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## The Illegality Doctrine and 501(c)(3) Organizations

Courts and the Internal Revenue Service (IRS) have long recognized an implied requirement that organizations exempt from taxation under Internal Revenue Code (IRC) Section 501(c)(3) must not have an illegal purpose. As explained by the Supreme Court in *Bob Jones University v. United States*, 461 U.S. 574 (1983), the origins of this illegality doctrine emanate from the law of charitable trusts. Loss of government revenues from tax exemption is often justified on the grounds that tax-exempt organizations serve desirable public purposes and lessen the government's costs and burdens. As a corollary to this public benefit principle, tax exemption is not justified when an organization has an illegal purpose because the organization does not serve a public purpose and the organization increases the government's costs and burdens. The illegality doctrine helps ensure that the government is not subsidizing activity that it aims to prevent. When an organization provides some public benefit but engages in substantial illegal activity, the IRS principally relies on the statutory text of IRC Section 501(c)(3)—requiring organizations to be organized and operated exclusively for one or more enumerated exempt purposes—to deny 501(c)(3) status.

This In Focus examines how and when courts and the IRS have used the illegality doctrine to deny organizations 501(c)(3) status.

### Illegal Purpose

To qualify for tax exemption under IRC Section 501(c)(3), an organization must be organized and operated exclusively for religious, educational, scientific, charitable, or other enumerated purposes. As explained by the Supreme Court in *Better Business Bureau of Washington, D.C., Inc. v. United States*, 326 U.S. 279 (1945), in which the Court interpreted a provision akin to IRC Section 501(c)(3), “the presence of a single [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly [exempt] purposes.” In general, when a taxpayer challenges the IRS's denial of tax-exempt status, the taxpayer bears the burden of proof to show that it is entitled to tax exemption.

In *Church of Scientology of California v. Commissioner*, 83 T.C. 381 (1984), the Tax Court held that a church did not qualify as a 501(c)(3) for certain tax years on several grounds, including an illegal purpose. The Tax Court found that the church conspired to impede the IRS in investigating, assessing, and collecting taxes from the church and affiliated churches. The church “filed false tax returns, burglarized IRS offices, stole IRS documents, and harassed, delayed, and obstructed IRS agents who tried to audit the Church's records.” The Tax Court determined that the church's course of conduct constituted a conspiracy to defraud the United States in violation of 18 U.S.C. § 371

and demonstrated that the church had a “substantial illegal purpose.”

The church argued that there were less restrictive ways for the government to purge misconduct than withholding its tax exemption. It claimed criminal prosecution of specific church officials could have vindicated the government's interest with less intrusion into its church members' First Amendment associational and free exercise rights. The Tax Court concluded neither the First Amendment nor charitable trust principles limited the government's remedy to criminal prosecution. The Tax Court remarked:

[T]he Government's interest in ferreting out crime is not the only interest at stake here. The Government also has an interest in not subsidizing criminal activity. Were we to sustain [the church's] exemption, we would in effect be sanctioning [its] right to conspire to thwart the IRS at taxpayer's [sic] expense. We think such paradoxes are best left to Gilbert and Sullivan.

### Engaging in Illegal Activities

The “operational test” in Treasury Regulation Section 1.501(c)(3)-1, which some courts have embraced, makes plain that an organization will not be regarded as operating for exempt purposes “if more than an insubstantial part of its activities” further a nonexempt purpose. The IRS has applied the operational test to stress that even an organization with a legal purpose will not qualify for tax exemption under IRC Section 501(c)(3) if it engages in substantial illegal activity.

Treasury Regulation Section 1.501(c)(3)-1(d)(2) clarifies that an organization is not precluded from qualification under IRC Section 501(c)(3) if, in carrying out its primary purpose, the organization advocates for social or civil change or opines on controversial issues with the intent to mold public opinion or gain public acceptance so long as it is not an “action organization.” In general, an organization is an action organization if (1) a substantial part of its activities is attempting to influence legislation; (2) it participates or intervenes in a political campaign on behalf of or in opposition to a candidate for public office; or (3) its main or primary objective or objectives can only be accomplished by legislation or a defeat of proposed legislation and it advocates or campaigns for the attainment of that objective.

In *Mysteryboy, Inc. v. Commissioner*, T.C. Memo 2010-13, the Tax Court held that an organization did not qualify as a 501(c)(3), in part, because it found that the organization's proposed activities caused the organization not to be operated exclusively for a tax-exempt purpose. The organization's

proposed activities included activities to (1) legalize sex between adults and children, (2) change child pornography laws, (3) observe sexual behavior between adults and “underagers”, and (4) promote the artistic use of human nudity “YOUNG AND OLD[.]”

The Tax Court explained,

we find that petitioner proposes to operate in a manner that promotes activities which are prohibited by Federal and State laws, violate public policy as reflected in those laws, and tend to promote illegal activities.

The Tax Court also determined that the organization failed to carry its burden of proving that it was not an action organization.

### Application of Illegality Doctrine

The varied, and sometimes overlapping, considerations that factor into courts’ and the IRS’s application of the illegality doctrine are exhibited in *Iowaska Church of Healing v. Werfel*, No. 23-5122 (D.C. Cir. June 21, 2024). In *Iowaska Church of Healing*, an organization whose members’ sincerely held religious beliefs involved the consumption of a hallucinogenic drug regulated by the Controlled Substances Act (CSA) challenged the IRS’s denial of its application for 501(c)(3) status. While the organization’s application was pending, the organization distributed Ayahuasca, a tea that contained the controlled substance dimethyltryptamine (DMT), to its members at religious ceremonies without a religious exemption from the CSA. The IRS denied the organization’s application because (1) the organization was formed in part for the illegal purpose of distributing a controlled substance; and (2) a substantial part of the organization’s activities was in furtherance of that illegal purpose.

The organization sued the government in the U.S. District Court for the District of Columbia to challenge the IRS’s determination. In a memorandum opinion on a motion for summary judgment, the district court held that the IRS correctly determined that the organization was not entitled to 501(c)(3) status. The district court concluded that

until [the organization] obtains a CSA exemption, its promotion and use of Ayahuasca remains illegal under federal law, and [the organization] is neither organized nor operated exclusively for public purposes.

On appeal, citing *Bob Jones*, the D.C. Circuit assessed that the organization’s illegal purpose foreclosed eligibility for tax exemption under IRC Section 501(c)(3). The D.C. Circuit held:

The Church’s primary organizational and operational purpose—Ayahuasca use and ceremony—is illegal on its face without a CSA exemption and the Church did not prove otherwise to either the IRS or the District Court.

The IRS has issued a variety of materials that provide insight into when the IRS considers illegal activities to be grounds for disqualification. The IRS has conveyed that the quality of illegal activities is just as important as the quantity of illegal activities when determining whether an organization is engaging in substantial illegal activity. The quantitative test considers the amount of time and attention an organization spends on the illegal activities, such as the ratio illegal activities bear to activities in furtherance of the organization’s tax-exempt purpose. The qualitative test considers the seriousness of the illegal activities involved and the extent those activities are attributable to the organization based on the involvement of the organization’s officers and directors or ratification by the organization’s governing body. In an IRS Office of Chief Counsel legal memorandum, General Counsel Memorandum 34631 (Oct. 4, 1971), the IRS explained:

A great many violations of local pollution regulations relating to a sizable percentage of an organization’s operations would be required to disqualify it from 501(c)(3) exemption. Yet, if only .01% of its activities were directed to robbing banks, it would not be exempt. This is an example of an act having a substantial non-exempt quality, while lacking substantiality of amount. A very little planned violence or terrorism would constitute “substantial” activities not in furtherance of exempt purpose.

In practice, the IRS has issued several rulings denying 501(c)(3) status to organizations that engage in criminal acts or induce or encourage the commission of criminal acts by planning or sponsoring illegal activities. For example, the IRS regularly issues private letter rulings denying exemption under IRC Section 501(c)(3) to organizations that distribute or encourage the use of controlled substances, including marijuana. The IRS has also denied 501(c)(3) status to organizations based on illegal activities involving civil disobedience, polygamy, and animal cruelty.

### Considerations for Congress

The reach of the illegality doctrine is uncertain due to limited illegality doctrine jurisprudence and IRS materials delineating the types and level of illegal activities that could constitute grounds for denial of 501(c)(3) status. Even cautious 501(c)(3)s that seek out tax advice before engaging in activities that are conceivably in furtherance of their charitable goals, but could also be viewed as illegal, may be ill-prepared for potential risks. To clarify the scope of the illegality doctrine, Congress could draft legislation codifying the illegality doctrine and demarcating the doctrine’s limits. Alternatively, Congress could draft legislation partially codifying the illegality doctrine by listing specific activities that can lead to loss of 501(c)(3) status. To the extent such activities involve speech or expressive conduct, Congress may wish to consider whether they involve protected or unprotected speech, and whether the nature of the restriction would implicate the free speech or free exercise interests of the taxpayer.

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