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Robert Charkovsky

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NOTES
TAX EXEMPTION FOR
BUSINESS LEAGUES NARROWED—
NATIONAL MUFFLER DEALERS
ASSOCIATION, INC. V. UNITED STATES

When Congress adopted the modern income tax in 1913,¹ it exempted certain classes of organizations from federal income taxation. Business leagues are one such tax-exempt class. The 1913 Act contained a specific provision exempting business leagues from income taxation,² and the business league exemption survives to the present day as part of Internal Revenue Code section 501(c)(6).³ The scope of the exemption, however, is less clear, and there has been considerable controversy concerning the types of organizations that will qualify as "business leagues."⁴ Organizations seeking tax exemption understandably seek a broad definition of the term "business league," while the Internal Revenue Service usually argues for stricter construction.⁵

Recently, in *National Muffler Dealers Association, Inc. v. United States*,⁶ the United States Supreme Court denied the business league exemption to an association of retailers that had confined its membership to franchisees of one company. In reaching its decision, the Court upheld the Internal Revenue Service's restrictive interpretation⁷ of the business league exemption.

1. Tariff Act of October 3, 1913, ch. 16, 38 Stat. 114 (1913) (codified in scattered sections of 19, 26 & 46 U.S.C.).

2. *Id.* § II(G)(a), 38 Stat. 172.

3. I.R.C. § 501(c)(6) lists several types of exempt organizations, including therein: "Business leagues, chambers of commerce, real-estate boards, boards of trade, or professional football leagues (whether or not administering a pension fund for football players), not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual." Other tax-exempt organizations include labor unions (§ 501(c)(5)), credit unions (§ 501(c)(14)), and churches (§ 501(d)). Although the statutory exemption is not absolute (*see* I.R.C. § 511-15, providing for taxation of "unrelated business income"), tax exemption continues to be extremely valuable to many organizations. Donations to a church, for example, are not taxable income to the church. Similarly, a labor union does not pay taxes on dues levied and received.

4. *See generally* B. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 260-76 (3d ed. 1979); 6 MERTENS, LAW OF FEDERAL INCOME TAXATION § 34.20 (1975); Note, *Creation of Tax-Exempt Business Leagues: For the Section 501(c)(6) "First Timer"*, 16 WASHBURN L.J. 628 (1977) [hereinafter cited as Note].

5. *See, e.g.*, notes 39-40 and accompanying text *infra*.

6: 440 U.S. 472 (1979).

7. Treas. Reg. § 1.501(c)(6)-1 (1978). This regulation limits the business league exemption by defining a "business league" as

... an association of persons having some common business interest, the purpose of which is to promote such common interest and not to engage in a regular business of a kind ordinarily carried on for profit. It is an organization of the same general class as a chamber of commerce or board of trade. Thus, its activities should be directed to the improvement of business conditions of one or more lines of business as distinguished from the performance of particular services for individual persons. An organization whose purpose is to engage in a regular business of a kind

The Court then addressed a conflict between the Second⁸ and Seventh⁹ Circuits over the exemption's applicability to common franchisor associations. The *National Muffler* Court upheld the Second Circuit's denial of exemption to one such group, but failed to state whether all common franchisor associations now will be denied exemption as a matter of law, or whether some such associations might qualify for exemption if their activities do, in fact, meet the Internal Revenue Service test.

This Note traces the history of the business league exemption and demonstrates that, notwithstanding a clear line of prior case law supporting the *National Muffler* result, the Court erred in its failure to clarify the exemption's remaining applicability to common franchisor associations. An alternative standard, which grants exemptions based solely on an association's activities, is proposed. The decision's restrictive impact on the business league exemption is discussed and comment is addressed to the United States Supreme Court's reaffirmance of its policy of deferring to the Internal Revenue Service.

FACTS AND PROCEDURAL HISTORY

Midas International Corporation, a large retailer of automobile mufflers,¹⁰ conducts a substantial part of its business through a network of several hundred dealer/franchisees.¹¹ In 1971, Midas franchisees formed the National Muffler Dealers Association (Association), a nonprofit corporation that was intended to strengthen its members' bargaining position vis-a-vis

ordinarily carried on for profit, even though the business is conducted on a cooperative basis or produces only sufficient income to be self-sustaining, is not a business league. An association engaged in furnishing information to prospective investors, to enable them to make sound investments, is not a business league, since its activities do not further any common business interest, even though all of its income is devoted to the purpose stated. A stock or commodity exchange is not a business league, a chamber of commerce, or a board of trade within the meaning of section 501(c)(6) and is not exempt from tax.

8. See *National Muffler Dealers Ass'n, Inc. v. United States*, 565 F.2d 845 (2d Cir. 1977). Exemption was not allowed to an association of muffler dealers, all of whom shared a common franchisor. The Second Circuit upheld the Internal Revenue Service position that a business league must benefit one or more lines of business to qualify for tax exemption, an interpretation that prevented the *National Muffler* plaintiff from qualifying as a business league. *Id.* at 846-48.

9. See *Pepsi-Cola Bottlers' Ass'n, Inc. v. United States*, 369 F.2d 250 (7th Cir. 1966). Exemption was allowed to an association of soft drink bottlers, all of whom shared a common franchisor. The *Pepsi* court reasoned that the exemption could not be denied merely because all association members bottled a particular soft drink product. *Id.* at 252. *But see* notes 43-48 and accompanying text *infra*.

10. *National Muffler Dealers Ass'n, Inc. v. United States*, 565 F.2d 845, 847 n.2 (2d Cir. 1977). The Second Circuit decision articulated data presented by a market researcher who had conducted a study for Midas. This testimony suggested that, in 18 major metropolitan areas, Midas owned a 21% share of the muffler replacement market.

11. *National Muffler Dealers Ass'n, Inc. v. United States*, 440 U.S. 472 (1979). The Court suggested that, during 1971-73, there were approximately 580 Midas dealers. *Id.* at 473 n.2.

Midas.¹² Service as a bargaining agent has, in fact, been the Association's principal activity.¹³ Most Midas franchisees have joined the Association.¹⁴ Non-Midas franchisees, however, were excluded from membership under the Association's original bylaws.¹⁵

The Association applied to the Internal Revenue Service for exemption from income taxes as a "business league" under Code section 501(c)(6).¹⁶ The Internal Revenue Service, however, restricts business league status to organizations that are "directed to the improvement of business conditions of one or more lines of business."¹⁷ Noting that the Midas dealers excluded non-Midas dealers from membership, the Internal Revenue Service rejected the Association's initial application for tax exemption.¹⁸ The Internal Revenue Service stated that the business league exemption would not apply to an organization that was not industry wide.¹⁹ After eliminating the requirement that members be Midas franchisees, the Association submitted a second application, but the Internal Revenue Service again denied tax exemption to the Association.²⁰

Following the second rejection, the Association filed income tax returns and then filed suit in federal district court to recover the taxes paid with those returns.²¹ The United States District Court for the Southern District of New York dismissed the Association's complaint.²² Using the Internal Revenue Service "line of business" test,²³ the district court held that the

12. 440 U.S. at 473. In negotiating with Midas, the Association has proved to be a successful bargaining agent. For example, Midas dropped its requirement that customers pay a service charge when a guaranteed muffler was replaced. In addition, Midas' right to terminate franchises was significantly limited. *Id.*

13. *Id.* at 473-74. Secondary activities include publishing a newsletter, hosting an annual convention, and offering group insurance to members.

14. *Id.* at 473 n.2. During the tax years in question (1971-73), approximately 50% of all Midas franchisees were members. By 1975, this figure had soared to approximately 80%.

15. *See id.* at 474. Although the requirement that Association members be Midas franchisees later was dropped from the bylaws, the Association at no time recruited nor accepted a member who was not a Midas franchisee. *See* note 20 and accompanying text *infra*.

16. 440 U.S. at 474.

17. Treas. Reg. § 1.501(c)(6)-1 (1978). For the full regulatory text, see note 7 *supra*.

18. 440 U.S. at 474. According to the Internal Revenue Service, the Association was not directed to the improvement of one or more "lines of business" and therefore did not meet the regulatory requirement for qualification as a business league. *Id.*

19. *Id.*, quoting letter from District Director (New York), Internal Revenue Service, to National Muffler Dealers Association (March 28, 1972).

20. *Id.* at 474. *See* National Muffler Dealers Ass'n, Inc. v. United States, 565 F.2d 845 (2d Cir. 1977). The Second Circuit suggested that the Association's open door amendment was motivated solely by tax considerations, but the court did not state to what extent this suggested lack of a "valid business purpose" affected its decision. *Id.* at 845-46.

21. 440 U.S. at 475.

22. National Muffler Dealers Ass'n, Inc. v. United States, No. 77-6106 (S.D.N.Y. May 24, 1977).

23. *See* notes 7 & 17 *supra*.

applicable line of business encompassed *all* muffler franchisees, not just Midas franchisees. The district court then found no evidence that the Midas Association benefited the larger, generic group.²⁴

The Court of Appeals for the Second Circuit affirmed.²⁵ Like the district court, the Second Circuit upheld the "line of business" test.²⁶ The court then had little difficulty in concluding that, under the test, the Association's application for exemption properly had been denied.²⁷ The Association appealed once again, and the United States Supreme Court granted its petition for certiorari.²⁸

BACKGROUND LAW: DEFINITION OF A BUSINESS LEAGUE

An organization must meet three separate statutory tests before it can qualify for the business league exemption. First, the organization must be a business league. Secondly, it must not be organized for profit. Finally, the organization's earnings must not inure to any private benefit.²⁹ Exemption has been denied for failure to meet any one of the three tests,³⁰ but only the first test was at issue in *National Muffler*.³¹ The Second Circuit, even

24. *National Muffler Dealers Ass'n, Inc. v. United States*, No. 77-6106 (S.D.N.Y. May 24, 1977).

25. *National Muffler Dealers Ass'n, Inc. v. United States*, 565 F.2d at 848.

26. *Id.* at 847.

27. *Id.* The Second Circuit, in applying the "line of business" test, noted the parochial nature of the Association's membership and activities. *Id.* The court did not, however, delineate the interplay between membership and activities. A finding of limited membership, and a finding of parochial activity, could be either joint or alternative grounds for denial of exemption. Neither the Second Circuit nor the United States Supreme Court apparently found it necessary to decide this question, as both courts found that the Association possessed neither broadly-based membership nor widely beneficial activities.

28. *National Muffler Dealers Ass'n, Inc. v. United States*, 436 U.S. 903 (1978).

29. I.R.C. § 501(c)(6). See also *National Muffler Dealers Ass'n, Inc. v. United States*, 565 F.2d at 846; *Northwestern Municipal Ass'n, Inc. v. United States*, 99 F.2d 460, 461 (8th Cir. 1938); 6 MERTENS, LAW OF FEDERAL INCOME TAXATION § 34.20 (1975); Note, *supra* note 4, at 633.

30. For cases denying exemption to associations found to be organized for profit, see, e.g., *Clay Sewer Pipe Ass'n, Inc. v. Commissioner*, 139 F.2d 130 (3d Cir. 1943) (organization that was chartered under Ohio law as a "corporation for profit" was also organized for profit for tax purposes); *Northwestern Municipal Ass'n v. United States*, 99 F.2d 460 (8th Cir. 1938) (association chartered under Minnesota Business Corporation Act held organized for profit).

For cases denying exemption to associations whose earnings were found to inure to private benefit, see, e.g., *Evanston—North Shore Bd. of Realtors v. United States*, 320 F.2d 375 (Ct. Cl. 1963), cert. denied, 376 U.S. 931 (1964) (earnings of a realtor group that provided a listing service inured to the benefit of individual participating realtors); *Northwestern Jobbers' Credit Bureau v. Commissioner*, 37 F.2d 880 (8th Cir. 1930) (earnings of a trade group that provided legal and accounting services to members inured to the benefit of private shareholders or individuals). The *Northwestern* court also found the trade group to be organized for profit. *Id.* at 883. Both logic and a survey of the cases suggest that there might be a significant correlation between the "organization for profit" and "inurement of earnings" tests. See e.g., Webster & Combs, 331 T.M. *Trade Associations* at A-2-3.

31. *National Muffler Dealers Ass'n, Inc. v. United States*, 565 F.2d at 846.

in denying the Association's claim, conceded that there was no challenge to either the Association's nonprofit status or to its disposition of earnings. Rather, its decision was based on the premise that the Midas dealers did not fall within the business league definition.³²

Although the legislative history behind the business league exemption is scanty, it appears that congressional intent was to exempt only associations that aid an entire industry.³³ The Internal Revenue Service then assumed the responsibility of defining "business league." The first definition was promulgated in a 1919 regulation; it restated the not-for-profit statutory requirement, but contained no requirement that a business league benefit an entire line of business.³⁴ This requirement was not added until 1929, when the Internal Revenue Service rewrote its interpretative regulation.³⁵

Although an occasional court³⁶ has attempted to write its own definition of "business league," most courts now embrace the Internal Revenue Service definition as expressed in the "line of business" regulation.³⁷ The regulation itself,³⁸ however, is open to conflicting interpretations; perhaps the most reliable guide of what a business league is can be found by examining the case precedent relating to various types of organizations. The business league exemption has been granted³⁹ and denied⁴⁰ to innumerable associa-

32. *Id.*

33. See Briefs and Statements on H.R. 3321, filed with the Senate Committee on Finance, 63d Cong., 1st Sess., 2002-3 (1913).

34. Treas. Reg. 45, art. 518 (1919) stated:

A business league is an association of persons having some common business interest, which limits its activities to work for such common interest and does not engage in a regular business of a kind ordinarily carried on for profit. Its work need not be similar to that of a chamber of commerce or board of trade.

35. See Treas. Reg. 74, art. 528 (1929), which stated:

[A business league is] an organization of the same general class as a chamber of commerce or board of trade. Thus, its activity should be directed to the improvement of business conditions or to the promotion of general objects of one or more lines of business as distinguished from the performance of particular services for individual persons.

Note the similarity of the above language to the present regulation. See note 7 *supra*.

36. *Crooks v. Kansas City Hay Dealers' Ass'n*, 37 F.2d 83 (8th Cir. 1929). The *Kansas City Hay Dealers* court attempted to define the term "business league" by examining standard dictionary definitions of the words "business" and "league." *Id.* at 85.

37. See note 50 and accompanying text *infra*.

38. Treas. Reg. § 1.501(c)(6)-1 (1978). See note 7 *supra*.

39. See, e.g., *Commissioner v. Chicago Graphic Arts Fed'n*, 128 F.2d 424 (7th Cir. 1974) (organization promoting fair practices in the printing industry held exempt); *Retail Credit Ass'n of Minneapolis v. United States*, 30 F. Supp. 855 (D. Minn. 1938) (retail association formed to educate public in the value of credit held exempt); Rev. Rul. 76-400, 1976-2 C.B. 153 (association to promote the acceptance of women in business and the professions held exempt). Generally, in accordance with the line of business test, exemption has been allowed only to organizations that benefit an entire industry or all components of an industry within a geographical area.

40. See, e.g., *Contracting Plumbers Cooperative Restoration Corp. v. United States*, 488 F.2d 684 (2d Cir. 1973), *cert. denied*, 419 U.S. 827 (1974) (plumbers' cooperative formed to facilitate post-construction street repair held nonexempt); Rev. Rul. 76-38, 1976-1 C.B. 157

tions, with courts scrutinizing the type of association seeking exemption, its organization, and its activities in order to determine whether the association can fit under the statutory business league umbrella.

Prior to *National Muffler*, the only case that applied the business league exemption to a common franchisor association was *Pepsi-Cola Bottlers' Association, Inc. v. United States*.⁴¹ In *Pepsi*, the Seventh Circuit allowed a business league exemption to a common franchisor association of soft drink bottlers. In granting the exemption, the *Pepsi* court stated that the bottlers' association could not be disqualified "merely because its members all bottle a particular soft drink product."⁴²

The *Pepsi* decision, however, was criticized on several grounds. In its nonacquiescence to the decision,⁴³ the Internal Revenue Service stated that an organization promoting a single product could not qualify for the business league exemption.⁴⁴ The dissent in *Pepsi* argued that the association failed to meet the "line of business" test because bottling Pepsi-Cola was only one of many businesses in the soft drink industry and not a line of business in itself.⁴⁵ One commentator doubted *Pepsi's* precedential value,⁴⁶ while another criticized the decision on the ground that it gave a competitive advantage to one company within an industry.⁴⁷

In construing the term "business league," therefore, the *National Muffler* Court faced sparse legislative history, two Internal Revenue Service definitions, and voluminous prior case law capped by intercircuit conflict.⁴⁸ The United States Supreme Court resolved these ambiguities in *National Muffler* by affirming the Second Circuit's denial of the Midas dealer's exemption claim.⁴⁹

(credit union association that made interest-free loans to member credit unions held nonexempt because activity benefited only member businesses); Rev. Rul. 73-411, 1973-2 C.B. 180 (shopping center merchants' association held not to improve any line of business, but only the individual business interests of members).

41. 369 F.2d 250 (7th Cir. 1966). See note 9 *supra*.

42. *Id.* at 252.

43. Nonacquiescence is formal Internal Revenue Service disagreement with the result reached in a particular tax case. The effect of nonacquiescence is that the Internal Revenue Service will relitigate the issue, usually in a different, and perhaps more friendly, circuit. See BLACK'S LAW DICTIONARY 947 (5th ed. 1979).

44. Rev. Rul. 68-182, 1968-1 C.B. 263. After a restatement of the applicable statute and regulations, the Internal Revenue Service stated only that organizations promoting a single brand or product could not qualify for the business league exemption; therefore, the Internal Revenue Service would not follow the *Pepsi* decision.

45. *Pepsi-Cola Bottlers' Ass'n, Inc. v. United States*, 369 F.2d at 252-53 (Kiley, J., dissenting).

46. Note, *Business League Exemption Granted to Association of One Brand-Name Product*, 16 KANSAS L. REV. 113, 116 (1967).

47. Note, 35 FORDHAM L. REV. 738, 742 (1967). Although the author is not explicit, the competitive advantage would result from the *Pepsi* bottlers not having to pay income taxes, while bottlers of competing brands would be saddled with this extra expense.

48. See notes 8-9 and accompanying text *supra*.

49. 440 U.S. at 489.

ANALYSIS OF THE MAJORITY OPINION

The *National Muffler* opinion involved a two-step process: 1) validating the line of business test, and 2) applying that test to deny the Midas dealers their exemption. The first step is supported by a clear line of lower court decisions.⁵⁰ The second step also appears proper in light of the *National Muffler* fact situation.

In construing the term "business league," the *National Muffler* majority noted that the term had no well-defined meaning outside the perimeters of Code section 501(c)(6).⁵¹ Writing for the majority, Justice Blackmun declared that, in such a situation, the Supreme Court customarily defers to the Internal Revenue Service's interpretive regulations as long as they implement the statute in some reasonable manner.⁵² The Court then listed the following criteria for determining whether a regulation's manner of implementation is reasonable: the length of time the regulation has been in effect, its harmony and contemporaneity with the statute, the degree of con-

50. The line of business regulation has been upheld in at least four circuits as well as the Court of Claims. *See, e.g.*, *United States v. Oklahoma City Retailers Ass'n*, 331 F.2d 328 (10th Cir. 1964) (merchants' group that supplied credit information for a fee held nonexempt; court upheld the line of business regulation, citing only to precedent in other circuits); *Automotive Elec. Ass'n v. Commissioner*, 168 F.2d 366 (6th Cir. 1948) (exemption denied to auto parts store that published catalog; court upheld line of business regulation, stating that the regulation had been in effect for 30 years, that it had survived several congressional re-enactments of the underlying statute, and that exemption provisions must be strictly construed in favor of the taxing authority); *Apartment Operations Ass'n v. Commissioner*, 136 F.2d 435 (9th Cir. 1943) (apartment owners' association that furnished credit information held nonexempt; court upheld the line of business regulation, stating that it was "early adopted" and that it has "remained substantially unchanged through repeated re-enactments of the pertinent statute"); *Underwriters Laboratories v. Commissioner*, 135 F.2d 371 (7th Cir. 1943), *cert. denied*, 320 U.S. 756 (1943) (fire insurers' association providing claims adjustment services held nonexempt; court stated that the "long standing" regulation had survived statutory re-enactments and thus had taken on "the quality of law"); *Evanston-North Shore Board of Realtors v. United States*, 230 F.2d 375 (Ct. Cl. 1963), *cert. denied*, 376 U.S. 931 (1964) (realtor board providing listing services held nonexempt; court accorded the business league regulation "the force of law" based on the fact that the regulation remained "unchanged through repeated statutory re-enactments").

51. 440 U.S. at 476.

52. *Id.* at 476-77. A number of rationales support the doctrine of judicial deference to interpretive regulations. One is that legislative re-enactment of the underlying statute constitutes tacit congressional approval of the interpretive regulation. *See, e.g.*, *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939) (Congress must be taken to have approved the administrative construction and thereby to have given it the force of law). A second rationale is that interpretive regulations frequently are issued contemporaneously with the underlying statute and therefore constitute a timely, and presumably more reliable, interpretation of the law. *See, e.g.*, *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496 (1948) (regulations constitute contemporaneous constructions by those charged with administration of these statutes and should not be overruled except for weighty reasons). Finally, it has been argued that taxpayers can rely on interpretive regulations in structuring transactions. Judicial deference to the regulations, therefore, will result in consistent treatment for all taxpayers. *See H.R. REP. NO. 1882, 70th Cong., 1st Sess. 22 (1927).*

gressional scrutiny during any statutory re-enactments, and the regulation's consistency of application by the Internal Revenue Service.⁵³

Applying these criteria to the business league regulation, the Court noted that the line of business language has existed since 1929,⁵⁴ during which time there have been several re-enactments of and one amendment to the underlying statute.⁵⁵ Regarding the regulation's contemporaneity with the underlying statute, Justice Blackmun noted that the 1929 regulation was not contemporaneous with the 1913 statute, and that the prior 1919 regulation⁵⁶ contained no line of business requirement. Recognizing that the Association would have qualified as a business league under the 1919 definition, the *National Muffler* majority stated that contemporaneity,⁵⁷ as only one consideration, "need not control here."⁵⁸

Addressing the regulation's consistency of application, the *National Muffler* majority inferred that, in prior cases, "line of business" generally has been interpreted to mean either an entire industry⁵⁹ or all industry components within a geographical area.⁶⁰ This, coupled with the Internal Revenue Service's consistent denial of exemption to groups marketing a single branded product,⁶¹ led the *National Muffler* majority to conclude that the

53. 440 U.S. at 477.

54. The 1929 regulation is reprinted at note 35 *supra*.

55. 440 U.S. at 482. The amendment to I.R.C. § 501(c)(6) occurred in 1966, when Congress added professional football leagues to the list of exempt organizations. This addition would appear to have little effect on the scope of the business league exemption, particularly in light of House Ways and Means Committee Chairman Mills' statement that "no inference is intended by this change as to the applicability of section 501(c)(6) to other types of organizations." 112 CONG. REC. 28228 (1966).

56. See note 34 *supra*.

57. Note that the 1919 regulation, written six years after the 1913 statute, is itself not perfectly contemporaneous. The 1919 regulation was, however, the initial administrative interpretation of the business league exemption. 440 U.S. at 480.

58. *Id.* at 485. Dissenting Justices Stewart, Rehnquist, and Stevens apparently agreed with the majority that the Association would have met the 1919 test. *Id.* at 489 (Stewart, J., dissenting).

59. See, e.g., *American Plywood Ass'n v. United States*, 267 F. Supp. 830 (W.D. Wash. 1967) (court upheld the line of business test and granted an exemption to trade association devoted to promoting the use of plywood on basis that plywood manufacture constituted the required line of business); *National Leather & Shoe Finders Ass'n v. Commissioner*, 9 T.C. 121 (1947) (association of wholesalers of shoe repair supplies operated training programs and published trade journal; again, line of business test upheld but association found to satisfy test—exemption granted).

60. See, e.g., *Commissioner v. Chicago Graphic Arts Fed'n, Inc.*, 128 F.2d 424 (7th Cir. 1942) (group formed to promote fair trade practices among Chicago printers; line of business test upheld but Chicago printers found to constitute the required line of business—exemption granted); *Washington State Apples, Inc. v. Commissioner*, 46 B.T.A. 64 (1942) (organization formed to promote the sale of Washington apples; Washington apples found to constitute the required line of business—exemption granted). The *National Muffler* majority's notation of these cases is found at 440 U.S. at 483.

61. See, e.g., Rev. Rul. 68-182, 1968-1 C.B. 263 (announcing nonacquiescence in *Pepsi* decision); Rev. Rul. 67-77, 1967-1 C.B. 138 (single brand of automobile); Rev. Rul. 58-294, 1958-1 C.B. 244 (patented product).

Internal Revenue Service had administered the business league regulation consistently.⁶²

Reviewing all of the criteria, the *National Muffler* majority concluded that the Internal Revenue Service regulation was a reasonable interpretation of the business league exemption.⁶³ This conclusion appears well supported both by logic and by a clear line of lower court decisions.⁶⁴

Justice Blackmun then *applied* the line of business test to the *National Muffler* fact situation. Although this portion of the opinion is not extensive,⁶⁵ the Court appears correct in concluding that the Midas dealers did not meet the "line of business" test.⁶⁶ The district court had held that the Association failed the test.⁶⁷ Thus, a reversal would have sidestepped the customary deference accorded the trier of fact.⁶⁸ Also, the marketing of a *branded* product such as Midas Mufflers does not qualify as a line of business because Congress apparently intended to exempt only those organizations that aid an *entire* industry.⁶⁹ Manufacturers use branding to differentiate their products from competing wares. The mere existence of branding, therefore, is an indication that the branding manufacturer considers other brands to be relevant competition—that there is some common "line of business" within which the brands compete.

62. 440 U.S. at 484.

63. *Id.*

64. See note 50 *supra*.

65. 440 U.S. at 488-89. The Court stated only that the Internal Revenue Service view merits serious deference and that the Association had not shown that either the regulation or the commissioner's interpretation of it failed to implement the congressional mandate in some reasonable manner.

66. Conceivably, the *National Muffler* Court could have accepted the Internal Revenue Service line of business test while rejecting the Internal Revenue Service *result* of that test. Validating a regulation's text and validating its subsequent application to facts are two distinct steps which should not be confused. An Internal Revenue Service regulation may be accorded the force of law, but if the Internal Revenue Service also receives an exclusive license to interpret the regulation, courts will have forfeited their judicial function to an administrative agency. See, e.g., *Biddle v. Commissioner*, 302 U.S. 573 (1938); *Mercantile Bank & Trust Co. v. United States*, 441 F.2d 364 (8th Cir. 1970). These cases hold that revenue rulings (Internal Revenue Service interpretations of the code and regulations) are not binding on the courts.

67. See notes 22-24 and accompanying text *supra*.

68. The Association had advanced an alternative argument at the appellate level: that its activities benefited the line of business of *all* muffler franchisees because non-Midas franchisees would seek and be accorded the benefits won by Midas dealers. *National Muffler Dealers Ass'n, Inc. v. United States*, 565 F.2d at 847. The Second Circuit, however, accepted the trial court's finding that the Association failed to benefit muffler dealers in general. *Id.* At the Supreme Court level, Justice Blackmun distilled the Association's argument into a contention that the Internal Revenue Service regulation was unreasonable. 440 U.S. at 484. In upholding the regulation, the *National Muffler* majority disposed of this argument. The possibility that the Association might have *passed* the line of business test appears to have been ignored at the Supreme Court level, perhaps because of the district court's disposition of this essentially factual question.

69. See note 33 and accompanying text *supra*.

*Pepsi-Cola Bottlers' Association, Inc. v. United States*⁷⁰ appears to be the only case in which manufacturers of a *branded* product qualified as a business league. As previously discussed, however, the *Pepsi* decision was received with less than total approval.⁷¹ It appears that *National Muffler* has further limited the persuasive value of *Pepsi*, perhaps to the vanishing point.⁷² However, the two cases arguably remain distinguishable.⁷³

The *National Muffler* result, therefore, appears sound. The Court's validation of the line of business regulation is supported by the regulation's fifty year stability in the midst of statutory change. Similarly, the Court's use of the regulation to deny exemption to the Association is supported by the district court's finding that the Midas dealers in no way benefited the rest of the muffler industry.⁷⁴

CRITICISM AND ALTERNATIVE: AN OPERATIONAL LINE OF BUSINESS TEST

The soundness of the *National Muffler* result should not obscure the Court's failure to clarify the exact applicability of the business league exemption to common franchisor associations. Although it is clear that the Court upheld the line of business test, it is not clear exactly how the test will apply to common franchisor associations. Perhaps the mere presence of a common franchisor will not cause automatic failure of the line of business test, or perhaps other facts will remain pertinent.⁷⁵

In analyzing the business league cases, commentators have suggested two bases on which the tax exemption has been disallowed: 1) an organizational

70. 369 F.2d 250 (7th Cir. 1966). See note 9 and accompanying text *supra*. See also notes 41-48 and accompanying text *supra*.

71. See notes 41-48 and accompanying text *supra*.

72. In *National Muffler*, the Second Circuit stated only that it declined to follow *Pepsi* to the extent the two cases conflicted. 565 F.2d at 847 n.1. The Supreme Court, however, went further, stating that certiorari was granted to resolve the intercircuit conflict. 440 U.S. at 476. This would seem to indicate that *Pepsi* now has been overruled.

73. The Midas dealers apparently sold no competing brands, whereas 90% of the *Pepsi* association members also bottled other soft drinks. 369 F.2d at 251. Also, the *Pepsi* association sponsored management training programs for its members' executives. 369 F.2d at 251. This is a quasi-public activity not present in *National Muffler*. Thus, although the *National Muffler* Court stated that certiorari was granted to resolve the intercircuit conflict, a less expansive reading might confine each case, *National Muffler* and *Pepsi*, to its own facts.

74. Justice Stewart, joined by Justices Rehnquist and Stevens, dissented in *National Muffler*. In a one-paragraph opinion, Justice Stewart argued for the Association's exemption based on *Pepsi* and on the original pro-Association regulation of 1919. 440 U.S. at 489 (Stewart, J., dissenting).

75. In *National Muffler*, the district court held the applicable line of business to be the business of muffler franchisees taken as a whole. See note 24 and accompanying text *supra*. Suppose, for example, that the Association's principal activity had been a radio and television campaign exhorting the safety and noise-reduction benefits of *all* mufflers, without reference to brand name. The line of business test would appear to have been met: the Association's activities would have been directed to the improvement of the entire muffler industry, even though all Association members continued to own Midas franchises.

test, and 2) an operational test.⁷⁶ Under the first test, an association claiming exemption must demonstrate that it has been organized in such a way that inurement of earnings will not occur.⁷⁷ Once this first-level test is surmounted, an organization merits continued exemption only by demonstrating that its *activities* benefit the required line of business. Where an association's activities benefit interests too parochial to qualify as a line of business, tax exemption will be denied⁷⁸ or revoked.⁷⁹

In cases denying the business league exemption, the reasoning of the courts often is unclear because of failure to specify which test is being applied. The association in question may have failed both the organizational and operational tests.⁸⁰ *National Muffler* appears to be such a case.⁸¹ The *National Muffler* Court suggested that it was using an organizational test when it stated that the Internal Revenue Service consistently has denied the business league exemption to groups whose *membership and purposes* are less than industry wide.⁸² The Court also noted, however, that the Association's principal *activity* had been service as a bargaining agent in negotiations with Midas.⁸³ This implies that it was the principal activity of the Association, an operational test, which caused the denial of exemption. Thus, either an organizational or an operational test could support the *National Muffler* result.

The *National Muffler* holding likely will be interpreted as organizational: the presence of a common franchisor causes automatic failure of the line of business test. Such a holding, however, might be overinclusive.⁸⁴ In addition, any such holding would invite speculative follow-up questions regarding what degree of commonality would be necessary to poison a business league exemption. Any statistical definition of commonality would be both overinclusive and underinclusive; any non-quantitative definition would be vague.

76. See, e.g., Webster & Combs, TAX MGM'T (BNA) § 331, at A-2-3; Note, *supra* note 4, at 634-35.

77. See, e.g., Clay Sewer Pipe Ass'n, Inc. v. Commissioner, 139 F.2d 130 (3d Cir. 1943) (association held organized for profit because chartered under state corporation statute); Louisville Credit Men's Adjustment Bureau v. United States, 6 F. Supp. 196 (W.D. Ky. 1934) (organization held nonexempt when charter was "that of the ordinary private commercial corporation").

78. See, e.g., Apartment Operations Ass'n v. Commissioner, 136 F.2d 435 (9th Cir. 1943) (building owners' group held to be a nonexempt "cooperative buying organization" when members used group to take advantage of quantity purchase discounts).

79. See, e.g., Southern Hardwood Traffic Ass'n v. United States, 283 F. Supp. 1013 (W.D. Tenn. 1968) (original exemption revoked after freight association engaged in business *activities*; even in revoking exemption the court admitted that taxpayer's *organization* remained proper).

80. See Webster & Combs, TAX MGM'T (BNA) § 331, at A-3.

81. The opinion does not contain the terms organizational or operational, nor does it contain clear synonyms. The major part of the opinion is devoted to validation of the regulatory line of business test, without delineating whether the test will be applied on organizational or operational grounds.

82. 440 U.S. at 483-84.

83. *Id.* at 473.

84. See example at note 75 *supra*.

As the Pepsi-Cola Bottlers' Association noted in its amicus curiae brief, "[a]n Association of persons selling a branded product, or of franchisees of a common franchisor, is subject to the same standards under Section 501(c)(6) as is any other not-for-profit trade association."⁸⁵ The Association went on to suggest that no court should invest the line of business language with a rigid meaning that a priori precludes exemption for any one category of trade association.⁸⁶

One answer to the above criticism would be to interpret *National Muffler* as an operational holding. Under this interpretation, the Association's activity as a bargaining agent caused failure of the line of business test.⁸⁷ This approach is preferable for two reasons. First, it adheres strictly to the language of the line of business test, which mandates that an association's *activities* be directed to the improvement of one or more lines of business.⁸⁸ Secondly, an operational application of the line of business test would subject common franchisor associations to the same exemption standards as other types of associations. This would avoid the problems of overinclusivity and unfairness involved in denying exemption to all common franchisor associations based solely on membership grounds.⁸⁹

The problem, of course, is that most members of an organization derive benefits from the organization's activities. Few people would join an organization if they did not receive some benefit.⁹⁰ In the business league context, however, the question should be whether the benefit is based on co-membership in the line of business or whether it is based on a more parochial, albeit concurrent, commonality. An acid test might be the extent that members of the line of business who are *not* members of the association benefit from the association's activities.

This test probably would not have changed the *National Muffler* outcome, for the *National Muffler* court found no evidence that the Midas association benefited the non-Midas segment of the muffler line of business.⁹¹ The

85. Brief for Pepsi-Cola Bottlers' Association, Inc., as Amicus Curiae, at 14, *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472 (1979).

86. *Id.* at 25. A holding that no common franchisor association can qualify as a business league arguably discriminates in two ways: it benefits independent distributors at the expense of franchisees, and it benefits generic products at the expense of branded wares. These distinctions appear difficult to justify.

87. Note that the Court found service as a bargaining agent (and even then only in negotiations with Midas) to be the Association's principal activity. 440 U.S. at 473. Note also the district court's finding that this activity failed to benefit the applicable line of business, which was held to be muffler franchisees taken as a whole. See note 24 and accompanying text *supra*.

88. Treas. Reg. § 1.501(c)(6)-1 (1978) (emphasis added). The full text of the regulation is reprinted at note 7 *supra*.

89. See notes 84-86 and accompanying text *supra*.

90. "Human experience has taught us that few men would join an organization if they did not derive at least some benefit out of it." *Omaha Live Stock Traders Exch. v. United States*, 244 F. Supp. 384, 387 (D. Neb. 1965).

91. *National Muffler Dealers Ass'n, Inc. v. United States*, No. 77-6106 (S.D.N.Y. May 24, 1977).

distinction between organizational and operational testing, however, might take on greater importance in a case where the taxpayer would pass one test and fail the other.

CONCLUSION:
ANSWERED AND UNANSWERED QUESTIONS

For tax exemption purposes, the *National Muffler* Court embraced the Internal Revenue Service definition of business league, including that definition's line of business test. In so doing, the Court significantly limited the exemption's applicability to common franchisor associations. The Court also continued its policy of deference to the Internal Revenue Service.⁹²

Regarding common franchisor associations, however, several questions remain unanswered. Foremost among these is whether the line of business test is organizational or operational. If the test is organizational, then the degree of "outside" membership necessary to secure a tax exemption needs to be specified. If the test is operational, then criteria are needed both to define "line of business" and to specify what types of activities will be held to benefit the defined lines. One alternative would be to focus on an association's activities—an operational test—and on the extent that these activities benefit nonmembers of the association who *are* members of the "line of business."

By embracing the line of business test, the *National Muffler* Court attempted to resolve intercircuit conflict concerning the applicability of the business league exemption to franchisee organizations. By not specifying how the test could be met, however, *National Muffler* may well have posed more questions than it answered.

Robert Charkovsky

92. "The choice among reasonable interpretations is for the Commissioner, not the courts." 440 U.S. at 488.

