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Fifth Edition

Bruce R. Hopkins

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The Tax Law of Charitable Giving

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The fifth edition of this book is dedicated
to three individuals who are reshaping my life:
Patrick Oliver Hopkins, Isabel Marie Ash, and Sadie Helen Ash.
The first edition of this book was dedicated
to John J. Schwartz,
because of his tireless and selfless work
in the realm of philanthropy and charitable giving
for the good of others.

Contents

Preface

Although this sounds like a horrendous conceit, I marvel at this book. More accurately, I marvel at the *size* of this book. The very title suggests a subject that ought to be summarized in a pamphlet: *The Tax Law of Charitable Giving.* The principal reason for my amazement: How can something as seemingly simple and innocent as *charitable giving* generate so much law? It is, I suppose, a hallmark of our society; matters of law are quite complicated in the United States, and this includes the matter of the tax law consequences of transferring money and property to charitable organizations.

There is another reason for my wonder, one that is personal. By the early 1990s, this book had been on my mind for a long time. It had been written, in fits and starts, on many occasions over the years, with the manuscript pages ending up accumulating in this storage box and that file. It took some gentle prodding by the wonderful people at John Wiley & Sons—specifically, for the initiation of this project, Jeffrey Brown (long since promoted to Wiley's higher echelons) and Marla Bobowick (now a consultant in the charitable sector)—to get me going on completion of the book. The first edition appeared in 1993. Martha Cooley skillfully continued in the fashion of her predecessors; the second edition arrived in 1997. Susan McDermott provided the impetus for the third and fourth editions (2005, 2010) of the book. Lia Ottaviano oversaw production of this fifth edition.

It is not that I did not want to write this book; that is certainly not the case. In fact, I long dreamed of—it seems rather immodest to say it—a trilogy. This idea reflects what is now more than 45 years of law practice entirely in the realm of nonprofit organizations. I see the law uniquely affecting these organizations as falling into three general fields: the law of tax-exempt organizations, the law of fundraising, and the law of charitable giving.

By the time the pressure was mounting to write a book on charitable giving, the books on tax-exempt organizations law and fundraising law had been published (by Wiley, of course). Certainly, the time had come to begin (or rebegin) the writing of the third book. But I found my writing time diverted to other subjects (such as other books, book supplements, and my monthly newsletter); postponement of the charitable giving book had become the order of my days.

I have been writing books, published by Wiley, for more than 35 years. (The first book, the third edition of *The Law of Tax-Exempt Organizations*, was published in 1979. The predecessor to *The Law of Fundraising* was published in 1980.) These and other Wiley books I have been involved with entail the

writing of annual supplements. As the 1980s unfolded, I discovered something unusual: I enjoy writing supplements. (There is something perversely challenging about simultaneously correcting prior mistakes while capturing and integrating subsequent developments.)

Thus, while writing supplements to the tax-exempt organizations and fundraising books, I found myself wanting to write supplements for a book on the law of charitable giving. This was (and is) because of the immense swirl of developments in the law taking place in all three arenas. The problem, however, was obvious: One cannot supplement a book that does not exist—or exists only in the realm of the author's mind.

So I set about to finish what became the first edition of this book. This is not to imply that I wrote it just so I could justify the writing of supplements for it (although a case can be made that that was a partial reason). I wrote the book because I was impressed with the volume of law being generated in the field; I wanted readers to have a book that explains the basics and new developments concerning the law of charitable giving in a comprehensive manner.

The law on the subject of charitable giving has become intricate; there is no let-up in sight. Those who need to keep up with the law in this area deserve a single place to go to find both the fundamentals and the recent developments. With the trilogy now firmly in place (all three books being annually supplemented), the federal tax law of charitable giving can be placed in its appropriate context.

The first edition of this book captured the state of the law of charitable giving as of the close of 1992. Not surprisingly, the field exploded into new realms even as the book was being published. The Omnibus Budget Reconciliation Act of 1993 introduced law that significantly added to the administrative burdens of charitable organizations: more stringent substantiation rules and disclosure rules in the case of *quid pro quo* gifts. This legislation brought other revisions of the law of charitable giving, as did the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, and the IRS Restructuring and Reform Act of 1998. In these years, Congress also revised the antitrust and securities laws in the context of charitable giving.

The second edition was influenced only slightly by new legislation, the Tax Relief Extension Act of 1999. That edition would have been considerably different (and a bit thicker) had the Taxpayer Refund and Relief Act of 1999 not been vetoed.

The third edition took into account enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, the Victims of Terrorism Tax Relief Act of 2001, the Jobs and Growth Tax Relief Reconciliation Act of 2003, the Military Family Tax Relief Act of 2003, the American Jobs Creation Act of 2004, and the Working Families Tax Relief Act of 2004.

The two major relevant enactments that were introduced by the American Jobs Creation Act—concerning charitable gifts of intellectual property and motor vehicles—have since been augmented by guidance from the Internal

Revenue Service (IRS). These two provisions, bred of Congress's concern about abuses (read: overvaluations), are complex, discouraging of charitable giving, and otherwise troublesome. While the concept is understandable (given Congress's concerns), this matter of confining the federal income tax charitable contribution deduction to the amount the charity actually receives from holding or disposition of the property is terrible precedent. If that concept were extended to all charitable gifts of property (such as taking into account fundraising costs), the result would be disaster and chaos in the realm of charitable giving. More laws like this may be forthcoming unless something can be done about the underlying problem, which is standards and compliance as to gift property valuation.

The fourth edition summarized all of the applicable components of the Pension Protection Act of 2006, including the (temporary) rules pertaining to the exclusion from gross income for certain distributions from individual retirement arrangements, enhancements to the rules concerning contributions of inventory, the new law pertaining to recapture of tax benefits derived from certain gifts of tangible personal property, changes in the law concerning contributions for conservation purposes, new rules as to gifts of fractional interests, changes in the law concerning appraisals and appraisers, and, yes, the rules governing charitable contributions of taxidermy.

The case can be made that gift property valuation is the core issue, in the charitable giving law context, facing the charitable sector. This subject was, as noted, visited again when Congress enacted revised and new appraisal and appraiser rules in 2006. In advance of that, the House Committee on Ways and Means and Senate Finance Committee held hearings on the law pertaining to facade and conservation easements. The Commissioner of Internal Revenue at the time said that the IRS has discovered instances where the tax benefits resulting from these types of gifts (for the preservation of open space and historic buildings) have been "twisted for inappropriate individual benefit." The Commissioner of Tax Exempt and Government Entities (TE/GE) thereafter expressed the IRS's concern with the "misuse of our regulated tax-exempt community to generate unwarranted or hyper-inflated deductions" or other forms of participation in "tax abusive transactions." The IRS launched what the TE/GE commissioner termed a "robust examination program," investigating promoters, appraisers, contributors, and charitable organizations. "Most often," he said, the agency is finding "real valuation problems." Law that may dramatically affect the conservation easement community may also be indicative of more law on the subject of property gifts and valuation that directly impacts the entire charitable sector. Matters become even more dire as, increasingly, charitable deduction manipulation schemes become identified as abusive tax shelters.

The book also included references to the various provisions of charitable giving tax law that were extended (through 2009) by enactment of the Tax

Extenders and Alternative Minimum Tax Relief Act of 2008, which is Division C of the financial markets stabilization legislation.

As is commonly known, Congress has not been particularly productive recently; its legislative output has been scant. Thus, the only law that is new to this edition is the American Taxpayer Relief Act of 2012. That legislation, as is discussed in the book, extended four relevant tax provisions, altered some of the tax rates, reinstated a form of the personal exemption phaseout and limitation on itemized deductions, and made some changes in the estate tax rules.

The Treasury Department and the IRS are also quite busy in the charitable giving field, promulgating much in the way of regulations, notices, announcements, forms, private letter rulings, and technical advice memoranda. Issues and subjects in the realm of the tax law of charitable giving that the IRS has addressed in recent months include the timing of the charitable deduction in connection with gifts of stock options, gifts where the donor retains the ability to manage the gift property, regulations concerning the charitable remainder trust characterization and ordering rules, a controversial (and withdrawn) proposal concerning the impact of spousal elective share laws on the qualification of charitable remainder trusts, regulations concerning the taxation of charitable remainder trusts with unrelated taxable income, proposed record keeping and substantiation rules imposed in connection with cash and noncash contributions, proposed regulations concerning new rules pertaining to qualified appraisals and appraisers, and guidance issued by the IRS as to the federal tax consequences of division of charitable remainder trusts.

The IRS is engaged in a massive audit effort, targeting organizations such as credit counseling and down payment assistance organizations. While most of the law involved is that concerning tax-exempt organizations, some principles pertaining to charitable giving law are emerging. One in particular is the matter of the "mandatory contribution," evidenced in some of the factual situations concerning down payment assistance entities. This type of transfer is discussed in the book.

Still another IRS initiative discussed in the book is the agency's examination program pertaining to charitable contributions of certain so-called successor member interests in certain limited liability companies, launched by means of a prototype letter and information document request (IDR). This IDR asks some pointed questions that charitable organizations should ponder, particularly when formulating a gift acceptance policy.

The most momentous IRS initiative of all, however, is promulgation of the revamped Form 990, the annual information return filed by the larger charitable organizations. Of the many resulting ramifications of this return, one of the most significant is the reporting requirements concerning noncash contributions (reflected in Schedule M accompanying the return). The contents of this schedule and other relevant aspects of this annual information return are discussed in the book.

The courts continue to churn out opinions that shape and reshape the law of charitable giving. Certainly in recent years, there has been intense focus on cases concerning gifts of easements. In some instances, a charitable contribution deduction was allowed; in most instances, it was not. The latter instances involved circumstances where the special rules concerning conservation easements were not followed, there was a valuation issue, or the gift substantiation or appraisal requirements were not satisfied. Several recent opinions apply the accuracy-related and overvaluation penalties. These and other charitable giving tax law developments involving the judiciary are summarized in the book.

Overall, then, much more law concerning charitable giving is on the way, keeping this field alive, fascinating, and sometimes confusing. A year or so ago, it appeared that tax "reform" (if that is the right word) had some reasonable chance of advancing. At this writing, however, the efforts have stalled. (From the standpoint of the charitable deduction, that probably is a good thing.)

This book is offered as a vehicle to survey the law and minimize the confusion as to the federal tax law of charitable giving. This time around, I am generally satisfied that nearly everything relevant through 2013 has been captured.

If readers suspect that my using the writing of prefaces to praise the outstanding folks at John Wiley & Sons is simply a routine courtesy, please believe otherwise. These people have been marvelously supportive (and adept at enforcing deadlines). The publisher's devotion to the production of quality publications in the nonprofit field warrants unstinting praise. The Wiley Nonprofit Law, Finance, and Management Series is an unparalleled collection of books in the area. I am honored to be among those who have been and are contributing to this substantial body of knowledge.

Thus, my sincere thanks go to my development editor, Lia Ottaviano, and to Mary Daniello, production manager, for their assistance and support in connection with this project.

Bruce R. Hopkins

Book Citations

Throughout this book, four books by the author (in some instances, as coauthor), all published by John Wiley & Sons, are referenced as follows:

1. *The Law of Fundraising, Fifth Edition* (2013): cited as *Fundraising*
2. *The Law of Tax-Exempt Organizations, Tenth Edition* (2011): cited as *Tax-Exempt Organizations*
3. *The New Form 990: Law, Policy, and Preparation* (2009): cited as *New Form 990*
4. *Private Foundations: Tax Law and Compliance, Fourth Edition* (2014): cited as *Private Foundations*

The first, second, and fourth of these books are annually supplemented. Also, updates on all of the foregoing subjects (plus *The Tax Law of Charitable Giving*) are available in *Bruce R. Hopkins' Nonprofit Counsel*, the author's monthly newsletter, also published by John Wiley & Sons.

PART ONE

Introduction to the Tax Law of Charitable Giving

CHAPTER ONE

Charitable Giving Law: Basic Concepts

The purpose of this book is to summarize and analyze the law of charitable giving. For the most part, this law consists of federal tax law requirements, although state law can be implicated. The law of charitable giving frequently interrelates with the laws concerning tax-exempt status and public charity/private foundation classification of charitable organizations.

§ 1.1 INTRODUCTION TO THE CHARITABLE CONTRIBUTION DEDUCTION

The *charitable contribution* is the subject of extensive law. On the face of it, a charitable gift is a rather simple matter, requiring merely a *gift* and a *charitable* recipient. Though these elements are crucial (and are discussed throughout these pages), they by no means constitute the whole of the subject. Far more is involved in determining the availability and amount of the charitable contribution deduction.

There are, in fact, several charitable contribution deductions in American law, including three at the federal level: one for the income tax, one for the estate tax, and one for the gift tax. Most states have at least one form of charitable deduction, as do many counties and cities.

The principal charitable contribution deduction is the one that is part of the federal income tax system. A charitable contribution paid during a tax year generally is allowable as a deduction in computing taxable income for federal

income tax purposes. This deduction is allowable irrespective of either the method of accounting employed or the date on which the contribution may have been pledged.

The federal income tax charitable contribution deduction is available to both individuals and corporations. In both instances, the amount deductible may depend on a variety of conditions and limitations. These elements of the law of charitable giving are the subject of much of this book. The federal gift and estate tax charitable contribution deductions are also discussed.

An income tax charitable deduction may be available for gifts of money and of property. This deduction can also be available with respect to outright transfers of money or property to charity, as well as to transfers of partial interests in property.[1] A gift of a partial interest in property is often known as *planned giving*.[2]

Aside from the law underlying the charitable deduction itself, several other aspects of law can bear on the availability of the deduction. These elements of law include receipt, recordkeeping, reporting, and disclosure requirements.[3] Also involved is the battery of laws regulating the fundraising process.[4]

There is much additional law that relates to charitable giving but is outside the scope of this book. This book is part of a series on nonprofit organizations, however; the series includes books on the law governing charitable organizations as such, the law comprising regulation of the charitable fundraising process, tax and financial planning for charitable organizations, the fundraising process itself, and the accounting rules for charitable organizations.[5]

Prior to review of the laws specifically applicable to charitable giving, it is necessary to understand the fundamentals of the body of federal tax law concerning tax exemption for charitable organizations and the history underlying this jurisprudence.

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[1] See Part Three.

[2] See Part Four.

[3] See Part Six.

[4] See, e.g., ch. 25.

[5] Companion books by the author provide a summary of the law concerning tax-exempt organizations as such (*Tax-Exempt Organizations*), planning considerations for tax-exempt organizations (*Planning Guide*), IRS examinations of tax-exempt organizations (*IRS Audits*), and regulation of the charitable fundraising process (*Fundraising*). Governance of tax-exempt organizations is the subject of Hopkins & Gross, *Nonprofit Governance: Law, Practices, & Trends* (Hoboken, NJ: John Wiley & Sons, 2009). These bodies of law are reviewed in less technical detail in Hopkins, *Starting and Managing a Nonprofit Organization: A Legal Guide*, 6th edition (Hoboken, NJ: John Wiley & Sons, 2013). Coverage of these areas of the law (including the charitable giving rules) in even less technical detail is in these books by the author: *Nonprofit Law Made Easy* (Hoboken, NJ: John Wiley & Sons, 2005), *Charitable Giving Law Made Easy* (Hoboken, NJ: John Wiley & Sons, 2007), and *Fundraising Law Made Easy* (Hoboken, NJ: John Wiley & Sons, 2009). All of these areas of the law (and others) are also covered in the *Bruce R. Hopkins' Nonprofit Law Library*, an e-book published by John Wiley & Sons in 2013.

§ 1.2 DEFINING *TAX-EXEMPT ORGANIZATIONS*

A tax-exempt organization is a unique entity. Almost always, it is a nonprofit organization.[6] The concept of a *nonprofit organization* is usually a matter of state law, while the concept of a *tax-exempt organization* is principally a matter of the federal tax law.

The nonprofit sector of U.S. society has never been totally comfortable with this name. Over the years, it has been called, among other titles, the *philanthropic sector*, *private sector*, *voluntary sector*, *third sector*, and *independent sector*. In a sense, none of these appellations is appropriate.[7]

The idea of sectors of U.S. society has bred the thought that, in the largest sense, there are three of them. The institutions of society within the United States are generally classified as governmental, for-profit, or nonprofit entities. These three sectors of society are seen as critical for a democratic state—or, as it is sometimes termed, a civil society. *Governmental entities* are the branches, departments, agencies, and bureaus of the federal, state, and local governments. *For-profit entities* constitute the business sector of this society. *Nonprofit organizations*, as noted, constitute what is frequently termed the third sector, the voluntary sector, the private sector, or the independent sector of U.S. society. These terms are sometimes confusing; for example, the term *private sector* has been applied to both the for-profit sector and the nonprofit sector.

The rules concerning the creation of nonprofit organizations are essentially a subject for state law. Although a few nonprofit organizations are chartered by the U.S. Congress, most are incorporated or otherwise formed under state law. There is a substantive difference between nonprofit and tax-exempt organizations. While almost all tax-exempt organizations are nonprofit organizations, there are types of nonprofit organizations that are not tax-exempt. There is considerable confusion as to what the term *nonprofit* means—but it certainly does not mean that the organization cannot earn a profit (excess of revenue over expenses). The essential difference between a nonprofit organization and a for-profit organization, from a law standpoint, is found in the *private inurement doctrine.*[8]

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[6] The term *nonprofit organization* is used throughout, rather than the term *not-for-profit*. However, the latter term is used, such as in the federal tax setting, to describe activities (rather than organizations) whose expenses do not qualify for the business expense deduction. Internal Revenue Code of 1986, as amended, section (IRC §) 183. Throughout this book, the Internal Revenue Code is cited as the "IRC." The IRC constitutes Title 26 of the United States Code.

[7] A discussion of these sectors appears in Ferris & Graddy, "Fading Distinctions among the Nonprofit, Government, and For-Profit Sectors," in Hodgkinson, Lyman, & Associates, *The Future of the Nonprofit Sector*, ch. 8 (San Francisco: Jossey-Bass, 1989). An argument that the sector should be called the first sector is advanced in Young, "Beyond Tax Exemption: A Focus on Organizational Performance versus Legal Status," in *id.* ch. 11.

[8] See § 3.3(b), text accompanied by note 303.

The concept of a nonprofit organization is best understood through a comparison with a for-profit organization. In many respects, the characteristics of the two categories of organizations are identical; both require a legal form, have a board of directors and officers, pay compensation, face essentially the same expenses, make investments, produce goods and/or services, and are able to receive a profit.

A for-profit entity, however, has owners: those who hold the equity in the enterprise, such as stockholders of a corporation. The for-profit organization is operated for the benefit of its owners; the profits of the enterprise are passed through to them, such as the payment of dividends on shares of stock. This is what is meant by the term *for-profit organization*; it is one that is intended to generate a profit for its owners. The transfer of the profits from the organization to its owners is considered the inurement of net earnings to the owners in their private capacity.

Unlike the for-profit entity, the nonprofit organization generally is not permitted to distribute its profits (net earnings) to those who control and/or financially support it; a nonprofit organization usually does not have any owners (equity holders).[9] Consequently, the private inurement doctrine is the substantive dividing line that differentiates, for law purposes, nonprofit organizations and for-profit organizations.

Thus, both nonprofit organizations and for-profit organizations are able to generate a profit. The distinction between the two entities pivots on what is done with this profit.[10] The for-profit organization endeavors to produce a profit for what one commentator called its "residual claimants."[11] The nonprofit organization usually seeks to make that profit work for some end that is beneficial to society.

The private inurement doctrine is applicable to many types of tax-exempt organizations. It is, however, most pronounced with respect to charitable organizations.[12] By contrast, in some types of nonprofit (and tax-exempt) organizations, the provision of forms of private benefit is the exempt purpose

[9] The Supreme Court wrote that a "nonprofit entity is ordinarily understood to differ from a for-profit corporation principally because it 'is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees.'" *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 585 (1997), quoting from Hansmann, "The Role of Nonprofit Enterprise," 89 *Yale L.J.* 835, 838 (1980).

[10] One commentator stated that charitable and other nonprofit organizations "are not restricted in the amount of profit they may make; restrictions apply only to what they may do with the profits." Weisbrod, "The Complexities of Income Generation for Non-profits," in Hodgkinson et al., ch. 7.

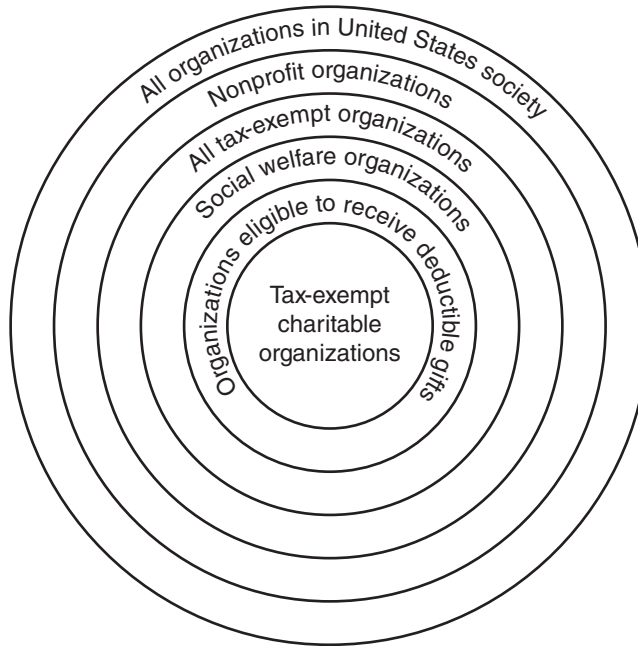
[11] Norwitz, "The Metaphysics of Time: A Radical Corporate Vision," 46 *Bus. Law.* (no. 2) 377 (Feb. 1991).

[12] The federal law of tax exemption for charitable organizations requires that each of these entities be organized and operated so that "no part of . . . [its] net earnings . . . inures to the benefit of any private shareholder or individual." IRC § 501(c)(3).

and function. This is the case, for example, with employee benefit trusts, social clubs, and, to an extent, political committees.[13]

As this chapter has indicated thus far, there are subsets and sub-subsets within the nonprofit sector. Tax-exempt organizations are subsets of nonprofit organizations. Charitable organizations (using the broad definition of that term[14]) are subsets of tax-exempt organizations. Charitable organizations in the narrow sense are subsets of charitable organizations in the broader sense of that term.[15]

These elements of the nonprofit sector may be visualized as a series of concentric circles, as shown here.



[13] IRC §§ 501(c)(9), (17), and (21) (employee benefit trusts), and IRC § 501(c)(7) (social clubs). The various categories of tax-exempt organizations and the accompanying Internal Revenue Code sections are summarized in § 1.5.

[14] This broad definition carries with it the connotation of philanthropy. See, e.g., Van Til, "Defining Philanthropy," in Van Til & Associates, *Critical Issues in American Philanthropy*, ch. 2 (San Francisco: Jossey-Bass, 1990). See also Payton, *Philanthropy: Voluntary Action for the Public Good* (New York: Macmillan, 1988); O'Connell, *Philanthropy in Action* (New York: The Foundation Center, 1987).

[15] The complexity of the federal tax law is such that the charitable sector (using the term in its broadest sense) is also divided into two segments: charitable organizations that are considered private (private foundations) and charitable organizations that are considered public (all charitable organizations other than those that are considered private); these nonprivate charities are frequently referred to as public charities. See § 3.4.

For a variety of reasons, the organizations constituting the nation's independent sector have been granted exemption from federal and state taxation; in some instances, they have been accorded the status of entities contributions to which are tax-deductible under federal and state tax law. Federal, state, and usually local law provide exemptions from income tax for (and, where appropriate, deductibility of contributions to) a wide variety of organizations, including churches, colleges, universities, health care providers, various charities, civic leagues, labor unions, trade associations, social clubs, political organizations, veterans' groups, fraternal organizations, and certain cooperatives. Yet, despite the longevity of most of these exemptions, the underlying rationale for them is vague and varying. Nonetheless, the rationales for exemption appear to be long-standing public policy, inherent tax theory, and unique and specific reasons giving rise to a particular tax provision.

§ 1.3 PRINCIPLES OF CHARITABLE ORGANIZATIONS LAW PHILOSOPHY

The definition in the law of the term *nonprofit organization* and the concept of the nonprofit sector as critical to the creation and functioning of a civil society do not distinguish nonprofit organizations that are tax-exempt from those that are not. This is because the tax aspect of nonprofit organizations is not relevant to either subject. Indeed, rather than defining either the term *nonprofit organization* or its societal role, the federal tax law principles respecting tax exemption of these entities reflect and flow out of the essence of these subjects.

This is somewhat unusual; most tax laws are based on some form of rationale that is inherent in tax policy. The law of charitable and other tax-exempt organizations, however, has very little to do with any underlying tax policy. Rather, this aspect of the tax law is grounded in a body of thought quite distant from tax policy: political philosophy as to the proper construct of a democratic society.

This raises, then, the matter of the rationale for tax-exemption eligibility of nonprofit organizations. That is, what is the fundamental characteristic—or characteristics—that enables a nonprofit organization to qualify as a tax-exempt organization? In fact, there is no single qualifying feature. This circumstance mirrors the fact that the present-day statutory tax exemption rules are not the product of a carefully formulated plan. Rather, they are a hodgepodge of federal statutory law that has evolved over nearly 100 years, as various Congresses have deleted from (infrequently) and added to (frequently) the roster of exempt entities, causing it to grow substantially over the decades. As one observer wrote, the various categories of tax-exempt organizations "are not the result of

any planned legislative scheme" but were enacted over the decades "by a variety of legislators for a variety of reasons."[16]

There are six basic rationales underlying qualification for tax-exempt status for nonprofit organizations. On a simplistic plane, a nonprofit entity is tax-exempt because Congress wrote a provision in the Internal Revenue Code according tax exemption to it. Thus, some organizations are tax-exempt for no more engaging reason than that Congress said so. Certainly, as to this type of exemption, there is no grand philosophical principle buttressing the exemption.

Some of the federal income tax exemptions were enacted in the spirit of being merely declaratory of, or furthering, then-existing law. The House Committee on Ways and Means, in legislating a forerunner to the provision that exempts certain voluntary employees' beneficiary associations, commented that "these associations are common today [1928] and it appears desirable to provide specifically for their exemption from ordinary corporation tax."[17] The exemption for nonprofit cemetery companies was enacted to parallel then-existing state and local property tax exemptions.[18] The exemption for farmers' cooperatives has been characterized as part of the federal government's posture of supporting agriculture.[19] The provision exempting certain U.S. corporate instrumentalities from tax was deemed declaratory of the exemption simultaneously provided by the particular enabling statute.[20] The provision according tax exemption to multiparent title-holding corporations was derived from the refusal of the Internal Revenue Service (IRS) to recognize exempt status for title-holding corporations serving more than one unrelated parent entity.

Tax exemption for categories of nonprofit organizations can arise as a by-product of enactment of other legislation. In these instances, tax exemption is granted to facilitate accomplishment of the purpose of another legislative end. Thus, tax-exempt status has been approved for funds underlying employee benefit programs. Other examples include tax exemption for professional football leagues that emanated out of the merger of the National Football League and the American Football League, and for state-sponsored providers of health care to the needy, which was required to accommodate the goals of Congress in creating health care delivery legislation.

There is a pure tax rationale for some tax-exempt organizations. Social clubs stand out as an illustration of this category.

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[16] McGovern, "The Exemption Provisions of Subchapter F," 29 *Tax Law.* 523 (1976). Other overviews of the various tax exemption provisions are in Hansmann, "The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation," 91 *Yale L.J.* 69 (1981); Bittker & Rahdert, "The Exemption of Nonprofit Organizations from Federal Income Taxation," 85 *Yale L.J.* 299 (1976).

[17] H. Rep. No. 72, 78th Cong., 1st Sess. 17 (1928).

[18] Lapin, "The Golden Hills and Meadows of the Tax-Exempt Cemetery," 44 *Taxes* 744 (1966).

[19] "Comment," 27 *Iowa L. Rev.* 128, 151–155 (1941).

[20] H. Rep. No. 704, 73d Cong., 2d Sess. 21–25 (1934).

The fourth rationale for tax-exempt status is a policy one—not tax policy, but policy with regard to less essential elements of the structure of a civil society. This is why, for example, tax-exempt status has been granted to entities as diverse as fraternal organizations, title-holding companies, farmers' cooperatives, certain insurance companies, and prepaid tuition plans.

The fifth rationale for tax-exempt status rests solidly on a philosophical principle. Yet, there are degrees of scale here; some principles are less majestic than others. Thus, there are nonprofit organizations that are tax-exempt because their objectives are of direct importance to a significant segment of society and indirectly of consequence to all of society. Within this frame lies the rationale for tax exemption for entities such as labor organizations, trade and business associations, and veterans' organizations.

The sixth rationale for tax-exempt status for nonprofit organizations is predicated on the view that exemption is required to facilitate achievement of an end of significance to the entirety of society. Most organizations that are generally thought of as *charitable* in nature[21] are entities that are meaningful to the structure and functioning of society in the United States. At least to some degree, this rationale embraces social welfare organizations. This rationale may be termed the *public policy* rationale.[22]

(a) Public Policy and National Heritage

The public policy rationale is one involving political philosophy rather than tax policy. The key concept underlying this philosophy is *pluralism*—more accurately, the pluralism of institutions, which is a function of competition between various institutions within the three sectors of society. In this context, the competition is between the nonprofit and governmental sectors. This element is particularly critical in the United States, whose history originates in distrust of government. (When the issue is unrelated business income taxation, the matter is one of competition between the nonprofit and for-profit sectors.) Here, the nonprofit sector serves as an alternative to the governmental sector as a means of addressing society's problems.

One of the greatest exponents of pluralism was John Stuart Mill. He wrote in *On Liberty*, published in 1859:

> In many cases, though individuals may not do the particular thing so well, on the average, as officers of government, it is nevertheless desirable that it should be done by them, rather than by the government, as a means to their own mental education—a mode of strengthening their active faculties, exercising their judgment, and giving them a familiar knowledge of the subjects with which they are thus left to deal. This is

[21] These are the charitable, educational, religious, scientific, and like organizations referenced in IRC § 501(c)(3).

[22] See *Tax-Exempt Organizations* § 1.3.

> a principal, though not the sole, recommendation of . . . the conduct of industrial and philanthropic enterprises by voluntary associations.

Following a discussion of the importance of "individuality of development, and diversity of modes of action," Mill wrote:

> Government operations tend to be everywhere alike. With individuals and voluntary associations, on the contrary, there are varied experiments, and endless diversity of experience. What the State can usefully do is to make itself a central depository, and active circulator and diffuser, of the experience resulting from many trials. Its business is to enable each experimentalist to benefit by the experiments of others; instead of tolerating no experiments but its own.

This conflict among the sectors—a sorting out of the appropriate role of governments and nonprofit organizations—is, in a healthy society, a never-ending process, ebbing and flowing with the politics of the day. A Congress may work to reduce the scope of the federal government and a president may proclaim that the "era of big government is over," while a preceding and/or succeeding generation may celebrate strong central government.

One of the greatest commentators on the impulse and tendency in the United States to utilize nonprofit organizations was Alexis de Tocqueville. Writing in 1835, in *Democracy in America*, he observed:

> Feelings and opinions are recruited, the heart is enlarged, and the human mind is developed only by the reciprocal influence of men upon one another. I have shown that these influences are almost null in democratic countries; they must therefore be artificially created, and this can only be accomplished by associations.

De Tocqueville's classic formulation on this subject came in his portrayal of Americans' use of "public associations" as a critical element of the societal structure:

> Americans of all ages, all conditions, and all dispositions constantly form associations. They have not only commercial and manufacturing companies, in which all take part, but associations of a thousand other kinds, religious, moral, serious, futile, general or restricted, enormous or diminutive. The Americans make associations to give entertainments, to found seminaries, to build inns, to construct churches, to diffuse books, to send missionaries to the antipodes; in this manner they found hospitals, prisons, and schools. If it is proposed to inculcate some truth or to foster some feeling by the encouragement of a great example, they form a society. Wherever at the head of some new undertaking you see the government in France, or a man of rank in England, in the United States you will be sure to find an association.

This was the political philosophical climate concerning nonprofit organizations in place when Congress, toward the close of the nineteenth century, began

considering enactment of an income tax. Although courts would subsequently articulate policy rationales for tax exemption, one of the failures of American jurisprudence is that the Supreme Court and the lower courts have never adequately articulated the public policy doctrine.

Contemporary Congresses legislate by writing far more intricate statutes than their forebears, and in doing so usually leave in their wake rich deposits in the form of extensive legislative histories. Thus, it is far easier to ascertain what a recent Congress meant when creating a law than is the case with respect to an enactment ushered in decades ago.

At the time a constitutional income tax was coming into existence (enacted in 1913[23]), Congress legislated in spare language and rarely embellished upon its statutory handiwork with legislative histories. Therefore, there is no contemporary record, in the form of legislative history, of what members of Congress had in mind when they first started creating categories of charitable and other tax-exempt organizations. Congress, it is generally assumed, saw itself doing what other legislative bodies have done over the centuries. One observer stated that the "history of mankind reflects that our early legislators were not setting precedent by exempting religious or charitable organizations" from income tax.[24] That is, the political philosophical policy considerations pertaining to nonprofit organizations were such that taxation of these entities—considering their contributions to the well-being and functioning of society—was unthinkable.

Thus, in the process of writing the Revenue Act of 1913, Congress viewed tax exemption for charitable organizations as the only way to consistently correlate tax policy to political theory on the point, and saw the exemption of charities in the federal tax statutes as an extension of comparable practice throughout the whole of history. No legislative history enlarges upon the point. Presumably, Congress simply believed that these organizations ought not to be taxed and found the proposition sufficiently obvious that extensive explanation of its actions was not required.

Some clues are found in the definition of *charitable activities* in the income tax regulations,[25] which are thought to reflect congressional intent. The regulations

[23] In 1894, Congress imposed a tax on corporate income. This was the first time Congress was required to define the appropriate subjects of tax exemption (inasmuch as prior tax schemes specified the entities subject to taxation). The Tariff Act of 1894 provided exemption for nonprofit charitable, religious, and educational organizations; fraternal beneficiary societies; certain mutual savings banks; and certain mutual insurance companies. The 1894 legislation succumbed to a constitutional law challenge. *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895), overruled on other grounds *sub nom. South Carolina v. Baker*, 485 U.S. 505 (1988). The Sixteenth Amendment was subsequently ratified, and the Revenue Act of 1913 was enacted. In general, Pollack, "Origins of the Modern Income Tax, 1894–1913," 66 *Tax Law.* (no. 2) (Winter 2013).

[24] McGovern, "The Exemption Provisions of Subchapter F," 29 *Tax Law.* 523, 524 (1976).

[25] Income Tax Regulations (Reg.) § 1.501(c)(3)-1(d)(2).

refer to purposes such as relief of the poor, advancement of education and science, erection and maintenance of public buildings, and lessening of the burdens of government. These definitions of charitable undertakings clearly derive from the Preamble to the Statute of Charitable Uses,[26] written in England in 1601. Reference is there made to certain "charitable" purposes:

> some for relief of aged, impotent and poor people, some for maintenance of sick and maimed soldiers and mariners, schools of learning, free schools, and scholars in universities, some for repair of bridges, ports, havens, cause-ways, churches, seabanks and highways, some for education and preferment of orphans, some for or towards relief, stock or maintenance for houses of correction, some for marriages of poor maids, some for supportation, aid and help of young tradesmen, handicraftsmen and persons decayed, and others for relief of redemption of prisoners or captives. . . .

As this indicates, a subset of the public policy doctrine implies that tax exemption for charitable organizations derives from the concept that they perform functions that, in the absence of these organizations, government would have to perform. This view leads to the conclusion that government is willing to forgo the tax revenues it would otherwise receive in return for the public interest services rendered by charitable organizations.

Since the founding of the United States and beforehand in the Colonial period, tax exemption—particularly with respect to religious organizations—was common.[27] Churches were uniformly spared taxation.[28] This practice has been sustained throughout the history of the nation—not only at the federal level, but also at the state and local levels of government, which grant property tax exemptions, as an example.

The Supreme Court concluded, soon after enactment of the income tax, that the foregoing rationalization was the basis for the federal tax exemption for charitable entities (although in doing so it reflected a degree of uncertainty in the strength of its reasoning, undoubtedly based on the paucity of legislative history). In 1924, the Court stated that "[e]vidently the exemption is made in recognition of the benefit which the public derives from corporate activities of the class named, and is intended to aid them when [they are] not conducted for private gain."[29] Nearly 50 years later, in upholding the constitutionality of income tax exemption for religious organizations, the Court observed that the "State has an affirmative policy that considers these groups as beneficial and stabilizing influences in community life and finds this classification

[26] Statute of Charitable Uses, 43 Eliz., c.4.
[27] Cobb, *The Rise of Religious Liberty in America*, 482–528 (1902).
[28] Torpey, *Judicial Doctrines of Religious Rights in America*, 171 (1948).
[29] *Trinidad v. Sagrada Orden de Predicadores de la Provincia del Santisimo Rosario de Filipinas*, 263 U.S. 578, 581 (1924).

[tax exemption] useful, desirable, and in the public interest."[30] Subsequently, the Court wrote that, for most categories of nonprofit organizations, "exemption from federal income tax is intended to encourage the provision of services that are deemed socially beneficial."[31]

A few other courts have taken up this theme. One federal court of appeals wrote that the "reason underlying the exemption granted" to charitable organizations is that "the exempted taxpayer performs a public service."[32] This court continued:

> The common element of charitable purposes within the meaning of the . . . [federal tax law] is the relief of the public of a burden which otherwise belongs to it. Charitable purposes are those which benefit the community by relieving it pro tanto from an obligation which it owes to the objects of the charity as members of the community.[33]

This federal appellate court subsequently observed, as respects the exemption for charitable organizations, that "[o]ne stated reason for a deduction or exemption of this kind is that the favored entity performs a public service and benefits the public or relieves it of a burden which otherwise belongs to it."[34] Another federal court opined that the justification of the charitable contribution deduction was "historically . . . that by doing so, the Government relieves itself of the burden of meeting public needs which in the absence of charitable activity would fall on the shoulders of the Government."[35]

Only one federal court has fully articulated the public policy doctrine, even there noting that the "very purpose" of the charitable contribution deduction "is rooted in helping institutions because they serve the public good."[36] The doctrine was explained as follows:

> [A]s to private philanthropy, the promotion of a healthy pluralism is often viewed as a prime social benefit of general significance. In other words, society can be seen as benefiting not only from the application of private wealth to specific purposes in the public interest but also from the variety of choices made by individual philanthropists as to which activities to subsidize. This decentralized choice-making is arguably more efficient and responsive to public needs than the cumbersome and less flexible allocation process of government administration.[37]

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[30] *Walz v. Tax Commission*, 397 U.S. 664, 673 (1970).
[31] *Portland Golf Club v. Commissioner*, 497 U.S. 154, 161 (1990).
[32] *Duffy v. Birmingham*, 190 F.2d 738, 740 (8th Cir. 1951).
[33] *Id.*
[34] *St. Louis Union Trust Co. v. United States*, 374 F.2d 427, 432 (8th Cir. 1967).
[35] *McGlotten v. Connally*, 338 F. Supp. 448, 456 (D.D.C. 1972).
[36] *Green v. Connally*, 330 F. Supp. 1150, 1162 (D.D.C. 1971), *aff'd sub nom. Coit v. Green*, 404 U.S. 997 (1971).
[37] *Id.*, 330 F. Supp. at 1162.

Occasionally, Congress issues a pronouncement on this subject. One of these rare instances occurred in 1939, when the report of the House Committee on Ways and Means, part of the legislative history of the Revenue Act of 1938, stated:

> The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.[38]

The doctrine also is referenced from time to time in testimony before a congressional committee. For example, the Secretary of the Treasury testified before the House Committee on Ways and Means in 1973 regarding organizations that he termed "voluntary charities, which depend heavily on gifts and bequests," observing:

> These organizations are an important influence for diversity and a bulwark against over-reliance on big government. The tax privileges extended to these institutions were purged of abuse in 1969 and we believe the existing deductions for charitable gifts and bequests are an appropriate way to encourage those institutions. We believe the public accepts them as fair.[39]

The literature on this subject is extensive. The contemporary versions of it are traceable to 1975, when the public policy rationale was reexamined and reaffirmed by the Commission on Private Philanthropy and Public Needs (informally known as the Filer Commission). The Commission observed:

> Few aspects of American society are more characteristically, more famously American than the nation's array of voluntary organizations, and the support in both time and money that is given to them by its citizens. Our country has been decisively different in this regard, historian Daniel Boorstin observes, "from the beginning." As the country was settled, "communities existed before governments were there to care for public needs." The result, Boorstin says, was that "voluntary collaborative activities" were set up to provide basic social services. Government followed later.
>
> The practice of attending to community needs outside of government has profoundly shaped American society and its institutional framework. While in most other countries, major social institutions such as universities, hospitals, schools, libraries, museums and social welfare agencies are state-run and state-funded, in the United States many of the same organizations are privately controlled and voluntarily supported. The institutional landscape of America is, in fact, teeming with non-governmental, noncommercial organizations, all the way from some of the world's

[38] H. Rep. No. 1860, 75th Cong., 3d Sess. 19 (1939).
[39] Department of the Treasury, Proposals for Tax Change, Apr. 30, 1973.

> leading educational and cultural institutions to local garden clubs, from politically powerful national associations to block associations—literally millions of groups in all. This vast and varied array is, and has long been widely recognized as, part of the very fabric of American life. It reflects a national belief in the philosophy of pluralism and in the profound importance to society of individual initiative.
>
> Underpinning the virtual omnipresence of voluntary organizations, and a form of individual initiative in its own right, is the practice—in the case of many Americans, the deeply ingrained habit—of philanthropy, of private giving, which provides the resource base for voluntary organizations.
>
> These two interrelated elements, then, are sizable forces in American society, far larger than in any other country. And they have contributed immeasurably to this country's social and scientific progress. On the ledger of recent contributions are such diverse advances as the creation of noncommercial "public" television, the development of environmental, consumerist and demographic consciousness, community-oriented museum programs, the protecting of land and landmarks from the often heedless rush of "progress." The list is endless and still growing; both the number and deeds of voluntary organizations are increasing. "Americans are forever forming associations," wrote de Tocqueville. They still are: tens of thousands of environmental organizations have sprung up in the last few years alone. Private giving is growing, too, at least in current dollar amounts.[40]

Here, the concept of *philanthropy* enters, with the view that charitable organizations, maintained by tax exemption and nurtured by an ongoing flow of deductible contributions, reflect the American philosophy that not all policy making and problem solving should repose in the governmental sector. Earlier, a jurist wrote, in a frequently cited article, that philanthropy

> is the very possibility of doing something different than government can do, of creating an institution free to make choices government cannot—even seemingly arbitrary ones—without having to provide a justification that will be examined in a court of law, which stimulates much private giving and interest.[41]

A component part of the public policy doctrine is its emphasis on *voluntarism.* This principle was expressed as follows:

> Voluntarism has been responsible for the creation and maintenance of churches, schools, colleges, universities, laboratories, hospitals, libraries, museums, and the performing arts; voluntarism has given rise to the public and private health and welfare systems and many other functions and services that are now an integral part

[40] Report of the Commission on Private Philanthropy and Public Needs: Giving in America—Toward a Stronger Voluntary Sector at 9–10 (1975).

[41] Friendly, "The Dartmouth College Case and the Public-Private Penumbra," 12 *Tex. Q.* (2d Supp.) 141, 171 (1969). Two other prominent sources are Rabin, "Charitable Trusts and Charitable Deductions," 41 *N.Y.U. L. Rev.* 912 (1966); Saks, "The Role of Philanthropy: An Institutional View," 46 *Va. L. Rev.* 516 (1960).