the income is derived. For instance, if a church owns an apartment building from which it derives income which is devoted to religious, charitable, educational, or scientific purposes, it will not be denied the exemption. The organizations which will be exempt from such taxes are churches, schools, colleges, and other educational institutions not operated for private profit, the Y.M.C.A., the Y.W.C.A., the Y.M.H.A., the Salvation Army, and other organizations which are exempt from income tax under section 101 (6) of the Revenue Act of 1932.

H.R. REP. NO. 615 at 33; S. REP. NO. 628 at 45.

Prior to the passage of the UBIT, the courts accordingly relied on the "destination of income" test to determine whether a charitable corporation or feeder organization operating a for-profit business was an organization exempt from income tax under the predecessor to § 501(c)(3) and so was entitled to the FICA tax exemption then afforded such entities. See *Sico Co. v. United States*, 102 F. Supp. 197 (Ct. Cl. 1952). Consequently, the "destination" test was used in this context for the same purpose as it was under the income tax laws, namely, to determine whether an organization was within the class entitled to the tax exemption allowed by the statute. After enactment of the UBIT, this test was no longer used, and eligibility was determined under the "organized and operated exclusively" test of § 501(c)(3). See *supra* notes 62 and 173 and accompanying text.

This exemption was repealed with respect to nonprofits in the same business as for-profit firms. The Social Security Act Amendments of 1983, Pub. L. No. 98-21, § 102, 97 Stat. 65, 70-71 (codified at scattered sections of 26 and 42 U.S.C.). 42 U.S.C. §§ 410(a)(10)(A) & (B) also provides an exemption for employees of schools, colleges, and universities. See Hansmann, *The Evolving Law of Nonprofit Organizations: Do Current Trends Make Good Policy?*, 39 CASE W. RES. L. REV. 807, 817 (1989).

<sup>185</sup> An employer could terminate the waiver on two years' notice, but could not thereafter re-enter the system. I.R.C. § 3121(k) (1982), repealed by Social Security Amendments Act of 1983, Pub. L. No. 98-21, § 102, 97 Stat. 65, 70-71.

Social Security Amendments Act of 1983,<sup>186</sup> as a result of Congressional concern over a trend among nonprofits to leave the system.<sup>187</sup>

Congress, however, has carved out special exemptions that allow certain religious organizations to elect whether to participate in the Social Security system. Religious orders whose members have taken a vow of poverty may choose to pay the tax in respect of services performed by their members.<sup>188</sup> In 1984, Congress responded to a Supreme Court decision requiring payment of Social Security taxes by certain groups opposed to such payments on religious grounds<sup>189</sup> by enacting an exemption election for certain churches and church groups.<sup>190</sup> These organizations may be exempted from liability for the tax upon certification that they oppose payment of FICA on religious grounds;<sup>191</sup> however, their employees are then subjected to self-employment tax on their earnings.<sup>192</sup>

186 Pub. L. No. 98-21, § 102, 97 Stat. 65, 70-71.

187 See H.R. REP. NO. 25, 98th Cong., 2d Sess., 16-17, reprinted in 1983 U.S. CODE CONG. & ADMIN. NEWS 219, 234.

188 I.R.C. § 3121(r). Once made, the election is irrevocable. I.R.C. § 3121(r)(1)(A). This provision was added to the law in 1972. Social Security Amendments of 1972, Pub. L. No. 92-603, § 123(b), 86 Stat. 1329.

189 See *United States v. Lee*, 455 U.S. 252 (1982) (no First Amendment Free Exercise violation in forcing payment of Social Security tax, even though religious beliefs forbid payment of tax or acceptance of benefits).

190 See Deficit Reduction Act of 1984, Pub. L. No. 92-603, § 2603(a)(2), (b), 98 Stat. 494, 1128, 1130, (codified at I.R.C. §§ 3121(b)(8)(B), 3121(w)). Qualified organizations are defined at § 3121(w)(3). See also B. HOPKINS, *supra* note 7, at 33-34.

191 I.R.C. § 3121(w)(1),(2). Organizations existing on July 18, 1984 must have made the election by the filing date of the first employment tax return due more than 90 days after that date. Subsequently-created organizations must elect by the time their first employment tax return is due.

192 I.R.C. §§ 1402(a)(14), (c)(2)(G). Ministers may be relieved of liability for self-employment taxes if they have taken a vow of poverty or oppose on conscientious grounds acceptance of government benefits with respect to their ministerial services. I.R.C. § 1402(c), (g).

## 11) Federal Excise Taxes

The Internal Revenue Code exempts a limited number of charitable nonprofits from various excise taxes levied on certain services and manufactured goods. For instance, Code Section 4253 exempts certain nonprofits from the 3% communications services excise tax.<sup>193</sup> Section 4221 exempts nonprofit educational organizations<sup>194</sup> from certain motor vehicle-related and other excise taxes.<sup>195</sup> A gasoline tax exemption is allowed, but it is limited to the highway trust fund portion of the tax, not the Leaking Underground Storage Tank (LUST) tax.<sup>196</sup> Section 4041(g)(4) exempts nonprofit educational organizations<sup>197</sup> from the special fuels tax imposed by Code Section 4041. Fuel used by aircraft museums for World War II planes is also exempt.<sup>198</sup> Section 4462 exempts certain organizations from the harbor maintenance tax. Section 5276 affords an exemption to the distilled spirit user fee.

In keeping with the special treatment often accorded nonprofits regarding organized gambling,<sup>199</sup> Code Section

193 Exempt organizations include: the American National Red Cross, I.R.C. § 4253(c); nonprofit hospitals, as defined in I.R.C. § 170(b)(1)(A)(iii), I.R.C. § 4253(h); nonprofit educational organizations, as defined by I.R.C. § 170(b)(1)(A)(ii); or a school operated by an I.R.C. § 501(c)(3) exempt organization, I.R.C. § 4253(j).

194 These are defined as I.R.C. § 170(b)(1)(A)(ii) organizations and schools operated by I.R.C. § 501(c)(3) organizations. I.R.C. § 4221(a)(5), (d)(5).

195 The exemption does not extend to the gas guzzler excise tax imposed by I.R.C. § 4064, the coal excise tax of I.R.C. § 4121, the diesel and aviation fuel excise tax of I.R.C. § 4091, or the vaccine excise tax of I.R.C. § 4131.

196 I.R.C. § 4081. I.R.C. § 4221(a) provides that the § 4081 exemption with respect to this excise tax will end on October 1, 1993, which is when the tax to which it relates is slated to expire (see I.R.C. § 4081(d)). Likewise, I.R.C. § 4071 tire tax exemption will expire in 1993, when that tax is to end (see I.R.C. § 4071(d)), and the I.R.C. § 4051 truck and trailer tax exemption will expire the same year, as the underlying tax is slated to expire then (see I.R.C. § 4051(c)).

197 These entities are defined as educational organizations within the meaning of I.R.C. § 170(b)(1)(A)(ii) and schools operated by I.R.C. § 501(c)(3) organizations.

198 I.R.C. § 4041(h). The exemption and tax will sunset on October 1, 1993. I.R.C. § 4041(a)(3), (g).

199 See text accompanying notes 415-419, *infra*.

4421(2)(b) exempts lotteries or raffles by certain nonprofits<sup>200</sup> from the federal wagering excise tax.

## 12) Exemptions Afforded from Taxes Generally Imposed by State Law

### a) Sales and Use Tax Exemptions

Many states exempt certain nonprofits, usually those corresponding to the description found in Code Section 501(c)(3), from both collecting and paying sales or use taxes on goods or services sold or purchased by them. Usually, the exemption is limited to transactions related to their charitable purposes. Tax relief is effected in two principal ways: first, purchases or sales of a particular product or service may be exempted, either entirely or partly, depending on the use to which the product or service is to be put; secondly, particular sellers or buyers may be relieved from collecting or paying the tax.<sup>201</sup>

Federal law generally does not affect these exemptions, but occasionally a state's law may trench upon some federally protected right or interest; usually, this occurs with respect to religious organizations. The Supreme Court recently has considered the permissible scope of these exemptions under the United States Constitution with respect to items sold by religious organizations. In *Texas Monthly v. Bullock*,<sup>202</sup> the Court ruled that a sales tax exemption granted exclusively to religious magazines violated the Establishment Clause. The Court held that such an exemption was permissible only if granted to a larger class of charitable publications which included those of religious organizations. Justice Scalia's vigorous dissent pointed out that previous Court decisions had not made such a distinction and had approved of exemptions exclusively granted religious bodies; the Court's ruling therefore called into question a host of these exemptions.

<sup>200</sup> The exemption extends to those organizations described in I.R.C. § 501 or § 521 (agricultural cooperatives).

<sup>201</sup> See generally Cline, *Sales Tax Exemptions*, in TAX EXEMPTIONS 121, 125-35 (1939).

<sup>202</sup> 489 U.S. 1 (1989).

Conversely, the Supreme Court has ruled that religious organizations may be held liable for nondiscriminatory sales and use taxes in the same manner as any other taxpayer.<sup>203</sup> The Court, however, has not hesitated to strike down laws that taxed or penalized protected expression.<sup>204</sup>

### b) Property Tax Exemptions

All states grant certain nonprofits, especially charities, exemptions from real property taxes.<sup>205</sup> As with state sales and use tax exemptions, federal law issues in this area are usually of Constitutional dimension and generally involve religious organizations. In 1970, the Supreme Court upheld state-granted property tax exemptions against an Establishment Clause challenge, reasoning that, although such an accommodation was not required by the Free Exercise Clause, merely refraining from requiring religious organizations to contribute to the support of the state was neither intended

<sup>203</sup> In *Swaggart Ministries v. California Bd. of Equalization*, 493 U.S. 378 (1990), the Court ruled that imposition of a non-discriminatory sales and use tax on religious articles sold by a church did not violate the Free Exercise Clause of the First Amendment.

<sup>204</sup> In *Murdock v. Pennsylvania*, 319 U.S. 105 (1943) and *Follett v. McCormick*, 321 U.S. 573 (1944), which struck down license fees imposed on door-to-door proselytizing and bookselling, the Court reasoned that these taxes constituted a precondition to the exercise of a "privilege granted by the Bill of Rights," that is, to disseminate religious beliefs. In *Swaggart Ministries*, the Court distinguished these holdings, noting that the tax at issue was merely imposed on the privilege of selling tangible property at retail. 493 U.S. at 389. The Court reaffirmed statements in *Murdock* and *Follett* that religious groups are not free from all burdens of government, and that they may be subject to general taxation in the same manner as other citizens. 493 U.S. at 386-87.

<sup>205</sup> See W. WELLFORD & J. GALLAGHER, *supra* note 5, at 122-38 & App. B (state-by-state summary of property and income tax exemptions); E.C. LASHBROOKE, TAX-EXEMPT ORGANIZATIONS 86-119 (1985)[hereinafter LASHBROOKE](50-state listing of property, income and sales tax exemptions); GREATER HARTFORD CHAMBER OF COMMERCE, PROPERTY TAX EXEMPTIONS FOR NONPROFIT ORGANIZATIONS: PROBLEMS AND PROPOSALS (1978) (table listing, state by state, the different types of entities entitled to property tax exemptions, as well as the types of property use for which exemption is available); Gabler & Shannon, *The Exemption of Religious, Educational, and Charitable Institutions from Property Taxation*, in RESEARCH PAPERS, TAXES, *supra* note 3, at 2535 (issues and policies respecting the property tax exemption); E. FISCH, D. FREED & E. SCHACHTER, CHARITIES AND CHARITABLE FOUNDATIONS 597-623 (1974 & Supp. 1989) (discussing property tax exemptions accorded nonprofits by the states). See also P. SWORDS, CHARITABLE REAL PROPERTY TAX EXEMPTION IN NEW YORK STATE (1981).

to nor did in fact effect an establishment of religion.<sup>206</sup> The Court's upholding of the law at issue also relied on the long-standing acceptance, dating from the earliest days of the Republic, of according exemptions to religious institutions.<sup>207</sup> The Court noted that the exemption minimized the entanglement of the state in the churches' affairs by obviating the need for close tax audits.<sup>208</sup>

Wellford and Gallagher<sup>209</sup> outline the present system of property tax exemptions in the following terms: thirty-six state constitutions exempt nonprofit charities from property taxes or permit the legislature to grant such exemptions.<sup>210</sup> The remaining state constitutions either generally permit granting exemptions, without restrictions on the class of eligible entities, or, if they contain no provision addressing the issue, have been interpreted as permitting exemptions for organizations carrying on activities similar to those enumerated in Code Section 501(c)(3).<sup>211</sup> Generally, all states condition exemption upon prohibition of private inurement and the irrevocable dedication of assets to exempt purposes.<sup>212</sup> To be exempt, most states require that the property be used either exclusively or primarily for exempt purposes. As the proportion of non-exempt use increases, so does the likelihood that all or a portion of the property will lose its exempt status.<sup>213</sup> In virtually every

<sup>206</sup> *Walz v. Tax Commission*, 397 U.S. 664, 673-75 (1970).

<sup>207</sup> *Id.* at 676-80.

<sup>208</sup> *Id.* at 676. The goal of avoiding excessive governmental entanglement in religion animates many of the decisions upholding special exemptions granted religious institutions. See *Lemon v. Kurtzman*, 403 U.S. 602 (1971). The case law suggests that exemption is to be preferred if it results in less entanglement than would result from subjecting religious organizations to regulation. *Walz v. Tax Commission*, 397 U.S. 664, 674-76 (1970).

<sup>209</sup> See *supra* note 5, at 122-38.

<sup>210</sup> *Id.* at 122.

<sup>211</sup> *Id.*

<sup>212</sup> *Id.* at 122-23.

<sup>213</sup> *Id.* at 123-24 See also CAL. REV. & TAX CODE § 214.05 (West 1991) (partial property tax exemption for portion of property producing unrelated business income is determined according to the percentage of non-unrelated business income produced by such part of the property or of time spent in non-unrelated business activities carried on in that part of the property).

state, property owned by an exempt entity, but dedicated to entirely non-exempt uses, will be taxed.<sup>214</sup>

## B) Antitrust Law Exemptions

Antitrust laws are federal and state statutes that protect trade and commerce from unlawful restraints, price discriminations, price fixing, and monopolies.<sup>215</sup> The principal federal acts are the Sherman Act,<sup>216</sup> the Clayton Act,<sup>217</sup> as amended by the Robinson Patman Act,<sup>218</sup> and the Federal Trade Commission Act.<sup>219</sup> Most states have their own antitrust acts, similar to the federal acts.<sup>220</sup>

It has been observed that antitrust "is rooted in a preference for pluralism, freedom of trade, access to markets, and freedom of choice" and that the "summarizing norm" of the antitrust laws is "a commitment to the maintenance of competitive process."<sup>221</sup>

Various legislative and common law exemptions from antitrust laws have developed over the years and, under certain circumstances, nonprofits may benefit from some of these exemptions.

<sup>214</sup> W. WELLFORD & J. GALLAGHER, *supra* note 5, at 123. Kentucky is a notable exception. *Id.*

<sup>215</sup> BLACK'S LAW DICTIONARY 86 (5th ed. 1979).

<sup>216</sup> Ch. 647, 26 Stat. 209 (1890) (current version at 15 U.S.C. §§ 1-7 (1988)).

<sup>217</sup> Ch. 323, 38 Stat. 730 (1914).

<sup>218</sup> Ch. 592, §1, 49 Stat. 1526 (1936) (current version, as amended, at 15 U.S.C. §§ 13-13c, 21a).

<sup>219</sup> Ch. 311, 38 Stat. 717 (1914) (current version at 15 U.S.C. §§ 41-58 (1988)).

<sup>220</sup> BLACK'S LAW DICTIONARY *supra* note 215, at 86. See, e.g., the Donnelly Act in New York (N.Y. GEN. BUS. LAW §§ 340-347 (McKinney 1984)), the Valentine Act in Ohio (OHIO REV. CODE ANN. § 1331.01-99 (Anderson Supp. 1986)), and the Cartwright Act in California (CALIF. BUS. & PROF. CODE §§ 16720-16761) (Deering 1976 & Supp. 1988)). See generally, Abrams, *Developments in State Antitrust Enforcement*, 62 N.Y.U. L. REV. 989 (1987).

<sup>221</sup> Fox & Sullivan, *Antitrust — Retrospective and Prospective: Where Are We Coming From? Where Are We Going?* 62 N.Y.U. L. REV. 936, 936 (1987).

## 1) Price Discrimination

The Robinson-Patman Act,<sup>222</sup> which prohibits price discrimination, was amended in 1938 to permit "schools, colleges, universities, public libraries, churches, hospitals, and charitable institutions not operated for profit" to purchase supplies "for their own use" for less than other purchasers might pay, thus exempting these particular nonprofits from the general regime of non-discriminatory pricing.<sup>223</sup>

Various courts, including the Supreme Court, have addressed the scope of the exemption.<sup>224</sup> It does not apply to independent activities operated for profit, such as self-sustaining college campus bookstores.<sup>225</sup> On the other hand, purchases of goods by a university or college, or by a university hospital, which are then resold to persons connected to that institution, do fall within the

<sup>222</sup> 15 U.S.C. §§ 13, 13a, 13b and 21 (1988).

<sup>223</sup> 15 U.S.C. § 13c. Also known as the "Nonprofit Institutions Act," the exemption was adopted by Congress in 1938. In discussing the meaning of "charitable institutions" for § 13c purposes, the United States Court of Appeals, Ninth Circuit, has observed that "the drafters of the Nonprofit Institutions Act wished to protect the same eleemosynary institutions that are given special consideration under the tax and charitable trusts laws." *De Modena v. Kaiser Found. Health Plan, Inc.*, 743 F.2d 1388, 1391 (1984), cert. denied, 469 U.S. 1229 (1985), citing S. REP. NO. 1769, 75th Cong. 3rd Sess. 1 (1938); H.R. REP. NO. 2161, 75th Cong. 3rd Sess. 1 (1938).

<sup>224</sup> W. Kirby, *Federal Antitrust Issues Affecting Institutions of Higher Education: An Overview*, 11 J.C. & U.L. 345, 372 (1984).

<sup>225</sup> *Id.*, discussing *Students Book Co. v. Washington Law Book Co.*, 232 F.2d 49 (D.C. Cir. 1955), cert. denied, 350 U.S. 988 (1956), and citing specific approval by the Supreme Court 20 years later of the D.C. Circuit's characterization of the purchases at issue in *Students Book Co.* as "not being transactions with the universities at all, but with the campus bookstores for resale at the latter's profit." *Abbott Laboratories v. Portland Retail Druggists Ass'n*, 425 U.S. 1, 18 n.10 (1976).

exemption;<sup>226</sup> so do purchases of goods by a nonprofit health maintenance organization for resale to its members.<sup>227</sup>

<sup>226</sup> Kirby, *supra* note 210, at 372-74, discussing *Logan Lanes v. Brunswick Corp.*, 378 F.2d 212 (9th Cir.), cert. denied, 389 U.S. 898 (1967) and *Abbott Laboratories*, 425 U.S. 1 (1976).

In *Logan Lanes*, Brunswick sold bowling lanes and equipment of like grade and quality to both a commercial bowling alley and a state university in the same geographic locale. The university paid substantially less. Although the university's bowling facilities were primarily for use by students, faculty and staff, they also were used by the public. A small uniform fee was charged to all users. 378 F.2d at 214-15. The district court granted summary judgment to Brunswick, and in affirming, the Ninth Circuit observed the following: one use made of the bowling equipment by students was to fulfill their physical education requirements; all net income from the bowling alleys was used to finance student activity programs and University improvement; even if used by the general public was substantial, the primary purpose of the lanes was to provide for the University's students, faculty and staff; therefore, the purchases were made for the use of the University within the meaning of § 13c of the Robinson-Patman Act. *Id.* at 216. The Ninth Circuit also defined "supplies," as used in the statute, to embrace "anything required to meet the institution's needs, whether it is consumed or otherwise disposed of, or whether it constitutes, or becomes part of, a material object utilized to enable the institution to carry on its activities." *Id.*

In *Abbott Laboratories*, an association of retail druggists challenged a drug manufacturer's custom of selling drugs at lower prices to nonprofit hospitals. The Court's decision described specific categories of drug sales which would not fit within the § 13c exemption (refills for former patients, dispensation to physicians for use in their private practices, and sales to walk-in prescription buyers), but the Court concluded that dispensation to physicians, employees or students for their own use or for their dependents' use "enhances the hospital function and qualifies as being in the hospital's 'own use' within the meaning of § 13c." See Kirby, *supra* note 224, at 373, discussing and quoting *Abbott Laboratories*, 425 U.S. at 16.

<sup>227</sup> See *De Modena v. Kaiser Found. Health Plan*, 743 F.2d 1388 (1984), cert. denied, 469 U.S. 1229 (1985), in which health maintenance organizations (HMOs) organized as nonprofit institutions were held to be "charitable institutions" within the meaning of the § 13c exemption of the Robinson-Patman Act, and drugs purchased by an HMO for resale to its members were held purchased for the HMO's "own use" within the meaning of § 13c.

Two years before denying certiorari in *De Modena*, the Supreme Court had held that "the sale of pharmaceutical products to state and local government hospitals for resale in competition with private pharmacies is not exempt from the proscriptions of the Robinson-Patman Act." *Jefferson County Pharmaceutical Ass'n v. Abbott Laboratories*, 460 U.S. 150, 171 (1983). In the Court's words;

the issue [in *Jefferson County Pharmaceutical Ass'n*] is narrow. We are not concerned with sales to the Federal Government, nor with state purchases for use in traditional governmental functions. Rather, the issue before us is limited to state purchases for the purpose of competing against private enterprise—with the advantage of discriminatory prices—in the retail market.

## 2) Unfair Competition

The Federal Trade Commission Act ("FTCA") prohibits "[u]nfair methods of competition in commerce, and unfair or deceptive practices in commerce . . ." <sup>228</sup> The jurisdiction of the Federal Trade Commission (the "Commission") extends only to persons, partnerships or corporations "organized to carry on business for [their] own profit or that of [their members] . . ." <sup>229</sup> The U.S. Court of Appeals for the Eighth Circuit has concluded:

Congress took pains in drafting [the FTCA] to authorize the Commission to regulate so-called nonprofit corporations, associations and all other entities if they are in fact profit-making. . . . Congress did not intend to bring within the reach of the Commission any and all nonprofit corporations regardless of their purposes. The limiting language . . . indicates an intention that the question of the jurisdiction over the corporations or other associations involved should be determined on an ad hoc basis. This interpretation would authorize the Commission to proceed against any legal entity without shares of capital which engages in business for profit within the traditional meaning of that language. <sup>230</sup>

460 U.S. at 154-55. In *Jefferson County Pharmaceutical Ass'n*, the scope of § 13c of the Robinson-Patman Act was not at issue. The Court specifically did not consider whether the § 13c exemption would support summary judgment against state hospitals purchasing products for their own use, because the district court had granted summary judgment for the hospitals, without regard to § 13c, on the basis that purchases by the hospitals were entirely exempt from the Act due to the hospitals' governmental status; in addition, the district court had assumed, for purposes of summary judgment, that at least some of the hospital purchases would not be covered by the § 13c exemption — an assumption the Supreme Court deemed proper. 460 U.S. at 155 n.8. See also Kirby, *supra* note 224, at 374.

228 15 U.S.C. § 45.

229 15 U.S.C. §§ 44-45. This language is in contrast to Congress' express exemption of nonprofit institutions from the price discrimination provisions of the Robinson-Patman Act and Congress' intended application of the Sherman and Clayton Acts to all corporations, whether for-profit or nonprofit. *Community Blood Bank v. F.T.C.*, 405 F.2d 1011, 1018 (8th Cir. 1969).

230 *Community Blood Bank*, 405 F.2d at 1018. The court's concept of the "traditional meaning" of "engaging in business for profit" encompassed three notions: (1) "Profit" means a gain over and above expenditures, (2) but the fact that income exceeds disbursements may not necessarily destroy a corporation's

## 3) Business of Insurance Exemption

The "business of insurance" exception <sup>231</sup> carved out by the McCarran-Ferguson Act <sup>232</sup> protects some nonprofits from antitrust liability. Generally, the exemption provides that state laws regulating the "business of insurance" are immune from invalidation, impairment, or supersession by Acts of Congress. In the absence of state regulation of the business of insurance, the Sherman, Clayton and Federal Trade Commission Acts apply. However, in 1979, the Supreme Court limited the exemption by narrowly defining the "business of insurance" to include only activities involving actual underwriting or risk-spreading. <sup>233</sup> Three years later, the Court described the standard for determining whether a practice is part of the business of insurance:

first, whether the practice has the effect of transferring or spreading a policy-holder's risk; second, whether the practice is

---

nonprofit character, and (3) engaging in business and making profits must be more than a subordinate or incidental characteristic of a corporation's existence. *Id.* at 1017. In *Community Blood Bank*, the Eighth Circuit held that evidence established that a hospital association and blood bank association were nonprofit corporations and exempt from provisions of the FTCA. *Id.* at 1022. At the same time, the court recognized that "Congress did not intend to provide a blanket exclusion of all nonprofit corporations." *Id.* at 1017. Compare *American Medical Ass'n v. F.T.C.*, 638 F.2d 443, 448 (2d Cir. 1980), *aff'd*, 455 U.S. 676, *reh'g. den.*, 456 U.S. 966 (1982) (business activities of the American Medical Association (AMA), state medical society and county medical association held within the scope of FTCA even if they are considered secondary to the charitable and social aspects of their work); *Casey v. F.T.C.*, 578 F.2d 793 (9th Cir. 1978) (FTC was not operating outside its scope of authority in investigating collective bargaining activities of a bona fide labor union nor in issuing subpoenas pursuant to the investigation); *F.T.C. v. National Comm'n on Egg Nutrition*, 517 F.2d 485, 488 (7th Cir. 1975), *cert. denied*, 426 U.S. 919 (1976) (nonprofit corporation organized to promote the general interests of the egg industry held within jurisdiction of the FTC; evidence sufficient to support finding that the organization "was organized for the profit of the egg industry, even though it pursues that profit indirectly"); *Chamber of Commerce v. F.T.C.*, 13 F.2d 673, 684 (8th Cir. 1926) (although not a trader or shipper, and thus not itself engaged in any commerce, a chamber of commerce was found to be an "instrumentality in the current of interstate commerce" and therefore held subject to the jurisdiction of the FTC).

231 Act of Mar. 9, 1945, ch. 20, 2(b), 59 Stat. 33, 34 (current version at 15 U.S.C. § 1012(b) (1988)).

232 15 U.S.C. §§ 1011-1015 (1988).

233 *Group Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205, 214-15 (1979).

an integral part of the policy relationship between the insurer and the insured; and third, whether the practice is limited to entities within the insurance industry.<sup>234</sup>

In both decisions the Supreme Court held that two common health insurance arrangements were not immune from antitrust scrutiny under the McCarran-Ferguson Act.<sup>235</sup> Subsequently, when arrangements between health insurers, providers and insured individuals have been challenged, courts generally have held the practices subject to antitrust scrutiny, but not in violation of the antitrust laws.<sup>236</sup> Indeed, few insurance industry practices have been held to meet the Supreme Court's "business of insurance" standards for immunity.<sup>237</sup>

The practical effect of these decisions is likely to be that the activities of HMOs or any other nonprofit organization offering insurance to its members as an incidental benefit will be subject to closer antitrust scrutiny and will qualify for the "business of

<sup>234</sup> *Union Labor Life Ins. Co. v. Pireno*, 458 U.S. 119, 130 (1982).

<sup>235</sup> In *Group Life & Health Ins. Co.*, a drugstore challenged an arrangement whereby Blue Shield entered contracts with participating pharmacies. Under the contracts, the pharmacies agreed to provide drugs to Blue Shield subscribers for a fixed price paid directly by Blue Shield. The Court held, in a 5-4 decision, that this arrangement was not immune from antitrust scrutiny under the McCarran-Ferguson Act. 440 U.S. 205, 214-16 (1979).

In *Union Labor Life Ins. Co.*, an insurer had contracted with a state chiropractic association to advise whether services provided to insured individuals were needed and priced reasonably. This practice was challenged by a chiropractor as a conspiracy to fix prices. The Court held that this arrangement was not part of the "business of insurance." 458 U.S. 119, 134 (1982). Three justices dissented. *Id.* at 135.

These decisions "have been sharply criticized as a misinterpretation of the intent of the Congress that adopted the McCarran-Ferguson Act." G. ANNAS, S. LAW, R. ROSENBLATT & K. WING, *AMERICAN HEALTH LAW* 807 (1990) [hereinafter ANNAS & LAW] (collecting articles).

<sup>236</sup> ANNAS & LAW, *supra* note 235, at 807.

<sup>237</sup> *Id.* But in one recent case, noted in ANNAS & LAW, Blue Cross and Blue Shield contracts that excluded coverage for chiropractic services were held part of the "business of insurance" and thus immune from antitrust scrutiny. *Id.*, citing *Health Care Equalization Comm. Iowa Chiropractic Society v. Iowa Medical Society*, 851 F.2d 1020 (8th Cir. 1988).

insurance" immunity only if they satisfy the Supreme Court's three-part test noted above.<sup>238</sup>

#### 4) State Action Antitrust Exemption

Another exemption from antitrust laws exists under the judicial doctrine of state action. The Supreme Court has held that the Sherman Act<sup>239</sup> was not intended "to restrain state action or official action directed by a state."<sup>240</sup> However, the Court also has sought to ensure that private parties could claim state action immunity from Sherman Act liability *only* when their anticompetitive acts were, in fact, the product of state regulation.<sup>241</sup> Accordingly, the Court has narrowed blanket state action immunity for private parties to actions undertaken pursuant to state legislation or high court decisions.<sup>242</sup> To determine whether anticompetitive conduct by private parties is protected state action, the Supreme Court has established a rigorous two-pronged test: "First, the challenged restraint must be 'one clearly articulated and affirmatively expressed as state policy.' . . . Second, the anticompetitive conduct must be 'actively supervised' by the State itself."<sup>243</sup> To claim state action

<sup>238</sup> See HOPKINS, *supra* note 7, at 109 (noting that HMOs are considered a special type of nonprofit entity whose risk spreading activities are not undertaken for profit), and at 315 (describing other types of nonprofit insurance providers, including, among others, churches or conventions or associations of churches providing property or casualty insurance for their member churches).

<sup>239</sup> Section 1 of the Sherman Act prohibits contracts, combinations and conspiracies in restraint of trade. 15 U.S.C. § 1 (1988). Section 2 of the Act prohibits monopolies, attempted monopolies and conspiracies to monopolize. 15 U.S.C. § 2 (1988).

<sup>240</sup> *Parker v. Brown*, 317 U.S. 341, 351 (1943).

<sup>241</sup> *Patrick v. Burget*, 486 U.S. 94, 100 (1988).

<sup>242</sup> *Kirby*, *supra* note 224, at 369 (discussing *California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. 97 (1980)).

<sup>243</sup> *Patrick v. Burget*, 486 U.S. at 100, quoting *California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.*, 445 U.S. 97, 105 (1980).

The "clear articulation" prong may be satisfied by a clearly articulated permissive policy; compulsion — while powerful evidence of the existence of state policy — is not a prerequisite to a finding of state action immunity. *Southern Motor Carriers Rate Conference, Inc. v. United States*, 471 U.S. 48, 60-63 (1985).

immunity from antitrust laws, private nonprofit institutions must show that their anticompetitive activities were undertaken pursuant to a clear state governmental mandate and involved regulation actively supervised by the state.<sup>244</sup>

"[T]he active supervision requirement mandates that the State exercise ultimate control over the challenged anticompetitive conduct . . . . The mere presence of some state involvement or monitoring does not suffice." *Patrick*, 486 U.S. at 101. "[T]he active supervision requirement stems from the recognition that '[w]here a private party is engaging in the anticompetitive activity, there is a real danger that he is acting to further his own interests, rather than the governmental interests of the State.'" *Id.* at 100, quoting *Hallie v. Eau Claire*, 471 U.S. 34, 47 (1985).

244 In *Goldfarb v. Virginia State Bar*, 421 U.S. 773 (1975), the Supreme Court refused to find state action in the anticompetitive activities of the State Bar. The Court held that § 1 of the Sherman Act was violated by the publication of a minimum-fee schedule by a county bar association and by the fee schedule's enforcement by the State Bar. Finding the activity constituted classic price fixing, the Court held that the action was not protected, emphasizing that "we need not inquire further into the state-action question because it cannot fairly be said that the State of Virginia through its Supreme Court Rules required the anticompetitive activities of [the bar associations]." *Id.* at 790. Ten years later, the Court observed that:

[a]lthough *Goldfarb* did employ language of compulsion, it is beyond dispute that the Court would have reached the same result had it applied the two-pronged test later set forth . . . . Virginia "as sovereign" did not have a "clearly articulated policy" designed to displace price competition among lawyers. In fact, the Supreme Court of Virginia had explicitly directed lawyers not "to be controlled" by minimum-fee schedules.

*Southern Motors Carriers Rate Conference, Inc. v. United States*, 471 U.S. 48, 61 (1985). By contrast, in *Bates v. State Bar*, 433 U.S. 350 (1977), the Supreme Court found a restraint upon attorney advertising to be "the affirmative command" of the Arizona Supreme Court, and that the Arizona Supreme Court was the "ultimate body wielding the State's power over the practice of law." *Id.* at 360. Therefore, the restraint was held not subject to attack under the Sherman Act. (However, stating that commercial speech is entitled to some First Amendment protection, the Court held that the attorney advertising in *Bates* was not misleading and was protected by the First Amendment. *Id.* at 363-82.)

More recently, in *Patrick v. Burget*, 486 U.S. 94 (1988), the Supreme Court held that the state action doctrine did not protect Oregon physicians from federal antitrust liability for their activities on hospital peer-review committees. The Court held that Oregon law could not satisfy the "active supervision" requirement because it specified no ways (other than general supervisory powers) in which the State's Health Division was to supervise the peer-review process. *Id.* at 105. The Court noted that, subsequent to the events at issue in the case, certain medical peer-review activities were insulated from antitrust liability by Congress. However, the federal immunization was not retroactive nor did it change other immunities under law, said the Court, thus allowing States to immunize peer-

## 5) Restraint of Trade — Sherman Antitrust Act

Section 1 of the Sherman Act declares illegal "[e]very contract, combination . . . [and] conspiracy in restraint of trade or commerce."<sup>245</sup> The Act clearly applies to nonprofits.<sup>246</sup> In analyzing cases under Section 1, courts apply either the "per se" rule or the "rule of reason."<sup>247</sup> One observer has commented that courts may be reluctant to apply the per se rule to nonprofit entities;<sup>248</sup> another has suggested the "rules of structure and conduct" developed under the Sherman Act in the for-profit sector, "may not be appropriate" in regulating the charity sector,<sup>249</sup> noting that "[c]ourts have recognized that the existence of noncommercial objectives in certain areas of commerce may require that a practice

review action that did not meet the federal standard. *Id.* at 105 n.8.

245 15 U.S.C. § 1 (1988).

246 "There is no doubt that the sweeping language of § 1 [of the Sherman Act] applies to nonprofit entities . . . ." *National Collegiate Athletic Ass'n v. Board of Regents of Univ. Of Okla.*, 468 U.S. 85, 100 n.22 (1984), (citing *Goldfarb v. Virginia State Bar*, 421 U.S. 773, 786-87 (1975)). See also *FTC v. Indiana Fed'n of Dentists*, 476 U.S. 447 (1986); Note, *United Charities and the Sherman Act*, 91 *YALE L.J.* 1593, 1596 n.22 (1982) (collecting and briefly describing seven other cases where courts have held activities of nonprofit organizations subject to the Sherman Act).

247 See *National Soc'y of Professional Eng'rs v. United States*, 435 U.S. 679, 692 (1978):

There are . . . two complementary categories of antitrust analysis. In the first category are agreements whose nature and necessary effect are so plainly anticompetitive that no elaborate study of the industry is needed to establish their illegality — they are "illegal per se." In the second category are agreements whose competitive effect can only be evaluated by analyzing the facts peculiar to the business, the history of the restraint, and the reasons why it was imposed.

*Id.* See also E.C. LASHBROOKE, JR., *supra* note 205, at 329-30 (1985); Note, *United Charities and the Sherman Act*, 91 *YALE L.J.* 1593, 1597 n.25 (1982).

248 See LASHBROOKE, *supra* note 205, at 329-30. Lashbrooke does state, however, that a clear per se violation will not rule out application of the per se rule, citing *Goldfarb v. Virginia State Bar*, 421 U.S. 773 (1975) (Virginia State Bar's minimum fee schedule for attorneys was held a per se violation of the Sherman Act). The Supreme Court also found a per se violation in *Arizona v. Maricopa County Medical Soc'y*, 457 U.S. 332 (1982) (maximum fees agreed upon by member doctors of medical society foundations were deemed price-fixing agreements and held per se unlawful under § 1 of the Sherman Act).

249 Note, *supra* note 247, at 1597.

be treated differently than it would be in traditional for-profit activities."<sup>250</sup>

In recent years, application of antitrust laws — in particular, the Sherman Act — to nonprofit organizations has been much discussed and debated.<sup>251</sup> The trend is increased application of the statutes to nonprofits,<sup>252</sup> in particular the learned professions (law, medicine, engineering, accounting), educational institutions, the medical care industry, amateur athletics, and united charities.

*Learned professions.* Since 1975, the Supreme Court, applying antitrust laws, has struck down all of the following: a state bar association's minimum-fee schedule;<sup>253</sup> a national engineering association's by-law limiting competitive bidding;<sup>254</sup> a county medical society's maximum-fee schedule;<sup>255</sup> and a state dental association rule forbidding members to submit x-rays to dental insurers in connection with patients' claims forms.<sup>256</sup>

*Educational institutions.*<sup>257</sup> Although nonprofit educational

<sup>250</sup> *Id.* at 1597 n.25. See also *National Collegiate Athletic Ass'n v. Board of Regents*, 468 U.S. 85 (1984), in which the Supreme Court, applying the rule of reason, held that it would be inappropriate to apply a per se rule when a case involves an industry where horizontal restraints on competition are essential if the product is to be available at all. 468 U.S. at 97-105. The Court also applied the rule of reason to a dental association policy in *Federal Trade Commission v. Indiana Fed'n of Dentists*, 476 U.S. 447, 458-59 (1986). The policy, forbidding dentist members to submit x-rays to dental insurers in connection with patients' claims forms, was found to establish an unreasonable restraint of trade, thus violating § 1 of the Sherman Act.

<sup>251</sup> A Westlaw search combining the terms "antitrust" and "nonprofit" produced a listing of 111 law review and periodical articles from 1981-89. A good deal of criticism has been levelled at the granting of favors and exemptions to nonprofit organizations, with some of the loudest objections coming from those who believe the favors allow government and other tax-exempt institutions to drive out small businesses from the marketplace. For an especially trenchant example of such criticism, see J. BENNETT & T. DI LORENZO, *UNFAIR COMPETITION: THE PROFITS OF NONPROFITS* (1989).

<sup>252</sup> See text accompanying notes 253-282, *infra*.

<sup>253</sup> *Goldfarb*, 421 U.S. 773 (1975). See *supra* note 244.

<sup>254</sup> *National Soc'y of Professional Eng'rs*, 435 U.S. 679 (1978). See *supra* note 247.

<sup>255</sup> *Maricopa County Medical Soc'y*, 457 U.S. 332 (1982). See *supra* note 248.

<sup>256</sup> *Indiana Fed'n of Dentists*, 476 U.S. 447 (1986). See *supra* note 250.

<sup>257</sup> For an overview of antitrust issues affecting institutions of higher education,

institutions have been found exempt from the Sherman Act in the past,<sup>258</sup> the Supreme Court's "rationale in *Goldfarb* would seem to preclude such holdings in the future."<sup>259</sup> Indeed, *Goldfarb* may have foreshadowed the Justice Department's decision to subject nonprofit colleges and universities to rigorous antitrust scrutiny. In 1989, the U.S. Justice Department began investigating whether the exchange of certain financial information among a group of colleges and universities violated antitrust laws.<sup>260</sup> Within months, the

see Kirby, *supra* note 224; W. Wang, *The Unbundling of Higher Education*, 1975 DUKE L.J. 53 (1975).

For an analysis of antitrust issues affecting graduate and professional schools — specifically, an argument that the Sherman Act is violated by the standard accreditation processes of American law schools, the American Bar Association and the Association of American Law Schools — see H. First, *The Business of Legal Education*, 32 J. LEGAL EDUC. 201 (1982); H. First, *Competition in the Legal Education Industry* (I and II), 53 N.Y.U. L. REV. 311 (1978), 54 N.Y.U. L. REV. 1049 (1979). Professor First states that his analysis "can be applied to education in general, and perhaps to other 'nonprofit' institutions as well." 54 N.Y.U. L. REV. at 1130. On the subject of accreditation, see also C. Oulahan, *The Legal Implications of Evaluation and Accreditation*, 7 J.L. & EDUC. 193 (1978).

<sup>258</sup> See, e.g., *Marjorie Webster Junior College, Inc. v. Middle States Ass'n of Colleges and Secondary Schools, Inc.*, 432 F.2d 650, 654 (D.C. Cir.), cert. denied, 400 U.S. 965 (1970).

<sup>259</sup> Note, *supra* note 247, at 1597 n.24. In *Goldfarb*, a county bar association in Virginia argued that competition was inconsistent with the practice of a profession because the goal of professional activities is to provide community services — not to enhance profits. In this way, the bar association sought to distinguish professions from trades, businesses and other occupations. The Supreme Court rejected the argument:

In arguing that learned professions are not "trade or commerce" the County Bar seeks a total exclusion from antitrust regulation. Whether state regulation is active or dormant, real or theoretical, lawyers would be able to adopt anticompetitive practices with impunity. We cannot find support for the proposition that Congress intended any such sweeping exclusion. The nature of an occupation, standing alone, does not provide sanctuary from the Sherman Act . . . nor is the public-service aspect of professional practice controlling in determining whether § 1 includes professions . . . Congress intended to strike as broadly as it could in § 1 of the Sherman Act, and to read into it so wide an exemption as that urged on us would be at odds with that purpose.

421 U.S. 773, 787 (1975) (citations omitted).

<sup>260</sup> The Justice Department's investigations were of practices for setting student financial aid, tuition and faculty salaries. See Putka, *Do Colleges Collude on Financial Aid?*, WALL ST. J., May 2, 1989, at B1, col. 3; Putka, *Educated Moves: Elite Private Colleges Routinely Share Plans for Raising Tuition*, WALL ST. J., Sept. 5, 1989,

probe had extended to at least 55 private colleges and universities, and members of an alliance of 23 northeastern colleges that had been meeting each spring to jointly set student financial aid awards were considering withdrawing from the 1990 meeting.<sup>261</sup> Of the members of the so-called "Overlap Group" — i.e., the eight Ivy League schools and M.I.T. — the Ivy League schools signed a consent decree, which prohibited them from cooperating in awarding need-based financial aid and in conferring about policies to determine the level of family contribution in a financial aid package.<sup>262</sup>

at 1, col. 1; Barrett, *U.S. Investigates Prestigious Universities, Colleges for Possible Antitrust Violations*, WALL ST. J., Sept. 5, 1989, at B2, col. 3.

See also, Flint and Bronner, *U.S. Probe Serves As Backdrop to Another Rise in College Fees*, BOSTON GLOBE, Aug. 10, 1989, at 1. (metro section); *Collegiate Price Fixers?*, WASH. POST, Aug. 17, 1989, at A26 (final ed.) (opinion editorial); *Campus Conspirators?*, N.Y. TIMES, Aug. 18, 1989, at A30 (late ed.); *Antitrust and Academe*, BOSTON GLOBE, Aug. 27, 1989, at A30 (city ed.); Becker, *If Colleges Are Fixing Prices, It's a Job for Antitrust*, BUS. WK., Sept. 25, 1989, at 30; Sontag, *Rougher, Tougher New Face*, NAT'L L.J., Oct. 9, 1989, at 1; Fiske, *Education: Colleges Expect a Backlash*, N.Y. TIMES, Oct. 25, 1989, at B7 (late ed.); *Bidding for the Best and the Poorest*, N.Y. TIMES, Feb. 19, 1990, at A16.

Also, compare Cotter, *Colleges' Efforts to Rationalize the Financial-Aid System Should Not Be Treated as Violations of Antitrust Laws*, CHRON. HIGHER EDUC., Sept. 6, 1989, at B1; with Carstensen, *Private Colleges Have No Special Right to Fix Prices or to Restrict Competition*, CHRON. HIGHER EDUC., Dec. 6, 1989, at B1.

<sup>261</sup> See Putka, *Colleges May Quit Alliance on Aid — War Could Result*, WALL ST. J., Jan. 11, 1990, at B1, col. 4; *Bidding for the Best and the Poorest*, N.Y. TIMES, Feb. 19, 1990, at A16. In late 1989, a Wesleyan University student filed a lawsuit against 12 private colleges and universities, claiming they had "engaged in a conspiracy to fix or artificially inflate the price of tuition and financial aid." *Student Sues Wesleyan on Tuition-Fixing*, N.Y. TIMES, Sept. 20, 1989, at B10. That suit subsequently was dismissed. *Price-Fixing Suit Against University is Dismissed*, WALL ST. J., Oct. 8, 1992 at B1.

<sup>262</sup> *Measure Need, Not Money*, N.Y. TIMES, July 22, 1991, at A15, col. 1. By May 22, 1991, Brown, Columbia, Cornell, Dartmouth, Harvard, the University of Pennsylvania, Princeton and Yale had entered into the consent decree with the Justice Department. See Mashek and Flint, *Ivy Colleges Settle Price-Fixing Charges*, BOSTON GLOBE, May 23, 1991, at 1.

Here is how the "Overlap Group" meetings had worked. Where colleges shared applicants in common, they evaluated the financial aid data and each decided based on more or less standardized calculations the amount of financial aid award they were prepared to make. The colleges would discuss their respective contemplated awards prior to making them known to the applicant in an effort to minimize the discrepancies among awards. The thinking was that needy students would not be forced to choose one college over another based solely on significant discrepancies in financial aid, and that colleges would not become

M.I.T. decided to fight the charges, arguing that it had done nothing wrong and that its policies actually benefitted needy students by effectively transferring scarce financial aid dollars from better-off students who might otherwise have qualified for non-need-based merit scholarships to the needier students served by a need-based financial aid system. M.I.T. argued that by giving aid only to students who need it, M.I.T. could spread its financial aid dollars further than if it gave merit-based scholarships based on academic performance.<sup>263</sup>

In September of 1992 M.I.T. was found guilty of violating the Sherman Antitrust Act by illegally conspiring with the other member colleges of the "Overlap Group" to restrain financial aid awards to individuals who had applied to two or more of the member schools. M.I.T. was condemned for meeting, as it had for more than 30 years, with the other prestigious colleges and universities to discuss financial aid packages being offered to common applicants.<sup>264</sup>

The philosophical difference in opinion between M.I.T. and the Justice Department regarding application of the antitrust laws could not be more clearly drawn. M.I.T. contended that, as a nonprofit institution, it was exempt from application of antitrust laws. The reason businesses typically engage in price-fixing is to raise consumer prices; M.I.T. argued that the exchange of financial aid information was designed instead to transfer money from non-needy consumers to needy ones.<sup>265</sup> The Justice Department attempted to

embroiled in bidding wars over talented students. De Palma, *In Trial, M.I.T. to Defend Trading Student-Aid Data*, N.Y. TIMES, June 24, 1992, Late Ed., at A17, col. 1.

<sup>263</sup> De Palma, *In Trial, M.I.T. to Defend Trading Student-Aid Data*, N.Y. TIMES, June 24, 1992, Late Ed., A17, col. 1.

<sup>264</sup> In September of 1992, federal District Judge Louis C. Bechtle of the Eastern District of Pennsylvania ruled that M.I.T. had violated the Sherman Antitrust Act by illegally conspiring with eight other colleges and universities to restrain price competition on financial aid to prospective students. The judge "clearly and pointedly rejected M.I.T.'s argument that it was engaged in charity, not conspiracy . . ." and called the activities of the universities in sharing financial aid information "plainly anti-competitive." The M.I.T. case represented the Justice Department's first attempt to apply federal antitrust laws to noncommercial activities of universities. See De Palma, *M.I.T. Ruled Guilty in Antitrust Case*, N.Y. TIMES, Sept. 3, 1992, at A1, col. 5.

<sup>265</sup> *A Needless Whack at Needy Students*, N.Y. TIMES, Sept. 6, 1992, Late Ed., Sec. 4, at 10, col. 1.

show — “based on weak and misleading data” in one account — that the money M.I.T. saved went into higher faculty salaries and other general expenses.<sup>266</sup> M.I.T. statistical data showed that the money was plowed back into more financial aid.<sup>267</sup> At least one commentator has described the potentially costly impact on the fundamentally nonprofit activity of education of a government victory in the M.I.T. case.<sup>268</sup>

*Medical care industry.* Prior to the 1970s, antitrust law was seldom applied to medical care activities.<sup>269</sup> Today, that is no longer true.<sup>270</sup> Within the last decade, the Supreme Court has held

266 *Id.*

267 *Id.*

268 Paul E. Gray, *Measure Need, Not Money*, N.Y. TIMES, July 22, 1992 Late Ed., A15, col. 1.

Given that funds are limited, once colleges and universities are forbidden to agree on aid, some will choose to compete for students by offering them sums beyond their needs, thus reducing the amount available to other students. Admissions practices may change to give preference to students whose families can pay for college rather than those with the highest academic ability.

Since the Justice Department began its investigation three years ago, M.I.T. and some 60 other private colleges have spent more than \$10 million in legal fees to respond to these inquiries. These funds could have been used for scholarships.

If successful, the Government's antitrust action will result in financial competition for individual students that will, over time, drive up college costs. It will erode the principle of intellectual merit as the primary factor in admissions decisions and deny many the full measure of assistance they require to attend college. In the end, the course suggested by the Attorney General will stifle, not aid, the American dream of access to higher education.

269 ANNAS & LAW, *supra* note 235, at 796. *But see American Medical Ass'n v. United States*, 130 F.2d 233 (D.C. Cir. 1942), *aff'd*, 317 U.S. 519 (1943) (two nonprofit corporations, the American Medical Association and its Washington, D.C. affiliate, convicted of criminal violation of the Sherman Act when they conspired to prevent a health maintenance organization from retaining staff doctors.) That decision was an anomaly.

270 *See id.* Indeed, a Legal Trac search in October 1989 combining the terms “antitrust” and “medical care” produced 103 titles in the system's database of journal articles. For a comprehensive overview of antitrust and the organization of medical care delivery, see ANNAS & LAW, *supra* note 235, at 796-845. The authors examine the substantive requirements of antitrust law, the weakening of doctrines that previously limited the application of antitrust laws to health care

that the state action doctrine did not protect physicians in Oregon from federal antitrust liability for their hospital peer review activities;<sup>271</sup> has struck down a county medical society's maximum-fee schedule as illegal *per se*;<sup>272</sup> has found no *per se* violation in a hospital's tying of its patients' purchases of anesthesia services to their consumption of surgical procedures (but divided on the analysis applied);<sup>273</sup> and has upheld an FTC order against a group of dentists who refused to submit X-rays to insurers to review the need for services provided.<sup>274</sup>

*Amateur athletics.* The message of several lower federal courts in the 1970s and '80s — that practices of amateur and collegiate athletic associations were subject to Sherman Act challenges<sup>275</sup> — was reinforced by the Supreme Court in 1984, when it ruled that the National Collegiate Athletic Association's (NCAA) plan for televising college football games of member institutions for the 1981-85 seasons violated § 1 of the Sherman Act.<sup>276</sup>

*United charities.* Federated charity campaigns appeal to businesses because they reduce the workplace disruption that inevitably follows from frequent charitable solicitation.<sup>277</sup> But for

arrangements, and the application of antitrust laws to arrangements such as the denial of hospital staff privileges, limits on insurance reimbursement, and denial of membership in professional associations. *See also, Antitrust and Health Care*, 51 LAW & CONTEMP. PROBS. 2 (1988). The entire volume is devoted to the subject.

271 *Patrick*, 486 U.S. 94. *See supra* note 243.

272 *Arizona v. Maricopa County Medical Soc'y*, 457 U.S. 332 (1982). *See supra* note 248.

273 *Jefferson Parish Hosp. Dist. No. 2 v. Hyde*, 466 U.S. 2 (1984).

274 *Federal Trade Commission v. Indiana Fed'n of Dentists*, 476 U.S. 447 (1986). *See supra* note 250.

275 *See Note, supra* note 247, at 1597 n.24 (collecting cases).

276 *National Collegiate Athletic Ass'n*, 468 U.S. 85. The Court held that the plan restrained competition in the relevant market of college football television broadcasts. The plan limited the total amount of televised intercollegiate football games and the number of games that any one college could televise; it further prohibited any NCAA member from making any sale of television rights that was not in keeping with the plan. For a glimpse at college officials' concerns in the post-NCAA *v. Bd. of Regents* era, *see Notre Dame's Pact May Cause A Dash for Cash*, WALL ST. J., Feb. 7, 1990, at B1.

277 *See Note, supra* note 247, at 1593.

charities excluded from united campaigns, such federations are threatening because "[e]mployees who give at the office are understandably less generous when approached for the second or third (or thirtieth) time."<sup>278</sup> Not surprisingly, various organizations have challenged different features of the so-called united charities system.<sup>279</sup> Except for a few suits brought under state antitrust statutes,<sup>280</sup> few of these challenges have been based on antitrust laws.<sup>281</sup> One commentator, exploring possible application of the Sherman Act to the conduct of united charities, concluded that the Act does not preclude formation of a united charity, but that it prohibits such charities from engaging in anticompetitive practices that restrict donor choices.<sup>282</sup>

278 *Id.*

279 *Id.* at 1593, n.3 (collecting cases). The exclusion of various charities from the united approach — and their subsequent exclusion from the payroll deduction system ("an extremely efficient fundraising device," *id.* at 1594) — is at the heart of the controversy.

In many cases, membership in a united charity is the only way to gain access to the payroll deduction system. As a result, some charities denied membership in a united charity are unable to survive. But many united charities only admit organizations that have proven their viability as independent charities for several years, thereby making it difficult for new charities to gain support. Others admit only agencies that operate on a national scale, thus excluding small charities that focus their efforts locally. In addition, many united charities openly acknowledge that membership in their organization is contingent upon the applicant's ability to appeal to shared values of the local community. This standard excludes many charities that address controversial issues . . .

*Id.* at 1594-95 (citations omitted).

280 *See id.* at 1596, n.20 (collecting cases brought under antitrust statutes).

281 *Id.* at 1596.

282 *See generally id.* for an exploration and examination of the possible application of the Sherman Act to the activities of united charities. *See id.* at 1594, 1611-12 for specific conclusions.

For a report on one United Way affiliate's response to criticism levelled at the disbursement system practiced by itself and other United Way organizations, *see* Teltsch, *United Way to Aid Smaller Agencies*, N.Y. TIMES, Feb. 22, 1990 at B4, col. 4:

Under criticism for supporting only long-established charities, United Way of New York City expects to devote \$70 million in the next five years to bolstering scores of small local agencies that help jobless youth, illiterate adults, AIDS patients, victims of domestic violence and the homeless . . .

## 6) Miscellaneous Federal Antitrust Law Exemptions

Nonprofit corporations may escape antitrust scrutiny when a regulatory statute creates an implicit exemption. However, such exemptions are strongly disfavored and "will be implied only to the minimum extent necessary to meet the ends of the statute."<sup>283</sup> Other exemptions from application of antitrust laws include a political speech exemption<sup>284</sup> and a modified exemption protecting trade unions and certain types of union activity from antitrust liability.<sup>285</sup>

Some critics of [United Way's] disbursement system complain that dividing funds by formula has slighted organizations representing the city's growing minority population, many created in the last decade.

*Id.* (There are 2,300 independent affiliates of United Way of America. *Id.*).

283 *Note, Antitrust and Nonprofit Entities*, 94 HARV. L. REV. 802, 806-07 n.32 (1981). *See National Gerimedical Hosp. & Gerontology Center v. Blue Cross*, 452 U.S. 378, 392-93 (1981), in which the Supreme Court held that participants in health planning programs created under federal law are immune from antitrust scrutiny only to the extent that the health planning law explicitly mandated anti-competitive conduct.

284 *See Note, supra* note 283, at 806 n.32 (collecting cases). *See also Eastern Railroad Presidents Conference v. Noerr Motor Freight, Inc.*, 365 U.S. 127, *reh'g denied*, 365 U.S. 875 (1961) (railroad group's publicity campaign designed to obtain governmental action opposed to interests of trucking industry not violative of Sherman Antitrust Act simply because it may have been affected by an anti-competitive purpose.) (" . . . no violation of the [Sherman] Act can be predicated upon mere attempts to influence the passage or enforcement of laws." *Id.* at 135) (" . . . the Sherman Act does not prohibit two or more persons from associating together in an attempt to persuade the legislature or the executive to take a particular action with respect to a law that would produce a restraint or a monopoly." *Id.* at 136) ("To hold that . . . the people cannot freely inform the government of their wishes would impute to the Sherman Act a purpose to regulate, not business activity, but political activity, a purpose which would have no basis whatever in the legislative history of that Act." *Id.* at 137.); *UIMW v. Pennington*, 381 U.S. 657 (1965), *on remand*, 257 F. Supp. 815 (E.D. Tenn., N.D. 1966) *aff'd in part and rev'd in part*, *Lewis v. Pennington*, 400 F.2d 806, *cert. denied*, *Pennington v. UIMW*, 393 U.S. 1045 (1969). "Joint efforts [by union and large coal producers] to influence public officials do not violate antitrust laws even though intended to eliminate competition. Such conduct is not illegal, either standing alone or as part of a broader scheme itself violative of the Sherman Act." *Id.* at 670. *Cf. infra* notes 66-68 and accompanying text regarding prohibitions on the lobbying efforts of 501(c)(3) organizations.

285 Originally, the Supreme Court extended the antitrust laws to cover activities of labor unions. Subsequently, Congress created exemptions that shield unions and certain types of union activity from antitrust liability. *See generally* E. Lock, *The Scope of the Labor Exemption in Professional Sports*, 1989 DUKE L.J. 339, 351-53.

## 7) State-Level Antitrust Enforcement Activities

Recent state antitrust enforcement activity affecting nonprofits appears chiefly to have been associated with health care industry practices,<sup>286</sup> such as proposed hospital mergers and joint ventures, as well as local Blue Cross/Blue Shield activities.<sup>287</sup> As noted above, lawsuits challenging the activities of united charities have been brought in state courts by private nonprofits.<sup>288</sup>

### C) Securities Regulation Exemptions

With a few notable exceptions, tax-exempt organizations are subject to federal securities laws<sup>289</sup> and "blue sky" laws that regulate the issuance and distribution of securities within each state.<sup>290</sup> "Security" is defined in § 2(1) of the Securities Act of

*See also* Note, *supra* note 283, at 808 n.37 (1981).

286 Telephone interviews with: Elena Boisvert, Business Regulation Coordinator, National Association of Attorneys General, Jan. 31, 1990; Doreen Johnson, Assistant Attorney General and Chief of the Antitrust Section, State of Ohio, Feb. 1, 1990; Carol Smith, Assistant Attorney General and Chief of the Antitrust Section, State of Washington, Feb. 1, 1990.

287 Telephone interviews with Assistant Attorneys General Doreen Johnson and Carol Smith. *See supra* note 286. In reviewing proposed mergers for possible antitrust violations, said Assistant Attorney General Smith, "we don't distinguish between for-profit and not-for-profit hospitals." *Id.*

288 *See supra* text accompanying notes 277-282.

289 Federal securities laws were first enacted by Congress to correct abusive practices that many believed contributed to the stock market crash of 1929. LASHBROOKE, *supra* note 205, at 122. The main statutes are the Securities Act of 1933, 15 U.S.C. § 77a (1988); the Securities Exchange Act of 1934, 15 U.S.C. § 78a (1988); the Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79-79Z-6 (1988); the Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbb (1988); the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1-80a-52 (1988); the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1-80b-21 (1988); and the Securities Investor Protection Act of 1970, 15 U.S.C. § 78aaa (1988).

"Of these seven pieces of federal legislation, tax-exempt organizations are likely to encounter the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, and the Investment Company Act of 1940." LASHBROOKE, *supra* note 205, at 122.

290 Every state (and the District of Columbia) has its own blue sky laws. An issuer planning a national issue must comply not only with federal securities laws, but also with every state's blue sky laws. LASHBROOKE, *supra* note 205, at

1933,<sup>291</sup> and, with minor variations, for many states, at § 401(2) of the 1956 Uniform Securities Act.<sup>292</sup> In determining whether an

135. While transactions of a purely intrastate nature may escape federal regulation, they are still subject to state regulation. *See* Halperin, *Introduction to State Securities Regulation*, BLUE SKY LAWS 1989 at 17 (P.L.I. 1989). While federal securities laws primarily emphasize the disclosure of material information, blue sky laws tend to impose substantive conditions as to who may offer securities and the terms on which they may be offered. *Id.* at 13-14.

291 Section 2(1)(c) of the Securities Act of 1933 defines "security" as

... any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Section 3(a)(10) of the Securities Exchange Act of 1934 defines "security" somewhat similarly, but also excludes "currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

The Supreme Court has consistently held that "[t]he definition of a security in § 3(a)(10) of the 1934 Act, is virtually identical [to the 1933 Act's definition]," *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 847 n.12 (1975), and recently reaffirmed that principle, noting that, "for present purposes, the coverage of the two Acts may be considered the same." *Reves v. Ernst & Young*, 494 U.S. 56, 57, n.1, 110 S. Ct. 945, *reh'g denied*, 494 U.S. 1092 (1990) (quoting *United Housing Found.* at 847 n.12).

292 The slight variations are in the wording of the provision pertaining to oil, gas and mineral rights or interests; and with respect to a provision dealing with insurance, endowment and annuity contracts, which does not appear in the federal statute. LASHBROOKE, *supra* note 205, at 134.

The 1956 Uniform Securities Act (the "Uniform Act") has been adopted in whole or substantial part by 38 states, the District of Columbia, Guam and Puerto Rico. The following states have *not* adopted the Uniform Act: Arizona, California, Florida, Georgia, Illinois, Louisiana, Maine, New York, North Dakota, Ohio, Texas and Vermont. *See* Uniform Securities Act, 1 Blue Sky L. Rep. (CCH) ¶ 5500 (Aug. 1992).

In 1985, the Uniform Act was revised with significant changes; as of 1989, however, only three states — Maine, Nevada and New Mexico — had adopted

instrument is a security, courts look beyond the label attached to the instrument, to the substantive economic reality of the transaction. In particular, the term "investment contract" has been interpreted broadly.<sup>293</sup> Thus, freely transferable memberships in recreational facilities organized as nonprofit corporations have been held to be securities.<sup>294</sup> On the other hand, when a housing foundation required prospective purchasers of low-cost housing to buy shares of "stock" for each room desired, the Supreme Court concluded that the "stock" was a security deposit, not a "security."<sup>295</sup>

### 1) Securities Act of 1933

Section 3(a)(4) of the Securities Act of 1933 exempts from registration:

any security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable or reformatory purposes and not for pecuniary profit, and no

---

versions of the Revised Act. 1 L. LOSS & J. SELIGMAN, SECURITIES REGULATION, 48-49 (3d ed. 1989).

<sup>293</sup> See, e.g., *Reves v. Ernst & Young*, 494 U.S. 56 (1990), see *supra* note 291; *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985); *Marine Bank v. Weaver*, 455 U.S. 551 (1982); *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979); *United Housing Found., Inc. v. Forman*, 421 U.S. 837 (1975); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946); *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943); *SEC v. Continental Commodities Corp.*, 497 F.2d 516 (5th Cir. 1976); *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir.), cert. denied, 414 U.S. 821 (1973).

With the exception of *Reves v. Ernst & Young*, descriptions of these major cases are included in a discussion of the scope of "security" under federal law, in W. CARY & M. EISENBERG, CORPORATIONS 1478-1493 (6th ed. 1988). For a discussion of the scope of "security" under blue sky laws and the Uniform Securities Act, see Halperin, *supra* note 290, at 30-38.

<sup>294</sup> See, e.g., *Riviera Operating Co.*, SEC No-Action Letter, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,569 (Mar. 8, 1978), and *Great Western Campers Ass'n*, SEC No-Action Letter [1971-72 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,386 (Aug. 13, 1971). The memberships (in a tennis club and campers association, respectively) were deemed securities because of the free transferability trait — even though the memberships did not entitle members to share in gains or losses of the nonprofit corporations. LASHBROOKE, *supra* note 205, at 125.

<sup>295</sup> *United Housing Found., Inc. v. Forman*, 421 U.S. 837 (1975).

part of the net earnings of which inures to the benefit of any person, private stockholder, or individual.<sup>296</sup>

The objective of this exemption is to "facilitate the raising of funds by eleemosynary issuers. [It] is not intended to allow promoters or managers of any institution to bring offerings of securities to the public, without registration, in order to realize profits for themselves."<sup>297</sup>

To qualify under § 3(a)(4), an organization must meet the same basic tests required to qualify for tax-exempt status, i.e., the nondistribution requirement and both the organizational and operational tests.<sup>298</sup> Thus, courts have held that either a substantial noncharitable purpose or a violation of the private inurement prohibition will disqualify an organization from the § 3(a)(4) exemption.<sup>299</sup>

---

<sup>296</sup> 15 U.S.C. § 77c(a)(4) (1988).

<sup>297</sup> *SEC v. Children's Hosp.*, 214 F. Supp. 883, 891 (D. Ariz. 1963).

<sup>298</sup> See *supra* text accompanying notes 62-65.

<sup>299</sup> See *SEC v. American Found. for the Advanced Educ. of Ark.*, 222 F. Supp. 828 (W. D. La. 1963) (the sale of debenture bonds in exchange for the privilege of naming a beneficiary to the foundation was found to be private inurement, and thus the debentures were held not exempt from registration). *SEC v. Children's Hosp.*, 214 F. Supp. 883 (D. Ariz. 1963) (where a hospital did not register a distribution of mortgage bonds, its failure to establish that it was not organized or operated for the benefit of private purposes, and the court's finding that a substantial purpose of the promoters was self-enrichment, resulted in the hospital's disqualification from the § 3(a)(4) exemption); See generally 3 LOSS & SELIGMAN, *supra* note 292, at 199-201; LASHBROOKE, *supra* note 205, at 127-28.

In construing "fraternal" in § 3(a)(4), the SEC has taken the position that the exemption does not apply to fraternities organized primarily for social, athletic or recreational purposes. 3 LOSS & SELIGMAN, *supra* note 292, at 1201-02. But an otherwise exempt organization will not lose its exemption if it engages in social or recreational activities. *Id.* at 1201. In this respect, the analogous exemption under the Uniform Securities Act is broader. That exemption is set forth at text accompanying note 292, *infra*. Nonprofit fraternal organizations formed exclusively to pursue charitable, religious, or educational purposes but which also conduct social or athletic events to raise funds for their primary charitable purpose would be eligible for the § 3(a)(4) exemption. For example, a fraternal organization dedicated to eradicating illiteracy which sponsored a softball game with a local radio station as a fundraising event would not be ineligible for the § 3(a)(4) exemption, since the game was not the primary purpose for the organization's existence.

## 2) Investment Company Act of 1940

Excluded from the definition of "investment company" in the Investment Company Act of 1940 are companies "organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes, in which no part of the net earnings inures to the benefit of any private shareholder or individual."<sup>300</sup>

The kinds of organizations exempted under the Investment Company Act of 1940 are the same as those whose securities are exempt from registration under the 1933 Securities Act.<sup>301</sup> These organizations are also included among (but do not constitute all of) the kinds of organizations exempt from federal income tax under Code Section 501(c)(3).<sup>302</sup> Other tax-exempt organizations (i.e., those not mentioned in the above list of excluded entities) may be subject to the Investment Company Act.<sup>303</sup>

## 3) Miscellaneous Federal Securities Law Exemptions

Charitable organizations also may be exempt from registration under provisions that apply to noncharitable organizations, such as exemptions for small offerings and private offerings, the intrastate

<sup>300</sup> 15 U.S.C. § 80a-3(c)(10) (1988).

<sup>301</sup> See *supra* text accompanying note 296. A difference is that the exemption from registration of securities under the 1933 Securities Act forbids inurement "to the benefit of any person, private stockholder, or individual." 15 U.S.C. § 80a-3(c)(10) (1988).

<sup>302</sup> See *supra* text accompanying notes 57-61. Section 501(c)(3) additionally exempts "[c]orporations, and any community chest, fund, or foundation, organized and operated exclusively for . . . scientific, testing for public safety, [or] literary . . . purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals . . ." Section 501(c)(3) also prohibits substantial attempts to influence legislation and any political campaign activities. *Id.*

<sup>303</sup> LASHBROOKE, *supra* note 205, at 124.

exemption, and exemptions under Regulations D and A.<sup>304</sup> Otherwise, nonprofits are fully subject to federal securities laws.<sup>305</sup>

## 4) Exemptions under State Securities Laws

Among various categories of securities exempt from registration<sup>306</sup> and from filing sales and advertising literature<sup>307</sup> under the Uniform Securities Act is "any security issued by any person organized and operated not for private profit but exclusively for religious, educational, benevolent, charitable, fraternal, social,

<sup>304</sup> LASHBROOKE, *supra* note 205, at 128-30 (discussing 15 U.S.C. § 77c(b) (1988) (exemption for small offerings); 15 U.S.C. § 77d (1988) (exemption for private offerings); 15 U.S.C. § 77c(a)(11) (1988) (the exemption for intrastate offerings); 17 C.F.R. §§ 230.501 - 230.506 (1990) (Regulation D)(for small nonpublic offerings); and 17 C.F.R. §§ 230.251 - 230.263 (1990) (Regulation A)(for offerings with an aggregate offering price of no more than \$1.5 million).

<sup>305</sup> See LASHBROOKE, *supra* note 205, at 122. Of special note are the antifraud provisions of the federal securities laws, particularly § 17 of the Securities Act of 1933 (15 U.S.C. § 77q (1988)), § 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j (1988)), and § 206 of the Investment Advisers Act of 1940 (15 U.S.C. § 80b-6 (1988)). These provisions apply to all securities; it does not matter that a security is exempt from registration; nor is it relevant that an issuer is a non-profit organization. LASHBROOKE, *supra* note 205, at 130.

In *SEC v. World Radio Mission, Inc.*, 544 F.2d 535 (1st Cir. 1976), the First Circuit held that interest-bearing notes sold by a religious organization were securities. The court looked at solicitations made by the organization and its leader, observing that the solicitations had been made to the general public, had stressed the security of the investment and recognized investors' need for steady income. For these reasons, said the court, the solicitations did not demonstrate the special circumstances that would permit First Amendment protection. The court held that, given Congressional failure to exempt religious organizations' securities from the antifraud provisions of the 1933 and 1934 Securities Acts, sufficient prospective injury to investors was shown to warrant enjoining the Mission from violating the Acts. The prospective injury and fraud centered on "significant economic facts defendants in no way disclosed [to the public it was soliciting]: most important, a substantially increasing operating deficit . . ." *Id.* at 539. The court said,

It is not to be disputed that many businesses start with "planned deficit operations." What defendants lose sight of is that the [federal securities] acts require that those who market securities must disclose that fact, rather than through silence, or worse, attract investors by indicating the opposite.

*Id.* at 540.

<sup>306</sup> UNIFORM SECURITIES ACT § 301, 7B U.L.A. 550 (1958).

<sup>307</sup> UNIFORM SECURITIES ACT § 403, 7B U.L.A. 620 (1958).

athletic, or reformatory purposes, or as a chamber of commerce or trade or professional association."<sup>308</sup>

The exemption from registration under the Uniform Act is broader than the analogous exemption under the 1933 Securities Act, because, unlike the Federal Act, the Uniform Act extends the exemption to organizations described in Code Section 501(c)(6).<sup>309</sup> In many states, the exemption for various nonprofits is permissive, not mandatory.<sup>310</sup> Some states also require that certain documents be filed even though the security is exempt.<sup>311</sup>

Exempt transactions under state securities law are not uniform.<sup>312</sup> Registration requirements are set forth in §§ 301-306 of the Uniform Act. Antifraud provisions, very similar to those under federal law,<sup>313</sup> appear at § 101. A nonprofit seeking the exemptions afforded by the Uniform Securities Act would do well to check the specific state requirements since Lashbrooke notes that the field of state securities law is in flux following adoption of Regulation D by the SEC.<sup>314</sup>

308 UNIFORM SECURITIES ACT § 402(a)(9), 7B U.L.A. 600 (1958)(emphasis added). The Revised Uniform Securities Act, *see supra* note 292, requires notice from these organizations at least ten days before any sale. Revised Act section 401(b)(10). *See* 1 LOSS & SELIGMAN, *supra* note 292, at 134 n.279.

309 *See supra* text accompanying note 296.

310 LASHBROOKE, *supra* note 205. In 1985, the exemption appeared to be permissive in 24 states. *See id.* at 135-37, Table 5. Exemption from registration under state securities laws in 1985 was available to securities issued by the following types of organizations (with the number of states offering the particular exemption noted in parentheses): religious (45); educational (46); benevolent (45); charitable (47); fraternal (45); social (34); athletic (31); reformatory (44); chambers of commerce, trade and professional associations (27); other (9). *See id.*

311 *Id.* at 138. In 1985, fifteen states had this requirement. *See id.* at 135-37, Table 5.

312 *Id.* at 138.

313 *See supra* note 305.

314 LASHBROOKE, *supra*, note 205, at 138. *See also* 1 LOSS & SELIGMAN, *supra* note 292, at 145-148.

#### D) Federal Involuntary Bankruptcy Exemption For Nonprofits

The federal bankruptcy code distinguishes between "voluntary" and "involuntary" bankruptcy cases. A "voluntary" case is one in which the debtor files the petition initiating the case.<sup>315</sup> An "involuntary" case is one in which the debtor's creditors commence the case by filing the petition.<sup>316</sup> The federal bankruptcy code does not limit the ability of a nonprofit to seek liquidation voluntarily under Chapter 7, or reorganization voluntarily under Chapter 11. However, a nonprofit may not be forced into involuntary liquidation or reorganization; a nonprofit organization is not eligible to be a debtor in an involuntary bankruptcy proceeding under the federal bankruptcy code.<sup>317</sup>

Judicial pronouncements, though never fully explaining the rationale, take this exemption to the general applicability of the federal bankruptcy statutes as a given.<sup>318</sup> This exception effectively

315 11 U.S.C. § 301 (1988).

316 11 U.S.C. § 303 (1988).

317 11 U.S.C. § 303(a) (1988) provides that:

An involuntary case may be commenced only under chapter 7 or 11 of this title, and only against a person, except a farmer, family farmer, or a corporation that is not a moneyed, business, or commercial corporation, that may be a debtor under the chapter under which such case is commenced.

318 *See United Kitchen Assocs., Inc.*, 33 Bankr. 214, 216 (W.D. La. 1983) (eleemosynary institutions exempt from involuntary bankruptcy); *Schuster v. Ohio Farmers Co-op Milk Ass'n*, 61 F.2d 337 (6th Cir. 1932)(religious, charitable, or educational corporations not subject to involuntary bankruptcy notwithstanding some acts of business or commerce incidentally performed); *Michigan Sanitarium and Benevolent Ass'n*, 20 F. Supp. 979 (E.D. Mich. 1937) *appeal dismissed sub nom.*, *North American Life Ins. Co. v. Mich. Sanitarium and Benevolent Assoc.*, 96 F.2d 1019 (6th Cir. 1938) (eleemosynary corporation not a "business corporation" amenable to involuntary bankruptcy petition); *Matter of Elmsford Country Club*, 50 F.2d 238 (S.D.N.Y. 1931)(country club organized to provide recreation to its members may not be adjudged an involuntary bankrupt); *In re Fulton Club*, 113 F. 997 (N.D. Ga. 1902); Similarly, Congress has been silent as to the rationale for this exception. *See* H.R. REP. NO. 95-595, 95th Cong., 2d. Sess. 5, *reprinted in* 1976 U.S. CODE CONG. & ADMIN. NEWS 5963, at 6278 "Eleemosynary institutions, such as churches, schools, and charitable organizations, and foundations, likewise are exempt from involuntary bankruptcy."

A possible explanation for this statutory exception for nonprofits may lie in Congressional recognition of the importance of the role which nonprofits serve in contributing to the general welfare. *See supra* notes 4-10 and accompanying text.

prefers the beneficiaries of a nonprofit, i.e., those whom it serves, to the nonprofit's unsecured creditors. The Chapter 11 reorganization exception for nonprofits may be a recognition that permitting a nonprofit to function unimpeded by the strictures of the bankruptcy court, while the nonprofit has unsatisfied obligations to unsecured general creditors, promotes the general welfare.<sup>319</sup> The nonprofit exemption under Chapter 7 liquidations may stem from the unseemliness of a creditor forcing a nonprofit entity to liquidate.

#### E) Preferred Postal Rates: Special Second And Third Class Nonprofit Postal Rates<sup>320</sup>

Preferential postal rates for certain types of mailers<sup>321</sup> predate the federal income tax exemption for charities.<sup>322</sup> The justification offered for providing preferential postal rates to certain nonprofits is that society benefits from subsidized circulation of

319 Michael L. Cook, Esq., Adjunct Professor of Law, New York University School of Law, has speculated that the exemptions for nonprofits from involuntary bankruptcy under 11 U.S.C. § 303(a) (1988) arose to prevent disgruntled applicants to private clubs from forcing the club into involuntary bankruptcy upon being denied membership. Conversation with Michael L. Cook, Esq., Autumn, 1989.

320 This discussion will focus primarily on the special nonprofit third-class rate, as it tends to be more significant to nonprofit mailers than the second-class rate which is reserved for newspapers and other periodicals. Approximately 10.8 billion pieces of mail are sent annually at the special nonprofit third-class rate. POSTAL RATE COMM'N, REP. TO CONGRESS: Preferred Rate Study, app. D at Table 1. Nonprofit second class mailers send approximately 3.4 billion periodicals a year. *Id.* at app. E at 4.

321 See Act of July 16, 1894, ch. 137, 28 Stat. 104, 105. See also Kielbowicz and Lawson, *Reduced-Rate Postage for Nonprofit Organizations: A Policy History, Critique, and Proposal*, 11 HARV. J.L. & PUB. POL'Y 347, 350 (1988) [hereinafter Kielbowicz and Lawson]. The authors note that preferential second class rates were initially denied to publications of fraternal and benevolent associations by the Mail Classification Act of 1879. Act of March 3, 1879, ch. 180, 20 Stat. 358. They also suggest a direct link between preferential second-class postal rates for publications by educational institutions, labor unions, and benevolent, fraternal, professional, literary, historical, and scientific societies granted in the Act of July 16, 1894, ch. 137, 28 Stat. 104, 105 and tax exemptions to certain nonprofits granted later that same year in the Act of August 27, 1894, ch. 349, § 32, 28 Stat. 556-57. Kielbowicz and Lawson at 350-51.

322 See *supra* text accompanying notes 54 and 55.

certain materials.<sup>323</sup> Current postal regulations<sup>324</sup> extend special second- and third-class nonprofit rates to religious, educational, scientific, philanthropic, agricultural, labor, veterans', and fraternal organizations, provided that the organization is "not organized for profit and none of its net income inures to the benefit of any private stockholder or individual."<sup>325</sup> The Postal Service requires that nonprofit second- and third- class mailers "be both organized and operated for the primary purpose" of the organization.<sup>326</sup>

323 See Kielbowicz and Lawson, *supra* note 321, at 348. Kielbowicz and Lawson are skeptical of this rationale. They maintain that Congress has seldom explicitly articulated a policy justification for reduced postal rates for nonprofits, *id.* at 358-59, arguing that preferred postal rates grew up out of exemptions from general increases and not in regard to any clearly defined policy of subsidizing nonprofit mailers to enhance the benefit to society which these organizations may provide. They note that in 1949, when Congress sought to exempt nonprofit organizations from a general increase in third-class rates that was to become effective in 1951, it "failed to articulate a clear policy justifying this preferential treatment, though lawmakers appeared particularly interested in protecting the mailings of groups engaged in charitable works." *Id.* at 354. See also Note, *The Postal Reorganization Act: A Case Study of Regulated Industry Reform*, 58 VA. L. REV. 1030, 1081-84 (1972) (positive externalities of preferential postal rates have been used implicitly to justify below-cost handling).

324 39 C.F.R. § 111.1 (1990) incorporates the provisions of the Domestic Mail Manual, the United States Postal Service's regulatory bible, by reference. UNITED STATES POSTAL SERV., DOMESTIC MAIL MANUAL NO. 40 (Sept. 15, 1991) [hereinafter DMM].

325 The lists of eligible second- and third-class nonprofit mailers are identical. Compare DMM § 424.121 with DMM § 625.21.

326 The primary purpose constraint applies equally to second- and third-class nonprofit mailers. Compare DMM § 424.122 with DMM § 625.22.

Kielbowicz and Lawson noted the primary purposes of nonprofit third-class mailings as follows:

First, and of perhaps greatest value, is the use of bulk mailings to solicit funds. Many nonprofit groups have no viable alternative to direct mail as a means of raising money. Charitable groups have long maintained that increases in postage cuts directly into the services they provide. A second and related use of bulk third-class mailings is to send reminders of dues. Third, bulk mailings of newsletters, periodicals, and brochures inform various audiences. Religious groups regularly send newsletters to congregations; universities distribute recruitment literature; cultural organizations apprise the public of their activities; and philanthropic groups disseminate information to donors, volunteers and those receiving services. Fourth, and most troubling, groups use the third-class mailing privilege to sell goods and services both to raise funds and to generate goodwill. The practices eliciting the most complaints include sponsoring tours, usually by educational institutions;

By all accounts, preferential postal rates are an important benefit for nonprofits.<sup>327</sup> Indeed, some organizations may seek exempt status simply to take advantage of the availability of preferential postal rates.<sup>328,329</sup>

Despite the linkage between the tax exemption for nonprofits and postal subsidies, some commentators have suggested<sup>330</sup> that

selling insurance, memorabilia, religious items and other materials; charging fees for services, including seminars; and distributing advertising for commercial firms under nonprofit mailing permits.

Kielbowicz and Lawson, *supra* note 321, at 399 (footnotes omitted).

<sup>327</sup> Kielbowicz and Lawson, *supra* note 321, at 347-48. P. TREUSCH, TAX-EXEMPT CHARITABLE ORGANIZATIONS (3d ed. 1988) 29 n.117, [hereinafter TREUSCH] ("How significant this special privilege is illustrated by the fact that the fiscal year 1985 mailing subsidy totalled \$716 million, including \$52.8 million attributable to nonprofit second-class mail and \$580.2 million is attributable to nonprofit third-class mail.")

<sup>328</sup> See TREUSCH, *supra* note 327, at 29 ("Organizations, such as professional associations, although anticipating no income subject to taxes and not dependent upon attracting tax-deductible contributions, may nevertheless seek a federal income tax ruling of exemption in order to qualify for reduced postal rates on certain types of third-class mailings . . .").

<sup>329</sup> Recent studies suggest that organizations that seek nonprofit status simply to take advantage of reduced postal rates may be getting what they pay for. See *Two-Thirds of Charity Mail Delivered Late, Study Finds*, CHRON. PHILANTHROPY, June 27, 1989, at 21 (noting that a recent Postal Service study indicated that 63% of nonprofit bulk third-class mail was delivered late, with an average delay in excess of six days. The study involved 71 separate mailings originating in 22 post offices in 14 states.)

<sup>330</sup> See Kielbowicz and Lawson, *supra* note 321, at 351. DMM § 625.4 lists "the following and similar organizations" which do not qualify for special third-class rates even though organized as nonprofit entities:

automobile clubs; business leagues; chambers of commerce; citizens' and civic improvement associations; individuals; mutual insurance associations; political organizations [other than qualified political organizations]; service clubs such as Civitan, Kiwanis, Lions, Optimist, and Rotary; social and hobby clubs; associations of rural electric cooperatives; and trade associations.

The DMM notes that while governments generally are ineligible for the special third-class rate, a governmental entity otherwise meeting the eligibility requirements of § 625.2 may be eligible despite its governmental status. For example, a public school might qualify under § 625.232 (educational), but governmental organizations will not generally be eligible under § 625.234 (philanthropic) "since their income is generally not derived primarily from voluntary contributions or donations." *Id.* at § 625.4. *Accord Deukmejian v. United States Postal Service*, 734 F.2d 460 (9th Cir. 1984) (Postal Service properly denied Attorney General's application to mail class action refund notices at bulk rate for philanthropic

perhaps the most striking feature of special nonprofit postal rates is that they are not generally available across the spectrum of nonprofits. For example, under Postal Service regulations, a Code Section 501(c)(8) fraternal beneficiary society may qualify for nonprofit rates, while a Code Section 501(c)(3) organization dedicated solely to amateur athletics might not. Organizations such as labor unions and Code Section 501(c)(19) veterans' organizations qualify for the special third-class rate, while other tax-exempt entities may not.

Mere organization as a nonprofit and operation on a nonprofit basis will not qualify an organization for third-class nonprofit postal rates. The entity must be either a religious, educational,<sup>331</sup> scientific, philanthropic, agricultural, labor, veterans', or fraternal organization,<sup>332</sup> it must demonstrate that it operates on a nonprofit basis,<sup>333</sup> and its application must be approved.<sup>334</sup>

At least one court has affirmed the Postal Service's authority to deny nonprofit second-class rates to a nonprofit religious

organizations since Attorney General's office not a philanthropic organization where it was supported by taxes and court awards and where its function as a class representative was incidental to its primary duty of law enforcement).

<sup>331</sup> DMM § 625.2

<sup>332</sup> DMM § 625.21.

<sup>333</sup> DMM § 626.131. The Postal Service also requires nonprofits applying for the special nonprofit second class rate to "submit evidence to establish nonprofit status." DMM § 424.152. While the regulations governing special nonprofit second-class rates are silent as to what constitutes acceptable evidence of nonprofit status, *id.*, the regulations governing special nonprofit third-class rates specifically provide that evidence of federal income tax exemption will qualify an I.R.C. § 501(c)(3) religious, educational, scientific, or philanthropic (charitable) organization, I.R.C. § 501(c)(5) agricultural or labor organization, I.R.C. § 501(c)(8) fraternal organization, or I.R.C. § 501(c)(19) veterans' organization for the special nonprofit third-class rate in the absence of other disqualifying factors. DMM § 626.131. Exemption from federal income tax is not a prerequisite for qualifying for the special nonprofit third-class rate. *Id.*

<sup>334</sup> DMM § 626.33 Nonprofits seeking a special third-class permit should be aware that failure to supply additional information requested by the general manager at the Postal Service Rates and Classification Center is sufficient grounds to deny the permit application. *Id.*

Differences in determining eligibility for the second- and third-class nonprofit rates seem perplexing considering that the list of organizations eligible for second- and third-class nonprofit rates is identical, compare DMM § 424.121 with DMM § 625.21, and the identical "primary purpose" constraint is imposed on both second- and third-class nonprofit mailers. Compare DMM § 424.122 with DMM § 625.22.

organization that did not demonstrate entitlement to such rates, noting that the mere filing of an application would not qualify an organization for the second-class rate.<sup>335</sup>

While currently the Postal Service considers evidence of tax-exempt status in determining nonprofit third-class rates, tax exemption is not a prerequisite for the nonprofit third-class rates.<sup>336</sup> Revocation of an organization's income tax exemption, however, probably is not a sufficient basis for Postal Service revocation of that organization's special nonprofit second- or third-class permits.<sup>337</sup>

---

<sup>335</sup> See *Christian Beacon v. United States Postal Serv.*, 322 F.2d 512 (3rd Cir. 1963). Additionally, in *Bates & Guild Co. v. Payne*, 194 U.S. 106 (1904) the Supreme Court established a pattern of deferring to Postal Service determinations on matters affecting rate classifications. "[T]he exercise of [the Postmaster's] discretion [regarding classification of mail matter] ought not to be interfered with unless the court be clearly of opinion that it was wrong." *Id.* at 108.

Similarly, appellate courts have been deferential to Postal Service rate determinations. See *Deukmejian*, 734 F.2d at 462 ("[a] court reviewing the rate determination of the Postal Service should presume that the determination is correct, and should not reverse unless the determination is so arbitrary and capricious as to be an abuse of discretion or unconstitutional") (citing *Sierra Club v. United States Postal Serv.*, 549 F.2d 1199, 1201 (9th Cir. 1976)).

Kielbowicz and Lawson note that the lack of judicial intervention in rate determination cases as evidenced by a dearth of reported cases is "striking" given that the number of nonprofit mailers since 1917 "run[s] at least into the tens, probably hundreds, of thousands." Kielbowicz and Lawson, *supra* note 321, at 388 n.244. Given the tendency of reviewing courts to accord Postal Service rate determinations considerable deference, perhaps the lack of actions is not so mysterious.

<sup>336</sup> DMM § 626.131.

<sup>337</sup> One court decision addressing this issue ultimately was decided on other grounds. See *Sierra Club v. United States Postal Service*, 386 F. Supp. 1102 (N.D. Cal. 1973), *aff'd*, 549 F.2d 1199 (9th Cir. 1976), in which the United States District Court for the Northern District of California noted in dicta that a decision by the IRS to revoke the Sierra Club's tax exemption because it failed to meet the "educational organization" criteria of I.R.C. § 501(c)(3) would not furnish independent grounds for the Postal Service to revoke the Club's special nonprofit second- and third-class mailing permits. The District Court stated that:

It is well established that rulings by administrative agencies do not have the effect of stare decisis on one another. Thus the [Postal] Service was not bound by the rulings or determinations of the Internal Revenue Service as to what constitutes an "education organization." Rather, the service must conduct its own reviews and make its own determinations concerning an organization's eligibility to mail at special second or third class rates.

The Postal Service has steadfastly maintained its authority to determine rate eligibility independently of IRS tax status determination<sup>338</sup> and declines to adopt the IRS determinations as controlling in every instance because "[t]here are thousands of small qualifying organizations which apply for nonprofit second- and third-class rates which do not have IRS exemptions and have no need for such."<sup>339</sup> On the other hand, where an organization has sought a federal income tax exemption, the Postal Service "generally acts in a parallel fashion to the IRS."<sup>340</sup>

Nonprofits apply for the special nonprofit second-class rate at the post office where the publication has original second-class entry;<sup>341</sup> final approval of the second-class nonprofit permit application is done by the General Manager of the Rates and Classification Center serving the post office at which the initial application is made.<sup>342</sup> Nonprofits apply for the third-class rate at the post office from which they intend to mail nonprofit third-class matter.<sup>343</sup> Eligibility determinations are made at the Rates and Classification Center serving the post office at which the application was submitted.<sup>344</sup> Postal regulations provide for appeals from denials of nonprofit mailing permits.<sup>345</sup> Among the criticisms leveled at the Postal Service in its administration of the nonprofit second- and third-class rates has been that of nonuniform

---

*Id.* at 1105. (emphasis added.) On appeal, the Ninth Circuit held for the Postal Service, relying on the Postal Service's determination that the Sierra Club was not an educational organization within the meaning of 39 C.F.R. §§ 132.1 and 134. Thus, the court never reached the issue of whether revocation of federal income tax exemption was sufficient to support revocation of nonprofit mailing permits. 549 F.2d 1199 (9th Cir. 1976).

<sup>338</sup> 42 Fed. Reg. 31,592 (1977).

<sup>339</sup> *Id.*

<sup>340</sup> *Id.* See generally Kielbowicz and Lawson, *supra* note 321, at 388.

<sup>341</sup> DMM § 424.151.

<sup>342</sup> DMM § 424.181. There are five such centers nationwide. See DMM § 132.

<sup>343</sup> DMM § 626.11.

<sup>344</sup> DMM § 626.321.

<sup>345</sup> DMM §§ 424.185 (nonprofit second-class rate) and 626.4 (nonprofit third-class rate).

determinations of eligibility.<sup>346</sup> Current criticisms have focused on enforcing the Postal Service's prohibitions on cooperative mailings (described below) and on monitoring the amount and nature of advertising in second- and third-class mail.<sup>347</sup>

### 1) Cooperative Mailings

A "cooperative mailing" is a mailing in which an eligible nonprofit third-class bulk mailer in effect lends its nonprofit permit to an ineligible entity by mailing matter for the ineligible entity under its nonprofit permit. Postal regulations forbid this. In general, an eligible bulk-rate mailer may mail only its own matter at the special rate. Cooperative mailings are permissible where two or more eligible nonprofit bulk-rate mailers are each eligible to mail at the special rate at the post office where the mailing is deposited.<sup>348</sup>

To determine whether a mailing is "cooperative", the Postal Service has traditionally employed a source test. Generally, a mailing will not be "cooperative" if it was prepared, printed and mailed by the eligible organization claiming the nonprofit rate.<sup>349</sup> A leading cooperative mailing case is *National Retired Teachers Ass'n v. United States Postal Service*,<sup>350</sup> in which the District of Columbia Circuit upheld the Postal Service's denial of preferential third-class rates to a cooperative mailing of a pharmaceutical catalog by the National Retired Teachers Association (NRTA) and the American Association

<sup>346</sup> Kielbowicz and Lawson note that before inception of the special nonprofit third-class rate, all nonprofit second-class permit applications were decided by a single office in Washington, D.C. The Postal Service has, at various times, left second- and third-class nonprofit eligibility determinations to local postmasters and subsequently consolidated the determinations at 62 regional service centers. Kielbowicz and Lawson, *supra* note 321, at 383. Today these determinations are made by the five Rates and Classification Centers. DMM § 132. See also *Charities Protest Challenges to Joint Mailings with Businesses*, CHRON. PHILANTHROPY, Dec. 12, 1989, at 23.

<sup>347</sup> Generally, publications designed primarily for advertising purposes will not qualify for second-class rates. DMM § 423.13.

<sup>348</sup> DMM §§ 625.51, 625.52.

<sup>349</sup> See *Owen v. Mulligan*, 640 F.2d 1130 (9th Cir. 1981).

<sup>350</sup> 593 F.2d 1360, 1361-62 (D.C. Cir. 1979) (interpreting Domestic Mail Classification Schedule § 134.57).

of Retired Persons (AARP). The catalog was produced by Retired Persons Services (RPS), a nonprofit engaged in commercial activity and controlled by NRTA and AARP. RPS was not entitled to a nonprofit rate. The court noted that, under Postal Service Regulations, groups joining together to mail under a third-class nonprofit permit are only entitled to the nonprofit rate where each could qualify separately for that rate.

### 2) Advertising

The enactment of the Postal Service Appropriations Act of 1991<sup>351</sup> changed the rules for nonprofit mailers advertising commercial products and services.<sup>352</sup> The act terminates eligibility for nonprofit second- and third- class rates for mail advertising, promoting, offering, recommending, announcing, or describing: 1) credit, debit, charge, and similar financial cards offered by an organization not eligible to mail at the nonprofit second- and third-class rates; 2) any insurance policy not offered by an organization qualifying for the nonprofit second- and third- class rates designed for and primarily promoted to members, donors, supporters, or beneficiaries of the organization, where such policy is generally not otherwise commercially available; and 3) travel arrangements, unless offered by an organization eligible to mail at the nonprofit second- and third- class rates where such travel contributes to one or more of the purposes for which the organization qualified for the nonprofit rates (not including attracting members or raising funds), and the travel is designed for and primarily marketed to members, donors, supporters, or beneficiaries of the organization.

The Act is a direct response to complaints about abusive mailing practices, e.g., aggressive commercial promotions of charge cards, insurance, and travel, among other things, by nonprofits.<sup>353</sup>

<sup>351</sup> P.L. 101-509, 104 Stat. 1389 (1990), amending 39 U.S.C. § 3626.

<sup>352</sup> Travel advertisements by nonprofit institutions of higher learning have been identified as a particularly blatant abuse of the postal subsidy. See Wilson, *Charges of Abuse Hurt Colleges in Fight to Keep Postal Subsidy*, CHRON. HIGHER EDUC., June 18, 1986, at 1, 20.

<sup>353</sup> See Kielbowicz and Lawson, *supra* note 321, at 395-399.

## F) Labor Regulation

Today, governmental regulation affects nearly every aspect of the employment relationship: major areas of oversight include wages and hours, workers' rights to unionize and bargain collectively, discrimination on the basis of status, and workers' compensation. In each of these areas, regulatory systems consider the unique character of certain nonprofits and make accommodations for them.

### 1) Federal Wage and Hour Laws

The Fair Labor Standards Act<sup>354</sup> ("FLSA"), which regulates wages and hours, contains no express exemptions for nonprofits; consequently, nonprofits generally must comply with FLSA when their activities fall within its scope.<sup>355</sup> However, there are two principal grounds upon which nonprofits may argue that the FLSA does not apply to them.<sup>356</sup> The first concerns the type of activity undertaken; the FLSA is intended to regulate only businesses, and it is generally accepted that charitable activities fall outside the Act's scope.<sup>357</sup> Conversely, the FLSA clearly applies to commercial

<sup>354</sup> 29 U.S.C. §§ 201-19 (1988).

<sup>355</sup> Nonprofit character alone is not sufficient to warrant an exemption from the FLSA. See *Marshall v. Baptist Hosp.*, 668 F.2d 234 (6th Cir. 1981); *W&H Ltr. No. 476* (5/16/66). But see *Isaacson v. Penn Community Serv.*, 456 F.2d 1306 (4th Cir. 1971) (nonprofit character of organization to be considered in determining whether work relationship is covered by FLSA). Usually, the FLSA will apply to commercial or revenue-producing undertakings carried on by nonprofits. See 29 C.F.R. § 779.214 (1989) (FLSA applicable to commercial activities of charitable organizations); *Tony & Susan Alamo Found. v. Secretary of Labor*, 471 U.S. 290, 296 (1985) (FLSA contains "no express or implied" exemptions for commercial activities of nonprofit organizations); *Mitchell v. Pilgrim Holiness Church Corp.*, 210 F.2d 879, 882 (7th Cir.), cert. denied 347 U.S. 1013 (1954); *Marshall v. Woods Hole Oceanographic Inst.*, 458 F. Supp. 709, 719 (D. Mass. 1978).

<sup>356</sup> See *Tony and Susan Alamo Found. v. Secretary of Labor*, 471 U.S. 290 (1985).

<sup>357</sup> The Act's protections extend to employees who are directly engaged in interstate commerce or the production of goods for commerce, or else are employed in enterprises so engaged. See 29 U.S.C. §§ 206(a), 207(a). However, Congress did not intend that the eleemosynary activities of nonprofit institutions be considered "enterprises" within the contemplation of the Act. The legislative history of the 1961 amendments extending the FLSA to "enterprises" engaged in commerce states that "eleemosynary, [or] religious . . . organizations not operated for profit" are not subject to the Act, since they are not operated for a "business purpose." See S. REP. No. 1744, 86th Cong., 2d Sess. 28 (1960). Judicial

activities of nonprofits.<sup>358</sup> The FLSA is applied on an activity-by-activity basis, so that some portions of an organization will be covered by it, while others will not.<sup>359</sup> However, the FLSA also expressly covers some charitable organizations, such as hospitals and schools, regardless of the nature of their operations.<sup>360</sup>

The second ground for exemption rests on the status of the individual rendering services. The FLSA applies only to "employees" and not to "volunteers," that is, persons working without expectation of compensation, or who work for their own purposes or pleasure.<sup>361</sup> Whether an individual is a "volunteer" or an "em-

---

and administrative rulings on this issue have followed this legislative direction. See *Brennan v. Harrison County*, 505 F.2d 901 (5th Cir. 1975) (employees of charitable home caring for the indigent not covered by FLSA); *Wagner v. Salvation Army*, 660 F. Supp. 466 (E.D. Tenn. 1986) (transient lodge operated by Salvation Army not subject to FLSA); *Wages and Hours Opinion Ltrs. No. 1040* (11/18/69), No. 927 (5/29/68), No. 624 (6/23/67) (institution operated by nonprofit organization as eleemosynary activity not covered by FLSA).

<sup>358</sup> In the early 1960's, Congress made clear that it intended the FLSA to reach the business activities of nonprofit organizations, rejecting on two occasions amendments that would have exempted I.R.C. § 501(c)(3) organizations from coverage, on the grounds that an exemption could confer an unfair advantage on such entities operating in competition with for-profit businesses. See *Tony & Susan Alamo Found. v. Secretary of Labor*, 471 U.S. at 297-98; Note, *The Applicability of the Fair Labor Standards Act to Volunteer Workers at Nonprofit Organizations*, 43 WASH. & LEE L. REV. 223, 237-39 (1986) (discussing the proposed amendments and the reasons for their rejection).

The test for distinguishing exempt eleemosynary activities and covered commercial ones is whether the business of a nonprofit organization "serve[s] the general public in competition with ordinary commercial enterprises", so that exemption would give the nonprofit an unfair competitive advantage. *Tony and Susan Alamo Found. v. Secretary of Labor*, 471 U.S. at 299. See also *Donovan v. Tony & Susan Alamo Found.*, 722 F.2d 397, 400 (8th Cir. 1983), *aff'd* 471 U.S. 290 (1985) (by "entering the economic arena and trafficking in the marketplace," an organization subjects itself to FLSA).

<sup>359</sup> See, e.g., *Wagner v. Salvation Army*, 660 F. Supp. 466 (E.D. Tenn. 1986).

<sup>360</sup> The 1966 amendments to the FLSA explicitly provided that hospitals or schools, whether or not operated for profit, were covered by the FLSA. Fair Labor Standards Amendments of 1966, Pub. L. No. 89-601, § 102(a) (codified at 29 U.S.C. § 203(r)(1)). See also 29 U.S.C. § 203(s), added by Fair Labor Standards of 1961, Pub. L. No. 87-30, 75 Stat. 65 (1961 Amendments to the Fair Labor Standards Act), and amended in 1966.

<sup>361</sup> The Act's protections extend only to "employees," very broadly defined, even including persons "suffered or permitted to work." See 29 U.S.C. § 203(g), (e). However, persons who work without expectation of compensation or for

ployee" is based on the "economic reality" of the relationship, but persons donating services to charitable or religious activities are usually outside the FLSA's coverage.<sup>362</sup>

## 2) Federal Collective Bargaining Laws

The National Labor Relations Act<sup>363</sup> (the "NLRA") regulates unfair labor practices, unionization of employees, and collective bargaining. The NLRA does not expressly exempt nonprofits, and the National Labor Relations Board (the "NLRB") does not decline jurisdiction over labor disputes solely because an employer is non-commercial.<sup>364</sup>

their own purposes are not considered "employees" for purposes of the Act. See *Tony & Susan Alamo Found. v. Secretary of Labor*, 471 U.S. at 302; *Isacson v. Penn Community Servs.*, 450 F.2d 1306 (4th Cir. 1971) (conscientious objector allowed to fulfill military service obligations by working for nonprofit organization not an employee under FLSA). This rule applies regardless of whether the enterprise as a whole is covered by the FLSA, or whether the organization is nonprofit or not. See *Walling v. Portland Terminal Co.*, 330 U.S. 148, 152 (1947) (railroad yard trainees); *Rogers v. Schenkel*, 162 F.2d 596 (2d Cir. 1947) (metal plating trainee).

<sup>362</sup> The "economic reality" test considers the degree of economic dependence of the workers on their employer, as well as the expectation of remuneration for services rendered. See *Tony & Susan Alamo Found.*, 471 U.S. at 301-02; Note, *supra* note 358, at 225. A worker's own statements concerning his status are not necessarily conclusive for a fact-finder. *Tony & Susan Alamo Found.*, 471 U.S. at 302.

The Department of Labor has distinguished employees and volunteers in a number of administrative rulings. See Wage-Hour Opinion Ltrs. No. 1350 (WH-298) (11/13/74) (day care center volunteers and foster parents not employees); No. 1282 (WH-230) (7/10/73) (church volunteer not employee); No. 1240 (WH-188) (12/27/72) (persons rendering services to their religious orders, or to other church-operated institutions pursuant to religious obligations, such as priests, nuns, deacons, lay brothers, and ministers, are not employees); No. 687 (11/7/67) (nursing home volunteer not an employee); No. 626 (6/28/67) (volunteers performing services of a charitable or religious nature for organizations to which they wish to contribute are not employees); No. 598 (5/1/67) (same); No. 573 (2/27/67) (volunteer teachers not employees). But see W&H Ltr. No. 476 (5/16/66), holding that existence of employment relationship depends on facts and circumstances, and that nonprofit character of organization alone is not determinative.

<sup>363</sup> 29 U.S.C. §§ 151-168 (1988).

<sup>364</sup> See *Rhode Island Roman Catholic Orphan Asylum*, 224 N.L.R.B. 1344 (1976). See also *NLRB v. Southwest Ass'n for Retarded Citizens*, 666 F.2d 428, 430 (9th Cir. 1982) (NLRA has no exemption for nonprofits, and NLRB has jurisdiction over them when their activities affect commerce). The NLRB did not always take this

However, certain grounds for exemption do exist, even where the Board can assert its authority over an employer. The agency often sets up "jurisdictional yardsticks" for particular industries, which enable the agency to determine whether it considers an employer large enough to warrant assertion of its authority,<sup>365</sup> similarly, an organization's activities may have only an insubstantial effect on interstate commerce, in which case the Board may decline jurisdiction.<sup>366</sup> Likewise, where an organization's activities are non-commercial, an exemption may be granted.<sup>367</sup>

position. Between 1951 and 1970, it generally declined jurisdiction over nonprofit employers where the work performed by the employees seeking to unionize was "intimately connected with the charitable purposes" of the employer and was "non-commercial in nature." See *Trustees of Columbia Univ.*, 97 N.L.R.B. 424, 427 (1951), *overruled by Cornell Univ.*, 183 N.L.R.B. 329 (1970). This policy was based on the legislative history of the Labor Management Relations (Taft-Hartley) Act of 1947, ch. 120, 61 Stat. 136, which expressed the view that the activities of charitable organizations came within the ambit of the NLRA "only in exceptional circumstances and in connection with purely commercial activities." H.R. REP. NO. 510, 80th Cong., 1st Sess. 32, *reprinted in* 1947 U.S. CODE CONG. & ADMIN. NEWS 1135, 1137. This language was taken as a Congressional endorsement of what purportedly had been the Board's policy with respect to charities at the time of the passage of the 1947 Act. See *Columbia University*, 97 N.L.R.B. at 427.

The "worthy cause" exemption was criticized in a 1970 Harvard Law Review article, which found the Board's practice to be contrary to the basic policies of the NLRA. See Sherman & Black, *The Labor Board and the Private Nonprofit Employer: A Critical Examination of the Board's Worthy Cause Exemption*, 83 HARV. L. REV. 1323 (1970). Later that year, the NLRB repudiated its earlier policy and announced that it would take jurisdiction over charitable institutions. *Cornell University*, 183 N.L.R.B. 329 (1970).

<sup>365</sup> See National Labor Relations Act, § 14(c), 29 U.S.C. § 164(c) (1988). For instance, the Board has announced that it will not take jurisdiction over colleges and universities with gross annual revenues under \$1 million. 29 CFR § 103.1 (1989).

<sup>366</sup> See *Children's Communities*, 210 N.L.R.B. 6 (1974); *Methodist Children's Home*, 209 N.L.R.B. 211 (1974); *Pennsylvania Labor Relations Bd.*, 209 N.L.R.B. 152 (1974) (activities of employer are local in character; labor disputes arising out of them would not have substantial impact on interstate commerce); *Epi-Hab Evansville, Inc.*, 205 N.L.R.B. 637 (1973) (same). See also *NLRB v. Peninsula Ass'n for Retarded Children & Adults*, 627 F.2d 202 (9th Cir. 1980) (no NLRB jurisdiction where no effect on interstate commerce resulting from employer's activities is shown).

<sup>367</sup> For instance, where an organization sought to rehabilitate workers, not produce a profit, the NLRB declined jurisdiction. *Goodwill Indus.*, 231 N.L.R.B. 536 (1977). The NLRB has also declined jurisdiction over a religious order providing non-commercial religious services. *Motherhouse of the Sisters of Charity*, 232 N.L.R.B. 318 (1977).

Other nonprofits may be exempted from the NLRA because the Board's jurisdiction does not extend to them. Section 2(2) of the NLRA<sup>368</sup> exempts states and their political subdivisions; nonprofits whose directors or officers are responsible to elected officials or the general public are exempt under this provision. Private nonprofit schools,<sup>369</sup> hospitals,<sup>370</sup> and other organizations<sup>371</sup> have obtained exemptions under this interpretation of

<sup>368</sup> 29 U.S.C. § 152(2) (1988).

<sup>369</sup> See *Laurel Haven School for Exceptional Children*, 230 N.L.R.B. 1179 (1977); *Perkins School for the Blind*, 225 N.L.R.B. 1293 (1976); *Children's Village, Inc.*, 197 N.L.R.B. 1218 (1972); *But see Mon Valley United Health Serv.*, 238 N.L.R.B. 916 (1978) (government-funded program was NLRA employer because not responsible to public school system).

<sup>370</sup> *Bd. of Trustees of Memorial Hospital of Fremont County, Wyoming v. NLRB*, 624 F.2d 177 (10th Cir. 1980); *Target, Inc.*, 263 N.L.R.B. 781 (1982); *Northhampton Center for Children and Families, Inc.*, 257 N.L.R.B. 870 (1981); *Madison County Mental Health Center, Inc.*, 253 N.L.R.B. 258 (1980); *Roman Catholic Orphan Asylum*, 227 N.L.R.B. 404 (1976); *Citizen Care, Inc.*, 226 N.L.R.B. 817 (1976).

From 1947 to 1974, nonprofit hospitals were exempted from the NLRA by § 2(2). Labor Management Relations Act of 1947, ch. 120, § 101, 61 Stat. 137, *repealed by* Act of July 26, 1974, Pub. L. No. 93-360, § 1(a), 88 Stat. 395. When this exemption was abolished, hospitals could gain exemption only if they could be considered government subdivisions, or if the NLRB declined jurisdiction on the basis of its jurisdictional yardsticks. (See text accompanying note 365, *supra*). The NLRB will take jurisdiction over private nonprofit hospitals with over \$250,000 in annual gross revenues. *East Oakland Community Health Alliance, Inc.*, 218 N.L.R.B. 1270 (1975).

<sup>371</sup> Other nonprofit organizations exempt under this principle include: *Founders' Soc'y Detroit Inst. of Arts*, 271 N.L.R.B. 285 (1984); *Rosenberg Library Ass'n*, 269 N.L.R.B. 1173 (1984); *Pennsylvania State Ass'n of Boroughs*, 267 N.L.R.B. 71 (1983) (town lobbying corporation); *Prairie Home Cemetery*, 266 N.L.R.B. 678 (1983); *Jervis Public Library Ass'n*, 262 N.L.R.B. 386 (1982); *Kent County Ass'n for Retarded Citizens*, 227 N.L.R.B. 1439, *summary judgment granted*, 233 N.L.R.B. 151 (1977), *enforced*, 590 F.2d 19 (1st Cir. 1978); *Transit Systems, Inc.*, 221 N.L.R.B. 299 (1975); *Rural Fire Protection Co.*, 216 N.L.R.B. 584 (1975).

However, government funding alone is insufficient to exempt an organization if it is otherwise autonomous. *Jefferson County Community Center for Development Disabilities v. NLRB*, 732 F.2d 122 (10th Cir.), *cert. denied*, 469 U.S. 1086 (1984); *National Soc'y of the Volunteers of Amer.*, 100 Lab. Cas. (CCH) para. 10,972 (10th Cir. 1984); *Radio Free Europe/Radio Liberty*, 262 N.L.R.B. 549 (1982); *United Servs. for the Handicapped*, 239 N.L.R.B. 976 (1978).

section 2(2). The courts have also held that the Board lacks jurisdiction over certain religious schools.<sup>372</sup>

### 3) Federal Anti-Discrimination Laws

As a general matter, nonprofits must comply with anti-discrimination and civil rights laws to the same extent as other institutions;<sup>373</sup> however, Congress has created a special, limited exception to these rules for religious organizations in Section 702 of the Civil Rights Act of 1964.<sup>374</sup> This provision exempts religious organizations from Title VII's prohibition against discrimination in employment on the basis of religion with respect to work connected with that organization's conduct of its activities.

When the 1964 Act originally was passed, the exemption covered only the religious activities of religious organizations. In 1972, however, Congress broadened the exemption to cover all activities of such entities, both secular and non-secular.<sup>375</sup>

<sup>372</sup> See *NLRB v. Catholic Bishop*, 440 U.S. 490 (1979); *Universidad Central de Bayamon v. NLRB*, 793 F.2d 383 (1st Cir. 1985); *NLRB v. Bishop Ford Cent. Catholic High Sch.*, 623 F.2d 818 (2d Cir. 1980), *cert. denied*, 450 U.S. 996 (1981). The holdings in these cases were based on a construction of the NLRA, rather than on the First Amendment directly.

However, the NLRB has successfully asserted jurisdiction over church-operated organizations, such as hospitals and social service organizations, which do not propagate religion but are operated as secular institutions. See *Volunteers of Amer., Los Angeles v. NLRB*, 777 F.2d 1386 (9th Cir. 1985); *NLRB v. Salvation Army of Mass. Dorchester Day Care Ctr.*, 763 F.2d 1 (1st Cir. 1985); *Institutional Food Servs.*, 258 N.L.R.B. 650 (1981) (church-owned food service company). See also cases cited in *Universidad Central, supra*, at 406.

<sup>373</sup> See, e.g., *McClure v. Salvation Army*, 460 F.2d 553, 557 (5th Cir.), *cert. denied*, 409 U.S. 896 (1972) (Salvation Army held to be an employer subject to anti-discrimination rules in Title VII of 1964 Civil Rights Act). Furthermore, organizations that practice discrimination can lose their federal income tax exemption. See I.R.C. § 501(i) (denying exemption to discriminatory social clubs); *Bob Jones Univ. v. United States*, 461 U.S. 574 (1983) (denying I.R.C. § 501(c)(3) status to racially discriminatory schools). *But see* I.R.C. § 501(i)(1), (2) (permitting clubs which are religious in nature to limit membership to persons of a particular religion).

<sup>374</sup> Pub. L. No. 88-352, § 702, 78 Stat. 241, 255 (codified at 42 U.S.C. § 2000e-1 (1988)).

<sup>375</sup> See Joint Explanatory Statement of Conference Managers, *reprinted in* 1972 U.S. CODE CONG. & ADMIN. NEWS 2137, 2180; 118 Cong. Rec. 4305 (1972) (remarks of Sen. Ervin); 118 Cong. Rec. 7567 (1972) (remarks of Rep. Erlenborn). See also *Amos v. Corporation of the Presiding Bishop of Church of Jesus Christ of Latter-*

Additionally, certain educational organizations controlled or supported by religious institutions may base employment decisions on whether an individual subscribes to the beliefs of that institution.<sup>376</sup>

The Supreme Court upheld Section 702 of the 1964 Act against a Constitutional attack, ruling that it did not violate the Establishment Clause.<sup>377</sup> The Court did not rule on the issue of whether the application of Section 702 to activities of religious organizations that are conducted solely to generate revenue would pass constitutional muster, but Justice Brennan, in a concurring opinion, suggested that it might not.<sup>378</sup>

#### 4) State Workers' Compensation Acts

Statutory systems providing compensation for job-related injuries exist in every state, and almost all of these laws require nonprofit employers to provide benefits prescribed by law to their employees.<sup>379</sup> Under the workers' compensation system, an employer pays a prescribed level of benefits to its workers if they suffer injury or death connected with their employment regardless of the employer's fault. In return, employees give up the right to sue their employer and recover damages in tort in most cases.<sup>380</sup> If an employer is exempted from the statutory compensation system, it need not pay the prescribed benefits or purchase compensation

---

*Day Saints*, 594 F. Supp. 791, 804 (D. Utah 1984) *rev'd on other grounds*, 483 U.S. 327 (1987).

<sup>376</sup> 42 U.S.C. § 2000e-2(e)(2) (1988).

<sup>377</sup> See *Corporation of the Presiding Bishop of Jesus Christ of Latter-Day Saints v. Amos*, 483 U.S. 327 (1987). This case dealt with employment in a nonprofit gymnasium operated by the Mormon Church.

<sup>378</sup> See *Amos*, 483 U.S. at 343-46 (Brennan, J., concurring). See also *id.* at 348-49 (O'Connor, J., concurring) (stating that this question was still open). However, at least one court has expressed the view that such activities are covered by the exemption, and that § 702 violates the Establishment Clause as a result. See *King's Garden, Inc. v. F.C.C.*, 498 F.2d 51, 54 & n.7 (D.C. Cir.), *cert. denied*, 419 U.S. 996 (1974).

<sup>379</sup> See 1 A. LARSON, LARSON'S WORKMEN'S COMPENSATION §§ 50.41-50.43 (Desk ed. 1989).

<sup>380</sup> See *id.* at §§ 1.00-3.00; J. NACKLEY, PRIMER ON WORKERS' COMPENSATION 1-10 (2d ed. 1989).

insurance, which is required by many states. Employers not covered by these compensation acts can be liable in tort to their employees, but, in such cases, recovery may be awarded only upon a showing of fault on the part of the employer. The employer may, in turn, plead such defenses as contributory or comparative negligence, assumption of the risk, and negligence of a fellow servant.<sup>381</sup>

An exemption from the compensation system for a nonprofit can arise based on the status of the person rendering services. The protections of the workers' compensation acts extend only to "employees;" volunteers are not eligible for benefits under these acts, and the organization for whom a volunteer renders services is only liable to the volunteer in tort.<sup>382</sup> Consequently, even if an employer is subject generally to the requirements of the law, it is not obligated to pay compensation to and carry insurance for every individual who performs services for it. This rule is beneficial to many nonprofit organizations that rely on volunteer workers, since such organizations can utilize the exemption to reduce operating costs.

#### G) Copyright Law

Generally, nonprofits are bound to respect the property rights of copyright holders to the same extent as other users of protected materials. Some nonprofits, however, particularly educational institutions and public broadcasters, benefit from certain relaxations of these rules.

##### 1) "Fair Use"

Nonprofit educational institutions are accorded greater freedom in copying copyrighted materials than other persons under the rules permitting "fair use" of a protected work.<sup>383</sup> Section 107

---

<sup>381</sup> See *Continental Sales Corp v. Stookesberry*, Colo. 459 P.2d 566 (Colo. 1969). See also cases cited in 101 C.J.S. *Workmens' Compensation* § 921 (1958); 81 AM. JUR. 2D *Workmens' Compensation* § 53 (1976).

<sup>382</sup> See *Edwards v. Hollywood Canteen*, 160 P.2d 94 (Cal. App. 1945), *superseded*, 167 P.2d 729 (1946); A. LARSON, *supra* note 379, at § 47.41.

<sup>383</sup> The "fair use" of a protected work does not constitute an infringement of the owner's copyright. See 3 M. NIMMER & D. NIMMER, NIMMER ON COPYRIGHT § 13.05 (1991) [hereinafter NIMMER ON COPYRIGHT]; Lawrence, *Copyright Law, Fair Use, and the Academy: An Introduction*, in FAIR USE AND FREE INQUIRY 3-16

of the Copyright Act of 1976 provides that "teaching" (including making multiple copies for classroom use) constitutes "fair use."<sup>384</sup> However, whether "fair use" is established in a particular case rests upon a consideration of several factors, one being the purpose of the use: if a work is used for nonprofit educational purposes, as opposed to commercial ones, the use is more likely to be permissible.<sup>385</sup> In order to reduce uncertainty as to the limits of the educational "fair use" privilege, guidelines for copying, developed by educators and publishers, were set out in the legislative history of the 1976 Copyright Act.<sup>386</sup> In 1981, additional guidelines governing off-air taping of broadcasts for educational purposes were developed.<sup>387</sup>

## 2) Performance or Display of Protected Works

The Copyright Act of 1976 also provides express exemptions permitting use of copyrighted works by certain nonprofits. Section 110 of the Act<sup>388</sup> specifies when the performance or display (but

---

(J. Lawrence and B. Timberg 2d ed. 1989); Oler and Kretsinger, *Copyright Law and the Fair Use of Visual Images*, in FAIR USE AND FREE INQUIRY, *supra*, at 258, 261-63; W. PATRY, *LATMAN'S THE COPYRIGHT LAW* 239-51 (6th ed. 1986).

384 17 U.S.C. § 107 (1988).

385 17 U.S.C. § 107(1)(1988). Consequently, although an educational purpose alone will not establish "fair use," it does suggest that no infringement has occurred. See H.R. REP. NO. 1476, 94th Cong., 2d Sess. 66, reprinted in 1976 U.S. CODE CONG. & ADMIN. NEWS 5659, 5679; NIMMER ON COPYRIGHT, *supra* note 383, § 13.05A at pp. 13-84 to 13-88.5. The other factors enumerated in the statute include the nature of the work, the relative amount of the work used, and the effect of the use on the potential market for or value of the work. 17 U.S.C. § 107(2)-(4) (1988). See also W. PATRY, *supra* note 383, at 247-51. These factors are not exclusive. 17 U.S.C. § 101 (1988).

386 See H.R. REP. NO. 1476, *supra* note 385, at 67-71. See also NIMMER ON COPYRIGHT, *supra* note 383, at § 13.05[E][3]; Oler and Kretsinger, *supra* note 383, at 263-66; W. PATRY, *supra* note 383, at 245-47. These guidelines provide a "safe harbor" for educational copying, but they do not represent the maximum permissible fair use of protected materials.

387 See H.R. REP. NO. 495, 97th Cong., 2d Sess., 6-11 (1982); FAIR USE AND FREE INQUIRY, *supra* note 383, at 113-16; Oler & Kretsinger, *supra* note 383, at 268-70; W. PATRY, *supra* note 383, at 247.

388 17 U.S.C. § 110 (1988). See generally H.R. REP. NO. 1476, *supra* note 385 at 81-88; NIMMER ON COPYRIGHT, *supra* note 383, § 8.15; W. PATRY, *supra* note 383, at 223-26, 229 (discussing the § 110 exemptions).

not the copying) of protected works will not infringe on the property rights of a copyright holder. Sanctioned uses of such works include:

- i) performance or display of any copyrighted work as part of face-to-face teaching activities conducted by a nonprofit educational institution;<sup>389</sup>
- ii) transmitted performances of nondramatic literary or musical work as part of a nonprofit educational organization's instructional program where the transmissions are made for reception in places of instruction;<sup>390</sup>
- iii) performance of nondramatic literary or musical work or dramatic-musical work of a religious nature as part of religious services;<sup>391</sup>
- iv) live performances of nondramatic literary or musical works conducted without purpose of commercial advantage or payment to performers or promoters, if no admission is charged; however, if admission is charged, the proceeds must be devoted to charity, and, in such a case, the work may not be used if the copyright holder objects;<sup>392</sup>
- v) performance of nondramatic literary or musical work by a nonprofit agricultural or horticultural organization during an annual fair or exhibition;<sup>393</sup>
- vi) broadcast performance of nondramatic literary work for sight or hearing impaired persons through facilities of government or nonprofit educational broadcaster, if not done for financial gain;<sup>394</sup>

---

389 17 U.S.C. § 110(1) (1988). The use of the work must occur in the course of instructional activities, and only teachers or pupils may perform or display it. This exemption does not apply to copying protected materials, which is governed by the "fair use" rule discussed above.

390 17 U.S.C. § 110(2) (1988). This exemption does not apply to the performance of dramatic works or audio-visual materials, such as movies. See W. PATRY, *supra* note 383, at 223.

391 17 U.S.C. § 110(3) (1988).

392 17 U.S.C. § 110(4) (1988).

393 17 U.S.C. § 110(6) (1988). This exemption also absolves these organizations from vicarious liability for unauthorized use by a concessionaire at such a fair.

394 17 U.S.C. § 110(8) (1988).

- vii) performance by such a broadcaster of a dramatic literary work at least ten years old,<sup>395</sup>
- viii) performance of a nondramatic literary or musical work in the course of a social function sponsored by a nonprofit veterans' or fraternal benefit organization, including a college fraternity or sorority, from which the general public is excluded, provided the net proceeds are devoted exclusively to charitable purposes.<sup>396</sup>

### 3) Nonprofit Broadcasters

An additional series of exemptions governing rights to perform and copy protected materials applies to nonprofit broadcasters.

Section 114(b) of the Copyright Act permits use of copyrighted sound recordings in educational television or radio programs produced for transmission by public broadcasters.<sup>397</sup> Section 111(a)<sup>398</sup> provides two cases in which retransmission of a broadcast through a cable system by a nonprofit does not infringe upon the owner's rights in the material so transmitted.<sup>399</sup> The first occurs where the original broadcast qualifies for the instructional broadcasting exemption of Section 110(2),<sup>400</sup> the second occurs

<sup>395</sup> 17 U.S.C. § 110(9) (1988).

<sup>396</sup> 17 U.S.C. § 110(10) (1988). This exemption was added by Act of Oct. 25, 1982, Pub. L. No. 97-366, § 3, 96 Stat. 1759.

<sup>397</sup> 17 U.S.C. § 114(b) (1988). See also NIMMER ON COPYRIGHT, *supra* note 383, at § 8.05[B]. Entities eligible for this privilege are defined as the public broadcasting entities chartered by Congress, as well as any licensee of a public broadcast station, or a nonprofit institution engaged in the production or distribution of educational television or radio programs. 17 U.S.C. § 118(g) (1988); 47 U.S.C. § 397(11) (1988). For purposes of the definition, the term "nonprofit" means an entity "no part of the net earnings of which inures, or may lawfully inure, to the benefit of any private shareholder or individual." 47 U.S.C. § 397(8) (1988).

<sup>398</sup> 17 U.S.C. § 111(a) (1988). See NIMMER ON COPYRIGHT, *supra* note 383, § 8.18[C][4] pp. 8-217 to 8-218.

<sup>399</sup> These exemptions apply to so-called "secondary" transmissions, defined as simultaneous retransmissions through a cable system of programming being broadcast to the public. 17 U.S.C. § 111(f) (1988).

<sup>400</sup> 17 U.S.C. § 111(a)(2) (1988). See H. HENN, COPYRIGHT PRIMER 235-36 (1979); H.R. REP. NO. 1476, *supra* note 385, at 92; See *supra* text accompanying notes

when the retransmission is made by a "booster" or "translator" service operated by a nonprofit, if the signal is provided on a cost basis without purpose of commercial advantage.<sup>401</sup>

Section 112 of the Act permits certain persons to make "ephemeral recordings" of copyrighted materials without violating the law; these are copies of broadcast programming made for limited purposes which are kept for only a short period of time.<sup>402</sup> Nonprofits may make up to 30 copies of a transmission qualifying for the instructional exemption under Section 110(2),<sup>403</sup> which may be exchanged among other instructional broadcasters: all copies, save one, must be destroyed within seven years of the date of first transmission.<sup>404</sup> Nonprofits also are permitted to include performances of religious musical works in copies of programs which they provide to broadcasters without infringing the owner's copyright, if certain conditions are observed.<sup>405</sup> Section 112(d) allows limited copying by nonprofits of works which qualify for the Section 110(8)<sup>406</sup> infringement exemption.<sup>407</sup>

Congress has conferred an additional benefit on public broadcasters by enabling them to acquire the right to use copyrighted material for reduced license fees. Section 118 of the Act grants noncommercial educational broadcasters, (i.e., the Public Broadcasting System and National Public Radio, and their affiliates), a

389-396, for a discussion of the instructional broadcasting exemption.

<sup>401</sup> 17 U.S.C. § 111(a)(5) (1988). See H.R. REP. NO. 1476, *supra*, note 385, at 92 (5706).

<sup>402</sup> 17 U.S.C. § 112 (1988). See NIMMER ON COPYRIGHT, *supra* note 383, §§ 8.06[A]-[F] at pp. 8-93 to 8-100; W. PATRY, *supra* note 383, at 237; H. R. REP. NO. 1476, *supra* note 385, at 101-05. The reproduction right extends only to programs which the copier has the right to transmit and does not permit the copying of motion pictures or other audio-visual material. 17 U.S.C. § 112(a) (1988).

<sup>403</sup> See *supra* discussion accompanying notes 389-396.

<sup>404</sup> 17 U.S.C. § 112(b) (1988). 17 U.S.C. § 118(d)(3) (1988) also allows public broadcasting entities to reproduce transmitted works for limited reuse.

<sup>405</sup> 17 U.S.C. § 112(c) (1988). See also NIMMER ON COPYRIGHT, *supra* note 383, § 8.06[E] at pp. 8-99 to 8-100; H.R. REP. NO. 1476, *supra* note 385, at 104.

<sup>406</sup> See *supra* text accompanying note 394.

<sup>407</sup> 17 U.S.C. § 112(d) (1988). See also NIMMER ON COPYRIGHT, *supra* note 383, § 8.06[F] at p. 8-100.

compulsory license enabling them to use copyrighted published pictorial, graphic, sculptural, and non-dramatic musical works in exchange for a pre-determined license fee set either by negotiation<sup>408</sup> or by the Copyright Royalty Tribunal.<sup>409</sup> The compulsory license allows use of such works in transmissions made by nonprofit educational broadcasting stations.<sup>410</sup> While these broadcasters are not allowed a compulsory license for non-dramatic literary works, the Copyright Act does exempt from the antitrust laws negotiated licensing agreements between owners and broadcasters which govern such works.<sup>411</sup>

#### H) Exemption for Nonprofits from Federal and State Criminal Liability

##### 1) Federal Conflict of Interest and Lobbying

Nonprofits benefit from limited exemptions from federal criminal liability. One important exemption pertains to the federal criminal conflict of interest provisions of 18 U.S.C. Section 207. Generally, Section 207 restricts lobbying by former government officials and authorizes a fine and imprisonment for government officials who lobby for a particular cause within a statutory period of disability of up to two years from that official's departure from government.<sup>412</sup> Former government officials or employees of

<sup>408</sup> Public broadcasters and copyright owners are given immunity under the antitrust laws with respect to agreements negotiated governing the amount of royalty payments and their division among copyright holders. 17 U.S.C. § 118(b) (1988).

<sup>409</sup> 17 U.S.C. § 118 (1988). See also H. HENN, *supra* note 400, at 217-30; H.R. REP. NO. 1476, *supra* note 385, at 116-20.

<sup>410</sup> Under 17 U.S.C. § 118(g) (1988), these stations are defined by reference to 47 U.S.C. § 397(6) (1988), which provides that they are to be owned by either governmental or nonprofit organizations. 47 U.S.C. § 397(8) (1988) defines a nonprofit entity as a "foundation, corporation, or association no part of the net earnings of which inures, or may lawfully inure, to the benefit of any private shareholder or individual."

<sup>411</sup> 17 U.S.C. § 118(e)(1) (1988). See H. HENN, *supra* note 400, at 228-29.

<sup>412</sup> 18 U.S.C. § 207 (1988). The problem of former government officials using their influence on behalf of private interests has been frequently noted. See *Do Ethics Bills Work?* WASH. POST, Apr. 11, 1988, at A14 (former White House aides Michael Deaver and Lyn Nofziger both convicted as a result of investigations

hospitals or medical research organizations exempt from federal income tax pursuant to Code Section 501(c)(3) are exempt from Section 207 when those former officials or employees appear or testify on behalf of their former employer.<sup>413</sup>

##### 2) Federal Antibribery Law

18 U.S.C. § 209 makes it criminal for officers or employees of the executive branch, independent federal agencies and the District of Columbia to accept compensation over and above their regular salary. It also criminalizes payments to government officials by any individual, partnership, association, corporation, or other organization.<sup>414</sup> Section 209 excepts from the statutory scheme payments received as compensation by a government official or employee for an injury received in connection with a Presidential, Presidential staff, Congressional, Cabinet, or Supreme Court assassination, kidnapping, or assault, if paid by an entity exempt from federal income tax under Code Section 501(a) and described in Code Section 501(c)(3).

##### 3) Gambling-Related Criminal Law Exemptions

Two federal criminal law exemptions for nonprofits go hand-in-hand. The first provides that individuals connected with bingo, lotteries, and games of chance conducted by organizations described in Code Section 501(c)(3) are exempt from prosecutions for obstructing enforcement of state criminal prosecutions for illegal gambling.<sup>415</sup> The second exempts from racketeering prosecutions

pursuant to the 1978 Ethics in Government Act). See also Ian Austen, *The President's Rogues*, MACLEAN'S, Apr. 25, 1988, at 6 ("According to a report issued by the House of Representatives Subcommittee on the Civil Service last month, a total of 242 Reagan administration officials have either violated criminal or government ethics laws or are under investigation for alleged violations.")

<sup>413</sup> 18 U.S.C. § 207(j)(2)(B) (1988) (amendment effective January 1, 1991 changed the designation of the statutory section from 18 U.S.C. § 207(d)(2)(B) to its present designation of § 207(j)(2)(B)).

<sup>414</sup> 18 U.S.C. § 209 (1988).

<sup>415</sup> 18 U.S.C. § 1955 (1988).

individuals connected with games of chance conducted by Code Section 501(c)(3) organizations.<sup>416</sup>

Because bingo games, raffles and the like have proven important sources of nonprofit fundraising,<sup>417</sup> many states also permit otherwise prohibited gambling for the benefit of nonprofit or charitable entities.<sup>418</sup> In several states, a permit applicant's federal

<sup>416</sup> 18 U.S.C. § 1955(e) (1988). This provision specifically exempts I.R.C. § 501(c)(3) organizations from the prohibitions on gambling contained in 18 U.S.C. § 1955, provided that none of the proceeds of the gambling operation "inures to the benefit of any private shareholder, member, or employee of such organization [the I.R.C. § 501(c)(3) organization] except as compensation for actual expenses incurred by him in the conduct of such activity." *Id.*

<sup>417</sup> See, e.g., Suhrke, *The Hype and the Reality about Charity Sweepstakes*, 22 THE PHILANTHROPY MONTHLY, Jan. 1989, at 6 ("From April 1, 1977 through December 31, 1987 nonprofit organizations received \$106,274,905 as a result of North Dakota games of chance."); *Charities Get Little from Gambling Increase*, THE CHRON. OF PHILANTHROPY, June 27, 1989, at 6 ("Nationwide, the total proceeds from charitable gaming are estimated at \$4.8 Billion for 1988 . . .") Hall, *\$2-Billion-a-Year Charity Bingo-Game Market Gets Closer Scrutiny From State Legislatures*, CHRON. OF PHILANTHROPY, April 18, 1989, at 1 (1987 survey showed charity bingo games brought in well over \$2 billion annually in states permitting charitable gambling — "more than raffles, card games and 'Las Vegas nights' put together.")

<sup>418</sup> See, e.g., ALA. CONST. of 1901, amend. nos. 386, 387, 413, and 440 (1990) (authorizing operation of bingo games by nonprofit organizations in Jefferson, Madison, Montgomery, and Mobile Counties, respectively); ALASKA STAT. §§ 05.15.020 - 05.15.210 (1988) (authorizing lotteries, games of chance, and the like); ARIZ. REV. STAT. ANN. §§ 5-401 - 5-415 (1989 & Supp. 1991) (authorizing bingo); ARIZ. REV. STAT. ANN. § 13-3302 (1989 & Supp. 1991) (exempting raffles conducted by nonprofits from application of criminal statute prohibiting gambling); CAL. PENAL CODE § 237.10 (West 1988 & Supp. 1992) (authorizing bingo games by entities exempt from state bank and corporation tax, provided proceeds used for charitable purposes); COLO. REV. STAT. § 12-9-104 (1991) (authorizing nonprofits to receive bingo/raffle license); GA. CONST. Art. 1, § 2, ¶ VIII (prohibiting all lotteries but providing that General Assembly may provide that bingo games conducted by nonprofit organizations are not lotteries); GA. CODE ANN. § 16-12-50, et. seq. (Michie 1984 & Supp. 1991) (statement of legislative intent that only properly licensed nonprofit, tax-exempt organizations be permitted to conduct bingo games, followed by regulatory scheme for administering such games); ILL. ANN. STAT. ch. 120, ¶ 1121.1 (Smith-Hurd Supp. 1991 & Supp. 1992) (statement of legislative intent recognizing important contributions nonprofit organizations make to welfare of Illinois residents, and authorization of games of chance as an appropriate fundraising device for nonprofit charitable organizations); ILL. ANN. STAT. ch. 120, ¶ 1128 (Smith-Hurd 1991 & Supp. 1992) (specifically authorizing the following charitable games of chance: roulette, blackjack, poker, pull tabs, craps, bang, beat the dealer, big six, gin rummy, five card stud poker, chuck-a-luck, keno, hold-em poker, and merchandise wheel); ILL. ANN. STAT. ch. 85, ¶ 2302 (Smith-Hurd 1987 & Supp.

tax-exempt status may be used to determine eligibility as a nonprofit or charity.<sup>419</sup>

1992) (authorizing raffles by nonprofits); IOWA CODE ANN. § 99B.7 (West 1984 & Supp. 1992) (authorizing entities exempt from federal income taxation to conduct games of skill, games of chance, and raffles) — (Subsection b of this section provides detailed restrictions on the use of proceeds of gambling sponsored by nonprofits); LA. REV. STAT. ANN. § 33-4861 (West 1988 & Supp. 1992) (authorizing raffles, bingo, and keno for charitable purposes conducted by organizations exempt from federal income taxation pursuant to §§ 501(c)(3), (4), (5), (6), (7), (8), (10), or (19) of the Internal Revenue Code); ME. REV. STAT. ANN. tit. 17, § 314 (West 1983 & Supp. 1991) (authorizing beano or bingo by nonprofit organizations); ME. REV. STAT. ANN. tit. 17, § 331 (West 1983 & Supp. 1991) (authorizing raffles by nonprofits); ANN. CODE MD. art. 27, §§ 236, 247-61 (1987 & Supp. 1991) (authorizing carnivals, bazaars or raffles by nonprofit organizations); MINN. STAT. ANN. § 349.12 (West 1990 & Supp. 1992) (authorizing gambling conducted by § 501(c)(3) articles as well as a wide variety of other charitable organizations); N.M. STAT. ANN. § 60-2B-2 (Michie 1989) (authorizing games of chance by certain nonprofits, including those specifically exempted from federal income tax pursuant to I.R.C. § 501(c)); N.C. GEN. STAT. § 14-309.5 (Michie 1988 & Supp. 1991) (authorizing licensed exempt organizations to conduct bingo games; § 14-309.6 defines "exempt organizations" as, among other things, organizations exempt from taxation under I.R.C. §§ 501(c)(3), (4), (8), (10), (19), or 501(d)); N.C. GEN. STAT. § 14-309.15 (1988 & Supp. 1991) (authorizing nonprofits to conduct up to two raffles per year); OHIO CONST. art. XV, § 6 (empowering General Assembly to authorize and regulate bingo games conducted by charitable organizations for charitable purposes); OHIO REV. CODE ANN. § 2915.08 (Anderson 1987 & Supp. 1990) (authorizing charitable organizations defined as, among others, entities exempt for federal income tax pursuant to I.R.C. §§ 501(a), 501(c)(3), (4), (8), (10), or (19), to apply for licenses to conduct bingo games); OKLA. STAT. ANN. tit. 21 § 995.1 (West 1983 & Supp. 1992) (authorizing district court clerk to license certain organizations, including those exempt from federal income tax pursuant to §§ 501(c)(3), (4), (5), (6), (7), (8), (10), and (19), to conduct bingo games); S.D. CONST. art. 3, § 25 (authorizing legislature to authorize games of chance by public-spirited organizations when the entire net proceeds of such games are devoted to public-spirited uses); S.D. CODIFIED LAWS ANN. § 22-25-25 (1988 & Supp. 1991) (authorizing bingo and lotteries by nonprofits); TENN. CODE ANN. § 48-3-519 (1988 & Supp. 1991) (recognizing raffles as permissible charitable fundraising); VA. CODE ANN. § 18.2-340.2 (Michie 1989 & Supp. 1991) (authorizing licensing of nonprofits, including § 501(c)(3) organizations, to conduct bingo and raffles); WASH. REV. CODE ANN. § 9.46.0341 (West 1988 & Supp. 1992) (authorizing golfing sweepstakes by nonprofits); W. VA. CODE § 47-21-1 (1992) (statement of legislative intent authorizing raffles by charitable organizations for fund-raising purposes).

<sup>419</sup> See *supra* text accompanying note 418, particularly in reference to Louisiana, Minnesota, New Mexico, North Carolina, Ohio, Oklahoma, and Virginia statutory provisions for determining eligible entities.

In 1989, Tennessee repealed its statutory provision authorizing bingo games conducted by charitable organizations. See TENN. CODE ANN. section § 39-6-609 (1991) (authorizing bingo games by entities exempt from federal income tax

I) Miscellaneous State Law Provisions Immunizing Nonprofits From Civil Liability Under Certain Circumstances

In addition to the specific statutory provisions singling out nonprofits for favorable treatment discussed in this article, there are a significant number of nonuniform state statutes designed to immunize certain types of nonprofits or their agents from civil liability under a broad range of circumstances. The following examples are intended only as illustrations and are not an exhaustive catalog of all such provisions.

Perhaps the most important state statutes of this type are those immunizing officers and directors of nonprofit organizations from civil liability for their actions.<sup>420</sup> Another growing trend among the states is to absolve nonprofits from civil and criminal liability for injuries resulting from distribution of donated perishable foods to needy individuals.<sup>421</sup> Additional nonprofit immunity from civil

---

under I.R.C. §§ 501(c)(3), (4), (5), (7), (8), (10), and (19)), repealed by 1989 TENN. PUB. ACTS 591. Earlier that same year the state had been rocked by a state-wide bingo scandal involving a scheme by the state's former top bingo regulator turned lobbyist to help bingo game operators obtain fraudulent charters as charities. See Smothers, *Tennessee Republicans See an Election Weapon in State's Bingo Scandal*, N.Y. TIMES, Mar. 26, § 1, at 1, col. 2.

<sup>420</sup> The subject is treated at length in C. TREMPER, RECONSIDERING LEGAL LIABILITY AND INSURANCE FOR NONPROFIT ORGANIZATIONS (1989), including a state-by-state catalog of the various state law provisions and relevant court decisions relating to immunity for civil liability for officers and directors of nonprofit organizations at Appendix D. See also *Nonprofits' Officers, but not Volunteers, Protected from Suits in Most States*, CHRON. PHILANTHROPY, Sept. 18, 1990 at 28 (chart listing various legal protections for nonprofit employees on a state-by-state basis).

<sup>421</sup> See, e.g., CAL. CIV. CODE § 1714.25 (West 1985 & Supp. 1992) (nonprofit not liable for injury or death unless nonprofit negligent, reckless, engaging in intentional misconduct); FLA. STAT. ANN. § 768.136(3) (West 1976 & Supp. 1992) (no civil or criminal liability arising from condition of donated food distributed to needy unless injury caused by gross negligence, recklessness, or intentional misconduct of the nonprofit); ILL. ANN. STAT. ch. 56½ ¶ 2004 (Smith-Hurd 1985 & Supp. 1992) (no civil liability for illness or injury unless nonprofit is willful, wanton or reckless); IOWA CODE ANN. § 122B.1 (West 1984 & Supp. 1992) (immunity from civil and criminal liability, though no immunity for negligent, reckless, or intentional misconduct of the nonprofit); ME. REV. STAT. ANN. tit. 14, § 166 (1980 & Supp. 1991) (no civil liability for injury or death unless direct result of gross negligence, recklessness, or intentional misconduct of organization); MICH. COMP. LAWS ANN. § 691.1536 (West 1987 & Supp. 1992) (no civil liability on part of nonprofit unless illness or disease results from willful,

liability also may benefit sports officials, coaches, referees,<sup>422</sup> blood bank trustees and volunteers,<sup>423</sup> volunteers for charitable organizations,<sup>424</sup> library trustees and commissioners,<sup>425</sup> nonprofit thoroughbred racing association trustees,<sup>426</sup> participants in risk-pooling organizations, health-care organizations, health-care

---

wanton, or reckless acts of the nonprofit); S.D. CODIFIED LAWS ANN. § 39-4-23 (1985 & Supp. 1991) (nonprofit exempt from criminal penalty or civil liability for injury related to condition of donated food unless injury results from nonprofit's gross negligence, recklessness, or intentional conduct); TEX. CIV. PRAC. & REM. CODE ANN. § 76.004(b) (West 1986 & Supp. 1992) (nonprofit not criminally or civilly liable in connection with distribution of apparently wholesome food distributed to the needy unless injury or death results from the nonprofit's gross negligence, recklessness, or intentional misconduct); WYO. STAT. § 35-7-1301(b) (1991) (liability of nonprofit only for willful, wanton, or reckless conduct). See also COLO. REV. STAT. § 13-21-113(1) (1987 & Supp. 1991) (no civil or criminal liability for nonprofit which donates food to another nonprofit which distributes the donated food to the needy arising from nature, age, condition, or packaging of donated food, except where injury results from donating nonprofit's willful, wanton, or reckless act); MD. HEALTH-GEN. CODE ANN. § 21-322 (1990 & Supp. 1991) (exempts donor of food to nonprofit from civil liability for any act or omission that affects the nature, age, condition, or packaging of donated food); OHIO REV. CODE ANN. § 2305.37 (Anderson Supp. 1989) (immunizes donor of perishable food only, and not nonprofit entity, from civil liability for injury or death resulting from donation of perishable food); VA. CODE ANN. § 3.1-418.1 (Michie 1983 & Supp. 1991) (exempts donor only, not nonprofit donee, from injury or death resulting from the condition of donated food); W. VA. CODE § 55-7-16 (1981 & Supp. 1991) (similar to VA. CODE ANN. § 3.1-418.1).

The recent enactment dates of all of these state law provisions suggest a link to the homelessness of the eighties and early nineties and attempts to alleviate that problem.

<sup>422</sup> See, e.g., N.J. STAT. ANN. § 2A:62A-6 (West 1987 & Supp. 1991) (exempting amateur sports coaches, trainers and officials from civil action in damages related to a player's injuries).

<sup>423</sup> See N.J. STAT. ANN. § 2A:53A-7.2 (West 1987 & Supp. 1991).

<sup>424</sup> See N.C. GEN. STAT. §§ 1-539.10 - 1-539.11 (1992); OHIO REV. CODE ANN. § 2305.38 (Baldwin 1990); TEX. CIV. PRAC. & REM. CODE ANN. § 84.004 (West 1986 & Supp. 1992).

<sup>425</sup> See N.J. STAT. ANN. § 2A:53A-7.3 (West 1987 & Supp. 1991).

<sup>426</sup> N.Y. RAC., PARI-MUT. WAG. AND BREED. LAW § 202-c (McKinney's 1991) (exempting trustees of nonprofit racing association and any person acting on their behalf from personal liability for acts done within scope of trustee's authority, except for acts of malfeasance or gross negligence).

practitioners, and homeowners associations,<sup>427</sup> if such persons are individuals acting on behalf of one or more nonprofit organizations.

#### J) Government Assistance Programs<sup>428</sup>

In addition to myriad federal statutes singling out nonprofits for beneficial treatment, the United States Department of Agriculture (USDA) administers a number of programs that are designed to benefit the general public and employ nonprofit status as a screen for the eligibility of participating programs. Many of these USDA programs involve efforts to provide for adequate child nutrition through the National School Lunch Program and affiliated programs.<sup>429</sup>

While nonprofit status is often a measuring rod for eligibility for certain directly-conferred benefits, a variety of programs administered by USDA use nonprofit status as a means of limiting the participants in government aid programs that are administered

<sup>427</sup> See TEX. CIV. PRAC. & REM. CODE ANN. § 84.003(10)(C) (West 1986).

<sup>428</sup> Nonprofit organizations are also advised to consult the Catalog of Federal Domestic Assistance for assistance and benefits available from the federal government. This book is published annually by the Executive Office of the President, Office of Management and Budget, and the General Services Administration and is available from the Superintendent of Documents, Government Printing Office, Washington, D.C. 20402, as well as from United States Government Bookstores. The catalog is available on magnetic tape and diskettes, and access can be obtained through Federal Assistance Programs Retrieval System (FAPRS), a computer program available at public access facilities. *Id.* A number of assistance programs are available only to nonprofit entities, while many others are available to nonprofits, among others.

<sup>429</sup> See 42 U.S.C. § 1751 (1988) (National School Lunch Act) (embodying several statutory sections authorizing, among other things, direct federal reimbursement to schools participating in the National School Lunch Program, direct federal appropriations for expenditures for agricultural commodities and training for workers participating in the Program, funding and food to be provided to schools for use in the Program, emergency assistance for feeding needy children, federal reimbursement to service institutions for summer food service programs, purchase of surplus agricultural commodities to be used in the Program, and authorization for private tax-exempt institutions to participate in the USDA's child care food programs; 7 CFR § 210.2 (1990) defines "nonprofit" for purposes of determining eligibility of institutions to participate in the National School Lunch Program and related programs as an institution "exempt from income tax under section 501(c)(3) of the Internal Revenue Code of 1954, as amended . . ." The same section defines "school" as either a component of a state's public school system or a privately owned nonprofit school.

by nonprofits and designed to benefit third parties. These programs deal principally with aid to farm laborers in securing adequate housing,<sup>430</sup> aid to rural and small-town mutual self-help housing organizations,<sup>431</sup> loan assistance for outdoor water-based recreation facilities, water and soil conservation facilities, and community water storage facilities;<sup>432</sup> loans for rental or cooperative housing to elderly, handicapped, and low and moderate income individuals and families in rural areas;<sup>433</sup> water and waste disposal facilities for rural areas;<sup>434</sup> loans to improve community facilities providing essential services in rural areas;<sup>435</sup> business and industrial loans for improving energy efficiency, improving the rural economic climate, pollution abatement technology, and aquaculture in rural areas;<sup>436</sup> rural electrification;<sup>437</sup> and establishment of rural telephone networks<sup>438</sup>. Mention of these programs is made only to suggest the large number of activities in which nonprofits may become involved and to show the wide range of nonprofit activities that are eligible to receive federal government benefits.

#### K) Surplus Government Property

Another potentially significant tangible benefit to nonprofits is eligibility for donations of federal surplus personal property.<sup>439</sup> Nonprofit educational or public health institutions exempt from

<sup>430</sup> See 42 U.S.C. §§ 1484, 1486 (1988).

<sup>431</sup> See 42 U.S.C. § 1490(c), (d) (1988).

<sup>432</sup> See 7 U.S.C. §§ 1010, 1011 (1988).

<sup>433</sup> See 42 U.S.C. § 1485 (1988).

<sup>434</sup> See 7 U.S.C. § 1926 (1988).

<sup>435</sup> See *id.*

<sup>436</sup> See 7 U.S.C. § 1932 (1988).

<sup>437</sup> See 7 U.S.C. § 904 (1988).

<sup>438</sup> See 7 U.S.C. § 922 (1988).

<sup>439</sup> Federal surplus personal property donated to nonprofits in fiscal 1989 had an original acquisition cost of approximately \$460 million. Telephone interview with Mr. Walter Cozzens, N.Y. Regional Office, General Services Administration (Nov. 15, 1989).

income tax under Code Section 501 may receive surplus government personal property for educational or public health purposes (including research).<sup>440</sup> Federal law also provides that nonprofits may be eligible to purchase surplus federal real property at less than market value.<sup>441</sup> Nonprofits also may lease unused federal real property on an interim basis.<sup>442</sup>

Federal law also authorizes the Department of the Navy to donate or loan surplus personal property (including vessels) to, among others, Code Section 501(c)(3) exempt educational institutions and nonprofit educational museums.<sup>443</sup> The "Tools for Schools" program authorizes the Department of Defense to loan machine tools and other manufacturing equipment to any nonprofit educational institution when such loan will contribute materially to the national defense.<sup>444</sup>

<sup>440</sup> 40 U.S.C. § 484(j)(3)(B) (1988). See also 40 CFR § 101-48 (1990) (providing for acquisition by eleemosynary institutions of abandoned or forfeited alcoholic beverages for medicinal purposes; eleemosynary institutions wishing to participate in this program must submit a satisfactory statement establishing their nonprofit status); 41 C.F.R. § 101-49.3 (1990) (providing for acquisition by nonprofits of foreign gifts and decorations for display purposes). 42 U.S.C. § 3020j (1988) provides that any nonprofit organization receiving funds appropriated for programs for older Americans shall be entitled to receive federal surplus property.

<sup>441</sup> 40 U.S.C. § 471 (1988) provides for acquisition by § 501(c)(3) organizations of federal surplus real property for public health purposes; purchase by the nonprofit is at a discount from market value equal to a "public benefit allowance" calculated by the government. The "public benefit allowance" equals the amount of benefit accruing to the United States as a result of the purchase of subject property by a nonprofit. The allowance can equal as much as 100% of the value of the subject property, effectively converting a purchase program into a donation program.

<sup>442</sup> 41 C.F.R. 101-47.312 (1990).

<sup>443</sup> 40 U.S.C. § 484(i) (1988); 32 CFR § 736.5(f)(1)(ii) (1990); 10 U.S.C. §§ 2572(a)(4), 7308(a)(3), 7545(a)(8) (1988). Cf. 14 U.S.C. §§ 92(d), 93(h) (1988) (conferring similar power on the Secretary of the Navy and on the Commandant of the Coast Guard, respectively); 14 U.S.C. 641(a) (1988) (empowering Commandant of the Coast Guard to dispose of surplus or obsolete Coast Guard property to, among others, nonprofits).

<sup>444</sup> 50 U.S.C. § 453(a)(7) (1988).

## L) Financial Reporting And Accounting Standards

### 1) Nonprofit Accounting Concepts

It has been remarked that in five main areas, accounting principles followed by nonprofits frequently have differed from those followed by commercial entities.<sup>445</sup>

First, while commercial organizations nearly always use the accrual basis of accounting, nonprofit groups often use cash basis accounting. Some nonprofits use modified cash basis accounting, recording certain items on an accrual basis and others on a cash basis, while others keep records on a cash basis but convert them at year's end to the accrual basis.<sup>446</sup>

Second, unlike commercial entities, nonprofit organizations must use "fund accounting" to separate assets into categories that reflect the restrictions placed on the assets by donors.<sup>447</sup>

Third, treatment of fixed assets may differ. In commercial businesses, fixed assets ordinarily appear on the balance sheet as assets and are depreciated over their expected useful lives. In nonprofit accounting, treatment of fixed assets and depreciation has generated tremendous controversy and confusion, "because everyone seems to have a different idea about how fixed assets should be handled, and there is no single generally accepted principle or practice to follow."<sup>448</sup>

Fourth, nonprofits often make transfers between "funds." These transfers, as well as appropriations for future programs, must

<sup>445</sup> M. GROSS, W. WARSHAUER & R. LARKIN, FINANCIAL AND ACCOUNTING GUIDE FOR NOT-FOR-PROFIT ORGANIZATIONS 12-16 (4th ed. 1991). In nonprofit accounting, emphasis is placed on accountability and stewardship. *Id.* at 13.

<sup>446</sup> *Id.* at 13. For a short definition of the cash and accrual methods, see, e.g., *Knight-Ridder Newspapers v. United States*, 743 F.2d 781, 787-89 (11th Cir. 1984).

<sup>447</sup> *Id.* at 14.

<sup>448</sup> *Id.* at 15. "Some organizations 'write off' or expense the asset when purchased; others record fixed assets purchased at cost and depreciate them over their estimated useful life in the same manner as commercial enterprises. Still others 'write off' their fixed asset purchases, and then turn around and capitalize them on the Balance Sheet. Some depreciate; some do not." *Id.*

be accounted for in financial statements. Commercial enterprises make no such transfers or appropriations.<sup>449</sup>

Fifth, nonprofits must record pledges and contributions (cash and noncash) as income. Commercial enterprises rarely receive such "income." Among the problems facing nonprofits in recording these items are: (i) where and how restricted (and unrestricted) contributions should be recorded, and (ii) when, and at what value, noncash contributions should be recorded.<sup>450</sup>

## 2) Setting Accounting Standards for the Nonprofit Sector

Historically, organizations responsible for setting accounting standards did so with profit-making entities in mind. Consequently, nonprofit accounting standards have developed gradually.<sup>451</sup> Various industries have developed guides for their own constituencies,<sup>452</sup> and, in the 1970s, the American Institute of Certified Public Accountants ("AICPA") published specialized pronouncements for specific types of nonprofits.<sup>453</sup>

449 GROSS, WARSHAUER & LARKIN, *supra* note 445, at 14.

450 *Id.* at 15.

451 R. Swieringa, *The Future of Financial Reporting for Nonprofit Organization*, PHILANTHROPY MONTHLY, Oct. 1989, at 6-7.

452 Associations such as the National Association of College and University Business Officers, the American Hospital Association, the National Health Council, the United States Catholic Conference, and the United Way of America have pioneered the development of these guides. See Swieringa, *supra* note 451, at 7.

453 These AICPA pronouncements "have some authoritative status" but "do not formally constitute generally accepted accounting principles." GROSS, WARSHAUER & LARKIN, *supra* note 445, at 368. The pronouncements consist of three industry "audit guides" — *The Audits of Providers of Health Care Services (formerly Hospital Audit Guide)* (1990), *Audits of Colleges and Universities* (1973), and *Audits of Voluntary Health and Welfare Organizations* (1974; 2d ed. 1988) — and a "statement of position" that applies to all other nonprofit organizations, *Statement of Position 78-10, Accounting Principles and Reporting Practices for Certain Nonprofit Organizations* (1978). Statement of Position 78-10 has since been reissued as part of the Audit Guide, "Audits of Certain Nonprofit Organizations". GROSS, WARSHAUER & LARKIN, *supra* note 445, at 309. "The Statement of Position is applicable to all not-for-profit organizations not covered by one of the three Audit Guides [other than governmental units and certain business-oriented entities, e.g., mutual savings banks]." *Id.* at 310. See generally *id.* at 201-342 for a discussion of all of these pronouncements.

In 1979, the Financial Accounting Standards Board ("FASB")<sup>454</sup> decided to issue as FASB statements the accounting and reporting principles and practices set forth in all then-existing AICPA pronouncements, including the specialized pronouncements for nonprofits. At the same time, FASB undertook a conceptual study to address inconsistencies among the AICPA guides for nonprofits. Subsequently, FASB issued two "concept statements" providing a basis for considering specialized nonprofit accounting principles. In 1986, FASB added to its agenda a project to develop accounting standards for contributions and depreciation. FASB also asked the AICPA to prepare a report on display issues (the display of financial information) for nonprofits.<sup>455</sup>

## 3) Current Developments

FASB's projects have taken substantial time to complete, although two major projects recently have been completed. Until official action is taken on an issue, the existing AICPA pronouncements<sup>456</sup> reflect the highest professional authority on the subject, and, along with various industry guidelines,<sup>457</sup> continue to have great impact.<sup>458</sup> Adoption of FASB's initiatives has faced roadblocks, according to one observer, because of four "conceptual challenges" or unanswered questions: *First*, Should distinctions be made between for-profit and nonprofit organizations? *Second*, what transactions and events should be reported in financial statements?

454 In 1973, the Accounting Principles Board of the AICPA turned over its authority to establish formal accounting principles (or "generally accepted accounting principles") to an independent, new organization — FASB. See GROSS WARSHAUER & LARKIN, *supra* note 445, at 369.

455 See generally, Swieringa, *supra* note 451; UNITED WAY OF AMERICA, ACCOUNTING & FINANCIAL REPORTING: A GUIDE FOR UNITED WAYS AND NOT-FOR-PROFIT HUMAN SERVICE ORGANIZATIONS 2-3 (rev. 2d ed. 1988) [hereinafter GUIDE FOR UNITED WAYS]; FINANCIAL ACCOUNTING STANDARDS BOARD, INVITATION TO COMMENT - FINANCIAL REPORTING BY NOT-FOR-PROFIT ORGANIZATIONS: FORM AND CONTENT OF FINANCIAL STATEMENTS (Aug. 29, 1989) [hereinafter "INVITATION TO COMMENT"].

456 See *supra* text accompanying note 453.

457 See *supra* text accompanying note 452.

458 See, GROSS & WARSHAUER, *supra* note 445, at 307-08; see generally GUIDE FOR UNITED WAYS, *supra* note 455.

*Third*, what form should financial statements take and what should be their content? *Fourth*, what are the boundaries of the reporting entity?<sup>459</sup>

Depreciation of capital assets had been the biggest unresolved issue blocking adoption of nonprofit accounting standards. That controversy was bound up with the existing jurisdictional distinction between FASB and the Governmental Accounting Standards Board (GASB).<sup>460</sup> In 1987, FASB Standard 93 was issued, requiring hospitals, health and welfare organizations, colleges, universities and other nonprofit organizations and universities to recognize depreciation. In 1988, FASB voted to postpone its implementation because, after Standard 93 was issued, GASB issued its own Statement 8 which "was carefully written to stop the extension of [FASB's] requirements to entities that currently are not required by industry or GASB pronouncements to depreciate capital assets."<sup>461</sup> FASB's

<sup>459</sup> See Swieringa, *supra* note 451, at 7-13.

<sup>460</sup> Both entities are the creations of a private, nonprofit organization organized in 1972, the Financial Accounting Foundation. Generally speaking, GASB is empowered to set standards for activities and transactions of state and local governments, while FASB's mandate is to set standards for all other entities. However, GASB also has jurisdiction over entities such as hospitals, colleges and universities (and utilities, authorities and pension plans) when those entities' financial statements are issued by state and local government units. Thus, as the jurisdictional lines are drawn, a private nonprofit hospital, college or university is within the jurisdiction of FASB, while its public counterpart may be within the jurisdiction of GASB. See *Facts & Circumstances about the FASB-GASB Dispute*, PHILANTHROPY MONTHLY, July/Aug. 1988, at 8; Swieringa, *supra* note 451, at 8.

Reporting standards for federal governmental entities are set by the General Accounting Office (GAO), an agency of Congress established by the Budget and Accounting Act of 1921. The body of principles and standards developed by the GAO appears as Title 2 of the General Accounting Office Policy and Procedures Manual for Guidance of Federal Agencies. The GAO also has audit rights, under law and contractual clauses, in most major Federal contracts and grants. See generally, J. BEDINGFIELD, ACCOUNTING AND FEDERAL REGULATION 284-298 (1982); J. BEDINGFIELD & L. ROSEN, GOVERNMENT CONTRACT ACCOUNTING (2d ed. 1985).

<sup>461</sup> Swieringa, *supra* note 451, at 9. In addition,

Statement 8 acknowledges that specialized accounting and reporting principles for hospitals, for health and welfare organizations and for certain nonprofit organizations (with exceptions) require depreciation accounting. It also acknowledges that governmental entities that use proprietary (enterprise) fund accounting principles are required to depreciate fixed assets used in the production of goods or services provided or sold. Those different requirements made it necessary for GASB to differentiate among governmental entities in writing GASB Statement 8.

decision to defer implementation of Standard 93 was an accommodation to ease the settling of the FASB/GASB jurisdictional issue.<sup>462</sup> As of yet, the jurisdictional overlap in certain areas has not been finally settled, although FASB Standard 93 was implemented in 1990. For example, governmental colleges are under the jurisdiction of GASB, not FASB. GASB does not require government entities to depreciate fixed assets. With FASB Standard 93 in place, governmental colleges may opt to depreciate fixed assets or not.<sup>463</sup>

FASB has just completed two other projects, in development since the late 1980's. Standard 116 addresses contributions and is titled "Accounting for Contributions Reserved and Contributions Made"; it has been the subject of considerable controversy as to some of its proposals.<sup>464</sup> Standard 117 is "Financial Statements of Not-For-Profit Organizations", known informally as the "Display Project".<sup>465</sup> Both Standards were published in June 1993. Standard

*Id.*

<sup>462</sup> Swieringa, *supra* note 451, at 9. See also H. Suhrke, *FASB Postpones Requiring Nonprofits to Recognize Depreciation*, PHILANTHROPY MONTHLY, Feb. 1988, at 2. ("Matters came to a head in the field of higher education because that field is split among 'public' and 'private' colleges and universities." *Id.* at 6). See also H. Suhrke, *Does the House of Accounting Have a Faulty Foundation?*, PHILANTHROPY MONTHLY, Jan. 1988, at 33 (discussing a meeting between the National Association of College and University Business Officers (NACUBO) and the Trustees of the Financial Accounting Foundation). Nonprofit accounting issues, FASB's initiatives to establish accounting standards for nonprofit organizations, and FASB/GASB jurisdictional quandaries have received ongoing coverage in *Philanthropy Monthly*.

<sup>463</sup> GROSS, WARSHAUER & LARKIN, *supra* note 445, at 260.

<sup>464</sup> For example, regarding the proposals leading up to Standard 116, "[R]egulators and consumer groups warn that the new rules, which could become final early next year, fail to address two of the greatest areas of abuse: the listing by nonprofits of solicitation costs as program expenses instead of as administrative costs, and the treatment of donated goods that are handled by more than one nonprofit group." Cowan, *Proposed Accounting Rules Stir Debate About Charities*, N.Y. TIMES, Nov. 9, 1992, at D1, col. 1. Also controversial is a proposal to have unconditional pledges reported as assets.

<sup>465</sup> The INVITATION TO COMMENT, *supra* note 455, "is concerned with whether and, if so, how certain information should be displayed in the *general-purpose external financial statement* of not-for-profit organizations." *Id.* at 1 (emphasis added). The report by the AICPA to FASB discusses four issues — basic financial statements; the balance sheet; statement of changes in net assets; and statement of cash flows — and offers "advisory conclusions." Readers of the INVITATION TO COMMENT were advised that,

116 becomes effective for statements issued subsequent to December 15, 1994.

#### 4) Trends in Nonprofit Accounting

Warshauer and Gross have identified eight reporting and accounting trends among nonprofit organizations: (1) reporting on the entire organization, rather than on its individual funds; (2) reporting a bottom line, i.e., the excess of revenue and support over expenses; (3) greater similarity to profit-oriented reporting; (4) emphasis on functional reporting; (5) evolution of a single set of accounting principles and reporting practices for all nonprofits; (6) continued development of accounting manuals by various nonprofit industries; (7) greater uniformity in state reporting requirements; and (8) the introduction of proposals for new federal regulatory- and disclosure- type legislation, reflecting increased emphasis on full disclosure and accountability.<sup>466</sup>

### III) Conclusion: Better Methods To Oversee The Benefits Accorded Nonprofits

#### A) Problems Facing the Nonprofit Sector

The privileges and exemptions granted nonprofits have evolved on an *ad hoc* basis.<sup>467</sup> At the federal level, for example, Congress typically creates regulatory systems to accomplish specific goals, such as revenue raising, controlling anti-competitive behavior, distributing mail, or ensuring integrity in securities markets, and each system makes accommodations for the perceived needs of

---

[b]ecause the outcome of [the] review [by the Financial Accounting Foundation of jurisdiction over standard setting for state and local governmental units] is uncertain, it is not clear whether the results of this FASB study of financial statement display for not-for-profit organizations will be applied to all hospitals, colleges and universities, and certain other units of state and local government. However, all are encouraged to respond to this Invitation to Comment.

*Id.* at 2, n.3.

<sup>466</sup> See GROSS, WARSHAUER & LARKIN, *supra* note 445, at 374-79.

<sup>467</sup> See discussion, *supra*, at notes 4-11 and accompanying text.

nonprofits. As a result, the tax collection agency, the Internal Revenue Service, oversees the income tax exemption and related deductions for nonprofits; the Justice Department monitors antitrust compliance by nonprofits; the Postal Service, charged with delivering the mail under postage rates that cover handling costs, monitors nonprofit eligibility for discounted postal rates; and the Securities and Exchange Commission, charged with ensuring compliance with securities laws, monitors nonprofit exemptions from those laws. These are but a few examples of subject-area regulation of nonprofits in which the regulatory body responsible for a particular subject area also interprets and enforces nonprofit-specific regulations within that area. Such fragmentation of oversight perhaps furnishes a convenient method for enforcing industry-wide or subject-area regulations and an easy means of deciding who will accept responsibility for monitoring nonprofits in connection with specific areas of concern. If, for example, orderly revenue collection is the only goal, the Service should interpret and enforce nonprofit-specific tax rules. However, there are drawbacks to the regulation of nonprofits by agencies specializing in particular subject areas.

In many cases, regulatory systems are created to remedy a particular problem and work with a particular group — generally a group other than nonprofits.<sup>468</sup> Core responsibilities have first call on the agency's resources,<sup>469</sup> and constituencies larger and more

---

<sup>468</sup> For example, the Securities and Exchange Commission was established during the Great Depression to assure orderly regulation of the securities markets. The Federal Aviation Administration was established to regulate the airline industry. The Federal Communications Commission was established to oversee the communications industry. The National Labor Relations Board was established to regulate labor-management relations.

<sup>469</sup> "The [Internal Revenue] Service's basic mission is to produce revenues by collecting taxes. Since supervision of exempt organizations is nonproductive in these terms, it will always be a 'stepchild' within the Service. The highest priorities of personnel and budget must always lie elsewhere; charities cannot compete with income tax collections for the attention of high officials within the Service." RESEARCH PAPERS, *supra* note 3, at 2640-44. Marion Fremont-Smith has written "[T]he Internal Revenue Service is not the most appropriate agency to regulate the independent [nonprofit] sector. It lacks the more refined tools for compelling compliance available to state equity courts. It is not well placed to police disclosure provisions. Even if granted equity-type powers, its staff is neither by training nor by inclination suited to enforcement that is not designed to raise revenue." Marion Fremont-Smith, *Trends in Accountability and Regulation of Nonprofits*, in THE FUTURE OF THE NONPROFIT SECTOR 81 (Virginia A. Hodgkinson & Richard W. Lyman, eds. 1989).

insistent than the nonprofit sector will occupy its attention.<sup>470</sup> Most likely, the interests, values and policies served by charitable exemptions will be subordinate to those of a particular regulatory scheme.<sup>471</sup>

Secondly, regulatory agencies may view both nonprofits and for-profit entities within their bailiwick from the same perspective. Agencies' values and regulatory approaches, while designed for profit-motivated private businesses and persons, may not always be suited to dealing constructively with nonprofits, whose aims and purposes do not include profit maximization. For instance, the Service collects taxes and attempts to ferret out tax evasion. The Service may be tempted to view nonprofits as potential taxpayers and sources of tax avoidance, and it may view their activities as potential revenue sources rather than as efforts by nonprofits to promote their tax-exempt purposes.<sup>472</sup> Other agencies, which are even less involved with nonprofits, are even more susceptible to a slanted vision. Might not the Postal Service view rates for nonprofits in the context of covering costs? Does the SEC deal with nonprofits from the perspective of how to ensure the integrity of the securities markets, rather than what nonprofits need?

---

<sup>470</sup> See *infra* notes 472 and 481 and accompanying text.

<sup>471</sup> Note, however, that the Filer Commission in 1977 opined that the IRS has done a good job of remaining nonpartisan, objective and non-ideological in supervising charities. RESEARCH PAPERS, *supra* note 3, at 2642.

<sup>472</sup> Witness the UBIT controversy (see, *supra*, notes 92-103 and accompanying text). Carrying out its revenue collection mandate, the Service viewed nonprofits' business activities as improper and sought to tax them. The Service focused on collecting taxes on income from profit-making activity. It viewed charitable fundraising by means of commercial activities in competition with for-profit firms through the same lens as commercial activity by profit-motivated enterprises, notwithstanding the beneficent uses of nonprofits' earnings. The Service consequently attacked nonprofits' business activities. Though unsuccessful in the courts, the Service helped sway Congress, which enacted the unrelated business income tax. While economically valid, the Service revenue collection mandate caused it to give less weight to the public purposes to which nonprofits' income is devoted, and consequently to adopt a policy which may not maximize societal benefit. Though an impartial weighing of the evidence may prove the Service correct, the Service may lack the institutional capacity or temperament to strike the proper balance between its revenue collection goal and the revenue-depleting but welfare-enhancing objectives of nonprofits. Service personnel are trained to favor revenue collection; moreover, charitable purposes have previously proven unavailing against concerns about tax base erosion.

Finally, there is no provision for coordination among these diverse agencies. Each agency acts on its own. Congress therefore, has not proven an effective architect of comprehensive nonprofit policy. It has been unable even to articulate a clear policy for regulating nonprofits.<sup>473</sup> Witness the scanty legislative history about and *ad hoc* character of most provisions of law affecting nonprofits. Exemptions have been created based on the exigencies of the moment without more than a generalized benevolence toward the nonprofit sector.<sup>474</sup> Nonprofits tend to come to the attention of Congress and state legislatures only when complaints are aired concerning their activities or when national crises intervene.<sup>475</sup> Lacking a clear policy toward the nonprofit sector, Congress may enact legislation unfairly detrimental to nonprofits. For instance, in shaping the tax rules affecting nonprofits, Congress originally sought to avoid negative impacts on charities; subsequently, it has changed the law to discourage perceived evasions and abuses involving the nonprofit sector.<sup>476</sup>

Furthermore, when Congress has focused attention on the nonprofit sector, its behavior sometimes has followed the shifting winds of politics. Sensationalism, opportunism, and populist distrust of private wealth have had significant impacts on shaping nonprofit policy.

Since the early twentieth century, assorted politicians have attempted to link nonprofits, especially private foundations, with reprehensible beliefs and practices or to depict nonprofits as manipulated by individuals for selfish purposes. In 1916, the Walsh

---

<sup>473</sup> See RESEARCH PAPERS, *supra* note 3, at 2642 ("The supervisory functions of the Service with respect to philanthropy result from history and convenience, not rational design.")

<sup>474</sup> See generally, Kielbowicz and Lawson, *supra* note 321 (detailing the history of *ad hoc* exemptions from general postal rate increases afforded nonprofits); discussion, *supra* notes 4-11 and accompanying text.

<sup>475</sup> See *supra* notes 66-68 (political advocacy restrictions on nonprofits result of complaints from lawmakers); 69-91 (various restrictions on private foundations stemming from general distrust); 92-103 (unrelated business income tax enacted as result of complaints from for-profit businesses); 347 (restrictions on nonprofit mailings of "advertising material" resulting from complaints by for-profit entities); 421 (state laws immunizing donors of food to nonprofits from tort liability may be result of homeless crisis of 1980s and 1990s).

<sup>476</sup> See *supra* notes 45, 46, 54-56 (legislation aiding nonprofits); 63-65, 92-103 (legislation restricting or taxing nonprofits) and accompanying text.

Commission portrayed nonprofits as tools of a monied plutocracy seeking to insinuate itself into the "social service" sector, extending a system of control that supposedly existed in the business and political worlds. Twice, specific instances led Congress to severely limit lobbying and political campaign activities open to tax-exempt charities.<sup>477</sup> After World War II, the Cox and Reece Commissions attempted to link nonprofits with pro-Communist and anti-American activities. In the 1950's and 1960's, the Patman investigations portrayed foundations as playthings of the rich, serving the special interests of America's wealthiest. From an institutional standpoint, history suggests that Congress is not the body best suited to develop, unaided, a comprehensive nonprofit policy or to balance the competing interests of nonprofits and other sectors of society. Congressional action would be better coordinated if an agency provided guidance on the needs of nonprofit organizations, especially charitable ones.

Nonprofit status is seen by some observers as a potential means of circumventing regulations legitimately imposed by government. Indeed, there is considerable support for treating nonprofits the same as for-profit entities.<sup>478</sup> Society has not reached a consensus on, or even seriously considered, what optimum level of public benefits nonprofits should produce. Given widespread public needs, arguably every effort should be made to increase the output of public benefits.

The perceptions that the nonprofit sector is degenerating from an engine of social good into a cloak for private interests seeking privileges to the detriment of the public, or that it is more important to equalize the tax treatment of for-profits and nonprofits, may well stem from the lack of an influential government agency dedicated to regulating nonprofits from a global perspective — taking into account the myriad interactions of nonprofits with society at large — and so providing a forum to understand the contributions made by

477 See text accompanying notes 67 and 68, *supra*.

478 Witness, for example, the Unrelated Business Income Tax (UBIT). See also, *infra*, note 481 and accompanying text; JAMES T. BENNETT & THOMAS J. DILORENZO, *THE PROFITS OF NONPROFITS* (1989) (advocating treating nonprofits as for-profit entities to avoid conferring undeserved and unfair windfalls on nonprofits). See also the controversy over exempt tax status for nonprofit hospitals, e.g., in the introductions in the 102nd Congress of H.R. 790 and 1374 and the Summer, 1991 hearings before the House Ways and Means Committee.

nonprofits to society at large. On the other hand, negative perceptions may, in some instances, stem from reality.<sup>479</sup> At present, there appears to be no entity in the political process that oversees, regulates, studies (and sometimes promotes) the activities of the nonprofit sector or polices nonprofits on a global scale so as to discourage abuses of nonprofit status.<sup>480</sup> No department of the federal government is charged with regulating nonprofits, or with studying issues affecting nonprofits on a global scale. Consequently, no department considers or advances their interests or provides necessary checks, as is the case with other areas of the economy, such as the securities, aviation, and communications industries.<sup>481</sup> Another natural source of political support, nonprofits' beneficiaries, are either not cohesive enough, or do not individually secure sufficient benefits to make them a politically effective force against those who profess injury at the hands of nonprofits. Nonprofits themselves have not been successful self-promoters in the forums of government. For example, nonprofits lost the UBIT debate and recently saw their ability to mail a variety of quasi-commercial material at nonprofit rates curtailed.<sup>482</sup>

479 See Barringer, *United Way Head is Forced Out in a Furor Over His Lavish Style*, N.Y. TIMES, Feb. 28, 1992, at A1, col.1; Gergen, *Reforming Welfare at the Very Top*, U.S. NEWS & WORLD REP. Apr. 20, 1992 Vol. 112, No. 15, p. 43 (United Way former chief William Aramony forced to resign in scandal over extravagant expenditures allegedly charged to the United Way over recent three-to-four year period including "\$92,265 for limousine services; \$40,762 for Concorde flights across the Atlantic; \$37,984 for 29 trips to Las Vegas for himself and his associates, and \$33,650 for trips to Gainesville, Fla., home of a special female friend."

480 Those who might respond that nonprofits are free to operate as any other interest group in national politics and hire lobbyists to advocate their cause miss the point. Lobbyists do not come cheaply. Employing them would stretch already thin nonprofit budgets, taking funds away from the nonprofits' primary purpose of a nonprofit organization and heightening perceptions that too little of the public's contributions to nonprofits go toward directly benefitting the public.

481 In fact, just the opposite may be true. See M. Fremont-Smith, *Trends in Accountability and Regulation of Nonprofits*, in *THE FUTURE OF THE NONPROFIT SECTOR* 81, (Virginia A. Hodgkinson & Richard W. Lyman, eds. 1989). Ms. Fremont-Smith mentions the United States Small Business Administration's attempts, beginning in 1980, to organize business people to sponsor state and local initiatives to rescind tax exemptions for charities carrying out commercial activities.

482 See *supra* notes 92-103 and 351-353 and accompanying text.

### B) Proposals for a Modified Regulatory System

In light of these problems, the idea of centralizing nonprofit regulation is appealing. An organization with an institutional mandate to focus on the nonprofit sector would be able to effect a consistent and constructive regulatory policy.<sup>483</sup> The decentralized approach, which leans heavily on the Internal Revenue Service as primary nonprofit regulator, while perhaps satisfactory at the inception of the regulatory system in the first half of this century, is no longer adequate. Both the areas regulated by government and the nonprofit sector have grown increasingly broad and complex, and issues arising from nonprofits' activities thus have multiplied. Subject area regulation by various expert regulatory agencies can be a source of conflicting policies and disparate treatment of nonprofits, as agencies developing enforcement policies take differing policy views of nonprofits and their societal roles. For instance, the NLRB abandoned the "not-engaged-in-business" theory for exempting nonprofits from labor regulation, but the FTC still uses it because it is a statutory prerequisite for its jurisdiction. The IRS and Postal Service employ different definitional tests for "educational" organizations,<sup>484</sup> so that nonprofit educational institutions may be subject to different treatment by each agency.

Occasionally, it is unclear who has the ultimate authority for regulating or promulgating standards for nonprofit conduct within a particular subject area. The current FASB/GASB jurisdictional turf war over nonprofit accounting and financial reporting standards is an obvious example. Currently, two different rule-making bodies set accounting and financial reporting standards for colleges in the U.S., solely because some colleges are private (and nonprofit) and others (also nonprofit) are run by state or local governments.

<sup>483</sup> This idea is not novel. See RESEARCH PAPERS, *supra* note 3, at 2640-44 (proposing a 'National Commission on Philanthropy'). Great Britain employs a system of Charity Commissioners who monitor nonprofits in a centralized fashion. See, generally, M. FREMONT-SMITH, FOUNDATIONS AND GOVERNMENT 409-423 (1965); Charities Act of 1992, ch. 41 (1992) (Eng.).

<sup>484</sup> See *Big Mama Rag, Inc. v. United States*, 494 F. Supp. 473 (D.D.C. 1979), *aff'd in part and rev'd in part*, 631 F.2d 1030 (D.C. Cir. 1980) (striking down as unconstitutional the Service's definition of "educational," which definition is substantially similar to the Postal Service's definition of "educational."). While the IRS has changed its working definition of "educational" as a result of this decision, the Postal Service still employs the older definition.

Two competing models of regulation of the nonprofit sector emerge. One, the currently prevailing model, relies on regulation of nonprofits by agencies within discrete fields of expertise. A nonprofit is subject to regulation by as many of these agencies as the nonprofit's activities embrace. Thus, a nonprofit which both issued securities and mailed solicitations for funds would be subject to SEC and Postal Service regulation. The other model envisions an agency responsible for regulating nonprofits *qua* nonprofits, regardless of the different activities and fields of for-profit regulation the nonprofit's activities include. Choosing one model over the other depends on whether common regulatory questions and issues affecting nonprofits as a group predominate over issues peculiar to various discrete areas of for-profit regulation.<sup>485</sup>

Is there a broad rule or policy specifically applicable to nonprofits in all their varied dealings with government, or to all regulation of nonprofits, which could be applied most consistently in different fields of regulation by a single central agency charged with oversight of nonprofits? Alternatively, are policies or values of a specific area of regulation equally applicable to all entities subject to that system, whether for-profit or nonprofit, so that administration by an expert agency specifically charged with implementing those policies best accomplishes the desired objectives in the nonprofit and for-profit areas? Put another way, is there a common denominator in regulating nonprofits in such diverse fields as labor, tax, trade regulation, civil rights, government transfer payments, and securities regulation?

There is a common nonprofit policy issue imperfectly addressed in the present regulatory system. It springs from the uniqueness of nonprofits. Nonprofits dedicate their assets to promoting the general welfare. Since nonprofits are organized and operated for socially beneficent purposes, it is in the government's interest to encourage their activities and to enable them to maximize their opportunities for doing good. This should be the unifying principle governing regulatory determinations affecting nonprofits. An agency charged primarily with implementing this policy might

<sup>485</sup> More simply, the choice of one regulatory model over the other may depend on whether a convincing case can be made that the nonprofit sector merits consideration as an "industry" unto itself, susceptible to regulation on an expert agency model. That question has yet to be satisfactorily addressed by the nonprofit community. It is a subsidiary purpose of this article to stimulate thinking about the nonprofit "industry" issue.

be able to harmonize all fields of regulation with this goal, thus achieving the maximum benefit from the nonprofit sector's activities, while protecting the integrity of other regulatory systems. Such an agency would be better equipped to judge whether nonprofit undertakings, perhaps looked on askance by an enforcement agency, produce significantly greater societal benefits than detriments.

For instance, while an antitrust perspective suggests it might be undesirable to allow colleges and universities to collaborate on tuition levels, financial aid, and faculty salaries, such concerted efforts might prove educationally beneficial, enhancing the diversity of educational opportunities at these institutions.<sup>486</sup> In seeking consistent application of antitrust laws, society may lose a more important benefit afforded by collaboration among institutions of higher learning. The principal reason for according these institutions protections from many demands imposed on the much larger for-profit sector is that they have goals different from society's more common profit-oriented aims. That higher educational institutions feel it necessary to collaborate on tuition, financial aid, and faculty salaries suggests the need for some agency capable of striking a balance between the competing values of vigorous antitrust enforcement and diversity and efficiency in education, giving due weight to each.

A second ground for centralized nonprofit regulation exists even if there were no special, different policy goals affecting charities. The structure of nonprofits may be fundamentally different from other organizations, and many unique questions arise because of this.<sup>487</sup> In other industries that are structurally unique, a parallel dedicated regulatory apparatus, expert in these special matters, is set up to decide questions affecting them.<sup>488</sup> Further

<sup>486</sup> Because it cannot afford to fund less popular areas which lend richness and diversity to these colleges and society at large, the "low bidder" producing education may very well seek to maximize efficiency by offering only the most popular and mainstream courses of study.

<sup>487</sup> For example, questions arise about the treatment of nonprofit accounting issues and questions about whether individuals who work for nonprofits should be treated as employees or volunteers.

<sup>488</sup> The analogy here is to the railroad, banking, and insurance industries, whose operations present specialized problems calling for expert regulation and oversight. An initial problem in setting up an industry-wide regulatory mechanism for nonprofits would be wasteful duplication of effort. Undoubtedly, until such a mechanism was fully operational, the IRS and other agencies

research may reveal that the nonprofit sector should be considered an industry of this nature, one that needs a parallel comprehensive administrative structure.<sup>489</sup>

The structure of a nonprofit industry regulatory agency can be sketched briefly.<sup>490</sup> At the federal level, it would take over those functions of the cabinet-level departments and independent agencies which affect nonprofits.<sup>491</sup> Alternatively, if regulating nonprofits via the Internal Revenue Code is simply too entrenched to abandon, a regulatory collaboration between the IRS and, for example, the FTC, the FCC, or the Postal Service, might be undertaken to regulate nonprofits much the same way the Internal Revenue Service and the Labor Department currently jointly regulate employee benefit plans.<sup>492</sup> Perhaps nonprofit regulation could be partly centralized by the National Association of Attorneys General (NAAG), which proved effective during the 1980s in building, coalescing, and supporting efforts by state attorneys general to enforce laws the

---

charged with monitoring nonprofits would need to continue that monitoring. Additionally, shifting personnel from the IRS and other government agencies to create a global regulatory body might deprive experts in nonprofit regulation of the benefits of professional exchanges with their colleagues regulating the for-profit sector.

<sup>489</sup> See RESEARCH PAPERS, *supra* note 3, at 2640-44. The Filer Commission ultimately declined to endorse creation of a National Commission on Philanthropy. Note, however, that the Commission Report was filed in 1977. Several important changes in the nonprofit sector have occurred since then, e.g., the Reagan era's "New Federalism" which slashed government aid to social service agencies, magnifying the importance of the nonprofit sector in providing essential services from which the government had pulled back.

<sup>490</sup> The precise structure of such a regulatory body is less significant than focusing thinking on the need to provide for uniform nonprofit regulation. Indeed, any bureaucratic structure is open to criticism, as the Filer Commission noted. *See id.* at 2640-44 (bureaucratic delays and personnel problems experienced by IRS in supervising nonprofits not likely to disappear on creation of a National Commission on Philanthropy).

<sup>491</sup> Perhaps one of the greatest challenges to face a national nonprofit regulatory body would be remaining apolitical. *See* RESEARCH PAPERS, *supra* note 3, at 2642 (noting IRS had done well at remaining apolitical in regulating nonprofits). Recall the audible groaning by environmentalists at former President Reagan's appointment of James Watt to head the Department of the Interior, controversies over administrators of the National Endowment for the Arts, and criticisms of members of the Civil Rights Commission.

<sup>492</sup> *See* M. Fremont-Smith, *Trends in Accountability and Regulation of Nonprofits*, *supra* note 481.

Reagan administration had chosen to neglect — such as antitrust and consumer laws.<sup>493</sup> For example, NAAG could sponsor communications programs, seminars and strategic planning sessions for assistant attorneys general who staff state charities bureaus. At the state level, an interstate compact along the lines of the Multistate Tax Compact could be entered into which could then develop regulatory programs to be carried out by individual states.<sup>494</sup>

---

493 See Abrams, *Developments in State Antitrust Enforcement*, *supra* note 220.

494 Separate statement of Jan E. Stone:

I do not think the “drawbacks” my co-authors attribute to the current regulation of nonprofit organizations justify the formation of a federal regulatory agency overseeing nonprofits. My co-authors argue, in part, that because the interests of for-profits dominate existing regulatory agencies, the “interests, values and policies” of nonprofits either are given short shrift or are not understood, and therefore are not well served. Pointing to the UBIT controversy and conceding that “an impartial weighing of the evidence may prove the Service correct” with respect to that controversy, my co-authors suggest that “the Service may lack the institutional capacity or temperament to strike the proper balance” between goals of revenue collection and the objectives of nonprofits (emphasis added). Similarly, they speculate about “what if” scenarios with respect to the regulation of nonprofit activity by the Postal Service and by the SEC.

More importantly, they assert that Congress “has not proven an effective architect of comprehensive nonprofit policy” and refer to the “*ad hoc* character of most provisions of law affecting nonprofits.” My co-authors speak of the “industry” of nonprofits as an area as susceptible to centralized regulation as, for example, the securities, aviation or communications industries. Although I recognize that nonprofits have a common purpose (essentially, serving the public and not paying out dividends), they perform many different functions and provide many different services. In my view, what nonprofits have in common is *not* the same thing that businesses within a for-profit industry have in common. Indeed, the nonprofit sector is extremely varied and diverse in the activities and the specific aims of its various members— its members include performing and visual arts organizations, social welfare agencies, country clubs and chambers of commerce. Can one federal agency effectively and efficiently serve the interests and regulate the practices of a sector that comprises such different “industries”?

Moreover, nonprofits are diverse in another way: Many are well-established institutions, with substantial assets and real estate holdings, operating on big budgets and led by well-paid executives and influential directors; at the other end of the spectrum are nonprofits that advocate for the few rather than for the many, are housed in store-front spaces (or have no permanent homes at all) and struggle on shoestring budgets. Is it not likely, following my co-authors’ own reasoning, that in a centralized agency whose mandate is to regulate nonprofits, the interests of smaller, less established (and quite possibly controversial) organizations would be subordinate to the interest of large, powerful “mainstream” nonprofit institutions?

One thing is clear for the future of nonprofits. In an age of interest group politics, nonprofits may be forced to lobby hard and at great expense to ensure continued government support of the nonprofit sector. This lobbying, in turn, will appropriate much-needed funds from the good works nonprofits perform. The federal government and state governments could allay this problem and allow the nonprofit sector to continue serving society at a high level by developing comprehensive regulatory guidelines for nonprofits either within the existing regulatory framework or by creating a global oversight agency. Governments have an interest in approaching nonprofit regulation from a global perspective in light of the growing importance of nonprofits that serve areas impoverished by slashed government funding.<sup>495</sup> Most simply, as nonprofits play a more important role, the argument for a government agency that centralizes or coordinates all aspects of nonprofit operations becomes increasingly persuasive.

---

In short, however attractive I find the idea or appearance of a federal agency that would tend to not-for-profit interests and activities — especially since I tend generally to favor federal regulation in many areas — the idea does not seem particularly practical or workable.

Nor do I think that the creation of such a regulatory agency would necessarily solve certain problems or curb certain abuses, as my co-authors suggest. For example, I think it is unrealistic to expect that the creation and existence of such an agency would prevent the “diversion” of nonprofit funds for lobbying efforts. If anything, a new federal bureaucracy would be supported by taxpayers’ dollars (which might otherwise have been used for charitable purposes). Even then, it seems unlikely that lobbying by nonprofits would be reduced.

My preference — an option advocated in part by my co-authors— is that if current federal regulation falls short, NAAG could pick up the ball. That approach has proven effective already (see *supra* text accompanying note 493). I also think that there is merit to the proposal of NAAG-sponsored seminars and planning sessions for assistant attorneys general who staff state charities bureaus.

In addition, the nonprofit sector itself might address common concerns by developing new (or increased) methods for greater and more systematic self-regulation.

---

495 See VIRGINIA A. HODGKINSON & RICHARD W. LYMAN, *THE FUTURE OF THE NONPROFIT SECTOR: CHALLENGES, CHANGES, AND POLICY CONSIDERATIONS 1* (1989) (mentioning major Reagan era cuts in federal nonprofit funding).