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Distributions by Charitable Organizations: Their Effect on Tax Exempt Status and Deductibility of Donations Received

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I. INTRODUCTION

The number and importance of tax exempt organizations has steadily grown in the past decade to the point where there were over 45,000 as of the beginning of 1963, as compared with 12,000 at the end of 1952.[1] "Unquestionably, the economic life of our nation has become so intertwined with foundations that unless something is done about them, they will hold a dominant position in every phase of American life."[2] This, according to the Patman Report, is because "multimillion-dollar foundations have replaced the trusts which were broken up during the Theodore Roosevelt administration."[3]

Both the Patman Report and the increased activity of the Internal Revenue Service in its audit program[4] demonstrate the increased interest in the tax exempt field. In spite of this, however, not a great deal has been written in this area in recent years. This note will attempt to set forth and clarify the tests and requirements established by the Internal Revenue Code of 1954,[5] and the Treasury Regulations issued thereunder, by which an organization may receive, and maintain tax exempt status,[6] and by which gifts to such organizations will qualify as deductible charitable contributions.[7]

Emphasis will be placed upon the effect on tax exempt status of distributions by exempt organizations to organizations which have not been ruled tax exempt. Consideration will also be given to inconsistencies among the sections of the Code in this area.

II. THE TAX STATUTE

The receipt and maintenance of tax exemption and the qualification as an organization to which deductible contributions may be made

1. CHAIRMAN OF HOUSE SELECT COMMITTEE ON SMALL BUSINESS, 87TH CONG., 2D SESS., TAX EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY v (Comm. Print 1962) [hereinafter cited as PATMAN REPORT, 1ST INSTALLMENT]. See also CHAIRMAN OF HOUSE SELECT COMMITTEE ON SMALL BUSINESS, 88TH CONG., 1ST SESS., TAX EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY (Comm. Print 1953) [hereinafter cited as PATMAN REPORT, 2D INSTALLMENT].

2. PATMAN REPORT, 1ST INSTALLMENT v.

3. *Ibid.*

4. See Rogovin, *Exempt Organizations: New Procedures and Current Policies within the IRS*, 20 J. TAXATION 28 (1964).

5. INT. REV. CODE OF 1954 is hereinafter cited as CODE.

6. CODE § 501.

7. Code §§ 170 (income tax), 2055 (estate tax), 2522 (gift tax).

are understandably the two aspects of taxation of prime importance to charitable institutions. Without adequate funds, they, as well as the objects of their distributions, would become direct charges upon the community, and would be forced out of existence. Without considerable tax advantages, adequate funds would not be available. Thus, the primary legislative purpose behind the charitable deduction has been the desire to encourage the support of organizations which perform public services.

A. *Tax Exemption*

The Internal Revenue Code of 1954 provides in section 501(a)[8] that certain described organizations[9] shall be exempt from taxation, including corporations and other organizations which are organized and operated exclusively for religious, charitable, or educational, etc. purposes,[10] "unless such organization is a 'feeder organization' (see

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8. This provision is substantially the same as the one set out in the 1939 Code (as well as in prior revenue acts) in § 101(6). The regulations which give the so-called "organizational test" for qualifying for an exempt ruling under § 501, however, are considerably more complete, and complex than the regulations for § 101(6) of the 1939 Code.

Since the regulations now set out more fully the attitude of the Treasury, and since the requirements are so much more definite than ever before, they are of extreme importance to prospective charitable organizations.

While an information return on form 990 or 990A is not required to be filed by an organization claiming an exempt status under § 501 prior to the establishment by the organization of such exempt status, if the date for filing an income tax return and paying the tax occurs before the exempt status has been established, the organization is required to file the return and pay the tax. Once exempt status is established, however, the organization may file a claim for a refund of taxes paid for the period for which its exempt status is established. Treas. Reg. § 1.6033-1(c) (1958). This is but one example of why it is so important to pay such close attention to detail in these sections.

Further, contributors are not allowed a deduction for charitable contributions until the ruling letter has been received by the donee organization. However, some flexibility is provided in this latter case by giving the donee sufficient time to obtain a ruling before taxes are asserted or deductions disallowed. See Sugarman & Fullmer, *The Requirements and Techniques for Filing Tax and Information Returns*, 5 N.Y.U. CONF. ON CHARITABLE FOUNDATIONS 169 (1961).

The new regulations, while more strict, are at the same time more beneficial to prospective organizations in two respects. First, since they provide means for more efficient administrative handling, applications may be handled faster, and new rulings will be more speedily forthcoming. Also, the organization which follows to the letter the form established by the "organizational test" can be assured of a favorable ruling. This should be welcomed by those who have a genuine desire to create a bona fide charitable organization. See Eaton, Sugarman, Mansfield & Cutler, *How to Draft the Charter or Indenture of a Charity So as to Qualify for Federal Tax Exemption*, 8 PRAC. LAWYER 13 (Oct. 1962).

9. Those which are described in CODE §§ 501(c) & (d), 401(a).

10. CODE § 501(c), provides that "the following organizations are referred to in subsection (a) [as being exempt from taxation unless otherwise denied the exemption by §§ 502, 503, or 504]: . . . "(3) Corporations, and any community chest, fund,

section 502), or unless it engages in a transaction described in section 503 or in an activity described in section 504. However, the exemption does not extend to 'unrelated business taxable income'[11] of such an organization."[12]

Qualifying for favorable treatment under section 501 is also significant for purposes other than the exemption granted thereby. With few exceptions, the same terms are used to describe, in other Code sections, the organizations to which deductible contributions may be made for income tax purposes,[13] and to which deductible gifts and bequests may be made for gift[14] and estate tax[15] purposes. The terms used have further significance, in that many other laws, state and federal, use similar terminology in their treatment of charitable and educational organizations.[16]

There are four main requirements with which an organization must comply in order to receive a tax exempt ruling[17] under section 501 (c)(3). First, it must be both organized and operated for one or more of the specified nonprofit purposes. There are actually two tests here —the organizational test and the operational test. If an organization fails to meet either test, it is not exempt.[18]

An institution is organized for an exempt purpose if its charter both limits the institution to one or more exempt purposes, and also does not empower the organization to engage, other than in an insubstantial part of its activities, in activities which are not in furtherance of an exempt purpose.[19] An organization is operated for an exempt purpose only if it actually engages primarily in activities which

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or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing statements), any political campaign on behalf of any candidate for public office."

11. See Code §§ 511-15.
12. Treas. Reg. § 1.501(a)-1 (1958).
13. Code § 170.
14. Code § 2522.
15. Code §§ 2055, 2106(a)(2).
16. Eaton, Sugarman, Mansfield & Cutler, *supra* note 8, at 14.
17. It is important to note that "an organization . . . is not exempt . . . merely because it is not organized and operated for profit." Treas. Reg. § 1.501(a)-1(a)(2) (1958). An application must be filed with a district director and a ruling letter must be received.
18. Treas. Reg. § 1.501(c)(3)-1(a)(1) (1959).
19. Treas. Reg. § 1.501(c)(3)-1(b)(1) (1959). For examples of articles of incorporation which properly limit an organization's purpose, see 7 CCH 1965 Stand. Fed. Tax Rep. ¶ 6391B.

accomplish one or more of the exempt purposes specified in section 501(c)(3).[20]

Although the policy of the Internal Revenue Service appears to be that the ruling on an applicant will be determined primarily by the contents of its charter or articles of incorporation,[21] there have been conflicting opinions as to whether "organized" and "operated" can be separately analyzed such that the actual activities, rather than the stated purposes and powers, will determine which way the Service will rule.[22] However, even if the actual activities were held to be determinative of the outcome of the ruling, articles of incorporation granting powers which are broader than the exempt purposes will bar an exempt ruling, even though such broad powers are authorized by state law.[23]

The second requirement of section 501(c)(3) is that the net income of the organization seeking exemption must not inure in whole or in part to the benefit of any private shareholder or individual. The words "private shareholder or individual" refer to persons who have a personal and private interest in the activities of the organization.[24]

Profitable, or even competitive activities in furtherance of the organization's religious or educational purposes, however, will not affect its exempt status as long as all of the receipts are devoted to the purpose for which the organization was founded, and no earnings inure to the benefit of any private shareholder or individual.[25]

It is this requirement which has been the most abused, and which, therefore, is most vulnerable to challenge by Congress and the IRS.[26] There are many forms of private inurement which will cause the loss of exempt status.[27] Distribution of profits in the form of salaries,[28] and

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

21. See Lebit, *Tax Exempt Organizations*, 13 CLEV.-MAR. L. REV. 172, 174 (1964).

22. Samuel Freidland Foundation v. United States, 144 F. Supp. 74 (D.N.J. 1956).

23. Announcement 62-19, 1962 INT. REV. BULL. No. 8, at 20. See Eaton, Sugarman, Mansfield & Cutler, *supra* note 8.

24. Treas. Reg. § 1.501(a)-1(c) (1958).

25. In A. A. Allen Revivals, Inc., 22 CCH Tax Ct. Mem. 1435 (1963), the taxpayer-corporation had been denied exemption by the Commissioner on the gronnd that it was organized and operated for private gain, in that the religious and educational activities were only incidental to its "miraculous healing" and "commercial" activities, such as the publication and sale of its magazines, books, pamphlets, Bibles, musie records, tape recordings and pictures. The Commissioner was reversed, however, and the exemption was allowed: publication and sale of religious materials is a common method of carrying out the religious and educational purposes of any exempt organization. The limitation is that no receipts may go to the benefit of any private shareholder or individual.

26. See PATMAN REPORT, 1ST & 2D INSTALLMENTS, *supra* note 1.

27. For an exposition on the purpose and the actual use of the private inurement prohibition, sce Note, *The Inurement of Earnings to Private Benefit Clause of Section 501(c): A Standard Without Meaning?*, 48 MINN. L. REV. 1149 (1964).

28. Birmingham Business College, Inc. v. Commissioner, 276 F.2d 476 (5th Cir. 1960). In another case, the salary of each doetor in a privately operated clinic was

the purchase at above-market prices[29] of securities from shareholders or individuals[30] are common causes for challenge and revocation of an organization's tax exempt status.[31] Generally, the policy of the IRS is to deny an exemption when the private interests of the owners or founders, rather than the public interests envisioned by Congress, are served by the organization.[32]

The third requirement is that the organization, to be exempt, must not carry on propaganda in any substantial part of its activities, or in any other way attempt to influence legislation. This requirement has not been the subject of much dispute, for the reason that very few organizations which have attempted to influence legislation have even sought an exemption.[33] There might be a tendency to forget the leeway built into this requirement, by completely prohibiting activities to influence legislation by propaganda or otherwise. This is unnecessary, since the IRS does not compel a restriction greater than the statute requires, and such a prohibition may prevent such activities in which the organization may participate either innocently, or necessarily in furtherance of its primary purpose.

Lobbying for an exempt purpose, such as would be done indirectly through a report to a legislative committee by an organization formed for the testing of public safety, should not be held to fall within this prohibition, though no case was found so stating. The policy behind the prohibition certainly would not seem to apply to lobbying carried out in furtherance of an exempt purpose. Caution should be exercised,

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based upon the number of patients he brought in. The clinic's exemption was lost as a result. Lorain Ave. Clinic, 31 T.C. 141 (1958).

29. A sale to a private shareholder or individual at below-market prices is in the same category.

30. Kolkney v. Commissiouer, 254 F.2d 51 (7th Cir. 1958).

31. Other schemes, designed to abuse the private inurement requirement, have been used by organizations, and these will undoubtedly come to be more closely scrutinized in the future. One scheme is for a foundation to acquire all the stock of a regular business corporation, dissolve it, sell, lease or license the assets to an operating company, and receive in return most of the operating company's profits. These profits are then used to pay off any indebtedness incurred in the acquisition of the original corporation. See Rev. Rul. 55-420, 1954-2 CUM. BULL. 128.

Another questionable plan is for a shareholder to contribute § 306 stock to his own foundation. The corporation then redeems the stock, and there is no tax effect on the contributor; he will effectively take a tax-free dividend from the corporation, in that he will receive a deduction for the contribution to the foundation of such stock.

The regulations set out in some detail what constitutes inurement and who might have a prohibited private interest. Treas. Reg. § 1.501(c)-1(a) (1959). Family membership is determined by the attribution rules of § 267(c)(4). Transactions prohibited by the private inurement clause are set out in Treas. Reg. § 1.503(c)-1(a) (1959) (with examples in Treas. Reg. § 1.503(c)-1(c) (1959)) and CODE § 503(c).

32. This policy, and the suggested solutions to the many problems involved in the many attempts to circumvent it, are fully presented in the PATMAN REPORT, 1ST & 2D INSTALLMENTS, *supra* note 1.

33. Lebit, *supra* note 21, at 175.

however, to insure that lobbying is not a substantial part of the organization's activities.

The fourth requirement is that the organization must not participate or intervene in any political campaign on behalf of any candidate for public office.[34] This may cause more losses of exemption than the propaganda prohibition, because here not even an insubstantial amount of intervention or participation in relation to the organization's total activities will be allowed. In fact, the regulations provide that if the articles of incorporation allow such activity, though the organization is not actually engaged in it, the exemption will not be allowed.[35]

B. *Tax Deduction*

Section 170(a) of the Code allows an income tax deduction for a "charitable contribution," as defined by section 170(c),[36] and as

34. It is interesting to note that § 170(c)(2), allowing charitable deductions, contains a limitation on influencing legislation, as does § 501(c)(3), but does not expressly prohibit political campaigning. Thus, observance of both prohibitions is necessary in order to maintain exempt status. The omission from § 170 of the campaigning prohibition was probably a mere oversight, as there appears no reason why such activity should be allowed in one case but not in the other.

35. Treas. Reg. § 501(c)(3)-1(b)(3)(ii) (1959).

36. CODE § 170(a), allows as a deduction "any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year." CODE § 170(c), defines "charitable contribution" as "a contribution or gift to or for the use of—

(1) A State, a Territory, a possession of the United States . . . but only if the contribution or gift is made for exclusively public purposes.

(2) A Corporation, trust, or community chest, fund, or foundation—

(A) created or organized in the United States or in any possession thereof, or under the law of the United States, any State or Territory, the District of Columbia, or any possession of the United States;

(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals;

(C) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and

(D) no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation.

A contribution or gift by a corporation to a trust, chest, fund, or foundation shall be deductible by reason of this paragraph only if it is to be used within the United States or any of its possessions exclusively for purposes specified in subparagraph (B).

(3) A post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, any such post or organization—

(A) organized in the United States or any of its possessions, and

(B) no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(4) In the case of a contribution or gift by an individual, a domestic fraternal society, order, or association, operating under the lodge system, but only if such contribution or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

(5) A cemetery company owned and operated exclusively for the benefit of its members, or any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, if such company or corporation is not operated for profit and no part

limited in amount by section 170(b).[37] The fact that an organization is tax exempt under section 501 does not necessarily mean that a contribution to that organization is deductible by the donor. The classes of organizations, contributions to which may be deducted, are considerably fewer in number than the classes of organizations which are entitled to tax exemption.[38]

In general, a donation will qualify for a deduction if it is made to a section 501 exempt organization, but the donee organization must meet certain requirements in addition to those of section 501. The two most troublesome ones are set out in section 170(c).

The first, the "domestic organization" requirement, is that if a deduction is to be received, the "corporation, trust, or community chest, fund, or foundation" which is receiving the donation, must be "created or organized in the United States . . . or under the law of the United States. . . ."[39] The other, the "domestic use" requirement, is that a contribution by a corporation will be deductible "only if it

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of the net earnings of such company or corporation inures to the benefit of any private shareholder or individual."

37. CODE § 170(b)(1) limits an individual's deduction for contributions to 20% of his adjusted gross income, except that an additional 10% is allowable for charitable contributions to certain hospitals, medical research organizations, educational institutions and churches. For contributious made after 1963, the Revenue Act of 1964 expands the extra 10% deduction to include (1) contributions to any organization to which the basic 20% limitation now applies if the organization normally receives a substantial part of its support from the public or a governmental unit and (2) contributions to a federal, state or local government unit if the contribution or gift is made exclusively for public purposes. This extra 10% allowance applies only if the charitable contribution is paid *to* the organization and not just *for the use of* the organization.

CODE § 170(b)(2) limits a corporation's deduction for contributions to 5% of net income computed without the contributions deduction, but also allows a 5 year carryover of contributions in excess of this 5%.

38. T. J. Moss Tie Co., 18 T.C. 188, *petition for review dismissed,* 201 F.2d 512 (8th Cir. 1953).

39. CODE § 170(c)(2)(A). If the organization does not qualify under this section—that is, it was not created or organized in the United States, etc.—a contribution thereto is not deductible under § 170. Muzaffer ErSelcuk, 30 T.C. 962 (1958); Dora F. Welti, 1 T.C. 905 (1943). "Prior to the passage of the Revenue Act of 1938 there were no restrictions as to the place of creation of charitable organizations to which individuals might make deductible contributions. (Section 102(c) of the Revenue Act of 1935, which first permitted a deduction for *corporate* charitable contributions, limited that deduction to contributions to 'domestic' organizations which used such contributions within the United States.) The rule as to individual contributions was changed with the passage of the Revenue Act of 1938. Section 23(o) of that Act provided that contributions by individuals were deductible only if the recipient was a 'domestic' organization." See discussion of that section in Ways and Means Committee Report, H.R. REP. No. 1860, 75th Cong., 3d Sess., 1939-1 CUM. BULL. (Part 2) 728, 742. "Section 224 of the Revenue Act of 1939 substituted for the requirement that a qualifying organization be 'domestic,' the requirement that it have been [sic] 'created or organized in the United States or any possession thereof,' etc. In substantially the same form, this requirement was re-enacted as section 170(c)(2)(A) of the 1954 Code." See Rev. Rul. 63-252, 1963-2 CUM. BULL. 101, 102.

is to be used within the United States . . ."[40] "exclusively for religious, charitable . . ."[41] purposes.[42]

The domestic use requirement is imposed only in the case of a gift by a corporation to a "trust, chest, fund, or foundation."[43] It does not apply to a gift by an individual, nor to a gift by a corporation to another institution organized in the corporate form under applicable state law. The requirement, then, becomes a problem only when a corporate donor makes a contribution to a charity which is itself organized in non-corporate form.[44] On the other hand, the first sentence of section 170(c)(2), which lists the types of organizations to which deductible contributions may be made generally, specifically includes corporations in the list of donees which must meet the domestic organization requirement.

It could have been argued that the words "trust, chest, fund, or foundation" should be construed to include corporations, in that the term "charitable foundation," being somewhat colloquial, usually refers to an organization (corporation or trust) organized and operated exclusively for one or more of the purposes listed in section 501 (c)(3).[45] In a 1937 ruling, however, the IRS chose not to construe the phrase as including corporate donees, and stated that:

> there is no indication that Congress intended to include within the exceptions domestic corporations whose funds are used exclusively for charitable purposes in a foreign country. Therefore, contributions made by the M Company, a domestic corporation, to the O Corporation, another domestic corporation, whose funds are used for charitable purposes in a foreign country, are allowable as a deduction . . . .[46]

This position has been followed in other rulings. In one involving corporate contributions to United Jewish Appeal, Inc., which were then used by the donee abroad, the IRS said that "corporations are not listed as one of the types of organizations contributions to which must be used in the United States or its possessions in order to be allowed as deductions."[47]

40. CODE § 170(c)(2). Compare this requirement, which applies only to *corporate* contributions, with that of § 170(c)(2)(A), which relates only to the place of creation of the charitable organization to which deductible contributions may be made, but which does not restrict the area in which deductible contributions may be used.

41. CODE § 170(c)(2)(B). This requirement is written into the last sentence of § 170(c)(2) by reference.

42. Contributions to other types of organizations are, of course, allowed, and these are set out in § 170(c)(1), (3), (4), and (5). Under § 170(c)(2), there is also the private inurement prohibition found in § 503(c), and the lobbying prohibition discussed at note 34 *supra*.

43. CODE § 170(c)(2).

44. Eaton, Sugarman, Mansfield & Cutler, *supra* note 8, at 29.

45. U. SO. CAL. 1960 TAX INST. 855, 856.

46. I.T. 3048, 1937-1 CUM. BULL. 85.

47. Special Ruling, March 14, 1947, 4 CCH 1947 STAND. FED. TAX REP. ¶ 6135.

In another ruling, handed down the same year, it was stated that:

> Both the Greek War Relief Association, Inc., U.S.A. and the United Jewish Appeal of Greater New York are domestic corporations organized under the laws of a State of the United States and inasmuch as domestic corporations are not one of the types of organizations contributions to which must be used in the United States or its possessions in order to be allowable . . . as deductions to corporate donors . . . it follows that contributions made by corporate donors to the two organizations named are deductible by such donors . . . .[48]

There is a more recent indication of the Treasury's position regarding corporate donees which distribute donated funds abroad.

> The Service has indicated that in certain cases it will allow a domestic business corporation a deduction for a contribution to a domestic charitable trust, which, in turn, makes a contribution to a domestic charitable corporation, which spends the funds for charitable purposes in a foreign country. The deduction will be allowed by the Service where the contribution by the trust to the charitable corporation goes into the corporation's general funds. It will be disallowed, however, where there is an understanding between the parties in the first instance that the contribution will be used in a foreign country.[49]

The domestic use requirement, then, may be avoided by being certain that corporate donors give only to corporate donees if the funds are to be used abroad. The restriction seems more like a trap than a useful limitation, and as such, is a rule of narrow application. The domestic organization requirement, on the other hand, is of much broader application, as it applies to contributions by all donors, and not just by corporations. Because of this restriction, a gift directly to a foreign charity, no matter how valid its purpose, will not be deductible.[50]

The question may be asked why the domestic use requirement shonld have this extremely narrow application, while the domestic organization requirement is applied so broadly. Although no definite answer may be given thereby, a look at the legislative history of these provisions may prove helpful.

A charitable deduction was first allowed by the Revenue Act of 1917,[51] which provided for a deduction in the case of a citizen or resident of the United States who contributed to a corporation or association organized and operated exclusively for the named exempt purposes. This was narrowed slightly by the Revenue Act of 1918,[52] which provided that a nonresident alien could obtain deduction only

48. Special Ruling, May 8, 1947, 4 CCH 1947 STAND. FED. TAX REP. ¶ 6175.

49. 17 A.B.A. SECTION OF TAXATION BULL. 83 (Oct. 1963).

50. Dora F. Welti, *supra* note 39; Louise K. Herter, 20 CCH Tax Ct. Mem. 78 (1961).

51. Revenue Act of 1917, ch. 63, § 1201(2), 40 Stat. 300.

52. Revenue Act of 1918, ch. 18, § 214(a)(11), 40 Stat. 1057.

for gifts made to domestic corporations. This change was regarded as merely clerical.[53] These same requirements were carried to the Revenue Act of 1934,[54] which broadened the class of possible donees from corporations alone to "a corporation, or trust, or community chest, fund, or foundation."[55] There still was no domestic organization or use requirement, however.

By the Revenue Act of 1935,[56] a charitable deduction was allowed to a corporation for the first time. It was here, furthermore, that the domestic organization requirement was first imposed. A corporate deduction was made allowable for a gift to "a domestic corporation, or domestic trust, or domestic community chest, fund, or foundation"[57] organized and operated for an exempt purpose. The language thus far in this section is basically the same as that in the 1934 act granting the deduction for donations by individuals, except for the addition of the word domestic before each possible donee. Then the ancestor of the present domestic use requirement was added: "(but in the case of contributions or gifts to a trust, chest, fund, or foundation of the word *domestic* before each possible donee. Then the United States exclusively for such purposes), . . ."[58] The committee reports indicate only that the prime motive behind the allowance of a deduction for a corporate donation was simply the encouragement of corporations to support unemployable people by donations to community chests and other charities. Corporations were beginning, at that time, to help the federal government carry out its announced policy of throwing the burden of caring for those people back on the state and local communities, and this encouragement was in furtherance of that policy.[59] No mention was found of any reason why the domestic use requirement was placed on a corporate gift while not even the domestic organization requirement was applied to an individual's donation at that time.

It might be noted that a proposed House bill in 1921 attempted to extend to corporations the deduction for charitable donations,[60] as did several other proposals between 1918 and 1935, when it was finally allowed.[61] The 1921 bill used the same language as the section

53. H.R. REP. No. 1037, 65th Cong., 3d Sess. 50 (1918).
54. Thus, there was still no domestic use or domestic organization requirement.
55. Revenue Act of 1934, ch. 277, § 23(*o*)(2), 48 Stat. 680.
56. Revenue Act of 1935, ch. 829, § 102(c), 49 Stat. 1014.
57. Revenue Act of 1935, ch. 829, § 102(c), 49 Stat. 1014, *amending* Revenue Act of 1934, ch. 277, § 23, 49 Stat. 1014 (added subdivision (r)).
58. Revenue Act of 1935, ch. 829, § 102(c), 49 Stat. 1014.
59. H.R. REP. No. 1681, 74th Cong., 1st Sess. 20 (1935).
60. H.R. 8245, 67th Cong., 1st Sess. § 234(a)(15) (1921). A senate amendment struck out the provision. See H.R. REP. No. 486, 67th Cong., 1st Sess. 36 (1921).
61. See, *e.g.*, *Hearings Before the Senate Finance Committee*, 70th Cong., 1st Sess. 204 (1928).

allowing a deduction for a contribution by an individual in the 1934 act.[62] So if that bill had passed, there would have been neither a domestic use or organization requirement on donations by corporations.

The Revenue Act of 1936,[63] left these sections on corporate and individual contributions exactly the same as they were in the 1935 act.[64] In 1938, however, the domestic organization requirement was made applicable to donations by individuals.[65] The language used was the same as that made applicable to corporate gifts in the 1935 act[66] and carried over to the 1936[67] and the 1938[68] acts. The reason for this added restriction was stated in the Report of the House Ways and Means Committee:

> The exemption from taxation of [*i.e.*, the deduction for] money or property devoted to charitable . . . purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden. . . . The United States derives no such benefit from gifts to foreign institutions, and the proposed limitation [*i.e.*, the domestic organization requirement] is consistent with the above theory. If the recipient, however, is a domestic organization and the fact that some portion of its funds is used in other countries for charitable and other purposes . . . will not affect the deductibility of the gift.[69]

It would appear from this language that the legislative intent was certainly not to apply the domestic use requirement to gifts made by individuals. Added to this is the fact that if the requirement had been intended to apply, the specific language of the 1936 act[70] providing for it could have been copied into the 1938 act along with the language making the domestic organization requirement applicable.

Although the policy was stated to have been the same toward gifts made by corporations and by individuals,[71] the difference in treatment persisted until the Revenue Act of 1942.[72] This act suspended the domestic use requirement, still applicable only in the

62. Revenue Act of 1934, ch. 277, § 23(*o*)(2), 48 Stat. 680. The only exception is that the 1921 House bill would not have allowed a deduction for a contribution by a corporation to a trust.

63. Revenue Act of 1936, ch. 690, § 23(o)(2) & (q), 49 Stat. 1648.

64. Except that § 23(r), created by the 1935 Act was changed to § 23(q) in the 1936 Act.

65. Revenue Act of 1938, ch. 289, § 23(*o*)(2), 52 Stat. 447.

66. Section 102(c) of the 1935 Act, creating a new subsection (r) to be added to § 23 of the 1934 Act.

67. Revenue Act of 1936, ch. 690, § 23(q), 49 Stat. 1648.

68. Revenue Act of 1938, ch. 289, § 23(q), 52 Stat. 447.

69. H.R. Rep. No. 1860, 75th Cong., 3d Sess. 19 (1938).

70. See text accompanying note 58 *supra*.

71. *Supra* note 69.

72. Revenue Act of 1942, ch. 619, § 23(q), 56 Stat. 798.

case of corporate gifts to non-corporate donees, for the duration of World War II. In its report on the provision, the Senate Finance Committee said:

> It is believed in view of the present situation [*i.e.*, the war] that it is unwise to limit this deduction to contributions or gifts used within the United States or any of its possessions. Accordingly, the bill provides that the deduction shall be allowed to corporations created or organized for the purposes described even though such gifts or contributions are used outside of the United States or its possessions.[73]

And in the Congressional discussion it was said, "We removed that [domestic use] limitation because there are at this time abundant reasons for many organizations, such as the Red Cross and others, spending money outside the United States."[74] The suspension was kept in force until the end of the war, although in the 1948 Revenue Revision Bill[75] an attempt was made to eliminate the domestic use requirement altogether. The reason given by the House Ways and Means Committee for the attempt was the desire to place the charitable deduction under the income, estate and gift taxes on a comparable basis.

> Probably the most important amendments deal with the question of whether or not contributions to religious, educational, charitable, etc., organizations are deductible if such contributions are used outside of the United States or its possessions. Present law provides that such deductions will be denied under the corporate income tax beginning in 1949 if such contributions are made to unincorporated organizations. The bill removes this limitation as far as domestic corporations are concerned, but adds it, in the case of the income tax, on nonresident aliens and foreign corporations. Such a limitation is already in the law in the case of the estate and gift taxes on nonresident aliens. Thus, residents of the United States and domestic corporations will not find their contributions limited in this fashion, although the limitation will apply in the case of nonresident aliens and foreign corporations.[76]

Unfortunately, no action was taken on this bill beyond its passage by the House, and the inconsistent treatment both as between individuals and corporations, and as among the income, estate, and gift taxes was carried over into the Code as it appears today.

It is indeed strange that there should be this dichotomy between the treatment of corporations on the one hand, and of non-corporate donors on the other. In the area of charitable, educational and religious organizations it would seem that there would be more overlap among the various forms of organization than clear cut distinction.

73. S. REP. No. 1631, 77th Cong., 2d Sess. 51 (1942).
74. 88 CONG. REC. 7801 (1942).
75. H.R. 6712, 80th Cong., 2d Sess. § 113(b)(1) (1948).
76. H.R. REP. No. 2087, 80th Cong., 2d Sess. 34 (1948).

Thus, a foundation, chest or fund could be organized in the corporate form although a trust certainly could not. While the policy of the Code seems to be in favor of equal treatment of similar organizations, nevertheless, this dichotomy does exist. As long as the donor is in the corporate form, the domestic use requirement applies to gifts made to donees which are not corporations. And as long as the donations are made to organizations which are in the cooperate form, the requirement is not imposed.

It is widely believed that the domestic organization requirement, applicable to donations by all donors, is based on the theory that since the tax advantage is given because charitable donations relieve the government of part of its burden, no such advantage should adhere to a donation going to an organization which helps carry out the burdens of another government.[77] However, our government certainly has a duty to help keep world peace and improve international relations, and gifts by our citizens to charities of other countries undoubtedly further these goals.

The domestic use requirement is also based, at least in part, on this same questionable theory. Since it applies only to corporate-donors, however, the thinking may have been that the only way to justify a deduction for a corporate gift, which was allowed only as a business expense before 1935,[78] was to require that some local use be made of the gift, such that benefit would result, by good will for instance, to the donor corporation. Also, under general corporation law a benefit to the donor corporation usually has been required to justify a gift. Recently, however, the justifications for corporate giving have become greatly liberalized,[79] and this theory is of little importance today.

C. *Inconsistencies*

Section 2055, allowing an estate tax deduction for a charitable devise or bequest, contains generally the same requirements as those appearing in section 170. However, there is no domestic organization requirement in section 2055.[80] Thus, a bequest or devise to a foreign charity may be deductible for estate tax purposes, while an inter vivos gift to the same donee will not be deductible for income tax purposes.

One may well wonder why the domestic organization requirement is not imposed upon a bequest or devise under section 2055, or

77. Eaton, *Charitable Foundations Making Gifts Abroad*, 17 Tax L. Rev. 41, 44 (1961).
78. Revenue Act of 1934, ch. 277, § 23(a), (*o*), 48 Stat. 680.
79. See Comment, 6 Utah L. Rev. 270 (1958).
80. See note 82 *infra*.

upon a gift under section 2522. As was seen in the discussion of the history of this requirement,[81] the desire of Congress was to provide equal treatment under the income, estate and gift taxes. There seems to be no logical explanation for these inconsistencies, then, other than that Congress went about providing the same policy in different ways in the various sections. The differences appear to be arbitrary and unintentional—a natural result of different committees having sponsored the various provisions.

Another difference is seen in the form a donee organization may take in order to insure deductibility of gifts as between the income and estate tax sections. In section 170(c)(2) corporations, trusts, and community chests, funds and foundations are all placed in the same position. Section 2055, however, makes no reference to chests, funds, foundations or unincorporated associations. It is doubtful that a deduction for a devise or bequest to one of these organizations would be denied because of this failure to include the specific language used in section 170, but such a result is possible.

Other minor differences between the estate and income tax sections may be found. While a deduction for income tax purposes is allowed for a contribution to a cemetery company, it is not specifically provided for under section 2055. But the estate tax treatment of veterans groups is broader than that of the income tax sections. And, neither the requirement of domestic use of section 170(c)(2) nor the sick benefit requirements of section 501(c)(8) appear in the estate tax provisions.

The gift tax provisions, like those of the estate tax, contain no requirement of domestic organization. This requirement, however, does appear in some less important sections[82] in addition to section 170(c)(2)(A).

Unlike section 2055, however, section 2522(a)(2) uses the "corporation, or trust, or community chest, fund, or foundation" language of section 170(c)(2). Thus, a strict construction of these sections might well allow a deduction for inter vivos gifts to these organizations for income and gift tax purposes, but not for devises and bequests to them for estate tax purposes. Again, however, although a ruling to this effect is possible, it is highly doubtful.

Two other differences occur among these sections. The encourage-

81. See text accompanying note 76 *supra.*

82. *E.g.,* CODE § 170(c)(3), (4) (contributions to fraternal lodges and veterans' organizations). CODE § 702(a)(4) (charitable contributions by partnerships), requires domestic organization by reference to § 170(c), as does § 642(c) (charitable deductions by trusts and estates). Section 170(c)(5) (contributions to non-profit cemeteries), however, does not have the requirement. The sections which apply to non-resident aliens all require domestic organization. CODE §§ 873(c) (income tax), 2106(a)(2)(A)(ii) (estate tax), 2552(b)(2) & (5) (gift tax).

ment of art appears as a specific purpose of the estate and gift tax deductions, but not of the income tax deduction nor of the section 501 exemption. Also, none of the estate, gift, or income tax deductions name as an exempt purpose the testing for public safety, while this is recognized as an exempt purpose under section 501(c)(3). This is another example of what could be an exempt organization, donations to which would not be deductible.[83]

Domestic use is not found as a gift tax requirement under section 2522. However, it is found in both the estate and the gift tax sections applicable to transfers by non-resident aliens.[84]

Again, there appears to be no rational basis for these inconsistencies in the requirements for exemption and deductibility of donations. The policies of the gift and estate tax sections have long been held to be the same,[85] or at least parallel, and the congressional intent has been to equate the policies of the three taxes.[86] Because of this overlapping policy, and the unorganized fashion by which each requirement was made a part of the Code,[87] it is more than likely that the inconsistencies are coincidental and unintentional.

III. Foreign Distributions

Perhaps the most significant difference among these sections allowing exemptions and deductions for charities and charitable contributions is that neither the domestic organization requirement of section 170(c)(2)(A) nor the domestic use requirement of section 170(c)(2) appears necessary for the granting of an exemption under section 501(c)(3). This may not be as important for organizations which receive all their funds through charitable donations, as these are not

83. See text accompanying notes 37 & 38 *supra.*

84. CODE §§ 2106(a)(2)(A)(ii), 2522(b)(3) & (4). The requirement, however, does not seem to apply to domestic charitable corporations, while it does to trusts, *etc.* Nor does it seem to apply to deductions for income tax purposes under § 873(c), but the reference in that section to § 170 is ambiguous.

85. "The two types of tax thus followed a similar course, like problems and purposes being expressed in like language." Merrill v. Fahs, 324 U.S. 308, 312 (1945). See to the same effect, Commissioner v. Wemyss, 324 U.S. 303 (1945). "[T]he purpose of the gift tax is to complement the estate tax by preventing tax-free depletion of the transferor's estate during his lifetime" and therefore "the federal estate tax and the federal gift tax . . . are construed in pari materia." Harris v. Commissioner, 340 U.S. 106-07 (1950).

86. See text accompanying note 76 *supra.*

87. See Eaton, *supra* note 77, at 43. The 1954 Code reveals "a continuing legislative tendency to seek highly specific and inflexible solutions by adding more detailed and complex exceptions, limitations and conditions to provisions that really are basically inadequate and unsatisfactory, or already overly lengthy and complex. Furthermore, the very specificity of some of these amendments seems to have little to do with either the amendment's purpose or with the underlying policy of the statute amended." Rea, *Changes in the Internal Revenue Code of 1954 Affecting Charitable Organizations,* 27 ROCKY MT. L. REV. 270, 304 (1955).

considered income to the donee anyway. However, it takes on great importance for those institutions which are supported by dues, or by income from a "related trade or business,"[88] such as a hospital.

According to the regulations, the requirement of domestic organization in section 170(c)(2)(A) does not prevent a deduction for a donation to a domestic charity which in turn distributes part or all of its funds abroad.[89] There is no language in the Code or in the regulations under section 501(c)(3) comparable to this allowance of a deduction for certain gifts to donees which in turn expend the funds abroad. However, nothing is said to the contrary, so as to require domestic use in order to maintain exempt status.[90] Moreover, the belief has been expressed that there are many exempt organizations which spend substantially all of their funds abroad.[91]

A. *Policy of Control*

The main concern seems to be with domestic organizations which donate primarily to one or more particular foreign organizations over whose expenditures the American donor-organizations have little or no control. Thus, the test is whether in substance the donor may be said to be soliciting funds for the use of foreign organizations. Examples are where the American donor is established by the foreign donees, or to substantially increase the proportion of such donations, where the domestic donor is required, by its charter or by a contract, to solicit funds expressly for a foreign organization. Further, if the domestic donor uses its funds principally for the support of foreign organizations, donations to the donor may be deemed made to or for the use of the foreign organizations rather than the domestic organization, unless the domestic organization retains control over the use of its funds in the hands of the foreign donees.[92]

> The answer seems to be that the gift is not 'for the use of' the foreign charity unless it is equivalent to a gift in trust for the foreign charity. If

88. See CODE § 513, which defines "unrelated trade or business" as any trade or business the conduct of which is not substantially related to the purpose constituting the basis for which the organization was granted an exemption. Income from this source is called "unrelated business taxable income" by § 512, and the tax, as provided in § 11, is imposed on such income by § 511.

89. "A contribution to an organization described in § 170(c) is deductible even though some portion of the funds of the organization may be used in foreign countries for charitable or educational purposes." Treas. Reg. § 1.170-2(a)(1) (1958). This regulation was apparently the subject of intensive study in 1959, see A.B.A. SECTION OF TAXATION BULL. 33 (Oct. 1959), and the only current ruling found set out the same rule, giving certain examples. See Rev. Rul. 63-252, 1963-2 CUM. BULL. 101. See also Louise K. Herter, *supra* note 50.

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

91. Eaton, *supra* note 77, at 47. See Quiggle & Myers, *Tax Aspects of Charitable Contributions and Bequests by Individuals*, 28 FORDHAM L. REV. 579, 582 n.11 (1960).

92. A.B.A. SECTION OF TAXATION BULL. 34 (Jan. 1960).

> the gift is not earmarked for the foreign charity and the domestic foundation legally and equitably has freedom of action with respect to the gift, *i.e.*, has the right and power to use the gift otherwise than for the foreign charity, then the gift is not in trust for the foreign charity, and a deduction should be allowed. In short, the phrase 'for the use of' means 'in trust for.'[93]

The IRS's concern has manifested itself in letters to charitable organizations from District Directors to the effect that a review of the organization's annual information return has shown that donations were made to organizations which have not received an exempt ruling under section 501(c)(3).[94] These letters usually request further information relating to the purposes for which the recipient was organized. But more important, they may add a warning that a continuation of gifts to these non-exempt organizations may jeopardize the donor's tax exempt status.[95] During 1963, moreover, the IRS revised the annual reports which exempt organizations must file (Form 990A),[96] and it was announced that the use of the warning letter would be expanded.[97]

Also, in an administrative guide recently released by the IRS, describing rules and procedures for organizations seeking tax exemption, called "How to Apply For Exemption For Your Organization" it was stated that the following information must be attached to an application for exemption if any funds are or will be expended in foreign countries:[98]

> (1) the manner in which and by whom recipients are or will be selected; (2) names of recipient organizations and/or purposes for which the funds are or will be expended; (3) extent to which you control or will control expenditure of funds donated by you to foreign organizations and whether there is or will be any required reporting of such expenditures to you; and (4) whether contributions are or will be solicited by you and earmarked for specific foreign distributees.

This administrative practice is used in order to control donations and to insure that they are used for proper purposes. The best way

93. Eaton, *supra* note 77, at 60.

94. Although § 2055(a)(2) allows a deduction, for estate tax purposes, from a decedent's gross estate for bequests to foreign charities, it may be of little value since some Internal Revenue agents auditing estate tax returns are requiring that the foreign charity be formally exempt by the Service as an organization described in § 501(c)(3). A.B.A. SECTION OF TAXATION BULL. 39 (Jan. 1959).

95. See Yager, *Practical Pointers on How to Get and Keep Tax-exempt Status for an Organization,* 7 J. TAXATION 62 (1957).

96. See note 8 *supra.*

97. 17 A.B.A. SECTION OF TAXATION BULL. 85 (Oct. 1963). This procedure stems from the IRS's expanded exempt organization audit program, as reported originally in 16 A.B.A. SECTION OF TAXATION BULL. 63 (Jan. 1963), and further expanded in 16 A.B.A. SECTION OF TAXATION BULL. 20 (April 1963). See also 16 A.B.A. SECTION OF TAXATION BULL. 131 (July 1963).

98. 7 CCH 1965 STAND. FED. TAX REP. ¶ 6391A.

to get information about a prospective donee is to require it to apply for an exempt ruling. However, the IRS unofficially admits that other evidence as to the propriety of the uses to which the donee's funds are put will be accepted, and thus that a ruling letter covering the donee is not required in all cases.[99]

There is no requirement in the Code, nor in the Treasury's own regulations, that an organization exempt under section 501(c)(3) must donate only to other section 501(c)(3) organizations in order to remain exempt.

Thus, although the Service may well be justified in its exercise of administrative control, it is doubtful whether it would be upheld in court.[100] This doubt is most likely the reason for the Service's admittedly liberal attitude toward its attempt to require domestic use of funds donated to exempt organizations. Irrespective of the Treasury's attitude toward gifts to donees which do not qualify for an exempt ruling under section 501, the general feeling is that the donor's status will be safe if it can be proven that the eventual donee is within the provisions of section 501(c)(3), and could obtain an exemption if one were sought.[101] But donors are warned to be cautious:

> If a substantial contribution is made to an organization not approved as exempt by the Revenue Service, the foundation may lose its exemption. Generally, if not more than 10% of the funds distributed in a year are granted to organizations not approved by the Revenue Service, the Service will on the first occasion issue only a warning that such contribution if continued will jeopardize the foundation's exemption.[102]

This warning, however, is not official, and certainly is not final.

Exemption rulings granted to organizations are effective only so long as there are no material changes in the organization's character, purposes, and method of operation.[103] A change in a donor-organization's policy so as to make most of its donations to questionable donees, or to substantially increase the proportion of such donations, or to make even a single large donation to a non-exempt organization

99. Eaton, *supra* note 77, at 48.

100. The Service undoubtedly feels that this is the only way it can exercise administrative control over the thousands of charitable organizations in existence. "In spite of the fact that the Service's threat to withdraw an exemption would not be upheld in litigation, one has only to scan the high sounding aud puritanical titles of many organizations on the Attorney General's subversive list to feel at least a twinge of sympathy for this administrative practice." Yager, *supra* note 95, at 63.

101. See Eaton, *supra* note 77, at 54; Yager, *supra* note 95.

102. Sugarman, *Foundations Established for Corporate Giving*, N.Y.U. 14TH INST. ON FED. TAX 77, 108-09 (1956).

103. Rev. Rul. 58-617, 1958-2 CUM. BULL. 260.

could well be considered a change in the method of operation, so as to cause a revocation of exempt status.[104] This appears to be in line with the *de minimus* doctrine which runs throughout the Code, and it corresponds to the established rule that in order to qualify for an exemption, an organization's activities need be only primarily, not exclusively, in furtherance of its exempt purposes. It might be noted here that this rule is the result of a realistic attitude on the part of the Treasury. Although the Code says that the organization must be organized and operated "exclusively" for the named exempt purposes, the regulations have interpreted this to mean only "primarily."[105] This is an extremely important administrative practice, in that the Treasury could prohibit a great many foreign distributions were it to adhere to the "exclusively" requirement.

Gifts by a domestic charitable organization to a foreign charity increase the policing problems of the IRS. Difficulties are created by differences in law, language and custom, as well as by the more obvious factors of distance and lack of jurisdiction. This is perhaps one of the primary reasons why the IRS is hesitant to exempt a domestic charity without the foreign donee's first obtaining its own exempt ruling.[106]

The problem caused by the inability of the IRS to control funds

104. It should be noted that an exemption can be revoked retroactively. Automobile Club v. Commissioner, 353 U.S. 180 (1957). In Society of Good Neighbors, 16 CCH Tax Ct. Mem. 306 (1957), the Commissioner's 1939 ruling that petitioner was exempt was based upon mistakes of law and fact. During the years 1943-1947, petitioner was not a charitable organization entitled to an exemption, and the Commissioner was held to have had authority to rescind his earlier ruling and determine the deficiencies in taxes for the taxable years.

As to deductions, however, the Commissioner's announced policy is that they shall remain allowable until an announcement of revocation is published in the Internal Revenue Bulletin, unless the donor had knowledge of the revocation before it was published. See Publication No. 78, Cumulative List of Organizations Described in Section 170(c). No such policy is followed with respect to the estate and gift taxes. The question is whether the institution qualifies on the date of the gift or bequest. Quiggle & Myers, *supra* note 91, at 587.

105. Treas. Reg. § 1.501(c)(3)-1(c)(1).

106. The United States is a party to five tax treaties which contain provisions for reciprocal exemption of charitable and similar organizations from income taxation. Australia, May 14, 1953, art. XIV, [1953] 2 U.S.T. & O.I.A. 2283, T.I.A.S. No. 2280; Canada, Mar. 4, 1942, art. X, 56 Stat. 1402, T.S. No. 983, Supp., Aug. 8, 1956, art. XIII D, [1957] 2 U.S.T. & O.I.A. 1662, T.I.A.S. No. 3916; Honduras, June 25, 1956, art. XIV, [1957] 1 U.S.T. & O.I.A. 227, T.I.A.S. No. 3766; Japan, April 16, 1954, art. XV [1955] 1 U.S.T. & O.I.A. 164, T.I.A.S. No. 3176, Supp., Mar. 23 [1957] 2 U.S.T. & O.I.A. 1445, T.I.A.S. No. 3901; Union of South Africa, Dec. 13, 1946, art. XI, and Supp., July 14, 1950, [1952] 3 U.S.T. & O.I.A. 3828, T.I.A.S. No. 2510. Two of these treaties also deal with the deductibility of contributions made to such exempt organizations. Canada, *supra*, art. XIII D; Honduras, *supra*, art. XIV.

Rev. Proc. 59-31, 1959-2 CUM. BULL. 949, contains the procedure applicable for obtaining rulings covering charities covered by the treaties with Canada and Honduras. The procedure given in Treas. Reg. § 1.501(a)-1 (1958) and Treas. Reg. § 501(c)(3)-

expended abroad, however, is not the only reason for this hesitance. This is shown by the reluctance in some cases to grant exemptions to domestic charities even when their proposed foreign donees have received favorable ruling letters.[107] Another major portion of the difficulty lies with the domestic organization requirement of section 170(c)(2)(A). The IRS is now becoming more strict in its position in order to prevent avoidance of this requirement.[108] If the domestic charity actively supervises the funds expended abroad there will probably be little hesitation in allowing deductions for gifts to it.[109] There also appears to be little difficulty in obtaining a deduction for a gift to a domestic charity which is not required by contract or articles of incorporation to turn over funds to a particular foreign charity.

It is the charity whose funds are earmarked for one or more particular foreign organizations, whether or not an exempt ruling covering them has been obtained, which may face serious problems. It is difficult, however, to make generalizations, since the vast majority of these cases are ruled on by private letter.[110] But if the domestic organization retains enough control over foreign expenditures so that it is not merely a conduit, it will probably be safe.

B. *Rulings*

It was stated in October of 1959 that, on request, the IRS would issue a ruling of exemption under section 501(c)(3), and of deductibility of gifts to such applicants under the estate and gift tax sections, although no ruling would be issued on the question of the deductibility of such gifts under section 170 for income tax purposes.[111]

In January of 1960, however, the IRS altered its position. Deductibility for income tax purposes will now be ruled on, to the extent that in certain circumstances involving foreign gifts, donations to the donor will be ruled non-deductible. The test announced was whether in substance the domestic organization may be said to be soliciting funds for the use of foreign organizations.

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1 (1959), should be followed when the foreign organization is in a country other than Canada or Honduras.

107. See Eaton, *supra* note 77, at 48-49.

108. *Ibid.*

109. "The IRS is apparently concerned with those situations in which the domestic organization is simply a collection agent for the foreign institution and is the 'creature' of that institution. It is not concerned with domestic organizations, such as 'CARE,' which have their own agents in foreign countries and make their own decisions as to distributions." Tax Barometer ¶ 37 (Dec. 12, 1959).

110. 17 A.B.A. SECTION OF TAXATION BULL. 148 (July 1964); 7 CCH 1965 STAND. FED. TAX REP. ¶ 6391; 16 A.B.A. SECTION OF TAXATION BULL. 130 (July 1963).

111. A.B.A. SECTION OF TAXATION BULL. 33 (Oct. 1959).

Further, if the domestic charity, in fact, uses its funds principally for the support of foreign organizations, the IRS might consider the contributions as made "to or for the use of" the foreign organization, rather than the domestic organization, unless the domestic organization retains control over the use of its funds in the hands of the foreign organizations, with the result that a deduction will be denied.[112] The authority for this position apparently is derived from the IRS's interpretation of the provision in the regulations which allows a deduction for a gift to a charity which meets the domestic organization requirement, even though some portion of the donee's funds are used abroad.[113]

The IRS in 1961 was reported to have been working on a formal ruling which would consolidate its policy regarding both deductibility and exempt status as it has developed through private rulings.[114] Although no such formal ruling has been found regarding the required characteristics of recipients of funds expended by section 501 exempt organizations, a 1963 revenue ruling was found which discussed the deductibility of contributions by an individual to certain domestic charities which thereafter transmit some or all of their funds to a foreign organization.[115]

The guidelines set down in that ruling are generally the same as had been established earlier in private decisions. Five possible situations were discussed, and decisions as to deductibility under section 170 were made:

> The 'foreign organization' referred to in.each of the examples is an organization which is chartered in a foreign country and is so organized and operated that it meets all the requirements of section 170(c)(2) of the Code excepting the [domestic organization] requirement set forth in section 170(c)(2)(A) of the Code. The 'domestic organization' in each example is assumed to meet all the requirements in section 170(c)(2) of the Code. In each case, the question to be decided is whether the amounts paid to the domestic organization are deductible under section 170(a) of the Code.
>
> (1) In pursuance of a plan to solicit funds in this country, a foreign organization caused a domestie organization to be formed. At the time of formation, it was proposed that the domestic organization would conduct a fund-raising campaign, pay the administrative expenses from the collected fund and remit any balance to the foreign organization.
>
> (2) Certain persons in this country, desirous of furthering a foreign organization's work, formed a charitable organization within the United States. The charter of the domestic organization provides that it will receive contributions and send them, at convenient intervals, to the foreign organization.

112. A.B.A. SECTION OF TAXATION BULL. 34 (Jan. 1960).
113. Treas. Reg. § 1.170-2(a)(1) (1958).
114. Eaton, *supra* note 77, at 50.
115. Rev. Rul. 63-252, 1963-2 CUM. BULL. 101.

(3) A foreign organization entered into an agreement with a domestic organization which provides that the domestic organization will conduct a fund-raising campaign on behalf of the foreign organization. The domestic organization has previously received a ruling that contributions to it are deductible under section 170 of the Code. In conducting the campaign, the domestic organization represents to prospective contributors that the raised funds will go to the foreign organization.

(4) A domestic organization conducts a variety of charitable activities in a foreign country. Where its purposes can be furthered by granting funds to charitable groups organized in the foreign country, the domestic organization makes such grants for purposes which it has reviewed and approved. The grants are paid from its general funds and although the organization solicits from the public, no special fund is raised by a solicitation on behalf of particular foreign organizatons.

(5) A domestic organization, which does charitable work in a foreign country, formed a subsidiary in that country to facilitate its operations there. The foreign organization was formed for the purposes of administrative convenience and the domestic organization controls every facet of its operaticns. In the past the domestic organization solicited contributions for the specific purpose of carrying out its charitable activities in the foreign country and it will continue to do so in the future. However, following the formation of the foreign subsidiary, the domestic organization will transmit funds it receives for its foreign charitable activities directly to that organizaton.

On the authority of a 1943 case[116] and a 1954 revenue ruling,[117] it was said that the qualifications of the donee organization are not the only points of inquiry. If funds are donated to an organization qualifying under the domestic organization requirement of section 170(c)(2)(A), the special earmarking of the use or destination of funds by that donee in favor of a foreign organization would deprive the donor of a deduction.

Also, if the donee is required for other reasons, such as a charter provision, to turn all or any particular contribution it receives over to another organization, it is proper to look to the qualifications of the ultimate recipient under section 170. Thus, if such recipient is a foreign organization, to which a direct donation would not be deductible, then an indirect donation to it of this type would also be non-deductible.[118] The theory here, of course, is that the ultimate recipient is the real donee, whereas the domestic organization is only a conduit and, thus, only a nominal donee.

For these same reasons, it was similarly stated that donations would be non-deductible if made to an organization which had con-

116. S. E. Thomason, 2 T.C. 441 (1943).

117. Rev. Rul. 54-580, 1954-2 Cum. Bull. 97.

118. "A given result at the end of a straight path is not made a different result because reached by a devious path." Criffiths v. Commissioner, 308 U.S. 355, 358 (1939); Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938).

tracted to conduct a fund-raising campaign on behalf of a foreign charity, and which had represented to prospective donors that the funds raised were to go to the foreign organization.

However, a deduction will be allowed for a donation to an organization which does not earmark its receipts in any manner, and at the same time maintains control over the use of such funds.

In the fifth case discussed, the ruling provided that a deduction will be allowed if the domestic donee can be considered the real beneficiary of the donation. Thus, where the domestic charity transmits the funds to a foreign subsidiary whose expenditures it controls, donations to it will be deductible, because the foreign organization is merely an administrative arm of the domestic donee, and not the ultimate donee.

Thus, if one factor were to be chosen as the key to which the IRS will look in order to determine deductibility, it most certainly is adequate control over the donation by the domestic organization. This factor is important not ouly because it indirectly determines how much control the IRS has over the funds, but also because it aids in determining who is the actual beneficiary of the donation. And the characteristics of the real beneficiary are what determine the deductibility of a donation.

It might be said that the domestic use requirement of section 170(c)(2) has been incorporated into the domestic organization requirement by means of this revenue ruling, in that whenever the domestic organization has any duty whatever, no matter how small, and from whatever source, to distribute its funds abroad, a deduction will be denied for donations received by it. This is certainly the construction the Treasury would like to adopt.

The ruling demonstrated, however, that when the domestic organization has control over the use of the funds in the foreign country, a deduction will be allowed for contributions to the donor. The domestic use requirement is a strict prohibition of any foreign use of funds donated by a corporation to an organization which is not in the corporate form. Even if a corporate donor were to have completc control over its distributions, contributions to it would be non-deductible if they were distributed to a foreign unincorporated organization.

If domestic use is incorporated into the domestic organization requirement by virtue of this ruling, so as to limit individuals and other non-corporate donors from making foreign distributions, it is only so incorporated in part. Its effect is not nearly so far-reaching as that of section 170(c)(2) has on corporations.

IV. THE FORCE AND EFFECT OF TREASURY RULINGS

In 1924, it was ruled that:

> A corporaton formed to dispense charity which does not actually engage in charitable undertakings itself but distributes its income to institutions organized and operated exclusively for the purposes named in subdivision (6) of section 231 [the 1921 Code's forerunner of the present section 501(c)(3)] is exempt from taxation under said section.[119]

This ruling was a recognition of an earlier Supreme Court holding to the same effect,[120] and only one case could be found which cited it.[121] That case cited it only as support for the main holding that even though the petitioner conducted business activities for profit, it still qualified for a tax exemption. The two cases established the controversial "ultimate destination" doctrine, which was that the statute did not mean "that to come within the exemption a corporation may not conduct business activities for profit. The destination of the income is more significant than its source."[122] This test has since been superceded by the provision that an exempt organization may operate a trade or business, but, in order to do so and still remain exempt, it must operate the trade or business in furtherance of the organization's exempt purpose. Further, the organization must not be organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513.[123]

In the 1959 Treasury Regulations promulgated under section 501(c)(3), it was provided that,

> articles stating that the organization is created solely 'to receive contributions and pay them over to organizations which are described in section 501(c)(3) and exempt from taxation under section 501(a)' are sufficient for purposes of the organizational test [of section 501(c)(3)].[124]

These rulings together form at least persuasive authority for the proposition that an organization formed to carry on charitable activities which does actually engage in charitable undertakings itself and also distributes its income to charitable organizations will maintain its exempt status. The difficulty, of course, lies with the nature of the operations of the recipient organization. If it does not qualify as an exempt charity under section 501(c)(3), and particularly if a ruling

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119. I.T. 1945, III-1 CUM. BULL. 273 (1924).
120. Trinidad v. Sagrada Order, 263 U.S. 578 (1924).
121. Roche's Beach, Ino. v. Commissioner, 96 F.2d 776 (2d Cir. 1938).
122. *Id.* at 778.
123. Treas. Reg. § 1.501(c)(3)-1(b)(1). See also CODE § 502, disallowing exemptions to feeder organizations.
124. Treas. Reg. § 1.501(c)(3)-1(b)(I) (1959).

has been requested and denied, the exempt status of the donor will certainly be jeopardized.

It should be noted, however, that the Treasury Regulation just cited does not require the recipient organization to be qualified under section 501(c)(3). It merely states that a donor which gives to an organization which is qualified will be exempt; it does *not* say that a donor which gives to one which is not qualified will not be exempt.

Nor does any other Treasury decision, published ruling, or court decision say specifically that a donor which gives to an organization which has not obtained an exempt ruling under section 501(c)(3) will lose its own exempt status.

A. *Informal Rulings*

Since there is no formal or published ruling, the question arises as to what authority and effect a private ruling by the Treasury Department may have.

In 1953 it was stated that,

> an I.T. is an instruction issued to the staff of the Bureau, [now Service] as to how the law should be administered by the staff. The Bureau has no power to make law by such an instruction, even to the extent that the Secretary of the Treasury may make law by regulation.[125]

In an earlier case, it was said that "these rulings . . . [have] no more binding or legal force than the opinions of any other lawyer. . . ."[126] Perhaps the best statement of the rationale behind the accepted rule that administrative interpretations have no binding force is that the commissioner may not be placed "in the position of a judge in his own cause who has written his decision before hand."[127]

B. *Regulations*

The next question which arises is what would be the result if the Treasury Department should see fit to promulgate a regulation to the effect that an exempt foundation, in order to maintain that status, must show that its distributions have been made only to organizations previously declared exempt by the Treasury Department.

The attitude of the courts toward the regulations is set forth in a 1920 case: "[A] regulation by a department of government, addressed to and reasonably adopted to the enforcement of an act of Congress, the administration of which is confined to such department, has the

125. Hirshon v. United States, 116 F. Supp. 135, 137 (Ct. Cl. 1953).
126. United States v. Bennett, 186 F.2d 407, 410 (5th Cir. 1951).
127. Fleming v. A. H. Belo Corp., 121 F.2d 207, 213 (5th Cir. 1941).

force and effect of law if it be not in conflict with expressed statutory provision."[128] This statement was refined in a later case:

> Where the act uses ambiguous terms, or is of doubtful construction, a clarifying regulation or one indicating the method of its application to specific cases not only is permissible but is to be given great weight by the courts. And the same principle governs where the statute merely expresses a general rule and invests the Secretary of the Treasury with authority to promulgate regulations appropriate to its enforcement. But where, as in this case, the provisions of the act are unambiguous, and its directions specific, there is no power to amend it by regulation.[129]

And again in a 1963 case it was stated:

> [A]n attempt to add a restriction to the statute which is not there . . . would come within the condemnation of the deeisions of the Supreme Court, exemplified by *Comissioner v. Acker,* 361 U.S. 87, at page 92 [1959] . . . where the court said: 'But the section contains nothing to that effect, and therefore, to uphold this addition to the tax would be to hold that it may be imposed by regulation, which, of course, the law does not permit [citing cases].'[130]

It certainly can be argued that the statute is not ambiguous in its coverage, since there is no provision in which donations are required to be given to exempt organizations. Thus, even though there is no official ruling or decision which conflicts with what would undoubtedly be the Commissioner's position in many cases, the fact that the Code is unambiguous indicates that any regulation which limits the breadth of the Code's application should not be given effect by the court.

A regulation adopted in the same form as the private letters warning against continued foreign donations discussed above[131] would be especially pernicious, since each determination would depend on the attitude of IRS.

It must be admitted, however, that the Treasury's position that donations must be given to exempt organizations is a convenient guide to potential donor-organizations. It gives them a degree of certainty in that, since the Treasury publishes a list of exempt organizations,[132] contributions may be made to listed organizations without

128. Maryland Cas. Co. v. United States, 251 U.S. 342, 349 (1920).
129. Koshland v. Helvering, 298 U.S. 441, 446-47 (1936).
130. United States v. Marett, 325 F.2d 28, 30 (5th Cir. 1963).
131. See text accompanying notes 94 & 95 *supra.*
132. *E.g.,* Publication No. 78 (Revised to Dec. 31, 1962), Cumulative List of Organizations. See also CODE § 6104(a); Treas. Reg. § 301.6104-1, providing for public inspection of applications for tax exemption. This section was modified by Rev. Proc. 58-20, 1958-2 CUM. BULL. 1134, 1137, to provide that a request for inspection of exemption applications and related documents must specify the name and address of each organization whose application it is desired to inspect.

concern for their own exempt status. This also eliminates much time and expense that would otherwise be spent investigating potential recipients. Without the restriction, smaller organizations might well be forced to restrict their contributions to a comparatively few organizations, since the cost of doing otherwise would likely be prohibitive.

The Treasury's position also gives it a convenient administrative guide. While the Treasury might not be justified in making such a regulation with regard to domestic recipients, it would have a basis for doing so with regard to foreign donees. The distinction is that if a donation were made to a domestic organization whose charitable nature was questionable, the Treasury could easily make its own investigation to determine whether the funds were in fact being diverted to non-charitable uses. Such an investigation, however, would be extremely difficult in a foreign country, if not impossible.

Administrative convenience notwithstanding, it does not necessarily follow that such an arbitrary regulation, requiring that a foreign organization receive an exempt ruling before receiving a donation, would be valid under the present unambiguous wording of the Code. All indications are to the effect that if the Treasury Department should, in the future, introduce a regulation requiring donees to be exempt under section 501, such a regulation might well be held unsupportable and thus invalid.

V. JUSTIFICATIONS FOR FOREIGN DISTRIBUTIONS

The distribution of funds by domestic charities to foreign recipients is a practice which is not on very solid ground. The philosophy behind the granting of a tax exemption to a charitable organization has been expressed as follows:

> The reason underlying the exemption granted by section 101(6) [now section 501] to organizations organized and operated for charitable purposes 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. . . .[133]

It may be said that the public is not relieved of a burden which otherwise belongs to it by reason of a foreign grant. The citizens of this country are under no obligation to keep those of another country out of their own poor-houses. However, international relations are

133. Duffy v. Birmingham, 190 F.2d 738, 740 (8th Cir. 1951).

improved and increased understanding among nations is furthered when the citizens and charitable organizations of one country give generously to those of another. Promotion of peace and understanding among countries can certainly be deemed part of the public burden, so as to justify an exemption granted to an organization which distributes funds abroad.

On the other hand, the Treasury's argument that subversive organizations should be prevented from obtaining American funds which they can use to subvert the democratic principles of this country is admittedly a strong one, and has become more convincing in the last ten years.[134] However, it probably has no place in many cases.

VI. Conclusion

In view of the Treasury's policy on foreign distributions as set out above, a few conclusions can be made. The letters of warning from the Treasury[135] are usually along the lines of a statement that the organization's tax exempt status may be jeopardized if, after the date of the letter, they persist in making distributions to organizations which have not established an appropriate exempt status. This is far from a threat to the effect that the organization's tax exempt status will be revoked if such distributions are made. Rather, it would seem that the warning merely means that such distributions endanger the organization's status in that the distribution may be questioned, and the Treasury Department can call upon the organization to prove that the distribution was justified in view of the nature and purposes of the recipient.

There is nothing in the Code or regulations to prevent an exempt organization from making a donation to an organization which has not been declared to be exempt under section 501.[136] Further, it appears unlikely that a regulation adding this requirement to the Code would be held valid.[137]

The Treasury's position, however, even though not based on binding authority, is probably not unreasonable when policy and administrative convenience are considered. There may well be justification for questioning such donations and jeopardizing the tax exempt status of donor organizations.[138]

If a potential donor is prepared to sustain the burden of proving the propriety of a gift to its intended non-exempt donee, which would

134. See note 100 *supra.*
135. See text accompanying notes 94 & 95 *supra.*
136. See text accompanying notes 99 & 100 *supra.*
137. See note 100 *supra.*
138. See text accompanying notes 97 & 98 *supra.*