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Chalk Talk

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The Tax Exempt Educational Organization

The complexity of the tax legislation is so pervasive that one is easily tempted to conclude that most of it is ghostwritten by Henry Clay.[1] The provisions pertaining to tax-exempt educational organizations are no exception.

How does an educational organization obtain tax-exempt status and does the Internal Revenue Service allow tax-free treatment to all of the organization's income? A brief response will be provided in answering the above questions before proceeding to an analysis of such.

The Treasury Regulations defines what can be considered an educational organization, but this definition has been viewed by some as inadequate to determine who will receive tax-exempt status. The Internal Revenue Service provides a methodological test to clarify the Treasury definition. However, even though this status is defined, it must be noted that tax-exempt status is revocable.

Not all income of a tax-exempt educational organization is tax free. Income which is unrelated to the organization's tax-exempt purpose will be deemed taxable. Additionally, the income derived from a taxable corporation owned by a tax-exempt organization is taxable.

I. Tax-Exempt Status

Educational defined. The Treasury Regulation originally provided the following definition of the statutory term "educational":[2]

> [A]n organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion.[3]

The Court in *Big Mama Rag Inc.*,[4] held that the Treasury Regulation definition of the term "educational" lacked sufficient specificity to pass constitu-

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[1] Louisiana Credit Union League v. United States, 693 F.2d 525, 530 (5th Cir. La. 1982).

[2] National Alliance v. United States, 710 F.2d 868, 869-70 (D.C. Cir. 1983).

[3] Treasury Reg. §1.501(c)(3-1d)(3)(i)(1985).

[4] Big Mama Rag, Inc. v. United States, 631 F.2d 1030, 1039 (D.C. Cir. 1980).

tional muster. The Court stated further that the "full and fair exposition" standard was too vague; it neither described who was subject to the standard nor articulated substantive requirements.[5] Additionally, the court stated that the regulations authorizing tax exemptions should not be so unclear as to afford freedom for subjective application by Internal Revenue officials.[6]

One may turn to the Internal Revenue Service for a further definition of "educational." The Internal Revenue Service has formulated the Methodology test to distinguish between educational and non-educational expressions. This test is concerned with the method employed by the advocate, rather than the accuracy or general acceptance of his communication. The Methodology test contains the following four criteria:

> 1. Whether...the presentation of viewpoints unsupported by a relevant factual basis constitutes a significant portion of the organization's communications.
> 2. To the extent viewpoints purport to be supported by a factual basis, are the facts distorted.
> 3. Whether...the organization makes substantial use of particularly inflammatory and disparaging terms, expressing conclusions based more on strong emotional feelings than objective factual evaluations.
> 4. Whether...the approach to a subject matter is aimed at developing an understanding on the part of the addressees, by reflecting consideration of the extent to which they have prior background or training.[7]

"The Methodology test, supervised by the courts, is a carefully charted middle course."[8] Furthermore, this test reduces the vagueness of the regulations found by the court in the *Big Mama Rag Inc.* decision.[9] However, with clarity came rigidity and reluctance to grant exemption.

As an extreme example of a court's unwillingness to find an activity educational consider the following situation. One organization published newsletters and bulletins for the stated purpose of arousing in Americans of European ancestry an understanding of, and a pride in their cultural heritage and awareness of the present dangers of losing that heritage.[10] This objective and mission was outside the range Congress intended to subsidize through tax-exempt status.[11] Accordingly the application for tax exempt status was denied.

Revocation of tax-exempt status. The Internal Revenue Code must be construed and applied in conjunction with the federal public policy against support for racial segregation in public or private schools.[12] The Internal Revenue

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[5] *Id.*
[6] *Id.* at 1034.
[7] National Alliance, 710 F.2d at 874.
[8] *Id.* at 876.
[9] *Id.* at 875.
[10] *Id.* at 869.
[11] *Id.* at 873.
[12] Green v. Connally, 330 F.Supp. 1150, 1163 (1971).

Service will no longer grant tax-exempt status to racially discriminatory schools, including those that are church-related.[13] To obtain a tax-exempt status, a private school must show that all of its programs and facilities are operated in a nondiscriminatory manner.[14] These implementations have had far-ranging consequences: Private schools in Mississippi that were discriminating against black students were denied federal tax exempt status;[15] a university had its tax-exempt status revoked when it forbad interracial marriage and dating based on its belief in the scriptures.[16] In the latter case, the court ruled that the Internal Revenue Service acted within its statutory authority in revoking the University's tax-exempt status.[17]

Political activities can warrant revocation of tax exempt status. If an organization engages in substantial activities aimed at influencing legislation, its tax-exempt status will be revoked.[18] Political activities which are not substantial, do not disqualify educational organizations from their tax exempt status.[19] Limitations on political involvement stem from the Congressional policy that the United States Treasury should be neutral in political affairs and accordingly these attempts to influence legislation should not be subsidized.[20]

II. The Revenue Act of 1950

The changes made by the Revenue Act of 1950, in the statutory pattern affecting tax-exempt educational organizations were twofold:

> 1. With respect to [a tax-exempt education organization] engaged in carrying on both charitable activities and an active trade of business Congress established a new concept of 'unrelated business taxable income' and imposed a tax upon such income derived from the unrelated trade or business...
> 2. With respect to a feeder corporation, Congress removed any pre-existing exemption of such an organization...[21]

Unrelated business taxable income. The Treasury Regulations have established the following three-part test to determine unrelated business taxable income. The courts must ask if:

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[13] Bob Jones University v. United States, 639 F.2d 147, 150 (4th Cir. S.C. 1980).
[14] Rev. Proc. 75-50, ____ Cum. Bull. ____.
[15] *Green*, 330 F.Supp. at 1153.
[16] Bob Jones University, 692 F.2d at 149.
[17] *Id.* at 152.
[18] Haswell v. United States, 500 F.2d 1133, 1142 (Ct. Cl. 1974).
[19] *Id.*
[20] Christian Echoes Nat. Ministry, Inc. v. United States, 470 F.2d 849, 854 (10th Cir. Ok. 1972).
[21] Sico Foundation v. United States, 295 F.2d 924, 926 (Ct. Cl. 1961).

(1) the income is from a trade or business;
(2) the trade of business is regularly carried on by the organization; and
(3) the conduct of the trade or business is not substantially related to the organization's peformance of its exempt functions...[22]

The Internal Revenue Code and the Treasury Regulations provide a standard for determining when an activity rises to the level of a trade or business.[23] The code provides that "any activity which is carried on for the production of income" is deemed a trade or business.[24] The "motive" test may be used in the determination of a trade or business: Where an organization's motive is the production of income, such an activity constitutes a trade or business in satisfaction of the Internal Revenue Code.[25] In satisfying the second part of the three-part test, one might inquire as to whether the trade or business is ongoing and continuous.[26]

The Internal Revenue Code provides no definition of substantial relationship, thus, one is compelled to turn to the pertinent regulations.[27] Treasury Regulations have great persuasive force due to the expertise of the Internal Revenue Service in administering tax laws.[28] Consequently, the Regulations are followed as a guideline unless found to be unreasonable and plainly inconsistent with the code.[29] Resolution of the substantial relationship issue requires "...An examination of the relationship between the business activities which generate the particular income in question...and the accomplishment of the organization's exempt purposes."[30]

Once it is established that there is unrelated business taxable income, the issue becomes one of allocation. In one instance, a tax-exempt, educational organization owned and operated a fieldhouse which it used for both student and commercial purposes. The net income from the commercial use of the fieldhouse was unrelated business taxable income, subject to taxation.[31] Indirect expenses such as depreciation were apportioned on the basis of the actual hours that the facility was used for both exempt and taxable purposes. The court determined this to be a rational distribution of the cost of the facility.[32] Therefore, one may reasonably conclude that the items allocated to the unrelated

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[22] Louisiana Credit Union League, 693 F.2d at 531.

[23] *Id.* at 532.

[24] I.R.C. 513(c) (1984).

[25] *Louisiana Credit Union League*, 693 F.2d at 532.

[26] *Id.* at 534.

[27] *Id.*

[28] Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652, 656 (5th Cir. 1968).

[29] Commissioner v. Portland Cement Co., 450 U.S. 156 (1981).

[30] Treas. Reg. 1.513-1(d)(1) (1985).

[31] Rensselaer Polytechnic Institute v. Commissioner Internal Revenue, 732 F.2d 1058, 1059 (2d Cir. 1984).

[32] *Id.* at 1061-62.

trade or business activity would be deducted in computing unrelated business taxable income.[33]

This allocation method is consistent with that held by the tax courts in the most common dual situation; that of home-office deduction litigation.[34] Most home office deduction cases follow the determination that the applicable fraction was the total time used for business divided by the time the space was actually used for all purposes.[35]

Feeder Corporations. A feeder corporation can be described as a taxable corporation which is owned by a tax exempt corporation. The taxable corporation feeds all of its profits to the exempt corporation.[36]

Prior to 1950 an exempt organizatin could acquire a commercial business and avoid paying taxes on the income generated from such a commercial business.[37] During this period the law had been established that the destination of an organization's income was more important than the source of its income in the determination of exemption from taxation.[38] The Third Circuit held that the income from the largest manufacturer of noodles in the country was tax exempt since the corporation had been purchased by the New York University School of Law. The income in question was earned during 1947.[39] This is a classic example of the destination of income test. The income from the taxable corporation was destined for the tax exempt university; therefore, the income was tax exempt.

A drastic change of attitude came with the Revenue Act of 1950. In this Act Congress stated that the source and not the destination of the income was the deciding factor in the determination of tax exempt income.[40] Consequently, in the above example the noodle manufacturer would have been taxed on its income for the years affected by the Act, regardless that its profits went to the tax exempt university.

One reason for the legislative reform was the unfair advantage that the tax-exempt had over the tax paying corporations.[41] However, the reform was not only to eliminate unfair competition, but also to raise revenue.[42]

The presence or absence of competition between exempt and nonexempt organizations does not determine whether an unrelated trade or business is to

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[33] *Id.* at 1061.

[34] *Id.* at 1062.

[35] Browne v. Commissioner of Internal Revenue, 73 T.C. 723, 728 (1980).

[36] *Sico Foundation*, 295 F.2d at 928.

[37] *Louisiana Credit Union League*, 693 F.2d at 539.

[38] *Sico Foundation*, 295 F.2d at 926.

[39] *Louisiana Credit Union League*, 693 F.2d at 539, citing C.F. Mueller Co. v. Commissioner, 190 F.2d 120 (3d Cir. 1951).

[40] *Sico Foundation*, 295 F.2d at 925.

[41] *Louisiana Credit Union League*, 693 F.2d at 540.

[42] Clarence LaBelle Post No. 217 v. United States, 580 F.2d 270, 272 (8th Cir. Minn. 1978).

be taxed.[44] The critical question is not that of unfair competition, but whether the activity constitutes an unrelated trade or business which is subject to taxation.[45] Even though an unrelated trade or business has no adverse affect on taxable corporations, it will still be subject to taxation.

III. Conclusion

When proclaiming status as an educational organization, one must comply with the Methodology test to obtain such a tax exempt status. This test is a refinement of the Treasury Regulations defining educational. The Internal Revenue Service has statutory authority to revoke an educational organization's tax exempt status. An organization's status can be revoked if it is operating in a discriminatory manner. Additionally, revocation can occur where the organization is involved in substantial political activities.

The Revenue Act of 1950 had a double effect on tax exempt educational organizations. First, it created the concept of unrelated business taxable income. Such income which is not related to the tax exempt purpose of the organization is subject to taxation. Second, feeder corporations were taxed on their income even though it was fed to a tax exempt organization. It was determined to be irrelevant whether the feeder corporation was in competition with other corporations.

Currently, we are in a year that should produce the most extensive tax reform since the 1954 amendments. Our present Internal Revenue Code is referred to as the 1954 Code. Commentators speculate that the reform, a major event in the history of our taxation law, will be so drastic that the Code will be renamed as the 1985 Code.

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[43] *Louisiana Credit Union League*, 693 F.2d at 540.

[44] *Id.* at 542.

[45] *Clarence LaBelle Post No. 217*, 580 F.2d at 275 (Lay, J. concurring).