B. UPDATE ON PRIVATE SCHOOLS

1. Introduction

During 1982, a number of events occurred that brought the Internal Revenue Service's policy on private schools into the public eye. This topic will review those developments as well as pending legislation that affects the private schools issue. Also included in the discussion will be a review of the relationship between education and day-care for purposes of federal income tax exemption. Background information on the Service position on private schools, particularly the case of Green v. Connally concerning private schools in Mississippi, can be found in the 1982 CPE Text, pages 89-91. Both the discussion in the 1982 text and the discussion below apply to private, as opposed to public, schools. Assistance in determining whether a given institution is a private or public school can be found in section 401(c) of the Civil Rights Act of 1964, 42 U.S.C. 2000c(c), which provides that, for purposes of the Act, "public school" means any elementary or secondary educational institution, and "public college" means any institution of higher education or any technical or vocational school above the secondary school level, provided that such public school or public college is operated by a state, subdivision of a state, or governmental agency within a state, or operated wholly or predominantly from or through the use of governmental funds or property derived from a governmental source. For purposes of federal income tax exemption, the concept of a public school is thus broader than the traditional public school system and includes institutions that obtain a predominant part of their funds from governmental sources. Such institutions are excluded from the class of organizations discussed in this topic.

2. Review of 1982 Developments

In the fall of 1981, the Department of Justice was preparing to argue the cases of Bob Jones University v. U.S. and Goldsboro Christian Schools, Inc. v. U.S. before the U.S. Supreme Court. Both cases involve private schools that maintain racially discriminatory practices and, therefore, do not qualify for federal income tax exemption under IRC 501(c)(3). Both institutions maintain that their practices are based on religious belief.

On January 8, 1982, the Treasury Department announced a change in policy under which Bob Jones University and Goldsboro Christian Schools would be recognized as exempt under IRC 501(c)(3) and the revenue rulings and revenue

procedures dealing with private schools and racial discrimination would be revoked. The Department stated that, after a thorough legal review, they were unable to support the legal authority concerning public policy asserted by the Service in denying tax exemption to racially discriminatory private schools. Also on January 8, the Department of Justice filed a motion with the Supreme Court asking that the court of appeals decisions in Bob Jones and Goldsboro be vacated.

Subsequent to the news release, President Reagan submitted legislation (H.R. 5313) to Congress which would provide express authority to deny tax-exempt status to racially discriminatory private schools and the organizations operating them. Hearings were held the first week of February on the proposed legislation in the Senate Finance Committee and the House Ways and Means Committee and there was widespread comment in the media.

Responding to the possibility of a contempt of court citation, the government informed the Green Court that the January 8 policy announcement did not apply to Mississippi private schools and that the Service would continue to comply with the Court's orders concerning denial of exemption to racially discriminatory Mississippi schools.

On February 18, 1982, the Service, in the case of Wright v. Regan, was enjoined by the U.S. Court of Appeals for the District of Columbia from granting or restoring IRC 501(c)(3) exempt status to any racially discriminatory private school thus precluding the carrying out of the January 8, 1982, announcement by Treasury. The procedural question in Wright concerning standing, which was discussed in the 1982 CPE Text, is still pending before the Supreme Court, which has yet to act on the government's petition for certiorari.

On February 25, 1982, the Department of Justice filed documents with the Supreme Court in the Goldsboro and Bob Jones cases which advised the Court of developments involving the cases since the January 8, 1982, filing. In a reversal of its request of January 8, Justice asked the Court to hear the cases because the two institutions had not been granted exemption and the cases were not, therefore, moot. Justice also noted that the relevant revenue rulings and procedures had not been revoked. In their brief, Justice argued that the Service does not have the authority to revoke or deny the schools' exemptions under IRC 501(c)(3) on the grounds that the institutions have racially discriminatory policies that contradict national public policy, but that, if the Service had been so authorized, its actions with regard to the schools would not have been prevented by the fact that the practices in questions are based on religious doctrines subject to First Amendment

protection. In light of its position on the case, Justice suggested that the Court should appoint counsel to argue in support of the Service position as presented in the lower courts. On April 19, 1982, the Supreme Court agreed to hear the cases in the 1982-83 term. The Court also appointed William T. Coleman, Jr., to argue in support of the earlier Service position.

The Supreme Court heard oral arguments in the cases on October 12, 1982. Attorneys representing the two schools argued that the Service policy of denying exemption to racially discriminatory schools exceeded the Service's statutory authority under IRC 501(c)(3). They also asserted that the Service policy violated their First Amendment right to maintain practices that are based on religious belief. William Bradford Reynolds, Assistant Attorney General for Civil Rights, presented the federal government's case in support of the schools. Reynolds argued that the legislative history of IRC 501(c)(3) did not support a broad common law definition of "charitable." William Coleman, arguing in support of the pre-1982 Service position, asserted that the Service had the authority to deny exemption for racial discrimination and that Congress had implicitly ratified the Service policy by adopting IRC 501(i) concerning IRC 501(c)(7) social clubs and racial discrimination and by rejecting numerous opportunities to overrule the policy through legislation. Although not permitted to present oral arguments, a number of organizations, including the NAACP and the Anti-Defamation League of B'nai B'rith, filed Amici Curiae briefs with the Court. A decision is not expected until the spring.

3. Legislation

A. IRC 501(j)

As indicated in the preceding discussion, on January 18, 1982, President Reagan proposed an amendment to the Code (H.R. 5313) which would create a new IRC 501(j) providing that private schools with racially discriminatory policies are not entitled to exemption from federal income tax. The current IRC 501(j) would become IRC 501(k). The proposed legislation would also incorporate a similar provision on discrimination in IRC 170, 642, 2055 and 2522. The amendments would be effective July 10, 1970.

Hearings have been held on the legislation in both the House of Representatives and the Senate but further action on the proposal is not expected until after the Supreme Court issues an opinion in Bob Jones and Goldsboro.

B. Tuition Tax Credits

The administration has proposed an amendment to the Code which would provide tuition tax credits to taxpayers with children enrolled in private elementary and secondary schools. The credits would not be available with respect to tuition paid to schools that practice racial discrimination.

There has been considerable debate in Congress over the provisions dealing with racial discrimination and it is unlikely that further action will be taken on the bill before the Supreme Court acts in Bob Jones and Goldsboro.

C. Appropriations Restrictions

The budget restrictions concerning private schools guidelines and procedures not in effect prior to August 22, 1978, (see the 1982 CPE Text, pp. 90-91), which first appeared in the 1980 Treasury Appropriations Act and which were, by reference to that Act, incorporated in subsequent Continuing Resolutions providing operating funds for the Service, have not been carried over into the Continuing Resolution currently providing operating funds. Additionally, neither the House nor the Senate version of the 1983 Treasury Appropriations Act, in the forms reported out of committee, contain such restrictions. It should be noted, however, that the proposed revenue procedure on private schools, at which the budget restrictions were directed, was never formally adopted by the Service and, consequently, even though the budget restrictions are no longer in effect, the proposed guidelines have been withdrawn from consideration and are not to be utilized. As indicated in previous CPE Texts, the guidelines of Revenue Procedure 75-50 are to be used as the standard for determining whether a private school discriminates on the basis of race.

4. Day-Care and Education

The question of federal income tax exemption for organizations providing day-care has been one which the Service has faced since the first years of the federal income tax. The basic issue has revolved around whether organizations providing day-care are educational in the sense that their activity is similar to that of a school or whether the provision of purely custodial day care is a charitable activity in its own right.

The Service's initial published position on the question was O.D. 340, 1919-1 C.B. 202, which stated that an organization, incorporated for the purpose of

establishing and maintaining a day nursery for young children whose parents were obliged to work and had no means to provide care for their children during the day, and which derived its income from subscriptions and donations, and a small amount from securities, all of which was used in promoting the activities of the nursery, was exempt from taxation under section 231(6) of the Revenue Act of 1918, a predecessor of IRC 501(c)(3).

O.D. 340 was superseded by Revenue Ruling 68-166, 1968-1 C.B. 255, which updated and restated the earlier ruling under current law. The 1968 ruling provides a currently accurate description of the requirements for exemption under IRC 501(c)(3) for an organization providing purely custodial day-care, namely that the service be provided solely to children from "needy" or low income families.

An organization providing day-care may also, however, be providing a structured program of learning for the children in its care. If the organization also meets the other criteria of IRC 170(b)(1)(A)(ii) and Reg. 1.501(c)(3)-1(d)(3)(ii), it may be recognized as exempt under IRC 501(c)(3) as a school and not have to restrict the provision of its services to low income families. The applicable criteria include: (1) a regularly scheduled curriculum; (2) a regular faculty, and; (3) a regularly enrolled body of students in attendance at a place where educational activities are regularly carried on. Such an educational day-care situation has been described in Revenue Ruling 70-533, 1970-2 C.B. 112, and Revenue Ruling 73-430, 1973-2 C.B. 362. Furthermore, an organization may be providing structured educational activities for children at early ages as noted by the courts in the cases of San Francisco Infant School v. Commissioner, 69 T.C. 957 (1978), acquiescence, 1978-2 C.B., and Michigan Early Childhood Center, Inc. v. Commissioner, T.C.M. 1978-186.

In order to be classified as a school under IRC 170(b)(1)(A)(ii), an organization's educational program must reflect instruction in a formal sense directed to achieving educational goals. It must be representative of a purposeful effort at the systematic transfer of knowledge. Whether such elements are present in any particular case will depend on each set of facts and circumstances. For instance, Revenue Ruling 79-167, 1979-1 C.B. 335, holds that a community center providing diffuse instruction in a variety of fields does not possess a "curriculum" within the meaning of IRC 170(b)(1)(A)(ii). However, Revenue Ruling 79-403, 1979-2 C.B. 362, concludes that a program of art therapy, therapeutic play sessions, psychotherapy, and speech therapy offered by a residential treatment center for emotionally disturbed children does qualify under IRC 170(b)(1)(A)(ii).

The two situations are distinguished by the presence of an integrated, planned educational program in the latter example.

In this context, it should be noted that such educational organizations and day-care organizations which are classified as schools under IRC 509(a)(1) and IRC 170(b)(1)(A)(ii) must establish that they have racially nondiscriminatroy policies in order to be recognized as exempt or to avoid jeopardizing their status if already exempt, unless they are considered "public schools."

5. Conclusion

Accordingly, organizations providing day-care services may be exempt from federal income tax under IRC 501(c)(3) either as schools, assuming they have a structured educational program and the other criteria of IRC 170(b)(1)(A)(ii) and Reg. 1.501(c)(3)-1(d)(3)(ii) are present, or as charitable organizations assuming the day care services are provided solely to children of low income families. If classified as private schools, such organizations must, along with more traditional private schools, establish that they have racially nondiscriminatory policies, a requirement the validity of which is currently under review by the Supreme Court. Because the Court's decision could have a dramatic impact, specialists should be alert to developments in this area.