TAX FORUM
No. 459

Public Policy Limits on Tax Benefits: *Bob Jones* Revisited

Harvey P. Dale*

April 2, 1990

*. Copyright © 1990 by Harvey P. Dale. All rights reserved.

Table of Contents

I. Introduction 1
II. Public Policy Denial of Tax Deductions 3
III. Background to Bob Jones 6
IV. Developments After Bob Jones 15
A. Attribution of Illegal Activities to Entities 15
B. The Scope of "Fundamental Public Policy" 18
C. The Application of Bob Jones to Other Tax Benefits 23
V. The Future of Bob Jones 26

Public Policy Limits on Tax Benefits: Bob Jones Revisited*

I. Introduction

In Bob Jones University v. United States,[1] the Supreme Court denied charitable tax-exempt status[2] to schools which discriminated against blacks. The majority opinion, by Chief Justice Burger, uses a simple syllogism. As its first premise, it interprets I.R.C § 501(c)(3)[3] as resting on "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."[4] As its second premise, it finds that "racial discrimination in education violates a most fundamental national public policy . . . ."[5] From these premises, it concludes that the institutions in question[6] do not qualify for tax exemption under I.R.C. § 501(c)(3).

The Justices were clearly concerned about the ultimate reach of this line of reasoning. Thus, the opinion cautions:

> "We are bound to approach these questions with full awareness that determinations of public benefit and public policy are sensitive matters with serious implications for the institutions affected; a declaration that a given institution is

---

* Copyright © 1990 by Harvey P. Dale. All rights reserved.

1. 461 U.S. 574 (1983), decided May 24, 1983.

2. This phrase is intended to refer to I.R.C. § 501(c)(3) generally.

3. All references to "I.R.C. §" are to the Internal Revenue Code of 1986, as amended. All references to "Treas. Reg." are to the most current version of the Treasury Regulations promulgated under the Code.

4. 461 U.S. at 586.

5. 461 U.S. at 593.

6. The Bob Jones opinion involved both Bob Jones University, located in Greenville, South Carolina, and Goldsboro Christian Schools, located in Goldsboro, North Carolina. Neither institution denied that it discriminated on racial grounds; both appear to have claimed that such discrimination was based on sincerely held religious beliefs. See 461 U.S. at 602 n. 28.

Part IV addresses selected legal developments since the date of that opinion. Part V contains some nominations of additional areas in which the notions underlying Bob Jones might yet be applied, and a few concluding comments.

II. Public Policy Denial of Tax Deductions[11]

As early as 1924, the Board of Tax Appeals denied a tax deduction on public policy grounds.[12] The taxpayer had committed perjury during an investigation of payoffs to union leaders. He claimed a business deduction for the costs of successfully defending himself in a subsequent criminal prosecution. The Court said:

> "Manifestly the commission of perjury can, under no circumstances, be recognized as part of a taxpayer's business; and so the expense incident to such criminal activity can likewise not be recognized. . . . It would be an anachronism to say that such an act, so inimical to the public interest as to justify punishment for its commission, may at the same time be so recognized that the expense involved in its commission is sanctioned by the revenue law as an ordi-

11. Many articles have been written about disallowance of deductions for public policy reasons. The following are a sample: Peace & Messere, Tax Deductions and Criminal Activities: The Effects of Recent Tax Legislation, 20 RUTGERS CAMDEN L.J. 415 (1989); Deal, Reining in the Unruly Horse: The Public Policy Test for Disallowing Tax Deductions, 9 VT. L. REV. 11 (1984); Note, The Judicial Public Policy Doctrine in Tax Litigation, 74 MICH. L. REV. 131 (1975); Taggart, Fines, Penalties, Bribes, and Damage Payments and Recoveries, 25 TAX L. REV. 611 (1970); Tyler, Disallowance of Deductions on Public Policy Grounds, 20 TAX L. REV. 665 (1965); Lindsay, Tax Deductions and Public Policy, 41 TAXES 711 (1963); Comment, Business Expenses, Disallowance and Public Policy: Some Problems of Sanctioning With the Internal Revenue Code, 72 YALE L.J. 108 (1962).

12. Backer v. Commissioner, 1 B.T.A. 214 (1924). There were two dissents; one member of the Board did not participate in the decision. Interestingly, the two dissenters were members of the three-judge panel which heard the case. One of them was Judge Sternhagen, of blessed memory the author of the initial decision in Gregory v. Commissioner, 27 B.T.A. 223 (1932), rev'd sub nom. Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934), aff'd sub nom. Gregory v. Helvering, 293 U.S. 465 (1935).

> nary and necessary expense of carrying on a business. . . . We do not believe that it is in the interest of sound public policy that the commission of illegal acts should be so far protected or recognized that their cost is regarded as a legitimate and proper deduction in the computation of net income under the revenue laws of the United States."[13]

The decision might have rested solely on the finding that the expense was not incurred in the taxpayer's trade or business. The public policy argument, however, was a major part of the Court's opinion, and has been cited as an early precursor of much of the law which later developed.[14]

An important issue is raised by the first clause of the first sentence quoted above: "Manifestly the commission of perjury can, under no circumstances, be recognized as part of a taxpayer's business." If illegal acts are treated as necessarily separate from business activities — as always constituting an unlawful frolic of the taxpayer's own — two results might follow. The first is clear and intended: no business deduction will be available to the sinner. The second is less obvious and unintended: the evil acts might not be attributed to the business (or other entity) with which the sinner is associated. This second result would obviously present a substantial obstacle to applying public policy notions to tax-exempt organizations. It thus raises the general question, considered further below at page 15, of whether and when illegal acts may be attributed to entities.

---

13. 1 B.T.A. at 216-17.

14. 1 B. BITTKER & L. LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 20.3.3 (2d ed. 1989). Interestingly, more than 40 years after the Backer decision, the Supreme Court permitted a taxpayer to deduct his costs in defending himself against charges of illegally selling securities. Commissioner v. Tellier, 383 U.S. 687 (1966). See also O'Malley v. Commissioner, 91 T.C. 352 (1988) (deduction permitted for costs of defense against criminal charges arising out of taxpayer's service as unpaid trustee of Teamster's Pension Fund).

The most frequently cited case in the area is Tank Truck Rentals, Inc. v. Commissioner,[15] in which the Supreme Court — explicitly relying on notions of public policy — denied deductions for fines paid as a result of violations of state highway maximum-weight laws.[16] Both before and after that decision, however, there were many uncertainties about and inconsistent applications of the rule. A leading treatise attributes this to "a basic flaw in the frustration-of-public-policy doctrine," i.e., that "[d]enial of the deduction . . . is not needed to preserve the sting of the penalty, but rather is a tax penalty in addition to the original penalty."[17]

As a result of these doctrinal problems, Congress, in 1969, preempted the field by adopting provisions now found, as amended, in I.R.C. §§ 162(c), (f), and (g). These disallow deductions, respectively, for illegal bribes, kickbacks, and other payments; fines and penalties; and two-thirds of the amount of certain antitrust damages.[18] Confusion has not been eliminated altogether, however, for at least two reasons. *First*, the scope of the preemptive legislation was not total. Although the regu-

15. 356 U.S. 30 (1958).

16. See also Hoover Motor Express Co. v. United States, 356 U.S. 38 (1958) (same result even for inadvertent violations). But contrast Commissioner v. Sullivan, 356 U.S. 27 (1958) (deductions permitted for wages and rent paid by illegal gambling enterprise). The Bob Jones majority opinion cited Tank Truck Rentals, albeit with an introductory "cf." signal, in support of its public-policy position. 461 U.S. at 591 n. 17.

17. 1 B. BITTKER & L. LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 20.3.3, at 20-50 (2d ed. 1989).

18. Extended analysis of these provisions is beyond the scope of this paper. See generally 1 B. BITTKER & L. LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶¶ 20.3.4, 20.3.5, and 20.3.6 (2d ed. 1989). See also the articles cited at n. 11, supra.

lations extend the I.R.C. § 162 subsections to I.R.C. § 212,[19] the Service and the courts have sometimes used the frustration-of-public-policy notion, instead, to disallow losses under I.R.C. § 165.[20] *Second*, a contrary line of precedent, permitting illegal payments to be added to the cost of goods sold (and thus to be offset against gross income), continues to have legal life.[21]

Thus, either because of the limited scope of the Congressional preemption effort, or because of the vitality of inconsistent lines of authority, it is possible that, but uncertain whether or to what extent, the frustration-of-public-policy doctrine may apply to deny tax benefits afforded under the Code outside of I.R.C. §§ 162 and 212.

III. Background to Bob Jones

The Supreme Court's action in Bob Jones had an engrossing history. The early part of it is primarily of legal interest;[22] the latter part primarily political.

---

19. Treas. Reg. § 1.212-1(p).

20. See, e.g., Rev. Rul. 77-126, 1977-1 C.B. 47; Holmes Enterprises, Inc. v. Commissioner, 69 T.C. 114 (1977). See also 1 B. BITTKER & L. LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 20.3.3, at 20-52 n. 39 (2d ed. 1989).

21. See, e.g., Max Sobel Wholesale Liquors v. Commissioner, 630 F.2d 670 (9th Cir. 1980). See also 1 B. BITTKER & L. LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 20.3.5, at 20-56 n. 52 (2d ed. 1989).

22. Helpful reviews of the history up to the end of the 1960's, together with citations and legal arguments, can be found in Note, Tax Exemptions for Racial Discrimination in Education, 23 TAX L. REV. 399 (1968); Note, Federal Tax Benefits to Segregated Private Schools, 68 COLUM. L. REV. 922 (1968); and Note, The Tax-Exempt Status of Segregated Schools, 24 TAX L. REV. 409 (1969).

For more than a decade after Brown v. Board of Education,[23] the IRS appeared to have little interest in the issue of tax exemption for racially discriminatory schools. By the mid-1960's, however, a growing number of segregated private schools had applied to the Service for confirmation of their tax-exempt status. On August 2, 1967, the Service published a News Release stating that it was reviewing the federal tax status of such schools, and that both tax exemption and charitable contribution deductions would be denied "if the operation of the school is on a segregated basis and its involvement with the state or political subdivision is such as to make the operation unconstitutional or a violation of the laws of the United States."[24] One possible implication of the quoted language was that such tax benefits would *not* be lost if the school could sustain itself without any state aid (outside of tax relief).[25] Later in the same year, the Service held that tax-exempt status and charitable contribution deductions would be unavailable for a racially-discriminatory recreational facility.[26]

On January 12, 1970, the Service was preliminarily enjoined, by a three-judge District Court in the District of Columbia, from approving tax exemption for racially

23. 347 U.S. 483 (1954).

24. IRS News Release, Aug. 2, 1967, 7 CCH 1967 STAND. FED. TAX REP. ¶ 6734, reprinted in Tax Exempt Status of Private Schools: Hearings Before the Subcommittee on Oversight of the House Comm. on Ways and Means, 96th Cong., 1st Sess. 9 (1979). [The hearings are hereinafter cited as "Oversight 1979 Hearings."]

25. See Note, Federal Tax Benefits to Segregated Private Schools, 68 COLUM. L. REV. 922, 925-26 (1968). The Note argues that "the IRS need not, and should not, have left upon [sic] this possibility . . . ." Id. at 926.

26. Rev. Rul. 67-325, 1967-2 C.B. 113. See Recent Cases, Taxation — IRS Rules Organization Which Discriminates on Basis of Race Not Charitable, 21 VAND. L. REV. 406 (1968).

discriminatory private schools in Mississippi.[27] In July of the same year, the IRS announced that it would no longer allow tax exemption for any private schools which so discriminate.[28] The three-judge District Court issued its final opinion on June 30, 1971, holding that racially discriminatory schools in Mississippi were not entitled to tax-exempt status, and that donors to them were not entitled to tax deductions for their gifts.[29] The Court enjoined the Service from approving tax exemption for any such school. The IRS promptly issued Revenue Ruling 71-447[30] adopting the rule of

27. Green v. Kennedy, 309 F. Supp. 1127, appeal dismissed sub nom. Cannon v. Green, 398 U.S. 956 (1970). For a discussion of the decision, see Rice, Can Federal Tax Benefits Constitutionally be Extended to Private Segregated Schools? The Implications of *Green v. Kennedy*, Sw. L.J. 705 (1970).

28. IRS News Release, July 10, 1970, and IRS News Release, July 19, 1970, reprinted in Oversight 1979 Hearings, cited supra at n. 24, at 10. The News Releases also denied tax deductions for gifts to such schools. Randolph W. Thrower, who was Commissioner of Internal Revenue in 1970 when the News Release was issued, later testified that "[p]erhaps no other decision made by me received as much study and attention from so many people in so many different departments and agencies of Government . . . ." Administration's Change in Federal Policy Regarding the Tax Status of Racially Discriminatory Private Schools: Hearing Before the Committee on Ways and Means, House of Representatives, 97th Cong., 2d Sess. 84 (Feb. 4, 1982) (statement of Randolph W. Thrower). [These Hearings are hereinafter cited as the "Ways and Means 1982 Hearings."]

29. Green v. Connally, 330 F. Supp. 1150 (D.D.C.) (three-judge court), aff'd mem. sub nom. Coit v. Green, 404 U.S. 997 (1971). Although the injunction applied only to Mississippi schools, the Court said that its judgment "is not to be misunderstood as laying down a special rule for schools located in Mississippi," and that the "underlying principle . . . is applicable to schools outside Mississippi." 330 F. Supp. at 1174.

30. 1971-2 C.B. 230.

the case. Subsequent Service pronouncements provided procedural guidelines, and strengthened, expanded, and clarified its positions.[31]

In the late 1970's, the Service proposed to publish still further Revenue Procedures,[32] but, in 1980 and before they were finally issued, Congress intervened to cut off appropriations "used to carry out" the proposals.[33] Shortly thereafter, on May 5, 1980, the District Court for the District of Columbia modified and supplemented its original 1971 injunction, requiring the Service to implement procedures stronger and more far reaching than those previously in effect to prevent racially discriminatory

31. Rev. Proc. 72-54, 1972-2 C.B. 834; Rev. Rul. 75-231, 1975-1 C.B. 158; Rev. Proc. 75-50, 1975-2 C.B. 587.

32. Proposed Revenue Procedure on Private Tax-Exempt Schools, 43 Fed. Reg. 37,296 (Aug. 22, 1978), revised at 44 Fed. Reg. 9,451 (Feb. 13, 1979), corrected at 44 Fed. Reg. 11,021 (Feb. 26, 1979). The controversial nature of the proposals prompted Congressional hearings. See Oversight 1979 Hearings, cited supra at n. 24. See also Wright v. Regan, 656 F.2d 820, 824-25 (D.C. Cir. 1981), discussing criticisms of the pre-existing standards.

33. Treasury, Postal Service, and General Government Appropriations Act of 1980, Pub. L. No. 96-74, 93 Stat. 559, 562, 577, §§ 103 and 615. These were referred to as the "Dornan-Ashbrook appropriation riders," after the names of their Congressional sponsors. See Note, The Judicial Role in Attacking Racial Discrimination in Tax-Exempt Private Schools, 93 HARV. L. REV. 378 (1979). The 1980 appropriations ban was extended for fiscal 1981. Pub. L. No. 96-536, 94 Stat. 3166 (1980). The co-sponsors, Rep. Dornan and Rep. Ashbrook, both indicated that their riders were not intended to interfere with the ability of the Service to continue to revoke tax exemption of racially discriminatory schools pursuant to the Service's pre-1978 Revenue Rulings and Procedures. 125 Cong. Rec. H5879, 5882 (July 13, 1979, daily ed.) (statement of Rep. Ashbrook); 125 Cong. Rec. H5982 (July 16, 1979, daily ed.) (statement of Rep. Dornan).

schools from being tax-exempt.[34] The resulting situation was succinctly described by Ex-Commissioner Randolph Thrower:

> "Thus, the Service is presently in the position of being prohibited by one branch of the government to act while being ordered to do so by another. The end result is a dual system: one method of review for Mississippi schools based on Green II, and another method for the rest of the country based, until recently, on procedures in effect prior to August 22, 1978, and now on no policy whatsoever."[35]

The direct history of the Bob Jones decision is fascinating.[36] Its early stages followed closely on the heels of the IRS announcements, in 1970, that racially-discriminatory schools would no longer be entitled to tax-exempt status. Bob Jones University commenced an action, in 1971, seeking to enjoin the Service from revoking the University's tax exemption. That suit was ultimately held to be barred by the anti-injunction provisions of the Code.[37]

Then, on January 19, 1976, the Internal Revenue Service issued a final notice of revocation of tax-exempt status to Bob Jones University, effective from December 1, 1970. On May 4, 1976, Bob Jones University filed suit in federal District Court in South Carolina seeking a refund of $21 in federal unemployment taxes. The United

---

34. Green v. Miller, 80-1 U.S.T.C. ¶ 9401, 45 A.F.T.R.2d 1566 (D.D.C. 1980) (not officially reported).

35. Ways and Means 1982 Hearings, cited supra at n. 28, 104-05 (statement of Randolph W. Thrower). See also id. at 254 (statement of Roscoe L. Egger, Jr., Commissioner of Internal Revenue).

36. Much of the direct history is recounted in the Bob Jones opinion itself. See 461 U.S. at 581-82.

37. The Supreme Court, applying I.R.C. § 7421(a), so held in Bob Jones University v. Simon, 416 U.S. 725 (1974).

States counterclaimed for approximately $480,000 in such taxes for the years 1971 through 1975.[38] The District Court, on December 26, 1978, held Bob Jones University qualified for tax exemption, entered judgment for the University in the refund suit, and ordered the Secretary of the Treasury and Commissioner of Internal Revenue Service to restore the University's tax-exempt status.[39]

On December 30, 1980, the Court of Appeals for the Fourth Circuit, in a 2-1 decision, reversed, held that Bob Jones University was *not* entitled to tax exemption, and entered judgment for the Government.[40] Bob Jones University filed a petition for a writ of certiorari to the Supreme Court on July 1, 1981. The U.S. government supported the University's petition, arguing that, although there was no conflict in the Circuits, the Supreme Court should affirm the decision below and confirm that the IRS had acted within its statutory authority in revoking the University's tax-exempt status. Certiorari was granted on October 13, 1981.[41]

Up to the end of 1981, the government had consistently followed its long-standing policy of denying I.R.C. § 501(c)(3) status to racially discriminatory schools. However, in an astonishing about-face, on January 8, 1982, the Reagan Administration announced that it was changing its position, and henceforth would *grant* such schools

38. At that time, 501(c)(3) organizations were sometimes exempt from social security taxes. The exemption was removed by the Social Security Amendments of 1983, Pub. L. No. 98-21, § 102(b)(1), 97 Stat. 70, repealing I.R.C. § 3121(b)(8)(B).

39. 468 F. Supp. 890 (D.S.C. 1978).

40. 639 F.2d 147 (4th Cir. 1980).

41. 454 U.S. 892 (1981). The companion case, Goldsboro Christian Schools, was granted certiorari on the same date.

tax exemption.[42] This, it explained, would moot the proceedings in Bob Jones and Goldsboro. The same day, it filed a memorandum with the Supreme Court asking that the judgments be vacated as moot. Its memorandum stated, in part:

> "Since the filing of our brief acquiescing in the granting of certiorari in these cases, the Department of the Treasury has initiated the necessary steps to grant petitioner Goldsboro Christian Schools tax-exempt status under Sec. 501(c)(3) of the Code, and to refund to it federal social security and unemployment taxes in dispute. Similarly, the Treasury Department has initiated the necessary steps to reinstate tax-exempt status under Sec. 501(c)(3) of the Code to petitioner Bob Jones University, and will refund to it federal social security and unemployment taxes in dispute. Finally, the Treasury Department has commenced the process necessary to revoke forthwith the pertinent Revenue Rulings that were relied upon to deny petitioners tax-exempt status under the Code."[43]

A few days later, after a fire-storm of criticism, the Administration said it would submit legislation to Congress to authorize the IRS to deny tax exemption to schools which discriminate on racial grounds.[44] The proposed legislation was released Janu-

---

42. Treasury News Release (Jan. 8, 1982), reprinted in Ways and Means 1982 Hearings, cited supra at n. 28, 607-08. The following discussion, in the text, above, covers only selected highlights of the relevant developments. For descriptions of the background to the change in government position, as set forth by two of its principal proponents, see Ways and Means 1982 Hearings, cited supra at n. 28, 153-59 (statement of Edward C. Schmults, Deputy Attorney General, Department of Justice) and 178-81 (statement of Robert T. McNamar, Deputy Secretary of the Treasury). For further details, see P. TREUSCH, TAX-EXEMPT CHARITABLE ORGANIZATIONS 164-79 (3d ed. 1988); U.S. COMMISSION ON CIVIL RIGHTS, DISCRIMINATORY RELIGIOUS SCHOOLS AND TAX EXEMPT STATUS 5-9 (Clearinghouse Pub. 75, Dec. 1982).

43. Reprinted in Ways and Means 1982 Hearings, cited supra at n. 28, 616, at 617 (footnote omitted).

44. Statement by President Reagan, Jan. 12, 1982, reprinted in Ways and Means 1982 Hearings, cited supra at n. 28, 620.

ary 18, 1982.[45] The Administration's summary states, in part, that its proposed legislation "will, for the first time, give the Secretary of the Treasury and the Internal Revenue Service express authority to deny tax-exempt status to private, nonprofit educational organizations with racially discriminatory policies."[46]

Congressional hearings were urgently scheduled to consider the Administration's change of position and its legislative proposal. On February 1, 1982, two Reagan Administration witnesses appeared before the Senate Finance Committee. As one source reported:

> "Administration witnesses testified on February 1 that the IRS lacks the statutory authority to deny tax exemptions to private schools that practice racial discrimination. According to Deputy Attorney General Edward C. Schmults and Deputy Treasury Secretary R. T. McNamar, the Administration felt compelled to reverse the 11-year-old policy on private schools after their review of the issue led them to the conclusion that 'there is neither a constitutional nor statutory basis for the practice followed by the Internal Revenue Service since 1970.'"[47]

Further, "[s]pecifically, Schmults stated that section 501(c)(3) does not require an educational or religious organization to also meet [sic] the standards of a common law charity."[48]

Because the Administration's position clearly indicated that it would not vigorously support the decisions below, and in line with suggestions contained in at least

45. See Reagan Proposes Bill to Prohibit Tax Exemption for Discriminatory Schools, 14 TAX NOTES 218 (Jan. 25, 1982).

46. Tax Exemption Bill Summary, reprinted in Ways and Means 1982 Hearings, cited supra at n. 28, 624-25.

47. Administration Defends Tax-Exempt School Policy Switch, 14 TAX NOTES 358 (Feb. 8, 1982).

48. Id.

one brief amicus curiae,[49] the Supreme Court appointed William T. Coleman, Jr., to argue the case as counsel for the *judgments* below.[50]

In the meantime, and still prior to the Supreme Court's decision in the case, the Administration directed the IRS to grant tax exemption to Bob Jones University and the Goldsboro schools, and to revoke its contrary rulings. The Service was slowly and carefully considering this directive,[51] when — on February 18, 1982 — it was prevented from complying with it. The D.C. Circuit Court of Appeals enjoined the Service from granting tax-exempt status to any racially-discriminatory school.[52] Ironically, the injunction was later reversed by the Supreme Court, which held that the plaintiffs in that suit lacked standing.[53] It remained in place, nevertheless, long enough to preserve the status quo pending the Court's decision in Bob Jones.

---

49. The brief was filed by Professors Bernard Wolfman and Lawrence Tribe of the Harvard Law School.

50. This is reflected in note 24 to the opinion of the Supreme Court, 461 U.S. at 599.

51. Commissioner Roscoe L. Egger, Jr., and Chief Counsel Kenneth Gideon disagreed with the Administration's reversal of position, and stated their opposition both to the Administration officials favoring the about-face and to members of Congress. See Ways and Means 1982 Hearings, cited supra at n. 28, 256, 259 (testimony of Roscoe L. Egger, Jr., Commissioner of Internal Revenue).

52. Wright v. Regan, No. 80-1124 (Feb. 18, 1982) (per curiam order). This is reflected in note 9 to the opinion of the Supreme Court, 461 U.S. at 585. The injunction is reproduced in the Ways and Means 1982 Hearings, cited supra at n. 28, at 363-64.

53. Allen v. Wright, 468 U.S. 737 (1984), reversing Wright v. Regan, 656 F.2d 820 (D.C. Cir. 1981).

IV. Developments After Bob Jones

As noted above,[54] the Bob Jones Court left open three areas for further legal development: (1) the scope of "fundamental public policy," particularly with respect to activities other than racial discrimination; (2) the application of the decision to tax benefits other than exemption under I.R.C. § 501(c)(3); and (3) the force of the constitutional arguments urged on, but not relied upon by, the Court in Bob Jones. After a preliminary discussion of another point, the first two of them will be discussed in turn.[55]

A. Attribution of Illegal Activities to Entities — The Bob Jones Court had no difficulty in attributing the racially-discriminatory activities of the agents of Bob Jones University and Goldsboro Christian Schools to those entities. Indeed, the issue appears not to have been contested by those institutions. As noted at page 4 above, however, it is not self evident whether and when an individual's activities, which are illegal or contrary to fundamental public policy, will be deemed to be those of the organization for which the individual is acting.

There is little tax-law precedent bearing on the question of when to attribute an individual's illegal acts to an entity.[56] The issue has been more deeply explored

54. See text at p. 2 above.

55. The third area — constitutional arguments — is beyond the scope of this paper, not because it is unimportant, but solely because the author feels the need for further research and rumination before writing about it.

56. Little does not mean none. See, e.g., Union Stock Farms v. Commissioner, 265 F.2d 712 (9th Cir. 1959) (illegal payments, in excess of O.P.A. price ceilings, although paid to corporate employees, taxed to corporation). Contrast Asphalt Indus. Inc. v. Commissioner, 384 F.2d 229, 232-35 (3d Cir. 1967) (corporation not liable for tax resulting from officer's fraudulent accounting and embezzlement).

in other areas of the law, however. Several features of the legal landscape are fairly clear:[57] although "[a]uthority to do illegal or tortious acts, whether or not criminal, is not readily inferred,"[58] a corporation may be criminally liable by virtue of illegal acts of its agents;[59] the liability may flow from explicitly or impliedly authorized acts, from acts done with apparent authority, or from unauthorized acts intended to benefit the corporation.[60] A corporation may be liable even if its agent is acting both illegally and entirely for his own benefit.[61] Furthermore, the liability cannot be avoided merely by establishing corporate policies against the illegal conduct if employees actu-

57. Most of what follows is taken from H. FIRST, BUSINESS CRIME: CASES AND MATERIALS 167-227 (1989), which discusses entity criminal liability generally, contains very helpful analyses of the issues, and includes further relevant citations.

58. RESTATEMENT (SECOND) OF AGENCY § 34, Comment *g* (1958).

59. See, e.g., New York Central and Hudson River R.R. v. United States, 212 U.S. 481 (1909) (payment of illegal rebates to shippers); Dillon v. AFBIC Development Corp., 597 F.2d 556 (5th Cir. 1979) (racial discrimination by real estate agent). Accord, RESTATEMENT (SECOND) OF AGENCY § 217D (1958).

60. See, e.g., Steere Tank Lines, Inc. v. United States, 330 F.2d 719 (5th Cir. 1963) (false logs filed by drivers to allow them work more overtime hours than legally permitted; liability to employer). Contrast Standard Oil Co. of Texas v. United States, 307 F.2d 120 (5th Cir. 1962) (employees were conspiring with third party to sell contraband oil; no benefit to corporation intended; no liability to employer).

61. E.g., Sparks v. Pilot Freight Carriers, Inc., 830 F.2d 1554, 1559-60 (11th Cir. 1987) (sexual harassment and discrimination by supervisor imputed to employer).

ally perform such acts in the course of their employment.[62] Racially discriminatory activity falls within these rules, and may be imputed to employer organizations.[63]

In 1982, the Supreme Court held a nonprofit trade association liable under the antitrust laws as a result of actions of one of its vice presidents. The American Society of Mechanical Engineers ("ASME") was, in part, a standards-setting trade association, and had published a boiler and pressure code. One of its vice-presidents was also an officer of a boiler manufacturing corporation. Hydrolevel Corp., a competitor, had developed and was marketing a new boiler. In response to an inquiry to ASME, from a potential Hydrolevel customer, the vice-president caused a letter to be sent, on ASME letterhead, suggesting that the Hydrolevel boiler might be dangerous. The customer canceled its order. In due course, Hydrolevel discovered this information and sued ASME. ASME defended on the basis that the actions of its vice-president should not be imputed to it. The Supreme Court, after an extended discussion of the issue, held ASME liable for treble damages.[64]

---

62. See, e.g., United States v. Hilton Hotels Corp., 467 F.2d 1000 (9th Cir. 1972), cert. denied, 409 U.S. 1125 (1973) (criminal antitrust prosecution for illegal boycott activities; employees ignored corporate instructions not to engage in such boycotts). Accord, RESTATEMENT (SECOND) OF AGENCY §§ 230-31 (1958).

63. See, e.g., Dillon v. AFBIC Development Corp., n. 59 supra (discrimination against black buyers). See also Sparks v. Pilot Freight Carriers, Inc., n. 61 supra (sexual harassment and discrimination).

64. Am. Soc'y of Mechanical Eng'rs, Inc. v. Hydrolevel Corp., 456 U.S. 556, 566-78 (1982), reh'g denied, 458 U.S. 1165 (1982). For case notes discussing the decision, see 38 U. MIAMI L. REV. 741 (1984); 68 MINN. L. REV. 439 (1983); 13 SETON HALL L. REV. 354 (1983); [1983] B.Y.U.L. REV. 483; 23 SANTA CLARA L. REV. 663 (1983); 17 SUFFOLK U.L. REV. 147 (1983); 87 DICKINSON L. REV. 465 (1983); 60 WASH. U.L.Q. 1487 (1983).

Thus, despite the language in some of the tax-deduction cases, there has been no insuperable obstacle to imputing an individual's contrary-to-public-policy or illegal activities to the organization for which he works. Indeed, the issue has only infrequently been raised by any of the parties. It involves, however, a factual inquiry, and the outcome will depend upon the circumstances of each case.

B. The Scope of "Fundamental Public Policy" — The uncertain reach of "fundamental public policy" properly concerns government officials. Fear of its potential scope was one of the reasons set forth by the Reagan Administration to explain its about-face, in early 1982, on the Bob Jones case:

> "For example, if we were to endorse the theory on which the Service was proceeding before the Supreme Court, what would prevent the Service from revoking the tax exempt status of Smith College, a school open only to women? Does sex discrimination violate a clearly ennunciated [sic] public policy? . . .
>
> "What about religious organizations that refuse to ordain priests of both sexes? And could the Commissioner decide that if Black Muslim organizations refuse to admit whites they should be denied a tax exempt status because they discriminate?
>
> "Further, should the IRS Commissioner be permitted — in the absence of legislation — to determine what is national policy on abortion? Should hospitals that refuse to perform abortions be denied their tax exempt status? Or, reading Federal policy another way, should hospitals that do perform abortions be denied their tax exempt status?"[65]

Because of the indefinite sweep of the concept, the Supreme Court, in Bob Jones, twice warned about the "sensitive" nature of the determinations involved.[66]

---

65. Ways and Means 1982 Hearings, cited supra at n. 28, 182-83 (statement of Robert T. McNamar, Deputy Secretary of the Treasury).

66. The language is quoted beginning at p. 1 supra.

The Service has been alert to this warning. For example, a recent General Counsel Memorandum states:

> "This caution expressed by the Supreme Court is an important factor in determining the limitations imposed by charitable trust law. We believe that in Bob Jones the Court set a standard that the public policy involved must be fundamental and there must be no doubt that the activity involved is contrary to that fundamental public policy."[67]

The same Memorandum observes that "[o]nly rarely has the Service asserted that an organization was not described in section 501(c)(3) based on illegal acts or violations of clear federal public policy outside the area of racial discrimination in education." Nevertheless, the Bob Jones rationale has been applied by the Service and the Tax Court in several other situations.[68]

Rev. Rul. 75-384[69] considers an anti-war group which encourages its members and others to engage in civil disobedience to further the group's purposes. The Service held that tax exemption should be denied. The Ruling states, in part:

> "In this case the organization induces or encourages the commission of criminal acts by planning and sponsoring such events. The intentional nature of this encouragement precludes the possibility that the organization might unfairly fail to qualify for exemption due to an isolated or inadvertent violation of a regulatory statute. Its activities demonstrate an illegal purpose which is inconsistent with charitable ends. Moreover, the generation of criminal acts increases the burdens of government, thus frustrating a well recognized charitable goal, i.e., relief of the burdens of government. Accordingly, the organization is not operated exclusively for charitable purposes and does not qualify for exemption from Federal income tax under section 501(c)(3) of the Code."

---

67. G.C.M. 39800 (June 20, 1989).

68. The instances set forth below are illustrative, and do not constitute a comprehensive compilation.

69. 1975-2 C.B. 204. Rev. Rul. 75-384 is supported by G.C.M. 36153 (Jan. 31, 1975).

By contrast, the Service is willing to grant I.R.C. § 501(c)(3) status to organizations which promote their otherwise-qualifying ends in a confrontational manner, so long as their tactics are not illegal.[70]

Note that the Ruling carefully put aside the question of the effect of an isolated or inadvertent violation of law. Furthermore, it deals with a violation — breach of the peace — which might fairly be characterized as malum in se. No guidance is provided about the meanings of "isolated" or "inadvertent," nor about whether a similar result would follow, for example, if a tax-exempt ambulance organization regularly and intentionally advises its drivers to exceed the speed limit. Future precedents will have to illuminate the boundaries of the realm of the sorts of illegality which imperil tax exemption.

One case dealt with a purportedly tax-exempt charity — the Church of Scientology of California — which was trying to forestall IRS inquiries into its activities. To that end, it falsified records, burglarized IRS offices, stole government records, and otherwise tried to prevent the Service from properly auditing it. The Tax Court said:

> "When we consider all the facts spread across the voluminous record in this case, we are left with the inescapable conclusion that one of petitioner's overriding purposes was to make money. We also conclude that criminal manipulation of the IRS to maintain its tax exemption . . . was a crucial and purposeful element of petitioner's financial planning."[71]

In an alternate holding, the Tax Court found these activities justified revocation of tax exemption based on Bob Jones. The organization's pattern of conduct was shocking,

---

70. G.C.M. 38415 (June 1980).

71. Church of Scientology of California, 83 T.C. 381, 504 (1984) (footnote omitted), aff'd on other grounds, 823 F.2d 1310 (9th Cir. 1987), cert. denied, 486 U.S. 1015 (1988).

and there were sufficient *other* grounds, including extensive private inurement, to support the result.[72]

At least one other Court has denied tax exemption to an organization for trifling with the Service. The D.C. Circuit Court of Appeals affirmed a denial of tax-exempt status to the Synanon Church where an earlier case against it, brought by a private party, had found that officials of the church had destroyed evidence relevant to the determination of its tax-exempt status, including its alleged advocacy of violence and deflection of funds to private persons. Since this constituted illegal conduct, tax-exempt status was properly revoked.[73]

One of the most interesting potential applications of the Bob Jones public-policy analysis is found in G.C.M. 39800.[74] There the IRS considered whether tax exemption should be accorded an organization that pays a teacher's salary for teaching three courses, in a public high school, on the Bible as literature and history. The issue was whether such payments give rise to a violation of the Establishment Clause of the First Amendment. If so, thought the Service, the organization in question would clearly be violating a fundamental public policy — what could be more "fundamental" than the U.S. Constitution? — and could not claim tax-exempt status. After a lengthy consideration of the facts and many of the precedents, the memorandum concludes that — in the particular case — the courses dealt with the Bible only as literature, and thus there was no violation of the Establishment Clause. The memorandum

72. The 9th Circuit affirmed solely on the private inurement basis.

73. Synanon Church v. United States, 820 F.2d 421 (D.C. Cir. 1987).

74. Cited at n. 67 supra.

clearly contemplates a loss of tax-exempt status, however, should a constitutional violation be found.

Although racial discrimination in education is indisputably condemned, the IRS position on racial discrimination in *grant making* is more complex. Prior to the Bob Jones decision, the Service had indicated that a scholarship program for whites only would be ineligible for tax exemption.[75] After that decision, however, the Service revoked its earlier memorandum, and opined that a whites-only scholarship policy would not *automatically* result in loss of I.R.C. § 501(c)(3) status. Rather, all the facts and circumstances would be examined to determine whether the administration of the fund fostered racial discrimination.[76] The reasoning is clearly stated in an IRS Training Publication:

> "For instance, a private educational trust that awards scholarships only to Caucasian students to attend a predominantly minority school could be said actually to *discourage* racial discrimination in education. On the other hand, scholarships for Caucasian students to attend a school that has a racially discriminatory policy would clearly *foster* racial discrimination in education and, therefore, would not qualify for exemption under IRC 501(c)(3)."[77]

The same line of reasoning was later applied to a minorities-only scholarship program.[78]

---

75. G.C.M. 37462 (Mar. 17, 1978).

76. G.C.M. 39082 (Nov. 30, 1983).

77. Update on Private Schools and Impact of *Bob Jones University v. U.S.*, EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR 1984 10 (Training 4277-06 (1-84)) (emphasis added).

78. G.C.M. 39117 (Jan. 13, 1984).

C. The Application of Bob Jones to Other Tax Benefits — The scope of the Bob Jones opinion is also unclear in another respect: to what classes of organizations and to what sorts of tax benefits will it apply? Subsequent authorities have only marginally clarified these questions.

The Bob Jones Court cautiously restricted its holding to religious *schools*, rather than "churches or other purely religious institutions."[79] Despite this, later cases and authorities have strongly indicated that the underlying notion of the case applies more broadly. Thus, for example, the Tax Court stated, "We believe the Bob Jones opinion unqualifiedly held that all organizations seeking exemption under 501(c)(3) must comply with fundamental standards of public policy."[80] The IRS agrees.[81] Furthermore, there is some indication that the Service might apply similar policy notions to I.R.C. § 501(c)(4) social welfare organizations. In Rev. Rul. 75-384, discussed above,[82] the Service, after denying charitable tax exemption to the organization in question, went on to hold that its illegal activities were *also* inconsistent with tax-exempt status under I.R.C. § 501(c)(4).

One seminal early decision considered racial discrimination by I.R.C. § 501(c)(8) fraternal beneficiary societies, as well as I.R.C. § 501(c)(7) social clubs. A three-judge district court, in McGlotten v. Connally,[83] held that an I.R.C. § 501(c)(8) fraternal beneficiary society was not entitled to tax-exempt status if it practiced racial

79. 461 U.S. at 604 n. 29.

80. Church of Scientology of California, cited at n. 71 supra, 83 T.C. at 503 n. 74.

81. G.C.M. 39792 (Aug. 17, 1987).

82. See p. 19 supra.

83. 338 F. Supp. 448 (D.D.C. 1972).

discrimination. The court carefully considered the scope of the tax-exemption benefits afforded such organizations, pointing out that the Code granted them both freedom from tax on investment income and eligibility to receive deductible charitable contributions. These, it held, constituted "sufficient government involvement to invoke the Fifth Amendment."[84] By contrast, it held that an I.R.C. § 501(c)(7) racially-discriminatory social club *was* entitled to remain tax exempt because the scope of the tax benefits granted to it was much less,[85] and thus its discriminatory activities did not constitute "state action." It stated "that the exemption of nonprofit clubs, limited as it is to member-generated funds and available regardless of the nature of the activity of the particular club, does not operate as a 'grant' of Federal funds."[86]

The McGlotten decision, unlike Bob Jones, rests firmly on constitutional grounds. It is interesting, also, for the care with which it attempts to appraise the precise scope of tax exemption for different entities, in order to decide whether the benefits rise to the level of state action. Congress disagreed with and reversed one aspect of the McGlotten case. It added I.R.C. § 501(i) to deny tax exemption to racially-discriminatory private clubs.[87] The Congressional remedy did *not*, however, out-

84. 338 F. Supp. at 459.

85. By virtue of I.R.C. § 512(a)(3), only member income of social clubs is exempt from tax. Their other income, whether from investments or from transactions with non-members, is subject to tax. See generally B. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS § 17.4, at 349-53 (5th ed. 1987). The Supreme Court, on Jan. 19, 1990, granted certiorari in Portland Golf Club, No. 88-7218, S. Ct. Docket 89-530, to resolve a conflict in the Circuits about how these tax rules should be applied when a social club has losses from one taxable operation and gains or income from another.

86. 338 F. Supp. at 462 (footnote omitted).

87. Pub. L. 94-658, § 2(a), 10 Stat. 2697 (1976).

law all forms of discrimination. It is limited to discrimination "on the basis of race, color, or religion," and even religious discrimination is permitted in specified circumstances.[88]

One later decision, which attempts to calculate the weight of particular tax benefits, is worthy of mention. The case involved alleged discrimination by airlines against the handicapped. The D.C. Circuit Court of Appeals held that special investment tax credits granted to the aviation industry were *not* enough to give rise to "state action" for this purpose. The court, discussing both Bob Jones and McGlotten, referred to:

> "the possibility that Congress did not intend, by granting a limited tax incentive to a particular industry or group, to thereby encompass [sic] every such industry or group, or, for that matter, individual within some ever-widening and potentially almost limitless definition of 'federal financial assistance.'"[89]

In its discussion of the issue, the Court stated:

> "[I]t is . . . true that the exemptions and deductions at issue in McGlotten, Bob Jones, and Regan were of a much more fundamental nature than the modest incentive to capital expenditures to which petitioners point here. To find that the government could force an airline to comply with a federal antidiscrimination mandate solely because it takes advantage of section 46(a)(8) tax credits would be to find the government impotent to compel such compliance if any airline should elect to forego such credits. If Congress did intend handicapped citizens to have access to air transportation and to apply the nondiscrimination principles of section 504 to all carriers, we would violate that intent by holding that a carrier could avoid compliance through its accountant, or that Congress would be giving a green light to discrimination if it ever chose to enhance fed-

88. I.R.C. § 501(i)(1) and (2).

89. Paralyzed Veterans of America v. Civil Aeronautics Board, 752 F.2d 694, 710 (D.C. Cir. 1985).

> eral revenues in this deficit-plagued era by closing tax loopholes or simplifying the Code."[90]

The opinion was written by Chief Judge Bazelon, who also authored the McGlotten decision.

V. The Future of Bob Jones

Although the Supreme Court carefully limited the reach of its holding in Bob Jones, the linguistic standard set forth in the opinion — violation of a "fundamental public policy" — fairly pulses with potential. The Court recognized this, issuing two warnings about the sensitivity of the required determinations.[91] Furthermore, both the Court's methodology and its interpretation of the statute heighten these perceptions.

The majority demonstrated that racial discrimination in education violates a fundamental public policy by examining the positions of each of the three branches of government. It referred to its decision in Brown v. Board of Education[92] as signalling an end to the era in which racial segregation prevailed in education in this country.[93] It looked to the "unbroken line" of subsequent cases following that decision to demonstrate the "Court's view that racial discrimination in education violates a most fundamental national policy . . . ."[94] It next directed its attention to Congress, find-

90. Id. (footnote omitted).

91. See p. 1 supra.

92. 347 U.S. 483 (1954).

93. 461 U.S. at 593.

94. Id.

ing that the passage of Titles IV and VI of the Civil Rights Act of 1964[95] and "numerous enactments since then, testify to the public policy against racial discrimination."[96] It then turned to the Executive Branch, and found in Executive Orders issued by Presidents Truman, Eisenhower, and Kennedy a demonstration of "the commitment of the Executive Branch to the fundamental policy of eliminating racial discrimination."[97]

This methodology knows no clear boundary. Would it be sufficient, for example, if the courts and Congress had taken strong positions, but the Executive Branch had remained silent? Suppose only *one* of the three branches had acted? In what balance scale and by what weights should the mass of a "public policy" be measured?

The Court, abjuring constitutional considerations, interpreted I.R.C. § 501(c)(3) as embodying "common law standards of charity."[98] Furthermore, it clearly contemplated that these would be dynamic, and would respond to "contemporary standards"[99] rather than being "'perpetual or immutable.'"[100] Here again no clear boundary emerges. Instead, an uncertain and ever-changing standard is to be discerned and applied by the Service, the courts, and others.

---

95. Pub. L. No. 88-352, 78 Stat. 241, codified at 42 U.S.C. §§ 2000c, 2000c-6, and 2000d.

96. 461 U.S. at 594.

97. 461 U.S. at 595.

98. 461 U.S. at 586.

99. 461 U.S. at 593 n. 20.

100. Id., quoting from Walz v. Tax Comm'n, 397 U.S. 664, 673 (1970).

Emphasizing the inherent uncertainty of these standards does not necessarily imply a criticism of their choice. Rather, it suggests that prudent administrators and judges, aware of the ambiguities, may not hastily leap forward with new glimpses of fundamental public policies. This, in turn, probably explains, in part, why the hypothetical feared applications of the public-policy rule, suggested in Deputy Secretary McNamar's testimony,[101] are still open and undecided.[102]

The converse of these observations, however, is that the future applications of the Bob Jones standard may yet be far reaching indeed. In addition to the suggestions made by Deputy Secretary McNamar — sex discrimination by non-coed schools, religious discrimination by churches, racial discrimination by black organizations, anti- or pro-abortion activities by hospitals — several other areas have been put forth. Two such additional areas involve age discrimination and discrimination against the handicapped.[103] The scope of illegal activities and constitutional violations also remain to be delimited.

In each of these areas, it will be necessary not only to determine whether a fundamental public policy has been violated, but whether the particular tax benefits afforded the organization in question are substantial enough to warrant administrative or judicial modification or revocation of them. Thus, the decision matrix is two di-

---

101. Quoted at p. 18 supra.

102. It is also in good part accounted for by the difficulty third parties have in achieving standing to challenge tax exemptions. See, e.g., Allen v. Wright, 468 U.S. 737 (1984). This leaves the Service in the position of virtually the sole arbiter of the area.

103. See, e.g., Bird, Exempt Organizations and Discrimination, 1 P-H TAX EXEMPT ORGANIZATIONS ¶ 3036 (1986), marshalling various non-tax statutory provisions and court decisions bearing on gender, religious, age, and handicap discrimination.

mensional, with various possible public policies in columns across the top and various types of tax benefits in rows down the side. Because so little has yet been done to fill in the resulting grid, and because the columns and rows are both intended to be dynamic over time, it seems likely that the pattern will take a long time to develop.