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Re-embracing the Commensurate Test

Published on: July 29, 2008 (<https://nonprofitlawblog.com/re-embracing-th/>) by Gene Takagi (<https://nonprofitlawblog.com>)

/author/gene-takagi/ Category: *IRS & FEDERAL TAX ISSUES* (<https://nonprofitlawblog.com/category/irs/>)

According to the Chronicle of Philanthropy (May 13, 2008), the IRS, in a recent private-letter ruling, denied a tax exemption to an organization for not spending enough of its money on charitable programs. Although the recipient's identity was not released, the organization is believed to be the National Foundation of America, and the ruling reflects the IRS' most recent effort to establish a standard that will enable the IRS to assess whether organizations are using their resources properly. The organization's application for tax-exempt status states that it planned "to coordinate and conduct, through its staff, evangelistic campaigns in a number of countries wherein people are receptive to the Gospel of Jesus Christ." However, the IRS concluded that the organization's primary purpose was running a business given that, among other things, most of their money was obtained from the sale of annuity plans and it spent only less than half of 1 percent of its total revenue on charitable programs, which constituted only 3 percent of its total expenses.

Just last month, **Steven T. Miller**, Commissioner of the IRS' tax-exempt and government-entities division, announced that the IRS was planning to return to the controversial "commensurate test" that was set aside years ago after first appearing in a 1964 revenue ruling. The commensurate test is aimed at monitoring an organization's efficacy and effectiveness by addressing whether a charity is using resources in line with its charitable mission, not through specific formulas or percentages, but on a case-by-case basis. Previously, the test had been directly applied to a charity only once in a 1990 high profile case in which the IRS revoked an organization's tax exemption in part because its charitable activities were not commensurate in scope with its financial resources.

Miller's announcement came with mixed reviews. Similar to the alarmed reaction by many charity officials in 1990 that prompted the IRS to set the test aside, Miller's announcement has provoked a negative reaction from some nonprofit leaders. **Noland MacKenzie Canter III**, a Washington lawyer who represented the United Cancer Council in a 1992 case in which the IRS backed away from the test, says that the re-embracing of the test is "an invitation to the IRS to engage in arbitrary decision making." Canter doubts whether the test is able to account for justifiable reasons such as future programming, anticipatory costs, projections about the market, and the like that provide good reasons for having a "nest egg." **Errol Copilevitz**, a Missouri lawyer, believes that the IRS has other existing tools available to regulate proper charity activity.

Bruce R. Hopkins, author of many nonprofit law books, raises the interesting point that "there is so little law on the commensurate test... The IRS has almost a clean slate... We all know what the test is, but applying it is a whole other thing." **Sen. Charles Grassley** (IA), senior Republican on the Senate Finance Committee, who pushed for the IRS officials' re-embrace of the commensurate test expressed a similar concern: "... the commensurate test requires legal analysis. It's not a black-and-white measurement, so it will require substantive effort from the IRS, not just a verbal commitment."

Miller defends the use of the IRS' involvement stating that although "No one wants the service dictating how a charity to do it's job," the purpose of the tax-exempt subsidy for charities that "make responsible and appropriate resources to achieve its charitable purposes" needs to be enforced. The IRS plans to focus first on colleges and find a way to apply the test to other types of charitable organizations throughout the next 18 months. **Diana Aviv**, president of Independent Sector, believes that the 18 month discovery period proposed by Miller provides some optimism that the public sector will not fall victim to a one size fits all test: "[Miller] never said it would apply universally in all situations... It doesn't have to be all or nothing."

The private letter ruling is available [here](http://www.irs.gov/pub/irs-wd/0818023.pdf) (<http://www.irs.gov/pub/irs-wd/0818023.pdf>).

– Emily Chan


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