J. ACTIVITIES THAT ARE ILLEGAL OR CONTRARY TO PUBLIC POLICY

1. Introduction

Exempt purposes may generally be equated with the public good, and violations of law are the antithesis of the public good. Therefore, the conduct of such activities may be a bar to exemption. Factors that have to be considered in determining the effect of illegal activities on an organization's qualification for exemption are the paragraph of IRC 501(c) under which the organization is exempt or is applying for exemption, and the nature and extent of the illegal activities engaged in by the organization.

2. IRC 501(c)(3) and IRC 501(c)(4) Organizations

A. Charity Law

Exemption recognized under IRC 501(c)(3) is unique in that, unlike exemption under other paragraphs of IRC 501(c), it is grounded in charity law, so that denial of exemption under IRC 501(c)(3) may be based on charity law.

(1) Substantiality Test

Violation of constitutionally valid laws is inconsistent with exemption under IRC 501(c)(3). As a matter of trust law, one of the main sources of the general law of charity, planned activities that violate laws are not in furtherance of a charitable purpose. "A trust cannot be created for a purpose which is illegal. The purpose is illegal ... if the trust tends to induce the commission of crime or if the accomplishment of the purpose is otherwise against public policy.... Where a policy is articulated in a statute making certain conduct a criminal offense, then ..., a trust is illegal if its performance involves such criminal conduct, or if it tends to encourage such conduct." IV Scott on Trusts Section 377 (3d ed. 1967). Thus, all charitable trusts (and by implication all charitable organizations, regardless of their form) are subject to the requirement that their purpose may not be illegal or contrary to public policy. Rev. Rul. 71-447, 1971-2 C.B. 230; Restatement (Second) of Trusts, Section 377, Comment c (1959). Moreover by conducting criminal activities, an organization increases the burden of government and thus thwarts a well recognized charitable goal, i.e., relief of the burdens of government.

Reg. 1.501(c)(3)-1(c)(1) states that an organization will not be regarded as operated "exclusively" for IRC 501(c)(3) purposes if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. The presence of a single non-charitable purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly charitable purposes. Better Business Bureau v. United States, 326 U.S. 279 (1945). Therefore, if an organization engages in illegal acts that are a substantial part of its activities, it does not qualify for exemption under IRC 501(c)(3).

(2) Determining Substantiality

According to the analysis of G.C.M. 34631, dated October 4, 1971, in determining whether disqualifying activities are present to a "significant extent" (that is, when they become "substantial"), more must be considered than the ratio they bear to activities in furtherance of exempt purposes. The nature of such acts is as important as their quantity. A great many violations of local pollution regulations amounting to a sizable percentage of an organization's operations might be required to disqualify it from 501(c)(3) exemption. Yet, if only a small fraction of its activities were directed to robbing banks, it would not be exempt. This is an example of an act having a substantial non-exempt nature, while lacking substantiality of amount. A very little planned violence or terrorism would constitute "substantial" activities not in furtherance of exempt purpose.

However, in determining whether illegal activities are substantial, it must be borne in mind that actions by members and officers of an organization do not always reflect on the organization. Because organizations act through individuals, it is necessary to distinguish those activities of individuals that are done in an official capacity from those that are not. Only (1) acts by an organization's officials under actual or purported authority to act for the organization, (2) acts by agents of the organization within their authority to act, or (3) acts ratified by the organization should be considered as activities "of the organization."

(3) Illegal Act of Contributors

Although illegal acts by an organization militate against exemption, G.C.M. 34631 states that the sources of an organization's contributions are not taken into consideration in determining its qualification for exemption. The Code and Regulations limit the inquiry to purposes and activities of the organization itself. Therefore, if an organization does not commit criminal acts, but simply receives contributions from those who do, this would not be grounds for denying or

revoking exemption. However, if the acceptance of such contributions or the use it makes of such contributions per se constitutes a violation of law, these activities would have to be taken into consideration in determining whether the organization has engaged in substantial illegal activities.

(4) Planning Illegal Acts

Not only is the actual conduct of illegal activities inconsistent with exemption, but the planning and sponsoring of such activities are also incompatible with charity and social welfare. Rev. Rul. 75-384 holds that an organization formed to promote world peace that planned and sponsored protest demonstrations at which members were urged to commit acts of civil disobedience did not qualify for IRC 501(c)(3) or (4) exemption. G.C.M. 36153, dated January 31, 1975, states that because planning and sponsoring illegal acts are in themselves inconsistent with charity and social welfare it is not necessary to determine whether illegal acts were, in fact, committed in connection with the resulting demonstrations or whether such a determination can be made prior to conviction of an accused. However, it is necessary to establish that the planning and sponsorship are attributable to the organization, if exemption is to be denied or revoked on this ground.

B. Promotion of Social Welfare

The conduct of illegal activities to a substantial degree is also a bar to exemption under IRC 501(c)(4). Reg. 1.501(c)(4)-1(a)(2)(i) provides that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. It is an organization that is operated primarily for the purpose of bringing about the civic betterments and social improvements. Illegal activities, which violate the minimum standards of acceptable conduct necessary to the preservation of an orderly society, are contrary to the common good and the general welfare of the people of the community and thus are not permissible means of promoting social welfare for purposes of IRC 501(c)(4). Rev. Rul. 75-384, 1975-2 C.B. 204.

C. Strikes, Boycotts, Picketing, Mass Demonstrations, and Other Confrontational Activities

It is generally recognized that activities designed to preserve and protect the natural environment for the benefit of the public promote a charitable purpose

within the meaning of (C)(3)-1 Reg. 1.501 (c)(3)-1(d)(2). Typically, such activities include saving land for food production, maintaining clean waterways, conserving energy, protecting endangered animal species from extinction or cruelty, and preserving historical buildings. Congress has recognized that promotion of conservation and protection of natural resources serve a broad public interest. See Rev. Rul. 80-278, 1980-2 C.B. 175; the National Environmental Policy Act of 1969, 42 U.S.C. Section 4321 (1976); and Rev. Rul. 76-204, 1976-1 C.B. 152, and the authorities cited therein.

Often IRC 501(c)(3) organizations of the type described above engage in activities designed to force an unrelated party to act or refrain from acting in a way that the organizations believe will assist them in the accomplishment of their purposes. Questions arise as to whether these activities, such as strikes, economic boycotts, picketing, and mass demonstrations, are permissible methods of furthering educational or charitable purposes. In determining whether activities of this type are consistent with IRC 501(c)(3), the Service relies on a three-part test. Rev. Rul. 80-278. Such activities will be considered permissible under IRC 501(c)(3) if:

(1) The purpose of the organization is charitable;

(2) the activities are not illegal, contrary to a clearly defined and established public policy, or in conflict with express statutory restrictions; and

(3) the activities are in furtherance of the organization's exempt purpose and are reasonably related to the accomplishment of that purpose.

As stated above, an organization's purpose of preserving and protecting the environment is charitable within the meaning of IRC 501(c)(3). Therefore, if such activities as economic boycotts, mass demonstrations, and picketing, etc., further the purposes of the organization and are not illegal, contrary to public policy, or in conflict with express statutory restrictions or limitations, they will not preclude IRC 501(c)(3) exemption. Whether the activities are in furtherance of an organization's IRC 501(c)(3) purposes and whether they are illegal or contrary to public policy are primarily matters of fact. Rev. Rul. 75-384, 1975-2 C.B. 204, holds that a non-profit organization formed to promote world peace and disarmament by nonviolent direct action and whose primary activity is the sponsoring of anti-war protest demonstrations in which demonstrators are urged to

commit violations of local ordinance and breaches of public order does not qualify for exemption under IRC 501(c)(3) or IRC 501(c)(4). Regarding IRC 501(c)(3) exemption, the revenue ruling, citing IV Scott on Trusts, Section 377 (3d. ed. 1967), states that all charitable trusts (and by implication all charitable organizations, regardless of their form) are subject to the requirement that their purposes may not be illegal or contrary to public policy. The revenue ruling also holds that illegal activities, which violate minimum standards of acceptable conduct necessary to the preservation of an orderly society, are contrary to the common good and the general welfare of the people of the community and thus are not permissible means of promoting social welfare for purposes of IRC 501(c)(4).

The discussion in G.C.M. 38415, dated June 20, 1980, is also a good illustration of the application of the three-part test. The activities of the organization in question were geared to its purpose of educating the public regarding environmental problems and protecting endangered species, especially certain types of marine mammals. The organization conducted research projects and furnished films and speakers to environmental conferences and schools. It prepared and distributed environmental literature and, to generate media publicity as a means of educating the public and protecting endangered species, it engaged in a significant amount of nonviolent confrontation activities with foreign hunters of the species.

It was clear that the organization's purposes were charitable because the films, speakers, and leaflets regarding the organization's attempts to protect the endangered species and publicizing their plight were charitable and educational in nature. See Rev. Rul. 76-204, 1976-1 C.B. 152. Also, through its confrontation tactics, it attempted to protect the endangered species directly, and it generated widespread publicity in order to inform and educate the public regarding the plight of the endangered species with the objective of eventually halting the killing of the species. Therefore, while the confrontation tactics did not directly protect the endangered species, they created an added awareness on the part of the general public of the plight of the species and, therefore, such activities were in furtherance of the organization's exempt purpose and reasonably related to the accomplishment of such purpose.

There was no evidence that the organization had used or advocated civil disobedience or any other illegal methods to accomplish its exempt purpose. It was clear that the public policy of the United States favored the protection of the endangered species in question. These animals were on endangered species lists in both the Marine Mammal Protection Act and the Endangered Species Act of 1973.

Generally, under these acts, citizens and businesses of the United States were banned from hunting these animals. In view of these factors, it was clear that the public policy of the United States strongly favored protecting the animals from potential extinction. Therefore, inasmuch as American public policy was not in conflict with the organization's confrontation tactics, the activities were not contrary to public policy and the organization was recognized as exempt under IRC 501(c)(3).

D. Violations of Public Policy

There have been cases, up to the present time limited to the issue of racial discrimination in education, where organizations have been held not to qualify for IRC 501(c)(3) on grounds that the activities of the organizations in question contravened public policy even though the organizations did not violate any federal statutes or state or local laws.

(1) Racial Discrimination in Education

In the case of Bob Jones University v. United States, 639 F 2d 147 (4th Cir. 1980), the court upheld the Service's revocation of the University's IRC 501(c)(3) exemption because the institution's racial restrictions were in violation of clearly defined public policy against racial discrimination in education. According to the court's decision, in order to be exempt under IRC 501(c)(3), an institution must be "charitable" in the common law sense and must not be contrary to public policy. In Goldsboro Christian Schools, Inc. v. United States, 436 F. Supp. 1314 (E.D.N.C. 1977), the Federal District Court ruled in favor of the Service on a claim for refund of FICA and FUTA taxes on the basis of a finding that Goldsboro was not described in IRC 501(c)(3) because it maintained a racially discriminatory admissions policy. The decision was affirmed on appeal. Goldsboro Christian Schools, Inc. v. United States, No. 80-1473 (4th Cir. 1981), aff'd per curiam.

Both institutions appealed to the United States Supreme Court and on May 24, 1983, the Court issued an opinion on the appeals. Bob Jones University v. United States, 461 U.S. 574 (1983). The Court ruled that educational institutions practicing racial discrimination based on religious beliefs are not charitable in the common law sense and thus are not entitled to federal tax exemption.

The majority opinion described the origins and extent of the federal public policy against racial discrimination and racial discrimination in education in particular, citing court decisions, legislation, and executive orders. The Court

stated that there is no question that the Service's interpretation of IRC 170 and IRC 501(c)(3) is correct, thus agreeing with the Service position enunciated in Rev. Rul. 71-447, 1971-2 C.B. 230. That revenue ruling holds that a private school that does not have a racially nondiscriminatory policy as to students does not qualify for exemption because racial discrimination in education is contrary to federal public policy and, therefore, is not "charitable" within the common law concepts reflected in IRC 170 and IRC 501(c)(3).

The Supreme Court stated that entitlement to tax exemption depends on meeting certain common law standards of charity - namely that an institution seeking tax exempt status must serve a public purpose and not be contrary to established public policy. The Court stated that its decision in Brown v. Board of Education, 347 U.S. 483 (1954) signaled an end to an era of racial segregation in primary and secondary education that prevailed in many parts of the country. It stated further that over the past quarter of a century, every pronouncement of the Court and myriad Acts of Congress and Executive Orders attest a firm national policy to prohibit racial segregation and discrimination in public education. The court also concluded that the Service did not exceed its authority in determining that Bob Jones did not qualify for exemption but that sensitive determinations such as this one should be made only where there is no doubt that an organization's activities violate fundamental public policy. The Court also rejected the argument that the Service's construction of IRC 170 and IRC 501(c)(3) could not be constitutionally applied to schools that engage in discrimination on the basis of sincerely held religious beliefs. Goldsboro and Bob Jones argued that this construction violated their free exercise rights under the Religion Clauses of the First Amendment. According to the Court, the government has a fundamental overriding interest in eradicating racial discrimination in education and this interest substantially outweighs whatever burden the denial of tax benefits places on the organizations' exercise of their religious beliefs.

(2) Scholarship Trusts and Discrimination

In view of Rev. Rul. 71-447 and the Bob Jones University decision, a question arises as to whether a privately created and administered scholarship trust that otherwise qualifies for IRC 501(c)(3) may be recognized as exempt if its governing instrument restricts eligibility for the scholarships to students of a particular race. G.C.M. 39082 dated December 1, 1983, discusses this question. While the principles of Rev. Rul. 71-447 are equally applicable to a private educational trust, it cannot be concluded that all educational trusts whose beneficiaries are limited to members of a particular race necessarily foster racial

discrimination. For example, a private educational trust that awards scholarships only for Caucasian students to attend a predominately minority school could be said to discourage racial discrimination in education. On the other hand, scholarships for Caucasian students to attend a school that has a racially discriminatory policy as to students would clearly foster racial discrimination in education, and, therefore, would not be charitable or exempt under IRC 501(c)(3). Further, a scholarship trust that limits scholarships to Caucasian students for attendance at a large university, which practices a nondiscrimination policy as to students, with the trust accounting for a comparatively very small share of the total assistance available to students at the school, indicates that the trust operates in furtherance of educational purposes consistent with the university's nondiscrimination policy. As these three examples show, there is no "per se" rule. Rather, the facts and circumstances of each case must be examined to determine whether a trust actually fosters racial discrimination in education.

(3) Church and Illegal Acts

Another recent court case agreed with the Service that an organization violated well-defined standards of public policy and did not qualify for IRC 501(c)(3) exemption. However, unlike the Bob Jones case, the organization was engaged in clear-cut violations of the law. The Church of Scientology of California, Commissioner, 83 T.C. No. 25 (1984).

The court concluded that on the basis of all the facts of record the organization's overriding purpose was to make money, and that criminal manipulation of the IRS to maintain its tax exemption (and the exemption of affiliated churches) was a crucial and purposeful element of the organization's financial planning. The court described this purpose as a conspiracy the major features of which were to block the IRS from investigating, determining, and collecting taxes from the organization and its affiliated churches. It stated that the conspiracy covered 8 years and involved the manufacture and falsification of records submitted to the IRS, burglarizing the IRS offices and stealing government documents, and subverting government processes for unlawful purposes. Officials of the organization were convicted of burglarizing offices of the IRS and conspiring to obstruct justice.

One of several specific issues dealt with by the court was whether applying the common law charitable trust doctrine to the organization, requiring conformity to fundamental public policy standards evidenced by criminal and civil statutes, violated the organization's constitutionally protected rights including the free

exercise clause of the First Amendment, inasmuch as there are less restrictive ways of regulating church-sponsored misconduct (such as criminal prosecution of individuals) than withholding exemption.

Citing Restatement (Second) of Trusts Section 377 (1959), the court stated that it is axiomatic that a charitable trust is invalid if it is created for an illegal purpose. According to the court, a trust can be voided at the request of an interested party if trust property is used to perpetuate a crime defined by statute, or if the object of the trust is to defraud the government, or if its purpose is to evade taxes. IV Scott on Trusts Section 377 (3d. ed. 1967) and Bogert, The Law of Trusts and Trustees, Section 211, pp. 63-64, 114 (2d. ed. Rev. 1979).

According to the court, the organization's conduct over a period of several years constituted a violation of 18 U.S.C. Section 371 and convincingly showed that the organization had a substantial illegal purpose during the years in question. The court stated that it was not required by either the First Amendment or charitable trust principles to find that the government's only remedy was criminal prosecution. It gave several reasons for this conclusion:

> (A) 18 U.S.C. Section 371, which provides that it is a felony offense for two or more persons to conspire to defraud the United States, is a venerable and major criminal statute;
>
> (B) the organization's conspiratorial efforts were systematic and long-lived;
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> (C) the government's interest in ferreting out crime is not the only interest at stake; and
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> (D) the government also had an interest in not subsidizing criminal activity.

The court stated that were it to sustain the organization's exemption from federal income tax under IRC 501(c)(3), it in effect would be sanctioning the organization's right to conspire to thwart the IRS at taxpayers' expense. The court noted that under the statutory scheme the denial of exemption is not a permanent loss to the organization because it was ruling only on the 1970-1972 years and the organization was free to show that it qualified for exemption in subsequent years.

According to the court, the public policy requirement is an implied condition of IRC 501(c)(3) and its application is consistent with the holding in the Bob Jones case that charitable organizations seeking to qualify for exemption from federally imposed taxes must serve a valid public purpose and confer a public benefit. Application of a public policy requirement is neither harsh nor oppressive because the organization had ample notice that it was against the law to conspire to obstruct the IRS (18 U.S.C. Section 371 had been in effect for over 100 years); IRC 7805(b) put the organization on notice that the Commissioner had broad authority to make tax rulings retroactive; and the public record belied the organization's assertion that it did not have warning that it must comply with public policy standards to maintain its eligibility for exemption. In support of the last reason, the court cited Rev. Rul. 67-235, 1967-2 C.B. 113, holding that an organization that is not "charitable" in the generally accepted legal sense does not qualify for IRC 501(c)(3) exemption, and Reg. 1.501(c)(3)-1(d)(2) which provides that the term "charity" is used in its generally accepted legal sense. It also quoted as follows from Rev. Rul. 71-447, 1971-2 C.B. 230:

> "All charitable trusts * * * are subject to the requirement that the purpose of the trust may not be illegal or contrary to public policy."

3. Other IRC 501(c) Organizations

While exemption under IRC 501(c)(3) is grounded in charity law and exemption under IRC 501(c)(4) is based on promoting the common good and general welfare of the people of the community, exemption under other paragraphs of IRC 501(c) is based on other grounds. Therefore, the standards described above in determining whether illegal activities are a bar to exemption under IRC 501(c)(3) or IRC 501(c)(4) are different from those applicable to other exempt organizations. The effect on exemption of violations of law by exempt organizations (other than IRC 501(c)(3) or IRC 501(c)(4) organizations) usually involves IRC 501(c)(5), 501(c)(6), and 501(c)(7) organizations. As explained below, there is considerable correlation among several of the paragraphs (except paragraphs (3) and (4)), and the conduct of substantial illegal activities by such organizations may not be grounds for denial or revocation of exemption.

(1) IRC 501(c)(6)

Illegal activities of IRC 501(c)(6) organizations often involve price-fixing schemes in violation of antitrust laws. G.C.M. 37111, dated May 4, 1977, discusses illegal activities, specifically antitrust violations, and IRC 501(c)(6) and suggests

that, generally, a basis for loss of exemption by an IRC 501(c)(6) organization may not exist unless the following conditions are present:

> (A) The activity has been judicially determined to be a violation of a provision of law;
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> (B) the unlawful activity is carried on to such an extent and in such magnitude that it can properly be said to be the principal activity, or one of the principal activities, of the organization;
>
> (C) the illegal activity must be of such a nature that it can be said to be harmful to the general line of business of the organization; and
>
> (D) the unlawful activity must be imputable to the membership of the organization.

As to the necessity for a judicial determination, the IRS is not in a position to make a determination as to the illegality of an act under a provision of law other than the Internal Revenue Code. That is a matter for the judiciary. Such a task would be impossible for the IRS to undertake from an administrative standpoint, and from a legal standpoint it would be improper to delegate such a determination to an administrative body without the procedural and substantive due process protection provided through the judicial process.

The reason for the principal activity test is that an unlawful activity should be such that in effect it nullifies or destroys the essential character of the organization as one with a purpose to promote the common business interests of its members, and activities directed to the improvement of business conditions in one or more lines of business. It is doubtful that such a conclusion could be reached without first finding that the illegal activity constituted one of the organization's principal activities.

A finding that unlawful activity is a principal one of the organization rests on a consideration of a number of factors. Of prime importance is the amount of time and effort expended on the activity by the organization and its members. This is a relative matter, and considerable effort expended by one key official may be comparable to lesser efforts expended by a number of other members. Equally important may be the amount of money received and expended by the organization

on the illegal activity. Again, dollar amounts may be of less importance than the relative amount of activity. It may also be significant to consider whether the illegal activity is conducted as a part of the organization's regular program of activities, or whether the activity is sporadic and incidental to the primary activities of the organization.

Regarding the requirement that the illegal act be harmful to the general line of business of the organization, Reg. 1.501(c)(6)-1 states that the activities of a business league should be for the improvement of one or more lines of business. When an activity of an organization is unlawful and of such a nature that it attempts to put artificial restraints on others within the trade, it cannot be said to be conducted for the improvement of the general line of business. For example, Congress has established definite guidelines in the Sherman Anti-Trust Act with respect to permissible conduct by United States businesses and violation of this statute cannot, in any sense, be equated with improvement of business conditions. See, for example, United States v. E. I. DuPont De Nemours & Co., 118 F. Supp. 41, 50 (1953), aff'd, 351 U.S. 377 (1955), where the District Court stated that:

> "The purpose of Congress in passing the Sherman Act was to preserve our system of free trade and competitive economy in order to protect the public from evils thought to flow from undue restraints and monopolies."

This language indicates that Congress equated restraint of trade with destruction of desirable and proper business conditions. If follows that violation of the antitrust laws cannot be regarded as an improvement of business conditions.

The reason for the requirement that an unlawful activity must be imputable to the membership of the organization was discussed in connection with illegal acts of IRC 501(c)(3) organizations.

(2) IRC 501(c)(5)

The above discussion with respect to IRC 501(c)(6) organizations engaging in illegal acts also, in general, applies to IRC 501(c)(5) organizations. In the case of a labor organization, exemption should be revoked or denied only where it can be shown that the union engages in improper activities to such an extent that it can be established that the union is not primarily engaged in proper labor activities. Thus, the illegal activity must have been judicially determined to be a violation of

a substantive provision of law and must be a principal activity or one of the principal activities of the organization.

(3) IRC 501(c)(7)

In the case of IRC 501(c)(7) social clubs, the position of the Service appears to be more liberal than that explained above. In Rev. Rul. 69-68, 1969-1 C.B. 153, the Service held that the operation of gambling devices, illegal under local law, by a social club would not be sufficient cause to revoke the club's IRC 501(c)(7) exemption. The rationale is that if the operation of gambling devices is solely for the pleasure and recreation of the members and their guests, the fact of illegality will not alone be sufficient to warrant revocation of exemption. Thus, if a social club is engaged in an activity that furthers purposes contemplated under IRC 501(c)(7), the fact that incidentally the activity is unlawful is not sufficient to cause loss or denial of the club's IRC 501(c)(7) exemption. The conclusion of the revenue ruling obviously was also attributable to the relatively innocuous nature of the activity. As the revenue ruling states, the fact that the club derives a principal part of its revenue from recreational facilities does not affect its exempt status as long as the facilities are used only by the members and their guests. Moreover, although it is not clear from the revenue ruling, it is inferable, at least, that this "recreational" gambling was the principal activity of the club. See Aviation Country Club, Inc. v. Commissioner, 21 T.C. 807 (1954), acq., 1954-2 C.B. 3.

It is unlikely that a comparable situation would arise in the case of a business league and, if it did, it is doubtful that a similar conclusion could be reached because illegal activity, however trivial, could hardly be said to improve business conditions or promote common business interests. Moreover, the statutory requirements of exemption under IRC 501(c)(6) and IRC 501(c)(7) are different, and it so happened in Rev. Rul. 69-68 that the illegal activity could reasonably be called pleasurable and recreational as well and thus within the purview of the statutory language.