Nonprofit Law Jargon Buster: The Commensurate Test

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For many years, practitioners had all but written off the rarely invoked commensurate in scope test. Then, in April of 2008, a high-ranking IRS official stated that the IRS was planning to develop an initiative focusing on the commensurate in-scope test. Since that time, the IRS has been invoking the commensurate in-scope test more frequently. Therefore, tax-exempt organizations and practitioners must be prepared to confront it.

A. Commensurate Test

Essentially, the commensurate test requires 501(c)(3) organizations to conduct charitable activities commensurate in scope with their resources. The idea is that donors fund charities to do charitable works, not to amass a fortune with no clear plan of how the funds will be spent.

Unfortunately, neither the Code nor the Treasury Regulations state what it means to be commensurate in scope. The IRS first introduced the concept in a relatively obscure 1964 ruling (64-182, 1964-1 CB 186).

Since then, the IRS has applied the test to reach the desired result, often without a clear legal rationale. As a result, the IRS' various applications of the commensurate test have muddied the waters so that no uniform understanding of what it means to be commensurate in scope has taken shape.

Historically, the IRS has applied the commensurate in scope test differently in different contexts. Initially, the service tested whether an activity was commensurate in scope with an organization's resources by scrutinizing the destination of its income. The Supreme Court has ruled in a handful of cases that if income is used for charitable purposes, the organization can be considered tax-exempt.

Congress later adopted the unrelated business income (UBI) tax rules and the prohibition on the exemption for feeder organizations. The unrelated business income rules taxed income from non-charitable commercial ventures while permitting passive investment income to go untaxed.

The prohibition on exemption for feeder organizations precluded exemption for organizations that operate a business and contribute the profits to charity as their primary activity rather than conducting inherently charitable activities.

Essentially, if the main purpose of the organization is inherently charitable, it can qualify as tax-exempt despite earning income from non-charitable activities. These changes in the law made the destination of income tests virtually obsolete.

More recent applications of the commensurate test indicate that the focus of the test has shifted. The Service has begun to compare gross and net revenues and relative proportion of business and charitable activities in order to determine tax-exempt status.

This shift is likely due to the fact that proving private benefit and private inurement is more difficult than comparing gross profit from fundraising and other revenue sources to net charitable activities.

B. Practical Application

Despite the confusion over the issue, there are a few key steps that charities can take to insulate themselves from the commensurate test. Whenever a charity is building up capital over an extended period, the organization should document the purpose.

Whether it is to build an endowment, fund capital expenditures, or some other legitimate charitable purpose, that purpose should be appropriately documented in board resolutions. Charities with endowments should periodically review their expenditure policy to determine whether it is spending its assets at an appropriate rate in light of its resources. Of course, where assets are donor-restricted, the charity may not have a choice in the matter and that should be documented as well.

Finally, while the application of the test has changed over the years, these elements have never been the most important considerations for determining tax-exempt status. Rather, the focus for tax-exempt determination has been on qualifying purpose, organization and operations intended to further that purpose, the absence of private benefit and private inurement, the absence of prohibited campaign interventions, and limited amounts of lobbying.

Bottom line, if the primary purpose of an organization is charitable, and the organization works to further that purpose, chances are good that the organization will qualify for tax-exempt status.

Ellis Carter is a nonprofit lawyer with Caritas Law Group, P.C. licensed to practice in Washington and Arizona. Ellis advises nonprofit and socially responsible businesses on corporate, tax, and fundraising regulations nationwide. Ellis also advises donors with regard to major gifts. To schedule a consultation with Ellis, call 602-456-0071 or email us through our contact form.

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