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RECOGNITION UNDER SECTION 501(C)(3) OF THE INTERNAL REVENUE CODE AS A PREREQUISITE TO ARTS GRANTS:
A SPECIAL PROBLEM FOR LITERARY PUBLISHERS AND ART GALLERIES

MICHAEL E. SKINDRUD*

The arts in America have experienced rapid, recent growth. A major factor has been the infusion of public money. The National Endowment for the Arts was established in 1965 with five million dollars to distribute as grants-in-aid, a sum now exceeding $100 million.1 State legislatures have increased their arts expenditures as well.2 Arts organizations, from the largest museum to the smallest community council, are in active competition for the arts dollars dispensed by these agencies.3

As a prerequisite to receipt of arts dollars from both public and private sources, arts organizations are frequently required to obtain recognition of exemption from federal income taxation under section 501(c)(3) of the Internal Revenue Code of 1954.4 Their application for recognition to the Internal Revenue Service comes at a time of increased congressional regulation of tax exempt organizations.5

Certain organizations have difficulty in obtaining recognition because they are perceived by the Internal Revenue Service as operating a trade or business for profit, or as delivering private, not public, benefits. Inability to achieve recognition under section 501(c)(3) curtails their ability to raise funds and frustrates the funding programs designed to assist them.

This Article will examine the origin and impact of section 501(c)(3) recognition as a prerequisite to arts grants. Arts organizations which have the most difficulty obtaining recognition under section 501(c)(3) include small presses and literary magazines, organizations which assist visual artists with marketing, and certain arts service organizations. Their special problems in obtaining recognition will be examined.

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2 For example, Minnesota’s biennial appropriation for the State Arts Board increased from $1 million in 1976 to $4 million in 1977. 1976 MINN. LAWS ch. 3, § 5, subd. 4; 1977 MINN. LAWS ch. 332, § 4, subd. 3.

3 For this Article, arts organizations will include those organizations whose activities are within the funding concern of the National Endowment for the Arts. See NATIONAL ENDOWMENT FOR THE ARTS, GUIDE TO PROGRAMS (August, 1976) [hereinafter cited as GUIDE TO PROGRAMS].

4 See note 22 infra for text of section.

5 Most significantly Congress imposed a tax on unrelated business income by the Revenue Act of 1950, ch. 994, 64 Stat. 906 (now I.R.C. § 501(b)) and imposed restraints on private foundations in 1969, some of which were modified in 1976 and are currently found in I.R.C. §§ 4940-4948.
This Article suggests the appropriate test for recognition of exemption under section 501(c)(3) for organizations whose sole activity is a business which furthers their exempt purposes. This includes most small presses and literary magazines. The appropriate test is whether an exempt purpose, or profit, is the primary motive for the organization. The test used by the Internal Revenue Service, whether the business is similar to commercial enterprises, often fails to measure profit motive, particularly when applied prior to the commencement of the business, and may improperly prevent recognition of exemption.

This Article will also suggest that exempt organizations may confer private benefit if private benefit is a vehicle for achieving a greater public benefit. Thus, art galleries which assist gifted artists to achieve self-sustaining economic levels, assist with services those they could assist with direct money grants. They serve the public by encouraging the arts and may be recognized under section 501(c)(3) for the public benefit they confer.

Finally, this Article recommends that state arts agencies and private funding sources develop programs permitting direct funding to organizations not exempt under section 501(c)(3), and suggests that they use fiscal agents, fellowship programs, and contracts for services to meet their legislative and charitable goals.

Recognition Under Section 501(c)(3) as a Grantee Requirement

Qualification as a section 501(c)(3) organization is an important prerequisite to the raising of funds. First, it is important for raising funds from individuals and corporations. Recognition by the Internal Revenue Service that an organization is of the type described in section 501(c)(3) will exempt the organization from federal income taxation, and will generally qualify the organization under section 160(c) which allows contributors to deduct their contribution to it from their taxable income. This benefit to contributors may be less significant to small donors who do not itemize personal deductions, but it provides a key incentive to major individual contributors and corporations.

Second, qualification under section 501(c)(3) and section 170(c) enables an organization to secure funds from the National Endowment for the Arts. The legislation which created the Arts Endowment limits the agency’s direct grant recipients:

6 I.R.C. § 501(a).
7 I.R.C. § 170(a)(1). See note 23 infra for text of section 170(c). Not all section 501(c)(3) organizations qualify under section 170(c), which requires that the recipient of a charitable contribution be created or organized in or under the laws of the United States, its states or possessions, and that a contribution by a corporation be used within the United States. Also, certain entities qualify under section 170(c) which are not found within section 501(c)(3), including states and their subdivisions, war veterans groups, fraternal societies, and cemetery companies.

8 Corporations may deduct up to five percent of their net taxable income for charitable contributions. I.R.C. § 170(b)(2). Individuals may deduct varying amounts under section 170(b)(1), to a maximum of 50 percent of their contribution base for the taxable year. Contribution base is defined as adjusted gross income, computed without regard to any net operating loss carryback for the taxable year under section 172. I.R.C. § 170(b)(1)(F).
Any group shall be eligible for financial assistance pursuant to this section only if (1) no part of its net earnings inures to the benefit of any private stockholder or stockholders, or individual or individuals, and (2) donations to such group are allowable as a charitable contribution under the standards of subsection (c) of section 170 of Title 26.9

This grantee requirement ensures that the organization can raise funds from the private sector, a key to congressional purpose. The federal funds dispensed by the Arts Endowment are designed to stimulate private philanthropy to benefit the arts.10 The grants given to groups represent only one half the cost of the funded project. The other one half must be raised by the grant recipient.11 This matching grant mechanism is designed to stimulate private donations.

Third, qualification under section 501(c)(3) may be a prerequisite for grants from state arts agencies. These state agencies receive money for redistribution from state legislatures and from the National Endowment for the Arts. As with the Arts Endowment, state agencies must require a fifty percent match for most of their grant recipients who receive federal money through them.12 Unlike the Arts Endowment, however, state agencies are not required by the receipt of federal money to give only to organizations which qualify under section 170(c). In this respect, state arts agencies have greater flexibility than the Arts Endowment in choosing grant recipients.13

Nonetheless, a number of state arts agencies have imposed a tax-related requirement for organizations applying for grants. Among twelve agencies sampled at random, state legislation binds only one, requiring that organizations which receive grants from that agency qualify as tax exempt under state law.14 Two sampled agencies have no tax-related applicant restriction.15 The others have adopted as agency policy some form of tax qualification for groups receiving grants.16

Finally, recognition as an organization described in section 501(c)(3) can

13 Other federal grantee requirements however are passed on to grantees of states receiving federal funds, including the requirement that their projects and productions meet federal criteria for selection, 20 U.S.C. § 954(g)(1) (Supp. V 1975), and that they meet federally set minimum labor standards, 20 U.S.C. § 954(i), (j) (1970).
14 Minnesota State Arts Board, MINN. STAT. § 139.07(d) (1976).
15 These two agencies require only that organizational applicants be nonprofit: California Arts Council and Illinois Arts Council.
16 Two state agencies require all applicant organizations to qualify under section 170(c): Colorado Council on the Arts and Humanities and Oregon Arts Commission. Two agencies require all organizational applicants to be tax exempt: Texas Commission on the Arts and Wisconsin Arts Board. The New York State Council on the Arts requires either tax exemption under 501(c)(3), a state education charter, or state charities registration. The others require either section 170(c) or 501(c)(3) qualification for larger, institutional applicants seeking operational funds, but require only nonprofit character or other applicants: Connecticut Commission on the Arts, Georgia Council for the Arts and Humanities, Kentucky Arts Commission, and Michigan Council for the Arts.
significantly improve funding prospects from private sources themselves exempt under section 501(c)(3). Money flowing from a section 501(c)(3) grantor to an organization not so qualifying may endanger the tax exemption of the grantor. It is proper to grant funds to an organization not itself exempt if the grant furthers the tax exempt purposes of the grantor, and if the grantor retains control and discretion over the funds.\(^\text{17}\) If the grantor is a private foundation,\(^\text{18}\) it will pay a tax on each grant to an organization not itself qualifying as a public, section 501(c)(3) organization, unless the grantor assumes "expenditure responsibility" for the grant.\(^\text{19}\) A grantor may not wish such control or involvement with its grantees. If so, it will seek only grantees which qualify as public, section 501(c)(3) organizations.\(^\text{20}\)

**QUALIFYING AS A SECTION 501(c)(3) ORGANIZATION**

1. *Arts Organizations Generally*

Charitable organizations have long received benefits within the federal tax scheme.\(^\text{21}\) They are exempt from federal income tax if they are described in section 501(c)(3).\(^\text{22}\) Their contributors receive tax deductions if they are described in section 170(c).\(^\text{23}\)

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\(^{18}\) For the distinction between private and non-private foundations, see I.R.C. § 509.

\(^{19}\) I.R.C. § 4945(a).


\(^{22}\) I.R.C. § 501(c)(3) states:

- Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

\(^{23}\) I.R.C. § 170(c) states in part:

For purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of —

1. A State, a possession of the United States, or any political subdivision of any of the foregoing or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes.

2. A corporation, trust, or community chest, fund, or foundation —

   a. created or organized in the United States or in any possession thereof, or under the laws of the United States, any State, the District of Columbia, or any possession of the United States;

   b. organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals;

   c. no part of the net earnings of which inures to the benefit of any private shareholder or individual; and

   d. which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or
Historically, the statutory term "charitable" has included educational purposes.\textsuperscript{24} Arts organizations are regarded as educational organizations, since they educate the public to various art forms. The regulations under section 501(c)(3) indicate that "educational" relates to:

(a) The instruction or training of the individual for the purpose of improving or developing his capabilities; or

(b) The instruction of the public on subjects useful to the individual and beneficial to the community.\textsuperscript{25}

Arts organizations qualifying under section 501(c)(3) include: museums and symphony orchestras;\textsuperscript{26} organizations presenting public discussions, forums, panels, and lectures;\textsuperscript{27} groups which perpetuate group harmony singing,\textsuperscript{28} organizations which teach dance and commission its composition and performance;\textsuperscript{29} repertory theatres;\textsuperscript{30} organizations which assist communities in establishing repertory theatres;\textsuperscript{31} community concert association;\textsuperscript{32} and organizations which promote jazz through the sponsorship of festivals.\textsuperscript{33} Arts organizations commonly understood as cultural have little difficulty achieving recognition under section 501(c)(3). The key to recognition is their educational purpose.\textsuperscript{34}

2. Organizations Which Operate a Trade or Business

Organizations with activities similar to those of commercial enterprises are denied recognition of exemption under section 501(c)(3) by the Internal Revenue Service. The arts organizations most affected by this test are small presses and literary magazines, and arts service organizations which provide management and other business services for a fee.

Section 501(c)(3) requires that exempt organizations be "organized and operated exclusively for religious, charitable, scientific ... literary, or..."

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\textsuperscript{26} Treas. Reg. § 1.501(c)(3)-.501(1)(d)(3)(ii)(4)(1959). See also S. 1176, 1 C.B. 147 (1919) in which it was determined that the pleasurable and social nature of arts performances did not detract from the educational worth of the instruction to the arts provided by such performances.


\textsuperscript{28} Rev. Rul. 66-46, 1966-1 C.B. 133.


\textsuperscript{30} Rev. Rul. 64-175, 1964-1 C.B. 185.

\textsuperscript{31} Rev. Rul. 64-174, 1964-1 C.B. 183.

\textsuperscript{32} Rev. Rul. 73-45, 1973-1 C.B. 220.


\textsuperscript{34} Bittker & Rahdert, supra note 24, at 335, indicates a significant rationale for granting tax exemption to arts and educational organizations: "[I]t is precisely in the area of education, including the arts, that private institutions are especially well suited to serve as independent centers of power and influence in our society, fostering innovation and diversity with a dedication that government agencies can seldom muster or sustain."
educational purposes." Commercial-type activities by an exempt organization suggests commercial purposes, which if sufficiently present, prevent recognition as an organization "operated exclusively" for exempt purposes. Commercial or for-profit purposes are not among those enumerated in section 501(c)(3).

Before recognition under section 501(c)(3) may be granted or denied, one issue for resolution is whether the business activities of the organization further its exempt purposes. If they do further its exempt purposes, the second issue is whether exempt purposes or profit motive are the primary purposes of the organization.

a. Small Presses and Literary Magazines Described

Small presses and literary magazines may be described generally as nonprofit organizations whose sole activity is the publication and sale of literary work. Often, they are reliant on a single editor. They seek gifted writers who are young or infrequently published. The publications give voice to quality writing not found in commercial literature, writing frequently associated with a particular geographic region. Press runs are small, but effective distribution is sought, often through commercial outlets. Writers may be paid royalties, which in some cases may be required by the grants they receive. They generally rely on grants and volunteer energy to survive.

To the extent that small presses and literary magazines resemble commercial publishers, they have difficulty in obtaining recognition under section 501(c)(3). The first issue is whether publication and sale of literature furthers their exempt purpose — the education of the public to quality writing. Assuming that publication does further their exempt purpose, the second and central issue is whether their primary motive for the publication and sale of literature is public education rather than profit generation.

b. Regulations Test Primary Purpose of Related Business

To receive recognition under section 501(c)(3), an organization must be "operated exclusively" for exempt purposes. The regulations allow an exempt organization to carry on unrelated activities which do not further exempt purposes, but only to an insubstantial degree. The regulations regard an organization as operated exclusively "only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose."

The regulations permit an exempt organization to carry on a related

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35 See note 22 supra for the full text.

36 The terms "small presses" and "small literary magazines" appear in Guide to Programs, supra note 3, at 33, but the terms remain undefined. The publications here considered are those with literary, not graphic emphasis. The latter are frequently marketed as a limited edition fine print.

37 Grants to small presses from the National Endowment for the Arts require authors to receive a minimum of 10 percent of the edition as partial payment of royalties. Guide to Programs, supra note 3, at 33.

business activity which furthers its exempt purposes. What is not permitted is the conduct of a related trade or business for the primary purpose of profit. The regulations express this by prohibiting recognition under section 501(c)(3) to organizations whose primary purpose is carrying on an unrelated trade or business.\(^{39}\)

An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes 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. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes.\(^{40}\)

Thus, the regulations test an organization with related business activity by its primary purpose. If the primary purpose of an organization's related activities is the furtherance of exempt goals and not profit, then recognition under section 501(c)(3) is permitted by the regulations.

c. Courts Test Primary Purpose of Related Business

Courts also use the test of primary purpose to determine whether an organization which operates a related business may qualify under section 501(c)(3). Frequently cited in court opinions is Better Business Bureau of Washington, D.C., Inc., v. United States, in which the United States Supreme Court considered a corporate taxpayer's exemption from social security taxes under language similar to section 501(c)(3) and found in the Social Security Act. The Court concluded that "in order to fall within the claimed exemption, an organization must be devoted to educational purposes exclusively. This plainly means that the presence of a single noneducational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes."\(^{41}\) The Court denied the exemption because a substantial purpose of the organization was commercial and non-exempt — the creation of a profitable business climate for the city.\(^{42}\)

\(^{39}\) The regulations under I.R.C. § 513 define unrelated income as money produced by that portion of related activity conducted on a scale larger than necessary for the performance of exempt functions. Treas. Reg. § 1.513-1(d)(3) (1967). This suggests that a related trade or business may become unrelated if its scale of operation exceeds by some degree exempt purposes. One way a related trade or business exceeds exempt purposes is its operation for profit, and if the organization exists for the primary purpose of an unrelated trade or business, recognition of exemption is not permitted.


\(^{41}\) 326 U.S. 279, 283 (1945).

\(^{42}\) One commentator suggests that Better Business Bureau is misapplied to organizations with commercial-type activities, since the commercial goals of Better Business Bureau, not its activities, were at issue in that case. Note, Profitable Related Business Activities and Charitable Exemption under Section 501(c)(3), 44 Geo. Wash. L. Rev. 270, 280 (1976).
In determining whether profit is a substantial purpose of an organization, courts ask whether the related business is conducted primarily for the furtherance of exempt goals, or whether the focus of the related business is upon its ability to generate income. The Tax Court has found exempt purposes primary for an organization which manufactures and sells pyrometric cones at a profit and which carries on research activities. Religious and charitable motives were found primary for a burial association operating at a profit. Another court permitted tax exemption to a profitable parking ramp where exempt purposes were found primary. Tax exemption was denied on a finding that profit was the primary motive for an investment education service, and for a resort and educational center.

The three cases most relevant to small presses and literary magazines all dealt with the publication and sale of religious literature as a sole or predominant activity. These include Scripture Press Foundation v. United States, Fides Publishers Association v. United States, and Elisian Guild, Inc. v. United States.

In each case, publication was found to be an activity which furthered exempt purposes. The court in Fides Publishers Association stated that "[t]he publication of literature is, concededly, the 'common method in carrying out the religious and educational purposes of any exempt organization.' . . . It cannot be logically argued otherwise." For small presses and literary magazines, publication furthers an exempt purpose — public education in literature and the art of writing. This resolves the first issue for recognition under section 501(c)(3) for small presses and literary magazines.

The next issue addressed in each case, and the key issue for small presses and magazines, is whether profit motive is sufficiently present to prevent recognition under section 501(c)(3). Scripture Press Foundation, a nonprofit Illinois corporation without denominational ties whose declared purpose was the betterment of Protestant Sunday Schools, furthered this purpose by the publication and sale of competitively-priced lesson material. Sales yielded accumulated capital and surplus in 1951 of $476,311, growing to $1,610,817 in 1957. During those same years, Scripture Press Foundation spent comparatively small sums from this profit, $21,000 to $72,000 annually, on other religious education activities.

45 Monterey Public Parking Corp. v. United States, 321 F. Supp. 972, 976 (N.D. Cal. 1970), aff'd, 481 F.2d 175 (9th Cir. 1973). See also Golden Rule Church Ass'n, 41 T.C. 719 (1964), in which several small businesses were operated for religious purposes, and Rev. Rul. 73-128, 1973-1 C.B. 222, in which toys were manufactured for educational and charitable purposes.
49 263 F. Supp. 924 (N.D. Ind. 1967).
51 263 F. Supp. at 935.
The Court of Claims concluded that financial gain was the primary end to which sales were directed and that "the sale of these materials, however religiously inspired, involved the plaintiff directly in the conduct of a trade or business for a profit." The presence of large profits alone did not force this conclusion. The test of "operated exclusively" for exempt purposes was this: "was the sale of religious literature by the plaintiff in this case incidental to the plaintiff's religious purposes? Or were plaintiff's religious objectives incidental to the sale of religious literature?"

The sole activity of Fides Publishers Association, a nonprofit Indiana corporation, was the publication and sale of religious literature. It achieved a profit in five of the nine years in question, the final year of which it had net sales of $221,049 and a net worth of $55,287. It promoted sales by advertising in Catholic magazines and by substantial direct-mail advertising. It priced its publications to return a profit. The district court found one purpose of Fides Publishers Association was the publication and sale of religious literature for profit. While the court did not find the profit motive to be primary, it did find profit motive to be substantial, thus defeating the claim to exemption.

Elisian Guild, Inc. published and sold nondenominational religious literature as its sole activity. The literature was priced to recover costs, including editorial costs. The operation was small, with 400 books typically sold in each year, and royalties were not paid. The Court of Appeals found the organization to be exempt on a test of "whether the Guild's exempt purpose transcends the profit motive rather than the other way around." An operational profit had never been achieved, as evidenced not by poor business planning but by a lack of profit motive.

Small presses and literary magazines resemble Elisian Guild, Inc. in size and operation. Their works are priced to return only costs, including overhead. Though they promote their works, sales tend to be regional and press runs small. The contents of the publications reflect editorial criteria which focus on the quality of writing and not salability. Though writers may be paid, volunteer time remains an essential aspect of these operations.

Courts ask whether the primary purpose of an organization whose activities are related to exempt purposes is the furtherance of exempt purposes, or profit. Small presses and literary magazines, like Elisian Guild, Inc., publish to further their exempt purposes, and these purposes are primary.

d. I.R.S. Test is Similarity to Commercial Practices

In determining the exemption of organizations which publish as their sole activity, the Internal Revenue Service examines the similarity of the organization's publishing activity to commercial practices. The Service looks for similarity in content, manner of assembly, and manner of distribution. If an
organization's practices are similar to commercial publishers in these respects, exemption is denied.

In two cases, an ethnic weekly newspaper\textsuperscript{57} and a foreign language magazine\textsuperscript{58} were denied recognition as exempt because their content was judged similar to other commercial community and foreign-language publications. They also sold advertising, distributed by newsstand and by subscription, and paid their staffs as any other commercial publication might do. In another ruling, the sharing of royalties between publisher and authors was cited as evidence of an enterprise conducted in an essentially commercial manner.\textsuperscript{59} In still another, a publication containing church news and distributed by solicitation within churches was recognized under section 501(c)(3), although it had income from advertising and subscription sales.\textsuperscript{60} Finally, two publications containing scientific articles were sold either below cost or distributed without charge. They were prepared by scholars donating their time or by those with special skills. Both were recognized as exempt.\textsuperscript{61}

Small presses and small literary magazines are often denied exemption on a test of similarity to commercial practices because their manner of assembly and distribution are frequently similar to commercial practices. They attempt to pay their writers and to distribute effectively, although press runs are not large. The contents of the publications, however, are not similar. The difficulty is that the distinction between quality literature with little commercial potential, and writing with commercial potential, is not commonly apparent. The small presses and magazines seek writing which commercial publishers do not publish for lack of sufficient market. Without small presses and literary magazines, much writing of quality would be unavailable to the public. It is difficult to demonstrate that editorial decisions are primarily based on quality and educational considerations, and not on profitability, especially prior to the commencement of publication. A period of operation would demonstrate editorial decision in operation.

The test of similarity to commercial practices fails to reach the legal conclusion that profit is the primary motive for business activity which furthers exempt purposes. The practices are evidence as to purpose,\textsuperscript{62} but even the presence of profit is not conclusive of profit motive.\textsuperscript{63} If there is no profit, the issue is whether such was the result of poor business planning or the lack of profit motive.\textsuperscript{64}

\textsuperscript{60} Rev. Rul. 68-306, 1968-1 C.B. 257.
\textsuperscript{61} Rev. Rul. 67-4, 1967-1 C.B. 121 and Rev. Rul. 66-147, 1966-1 C.B. 137. See also INTERNAL REVENUE SERVICE EXEMPT ORGANIZATIONS HANDBOOK § 3(11)2.2(6) (IRM 7751, 1977), where the primary purpose test is stated, but organizations which educate the general public are said to have greater difficulty in showing that business purpose is not primary.
\textsuperscript{64} Elisian Guild, Inc. v. United States, 412 F.2d 121, 125 (1st Cir. 1969). See also Note,
Though the test of similarity to commercial practices may be a better measure of potential competition with commercial enterprises, competition or lack of competition is not the test for recognition under section 501(c)(3). Congress enacted the unrelated business tax to control competition from unrelated business activities. Congress did not intend to deny tax exemption to organizations when business activities further exempt purposes.\footnote{See Edward Orton, Jr. Ceramic Foundation, 56 T.C. at 160-61; Desiderio, supra note 64, at 570. Note that until very recently, an organization denied recognition could not seek court relief from the Internal Revenue Service determination except in a suit to redetermine a tax deficiency or to determine a claim for refund, which would not be possible for organizations without profit. Thus, these organizations were denied section 170 benefits for fund raising without the opportunity for judicial review. The only option was to find a donor willing to test a denial of his deduction under section 170. Now section 7428, added by the Tax Reform Act of 1976, permits declaratory judgment actions brought by organizations denied recognition.}

e. The Test for Small Presses and Literary Magazines

The I.R.S. test of similarity to commercial practices does not show profit motive for small presses and literary magazines. These publications should be granted recognition under section 501(c)(3) on a showing that the literature to be published is selected for its quality of writing, and for its ability to educate the public to the art of writing and to new or unavailable writing. A showing that literature will be priced to recover the cost of material and overhead, including editorial supervision, may be required. Limited distribution goals may also be shown. A period of operation should be allowed to demonstrate, as with Elsion Guild, Inc., that exempt, noncommercial purposes are primary for the organization.

f. When Publication Is Not the Sole Activity

When an organization's activities are not solely publication, but include other educational activities such as poetry readings, lectures, and seminars, it is easier to establish that profit is not the primary motive of the organization as a whole even when the profit from publication may be substantial.\footnote{A.A. Allen Revivals, Inc. v. Commissioner, 22 T.C.M. (CCH) 1435 (1963).} Publication may then be viewed as an integral part of a total program of activities which furthers exempt purposes.\footnote{Saint Germain Foundation, 26 T.C. 648, 658 (1956); Rev. Rul. 68-26, 1968-1 C.B. 272.} However, if the other exempt activities are minor compared with publishing activities, the question of profit motive remains.\footnote{Scripture Press Foundation v. United States, 285 F.2d 800, 804-05 (Ct. cl. 1961).}

g. Art Service Organizations

Organizations providing business services to exempt arts organizations have also been denied recognition under section 501(c)(3) because they
resemble a trade or business. Here, however, the issue is not the profit motivation of a business activity in furtherance of exempt purposes. Rather, it is the existence of any exempt purpose that is in issue. The providing of management services does not serve to educate the public in its own right, as does publication or the production of music or plays.

If an organization providing management services is to receive recognition under section 501(c)(3), it must provide below cost services to show donative and thus charitable purpose. If the exempt organizations served are related or indeed control the service organization, however, then the provision of services at cost will qualify it for exemption since the service organization becomes an extension of the exempts served.

3. Organizations Which Confer Private Benefit

To obtain recognition under section 501(c)(3), organizations must meet the statutory test that "no part of the net earnings inures to the benefit of any private shareholder or individual." Under this language, exemption has been denied to organizations which pay the personal and living expenses of their founders, which provide loans to their substantial donors without adequate security or at below market interest rates, which as hospitals are operated to benefit their founding doctors while rendering negligible charitable care, or which pay excessive salaries to their officers.

Exempt organizations must also meet a related and broader test, found in the regulations, concerning public benefit:

An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this paragraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such interests.

For arts organizations, a major concern with the public-private benefit test

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69 One organization formed to promote dance had its exemption revoked and three arts service organizations formed to provide informational, managerial, and counseling functions were denied recognition as exempt. F. Mindlin, Art and the Law, 1, 6 (1976) [hereinafter cited as MINDLIN].


73 See United Hospital Services, Inc. v. United States, 384 F. Supp. 776 (S.D. Ind. 1974), in which a laundry serving several exempt hospitals was found exempt. Cooperative organizations serving hospitals and educational institutions are now provided for in section 501(e) and (f) respectively.

74 See I.R.C. § 501(c)(3), the full text of which is quoted in note 22 supra. See also Treas. Reg. § 1.501(c)(3)-501(1)(c)(2) (1959).

75 For a review of relevant cases, see 6 Mertens, Law of Federal Income Taxation § 34.13 (1975).

is that certain activities which benefit public interest also benefit the private interest of artists. Recognition under section 501(c)(3) has been denied to several arts organizations under this test.

a. Test for Private Benefit

Whether the presence of private benefit will jeopardize tax exemption depends upon several factual situations. First, private benefit sufficient to prevent recognition under section 501(c)(3) is more likely when the persons receiving private benefit either created the organization, or are shareholders of the organization. These persons are characterized by the regulations as private beneficiaries for whom the organization cannot be organized or operated. For example, in Benedict Ginsberg the creators of an organization formed to dredge a waterway for the safety of small craft were also the property owners adjacent to the waterway. They contributed to the organization in proportion to their access to the waterway. The Tax Court found private benefit to be the organization's purpose.\(^{77}\)

Second, when private benefit to individuals is indistinguishable from the public benefit conferred upon all, recognition of exemption will not be prevented. Several downtown merchants of Monterey, California formed a nonprofit organization to build and operate a parking ramp. They benefitted by the encouragement to downtown shoppers, but the court found that their benefit was indistinguishable from the benefit to all downtown merchants, and from the benefit to all in a healthy downtown and higher city property values.\(^{78}\)

Third, private benefit is permissible when it is the vehicle for achieving a greater public benefit. For example, the Internal Revenue Service has recognized under section 501(c)(3) an organization which provides low cost capital to for-profit businesses, not themselves in need of assistance, as an inducement to locate in areas of high unemployment and community deterioration.\(^{79}\) Also exempt are organizations which award unconditional, direct money grants to creators and scholars for projects which they would not be able to finish without funds, but which they may market later for personal gain. The public benefits from the encouragement to the arts and scholarship, and private benefit is but a vehicle to this end.\(^{80}\)

Fourth, exemption may be recognized when those receiving private benefit are themselves the objects of charity. An organization which operates a consignment store for the indigent to market their cooking and needle work for a small commission is exempt under section 501(c)(3). Exempt organizations may also provide assistance through services to those which they may assist with direct grants.\(^{81}\)

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\(^{78}\) Monterey Public Parking Corp. v. United States, 321 F. Supp. 972, 976 (N.D. Cal. 1970), aff'd, 481 F.2d 175 (9th Cir. 1973).


b. Benefit to Artists

The Internal Revenue Service has recognized under section 501(c)(3) several arts organizations which assist artists, but has denied recognition to organizations which assist visual artists by operating a consignment sale gallery. In one case, recognition under section 501(c)(3) was granted to an organization which exhibited films of unknown, independent filmmakers. While no film sales occurred at the film festivals, the recognition accorded filmmakers may have lead to subsequent financial reward. Such private benefit, however, "is merely a by-product of the organization's objective which is to promote a form of art."82

Recognition was also awarded an organization which exhibited unknown but accomplished artist not affiliated with art galleries. The works were not offered for sale, but a catalog listed the artists' names and addresses.83 Thus, when the work is exhibited only, the public benefit of education to an art form predominates and any private benefit to exhibited artists is acceptable.

Recognition may be denied, however, when sales of art works are an activity of the organization. A gallery was formed by 50 artists to exhibit and sell their own work.84 The gallery kept a commission on each sale to cover operating costs, and deficiencies were made up by special assessments against the members. In this case, those receiving private benefit were the ones who formed and controlled the organization. This ruling is consistent with the regulations which prohibit recognition to an organization operated for its own members' benefit. Here the intended, primary beneficiary is not the public. This reasoning has also been used to deny recognition to performing companies formed and guided by a single artistic director.85

A later ruling refused recognition to a sales gallery formed by art patrons for the purpose of promoting community understanding of modern art trends.86 The organization selected local artists for exhibition. When work was sold, a ten percent commission was retained by the gallery, a commission

85 A dance company was denied recognition under section 501(c)(3) where founded by its leading performer, who is paid in accordance with the company's fee structure. The public is charged admission to the company's performances. The Internal Revenue Service denied exemption, finding that the organization is operated for the benefit or aggrandizement of the performer(s), that it lacks donative intent, and that it is similar to a commercial enterprise. Mindlin, supra note 69, at 1.

Whether or not the company is operated for private benefit is in part a question of board composition and control. It must also be remembered that performance companies, especially in dance, are organized around a single artistic director. Furthering the public interest in art production frequently requires a subsidy to an organization directed by a single artistic voice. See text at note 92 infra for remarks of W. McNeil Lowery.

As for lack of donative intent, see Eastern Kentucky Welfare Rights Organization v. Simon, 506 F.2d 1278 (D.C. Cir. 1974), rev'd on other grounds, 426 U.S. 26 (1976), in which an exempt hospital is required to give free care only in its emergency room, but otherwise may refuse patients who are unable to pay. Part of the supporting reasoning was that health care is an activity long regarded as intrinsically charitable. Similarly, arts performance, long regarded as educational by its very nature, requires little showing of donative intent, a showing that should not be difficult since dance in America is hardly self-supporting.

86 Rev. Rul. 79-152, 1979-1 C.B. 152.
below that charged by commercial galleries and inadequate to meet costs. The ruling found private benefit to the artists chosen for exhibition, stating that:

Since ninety percent of all sales proceeds are turned over to the individual artists, such direct benefits are substantial by any measure and the organization's provision of them cannot be dismissed as being merely incidental to its other purposes and activities. The fact that the artists have no control over the selection does not change this conclusion.\textsuperscript{87}

The amount of sale proceeds returned to the artist does not, in itself, measure the balance of public and private interests served by exhibition and consignment sales as an activity of an exempt organization. Other factors must also be considered, including the public benefit from the encouragement of gifted artists. This public benefit is determined in the criteria for artist selection. Since no criteria were mentioned in the ruling, one conclusion is that the patrons selected their artist friends and operated the gallery for their friends' private benefit.

An arts organization which operates a consignment sales gallery as its sole activity may achieve recognition under section 501(c)(3). However, it must have clear public objectives and controls to meet those objectives. Two public benefits may be conferred. The first is education, in that the exhibition of art serves to educate the public to art forms.

The second public benefit is found in the encouragement of the arts through assistance to gifted and promising artists. The benefit received by artists in this case is similar to a grant or fellowship, awarded on the promise shown by an artist.\textsuperscript{88} The assistance enables the artist to exhibit, and provides an economic support for continued production. This kind of private benefit is a vehicle for achieving a greater public end, and on this basis recognition under section 501(c)(3) is consistent with prior revenue rulings.

The gallery must have controls to ensure that public ends are met. Artists should be selected for their creative promise alone. The salability of their work should not be a significant consideration, since salability is not a reliable mark of aesthetic quality. Additional requirements might specify artists who do not have adequate exhibition and sales opportunities elsewhere. Selection might be made by experts with independence from those who control the organization. Assistance might be terminated to artists once they have achieved self-sustaining economic levels apart from the gallery.

The gallery may take a commission to offset its cost, but it must be operated primarily for educational and other exempt purposes, not profit. If economic considerations are primary, the organization then operates a trade or business primarily for profit. On this ground, rather than on private benefit conferred, recognition under section 501(c)(3) will be denied.\textsuperscript{89} For this

\textsuperscript{87} Id.

\textsuperscript{88} Rev. Rul. 66-103, 1966-1 C.B. 134.

\textsuperscript{89} See text at notes 38-56 supra.
reason as well, the salability of an artist's work must not be a significant consideration for artist selection.90

In another ruling, the Internal Revenue Service accepted artist career assistance as a permissible exempt activity. Recognition has been awarded an organization which assists musicians in the latter stages of their training by conducting weekly workshops for them in concert technique, presenting them to the public in concerts for which it charges admission, and securing paying concert bookings for the artists without charging a booking fee.91 The organization terminates assistance to the artists when they become professionally self-sustaining.

The assistance of individual artists is a key concept for many exempt organizations which assist the arts, as reflected in those remarks by a former official of the Ford Foundation: "More than in most fields, any enterprise or activity in the arts is the reflection of one or more artistic talents, good, bad or indifferent. Strengthening the career development of the individual artist or artistic director is an objective that makes a natural bid for a very high priority."92 Assistance to individual artists is not an impermissible private benefit when it is controlled to serve articulated public goals.

c. Benefits to For-Profit Organizations

Another area of caution for arts organizations concerns the private benefits they may confer upon organizations not themselves exempt under section 501(c)(3).

Exempt organizations may use private interests to further public ends unless the exempt organization becomes a captive of the private interest. Community concert associations may enter exclusive contracts with private booking agents to provide professional theatre and music performances in their communities, even though the booking agents are instrumental in the formation of the association. However, the contract must not impose a controlling superstructure on the community association, and the association must be free to book elsewhere at the end of each year's exclusive contract.93

The promotion of the broadcast of classical music may be an exempt purpose, but an organization which assists a local for-profit radio station with solicitation of advertisers to retain a classical music program serves the private interests of that station.94 However, an exempt nonprofit organization was allowed to produce, and sell below cost, educational programs to for-profit cable television operators for use on their advertising-free educational or public access channels.95

90 Also, the gallery may restrict its artists to those meeting a low income qualification, bringing the gallery within the facts of Rev. Rul. 68-167, 1968-1 C.B. 255, where those receiving private benefits are themselves the objects of charity. If the sole activity of the gallery is not exhibition and sales, but it also carries on other activities commonly understood to be education, private benefit is further diluted and recognition under section 501(c)(3) becomes easier to obtain.


RECOMMENDATIONS FOR GRANTORS

When desired grant recipients are not exempt, state arts agencies, foundations, and other funding sources have several options. One is the use of "fiscal agents" who, as tax-exempt sponsors, receive the grant and administer the funded project. In passing on the grant to its ultimate intended recipient, the sponsor must ensure the furtherance of its own exempt purposes by retaining control and discretion over the use of the grant. If the grantor is not a private foundation, its grant may suggest the ultimate intended recipient, but the grant may not be so conditioned as to deprive the sponsor of its control and responsibility for the use of the funds. If the grantor is a private foundation, the regulations govern selection of secondary grantees.

Another option is direct grants to non-501(c)(3) recipients. The grantor must retain control and discretion over the use of the grant for exempt purposes. Private foundations must assume "expenditure responsibility" over organizational recipients or receive prior approval from the Internal Revenue Service for grants to individuals. Direct grants from state arts agencies to organizations not exempt under section 501(c)(3) are not prohibited by the receipt of federal funds, nor by state legislation in most cases. State arts agencies should use this flexibility in designing grant programs for certain organizations not exempt under section 501(c)(3). Small presses and literary magazines, as well as art marketing organizations, might be served by such grant programs. Also, new small or neighborhood arts organizations should not be required to obtain recognition as a grant prerequisite since such groups may be formed for a one-time project, or may evolve substantially before permanent form is achieved.

As recipients increase in number and grants increase in size, it becomes appropriate to require recognition under sections 501(c)(3) and 170(c). Larger recipients need section 170(c) benefits to successfully raise their grant match. State arts agencies need protection for their larger grants, protection provided by Internal Revenue supervision of grantees under section 501(c)(3). Several states use sliding scales of grantee requirements which effectively serve the agency objectives.

Other options include individual fellowship programs to artists who work for organizations not eligible for direct grants, and contracts for services to artists for specific production projects.

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97 The National Endowment for the Arts provides support to the exempt Coordinating Council of Literary Magazines, support which is earmarked for grants and services to magazines the Arts Endowment cannot directly fund because they do not qualify under section 170(c). Guide to Programs, supra note 3, at 35.
100 I.R.C. § 4945(d)(4).
101 See text at notes 12-14 supra.
102 See note 16 supra. Of the sampled agencies, the arts agencies of Connecticut, Georgia, Kentucky, and Michigan base tax requirements on the size of the applicant and the requested grant.
103 The National Endowment for the Arts awards matching grants in the form of fellowships to small press publishers. Guide to Programs, supra note 3, at 33.
104 See cases cited in notes 59 and 93 supra.
Conclusions

Qualification as an organization within section 501(c)(3) is a necessary prerequisite to successful fund-raising among individuals and corporations. Thus, as a prerequisite for matching funds from the National Endowment for the Arts, it serves a key Congressional purpose — the stimulation of private giving to benefit the arts. For the same reason, state arts agencies should adopt this matching grant prerequisite for their major grant recipients.

While most cultural organizations secure recognition without difficulty, small presses and literary magazines are often denied recognition because they appear similar to commercial publishers. The distinction between literature selected for quality, and literature published for commercial gain, is not commonly apparent. Since the test for recognition under section 501(c)(3) for an organization with related business activity is whether exempt or profit motive is primary, the Internal Revenue Service should grant recognition on a preliminary showing of exempt purpose by small publishers, and should allow a period of operation to test the primary motive.

Consignment-sales art galleries also have difficulty in obtaining recognition under section 501(c)(3) because they confer private benefit to artists. With criteria for artist selection to ensure public purpose, however, such galleries may be recognized under section 501(c)(3) because they deliver a service to the same individuals which they could assist with fellowship grants. Career assistance for gifted artists is a vehicle to greater public benefit — the encouragement of the arts generally. However, both small publishers and groups which assist artists must articulate clearly their public goals and the controls they use to achieve those goals.

Finally, state arts agencies and other funding sources for the arts should develop grant programs which provide direct assistance to organizations which are either unable to obtain recognition under section 501(c)(3), or are too small or formative to justify such a grant prerequisite. In all cases, grant requirements should reflect and support funding goals to accomplish a strong and healthy creative climate.