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## Can Nonprofits Save Journalism? Legal Constraints and Opportunities

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## ABSTRACT

The current economic plight of the newspaper industry has led to consideration of whether nonprofit, tax-exempt status might be the answer for some publications. Legal precedents, including IRS rulings, dating to the 1960s have held that this was not possible. However, review of the law and these rulings strongly suggests that, under existing conditions, a nonprofit newspaper could qualify for tax exemption without the need for legislation by Congress or waiting for the IRS to issue new guidelines.

This paper argues that the current economic situation of the newspaper industry warrants reconsideration of these rulings. To this end, the paper contains a description of the current laws under which nonprofit organizations can qualify for tax exemption, with special attention to the specific rulings dealing with publishing.

It examines the manner in which existing rulings could be interpreted to permit daily newspapers to qualify for exemption and become eligible to receive contributions and grants from the general public.

The paper also contains explanations of certain tax law restrictions that impede the ability of foundations to support nonprofit publishing or make grants to exempt organizations that conduct investigative journalism.

Finally, the paper contains an analysis of a 2009 bill pending in the Senate that would grant federal tax exemption to nonprofit news organizations that otherwise qualify as educational and charitable organizations, together with suggestions for modification should the Treasury Department and the Internal Revenue Service decline to reexamine their existing positions.

The growing interest in nonprofit journalism is manifest in almost daily news reports of the economic plight of newspapers. The situation has led to closings of newspapers in major cities such as Denver and Seattle, and severe reductions of staff nationwide, particularly the elimination of positions for investigative reporters. Many of those seeking a solution look to the nonprofit sector as a means by which newspapers could continue to be published, and investigative reporting could be subsidized.

Being nonprofit, in common parlance, means being eligible for the benefits of exemption from federal income tax and qualification to receive tax deductible contributions. The laws in each state make it easy to create a nonprofit organization. It is the federal tax laws, found in the Internal Revenue Code, Treasury Regulations and Revenue Rulings that contain specific requirements and limitations that set the parameters for “nonprofit” status. There is precedent in these laws dating back to the 1960s denying exemption to nonprofit organizations whose principal activity is publication of a newspaper in the same manner as their for-profit counterparts.

Today, however, with commercial news organizations closing or drastically reducing their coverage, this change in the economic situation warrants reconsideration of these rulings to permit newspapers and other news organizations that meet the standards for educational and charitable organizations to qualify for tax exemption. Alternatively, Congress could now amend the provisions of the Internal Revenue Code to provide explicitly that nonprofit newspapers meeting certain restrictions applicable to other charitable and educational organizations that are entitled to exemption. A bill that would achieve this result was introduced in the United States Senate in March 2009, with the backing of a group of individuals interested in saving *The Baltimore Sun*, a daily newspaper owned by The Tribune Company, a company undergoing bankruptcy reorganization.

The purpose of this paper is to describe the current laws under which nonprofit organizations can qualify for tax exemption, with special attention to the specific rulings dealing with publishing; and to suggest the manner in which existing rulings could be interpreted or modified to permit daily newspapers to qualify for exemption and

become eligible to receive contributions and grants from the general public. It also contains explanations of certain restrictions imposed under the tax laws on foundations that may in some instances impede their ability or willingness to support nonprofit publishing and exempt organizations that conduct investigative journalism. Finally, it contains an analysis of the 2009 bill pending in the Senate that would grant federal tax exemption to nonprofit news organizations, together with suggestions for modification should the Treasury Department and the Internal Revenue Service decline to reexamine their existing positions and should Congress decide to consider amending the Internal Revenue Code to permit nonprofit newspapers to qualify as tax-exempt charities.

There is another important aspect of nonprofit journalism that this paper does not address, namely, the rules governing the conversion of for-profit entities such as private or publicly owned newspapers to nonprofit status. Dissolutions of corporations and sales of their assets are governed under state laws. If a company is in bankruptcy, the disposition of its assets will be governed by federal bankruptcy rules designed to obtain the greatest amount possible for the creditors of the corporation. The tax ramifications of conversions and dissolutions of for-profit newspapers depend in the first instance on whether the organization is subject to the corporate income tax or is treated as a pass-through entity with taxes levied on the owners. The tax consequences will vary greatly depending on the nature of the ownership and the cost basis of individual owners. The wide variations in fact patterns and the consequential different tax ramifications of conversions require separate consideration of the subject. However, if creation of a foundation is part of a plan for conversion, as has been reported in connection with the possible sale of *The Boston Globe* by its owner, *The New York Times*, the rules governing creation and operation of a foundation organized to support investigative journalism are described below.

## **1. BASIC RULES GOVERNING TAX EXEMPTION FOR CHARITIES AND PRIVATE FOUNDATIONS**

The legal rules that govern tax-exempt charitable and educational organizations that are eligible to receive deductible contributions are set forth in Sections 501(c)(3) and 170(b)(1)(a) of the Internal Revenue Code and the regulations under those sections. Tax-exempt educational and charitable organizations are subject to certain constraints on their general operations and grant-making activities imposed under the provisions of the Internal Revenue Code. Those exempt organizations that are classified as “private foundations” must comply with an even stricter set of limitations on their activities and the limits on the amount of deductible contributions to them are narrower than those applicable to public charities. The basic rules for public charities and the additional limits on private foundations are as follows:

### **Exempt Purposes**

The requirements for obtaining exemption from federal income, estate and gift taxes – and eligibility to receive tax deductible contributions – are that an organization, whether a corporation or trust, must be “organized and operated exclusively” for a broad range of purposes listed in the Internal Revenue Code. These purposes include “religious, charitable, scientific, testing for public safety, literary or educational purposes, or for the prevention of cruelty to children or animals.” The generic name for an organization with any of these purposes is a “charity,” used in a broad sense and not its alternative meaning of aid to the poor.<sup>1</sup> The regulations state that the specific enumeration is not exclusive, and that exemption is available to organizations with other purposes generally accepted as charitable under judicial decisions. Thus, the law permits expansion to meet changing times and values. On the other hand, the operation of a business may not be a primary purpose, and a ruling issued in the 1960s held that operation of a newspaper was not an exempt purpose. However, the definition of what constitutes education is, as noted below, very broad and in many instances includes

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<sup>1</sup> Treas. Reg. § 1.501(c)(3)-1.

publishing, while the definition of charitable includes not only relief of the poor, the distressed, or the underprivileged, but advancement of education, lessening the burdens of government or neighborhood tensions, elimination of prejudice and discrimination, and defense of human and civil rights secured by law.

### **Organizational and Operational Tests**

In addition to having a qualifying purpose, an organization must meet two tests and comply with certain other limitations.<sup>2</sup> The first test is an organizational test under which the governing documents must contain provisions designed to assure compliance with the basic requirements for exemption, including assurance that on dissolution, any asset will be distributed to another tax-exempt charitable organization. The second test is an operational test that requires demonstration that the organization in its actual activities will be in compliance with the Internal Revenue Code. Although the Code requires that an organization be “operated exclusively” for exempt purposes, the regulations interpret this phrase as “operated substantially” for exempt purposes, so that an exempt organization may conduct unrelated activities so long as it engages primarily in activities that accomplish one or more exempt purposes and no more than an insubstantial part of its activities are not in furtherance of those purposes.<sup>3</sup>

### **Limits on Private Inurement and Private Benefit**

There are two other limits on tax-exempt charitable and educational organizations that relate to their dealings with other individuals and organizations. The first is a prohibition against providing what is described as “private inurement” to insiders of the organization. This limitation does not prohibit self-dealing but requires that transactions with directors, officers and employees be reasonable and negotiated at arms’ length. The second limit is on the provision of “private benefit” to any persons or entities. This requires that the organization establish that it is not organized or operated for the

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<sup>2</sup> I.R.C. § 501(c)(3).

<sup>3</sup> Treas. Reg. §1.501(c)(3)-1(c)(1), (2).

benefit of private interests such as designated individuals, the creator or his family, or persons controlled directly or indirectly by such private interests.

### **Prohibition Against Campaigning and Limits on Lobbying**

All tax-exempt charities are absolutely prohibited from participating in or supporting candidates for public office. For example, a tax-exempt daily newspaper would not be able to endorse candidates for any election, a limit that may be viewed by some as a serious drawback to exempt status. Exempt organizations other than private foundations may conduct lobbying activities, but only to the extent that these activities are an insubstantial part of their entire operations. Educational activities are not deemed to be lobbying and an organization may support a position on an issue under consideration by a legislature if both sides of the issue are first fairly presented. Public charities may also elect to have specific dollar limits placed on the amount they may expend for lobbying, thereby obviating the uncertainty that underlies the test in which the limitation is as imprecise as “insubstantial.”

### **Sanctions for Violation of Exemption Requirements**

The sanction for violation of any of these requirements is loss of exemption and thus the inability of donors to deduct from their taxes contributions to the organization. In many states, a violation will also result in taxation of real estate owned by the charity. State attorneys general are also empowered to correct breaches of duty by charitable fiduciaries. Loss of exemption can be grounds for such actions.

### **Limitations on Fiduciaries for Self-Dealing**

In 1969, Congress recognized that loss of exemption was in many instances an inadequate sanction and imposed an absolute ban on self-dealing on those exempt charitable organizations that were classified as private foundations by virtue of the fact that they did not receive broad support through contributions from the general public, or that were religious organizations, schools, colleges and universities, or hospitals.<sup>4</sup>

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<sup>4</sup> I.R.C. § 4941.

Sanctions were imposed on the self-dealers and those fiduciaries that approved the transaction willingly and knowing that it was a violation. In 1996, a similar set of sanctions was applied to transactions involving all other exempt charitable organizations in which self-dealing transactions provided an “excess benefit” to parties involved in a transaction.<sup>5</sup>

### **Limitations on Private Foundations**

As described above, the 1969 Tax Reform Act separated the universe of exempt charitable organizations into private foundations and all organizations that are defined in section 501(c)(3) of the Internal Revenue Code. The 1969 Act contained restrictions on the operation of private foundations not applicable to the remaining group, called for short-hand purposes “publicly supported charities” or “public charities.”<sup>6</sup> This definition by exclusion means that churches, schools, hospitals, and organizations that receive most of their support from gifts, grants and contributions from the general public or from the government are subject to a more lenient regulatory regime. The restrictions on private foundations in the 1969 Act, in addition to prohibiting self-dealing as described above, limited foundation activities and imposed excise taxes on any foundation that did not abide by the restrictions, as well as taxes on its managers who approved the prohibited activity.<sup>7</sup> Among the limits on private foundations enacted in 1969 were absolute prohibitions against:

1. grassroots lobbying and attempting to influence legislation through communication with legislators (the definitions of these prohibited activities are narrow and permit “educational activities even when they address a subject that may be under consideration by Congress or a state or local legislature”);

2. grants to individuals and private foundations unless the grantor organization exercises “expenditure responsibility” (this requires that the foundation adopt procedures designed to assure that the grants are not used for prohibited purposes and

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<sup>5</sup> I.R.C. § 509(a).

<sup>6</sup> *Id.*

<sup>7</sup> I.R.C. Chapter 42.

that accounting and reporting procedures are established to assure compliance with the rules); and

3. any grants for non-charitable purposes.

As a result of the stringency of the latter two requirements, many foundations have adopted policies restricting their grant-making to public charities. Finally, in addition to these limitations, private foundations must distribute annually for their charitable purposes an amount equal to five percent of their capital assets<sup>8</sup> and cannot own but a *de minimus* amount in any business enterprise.<sup>9</sup>

### **Definition of Publicly Supported Charities**

As noted above, private foundations are defined by exclusion, namely all organizations exempt from tax under section 501(c)(3) other than those that fall into one of three categories: (1) publicly supported charities; (2) charities that rely primarily for support from receipts from related services or activities; and (3) organizations that support public charities that qualify under the first two categories.<sup>10</sup> In addition to churches, schools, and hospitals, the first category includes organizations that receive at least one third of their support from gifts, grants and contributions from other public charities, the government, or individuals and foundations. In determining the amounts that qualify to meet the one-third test, gifts from individuals and foundations are reduced so that they do not exceed two percent of total support. In addition, revenue from related activities is not included in determining compliance with the support test. This means that a small group of contributors can, in fact, provide sufficient support for a charity to meet the one-third support test.<sup>11</sup> The second category of publicly supported charities are those that receive at least one-third of their support from fees from related service such as tuition or membership charges, and no more than one-third from

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<sup>8</sup> I.R.C. § 4942.

<sup>9</sup> I.R.C. § 4943.

<sup>10</sup> I.R.C. § 509(a).

<sup>11</sup> Charities that are unable to meet the one-third support test may nonetheless qualify as publicly supported if at least ten percent of their support is from the general public and if they meet a facts and circumstances test that requires that there be a representative board, services and programs that benefit the general public and no individuals who control the organization.

investment income, which includes unrelated business income. The final category of organizations that are not private foundations is charities that are organized and operated to support one or more public charities qualifying under the first two tests. Legislation passed in 2006 amended the requirements for supporting organizations so that, for all practical purposes, an organization can qualify only if it is controlled by the supported public charity.

### **Exempt Organizations Operating “Businesses”**

The Internal Revenue Code also contains limitations on tax-exempt organizations that operate business activities that do not contribute importantly to their exempt purposes. As noted above, exemption is not available to an organization the primary purpose of which is to operate a business; and in a 1967 ruling, the IRS held that publication of a newspaper was not a valid exempt purpose. However, operation of a business will not disqualify an organization so long as it actively carries on its exempt activities and so long as carrying on the business is not its primary purpose. As described below, this ruling has been referred to as establishing a “commerciality” doctrine, applied by the Internal Revenue Service in situations in which there is little or no activity carrying out exempt purposes. Under the rulings relating to business activities, religious publishing companies are generally entitled to exemption, although the courts have had difficulty rationalizing the result in a number of cases where the publishing was carried on by a single family unrelated to any church, or, as described below, was too profitable.

The court decisions and Treasury rulings dealing specifically with publishing are described in detail below. There are, however, several court decisions upholding the exemption of nonprofit organizations that operated for-profit-like activities that would serve as precedent for nonprofit newspapers. In *Aid to Artisans, Inc. v. Commissioner*, the court overruled the Internal Revenue Service’s denial of exemption to an organization that provided technical assistance to artisans in developing countries in order to improve their ability to market products and included among its activities the purchase,

import and sale of their handicrafts.<sup>12</sup> Similarly, two years later, in *Goldsboro Art League, Inc. v. Commissioner*, exemption was denied by the Internal Revenue Service to an organization that operated an art center in which it conducted art classes, sponsored demonstrations and operated a museum.<sup>13</sup> It also operated two public art galleries in which it acted as the dealer for works of local artists, retaining a twenty percent commission on sales. The Internal Revenue Service's denial of exemption was made on the basis that the organization was operated in furtherance of a substantial commercial purpose, namely the operation of the art galleries; that these operations were indistinguishable from those of for-profit galleries; and that it was providing more than incidental private benefit to individual artists. The Tax Court overruled the Internal Revenue Service and upheld the exemption, finding that the educational activities were substantial, and that the operation of the galleries was secondary to the carrying out of the organization's purposes.

There is no prohibition in the Internal Revenue Code against a nonprofit organization conducting a business that is other than as its primary purpose. However, although eligible for tax exemption, the organization must pay income tax on income generated from any business activity it carries on regularly if that activity is "unrelated" to the carrying out of its exempt purposes. The tax is on "unrelated" business income and it applies to advertising income received by charities that publish magazines, newsletters, student newspapers and scholarly journals. Special rules permit aggregation of total income so that no tax is imposed if income from all sources results in a loss, even though the advertising income, by itself, would show a profit.<sup>14</sup>

The definition of advertising on the air, but not in print journals and internet, was modified when Congress amended the Internal Revenue Code in 1997 to define a category of exempt organization income denominated "qualified sponsorship income" that would not be considered unrelated business income.<sup>15</sup> It includes amounts that are

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<sup>12</sup> *Aid to Artisans, Inc. v. Comm'r*, 71 T.C. 202 (1978).

<sup>13</sup> *Goldsboro Art League, Inc. v. Comm'r*, 75 T.C. 337 (1980).

<sup>14</sup> I.R.C. § 513.

<sup>15</sup> I.R.C. § 501(i).

acknowledged as contributions or support that contains the locations, phone numbers and internet addresses of the contributor, but not price information or other indication of savings or values. To qualify, these payments may not contain qualitative or comparative descriptions of the donor's products, services, facilities or company. They may recite value-neutral descriptions of a product line or brand, but not an inducement to purchase. Examples are found in the acknowledgements of support on National Public Radio and public television stations.

A bill introduced in the Congress in 2009 would grant exemption to qualified newspaper corporations as a subset of organizations with educational purposes and would exempt a certain amount of advertising income. However, given the fact that the failure of newspapers is attributed in large part to a decline in advertising income, it is unclear what the value of such an exemption would be.<sup>16</sup> In his paper, "Financing the American Newspaper in the Twenty-First Century," Schmalbeck points out that the unrelated business income tax would probably not be a problem for most newspapers. The reason is that, because it is a tax on income, it is subject to deductions for the reasonable expenses of operating a business, and the rationale for operating a newspaper as a nonprofit organization is that its expenses will ordinarily equal or exceed its total revenue, such that they would likely exceed its advertising revenue.<sup>17</sup>

Finally, there is an important residual issue that any exempt organization with unrelated business income must face, namely, whether the unrelated activity is so large that it overwhelms the exempt purpose activity. Some commentators refer to a "commerciality" doctrine, citing a section of the Treasury Regulations that provides that exemption is not available to an organization "if more than an insubstantial part of its activities is not in furtherance of an exempt purpose." However, there is no precedent defining "insubstantial"; and although some authorities caution loss of exemption where unrelated business income is decidedly larger than exempt income or support, a better

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<sup>16</sup> Newspaper Revitalization Act, S.L.C., 111<sup>th</sup> Cong. (2009).

<sup>17</sup> Richard Schmalbeck, "Financing the American Newspaper in the Twenty-First Century," paper presented at the Duke Conference on Nonprofit Media, May 4-5, 2009, [http://www.pubpol.duke.edu/nonprofitmedia/documents/DWC\\_Conference\\_Report.pdf](http://www.pubpol.duke.edu/nonprofitmedia/documents/DWC_Conference_Report.pdf).

view looks to the scope of the activities, so that a successful unrelated business venture will not result in loss of exemption if the scope of the related activities is larger than the unrelated ones, measured by the relative size of staff, programs and outreach of the exempt organization.

### **Joint Ventures of Nonprofits and For-Profits**

During the past ten years Congress and the Internal Revenue Service have been concerned with the extent to which nonprofit organizations have entered into joint ventures with for-profit entities, with the rules still being formulated. In the leading case, *Plumstead Theatre Society, Inc. v. Commissioner*, decided in 1980, the Tax Court overruled the revocation of exemption of the theatre society which, in order to raise funds to produce a play, had formed a limited partnership of which it was the general partner and then sold limited partnership interests to individual investors.<sup>18</sup> The court held that the fact that the organization entered into a partnership was not by itself cause for revocation of exemption. It did not cause the organization to be operated for a private purpose. Rather the arrangement was only one of Plumstead's activities, it controlled the partnership and none of the limited partners was an officer or director of the organization. The rationale in *Plumstead* remains the basis for determinations by the Internal Revenue Service in regard to joint ventures between nonprofit and for-profit entities. It provides a blue print for organizations wishing to enter a safe joint venture, namely that the organization retains control of the venture and that the purposes of the venture are exempt and not for private benefit. Unless the case is subsequently overruled, it would accordingly be controlling should a nonprofit newspaper that could qualify for exemption enter into a joint venture with for-profit partners.

### **Organizations Exempt under Section 501(c)(4)**

There is a category of exempt organizations that are formed for charitable, educational purposes, but do not qualify for exemption under section 501(c)(3) because their principal activity is lobbying or their lobbying activities will be larger than those

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<sup>18</sup> *Plumstead Theatre Soc'y, Inc. v. Comm'r.*, 74 T.C. 1324 (1980).

permitted under section 501(c)(3). These organizations can qualify for exemption from income tax under section 501(c)(4). They must be operated exclusively for the promotion of social welfare and their net earnings must be devoted exclusively to charitable educational or recreational purposes. These organizations are subject to the prohibitions against providing excess benefits and will be taxed on unrelated business income in the same manner as organizations exempt under section 501(c)(3). They may lobby without limit and may participate in political campaigns to a limited degree. They are not eligible to receive contributions that are deductible by their donors and are eligible to receive grants from foundations only if the foundations require strict compliance with rules designed to assure that the funds will be used exclusively for exempt charitable purposes.

## **2. TREASURY AND IRS RULINGS DIRECTLY RELATING TO PUBLISHING AND JOURNALISM**

Supplementing the rules described in the first section that are found in the Internal Revenue Code and Treasury Regulations, there are three other sources of precedent that interpret the Code and Regulations: (1) Revenue Rulings, issued by the Service to provide guidance on certain issues of general application; (2) Court decisions interpreting these rulings; and (3) Private Letter Rulings, which are decisions made at the national office of the Internal Revenue Service (IRS) of individual cases that are available to the public in redacted form. Private Letter Rulings are for informational purposes but may be relied on as legal precedent only by the parties to whom they are issued. However, they do provide insight into the rationale used by IRS agents in specific instances and thus important informal guidance when there is no official guidance from the IRS on a particular matter.

This section contains a description of the IRS rulings and court decisions that specifically deals with publishing and journalism, first setting forth the parameters for organizations with “educational” purposes, and then describing the seminal 1967 Revenue Ruling 67-4 that dealt directly with the question of whether exemption could

be granted to an organization engaged in publishing as its primary activity, as well as the subsequent decisions applying this ruling to specific situations. The first set of these rulings describes court decisions and IRS rulings in which publishing activities were held to qualify for exemption, while the subsequent set describes cases and rulings in which exemption was denied.

### **Rulings and Cases Defining “Educational” Purposes**

The Treasury Regulations define educational purposes as the instruction or training of individuals for the purpose of improving or developing their capabilities or the instruction of the public on subjects useful to individuals and beneficial to the community.<sup>19</sup>

There are also a number of rulings holding that publishing the results of investigations and analyses are permitted activities for educational organizations. The earliest, issued in 1966, held that dissemination of publications describing a particular method of painless childbirth furthered an educational purpose.<sup>20</sup> In 1968, the Internal Revenue Service held that publication of the results of investigations and research on discrimination against minority groups also furthered an educational purpose.<sup>21</sup> A similar ruling in 1974 applied to dissemination of results of investigations and research on sex discrimination in employment.<sup>22</sup> From 1974, most importantly, rulings affirmed that publication of the results of investigations and analyses of the policies and practices of newspapers for the purpose of achieving higher standards in journalism furthers an educational purpose.

The Treasury Regulations also specify that an 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 facts to permit the public to form an independent opinion or conclusion. Organizations whose purpose includes advocacy are thus subject to an additional test to determine qualification for exemption. However,

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<sup>19</sup> Treas. Reg. § 1.501(c)(3)-1(d)(3).

<sup>20</sup> Rev. Rul. 66-255, 1966-2 C.B. 210.

<sup>21</sup> Rev. Rul. 68-438, 1968-2 C.B. 209.

<sup>22</sup> Rev. Rul. 74-615, 1974-2 C.B. 165.

the test was held to be unconstitutional in a 1980 decision of the U.S. Court of Appeals for the District of Columbia.<sup>23</sup> The court held that the “full and fair exposition” test was in violation of the right of free speech on the grounds that it was excessively vague in that (1) it did not clearly indicate which organizations would be advocacy groups and therefore subject to the test, and (2) it did not articulate the requirements for the test. The case involved the application for exemption of Big Mama Rag, Inc., an organization with a feminist purpose that, among its other activities promoting women’s rights, published a monthly newspaper with items of interest to women.

In its opinion the court provided an important rationale for granting exemption to newspapers that otherwise met the requirements for such status, when it stated that the purpose of the First Amendment was in part to prohibit taxes on knowledge that would “limit the circulation of newspapers and therefore the public’s opportunity to acquire information about governmental affairs.”<sup>24</sup> In his paper, “Can the Third Sector Save the Fourth Estate? Nonprofit Ownership of Daily Newspapers,” Hanlon suggests that this language provides “... reason to believe that the IRS would be wary of questioning a newspaper’s taxable status based on its editorial positions.”<sup>25</sup>

Subsequent to the decision in *Big Mama Rag*, the Internal Revenue Service issued a Revenue Procedure in which it formulated a “methodology test” to determine whether an advocacy organization qualified as educational.<sup>26</sup> In describing the test, the Service stated that it would render no judgment as to the viewpoint or position of an advocacy organization seeking exemption as educational, but rather would look to the method it used to develop and present its views; if it failed to provide a factual foundation for the viewpoint or position being advocated or failed to provide a development from the relevant facts that would materially aid a listener or reader in a learning process, it would not be considered educational. Although it was anticipated that the publication of this test would have settled most controversies over the definition of education for

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<sup>23</sup> *Big Mama Rag, Inc. v. U.S.*, 631 F.2d 1031, 1034 (D.C. Cir. 1980).

<sup>24</sup> *Id.*

<sup>25</sup> Seth Hanlon, *Can the Third Sector Save the Fourth Estate? Nonprofit Ownership of Daily Newspapers*, unpublished paper, copy with author.

<sup>26</sup> Rev. Proc. 86-43, 1986-2 C.B. 792.

advocacy organizations, in the 1990s there were two reported instances of the Internal Revenue Service questioning the exemption of organizations supporting gays and lesbians. In both cases, however, the Service revised its initial position, stating that it was relying on the methodology test.<sup>27</sup>

### **Precedents Upholding Exemption for Nonprofit Publishers**

The question of whether publishing newspapers and magazines is an exempt purpose has been controversial within the Internal Revenue Service, and the courts have also been in disagreement as to whether a particular organization was eligible for exemption. This has been notably the case for religious organizations and independent nonprofits that publish religious materials. In 1967, the Internal Revenue Service issued Revenue Ruling 67-4 in which it outlined four criteria that an organization engaged in publishing must meet in order to qualify for exemption:

1. the content of the publication is educational;
2. the preparation of the material follows methods generally accepted as educational in character;
3. the distribution of the materials is necessary or valuable in achieving the organization's exempt purpose; and
4. the manner in which the distribution is accomplished is distinguishable from ordinary commercial publishing practices.

In the ruling, the Service held that an organization formed for the purposes of encouraging basic research in specific types of physical and mental disorders, and disseminating educational information about such disorders by publication of a journal containing current technical literature relating to those disorders may qualify for exemption but only if it met the four criteria set forth in the ruling.

In May of 1982, the Internal Revenue Service published a General Counsel Memorandum in which it attempted to clarify the fourth factor in the 1967 Revenue

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<sup>27</sup> Fred Stokeld, "IRS Letter to Youth Group Raises Concerns in Gay Community," 76 Tax Notes 324 (July 21, 1997); Fred Stokheld, "Lesbian Group Gets Exempt Status After Flap with IRS", 79 Tax Notes 817 (May 18, 1998).

Ruling, namely that the manner in which distribution of a newspaper is accomplished by an exempt organization would have to be distinguishable from ordinary commercial publishing practices.<sup>28</sup> The memorandum set forth five factors that would be used to determine whether an organization met the fourth criteria, stating that activities that indicate commerciality include:

1. if the organization's only activity was publishing and it used standard commercial techniques that generated ongoing profits;
2. if it priced materials competitively with other commercial publications, or to return a profit;
3. if it conducted the business in a manner in which all participants expected to receive a monetary return;
4. if it published its materials almost exclusively for sale with only a *de minimis* amount of material donated to charity; and
5. if it created or accumulated large profits and if the accumulation of profits from sales activities was greatly in excess of amounts expended for educational purposes.

Revenue Ruling 68-306, issued after Revenue Ruling 67-4, employs similar reasoning, although it does not cite Revenue Ruling 67-4.<sup>29</sup> Here the Internal Revenue Service held that a nonprofit corporation formed to publish and distribute a monthly newspaper carrying regional church news of interdenominational interest was entitled to exemption because it served the charitable purpose of advancing religion by facilitating communication between churches and their members; it was not operated in an ordinary commercial manner; and its revenue from subscription sales and advertizing did not cover all of its costs.

Revenue Ruling 66-47, in which a publishing venture was approved, although it preceded Revenue Ruling 67-4, provided a foretaste of the subsequent ruling.<sup>30</sup> The organization involved in Revenue Ruling 66-47 was formed to distribute free of charge abstracts of scientific and medical literature published globally that it would survey. In

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<sup>28</sup> Gen. Couns. Mem. 38,845 (May 4, 1982).

<sup>29</sup> Rev. Rul. 68-306, 1968-1 C.B. 257; Rev. Rul. 67-4, 1967-1 C.B. 121.

<sup>30</sup> Rev. Rul. 66-47, 1966-1 C.B. 149; Rev. Rul. 67-4, 1967-1 C.B. 121.

ruling that the organization was entitled to exemption, the Internal Revenue Service emphasized that the activity was scientific and educational in nature, that it would be distributing the abstracts free of charge and that its support would be coming from contributions and government grants.

The 1967 Ruling and the General Counsel Memorandum that attempted to clarify it provide today's basic standard for any organization with publishing as its primary purpose. Subsequent to their promulgation, one Court decision and two Private Letter Rulings have relied on this standard to find whether a particular organization was entitled to exemption. The Court decision, *Presbyterian and Reformed Publishing Company v. Commissioner of Internal Revenue*, dealt with a religious publishing house that had increased profits due to an unexpected increase in the popularity of one of its authors and had been accumulating the profits for physical expansion.<sup>31</sup> The Court held that an unexpected fluctuation in expected profits was not grounds for loss of tax exemption as a violation of the fourth requirement that the operation must be distinguishable from ordinary commercial publishing.

The first Private Letter Ruling that relied on Revenue Ruling 67-4 to uphold exemption was issued in 1983.<sup>32</sup> This ruling held that a nonprofit corporation formed to eliminate prejudice and discrimination and to defend human and civil should not be denied exemption for publishing a journal of academic papers and producing programs distributed without cost to local radio stations. In analyzing the fourth requirement, it held that the emphasis should be on "commercial" not "distribution." With that perspective, the relevant facts for it to consider would include whether the publication was intended to generate a profit; the existence of accumulation of large profits; and whether the materials were published exclusively for sale.

In the second of the two private letter rulings, issued in 1987, the IRS held that a magazine published by an organization dedicated to increasing public awareness of health issues met the standards in Revenue Rule 67-4, even though many of the features

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<sup>31</sup> *Presbyterian and Reformed Pub. Co. v. C.I.R.*, 743 F.2d 148 (3rd Cir. 1984).

<sup>32</sup> Priv. Ltr. Rul. 8351008 (1983).

of the magazine did not relate to the promotion of public health.<sup>33</sup> These features were held to be not more than an insubstantial unrelated activity and would not, therefore warrant revocation of exemption. The IRS held that the organization met the four criteria of Revenue Ruling 67-4.

In regard to the fourth standard, the Private Letter Ruling stated that the manner in which the magazine was distributed was distinguishable from ordinary commercial purposes, noting that it was not operated to produce a profit. Rather, it was priced at a rate that would cover only costs, and incurred costs that a commercially oriented magazine would not normally incur such as conducting frequent reader participation surveys and notifying readers who were at high risk of disease. The Internal Revenue Service also found that the inclusion of general material with health-related material served the purpose of enabling the organization to reach the segment of the population that it desired to provide with health information.

It is evident from this summary that the Internal Revenue Service has had difficulty identifying factors that distinguish organizations that are similar in operation to their for-profit counterparts, yet have been established as nonprofit entities with purposes that meet the legal definition of charity. The attempt to make this differentiation in the 1967 Revenue Ruling was manifestly unworkable and led to the issuance of the General Counsel Memorandum in 1982 in which the attempt was made to clarify the fourth factor in the Revenue Ruling, namely that the manner in which the distribution was accomplished was indistinguishable from “ordinary commercial publishing practices.” The Service has faced similar problems with organizations such as the YMCAs that operate health clubs, and with hospitals that operate in all respects like their for-profit counterparts. In an important Tax Court case, decided in 1978, the court upheld denial of exemption to a corporation that provided consulting services to exempt organizations at market price on the grounds that it operated in a manner identical to for-profit organizations and offered no services at a reduced rate or without charge.<sup>34</sup>

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<sup>33</sup> Priv. Ltr. Rul. 8751007 (September 14, 1987).

<sup>34</sup> *B.S.W. Group, Inc. v. Com’r*, 70 T.C. 352 (1978).

### Precedents Denying Exemption to Nonprofit Publishers

In contrast to these precedents and private rulings, all upholding exemption, there are four court decisions and two revenue rulings in which exemption was denied to nonprofit publishers. The first court decision, *Scripture Press Foundation v. United States*, dealt with a corporation formed by two individuals to publish and sell religious literature designed to upgrade the quality of current teaching materials for Bible instruction and Sunday school.<sup>35</sup> The court found that the large profits realized by the organization were indicative of a commercial character, warranting denial of exemption.

In the second case, a Tax Court memorandum decision, *Foundation for Divine Meditation, Inc. v. Commissioner*, exemption was denied to an organization seeking exemption as a church, which had published many pamphlets, newsletters and a newspaper, all written by its leader, and for which it required minimum “donations” from its recipients for financing.<sup>36</sup> The court held that the scope, extent and non-religious subject matter of the publications, coupled with its large annual profits, evidenced the organization’s substantial nonreligious purposes.

The third and fourth court decisions also dealt with religious publishing houses. In *Fides Publishers Association v. United States*, a Federal District Court held that the organization in question was operated in a commercial manner independent of any religious body and carried on no other activities, thereby failing to qualify for exemption.<sup>37</sup> The court acknowledged that the organization’s operations furthered the exempt purpose of educating individuals, but concluded that there was a substantial non-exempt purpose, namely the publication and sale of religious literature in a manner that generated large profits, employing a commercial pricing pattern.

The fourth and most recent of the court decisions denying exemption, *Incorporated Trustees of the Gospel Workers Society v. United States, Department of Treasury*, dealt with an organization that published literature of a non-denominational nature as its exclusive

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<sup>35</sup> *Scripture Press Found. v. U.S.*, 285 F.2d. 800 (Ct.Cl. 1961), cert. denied 368 U.S. 185 (1962).

<sup>36</sup> *Found. for Divine Meditation, Inc. v. Com’r*, T.C. Memo 1965-77 (April 5, 1965).

<sup>37</sup> *Fides Publishers Ass’n v. U.S.*, 263 F.Supp. 924, (N.D.Ind. 1967).

activity.<sup>38</sup> The court noted that the organization had paid large salaries to its top personnel, had accumulated substantial profits, and was in direct competition with a large number of commercial publishers. The accumulation of profits was, again, an important consideration in the denial of exemption.

The first of the revenue rulings in which exemption was denied to a publisher, Revenue Ruling 60-351, was issued in 1960.<sup>39</sup> It involved an organization established to publish a foreign language magazine that was to provide a vehicle for the creative activity of writers and scholars emigrating from a certain foreign country to the United States and to acquaint other immigrants from that country with American life and to help them to become integrated. Income was to come primarily from subscription and newsstand sales, with some from advertising and contributions. The Internal Revenue Service held that although the organization was organized for the primary purposes of publishing, its assets were not imposed with any restriction designed to assure their dedication to charitable purposes and the corporate activities were per se business activities.

The second of the revenue rulings in which exemption was denied was issued in 1977 and relied on Revenue Rulings 67-4 and 68-306.<sup>40</sup> The organization in question published a newspaper that contained articles with local, national and international news with an ethnic emphasis that raised revenue through advertising and subscriptions “in a manner indistinguishable from ordinary commercial publishing practices.”

### **3. SUMMARY: CASES AND RULINGS APPLICABLE TO PUBLISHING**

The four standards in Revenue Ruling 67-4, as amplified in the 1982 General Counsel Memorandum, provide current guidelines for an organization formed to publish a daily newspaper that is seeking exemption under Internal Revenue Code section 501(c)(3). In the past, the most difficult standard to meet has been the fourth, namely, that the

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<sup>38</sup> *Incorporated Trustees of the Gospel Workers Soc. v. United States*, 510 F.Supp. 374 (D.C.D.C. 1981).

<sup>39</sup> Rev. Rul. 60-351, 1960-2 C.B. 169.

<sup>40</sup> Rev. Rul. 77-4, 1977-1 C.B. 141.

manner in which distribution is accomplished must be distinguishable from ordinary commercial publishing. However, in the court decisions upholding the Internal Revenue Service's denial of exemption, there was an element of private inurement to the creators and managers of the organization that appeared to support the Internal Revenue Service's conclusion that the organizations were operated in a manner indistinguishable from ordinary commercial publishing practices. As noted above, there are examples of organizations that did obtain exemption that provide a foretaste of the manner in which exemption could be obtained in the years 2009 and thereafter for an organization formed for the charitable and educational purpose of publishing a daily newspaper.

Ironically, it is not the fact that newspaper content has changed that warrants reexamination of the prior rulings, rather it is the changed economics of newspaper publishing that renders the tests obsolete, notably the vast reduction in advertising revenues, which has historically been the principal source of income for daily newspapers. There are few newspapers that are surviving in the commercial market. In fact, when one applies the five-part test in the 1982 General Counsel Memorandum to a newspaper that can no longer survive on revenue from advertising and circulation, a nonprofit organization meeting the organizational test should be able to substantiate that the standard techniques it was using would not lead to any profit; there were no participants in the organization expecting to receive a monetary return; it was providing a public service by investigations, notices of public meetings, and matters of local interest not obtainable otherwise in print; and there was no expectation that the organization could create or accumulate large profits, when in fact it was formed to provide educational information that previously had been disseminated by organizations that had been able to accumulate large profits, but could no longer do so.

### **Rulings Granting Tax Exemption to Nonprofit Broadcasting and Internet Publications**

There are a number of Internal Revenue Service rulings that provide a strong precedent for a determination by the IRS that a nonprofit newspaper could meet the

exemptions from taxation set forth in revenue ruling 67-4 and the 1982 General Counsel Memorandum. The first of these was issued in 1966, in which exemption was granted to a noncommercial radio broadcasting organization.<sup>41</sup> The rationale for this determination was used as the grounds for extending exemption to public radio stations, with the best known of these being National Public Radio, Public Radio International and their affiliated stations across the country. More recently, there have been a number of organizations created to provide internet news that have received exemption determinations from the Internal Revenue Service. Three of these have been singled out in press reports as examples of the new nonprofit journalism. *Voice of San Diego* publishes on the internet with support from the San Diego Community Foundation. *MinnPost.com* started publishing news both in print and on the internet, but discontinued its print publication as of July 2008.<sup>42</sup> A third, the *Atwater Sunfish Gazette*, went out of business due to failure to obtain financial support from foundations and the general public.<sup>43</sup> It is difficult to distinguish this new journalism from that of a provider of news in print format if, as appears to be the case in the cities in which a nonprofit newspaper would continue to provide the information formerly provided by a for-profit publisher, there is no commercial publisher in the vicinity in which the nonprofit will operate.

One of the important differentiations among nonprofit newspaper publishers is whether they are operating as free standing nonprofit organizations, or whether they are a related activity of an organization whose purposes may include publishing but does not have that as its principal purpose. The most common of these is newspapers published by students. The most recent example of this is the Investigative Reporting Workshop, a program of American University in Washington, D.C., established in 2008.<sup>44</sup> Another example of exempt organizations that publish newsletters and other

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<sup>41</sup> Rev. Rul. 66-220, 1966-2 C.B. 209.

<sup>42</sup> "About Us," *Voice of San Diego*, [http://www.voiceofsandiego.org/support\\_us/about\\_us/](http://www.voiceofsandiego.org/support_us/about_us/); "About Us," *MinnPost.com*, <http://www.minnpost.com/about/>.

<sup>43</sup> Doug Hanneman, "Atwater Newspaper Ceases Publication," *Hutchingson Leader*, September 3, 2008.

<sup>44</sup> "About the Investigative Reporting Workshop," American University School of Communication, <http://investigativereportingworkshop.org/about/>.

communications is religious organizations. The *Christian Science Monitor* was operated as an educational and religious program of First Church of Christ, Scientist.<sup>45</sup> It was published as a daily newspaper until 2009 when the Church announced it would henceforth be published primarily on the internet.<sup>46</sup> *National Geographic* is a magazine published by the National Geographic Society, a tax-exempt membership organization.<sup>47</sup> *The St. Petersburg Times* is owned by the Poynter Institute, an educational organization that operates as a college, thereby qualifying as a publicly supported charitable organization eligible to hold a more than minimal interest in a business.<sup>48</sup> The original conception for the Poynter Institute and others that follow its model was that the dividends from the newspaper company would support the organization's educational programs. However, if the fortunes of a newspaper decline, as appears to be the case with daily newspapers, the organization will have to seek alternative means of support for its educational programs. *Harper's Magazine*, *Mother Jones*, and *Ms. Magazine* are other examples of publications that are the sole exempt activity of a tax-exempt nonprofit organization.<sup>49</sup>

### **Rules Governing Organizations that Conduct Investigative Journalism**

Starting in the mid-1990s when daily newspapers began to reduce the number of reporters assigned to what is termed investigative journalism, a number of organizations were formed to fill the gap, and they have received determinations of tax exemption by successfully meeting the definition of a tax-exempt educational organization. The Center for Public Integrity, created by Charles Lewis in March 1989, now supports almost one-hundred investigative journalists around the world and has received numerous awards

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<sup>45</sup> "Who We Are, What We Stand For," *The Christian Science Monitor*, [http://csmonitor.com/aboutus/about\\_the\\_monitor.html](http://csmonitor.com/aboutus/about_the_monitor.html).

<sup>46</sup> David Cook, "Monitor Shifts From Print to Web-Based Strategy," *The Christian Science Monitor*, <http://csmonitor.com/2008/1029/p25s01-usgn.html>.

<sup>47</sup> National Geographic Education Foundation, <http://www.nationalgeographic.com/foundation/about.html>.

<sup>48</sup> "Who We Are and What We Do," Poynter Institute, [http://www.poynter.org/content/content\\_view.asp?id=8090](http://www.poynter.org/content/content_view.asp?id=8090).

<sup>49</sup> "About Harper's Magazine," *Harper's Magazine*, <http://www.harpers.org/harpers/about>; "What is Mother Jones?" *Mother Jones*, <http://www.motherjones.com/about>; "Her Story – 1971 to Present," *Ms. Magazine*, <http://www.msomagazine.com/about.asp>.

for its reporting.<sup>50</sup> The Center for Investigative Journalism, founded in 1997, operates from San Francisco in a similar manner.<sup>51</sup> These organizations qualified as public charities with purposes that are broadly charitable and educational. They rely on contributions from foundations and individuals in sufficient number so that they are not subject to the private foundation restrictions. An investigative journalism organization with similar purposes, *ProPublica*, was created in 2008 with major support from one family and hope of garnering support from private foundations and the public.<sup>52</sup>

On June 12, 2009, the Associated Press announced that it would deliver work by these three organizations and the Investigative Reporting Workshop at American University to the 1,500 newspapers that are members of the Associated Press and that these members will be free to publish the material.<sup>53</sup> The arrangement was described as “a six-month experiment” that could later be broadened to include other investigative nonprofits, and to serve its nonmember clients, which include broadcast and internet outlets. These three nonprofit organizations provide additional precedents for the proposal that nonprofit newspapers do meet the requirement for tax exemption under the Internal Revenue Code as charitable and educational organizations.

Finally, there are two examples of support for investigative reporting that have been established with direct connections to for-profit news organizations. One example is the Huffington Post Investigative Fund, an independent nonprofit charity, initially funded by Atlantic Philanthropies and *The Huffington Post*, but seeking support from the general public and other foundations. Although it has close ties to *The Huffington Post*, its stories are made immediately available to the general public.<sup>54</sup> The second example is The Nation Institute, a tax-exempt organization that supports internships, journalism

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<sup>50</sup> “2000 Annual Report,” The Center for Public Integrity, [http://www.publicintegrity.org/docs/annualreports/2000\\_CPI\\_Annual\\_Report.pdf](http://www.publicintegrity.org/docs/annualreports/2000_CPI_Annual_Report.pdf). See Charles Lewis, “The Growing Importance of Non-Profit Journalism,” The Joan Shorenstein Center on the Press, Politics, and Public Policy, [http://www.ksg.harvard.edu/presspol/research\\_publications/papers/working\\_papers/lewis\\_april\\_07.pdf](http://www.ksg.harvard.edu/presspol/research_publications/papers/working_papers/lewis_april_07.pdf).

<sup>51</sup> “About CIR,” Center for Investigative Reporting, <http://www.centerforinvestigativereporting.org/about>.

<sup>52</sup> “About Us,” *ProPublica*, <http://www.propublica.org/about>.

<sup>53</sup> Richard Perez-Pena, “A.P. in Deal to Deliver Nonprofits’ Journalism,” *New York Times*, June 13, 2009.

<sup>54</sup> “Huffington Post Launches Investigative Journalism Venture,” *The Huffington Post*, [http://www.huffingtonpost.com/2009/03/29/huffington-post-launches-\\_0\\_n\\_180498.html](http://www.huffingtonpost.com/2009/03/29/huffington-post-launches-_0_n_180498.html).

fellowships, conferences and investigative reporting, working in cooperation with *The Nation* magazine, but making its results broadly available.<sup>55</sup>

### **Limits on Private Foundation Grant-Making to Support Nonprofit Journalism**

One of the major sources for support for nonprofit journalism that is commonly suggested is grants from foundations. In fact, in an opinion column in *The New York Times* on January 27, 2009, Swenson and Schmidt suggested that the largest foundations could provide an endowment of \$5 billion to support *The New York Times* or the *Washington Post* as nonprofit organizations.<sup>56</sup>

However, foundations are subject to several restrictions that may be perceived as inhibiting their support of either for-profit or nonprofit newspapers, as well as organizations that conduct investigative journalism. The restrictions, as noted above, include an absolute prohibition against lobbying or supporting candidates for public office; a prohibition against making grants to any organization not classified as a public charity unless the foundation takes prescribed steps to assure that its grant will be used for the exempt purposes for which it was made; and an overall prohibition against expending any funds for a nonexempt purpose. This does not mean that a foundation may not make grants to other private foundations or to nonexempt organizations, whether for-profit or nonprofit. Such grants can be made if the foundation requires strict compliance with the purposes of the grant, limiting its use only to activities permitted by the foundation and requiring separate accounting and reporting to it on all expenditures. Many private foundations have found these restrictions too cumbersome and too costly to administer and accordingly limit their grant-making to public charities. Thus, to be eligible to receive the widest possible support, nonprofit organizations that operate newspapers or conduct investigative journalism do well to assure that they qualify as public charities by obtaining support from a sufficient number of donors so

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<sup>55</sup> "About Us," The Nation Institute, [http://www.nationinstitute.org/p/about\\_us](http://www.nationinstitute.org/p/about_us).

<sup>56</sup> David Swensen and Michael Schmidt, "News You Can Endow," *New York Times*, January 27, 2009. See also Penelope Muse Abernathy, "A Nonprofit Model for the *New York Times*?", [http://www.pubpol.duke.edu/nonprofitmedia/documents/DWC\\_Conference\\_Report.pdf](http://www.pubpol.duke.edu/nonprofitmedia/documents/DWC_Conference_Report.pdf). See also David Westphal, "Philanthropic Foundations: Growing Funders of the News", USC Center on Communications and Policy, <http://www.communicationleadership.org>.

that they can meet the arithmetic tests demonstrating support from the public described in the Internal Revenue Code.<sup>57</sup>

Finally, there is no legal prohibition against a private foundation being formed for the sole purpose of supporting qualified nonprofit news media or investigative journalism, all of which currently qualify under the broad definition of education found in the Internal Revenue Code. At present, what is prohibited is a private foundation owning other than a *de minimus* amount of stock of a for-profit newspaper. However, a private foundation with its own endowment could qualify for special status as a private operating foundation if the endowment is sufficiently large to support its activities; if it directly operates a newspaper or media outlet; and if it demonstrates that its purposes meet the definition of “educational” under the Internal Revenue Code.

In the final report of the May 2009 Duke Nonprofit Media Conference, Hamilton summarized a set of suggestions for foundations that included establishing a donor collaborative to support nonprofit public affairs journalism; providing assets to regional and state nonprofit investigative centers at universities to learn management, fundraising and administration; creating a clearing house to vet the qualification of foundation investments in nonprofit media as program related investments; and encouraging community foundations to work with traditional local media.<sup>58</sup> As a follow up to the first recommendation, in July, 2009, at a conference held at Pocantico, New York, seventeen nonprofit news publishers agreed to establish a steering committee with the working name, The Investigative News Network, “to aid the work and public reach of its member news organizations and to foster the highest quality investigative reporting.”<sup>59</sup> The committee’s first function was to seek funding to permit the formation of a new tax-exempt organization to carry out its mission.

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<sup>57</sup> I.R.C. § 509(a)(1), (2).

<sup>58</sup> James T. Hamilton, “The Road Ahead for Media Hybrids: Report of the Duke Nonprofit Media Conference May 4-5, 2009,” [http://www.pubpol.duke.edu/nonprofitmedia/documents/DWC\\_Conference\\_Report.pdf](http://www.pubpol.duke.edu/nonprofitmedia/documents/DWC_Conference_Report.pdf).

<sup>59</sup> The Pocantico Declaration, <http://www.communicationleadership.org>.

#### 4. IS TAX EXEMPTION FOR NONPROFIT NEWSPAPERS POSSIBLE?

An organization formed to publish a newspaper would likely have its request for exemption forwarded to the National Office of the IRS for a ruling that it qualifies for exemption as an educational organization. A carefully crafted request for exemption should be approved, based on precedents ruling that educational broadcasting organizations and those who provide news on the internet and who meet the other Internal Revenue Code requirements are eligible for exemption as educational organizations. The Internal Revenue Service itself could issue a ruling modifying Revenue Ruling 67-4, citing the changed economics of the newspaper industry, noting that in today's economic circumstances, operation of a newspaper could in fact meet the tests in that ruling and the General Counsel Memorandum that expanded on it. Faced with a request for determination, the Internal Revenue Service might seek assistance from its general counsel with the publication of a new memorandum setting forth the rationale for a change based on changed circumstances. If exemption was denied, the organization could seek review of the decision in the Tax Court. This could be costly, particularly if the Service appealed an adverse decision.

It is rare that Treasury Regulations would be amended to address an issue of this nature. However, there is precedent for Congress to amend the Code provisions governing qualification for exemption in some instances expanding and, in others, limiting the purposes that qualify an organization for exemption under section 501(c)(3) of the Internal Revenue Code and limiting the reach of the tax on unrelated business income. In March, 2009, in fact, a bill was introduced in the U.S. Senate and referred to the Finance Committee on March 24, 2009, that would allow certain newspapers to qualify for exemption from tax under section 501(a) of the Internal Revenue Code. The bill would add to the definition of exempt purposes after the words "educational purposes" the parenthetical phrase "(including a qualified newspaper corporation)."<sup>60</sup> The definition of this phrase in the proposed legislation would be provided in a new

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<sup>60</sup> Newspaper Revitalization Act, S.L.C., 111<sup>th</sup> Cong. (2009).

subsection of the Internal Revenue Code, namely, a qualified newspaper corporation would be:

a corporation or organization whose trade or business consists of publishing on a regular basis a newspaper for general circulation; the newspaper contains local, national, and international news stories of interest to the general public and the distribution of the newspaper is necessary or valuable in achieving an educational purpose; and the preparation of the material contained in the newspaper follows methods generally accepted as educational in character.<sup>61</sup>

The bill would also amend the unrelated business income tax provisions, excepting from that tax income from the sale by a qualified newspaper corporation of any space for commercial advertisement to be published in a newspaper to the extent that the space allotted to all such advertisements does not exceed the space allotted to fulfilling the papers educational purpose. Enforcement of this section would be fraught with difficulty, notably if it meant that the Internal Revenue Service was required to determine whether specific content was “fulfilling the organization’s educational purpose. Furthermore, providing an exemption from the tax on unrelated business income tax for advertising income may well be unacceptable to Congress, even if the bill should go forward. Press reports describing the bill indicated that it had been submitted with the support of individuals who were interested in preserving *The Baltimore Sun*, a newspaper owned by The Tribune Company which filed for bankruptcy in late 2008.

Examples of earlier amendments to the provisions of section 501(c)(3) include legislation adopted in amending the Internal Revenue Code to permit amateur athletic organizations to qualify as charities, legislation considered necessary to permit exempt organizations to support training for athletes participating in the Olympics and similar competitions. In contrast, in 1986, Congress added a new paragraph (m) to section 501 of the Internal Revenue Code that removed exemption from BlueCross/BlueShield and other organizations providing similar types of health insurance. Another example occurred in the early 1990s when Congress passed legislation exempting the tax on

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<sup>61</sup> *Id.*

unrelated business income payments from advertisers to colleges and universities for television rights to broadcast athletic games. More recently, some members of Congress have been seriously questioning whether hospitals that do not differ in their sources of income or methods of operation from their for-profit counterparts should be granted the tax benefits they currently enjoy and whether universities with very large endowments should not be forced to expend currently a fixed percent of their value, as is the case with private foundations.<sup>62</sup>

Another approach to achieving tax-exempt status for nonprofit newspapers is to persuade the Internal Revenue Service to provide new guidance as to whether and under what circumstances nonprofit charitable organizations can publish or support the publication of newspapers. Such was the case in a letter to the Internal Revenue Service dated May 28, 2009, in response to its request for recommendations from the public with respect to items that merit inclusion on the 2009-2010 Guidance Priority List of the Internal Revenue Service. The signatories were participants at the conference held in May 2009 at Duke University that was devoted to the issues explored in the letter.<sup>63</sup> Specifically, they asked the Internal Revenue Service to consider the questions of whether publishing could be considered as a “charitable” purpose; whether the absence of volunteers in a publishing venture should be grounds for denying exemption; whether income from advertising is unrelated business income; that there should not be a differentiation between charities that provide news on-line and those that print the news; and clarification of the types of support that foundations can provide for newspapers in the form of grants and program-related investments.<sup>64</sup>

## **5. NEW HYBRID ORGANIZATIONS THAT ARE QUASI-NONPROFIT**

There is still another approach, supported by a number of advocates of what is sometimes called “the new philanthropy,” that calls for creation of a new, separate

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<sup>62</sup> “Grassley on Certain Veterans Charities, Overall Need for Accountability, Key Reforms,” Senator Chuck Grassley of Iowa, [http://grassley.senate.gov/news/Article.cfm?customel\\_dataPageID\\_1502=10632](http://grassley.senate.gov/news/Article.cfm?customel_dataPageID_1502=10632).

<sup>63</sup> James T. Hamilton, “The Road Ahead for Media Hybrids: Report of the Duke Nonprofit Media Conference,” May 4-5, 2009, <http://www.pubpol.duke.edu/nonprofitmedia>.

<sup>64</sup> Copy of Letter in possession of author.

category of quasi-nonprofit or “hybrid” organizations, created under state laws and eligible for tax exemption as charities, but with individual investors who could share to some degree in any appreciation on their investment and possibly any operating profits. Some of those urging creation of such a new category of tax-exempt organizations also propose that they not be subject to the existing restrictions on private foundations, specifically the prohibitions against self-dealing, the limits on ownership of business enterprises, and the constraints on investments and expenditures.

The primary drawback to legal status for a hybrid form lies not just in the federal rules governing tax exemption, but in the state laws applicable to all exempt charitable organizations that impose on their fiduciaries a duty of loyalty. This duty was first framed in the laws applicable to trusts where a trustee, holding assets for the benefit of other individuals, was prohibited from benefitting in any way from his position. This meant an absolute ban on self-dealing and a requirement that the interests of the beneficiaries be above any private interest of the trustee. The duty was adopted as part of the laws governing business corporations, framed in that case as a duty to the shareholders. For charitable trusts and corporations, which by definition are established to benefit the public, the duty of loyalty is to the purposes or mission for which the organization was formed. As noted above, these purposes, in turn, are defined under the laws in each state, based on a statute adopted in England in 1601. Treasury Regulations refer to this same statute as the basis for the definition of exempt purposes set forth in section 501(c)(3) of the Internal Revenue Code. In all instances, the purposes must ultimately be considered of public benefit.

The conceptual difficulty presented by hybrid organizations lies in determining to whom the duty of loyalty is owed - the investors (shareholders) or the ultimate charitable beneficiaries. Attempts to circumvent this dilemma have led to proposals to permit creation of corporations with “social purposes” or “low profit companies.” In fact, a new form of limited liability company called a “Low Profit Limited Liability Company” or “L3C” had been recognized under the laws of Vermont, Michigan,

Wyoming, Utah, North Dakota, Illinois, and Maine, as of September 2009.<sup>65</sup> The L3C was not originally contemplated to be a tax-exempt entity. Rather, it was designed to attract investments by foundations that would qualify as a special category of investments described in the Internal Revenue Code as “program related investments.” Section 4943 of the Code prohibits foundations from making “jeopardy investments,” but contains a specific exemption for program related investments that was designed to encourage foundations to support private, taxable enterprises that were furthering charitable purposes such as minority owned businesses or social enterprises. Despite the existence of the exception, private foundations have been reluctant to make investments of this nature, in part because the IRS has offered limited guidance as to the type of investments that would qualify. The laws authorizing creation of L3Cs requires that they be created and operated in such a manner that they would meet the definition in the Internal Revenue Code of a program related investment. The L3C has garnered wider interest because, by definition, it modifies the traditional duty of directors of business corporations to maximize profits for shareholders (thereby the word “low profit” in the name, although the amount of profit is not defined).

Another form of hybrid corporation was approved by Parliament in England in 2004 to permit charities, who are otherwise prohibited from operating unrelated businesses, defined as “trading,” as well as private organizations and individuals to invest in community improvements. Called a “community interest company” (CIC), this new form of company is not treated as a tax-exempt charity, rather it is given special status because its purpose is to benefit a particular community. Here the definition of community interest is designed to be more liberal than the legal definition of charity which requires a showing of public benefit. There are limits on the amount of dividends or interest these companies can pay and their assets are subject to a “lock,” which means that on merger or dissolution, the company’s property must be distributed to another

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<sup>65</sup> VT. STAT. ANN. Tit. 11, Ch. 21, § 3001(27) (); MICH. COMP. LAWS § 450.4102 (2009); WYO. STAT. ANN. § 17-15-102, 105, 112 (2009); UTAH CODE ANN. §§ 48-2c-412, 1411 (2009); N.D. CENT. CODE §§ 10-32-02, 10-32-10, 10-32-114, 10-32-149, 57-38-31 (2009); 805 ILL. COMP. STAT. 180/1-5, 1-10, 1-26, 15-5 (2009); 2009 Me. Laws §§ 602(10-a), 603(1), 622(1).

CIC or to a charity. A CIC can only come into existence if approved by a newly established regulator. By June 2007, one-thousand CICs had been registered, and it was estimated that this number would double in six months, but this did not happen for another two years. In contrast, in 2005 it was reported that there were about 15,000 social enterprises in existence in England, leading Breen to conclude that the use of the CIC as an organizational form was quite insignificant.<sup>66</sup>

CICs are similar to L3Cs in that they are designed to appeal to investors who do not have profit maximization as their primary purpose. By placing a statutory limit on the amount they may distribute to investors, combined with the asset lock, they reflect an attempt to resolve the tension for investors who desire profits yet also have a donative intent. For charities, they offer a way in which they may themselves participate in business ventures, an action from which they had theretofore been prohibited. Thus, the CIC may not be an appropriate precedent for U.S. charities which are permitted to conduct unrelated businesses and to participate in partnerships and limited liability companies with private investors so long as the charities maintain control of the venture.

The L3C form of organization might be a suitable legal form for a nonprofit newspaper if tax exemption and the ability to receive tax deductible contributions were not needed for its economic viability. However, under existing law in all states, a limited liability company, or LLC would be as suitable for a nonprofit newspaper as an L3C if in its purpose clause and its operations it met the requirements for a program related investment, namely charitable purposes and little or no expectation that it would be profitable for its investors.

In the "Report of the Duke Nonprofit Media Conference," consideration by those present was given to the possibility of a daily newspaper being organized as an L3C with three tiers of investors: (1) foundations making program related investments; (2) public-minded private investors willing to accept a limited rate of return; and (3) investors interested in financial returns that they would likely receive if the returns to

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<sup>66</sup> Oonagh Breen, "Border Control Issues – Free Trade for All?" QUT, April 16-18, 2009.

the first two tiers were well below market rate.<sup>67</sup> The major drawback to such a proposal was thought to be the uncertainty as to the likelihood of obtaining approval from the Internal Revenue Service that investment by foundations would qualify as program related.

## 6. CONCLUSION

Despite the interest in providing exempt status for hybrid organizations, or amending the Internal Revenue Code to include publication of a nonprofit newspaper as a charitable purpose, it is unlikely that Congress would relax the basic prohibitions against supporting candidates in elections or carrying on more than insubstantial lobbying by tax-exempt charitable, educational organizations. Thus, the first drawback to publishing is the need to forgo what has been a traditional, and extremely important, role for newspapers, namely supporting candidates in elections. The limits on lobbying should not be as formidable a barrier, as the definition of educational is extremely liberal and there are at present no limits on lobbying for or against executive actions. Furthermore, the dollar limits should not be a problem for some of the larger organizations that might convert their status from for-profit to nonprofit.

For organizations willing to accept the limitations under section 501(c)(3), nonprofit status could be obtained if Congress were to approve the bill introduced in the Senate in 2009 that would include newspaper publishing as a valid exempt purpose. If this is not the case, an attempt should be made to obtain an affirmative exemption ruling from the Internal Revenue Service based on the fact that current economic circumstances differ so markedly from those existing in 1967 and 1982 that revision of the rulings issued in those years is appropriate and that operation of a newspaper that is not in competition with for-profit counterparts is a valid charitable and educational purpose. As described above, such an attempt was made in May 2009 by thirteen participants at the Duke University Media Conference.<sup>68</sup>

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<sup>67</sup> James T. Hamilton, "The Road Ahead for Media Hybrids: The Duke Nonprofit Media Conference," p. 8-9, May 4-5, 2009, <http://www.pubpol.duke.edu/nonprofitmedia>.

<sup>68</sup> Copy of letter in possession of author.

Revision of prior precedent due to changed circumstances is the essence of charity law, for without it we would not have the many institutions founded in the early days of this country (and before) that have set the precedents that underlie the nonprofit charitable sector today. This ability to change to meet new circumstances is recognized in Internal Revenue Service regulations defining “charitable”, which state “that the term charitable is used in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of charity as developed by judicial decisions.” This would mean that an organization organized and operated to publish a newspaper that otherwise meets the qualifications for exemption is entitled to a determination that it is a charitable, educational organization described in section 501(c)(3) of the Internal Revenue Code.

In addition to the avenues described above (legislation or guidance of the Internal Revenue Service), another avenue to establish exemption would be for a newly established nonprofit newspaper to apply for exemption as a charitable and educational organization described in section 501(c)(3), relying on prior precedents to establish that its purposes qualify under that section, and setting forth the manner in which it believes that it meets the tests set forth in Revenue Ruling 67-4, as amplified by General Counsel Memorandum 38,845. In particular, it would have to argue successfully that the economic situations in 1977 and 1982 differ vastly from that of today in regard to the number of newspapers, the manner in which they obtain support, and the manner in which newspaper publishers now operate is distinguishable from commercial operations. If, as some predict, the Service were to deny the application for exemption, the organization would have recourse to the courts where the result will likely be favorable, particularly in light of the large number of affirmative determinations given to nonprofit broadcasting organizations and internet newspapers in recent years. The cost will be considerable, but the issue is of sufficient public concern that it may be possible to obtain financial support to mount a legal challenge to an adverse determination.