



Eternal Inconsistency

The Stunning Variability in, and Expedient Motives Behind the Tax Regulation of Nonprofit Advocacy Groups

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Introduction

For many, a meeting of the American Bar Association’s Tax Section’s Exempt Organizations would not be expected to elicit much excitement. A typical audience for this event would be limited to those with considerable personal reserves of endurance and those that bill by the hour. The congregation attending the May 2013 gathering no doubt expected something quieter than the IRS scandal that erupted. On that occasion, however, Lois Lerner, head of the IRS Exempt Organizations division, asked an attendee to pose a specific question – seeking an update on concerns raised by Tea Party groups that their applications for exemption under Internal Revenue Code Section 501(c)(4) were being reviewed unfairly.¹

Were they being treated fairly? Lerner’s answer: No, they were not.

The Treasury Inspector General concurred in a report publicly released (not coincidentally) soon after this meeting.² In the wake of the ensuing uproar, senior tax officials lost their jobs. Countless pages of Congressional testimony were generated. Experts exchanged pointed analyses over what the legal requirements are, and whether the IRS should be clearer, or even more restrictive, in articulating and applying exemption standards.

Six months after revealing that it had targeted the applications of Tea Party organizations for additional scrutiny, the IRS released proposed regulations defining if, and when, a group that is tax exempt as a “social welfare” organization may be active in politics.³ The proposal departed from the “facts and circumstances” approach currently employed in exemption determinations. It stated explicitly that the exempt social welfare purpose “does not include direct or indirect candidate-related political activity.”⁴ It then defined eight different kinds of “candidate-related” political activity.⁵ Among those were express advocacy communications; public communications within 30 days of a primary or 60 days of a general election that refer to a candidate or, in the context of a general election, a political party; FECA reportable expenditures; or contributions to candidates, Section 527 (political) organizations, or other exempt organizations that do one of the eight forms of “candidate-related political activity”. “Candidate-related political activity” would also include voter registration or get-out-the-vote drives, distributing material from a candidate or 527 organization, distributing voter guides, and hosting events with candidates within 30 days of a primary or 60 days of a general election.

This proposal went beyond any fix required by the IRS scandal, which centered around the selective mistreatment of groups seeking exemption. Instead, it betrayed a desire to restrict certain common and effective ways of communicating about policy issues that involve officeholders and candidates. This proposal also iterated a wish list of regulations that have at various times been imposed in the campaign finance arena, and as often been found constitutionally deficient in court.

1 See *The Fact Checker*, WASH. POST, May 20, 2013.

2 TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION, INAPPROPRIATE CRITERIA WERE USED TO IDENTIFY TAX-EXEMPT APPLICATIONS FOR REVIEW, No. 2013-10-053 (May 14, 2013).

3 Guidance for Tax-Exempt Social Welfare Organizations on Candidate-Related Political Activities, Notice of Proposed Rulemaking, 78 Fed. Reg. 71535 (November 29, 2013).

4 *Id.* (amending Treas. Reg. 1.501(c)(4)-1).

5 *Id.*

The agency received over 140,000 comments from experts and members of the public, 87% of which were opposed to the rulemaking (94% were either opposed or partially opposed).⁶ After meeting such stiff opposition from a wide range of organizations and experts the IRS indicated it would rewrite the proposed regulation.⁷

When the next version emerges, we should study that draft mindful not only of present contexts, but of the legacy of tax regulation of political activity by nonprofit groups. Much of this history has not been a happy one. Indeed, whether on purpose or not, the IRS has waded into an ancient sea of ill-advised restrictions.

The proper tax treatment of what this monograph will call “Nonprofit Advocacy” groups has perplexed and antagonized activists and tax collectors from the first days of corporate taxation.⁸ This history reveals persistent problems. First, Members of Congress seem not to appreciate the effects tax amendments will have. They often write tax law to further a short-term political agenda, ignoring likely longer term problems. Often, the short-term plan fails, so the tax rule lacks even that dubious achievement. Second, federal tax collectors overregulate, apply regulations inconsistently, examine controversial groups selectively, and disregard legislative intent to tread lightly. They also generally do not feel restrained by judicial rulings that weigh against aggressive interpretations of the Code or regulations.

Must this “eternal inconsistency” -- in which modest if short-sighted statutes become bludgeons of regulation in the IRS’s hands -- be inevitable? Especially in this context where revenue considerations are weak, it would seem that courts should recognize unconstitutional burdens in many situations where courts otherwise give revenue collectors more discretion in other tax matters. In any event, the history leading to 1959 documented here should resonate with groups concerned about IRS overreach today.

This monograph provides the reader with a rich appreciation of how modern regulations governing the activities of these groups (enacted in 1959) came about, and what the rules were before. First, it will show the roots of the tax-exempt corporation in early American laws affecting charities. Then, with the 1909 enactment of the federal corporate excise tax (and the corporate income tax in 1913), it will cover the development of a number of key concepts that remain in federal tax law today.

With the 1917 enactment of a donor deduction for charitable contributions, the question of which groups should be able to offer this valuable benefit became more acute. This monograph will show how the Internal Revenue process began to puzzle through how these lines should be drawn. Finally, it will examine the modern Internal Revenue Code’s enactment in 1954, and the four-year process in writing the modern regulations that distinguish charities from social welfare organizations.

6 Matt Nese and Kelsey Drapkin, *Overwhelmingly Opposed: An Analysis of Public and 955 Organization, Expert, and Public Official Comments on the IRS’s 501(c)(4) Rulemaking*, Center for Competitive Politics, (July 2014), available at: http://www.campaignfreedom.org/wp-content/uploads/2014/07/2014-07-08_Issue-Review_Nese-And-Drapkin_Overwhelmingly-Opposed.pdf.

7 *Guidance for Tax-Exempt Organizations on Political Campaign Intervention*, <http://www.reginfo.gov/public/do/eAgendaViewRule?pubId=201410&RIN=1545-BL81>.

8 This narrative has coined the term “Nonprofit Advocacy” so the discussion can transcend the various terms of art that have appeared in different iterations of tax law (terms such as “social welfare,” “action organization” and “propaganda”). It is meant to describe a group that engages in public advocacy of specific policy goals, which themselves are significant to the politics of the era. Not every modern “social welfare” organization would come within this class, but the ones that seem to most vex reformers and regulators would.



Section I

Why Nonprofit Groups Incorporate

English Roots

The reason charitable, civic, and other kinds of nonprofit groups choose to incorporate at all is partly historic accident. Prior to independence, charity in the American colonies was governed by English law, specifically the preamble to the Statute of Elizabeth, 1601 (which itself was based on earlier common law understandings of the proper scope of charity).⁹ “Charitable” uses included:

for Releife of aged impotent and poore people, some for Maintenance of sicke and maymed Souldiers and Marriners, Schooles of Learninge, Free Schooles and Schollers in Universities, some for Repaire of Bridges Portes Havens Causwaies Churches Seabankes and Highwaies, some for Educacion and prefermente of Orphans, some for or towards Reliefe Stocke or Maintenance of Howses of Correccion, some for Mariages of poore Maides, some for Supportacion Ayde and Helpe of younge tradesmen Handicraftesmen and persons decayed, and others for reliefe or redemption of Prisoners or Captives, and for aide or ease of any poore Inhabitanes concerninge paymente of Fifteenes, setting out of Souldiers and other Taxes...¹⁰

The vehicle for administering charitable gifts at this point was generally a trust, supervised ultimately by the Crown.¹¹ If such resources were not used for charity, the Statute established legal redress.

The Statute’s listed purposes – relief for the poor and sick, education, infrastructure repair, prisons, trains and the rest – was not exhaustive. Analogous uses “within its spirit and intendment” were also included.¹² For example, the law deemed hospitals as charitable, although the Statute said nothing about them.

Charity included groups with creeds – even controversial ones. Propagating the gospel was “charitable,” as were religious uses outside the Church of England. Charitable treatment was denied to grants for personal benefit and not of general public use; for example, money used to establish a monument celebrating its donor.¹³

In short, under English precedent, charitable status was open to interpretation, and the Statute was not interpreted strictly against the entity seeking such status.

Charity Law in America

At independence, American states pursued diverse paths in regulating charities. Many states rejected all English statute law, including the Statute of Elizabeth. This wholesale rejection had profound consequences. Charities in many states that depended on the Statute of Elizabeth for legal recognition became no longer viable. In *Philadelphia Baptist Ass’n v. Hart*, the Supreme Court held that

9 CARL ZOLLMAN, *AMERICAN LAW OF CHARITIES* 4-5 (1924).

10 The Statute of Charitable Uses Act (1601), 43 Elizabeth I c. 4.

11 William R. A. Boyle, *A Practical Treatise on the Law of Charities*, Bk. 1 at 12 (1837); see also James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L. J. 617, 619-21 (1985).

12 Boyle at 18. (citing *Turner v. Ogden*, 1 Cox. 316; *Morice v. Bishop of Durham*, 9 Ves. 405).

13 *Id.* at 50.

Virginia's repeal of English statutes in 1792 destroyed the doctrine of charitable trusts.¹⁴ In this case, Virginia forbade the Baptist Association from taking property by devise (unless it incorporated).¹⁵

As a result, in such jurisdictions, a charitable gift would need to be accepted by an incorporated entity to be secure and not found void.¹⁶ In contrast to a trust, a charitable corporation could withstand legal attacks and serve as a proper beneficiary.¹⁷ Corporations formed in record numbers immediately following independence, and a significant percentage of those were religious, educational, charitable, or formed for other nonprofit purposes.¹⁸ As historian Pauline Maier observed;

incorporation allowed a group to make binding rules for its self-government, to function in law as a single person with the right to hold property and to sue and be sued – and so to protect its assets – and to persist after the lifetimes of its founding members. Those privileges were as important to towns, churches, charities, and colleges as to business companies.¹⁹

Some states, predominantly in the Northeast, concluded the opposite - that charities drew their existence from preexisting English common law, not merely the Statue of Elizabeth. In these jurisdictions, English charitable trust law remained intact.²⁰ Even in these states, however, charitable corporations proved a more nationally secure and reliable form of organization.²¹

Incorporation became even more secure and reliable as legislatures lost the power to interfere with incorporation via chartering authority. Such powers withered as states adopted general incorporation laws. General incorporation statutes allowed groups to incorporate without a special legislative act. They were first extended to religious corporations in the late 1700s, and then became prevalent in the latter 1800s as reformers argued against the corruptive and time-consuming special charter system.²²

14 17 U.S. (4 Wheat) 1 (1819); ZOLLMAN, *supra* note 9 at 5; Irvin Wyllie, *The Search for an American Law of Charity 1776-1844*, 46 MISS. VALLEY HIST. REV. 203, 208-10 (1959); Fishman, *supra* note 11, at 624.

15 This is because the Statute excepted charitable trusts from the general requirement, for private trusts, that they specify particular beneficiaries. Fishman, *supra* note 11 at 625.

16 See ZOLLMANN, *supra* note 9.

17 *Id.* at 222-29.

18 Pauline Maier, *The Revolutionary Origins of the American Corporation*, 50 WM. AND MARY QUARTERLY 51, 53 (1993).

19 *Id.* at 54.

20 ZOLLMAN, *supra* note 9, at 6, Wyllie, *supra* note 14, at 211; Fishman, *supra* note 11, at 624.

21 Fishman, *supra* note 11, at 628-29.

22 *Id.* at 632-35 (for example New York general incorporation statute for religious corporations dated from 1784, general corporation statute for all classes of charities from 1848, membership corporation statute for all non-pecuniary corporations other than religious and educational from 1895).



Section II Tax Exemptions

The 1909 corporate excise tax – the first federal corporate tax – formed the foundation for the federal income tax. But states had been taxing corporations for decades before then. Understanding the taxation record in the states is therefore a necessary starting point for understanding the 1909 excise tax and the 1913 income tax.

State Taxation

State approaches to the taxation of corporations were nearly as various as the states themselves.²³ Corporate taxes were an important revenue source for state governments, in some cases providing over half of a state’s revenues.²⁴ The dominant type of corporate tax levied was property tax.²⁵ States also applied other special taxes based on a corporation’s line of business; for instance, railroad corporations might be subject to a capital stock tax.²⁶

Because state nonstock corporations, which would include entities like charities, were neither among the delineated classifications of for-profit corporations, nor would have been subject to special taxes like a capital stock tax (since they did not issue stock) they would not have been taxed. Thus, some states exempted charities and other kinds of nonbusiness corporations by implication.

To the extent states levied a general tax or fee on corporations *per se*, their laws exempted charitable corporations using a variety of formulations.²⁷ For example, Virginia’s code stated that “[t]he property of public, religious, charitable, cemetery, educational, and similar corporations is exempt from taxation.”²⁸ So, a group’s tax exemption could be by omission (that is, the legislature simply didn’t consider it as a source of revenue), or by legislative declaration (the legislature spared certain groups from tax burdens).

Federal Taxation

In 1894, Congress enacted a two percent tax on the “net profits or income” of all corporations doing business for profit in the United States, no matter how created and organized.²⁹ However, this law spe-

23 From 1909 to 1915, the United States Bureau of Corporations published a six-volume report detailing the tax laws and tax revenues of the 48 states. The last of these reports summarizes finding from previous reports, and is the source cited here. TAXATION OF CORPORATIONS, PART VI, SOUTHERN AND SOUTHWESTERN STATES; REPORT OF THE COMMISSIONER OF CORPORATIONS, U.S. DEPARTMENT OF COMMERCE (March 15, 1915).

24 *Id.* at 2.

25 *Id.* at 6.

26 A detailed chart of the special classifications and taxes in the states is in *id.*, pages 8-15.

27 See *id.* at 43 (Virginia exemption from corporate registration fee); *id.* at 68 (West Virginia exemption for property used for educational, literary, scientific, religious, or charitable purposes, all cemeteries, and public property); *id.* at 89 (North Carolina exemption for property held for public, religious, charitable, educational, literary, benevolent, and cemetery purposes); *id.* at 106 (same as to South Carolina); *id.* at 121 (Same as to Georgia); *id.* at 139 (Florida); *id.* at 157 (Kentucky exemption for certain property used for religious worship, parsonages, cemeteries and educational institutions not for profit, public charitable institutions, public libraries); *id.* at 274 (noting Louisiana exemption dated to constitution of 1864). State exemptions from other regions of the nation are delineated in the other Reports in this series. See e.g. TAXATION OF CORPORATIONS PART I, NEW ENGLAND (May 17, 1909); (N.B. Maine exemption of corporations “not of a business nature” from franchise tax, *id.* at 35; Vermont, *id.* at 72); PART III EASTERN CENTRAL STATE (July 31, 1911); see also SPECIAL REPORT ON TAXATION SUPPLEMENTING PREVIOUS REPORTS (December, 1913).

28 *Id.* at 48.

29 H. Res. 4864, 53rd Cong. 2d Sess. § 32, Ch. 349, 28 Stat. 509 (1894).

cifically excluded from taxation “corporations, companies, or associations organized and conducted solely for charitable, religious, or educational purposes... nor to the stocks, shares, funds or securities held by any fiduciary or trustee for charitable, religious, or educational purposes.”³⁰

The 1894 tax law was declared an unconstitutional direct tax in *Pollock v. Farmers’ Loan & Trust Co.*³¹ The Supreme Court in *Pollock* held that the power of direct taxation belonged to the states under the Constitution. The federal government could only impose direct taxes if the tax was apportioned among the states, much as membership in the House of Representatives.³²

In 1909, Congress returned to the taxation table with a *Pollock* work-around. It enacted a one-percent excise corporate tax on “the entire net income over and above \$5,000” of “every corporation, joint-stock company or association, organized for profit.” This tax was on “the privilege of doing business,” not income, and accordingly *not* an unconstitutional direct tax.

This tax also specifically exempted corporations not organized for private profit. Tellingly, a number of Members disputed the need for any additional exemption for charitable corporations, since the tax facially applied only to corporations “organized for profit.”³³ A majority eventually followed the lead of Senator Augustus Bacon of Georgia, who crafted an exemption for:

any corporation or association organized and operated for religious, charitable, or educational purposes, no part of the profit of which inured to the benefit of any private stockholder or individual, but all of the profit of which is in good faith devoted to the said religious, charitable or educational purpose . . .³⁴

Members immediately questioned whether charities that hold and rent property would be exempt. Their specific concern was the Trinity Church corporation in New York, which had attracted negative attention by owning tenement apartments among its considerable landholdings.³⁵ Senator Bacon responded that features not “strictly religious, educational, or benevolent . . . would not be screened by this amendment.”³⁶

In light of these concerns, and to satisfy certain colleagues, Bacon inserted the word “exclusively” to his amendment after “operated,” yielding the clause “exclusively for religious, charitable or educational purposes.”³⁷ This is the genesis of the term “exclusively” in our modern tax code.

In another Senate exchange, Members debated how to determine a corporation’s “purpose” or “business,” particularly where fraternal corporations would be providing insurance. Senator Frank P. Flint, of California, speaking for the measure, assured his colleagues that an entity with a charitable

30 *Id.* This Act also exempted mutual savings banks, mutual life insurance companies, and building and loan associations that made loans only to their shareholders.

31 158 U.S. 601 (1895).

32 *Id.* at 621.

33 44 CONG. REC. 4149, 4148-49 (1909) (Sen. Burkett); *id.* at 4151 (Sen. Flint); *id.* at 4154-55 (Sen. Crawford).

34 *Id.* at 4149.

35 *Id.* at 4150. Trinity Church had been criticized for operating unsanitary and dangerous tenements. See *Trinity Parish, Its Millions and Its Tenements*, N.Y. TIMES, July 19, 1908.

36 44 CONG. REC. at 4151.

37 *Id.*



purpose could engage in other activities, such as providing insurance, and remain exempt from tax.³⁸ Already “exclusively” was less than absolute. In a later line of questions, Senator Albert Cummins, a progressive Republican from Iowa, challenged Senator Knute Nelson about how a person or corporation’s “business” was to be determined. Nelson replied: “The business of a corporation is determined by the articles under which the corporation is incorporated...”³⁹ Senators thus showed little interest in enacting a statute that would necessitate official inquiries into the internal dealing of exempt groups.

The Supreme Court upheld the constitutionality of the 1909 Act in *Flint v. Stone Tracy*.⁴⁰ This case was brought by Stella P. Flint on behalf of her son by her first marriage, Samuel N. Stone Jr. – her first husband (and Samuel’s father) having founded the Stone Tracy mercantile company.⁴¹ Her suit sought to enjoin the company from filing a tax return as required under the Act, and paying the tax (Samuel Stone Jr. owned shares in the company).⁴² Flint’s briefs echoed the Court’s *Pollock* reasoning, arguing that the excise tax was really an unapportioned direct income tax that infringed on states’ powers. Flint also argued that the law drew an impermissible distinction between taxed and exempt corporations.⁴³

The Supreme Court upheld the 1909 tax, concluding that it was properly an excise tax within Congress’s power to impose. It also easily dismissed the second argument against exempting certain corporations:

[T]he right of Congress to select the objects of excise taxation, and within this power to tax some and leave others untaxed must be included the right to make exemptions such as are found in this act.⁴⁴

By upholding Congressional discretion, the Court affirmed Congress’s power to draw exemptions, and honored Congress’s interpretation of those exemptions.

Revenue bureaucrats in the Executive Branch felt otherwise. Notwithstanding the temper of Congress to “rather exempt some that ought to be taxed than to tax some that ought to be exempt”⁴⁵ the administrators of the 1909 Act took the opposite approach. Franklin MacVeagh, the Secretary of the Treasury, noted that the Act’s purpose was to produce revenue, and so should be construed aggressively to favor taxation.⁴⁶ Early Treasury decisions broadly defined what organizations would pay tax, and sought returns from limited partnerships and trusts that were, technically, not corporations at all.⁴⁷ That interpretation was especially interesting because the excise tax was justified as a tax on the

38 JACOB S. SEIDMAN, SEIDMAN’S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861 at 1009 (1938).

39 *Id.* at 1010.

40 220 U.S. 107 (1911).

41 Stella Flint’s second husband was, coincidentally, named Frank Flint, but seems to bear no relation to the Senator from California quoted above. See Frank W. Flint Obituary, VERMONT JOURNAL, November 26, 1909.

42 *Push Corporation Tax Suit*, N.Y. TIMES, January 23, 1910.

43 *Flint*, 220 U.S. at 173.

44 *Id.*

45 44 CONG. REC. at 4153.

46 Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 119-20 (1990).

47 *Id.* at 121.

privilege of doing business in the corporate form. Not surprisingly, when the taxation of noncorporate “trusts” reached the courts, Treasury lost.⁴⁸

1913 Income Tax Law, the “Social Welfare” Exemption, and Educational Groups

Once a sufficient number of states ratified the 16th Amendment, providing Congress with the authority to levy a direct income tax, lawmakers began crafting the details. The income tax was incorporated into the Underwood-Simmons tariff bill of that session. For Democrats, the income tax would fulfill campaign pledges and replace revenue lost as a result of tariff reductions they had promised.

The 1913 corporate tax language borrowed in large measure from the 1909 Act. But the Treasury’s strict treatment of exemptions in the intervening years now prompted Congress, no doubt at the behest of outside interests, to seek greater specificity in those exemptions, so as to protect groups from revenue overreach.

The Senate Committee on Finance thus amended the bill to specifically exempt “business leagues... chambers of commerce or boards of trade, not organized for profit or no part of the net income of which inures to the benefit of the private stockholder or individual; nor to any civic league or organization not organized for profit, but operated exclusively for the promotion of social welfare.”⁴⁹ Here is the inaugural appearance of the “social welfare” exemption found now in Section 501(c)(4) of the Internal Revenue Code.

The “social welfare” category may have been added in response to testimony filed with the Senate Finance Committee by Elliott H. Goodwin, General Secretary of the U.S. Chamber of Commerce, and Charles Criss, Secretary of the American Warehousemen’s Association.⁵⁰ Both groups argued that the scope of taxable corporations in the 1913 law was broader than in the 1909 law and that under the plain reading of the proposed tax, chambers of commerce, boards of trade, and other nonprofit commercial entities would be subject to income tax unless made exempt.

The first clause of the Senate amendments (listing business leagues, boards of trade and chambers as exempt) appears responsive to this request. It would not seem necessary to then add an exemption for organizations operated “exclusively for the promotion of social welfare.” This “social welfare” clause provoked no apparent debate that could assist in deciding what it meant, and records from the Committee for these years were not archived. The amendment met with the approval of the Senate Democratic Caucus, which meant it was secure for passage in the Senate, and the House leadership also supported it.⁵¹ The clause referring to “social welfare” organizations may be best seen as an open-ended exemption to save unenumerated nonprofit groups from tax - a push by Congress against the Treasury’s tendency to strictly interpret exemptions.⁵²

On October 3, 1913, President Wilson signed the legislation, and enacted the first income tax since

48 *Eliot v. Freeman*, 220 U.S. 178 (1911), Kornhauser, *supra* note 46, at 122-23.

49 SEIDMAN, *supra* note 38, at 1002.

50 INCOME TAX AND CUSTOMS ADMINISTRATION, BRIEFS AND STATEMENTS FILED WITH THE COMMITTEE ON FINANCE, UNITED STATES SENATE (January 1913), at 2001, 2040.

51 *Wields Ax On Tariff*, WASH. POST., June 22, 1913 at 4.

52 Boris Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L. J. 299, 302-03 (1976).



1870, as well as the first individual income surtaxes ever imposed by Congress.⁵³

“Social Welfare” or “Educational”

The inchoate “social welfare” exemption was but one basis under which a nonprofit advocacy group might seek exemption. Both the 1909 and 1913 Acts exempted “educational” corporations from tax, and as noted before, state income tax regimes predating the federal tax, as well as English practice, also exempted “educational” organizations.

Congress likely intended to adopt a broad definition of what constituted an educational purpose. State tax exemptions predating the federal law had been extended broadly to “educational” organizations beyond schools, including advocacy groups like the YMCA and temperance groups.⁵⁴ A “charitable educational” purpose had also been extended by state courts to bequests “for the attainment of women’s suffrage,” and to improve the structure of government through changes in voting and ballot reform.⁵⁵ Teaching the doctrines of Socialism qualified as a charitable educational purpose.⁵⁶ Perpetuation of the United States flag was also exempt as a charitable educational purpose.⁵⁷ In extending educational charity status to the “Friendship Liberal League” one Pennsylvania court noted this group was:

as much a charity as an anti-tobacco society, or an anti-meat diet brotherhood, or an anti-chewing gum circle, or even as the famous “United Metropolitan Improved Hot Muffin and Crumpet Baking and Punctual Delivery Company” immortalized by Charles Dickens would have been if it had devoted itself to teaching the English people how to bake.⁵⁸

It bears repeating that, at this point, exemptions packed a limited revenue impact. Only the group’s own “income” was at issue, so Congress’s overall intent to recapture some of the vast private wealth in business corporations was not well served by pursuing nonbusiness social movements. It wasn’t until Congress raised tax rates to pay for World War I that donors could deduct contributions from their own taxes.⁵⁹

It remained the case, however, that a nonprofit advocacy group could have sought exemption as an educational organization and would not have needed to inquire whether “social welfare” described it at all. Thus, there would not have been much pressure to define “social welfare” at this point, generating little precedent to help us understand its intended scope.

53 SIDNEY RATNER, *AMERICAN TAXATION* 333 (1942). Corporations paid a 1 percent tax on net income, with no \$5,000 exemption (as was included in the 1909 Act). As noted above, the exceptions extended to nonprofit corporations were very similar to those in the 1909 excise tax law.

54 FRANK WHITE AND GODFREY GOLDMARK, *WHITE AND GOLDMARK ON NON-STOCK CORPORATIONS* 433 (1913) (citing *Matter of Moses*, 138 N.Y. App. 525 (1910), *Matter of Field*, 71 N.Y. Misc. 396 (1911); *Matter of Moore*, 66 N.Y. Misc. 116 (1910)).

55 ZOLLMAN, *supra* note 9 at 209, citing *Garrison v. Little*, 75 Ill. App. 401 (1898); *Taylor v. Hoag*, 116 Atl. Rep. 826 (Pa. 1922).

56 *Id.* at 210 (citing *Peth v. Spear*, 63 Wash. 291, 115 P. 162 (1911)). *Peth* cited the Statute of Elizabeth as authority for its holding. See 115 P. at 165

57 *Id.* at 209 (citing *Sargent v. Cornish*, 54 N.H. 18 (1873)).

58 *Id.* at 210, quoting *In re Knight*, 10 Pa. Co. Ct. Rep. 225, 229 (1891). In subsequent decisions the League was held to be a religious organization. See *In re Knight’s Estate*, 28 Atl. Rep. 303 (1894).

59 A donor deduction amendment was offered during the House debate on the 1913 Act, but was rejected. SEIDMAN, *supra* note 38, at 945, citing 50 CONG. REC. 1259.

Section III

Deductibility Raised the Stakes

Defense spending in response to World War I compelled Congress to raise tax rates in 1916, increasing the top rate to 13%. Congress also revised the clause enumerating exempt organizations. This was a reaction to the Treasury department's strict interpretations of exemptions, which contradicted congressional intent that the exemption should apply to any bona fide nonprofit.⁶⁰

The 1916 Act edited the exemption paragraph, breaking each category of exemption into its own numbered clause.⁶¹ Thus, the prior single exemption clause, amended with new exemptions, became a series of thirteen sub-clauses within section 11, exempting any income of, among others, a:

- 6) corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual,
- 7) business league, chamber of commerce, or board of trade not organized for profit and no part of the net income of which inures to the benefit of any private stockholder or individual,
- 8) civic league or organization not organized for profit but operated exclusively for the promotion of social welfare,
- 9) club organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes,

There is no evidence that Congress intended to change the substantive tax law by breaking the exemption out in this way.

Donor Deductibility and the 1917 Act.

When deficits persisted, the War Revenue Act of 1917 extended income taxes and raised rates. The per person exemption fell from \$3,000 to \$1,000, the normal tax rate for corporations increased from 2% to 4% (with a \$3,000 exemption) and graduated rates topped out at 63%.⁶²

To counteract the effect of high tax rates on donor-funded groups, Congress made some individual donations deductible. As amended, the 1917 Act provided a donor deduction for “contributions or gifts actually made within the year to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals...” not to exceed 15 percent of the taxpayer's taxable income.⁶³

Senator Hollis, for this deduction, anticipated that high tax rates in the 1917 Act would absorb great amounts of “surplus” funds that individuals might otherwise donate to charity. He specifically emphasized the impact on colleges and universities, which also suffered from decreased enrollment as students went to war.⁶⁴ Hollis, significantly, did not key the deduction to the subsections created in

⁶⁰ Bittker and Rahdert, *supra* note 52, at 303.

⁶¹ SEIDMAN, *supra* note 38 at 975-78.

⁶² ROY G. BLAKEY AND GLADYS C. BLAKEY, *THE FEDERAL INCOME TAX* 151 (1940).

⁶³ SEIDMAN, *supra* note 38 at 944. Initially, the cap was 20%, but in Senate debate Senator Henry F. Hollis agreed to reduce it to 15% to gain support for its passage. 55 CONG. REC. at 6729. The amendment was adopted unanimously. *Id.* at 6741.

⁶⁴ 55 CONG. REC. at 6728.



the 1916 Act – he did not declare, for instance, that only gifts to organizations exempt under section 11(a)(6) (the subsection about religious, charitable, scientific, or educational exempt purposes, see above) would be deductible. He used the phrase “religious, charitable, scientific or educational” which, as we have seen, could mean a wide variety of groups, including nonprofit advocacy groups, under previous interpretations, state law, or common law.

Hollis’s amendment included an important caveat, as it turned out – deductions would be subject to regulations from the Bureau of Internal Revenue. This deduction against taxable income for individuals prompted increased scrutiny of exempt organizations. Recall that at this point all exempt organizations were “lumped together and exempted from tax as though fungible members of an undifferentiated mass.”⁶⁵ Yet the obvious differences in the social roles of different kinds of nonprofits received greater attention once donors also enjoyed a tax break. Moreover, the 1916 Act had divided the exemption section into subsections, providing (unintentionally) a way to differentiate among exempt organizations.

At first, the Bureau of Internal Revenue approved exemptions (and deductibility of gifts) for advocacy groups. Such activity was deemed “educational.” For example, a Bureau Solicitor’s Memorandum stated: “An association organized and operated solely in order to educate the public sentiment of a State in favor of the prohibition of the sale of intoxicating liquors, and devoting all of its funds to this purpose is organized and operated exclusively for an ‘educational purpose.’”⁶⁶ Similarly, “[a] corporation organized and operated in order to educate public sentiment in favor of the doctrine of protection is ‘educational’ in character and exempt from income tax; and donations to its funds may be deducted in computing the net Income of the donor.”⁶⁷

Treasury Rejects Deductions for Controversial Groups

This generous treatment was short lived. In 1919, the Treasury Department adopted the first regulation restricting political activity by exempt organizations, as part of a comprehensive set of regulations titled Regulation 45.⁶⁸ It declared “associations formed to disseminate controversial or partisan propaganda are not educational within the meaning of the statute.”⁶⁹

By this regulation, the Bureau overruled those decisions allowing nonprofit advocacy groups their tax exemptions, and the deductibility of donations made to them. As the Bureau’s Solicitor now observed:

It is a matter of common knowledge that propaganda in the popular sense is disseminated not primarily to benefit the individual at whom it is directed, but to accomplish the purpose or purposes of the person instigating it. In my opinion this is a very material difference. I

65 Bittker and Rahdert, *supra* note 52, at 302. That “lumping” problem only increased with amendments made in the Revenue Act of 1918, which defined “corporation” broadly to include, not just corporations formed under state law, but “associations, joint-stock companies, and insurance companies.” Until this time, state laws had defined what was a “corporation,” since corporations were creature of state corporation statutes.

66 S. 200, May 16, 1918, quoted in S. 1362, 1 Cum. Bull. 153 (1920). “S” stands for “Solicitor’s Memorandum.”

67 S. 455, August 28, 1918, *quoted in* S. 1362, 1 Cum. Bull. 153 (1920). The “doctrine of protection” supported using tariffs to protect domestic industry from foreign competition.

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

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

believe that it was Congress' intention, when providing for the deduction of contributions to educational corporations, not to benefit and assist the aims of one class against another, not to encourage the dissemination of ideas in support of one doctrine as opposed to another, to the profit of one class and to the detriment perhaps of another, but to foster education in its true and broadest sense, thereby advancing the interest of all, over the objection of none.⁷⁰

The Solicitor did not expand on what evidence convinced him that this result agreed with Congressional intent, perhaps because there was none. Accordingly, in a subsequent decision the Bureau denied a prohibition group both a tax exemption and the deductibility of donations.⁷¹

Regulation 45 also defined which groups could offer donors deductions for gifts. As noted previously, tax law had lumped various kinds of entities into one tax-exempt class. Regulation 45, in article 251, however, only extended deductibility to gifts to "religious, charitable, scientific and educational groups" described in article 517.⁷² Regulation 45 also, as the footnote text shows, drew lines within the "educational" class that seem odd, excluding symphonies, groups formed to disseminate "controversial views" (as noted) but specifically allowing Chautauqua associations. Regulation 45 also blessed the "scientific study of law" (whatever that meant) as worthy of a charitable deduction.

Members of Congress had been keen to identify certain groups as tax exempt, such as Chambers of Commerce, cemetery companies and social welfare groups, so as to counteract the Bureau's tendencies to interpret the exemption narrowly. But Regulation 45 extended donor deductions to only a subset of exempt organizations, then read out of the tax-exempt class entirely groups engaged in disseminating controversial or partisan propaganda. The Bureau had a justification:

Congress, by enumerating these various classes of exempt organizations, expressed an intention that if the organization, by name or operation, falls within one of the subdivisions other than (6), it should not be classified under (6) as a charitable organization, even though it or similar organizations may have been held for other purposes to be charitable. ... Had Congress intended that cemetery companies, labor organizations, civic leagues, etc. which might reasonably be classed as charitable organizations under some of the decisions of the State courts, should be classified as such under subdivision (6) it scarcely would have gone to the

70 S. 1362, 1 Cum. Bull. at 154.

71 O.D. 704, 1 Cum. Bull. 240. "O.D." stands for "Office Decision."

72 Regulation 45, Article 517 reads in pertinent part: "Religious, charitable, scientific and educational corporations. — ... In order to be exempt the corporation or association must meet three tests: (a) it must be organized and operated for one or more of the specified purposes; (b) it must be organized and operated exclusively for such purposes; and (c) no part of its income must inure to the benefit of private stockholders or individuals. (1) Charitable corporations include an association for the relief of the families of clergymen, even though the latter make a contribution to the fund established for this purpose; or for furnishing the services of trained nurses to persons unable to pay for them; or for aiding the general body of litigants by improving the efficient administration of justice. Educational corporations may include an association whose sole purpose is the instruction of the public. This is true of an association to promote acquaintance with the Spanish language and literature, although it has incidental amusement features; of an association to increase knowledge of the civilization of another country; and of a Chautauqua association whose primary purpose is to give lectures on subjects useful to the individual and beneficial to the community and whose amusement features are incidental to this purpose. But associations formed to disseminate controversial or partisan propaganda are not educational within the meaning of the statute. Societies designed to encourage the performance of first class orchestral music are not exempt, the purpose being merely to provide a high grade of entertainment. Scientific corporations include an association for the scientific study of law, to the end of improvement in its administration."



trouble of specifically exempting them under other subdivisions.⁷³

The Bureau ignored the legislative and drafting history of the exemption statute, not to mention the stated intent of Senator Hollis when presenting the deduction language. It dramatically narrowed the application, and the utility, of the tax deduction. Ironically, those Members of Congress who believed that naming certain groups specifically would insulate them from erosion of their tax advantages accomplished the exact opposite.

The genesis of the “controversial or partisan propaganda” clause in Regulation 45 is unclear. But the consequences for advocacy groups were severe. Under the “propaganda” restriction, a prohibition group lost both its exemption as an educational group, and deductibility for its donors. An organization formed to “encourage the study of labor conditions in the United States with a view to promoting desirable labor legislation” was deemed “propagandist,” thus neither an educational association nor eligible for deductible donations.⁷⁴ This was a very damaging development for these previously exempt advocacy organizations.

Regulation 45 Applied Strictly and Inconsistently

As the Board of Tax Appeals began hearing appeals brought under the Act and Regulation 45, it announced that tax exemption, and the deduction of contributions, must be “strictly construed, and the taxpayer must establish clearly that it comes squarely within its provisions.”⁷⁵ Moreover, as revealed in Board decisions, the Bureau of Internal Revenue’s initial application of the regulation was both strict and inconsistent.

In an appeal related to a 1918 tax return, the Board rightly approved without much comment deductions for charitable contributions to a host of religious groups.⁷⁶ Yet that same month, the Board determined, with some overt hostility, that a religious commune of Hutterites could not claim an exemption, because “it is difficult to discover any benefit to the public flowing from the activities of this taxpayer. It sells its commodities and services on the open market in direct competition with other producers.”⁷⁷ As German-speaking communal pacifists, Hutterites were less than popular among the larger community during World War I.⁷⁸

Technical burdens on taxpayers abound in some of these denials. The Board affirmed the Commissioner’s denial of a deduction for a contribution in 1923 to the Daughters of the American Revolution, because the taxpayer had failed to prove it was an organization entitled to exemption.⁷⁹ A

73 A.R.R. 1122, Cum. Bull. 1922-1 at 142, 143 (cemetery); see also INCOME TAX RULING, INTERNAL REV. BULLETIN (Jan.- June 1922) (concluding that an association that runs youth programs, citizenship organizations and social work was civic, not charitable, denying deduction). A.R.R. stands for “Appeals and Review Recommendation.”

74 S. 1362, 1 Cum. Bull. 152 (April- December 1919) (1922).

75 Appeal of Waynesboro Manufacturers Association, 1 B.T.A. 911 (March 30, 1925) (overturning Commissioner’s determination that taxpayer was not an exempt business league.)

76 Appeal of Douglas, 1 B.T.A. 372, 375 (January 27, 1925). Groups included YMCA and YWCA, American Red Cross, “French orphans,” Seton Guild, a Presbyterian church, Bethany Home Association, Boy Scouts, Salvation Army, Infant Welfare Society, Jewish War Relief, Women’s Council of National Defense, Women’s Missionary Society, and the Sunshine Society.

77 Appeal of Hutterische Bruder Gemeinde, 1 B.T.A. 1208, 1211 (May 23, 1925).

78 Hutterites trace their history to radical Anabaptist movements, and share history with Mennonites and Amish. See HUTTERIAN BRETHERN, <http://www.hutterites.org> (last visited April 10, 2015).

79 Appeal of Tucker, 2 B.T.A. 796 (October 5, 1925). A deduction was also denied this taxpayer for contributions made to “other churches.”

similar failure of proof denied a deduction for a gift in 1919 to the Zionist Organization of America.⁸⁰ Another taxpayer failed to prove that the League to Enforce Peace was an organization deserving the charitable deduction in 1919, notwithstanding the group's prominent and newsworthy role in advocating for the League of Nations.⁸¹

The Board explicitly invoked the rule barring deductions to groups formed to disseminate controversial or partisan propaganda in *Appeal of Fales*.⁸² The Commissioner had denied deductions for contributions made in 1920 to a number of advocacy groups, among them the Massachusetts Anti-Saloon League, the Massachusetts Anti-Cigarette League, and the International Reform Bureau. The Board, without elaboration, concluded that these groups were not educational, due to their "controversial or partisan" views.⁸³

If the Board of Tax Appeals adopted a strict interpretation, it was still often more reasonable than the Commissioner's. The Board reversed the Commissioner's denial of a deduction for a 1917 gift of \$100 to the American Red Cross.⁸⁴ The Board also reversed the Commissioner's denial of a deduction for a 1922 donation of \$1,000 to the Beth Levy Congregation in Santa Rosa, California, and 1923 contributions of \$150 to a synagogue, \$200 to the "Old Folks Home Association," and \$1,015 to a public park.⁸⁵ One taxpayer's series of church contributions made from 1922-25 were disallowed, with the Board reversing, eventually, in 1930.⁸⁶ None of these decisions reveal what reason the Commissioner could have had for these denials, which seem legally unsupportable. One is left to wonder how many similar rulings went unchallenged on appeal.

Propaganda was sometimes tolerated, sometimes not. In 1926 the Bureau's General Counsel opined that the National Rifle Association was an exempt educational organization, notwithstanding that one of the objects listed in its bylaws was "to encourage legislation for the establishment and maintenance of ranges; and to create a public sentiment in respect to the necessity of rifle practice as a means of national defense."⁸⁷ This would contrast starkly with the Commissioner's denial of deduction in 1929 for a contribution to the World League Against Alcoholism, because the group "spread propaganda against alcoholism and is not an educational institution."⁸⁸

Taken together, these rulings, interpretations and appeals demonstrate the Treasury Department and the Bureau of Internal Revenue's unwillingness to adopt a lenient interpretation favoring non-profit advocacy groups, in contrast to the stated preferences of Members of Congress when enacting

80 *Appeal of Lindheim*, 2 B.T.A. 913 (October 19, 1925). The taxpayer's contribution was made to the "Federation of American Zionists," which was the group's previous name. In that decision, the Board noted that the taxpayer produced the constitution and bylaws of the group, as well as an excerpt of the group's minutes, yet in the Board's eyes somehow failed to establish the group's status as an exempt organization.

81 *Appeal of Coe*, 5 B.T.A. 261 (October 29, 1926).

82 9 B.T.A. 828 (December 23, 1927).

83 It is unclear whether the Bureau also withdrew their tax-exempt status.

84 *Appeal of Anderson and Gustafson*, 3 B.T.A. 531 (January 30, 1926).

85 *Levin v. Comm'r*, 5 B.T.A. 892 (December 21, 1926); *Blydenburgh v. Comm'r*, 5 B.T.A. 834 (December 17, 1926), *Lobsenz v. Comm'r*, 17 B.T.A. 81 (August 6, 1929).

86 *Stimpson v. Comm'r*, 19 B.T.A. 1059.

87 G.C.M. 443, I.R. Bull. 1926 at 66.

88 See *Cochran v. Comm'r*, 78 F.2d 176 (4th Cir. 1935) (summarizing appeal history, reversing Board, and upholding exemption because group was educational).



the statute, as well as the tradition in the states and at common law. This agency intransigence didn't receive much public attention until 1930.

Slee v. Commissioner

Treasury's approach toward deductibility, and its distaste for "controversial or partisan propaganda" drew public attention with the 1930 case *Slee v. Commissioner*.⁸⁹ Margaret Sanger, the birth control crusader and founder of Planned Parenthood, received substantial financial support for her birth control clinics from J. Noah Slee, her second husband.⁹⁰ Although these clinics were considered charitable and educational under New York law, the Bureau rejected Slee's tax deductions in 1926, and the Board of Tax Appeals concurred.⁹¹

The Board held that Sanger's group had a number of purposes. It determined that groups having any one purpose that was not "charitable" could not offer donors deductions, and that one clear non-charitable purpose of the group was "the dissemination of controversial propaganda."⁹² The decision concluded, amusingly, "such has also been the uniform interpretation of the Commissioner of Internal Revenue in all of his regulations, beginning with those promulgated April 17, 1919."⁹³

The Second Circuit Court of Appeals stood with the Bureau. In an opinion authored by the highly respected Judge Learned Hand, the court concluded "political agitation as such is outside the statute, however innocent the aim."⁹⁴ The court did not discuss Regulation 45, only the statute, which itself said nothing about propaganda, agitation, or controversial views.

Bureau Holds that "Controversial" Views Sufficient to Deny Deduction

Post-*Slee*, the Board of Tax Appeals persisted with its focus on "controversial" organizations, even those that did not "propagandize" or lobby. It affirmed the Commissioner's denial of a deduction for contributions to the League for Industrial Democracy, in *Weyl v. Commissioner*.⁹⁵ The League had been founded in 1905 by a group of prominent Socialists, among them Upton Sinclair, Clarence Darrow and Norman Thomas, to educate college students about socialism and the labor movement.⁹⁶ The Board conceded that the group did no lobbying, but observed that its literature was advocacy, not balanced argumentation. The Board insisted that the group's publications were "directed to political matters rather than educational objects." Its goal of a new social order was, in the Board's view, "highly controversial."⁹⁷ Thus, under *Weyl*, a group need not engage in propaganda/lobbying to be

89 42 F.2d 184 (2d Cir. 1930).

90 See OLIVIER ZUNZ, *PHILANTHROPY IN AMERICA* 95 (2012).

91 *Slee*, 15 B.T.A. 710 (1929), see also *Loses Plea to Exempt Birth Control Gifts: J.N.H. Slee Must Pay Taxes on \$17,150 Given to League Founded by Margaret Sanger, His Wife*, N.Y. TIMES, March 7, 1929 at 9.

92 15 B.T.A. at 715. This would seem to a modern practitioner to be more of an "activity" test than a "purpose" test. Gifts to the League were to two different groups, one an unincorporated association, and the other an incorporated New York nonprofit that claimed tax exemption as a social welfare organization. Slee apparently argued that contributions to both groups should be deductible. The Board's decision fails to address this argument.

93 *Id.*

94 42 F.2d at 185.

95 *Weyl v. Comm'r*, 18 B.T.A. 1092 (February 11, 1930).

96 See description at GUIDE TO THE TAMIMENT LIBRARY, http://dlib.nyu.edu/findingaids/html/tamwag/pe_033/pe_033.html (last visited April 10, 2015).

97 Tax Judge John M. Sternhagen dissented, rejecting the view that a controversial position could not also be educational. *Id.*, see

denied treatment as an educational tax-exempt.

It wasn't long before the Commissioner argued that advocacy of economic change "contrary to the present order" would disqualify a group from exemption as an educational organization in *Lebuscher v. Commissioner*.⁹⁸ The estate of Robert Schalkenbach, who died in 1924, contested the Commissioner's denial of a deduction for his bequest to establish the Robert Schalkenbach Foundation, to further the scholarship of Henry George.⁹⁹ George, the author of *Progress and Poverty*, was a radical economic reformer.

The Board upheld the Commissioner's denial, because the will "shows an intent and purpose not only to educate, but also, and perhaps more so, to bring about legislation." The fact the Foundation itself disavowed any lobbying or political activity in its formative documents – and had no such activity in its history – was not dispositive.¹⁰⁰ The Board claimed that radical advocacy, alone, was not disqualifying. Nevertheless, it appears it was, since Schalkenbach's estate lost.

The Revenue Act of 1934

Any opportunity to revise the *Slee* standard (or Regulation 45) administratively ended in 1934, when Congress enacted the first law "to single out political advocacy" in the tax code.¹⁰¹ The Revenue Act of 1934 required that, for a donation to be tax deductible, no substantial part of the activities of the recipient could "be the carrying on of propaganda or otherwise attempting to influence legislation."¹⁰² The restriction applied not to the recipient's exempt status but only the donation's deductibility.¹⁰³

Originally, the language, offered by Senator Byron "Pat" Harrison, read "and no substantial part of the activities of which is **participation in partisan politics**, or is carrying on of propaganda, or otherwise attempting to influence legislation." (Emphasis added). Proponents of this language perhaps wanted to make the existing regulatory prohibition more precise, thus continuing in the tradition of Congress pushing back against broad Treasury interpretations.¹⁰⁴ Noted one expert in retrospect, "Congress at the time was reluctant to require a narrow application of section 202(6) as to 'educational' organizations as the Service had at first attempted."¹⁰⁵

Perhaps, additionally, Members were involved in their own politicking. The American Legion and the National Economy League (a prestigious "educational" organization that counted among its advisors Elihu Root and Calvin Coolidge) were locked in a battle over bonuses, pensions and payments

also *Upsets Gift Tax Appeal*, N.Y. TIMES, Feb. 12, 1930. The Second Circuit agreed with his dissent, see *Weyl v. Commissioner*, 48 F.2d 811 (2d Cir. 1931).

98 *Lebuscher v. Comm'r*, 21 B.T.A. 1022 (Dec. 31, 1930). The Second Circuit reversed in part, see 54 F.2d 998 (2d Cir. 1932).

99 The Foundation still operates. See ROBERT SCHALKENBACH FOUNDATION, <http://www.schalkenbach.org>. The IRS lists it as a private operating foundation (ID 13-1656331), to which contributions are deductible.

100 Judge Sternhagen (the *Weyl* dissenter) authored the opinion.

101 ZUNZ, *supra* note 90, at 98; 48 Stat. 690, 700 (1934)

102 "Propaganda" did not have as negative a connotation at this time, and probably referred to what modern observers label "grassroots" lobbying. See Note, *Tax Treatment of Lobbying Expenses and Contributions*, 67 HARV. L. REV. 1408, 1412 (1954).

103 SEIDMAN, *supra* note 38, at 312.

104 Clark, *supra* note 69 at 447 n.39

105 *Tax Exempt Foundations, Hearings before the Special Committee to Investigate Tax-Exempt Foundations and Comparable Organizations*, 83rd Cong., 2d Sess. Part I at 433 (1954), (testimony of Norman Sugarman) (hereinafter "Hearings").



for disabled veterans.¹⁰⁶ When the League succeeded legislatively, veterans' groups pushed Senators to have restrictions on lobbying and partisan politics placed into the Revenue Act.

Senator David Reed observed during debate on the Revenue Act that the authors intended to restrict the deductibility of contributions that were “selfish one(s) made to advance the interests of the giver of the money” – specifically donations by wealthy supporters to the National Economy League.¹⁰⁷ In conference, the committee deleted Senator Harrison’s restriction on “partisan politics” from the final language at the request of House members, who “were afraid this prohibition was too broad.” Moreover, the amendment would be just as effective against the National Economy League without it.

As a consequence, groups classified as religious, charitable, educational or scientific organizations could lose the ability to offer tax deductions, if they engaged in substantial lobbying or “propaganda” activities. Other tax-exempt groups, such as social welfare organizations and business leagues (and the American Legion), remained unaffected. Groups that engaged chiefly in “partisan politics” were ignored. Historian Olivier Zunz noted, “Thus Congress made for the first time a distinction that has become increasingly important between different kinds of exempt groups, a distinction that reflected political muscle more than logical categorization.”¹⁰⁸

But this language also changed the focus of analysis from whether what a group was doing was of proper tone and purpose (i.e. not “controversial and partisan”) to how much of the questionable activity was being done, whatever the group’s purpose or attitude might be. Ironically, under the 1934 Act, it seems likely that J. Noah Slee would have been able to deduct his contributions to Margaret Sanger’s organization, since her clinics were not engaged in “substantial” lobbying.¹⁰⁹

Enforcement Overreach Under the 1934 Act

Since “substantial” propaganda or lobbying became the crucial threshold under the 1934 Act, the question became - how much lobbying or propaganda activity would it take for an “educational” group to lose that status? In January 1940, in the tax appeal of the estate of Ida Simpson, the Board denied deductions for donations to the Methodist Board of Temperance, which did some lobbying, issued propaganda, and endorsed candidates.¹¹⁰ The Board stated “That a large part, perhaps a major part, of the Methodist Board’s activities were admittedly religious, charitable, or educational, does not help petitioners if, as we are impelled in the light of the evidence to hold, it was engaged to a substantial extent in other activities.” Thus, a tax practitioner attempting to advise a client under the 1934 Act would find little guidance to ascertain more precisely what “substantial” meant.

Nor was “substantial” non-exempt activity the only route that could defeat a claim of exemption. As we saw, the National Rifle Association had been deemed an “educational” organization in 1926 that was both tax-exempt and could offer its donors deductions for their gifts. But in 1938, the NRA litigated its status as an exempt organization against a claim by the District of Columbia that it owed

106 See *National Affairs: Economy Lobby*, TIME, Jan. 2, 1933; *The National Economy League*, HARV. CRIMSON, Oct. 14, 1932,

107 Clark, *supra* note 69 at 447 n.40, citing 78 CONG. REC. 5861 (1934), ZUNZ, *supra* note 90 at 101. The Revenue Act of 1935 extended the deduction to gifts made by corporations.

108 ZUNZ, *supra* note 90 at 102.

109 JUDITH KINDELL AND JOHN F. REILLY, LOBBYING ISSUES; EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM (1997 EO CPE) at 266.

110 Girard Trust, 41 B.T.A. 157 (Jan. 24, 1940), *rev'd* 122 F.2d 108 (3d. Cir. 1941).

unemployment payments to the District. The NRA lost, primarily because in 1871 it had organized under the New York statute applicable to social clubs, not the one applicable to charities and educational organizations – making it hard to claim it had been organized “exclusively” for educational purposes.¹¹¹ The Bureau’s General Counsel took notice, and in 1944 revoked its prior opinion, holding that the NRA was a social welfare organization, not an educational organization.¹¹² It did not evaluate whether the NRA had engaged in “substantial” non-exempt activities at all – the State law status was dispositive.

Under the 1934 Act, the Bureau began revising a challenged group’s status. This would preserve the group’s own exemption, by finding it exempt under another section of the Act. A group formed to promote medicine, “for the purpose of elevating the standard of medical education,... enlightening and directing public opinion in regard to the problems of State medicine and public health; of securing the enactment and enforcement of just medical laws . . .” was denied an exemption as an educational organization, but was held exempt as a business league.¹¹³ Recategorized groups were displeased– not only because their donors could not deduct contributions, but also because – having retained their exemption – groups were unable to contest these decisions.¹¹⁴

In addition to probing the meaning of “substantial”, the word “exclusively” – which as we have seen was never given its ordinary meaning – remain contentious under the 1934 Act. The Bureau challenged exempt groups using for-profit businesses to garner financial support, contending that this activity was hardly consistent with a charitable purpose. The most notorious example of the time was New York University Law School’s ownership of Mueller Macaroni – which it operated tax-free.¹¹⁵ Congress stepped in and enacted a tax on unrelated business income.¹¹⁶ Exempt organizations were still permitted to engage in business, provided their primary purpose remained entitled to the exemption.

Finally, before this paper turns to the recodification and amendments of the 1954 Act, there was one major caveat to any tax exemption or deduction. The recipient organization could not be one required to register with the government as a subversive organization under the Internal Security Act of 1950.¹¹⁷ Known popularly as the McCarran Act, this law required Communist action organizations and communist front organizations to register with the government, and provide their accounts and membership information.¹¹⁸

111 *National Rifle Ass’n v. Young*, 134 Fed. 2d 524 (D.C. Cir. 1943).

112 G.C.M. 24100 I.R. Bull. 1944 at 192.

113 I.T. 3182, IRS Bull. 1938 at 168-69 (applying Revenue Act of 1936). Interestingly, the opinion makes no mention of the prohibition against “carrying on propaganda, or otherwise attempting to influence legislation”, which would seem to be the most direct argument against this group’s status as an educational organization.

114 Proceedings of New York University Fourth Biennial Conference on Charitable Foundations 199 (1959) (statement of Harold T. Swartz, Assistant Commissioner of Internal Revenue).

115 A brief and entertaining account of this is provided by Ellen Aprill, *The IRS’s Tea Party Tax Row: How “Exclusively” Became “Primarily”*, PACIFIC STANDARD, June 7, 2013; see also Ethan G. Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Tax*, 54 EMORY L. J. 1475, 1483 (2005), *C.F. Mueller v. Comm’r of Internal Revenue*, 190 F.2d 120 (3d. Cir. 1951). It is clear, however, that the modification of “exclusively” to mean “predominate” or “primarily” predated the 1950 amendment. See *Hearings*, Part 1, *supra* note 105 at 430 (testimony of Norman Sugarman, citing 1942 tax treatise).

116 Revenue Act of 1950, H. Res. 8920, 81st. Cong. 2d Sess., Pub. L. 814.

117 T.D. 5924, I.R.S Bull. 1952, at 100-03.

118 Internal Security Act of 1950, Pub. L. 81-831; 64 Stat. 98 (1950).



Section IV

The 1954 Revenue Act and the Modern Tax Code

The World War II tax system persisted after the end of war, and there were not reductions like those following World War I. Noted author John Witte: “Whereas the Second World War established the modern income tax, the inaction of the Eisenhower years sustained it.”¹¹⁹ Yet federal tax saw a transformation in the comprehensive rewriting of the Code, via the 1954 Revenue Act.

The 1954 Act included language prohibiting engagement in politics – the so-called “Johnson Amendment” after its sponsor, Senator Lyndon Johnson – in the clause relating to charities now numbered Section 501(c)(3). The Johnson Amendment added the phrase “and which does not participate in, or intervene in (including the publishing and distributing of statements) any political campaign on behalf of any candidate for public office.”¹²⁰ (No such restriction was attached to social welfare groups exempt under the section now numbered 501(c)(4)). This analysis now turns to the context and politics that lay behind the Johnson Amendment.

The Roots of the 1954 Recodification

In the years leading up to the 1954 Act, Internal Revenue administrators faced discredit and criticism. In 1951, “irregularities” in the handling of tax matters came to light. Internal Revenue staff had accepted payment in return for lenient treatment, and related corruption.¹²¹ In response to the scandal, President Truman proposed, and Congress adopted, a reorganization plan in 1952. Its chief feature was to place IRS agents under the civil service.¹²² Yet this did not put congressional concerns to rest. The reorganization’s effects on the Service’s efficiency, morale, and fairness to taxpayers received stern criticism from the Hill.¹²³

Also in 1952, Delaware Republican Senator John Williams revealed that the Bureau of Internal Revenue had approved the deduction of “bad debts” made to the New York State Democratic Committee. These bad debts included \$210,000 owed to tobacco businessman Richard J. Reynolds, \$50,000 owed to Chicago businessman Marshall Field, and another \$50,000 owed New York retailer David A. Schulte.¹²⁴ These transactions were contrary to existing tax law.¹²⁵ Nevertheless, Williams’ revelation apparently provoked the enactment of a specific ban on bad debt deductions for political party debts.¹²⁶

119 JOHN WITTE, *THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX* 144 (1986).

120 Internal Revenue Code of 1954 § 501(c)(3), Pub. L. No. 591, 68A Stat. 1, 163 (1954).

121 See *Tax Scandal: An Issue for '52*, N.Y. TIMES, Dec. 9, 1951.

122 *Senate, 53-37, Votes Truman’s Revision of Revenue Bureau*, N.Y. TIMES, March 14, 1952.

123 See *THE INTERNAL REVENUE SERVICE, ITS REORGANIZATION AND ADMINISTRATION*, JOINT COMMITTEE ON TAXATION (July 25, 1955). Objectionable new policies included quotas and promotions for employees based on producing large tax deficiencies. *Id.* at 50-53.

124 R.T. Boehm, *Taxes and Politics*, 22 TAX L. REV. 369, 389 (1967); see also Jeffrey Schoenblum, *From De Facto to Statutory Exemption: An Analysis of the Evolution of Legislative Policy Regarding the Federal Taxation of Campaign Finance*, 65 VA. L. REV. 513, 522-23 (1979).

125 Boehm, *supra* note 124, at 392.

126 *Id.* at 393; see also 66 Stat. 467 (1952). The ban did not extend to candidate loans or loans to nonparty advocacy groups. Boehm at 396.

Congress wasn't the Bureau's only problem. Federal courts rejected the Bureau's tough stand against exemptions and deductions for nonprofit advocacy groups. By 1954, the courts had generated a strong series of precedents holding that the deduction for charitable and educational donations should be liberally construed in favor of the taxpayer.¹²⁷ Contributions to advocacy groups like the League of Women Voters, women's clubs, birth control leagues and the like were held to be properly tax deductible because the groups were exempt as educational organizations – contrary to the Bureau's position.¹²⁸

Against these developments, tax writers began to assemble the language that became the 1954 Act. In 1946, the American Law Institute launched an income tax project, and its drafts had significant influence on the final Act.¹²⁹ There is no evidence that during this process the ALI, or anyone else, entertained any limitation on political activity resembling the Johnson Amendment.¹³⁰

In 1953, congressional staff began consolidating suggestions for revisions to the Code, but nothing like the Johnson Amendment can be found in them. Suggested revisions to the category of exempt organizations instead focused on reducing the perceived advantage they enjoyed in competition with for-profit entities.¹³¹

This lengthy and secretive drafting process produced a complicated, pervasive and technical statute. Leadership attracted support for the legislation by including items beneficial to certain constituents. Members of Congress also apparently (again) believed that increased specificity would limit Treasury and the unpopular Bureau of Internal Revenue's discretion, and prevent regulators from interpreting tax rules aggressively against congressional intent.¹³²

Lyndon Johnson's Amendment

The idea of amending the Internal Revenue Code in 1954 to prohibit political activities by certain exempt organizations may have come, not from tax specialists, but in part from the efforts of anticommunists in Congress to thwart support for radical groups. In April 1954, Congressman B. Carroll Reece led the Select Committee to Investigate Tax-Exempt Foundations and Comparable Organizations in investigating the political and propaganda activities of tax-exempt foundations.¹³³ Its authorizing resolution specifically instructed the Committee to investigate the use of tax-exempt resources

127 *Seasongood v. Comm'r*, 227 F.2d 907, 910 (6th Cir. 1955); *Liberty National Bank v. US*, 122 F. Supp. 759, 762 (W.D. Ky. 1954) (citing cases).

128 *Id.*

129 William Cary, *Reflections upon the American Law Institute Tax Project and the Internal Revenue Code: A Plea for a Moratorium and Reappraisal*, 60 COLUM. L. REV. 259 (1960).

130 Nor did Johnson's language adopt the rejected language from Senator Harrison's 1934 amendment, which read: "and no substantial part of the activities of which is participation in partisan politics..." Harrison's amendment contained a substantiality test, but Johnson's amendment created an absolute ban. Harrison's amendment limited "partisan politics" rather than Johnson's focus on political campaigns and candidates. Conceivably Harrison's wording would allow groups to engage in nonpartisan races, while Johnson's, on its face, would allow groups to intervene in political party contests.

131 See PRELIMINARY DIGEST OF SUGGESTIONS FOR INTERNAL REVENUE REVISION SUBMITTED TO THE JOINT COMMITTEE ON INTERNAL REVENUE TAXATION (April 21, 1953) at 64-65. Two potential revisions touched on politics, but did not resemble the Johnson Amendment at all – one suggestion was to make graft payments (i.e. bribes and extorted payments) deductible "to the extent they are ordinary and necessary in the taxpayer's business." *Id.* at 21. The second suggestion would allow candidates who pay filing fees or otherwise bear costs of primary elections to deduct those expenses from gross income. *Id.* at 47.

132 WITTE, *supra* note 119, at 149-50; Cary, *supra* note 129, at 280.

133 *Hearings*, *supra* note 105.



“for subversive activities, for **political purposes**, propaganda, or attempts to influence legislation.”¹³⁴ (Emphasis added).

These hearings commenced in May, 1954, and drew to a close in July. Among the committee’s conclusions: that the substantiality test was “a futility” and “the tax law might better proscribe all political activity, leaving it to the courts to make exceptions on the principle of *de minimis non curat lex*.”¹³⁵

By the time the Committee released its Report, the Code had been amended (by the Johnson Amendment) to prohibit political participation or intervention by groups exempt under 501(c)(3).¹³⁶ Yet the Reece Committee (and its predecessor the Cox Committee) had spent months badgering foundations about whether they had used their resources for political purposes or propaganda. These allegations had made news.¹³⁷ Perhaps this publicity primed the pump for Senator Johnson. At the very least, it may have called his attention to an area where he could advance popular legislation as well as further his personal political aims.

The Johnson Amendment’s legislative and political history, such as it exists, has been exhaustively researched by others.¹³⁸ Briefly, Johnson introduced his amendment, seemingly out of the blue, during a July 2 Senate floor debate. His explanation for his amendment to section 501(c)(3):

[T]his amendment [would deny] tax-exempt status to not only those people who influence legislation but also to those who intervene in any political campaign on behalf of any candidate for any public office.

He continued by stating that he had discussed the amendment with committee members and it was “acceptable to them.”¹³⁹ The amendment was included in the final legislative draft, and enacted as part of the Internal Revenue Code of 1954.

Johnson’s sudden interest in the tax treatment of exempt organizations was possibly pragmatic. Johnson had drawn a Democratic primary contender with deep pockets, who could depend upon support from anti-communist interest groups. These groups claimed exemption as educational organizations. Johnson went so far as to inquire of an IRS Commissioner (via an intermediary) whether their activities were in accord with existing law. Johnson received the Commissioner’s inconclusive response on July 2, the day he offered the floor amendment.¹⁴⁰ July 2 was also the second-to-the-last day of Reece Committee Hearings.

In context, Johnson’s reference to “those people” must have meant groups exempt under what became Section 501(c)(3). Evidently Johnson thought, or wanted others to think, that his amendment

134 H. Res. 217, 83rd Cong. 1st Sess., reproduced in *id.*, Part 1, at 1-2.

135 *Id.*, Part 3, at 95.

136 *Id.*

137 See *The Nation*, N.Y. TIMES, May 16, 1954; *Education: Two-Edged Weapon*, TIME, July 19, 1954.

138 See Howard Rea, *Changes in the Internal Revenue Code of 1954 Affecting Charitable Organizations*, 27 ROCKY MTN. L. REV. 270 (1955); Lobbying and Political Activities of Tax-Exempt Organizations, Hearings before the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, 100th Cong. 1st Sess. (1987); Deirdre Halloran & Kevin Kearney, *Federal Tax Code Restrictions on Church Political Activity*, 38 CATH. U.L. REV. 105 (1998); Patrick L. O’Daniel, *More Honored in the Breach: A Historical Perspective of the Permeable IRS Prohibitions on Campaigning by Churches*, 42 B.C. L. REV. 733 (2001).

139 100 CONG. REC. 9604 (1954).

140 Halloran & Kearney, *supra* note 138, at 108. This was also the last day of deliberations by the Reece Committee. O’Daniel, *supra* note 138, at 765.

enhanced an existing ban on propaganda. As we know, there was no such ban on propaganda, but an ill-defined “substantiality” limit. Did Johnson mean to add campaign intervention to those activities subject to a substantiality test? Did he mean to impose an intervention and propaganda ban, as suggested by the Reece Committee? Had he thought about these issues at all?

One article written soon after the Code’s enactment observed:

[S]ince participation in a political campaign may be, in effect, an indirect method of attempting to influence legislation, discrimination between these two activities would seem inconsistent. In view of the fact that the substantiality concept has been applied in the legislative area, it would appear that the present Code should be construed to apply equally to the political campaign situation.¹⁴¹

At enactment, then, some reasonable minds believed the Johnson Amendment would only bar “substantial” political intervention for 501(c)(3)s.

Johnson himself seemed to understand that it wouldn’t deter his right-wing detractors in Texas, unless they went beyond their extant activities to intervene specifically in campaigns – perhaps something he wanted to ensure wouldn’t occur.¹⁴² Johnson also understood that his amendment would have no effect on entities that were exempt under a code section other than section 501(c)(3) – in fact, Johnson tapped staff to draft a reassuring memo to labor unions (exempt under 501(c)(5)) concluding that the measure “will have no effect upon labor organizations.”¹⁴³ The same analysis should then apply to social welfare organizations, who, like labor unions, were exempted under a separate section of the Code.

But what evidence is there that these groups might have been inclined to intervene in politics? Not much, unless one believed having anticommunist or radical opinions amounted to intervention. One observer at the time stated “it is difficult to see what this new pious and pointless protestation of legislative virtue can add to the statute.”¹⁴⁴ This author suggested instead that if Congress felt the law had become too lenient toward “educational” groups, Congress should address the definition of “education.” In this author’s view, the Johnson amendment created uncertainty by enacting a new measure that stated something many believed was already in the law.¹⁴⁵

Developing The Regulations: 1956 vs. 1959.

With the enactment of the 1954 Code, Treasury started the lengthy task of writing regulations interpreting the new law. As we will see, Johnson’s “absolute” prohibition (or ban on “substantial” election intervention depending on your point of view) evolved in dramatic and unanticipated ways.¹⁴⁶

In Treasury’s initial Notice of Proposed Regulations, the rule limiting election intervention by groups

141 Note, *Income Tax Disadvantages of Political Activities*, 57 COLUM. L. REV. 273, 280 (1957). In 1955, a decision arising under the 1939 Code concluded that a group which devoted less than 5 percent of its time (and minimal expenses) on “political” and lobbying activities was entitled to an educational exemption. *Seasongood v. Comm’r*, 227 F.2d 907 (6th Cir. 1955).

142 O’Daniel, *supra* note 138, at 766.

143 *Id.* at 765-66.

144 Rea, *supra* note 138, at 296.

145 *Id.* at 299.

146 Notice of Proposed Regulation, Income Tax: Taxable Years Beginning After December 31, 1953: Exempt Organizations, 21 Fed. Reg. 460 (Jan. 21, 1956).



exempt under 501(c)(3) was expressed as follows:

Activities which constitute participation or intervention in a political campaign on behalf of a candidate include, but are not limited to, the publication or distribution of written or printed statements or the making of oral statements on behalf of such a candidate. The coincidental advocacy or espousal of a principle or philosophy or an issue, as distinguished from the advocacy of the candidacy of an individual, will not of itself operate to deny exemption to an organization which is otherwise exempt under this section merely because a particular candidate for public office also advocates or espouses the same principle, issue, or philosophy. If, in fact, however, the primary purpose of an organization is thereby to support or oppose a particular candidate for public office rather than to espouse a principle, exemption may be denied.¹⁴⁷

In short, a 501(c)(3) exempt group could not engage in what might now be called “express advocacy” but seemingly could engage in “issue advocacy.” Beyond the group’s activities, however, the IRS would also consider its purpose, and “may” deny an exemption under 501(c)(3) if the group’s purpose was campaign advocacy. If this reading is correct, this proposed regulation allowed 501(c)(3) exempt groups to discuss issues related to candidates, during campaigns, provided they avoided express advocacy, and also maintained a primary purpose other than advocacy for or against a particular candidate.

Additionally, the Proposed Regulation specified that groups failing to qualify for exemption under 501(c)(3) because of their legislative agenda (or their controversial opinions) could be exempt under section 501(c)(4):

Organizations embraced within this section include those which are operated primarily for the purpose of bringing about social changes or for purposes relating to the private rights of individuals and to human relationships generally, and which cannot meet the requirements of 501(c)(3). The fact that such an organization in carrying on its primary purpose or purposes presents opinion on controversial questions and issues with the intention of molding public opinion or creating public sentiment to an acceptance of its views, or advocates social changes which may require legislation to achieve, will not preclude exemption under 501(c)(4).¹⁴⁸

Given that one common question in this area was whether a particular group had done too much advocacy to be “educational,” the (c)(4) classification would remain the catch-all exemption for non-profit advocacy groups (as the 11(a)(8) classification had been under previous versions of the Code).

There things stood for almost three years. Activists and their lawyers had little regulatory guidance to rely upon. The Service denied exemptions using tests that were contrary to the proposed rule (although in some ways reflecting prior practice.)¹⁴⁹ To add to the confusion, appeals courts continued

¹⁴⁷ *Id.* at 464.

¹⁴⁸ *Id.* at 465. The proposed regulations were silent about whether groups exempt under section 501(c)(5) (such as labor organizations) or groups exempt under Section 501(c)(6) (such as chambers of commerce) could also engage in such public advocacy or advocacy of legislation.

¹⁴⁹ See NEW YORK UNIVERSITY FOURTH BIENNIAL CONFERENCE ON CHARITABLE FOUNDATIONS 224-26 (Henry Sellin ed. 1959) (statement of Albert Arent) (“Proceedings Fourth”). Specifically, the Service would deny 501(c)(3) status to a group if it found the group had a “social welfare” purpose, even if in all other respects it met the requirements of 501(c)(3).

to reject Service interpretations of key concepts (such as “educational”).¹⁵⁰

The ABA Committee on Exempt Organizations complained about backlogs of many months to obtain exemption rulings, and about the vagueness and unnecessary scope of the Proposed Rule.¹⁵¹ “[A]lthough the amendments were eminently fair in their description of political activities, they had tended to confuse rather than clarify the balance of the situation, and [the ABA Committee] by and large preferred the old Regulations.”¹⁵² Norman Sugarman noted that the proposed rule was “a fair statement following from the various court decisions in this field” but “lacked the preciseness which might otherwise be desired.”¹⁵³ Sugarman was also troubled with the broad discretion these rules left with individuals within the Revenue Service, and placed the service in the dangerous role of censor.¹⁵⁴

However, something happened on the way to a Final Rule. Slightly more than three years after the initial publication of the Proposed Rule, the Commissioner of Internal Revenue withdrew it.¹⁵⁵ The Commissioner replaced the 1956 regulation with language that looks much like the current regulations.

These revised regulations introduced the concept of the “action organization” that could never be exempt under Section 501(c)(3). A group would be deemed an “action organization” if a substantial part of its activities were attempting to influence legislation, if it participated in political campaigns, if its main objective could only be attained by legislation, and it advocated for this objective “as distinguished from engaging in nonpartisan analysis.”¹⁵⁶ The rule notes that “action organizations” could qualify for exemption under 501(c)(4).

The 1959 Proposed Rule also defined “educational” for 501(c)(3) exemption, specifying that “an organization may be educational even though it advocates a particular position or viewpoint so long as it presents full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion... an organization is not educational if its principal function is the mere presentation of unsupported opinion.”¹⁵⁷ The explanatory material in the January 1956 version of the Proposed Rule, which acknowledged that 501(c)(3) exempt groups could advocate on an issue being raised in a campaign, vanished from the 1959 version.

The 1959 Proposed Rule also set forth the key language that stirs debate today – that a group is “operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community.” This version of the Rule also establishes that a “social welfare” purpose is consistent with 501(c)(3) – unless the group is an “action organization.” It furthermore establishes that the fact a group “advocates social

150 1956 ABA SEC. TAXATION PROGRAM & COMM. REPORT 99 (1956).

151 *Id.* at 98, 104.

152 *Id.* at 104. The ABA Section’s 1957 report described the Service’s 1956 hearings on the proposed rule “tempestuous.” 1957 ABA SEC. TAXATION PROGRAM & COMM REPORT 95 (1957). A transcript of those hearings seems not to have been preserved.

153 Norman Sugarman, *The Line Between Education and Propaganda*, in PROCEEDINGS OF NEW YORK UNIVERSITY THIRD BIENNIAL CONFERENCE ON CHARITABLE FOUNDATIONS (Henry Sellin, ed. 1957) at 181.

154 *Id.* at 182, 189.

155 24 Fed. Reg. 1421 (February 26, 1959).

156 *Id.* at 1422.

157 *Id.* at 1423. Readers should know that the “full and fair exposition” standard was found unconstitutionally vague by the U.S. Court of Appeals for the District of Columbia Circuit, in *Big Mama Rag v. United States*, 631 F.2d 1030 (D.C. Cir. 1980).



or civic changes or presents opinion on controversial questions with the intention of molding public opinion” does not preclude exemption under 501(c)(3) – unless, again, it is an “action organization.”¹⁵⁸ Finally, the 1959 Rule adds the admonition that “the promotion of social welfare does not include direct or indirect participation or intervention in political campaigns on behalf of or in opposition to any candidate for public office.”¹⁵⁹ These sections remain essentially unchanged in the Final Rule, published in June 1959.¹⁶⁰

In summary, significant changes emerged in the three years between the regulation’s initial publication and the 1959 revisions. The 1959 rules protected 501(c)(3) status for groups with controversial views that seek to mold public opinion, in accord with court cases. The 1959 version rejected aggressive interpretations the Service used in the period between the publication of the first Proposed Rule in 1956 and the Final Rule. But the 1959 rule created a new class– the aforementioned “action organization” that would never qualify as a 501(c)(3). “Action organizations” could, however, be exempt as 501(c)(4)s, and could intervene in politics, so long as that was not what it was “primarily” engaged in doing.

The reason for the changes in the 1959 version is not clear. The awkward phrasing in the 1959 language suggests it was the product of compromise. It is evident, however, that the new Rule offered clearer and more precise guidance (the invention of “action organizations” for instance), perhaps in response to criticisms that the first draft was vague. It also struck directly at Service interpretations that barred groups with social welfare purposes and groups that sought to influence public opinion from 501(c)(3) status.

As noted before, no transcripts or records survive from the IRS hearings held to consider the final rules. One newspaper account of an April 16, 1959 hearing reported only that attendees were critical of the rules, and feared they would deny exemptions to groups that were deemed exempt under the former rules.¹⁶¹

Fear of the Service’s enforcement attitude may have been justified. At the Fourth Biennial Conference on Charitable Foundations in May 1959, Herman Reiling, the Assistant Chief Counsel for the IRS, remarked (seemingly out of the Regulation 45 era) that the organizations giving the Service the most “trouble” were the “crusading organizations” which call their activities “educating the public” by “spraying’ information to the public.”¹⁶² He seemed to feel the new regulations would allow this “trouble” to persist.

At that same conference, Albert Arent, a tax attorney, welcomed the new rule’s recognition that “social welfare” was itself a charitable purpose, and that a group with social welfare goals that otherwise complied with the restrictions of 501(c)(3) would qualify as exempt under that section.¹⁶³ He reported that during the drafting of the first Proposed Rule, language was under consideration that would exclude organizations with social welfare goals from 501(c)(3) altogether, reflecting what was then an

158 24 Fed Reg. at 1423.

159 *Id.* at 1424.

160 T.C. 6391, published in 24 Fed. Reg. 5217 (June 26, 1959).

161 *Tax Shift Scored by Exempt Units*, N.Y. TIMES, April 17, 1959.

162 Proceedings Fourth, *supra* note 149 at 207.

163 *Id.* at 221.

emerging restrictive Service interpretation.¹⁶⁴ But, “fortunately, the impact of this approach upon a large segment of traditional and respected American philanthropy was recognized in time to cause the draft regulations to be toned down” Arent stated.

After 1959, the regulations governing the political activities of tax exempt nonprofits remained relatively stable. The aggressiveness of the IRS in certain contexts, its use and abuse by political leaders, and public outcry in response to misuse of the tax code also persisted. The intersection of taxation and activism remains a treacherous one for the activist.

¹⁶⁴ *Id.* at 224. The Bureau had denied charitable status to a number of civil liberties groups, because their purposes involved “social welfare” rather than “charity” or “education.” *Id.*



Conclusion

The current debate over the proper tax treatment of nonprofit advocacy groups is a continuation of a long struggle between Congress's vision of the tax law, and administrative hostility toward exemptions and deductions in this area. Once donors were able to deduct donations from their tax bill in 1917, this disconnect became acute, and has persisted in one form or another ever since.

Congress may deserve some blame. Amendments to the tax laws were not always crafted with the utmost care, or explained in the clearest terms. For example, the term "exclusively" which related to a group's purpose (not its activities) still perplexes analysis today even though it has always been the case that "exclusively" was to be applied as a very general level to allow a variety of other activities in furtherance of the exempt purpose. One searches in vain for the definitive explanation for adding "social welfare" to the enumerated exemptions in 1913, although the context strongly suggests Congress meant the phrase to encompass nonprofits not otherwise named in the statute, and liberalize the Bureau of Internal Revenue's approach to nonprofit advocacy groups.

The term "substantial part" comes to us via amendments in 1934, but Congress never clarified what it meant by "substantial" lobbying or propaganda activities. The evidence suggests that the restriction was designed not only to push back against Bureau decisions like *Slee*, but also to cripple the advocacy of one particular "selfish" organization – the National Economy League. That should argue against broadly interpreting the new language to restrict the activities of many others.

The genesis and context of the Johnson amendment, prohibiting 501(c)(3) exempt groups from political intervention, has been the topic of scholarly interest. Yet it was unclear at the time whether Senator Lyndon Johnson meant to bar 501(c)(3) exempt groups from political intervention, or just add politics to those activities subject to a substantiality test – like lobbying. Here, too, the context suggests Johnson's desire was to thwart the activities of his political foes in Texas, rather than reform the rules applicable to a broad array of groups.

Whatever the imprecision of congressional drafters, the administrative enforcement and interpretation of these exemptions has been almost universally hostile toward nonprofit activists. That posture traces back to the 1909 corporate excise tax, but becomes particularly evident in the 1920s after the Bureau declared (seemingly out of the blue) in Regulation 45 that groups engaged in controversial or partisan propaganda could not be exempt as "educational" organizations.

The Bureau assumed the role of arbiter of proper tone, rejecting exemptions for temperance, Socialist and birth control causes because of their embrace of controversial views, demand for changes in the law, and bias. It eagerly devised restrictions to deny deductions to charitable and educational groups. The courts, for their part, rejected many of the more extreme interpretations, only for the Bureau to ignore these precedents in future matters. Even as late as 1959, representatives of the Service complained publicly about exempt groups agitating in the public square, notwithstanding that the law specifically permitted them to do so.

Presently, history appears to be repeating itself. The Service has shown hostility to exemption applications from controversial groups on the political right. It also proposed a new rule, purportedly in the service of clarity for social welfare groups, but in fact containing a wish list of restrictive provisions. Many of these proposed restrictions resembled ones that courts have rejected in the campaign

finance context, so apparently the Service's tone deafness toward constitutional liberties persists, too. We should draw several lessons from this history. First, the Internal Revenue Service, while effective at raising revenue, is a poor agency to task with regulating advocacy organizations, especially those that cannot offer donors a tax deduction. Only trivial amounts of revenue are at stake. Whether a certain message, or viewpoint, or advertisement, or tone is proper should not be a concern of the tax man. Second, Congress must resist the temptation to even political scores through tax legislation. Not only is it poor governance, but it rarely works. Finally, the courts should remain vigilant in protecting groups from Service overreach and congressional mischief. While it remains a canard of legal analysis that nobody has a right to avoid paying taxes, in this context – again – revenue is not the issue. Courts should feel free to identify and excise laws, even tax laws, which abridge political freedoms.



Postscript: What About Campaign Groups?

The tax status of overtly political groups, such as political party committees and candidate election committees, has not been raised in this Monograph.

Theoretically, under the 1954 Code, and the Revenue Acts of decades before, political organizations could have been taxed, since they did not fall within an exempt class.¹⁶⁵ Even if such groups were unincorporated associations, tax regulations could extend to such organizations.¹⁶⁶

Yet the Treasury Department and the Commission of Internal Revenue offered little guidance to instruct political donors or organizations about their tax burdens. One singular bit of advice from the 1930s suggests why: no one thought that receipt of a contribution would result in taxable income, nor that there would be a deduction for political contributions. In response to a request for advice in 1939, under the Revenue Act of 1938, one income tax ruling concluded:

contributions to a political organization are not proper deductions in the donor's federal income tax return, there being no provision in the Revenue Act of 1938 which allows such deductions. ... [I]t is held that a political gift received by an individual or by a political organization is not taxable income to the recipient.¹⁶⁷

Similarly, campaign expenditures to attain or retain elective office could not be deducted against the candidate's income.¹⁶⁸

In fact, candidate and political party committees were not taxed.¹⁶⁹ A researcher writing in 1967 searched existing tax citations and found no matters involving political parties, or individuals associated with party activity.¹⁷⁰ He reported:

An accommodating and seemingly informed public relations person in the Commissioner of Internal Revenue's office believes that parties pay no taxes but said the national office had no statistics on this, and courteously withheld permission to be identified here.¹⁷¹

Additionally, sometime in the late 1940s, the IRS internally directed its field offices not to require political organizations to file income tax returns, according to a 1973 Service announcement.¹⁷²

Contributions might be taxable as gifts, theoretically. It would be the contributor, not the recipient, who would owe whatever taxes might be due, after taking into effect the annual and lifetime gift tax

165 Schoenblum, *supra* note 124, at 516-17.

166 For an examination of the proper form of a political fund for tax purposes, see William P. Streng, *The Federal Tax Treatment of Political Contributions and Political Organizations*, 29 *Tax Lawyer* 139, 154 -56 & n.90 (1975) (weighing classification of political funds as corporations or trusts.)

167 I.T. 3276, IRS Bull. 1939-1 at 108.

168 *McDonald v. Commissioner*, 1 T.C. 738, aff'd 139 Fed. 2d 400, cert. granted 321 U.S. 762, aff'd 323 U.S. 57 (1944). Four Justices dissented from this holding, concluding that if federal taxes applied to salaries of local officials, the expenses those officials incur to retain that income should be deductible against gross income.

169 Schoenblum, *supra* note 124, at 515; Boehm, *supra* note 124, at 375. In his 1954 Reece Committee testimony, then Assistant Commissioner of Internal Revenue Norman Sugarman testified that "there is no provision of law exempting political organizations" yet none of the Committee members followed up on whether this meant that such groups had to file tax returns and pay taxes. See Hearings, Part 1, *supra* note 105, at 429.

170 Boehm, *supra* note 124, at 376.

171 *Id.* at 376.

172 Announcement 73-84, 1973-2 C.B. 461 (1974), cited in Streng, *supra* note 166, at 142.

exemptions.¹⁷³ For its part, the IRS never asserted (until a revenue ruling in 1972) that political contributions could be taxed as gifts.¹⁷⁴ As noted in the main paper, the practice of loaning parties money, then forgiving the “debt” had also been permitted administratively.¹⁷⁵

The tax status of political parties became an important issue in the litigation that began in 1954 between the Communist Party and the IRS. The Communist Party asserted that IRS prosecution showed it was being selectively singled out, since no other parties paid taxes.¹⁷⁶ The government argued that the Party was not a “party” at all, but an illegal instrumentality of a conspiracy to overthrow the government.¹⁷⁷ As noted before, subversive groups were not eligible for any exemptions, and so the Party’s status as a “political party” – whatever it was – would not be sufficient to save it.

Candidates, and by extension their committees, were also not taxed. This was because the donor’s gift came with strings attached – it was a contribution intended to support campaign activities. If used as intended, the funds would not be income to the candidate, but given to the candidate in trust to be spent for these purposes.¹⁷⁸ The candidate would be merely a conduit, and would not realize income.¹⁷⁹ The candidate, if challenged, would need to prove that proper use was made of the money.¹⁸⁰ The donor would not deduct donations, as these would be nondeductible personal expenditures.¹⁸¹

The Bureau had occasion to opine about the tax consequences of taking political contributions for one’s personal use in 1954. The Bureau reiterated that political contributions were not income to the recipient, nor deductible by the donor. “However, any amount diverted from the channel of campaign activities and used by a candidate or other individual for personal use constitutes taxable income to such candidate or individual...”¹⁸²

173 See Schoenblum, *supra* note 124 at 517. Although a 1973 Revenue Ruling asserted that treatment of political contributions as gifts extended back to the 1932 enactment of the gift tax, the Service had issued no rulings or regulations indicating that contributions were taxable as gifts. In 1959, the IRS stated, without support, that campaign contributions were subject to gift tax. *Id.* at 517 n. 12, quoting *Carson v. Comm’r*, 71 T.C. 252 (1978).

174 *Id.* at 517 n. 12.

175 *Id.* at 518-19, 522-24.

176 *Id.* at 525 n. 37.

177 Boehm, *supra* note 124, at 377-78.

178 *Id.* at 380.

179 *Id.* at 383.

180 *Id.* at 381, citing *O’Dwyer v. Comm’r*, 266 F.2d 575 (4th Cir. 1959).

181 *Id.* at 387. In 1968, the Service issued Revenue Procedure 68-19, confirming that “[p]olitical funds are not taxable to the political candidate by or for whom they are collected if they are used for expenses of a political campaign or some similar purpose. Rev. Proc. 68-19, 1968-1 C.B. 810.

182 Rev. Rul 54-80, I.R. Bull 1954 at 11, 12.



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