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NOTES

Has the Supreme Court Laid Fertile Ground for Invalidating the Regulatory Interpretation of Internal Revenue Code Section 501(c)(3)?

Recently, an enormous amount of litigation has arisen over refusals by the Commissioner of the Internal Revenue Service (Commissioner) to recognize certain nonprofit organizations as tax-exempt. Applications of the Internal Revenue Code (Code) continually result in a struggle between taxpayers' intentions regarding the exchanges or transactions in which they engage and practical reality. Although reluctant to recast the form taxpayers give to their transactions, courts have made a vigilant effort to assure that tax consequences turn on a transaction's substance rather than on its form.[1] In the tax exemption area, recent decisions indicate that courts are more likely to step in, guided by the Commissioner's characterization of an organization rather than by the organization's actual purposes and activities, to determine whether that organization is entitled to tax-exempt status.

To guide taxpayers in interpreting and applying Internal Revenue Code provisions, Congress has empowered the Secretary of the Treasury (Secretary) and his delegate, the Commissioner, to interpret the Code in treasury regulations.[2] While treasury regulations usually lack the force of law[3] Congress and the courts generally acquiesce to

1 In Helvering v. F & R. Lazarus & Co., 308 U.S. 252 (1939) the Supreme Court noted that "[i]n the field of taxation, adminstrators of the laws, and the courts, are concerned with substance and realities." *Id.* at 255. *See also* Gregory v. Helvering, 293 U.S. 465 (1935). Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Frank Lyon & Co. v. United States, 435 U.S. 561 (1978).

2 The Supreme Court upheld this delegation of interpretive authority as constitutional in Brushaber v. Union Pacific Railroad Co., 240 U.S. 1, 26 (1916). *See also* I.R.C. § 7805(a); United States v. Correll, 389 U.S. 299, 307 (1967). The Supreme Court noted in National Muffler Dealers' Ass'n v. United States, 440 U.S. 472, 477 (1979), "[t]hat delegation helps ensure that in 'this area of limitless factual variations,' like cases will be treated alike. It also helps guarantee that the rules will be written by 'masters of the subject,' who will be responsible for putting the rules into effect." (Citations omitted).

3 It is a well-settled principle that, "[t]reasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law." Helvering v. Winmill, 305 U.S. 79, 83 (1938). *See also* Fribourg Navigation Co. v. Commissioner, 383 U.S. 272, 283 (1966). After the Treasury interprets a revenue statute, passage of a

these interpretations.[4] Congress and the courts will not acquiesce when the Treasury exceeds its regulatory authority by applying the regulations inconsistently or by imposing an improper regulatory gloss on a Code section.[5]

In January 1982, the Supreme Court of the United States checked the Secretary and the Commissioner in the exercise of their regulatory authority. It did so by invalidating a treasury regulation that failed to comport with the Code section the Secretary intended to interpret and clarify.[6] This note asserts that by doing so the Court laid fertile ground for other courts, deciding whether to defer to the Commissioner when other reasonable Code interpretations exist, to invalidate treasury regulations.[7] The confusing and formalistic regulatory interpretation of section 501(c)(3),[8] and the burgeoning case law in this area indicate that it may be time to test the validity of the section 501(c)(3) treasury regulations against the standards articulated by the Court in its 1982 decision, *United States v. Vogel Fertilizer Company*.[9] Part I of this note describes the scope of the problem; Part II reviews the origin and purpose of tax exemption for organizations described in section 501(c)(3); Part III discusses the regulatory interpretation of section 501(c)(3); Part IV presents the Supreme Court's most recent challenge to the Secretary and Commissioner's authority; and Parts V and VI propose a means for using the *Vogel Fertilizer* approach in the section 501(c)(3) area.

I. The Scope of the Problem

Over a century ago, Justice Holmes provided a pragmatic justification for looking beyond formal qualities to underlying substance when he described lawyering as a process of abstraction.[10] By purging cases of the "dramatic elements," Holmes explained, lawyers ar-

similar statute with the same wording indicates that Congress was satisfied with the Secretary's construction. *See, e.g.*, Commissioner v. Estate of Noel, 380 U.S. 678 (1965).

4 *See, e.g.*, United States v. Correll, 389 U.S. 299.

5 *See, e.g.*, Rowan Cos., Inc. v. United States, 452 U.S. 247 (1981).

6 United States v. Vogel Fertilizer Co., 455 U.S. 16 (1982). *See* Part IV *infra*.

7 *See, e.g.*, Bolton v. Commissioner, 694 F.2d 556 (9th Cir. 1982). In *Bolton* the United States Court of Appeals for the Ninth Circuit used the *Vogel Fertilizer* approach to test the regulatory interpretation of Code § 280A(c)(5).

8 T.D. 6391, 1959-2 C.B. 139 (1959). Section 501(c)(3) deals with the qualification of certain nonprofit organizations for exemption from the income tax. See Part II *infra* for a discussion of Section 501(c)(3) and Part III for a discussion of the regulations promulgated thereunder.

9 455 U.S. 16 (1982). *See* Part IV *infra* for a detailed discussion of the *Vogel Fertilizer* standards.

10 Holmes, *The Path of the Law*, 10 HARV. L. REV. 457 (1897).

rive at "final analyses and abstract universals of theoretical jurisprudence."[11] The point of this distillation, in Holmes' opinion, is to facilitate "the prediction of the incidence of the public force through the instrumentality of the courts."[12] Holmes wrote,

> The reason why a lawyer does not mention that his client wore a white hat when he made a contract, while Mrs. Quickly would be sure to dwell upon it . . . is that he foresees that the public force will set in the same way whatever his client had upon his head. It is to make the prophecies easier to be remembered and to be understood that the teachings of the decisions of the past are put into general propositions and gathered into textbooks, or that statutes are passed in general form.[13]

Two factors suggest that the regulations aimed at eliminating tax fraud and other abuses, may, like Holmes' appearance-conscious Mrs. Quickly,[14] have dwelt excessively upon details that are of little assistance in analyzing a nonprofit organization's substance. First, a comparison of Internal Revenue Code section 501(c)(3), its underlying history, and its policies with the regulations promulgated under it shows that the regulations have missed their mark. Second, the many recent cases in this area indicate that the Secretary and the Commissioner may have exceeded the limits of their authority.

By becoming enamored of the formal attributes of certain organizations, the Commissioner has lost sight of the practical realities of the nonprofit organizations to which he grants or denies tax exempt status. The regulations' use over the past twenty-four years provides substantial evidence that the regulatory interpretation is unduly formal,[15] is at odds with the manifest congressional design, and has been inconsistently applied by both the courts and the Commissioner.[16]

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11 *Id.* at 458.

12 *Id.* at 457.

13 *Id.* at 458.

14 *Id.* Apparently Mrs. Quickly is a manifestation of Holmes' imagination; an appearance-conscious socialite conjured up during the address he delivered at the dedication of the new hall of the Boston University School of Law on January 8, 1897.

15 For example, in Federation Pharmacy Servs., Inc. v. Commissioner, 625 F.2d 804 (8th Cir. 1980), the Court of Appeals held that Federation, which provided prescription drugs at a discount to elderly and handicapped persons, did not qualify as a charitable organization and remarked that "[i]t is immaterial that Federation's objectives may be laudable." *Id.* at 809. Additionally, the Tax Court and the IRS have long disagreed as to whether all organizations dedicated solely "to the promotion of social welfare" should be classified as "charitable." Rev. Rul. 59-310, 1959-2 C.B. 146.

16 *See* text accompanying notes 65-87 *infra*. *See also* B.H.W. Anesthesia Found. v. Commissioner, 72 T.C. 681 (1979); and University of Mass. Med. School v. Commissioner, 74 T.C. 1299 (1980) (two factually indistinguishable cases where Commissioner twice misapplied regulations to groups of teaching physicians operating tax-exempt clinics).

Because a nonprofit group does not qualify for tax exemption merely by technically complying with Section 501(c)(3), but now must seek the Commissioner's recognition,[17] the regulations' burdensome effect is apparent. As a result, an organization might successfully challenge the validity of the treasury regulations promulgated to implement section 501(c)(3)[18] using the *Vogel Fertilizer* approach.

II. The Origin and Purpose of Tax Exemption Under Internal Revenue Code Section 501(c)(3)

Because certain organizations are charitable or otherwise promote the general welfare, the money and property they devote to charitable or related purposes is exempted from taxation.[19] In 1934, Justice Roberts of the United States Supreme Court explained that Congress reduced charities' capital gain tax rates and exempted their income from taxation for public policy reasons.[20]

Before the 1894 income tax statutes, organizations that section 501(c)(3) now specifically exempts from taxation were simply exempted by omission. Congress drafted section 32 of the Tariff Act of 1894 to explicitly exempt "corporations, companies or associations organized and conducted solely for charitable, religious, or educational purposes."[21] Under the corporate provisions of that Act, Congress imposed tax only upon "corporations, companies, or associations doing business for profit."[22] Although a paucity of legislative history exists, the theoretical underpinnings for eleemosynary organizations' favorable tax treatment apparently predate the seventeenth century statute of charitable uses.[23]

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17 *See* text accompanying notes 41-51 *infra*.

18 *See* text accompanying notes 53-76 *infra*.

19 *See* text accompanying notes 22-32 *infra*. For discussion of possible rationales for exempting religious organizations from taxation see Schwarz, *Limiting Religious Tax Exemptions: When Should the Church Render Unto Caesar?* 29 U. Fla. L. Rev. 50, 54-57 (1976).

20 Helvering v. Bliss, 293 U.S. 144, 150-51 (1934). Justice Roberts noted that the favorable tax treatment Congress accorded charities was "begotten from motives of public policy" and consequently the statutes were "not to be narrowly construed." *Id.* at 151. *See also* H.R. Rep. No. 1860, 75th Cong., 3d Sess. (1939).

21 Tariff Act of 1894, ch. 349, § 32, 28 Stat. 556 (1894).

22 *Id.*

23 In 1601, the English Parliament enacted the statute of 43 Elizabeth c.4, which is referred to as the "Statute of Charitable Uses." For historical discussion, see Whelan, *"Church" in the Internal Revenue Code: The Definitional Problems*, 45 FORDHAM L. REV. 885 (1977). According to Father Whelan, mankind's history reflects the fact that our early legislators were not the first to exempt religious or charitable organizations. For instance, *Ezra* 7:24 reads "also we certify you, that touching any of the priests and Levites, singers, proters, Nethinim, or Ministers of this House of God, it shall not be lawful to impose toll, tribute or customs upon them." *See also* Walz v. Tax Comm'n, 397 U.S. 664, 676-77 (1970).

Considerations other than tradition have prompted Congress to exempt certain nonprofit organizations from income tax. For example, the legislative history of income tax exemption for mutual benefit organizations reveals Congress's value judgment that it is inappropriate to tax poor people's pooled savings.[24] Additionally, Congress believed that mutual benefit organizations, like most nonprofit associations, were unable to generate large amounts of taxable income.[25] Consequently, the potential revenues did not warrant income tax imposition.

Congress's long-standing policy to exempt certain nonprofit organizations' income from taxation rests largely on its interest in nurturing educational, civil, charitable, and other public service organizations that help relieve Congress's governmental burdens.[26] Theoretically, the relief from the financial burdens that would otherwise have to be met with public funds compensates the government for the potential revenue loss.[27] The United States Court of Appeals for the Eighth Circuit has explained that,

> The reason underlying the exemption . . . is that the exempted taxpayer performs a public service. The common element of charitable purposes within the meaning of the section is the relief of the public of a burden which otherwise belongs to it. Charitable purposes are those which benefit the community by relieving it pro tanto from an obligation which it owes to the objects of the charity as members of the community.[28]

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24 During the 1894 debate over exemption of mutual savings banks Senator Hill declared that "mutual savings banks should be absolutely exempt from any income tax" because,

> They represent the savings of the poor; they are not established for ordinary business purposes; the earnings—aside from those necessary for legitimate expenses—belong to the depositors, and are paid to them from time to time in the shape of interest or dividends; they ordinarily have no capital stock, and the managers are simply the agents or trustees or the depositors.

Hearings on Exemption of Mutual Savings Banks, 26 Cong. 6622 (1894).

25 *See* Helvering v. Bliss, 293 U.S. at 150-51; Duffy v. Birmingham, 890 F.2d 738 (8th Cir. 1951).

26 B. Hopkins, The Law of Tax-Exempt Organizations 5 (3d. Ed. 1979). *See also* H.R. Rep. No. 1860, 75th Cong., 3d Sess. (1939), at 19. As syndicated columnist Sylvia Porter recently reported, this policy figures prominently in the Reagan Administration's "new federalism" policies. Porter, *Starving Out the Non-Profit Agencies*, South Bend (Ind.) Tribune, Sept. 27, 1982, at 23. Porter pointed out that President Reagan anticipates increasing the role that nonprofit organizations play because of the public services they perform. *Id.* However Porter suggests that budget cuts in social programs may slowly force not-for-profits out of business. She notes that over 103,000 organizations currently provide charitable services in the United States. *Id.*

27 Haswell v. United States, 500 F.2d 1133, 1139-40 (Ct. Cl.), *cert. denied*, 419 U.S. 1107 (1974).

28 Duffy v. Birmingham, 190 F.2d 738 (8th Cir. 1951).

In short, Congress's decision to exempt certain organizations' income from taxation can be attributed to a cascade of moral, political, historical, and pragmatic considerations.

Every revenue act since section 32 of the Tariff Act of 1894 has provided similar exemptions.[29] The 1913 prototype for section 501(c)(3) provided an exemption from taxation for any "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."[30] In 1934 and 1954, Congress added restrictions prohibiting section 501(c)(3) organizations from "substantially" attempting to influence legislation and from intervening in political campaigns.[31]

Today, to be recognized as a tax-exempt organization under section 501(c)(3), a nonprofit organization must meet three statutory requirements. First, the organization must be organized exclusively for exempt purposes.[32] Second, the organization must operate exclusively for exempt purposes.[33] Third, no part of the organization's net earnings may inure to the benefit of any stockholder or private

29 *See* Act of Aug. 5, 1909, ch. 6, § 38, 36 Stat. 556; Act of Oct. 3, 1913, ch. 16, § 11(G), 38 Stat. 172; 1916: ch. 463, § 11(6), 39 Stat. 172; 1919: ch. 18, § 231(6), 40 Stat. 1076; 1921: ch. 136, § 231(6), 42 Stat. 253; 1924: ch. 234, § 231(6), 43 Stat. 282; 1926: ch. 27, § 231(6), 44 Stat. 1928: ch. 852, § 103, 45 Stat. 812; 1932: ch. 209, § 103, 47 Stat. 193; 1934: ch. 277, § 101, 48 Stat. 700; 1936: ch. 690, § 101, 49 Stat. 1673; 1939 Internal Revenue Code, §§ 101(1) - (11), (13) - (19), 165(a) derived from Act, May 28, 1938, ch. 289, § 101, 52 Stat. 480; now IRC § 501(c)(3). *See also* Haswell v. United States, 500 F.2d at 1139.

30 38 Stat. 172 (1913). Note that "no part of the net income" has been altered to read "no part of the net earnings." *Compare* § 501(c)(3).

31 For a historical explanation, see Cammarano v. United States, 358 U.S. 498, 512 (1959). In *Cammarano*, the Court upheld treasury regulations that prohibited business deductions of lobbying expenses. The court reasoned that the "nondiscriminatory" provisions were intended to put "everyone in the community . . . on the same footing." *Id.* at 513. *See also* Haswell v. United States, 500 F.2d at 1140. In their treatise on tax exempt organizations, Hopkins and Myers report that the lobbying provision was intended to curb the National Economy League's activities and that the absolute political prohibition was suggested by then-Senator Lyndon B. Johnson to limit the activities of a private group. Apparently Johnson believed that the private group was substantially backing an opponent of his. B. HOPKINS & J. MYERS, THE LAW OF TAX EXEMPT ORGANIZATIONS 124 (1975).

32 I.R.C. § 501(c)(3) (West Supp. 1981); Treas. Reg. § 1.501(c)(3)-1(d)(i) (1959). *See* text accompanying notes 52-64 *infra*. Curiously, the regulations provide that the Commissioner will grant an organization exemption regardless of the purpose or purposes specified in its application "if, in fact, an organization is organized and operated exclusively for an exempt purpose or purposes." Treas. Reg. § 1.501(c)(3)-1(d)(iii) (1959). It is unclear how the Commissioner would make such a determination, since the regulations also provide that the Commissioner will not consider parol evidence in determining whether the organizational test is met. *See* Treas. Reg. § 1.501(c)(3)-1(b)(l)(iv) (1959); note 57 *infra*.

33 I.R.C. § 501(c)(3) (West Supp. 1981).

individual.[34]

The first requirement, referred to as the "organizational test," focuses on the purpose for an organization's existence. A nonprofit organization seeking to qualify as tax-exempt under section 501(c)(3) must be organized or operated for "religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals."[35] Because of the similarities in these organizations' general characteristics, they are often collectively referred to as "charities."[36]

The second requirement, the "operational test," focuses on the manner in which an organization's activities further its exempt purpose. The vast majority of courts have held that the specific nature of an organization's activities is not a proper subject of scrutiny so long as the organization carries on its activities primarily for exempt purposes.[37]

Lastly, the third statutory requirement prohibits an organization from paying off its net earnings to private individuals or shareholders. Case law has muddied the distinction between the second and third requirements.[38] Frequently courts consider these requirements simultaneously, collectively terming them the operational test.

III. The Treasury Regulations Promulgated Under Section 501(c)(3)

In 1959, the Secretary, acting under his general authority to "prescribe all needful rules and regulations"[39] issued regulations for section 501(c)(3). As section 501(c)(3) suggests, in order to qualify for tax-exempt status, an organization must meet the organizational and operational tests and the private inurement requirement. It must be

34 *Id. See also* Greater United Navajo Dev. Enters., Inc. v. Commissioner, 74 T.C. 69, 76 (1980); Baltimore Regional Joint Bd. Health and Welfare Fund v. Commissioner, 69 T.C. 554, 556-557 (1978).

35 I.R.C. § 501(c)(3) (West Supp. 1981).

36 Schwarz, *supra* note 19, at 53.

37 *See, e.g.*, Kentucky Bar Found. v. Commissioner, 78 T.C. 921, 923 (1982). *See also* Federation Pharmacy Servs., 72 T.C. 687 (1979), *aff'd*, 625 F.2d 804 (8th Cir. 1980); Senior Citizens Stores, Inc. v. United States, 602 F.2d 711 (5th Cir. 1979); est of Hawaii v. Commissioner, 71 T.C. 1067 (1979); BSW Group, Inc. v. Commissioner 70 T.C. 352 (1978); Golden Rule Church Ass'n v. Commissioner, 41 T.C. 719 (1964).

38 See Part III, B *infra* for discussion of how organizational test and private inurement proscription overlap.

39 T.D. 6391, 1959-2 C.B. 139 (1959); I.R.C. § 7805(a) (West 1967).

both organized and operated for one or more of the purposes specified in section 501(c)(3). Failure to meet any of these conditions will be fatal to an organization's quest for income tax exemption.[40] The regulations now dictate the exclusive manner for satisfying these conditions.[41]

Prior to 1969, tax exemption for nonprofit organizations did not depend upon a favorable ruling from the Commissioner. If an organization technically complied with the language of section 501(c)(3), it was not required to notify the Commissioner. It filed informational returns and was automatically exempt from taxation. If the organization hoped to solicit tax-deductible contributions, it did not have to apply to the Commissioner for a ruling on its tax-exempt status.[42]

Reacting to a number of well-publicized tax law abuses by private foundations,[43] Congress divided nonprofit organizations claiming exemption from taxation under section 501(c)(3) into two groups, public charities and private foundations.[44] Private foundations became subject to a series of excise taxes as well as restrictions on permissible activities.[45]

The Tax Reform Act of 1969 increased the importance of the Commissioner's ruling process. It provided, among other things, that new organizations (organized after October 8, 1969) must notify the Commissioner within fifteen months from the end of the month in which the organization is formed that they are filing for exemption under Code section 501(c)(3).[46] Existing organizations were given a similar grace period to apprise the Commissioner of their existence and to make their claimed tax-exempt status known. Organizations failing to notify the Commissioner within the prescribed time re-

40 Treas. Reg. § 1.501(c)(3)-1(a)(1) (1959). *See, e.g.*, Commissioner v. John Danz Charitable Trust, 284 F.2d 726 (9th Cir. 1960). Exemption from social security taxes under § 811(b)(8) of the Social Security Act hinges on meeting the same requirements as those in I.R.C. § 501(c)(3). I.R.C. § 3121(k) (West 1979)). *See also* Better Business Bureau v. United States, 326 U.S. 279 (1945). Section 811(b)(8)'s legislative history reveals that the provision was intended to track the § 501(c)(3) requirements. *See* note 68 *infra* and accompanying text.

41 Treas. Reg. § 1.501(c)(3)-1(a) (1959). Rev. Proc. 80-25 details the procedure for seeking recognition of tax-exempt status. *See* text accompanying notes 44-51 *infra*.

42 All these requirements were added in 1969. *See* text accompanying notes 44-51 *infra*.

43 Professor Schwarz noted that "[T]he proliferation of gurus, meditators, maharajahs and other esoteric religious cults, some with a political bent, others with a more commercial emphasis, plus the accumulation of substantial wealth by established religions, has provoked public interest and suspicion." Schwarz, *supra* note 19, at 51.

44 I.R.C. §§ 507-09, 4940-48 (West Supp. 1981).

45 I.R.C. §§ 4940-48 (West Supp. 1981).

46 I.R.C. § 508(a) (West Supp. 1981). *See* Tax Reform Act of 1969, Pub. L. No. 91-172, § 101(a), 83 Stat. 494, (1969). For legislative history and purpose of Pub. L. No. 91-172 see 1969 U.S. Code Cong. and Adm. News, pp. 1682, 1884, 2052, 2055, 2081, 2123, 2401, 2411.

ceived private foundation treatment.[47] To ensure that nonprofit organizations seeking tax-exempt status would comply with the notification requirements, Congress required taxpayers deducting charitable contributions to list on their individual tax returns the tax exempt-number assigned to particular nonprofits in the IRS's "bluebook".[48]

Theoretically, section 501(c)(3) organizations such as churches were excepted from the 1969 compulsory filing requirements.[49] In treasury regulation section 1.508-1(a)(4), the Secretary stated that excepted organizations that technically complied with section 501(c)(3) would be tax exempt; however, the Secretary continued, "to establish [their] exemption with the Internal Revenue Service" the group would have to comply with the regular filing requirements.[50] In order to protect their contributors, churches wishing to be recognized as tax-exempt had to file properly completed applications for exemption under section 501(c)(3).[51]

By hinging a nonprofit's tax-exempt status on complying with the Commissioner's ruling process, the Tax Reform Act of 1969 concommitantly increased the force of the treasury regulations interpreting section 501(c)(3). If the Commissioner is to recognize an organization as tax-exempt, he must be satisfied that the criteria detailed in the treasury regulations are met.

A. *The Organizational Test*

The regulations state that, as a threshold test for determining whether a group is organized properly within the meaning of section 501(c)(3), a group's organizational documents must limit the group's purposes "to one or more exempt purposes."[52] Additionally, these documents cannot "expressly empower the organization to engage,

47 I.R.C. § 508(b) (West Supp. 1981); S. REP. NO. 552, 91st Cong., 1st Sess. (1969).

48 Publication 78, Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1954. The Cumulative List is the Service's official roster of tax-exempt organizations. Rev. Proc. 72-39, 1972-2 C.B. 818. *See also* Rev. Proc. 82-39, I.R.B. 1982-27, 18, which describes the extent to which contributors may rely on Publication 78 for purposes of deducting contributions under § 170 and for making grants under § 4945.

49 I.R.C. § 508(c) (West Supp. 1981). Even recognized 501(c)(3) organizations must file annual informational returns. *Id. See also* Rev. Rul. 80-113, 1980-1 C.B. 58; Miller, *Penalties for Failure to File a Timely Application for Exemption*, 59 Taxes 221, 222 (1981).

50 Treas. Reg. § 1.508-1(a)(4) (1976). *See also* B. HOPKINS & J. MYERS, THE LAW OF TAX-EXEMPT ORGANIZATIONS, *supra* note 31, at 507.

51 By 1975, nearly a third of the section 501(c)(3) organizations listed in the "bluebook" were religious organizations. *See* Schwarz, *supra* note 19, at 53.

52 Treas. Reg. § 1.501(c)(3) - 1(b)(1)(i)(a) (1959).

otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes."[53]

To determine whether this organizational test is satisfied, the Commissioner relies on the group's articles of organization (articles).[54] In the Secretary's view, the only way that an organization can be "organized exclusively for one or more exempt purposes" under section 501(c)(3) is if its articles meet the requirement noted above.[55] The regulations specify which documents will qualify as "articles."[56] The Commissioner refuses to consider parol or other evidence showing that the organization's members intend to operate a bona fide charity.[57]

The regulations further provide that the "organized exclusively for exempt purposes" criterion cannot be met unless a group's assets are "dedicated to an exempt purpose."[58] A group must demonstrate that its assets are dedicated to an exempt purpose by stating in its organizational documents that if it dissolves, it assets will "be distrib-

53 Treas. Reg. § 1.501(c)(3) - 1(b)(1)(i)(b) (1959).

54 Treas. Reg. § 1.501(c)(3) - 1(b)(1)(i) (1959).

55 *Id.* *See* text accompanying notes 52-53 *supra*.

56 Documents qualifying as "articles" include "the trust instrument, the corporate charter, the articles of association, or any other written instrument by which an organization is created." Treas. Reg. § 1.501(c)(3) - 1(b)(2) (1959).

57 Treas. Reg. § 1.501(c)(3) - 1(b)(1)(iv) (1959). This inflexible requirement precariously positions groups that had organized and had been operating prior to July 28, 1959, and that seek recognition of their tax-exempt status after July 27, 1959. Regardless of the fact that an organization's actual operations have been exclusively in furtherance of one or more exempt purposes, according to the regulatory interpretation, this "shall not be sufficient to permit the organization to meet the organizational test." *Id.* As noted above, failure to meet this test is fatal to gaining recognition of tax-exempt status.

For example, for a group founded in 1955 to seek recognition of its tax-exempt status for the first time in 1982, it would have to draft appropriate organizational documents to survive this threshold test. Treas. Reg. § 1.501(c)(3) - 1(b)(6) (1959). Assume that the organization's members do not object to having to adopt an organizational document that contains the requisite statutory references. Even so, a strict application of the regulations would result in the organization receiving recognition of its tax-exempt status beginning only with the date the organization adopted the appropriate document. Broadway Theatre League v. United States, 293 F. Supp. 346 (W.D. Va. 1968). *See also* text accompanying notes 142-43 *infra*. Technically, the Commissioner could tax the group as a private foundation, or, depending upon the organization's structure, as a corporation or unincorporated association, and thereby deny any individual deductions taken for charitable contributions made to the group. Furthermore, since the group believed it was automatically exempt from taxes (e.g., a church), it may never have filed informational or other tax returns. The statute of limitations would not have been tolled. I.R.C. § 6501(c)(3) (West 1967). The Commissioner could assess taxes as far back as the year in which the group organized. A maximum penalty of $5,000 could be imposed upon the group for failing to file returns. I.R.C. §§ 6033(b), 6522(d) (West Supp. 1981). *See* text accompanying note 33 *supra*.

58 Treas. Reg. § 1.501(c)(3) - 1(b)(4) (1959).

uted for one or more exempt purposes," in a manner allowed by the regulations.[59]

Before the Secretary issued these regulations, courts considered the "organized" issue to be a factual question to be resolved by an examination of the actual objects motivating the organization, and the subsequent conduct of the organization, as well as by inspecting its organizing documents.[60] By placing greater emphasis on an organization's activities, the courts' determinations regarding appropriateness of tax-exemption turned largely on whether the organization was operating or would be operated exclusively for exempt purposes.[61]

In a few instances courts have refused to apply the regulations' mechanical standards, preferring instead a factual inquiry. For example, the United States Court of Appeals for the Fourth Circuit believes that "courts are not necessarily bound by the recitals in certificates of organization and in proper cases may consider extrinsic evidence."[62] The First and Fifth Circuits have subtly ignored the regulations when deciding whether an organization qualifies for tax exempt status. These circuits focus on the way an organization operates its business.[63] Similarly, the Ninth Circuit refuses to place a premium on the nonprofit organization's formal attributes and holds that courts can best discern an organization's true character by examining its activities.[64]

Neither Congress nor the courts selected organizational articles as the sole evidence of the "objects motivating the organization." Perhaps the Secretary established this requirement for administrative convenience and uniformity. However, considering the differences

59 *Id.* Courts have noted that the treasury regulations impose burdens on groups seeking exemption under § 501(c)(3) in addition to those the statute explicitly imposes. Big Mama Rag, Inc. v. United States, 631 F.2d 1030 (D.C. Cir. 1980). In *Big Mama Rag*, the publisher of a feminist periodical sought recognition of tax-exempt status as an educational organization. Big Mama intimated that the IRS refused to recognize its tax-exempt status for political reasons and raised a first amendment challenge to the treasury regulations. The court struck down the portion of the treasury regulations that set out criteria for qualification as an "educational" organization as being impermissibly vague and ambiguous. *Id.*

60 Samuel Friedland Found. v. United States, 144 F. Supp. 72, 85 (D.N.J. 1956); Squire v. Students' Book Corp., 191 F.2d 1018 (9th Cir. 1951); United States v. Comm. Services, 189 F.2d 421 (4th Cir. 1951); Gemological Inst. of Am., Inc. v. Riddell, 149 F. Supp. 128 (S.D. Cal. 1957).

61 149 F. Supp. at 129-30.

62 Taxation with Representation v. United States, 585 F.2d 1219, 1222 (4th Cir. 1978).

63 Senior Citizens Stores, Inc. v. United States, 602 F.2d 711 (5th Cir. 1979); Elisian Guild, Inc. v. United States, 412 F.2d 121 (1st Cir. 1969).

64 Evergreen Cemetary Ass'n of Seattle v. United States, 444 F.2d 1232, 1234 (9th Cir. 1971).

between the organizations seeking tax exemption under section 501(c)(3) and the strong public policy favoring growth and development of charities, this requirement is too rigid to carry out Congress's purpose.

B. *The Operational Test and Private Inurement Proscription*

After meeting the organizational test, a group claiming exemption under section 501(c)(3) must also prove that it "operates exclusively" for one or more exempt purposes.[65] "Exclusively," in the context of section 501(c)(3), has been interpreted to mean "substantially" rather than "solely" or "absolutely without exception."[66]

The treasury regulations require an organization to meet the following requirements to pass this operational test: first, the organization must engage primarily in activities that accomplish one or more of the exempt purposes specified in section 501(c)(3); second, no more than an insubstantial part of the group's activities may further nonexempt purposes; and third, the group may not impermissibly engage in political activities such that it takes on the appearance of an "action" organization.[67] In recent litigation, the Commissioner has successfully argued that an organization fails the operational test if it serves private rather than public purposes. Alternatively, when a "commercial hue" permeates an organization's activities, the Commissioner argues that organization is serving private interests.[68]

Unfortunately, the case law regarding the extent to which the operational test overlaps with the prohibition against private inurement is murky.[69] The treasury regulations state that "[a]n organiza-

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65 Treas. Reg. § 1.501(c)(3) - 1(c)(1) (1959). *See* notes 34-35 *supra* and accompanying text. *See also* Levy Family Tribe v. Commissioner, 69 T.C. 615 (1978).

66 Kentucky Bar Foundation v. Commissioner, 78 T.C. 921, 923 (1982); Church in Boston v. Commissioner, 71 T.C. 102, 107 (1978). "Exclusively" means that the organization engages "primarily in activities which accomplish" the purposes for which it was organized. It will lose its exempt status "if more than an insubstantial part of its activities is not in furtherance of an exempt purpose." However, insubstantial non-exempt activities do not destroy the exemption. Northern Cal. Cent. Serv. v. United States, 591 F.2d 620, 626 (Ct. Cl. 1979). *Accord* Better Business Bureau v. United States, 326 U.S. 279, 283 (1945); St. Louis Union Trust Co. v. United States, 374 F.2d 427, 431 (8th Cir. 1967).

67 Treas. Reg. § 1.501(c)(3) - 1(c)(1),(3) (1959).

68 *See, e.g.*, Copyright Clearance Center v. Commissioner, 79 T.C. 793, 804-05 (1982); Retired Teachers' Legal Defense Fund v. Commissioner, 78 T.C. 280 (1982); Goldsboro Art League v. Commissioner, 75 T.C. 337, 343; Greater United Navajo Enterprises Dev. Enters. Inc. v. Commissioner, 74 T.C. 69, 79. Better Business Bureau v. United States, 326 U.S. 279 (1945). *See also* Rev. Rul. 81-94, 1981-1 C.B. 330, Treas. Reg. § 1.501(c)(3) - 1(d)(1)(ii) (1959).

69 *See, e.g.*, Lowry Hosp. Ass'n v. Commissioner, 66 T.C. 850, 857 n.8 (1976) The operational test requires that the supposed 501(c)(3) organization's activities serve the public in

tion is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals."[70] However, as the Tax Court has noted, "the proscription against private inurement to the benefit of any shareholder or individual does not apply to unrelated third parties."[71]

Also, it is unclear whether the organization or the Commissioner bears the burden of proof on the private inurement issue.[72] The treasury regulations state that to meet the operational test standards, an organization "must establish that it is not organized or operated for the benefit of private interests."[73] Instead of allocating the burden of proof on this issue to the organization, recent decisions have required the Commissioner to prove that a group's net earnings inure in whole or in part to the benefit of private individuals.[74] The Commissioner has demonstrated impermissible private inurement by proving that an organization has failed the operational test. For example, by showing that an organization serves private rather than public purposes, the Commissioner establishes impermissible private inurement.[75] Alternatively, the Commissioner has argued that when "a commercial hue permeates" an organization's operations, despite any truly exempt purposes, the organization's net earnings impermissibly inure to the benefit of private shareholders or individuals.[76]

In a recent Tax Court case, a taxpayer criticized several regulations concerning private inurement and the operational test[77] for being excessively vague," and for resulting in "arbitrary and

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some way. If the bulk of the organization's activities inure to the benefit of its members, it is deemed to serve a private rather than a public purpose. Consequently, it will fail the operational test. B.H.W. Anesthesia Found., Inc. v. Commissioner, 72 T.C. 681, 684 n.3 (1979).

70 Treas. Reg. § 1.501(c)(3) - 1(c)(2) (1959).

71 Goldsboro Art League v. Commissioner, 75 T.C. 337, 345 (1980).

72 *See* note 74 *infra* and accompanying text. Treas. Reg. § 1.501(c)(3) - 1(d)(1)(ii) (1959).

73 Treas. Reg. § 1.501(c)(3) - 1(d)(1)(iii) (1959). As a general matter, an organization bears the burden of proof on all issues pertaining to its qualification for tax-exemption. *See, e.g.*, Harding Hospital, Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974).

74 Church of the Transfiguring Spirit, Inc. v. Commissioner, 76 T.C. 1, 5 n.6 (1981). *But see* Retired Teachers' Legal Defense Fund v. Commissioner, 78 T.C. 280, 289 (1982).

75 Rev. Rul. 81-94, 1981-1 C.B. 310. In several cases, the Tax Court has noted the overlap of the prohibitions against private inurement and private purposes. *See, e.g.*, Goldsboro Art League v. Commissioner, 75 T.C. at 345 n.10; People of God Community v. Commissioner, 75 T.C. 127, 132-33 (1980); Western Catholic Church v. Commissioner, 73 T.C. 196, 206 n.27 (1979), *aff'd in an unpublished opinion*, 631 F.2d 736 (7th Cir. 1980).

76 *See, e.g.*, Goldsboro Art League, Inc. v. Commissioner, 75 T.C. at 342-43 (1980).

77 *Retired Teachers'* challenge was focused on the following regulations: Treas. Reg. § 1.501(c)(3)-1(a)(3)(1) (1959), the three subparagraphs of § 1.501(c)(3)-1(c), and § 1.501(c)(3)-1(d)(2)(iii) (1959).

discriminatory enforcement."[78] The taxpayer alleged that the regulations improperly added requirements to those spelled out in section 501(c)(3). The taxpayer also contended that "the term 'benefit' as used in section 1.501(c)(3)-1(d)(1)(ii), Income Tax Regs., [was] used out of context with the statute, [was] vague, and contained[ed] no guidelines for its usage."[79] The Tax Court rejected this challenge and explained that the regulation focused not on the term "benefit" standing alone, but rather on an impermissible benefit to "private interests."[80] Returning to common law notions regarding charitable organizations, the Tax Court noted that the regulation prohibits organizations seeking section 501(c)(3) treatment from serving private interests. And "[t]he fundamental reason for granting an organization tax exemption is that it serves a public benefit."[81]

The Tax Court also dismissed the organization's argument that, by using the term "benefit" with the phrase "private interests," the regulations added a requirement not present in the statute. The organization believed that the regulation's prohibition against a private purpose went beyond the statute's prohibition against private inurement. The court stated simply that the section 501(c)(3) proscription against private inurement had a broader meaning than that suggested by the organization.[82] Thus, the court concluded, the regulation was safely within the statute. In Judge Tietjens' words, "[a]lthough an organization may not benefit [interested individuals] financially, it still may emphasize a private purpose which . . . is contrary to being organized and operated exclusively for an exempt purpose."[83] Rather than citing cases involving like organizations, the court cited cases in which tax-exempt status had been denied religious organizations[84] and reported that it saw "no evidence of dis-

78 Retired Teachers' Legal Defense Fund v. Commissioner, 78 T.C. at 284-85.

79 *Id.* at 286.

80 *Id.*

81 *Id.* The court did not discuss what constitutes a "public benefit," but cited Trinidad v. Sagrada Orden, 263 U.S. 578 (1924). In *Trinidad*, the Supreme Court noted the common law principle that Congress exempts certain organizations because of the benefit they confer on the public. *Id.* at 581.

82 78 T.C. at 286.

83 78 T.C. at 287.

84 Unitary Mission Church v. Commissioner, 74 T.C. 507 (1980), *aff'd by unpublished order* (2d Cir., Jan. 19, 1981) (tax-exempt status denied a religious organization on the ground that part of its net earnings had inured to the benefit of private shareholders or individuals); Southern Church of Universal Brotherhood Assembled, Inc. v. Commissioner, 74 T.C. 1223 (1980) (tax-exempt status denied a religious organization because the administrative record did not establish that the church served a public rather than a private purpose).

criminating enforcement of this regulation."[85]

Courts purport to construe the revenue statute and treasury regulations liberally because of the sensitive public interests at stake.[86] However, any impermissible private inurement, regardless of the quantity, is fatal to an organization's application for tax exempt status[87] despite the organization's furtherance of the public interest.

IV. *United States v. Vogel Fertilizer Company*

In January 1982, the United States Supreme Court rendered a decision that may encourage more careful judicial scrutiny of treasury regulations. In *Vogel Fertilizer*, the Court resolved a controversy over the proper definition of "brother-sister controlled group."[88] More importantly, it did so by invalidating the regulatory interpretation of Code section 1563(a)(2) as an unreasonable implementation of the manifest congressional design.[89]

Under section 1561(a), Congress intended to limit groups of interrelated corporations, characterized by common control and own-

85 78 T.C. at 287. However in Rev. Rul. 81-29, 1981-1 C.B. 329, the Commissioner held that an organization operating a computer network to facilitate the exchange of bibliographical information among member libraries, some of which were not tax-exempt, could qualify for exemption under § 501(c)(3). It is unclear why this membership organization, as distinguished from Retired Teachers, did not fall into the public inurement/private purposes quagmire.

86 *See, e.g.*, Trinidad v. Sagrada Orden, 263 U.S. at 580; American Inst. for Economic Research v. United States, 302 F.2d 934 (Ct. Cl. 1962), *cert. denied* 372 U.S. 976 (1963), *reh'g denied* 373 U.S. 954 (1963); Harrison v. Barker Annuity Fund, 90 F.2d 286 (7th Cir. 1937).

87 To avoid formulas or percentages for calculating the impermissible quantity of private inurement, Congress conditioned exemption on "no part" of an organization's net earnings inuring to private individuals' benefit. Founding Church of Scientology v. United States, 412 F.2d 1197, 1199, 1202 (Ct. Cl.), *cert. denied*, 379 U.S. 1009 (1969). In short, even if the benefit inuring to a private shareholder or individual from net earnings is small, it is still impermissible. Beth-El Ministries, Inc. v. United States, 79-2 U.S.T.C. 9412, 44 A.F.T.R.2d 79-5190 (D.D.C. 1979).

88 United States v. Vogel Fertilizer Co., 455 U.S. 16 (1982). I.R.C. § 1563(a)(2) (West 1982) defines a "brother-sister controlled group" as:

> Two or more corporations if five or fewer persons who are individuals, estates, or trusts own (within the meaning of subsection (d)(2)) stock possessing —
>
> (A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and
>
> (B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.

89 455 U.S. at 18.

Treasury Regulation § 1.1563-1(a)(3) (1975) provided that:

ership, to a single surtax exemption.[90] Among the "controlled groups of corporations" Congress targeted with this provision are "brother-sister controlled groups."[91] Congress prescribed two numerical tests for determining whether two or more corporations are brother-sister corporations—the 50% test and the 80% test.[92] These tests help ascertain whether two or more corporations are so closely related that they should be treated as one corporation for certain purposes.

Arthur Vogel owned 77.49% of the Vogel Fertilizer common stock and Richard Crain, an unrelated party, owned the remaining 22.51%.[93] During the years in question, Arthur Vogel also controlled 87.5% of the voting power, and held over 90% of the stock, of Vogel Popcorn Company.[94] Crain owned no Vogel Popcorn stock during this time. Because Vogel's ownership of more than 50 percent of both corporations satisfied the 50 percent identical ownership requirement in section 1563(b)(2)(B), only the 80 percent requirement was disputed.[95]

Courts had interpreted the much-criticized 80% test of a

> [t]he term 'brother-sister controlled group' means two or more corporations if the same five or fewer persons who are individuals, estates, or trusts own . . . *singly or in combination*, stock possessing —
>
> (A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of shares of all classes of the stock of each corporation, and
>
> (B) more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation.

90 455 U.S. at 18.

91 *See* I.R.C. § 1561(a) (West 1982).

92 *See* note 89 *supra*.

93 455 U.S. at 20.

94 *Id.*

95 *Id.* Vogel Fertilizer Company filed refund claims, contending that its relationship with Vogel Popcorn Company did not constitute a "brother-sister controlled group" within the meaning of the revenue statute. *Id.* Vogel Fertilizer relied on a 1976 Tax Court decision, Fairfax Auto Parts of N. Va., Inc. v. Commissioner, 65 T.C. 798 (1976), *rev'd*, 548 F.2d 501 (4th Cir. 1977), that had held treasury regulation § 1.1563(a)(2)-1 invalid as an unreasonable interpretation. Vogel Fertilizer had not claimed its full surtax exemption believing that treasury regulation § 1.1563-1(a)(3) precluded it from doing so. 455 U.S. at 20. When the Internal Revenue Service refused Vogel Fertilizer's claims for each of the taxable years from 1973 through 1975, Vogel Fertilizer sued for a refund in the United States Court of Claims. Vogel Fertilizer Co. v. United States, 634 F.2d 497 (Ct. Cl. 1980).

The Court of Claims agreed with Vogel Fertilizer and ruled that treasury regulation § 1.1563-1(a)(3) (1975) was invalid to the extent that it took into account, in applying the 80% test, stock held by a shareholder who owned stock in only one of the controlled corporations. 634 F.2d at 501. The Supreme Court granted certiorari to resolve the conflict among the circuits regarding the appropriate interpretation of "brother-sister controlled group."

"brother-sister controlled group"[96] in markedly different ways, thus producing inconsistent results.[97] Courts at one end of the spectrum had interpreted the definition narrowly, holding that section 1561 required each of the five or fewer persons comprising the 80% ownership group to own stock in each corporation.[98] At the other end, courts had construed the statute to allow the five or fewer persons in the 80% ownership group to "singly or in combination" own stock in each of the brother-sister corporations.[99] Treasury regulation section 1.1563(a)(2)-1[100] contains this "singly or in combination" language, but the Code itself does not.

The Commissioner urged the Court to interpret the 80% requirement to mean that any of the five or fewer persons could satisfy the test by owning, "singly or in combination," the requisite 80%.[101] The Commissioner, focusing merely on stock ownership by a small number of persons in related companies, would have found the 80% requirement to have been satisfied regardless of how many of the control persons owned the stock.

Vogel Fertilizer Company invited the Court to apply an objective common-ownership requirement "to identify brother-sister corporations.[102] According to Vogel Fertilizer, each of the persons comprising the 80% ownership group must own stock in each corporation.[103]

To decide which interpretation of section 1563 to adopt, Justice Brennan, writing for the Court, began his analysis by establishing the deference that the Court ought to accord the regulatory interpretation.[104] Justice Brennan wrote, "[d]eference is ordinarily owing to the agency construction if we can conclude that the regulation 'implement[s] the congressional mandate in some reasonable

96 *See* note 88 *supra*.

97 *Compare* Delta Metalforming Co. v. Commissioner 632 F.2d 442 (5th Cir. 1980) (holding that a person must own stock in each member of an alleged brother-sister controlled group to satisfy the 80% test under I.R.C. § 1563(a)(2)(A) (1982)) *and* Fairfax Auto Parts of N. Va. v. Commissioner, 548 F.2d 501 (4th Cir. 1977) (*per curiam*) (holding that the same five or fewer persons, who *singly or in combination*, owned stock would satisfy the 80 percent test under I.R.C. § 1563(a)(2)(A)). *See also* 455 U.S. at 22 n.6.

98 *See, e.g.*, Delta Metalforming Co. v. Commissioner, 632 F.2d 442 (5th Cir. 1980).

99 *See, e.g.*, Allen Oil Co. v. Commissioner, 614 F.2d 336 (2d Cir. 1980); T.L. Hunt, Inc. v. Commissioner, 562 F.2d 532 (8th Cir. 1977).

100 *See* notes 88-89 *supra*.

101 455 U.S. at 23.

102 *Id.* at 22.

103 *Id.*

104 *Id.* at 24.

manner.' "[105]

One of the factors a court considers when deciding whether a regulation reasonably implements the congressional mandate is the source of the Secretary's authority. Because Treasury Regulation section 1.1563-1(a)(3) had been issued under the Secretary's general authority to "prescribe all needful rules and regulations,"[106] Justice Brennan reasoned that the Court owed it less deference than a regulation advanced under a specific grant of authority.[107] Had it been advanced under a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision, the Court's primary inquiry would have been "whether the interpretation . . . [was] within the delegation of authority."[108] But, because the regulation was advanced under a general grant of authority, the Court owed it less deference.

Other factors a court considers when determining deference owed to regulatory interpretations of the Code include "the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent reenactments of the statute."[109] Moreover, when the Secretary interprets a term or phrase which is so general that it has escaped precise definition and caused judicial confusion,[110] courts will accord a greater degree of deference to the regulatory interpretation.[111]

Having resolved the threshold issue as to the degree of deference owing the Commissioner's interpretation of the revenue statute, the Court examined the regulations through two harmonizing tests. First, the court compared the treasury regulation's wording with the statutory language for technical consistency.[112] However, as Justice Brennan noted, even though a treasury regulation technically com-

105 *Id.* (citing United States v. Correll, 389 U.S. 299, 307 (1967)). *See also* Commissioner v. Portland Cement Co., 450 U.S. 156, 169 (1981); Rowan Cos. v. United States, 452 U.S. 247, 252 (1981).

106 I.R.C. § 7805(a) (West 1967).

107 455 U.S. at 24. In their dissent, Justice Blackmun and Justice White argue that, even though the Commissioner's interpretation should be accorded less deference under these circumstances, the Court must establish that the Commissioner's interpretation is incorrect before acquiescing to another interpretation of the revenue statute. *Id.* at 35 (Blackmun, J., dissenting).

108 Rowan Cos. v. United States, 452 U.S. at 253.

109 455 U.S. at 24. (citing National Muffler Dealers' Ass'n v. United States, 440 U.S. 472, 476 (1979)).

110 440 U.S. at 477.

111 455 U.S. at 24.

112 *Id.* at 25.

ports with the Code, it cannot be sustained if it is "fundamentally at odds with the manifest congressional design."[113] Thus, the Court employed a second harmonizing test examining intent. To decide whether the regulation harmonized with congressional intent, the Court scrutinized the regulation to see if it agreed with the statute's origin and purpose.[114]

After reviewing section 1563's background and legislative history, the Court found nothing to justify the "singly or in combination" language that treasury regulation section 1.1563-1(a)(3) added.[115] Consequently, the Court invalidated this portion of the regulation. The Court also decided that, because Vogel Fertilizer's interpretation of "brother-sister controlled group"[116] implemented the legislative intent, it was a reasonable statutory interpretation.[117]

In summary, the analytic framework that emerges from *Vogel Fertilizer* involves two separate harmonizing tests; one focusing on technical consistency of language, the other contrasting the regulation's practical effect with the revenue statute's legislative history. In Justice Brennan's words the two tests are "refined by consideration of the source of the authority to promulgate the regulation at issue."[118] To determine the degree of deference it should accord the regulatory interpretation of the Code, a court must look to the grant of authority under which the Secretary issued its interpretive regulation and the reasonableness of the agency's exercise of this authority.[119] When the Secretary and Commissioner act under a specific grant of authority, greater deference will be accorded the regulation interpretation. Although not prominent in *Vogel Fertilizer*, other factors a court should weigh when examining the deference owed to regulatory interpretations include the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent reenactments of the statute.[120]

The first harmonizing test focuses on how well the regulation comports with the statutory language. Regard to any judicial decisions and definitions or criteria contained in the statute itself is help-

113 *Id.* (citing *National Muffler Dealers*, 440 U.S. at 477).
114 *Id.* at 26.
115 *Id.* (citing United States v. Cartwright, 411 U.S. 546, 557 (1973)).
116 *See* text accompanying notes 102-103 *supra*.
117 *See* text accompanying notes 102-103 *supra*.
118 *See* text accompanying notes 104-108 *supra*.
119 455 U.S. at 26.
120 *See* note 109 *supra* and accompanying text.

ful in answering this question.[121] The second *Vogel Fertilizer* test examines whether the regulation is fundamentally at odds with the manifest congressional design. A court must consult the statute's origin and purpose to determine whether the agency has furthered the legislative intent through its interpretive provisions.[122]

V. Applying the *Vogel Fertilizer* Analysis to the Regulatory Interpretation of Section 501(c)(3)

An application of the *Vogel Fertilizer* analysis to the regulatory interpretation of section 501(c)(3) begins with a determination of the degree of deference that must be accorded the regulations. Like the treasury regulations invalidated by the Supreme Court in *Vogel Fertilizer*, the Secretary promulgated the treasury regulations interpreting section 501(c)(3) under Code section 7805—his general grant of authority.[123] Consequently, the regulations must be found to "implement the congressional mandate in some reasonable manner,"[124] but are accorded less deference than if Congress had specifically authorized the Secretary to interpret section 501(c)(3).[125]

Considering other factors relating to deference owed a regulation, the regulations do not fare much better. Because Congress had specifically exempted certain organizations from taxation for sixty-five years prior to the regulations' promulgation, and because of their relatively short life, it is unlikely that the section 501(c)(3) treasury regulations have acquired the force of law.[126] Moreover, the courts had not considered the statutory terms to be "so general . . . as to render an interpretive regulation appropriate prior to the treasury regulations' promulgation."[127] In fact, because of the delicate policy considerations at stake, courts had made case-by-case factual determinations regarding the validity of an organization's claim to tax-exempt status.[128]

In interpreting the statutory language, the first harmonizing test in *Vogel Fertilizer* requires a court to determine whether the regulation harmonizes with the plain statutory language.[129] Section

121 *See* text accompanying note 113 *supra*.
122 *See* notes 114-17 *supra* and accompanying text.
123 *See* notes 104-11 *supra* and accompanying text.
124 United States v. Correll, 389 U.S. 299, 307 (1967).
125 *See* notes 104-11 *supra* and accompanying text.
126 *See* notes 3, 109 *supra* and accompanying text.
127 Helvering v. Reynolds Co., 306 U.S. 110, 114 (1939).
128 *See* notes 60-64 *supra* and accompanying text.
129 *See* note 113 *supra* and accompanying text.

501(c)(3) establishes three conditions for organizations seeking tax-exempt purposes: they must be organized exclusively for tax-exempt purposes, they must be operated exclusively for tax-exempt purposes, and no part of the organizations' net earnings may inure to the benefit of private individuals.[130] The regulations, in addition to defining many tax-exempt purposes,[131] prescribe specific methods for meeting the organizational and operational tests.[132]

To meet the organizational test, the Commissioner requires that an organization be organized for one or more of the statutory purposes and that its organizational articles limit its purposes and activities to those statutory purposes.[133] Moreover, the treasury regulations provide that an organization cannot meet the organizational test unless its assets are dedicated to an exempt purpose.[134] An organization can satisfy the Commissioner's requirement that its assets are dedicated to exempt purposes only if its articles provide that upon the organization's dissolution, the assets will be properly disposed of.[135] The Code contains no such requirement, nor do the origin and purposes of tax-exempt organizations offer any reasons why this requirement would further the congressional intent.

The Secretary's interpretation of section 501(c)(3) and the Commissioner's implementation of the treasury regulations have not only imposed several formal burdens on nonprofit organizations, but now require these organizations to establish that they serve public rather than private purposes.[136] The regulations provide no guidance regarding when an organization impermissibly "emphasizes a private purpose."[137] Moreover, the Commissioner has incorporated the *Better Business Bureau* "commercial hue" test, used in connection with social security tax cases, in his determination of whether an organization is operating exclusively for tax-exempt purposes. Congress, however, intended section 811(b)(8) of the Social Security Act to track the development of Code section 501(c)(3) rather than the other way

130 I.R.C. § 501(c)(3) (West Supp. 1981).

131 Treas. Reg. § 1.501(c)(3) - 1(d) (1959). *See* note 52 *supra* and accompanying text.

132 Treas. Reg. § 1.501(c)(3) - 1(b)(6) (1959). *See* note 41 *supra* and accompanying text.

133 Treas. Reg. § 1.501(c)(3) - 1(b)(1) (1959). *See* notes 52-64 *supra* and accompanying text.

134 Treas. Reg. § 1.501(c)(3) - 1(b)(4) (1959). *See* notes 58-59 *supra* and accompanying text.

135 Treas. Reg. § 1.501(c)(3) - 1(b)(4) (1959). *See* notes 58-59 *supra* and accompanying text.

136 *See* notes 68-85 *supra* and accompanying text.

137 *See* notes 70-85 *supra* and accompanying text.

around.[138] For all these reasons, the regulations fail the first harmonizing test.

Finally, the second *Vogel Fertilizer* test for determining the regulatory interpretation's validity asks whether the interpretation is fundamentally at odds with the manifest congressional design.[139] As noted above, section 501(c)(3) has no detailed legislative history. However, neither Congress nor the courts have ever hinged tax-exempt status upon a nonprofit organization's ability to satisfy a cascade of formal requirements. Preregulation case law indicates that courts looked to the facts surrounding the organization and operation of each nonprofit group to determine whether tax-exempt status was appropriate.[140]

The regulations now specifically state that "[t]he fact that the actual operations of . . . an organization have been exclusively in furtherance of one or more exempt purposes shall not be sufficient to permit the organization to meet the organizational test."[141] Consider the effect of this regulation on an organization that has operated for thirty years without notifying the Commissioner of its claimed tax-exempt status.[142] An example of such an organization is a Mennonite Church serving a conservative Amish community. Because these groups tend to lead modest lives in relatively isolated rural areas, they are unlikely to have drafted sophisticated organizational documents. More importantly, because many of their beliefs and practices differ radically from the familiar rituals of religions such as Catholicism or Judaism, it is unlikely that the organizational documents they would have could satisfy the organizational test. Thus, the best evidence that this hypothetical church deserved tax-exempt status would be its thirty years of actual operation as a church. However, under treasury regulation section 1.501(c)(3)-1(b)(1)(iv), this bona fide religious organization would fail the organizational test.[143]

VI. Conclusion

Internal Revenue Code section 501(c)(3) focuses on the extent to which an organization is created and conducted in a manner merit-

138 *See* notes 40, 77 *supra* and accompanying text.

139 455 U.S. at 25.

140 *See* note 128 *supra* and accompanying text.

141 Treas. Reg. § 1.501(c)(3) - 1(b)(1)(iv) (1959).

142 Bethel Conservative Mennonite Church v. Commissioner, No. 14992-81"x", 1983 T.C., Dec. (CCH) ¶ 7414 (Feb. 7, 1983).

143 *Id.*

ing preferred tax treatment. Holmes's Mrs. Quickly would, in Holmes' opinion, be unable to detect the substance of transactions and exchanges because her perception would be so tainted by appearances. Likewise, the Secretary and Commissioner lose sight of the reality of the activities and purposes which motivate individuals to create and operate nonprofit organizations. Remember that the lawyer Holmes describes in *The Path of the Law* does not mention the color of the hat his client wore when executing a contract. Similarly, Congress did not legislate particular methods or characteristics that would qualify organizations for tax-exempt status; rather, Congress expected the substance of an organization to always be paramount to its attributes.

If an organization, through its operations, relieves the public of a burden which otherwise belongs to it, it matters little what information may be contained within the four corners of its organizational articles. Conversely, organizations that shrewdly draft their documents and supply the Commissioner with information that conforms to the regulatory interpretation of section 501(c)(3), but which are really not bona fide tax-exempt organizations, should not receive tax-exempt status. By paying undue attention to highly formalistic organizational and operational tests that fail to provide nonprofit organizations with reasonable guidelines for organizing and operating in accordance with statutory requirements, the Secretary aligns himself with Mrs. Quickly—noticing appearances, but losing sight of manifest congressional intent.

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