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The "Inurement of Earnings to Private Benefit" Clause of Section 501(c):
A Standard Without Meaning?

Section 501(c) of the Internal Revenue Code requires of several of the enumerated tax-exempt organizations that no part of their net earnings inure to an individual's private benefit. The author of this Note traces the legislative history and the judicial development of the "benefit" clause to determine what Congress and the courts are actually attempting to achieve. He concludes that in applying the benefit clause to deny exemption to organizations because of the manner in which they acquire or distribute their earnings, courts have ignored the underlying purpose of the section 501(c) exemption. The result in one class of cases has been to invoke the benefit clause to decide cases to which it was never intended to apply; in another, to obscure the fact that a denial of exemption under the benefit clause represents a conclusion rather than the application of a standard.

Section 501 of the Internal Revenue Code exempts certain organizations from income tax. Among the various qualifications for several of these organizations is the requirement that no part of their net earnings inure to the benefit of any private shareholder or individual. The courts have purported to apply this requirement to two different classes of cases: first, where the conduct of the organization's tax-exempt purpose results in benefit to individuals; and second, where the organization conducts profit-making activities that are not related to its tax-exempt purpose. This Note will examine, in light of the objectives and limitations of the exemption, the legislative history and judicial interpretation of this requirement and determine the significance of the benefit qualification.

I. LEGISLATIVE HISTORY OF THE BENEFIT CLAUSE

The present language of section 501, "that no part of the net earnings of which inures to the benefit of any private individual or shareholder," originated in the corporation excise tax of 1909. The bill, as reported by the Senate Committee on Finance, imposed a tax upon "every corporation, joint stock company or association, organized for profit and having a capital stock represented by shares . . . "

The bill thus implicitly granted exemption to any corporation that was not organized for profit or had not issued capital stock. The meaning of "organized for profit" was unclear, however, and troubled a number of senators. Although the bill's supporters argued that the language served to exempt religious, charitable, and educational organizations and fraternal beneficiary societies, many senators remained unconvinced. Senator Augustus O. Bacon offered an amendment to exempt from tax "any corporation or association organized and operated for religious, charitable, or educational purposes, no part of the profit of which inures to the benefit of any private stockholder or individual, but all of the profit of which is in good faith devoted to the said religious, charitable, or educational purpose." When asked why he did not believe that these organizations were covered by the "organized for profit" language, Senator Bacon replied that he had in mind an organization known as the Methodist Book Concern, "which is a very large printing establishment, and in which there must necessarily be profit made exclusivley for religious, benevolent, charitable, and educational purposes, in which no man receives a scintilla of individual profit." He argued that such an organization "is organized for profit, but it is not organized for individual profit. It is organized to make a profit to extend religious work, and to extend benevolent work, charitable work, and educational work."
These statements do not clearly indicate whether Senator Bacon believed that the Methodist Book Concern should be exempt because its sale and distribution of reading materials alone constituted the performance of educational, religious, and charitable functions or because the profits derived from this activity were devoted exclusively to the support of such functions. His emphasis on the manner in which profits were distributed and his concession that the Book Concern was “organized for profit” indicate that he was concerned primarily with the distribution of income; so that the clause of his amendment “organized and operated for religious, charitable or educational purposes” referred to the use of income rather than the manner in which income was obtained. In any event, the substance of Senator Bacon’s amendment was enacted, with minor changes.10

Similar concern was expressed as to whether the bill exempted building and loan associations. Although the bill’s manager argued that it did since “a corporation that divides its earnings among its members is [not] a corporation for profit,” Senator Bacon moved that building and loan associations “organized and operated exclusively for mutual benefit, and no part of the profit of which inures to the benefit of any private individual” be expressly exempted. Immediately after proposing this amendment, however, Senator Bacon stated that he thought “it would be sufficient just to say ‘organized and operated exclusively for mutual benefit,’ and [he would] offer the amendment in that way.” In that form the amendment passed.14 Apparently Senator Bacon recognized that the clause dealing with the purposes of organization and operation effectively restricted the use of profit and obviated any necessity for an “inurement to benefit” clause. One may only speculate why he did not reach the same conclusion with respect to the exemption of religious, charitable, and educational organizations. In fact, he did not, and the result has been a proliferating use of the bene-

10. 36 Stat. 113 (1909). The word “exclusively” was inserted after “organized and operated,” and the clause requiring all profit to be “in good faith” devoted to religious, charitable, or educational purposes was deleted, in all likelihood because it was redundant.

11. 44 Cong. Rec. 3839 (1909) (remarks of Senator Flint). President Taft, however, apparently believed that building and loan associations were organized for profit, for in his original recommendations he proposed to impose a tax upon all corporations and joint stock companies for profit, except national banks, savings banks, and building and loan associations. 44 Cong. Rec. 3844–45 (1909), printed in S. Doc. No. 98, 61st Cong., 1st Sess. (1909).


fit clause throughout the exemption provisions of the income tax laws and a reliance upon it by courts as a ground for denying exemption.

II. PRIVATE BENEFIT INFERRED FROM DESTINATION

The "inurement to benefit" clause of section 501(c) denies exemption to organizations whose net earnings inure to the benefit of any private shareholder or individual. The Treasury Regulations define a "private shareholder or individual" as a person "having a personal and private interest in the activities of the organization." An early Treasury ruling containing a more definitive discussion of the phrase involved a private school, all of whose stockholders were active in its management and received dividends from net earnings. The school contended that the word "private" was introduced into the statute to distinguish between managing and investing stockholders. The Treasury, however, ruled that "private" was designed to distinguish between one who is benefited by earnings that inure incidentally to, or in satisfaction of, the organization's tax-exempt purpose and one who is benefited in any other — private — capacity. This construction of the statute appears preeminently reasonable; since every organization presumably is organized and operated to benefit certain individuals or groups, the only apparent way to distinguish between exempt and nonexempt organizations on the basis of their use of earnings is whether a particular use is consistent with the purposes upon which exemption is founded.

15. See note 2 supra.
16. See the sections of INT. REV CODE OF 1954 cited in note 2 supra.
19. It has frequently been said that net earnings inure to the private benefit of members of social clubs where they result in the maintenance of a level of club facilities and services notwithstanding a reduction in dues, or in a higher level of facilities and services without a corresponding increase in dues. See, e.g., Rev. Rul. 588, 1958–2 Cum. Bull. 266, 267. The difficulty with this test is that it could be met only if the net earnings were never used.

One court has used the following language to put the matter in perspective: "[T]hough every improvement in a charitable institution confers additional benefits on those using it, or availing themselves of its benefits, such benefits have never been considered as taking the institution out of the class of charitable institutions because it has enabled it to do better educational, literary or charitable work, or because it resulted in distributing its benefits among private shareholders or individuals." United States v. Proprietors of Social Law Library, 102 F.2d 461, 464 (1st Cir. 1939). Cf. Hutterische Bruder Gemeinde, 1 B.T.A. 1208 (1929) (determination that taxpayer was not operated for religious purposes, partly on ground that earnings inured to benefit of members beyond
Thus, the conferral of private benefit would appear to be wholly a definitional conclusion from a necessarily prior determination that the organization's income had been used in a manner inconsistent with the purpose upon which its exemption rested. The Treasury Regulations inversely recognize this logic: An organization that confers private benefit has departed from operation exclusively for exempt purposes.  

This peculiar relationship between purpose and private benefit results in making the meaning of private individual, shareholder, or member in any given case depend upon the scope of the exempt purpose. Thus, a recent Treasury ruling held labor organizations exempt notwithstanding that they had established death, sick, and accident funds for the benefit of their members — the betterment of the condition of labor union members in this manner was one of the purposes for which the organization was granted exemption. Conversely, the expenditure of funds by an automobile club in aid of the war effort was held to defeat exemption because the club had conferred a benefit beyond the scope of its exempt purpose — it was not the exempt purpose of the club to benefit the entire country. Both of these decisions implicitly recognize that to accomplish the exempt purpose an organization must necessarily confer a benefit and that the important question is whether the benefit is within the scope of the purpose.

the scope of religious purposes); Rev. Rul. 78, 1962–1 Cum. Bull. 80 (propriety of distribution of income dependent upon basis of organization's exemption). Arguably the statement in Social Law Library would make equally good sense if any other tax-exempt purpose were substituted for "charitable." But see Part III of this Note, infra.

20. See Treas. Reg. § 1.501(c)(3)–1(c)(2) (1958); cf. Spokane Motorcycle Club v. United States, 222 F. Supp. 151, 153 (E.D. Wash. 1963) (plaintiff "may have been operated for exempt purposes provided all of the funds realized as net profits were used for exempt purposes..."


23. Smyth v. California State Auto. Ass'n, 175 F.2d 752 (9th Cir. 1949). See also Keystone Auto. Club v. Commissioner, 181 F.2d 402 (3d Cir. 1950). Where death, sick, and accident payments are made to members of a club, the club is held nonexempt on the ground that the payments are beyond the scope of exempt club purposes and hence constitute the inurement of earnings to private benefit. Polish Army Veterans Post 147 v. Commissioner, 238 F.2d 509 (3d Cir. 1956); Allied Trades Club, Inc. v. Commissioner, 228 F.2d 809 (3d Cir. 1956); Spokane Commercial Travelers v. Squire, 126 F. Supp. 424 (W.D. Wash. 1954).
A similar problem of deducing the scope of the exempt purpose arises frequently with respect to trusts and foundations seeking exemption under section 501(c)(3). For example, a trust or foundation that primarily benefits a relatively small group of individuals, such as the members of the settlor’s or founder’s family, in all probability will be denied exemption. On the other hand, an incorporated law library was held to be an exempt “educational institution” notwithstanding that its use was restricted to certain governmental officials and dues-paying subscribers. Whether exemption is denied or granted in cases such as these would seem to depend entirely upon the construction given the words “charitable,” “educational,” etc., by means of which the statute defines exempt purpose. From that construction will follow automatically the determination whether earnings have inured to private benefit.

A problem that has particularly vexed the courts is that of an individual who reserves the right to receive specified annuities from an otherwise clearly exempt organization created by him. The courts have rejected a categorical approach in this area because of their reluctance either to deny exemption to bona fide charitable organizations merely because the founder has reserved relatively small annuities or to exempt income received by the founder from a private investment. Instead, they have held organizations exempt or nonexempt largely on the basis of their

24. See United States v La Societe Francaise de Bienfaisance Mutuelle, 152 F.2d 243 (9th Cir. 1945), cert. denied, 327 U.S. 793 (1946) (use of income to provide members inexpensive medical treatment not in fulfillment of charitable purpose); Amy Hutchison Crellin, 46 B.T.A. 1152 (1942); Rice & Rice, Charitable Foundations and the Federal Income Tax, The Year Book of the Selden Society, Feb., 1948, p. 16. However, exemption has been granted, presumably on the basis of a finding of charitable purpose, where a foundation was established to provide financial relief to the employees and their families of a particular employer, so long as employee contributions represented only a minor portion of the organization’s revenue. See G.C.M. 10028, 1937–2 Cum. Bull. 125. But cf. C. R. Lindback Foundation, 4 T.C. 552, aff’d, 160 F.2d 856 (3d Cir. 1945).

25. United States v Proprietors of Social Law Library, 102 F.2d 431 (1st Cir. 1939); cf. Rev Rul. 403, 1956-2 Cum. Bull. 807 (exemption granted scholarship foundation whose beneficence was restricted to members of particular fraternity).


27. See 34 Va. L. Rev. 225, 226 (1948).


29. See Scholarship Endowment Foundation v Nicholas, 106 F.2d 552 (10th Cir. 1939), cert. denied, 308 U.S. 623 (1940); The Davenport Founda-
"dominant purpose," as determined by the size of the annuity reserved in relation to the size of the gift. Although this standard appears to conflict with the requirement of an "exclusive" exempt purpose, the two might be compatible where the charter or trust instrument does not require payment of the annuity from net earnings but places a charge upon the property in reduction of the gift which the exempt organization must pay to enjoy the remainder. This drafting technique would not, however, be likely to persuade a court to grant exemption where an amount of principal equal to the bulk of the income is payable in annuities to the settlor or founder for a substantial period of time.

In addition to the questions presented by current distributions of earnings, the courts have also been confronted with the problem of determining how to treat an organization whose charter or by-laws or the statute under which it was created permits distributions out of current or accumulated earnings or appreciated assets at some time in the future or at dissolution. Early Treasury rulings, emphasizing that the organizations under consideration were neither organized nor operated with the expectation of dissolution, held that the mere possibility of distribution at dissolution was too remote to constitute a basis for denying tax exemption. Although courts have, as a general rule, adopted this reasoning,
the Treasury Regulations provide that an organization will not be considered as organized exclusively for exempt purposes under section 501(c)(3) "if its articles or the law of the State in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders." The efficacy of this regulation is doubtful in jurisdictions where nonprofit organization statutes provide for distribution of assets at dissolution in accordance with the articles or by-laws of the organization, since they could be amended immediately prior to dissolution. Although the regulation may be less effective than a case-by-case examination of the history of each organization to determine the likelihood of future distributions of income, it does recognize an evident truth: The "organizational" purposes test rather than the "benefit" clause must be relied upon in denying exemption because of the possibility of future, illicit distributions of income. Thus, in this area, as in the area of present distributions, the propriety of the distribution can be determined only with reference to the purpose for which exemption was granted.

III. BENEFIT INFERRED FROM PROFIT-MAKING ACTIVITIES

Although the legislative history indicates that the benefit clause was apparently aimed at restricting the use of an exempt organization's income, courts in a number of cases have professed to infer a prohibited inurement of earnings to private benefit from the nature of the organization's profit-making activities, even

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36. E.g., Minn. Stat. § 317.57(2) (1961): "[W]here the articles or bylaws of the dissolving corporation, or the rules or canons of a superior body or entity by which the dissolving corporation is bound, provide for a particular distribution of the property and assets of the dissolving corporation, the property and assets shall be distributed accordingly."
though no private individual or shareholder within the meaning of the Code received any benefit. This part of the Note will show that the common characteristic of those cases was that the organization's profit-making activities were beyond the scope of the purposes for which exemption was granted; therefore, the denial of exemption in such cases might more properly be based upon violation of the "purposes" clause.

In three cases involving taxpayers seeking classification as "business leagues," exempt under predecessors of section 501(c)(6), the Board of Tax Appeals held that various services provided members at less than cost constituted an inurement of net earnings to private benefit. The net earnings had accrued to the organizations from the sale to nonmembers of goods and services, including: management of bankrupt properties; bill collecting; and life insurance and scientific research. The benefits respectively received by the members included: credit information; education of employees with respect to credit practices, public relations work directed toward the prompt payment of debts and the promotion of honesty; and the promotion of fair dealing in trade through the inspection and weighing of particular commodities. These benefits would appear to stem from activities "directed to the improvement of business conditions" in a line of business, rather than the performance of particular services for individuals; therefore, the conferral of benefit was within the scope of the tax-exempt purpose of a business league, for any benefit to members in their private capacities was incidental to achievement of the organization's tax-exempt purpose. If these organizations were to have been denied exemption, it should not have been done on the ground that their net earnings inured to the benefit of private

37. See text accompanying notes 16-20 supra.
38. Retailers Credit Ass'n, 33 B.T.A. 1166 (1936), aff'd, 90 F.2d 47 (8th Cir. 1939); Fort Worth Grain & Cotton Exch., 27 B.T.A. 983 (1933); Northwestern Jobbers' Credit Bureau, 14 B.T.A. 362 (1928), aff'd, 37 F.2d 880 (8th Cir. 1930).
40. Retailers Credit Ass'n, 33 B.T.A. 1166 (1939).
43. Moreover, in the Retailers Credit Ass'n case all earnings were derived from dealings with members. It has been stated in dicta in several cases that the forbidden private benefit does not arise in such circumstances. See West Side Tennis Club v. Commissioner, 111 F.2d 6 (2d Cir.), cert. denied, 311 U.S. 674 (1940); Jockey Club v. Helvering, 76 F.2d 597 (2d Cir. 1935); California State Auto. Ass'n v. Smyth, 77 F. Supp. 131 (N.D. Cal. 1948), rev'd on other grounds, 175 F.2d 752 (9th Cir. 1949).
individuals or shareholders, but that the organizations were not in fact business leagues within now section 501(c)(6), since a substantial purpose of each was "to engage in a regular business of a kind ordinarily carried on for profit." 44

A similar misapplication of the benefit clause has occurred in cases involving the exemption of clubs under the predecessors of section 501(c)(7). In Jockey Club v. Helvering, 45 exemption was denied a club that derived substantial net earnings from the operation of a race track. The court held that where a club derives income from "outsiders" over a sufficiently lengthy period to justify the conclusion that the derivation of profit is "deliberate," the club violates the statutory prohibition against inurement of net earnings to private benefit. Since all of the earnings were devoted to the Club's tax-exempt purpose of providing pleasure, recreation, and other similar benefits to its members, 46 the decision might better be based on the ground that the taxpayer was not in fact a section 501(c)(7) "club" because one of its substantial purposes was the operation of a race track for profit. That this was substantially what the court itself had in mind in articulating its test is indicated by the emphasis it placed upon the intent of the Club to engage in business for profit rather than upon the disposition of the resulting profit.

The same courts that decided Jockey Club reached the same result in a similar fact situation in West Side Tennis Club. 47 The taxpayer, having derived considerable income from national tennis tournaments held on its property, was denied exemption partly in reliance upon Jockey Club and partly upon the ground that taxpayer was not operated for exempt purposes. The case suggests two comments: First, the income derived by the Club from hosting the tournaments, like the income from the race track in Jockey Club, was used exclusively to finance the club activities that constituted the basis for exemption under section 501(c)(7); hence earnings did not inure to the benefit of members in their "private" capacities, but only as beneficiaries and users of the services and facilities provided by the Club pursuant to its tax-exempt purpose. Second, the Second Circuit stated by way of

44. Treas. Reg. § 1.501(c)(6)-1 (1958). One of the three cases was affirmed on that limited ground. Retailers Credit Ass'n v. Commissioner, 90 F.2d 47 (9th Cir. 1937).
45. 76 F.2d 597 (2d Cir. 1935), affrming 30 B.T.A. 670 (1934).
47. 39 B.T.A. 149 (1939), aff'd, 111 F.2d 6 (2d Cir.), cert. dened, 311 U.S. 674 (1940).
dictum that the Club might have sold or leased a portion of the property which it had originally acquired for tax-exempt purposes and devoted the proceeds of such conveyance to the support of those purposes without losing its exempt status, so long as the proceeds constituted only incidental, trifling, or non-recurrent contributions to income. This dictum, with its emphasis upon the nature of the profit-making activity and the magnitude of the profit, rather than upon the disposition of the profit, seems to indicate tacit recognition by the court that its decision was actually based on the failure of the Club to be “operated exclusively for pleasure, recreation, and other non-profitable purposes.”

The theory of private benefit espoused in *Jockey Club* and *West Side Tennis Club* has been rejected in other cases involving clubs where the destination or disposition of income was no different. In *Santee Club v. White* a club organized to purchase and maintain lands as a hunting, fishing, and health resort for its members sold a small portion of its property at a gain after having held and devoted it to exempt purposes for thirty years. The sale was made because the growth of food-killing weeds on the land had made it useless for the Club’s purposes. The proceeds of the sale were used for improvements on other parts of the Club’s property and for general club purposes. Notwithstanding that there was no apparent distinction between the Santee Club, the Jockey Club, and the West Side Tennis Club with respect to the use of earnings, the Santee Club was held tax exempt. The First Circuit, implicitly rejecting the reasoning of *Jockey Club*, stated that in *Santee* “no part of the profit on the sale of real estate in question inured to the benefit of the Club’s shareholders except through their use of the Club’s facilities, which is clearly not the benefit referred to in the exempting clause of the statute . . . .” What does seem to distinguish Santee from the other two clubs is that its net earnings arose from the sale of real estate that had been purchased many years before to implement its exempt purposes, had been devoted to those purposes while held, and was sold only because it was no longer useful for those purposes. Thus, every transaction of the Club with respect to the property in question

51. 87 F.2d at 7.
was incidental to promotion of the Club's tax-exempt purposes.\textsuperscript{52} Hence, unlike the other two cases, a purpose to operate the Club for profit could not reasonably be inferred from the profit-making activity in Santee. Results similar to Santee were subsequently reached by the Fifth Circuit in two cases involving clubs that granted oil leases on portions of their properties;\textsuperscript{58} the court recognized quite clearly that it was dealing with a problem of income source rather than conferral of benefit.

The distinction between problems of income source and conferral of benefit was again confused in Aviation Club v. Commissioner,\textsuperscript{54} a Tenth Circuit case after Santee Club, but certain statements in the court's opinion shed some light on the basis of the confusion. In Aviation Club the Club had engaged in a "substantial and continuing" business for profit that was beyond the scope of its tax-exempt purposes, and the net earnings were used to purchase furniture and equipment for the clubhouse and to make extensive plans for the improvement of club property. The Tenth Circuit relied upon West Side Tennis and Jockey Club in holding that business activities of the club had produced the forbidden inurement of net earnings to private benefit. It then proceeded to distinguish between two situations: an otherwise exempt organization that operates a "substantial and continuing" business, the net earnings of which are used by the organization to support its exempt activities; and an organization that operates a business for profit, all of the net earnings of which do not and cannot inure to the benefit of its members, but must be used to support and maintain a wholly exempt organization.\textsuperscript{55} The court said that

\textsuperscript{52} Cf. Mill Lane Club, Inc., 23 T.C. 433 (1954), \textsc{acq.}, 1955–1 \textsc{Cum. Bull.} 5; Anderson Country Club, Inc., 2 T.C. 1238 (1943), \textsc{acq.}, 1944 \textsc{Cum. Bull.} 2 (purchase, holding, and sale of property incidental to club purpose); Town & Country Club, 1942 P-H Tax Ct. Mem. Dec. \textsc{\#} 42872; Juniper Hunting Club, Inc., 28 B.T.A. 525 (1938) (exemption denied where sale of club property dictated primarily by desire to realize profit); Unity School of Christianity, 4 B.T.A. 61 (1926), \textsc{acq.}, VI–1 \textsc{Cum. Bull.} 6 (1927) (operation of vegetarian restaurant, farm to supply restaurant, and religious publishing house incidental to religious purposes); Rev Rul. 501, 1958–2 \textsc{Cum. Bull.} 282 (sale of club property to facilitate dissolution not motivated by desire to realize profit is incidental to tax-exempt purposes); G.C.M. 19465, 1938–1 \textsc{Cum. Bull.} 172.

\textsuperscript{53} Scofield v. Corpus Christi Golf & Country Club, 127 F.2d 452 (5th Cir. 1942), 27 Minn. L. Rev 98; Koon Kreek Klub v. Thomas, 108 F.2d 616 (5th Cir. 1939).

\textsuperscript{54} 162 F.2d 984 (10th Cir. 1947), \textsc{affirming} 7 T.C. 377 (1946), \textsc{cert. denied}, 332 U.S. 837 (1947).

\textsuperscript{55} A third class of cases discussed by Aviation Club were those where revenue was derived from isolated transactions as in Santee. See text accompanying notes 44–46 \textit{supra}. The court said that these organizations, like those in the second category, would be exempt.
organizations in the second category were exempt, while those in the first were not.

The reason that the court placed Aviation Club in the first category, concluding that net earnings in that case inured to private benefit, and that the courts in West Side Tennis Club and Jockey Club so readily found private benefit may perhaps be better understood by an examination of the cases placed by the Aviation Club court in the second category, since the only difference between the two categories appears to be the legal conclusion in one that there was private benefit and in the other that there was not. The second category originated in Trinidad v. Sagrada Orden de Predicadores, the basic decision of the United States Supreme Court with respect to exempt organizations. Trinidad involved a religious order that received investment income in the form of rent, dividends, interest, and capital gains and business income in the form of revenue from sales to its members of chocolate, wine, and other articles apparently used by them in the performance of their religious, educational, and charitable functions. In discussing the effect of the organization's receipt of investment income upon exemption, the Court noted that the destination or use of such income was made controlling by the benefit clause. When the Court turned to a consideration of business income, however, it was not content to rely simply upon the fact that the business income was used to support tax-exempt purposes; instead, it emphasized that the organization had not actually engaged in trade "in any proper sense of the term" since it had not sold to the public or in competition with others, since the merchandise was used by members of the organization for purposes incidental to the organization's tax-exempt purposes, and since the organization did not intend that the sales produce profit.

Subsequent decisions, overlooking the fact that the Trinidad Court used the destination test only with respect to investment income, misapplied the test to business income. Two rules evolved:

56. 263 U.S. 578 (1924).
57. The distinction which the Supreme Court intimates between investment or passive income, on the one hand, and income derived from trade or business, on the other, is not without rational foundation. It is reflected in Int. Rev. Code of 1954, §§ 501(c)(2) (exemption of corporations organized for exclusive purpose of holding title to property, collecting income therefrom, and paying income, less expenses, to exempt organization), 512(b) (exempting dividends, interest, annuities, royalties, most real property rents, and capital gains from tax on unrelated business income). The basis of the distinction is the fact that the exemption of passive income is not likely to result in serious competition with taxable businesses having similar income. See S. Rev. No. 2375, 81st Cong., 2d Sess. 30-31 (1950).
first, a “feeder” corporation, organized and operated solely to conduct a trade or business for profit and to pay all of the income to an organization exempt under section 501, was exempt; and second, an organization exempt under section 501 but whose substantial purpose was to conduct a profit-making trade or business was nonetheless exempt, provided only that all profits were devoted to tax-exempt purposes.68

The courts, however, were unwilling to grant exemption to all organizations enumerated in section 501 merely because business earnings were used to further the organization’s tax-exempt purpose. Some courts, ignoring the Trinidad destination test and considering only the source of income, frankly admitted that the requirement of organization and operation for exclusively exempt purposes was to be more liberally construed with respect to religious, educational, and charitable organizations than others.69 Other courts purported to rely on the destination test, but found an inurement of earnings to private benefit in those cases in which it sought to deny exemption—the benefit being inferred from the source of the earnings. The result was that religious, charitable, and educational organizations61 or civic leagues62 could earn business income and retain their exemption but that clubs63 or business leagues64 could not, notwithstanding that in each case

58. Roche’s Beach, Inc. v. Commissioner, 96 F.2d 776 (2d Cir. 1938), reversing 35 B.T.A. 1087 (1937); Home Oil Mill v. Willingham, 68 F. Supp. 525 (N.D. Ala. 1945). But see Bear Gulch Water Co. v. Commissioner, 110 F.2d 975 (9th Cir.), cert. denied, 314 U.S. 652 (1941) (exemption denied where taxpayer was bound by neither charter nor contract to pay earnings to sole stockholder, an exempt organization, and in fact paid none); Banner Bldg. Co., 46 B.T.A. 857 (1942) (same).


61. See Bohemian Gymnastic Ass’n Sokol v. Higgins, 147 F.2d 774 (2d Cir. 1945); Roche’s Beach, Inc. v. Commissioner, 96 F.2d 776 (2d Cir. 1945).

62. See Debs Memorial Radio Fund, Inc. v. Commissioner, 148 F.2d 948 (2d Cir. 1945).

63. See Aviation Club, 7 T.C. 377 (1946), aff’d, 162 F.2d 984 (10th Cir.), cert. denied, 329 U.S. 357 (1947); West Side Tennis Club, 39 B.T.A. 149 (1939), aff’d, 111 F.2d 6 (2d Cir.), cert. denied, 311 U.S. 674 (1940); Jockey Club v. Helvering, 76 F.2d 697 (2d Cir. 1935).

64. See Retailers Credit Ass’n, 33 B.T.A. 1106 (1936), aff’d, 90 F.2d 47 (9th Cir. 1939); Fort Worth Grain & Cotton Exch., 27 B.T.A. 985 (1939); Northwestern Jobbers’ Credit Bureau, 14 B.T.A. 392 (1928), aff’d, 37 F.2d 880 (8th Cir. 1930).
the destination of the earnings was the support of the tax-exempt purpose.

The courts' reason, then, for distinguishing between the two categories of cases enumerated in *Aviation Club* was to discriminate among the various section 501 organizations on the basis of the exempt purpose to which their earnings were to be devoted. This use of the benefit clause is not proper because the Code clearly contemplated that a qualifying organization would retain its exemption so long as its earnings were devoted to the purposes upon which exemption was based. In 1950 Congress legislatively overruled the destination test with respect to certain organizations: All feeder organizations were denied exemption without discriminating among them on the basis of the exempt purpose to which their earnings were to be devoted.65 Similarly, the net earnings of a trade or business regularly carried on by certain enumerated organizations, the conduct of which is not substantially related to the performance by the organization of its exempt purpose, were, with a few exceptions, made taxable.66 Since Congress has more clearly defined which exempt organizations shall be taxed because they conduct profitable trades or businesses and to what extent they shall be taxable, continued judicial discrimination among such organizations on the basis of what has always been a highly dubious application of the benefit clause would seem now to be unnecessary, if not improper.


66. See Int. Rev. Code of 1954, §§ 511–14. Clubs and civic leagues constitute notable exceptions to the applicability of the unrelated business taxable income provisions. See Int. Rev. Code of 1954, § 511(a)(2), (b)(2). Thus, though the income of an organization “feeding” a club or civic league is taxable (see § 502), it might be argued that Congress, by failing to include clubs, civic leagues, and other organizations within § 511, manifested its intent that such organizations remain totally exempt from tax on all income, from whatever source derived, so long as it is devoted to exempt purposes—a strict destination test. The legislative history does not indicate the reason for the limited applicability of § 511. See S. Rep. No. 2375, 81st Cong., 2d Sess. 28 (1950); H.R. Rep. No. 2319, 81st Cong., 2d Sess. 36 (1950); 96 Cong. Rec. A4895 (1950) (extension of remarks of Rep. Richard M. Simpson). This would impute to Congress the intent to overrule sub silentio cases such as *Jockey Club* and *West Side Tennis Club* where, it has been argued in this Note, exemption was denied because the organizations involved engaged in substantial business activities unrelated to achievement or performance of their tax-exempt purposes. It is submitted that it was not the intent of Congress to adopt a strict destination test for all organizations except those subject to the unrelated business income tax. Rather, the purpose would seem to have been to impose a tax upon the business income of certain enumerated organizations, leaving to all other exempt organizations except those specifically exempted by § 511 (see
CONCLUSION

In those cases in which a substantial purpose of an organization is to operate an unrelated, income-producing trade or business, the organization will now be subject to tax on one of two grounds: If the organization is enumerated in the unrelated business income tax provisions, added in 1950, its unrelated trade and business income will be taxable. An organization which is neither enumerated in nor specifically exempted from tax by those provisions, for example, a social club, should be denied exemption only where, because of its business operations, it fails to meet the “purposes” test. The proposition is that the purposes test has been and ought to be used as a basis for denying exemption to classes of exempt organizations which are unmentioned in the unrelated business income provisions, yet which receive substantial unrelated trade and business income, regardless of the use to which it is devoted.

In the other class of cases discussed in this Note, those in which objection to exemption is truly founded on the disposition rather than the source of organizational income, the benefit clause is not a helpful test to determine whether an organization is exempt. This is simply because the meaning of “private shareholder or individual” in any particular context depends wholly upon the scope of the exempt purpose of the organization in question. If the conferral of benefit is incidental to the performance or achievement of the organization’s tax-exempt purpose, earnings clearly have not mured to the benefit of a “private shareholder or individual” within the meaning of the Code. If the receipt of benefit is not incidental to the performance or achievement of a tax-exempt purpose, the basis for the exemption is no longer present; it is plainly within the contemplation of the statute that exemption be denied.

The “inurement to benefit” clause is irrelevant and ought not to be applied to situations where the real issue is the legitimacy of the organization’s source of earnings. Moreover, where the question involves the propriety of a distribution of earnings, the benefit clause, although relevant at first blush, in fact is surplusage, representing a conclusion rather than a test. In neither situation does the clause serve a significant independent function in the determination of exemption.

note 68 infra) the prospect of forfeiting their exemptions entirely if they engage in substantial unrelated business pursuits.


68. The only organizations named as exempt from the unrelated business income tax are churches or conventions or associations of churches. See Int. Rev Code of 1954, § 511(a)(2). There are, of course, other exempt organizations to which § 511 does not refer. See note 66 supra.