NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT TO TREASURY REGARDING

THE USE OF THE "COMMENSURATE IN SCOPE" TEST

REPORT TO TREASURY REGARDING THE USE OF THE "COMMENSURATE IN SCOPE" TEST[1]

The growing endowments of private universities have attracted considerable attention from Congress and the Internal Revenue Service (the "IRS").[2] They have asked whether a public charity's expenditures for charitable purposes, when compared to the charity's investment assets and the income derived from them, are sufficient for the charity to qualify for tax-exempt status. Various members of Congress have suggested that the IRS apply the "commensurate in scope" test (referred to herein as the "commensurate test") as a means of evaluating qualification under section 501(c)(3).[3] In response, the IRS has indicated that it may indeed reinvigorate that test.

The commensurate test was introduced by the IRS in Revenue Ruling 64-182.[4] In that ruling, a grant-making charity derived its income principally from the rental of space in a large commercial office building that it owned and operated. The IRS held that the charity would qualify as tax-exempt where it was shown to be carrying on its grant-making under a charitable program that was "commensurate in scope" with its financial resources.

This report reviews the regulatory and judicial history of the commensurate test and examines various statutory and regulatory precedents for comparing a charity's accumulation of

---

[1] The principal drafters of this Report are Stuart L. Rosow and LD Sergi, with substantial assistance from David S. Miller and Richard R. Upton. Initial research provided by Andrew C. Day, Stacey P. Klein, Timothy Donovan and Nicole A. Spooner. Helpful comments were received from Elizabeth Kessenides and Michael Schler.

[2] Yale University's total endowment currently stands at over $22 billion. Geraldine Fabrikant, *Yale Endowment Grows 28%, Topping $22 Billion*, N.Y. Times, Sept. 27, 2007. However, Yale endowment grew at a modest 4.5% for the fiscal year ending June 30, 2008, and now stands at $22.9 billion; and Harvard University announced recently that its endowment stood at a staggering $36.9 billion for the fiscal year ending June 30, 2008. Geraldine Fabrikant, *Return of 8% for Harvard Endowment*, N.Y. Times, Sept. 13, 2008.

[3] All section references are to the Internal Revenue Code of 1986, as amended (the "IRC" or "Code"), unless otherwise noted.

[4] 1964-1 C.B. 186.

assets or production of income with its charitable expenditures as a means of testing its qualification for tax exemption. Based upon our review and analysis of the historical application of the commensurate test, we conclude that it is inappropriate for the IRS to use the commensurate test to address the increasing size and use of endowments. We do not address whether Congress as a policy matter should require public charities (or some category of public charities, such as educational organizations and nonprofit hospitals) to distribute a portion of their endowments annually. However, we do discuss some of the legal issues that such a requirement would raise.

I. INTRODUCTION

A. Congress and IRS Renew Interest in Commensurate in Scope Test

Beginning in early 2007, Senators Max Baucus and Chuck Grassley, the Chairman and Ranking Member, respectively, of the Senate Finance Committee, intensified their scrutiny of tax-exempt organizations with a particular focus on those organizations with significant endowments. On May 29, 2007, Senators Baucus and Grassley sent a letter to Treasury Secretary Henry Paulson reiterating Congressional interest in ensuring that tax-exempt universities and nonprofit hospitals do not misuse their tax-exempt status.[5]

In that May 29 correspondence, the Senators referenced the commensurate test, which up to this point had been used only sporadically and most often inconsistently by both the IRS and various courts to address a number of special issues for tax-exempt organizations. The Senators, quoting Revenue Ruling 64-182, stated that the commensurate test requires "charities to provide

---

[5] Letter from Sens. Chuck Grassley & Max Baucus, Senate Committee on Finance, to Henry Paulson, Secretary, Department of the Treasury, (May 25, 2007), *available at* finance.senate.gov/press/Bpress/2007press/prb052907.pdf.

charitable work commensurate with their resources."[6] In other words, the organization must be "shown to be carrying on through such contributions and grants a charitable program commensurate in scope with its financial resources."[7] The Senators asked the Secretary to provide guidance to the Treasury Department and the IRS in an effort to "put more teeth into the commensurate test."

Earlier this year, Senators Grassley and Baucus took another significant step toward more closely monitoring the growth and use of endowments by private universities. In correspondence dated January 24, 2008, the Senate Finance Committee sent questionnaires to 136 colleges and universities with endowments of $500 million or more,[8] requesting a significant amount of information from the institutions regarding their finances, including endowment growth and spending on student aid.

The Senate Finance Committee press release explained the purpose of the Committee's inquiry by citing to a study from the National Association of College and University Business Officers showing explosive growth in college and university endowments, but also increases in college tuition over the rate of inflation. The press release indicated that, given the growth of university endowments, the Committee expected tuition relief would rise significantly as well.[9] The Senators hoped that the information received from the colleges and universities through the questionnaire would allow Congress to make informed decisions about "potential pay-out

---

6 *Id.*

7 *Id.*

8 Press release from Sens. Chuck Grassley & Max Baucus, Senate Committee on Finance (Jan. 24, 2008), *available at* finance.senate.gov/press/Gpress/2008/prg012408b.pdf.

9 Note recent new financial aid policies.

requirements" while offering the organizations the opportunity to address the Committee's concerns through their own initiative.[10]

The IRS has also begun to focus on the use of the commensurate test to address the growth of certain public charity endowments. Steven Miller, the Commissioner of the IRS's tax-exempt and government entities division, echoed the concerns of Senators Baucus and Grassley earlier this year. In prepared remarks before a conference at the Georgetown University Law Center on April 24, 2008, Mr. Miller stated that he wanted to "re-energize" the commensurate test.[11] In his view, the tax-subsidy for colleges and universities is designed to ensure that these institutions make responsible and appropriate use of their resources to achieve their charitable purpose. As part of the IRS's plan, Mr. Miller informed the group that the director of exempt-organizations, Lois Lerner, had been charged with developing a program initiative focusing on commensurate issues over the next eighteen months. In the words of Mr. Miller, "[i]t is time for the IRS to get more aggressive in this area."[12]

B. Uncertainties Surrounding Commensurate in Scope Test

Despite this recent Congressional and IRS focus on the commensurate test, the commensurate test has been poorly defined and unevenly applied (if at all) from its inception. As mentioned above, in 1964, the IRS first introduced the commensurate test in the two-

---

[10] *Id. See also* Senator Grassley's mention of potential legislation requiring a 5% endowment pay-out in the May 30, 2008 publication of Chronicle of Higher Education.

[11] Commissioner Steven T. Miller, Remarks before the Georgetown Law Center Seminar on Representing and Managing Tax-Exempt Organizations (Apr. 24, 2008), *available at* http://pubs.bna.com/NWSSTND/IP/BNA/dtr.nsf/SearchAllView/85256453007E2C8D8525743B0009113B

[12] *Id.*

paragraph Revenue Ruling 64-182.[13] In that ruling, the IRS held simply that an organization is entitled to tax-exempt status "where it [was] shown to be carrying on through such contributions and grants a charitable program commensurate in scope with its financial resources."

Subsequent rulings and judicial interpretations have not clarified what the test is intended to measure or its scope, and the IRS has been inconsistent in identifying the factors that are to be compared in applying the test. At different times, the IRS has focused on the disparity between the time spent on the charitable activities compared to the non-charitable activities,[14] the ratio of gross revenues to amounts donated to charity[15] and the type of non-charitable activity in which the organization was involved.[16] This inconsistency poses several questions. For example, is the comparison between the assets of the entity and how they are being used for charitable purposes, including whether those assets are being used currently or reserved for future charitable use? Alternatively, does the test compare, as some of the history would seem to suggest, the type and level of profit making or income producing activity with the use of funds or earnings for charitable purposes? A third approach, which might be applicable to organizations directly conducting exempt activities (as opposed to grant-making organizations) would measure whether the activities are conducted in a manner which is commensurate with the organization's charitable purpose.

Furthermore, the scope of the test is itself unclear. Specifically, which types of organizations are subject to the commensurate test? The test was initially directed at grant

---

[13] Rev. Rul. 64-182, 1964-1 C.B. 186.

[14] Private Letter Ruling ("PLR") 200825046 (June 20, 2008).

[15] PLR 200738032 (September 21, 2007); PLR 200634046 (August 265, 2005); PLR 200508017 (February 25, 2005).

[16] PLR 200825051 (June 20, 2008); PLR 200512027 (March 25, 2005).

making organizations that derive income from profit making activities. However, starting in the 1990s, the IRS began to apply the test to non-grant making entities deriving income from non-charitable activities,[17] apparently attempting to increase the scope of the commensurate test.

The commensurate test is derived from Treasury Regulation Section 1.501(c)(3)-1(e)(1). This section, which is entitled, "Organizations carrying on a trade or business," provides that an organization that operates a trade or business may qualify under section 501(c)(3) if the operation of the trade or business is in furtherance of the organization's purpose(s) and if the organization is not organized or operated "for the primary purpose" of carrying on an unrelated trade or business as defined in section 513. However, the test, as applied by the IRS, has evolved to ask whether an organization's expenditures for charitable purposes are sufficient in light of its resources. Facets of this issue have already been addressed by both Congress and the Treasury. For example, specific payout requirements for private foundations are imposed by statute[18] and regulations impose similar limitations on specialized tax-exempt entities like medical research organizations.[19]

The specific focus of this report is an examination of the historic precedent of the commensurate test and analogous approaches to measuring charitable activity. On the basis of that review, we recommend that commensurate test not be used to condition or determine an organization's entitlement for a tax exemption based simply on whether the organization has a large endowment or sizeable investments.

---

[17] Although most operating organizations that were the subject of CIS analysis were engaged in unrelated trade or business activities, several private letter rulings discussed excessive investment activities by those organizations. *See* PLR 8717002 (January 7, 1987); and GCM 36130 (January 6, 1975).

[18] IRC Section 4942(e).

[19] IRC Section 170(b)(1)(A)(iii).

We recognize, however, that the questions posed by Congress present substantial issues of tax policy concerning the entitlement of certain organizations to tax exempt status. Those issues, some of which we identify in this report, are best addressed by Congress.[20] While legitimate concerns exist when investment or other income producing activities of a public charity (such as a college, university or hospital) are disproportionate to its charitable expenditures, we do not believe that this issue should be addressed by the IRS through application of the commensurate test.[21] Nevertheless, in the event that the IRS decides to expand the commensurate test and apply it or a related approach that would compare the accumulation of investment assets with charitable expenditures when evaluating colleges and universities with large endowments, we offer some suggestions.

II. RECOMMENDATIONS

Our recommendations are as follows:

1. Because Congress has directly addressed the issue of a minimum current use of charitable assets and applied this standard to private foundations but declined to do so for public charities, we believe that the IRS should refrain from using the commensurate in scope test (or other similar approach) to deny tax-exempt status to a charitable organization (like a college or university) solely because the organization fails to make a specified minimum amount of

---

[20] We have in the past recommended legislation requiring certain payout requirements for donor advised funds and certain supporting organizations (2007 New York Bar Report No. 1129). In the instant situation, we believe that Congress should determine the issue for public charities. Note that in the Pension Protection Act, Congress gave the IRS authority to issue regulations requiring a payout for Type III nonfunctionally integrated supporting organizations.

[21] References in this report to "public charities" do not include donor advised funds, certain Type III supporting organizations and medical research organizations.

expenditures from its endowment.[22] Although there may be extreme cases in which application of the commensurate test might be grounds to deny the exempt status of an organization, we are not aware of any college or university that presents such a case. Furthermore, the proper application of the primary purpose test under the current regulations can be used to address those cases in which the income producing activities dwarf the charitable activities, without resorting to the use of specific payout percentages under a reformulated commensurate test.

2. If the commensurate test is to be applied, it is most consistent with the regulations to use it as simply one measure of whether the organization's activities are carried out primarily for exempt purposes. A measurement of the use of resources may be a significant factor in this analysis. Nevertheless, we believe that the overall primary purpose standard requires an examination of all of the organization's activities and ultimately a judgment based upon the facts and circumstances of each individual case.

3. Finally, we urge the IRS to be cautious in providing quantitative measures or tests. Although we do not believe that a specific quantitative requirement of expenditures would be appropriate, if any such test is to be employed, it should be provided simply as a safe harbor, which if satisfied would be sufficient to establish that the exempt organization has sufficient charitable expenditures to qualify for exemption. We caution that even this approach presents considerable complexity and requires a significant intrusion on the fiduciary obligations of managers and boards of directors in determining whether assets should be spent currently or reserved for future needs.

---

[22] Although the IRS has broad authority to interpret the statutory standard that the charity be operated exclusively for a public purpose, we are not certain that such authority would include the power to impose such a draconian test.

III. DISCUSSION

A. History of IRS Application

1. Origins of Commensurate in Scope Test

The first reference to the commensurate test is found in Revenue Ruling 64-182.[23] In Revenue Ruling 64-182, a charity derived its income principally from the rental of space in a large commercial office building that it owned and operated. The charitable purposes of the organization were carried out by aiding other charitable organizations, selected by the entity's governing body, through contributions and grants. The IRS ruled that the organization met the primary purpose test of Treasury Regulations Section 1.501(c)(3)-1(e)(1) where it was shown to be carrying on through such contributions and grants a charitable program "commensurate in scope" with its financial resources.

The Ruling did not elaborate on how "commensurate in scope" is to be measured or what constituted an appropriate level of spending in relationship to financial resources. Still, applying the requirements of Treasury Regulation Section 1.501(c)(3)-1(e)(1), the Ruling appears to hold that an entity is considered organized and operated exclusively for charitable purposes even if it derives its income principally from commercial activities so long as that income is used to further its charitable purposes.

The text of Revenue Ruling 64-182 did not provide any reasoning for its holding. Instead, the basis for the Ruling is explained in two versions of General Counsel Memorandum ("GCM") 32689, which were part of the background to the Ruling. The first version of GCM 32689 (October 9, 1963) explained that the case did not turn on whether the income at issue was

---

[23] Rev. Rul. 64-182, 1964-1 CB 186.

active or passive, and thus taxable income or not, but turned instead on whether the primary purpose test of Treasury Regulation Section 1.501(c)(3)-1 had been properly applied.[24]

The second version of GCM 32689 provided an additional explanation. First, the GCM concluded that the amount of expenditures of an organization for charitable purposes must be taken into consideration in equating business activities with charitable activities under the primary purpose test of the regulation. Second, if an organization is shown in fact to be carrying on a real and substantial charitable program reasonably commensurate in financial scope with its financial resources and its income from its business activities and other sources, it cannot be said that an organization's "primary purpose" is other than charitable. According to the GCM, the amount of money expended for charitable objects is one reasonable indicator of the relative magnitude and importance of a charitable activity, at least for purpose of comparison with business activity. Under this approach, the commensurate test is satisfied if there is a real, bona fide or genuine charitable purpose, as manifested by the charitable accomplishments of the organization, and is not determined by comparing business purpose with charitable purpose. In other words, the commensurate test requires "clear proof of charitable purpose manifested in [the charitable organization's] actual operations."

Clearly then, GCM 32689 does not consider the commensurate test to be a litmus test for determining whether a charitable organization should be granted or continue to maintain its tax-exempt status. Instead, the GCM appears to require a case-by-case evaluation as to how the income produced by the commercial activity is used – if it is not used for charitable purposes of the organization, then the commensurate test will not be satisfied. Implicitly, however, this test

---

[24] This first version also stated that the primary purpose test "presents a number of fundamental problems for which the current regulations do not give us adequate guidance." Notably, these regulations are still in the same unchanged form today.

would appear to be met if a substantial portion of the income is actually devoted to charitable purposes.

In Revenue Ruling 67-5,[25] the IRS applied the commensurate test to a private foundation that was controlled by the donor and members of the donor's family, and was funded with common stock in the donor's closely-held corporation. Through a series of financial transactions involving the corporation, the donor and his family shifted the economic advantages, including payment of dividends and voting control in the closely-held corporation from the common stock held by the foundation to the preferred stock held by the donor and his family. As a result, the IRS found that the foundation owned non-income producing assets and was prevented from carrying on a charitable program commensurate in scope with its financial resources. The IRS determined that the resulting investments by the foundation in assets which failed to produce income for a charitable program commensurate in scope with its financial resources, along with other factors, established that the foundation was operated for substantially a non-exempt purpose. Accordingly, the foundation was not tax-exempt under Section 501(c)(3).

2. Inconsistent Nature and Scope in IRS Rulings and Litigation Positions

After Revenue Rulings 64-182 and 67-5, subsequent rulings reflect an inconsistent application of the commensurate test in determining what is being measured and to whom such measurements apply.

In the 1970 and 1980s the rulings generally concern fundraising activities, and the test was employed most often to affirm a charity's tax-exempt status and to conclude that income from certain activities which did not rise to a sufficient level of activity were excluded from the

---

[25] Rev. Rul. 67-5, 1967-1 C.B. 123.

definition of "unrelated business taxable income" ("UBTI").[26] The IRS based its decisions in these cases on the grounds that the fundraising activity was not generally a typical trade or business activity and the charity was using the proceeds from the activity to further its charitable purposes. However, beginning in the 1990s, the tenor of the commensurate test rulings changed and the IRS appeared to use the commensurate test primarily in abusive situations in an effort to revoke charities tax-exempt status. In these later rulings, the IRS applied various numeric formulations of the commensurate test (amount of time spent on charitable activities vs. non-charitable activities and gross revenues vs. net revenues, etc), instead of the more general facts and circumstances analysis that was used in Revenue Ruling 64-182 and the associated GCMs.

For example, in Private Letter Ruling ("PLR") PLR 8142024,[27] an organization had been incorporated to encourage participation in sports through financial aid to education programs and sporting facilities. As part of its fundraising efforts, the organization sponsored two sporting tournaments attended by professional athletes and published a program with paid advertisements solicited by volunteers. The organization donated approximately one-third of its net profits to various charitable and educational programs. The IRS ruled that the organization is carrying on a "concrete program of charitable giving commensurate in scope with its financial resources." The primary purpose of the organization was to provide charitable funds rather than carry on a trade or business.

PLR 8725056 is another example of a grantmaking organization that qualified for tax-exempt status. In that case, the organization raised funds from the operation of a group insurance program for its members. The members would pay the organization for insurance coverage and

---

[26] IRC Section 512.

[27] PLR 8142024 (October 16, 1981).

the organization would pay a premium to an insurance company. If the cost of the insurance company were lower than the premium paid, the insurance company would refund the difference. The insurance company, with the members' permission, would donate this difference to charitable organizations. Although the IRS found that the organization operated a trade or business, the insurance program was in furtherance of its exempt purpose. The funds from the insurance program that are available to charities were found to be commensurate in scope with the organization's financial resources. The organization, therefore, qualified for tax-exempt status.

The IRS also appeared to employ the commensurate test to analyze whether activities that generate income rise to the level of a trade or business so that the income will be classified as UBTI. In PLR 8813067,[28] the IRS examined whether the sale of candy by a tax-exempt organization would result in taxable income. The entity would sell candy to clubs and use the proceeds for charitable purposes of its choice. In ruling that the organization was not engaged in a trade or business, the IRS noted that the activities of the organization were carried on without compensation. In addition, the sale of candy was used as a form of fundraising to generate income for charity. Finally, the IRS stated that the organization's fundraising was commensurate in scope with its financial resources as evidenced by its large contributions to charity. Any income derived from the sale of the candy, therefore, was exempt from taxation.

---

[28] PLR 8813067 (January 1, 1988).

But starting in the early 1990s, the IRS used the commensurate test as a means to revoke the tax-exempt status of organizations it saw as abusive.[29] In these later rulings the IRS seems to alter the original nature of the test as described in GCM 32689.[30]

In certain circumstances, the IRS has looked to the organization's gross receipts in determining whether it qualifies for tax-exempt status. In PLR 9132005,[31] an entity was established to conduct research for vision and hearing impairments. The organization soon began operating bingo games as a fundraising activity. Although the organization received gross amounts of $570,411, the organization's operations resulted in a loss and no payments were made to charity. In the following year, the organization had $965,734 in gross receipts, but only contributed $1,218 to charity. Over the next three years, the organization had $2,847,025 in gross receipts but made charitable grants of only 1% of that amount. Citing the commensurate test, the IRS ruled that "[w]here the actual payments to charity are an insubstantial amount when compared to its gross receipts, it will not qualify for exemption." Due to the small amount given to charity, the organization did not qualify for tax-exempt status.

The IRS took a similar approach in PLR 200508017.[32] In that ruling, the organization seeking tax-exempt status ran a website that directed patrons to online retailers. The online

---

[29] *But see* PLR 9417003 (December 1, 1993). The entity raised funds by organizing a charity ball and distributed those funds to other charities. To facilitate the ball, the individual who controlled the organization caused it to enter into a contract with her wholly owned, for-profit fund-raising company. The tax-exempt organization made charitable donations of approximately 20% of the gross receipts from the ball. The IRS referenced the holding in Rev. Rul. 64-182 that an organization may be exempt where carries on a charitable program commensurate in scope with its financial resources. In finding that the organization qualified for tax-exempt status, however, the IRS merely recognized that the organization had given significant amounts of money to recognized charities.

[30] General Counsel Memorandum 32689 (Apr. 27, 1964).

[31] PLR 9132005 (May 3, 1991).

[32] PLR 200508017 (February 25, 2005).

retailer paid the organization a commission and the patron could select certain charities and nonprofit organizations that would receive the commission. The organization also sold advertising on its website, the income from which was not being contributed to charity. In denying the organization tax-exempt status, the IRS held that the discrepancy between the small amounts received as commission compared to the potentially significant amounts received from advertising caused the organization to fail the commensurate test.

At other times, the IRS has examined the scope of the commercial activity in which the organization engages in order to reject an organization's tax exempt status. For example, in PLR 200825051[33] the entity received donations of real property, made repairs, sold the property and donated the net proceeds to a charitable organization designated by the donor. The purpose of this structure was to allow the donor to receive an immediate tax deduction and prevent the charitable organization from being burdened with ownership, liability and sales responsibilities. The IRS found that the entity's actions constituted common commercial activities. In a brief statement, the IRS simply stated that the entity did not carry on a charitable program commensurate with its financial resources. The IRS reached a similar conclusion in the context of boats donated to charities through a middleman in PLR 200512027.[34]

In these rulings, the IRS applied a numeric formulation of the commensurate test which was quite different than the commensurate test first articulated in Revenue Ruling 64-182; allowing the IRS to avoid a more detailed analysis of the charity's activities. And although these new formulations of the commensurate test were used by the IRS to revoke the tax-exempt status of questionable organizations, it is extraordinarily difficult to understand the basis for the

---

[33] PLR 200825051 (June 20, 2008).

[34] PLR 200512027 (March 25, 2005).

revocations or the standard applied by the IRS in these rulings because they failed to clarify either the purpose of the commensurate test or when it is to be applied.

The IRS has also changed its position regarding whether the test applies equally to grantmaking organizations and tax-exempt entities who themselves directly conduct charitable activities. Initially, under GCM 32689, the commensurate test was applied just to grantmaking organizations. The sole charitable purpose of grantmaking organizations is to give money to charities and charitable activities and, therefore, it is a more straightforward analysis to determine if such an entity is providing charitable benefits commensurate with its resources. Applying such a test to operating charities is considerably harder, particularly when the organization derives revenues from its charitable activities. Furthermore, each type of operating charity would require different levels of spending, reserves and investing. In such case a simple numerical payout test would be unable to take into account all of the necessary variables.

It appeared initially that the IRS agreed. Prior to 1990, grantmaking organizations were almost exclusively the target of the commensurate analysis in rulings and determinations.[35] In 1997, in Technical Advice Memorandum 9711003,[36] the IRS held "[t]he 'commensurate test'.....would not be applicable since [the tax-exempt organization] has a substantial charitable program in addition to its fundraising activities." In several other rulings, however, the IRS indicated that the commensurate test might be applicable to organizations directly conducting charitable activities. For example, in TAM 9636001, the IRS concluded that a religious publisher, which operated a school, was exempt under section 501(c)(3) because its charitable

---

[35] Siegel, "Commensurate in Scope: Myth, Mystery or Ghost?" Taxation of Exempts, July 21, 2008 (not yet published).

[36] TAM 9711003 (November 8, 1997).

program was commensurate with its financial resources, even though those resources were obtained through the unrelated taxable publishing business. In GCM 36130, the IRS considered the potential application of the commensurate test to an operating school which derived its income from real estate development activities, but concluded that the factual record was insufficient and that a mere numerical computation was not appropriate in that case.

Thus, it remains entirely unclear whether the commensurate test is applicable to an organization with direct charitable programs. The issue is, in part, as noted in TAM 9636001 and GCM 36130, that the presence of the charitable program is itself often adequate proof that the organization meets the primary purpose test under the regulations. However it appears that the IRS now believes that the commensurate test is applicable to all public charities and has recently applied the test to operational organizations in addition to grantmaking organizations.[37]

B. Summary of Relevant Case Law

The courts have also have struggled with how to appropriately evaluate the sufficiency of an exempt organization's charitable activities compared to its resources and, as with the IRS, have not clearly articulated a commensurate test. Moreover, it is not even clear that the courts have ever used such a test as the basis for their holding. Although in the relevant case law, the issue involves a comparison of income producing activity with the organization's charitable

---

[37] *See* PLR 200825051 (November 16, 2007). The organization's main purpose in PLR 200825051 was to assist individuals in donating real estate property to charities. The individuals transferred legal title of the property to the organization, the organization assumed full responsibility and arranged for the appropriate services, repairs or upgrades needed to make the property more readily marketable. The organization also arranged for the property to be sold and that after the sale, the net proceeds were donated to the designated charity on behalf of the donor. The IRS held that, as a result of serving as an agent of each donor, the organization was performing commercial services for the individuals, rather than activities that further a charitable purpose. The IRS further held that, unlike the organization described in Rev. Rul. 64-182, the organization did not carry on a charitable program commensurate in scope with its financial resources.

endeavors, the courts' ultimate decisions were based on other factors, with any analysis of income producing versus charitable activity contained only in dicta. At most, it could be said that courts have been influenced by the fact that the organization's charitable spending is consistent with its financial resources and charitable goals.

Illustrative of this issue is *Samuel Friedland Foundation v. United States*, a case that predated the IRS formulation of the commensurate test. In *Friedland Foundation*, the court was concerned with whether the charity engaged in unreasonable accumulation of income under Section 3814 of the Internal Revenue Code of 1939 (this section later became Section 504, and then was repealed in 1969). Section 3814 provided that a charitable organization may not accumulated an unreasonable amount of income given the charity's purpose or function constituting the basis for such organization's tax exemption. Although the case was decided under prior law dealing with unreasonable accumulations of income, and therefore is not directly relevant to the commensurate test, the case is instructive for its analysis of the charity's planned activities as proving the organization's primary purpose was charitable.

The court in *Friedland Foundation* recognized the Congressional concerns articulated in 1950 that "exempt organizations were using or distributing little or none of their income for current charitable purposes, but were amassing vast amounts of money without any apparent limitation." However, the court stated that the investment of funds of a charitable organization in securities has never been conceived of as a "purpose" of the organization and has always been treated as an incidental activity subservient to the fundamental charitable objectives. Therefore, the determination of whether the organization was operated "exclusively" depended upon the actual activities. In evaluating those activities, the court looked to the planned uses of the funds, the amount that such endeavors would reasonable cost and the likelihood of achieving those

goals. The court concluded that the accumulation of funds was reasonable and light of the organization's plans and goals. In essence, the court's conclusion that the accumulation was reasonable is to a certain degree, a conclusion that the amount of accumulation was commensurate with the organization's goals, although the court did not articulate the standard in that manner. This conclusion was not based upon any precise formula, but a review of all of the organization's circumstances.[38]

Another case that applied a similar type of analysis involving the comparison of expenditures in relation to resources involved a foundation organized primarily for aiding and promoting the science of ceramic engineering, and secondarily to provide aid to research for the advancement of the ceramic arts.[39] The foundation operated a profit-making enterprise that manufactured and sold pyrometric cones, expending approximately 80 percent of its gross income to meet manufacturing costs, with the remaining 20 percent of its income being spent to promote research in ceramic engineering. Nevertheless, likening the foundation to the tax-exempt organization described in Revenue Ruling 64-182, the court found that the foundation's spending on its tax exempt program was "shown to be commensurate with its financial resources" and therefore upheld its tax exemption. The court argued that profit-making was not the primary purpose of the foundation, but rather was a means toward accomplishing its charitable purposes. It reasoned that the manufacture and sale of the pyrometric cones facilitated

---

[38] The court considered the following factors in determining that the foundation's accumulation of income was reasonable included: (a) the purpose of the accumulation of income and the dollar goal; (b) the initial funds available for devotion to the accumulation of income; (c) the availability of additional contributions to supplement the accumulated income to achieve the dollar goal; and (d) the time required to reach the dollar goal. The court emphasized that a foundation's retention of income for many years in pursuit of its goals for the public benefit are "of equal if not greater benefit to the public than requiring the distribution in each taxable year of income received by that organization."

[39] *Orton v. Comm'r*, 56 T.C. 147 (1971).

further research in ceramic engineering. The court pointed to evidence of a principal pursuit of charity including a self-imposed cap on the foundation's profitability and moderate spending on employee compensation. Furthermore, the court noted that the foundation's expenditures to advance ceramic engineering research were commensurate with its resources, as the majority of its net profits—after deducting the manufacturing and other costs—and its investment income were in fact expended on promoting research. The court recognized that the foundation did not have "burgeoning profits" or "greatly increasing accumulations of income in relation to distributions," such that its exemption from taxation was inappropriate.[40]

Both *Friedland* and *Orton* involve the accumulation of income by a private foundation, which was perceived to be a substantial problem prior to the 1969 Act which established payout rules for private foundations. Public charities were not subject to these payout requirements. Therefore, any analysis from these cases is likely of very limited applicability in determining the appropriateness of a commensurate test that would require such payouts.

C. Statutory and Regulatory Approaches and Precedent for testing the Use of Resources

Other precedents, both statutory and regulatory, exist for requiring certain levels of expenditures by organizations in order to maintain their status as either public charities or tax-exempt entities. Certain precedents dictate strict numerical formulas, while others are implemented through a facts and circumstances inquiry. For example, the Tax Reform Act of 1969 mandated that private foundations make certain minimum distributions for charitable purposes. Medical research organizations are also subject to specific spending requirements with regard to charitable contributions and, under the "community benefit standard," hospitals are

---

[40] *Id.* at 159.

required to provide a certain amount of care to those who cannot pay. Educational institutions are subject to a somewhat vague, but similar standard.

1. The Tax Reform Act of 1969

In 1969, Congress enacted Section 4942 in order to provide an objective formula by which private foundations would be required to distribute an ascertainable minimum amount of their income for charitable or other tax-exempt purposes.[41] Part of the reason for the minimum distribution rule was to replace the existing system where foundations could lose their exempt status if they had "excessive accumulations," which was a vague standard that often led to expensive litigation. In addition, Congress believed that private foundations, often controlled by a single individual, were behaving in a manner inconsistent with their tax-exempt status. Specifically, critics alleged that the organizations had been established to avoid taxation, to ensure control of family businesses, to protect from taxation income generated by business-type activities unrelated to the organization's charitable purposes and to accumulate income without distribution to charitable causes. The same criticisms were not leveled at public charities and, therefore, public charities were exempted from most of these statutory restrictions.

Prior to 1969, only subjective distribution requirements existed and some organizations exempt under Section 501(c)(3) of the Code transferred little, if any, of their income to charitable causes. The excise taxes and regulations applicable to foundations reflect a concern that Section

---

[41] In addition to Section 4942 requiring a minimum payout, the 1969 Act also enacted additional statutes were largely aimed at prohibiting private foundations and their managers from engaging in self-dealing transactions, maintaining excess holdings in business enterprises, lobbying and electioneering, investing unwisely, and either retaining assets within the domestic private foundation for self-motivated purposes rather than disbursing them for charitable activities or endowing a second domestic private foundation that would stockpile the funds with no intent to utilize them for charitable endeavors. These statutes all provided for the imposition of excise taxes for violations in lieu of revocation of the foundations tax-exempt status.

501(c)(3) not be used to provide private benefits and that the charitable purpose be served by preventing the accumulation of assets in the foundation. The two tax-writing committees initially reported a 5% minimum, but that number was increased to 6% on the Senate floor; the figure could be adjusted by the Treasury based on investment yields. The provision also required a distribution of all net income if that amount were larger.

This restriction was followed by two additional reductions of the distribution requirement. First, the minimum distribution, which had become 6.75% by 1976, was lowered to 5% and fixed at that level by the Tax Reform Act of 1976. The Economic Recovery Tax Act of 1981 eliminated the requirement that all net income be paid out if that amount were larger than 5%. The reason for this change was that payment of all income would gradually erode the value of the real assets because of inflation, a problem that had become much more severe over time. Reasonable and necessary administrative expenses are included in calculating this minimum distribution requirement.[42]

2. Related Doctrinal Theories for Public Charities

The Code provides tax-exempt public charity status for certain entities that may not meet the public support test. Among the entities included in the definition of public charities are educational organizations, medical research organizations and certain hospitals. These three types of tax-exempt organizations are unique from other public charities because they are subject to certain expenditure levels in order to maintain their tax-exempt status.

---

[42] The Deficit Reduction Act of 1984 capped administrative expenses at 0.65% of assets. However, this limit expired in 1990.

a. Medical Research Organization

In order for a charity to qualify as a medical research organization, (1) it must be directly engaged in the active conduct of medical research and (2) the medical research must be in conjunction with a hospital.[43]

The medical research organization must be expressly organized to conduct medical research. Medical research includes the study to discover, develop or verify knowledge relating to the causes, diagnosis, treatment, prevention or control of physical or mental diseases and impairments in biological, social and behavioral sciences.[44] The organization must also have (or continuously have available) the appropriate equipment and professional personnel necessary to carry out the organization's principal purpose.

The regulations set out two safe harbors under which an organization will be considered to be primarily engaged in the continuous active conduct of medical research.[45] First, if the organization spends 3.5% of the fair market value of its endowment on medical research over the course of the year (or an average of 3.5% over the course of the preceding four years), the organization will be primarily engaged in the continuous active conduct of medical research. Second, the organization will meet this requirement if the organization devotes 50% of its assets to the continuous active conduct of medical research.

The failure to meet either of the safe harbors does not necessarily prevent an entity from being treated as a medical research organization. Instead, the Treasury Regulations provide a number of factors that the courts and the IRS should consider in determining whether the

---

[43] Treas. Reg. Section 1.170A-9(c)(2)(i).

[44] *Id.* at Section 1.170A-9(c)(2)(iii).

[45] *Id.* at Section 1.170A-9(c)(2)(v).

organization is primarily engaged in the continuous active conduct of medical research.[46] These factors include (1) whether the organization failed the numeric tests due to improper valuation of assets and thereafter devoted additional assets to satisfy the tests, (2) whether the entity acquired additional assets and this rise in the value of assets was not included in the previous budget, (3) whether the organization failed to make the proper expenditures due to unexpected changes in the budget that could not be altered due long-term planning requirements and (4) whether or not the entity planned to spend less than a significant percentage in a given year but make up the difference in the subsequent few years.

The requirement that the medical research be conducted in conjunction with a hospital does not require a formal association between the organization and the hospital.[47] There must, however, be at least a joint effort to maintain close cooperation between the medical research organization and a hospital. The medical research organization may conduct the medical research in or adjacent to the hospital or use the hospital's facilities on a continuous basis. Evidence of cooperation between the medical research organization and the hospital will also exist where the staffs of the two entities work closely together.

b. Hospitals

Certain nonprofit hospitals may also qualify for tax-exempt status if they qualify as a public charitable organization. The IRS in Revenue Ruling 56-185 first introduced the "community benefit doctrine" to determine whether a hospital qualifies as a public charitable organization.[48] It put forth four criteria that a hospital must meet. First, the hospital must be

---

[46] *Id.*

[47] *Id.* at Section 1.170A-9(c)(2)(vii).

[48] Rev. Rul. 56-185, 1956-1 C.B. 202.

organized as a nonprofit charitable organization for the purpose of operating a hospital for the care of the sick. Second, the hospital must be operated to the extent of its financial ability for those not able to pay for the IRSs rendered and not exclusively for those who are able and expected to pay. Third, the hospital may not restrict the use of its facilities to a particular group of physicians to the exclusion of others. Finally, the net earnings of the hospital must not inure directly to the benefit of any private shareholder. A hospital that satisfies these four criteria will be found to be a public charity.

The IRS dramatically changed its tax-exempt criteria for hospitals in Revenue Ruling 69-545.[49] In that ruling, the IRS removed the second requirement of Revenue Ruling 56-185 that a hospital must provide care to individuals who are unable to pay for services. Instead, the promotion of health alone was found to be a charitable purpose. Moreover, the hospital need not serve every member of the community, so long as the hospital is promoting the health of a class of individuals that is not so small that its relief is not a benefit to the community. A hospital with an emergency room open to all but that limited admissions to the rest of the hospital to individuals who could pay would satisfy the new community benefit standard.

Revenue Ruling 83-157 further relaxed the requirements a hospital must meet to qualify as tax-exempt.[50] That ruling stated that a hospital need not operate an emergency room open to individuals unable to pay for its services. Instead, it is sufficient that the hospital has a board of directors drawn from the community, an open medical staff policy, treats patients who pay their bills with the aid of Medicare and applies any surplus revenues to expanding the IRSs of the

---

[49] Rev. Rul. 69-545, 2969-2 C.B. 117.

[50] Rev. Rul. 83-157, 1983-2 C.B. 94.

hospital. Tax-exempt hospitals, therefore, may deny service to an entire segment of the community and still satisfy the community benefit standard.

In a recent Field Service Advice ("FSA") memorandum, the IRS has attempted to clarify and strengthen the community benefits standard. In FSA 200110030, the IRS noted that it is insufficient for a hospital to merely state that it will provide services to the indigent. Instead, the hospital must actually do so, by ensuring that adequate health care services are delivered to those in the community who need them.[51] The IRS then produced a set of guidelines to determine whether the hospital meets the charity care requirement of the community benefit standard.[52]

c. Educational Organizations

In order for a charity to qualify as an educational organization, Section 170(b)(1)(A)(ii) requires that the organization normally maintain (1) a regular faculty, (2) a regular curriculum and (3) a regularly enrolled body of pupils or students in attendance at the place where the educational activities are regularly carried on.[53] The Regulations add a fourth requirement that focuses on the efforts, activities and expenditures of the organization. It requires that the "primary function" of the educational organization be the presentation of formal instruction.[54]

An educational organization's regular faculty may consist of more than teachers or tenured professors. For example, courts have found that curators and staff of a museum constituted a regular faculty where those individuals presented the museum's educational

---

[51] FSA 200110030 (March 12, 2001).

[52] *Id.*

[53] IRC Section 170(b)(1)(A)(ii).

[54] Treas. Reg. Section 1.170A-9(b)(1).

programs.[55] Unpaid volunteers and guest lecturers at the museum, however, did not satisfy the regular faculty requirement.[56]

The regularly scheduled curriculum of the educational organization must consist of courses organized into an interrelated curriculum and offered on a regular basis. A program consisting of various optional courses, such as lectures and workshops, will not satisfy the curriculum requirement.[57] The curriculum, however, need not be of an academic nature. For example, tax-exempt educational organizations have been found to exist where the regular curriculum was made up of ballet instruction, martial arts training and wilderness survival training.[58] The educational organization must also have a regularly enrolled body of students in attendance at the place where the educational activities regularly occur. Instruction in a student's home, however, will not satisfy this requirement.[59]

The final requirement for an educational organization is that its primary function must be the presentation of formal instruction. As the regulations indicate, the operation of a school by a museum does not necessarily qualify the museum as an educational institution.[60] An educational organization may not be engaged in noneducational activities unless these activities are merely incidental to the educational activities.[61] In one ruling, the IRS confronted the situation where an organization, in addition to its regular educational program, granted up to 25% of its annual total

---

[55] *Brundage v. Comm'r*, 54 T.C. 1468 (1963).

[56] Rev. Rul. 76-384 1976-2 C.B. 57; Rev. Rul. 78-82, 1978-1 C.B. 70.

[57] Rev. Rul. 78-82, 1978-1 C.B. 70.

[58] Rev. Rul. 83-140, 1983-2 C.B. 185; Rev. Rul. 78-309, 1978-2 C.B. 123; Rev. Rul. 67-447 1967-2 C.B. 121.

[59] Rev. Rul. 76-384, 1976-2 C.B. 57.

[60] Treas. Reg. Section 1.170A-9(b)(1).

[61] Treas. Reg. Section 1.170A-9(b)(1).

support and revenues to other public charities. The IRS ruled that the organization was still primarily engaged in the presentation of formal instruction.[62] We are not aware of the status of any educational organization being challenged on the basis of the size of its endowment or investment income.

IV. ANALYSIS AND ANALYTICAL FRAMEWORK

Given this historical background, the issue for the IRS is whether the "commensurate in scope" test adequately addresses the issues presented by Senators Baucus and Grassley's recent Congressional inquiry. We believe that as articulated in the IRS's rulings, the commensurate test does not. The test is grounded in the requirement under Treasury Regulations Section 1.501(c)(3)-1(e)(1) that the organization not be organized "for the primary purpose of carrying on an unrelated trade or business as defined in section 513." However, it is unclear what the commensurate test is intended to measure, and what types of entities are subject to such measurement. Is the commensurate test merely measuring expenditures and, if so, current or future or is there also some evaluation of the other effort involved in the charitable activity? As set forth in the rulings, the test seems to be a measure of proof that the organization engages in a substantial charitable activity. Clearly, where the organization directly has charitable operations, this proof would seem to be present, almost without regard to the amount of funds available.

We believe that Congress is asking different questions. In addition, Congress' understanding of the commensurate test seems to differ from its historic application. On January 24, 2008, the Senate Finance Committee (the "Committee") requested detailed information from the nation's wealthiest colleges and universities on tuition increases over the last decade, their

---

[62] PLR 9643039 (October 25, 1996).

financial aid practices and how they manage and spend their endowments. The Committee stated in its letter: "We would appreciate additional information about tuition costs and your institution's endowment," which receive "very generous tax breaks under the Internal Revenue Code....We want to better understand how these tax benefits for higher education endowments are improving education and making undergraduate studies more affordable for low and middle income families today." Specifically, the Committee's letter expresses a concern about the lag time. It notes: "Tuition has gone up, college presidents' salaries have gone up, and endowments continue to go up and up. We need to start seeing tuition relief for families go up just as fast."

Thus, the Committee's letters appear to (i) highlight a lag time between the donation generating the tax benefit and the use of the donation for charitable purposes and (ii) argue that charities, including universities, need to provide charitable work commensurate with their resources, regardless of any commercial activity. The Committee also requests a "clearer" understanding of a charity's endowment, including, among other things, what the endowment funds are being spent on, the amount and percentage of the endowment being spent, how those endowment funds are being invested and the size of the endowment. Further, the Committee noted the "ever-growing endowments" of public charities, which unlike private foundations, have no legal minimum distribution requirement.

The focus of the Congressional inquiry involves matters not addressed by the commensurate in scope test. For example, the Committee appears to concentrate on the lag between the time of the donation and the subsequent use of that donation by the university. The Committee then uses this lag time to indicate that the university is not providing enough of a charitable benefit. However, the commensurate test has never examined the period between the time a contribution is made and the time it is used.

Moreover, the Committee's questions address only the charitable benefit of money that is given to the students in the form of student aid. The Committee indicated in its communications that it was seeking answers regarding endowment growth and spending on student aid. A university's charitable benefit traditionally has been considered to be broader than the money that is spent per year on students' financial aid. For example, historically an appropriate use of an endowment would include improving a classroom or laboratory or library, which will benefit its students in the long term. The Committee's definition of the commensurate test is particularly limited and not suited to a determination of whether a university has met the primary purpose test, and is therefore entitled to its charitable tax-exemption.

Finally, the Committee suggests that the commensurate test may impose some requirement that a portion of the endowment be expended currently. While the IRS's rulings have stated that the level of expenditures on charitable activity are a significant element of the proof of an organization's primary charitable purpose, no ruling has required any minimum expenditure from its investments, especially where the organization directly conducts a charitable activity, as is the case with a school or hospital, and makes substantial expenditures in conducting that activity.

The inappropriateness of the commensurate test to address the questions presented by Congress can be illustrated by the analysis of the following example under current law. An organization operates a school with a regular faculty and students, including those with special needs. The school is funded exclusively through income from the endowment and no tuition is charged. However, the school's endowment is many times in excess of its needs and only a tiny portion of the income generated is spent each year on the school. Assume also that the

organization employs more professionals to manage the endowment than it does teachers at the school, but that all of the organization's funds will ultimately be used for charitable purposes.

Under the commensurate test, it is clear that this organization would qualify for tax exemption. The operation of the school demonstrates that its primary purpose is charitable. In addition, its non-charitable activity, managing its endowment, produces funds that will ultimately be used for charitable purposes. No ruling applying the commensurate test would reject tax-exempt status in this situation. Moreover, under current law, while it is not entirely clear whether or not such an organization would meet the primarily test to qualify as an educational organization, substantial arguments can be made that because its sole charitable activity is the operation of the school with a regular student body and regular faculty, the primarily test is satisfied. Nevertheless, it is exactly this situation which presents the issues as to use of the endowment that have received Congress' attention. It is also clear that the commensurate test does not address the salient issues.

Despite our view that the commensurate test is not appropriate to address the issues raised by Congress with regard to the growth and use of endowments and other assets of charitable organizations, we recognize that Treasury and the IRS may feel compelled to offer guidance in this area. In that regard, we believe that the history of the commensurate test and the nature of the Congressional questions argue for caution.

In particular, there are difficult issues to be faced in providing rules which would impact the use or decision to use endowment funds of public charities. Organizations such as schools and hospitals may have many competing needs or claims for funds, each of which would be considered "charitable" under current law. The questions raised by Congress seem to suggest

that a differentiation among charitable activities or expenditures under which some (such as financial aid) would qualify but others may not. For example, under current law, a school may use its endowment funds to build new athletic facilities, which would certainly be considered a charitable activity. Such an expenditure would not reduce the cost of education, but arguably improve its quality. It is uncertain whether the Committee would view such an expenditure as satisfying a current payout requirement. Finally, as is the case with any ongoing business operation, it may be appropriate that funds be accumulated to insure the organization's long term health or expended on projects which do not reduce costs to students or patients. Next, evaluations may need to be made concerning the manner in which otherwise charitable activities are conducted. In particular, how the organization expends its funds may also depend upon how it obtains support, particularly if it charges for its charitable services. Thus, an organization that does not charge tuition may be viewed differently from an organization that charges full tuition to all students and operates at a net profit after its revenues from tuition and other activities are taken into account. Finally, absent a Congressional change, any application of the commensurate test would need to conform to the statutory primary purpose test, which by its nature looks to all facets of the organization's operation. In other words, any reinvigorated commensurate test may be one factor in a more involved examination of a charitable organization's primary purpose but should not be applied without regard to other important factors that indicate an organization's "primary purpose."

These considerations present fundamental policy questions concerning qualification for tax exemption. Equally important, the questions presented require a reexamination of well settled law. In those cases, it would seem that the issues are best addressed by Congress, rather than the IRS. Nevertheless, we understand that the IRS may need to be responsive to the

concerns of the Senate Finance Committee that organizations with large endowments and investment income are not spending a sufficient amount on charitable activities. If the IRS feels compelled to act, we believe that any such regulatory guidance should be carefully limited in scope, leaving Congress ample room to address the broader issues. Accordingly, we offer the following suggestions for approaches to be undertaken if the IRS comes to a decision to offer additional guidance.

1. As we have noted above, Congress has addressed the issue concerning a requirement that certain charities dispense a minimum amount of funds on a current basis in order to maintain their tax-exempt status. Given that Congress has spoken in a specific manner (and has exempted public charities from the minimum distribution requirement imposed on private foundations), we believe it would be imprudent for the IRS by regulation to attempt to impose such a requirement on public charities. Rather, even if the IRS believed that it had such authority, the better course would be to let Congress make that determination.

2. Second, any guidance should explain the role of the commensurate test in the context of examining all of the factors involved in assessing an organization's primary purpose. This would involve determining not only what the commensurate test is intended to measure or compare, but also how it would be applied in making an overall determination. For example, the IRS should make it clear in any guidance that (absent specific Congressional action), a school with even an excessive endowment (but no private inurement or private benefit) will continue to remain tax-exempt so long as there are actual substantial expenditures for the school and its activities.

3. Although we believe that any numerical test may seriously impair the functioning of tax-exempt organizations, to the extent that some numerical test is applied, the IRS's guidance should do no more than provide a safe-harbor spending floor (for example, a percentage of net asset value must be spent on charitable programs each year similar to that in the private foundation and medical research area). If such an approach is adopted, we understand that the test may be set at a level sufficient to insure that there is a consensus that such expenditures demonstrate satisfaction of the primary purpose test. While this may aid organizations that seek certainty that they are meeting the primary purpose test, we are concerned that it should not become a standard which all organizations will seek to achieve. Accordingly, similar to the safe-harbor in the intermediate sanctions area, no inference should result from an organization's failure to meet the safe harbor. Also in connection with any safe harbor, the IRS should provide a mechanism to include amounts set aside for future projects in those expenditures qualifying for the safe harbor. Such a procedure exists for private foundations and could serve as a precedent for the approach here.