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*European Office: Lime Tree Farm, East Hunsbourne, Berkshire, England. Telephone Ditton 3317

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Tax Exemption

Certain institutions that serve a public interest have long been exempted from taxation on their income. The principle has been established by Congress, and the Internal Revenue Service (IRS) has granted tax exemption to schools, churches, philanthropic foundations, and a variety of educational, scientific, trade, and other associations. In 1950 Congress confronted the fact that a few tax-exempt institutions had unwisely engaged in business enterprises quite unrelated to the activities and objectives which justified their tax-exempt status. The most notorious example was a university that purchased and operated a macaroni factory. Congress therefore distinguished between activities related to an institution’s tax-exempt purposes, which continued to be free from taxation, and unrelated activities, which became taxable. This distinction has been observed for 17 years.

In April, IRS announced its intention to distinguish between taxable and nontaxable income in a new way. The proposal is to tax specific parts of the income of an activity, or aggregate of activities, otherwise related to the tax-exempt purposes of an organization, if the particular part is considered not to be related.

Hearings which IRS held on this proposal in mid-July made it clear that the primary target is the advertising income of a few magazines published by tax-exempt organizations. The American Business Press, Inc., representing some commercially published magazines, took credit for having prodded IRS into announcing the new regulation.

Although advertising in a few magazines is the primary target, the proposed change would also apply to universities, Boy Scouts, labor unions, hospitals, scientific societies, and other tax-exempt organizations that regularly receive income that IRS considers not substantially related to the purposes or functions for which tax exemption was granted. IRS has given some examples of what this change would mean. A hospital pharmacy that sells pharmaceuticals to the general public or a college bookstore that regularly sells to nonstudents should expect to be taxed on the profit from such sales. A school of agriculture could, without tax, sell the milk produced by its dairy herd, because maintaining a dairy herd contributes directly to education in agriculture; but if the dairy makes and sells ice cream, the university would be taxed, for making ice cream is not substantially related to education in agriculture.

Among the several issues raised by the proposal, the most fundamental is this: If the principle of tax exemption needs to be reexamined, Congress and not IRS is the proper body to conduct the examination. In the July hearings, IRS was both advocate and judge of its own proposal, and the intent of that proposal, an IRS spokesman had announced in April, was not primarily to raise revenue, which is IRS business, but to control competition, which is not. Numerous congressmen have contended that IRS is attempting to invade congressional rights and to violate the clear intent of the action taken by Congress in 1950. Several congressmen have introduced bills to prevent IRS from making its proposed changes. On the basis of testimony at its own hearings and statements filed by interested parties, IRS is entitled to withdraw its proposal. If it does not, Congress should hold hearings. IRS would then have an opportunity to present its case. So would the American Business Press and other IRS supporters. And so would any tax-exempt organization that feels threatened by the proposed change. Congress could then decide. It is proper that Congress make the decision, for it is Congress that establishes the revenue laws of the nation. —Dael Wolfle