News in the News: Current Issues in Nonprofit Journalism

ABA Tax Section Exempt Organizations Committee
May Meeting

Friday, May 10, 2019, 2-3 p.m.
Marriott Marquis
901 Massachusetts Ave., NW, Washington, DC

Program Description:

This panel will discuss tax issues impacting nonprofit news organizations, philanthropic funders of journalism in the public interest, and community news outlets seeking alternative structures.

Speakers:

Moderator: Nancy McGlamery, Adler & Colvin (San Francisco, CA)
Panelists: Monika Bauerlein, Mother Jones and Foundation for National Progress (San Francisco, CA); Kimberly Eney, Latham & Watkins LLP (Washington, D.C.); Richard Fox, Buchanan, Ingersoll & Rooney PC (Philadelphia, PA)

Materials prepared with assistance by Shira Helstrom, Morgan, Lewis & Bockius LLP (Washington, D.C.)

1) Publishing as a Section 501(c)(3) Activity

a) To qualify as a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code, an organization must satisfy two basic tests: the organizational test and the operational test. Under the operational test, first, the organization must be “organized exclusively” for one or more exempt purposes. Its organizing documents generally must limit its purposes to one or more exempt purposes, and must not expressly empower the organization to engage, as more than an insubstantial part of its total activities, in activities that are not in furtherance of one or more exempt purposes. Second, the organization must be “operated exclusively” for one or more exempt purposes. It must “engage primarily” in activities that accomplish one or more exempt purposes specified in Section 501(c)(3).

b) “Educational” within the meaning of Section 501(c)(3) is defined as “(a) the instruction or training of the individual for the purpose of improving or developing his capabilities, or (b) the instruction of the public on subjects useful to the individual and beneficial to the community.” Treas. Reg. § 1.501(c)(3)-1(d)(3)(i). The Treasury Regulations provide that “[a]n organization may be educational even though it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion.” Id. An organization is not educational if “its principal function is the mere presentation of unsupported opinion.”

{01111082.DOCX; 1}
DB1/ 103317397.4
c) A publication will be considered educational in nature if (1) the content is “educational”, (2) the material was prepared by following procedures generally accepted as “educational”, (3) the publication’s distribution is necessary or useful to accomplish the organization’s educational purposes, and (4) the manner in which the material is distributed is distinguishable from ordinary commercial practices. Revenue Ruling 67-4, 67-1 C.B. at 122.

i) In Revenue Ruling 67-4, the IRS considered whether an organization formed to encourage scientific research in, and to disseminate educational information about, specific types of physical and mental disorders through the publication of a journal was exempt within the meaning of Section 501(c)(3). The organization received income from subscriptions, contributions, and government grants. Its operating deficits were defrayed by contributions.

ii) The IRS ruled that the organization qualified for tax exemption because it met the four factors described above. First, the content of the publication was “educational” because it disseminated information on physical and mental disorders. Second, its methods of publication were “educational in character” because it provided a reference to research and “enabled the afflicted to receive improved instruction and treatment.” Third, distribution was necessary to accomplish the organization’s purposes. Finally, the methods of distribution were different from ordinary practices because the governing body was composed of well-known experts in the field. There was a “public benefit derived from the distribution.” In addition, charges for the publication recovered only a portion of the costs.

2) Methodology Test for Organizations Advocating a Particular Position or Viewpoint

a) In Big Mama Rag, Inc. v. Commissioner, 631 F.2d 1030 (D.C. Cir. 1980), the IRS denied tax-exempt status to an organization with a “feminist orientation” that published a monthly newspaper that included articles, editorials, calendars of events, “and other information of interest to women.” The IRS denied exemption on the basis that the newspaper wasn’t educational because it would “print anything that will advance the cause of the women’s movement” and “refuses to publish material it considers damaging to that cause.” Big Mama Rag, Inc. v. Comm’r., 494 F. Supp. 473 (D.D.C. 1979). The district court upheld the IRS determination. On appeal, the DC Circuit Court held that the definition of “educational” in Treas. Reg. § 1.501(c)(3)-1(d)(3) was unconstitutionally vague in violation of the First Amendment.

i) Around the same time as Big Mama Rag was being decided, the IRS had also denied exemption to another organization, National Alliance, on the grounds that it was neither charitable nor educational. National Alliance was a white supremacist organization that published a monthly newsletter and engaged in other activities “all for the stated purpose of arousing in white Americans of European ancestry an understanding of and a pride in their racial and cultural heritage and an awareness of the present dangers to that heritage.” National Alliance appealed the IRS determination, and the IRS argued a “methodology” approach in determining that the organization’s activities were not educational. National Alliance v. United States, 48
AFTR 2d 81-5138 (D.D.C. 1981). The district court held that the “methodology” approach did not cure the constitutional issue in *Big Mama Rag*, and noted that “because the methodology approach is not embodied in a written regulation, it is even more susceptible to subjective interpretation and selective application than the previous §1.501(c)(3)-1(d)(3).” The district court vacated the IRS determination that the organization was not educational or charitable based on the ruling in *Big Mama Rag*.

ii) On appeal, the court held that National Alliance failed to qualify under any reasonable interpretation of “educational” and upheld the IRS’s denial of tax exemption. The court did not, however, address whether the method used by the IRS cured the constitutional issue of vagueness in the Treasury Regulations. *National Alliance v. United States*, 710 F.2d 868, 875–76 (D.C. Cir. 1983).

iii) The IRS did not change the regulations that the court held were unconstitutional in *Big Mama Rag*. Instead, it published Revenue Procedure 86-43, which provides for the “methodology test” in *National Alliance* as the test for “all situations where the educational purposes of an organization that advocates a particular viewpoint or position are in question.”

b) Under Revenue Procedure 86-43, the method used by an organization must provide (i) a factual foundation for the viewpoint being advocated and (ii) a “development from the relevant facts that would materially aid a listener or reader in a learning process.” Revenue Procedure 86-43 also provides that the following factors indicate that the method used to advocate viewpoints or positions is not educational:

1. The presentation of viewpoints or positions unsupported by facts is a significant portion of the organization’s communications.

2. The facts that purport to support the viewpoints or positions are distorted.

3. The organization’s presentations make substantial use of inflammatory and disparaging terms and express conclusions more on the basis of strong, emotional feelings than of objective evaluations.

4. The approach used in the organization’s presentations is not aimed at developing an understanding on the part of the intended audience or readership because it does not consider the audience’s background or training in the subject matter.

Revenue Procedure 86-43 also provides that the IRS ultimately “will look to all the facts and circumstances to determine whether an organization may be considered educational despite the presence of one or more of such factors.”

c) In *Nationalist Movement v. Commissioner*, 37 F.3d 216 (5th Cir. 1994), the IRS denied exempt status for the Nationalist Movement, an organization formed to promote the “interest of white Americans.” The Tax Court upheld the IRS determination and held that the methodology test in Revenue Procedure 86-43 was constitutional. The Fifth Circuit
subsequently affirmed the Tax Court’s ruling to uphold the IRS determination, but did not address the constitutionality of the methodology test.

3) Funding of Section 501(c)(3) Nonprofit News Organizations and Commerciality

a) Section 501(c)(3) organizations may receive funding from multiple sources, including grants, donations, qualified sponsorship payments, subscription revenue, licensing and advertising.

i) Every organization recognized as exempt under Section 501(c)(3) is classified as either a public charity or a private foundation. Classification as a public charity or private foundation is generally based upon the nature and diversity of the organization’s financial support (rather than its activities). Private foundations receive support from relatively few sources—often an individual, a family or a company—while public charities usually receive support from multiple sources.

ii) Most Section 501(c)(3) nonprofit news organization generally must meet one of two public support tests to be classified as a public charity: (1) the 509(a)(1) test, which is designed for organizations that are supported primarily from grants and contributions from the public or government sources; or (2) the 509(a)(2) test, which is designed for organizations that are supported primarily by revenue from programs or services they provide that are related to their exempt purposes.

b) As with other Section 501(c)(3) organizations, a nonprofit news organization is subject to limitations on the amount of revenue it can earn from unrelated business activities. One source of funding for Section 501(c)(3) nonprofit news organizations is advertising, which is often treated as an unrelated business activity and exposes the organization to the unrelated business income tax (“UBIT”). Other forms of revenue may not subject the organization to UBIT.

i) Section 501(c)(3) nonprofit news organizations are subject to tax on their unrelated business income as provided in Sections 511-514 of the Internal Revenue Code. The UBIT provisions generally impose a tax, at normal corporate rates, on net income derived by an exempt organization from the conduct of certain business activities that are not substantially related to the organization’s exempt purposes.

(1) Whether an activity is “substantially related” is a factual question based on the relationship between the activity and the accomplishment of the organization’s exempt purposes. If the activity contributes importantly or furthers the organization’s exempt purposes (other than through the generation of revenues), the income produced will not be unrelated business income. The UBIT rules provide that “an activity will not lose its identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization.”
Income from advertising typically results in unrelated business income. The Treasury Regulations provide that the “activities of soliciting, selling, and publishing commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization.”

Section 513(i) provides a safe harbor from the definition of “unrelated trade or business” for “qualified sponsorship payments” within the meaning of Section 513(i) and the related Treasury Regulations that will be treated as contribution income. A “qualified sponsorship payment” is a payment from which the donor does not expect any substantial return benefit other than the use or acknowledgment of the sponsor’s name, logo, or products. Qualified sponsorship payments do not include advertising, including messages that contain qualitative or comparative language, price information, an endorsement, or an inducement to buy, sell, or use the donor’s products or services. Payments that entitle the payor to an acknowledgment in an organization’s regularly scheduled periodicals will not, however, qualify as a “qualified sponsorship payment” for an exemption from UBIT. I.R.C. § 513(i). As a result, while some payments may constitute use or acknowledgments that enable the payment to be treated as a “qualified sponsorship payment,” others do not and are more appropriately characterized as advertising, thereby implicating UBIT.

ii) Commensurate in scope test. A Section 501(c)(3) organization may also operate a trade or business as a substantial part of its activities if (i) the trade or business is operated in furtherance of the organization’s exempt purpose or purposes, and (ii) the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business. See, e.g., Revenue Ruling 64-182, 1964-1 C.B. 186 (ruling that an organization was “organized and operated exclusively for charitable purposes within the meaning of section 501(c)(3) . . . where it is shown to be carrying on through such contributions and grants a charitable program commensurate in scope with its financial resources”); see also Gen. Couns. Mem. 38742 (June 3, 1981) (finding that in a program of charitable giving that is commensurate in scope with its financial resources, the organization in question qualified as a charitable organization under Section 501(c)(3) because it was “carrying out a program of charitable giving which is commensurate in scope with its financial resources”).

iii) Royalties. Section 512(b)(2) excludes from unrelated business taxable income payments for many different types of intangible property rights, including payments for use of the name and logo of an exempt organization. Royalties, as defined for the purpose of this exception, do not include payments for personal services. As a result, some royalties that a Section 501(c)(3) nonprofit news organization receives may not be subject to tax.

c) The IRS has also examined the extent to which a Section 501(c)(3) nonprofit news organization’s activities are distinguishable from commercial practices, indicating that
there should not be a “commercial hue” to a Section 501(c)(3) nonprofit news organization’s activities.

i) In Revenue Ruling 67-4, the fourth factor looks to the manner of distribution and whether an organization distributes its publications in a manner distinguishable from commercial practices. In GCM 34340 (Aug. 28, 1970), the IRS evaluated the publication activities of a religious and educational organization and identified the following practices as those reflecting a purpose to engage in publishing operations for ordinary commercial gain:

1. Making its literature available to the general public, either through its own facilities or through subscription agencies, by “regular” paid subscriptions at “regular” subscription rates;
2. Actively soliciting the purchase of its materials through such means as commercial mailing lists and radio and newspaper advertising;
3. Pricing its materials “competitively” or to return a “profit” or conducting the enterprise in a manner in which all participants expect to receive a monetary return;
4. Publishing its materials almost exclusively for sale, with only a de minimis amount of material donated to “charity”;
5. Engaging in the publication and distribution of literature as its sole activity; and
6. Accumulating amounts resulting from its sales activities that are greatly in excess of the amounts expended for educational programs.

d) Courts that have evaluated publishing activities of nonprofit organizations have held that the presence of profits, however, is not fatal to a tax exemption. See, e.g., *Pulpit Resource v. Comm’r*, 70 T.C. 594 (1978); *Presbyterian & Reformed Publ’g Co. v. Comm’r*, 79 TC 1070 (1982), rev’d, 743 F.2d 148 (3d Cir. 1984).

i) In *Pulpit Resource*, the Tax Court ruled that the profit-motivated pricing, and realization of profits, by a religious periodical to clergy was not fatal to a religious publisher’s exemption. The court stated that “[t]he fact that petitioner intended to make a profit, alone, does not negate that petitioner was operated exclusively for charitable purposes,” noting a lack of evidence that the publisher was in competition with any commercial enterprise; “[t]he market for petitioner’s product was so limited in scope that it would not attract a truly commercial enterprise.” The court also stated that the fact that the organization “dedicated all of its property and funds to [tax-exempt] purposes” was “relevant evidence that petitioner’s activity was not conducted for a commercial purpose.”

ii) In *Presbyterian & Reformed Publishing Co.*, the court held that a denial of exemption cannot be sustained solely because a publishing organization derives profit from its activities. In that case, a nonprofit religious publishing organization operated without
profits for several years, depending on contributions to finance its operations. It then began to earn substantial revenues from its publication of theological works by Jay Adams that became unexpectedly popular. The organization accumulated profits that it intended to use to expand its operations at a later time. The court held that, under the circumstances, the profits did not constitute evidence of a substantial nonexempt purpose.

4) Constraints on Taking Positions—Campaign Intervention and Lobbying

a) Political Campaign Intervention. As with all Section 501(c)(3) organizations, nonprofit news organizations are prohibited from participating, directly or indirectly, or intervening in (including the publishing or distributing of statements) any political campaign on behalf of or in opposition to any candidate for public office. Organizations that violate this ban are subject to revocation of their tax exemption. They also risk the imposition of excise tax penalties on the organization itself, as well as on organization managers who approve the making of expenditures for impermissible political purposes.

b) Lobbying. Section 501(c)(3) provides, as a requirement for exemption, that “no substantial part of the activities” of the organization may constitute “carrying on propaganda, or otherwise attempting to influence legislation.” Although the “no substantial part” requirement has been a part of the law for decades, there is remarkably little guidance on the subject. This leaves public charities in a quandary—they are permitted to engage in some lobbying, but too much may jeopardize their tax exemption, and there is no bright-line test for determining how much lobbying is too much. The vagueness of the “no substantial part” test led Congress to enact Sections 501(h) and 4911, which permit charities to elect to be subject to specific expenditure limitations on their lobbying activities. The IRS has issued extensive regulations that provide electing charities with a clear set of standards that govern their lobbying activities. The lobbying election establishes different expenditure limits on direct lobbying and grassroots lobbying, and it is important for electing charities to categorize their lobbying activities accordingly.

c) These limitations have imposed significant constraints on nonprofit news organizations seeking to provide editorials and other commentary regarding news issues of the day. Because the nature of news reporting, it has also meant that these organizations must filter certain types of content may be problematic under these restrictions. Including, for example, editorials, such as advertising, social media and user-generated content, to ensure compliance with the relevant requirements.

5) Converting from For-Profit to Nonprofit News Organization

a) Under Section 337, if a taxable organization converts into, or liquidates and distributes its assets to, a tax-exempt organization, it must pay taxes as if it sold its assets for fair market value to the nonprofit organization immediately before the transfer. Treas. Reg. § 1.337(d)-4(a). The nonprofit entity receiving the assets would not be subject to tax. These rules apply to news organizations, and a for-profit news organization would generally be obligated to recognize gain and pay tax on any built-in gain upon a conversion to, or
transfer of its assets to, a tax-exempt organization. These rules do not apply, however, to assets that will be used in an unrelated trade or business by the resulting nonprofit organization. I.R.C. § 337(b)(2)(B).

b) Conversions can occur through merger, transfer of substantially all assets, or conversion in place depending on the applicable state law.

6) Commercial News Organizations as Taxable Subsidiaries of 501(c)(3) Entities

a) A Section 501(c)(3) organization that has a subsidiary that is a taxable commercial news organization may be subject to UBIT if the activities of the subsidiary are not “substantially related” to the exempt purposes of the parent. Similarly, if a private foundation has an interest in a taxable commercial news organization that is not a “functionally related business” for purposes of Section 4943, the private foundation may be subject to excise tax under the excess business holdings rules.

i) Section 4943 imposes a tax equal to 10% of the value of any excess business holdings of a private foundation in a business enterprise. The term “business enterprise” does not include a “functionally related business.” A functionally related business is defined as (1) a trade or business that is not an unrelated trade or business (as defined in Section 513 relating to the unrelated business income tax), or (2) an activity that is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors that is related (aside from the need of the organization for income or funds or the use it makes of the profits derived) to the exempt purposes of the organization.

b) Case Study: The Philadelphia Inquirer

i) In 2015, the sole owner of The Philadelphia Inquirer, a for-profit daily newspaper established in 1829, sought to (1) ensure that public interest journalism so important to the local community would be sustained into the future; (2) use philanthropy to support local journalism, including for-profit newspapers; (3) have ownership of the newspaper put in the hands of the community; and (4) support the transition of the newspaper from printed to digital form. Conversion to a Section 501(c)(3) tax-exempt organization was not a possibility, so a new independent charitable entity was formed to which the owner could transfer ownership of the newspaper. The purpose of new charitable entity included providing support for local journalism and the transition to digital journalism. The owner also provided a significant endowment to support the new charitable entity.

ii) To avoid challenges that may have arisen if the charitable entity were a private foundation, the charity entity was formed as single-member limited liability company (“SMLLC”) owned and controlled by Type I Supporting Organization to a community foundation. The SMLLC was treated as a disregarded entity for tax

---

1 Note that Section 4943(g) now allows for private foundations in certain limited circumstances to own 100% of a business enterprise. See Richard L. Fox, “Private Foundations Can Now Own 100% of Business Enterprise,” for a discussion of the history of Section 4943 and the enactment of the “Newman’s Own” exception.
purposes and therefore considered to be one and the same with the Type I Supporting Organization. See IRS Notice 2012-52. The Certificate of Formation and Operating Agreement of the SMLLC closely resembled articles of incorporation and bylaws of a Section 501(c)(3) tax-exempt organization.

7) Philanthropic Funding of Commercial News Organizations

a) As an alternative or supplement to forming a Section 501(c)(3) nonprofit news organization, private foundations and other charitable organizations can provide funding to commercial news organizations in order to help these organizations continue coverage that they might otherwise drop due to commercial pressures and that often involve the same types of stories that Section 501(c)(3) nonprofit news organizations would otherwise cover.

b) Section 501(c)(3) charities have less constraints with respect to their funding, but Section 501(c)(3) private foundations still have a number of tools in their philanthropic toolbox to provide support, including expenditure responsibility grants, program-related investments, and contracts for services. Each of these forms of support comes with some additional considerations, but they all offer significant possibilities for ensuring that the commercial news space continues to offer important coverage that advances charitable and educational purposes.