

THE TAX EXEMPTION UNDER I.R.C. § 501(C)(4)

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This Article discusses the justification for income tax exemption for organizations qualifying under § 501(c)(4). It explores why these organizations are entitled to exemption on their entire income though they are deemed unworthy of the charitable contribution deduction. The Article notes that income tax exemption generally only benefits entities that accumulate funds and points out that the subsidy from income tax exemption for long-term accumulation can exceed the benefit of the charitable deduction. It concludes that full income tax exemption under § 501(c)(4) cannot be justified either on the grounds that it is relatively unimportant or by analogy to the treatment of mutual organizations, whose exemption has been circumscribed. However, exemption for income from performance of services related to the exempt purpose and for a limited amount of investment income may be appropriate in some circumstances.

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INTRODUCTION

Prior literature has disagreed as to whether the income tax exemption for nonprofits under the Internal Revenue Code (the “Code”) is a special subsidy or whether the exemption is, in fact, consistent with an income tax. Boris Bittker has “suggested that an income tax could be appropriately imposed only on activities conducted for

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profit” and therefore should not be applied to nonprofit organizations.¹ Henry Hansmann disagrees but defends the exemption for many nonprofits as a justifiable subsidy.² In two prior articles, the first dealing with the treatment of mutual organizations³ and the second with charities exempt under § 501(c)(3),⁴ I concluded that the answer is much more nuanced and complex than either of these views suggest.

I found that, in some situations, the exemption followed from application of the principles that underlie our income tax.⁵ In other cases, the exemption amounted to special treatment or a subsidy.⁶ Importantly, in my view, the existence of special treatment and the appropriateness of a subsidy, if any, depends very much on both the nature of the organization and the type of income at issue.⁷

In the case of a charity, I determined that a significant subsidy exists only with respect to the exemption for investment and unrelated business income and for the treatment of income from related activities used for capital expenditures.⁸ I concluded that the current subsidy was acceptable except with respect to very large endowments.⁹ Although I do not believe a subsidy is justified for mutual organizations, which exist primarily to serve their members, I found that in some cases—for example, income from transactions with members in the case of a social club—exemption was not necessarily inconsistent with an income tax.¹⁰

This Article examines the tax exemption for § 501(c)(4) organizations. Such organizations, described in the Code as “civic leagues or organizations . . . operated exclusively for the promotion of *social welfare*,” are unique and do not fit as neatly as either charities or mutual organizations.¹¹ Congress appears to put § 501(c)(4) entities in the category of organizations providing public benefit rather than the

1. Boris I. Bittker & George K. Radhert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 *YALE L.J.* 299, 302 (1976).

2. Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from the Corporate Income Tax*, 91 *YALE L.J.* 54, 59 (1981).

3. Daniel Halperin, *Income Taxation of Mutual Nonprofits*, 59 *TAX L. REV.* 133 (2006) [hereinafter Halperin, *Mutuals*].

4. Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 *TAX L. REV.* 283 (2011) [hereinafter Halperin, *Charities*].

5. *Id.* at 284-85.

6. *Id.* at 285-86; see Halperin, *Mutuals*, *supra* note 3, at 135.

7. Halperin, *Charities*, *supra* note 4, at 287; Halperin, *Mutuals*, *supra* note 3, at 135.

8. Halperin, *Charities*, *supra* note 4, at 285-86.

9. *Id.* at 310 (citing Daniel Halperin, *Tax Policy and Endowments — Is Excessive Accumulation Subsidized?*, 67 *EXEMPT ORG. TAX REV.* 17, 25 (2011)).

10. Halperin, *Mutuals*, *supra* note 3, at 139-48.

11. I.R.C. § 501(c)(4)(A) (2012) (emphasis added).

category of mutual organizations providing benefits solely to their members. Thus, like § 501(c)(3) organizations, § 501(c)(4) organizations are subject to the so-called non-distribution constraint¹² in that “no part of the net earnings . . . inures to the benefit of any private shareholder or individual.”¹³ Accordingly, they are prohibited from distributing profits to their members. To help enforce this restriction, § 501(c)(4) organizations are also, like § 501(c)(3) organizations, subject to the penalty taxes on so-called “excess benefit transactions,” including unreasonable compensation.¹⁴

Comparable restrictions on benefits to members might suggest that Congress believes that § 501(c)(4) organizations may, like § 501(c)(3) organizations, be entitled to a subsidy in some circumstances. However, unlike charities, and like most mutual organizations, contributions to these organizations cannot be deducted.

It follows, therefore, that transfers of appreciated property to § 501(c)(4) entities should result in recognition of the unrealized gains. Non-recognition of such gains on transfers to charity, like the charitable deduction, allows income to escape taxation, presumably as an incentive to charitable contributions. It has been argued that if gains were taxable on transfers to charity, appreciated property would be held to death and the gains would never, in any event, be subject to tax.¹⁵ Whether or not this is true, the non-recognition of unrealized gains for transfers to charities increases what I view as the unwarranted advantage of basis step up, by allowing early diversification without gain recognition.¹⁶ This advantage should not be extended to § 501(c)(4) organizations where contributions are not deductible.

A more difficult question is why § 501(c)(4) organizations, which are deemed unworthy of the charitable contribution deduction, should nevertheless be entitled to exemption on their entire income. In this Article, I consider and evaluate in turn the following arguments for exemption: (1) exemption is relatively unimportant, and a subsidy is not inappropriate if it is at a lesser scale than the subsidy made available by the charitable deduction; (2) the § 501(c)(4) exemption

12. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980).

13. I.R.C. § 501(c)(4)(B).

14. I.R.C. § 4958(e)(1).

15. Peter J. Wiedenbeck, *Charitable Contributions: A Policy Perspective*, 50 MO. L. REV. 85, 122 & n.117 (1985) (citing COMM'N ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS, GIVING IN AMERICA: TOWARD A STRONGER VOLUNTARY SECTOR 145–46 (1975) (generally known as the Filer Commission Report)).

16. Daniel Halperin, *A Charitable Contribution of Appreciated Property and the Realization of Built-In Gains*, 56 TAX L. REV. 1, 12 (2002).

follows from the exemption generally provided for nonprofit mutual organizations operated for the benefit of their members; (3) exemption is consistent with normal income tax treatment; and (4) exemption relieves the pressure to expand the category of § 501(c)(3).

Part I of this Article outlines the scope of I.R.C. § 501(c)(4). Parts II, III, and IV discuss the specific types of § 501(c)(4) organizations in more detail and conclude that a full income tax exemption is not justified by analogy to the treatment of mutual organizations, nor is it relatively unimportant compared to the charitable deduction. Part V considers the argument that an exemption for income from the performance of services related to a § 501(c)(4) organization's exempt purpose is not inconsistent with normal income tax treatment. Part VI concludes that an income tax exemption for § 501(c)(4) organizations for investment income is appropriate only if long-term accumulation or accumulation which is a large multiple of annual expenditures is prohibited or, at least, causes some investment income to be taxable. Part VII then considers the argument that the exemption for § 501(c)(4) organizations relieves the pressure to expand the category of § 501(c)(3).

I.

THE SCOPE OF § 501(c)(4)

The world of § 501(c)(4) cannot be neatly described. Code regulations provide that an organization is operated *exclusively* for the promotion of social welfare if it is *primarily* engaged in promoting in some way the common good and general welfare of the community.¹⁷ It is not readily obvious why such an organization fails to qualify as a charitable organization under § 501(c)(3),¹⁸ which would entitle contributors to a charitable deduction. There seem to be two totally separate reasons.

First, the regulations provide that an organization, disqualified under § 501(c)(3) as an *action organization* because of excessive lobbying or participation in a political campaign, can qualify under § 501(c)(4).¹⁹ Second, § 501(c)(4) has become a default option for organizations that provide some public benefit but either fail to provide *sufficient community benefit* to qualify under § 501(c)(3) or cannot so qualify because they carry on more than an *incidental* level of non-exempt activities, most likely providing benefits for members. These

17. Treas. Reg. §§ 1.501(c)(4)-1(a)(1)(ii), (a)(2)(i) (as amended in 1990) (emphasis added).

18. Compare *id.*, with Treas. Reg. § 1.501(c)(3)-1(d)(2) (as amended in 2017).

19. Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii) (as amended in 1990).

two conditions may well overlap. This second category of social welfare organizations is not, in fact, described in the regulations and its scope is quite murky to both the Internal Revenue Service (“IRS”) and the commentators.²⁰

The various types of § 501(c)(4) organizations will next be discussed in more detail.

II.

ACTION ORGANIZATIONS—LOBBYING

Many § 501(c)(4) organizations are affiliates of § 501(c)(3) organizations organized to engage in unlimited lobbying. As noted above, the regulations provide that an organization which cannot qualify under § 501(c)(3) because it is a so-called action organization can qualify under § 501(c)(4).²¹ An organization is disqualified under § 501(c)(3) as an action organization if a “substantial part of its activities is attempting to influence legislation”²² or “[i]ts main or primary objective . . . may be attained only by legislation or a defeat of proposed legislation . . . [and] it advocates, or campaigns for, the attainment of such . . . objective . . . as distinguished from engaging in nonpartisan analysis, study, or research and making the results thereof available to the public.”²³ A § 501(c)(4) organization, in contrast to a § 501(c)(3) organization, may engage in unlimited lobbying.²⁴

It seems to me that status as a § 501(c)(3) organization should turn on whether the organization is serving charitable and educational purposes. If so, lobbying would seem to be as legitimate as any other means of furthering the organization’s goals. The lobbying limitation for § 501(c)(3) organizations is therefore inappropriate. The charitable deduction amounts to government intervention regardless of the employed tactics, which now can include litigation, boycotts, picketing, and other legal activities. It is not obvious to me that lobbying is any different.

Congress, however, has denied a business deduction for lobbying expenses²⁵ and has precluded a charitable deduction where a principal purpose of the contribution was to avoid disallowance of a business

20. Ellen P. Aprill, *History and Policy: Mapping Social Welfare Organizations*, 21 N.Y.U. J. LEGIS. & PUB. POL’Y 345, 351-52 (2018); see also Lloyd Hitoshi Mayer, *A (Partial) Defense of § 501(c)(4)’s “Catchall” Nature*, 21 N.Y.U. J. LEGIS. & PUB. POL’Y 439, 447 (2018).

21. Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii) (as amended in 1990).

22. Treas. Reg. § 1.501(c)(3)-1(c)(3)(ii) (as amended in 2017).

23. Treas. Reg. § 1.501(c)(3)-1(c)(3)(iv) (as amended in 2017).

24. Rev. Rul. 71-530, 1971-2 C.B. 237.

25. I.R.C. § 162(e)(1) (2012).

deduction.²⁶ Further, tax-exempt institutions, other than charities, must either notify their members as to the portion of the dues to which the lobbying limit on a deduction would apply or pay an entity level proxy tax on this amount.²⁷ Inability to deduct lobbying expenses, which are related to producing taxable income, would overstate such income and amount to a tax penalty. In this circumstance, a subsidy for lobbying expense through a charity may seem inappropriate.²⁸

If Congress believes that the lobbying restriction is wise, it is hard to see why the exemption for investment income tax is acceptable unless one thinks that a smaller subsidy seems appropriate and the income tax exemption seems *relatively unimportant* as compared to the charitable deduction. Intuitively this seems correct but, as shown below,²⁹ this subsidy can be surprisingly large, even exceeding the benefit of the charitable deduction for long-term accumulation. This would suggest that if investment income is to be exempt, long-term accumulation or accumulation that is a large multiple of annual expenditures should be prohibited or, at least, cause some income to be taxable.

III.

ACTION ORGANIZATIONS—POLITICAL ACTIVITIES

An organization is also an action organization if it participates to any extent in a political campaign.³⁰ The regulations under § 501(c)(4) provide that, unlike lobbying, social welfare does not include participation in a political campaign.³¹ However, the regulations permit a § 501(c)(4) organization to engage in political activity so long as it is not the primary activity of the organization,³² which some think can comprise up to just short of fifty percent of all its activity.³³

There has been considerable recent interest in the use of § 501(c)(4) organizations to avoid the disclosure applicable to politi-

26. I.R.C. § 170(f)(9). Section 170(f)(9) was enacted in 1993, Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, tit. XIII, § 13222(b), 107 Stat. 312, 479-80, when 162(e) was expanded to deny a deduction for direct lobbying costs, § 13222(a), 107 Stat. at 477-79.

27. I.R.C. § 6033(e).

28. Terence Dougherty, *Section 501(c)(4) Advocacy Organizations: Political Candidate-Related and Other Partisan Activities in Furtherance of the Social Welfare*, 36 SEATTLE U. L. REV. 1337, 1378 (2013).

29. See *infra* note 68 and accompanying text.

30. Treas. Reg. § 1.501(c)(3)-1(c)(3)(iii) (as amended in 2017).

31. Treas. Reg. § 1.501(c)(4)-1(a)(2)(ii) (as amended in 1990).

32. Rev. Rul. 81-95, 1981-1 C.B. 332.

33. Roger Colinvaux, *Social Welfare and Political Organizations: Ending the Plague of Inconsistency*, 21 N.Y.U. J. LEGIS & PUB. POL'Y 481, 487 (2018).

cal parties and PACs under § 527.³⁴ Moreover, Congress has specifically limited the tax exemption of organizations subject to § 527, excluding certain kinds of income from exemption, such as investment income.³⁵ Using § 501(c)(4) organizations, therefore, will not only avoid disclosure but may also, inappropriately, achieve better tax treatment than what is available under § 527.³⁶

Although a § 501(c)(4) organization loses its full exemption when it engages in political activities, and is subject to tax on the lesser of expenditures for such purpose or its investment income, it may still have a lower tax burden than under § 527.³⁷ Importantly, donors of appreciated property are taxed on contributions to § 527 organizations but, as noted above, not on contributions to § 501(c)(4) organizations.³⁸

I agree with Roger Colinvaux's article³⁹ that the treatment of § 501(c)(4) organizations engaged in political activities should be consistent with the treatment under § 527. I defer to him as to the best way to achieve this goal.

IV.

NOT QUITE A § 501(C)(3) ORGANIZATION OR OTHER EXEMPT ENTITY

Aside from being a home for action organizations, as discussed in the previous two sections, the contours of § 501(c)(4) are decidedly murky. In practice, § 501(c)(4) has been used by both the courts and the IRS as a haven for organizations that they believe lack the essential characteristics of a taxable entity but elude classification under other subparagraphs of § 501(c).

In 2003, an IRS training manual put it this way:

Although the Service has been making an effort to refine and clarify this area, section 501(c)(4) remains in some degree a catch-all for presumptively beneficial non-profit organizations that resist classification under the other exempting provisions of the Code. Unfortunately, this condition exists because, "social welfare" is inherently an abstruse concept that continues to defy precise definition.⁴⁰

34. *Id.* at 490.

35. I.R.C. §§ 527(c)(1), (3) (2012).

36. Colinvaux, *supra* note 33, at 490-91.

37. I.R.C. § 527(f); Treas. Reg. § 1.527-6 (1980).

38. I.R.C. § 84.

39. Colinvaux, *supra* note 33, at 499-500.

40. John Francis Reilly, Carter C. Hull & Barbara A. Braig Allen, *IRC 501(c)(4) Organizations*, in EXEMPT ORGANIZATIONS: CONTINUING PROFESSIONAL EDUCATION

The IRS appears to believe that “social welfare” under § 501(c)(4) is less stringent than the similar concept that qualifies an organization as “charitable” under § 501(c)(3). This would, accordingly, permit less community benefit and more private benefit. Thus, the IRS has made clear in its Private Letter Rulings that an important distinction between §§ 501(c)(3) and 501(c)(4) is that the latter may include organizations with “more than an incidental amount of . . . non-exempt activities, and still qualify for exemption, as long as those activities are not primary.”⁴¹

The IRS found that a nonprofit organization with membership limited to the residents and business operators within a city block and formed to preserve and beautify the public areas in the block, thereby benefiting the community as a whole, may qualify under § 501(c)(4) even though it will not qualify for exemption under § 501(c)(3).⁴² On the other hand, an organization formed for the beautification of an entire city is operated exclusively for charitable purposes and thus qualifies for tax-exempt status under § 501(c)(3).⁴³ There is no clear indication of how the line is drawn, and the Revenue Rulings just discussed are unusual because the exemption status of the two similar organizations differed based only on the size of the community they each benefited. In most cases, the IRS rules that § 501(c)(4) is available without describing why § 501(c)(3) is not.⁴⁴

Another set of rulings approving § 501(c)(4) status reflects the distinction between § 501(c)(3) and § 501(c)(4) organizations, in that the latter can have more than an *insubstantial* level of nonexempt activities, as long as these activities are not *primary*. This is perhaps

TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 2003, at I-1, I-3 (2002): (quoting Internal Revenue Serv., *Chapter G: Social Welfare: What Does It Mean? How Much Private Benefit Is Permissible?*, in EXEMPT ORGANIZATIONS: CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 1981, at [39] (1980) [hereinafter *Chapter G: Social Welfare*], <http://www.irs.gov/pub/irs-tege/eotopicg81.pdf>), <https://www.irs.gov/pub/irs-tege/eotopic03.pdf>.

41. I.R.S. Priv. Ltr. Rul. 201123047 (June 10, 2011), 2011 WL 2274642.

42. Rev. Rul. 75-286, 1975-2 C.B. 210.

43. Rev. Rul. 68-14, 1968-1 C.B. 243.

44. See, e.g., Rev. Rul. 75-386, 1975-2 C.B. 211 (approving § 501(c)(4) status for an organization contracting for security patrols designed to increase public safety and reduce crime in the community); Rev. Rul. 78-69, 1978-1 C.B. 156 (approving § 501(c)(4) status for an organization formed by residents of a suburban community to provide bus transportation during rush hours between the community and the major employment center in a metropolitan area); Rev. Rul. 81-116, 1981-1 C.B. 333 (approving § 501(c)(4) status for an organization whose membership is open to the community and that provides free parking to anyone visiting the city’s downtown business district and thereby contributes to civic betterment by relieving congested parking conditions).

most clear in a Revenue Ruling describing several types of garden clubs.⁴⁵ In that ruling, Situation 1 describes an organization, qualifying under § 501(c)(3), that instructs the public on horticultural subjects and stimulates interest in the beautification of the geographic area.⁴⁶ Situation 2 is distinguished from Situation 1 in that the organization in Situation 2 conducts substantial, more than incidental, social functions not in furtherance of any purposes specified in § 501(c)(3).⁴⁷ Accordingly, the organization does not qualify for exemption under § 501(c)(3). Still, even though social activities are more than *incidental*, because the organization is operated primarily to bring about civic betterment and social improvements, and because the social functions for the benefit, pleasure, and recreation of the members do not constitute its primary activity, the organization qualifies for exemption under § 501(c)(4). However, when social activities *predominate*, the organization can only seek exemption as a social club under § 501(c)(7).⁴⁸

Civic leagues with insufficient community benefit or that provide more than incidental benefits to members could be viewed as just another category of a mutual organization, in the sense that the organization benefits a limited group of people. If so, in light of the income tax exemption extended to many mutual nonprofits, similar treatment for these § 501(c)(4) organizations would seem fairly straightforward. If both civic leagues and social clubs are exempt, an organization that is a hybrid of both should be as well. This could explain the exemption. However, although this position made sense when social clubs were totally exempt from tax, the situation has changed.

In 1969, Congress determined that social clubs should be taxable except for income from transactions with members.⁴⁹ This approach has been applied to homeowner associations, cooperatives, and, as noted above, political parties.⁵⁰ I believe all exempt consumer mutual organizations should track the treatment of social clubs so that investment income would be taxable.⁵¹ Further, full taxation has been extended⁵² to additional nonprofits, including mutual savings banks and

45. Rev. Rul. 66-179, 1966-1 C.B. 139.

46. *Id.* at 139.

47. *Id.* at 140.

48. *Id.* at 141.

49. Tax Reform Act of 1969, Pub. L. No. 91-172, § 121(b)(1), 83 Stat. 487, 537-38 (codified as amended at I.R.C. § 512(a)(3)(A), (B) (2012)).

50. See Halperin, *Mutuals*, *supra* note 3, at 150-52.

51. *Id.* at 135.

52. *Id.* at 148 & n.44. Some mutual organizations—for example, the American Automobile Association—have always been taxable.

Blue Cross, which were at one time exempt.⁵³ I have recommended that the category of fully taxable mutual organizations be expanded to encompass commercial-type mutual organizations, such as credit unions.⁵⁴

In any event, now that social clubs are exempt only on transactions with members and are fully taxable on investment income, it is troublesome to allow full exemption to an organization that may spend just short of half its resources on social activities. It can no longer be said, as the IRS said in 1981, that such organizations “lack the accepted essential characteristics of a taxable entity.”⁵⁵ An organization that conducts substantial, more than incidental, social activities should be taxed like social clubs. If this recommendation and my suggestion as to political activities are followed, this leaves open the treatment of organizations with excessive lobbying and organizations that provide benefits to a limited community but no significant private benefit. Since I do not believe that exemption for § 501(c)(4) organizations can be said to follow from the exemption generally provided for non-profit mutual organizations operated for the benefit of their members, exemption needs to be specifically justified, as considered next.

V.

EXEMPTION IS NOT INCONSISTENT WITH INCOME TAX— INCOME FROM RELATED ACTIVITIES

Sometimes exemption is consistent with an income tax. Donative contributions or gifts would not normally be taxable. In the case of § 501(c)(4) organizations, an exemption for contributions seems appropriate since, because the contribution is not deductible, income would otherwise be taxed twice and contributions would unnecessarily be discouraged.⁵⁶ Moreover, given the non-distribution constraint, which distinguishes charitable and § 501(c)(4) organizations from taxable businesses, the exemption of income from the performance of services or sale of goods related to the organization’s exempt function does not necessarily result in an inaccurate measurement of income.

Since § 501(c)(4) organizations, like charities, cannot make distributions to members or shareholders,⁵⁷ funds, generally, must eventually be used for the organization’s exempt purpose. For example, in the case of a hospital, patient fees from the performance of services

53. *Id.* at 150.

54. *Id.* at 149-50.

55. *Chapter G: Social Welfare, supra* note 40, at [2].

56. Halperin, *Charities, supra* note 4, at 311.

57. I.R.C. § 501(c)(4)(B) (West 2017).

may be set aside and used to provide future services to patients. Moreover, my work on time value of money led to the *surprising* conclusion that exemption of an amount of income set aside for a future expenditure is equivalent to a current deduction for the present value of the future expenditure.⁵⁸ Exemption of the amount set aside is, in effect, a current deduction for a future expenditure, effectively discounted by the after-tax rate of return. In such circumstances, measured in present value, the deduction is correct even though it is allowed too early.⁵⁹

Therefore, if the amount set aside would be deductible when used, exemption does not increase the present value of the tax deduction, as compared to a for-profit entity, even if these expenditures are deferred. In short, this treatment does not reduce the present value of tax liability.⁶⁰ This would not necessarily hold true for other non-profit entities, which, like for-profits, could distribute profits to members.

To illustrate, consider a charitable hospital that produces \$100 surplus of income over expenses in year 1. This amount is set aside for future needs. Let us assume a 10% return on investment, which we will assume is taxable at a 35% tax rate. At the assumed interest and tax rate, the hospital will accumulate \$113.42 at the end of year 3. As more fully developed in the table below, the same amount could be available even if the profit of \$100, which is set aside, is taxed. Initially, of course, only \$65 would be available for investment accumulating to \$73.72 after two years. However, if a \$113.42 expenditure made at that point is deductible, the tax savings from the deduction, \$39.70, combined with the accumulation of \$73.72, would be sufficient to enable an expenditure of \$113.42 to be made.

58. Daniel I. Halperin, *Interest in Disguise: Taxing the Time Value of Money*, 95 YALE L.J. 506, 519 (1986).

59. See Alan J. Auerbach & Dale W. Jorgenson, *Inflation-Proof Depreciation of Assets*, HARV. BUS. REV., Sept.–Oct. 1980, at 113, 114 (demonstrating that deducting a percentage of the asset's cost in the year of acquisition can be equivalent to the present value of depreciation deducted over time).

60. Halperin, *Charities*, *supra* note 4, at 292-94, 299-301; see also Halperin, *Mutuals*, *supra* note 3, at 140-42.

TABLE I

	<i>No Current Tax</i>	<i>Current Tax</i>
Income	\$100.00	\$100.00
Tax at 35%	—	\$35.00
Investment (Year 1)	\$100.00	\$65.00
Earnings at 10%	\$10.00	\$6.50
Tax at 35%	\$3.50	\$2.27
Earnings at 6.5%	\$6.50	\$4.23
Investment (Year 2)	\$106.50	\$69.23
Earnings at 10%	\$10.65	\$6.92
Tax at 35%	\$3.73	\$2.43
Earnings at 6.5%	\$6.92	\$4.49
Accumulation (Year 3)	\$113.42	\$73.72
Tax Savings	—	\$39.70
Expenditure (Year 3)	—	\$113.42

Exemption for income from related activities immediately used for capital expenditures, or set aside for such purpose, amounts to an immediate deduction for such expenditures, which is undoubtedly special treatment.⁶¹ Are there, nevertheless, reasons to exempt such income?

In considering the possible justification for a subsidy to capital expenditures in the case of charities, I relied primarily on Henry Hansmann's contract failure analysis.⁶² He suggests that, because of the difficulty of monitoring the delivery and quality of certain goods and services, individuals would prefer to deal with charities to supply these goods and services. Because of the non-distribution constraint, charities were said to have less motivation to cheat on the quality of goods and services. However, because of limited access to capital, charities might not be able to expand sufficiently to meet the demand for such goods or services. Thus, a subsidy for capital expenditures by charities could be justified.

Whether a similar case can be made for a subsidy to § 501(c)(4) organizations may depend on the scope of the category. It seems easiest to justify if, as I have suggested, this category is limited to action

61. Halperin, *Charities*, *supra* note 4, at 285. The Tax Cuts and Jobs Act now allows immediate expensing for specified property placed in service before January 1, 2023. Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13201, 131 Stat. 2054, 2106 (2017) (amending I.R.C. § 168(k)); *see also* § 13101, 131 Stat. at 2102 (raising the limits for immediate expensing for small businesses under I.R.C. § 179(b)).

62. Halperin, *Charities*, *supra* note 4, at 295-97 (discussing Hansmann, *supra* note 2).

organizations engaged in lobbying and to those organizations that do not provide substantial private benefits. It is more problematic if the category remains as is. However, there may be other reasons not to worry about capital expenditures.

Boris Bittker has asserted that there is little to be served by taxing income related to capital expenditures, stating that “[s]ince . . . capital outlays are irrevocably dedicated to the institution’s nonprofit objectives, . . . we do not regard [deferring the deduction for such expenditures in] computing a nonprofit’s income as very appealing; nor can we see that it has any economic or social advantages over a regime of complete exemption.”⁶³ Bittker notes the dedication of the funds to the institution’s nonprofit objective, which suggests that, as opposed to unrelated investments, the current generation may, in fact, benefit.

Thus, the purchase of a painting or environmentally sensitive land offers current benefits even though the asset will last for a long time. These items cannot easily be rented. Although the excess of the purchase price of a building over the rental cost of alternative space could, like unrelated investments, reduce the current expenditures on charity, it will not if the purchase is made in part with borrowed funds and the loan is paid off over the period of use in amounts comparable to the rental cost of the space.

It is therefore not easy to distinguish those capital expenditures that provide current benefit, in the least costly manner possible, from those that defer the charitable benefit similar to investments in endowments. It may be noted that for private foundations, amounts expended to acquire an asset used in carrying out a charitable purpose are treated as meeting the five percent distribution requirement.⁶⁴ In the case of a social club, I was not disturbed by the possible use of income from transactions with members for nondeductible capital expenditures, in part because I recognized that the organizations had the ability to raise funds for such expenditure without incurring taxable income (most likely by contributions from members).⁶⁵ Therefore, it may not be troublesome to exempt all income from related activities even if used for capital expenditures.

63. Bittker & Radhert, *supra* note 1, at 312.

64. Treas. Reg. § 53.4942(a)-3(a)(2)(ii) (as amended in 2015).

65. Halperin, *Mutuals*, *supra* note 3, at 145-48.

VI.

IS SPECIAL TREATMENT FOR INVESTMENT INCOME
AN APPROPRIATE SUBSIDY?

Exemption for investment income, including income from unrelated business, is undoubtedly a departure from an income tax. My prior article concluded that the deduction for charitable contributions did not necessarily mean that exemption for income was appropriate.⁶⁶ The charitable deduction has the effect of reducing the cost of charitable outputs both current and in the future. An income tax exemption, on the other hand, will not, for the most part, reduce the cost of current operations. It will affect only the relative costs of setting aside funds for the future as compared to providing current benefits. Exemption requires a showing that accumulation is appropriately treated, and I found the current treatment of large endowments troubling.⁶⁷

However, while income tax exemption does not necessarily follow from the charitable deduction, the existence of a charitable deduction, which is undoubtedly a subsidy, can be considered an indication that Congress thinks a subsidy can be justified. Therefore, § 501(c)(4) raises the additional question as to whether the absence of the deduction signals that a subsidy in the form of an exemption for income, which would subsidize *only* those organizations that accumulate funds, is inappropriate.

If the scope of organizations qualifying under § 501(c)(4) is limited to action organizations engaged in lobbying and those organizations that do not provide substantial private benefits, a subsidy may not be inappropriate. Still, it is hard to think of a reason to intentionally limit a subsidy to those organizations that accumulate. It may be, however, that a smaller subsidy seemed appropriate and the income tax exemption seemed *relatively unimportant* as compared to the charitable deduction. But, as noted above, this subsidy can be surprisingly large, even exceeding the benefit of the charitable deduction, for long-term accumulation.

For example, due to the charitable deduction, a donor in a 35% bracket can purchase \$100 worth of charitable services by forgoing \$65 of private consumption out of after-tax income (a price reduction of 35%). However, the discount would increase if future personal consumption were compared to a current gift for future consumption by the charity. For example, assuming all income was fully and immedi-

66. Halperin, *Charities*, *supra* note 4, at 287-90.

67. *Id.* at 310; Daniel Halperin, *Tax Policy and Endowments—Is Excessive Accumulation Subsidized?*, 67 EXEMPT ORG. TAX REV. 17, 25 (2011).

ately taxed at ordinary income rates, if the individual neither spent the \$65 on personal consumption nor made a charitable contribution, after one year, she would, if she earned 10%, have \$69.23 available.⁶⁸ This would support a charitable contribution of \$106.50 (again a 35% discount).⁶⁹ On the other hand, if the gift is made initially and investment income of the donee is not taxed, the charity would have \$110 after one year, while the donor is giving up just \$69.23 of personal consumption at that time, effectively a discount of 37%.

The discount would increase significantly as consumption is further delayed. After thirty years, nearly three times as much can be accumulated at the charity level, or a discount of nearly two-thirds. If the exemption for investment income is justified as a relatively small subsidy, it seems clear that long-term accumulation or accumulation which is a large multiple of annual expenditures needs to be prohibited or, at least, cause some income to be taxable.

VII.

RELIEVE PRESSURE ON CATEGORY OF § 501(C)(3)

Ellen Aprill has suggested that § 501(c)(4) relieves the pressure to expand § 501(c)(3) (or other provisions of § 501(c)) by providing an alternative.⁷⁰ Most famously, in *Regan v. Taxation with Representation of Washington*, the Supreme Court held that restrictions on lobbying were not unconstitutional since Congress is free to impose conditions on a subsidy—in this case, the charitable deduction.⁷¹ In a concurring opinion, Justice Blackmun emphasized that the IRS permitted a close relationship between a charity, exempt under § 501(c)(3), and a § 501(c)(4) organization that engaged in lobbying.⁷² Thus, an organization could lobby without losing any tax benefits for its non-lobbying activities.⁷³ Blackmun's opinion apparently did not require that the § 501(c)(4) affiliate be exempt from tax.

There has been considerable controversy about tax exemption for health maintenance organizations (“HMOs”) under § 501(c)(3), with the IRS insisting that exemption should be limited to § 501(c)(4) because the organizations serve a limited group.⁷⁴ In most cases, exemp-

68. If she invested the \$65 of after-tax income to earn 10%, she would earn \$6.50 before tax. After paying tax at 35%, she would have \$69.23.

69. The tax savings from the contribution of \$106.50 (\$37.27) when added to the accumulation of \$69.23 totals \$106.50.

70. Aprill, *supra* note 20, at 375-76.

71. 461 U.S. 540, 548-49 (1983).

72. *Id.* at 552-53 (Blackmun, J., concurring).

73. *Id.* at 553.

74. Aprill, *supra* note 20, at 380-83.

tion is now allowed under § 501(c)(4), perhaps as a compromise solution. Since I would guess that charitable contributions are not significant for an HMO, the organization would generally be satisfied with income tax exemption. I have suggested that income from related activities of § 501(c)(4) organizations remain fully exempt. Therefore, the status quo would not be upset under my proposal unless an HMO had a significant amount of investment income.

An organization that does not rely on charitable contributions would be satisfied with § 501(c)(4) status or even prefer it as a way to avoid the scrutiny of the application process or special restrictions, such as those that apply to private foundations.⁷⁵ But as Aprill notes, while we may be protecting the boundaries of § 501(c)(3), this opportunity can undermine the limits applicable to charity.⁷⁶ Thus, we need to be comfortable that income tax exemption or other benefits for § 501(c)(4) organizations are appropriate. In my view, as described above, full exemption for investment income is too generous.

CONCLUSION

In light of the substantial changes to the rules for tax exemption, it is past time for § 501(c)(4) to be reconsidered. On contributions to these organizations, unrealized gain should be taxed. The treatment of organizations engaged in campaign activities should be aligned with the treatment of political parties. Section 501(c)(4) organizations that provide more than incidental benefits to members should be taxed like social clubs.

Section 501(c)(4) should be limited to organizations denied § 501(c)(3) status because they conduct excessive lobbying or benefit too narrow a group. These organizations should remain exempt on income from related activities. However, I believe that exemption from investment income should be limited to short term savings or an accumulation that is not large in relation to annual expenditures.

75. See David S. Miller, *Social Welfare Organizations as Grantmakers*, 21 N.Y.U. J. LEGIS. & PUB. POL'Y 413, 436 (2018).

76. Aprill, *supra* note 20, at 410.