LEGAL UPDATES

Tax-Exemption Implications of "Illegal DEI"

04/11/2025 | 6 minute read

Recent Executive Orders issued by President Trump repeatedly refer to "illegal" diversity, equity and inclusion (DEI) preferences and activities. Among other actions, the Executive Orders instruct executive agencies to "terminate all discriminatory and illegal preferences," enforce civil rights laws, and "combat illegal private-sector DEI preferences, mandates, policies, programs, and activities" (*see* EO 14173, "Ending Illegal Discrimination and Restoring Merit-Based Opportunity").

Executive Order 14151, "Ending Radical and Wasteful Government DEI Programs and Preferencing," further directs an examination into federally sponsored "environmental justice" programs, suggesting that, in the administration's view, such programs fall within the ambit of "illegal DEI," or otherwise radical or wasteful activities. What – if anything – does such language mean for nonprofits engaged in or funding racial, social and environmental justice programs and initiatives?

One Reason Nonprofits Should Care – The Public Policy Doctrine

Since at least 1971, the IRS has recognized the existence of the so-called "public policy doctrine" developed in the common law, which provides that activities cannot be charitable if they are either illegal or contrary to federal public policy. (*See* Rev. Rul. 71-447, 1971-2 C.B. 230; *Green v. Connally,* 330 F. Supp. 1150 (D.D.C. 1971)). Thus, a nonprofit organization that engages in such activities places its tax-exempt status in jeopardy. [1]

The relevant question, then, is whether engaging in activities that advance diversity, equity and inclusion – or, indeed, environmental justice – is illegal or against public policy? No federal statute or court case says that it is, nor, to our knowledge, has any working definition of "illegal DEI" been written into law or developed through court proceedings. Nevertheless, *racially discriminatory* conduct, at least in certain contexts, may violate the law and be against public policy.

Related People

Greg A. Larson

Partner

Minneapolis

612.632.3276

greg.larson@lathropgpm.com

Wade S. Hauser

Partner

Minneapolis

612.632.3061

wade.hauser@lathropgpm.com

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The Bob Jones University Case

The most famous example of the IRS revoking the tax-exempt status of an organization based on racially discriminatory conduct occurred in 1976, when the IRS revoked the exempt status of Bob Jones University, a private nonprofit institution that had a history of refusing to admit Black students. It changed its policies over time to exclude only *unmarried* Black students and, finally, to prohibiting interracial dating and marriage. The university challenged the revocation in court, claiming the IRS exceeded its authority and violated the university's religious liberties guaranteed by the First Amendment. Eventually, the U.S. Supreme Court upheld the revocation (and the revocation of another school that denied admission to Black students) in an 8-1 decision, holding that "entitlement to tax exemption depends on meeting certain common law standards of charity – namely, that an institution seeking tax-exempt status must serve a public purpose and not be contrary to established public policy." (*Bob Jones Univ. v. United States,* 461 U.S. 574, 586 (1983)). The court went on to say:

We are bound to approach these questions with full awareness that determinations of public benefit and public policy are sensitive matters with serious implications for the institutions affected; a declaration that a given institution is not "charitable" should be made *only where there can be no doubt that the activity involved is contrary to a fundamental public policy* [emphasis added].

The court cited an "unbroken line" of prior Supreme Court cases, the Civil Rights Act of 1964, and Executive Orders enforcing school desegregation to demonstrate that "the position of *all three branches* of the Federal Government was unmistakably clear" with respect to racial discrimination in education when the IRS revoked the university's exempt status. [2]

Applying the Public Policy Doctrine to DEI Activities

It is critical to understand that the question the *Bob Jones* court was answering in 1983 – is it against public policy for a private school to discriminate based on race? – and the historical context in which it was answering it, was very different from the question at hand, which is, in 2025, are (all, some, any) DEI programs and initiatives illegal or against public policy? The *Bob Jones* court based its decision on more than 25 years of Congress, the courts and the executive branch staking out, in the court's words, "unmistakably clear" and consistent positions on the issue. We do not have anything like that today with respect to the great majority of activities included within the broad universe of DEI initiatives.

To be sure, some of the legal principles in operation are well-established: Title VI of the Civil Rights Act of 1964 prohibits discrimination on the basis of race, color and national origin in programs and activities receiving federal financial assistance. Section 1981 of the Civil Rights Act of 1866 prohibits discrimination based on race in the making and enforcement of contracts. The meaning and application of these prohibitions, however, is evolving and is at the heart of a furiously contested public debate.

Until 2023, affirmative action in college admissions was permitted in some circumstances. After *Students for Fair Admissions v. Harvard,* there is no question that it is unlawful for a higher education institution that receives federal funding to take race into account when making admissions decisions. [3] For federal law purposes, it remains to be seen whether and to what extent the U.S. Supreme Court's holding in that case applies beyond college admissions decisions. [4] We also know from the *Fearless Fund* litigation settled in 2024 that race-exclusive grants and awards made by nonprofits – even those that do not receive federal funding – are susceptible to attack as illegally discriminatory "contracts" under Section 1981.

Practically everything else we know about the legal status of DEI activities is brand new or in a state of flux. The January 2025 Executive Orders cited above and other recent administrative guidance make it plain that the current administration views all DEI activities with intense suspicion, and some unspecified subset of "DEI" activities as "illegal." These pronouncements could be interpreted to apply even to activities merely intended to foster inclusion or belonging, or to recognize past injustices and ongoing disparities. The executive branch's policy is, however, barely four months old, and we have very little evidence so far that the judicial branch and Congress are collectively in step with the new policy.

In short, even though federal enforcement priorities have dramatically shifted, we do *not* have a "fundamental public policy" against DEI in all its potential applications. Moreover, the IRS has long ruled that efforts to "lessen prejudice and discrimination against minority groups" or provide support to members of an "ethnic minority" can be charitable. (*See, e.g.*, Rev. Rul. 74-587; Treas. Reg. § 53.4945-4(b)(5), ex. 2.) These precedents remain good law. Thus, many efforts to promote diversity, equity and inclusion remain legal and, even if they run counter to current trends, should not form the basis for revocation of tax-exempt status.

Evaluating Your Organization's Risks

There is a near daily drumbeat of efforts by various government agencies, activist groups and individuals to challenge the legality and propriety of DEI-related programs, grants and activities. However, the actual risks faced by nonprofits can vary widely depending on their funding sources, specific programs, and even their size and location. Furthermore, each organization's risk tolerance will be different.

We recommend that nonprofit organizations conduct an individualized audit of their DEI-related practices – ideally with the assistance of legal counsel in privileged communications – to identify any that might be illegally discriminatory or otherwise high-risk, and to develop a mitigation plan.

Considerations and areas of focus may include, but are certainly not limited to:

- Sources of funding and, in particular, the sources and amounts of federal funding.
- Whether your organization conducts race-conscious programs or activities that provide benefits to individuals or organizations (such as scholarships, fellowships and grants).
- Whether your organization engages in race-conscious employment practices.
- Whether your organization supports or encourages protests and/or civil disobedience.
- Whether your organization engages in political activities that might be inconsistent with its tax-exempt status.

It is also important to triage the risks you identify by how likely they are to occur and what their potential operational or programmatic impact could be.

Finally, when considering what risk-mitigation steps might be appropriate for your organization, keep mission front and center. Some organizations may decide that to pull back on DEI-related activities would be to negate the very reason for the organization's existence. Other organizations may have more flexibility to adapt their activities or their messaging in a way that does not threaten the core of what they do or who they are. Again, this should be an individualized determination informed by an organization's risk profile and risk tolerance.

If you have questions about the potential impacts of the DEI-related Executive Orders on your organization, please contact Greg Larson, Wade Hauser, or your regular Lathrop GPM attorney.

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[1] This alert is focused on tax-exemption considerations for nonprofit organizations. It does not seek to answer what constitutes "illegal DEI" in employment or other settings. For more consideration of employment issues, see here. In addition, the EEOC recently provided this guidance regarding its interpretation of anti-discrimination laws.

[2] The Supreme Court also rejected the arguments of Bob Jones University and the other petitioner that they were entitled to tax-exemption because their racial discriminatory policies were motivated by sincerely held religious beliefs.

[3] The *SFFA* decision does permit colleges and universities to continue to consider an "applicant's discussion of how race affected his or her life, be it through discrimination, inspiration, or otherwise," provided that the "the student must

be treated based on his or her experiences as an individual—not on the basis of race." *Students for Fair Admissions, Inc. v. President & Fellows of Harvard Coll.*, 600 U.S. 181, 230 (2023).

[4] The Court of Appeals in Wisconsin recently held that the *Harvard* decision's prohibition extends to racial preferences in student financial aid. *Rabiebna, et al. v. Higher Educational Aids Board.*