Duquesne Law Review

Volume 23 | Number 4 Article 22

1985

Internal Revenue Code - Exempt Organizations - Standard for Loss of Exemption under IRC Section 501(c)(3)

William M. Thomson

INTERNAL REVENUE CODE—EXEMPT ORGANIZATIONS—STANDARD FOR LOSS OF EXEMPTION UNDER IRC SECTION 501(c)(3)—The Third Circuit Court of Appeals has promulgated a two-prong test to be applied to determine whether an organization, qualified as exempt under section 501(c)(3) of the Code, has overstepped the boundaries of its exemption.

Presbyterian and Reformed Publishing Co. v. Commissioner, 743 F.2d 148 (3d Cir. 1984).

In 1939 the Internal Revenue Service (Service) granted the Presbyterian and Reformed Publishing Company (P & R), a religiously-oriented publishing house, tax-exempt status under section 501(c)(3) of the Internal Revenue Code.[1] Since its incorporation in 1931, P & R has been associated closely, though not formally, with the Orthodox Presbyterian Church (OPC).[2]

Until 1969, P & R's income had never exceeded its expenses.[3] Between 1939 and 1963 the company had occasionally relied on personal contributions for its continued existence.[4] However, P & R's volume of business increased dramatically in 1969 due to the

---

1. Presbyterian and Reformed Publishing Co. v. Commissioner, 743 F.2d 148 (3d Cir. 1984). Section 501(c)(3) lists the following organizations as eligible for tax-exempt status:

> Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distribution of statements), any political campaign on behalf of any candidate for public office.

I.R.C. § 501(c)(3) (West Supp. 1984).

2. 743 F.2d at 150. The OPC was founded in 1932 by one of P & R's three incorporators and original directors. In 1976, the OPC's seminary, the Westminster Theological Seminary of Philadelphia (WTS), was named in P & R's amended charter as the sole recipient of P & R's assets in the event of P & R's dissolution. WTS officials or pastors of OPC or OPC-affiliated denominations comprise seven of P & R's nine directors. *Id.* at 151.

3. *Id.*

4. *Id.* Three successive generations of the Craig family had run P & R since its inception. Samuel, Charles, and Bryce Craig, all ministers, worked without compensation. Samuel contributed $500 in 1939 and $3,000 in 1954. Charles donated a total of $19,600 from 1955 to 1963. *Id.*

sudden popularity of books written by Jay Adams, an otherwise obscure author.[5] P & R's gross profits suddenly increased from approximately $20,000 in 1969 to over $300,000 in 1979.[6] In 1974, following several years of increased business, P & R notified the Service of its intention to accumulate surplus cash as a "building fund."[7] It acquired 5½ acres of land in 1976 and, in 1978, completed construction of a combined office building and warehouse at a cost of $263,000.[8] Equipment was purchased one year later at a cost of $27,000.[9]

In 1980, following an audit, the Service revoked P & R's tax-exempt status on the grounds that it was not "operating exclusively for purposes set forth in 501(c)(3)" and was "engaged in a business activity which is carried on similar to a commercial enterprise."[10] The Tax Court affirmed this revocation,[11] relying on three factors: P & R's substantial profits between 1969 and 1979,[12] its manner of price setting,[13] and its dealings with a commercial publishing house.[14] Pursuant to P & R's motion for reconsideration, the Tax Court issued a second opinion which left its prior judgment intact.[15] P & R appealed to the United States Court of Appeals for the Third Circuit.

Judge Adams delivered the opinion of the court.[16] In determining the point at which a successful tax-exempt enterprise should be deemed transformed into a non-exempt commercial enterprise, Judge Adams rejected the analysis of the Tax Court.[17] While find-

---

5. *Id.* Adams was a faculty member at the Westminster Theological Seminary of Philadelphia. *See supra* note 2 and accompanying text.

6. *Id.* In addition, although P & R had no paid employees until 1973, relying instead on volunteers, it had seven paid employees by 1979. Five of these employees received salaries under $6,250, one received $12,500, and Bryce Craig, then in charge of the operation, received $15,350. *Id.*

7. *Id.*

8. *Id.*

9. *Id.*

10. *Id.* This revocation was made retroactive to January 1, 1969. *Id.*

11. 79 T.C. 1070, 1089 (1982). The Tax Court set the effective revocation date at 1975, holding that the Service had abused its discretion in making its revocation retroactive to 1969. *Id.*

12. 743 F.2d at 152.

13. *Id.* The Tax Court indicated that P & R's method of setting prices generated "consistent and comfortable" net profit margins. *Id.*

14. *Id.* The Tax Court found these dealings sufficient to enable it to conclude that P & R was "in competition with commercial publishers." *Id.*

15. *Id.*

16. *Id.* at 150.

17. *Id.* at 152.

ing relevant the "indicia of non-exempt business activity"[18] on which the Tax Court relied in arriving at its decision,[19] Judge Adams indicated the court's dissatisfaction with the inflexibility of the approach used by the Tax Court,[20] and voiced the court's concern that the Tax Court's approach would not permit a small exempt organization to increase its economic activity without forfeiting its tax-exempt status.[21]

In place of the Tax Court's "composite effects" approach the Court of Appeals promulgated a two-prong test, drawn directly from the wording of section 501(c)(3) and its legislative history, to be applied to determine whether an exempt organization has overstepped the boundaries of its exemption.[22] The test involves a determination of, first, the purpose of an organization claiming tax-exempt status and, second, to whose benefit its activity inures.[23]

Analyzing the "inurement" prong first, Judge Adams found that the language of section 501(c)(3) specifies that "no part of an organization's net earnings may inure to the benefit of any private shareholder or individual."[24] Judge Adams noted that the Treasury regulations adopt the "non-inurement" rule,[25] and observed that the policy underpinnings of the rule stemmed from the belief that charities exist for the public good, rather than for private benefit.[26]

After examining the factual circumstances of several cases in which private inurement was found to exist in organizations either seeking qualification or previously qualified under 501(c)(3),[27]

---

18. *Id.* These indicia included P & R's profitability, its associated accumulations of capital, and the company's development of a professional staff. *Id.*

19. *Id. See supra* notes 12-14 and accompanying text.

20. 743 F.2d at 152.

21. *Id.*

22. *Id.*

23. *Id.*

24. *Id.* at 153.

25. Treas. Reg. § 1.501(c)(3)-1(c)(2)(1984) includes the requirement that "no part of an organization's net earnings may inure to the benefit of any private shareholder or individual." *Id.*

26. 743 F.2d at 153.

27. *Id.* at 153-54. Cases cited by the court for denial of tax-exempt status based on a finding of private inurement included three that deserve brief examination here. In Basic Unit Ministry of Alma Karl Schurig v. Commissioner, 670 F.2d 1210 (D.C. Cir. 1982), the court concluded that the taxpayer, bearing the burden of establishing its qualification for tax exemption, failed to establish that none of its earnings inured to the private benefit of any individual. The taxpayer had stated that thirty percent of its income was spent on exempt purposes, excluding the maintenance of its fifteen members. However, the taxpayer offered no details in this regard, and the court found that the remaining seventy percent of the church's income was used to support its members. *Id.* at 1211.

Similarly, in Bubbling Well Church of Universal Love v. Commissioner, 670 F.2d 104 (9th

Judge Adams concluded that there was no basis in the record to support a finding that P & R's increased business activity resulted in the personal enrichment of any individual.[28] Therefore, Judge Adams concluded that a denial of P & R's tax-exempt status would have to result from a determination that P & R's purpose was incompatible with section 501(c)(3); in other words, that its activity violated the second part of the test.[29]

In its analysis of the "purpose" prong of the test, the court found that section 501(c)(3) requires that an organization seeking exemption demonstrate itself to be organized exclusively for an exempt purpose.[30] Judge Adams relied on *Better Business Bureau v. United States*[31] to find that "[t]he presence of a single [non-exempt] purpose, . . . substantial in nature," is sufficient to destroy the exemption.[32] Indicating that other courts having to pass upon a potentially non-exempt purpose have searched for objective indicia of that purpose, Judge Adams reviewed the Tax Court's decision in light of the proper objective factors that must be considered.[33]

Addressing first the Tax Court's conclusion that P & R's character was nondenominational,[34] Judge Adams failed to find P & R's lack of formal affiliation with, or control by, any particular church

---

Cir. 1981), the court held that the church had not carried its burden of proving that none of its income inured to the benefit of private individuals. The church was controlled by a family whose members were the church's sole employees and voting directors. Approximately forty-four percent of the church's 1977 budget was received by the family in the form of parsonage and living allowances and other payments. In addition, the church offered inadequate disclosure of facts bearing on its claimed exemption. *Id.* at 105-06.

The Tax Court, in Unitary Mission Church v. Commissioner, 74 T.C. 507 (1980), denied the church tax-exempt status based, in part, on a finding that the salaries paid by the church to its three ministers were excessive and resulted in inurement of benefit to those individuals. *Id.* at 512.

28. 743 F.2d at 154.

29. *Id.*

30. *Id.*

31. 326 U.S. 279 (1945).

32. 743 F.2d at 155 (quoting *Better Business Bureau*, 326 U.S. at 283). In *Better Business Bureau*, the Court found that a substantial purpose of the Better Business Bureau of the District of Columbia was "the mutual welfare, protection and improvement of business methods among merchants" and, accordingly, found that organization to be non-exempt. 326 U.S. at 281. *See infra* notes 66-75 and accompanying text.

33. 743 F.2d at 155. Judge Adams noted the difficulties courts face in passing on the legality of an action by examining legal standards which are predicated on the subjective intent of the actor. He indicated that in such cases, similar acts can lead to opposite legal conclusions. To minimize the possibility of this occurring, courts look for objective indicia to discern the intent of the actor. *Id.*

34. *Id.* at 156. The Tax Court found that P & R's being neither controlled by nor affiliated with any particular church contributed to its resemblance to the commercial publishers with whom it competed. *Id.*

to be dispositive in answering the question of the connection between its goals as a publishing enterprise and OPC dogma.[35]

Second, with respect to P & R's accumulation of "profits", the court concluded that the Tax Court's determination that P & R's accumulation of cash was strong evidence of a non-exempt purpose must be rejected.[36] Refusing to read section 501(c)(3) as defining the purpose of an organization claiming tax-exempt status in terms of that organization's business volume, Judge Adams instead found that the inquiry should be directed to "the purpose to which the increased business activity is directed."[37] After all, he noted, the Tax Court had itself determined that the presence of profitmaking activities which further an exempt purpose does not automatically bar qualification of an organization as exempt.[38] Additionally, Judge Adams expressed concern that the Tax Court's treatment of P & R's accumulation of profits could lead to arbitrary or ad hoc treatment without a clearer legal standard for tax-exempt status.[39] Addressing this problem, Judge Adams turned to the accumulated earnings provision of the Tax Code[40] for guidance in determining when cash accumulations in the section 501(c)(3) context might be considered evidence of a non-exempt purpose.[41] He found that the legislative history of this provision reflected concern that inflexible application of the tax laws would stifle legitimate business expansion,[42] and noted that the Treasury regulations[43] have recognized

---

35. *Id.* Instead, the court placed weight on the strength of the informal ties between P & R and the OPC. *Id.*

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.* at 157. Judge Adams identified the cause of his concern to be the absence of regulations or case law sufficiently defining "purpose" under section 501(c)(3) to protect against "arbitrary, ad hoc decisionmaking." *Id.* at 156.

40. *Id.* at 157. *See* I.R.C. §§ 531-537 (West Supp. 1984). The accumulated earnings section of the Tax Code is violated when a corporation, seeking to avoid greater tax exposure to its shareholders, fails to pay dividends on earnings accumulated beyond the reasonable needs of the organization. 743 F.2d at 157.

41. *Id.*

42. The House Ways and Means Committee wrote that one purpose of the 1954 Amendments was "to reduce tax barriers to future expansion of production and employment." H.R. REP. No. 1337, 83d Cong., 2d Sess. 52, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4017, 4025. The Senate Finance Committee concurred with this purpose. S. REP. No. 1622, 83d Cong., 2d Sess. 68, *reprinted in* 1954 U.S. CODE CONG. & AD. NEWS 4621, 4629.

43. Treas. Reg. § 1.537-1(b)(1)(1984). This section states, in pertinent part: "In order for a corporation to justify an accumulation of earnings and profits for reasonably anticipated future needs, there must be an indication that the future needs of the business require such accumulation, and the corporation must have specific, definite, and feasible plans for the use of such accumulation." *Id.*

this concern.[44] The court then relied on three factors in refusing to accept the Tax Court's determination that P & R's accumulation of profits was strong evidence of a non-exempt purpose: (1) P & R's notice to the Service of its intention to expand its physical capacity; (2) its claim that the accumulated profits were to be used for that purpose; and (3) the Service's recognition[45] of expansion of business as a reasonable basis for the accumulation of earnings.[46]

Finally, the court examined the competing policy issues involved in developing the two-prong test. Judge Adams expressed the court's concern that, without the protection of the two-part test, organizations seeking tax-exempt status under section 501(c)(3) might be forced into choosing between expanding their influence and maintaining their tax-exempt status, due to the apparent incompatibility of the two choices.[47]

Although the form of the Third Circuit's reply—the articulation of the two-prong inquiry[48]—is new, the substance of that reply is not new at all, each prong having been derived from section 501(c)(3)[49] and its legislative history.[50]

The earliest congressional usage of the non-inurement and purpose language of section 501(c)(3)[51] appears in an amendment to the Tariff Act of 1909,[52] a forerunner of section 501(c)(3). The

---

44. 743 F.2d at 157.

45. Treas. Reg. § 1.537-2(b)(1) (1984). This section identifies as a reasonable ground for the accumulation of earnings and profits the need to "provide for bona fide expansion of business or replacement of plant . . . ." *Id.*

46. 743 F.2d at 158-59.

47. *Id.* at 152. The court recognized that, although the Tax Court is entitled to deference in the determination of whether a substantial, non-exempt purpose exists, that court's focus on factors which failed to disclose the presence of such a purpose required the court of appeals to determine whether all the evidence of record supported a finding of non-exemption. The court concluded that it did not. *Id.*

48. 743 F.2d at 152.

49. *Id.* The court cited section 501(c)(3) as its authority for promulgating the "purpose" prong of the test. The language of section 501(c)(3) identifies organizations qualifying for tax-exempt status as those "organized exclusively for religious, charitable . . . or educational purposes." I.R.C. § 501(c)(3) (West Supp. 1984). *See supra* note 1.

50. 743 F.2d at 152. The court cited remarks made by the statute's original sponsor, Senator Bacon, at the time the section was being considered by Congress, as evidence that the exemption was applicable only to those institutions devoted to religious, benevolent, charitable, or educational purposes. The court identified the senator's remarks as emphasizing that the purpose of an enterprise and the absence of individual profit, rather than the volume of an organization's business, are the key factors of non-taxable activity. Coincidentally, Senator Bacon also referred to a religious publishing house, the Methodist Book Concern, as precisely the type of institution his amendment was intended to benefit. 44 CONG. REC., pt. 4, at 4151 (1909). *Id.* at 152-53.

51. *See supra* note 1.

52. Tariff Act of 1909, ch. 6, 36 Stat. 11, 113.

Tariff Act of 1909 contained the following exemption provision:

> [N]othing in this section contained shall apply to . . . [certain organizations and associations] organized and operated exclusively for the mutual benefit of their members, nor to any corporation or association organized and operated exclusively for religious, charitable, or educational *purposes*, no part of net income of which *inures* to the benefit of any private stockholder or individual.[53]

In 1909, speaking in support of the proposed amendment, Senator Bacon, the bill's sponsor, explained in general terms the propriety of exempting certain corporations from taxation, although he failed to explain the underlying rationale behind doing so.[54] While this explanation did little more than state that certain corporations received an exemption because it was "proper" for Congress to grant it,[55] subsequent cases shed additional light on Congress' ultimate intention in granting the exemption. For instance, in one frequently-cited case, *Duffy v. Birmingham*,[56] the court identified Congress' rationale for granting an exemption to corporations organized and operated exclusively for charitable purposes as a recognition that such organizations typically relieve the community of an obligation which otherwise belongs to it.[57]

Later, in *Erie Endowment v. United States*,[58] the court explained Congress' intent slightly differently, characterizing the 501(c)(3) exemption as a "Congressional balm" which was granted because the social value of a charitable organization's work was deemed to compensate for the government's losses in tax revenues.[59]

---

53. *Id.* (emphasis added).

54. Senator Bacon stated:

> "[I]n this partial levy of tax, where we are seeking to reach a certain class of wealth, we very properly except those institutions and those enterprises which have no element of personal gain in them whatever, and which are devoted exclusively to the relief of suffering, to the alleviation of our people, and to all things which commend themselves to every charitable and just impulse."

H.R. 1438, 61st Cong., 1st Sess., 44 CONG. REC. 4148, 4150 (1909).

55. *Id.*

56. 190 F.2d 738 (8th Cir. 1951).

57. *Id.* at 740. *Duffy v. Birmingham* involved a claim for refunds of federal income tax payments by trustees of the Eastman Memorial Trust, an organization the trustees claimed was organized and operated exclusively for charitable purposes under section 101(6) (now section 501(c)(3)) of the Internal Revenue Code. The court concluded that the trust, having been created for the purposes of paying pensions to retired employees of a related company and for paying additional compensation to active employees of that company, was not exempt as a charitable organization under the Code. *Id.* at 740-41.

58. 316 F.2d 151 (3d Cir. 1963).

59. *Id.* at 153. *Erie Endowment v. United States* was a suit for refund of income taxes

Finally, in *Founding Church of Scientology v. United States*,[60] the Court of Claims identified Congress' purpose for granting a 501(c)(3) exemption as a recognition that certain organizations exist for purposes beneficial to society. Tax exemption encourages these beneficial efforts by leaving in the control of these organizations funds which would otherwise have to be spent by the government.[61]

Reflective of the courts' application of section 501(c)(3) to the facts of a particular case, *Founding Church of Scientology v. United States* has become the leading case articulating the non-inurement test. In that case, the church sought to recover federal income taxes and assessed interest which it had paid, arguing its entitlement to tax exemption under section 501(c)(3).[62] The Court of Claims did not find it necessary to decide whether the church's operations were conducted solely for religious or educational purposes because it found that the church failed to carry its burden of proving that its earnings did not inure to the personal enrichment of private individuals.[63] L. Ron Hubbard, the church's founder, received ten percent of the church's gross income in lieu of a salary.[64] The court found this direct inurement sufficient to destroy the possibility of tax exemption for the church.[65]

The purpose prong of the Third Circuit's test similarly evolved from the statutory language of the Internal Revenue Code and case law development. *Better Business Bureau v. United States*[66] is the seminal case clarifying the purposes considered exempt under section 501(c)(3).[67] *Better Business Bureau* reached the Supreme Court on a petition for certiorari, which the Court granted in order to resolve a conflict between the Tenth Circuit[68] and the D.C. Cir-

---

by a charitable corporation which, although previously qualified by the IRS as tax-exempt under section 501(c)(3) of the Code, had lost its tax-exempt status because it was found to have unreasonably accumulated income. *Id.* at 152.

60. 412 F.2d 1197 (Ct. Cl. 1969), *cert. denied*, 397 U.S. 1009 (1969).

61. *Id.* at 1199.

62. *Id.* at 1198-99.

63. *Id.*

64. *Id.*.

65. *Id.*

66. 326 U.S. 279 (1945).

67. 743 F.2d at 154-55.

68. In Jones v. Better Business Bureau of Oklahoma City, 123 F.2d 767 (10th Cir. 1941), the circuit court affirmed a judgment of the district court in favor of the Better Business Bureau. The Better Business Bureau had paid social security taxes under protest for a period of approximately two years and then brought suit to recover the amounts paid. The court found that the Bureau was entitled to an exemption because it was organized for educational purposes under section 811 of the Social Security Act. In so holding, the court

cuit.[69] The Court was asked to decide whether the Better Business Bureau of Washington, D.C. (Bureau) was exempt from taxation as a corporation organized and operated exclusively for scientific or educational purposes under the Social Security Act.[70] Although the Bureau did not seriously contend that it was devoted exclusively to scientific purposes, it did claim that all of its activities were directed toward the education of both the business community and the general public.[71] The Court rejected the Bureau's argument, indicating that tax exemption under the Social Security Act would require an *exclusive* devotion to educational purposes,[72] and finding that the Bureau existed for the substantial non-educational purpose of promoting a profitable, as well as ethical, business community.[73] Although *Better Business Bureau* stood specifically for the unavailability of tax exemption under the Social Security Act where an organization failed to operate exclusively for educational purposes,[74] it has been widely relied on for the general proposition that the presence of *any* substantial non-exempt purpose is sufficient to destroy the exemption provided by section 501(c)(3).[75]

Both the inurement and purpose language of the Tariff Act of 1909 were adopted, substantially unchanged, in the Tariff Act of

---

interpreted "educational purposes" broadly, concurring in the district court's definition of education as "acquiring information or inspirational suggestions which cause the individual to think and act along proper lines." The court continued: "[c]ertainly, the teaching of honesty, integrity, and truthfulness is the very highest objective of an education." The Tenth Circuit thereby found that the Better Business Bureau's purpose was to educate the public in matters of fraud, to teach members of the public to become more intelligent buyers, and to promote higher ethical standards on the part of businessmen, and concluded that the Better Business Bureau's purpose was educational in character. *Id.* at 768-69.

69. Better Business Bureau of Washington, D.C., Inc. v. United States, 148 F.2d 14 (D.C. Cir. 1945).

70. *Id.* at 14. *See* section 811(b)(8) of the Social Security Act (previously 42 U.S.C.A. § 1011(b)(8), now codified at I.R.C. § 3121(k)). This section provides that organizations exempt from income tax under section 501(c)(3) are also exempt from social security taxes, although they may waive that exemption. The court indicated that section 811(b)(8) of the Social Security Act was taken almost verbatim from section 101(b) of the Internal Revenue Code of 1939 (now codified in section 501(c)(3) of the Code).

71. 326 U.S. at 282. Specifically, the Better Business Bureau contended that businessmen were taught to conduct their business honestly and consumers were taught to avoid being victimized. *Id.* at 282-83.

72. *Id.* at 283.

73. *Id.*

74. *Id.* at 284.

75. Though it was decided forty years ago, *Better Business Bureau* continues to be cited for this general proposition. *See, e.g.*, Hutchinson Baseball Enterprises, Inc. v. Commissioner, 696 F.2d 757, 762 (10th Cir. 1982); Freedom Church of Revelation v. United States, 588 F. Supp. 693, 696 (D.D.C. 1984); Mutual Aid Association of Brethren v. United States, 578 F. Supp. 1451, 1457 (D. Kan. 1983).

1913 and the Revenue Acts of 1918, 1921, 1924, 1926, 1928, 1932, 1934, 1936, 1938 and, finally, 1954, where it became codified in its current section, 501(c)(3). Because Congress continued to enact the same, or virtually the same, language in these subsequent Acts, it is logical to conclude that Congress was satisfied with the construction given the language by the courts.

The Third Circuit's conclusion that nothing in the record suggested that P & R's increasing economic fortunes inured to any individual's personal benefit[76] was a predictable application of the legislative policy behind section 501(c)(3). In marked contrast to the clear evidence of personal enrichment in the cases examined by the court, the individuals involved in the operation of P & R were not personally enriched through their organization's activities. Searching for such evidence, the court correctly pointed out that the salaries and wages paid by P & R were "relatively modest".[77] Indeed, not even mentioned by the court at this point were indicators of a type of behavior quite contrary to anything that could be called "personal enrichment", for instance, that between 1939 and 1954 the Craig family had contributed personal funds totalling over $23,000 in order to keep P & R operating.[78] Based on this, and on the lack of any evidence that P & R's net earnings inured to the personal benefit of any individual, the court properly found that P & R had passed the inurement prong of its two part test.[79]

The analysis leading to the court's conclusion that P & R had survived the more difficult purpose prong of the test was similarly and predictably grounded in legislative intent. This conclusion was properly based on the court's analysis of the manner in which P & R's activities were carried on[80] and the purposes toward which the increase in those activities was directed.[81] The court was unable to interpret the legislative history of section 501(c)(3) as determining the validity of an organization's claimed exemption in terms of its business volume, preferring instead to focus on the more pragmatic question of the purpose to which that increased volume was directed.[82]

---

76. 743 F.2d at 154.
77. *Id.*
78. *Id.* at 151. *See also supra* note 4.
79. *Id.* at 154.
80. *Id.* at 155-56.
81. *Id.* at 156-57.
82. *Id.* at 156.

In applying the accumulated earnings sections of the Tax Code[83] to the question of whether P & R's accumulation of cash was evidence of a possible non-exempt commercial purpose, the court relied on the legislative history and congressional intent behind that provision,[84] finding that Congress did not intend to stifle legitimate business expansion,[85] and that P & R's expansion was, indeed, legitimate and in furtherance of its tax-exempt purpose.[86]

If narrowly construed, the two-prong test of *P & R Publishing* would seem to apply solely to religiously-oriented publishing houses. However, the court clearly intended that its holding apply to all organizations previously qualified as tax-exempt under section 501(c)(3).[87]

The Third Circuit, in devising a straightforward test well-grounded in the Internal Revenue Code and case law, took a practical, common sense approach to the problem presented. What is key, however, is not the way in which the court's approach is characterized, but whether the test resulting from its decision will accomplish the purposes for which it was promulgated.

The *P & R* test has two objectives, one of which is explicit, the other more implicit. The explicit objective of the test is to protect from loss of tax-exempt status successfully-operated organizations qualified as tax-exempt under section 501(c)(3), which remain true to the purposes for which their exemption was granted.[88] The implicit objective of the test is to protect the public from loss of tax revenues from undeserving commercial enterprises claiming status as tax-exempt organizations.[89] Ideally, the test should balance these two important objectives in an equitable manner that does not favor either. The important inquiry is whether, balancing these conflicting objectives, the test goes too far in either direction.

By its very definition the test succeeds in accomplishing its explicit objective—protecting from loss of tax-exempt status success-

---

83. I.R.C. §§ 531-537 (West Supp. 1984).

84. 743 F.2d at 157.

85. *See supra* notes 42-43 and accompanying text.

86. 743 F.2d at 157-58.

87. *Id.* at 152. The court's intent in this regard is reflected in the manner in which it framed the principal issue of the case: "The principal issue we must address is at what point the successful operation of a tax-exempt organization should be deemed to have transformed that organization into a commercial enterprise and thereby to have forfeited its tax exemption." *Id.*

88. *Id.*

89. The court's earlier reliance on the legislative history and case law interpretations of section 501(c)(3) supports this view. These sources emphasize the value of a charitable organization's work to the public. *See supra* notes 51-61 and accompanying text.

fully-operated organizations qualified under section 501(c)(3).[90] However, the question remains whether the test is overprotective of tax-exempt organizations to the detriment of the interests of the public; that is, whether the test is too lenient.

It must be remembered that the *P & R* test only protects organizations that have already been qualified as tax-exempt.[91] Conceptually, then, the most logical point at which to place the heaviest burden on the taxpayer/organization is at this qualification stage.

This is, in fact, precisely what occurs, for it is at this stage that the organization has the burden of proving every element necessary for an original grant of tax-exempt status.[92] At this stage, the organization undergoes close scrutiny and the elements necessary for section 501(c)(3) qualification are narrowly construed and applied.[93] It is logical to conclude, then, that if the organization can overcome this difficult hurdle, it more than likely deserves the protection of the *P & R* test. To reiterate, if an organization is capable of qualifying as tax-exempt, that status should be protected by the *P & R* test; in contrast to the heavy burden the organization must carry at initial qualification, the burden of the *P & R* test is quite light and represents a far easier obstacle to overcome.[94] Because the true test of whether an organization deserves tax-exempt status occurs at initial qualification, and since the *P & R* test is not nearly as difficult as that of initial qualification,[95] it cannot be said that the test is overprotective of tax-exempt organizations.

Examining the unstated objective of the two-part test—protecting the public from loss of tax revenues due to tax-exempt status being granted to commercial organizations not deserving of such a benefit[96]—the inquiry becomes whether the inter-

---

90. 743 F.2d at 153.

91. *Id.*

92. *See, e.g.*, Harding Hospital v. United States, 505 F.2d 1068 (6th Cir. 1974), where the court stated that, because an exemption is an exception to the norm in taxation, an organization seeking tax-exempt status must bear the heavy burden of proving that it satisfies all the elements of the exemption statute. Relying on Mescalero Apache Tribe v. Jones, 411 U.S. 145, 156 (1973), the *Harding* court found that exemptions from taxation are not granted by implication. 505 F.2d at 1071.

93. *Id.*

94. The burden of the *P & R* test is comparatively light due primarily to the presumption it creates in favor of the taxpayer/organization. Unlike initial qualification, where the organization must prove each element of the exemption statute, *see supra* note 92, a reexamination of an organization's tax-exempt status only involves the two-step purpose/inurement analysis, and is framed in terms of the organization "forfeiting" its exemption. 743 F.2d at 152.

95. *Id.* at 153.

96. *See supra* note 89.

ests of the public are so well-protected by the test that legitimate tax-exempt organizations which were previously qualified by the IRS may lose that status under the *P & R* test. Stated differently, the question becomes whether the test is too strict.

This inquiry is easily answered in the negative. The new two-part test could be characterized as "passive" rather than "active" since it begins not with a presumption in the government's favor, as an initial qualification would,[97] but with a presumption in favor of the organization claiming exemption.[98]

Perhaps more importantly, the legitimacy of an organization's exemption-worthiness is tested at the initial qualification stage.[99] It is significant that the two prongs of the *P & R* test amount to a reevaluation of an organization's legitimacy in light of an allegation of possibly changed circumstances. Because of its reevaluative nature, based on standards similar to those used at its initial qualification, the *P & R* test cannot be said to favor the interests of the public to the detriment of the interests of legitimate tax-exempt organizations.

Although the two-prong test promulgated by the court appears to result in a proper balancing of the policy issues involved, the scope of the test's application is impliedly limited to organizations engaged in a single activity; it does not apply to organizations which operate a number of activities, some in furtherance of exempt purposes and some unrelated to those purposes. This limitation on the test's application is necessary to avoid conflict with the unrelated business income provisions of the Tax Code,[100] which clearly contemplate that an exempt organization may engage in non-exempt activities.[101]

While the test must be limited in application as a result of the unrelated business income provisions of the Code, an exploration of the evolution of those provisions strongly supports the court's

---

97. *See supra* note 92.

98. *See supra* note 94.

99. *See supra* note 92.

100. I.R.C. §§ 511-515 (West Supp. 1984).

101. Although the Code does not prohibit exempt organizations from engaging in non-exempt activities, an organization's decision to do so should be made only after consideration of the possible sanctions involved. I.R.C. § 511 imposes a tax on the "unrelated business taxable income" of exempt organizations described in section 501(c)(3), among others. "Unrelated business taxable income" is defined, in sections 512 and 513 of the Code, as "the gross income derived by any organization" from the conduct of any trade or business "which is not substantially related . . . to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption." *See supra* text accompanying note 30.

adoption of the purpose element of the test for single activity organizations. Because the court adopted a test designed to examine the true purpose of an activity purported to be exempt, rather than the uses to which the income generated from such an activity are put, it avoided the resurrection of the "destination of income" doctrine, which had been legislatively overruled by Congress over thirty years earlier.[102]

The origins of the "destination of income" test are found in *Trinidad v. Sagrada Orden de Predicadores.*[103] This test, which was designed to draw a clear line between an organization's ultimate purposes and its activities, held that it is the ultimate purpose to which the activities of an organization are devoted, not the activities themselves, that is important.[104] As a consequence of this view the organization in question, a corporation representing an ancient religious order, was held exempt despite its extensive investments in real estate and chocolate.[105] The reasoning behind the test was that if the profits were devoted to charitable (i.e. exempt) uses, exemption was appropriate.[106]

In the years following *Trinidad* it became apparent that one result of this liberal view was the implicit grant of a competitive advantage to exempt organizations which, in furtherance of their ultimate exempt purpose, operated activities traditionally occupied by commercial enterprises.[107] Simply stated, this advantage resulted from the ability of tax-exempt organizations to compete, using untaxed dollars, with non-exempt companies using after-tax dollars.[108]

Congress, following some prodding by President Truman,[109] ad-

---

102. Congress imposed the tax on unrelated business income in 1950. *See infra* notes 109-11 and accompanying text.

103. 263 U.S. 578 (1924).

104. *Id.* at 582.

105. *Id.*

106. *Id.*

107. In its report on the Revenue Act of 1950 (H.R. 8920) the Senate Finance Committee identified unfair competition as the primary problem necessitating the passage of the unrelated business income provisions of the Code (I.R.C. §§ 511-513 (West Supp. 1984)). S. REP. No. 2375, 81st Cong., 2d Sess., *reprinted in* 1950 U.S. CODE CONG. SERV. 3053, 3081.

108. *Id.*

109. In his January 23, 1950 tax message to Congress, President Truman urged the closing of inequitable loopholes in the tax laws. Concerning tax-exempt educational and charitable organizations, the President stated:

> Some tax loopholes have also been developed through the abuse of the tax exemption accorded educational and charitable organizations. It has properly been the policy of the Federal Government since the beginning of the income tax to encourage the development of these organizations. That policy should not be changed. But the few

dressed the problem in 1950 by imposing a tax on unrelated business income earned by an exempt organization.[110] This action rendered the *Trinidad* "destination of income" test void. Emphasizing the aspects of unfair competition and of garnering greater tax revenues, Congress recognized that, regardless of the genuineness of an organization's exempt purposes, activities which themselves are not directed toward the furtherance of those exempt purposes were subject to taxation as unrelated business income, even if the income generated by such activities was used to pay for the exempt purposes.[111] To avoid the problem in a single activity organization, as the Third Circuit faced in *P & R Publishing*, the requirement that the activity be devoted *exclusively* to an exempt purpose to qualify as exempt was properly reflected in the second prong of the test generated by the court.

In the final analysis, the *P & R* court merely put into a simple, manageable package a two-part test that has been available elsewhere for many years. Although its decision amounts to a reaffirmation of these well-grounded principles, rather than the creation of a test founded on new analysis, it is likely to have one very valuable result. Because the test is now located in one place, rather than in several (namely the Code, Treasury regulations, and case law sources), *Presbyterian and Reformed Publishing Co. v. Commissioner* is quite likely to result in more consistent opinions in this area, rather than the miscellaneous collection of decisions seen previously.

William M. Thomson

---

glaring abuses of the tax exemption privilege should be stopped. Responsible educational leaders share in the concern about the fact that an exemption intended to protect educational activities has been misused in a few instances to gain competitive advantage over private enterprise through the conduct of business and industrial operations entirely unrelated to educational activities.

. . . .

These and other unintended advantages can and should be removed without jeopardizing the basic purposes of those organizations which should rightly be aided by tax exemption.

President's Tax Message to Congress, 96 CONG. REC. 769, 771, *reprinted in* 1950 U.S. CODE CONG. SERV. 1349, 1352.

110. *See supra* notes 101-02 and accompanying text.

111. *Id.*