
P A R T O N E

Introduction to the Law of Tax-Exempt Organizations

Chapter One

Definition of and Rationales for Tax-Exempt Organizations

Chapter Two

**Overview of Nonprofit Sector and Tax-Exempt
Organizations**

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C H A P T E R O N E

Definition of and Rationales for Tax-Exempt Organizations

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Nearly all federal and state law pertains, directly or indirectly, to tax-exempt organizations; there are few areas of law that have no bearing whatsoever on these entities. The fields of federal law that directly apply to exempt organizations include tax exemption and charitable giving requirements, and the laws concerning antitrust, contracts, education, employee benefits, the environment, estate planning, health care, housing, labor, political campaigns, the postal system, securities, and fundraising for charitable and political purposes. The aspects of state law concerning exempt organizations are much the same as the federal ones, along with laws pertaining to the formation and operation of corporations and trusts, insurance, real estate, and charitable solicitation acts. Both levels of government have much constitutional and administrative law directly applicable to exempt organizations. A vast array of other civil and criminal laws likewise apply. The principal focus of this book is the federal tax law as it applies to nonprofit organizations, although other laws applicable to exempt organizations are referenced throughout.

§ 1.1 DEFINITION OF NONPROFIT ORGANIZATION

A tax-exempt organization is a unique entity; among its features is the fact that it is (with few exceptions) a nonprofit organization. Most of the laws that pertain to the concept and creation of a nonprofit organization originate at the state level, while most laws concerning tax exemption are generated at the federal level. Although almost every nonprofit entity is incorporated or otherwise formed under state law, a few nonprofit organizations are chartered by federal statute. The

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nonprofit organizations that are the chief focus from a federal tax law standpoint are corporations, trusts, and unincorporated associations. There may, however, be use of limited liability companies in this regard.

A nonprofit organization is not necessarily a tax-exempt organization. To be exempt, a nonprofit organization must meet certain criteria. As noted, most of these criteria are established under federal law. State law, however, may embody additional criteria; those rules can differ in relation to the tax from which exemption is sought (such as taxes on income, sales of goods or services, use of property, tangible personal property, intangible personal property, or real property).¹ Thus, nonprofit organizations can be taxable entities, under both federal and state law.

(a) *Nonprofit Organization Defined*

The term *nonprofit organization* does not refer to an organization that is prohibited by law from earning a *profit* (that is, an excess of earnings over expenses). In fact, it is quite common for nonprofit organizations to generate profits. Rather, the definition of nonprofit organization essentially relates to requirements as to what must be done with the profits earned or otherwise received.

The legal concept of a nonprofit organization is best understood through a comparison with a *for-profit* organization. The essential difference between nonprofit and for-profit organizations is reflected in the private inurement doctrine.² Nonetheless, the characteristics of the two categories of organizations are often identical, in that both mandate a legal form,³ one or more directors or trustees, and usually officers; both of these types of entities can have employees (and thus pay compensation), face essentially the same expenses, make investments, enter into contracts, sue and be sued, produce goods and/or services, and, as noted, generate profits.⁴

A fundamental distinction between the two entities is that the for-profit organization has owners that hold the equity in the enterprise, such as stockholders of a corporation. The for-profit organization is operated for the benefit of its owners; the profits of the business undertaking are passed through to them, such as by the payment of dividends on shares of stock. That is what is meant by the term *for-profit* organization: It is one that is designed to generate a profit for its owners. The transfer of the profits from the organization to its owners is the inurement of net earnings to them in their private capacity.

¹ In establishing its criteria for tax exemption, however, a state may not develop rules that are discriminatory to the extent that they unconstitutionally burden interstate commerce (*Camps Newfoundland/Owatonna, Inc. v. Town of Harrison, et al.*, 520 U.S. 564 (1997)).

² The doctrine states that the entity be organized and operated so that "no part of . . . [its] net earnings . . . inures to the benefit of any private shareholder or individual" (e.g., Internal Revenue Code of 1986, as amended, section (IRC §) 501(c)(3)). The technical aspects of the private inurement doctrine are the subject of Chapter 20.

³ See § 4.1.

⁴ The word *nonprofit* should not be confused with the term *not-for-profit* (although it often is). The former describes a type of organization; the latter describes a type of activity. For example, in the federal income tax setting, expenses associated with a not-for-profit activity (namely, one conducted without the requisite profit motive) are not deductible as business expenses (IRC § 183).

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By contrast, a nonprofit organization generally is not permitted to distribute its profits (net earnings) to those who control it (such as directors and officers).⁵ (A nonprofit organization rarely has owners.⁶) Simply stated, a nonprofit organization is an entity that cannot lawfully engage in private inurement. Consequently, the private inurement doctrine is the substantive defining characteristic that distinguishes nonprofit organizations from for-profit organizations for purposes of the federal tax law.

To reiterate: Both nonprofit and for-profit organizations are legally able to generate a profit. Yet, as the comparison between the two types of organizations indicates, there are two categories of profit: one at the *entity level* and one at the *ownership level*. Both can yield the former type of profit; the distinction between the two types of entities pivots on the latter category of profit. The for-profit organization endeavors to produce a profit for its owners. For-profit organizations are supposed to engage in private inurement; nonprofit entities may not lawfully do so.

In addition to the prohibition on private inurement, several state nonprofit corporation acts require the nonprofit entity to devote its profits to ends that are beneficial to society or the public, such as purposes that are classified as arts promotion, agricultural, athletic, beneficial, benevolent, cemetery, charitable, civic, cultural, debt management, educational, eleemosynary, fire control, fraternal, health promotion, horticultural, literary, musical, mutual improvement, natural resources protection, patriotic, political, professional, religious, research, scientific, and/or social.

(b) Nonprofit Sector

Critical to an understanding of the nonprofit organization is appreciation of the concept of the *nonprofit sector* of society. This sector of society has been termed, among other titles, the *independent sector*, the *third sector*, the *voluntary sector*, and the *philanthropic sector*. The English language has yet to capture the precise nature of this sector; in a sense, none of these appellations is appropriate.

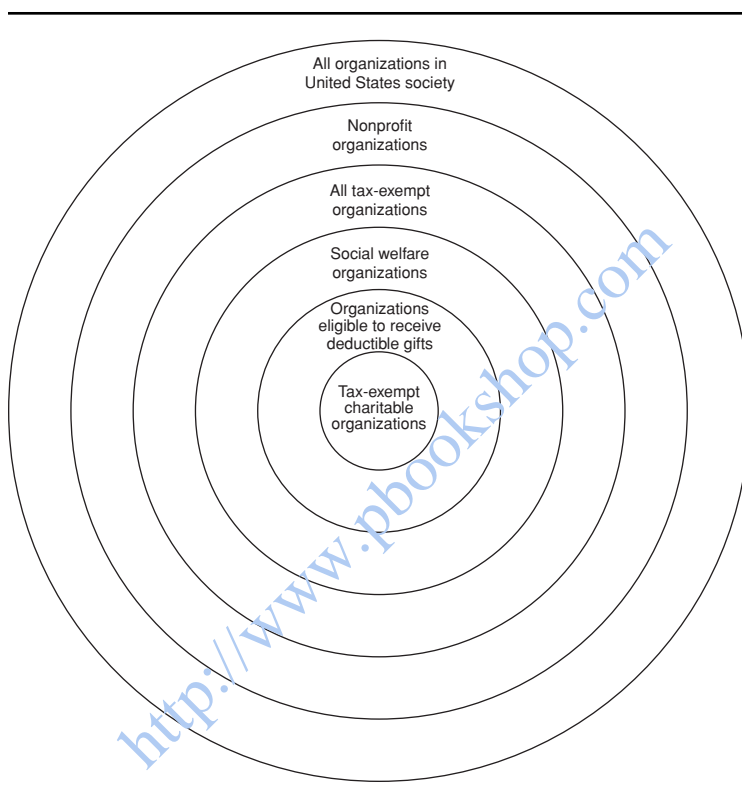
A tenet of political philosophy is that a democratic state—or, as it is sometimes termed, civil society—has three sectors. These sectors contain institutions and organizations that are governmental, for-profit, and nonprofit in nature. Thus, in the United States, the governmental sector includes the branches, departments, agencies, and bureaus of the federal, state, and local governments; the class of for-profit entities comprises the business, trade, professional, and commercial segment of society; and nonprofit entities constitute the balance of this society. The nonprofit sector is seen as being essential to the maintenance of freedom for individuals and a bulwark against the excesses of the other two sectors, particularly the governmental sector.

⁵ The U.S. Supreme Court wrote that a “nonprofit entity is ordinarily understood to differ from a forprofit corporation principally because it ‘is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees’” (Camps Newfound/Owatonna, Inc. v. Town of Harrison, et al., 520 U.S. 564, 585 (1997)).

⁶ A few states allow nonprofit organizations to issue stock. This is done as an ownership (and control) mechanism only; this type of stock does not carry with it any rights to earnings (such as dividends).

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There are subsets within the nonprofit sector. Tax-exempt organizations represent a subset of nonprofit organizations. Organizations that are eligible to attract deductible charitable gifts, charitable organizations (using the broad definition⁷), and other types of exempt organizations are subsets of exempt organizations. Charitable organizations (in the narrow, technical sense of that term) are subsets of charitable organizations (as defined in the broader sense).⁸ These elements of the nonprofit sector may be portrayed (see below) as a series of concentric circles.



§ 1.2 DEFINITION OF TAX-EXEMPT ORGANIZATION

For the most part in this book, the term *tax-exempt organization* refers to a nonprofit organization that is exempt from (excused from paying) the federal income tax.

⁷ This broad definition carries with it connotation of *philanthropy*.

⁸ The complexity of the federal tax law is such that the charitable sector (using the term in its broadest sense) is also divided into two segments: charitable organizations that are considered *private* (private foundations) and charitable organizations that are considered *public* (all charitable organizations other than those that are considered private); these nonprofit charities are frequently referred to as *public charities*. See Chapter 12.

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There are, of course, other federal taxes (such as excise and employment taxes), and there are categories of exemptions from them. At the state level, there are exemptions associated with income, sales, use, excise, and property taxes.

Nonetheless, there is no category of nonprofit organization that is not subject to some form of federal tax. The income tax that is potentially applicable to nearly all tax-exempt organizations is the tax on unrelated business income.⁹ Exempt entities can be taxed for engaging in political activities;¹⁰ public charities are subject to tax in the case of substantial efforts to influence legislation¹¹ or participation in political campaign activities;¹² and some exempt organizations, such as social clubs, are taxable on their investment income.¹³ Associations and like organizations can be subject to a proxy tax when engaged in attempts to influence legislation or engage in political activities.¹⁴ Private foundations are caught up in a variety of excise taxes.¹⁵

There is no entitlement in a nonprofit organization to tax exemption; there is no entity that has some inherent right to exempt status. The existence of tax exemption and the determination of entities that have it are essentially the whim of the legislature involved. Thus, the IRS wrote that “[e]xemption from federal income taxation is not a right, it is a matter of legislative grace that is strictly construed.”¹⁶ There is no constitutional law principle mandating tax exemption.¹⁷

An illustration of this point is the grant by Congress of tax-exempt status to certain mutual organizations—albeit with the structure that to qualify for the exemption, an organization must be organized before September 1, 1957.¹⁸ Prior to that date, exemption was available for all savings and loan associations. This exemption was repealed because Congress determined that the purpose of the exemption, which was to afford savings institutions that did not have capital stock the benefit of exemption so that a surplus could be accumulated to provide the depositors with greater security, was no longer appropriate, because the savings and loan industry had developed to the point where the ratio of capital account to total deposits was comparable to nonexempt commercial banks. A challenge to this law by an otherwise qualified organization formed in 1962 failed, with the U.S. Supreme Court holding that Congress did not act in an arbitrary and unconstitutional manner in declining to extend the exemption beyond the particular year.¹⁹

There are other illustrations of this point. For years, organizations like Blue Cross and Blue Shield entities were tax-exempt;²⁰ Congress, however, determined that these organizations had evolved to be essentially no different from commercial

⁹ See Chapter 24.

¹⁰ See § 17.5.

¹¹ See § 22.4.

¹² See § 23.3.

¹³ See § 15.5.

¹⁴ See §§ 22.6(c), 23.7(b).

¹⁵ See § 12.3.

¹⁶ IRS Private Letter Ruling (Priv. Ltr. Rul.) 200830028.

¹⁷ Nonetheless, see *supra* note 1.

¹⁸ IRC § 501(c)(14)(B).

¹⁹ *Maryland Sav.-Share Ins. Corp. v. United States*, 400 U.S. 4 (1970).

²⁰ By reason of IRC § 501(c)(4).

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health insurance providers and thus generally legislated this exemption out of existence.²¹ (Later Congress realized that it had gone too far in this regard and restored exemption for some providers of insurance that function as charitable risk pools.²²) Congress allowed the exempt status for group legal services organizations²³ to expire without ceremony in 1992; it also created a category of exemption for state-sponsored workers' compensation reinsurance organizations, with the stipulation that they be established before June 1, 1996.²⁴ Indeed, in 1982, Congress established exemption for a certain type of veterans' organization, with one of the criteria being that the entity be established before 1880.²⁵

There is a main list of tax-exempt organizations,²⁶ to or from which Congress periodically adds or deletes categories of organizations. Occasionally, Congress extends the list of organizations that are exempt as charitable entities.²⁷ Otherwise, it may create a new provision describing the particular exemption criteria.²⁸

²¹ See § 27.10(b).

²² See § 11.6.

²³ See Former IRC § 501(c)(20).

²⁴ See § 19.5.

²⁵ See § 19.11(b).

²⁶ IRC § 501(c).

²⁷ IRC §§ 501(e), 501(f), 501(k), 501(m), 501(n).

²⁸ IRC §§ 521, 526–529. The staff of the Joint Committee on Taxation and the Department of the Treasury measure the economic value (revenue “losses”) of various tax preferences, such as tax deductions, credits, and exclusions (termed *tax expenditures*). Although the income tax charitable contribution deduction tends to be the sixth or seventh largest tax expenditure, the ones that are greater than it include the net exclusions for pension plan contributions and earnings, the exclusion from gross income of employer contributions for health insurance premiums and health care, the deductibility of mortgage interest on personal residences, the reduced rates of tax on long-term capital gains, and the deduction for state and local governments' income and personal property taxes. The staff of the Joint Committee on Taxation estimated that, for the federal government's fiscal years 2009 to 2013, the tax expenditure for the income tax charitable contribution deduction will be \$237.6 billion, of which \$32.4 billion is in connection with the deduction for gifts to educational institutions and \$21.1 billion is for gifts to health care organizations (Estimates of Federal Tax Expenditures for Fiscal Years 2009–2013 (JCS-1-10)). The Joint Committee on Taxation changed its approach for the identification and classification of tax law provisions as tax expenditures, with goals of improving the utility of tax expenditure analysis and reemphasizing its neutrality. The committee issued an extensive report that stated that this analysis “can and should serve as an effective and neutral analytic tool for policymakers in their consideration of individual tax proposals or larger tax reforms” (A Reconsideration of Tax Expenditure Analysis (JCX-37-08)). This report formally presented the committee's “new paradigm” for tax expenditures classification by which these expenditures are now divided into *tax subsidies* and *tax-induced structural distortions*; tax subsidies are divided into three subcategories, one being *social spending*. The charitable deduction is a social spending tax subsidy. Tax exemption for qualified nonprofit organizations is not considered a tax expenditure. There are two rationales for this approach. One is that exempt status is not a tax expenditure because the nonbusiness activities of these organizations, such as charities, generally must predominate and their unrelated business activities are subject to tax. The exemption of certain nonprofit cooperative business organizations, including trade and business associations, is not treated as a tax expenditure because the tax benefits are available to any entity that chooses to organize itself and operate in the required manner to avoid the entity-level tax. Under the new Joint Committee on Taxation staff approach, however, tax exemption for credit unions (see § 19.7) is treated as a tax subsidy, in the subcategory of *business synthetic spending*. Also, exceptions to the rules for the taxation of unrelated business income (see §§ 24.6, 24.7) are business synthetic spending tax subsidies.

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§ 1.3 TAX-EXEMPT ORGANIZATIONS LAW PHILOSOPHY

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

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

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

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

Some of the federal income tax exemptions were enacted in the spirit of being merely declaratory of, or furthering, then-existing law. The House Committee on Ways and Means, in legislating a forerunner to the provision that exempts certain voluntary employees' beneficiary associations,²⁹ commented that "these associations are common today [1928] and it appears desirable to provide specifically for their exemption from ordinary corporation tax."³⁰ The exemption for nonprofit cemetery companies³¹ was enacted to parallel then-existing state and local property tax exemptions. The exemption for farmers' cooperatives³² is an element of the federal government's policy of supporting agriculture. The provision exempting certain U.S. corporate instrumentalities from tax³³ was deemed declaratory of the exemption simultaneously provided by the particular enabling statute.³⁴ The

²⁹ See § 18.3.

³⁰ H. Rep. No. 72, 78th Cong., 1st Sess. 17 (1928).

³¹ See § 19.6.

³² See § 19.12.

³³ See § 19.1.

³⁴ H. Rep. No. 704, 73d Cong., 2d Sess. 21–25 (1934). This policy has changed, however (see § 19.1, text accompanying note 1).

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provision according exemption to multiparent title-holding corporations was derived from the IRS's refusal to recognize exempt status for title-holding corporations serving more than one unrelated parent entity.³⁵ The exemptions for certain workers' compensation reinsurance organizations³⁶ and for state-sponsored qualified tuition plans³⁷ were created to avoid having their exemption rested on the view that these entities are instrumentalities of states.³⁸

Tax exemption for categories of nonprofit organizations can arise as a byproduct of enactment of other legislation. In these instances, exemption is granted to facilitate accomplishment of the purpose of another legislative end. Thus, exempt status was approved for funds underlying employee benefit programs.³⁹ Other examples include exemption for professional football leagues that emanated out of the merger of the National Football League and the American Football League,⁴⁰ and for state-sponsored providers of health care to the needy and for certain insurance issues, which were required to accommodate the goals of Congress in creating health care delivery legislation.⁴¹

There is a pure tax rationale for a few tax-exempt organizations. The exemption for social clubs, homeowners' associations, and political organizations is reflective of this rationale.⁴²

The fourth rationale for tax-exempt status is a policy one—not tax policy, but policy with regard to less essential elements of the structure of a civil society. This is why, for example, exempt status has been granted to fraternal organizations,⁴³ title-holding companies,⁴⁴ and qualified tuition plans.⁴⁵

The fifth rationale for tax-exempt status is one that rests solidly on a philosophical principle. Yet there are degrees of scale here; some principles are less grandiose than others. Thus, there are nonprofit organizations that are exempt because their objectives are of direct importance to a significant segment of society and indirectly of consequence to all society. Within this frame lies the rationale for exemption for entities such as labor organizations,⁴⁶ trade and business associations,⁴⁷ and veterans' organizations.⁴⁸

The sixth rationale for tax-exempt status for nonprofit organizations is predicated on the view that exemption is required to facilitate achievement of an end of significance to the entirety of society. Most organizations that are generally thought of as *charitable* in nature⁴⁹ are entities that are meaningful to the structure

³⁵ See § 19.2(b).

³⁶ See § 19.16(b).

³⁷ See § 19.17(a).

³⁸ See § 19.19.

³⁹ See Chapter 18.

⁴⁰ See § 19.20.

⁴¹ See §§ 19.16(a), 19.18.

⁴² See § 1.5.

⁴³ See § 19.4.

⁴⁴ See § 19.2.

⁴⁵ See § 19.17.

⁴⁶ See § 16.1.

⁴⁷ See Chapter 14.

⁴⁸ See § 19.11.

⁴⁹ These are the charitable, educational, religious, scientific, and like organizations referenced in IRC § 501 (c)(3).

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and functioning of society in the United States. At least to some degree, this rationale embraces social welfare organizations.⁵⁰ This rationale may be termed the *political philosophy* rationale.

§ 1.4 POLITICAL PHILOSOPHY RATIONALE

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

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

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

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

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

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

⁵⁰ See Chapter 13. Tax exemption for social welfare organizations originated in 1913; the promotion of social welfare is one of the definitions of the term *charitable* for federal tax purposes (see § 7.11).

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

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

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

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

This was the political philosophical climate concerning nonprofit organizations in place when Congress, toward the close of the nineteenth century, began considering enactment of an income tax. Although courts would subsequently articulate policy rationales for tax exemption, one of the failures of American jurisprudence is that the Supreme Court and the lower courts have never fully articulated this political philosophical doctrine.

Contemporary Congresses legislate by writing far more intricate statutes than their forebears, and in doing so usually leave in their wake rich deposits in the form of extensive legislative histories. Thus, it is far easier to ascertain what a recent Congress meant when creating law than is the case with respect to an enactment nearly a 100 years ago.

At the time a constitutional income tax was coming into existence (the first enacted in 1913⁵¹), Congress legislated in spare language and rarely embellished on its statutory handiwork with legislative histories. Therefore, there is no contemporary record in the form of legislative history of what members of Congress had in mind when they first started creating categories of tax-exempt organizations.

⁵¹ In 1894, Congress imposed a tax on corporate income. This was the first time Congress was required to define the appropriate subjects of tax exemption (inasmuch as prior tax schemes specified the entities subject to taxation). The Tariff Act of 1894 provided exemption for nonprofit charitable, religious, and educational organizations; fraternal beneficiary societies; certain mutual savings banks; and certain mutual insurance companies. The 1894 legislation succumbed to a constitutional law challenge (*Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895)), overruled on other grounds, *State of S.C. v. Baker*, 485 U.S. 505 (1988)), the Sixteenth Amendment was subsequently ratified, and the Revenue Act of 1913 was enacted.

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Congress, it is generally assumed, saw itself doing what other legislative bodies have done over the centuries. That is, the political philosophical policy considerations pertaining to nonprofit organizations at that times were such that taxation of these entities—considering their contributions to the wellbeing and functioning of society—was unthinkable.

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

Some clues in this regard are found in the definition of *charitable activities* in the income tax regulations,⁵² which are considered to be reflective of congressional intent. The regulations refer to purposes such as relief of the poor, advancement of education and science, erection and maintenance of public buildings, and lessening of the burdens of government. These definitions of charitable undertakings have an obvious derivation in the Preamble to the Statute of Charitable Uses,⁵³ written in England in 1601. Reference is there made to certain charitable purposes:

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

As this indicates, a subset of this political philosophical doctrine implies that tax exemption for charitable organizations derives from the concept that they perform functions that, in the absence of these organizations, government would have to perform. This view leads to the conclusion that government is willing to forgo the tax revenues it would otherwise receive in return for the public interest services rendered by charitable organizations. This rationale is, of course, inapplicable in the case of many religious organizations.⁵⁴

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

The U.S. Supreme Court concluded, soon after enactment of the income tax, that the foregoing rationalization was the basis for the federal tax exemption for

⁵² Income Tax Regulations (Reg.) § 1.501(c)(3)-1(d)(2).

⁵³ Stat. 43 Eliz. i, ch. 4.

⁵⁴ See § 10.1.

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charitable entities (although in doing so it reflected a degree of uncertainty in the strength of its reasoning, undoubtedly based on the paucity of legislative history). In 1924, the Court stated that “[e]vidently the exemption is made in recognition of the benefit which the public derives from corporate activities of the class named, and is intended to aid them when [they are] not conducted for private gain.”⁵⁵ Nearly 50 years later, in upholding the constitutionality of income tax exemption for religious organizations, the Court observed that the “State has an affirmative policy that considers these groups as beneficial and stabilizing influences in community life and finds this classification [tax exemption] useful, desirable, and in the public interest.”⁵⁶ Subsequently, the Court wrote that, for most categories of nonprofit organizations, “exemption from federal income tax is intended to encourage the provision of services that are deemed socially beneficial.”⁵⁷

Other courts have taken up this theme. A federal court of appeals wrote that the “reason underlying the [tax] exemption granted” to charitable organizations “is that the exempted taxpayer performs a public service.”⁵⁸ This court continued:

The common element of charitable purposes within the meaning of the ... [federal tax law] is the relief of the public of a burden which otherwise belongs to it. Charitable purposes are those which benefit the community by relieving it pro tanto from an obligation which it owes to the objects of the charity as members of the community.⁵⁹

This federal appellate court subsequently observed, as respects tax exemption for charitable organizations, that one “stated reason for a deduction or exemption of this kind is that the favored entity performs a public service and benefits the public or relieves it of a burden which otherwise belongs to it.”⁶⁰ Another federal court opined that the justification of the charitable contribution deduction was “historically ... that by doing so, the Government relieves itself of the burden of meeting public needs which in the absence of charitable activity would fall on the shoulders of the Government.”⁶¹

Only one federal court has fully articulated this political philosophical doctrine, noting that the “very purpose” of the charitable contribution deduction is “rooted in helping institutions because they serve the public good.”⁶² The doctrine was explained as follows:

[A]s to private philanthropy, the promotion of a healthy pluralism is often viewed as a prime social benefit of general significance. In other words, society can be seen as benefiting not only from the application of private wealth to

⁵⁵ *Trinidad v. Sagrada Orden de Predicadores de la Provincia del Santisimo Rosario de Filipinas*, 263 U.S. 578, 581 (1924).

⁵⁶ *Walz v. Tax Comm’n*, 397 U.S. 664, 673 (1970).

⁵⁷ *Portland Golf Club v. Comm’r*, 497 U.S. 154, 161 (1990).

⁵⁸ *Duffy v. Birmingham*, 190 F.2d 738, 740 (8th Cir. 1951).

⁵⁹ *Id.*

⁶⁰ *St. Louis Union Trust Co. v. United States*, 374 F.2d 427, 432 (8th Cir. 1967).

⁶¹ *McGlotten v. Connally*, 338 F. Supp. 448, 456 (D.D.C. 1972).

⁶² *Green v. Connally*, 330 F. Supp. 1150, 1162 (D.D.C. 1971), *aff’d sub nom. Coit v. Green*, 404 U.S. 997 (1971).

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specific purposes in the public interest but also from the variety of choices made by individual philanthropists as to which activities to subsidize. This decentralized choice-making is arguably more efficient and responsive to public needs than the cumbersome and less flexible allocation process of government administration.⁶³

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

The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.⁶⁴

The doctrine is also referenced from time to time in testimony before a congressional committee. For example, the Secretary of the Treasury testified before the House Committee on Ways and Means in 1973, observing:

These organizations [which he termed "voluntary charities, which depend heavily on gifts and bequests"] are an important influence for diversity and a bulwark against over-reliance on big government. The tax privileges extended to these institutions were purged of abuse in 1969 and we believe the existing deductions of charitable gifts and bequests are an appropriate way to encourage those institutions. We believe the public accepts them as fair.⁶⁵

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

Few aspects of American society are more characteristically, more famously American than the nation's array of voluntary organizations, and the support in both time and money that is given to them by its citizens. Our country has been decisively different in this regard, historian Daniel Boorstin observes, "from the beginning." As the country was settled, "communities existed before governments were there to care for public needs." The result, Boorstin says, was that "voluntary collaborative activities" were set up to provide basic social services. Government followed later.

The practice of attending to community needs outside of government has profoundly shaped American society and its institutional framework. While in most other countries, major social institutions such as universities, hospitals, schools, libraries, museums and social welfare agencies are state-run and state-funded, in the United States many of the same organizations are privately

⁶³ *Id.*, 330 F. Supp. at 1162.

⁶⁴ H. Rep. No. 1860, 75th Cong., 3d Sess. 19 (1939).

⁶⁵ Department of the Treasury, "Proposals for Tax Change," Apr. 30, 1973.

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controlled and voluntarily supported. The institutional landscape of America is, in fact, teeming with nongovernmental, noncommercial organizations, all the way from some of the world's leading educational and cultural institutions to local garden clubs, from politically powerful national associations to block associations—literally millions of groups in all. This vast and varied array is, and has long been widely recognized as part of the very fabric of American life. It reflects a national belief in the philosophy of pluralism and in the profound importance to society of individual initiative.

Underpinning the virtual omnipresence of voluntary organizations, and a form of individual initiative in its own right, is the practice—in the case of many Americans, the deeply ingrained habit—of philanthropy, of private giving, which provides the resource base for voluntary organizations.

These two interrelated elements, then, are sizable forces in American society, far larger than in any other country. And they have contributed immeasurably to this country's social and scientific progress. On the ledger of recent contributions are such diverse advances as the creation of noncommercial "public" television, the development of environmental, consumerist and demographic consciousness, community-oriented museum programs, the protecting of land and landmarks from the often heedless rush of "progress." The list is endless and still growing; both the number and deeds of voluntary organizations are increasing. "Americans are forever forming associations," wrote de Tocqueville. They still are: tens of thousands of environmental organizations have sprung up in the last few years alone. Private giving is growing, too, at least in current dollar amounts.⁶⁶

Here the concept of *philanthropy* enters, with the view that charitable organizations, maintained by tax exemption and nurtured by the ability to attract deductible contributions, reflect the American philosophy that not all policymaking and problem-solving should be reposed in the governmental sector.

Consequently, it is error to regard tax exemption (and, where appropriate, the charitable contribution deduction) as anything other than a reflection of this larger political philosophical construct. Congress is not merely "giving" eligible nonprofit organizations "benefits"; the exemption from income taxation (or charitable deduction) is not a "loophole," a "preference," or a "subsidy"—it is not really an "indirect appropriation."⁶⁷ Rather, the various provisions of the federal and state tax exemption system exist as a reflection of the affirmative policy of American government to refrain from inhibiting by taxation the beneficial activities of qualified tax-exempt organizations acting in community and other public interests.

Regrettably, however, the tax law is not evolving in conformity with this political philosophical framework; long-term political philosophical principles are being sacrificed to short-term views as to practical economical realities. This is reflected in the U.S. Supreme Court's confusion in thinking; the Court has been correct on some occasions as to the rationale for tax exemption for nonprofit organizations,⁶⁸ yet in its fear of misuse of exemptions, such as to promote racial

⁶⁶ *Giving in America: Toward a Stronger Voluntary Sector*, Report of the Commission on Private Philanthropy and Public Needs 9–10 (1975).

⁶⁷ Cf. *supra* note 28, second paragraph.

⁶⁸ See text accompanied by *supra* notes 55–57.

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discrimination,⁶⁹ or in furtherance of unconstitutional ends, such as government promotion of religion,⁷⁰ it has on other occasions inexplicably ignored the political philosophical construction. Thus, for example, in striking down a state sales tax exemption solely for the sale of religious publications, the Court wrote that it is “difficult to view” this “narrow exemption as anything but state sponsorship of religious belief.”⁷¹

From a constitutional law perspective, it may have been appropriate for the Court to use the word *sponsorship* in that setting. Certainly it would have been preferable, not to mention more accurate, for the Court to have confined this characterization to that word. Unfortunately, the Court found it necessary to amplify this point by observing that “[e]very tax exemption constitutes a subsidy that affects nonqualifying taxpayers.”⁷² While this “subsidy” is accurate terminology from the standpoint of the pure economics of the matter,⁷³ it misconstrues and distorts the larger (and far more important) political philosophical rationalization for tax exemption for nonprofit organizations. The policy underlying this tax exemption simply reflects the nature of the way U.S. society is structured. Inasmuch as it is not the government’s money to begin with, the governmental sector and those who fund it should not be seen as “subsidizing” the nonprofit sector.

§ 1.5 INHERENT TAX RATIONALE

Aside from considerations of public policy, there exists an inherent tax theory for tax exemption. The essence of this rationale is that the receipt of what otherwise might be deemed income by an exempt organization is not a *taxable event*, in that the organization is merely a convenience or means to an end, a vehicle by which each of those participating in the enterprise may receive and expend money in much the same way as they would if the money was expended by them individually.

⁶⁹ E.g., *Bob Jones Univ. v. United States*, 461 U.S. 574 (1983).

⁷⁰ *Texas Monthly, Inc. v. Bullock*, 489 U.S. 1 (1989).

⁷¹ *Id.* at 15.

⁷² *Id.* at 14. The lower courts, not surprisingly, follow the Supreme Court’s view that tax exemption is a government-provided subsidy (e.g., *American Civil Liberties Union Found. of Louisiana v. Crawford*, 2002 WL 461649 (E.D. La. 2002)) (where the court enjoined application of three state statutes providing tax exemptions only for religious organizations) *rev’d* (on another issue), *American Civil Liberties Union Found. of Louisiana v. Bridges*, 334 F.3d 416 (5th Cir. 2003).

Actually, the matter is somewhat worse. The Supreme Court, in addition to asserting that these tax exemptions are subsidies, also regarded nonexempted taxpayers as “indirect and vicarious donors” (*Bob Jones Univ. v. United States*, 461 U.S. 574, 591 (1983), quoted in *Texas Monthly, Inc. v. Bullock*, 489 U.S. 1, 14 (1989)). Persons who are required to pay a tax because they do not qualify for an exemption, however, are hardly “donors,” indirect or otherwise; characterization of such persons as “donors” is wholly inconsistent with the Court’s jurisprudence on that subject (e.g., *Comm’r v. Duberstein*, 363 U.S. 278, 285 (1960), where the Court stated that a *gift* is a transfer of money or property motivated by “detached or disinterested generosity”). In general, *Charitable Giving* § 3.1.

⁷³ Usually, every tax exemption, deduction, credit, or other preference accorded to certain persons causes other persons to pay more tax; that almost always is an inevitable outcome when a tax base is narrowed (see *supra* note 28).

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This rationale chiefly underlies the tax exemption for certain social clubs, which enable individuals to pool their resources for the purpose of provision of recreation and pleasure more effectively than can be done on an individual basis.⁷⁴ This tax rationale was summarized by a federal court as follows:

Congress has determined that in a situation where individuals have banded together to provide recreational facilities on a mutual basis, it would be conceptually erroneous to impose a tax on the organization as a separate entity. The funds exempted are received only from the members and any "profit" which results from overcharging for the use of the facilities still belongs to the same members. No income of the sort usually taxed has been generated; the money has simply been shifted from one pocket to another, both within the same pair of pants.⁷⁵

This rationale is likewise reflected in congressional committee reports.⁷⁶ It was invoked by Congress when enacting the tax exemption for homeowners' associations.⁷⁷ Thus, the Senate Finance Committee observed that, "[s]ince homeowners' associations generally allow individual homeowners to act together in order to maintain and improve the area in which they live, the committee believes it is not appropriate to tax the revenues of an association of homeowners who act together if an individual homeowner acting alone would not be taxed on the same activity."⁷⁸ This rationale, however, operates only where "public" money is not unduly utilized for private gain.⁷⁹

The inherent tax theory also serves as the rationale for the tax exemption for political organizations.⁸⁰ Thus, the legislative history underlying this exemption stated that these organizations should be treated as exempt organizations, inasmuch as "political activity (including the financing of political activity) as such is not a trade a business which is appropriately subject to tax."⁸¹

§ 1.6 OTHER RATIONALES AND REASONS FOR EXEMPT ORGANIZATIONS

There are, as noted,⁸² rationales for exempting organizations from federal income tax other than the political philosophy rationale⁸³ and the inherent tax rationale.⁸⁴

One of these rationales, less lofty than that accorded charitable and social welfare organizations, is extended as justification for the exemption of trade

⁷⁴ See Chapter 15.

⁷⁵ *McGlotten v. Connally*, 338 F. Supp. 448, 458 (D.D.C. 1972).

⁷⁶ H. Rep. No. 91-413, 91st Cong., 1st Sess. 48 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 71 (1969).

⁷⁷ See § 19.14.

⁷⁸ S. Rep. No. 938, 94th Cong., 2d Sess. 394 (1976).

⁷⁹ *West Side Tennis Club v. Comm'r*, 111 F.2d 6 (2d Cir. 1940), *cert. den.*, 311 U.S. 674 (1940).

⁸⁰ See Chapter 17.

⁸¹ S. Rep. No. 1357, 93d Cong., 2d Sess. 26 (1974).

⁸² See § 1.3.

⁸³ See § 1.4.

⁸⁴ See § 1.5.

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associations and other forms of business leagues.⁸⁵ These entities function to promote the welfare of a segment of society: the business, industrial, and professional community. An element of the philosophy supporting this type of exemption is that a healthy business climate advances the public welfare. The exemption for labor unions and other labor organizations rests on a comparable rationale.

The tax exemption for fraternal beneficiary organizations also depends, at least in part, on this concept. A study of the insurance practices of large fraternal societies by the U.S. Department of the Treasury⁸⁶ concluded that this rationale is inapplicable with respect to the insurance programs of these entities because the "provision of life insurance and other benefits is generally not considered a good or service with significant external benefits" to society generally. This report added, however, that "tax exemption for these goods and services [insurance and like benefits] may be justified in order to encourage" the charitable activities conducted by these organizations. The inherent tax rationale⁸⁷ "may" provide a basis for exemption for "certain" of these societies' services, according to the report. Further, the report observed that "[i]nsurance is not a type of product for which consumers may lack access to information on the appropriate quantity or quality that they need."

Other federal tax exemption provisions may be traced to an effort to achieve a particular objective. These provisions tend to be of more recent vintage, testimony to the fact of a more complex Internal Revenue Code. For example, exemption for veterans' organizations⁸⁸ was enacted to create a category of organizations entitled to use a particular exemption from the unrelated business income tax,⁸⁹ and exemption for homeowners' associations⁹⁰ came about because of a shift in the policy of the Internal Revenue Service⁹¹ regarding the scope of exemption provided for social welfare organizations. The exemption for college and university investment vehicles was the result of Congress's effort to salvage the exempt status of a common investment fund in the face of a determination by the IRS to the contrary.⁹² As is so often the case with respect to the tax law generally, a particular exemption provision can arise as the result of case law, or to clarify it; this was the origin of statutes granting exemption to cooperative hospital service organizations,⁹³ charitable risk pools,⁹⁴ child care organizations,⁹⁵ public safety testing entities,⁹⁶ and prepaid tuition programs.⁹⁷

⁸⁵ See Chapter 14.

⁸⁶ "Report to the Congress on Fraternal Benefit Societies," U.S. Department of the Treasury, January 15, 1993. See § 19.4(a), note 96.

⁸⁷ See § 1.3.

⁸⁸ See § 19.11(a).

⁸⁹ See § 24.10, text accompanied by note.

⁹⁰ See § 19.14.

⁹¹ Hereinafter IRS or agency.

⁹² See § 11.5.

⁹³ See § 11.4.

⁹⁴ See § 11.6.

⁹⁵ See § 8.8.

⁹⁶ See § 11.3.

⁹⁷ See § 19.17.

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§ 1.7 FREEDOM OF ASSOCIATION DOCTRINE

Tax exemption for nonprofit membership organizations may be viewed as a manifestation of the constitutionally protected right of association accorded the members of these organizations. There are two types of *freedoms of association*. One type—termed the *freedom of intimate association*—is the traditional type of protected association derived from the right of personal liberty. The other type—the *freedom of expressive association*—is a function of the right of free speech protected by the First Amendment to the U.S. Constitution.

By application of the doctrine of freedom of intimate association, the formation and preservation of certain types of highly personal relationships are afforded a substantial measure of sanctuary from interference by government.⁹⁸ These personal bonds are considered to foster diversity and advance personal liberty.⁹⁹ In assessing the extent of constraints on the authority of government to interfere with this freedom, a court must make a determination of where the objective characteristics of the relationship, which is created where an individual enters into a particular association, are located on a spectrum from the most intimate to the most attenuated of personal relationships.¹⁰⁰ Relevant factors include size, purpose, policies, selectivity, and congeniality.¹⁰¹

The freedom to engage in group effort is guaranteed under the doctrine of freedom of expressive association¹⁰² and is viewed as a way of advancing political, social, economic, educational, religious, and cultural ends.¹⁰³ Government, however, has the ability to infringe on this right where compelling state interests, unrelated to the suppression of ideas and not achievable through means significantly less restrictive of associational freedoms, are served.¹⁰⁴

These two associational freedoms were the subject of a U.S. Supreme Court analysis concerning an organization's right to exclude women from its voting membership.¹⁰⁵ The Court found that the organization and its chapters were too large and unselective to find shelter under the doctrine of freedom of intimate association. While the Court conceded that the "[f]reedom of association therefore plainly presupposes a freedom not to associate," it concluded that the governmental interest in eradicating gender-based discrimination is superior to the associational

⁹⁸ *Pierce v. Society of Sisters*, 268 U.S. 510 (1925); *Meyer v. Nebraska*, 262 U.S. 390 (1923).

⁹⁹ *Zablocki v. Redhail*, 434 U.S. 374 (1978); *Quilloin v. Walcott*, 434 U.S. 246 (1978); *Smith v. Organization of Foster Families*, 431 U.S. 494 (1977); *Carey v. Population Servs. Int'l*, 431 U.S. 678 (1977); *Moore v. East Cleveland*, 431 U.S. 494 (1977); *Cleveland Bd. of Educ. v. LaFleur*, 414 U.S. 632 (1974); *Wisconsin v. Yoder*, 406 U.S. 205 (1973); *Stanley v. Illinois*, 405 U.S. 645 (1972); *Stanley v. Georgia*, 394 U.S. 557 (1969); *Griswold v. Connecticut*, 381 U.S. 479 (1965); *Olmstead v. United States*, 277 U.S. 438 (1928).

¹⁰⁰ *Runyon v. McCrary*, 427 U.S. 160 (1976).

¹⁰¹ *Roberts v. United States Jaycees*, 468 U.S. 609 (1984).

¹⁰² *Rent Control Coalition for Fair Hous. v. Berkeley*, 454 U.S. 290 (1981).

¹⁰³ *NAACP v. Claiborne Hardware Co.*, 458 U.S. 886 (1982); *Larson v. Valente*, 456 U.S. 228 (1982); *In re Primus*, 436 U.S. 412 (1978); *Abood v. Detroit Bd. of Educ.*, 431 U.S. 209 (1977).

¹⁰⁴ *Brown v. Socialist Workers '74 Campaign Comm.*, 459 U.S. 87 (1982); *Democratic Party v. Wisconsin*, 450 U.S. 107 (1981); *Buckley v. Valeo*, 424 U.S. 1 (1976); *Cousins v. Wigoda*, 419 U.S. 477 (1975); *American Party v. White*, 415 U.S. 767 (1974); *NAACP v. Button*, 371 U.S. 415 (1963); *Shelton v. Tucker*, 364 U.S. 486 (1960); *NAACP v. Alabama*, 347 U.S. 449 (1958).

¹⁰⁵ *Roberts v. United States Jaycees*, 468 U.S. 609 (1984).

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rights of the organization's male members.¹⁰⁶ In general, the Court held that to tolerate this form of discrimination would be to deny "society the benefits of wide participation in political, economic, and cultural life."¹⁰⁷

A state supreme court held that the state's antidiscrimination law was violated when a youth organization expelled a member, who was in a leadership position, because he was gay.¹⁰⁸ The court found that the organization was a "public accommodation" rather than a private organization, so the doctrine of freedom of association did not operate to protect the expulsion decision. The organization was held not to be private, in part, because it was "inclusive, not selective, in its membership practice."¹⁰⁹ The free speech doctrine argument failed before this court, in part, because the organization's members "do not associate for the purpose of disseminating the belief that homosexuality is immoral."¹¹⁰

Nonetheless, the U.S. Supreme Court, holding that the organization has a constitutional right, under the First Amendment, to exclude gays from leadership positions because of their sexual orientation, overruled this opinion.¹¹¹ Application of the state's antidiscrimination law was found to be a "severe intrusion" on the organization's rights to freedom of expressive association.¹¹² The Court's review of the record resulted in a finding that there was a sufficient basis to conclude that the organization does "not want to promote homosexual conduct as a legitimate form of behavior."¹¹³ The Court wrote: "The forced inclusion of an unwanted person in a group infringes the group's freedom of expressive association if the presence of that person affects in a significant way the group's ability to advocate public or private viewpoints."¹¹⁴

The Court observed that organizations do not have to associate for the "purpose" of disseminating a certain message to be entitled to First Amendment protections.¹¹⁵ Rather, an organization need merely engage in expressive activity that could be impaired to be entitled to protection. The Court also noted that the First Amendment does not require that every member of a group agree on every issue in order for the group's policy to be expressive association. The dissenters wrote that the organization did not engage in the requisite level of expression on the subject to trigger the constitutional law protections.

¹⁰⁶ *Id.* at 622–629.

¹⁰⁷ *Id.* at 625.

¹⁰⁸ Dale v. Boy Scouts of Am., 734 A.2d 1196 (N.J. Sup. Ct. 1998).

¹⁰⁹ *Id.* at 1216.

¹¹⁰ *Id.* at 1223.

¹¹¹ Boy Scouts of Am. et al. v. Dale, 530 U.S. 640 (2000).

¹¹² *Id.* at 659.

¹¹³ *Id.* at 651.

¹¹⁴ *Id.* at 648.

¹¹⁵ *Id.* at 655.

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