L. INSTRUMENTALITIES - LESSENING THE BURDENS OF GOVERNMENT

1. Introduction

Two categories of organizations that qualify for recognition of exemption under IRC 501(c)(3) are instrumentalities wholly-owned by a state or by a political subdivision, and organizations whose purpose is to lessen the burdens of government. The purpose of this article is to discuss the considerations that are brought to bear in deciding whether an organization may be properly classified in either of the above categories. Further, since instrumentalities are unique organizations, they present unique issues under other sections of the Code. These issues, insofar as they relate to exempt organizations matters, also will be discussed.

2. Instrumentalities

A. History to the Publication of Rev. Rul. 60-384

Prior to the enactment of the Social Security Act Amendments of 1950, many instrumentalities, among them educational organizations, were held to qualify for exemption under the predecessor of IRC 501(c)(3), IRC (1939) 101(6). However, the amendments to the Social Security provisions introduced by the 1950 Act raised some problems in this regard. Separate exceptions from social security coverage were provided for services performed in the employ of (1) a state instrumentality, and (2) an educational organization exempt from income tax under IRC 101(6). These overlapping exceptions and conflicting methods for waiving them caused the Service to treat instrumentalities as organizations not within the meaning of IRC 101(6). Therefore, during the period from 1950 to 1955, the Service refrained from recognizing instrumentalities as exempt charitable organizations.

Instrumentalities were ineligible to purchase tax sheltered annuities for their employees, however, so long as they failed to qualify for exemption under IRC 101(6). Since these annuity programs were available to private charitable counterparts of many state instrumentalities, such as colleges and universities, consideration was given to whether instrumentalities should be eligible for the same benefits. The problem was resolved by the publication or Rev. Rul. 55-319, 1955-1 C.B. 119.

(Also Section 501.) Rev. Rul. 55-319
(Also Part II, Section 1426; Regulations 128,Section 408.214.)

A wholly-owned State instrumentality may in some circumstances qualify for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954. Coverage under the Social Security Act of employees of a wholly-owned State instrumentality may be effected only pursuant to a compact under section 218 of the Social Security Act. The "waiver" procedure provided in section 3121(k) of the Federal Insurance Contributions Act is not applicable to a wholly-owned State instrumentality irrespective of whether the particular instrumentality is exempt under section 501(c)(3) of the Code.

An inquiry has been received whether (1) a wholly-owned State instrumentality may also qualify for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954 and (2), if so, whether the "waiver" procedure provided in section 3121(k) of the Federal Insurance Contributions Act (chapter 21, subtitle C, Internal Revenue Code of 1954) is applicable in effecting coverage for its employees under the Social Security Act.

It is held that where an organization desires to have the benefit of a particular tax feature extended to its employees, such as the exception provided by section 403 of the Code, which depends on exemption under section 501(a) of an employer described in section 501(c)(3), and the particular organization meets the statutory requirements for exemption under section 501(c)(3) of the Code, it may be granted exemption thereunder, regardless of the fact that it also qualifies as a wholly-owned State instrumentality and, as such, would not be subject to Federal income tax.

It does not follow, however, that coverage under the Social Security Act may be effected for employees of such an organization by the "waiver" procedure provided by section 3121(k) of the Federal Insurance Contributions Act.

Section 3121(b)(8)(B) of the Act, as amended by the Social Security Amendments of 1954, excepts from "employment" service performed in the employ of an organization exempt from income tax under section 501(c)(3) of the Code. However, such an organization may waive its exception as to certain employees by complying with the provisions of section 3121(k) of the Act.

Section 3121(b)(7) of the Act excepts from "employment" service performed in the employ of a State, or any political subdivision thereof, or any instrumentality of any one or more of the foregoing, which is wholly owned by one or more States or political subdivisions. Section 218 of the Social Security Act, as amended, 42, 4 S.C. 418, provides for the coverage of employees of wholly-owned State organizations if the State and the Department of Health, Education, and Welfare enter into a compact providing for such coverage.

To secure coverage under the Social Security Act of employees of an organization exempt under section 501(c)(3) of the Code, section 3121(k) of the Federal Insurance Contributions Act requires the consent of the particular organization and two-thirds of its employees; but to secure coverage for a wholly-

> owned State instrumentality, section 218 of the Social Security Act requires the consent of the State, rather than that of the particular instrumentality.
>
> In view of the Congressional purpose behind section 218 of the Social Security Act of allowing State governments, rather than a particular State instrumentality, discretion in determining which State employees should be covered under the Social Security Act, it is held that employees of wholly-owned State instrumentalities may secure social security coverage only by the procedure outlined in section 218 of the Social Security Act. See Senate Report No. 1669 on Social Security Act Amendments of 1950, C.B. 1950-2, 302, at 307, and 324. Therefore, the "waiver" procedure provided in section 3121(k) of the Federal Insurance Contributions Act is not applicable to a wholly-owned State instrumentality irrespective of whether the particular instrumentality also qualifies for exemption under section 501(c)(3) of the Code.

The principles enunciated by Rev. Rul. 55-319 endure; even the statements relating to social security coverage remain in effect. What Rev. Rul. 55-319 does not address, however, is how these principles were to be administered. Administration had to flow from the proposition that Congress had a policy of exempting under IRC 501(a) organizations which are carrying on educational, charitable, etc., work, regardless of what may or may not be their status under some <u>other</u> provision or principle of law. In other words, IRC 501(c)(3) is a descriptive section, and in order for an organization (instrumentality or otherwise) to qualify for exemption, it must be described therein, regardless of whether it would be otherwise subject to federal income tax. The circumstances under which an instrumentality may qualify for IRC 501(c)(3) exemption were addressed in Rev. Rul. 60-384, 1960-2 C.B. 172, which in pertinent part is excerpted below:

> Revenue Ruling 55-319 holds, in part, that where an organization desires to have the benefit of a particular tax feature extended to its employees, such as the exemption provided by section 403 of the Code, which depends on exemption under section 501(a) of an employer described in section 501(c)(3), and the particular organization meets the statutory requirements for exemption under section 501(c)(3) of the Code, it may be granted exemption thereunder, regardless of the fact that it also qualifies as a wholly-owned state instrumentality and, as such, would not be subject to Federal income tax.
>
> Thus, such an organization may be exempt under section 501(c)(3) of the Code if it is organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals.
>
> A state or municipality itself, however, would not qualify as an organization described in section 501(c)(3) since its purposes are clearly not exclusively those described in section 501(c)(3) of the Code. See for example, *Estate of John C. F. Slayton v. Commissioner*, 3 B.T.A. 1343. It follows, therefore, that where the particular branch or department under whose jurisdiction

> the activity in question is being conducted is an integral part of a state or municipal government the provisions of section 501(c)(3) would not be applicable. For example, where a public school, college, university or hospital is an integral part of a local government, it could not meet the requirements for exemption under section 501(c)(3) of the Code.
>
> On the other hand a wholly-owned state or municipal instrumentality which is a counterpart of an organization described in section 501(c)(3) of the Code such as a separately organized school, college, university, or hospital may qualify for exemption under section 501(c)(3) of the Code. If the organization conducting the activity, although a separate entity, is clothed with powers other than those described in section 501(c)(3) it would not be a clear counterpart of a section 501(c)(3) organization. For example, where a wholly-owned state or municipal instrumentality exercises enforcement or regulatory powers in the public interest such as health, welfare, or safety, it would not be a clear counterpart of an organization described in section 501(c)(3) of the Code even though separately organized since it has purposes or powers which are beyond those described in section 501(c)(3).
>
> In order for a wholly-owned instrumentality to establish an exemption under section 501(c)(3) of the Code, it is necessary to file an application on Form 1023, Application for Exemption, with the District Director of Internal Revenue for the internal revenue district in which is located the principal place of business or principal office of the organization. See section 1.501(a)-1 of the Income Tax Regulations.
>
> Revenue Ruling 55-319, C.B. 1955-1, 119, is hereby amplified.

Essentially, therefore, in this area the applicant must be (1) a separately organized entity (2) whose activities are described in IRC 501(c)(3). How these standards are met will be discussed below.

B. <u>Satisfaction of the Separately Organized Entity Requirement</u>

As noted above, an indispensible characteristic that the instrumentality must have to achieve IRC 501(c)(3) exemption, is that it must be a separately organized entity and not a mere integral part of the state or local government itself. If the instrumentality is just a unit or department of the state or local government, the activity in question would be the government's activity, and exemption would be unattainable because the government's purposes are clearly not those described in IRC 501(c)(3). (For an example of an organization that fails to qualify for exemption on this basis, see Rev. Rul. 62-66, 1962-1 C.B. 83.) Thus, the first issue to be dealt with is whether the instrumentality seeking exemption is "separately organized."

The statutory language speaks in terms of exemption only of certain organizations, namely, "corporations, and any community chest, fund, or foundation" described therein. Thus, although a formless aggregation of individuals, or possibly even a partnership, conceivably might be utilized by a state or local government as its instrumentality for the conduct of a particular undertaking, such a group, not being an organization distinct from its creators within the contemplation of the IRC, could not qualify for exemption, whatever its functions might be.

The groups considered capable of having an existence of their own apart from their creators for purposes of the IRC are corporations, trusts, and associations. (See, for example, the following IRC provisions: Part II of Subchapter A, Subchapter J, and Chapter 79.)

The documents pertaining to the creation of the organization normally will disclose the nature of its formal structure, that is, whether it is in form a corporation, a trust, or an association, as well as the legal authority for its formation. Absent evidence of sham or other lack of reality, an organization will be viewed in substance as the kind of organization that, in form, it purports to be. (See, for example Rev. Rul. 64-220, 1964-2 C.B. 335; Reg. 1.501(a)-1(a)(3)(i) [applicants for exemption must submit conformed copy of articles of incorporation, declaration of trust or instrument of similar import].) Accordingly, if the instrumentality in question is in substance and in form a corporation, it must be considered legally separate and distinct from the government that it serves. This is because by definition a corporation is an artificial person or legal entity created under the authority of the laws of a state or nation that is regarded as having a personality and existence completely distinct from that of its creators and constituents. (See Black's Law Dictionary 409 (Rev. 4th Ed. 1968).

Similarly, where an instrumentality is organized and operated as a trust, it must be regarded as legally separate from its governmental creator for purposes of the IRC (See, for example, Rev. Rul. 57-151, 1957-1 C.B. 64.)

The difficult problem in this area arises in determining whether an instrumentality that is neither a corporation nor a trust is separately organized for purposes of applying the principles established in Rev. Rul. 60-384. What follows is a discussion of the hallmarks or distinguishing features such an unincorporated body must have in order to be considered an entity separate and distinct from its creators and constituents, that is, "separately organized" for federal tax purposes.

The only available insights for resolving this issue are to be found in the regulations implementing IRC 7701(a)(3) with respect to "associations." As noted above, this is because the only unincorporated bodies [other than trusts] that the IRC recognizes as separate entities for tax purposes are associations.) Therefore, if an unincorporated body other than a trust is to achieve status as a separate entity for IRC 501(c)(3) purposes, it must be an "association," that is, it must possess certain requisite corporate characteristics as provided in Reg. 301.7701-2.

Reg. 301.7701-2 enumerates the following six major characteristics ordinarily found in a pure corporation, which, taken together, distinguish it from other organizations: associates, an objective to carry on business and divide the gains therefrom, continuity of life, centralization of management, liability for corporate debts limited to corporate property, and free transferability of interests.

Reg. 301.7701-2 proceeds to prescribe a "weighing test," that is, a rule that an unincorporated association shall not be classified as an association unless it has more corporate than non-corporate characteristics. If the inquiry is whether the organization more nearly resembles a corporation than a partnership, then in determining whether it has more corporate than noncorporate characteristics the characteristics common to both types of organizations are not considered. Similarly, if the inquiry is whether the organization more nearly resembles a corporation than a trust, the characteristics common to both types of organizations are not taken into account.

There are obvious problems here: the "weighing test" and some of the corporate characteristics enumerated above (particularly "an objective to carry on business and divide the gains therefrom") are not relevant to unincorporated nonprofit bodies. Thus, it is not possible to apply the Reg. 301.7701-2 rules as they are written in determining when an unincorporated organization can qualify as an association, and hence as a separately organized body distinct from its creator. Nevertheless, the rules of Reg. 301.7701-2 are not limited in their application only to cases involving classification of <u>for profit</u> organizations. Therefore, the rules of Reg. 301.7701-2 have to be adapted to cases involving classification of nonprofit organizations.

The adaptation that has evolved has taken the following form:

(1) Unlike most classification cases, the issue in the nonprofit area almost always is not whether the organization is an association as distinguished from a partnership or a trust; rather, the issue is

whether it is an association or a mere formless aggregation of individuals having no status as an entity at all. In other words, there are no common characteristics essential to both groups to be disregarded under the rules established in Reg. 301.7701-2(a).

(2) As noted above, the characteristic "an objective to carry on business and divide the gains therefrom" is neither relevant nor apt in this area. Accordingly, an adaptation has been made - this activity is considered as present if it is established that the organization has an objective to carry on, jointly, activities in furtherance of the purposes for which it was formed.

(3) Therefore, in applying the "weighing test," all of the corporate characteristics are taken into account and an organization would not be entitled to association classification unless establishes that it possesses a majority of them.

(4) The ordinary nonprofit unincorporated organization will lack both limited liability and free transferability of interests. However, if it has associates, continuity of life, centralization of management, and an objective to carry on, jointly, activities in furtherance of the purposes for which it is formed, it will possess a preponderance (four) of the six corporate characteristics.

(5) Therefore, if an unincorporated nonprofit instrumentality possesses at least four of the six corporate characteristics, it will be an association for federal tax purposes and, therefore, may be considered to be an organization distinct from its creator and constitutes a separate entity for purposes of IRC 501(c)(3), and more specifically Rev. Rul. 60-384.

Once an organization establishes it has the proper organizational form (corporation, trust, or association), it will be considered to have met the separately organized entity test, unless, in substance, it is not a separately organized entity. Two examples where an organization possessed the formal requirements but substantively lacked the qualities of a separately organized entity follow:

1. An unincorporated division of mental health created by state statute was also created to operate as a unit within a state governmental department, and was subject to managerial control

by that department. (The organization's affairs were conducted and managed entirely by state officers acting as such, and the department head had veto power over the organization's proposals.) Substantively, this organization is a component part of the state government, rather than a separate entity.

2. A city ordinance provided for the establishment of a police force "separate and distinct from the regular force of the police department of the city." A constitution virtually identical to the city ordinance was then drawn up. Under the city ordinance, the police chief selected its membership, approved its standard operating procedures, prescribed its uniforms and badges, etc. The organization is not an association. The "constitution" did not set up an organization separate from the city; it accomplished nothing not already accomplished by the government under the city ordinance.

C. Satisfaction of the Requirement that Activities are Described in IRC 501(c)(3)

As noted above, Rev. Rul. 60-384 establishes that a state or municipality could not qualify as an IRC 501(c)(3) organization since its purposes are not exclusively purposes described in IRC 501(c)(3). Furthermore, an organization wholly-owned by a state or a municipality is not a clear counterpart of an IRC 501(c)(3) organization and is not entitled to exemption if it exercises powers that are governmental in nature, that is, "enforcement or regulatory powers in the public interest such as health, welfare or safety." Exemption is denied because the organization "has purposes or powers which are beyond those described in section 501(c)(3)." (This position has been implicitly supported by the courts. See Estate of Leslie Johnson v. Commissioner 56 T.C. 944 (1971), acq. 1973-2 C.B. 2; Old Colony Trust Company v. United States, 438 F. 2d 684 (1st Cir. 1970).)

The government governs by exercise of its sovereign powers. These powers are, the power of eminent domain, the power of taxation, and the police power. (See Estate of Shamberg v. Commissioner, 31 T.C. 131 (1944), aff'd 144 F. 2d 998 (1944).) Not every exercise of a sovereign power, however, is the exercise of a disqualifying regulatory or enforcement power within the meaning of Rev. Rul. 60-384. The power of eminent domain, for example, is not disqualifying if the grant of the power is limited to aiding an exempt organization in accomplishing its own purposes. See Rev. Rul. 67-290, 1967-2 C.B. 183. The reasoning here is based on the view that a regulatory or enforcement power is a power akin to that possessed by governmental agencies to promulgate and enforce standards and modes of conduct. The organization described in Rev. Rul. 67-290 is a public hospital corporation organized under a statute conferring on it the power to acquire by the right of eminent domain any property essential to its purposes. The exercise of this limited power of eminent domain entailed neither regulation nor enforcement. Thus, it was concluded that the organization's limited power of eminent domain did not so enlarge the scope of its permissible activities so as to authorize its operation for purposes beyond those described in IRC 501(c)(3).

Few cases involving taxation have been considered. However, a power to determine a tax rate necessary to support an organization's operations, a power related more to the disposition of tax than to the exercise of the taxing power of the political unit involved, does not constitute a regulatory or enforcement power. See Rev. Rul. 74-15, 1974-1 C.B. 126.

The situation regarding police power, however, is quite complex. Obviously, the exercise of "enforcement or regulatory powers in the public interest such as health, welfare, and safety" discussed in Rev. Rul. 60-384 encompasses at least the exercise of a portion of the state's police power. ("Police power" is defined in 16 C.J.S. Constitutional Law, section 174 as "the power inherent in a government to enact laws, within constitutional limits, to promote the general order, safety, health, morals, and general welfare of society.)"

The classic case of an organization with extensive and, therefore, disqualifying police powers is described in Rev. Rul. 74-14, 1974-1 C.B. 125. The organization described therein was a municipal housing authority that investigated whether unsanitary or unsafe conditions existed. The authority was authorized to issue subpoenas, take testimony under oath, and to share with appropriate agencies its findings concerning property where conditions existed that were dangerous to public health, safety, or welfare. The ruling concludes that the authority's investigative powers were regulatory or enforcement powers. Accordingly, the organization does not qualify for exemption under IRC 501(c)(3). The problem here is the power of subpoena, which involves the power to compel testimony under threat of imprisonment if the testimony is not forthcoming. The power to punish is a power of the state alone. See 8 Wigmore, Evidence, section 2195.

Other situations not involving a power so drastic as the power to subpoena, may be used in a fashion that is either consistent or inconsistent with exemption under IRC 501(c)(3). The key question is whether the purpose for which the power may be used falls within or without those enumerated in IRC 501(c)(3).

Consider an organization empowered to operate major transportation facilities. The purpose served by this authorization may be the maintenance of channels for the orderly flow of commerce, similar to that furthered by the construction and maintenance of highways and bridges. On the other hand, the purpose may be to regulate the flow of commerce and to assume the governing role of a state agency. The power to adopt and enforce regulations likewise may be viewed as either the proprietary prerogative of any organization to control the use of its property, or a mandate to regulate the flow of commerce to achieve governmental goals.

Any organization, charitable or otherwise, may adopt rules and regulations for the use of its property. If that property is a public facility necessary to the orderly flow of commerce within a state, however, the organization's rules and regulations have a direct impact on commerce. This is especially true if the state relinquishes its control over the facility and places broad authority in the organization to administer it. Substantial public safety and public health problems accompany the operation of a large, complex commercial facility such as a port or airport. For example, may ships empty their bilge pumps into waters around docks; must trucks carrying aviation fuel have specific safety devices? Some authority must regulate these activities, not solely to protect the facility, but to protect the interests of the public. Therefore, the granting of authority to a transportation operator, unless severely circumscribed would clothe that organization with regulatory and enforcement powers, and thus disqualify it from IRC 501(c)(3) status.

There are further precedents under IRC 103 that consider whether an organization exercises a substantial part of the state's sovereign power. Under Reg. 1.103-1(b), a corporation that has been delegated the right to exercise a substantial part of the sovereign power of the state is a political subdivision. Consideration of these precedents are helpful in determining whether a particular exercise of the police power is a disqualifying enforcement or regulatory power of the type described in Rev. Rul. 60-384.

For example, Rev. Rul. 77-165, 1977-1 C.B. 21, holds that a state university, whose only connection with the power to tax is that it is supported by legislative appropriations based on budgets it submits, that does not have the power of eminent domain and that was granted the limited power of regulating traffic within its confines and a limited arrest power does not qualify as a political subdivision within the meaning of Reg. 1.103-1(b). The important factor to note here is that the traffic and arrest powers were considered too limited to constitute delegation of a substantial police power.

Philadelphia National Bank v. United States, 666 F.. 2d 834, 840 (3rd Cir. 1981), is similar. At issue was whether Temple University exercised a substantial part of the state's sovereign power because it received state funds (allegedly, the power to tax), because it could petition a state authority to exercise eminent domain power, and because it could petition a state authority to exercise eminent domain power, and because it operated a campus police force (allegedly an exercise of the police power). The Third Circuit determined that Temple had not taxing or eminent domain power and only a limited authorization to exercise one small aspect of the police power. (Temple only patrolled property it owned, and had to present those arrested to the city police for booking.) Accordingly, it was concluded that Temple was not a political subdivision under IRC 103.

Unlike Temple University, the Port Authority of New York, considered in Shamberg, (supra), was determined to be a political subdivision. It had been delegated eminent domain power and had been given the power to enact rules and regulations effective as to the general public and could enforce its own rules and regulations through the criminal courts. This indicated that the Port Authority was delegated substantial portions of the state police power to ensure the proper operation and control of the bridges and tunnels within its jurisdiction.

In summary, not every grant of governmental power is the grant of a regulatory or enforcement power that would disqualify an organization from IRC 501(c)(3) status. What must be considered are the following:

1. The nature of the power granted. If the power involves an inherent right reserved to the state alone, such as the power to subpoena, which, in turn, involves the right to punish, the power is a disqualifying regulatory or enforcement power.

2. The purpose and extent of the power granted. If the nature of the power granted is ambiguous, purpose and extent are pivotal. Thus, the power of eminent domain granted to the organization described in Rev. Rul. 67-290 was not disqualifying because it was limited to the acquisition of property essential to the purpose of the organization, that is, the construction and maintenance of

hospital facilities. If the organization was not so limited in the use of its eminent domain power, the power could be a disqualifying regulatory or enforcement power.

D. Miscellaneous Issues

1. Issue: Is an instrumentality that has been recognized as an exempt organization under IRC 501(c)(3) subject to the tax on unrelated business income imposed by IRC 511?

Conclusion:

When an instrumentality qualifies for and elects exemption under IRC 501 (c)(3), it is subject to the burdens as well as the benefits of Subchapter F. In order for an instrumentality to qualify for exemption under IRC 501(c)(3), it must establish that it is separate and apart from a state. (Rev. Rul. 60-384).

If an instrumentality qualifies for and elects treatment as an organization "separate and apart" from the state, it will not be within the rationale of Rev. Rul. 71-131, 1971-1 C.B. 28, which holds that income derived by a state itself from an activity it carries on directly is not subject to federal income tax. Consequently, it should be treated in the same manner as any other IRC 501(c)(3) organization for purposes of the unrelated business income tax provisions.

Therefore, if an instrumentality is exempt under IRC 501(c)(3), it will be subject to the unrelated business income tax under IRC 511(a)(2)(A).

2. Issue: It is mentioned above that instrumentalities exempt under IRC 501(c)(3) are subject to tax under section 511(a)(2)(A) on their income derived from unrelated trade or business. What is the purpose of section 511(a)(2)(B)?

Conclusion:

Congress enacted what is now IRC 511(a)(2)(B) to tax the unrelated business income of state colleges and universities that did not have exemption rulings under what is now IRC 501 (c)(3), but which were, nevertheless, exempt from tax on their income because they were agencies or instrumentalities of the state. Congress wanted to place these entities on a parity with colleges and universities that are exempt under IRC 501(c)(3) and subject to IRC 511(a)(2)(A).

S. Rep. No. 781, 82d Cong., 1st Sess., pt. 2 (1951), 1951-2 C.B. 545, 584-5 in support of this conclusion. In part, this report stated:

This section of your committee's bill, in effect subjects colleges and universities run by governments to similar tax treatment under Supplement V with respect to their unrelated business activities as is now provided under Supplement V in the case of private colleges and universities exempt under IRC 101(6).

Thus, governmental colleges and universities that are instrumentalities have a somewhat different status with respect to IRC 511 than other instrumentalities. Other instrumentalities are subject to the tax imposed by IRC 511 on unrelated business income only if they are recognized as exempt under IRC 501(c)(3). Governmental colleges and universities are subject to the tax imposed by IRC 511 regardless of their status under IRC 501(c)(3).

This potential liability for IRC 511 tax derives not from their IRC 501(c)(3) status, but from Congress' intention to treat them similarly to private colleges and universities that are exempt under such section.

3. Issue: The peculiar status of governmental colleges and universities has been noted. Suppose a state university derived income from the operation of utility services. Under IRC 511 this income would be taxable. However, IRC 115(1) provides that gross income does not include income derived from any public utility or the exercise of any essential governmental function and accruing to a State or political subdivision thereof. If the state university's income from the operation of utility services accrued to the state, therefore, this income would not be taxable under IRC 115(1). Which section prevails?

Conclusion:

IRC 511. As noted above, it is apparent that Congress intended that both governmental and private universities should be subject to the same standard in determining liability for the tax on unrelated trade or business income. Accordingly, the scope of the trade or business activities that are considered to be unrelated to a state university are the same as if it were a private university.

4. Issue: Is there a situation where an instrumentality exempt under IRC 501(c)(3) is not required to file annual information returns?

Conclusion:

In general, organizations exempt from taxation under IRC 501(a) must file an annual information return pursuant to IRC 6033(a). However, such returns are not required to be filed by organizations that are state institutions, the income of which is excluded from gross income under IRC 115(1). Reg. 1.6033-2(g)(1)(v).

IRC 115(1) provides that gross income does not include income derived from the exercise of any essential governmental function and accruing to a state or any political subdivision thereof.

For an organization to qualify under Reg. 1.6033-2(g)(1)(v) all the income must be excluded by reason of IRC 115. An organization having unrelated business taxable income or income within the scope of IRC 513(a)(2) would not come within the scope of Reg. 1.6033-2(g)(1)(v).

Therefore, it has been determined that if an organization's income is excluded under IRC 115(1) and it has no income within the scope of IRC 511 or 513(a)(2), it does not have to file an annual information return. Such organizations should be informed, however, that, if they receive IRC 511 or 513(a)(2) income, an annual information return will be required.

It also should be noted that instrumentalities with annual gross receipts of less than $25,000 are excepted from filing annual information returns. See Rev. Proc. 83-23, 1983-1 C.B. 687.

5. Issue: May an instrumentality which has been recognized as exempt under IRC 501(c) voluntarily relinquish its exempt status in order to avoid the IRC 6033 requirement that it file an annual information return:

Conclusion:

Neither the IRC nor the Regulations makes provision for voluntary relinquishment by organizations, such as instrumentalities, that are not private foundations.

6. Issue: What are the effects if an instrumentality is held not to qualify for exemption under IRC 501(c)(3)?

Conclusion:

If denied exemption under IRC 501(c)(3) the income of an instrumentality would still be excluded from taxation and contributions would still be deductible under IRC 170(c)(1) (not IRC 170(c)(2)). Returns would generally not be required under IRC 6033.

7. Issue: Are Indian Tribes instrumentalities?

Conclusion:

The long-standing Service position, set forth in Rev. Rul. 67-284, 1967-2 C.B. 55, 58, is that income tax statutes do not tax Indian tribes; a tribe is not a taxable entity. However, Pub. L. 97-473, January 14, 1983, amends Chapter 80 of the IRC to add section 7871 to provide that an Indian tribal government shall be treated as a State for the purpose of determining whether contributions for such government are deductible under IRC 170, for purposes of IRC 511(a)(2)(B) (relating to taxation of colleges and universities which are agencies or instrumentalities of governments or their political subdivisions), for purposes of IRC 117(b)(2)(A) (relating to scholarship or fellowship grants), and for purposes of Chapter 41 (relating to tax on excess expenditures to influence legislation) and Subchapter A of Chapter 42 (relating to private foundations).

8. Issue: What is an instrumentality?

Conclusion:

Rev. Rul. 57-128, 1957-1 C.B. 311, states that in cases involving the status of an organization as an instrumentality the following factors and taken into consideration: (1) whether it is used for a governmental purpose and performs a governmental function; (2) whether performance of its function is on behalf of one or more states or political subdivisions; (3) whether there are any private interests involved or whether the states or political subdivisions involved have the power and interests of an owner; (4) whether control and supervision of the organization is vested in public authority or authorities; (5) if express or implied statutory or other authority is necessary for the creation and/or use of such an instrumentality, and whether such authority exists; and (6) the degree of financial autonomy and the source of its operating expenses.

Resolution of these factors, however, is not an exempt organization function; the term "instrumentality" appears in IRC 3121(b)(7), and employment tax personnel are charged with the responsibility of administering that section. Therefore, often it is not known whether the applicant organization is an instrumentality, and in a rare situation it may be necessary to seek technical assistance. Most cases, however, can be resolved without assistance. The same rules apply with respect to organizational requirements; regulatory or enforcement powers may be a disqualifying feature of an organization that, while not an instrumentality, has been vested with such powers; and, operationally, the organization may qualify for exemption on such grounds as lessening the burdens of government. This brings us to the next topic.

3. Lessening the Burdens of Government

A. Background and General Principles

The phrase "lessening the burdens of government" was not included in the regulations until 1959. It is only since that time that the Service has cited that phrase in revenue rulings. There are, however, early precedents according to such authorities as Bogert and Scott. The following excerpt from Scott, The Law of Trusts 3d Ed. 1967, Vol. IV, section 373.2 (as amended), is particularly instructive in establishing the charitable basis of this category of organizations:

> Section 373.2. Relieving burdens of government. In many of the cases cited in the two preceding sections there was a gift directly to the nation, or to a state or to a municipality. In others a trust was created, the performance of which would relieve the government of a burden which it would or might otherwise have had to bear out of its own resources, and thus was a relief to the taxpayers. This is the case where provision is made for the establishment or maintenance of parks, water supply, fire protection, public or community buildings, roads and bridges, or for various other purposes which are normally taken care of by the government. Trusts for such purposes are charitable, although they benefit the rich as well as the poor.

Therefore, the first principle: Lessening the burdens of government is itself a charitable purpose and there is no requirement that an organization be doubly charitable in order to qualify under IRC 501(c)(3). Indeed, such a requirement would make inclusion of the term "lessening the burdens of government" in the list of charitable purposes in Reg. 1.501(c)(3)-1(1)(2) superfluous. In many cases, organizations lessening the burdens of government will be able to qualify for exemption under IRC 501(c)(3) as fulfilling another charitable purpose. (See, for example, Rev. Rul. 65-2, 1965-1 C.B. 227; Rev. Rul. 66-257, 1966-3 C.B. 212; Rev. Rul. 66-358, 1966-2 C.B. 218; Rev. Rul. 67-138, 1967-1 C.B. 129, Rev. Rul. 68-17, 1968-1 C.B. 247; and Rev. Rul. 70-583, 1970-2 C.B. 114.) However, there are, as the excerpt from Scott indicates, numerous examples of situations in which an organization was held to be charitable even though it fulfilled no charitable purpose beyond relieving the burdens of government. This article will focus on these situations.

B. Evolution of a Standard

The revenue rulings cited in the preceding paragraph cite the "burdens" phrase and either make no further reference to it or simply conclude that the activity involved lessens the burdens of government. Other published rulings, however, took particular, and different, approaches to determine whether an organization's activities could be characterized appropriately as lessening the burdens of government.

One approach focused on whether there are direct or implied cost or work force savings to the government that are attributable to the activities of the organization. In Rev. Rul. 62-78, 1962-1 C.B. 86, the Service ruled that an exempt organization that distributes its income to a state or municipality or to an activity that is an integral part thereof does not jeopardize its exempt status under IRC 501(c)(3) provided that the funds are used to carry out the purposes which constitute the basis of the donor organization's exemption. Consequently, in Rev. Rul. 68-14, 1968-1 C.B. 243, it is held that an organization that preserves and develops the beauty of a city may qualify for exemption under IRC 501(c)(3) because it lessens the burdens of government by planting trees in public areas for which the city does not have sufficient funds and assists the city authorities in programs to keep the city clean.

Another approach involved a finding of assistance in the performance of governmental functions. In Rev. Rul. 74-246, 1974-1 C.B. 130, it is held that an organization that assists a police department in the apprehension and conviction of criminals by making funds available for rewards qualifies for exemption under IRC 501(c)(3) because "the gratuitous performance of services to federal, state, or local governments is charitable in the generally accepted legal sense" and that such activity lessens the burdens of government. Consistently, in Rev. Rul. 76-418, 1976-2 C.B. 145, it is noted that traffic control and safety are universally recognized as a government responsibility and that an organization which provides expert opinions to local government officials regarding the existence of hazardous traffic conditions in their communities is lessening the burdens of government and thus is engaged in a charitable activity.

Yet another approach involved a determination whether the activity conducted is a governmental activity or function. Initially, the Service considered what independent legal authorities have determined to be governmental functions. Thus, the Statute of Charitable Uses was cited in Rev. Rul. 71-29, 1971-1 C.B. 150; the work of commentors in Rev. Rul. 71-99, 1971-1 C.B. 151; and court cases in Rev. Rul. 74-361, 1974-2 C.B. 159.

Finally, in Rev. Rul. 74-117, 1974-1 C.B. 128, the Service expressed the view that the government is the party best qualified to determine whether an activity is sufficiently in the public interest to warrant its recognition as a legitimate function of government. In Rev. Rul. 74-117, the state in question had never provided for a transition committee for new governors. Even though other states had provided for such committees, the committee's activities in this particular state were not recognized as governmental. (Moreover, the committee's activities were found to be serving partisan interests.) Conversely, in Rev. Rul. 78-68, 1978-1 C.B. 149, it is concluded that an organization formed as a model cities demonstration project under the Demonstration Cities and Metropolitan Development Act of 1966 to provide bus transportation to isolated areas of a community not served by the existing city bus system qualifies for exemption under IRC 501(c)(3) as an organization relieving the burdens of government. Great emphasis was placed on the organization's connections with the local and federal governments.

These various approaches were by no means invalid. Nevertheless, a framework was missing; a standard had to be developed. This standard will be set forth below.

C. The Standard

The standard developed involves a two-step test. First, it is necessary to identify whether the organization's activities are activities that a governmental unit considers to be its burden, and, second, whether such activities actually "lessen" the governmental burden.

To determine whether an activity is a burden of government, the question to be answered is whether there is an objective manifestation by the government that it considers such activity to be part of its burden. The fact that an organization is engaged in an activity that is sometimes undertaken by a government is insufficient to establish a burden of government. Similarly, the fact that the government or an official of the government expresses approval of an organization and its activities is also not sufficient to establish that the organization is lessening the burdens of government. The interrelationship between the organization and the government may provide evidence that the government considers the organization's activities to be its burden.

To determine whether an organization is actually lessening the burdens of government, all the relevant facts and circumstances must be considered. A favorable working relationship between the government and the organization is strong evidence that the organization is actually "lessening" the burdens of the government.

D. The Standard Discussed

A governmental unit can indicate in several ways that it considers a specific activity carried on by a particular organization to be a governmental function and that it recognizes the organization as acting in its behalf in performance of this function. The most obvious case is one in which the governmental unit permits the organization to take part in an activity actually being performed by the governmental unit. The governmental unit might act jointly with the organization or allow the organization to assume the operation of this activity. On the other hand, the organization might conduct an activity which is an integral part of a larger program of a governmental unit. Finally, in certain cases the governmental unit may otherwise make it clear that it considers the specific activity carried on by the organization to be one of its responsibilities and that it views the organization to be acting in its behalf.

Relevant factors, in addition to "a favorable working relationship," would include whether the government had actually undertaken this activity itself and whether there have been formal actions by a legislative body or other official actions by the governmental unit establishing that it expressly accepts the activity as a governmental burden and recognizes the organization as acting on its behalf.

Above all, as the standard focuses on the actual relationship of governmental unit and private organization, evidence of that relationship must be advanced. This is particularly true in the case of organizations claiming to render gratuitous, non-educational, and non-financial assistance to governmental agencies, such as police departments. There must be evidence of cooperation between the organization and the government it purport to serve.

D. The Standard Applied

That the presence or absence of a working relationship is often critical perhaps is best illustrated by a comparison between Rev. Rul. 78-68 (supra) and Rev. Rul. 78-69, 1978-1 C.B. 156. Both revenue rulings are concerned with nonprofit, nonmember organizations that provide bus service. As a general, abstract statement, it can be said that the provision of some type of bus service is a governmental burden. However, we are not concerned with general abstractions, but with particular, actual relationships. The organization discussed in Rev. Rul. 78-68 was created pursuant to a federal statute and worked closely with local government agencies. The working relationship was thus established, and the organization qualified for IRC 501(c)(3) status on the basis of relieving the burdens of government. In Rev. Rul. 78-69 there was no evidence that the local transit authority or any local government unit had assumed the responsibility of providing bus service of the quality or extent provided by the organization. (It should perhaps be noted here that the organization described in Rev. Rul. 78-68 receives some of its income from fares. Charging reasonable fees for services is not incompatible with recognition of charitable status for an organization found to be relieving the burdens of government.)

Relationships may be ongoing, such as in Indiana Crop Improvement Association, Inc. v. Commissioner, 76 T.C. 394 (1981) acq., 1981-2 C.B.1, where the organization involved was the official seed certifying agency for the state pursuant to a delegation of authority from the state legislature. Alternatively, it may arise from the fact that a governmental unit wants an activity conducted in a different form, as in a situation where a state statute mandates a governmental activity and the responsible governmental unit, which formerly paid individuals to perform the activity, decides to use volunteers, and funds an organization to train them. The activity need not be one that is traditionally governmental -see the professional standards review organization discussed in Rev. Rul. 81-276, 1981-2 C.B. 129.

Where statutes are present, they should be scrutinized carefully. If a development authority is organized by private persons, is thereafter controlled by a political subdivision of a state, and is authorized to borrow money, it cannot be said to be relieving a burden of government if the local government is prohibited from making expenditures for the purposes for which the authority will expend money. The prohibition evidences the absence of a governmental burden.