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IN FOCUS

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The Public Policy Doctrine and 501(c)(3) Organizations

The Supreme Court first applied the public policy doctrine to organizations exempt under Internal Revenue Code (IRC) Section 501(c)(3) in a pair of cases, *Bob Jones University v. United States* and *Goldsboro Christian Schools, Inc. v. United States*, 461 U.S. 574 (1983) (collectively *Bob Jones*). In *Bob Jones*, the Court established that entitlement to 501(c)(3) status "depend[ed] on meeting certain common-law standards of charity," which meant that a 501(c)(3) organization "must serve a public purpose and not be contrary to established public policy." Then, the Court held that two schools with racially discriminatory admissions policies did not qualify for 501(c)(3) status. Lower courts and the Internal Revenue Service (IRS) had begun relying on common law concepts of charity to deny tax-exempt status to organizations discriminating based on race several years before the Court's decision. Despite *Bob Jones*'s noteworthiness, the public policy doctrine has had limited application outside racial discrimination in education. Courts only occasionally reference the public policy doctrine as potential grounds for revocation or denial of 501(c)(3) status, and the IRS rarely asserts it as a basis to revoke or deny tax exemption.

This In Focus provides background on the public policy doctrine and discusses its application.

The Origins of the Public Policy Doctrine

In 1969, a group of Black taxpayers and their minor children brought a class action to enjoin the IRS from granting 501(c)(3) status to Mississippi private schools that excluded Black students. At the time, the IRS granted 501(c)(3) status to private schools regardless of their racial admission policies. The class sought a declaration that granting tax-exempt status to schools that excluded students based on race violated IRC Section 501, governing charities, and IRC Section 170, governing charitable contributions. If the court found that the IRC provisions did authorize granting schools such status, the class sought a declaration that those provisions were unconstitutional. On January 12, 1970, in *Green v. Kennedy*, 309 F. Supp. 1127 (D.D.C. 1970), a three-judge district court for the District of Columbia granted the class a preliminary injunction prohibiting the IRS from granting tax-exempt status to Mississippi private schools with racially discriminatory admissions policies. The court concluded that the class had a "reasonable probability of success on the merits."

Before the court reached a decision on the merits, the IRS issued two news releases in July 1970 announcing that it had reversed its position and would deny tax-exempt status to racially discriminatory private schools. In its July 10, 1970, news release, the IRS avowed that "it c[ould] no longer legally justify allowing tax-exempt status to private schools which practice racial discrimination nor c[ould] it treat gifts to such schools as charitable deductions."

In testimony before the Senate Select Committee on Equal Educational Opportunity on August 12, 1970, the IRS Commissioner stated that the IRS's position change rested on the "basic principles of the common law of charities." He explained, "An organization seeking exemption as being organized and operated exclusively for educational purposes, within the meaning of section 501(c)(3) and section 170, must meet the tests of being 'charitable' in the common-law sense."

On June 30, 1971, the three-judge district court for the District of Columbia issued an opinion on the merits in *Green v. Connally*, 330 F. Supp. 1150 (D.D.C. 1971), *aff'd sub nom Coit v. Green*, 404 U.S. 997 (1971) (per curiam). Although the court determined there was "merit" in interpreting IRC Sections 170 and 501(c)(3) by reference to their common-law background, it concluded the "ultimate criterion" for determining whether an organization was charitable rested on federal policy. The court referred to the "general and well-established principle that Congressional intent in providing tax deductions and exemptions is not construed to be applicable to activities that are either illegal or contrary to public policy." Thus, "charitable exemptions and deductions must be construed to avoid frustrations of Federal policy." Because the court found that there was a declared federal public policy against support for racial discrimination in education, it held that IRC Sections 170 and 501(c)(3) could "no longer be construed" to provide tax exemption for racially discriminatory private schools and charitable deductions to their donors. The court determined there was such a federal public policy based on civil rights cases, including *Brown v. Board of Education*, 347 U.S. 483 (1954); the Civil Rights Act of 1964, 42 U.S.C. §§ 2000c to 2000d-4; and the "ultimate source," the Thirteenth Amendment's Enforcement Clause.

After the opinion on the merits in *Green v. Connally*, the IRS formalized its change in position in Revenue Ruling 71-447, 1971-2 C.B. 230. In the ruling, the IRS stated that a private school that did not have a "racially nondiscriminatory policy as to students" did not qualify for exemption under IRC Section 501(c)(3) because the private school was not "charitable" within the common law concepts reflected in IRC Sections 170(c) and 501(c)(3). Relying on the common law of charitable trusts, the IRS concluded that the purpose of a 501(c)(3) must not be "illegal or contrary to public policy." While the IRS determined that a private school operating on a discriminatory basis was "not prohibited" by federal law, Titles IV and VI of the Civil Rights Act of 1964, *Brown*, and subsequent federal court cases reflected a federal public

policy against racial discrimination that extended to public and private education. Private schools remain subject to Revenue Ruling 71-447 today.

Bob Jones

On January 19, 1976, the IRS revoked Bob Jones University's 501(c)(3) status effective as of December 1, 1970, the day after the university was formally notified of the IRS's change in position. The university sued seeking to challenge the revocation. During the tax periods at issue, the university had changed its policies from excluding Black students, to not admitting unmarried Black students, and then to instituting a disciplinary rule prohibiting interracial dating and marriage. The U.S. District Court for the District of South Carolina ruled against the government, in part, because the court determined that the IRS's revocation of tax-exempt status exceeded the powers delegated to the IRS. The U.S. Court of Appeals for the Fourth Circuit reversed, citing *Green v. Connally*. Against the background of charitable trust law, the Fourth Circuit read IRC Section 501(c)(3) to require organizations to be "charitable" in the common law sense, which required organizations not to violate public policy.

In the companion case, the IRS had determined pursuant to an audit that Goldsboro Christian Schools was not a 501(c)(3) organization. Goldsboro challenged the tax due as a result of the IRS's determination. Since its incorporation in 1963, Goldsboro had "maintained a racially discriminatory admissions policy." It had accepted White students and, on occasion, students from "racially mixed marriages" in which one parent was White. The U.S. District Court for the Eastern District of North Carolina rejected Goldsboro's claim for 501(c)(3) status, citing *Green v. Connally*. It held that "private schools maintaining racially discriminatory admissions policies violate clearly declared federal policy," and thus, 501(c)(3) status "must be denied." The Fourth Circuit affirmed.

The Supreme Court affirmed the Fourth Circuit in each case. The Court explained that courts should "go beyond the literal language of a statute if reliance on that language would defeat the plain purpose of the statute." Accordingly, the Court "analyzed and construed" IRC Section 501(c)(3) "within the framework of the [IRC] and against the background of the congressional purposes." The Court's review of the law of charitable trusts and the legislative history of statutes providing tax preferences to organizations that confer a public benefit revealed "unmistakable evidence" that

> entitlement to tax exemption depends on meeting certain common law standards of charity—namely, that an institution seeking tax-exempt status must serve a public purpose and not be contrary to established public policy.

Still, the Court discerned that making a declaration that an organization is not "charitable," and therefore not entitled to tax exemption, "should be made only where there can be no doubt that the activity involved is contrary to a fundamental public policy." The Court found that there was a fundamental public policy against racial discrimination in education based on a quarter of a century of pronouncements across all three branches of the federal government. As evidence, the Court cited its own cases, beginning with *Brown*; acts of Congress, including Titles IV and VI of the Civil Rights Act of 1964; and executive orders, such as Executive Order 10730 "employ[ing] military forces to ensure compliance with federal standards in school desegregation programs."

Public Policy Doctrine Post-*Bob Jones*

Bob Jones has served as a basis for denial or revocation of 501(c)(3) status when an organization has an "illegal" purpose or violates the "fundamental public policy" against racial discrimination in education, which has been broadly applied. For example, in *Calhoun Academy v. Commissioner*, 94 T.C. 284 (1990), the Tax Court upheld the IRS's decision to deny 501(c)(3) status to a private school despite the school's publication of its "racially nondiscriminatory policy as to students" in a local newspaper. The IRS contended that three factors established an inference that the academy discriminated based on race—the academy (1) was formed when nearby public schools were desegregating; (2) never had a Black student apply or enroll despite Black people making up about 50% of the local population; and (3) did not adopt a racially nondiscriminatory policy until shortly before applying for 501(c)(3) status. The Tax Court explained that, while the academy was not required to take affirmative steps to show operation in a nondiscriminatory manner, the IRS's decision was not erroneous because the academy had not met its evidentiary burden to show that it operated in "good faith" in accordance with its policy.

In *Virginia Education Fund v. Commissioner*, 85 T.C. 743 (1985), the Tax Court upheld the IRS's revocation of a fund's 501(c)(3) status where the fund did not introduce evidence establishing that the private schools it contributed to had adopted, and operated within, racially nondiscriminatory admissions policies. The IRS had found the fund distributed a "substantial portion" of its contributions to private schools that did not adopt racially nondiscriminatory admissions policies in accordance with Revenue Ruling 71-447 and revenue procedures. The IRS had determined that the fund was no longer tax exempt because the fund was not "operated exclusively" for exempt purposes as specified in IRC Section 501(c)(3).

Considerations for Congress

Even though *Bob Jones* did not limit violations of fundamental public policy to the area of racial discrimination, it is unclear whether there are fundamental public policies against other forms of discrimination. In the past, the IRS indicated federal public policies against other forms of discrimination were "not so clearly and uniformly established." One study of IRS written determinations since 2004 found that the IRS "never invoke[d] sex, age, disability, or sexual-orientation discrimination" as a basis for denying exemption. To expressly deny 501(c)(3) status to organizations engaging in discrimination, Congress could amend IRC Section 501(c)(3) to include language delineating the forms of discrimination prohibited.

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