

# Serving Two Masters: Commercial Hues and Tax Exempt Organizations\*

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No man can serve two masters: for either he will hate the one, and love the other; or else he will hold to the one and despise the other. Ye cannot serve both God and mammon.

Matthew 6:24

Many organizations claiming tax exempt status under section 501(c)(3) of the Internal Revenue Code<sup>1</sup> (I.R.C.) engage solely or primarily in activities that both directly accomplish an exempt purpose and earn a profit. A hospital, for example, directly accomplishes an exempt charitable purpose by serving the medical needs of its community, but it also may make a profit from the fees it charges for its services. A college directly accomplishes an exempt educational purpose by teaching its students, but it may also make a profit from tuition receipts. The Internal Revenue Service (the Service) and the courts have had difficulty analyzing whether such organizations, which attempt to do well and to do good at the same time, are entitled to exempt status. The Service and the courts are concerned that

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1. The I.R.C. defines tax exempt organizations as:

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 . . . amateur sports competition . . . , 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 . . . , and which does not participate in, or intervene in . . . , any political campaign on behalf of any candidate for public office.

I.R.C. § 501(c)(3) (1982). Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended.

the pursuit of profit may be incompatible with operation exclusively for exempt purposes; it is the old problem of serving two masters.

In *B.S.W. Group, Inc. v. Commissioner*,<sup>2</sup> the Tax Court explained the approach that it takes in ruling on the exempt status of an organization whose sole or primary activity of selling goods or services for a profit directly furthers an exempt purpose:

The fact that petitioner's activity may constitute a trade or business does not, of itself, disqualify it from classification under section 501(c)(3), provided the activity furthers or accomplishes an exempt purpose. Rather, the critical inquiry is whether petitioner's primary purpose . . . is an exempt purpose, or whether its primary purpose is the nonexempt one of operating a commercial business producing net profits for petitioner. This is a question of fact to be resolved on the basis of all the evidence. . . . Factors such as the particular manner in which an organization's activities are conducted, the commercial hue of those activities, and the existence and amount of annual or accumulated profits are relevant evidence of a forbidden predominant purpose.<sup>3</sup>

In one respect, this analysis has been modified by later Tax Court decisions, which hold that an organization is not qualified for exemption if it has a *substantial* nonexempt commercial purpose. The commercial purpose need not be *primary* in order to disqualify the organization.<sup>4</sup> Regardless of how the test is articulated, however, an organization whose activities strike the Service and the courts as having too much of a "commercial hue" will be denied tax exempt status on the theory that it has a substantial nonexempt commercial purpose.<sup>5</sup>

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2. 70 T.C. 352 (1978).

3. *Id.* at 357 (footnotes and citations omitted).

4. *Presbyterian & Reformed Publishing Co. v. Commissioner*, 79 T.C. 1070, 1082 n.16 (1982), *appeal docketed*, No. 1759-81X (3d Cir. Dec. 23, 1982); *Copyright Clearance Center, Inc. v. Commissioner*, 79 T.C. 793, 804 (1982).

5. It seems conceivable, under the *B.S.W. Group, Inc.* analysis, that an otherwise qualified organization—such as a school or a hospital—could lose its exempt status merely for trying to make a profit, even if the attempt were unsuccessful. Other factors might indicate a predominant commercial purpose, even in the absence of a profit. If such an organization were denied exempt status, it would have no tax liability (since it operated at a loss), but it would lose the right to receive deductible charitable contributions. See I.R.C. § 170(c)(2) (1982). There do not appear, however, to be any instances of the Service's challenging the exempt status of an unprofitable organization on the basis that it possessed a forbidden commercial hue.

The test described by the Tax Court in *B.S.W. Group, Inc.* is not justified by the terms of section 501(c)(3). This article will describe the statutory and regulatory framework of section 501(c)(3), examine how the test has been applied, criticize the test, and suggest a test more in keeping with the language and the spirit of section 501(c)(3). The proposed test is this: If the questioned activity directly accomplishes an exempt purpose of the organization, and if all profits from the activity are used in a manner consistent with the organization's exempt purposes,<sup>6</sup> then the organization should be granted exempt status, whether or not the organization's activities are imbued with a "commercial hue."<sup>7</sup>

## I. THE STATE OF THE LAW

### A. *The Statutory and Regulatory Framework*

Organizations described in I.R.C. section 501(c)(3) are exempt from federal income tax under section 501(a)<sup>8</sup> and are also eligible to receive tax deductible charitable contributions under section 170. In order to be described in section 501(c)(3), an organization must satisfy four statutory requirements. First, it must be organized exclusively for one or more exempt purposes (religious, charitable, scientific, testing for public safety, literary, educational, promoting amateur sports, or preventing cruelty to animals).<sup>9</sup> Second, it must be operated exclusively for one or more exempt purposes.<sup>10</sup> Third, no part of its net earn-

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6. See *infra* notes 71-78 and accompanying text.

7. For another analysis (based in part on the common law definition of "charitable") concluding with a similar suggestion, see Note, *Profitable Related Business Activities and Charitable Exemption Under Section 501(c)(3)*, 44 GEO. WASH. L. REV. 270 (1976). See also Desiderio, *The Profitable Nonprofit Corporation: Business Activity and Tax Exemption Under Section 501(c)(3) of I.R.C.*, 1 N.M.L. REV. 563 (1971). Desiderio argues (with special emphasis on community development corporations) that an organization, otherwise qualified for exempt status, which engages in substantial business activities intending to make a profit, is entitled to exemption under § 501(c)(3) as it currently stands. However, he suggests an amendment to § 501(c)(3) to make such an organization ineligible for exemption. *Id.* at 585-89. Finally, see the brief discussion of this issue in Rogovin, *The Charitable Enigma: Commercialism*, U. SOUTHERN CAL. 17TH ANN. INST. ON FED. TAX'N 61, 80-82 (1965).

8. The exemption does not apply, however, to unrelated business income. See I.R.C. §§ 511-14 (1982).

9. I.R.C. § 501(c)(3) (1982); Treas. Reg. § 1.501(c)(3)-1(b) (1960).

10. I.R.C. § 501(c)(3) (1982); Treas. Reg. § 1.501(c)(3)-1(c)(1) (1960); Treas. Reg. § 1.501(c)(3)-1(d) (1960).

ings may inure to the benefit of any private individual.<sup>11</sup> Fourth, it must observe the statutory restrictions on involvement in legislative lobbying and political campaigns.<sup>12</sup>

The Service may challenge an organization engaged in business activities for not satisfying the second of these requirements, the "operational test," which mandates that the organization be operated exclusively for exempt purposes. Under the operational test, the organization's purposes, rather than its activities, must qualify as exempt. The statutory language requires that the organization be "operated exclusively" for exempt "purposes."<sup>13</sup>

No activity is inherently exempt or nonexempt. Whether an activity is consistent with exempt status depends on the organization's purpose for engaging in that activity. The regulations emphasize this crucial distinction between purpose and activity by stating that an organization satisfies the operational test if its activities accomplish one or more of the exempt purposes specified in section 501(c)(3).<sup>14</sup> Although the language of the statute literally requires operation *exclusively* for exempt purposes, the regulations indicate that an insubstantial nonexempt purpose will not destroy an organization's exempt status.<sup>15</sup>

It follows from the focus on purposes rather than on activities, that the fact that an organization earns income by engaging in a business should not automatically make it ineligible for exemption.<sup>16</sup> Engaging in a business is an activity that, like many other activities, can be undertaken for exempt or nonexempt purposes. The regulations acknowledge that an organization operating a trade or business may meet the requirements of

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11. I.R.C. § 501(c)(3) (1982); Treas. Reg. § 1.501(a)-1(c) (1960); Treas. Reg. § 1.501(c)(3)-1(c)(2) (1960).

12. I.R.C. § 501(c)(3) (1982); Treas. Reg. § 1.501(c)(3)-1(c)(3) (1960).

13. I.R.C. § 501(c)(3) (1982).

14. An organization will be regarded as 'operated exclusively' for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Treas. Reg. § 1.501(c)(3)-1(c)(1) (1960).

15. Treas. Reg. § 1.501(c)(3)-1(c)(1) (1960). *Accord* Better Business Bureau v. United States, 326 U.S. 279, 283 (1945) (the presence of a "single . . . [nonexempt] purpose, if substantial in nature, will destroy the exemption").

16. The mere fact that an organization has income does not make it ineligible for exemption. If it did, there would be no point to § 501(c)(3), since the only organizations that could qualify for exemption from income tax would be those with no income.

section 501(c)(3) if the operation of the trade or business is in furtherance of the organization's exempt purposes (unless the organization's primary purpose is the carrying on of an unrelated trade or business).<sup>17</sup>

Section 513(a) defines an unrelated trade or business as a trade or business that is not substantially related to the accomplishment of the organization's exempt purposes (aside from the use the organization makes of the profits).<sup>18</sup> Such unrelated trade or business income is taxed under I.R.C. sections 511-514.<sup>19</sup>

This article considers business activities that are substantially related to the accomplishment of an organization's exempt purposes, and to which the tax on unrelated business income therefore does not apply. Two examples of substantially related business activities are the operation of a hospital by a charitable organization and the operation of a college by an educational organization. When the tax on unrelated business income applies, it permits a compromise solution: imposition of a tax on unrelated business income, but tax exemption for other income and eligibility to receive deductible charitable contributions. Such a compromise solution is not statutorily available when the organization's major activity is conducting a business substantially related to the organization's exempt purposes. Either the organization is totally tax exempt, or it is not exempt at all.

### B. Rulings and Case Law

The Service has emphasized its objection to exempt organizations' commercial hues in several published rulings. In 1960<sup>20</sup>

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17. An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513.

Treas Reg. § 1.501(c)(3)-1(e)(1) (1960).

18. The term 'unrelated trade or business' means . . . any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption . . .

I.R.C. § 513(a) (1982). The "substantially related" standard is discussed in Treas. Reg. § 1.513-1(d)(2) (1967).

19. See *infra* notes 84-95 and accompanying text.

20. Rev. Rul. 60-351, 1960-2 C.B. 169.

the Service ruled that a nonprofit organization that published a foreign language magazine containing literary, scientific, and educational articles was not exempt because the magazine was sold to the general public through paid subscriptions. The ruling explained: "[T]he corporate activities . . . are, *per se*, business activities. They are devoted to publishing a magazine and selling it to the general public in accordance with ordinary commercial practices."<sup>21</sup> This decision was cited with approval in a 1967 ruling,<sup>22</sup> which stated that an organization engaged in publishing scientific and medical literature could qualify for exempt status only if, among other things, "the manner in which the distribution is accomplished is distinguishable from ordinary commercial publishing practices."<sup>23</sup> In 1977 the Service relied on that reasoning in ruling that a nonprofit organization publishing an ethnic newspaper was not entitled to exemption because the organization's activities of publishing the newspaper, soliciting advertising, and selling subscriptions, were "indistinguishable from ordinary commercial publishing practices."<sup>24</sup>

The analysis underlying these rulings is also reflected in the Service's position in the reported cases. The Service has challenged, with mixed results, the exemptions of organizations involved in many different kinds of business activities, on the basis that the organizations possessed forbidden commercial hues. Challenged activities have included producing plays,<sup>25</sup> commercial farming,<sup>26</sup> operating a pharmacy,<sup>27</sup> manufacturing

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21. *Id.* at 171.

22. Rev. Rul. 67-4, 1967-1 C.B. 121.

23. *Id.* at 122.

24. Rev. Rul. 77-4, 1977-1 C.B. 141 (citing Rev. Rul. 67-4, 1967-1 C.B. 121, 122).

25. *Plumstead Theatre Soc'y, Inc. v. Commissioner*, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982). The organization coproduced a play with the Kennedy Center. The Tax Court rejected the Service's argument that the organization was disqualified from exempt status because of the commercial manner in which the play was produced. *Id.* at 1334.

26. *Dumaine Farms v. Commissioner*, 73 T.C. 650 (1980). The organization operated an experimental demonstration farm. The Tax Court rejected the Service's argument that the organization was operated for the substantial nonexempt commercial purpose of farming. *Id.* at 669.

27. *Federation Pharmacy Servs., Inc. v. Commissioner*, 72 T.C. 687 (1979), *aff'd*, 625 F.2d 804 (8th Cir. 1980). The organization operated a pharmacy that sold drugs at a discount to the elderly and the handicapped. The Eighth Circuit and the Tax Court agreed with the Service that the organization had a substantial nonexempt commercial purpose of selling drugs in direct competition with commercial drug stores. 625 F.2d at 808-09; 72 T.C. at 692-93.

and selling pyrometric cones,<sup>28</sup> aiding artists and artisans by selling their works,<sup>29</sup> aiding the blind by selling their handicrafts,<sup>30</sup> teaching and disseminating economic information by selling publications containing investment advice,<sup>31</sup> and providing consulting services for a fee to nonprofit organizations.<sup>32</sup>

The most frequent targets of the Service, however, have been religious publishers. In a number of difficult to reconcile cases, the courts have drawn fine factual distinctions between exempt religious publishers<sup>33</sup> and those religious publishers with too many commercial characteristics to qualify for exemption.<sup>34</sup>

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28. *Edward Orton, Jr., Ceramic Found. v. Commissioner*, 56 T.C. 147 (1971). The organization manufactured and sold pyrometric cones used in ceramics and applied the profits to ceramic engineering research. In a decision reviewed by the entire court, the Tax Court held the organization qualified for exemption. *Id.* at 157-61.

29. *See, e.g., Goldsboro Art League, Inc. v. Commissioner*, 75 T.C. 337 (1980). The organization promoted art by exhibiting and selling artworks on commission at two art galleries. The Tax Court rejected the Service's claim that commercial aspects of these activities precluded exempt status. *Id.* at 346. *See also Aid to Artisans, Inc. v. Commissioner*, 71 T.C. 202 (1978). The organization purchased, imported, and sold handicrafts of disadvantaged artisans. The Tax Court found that the organization qualified for exempt status, despite the Service's contention that the organization possessed a substantial nonexempt commercial purpose. *Id.* at 214.

30. *Industrial Aid for the Blind v. Commissioner*, 73 T.C. 96 (1979). The organization purchased and sold products manufactured at a workshop for the blind. The Tax Court disagreed with the Service's position that its primary purpose was the nonexempt purpose of carrying on a trade or business at a profit. *Id.* at 102.

31. *American Inst. for Economic Research v. United States*, 302 F.2d 934 (Ct. Cl. 1962). The organization published and sold periodicals containing investment advice. The court found that the organization's primary purpose was commercial, and held that the organization was not exempt. *Id.* at 938.

32. *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352 (1978). The organization's sole planned activity was to sell consulting services, at or near cost, to nonprofit organizations. The Tax Court agreed with the Service that the organization's primary purpose was commercial, which made it ineligible for exemption. *Id.* at 360-61.

33. *See, e.g., Elisian Guild, Inc. v. United States*, 412 F.2d 121 (1st Cir. 1969). The organization published and sold religious works of one author. The court held that the organization was entitled to exempt status because its exempt purpose transcended the profit motive. *Id.* at 124-25. *See also Pulpit Resource v. Commissioner*, 70 T.C. 594 (1978). The organization's sole activity was publishing and selling a periodical devoted to the improvement of preaching. In a lengthy opinion, the Tax Court agreed with the Service that the organization had a commercial hue, but found that the commercial aspect was so slight that it did not disqualify the organization from exemption. *Id.* at 611-12. The court emphasized the lack of commercial competition, the small size of the profit, and the sincerity and devotion of the organization's president. *Id.*

34. *Incorporated Trustees of the Gospel Worker Soc'y v. United States*, 510 F. Supp. 374 (D.D.C.), *aff'd*, 672 F.2d 894 (D.C. Cir. 1981). The organization published and sold religious literature. In holding that the organization was nonexempt, the court emphasized its increasing profits, its large accumulation of earnings, the high salaries of its top officials, and its competition with commercial publishers. *Id.* at 378-79.

In *Fides Publishers Ass'n v. United States*, 263 F. Supp. 924 (N.D. Ind. 1967) the

*Presbyterian & Reformed Publishing Co. v. Commissioner*<sup>35</sup> is a recent and typical example of the cases denying exempt status to religious publishers. The organization published books relating to the Presbyterian faith. Book prices were set so that the organization would not lose money on any sales, even those at maximum discount.<sup>36</sup> The organization, which had been founded in 1931, greatly expanded the scale of its operations during the 1970s. Wages and salaries rose from nothing in 1970, to \$57,000 in 1979, with the highest single salary at \$15,350.<sup>37</sup> Royalties paid to authors grew from \$350 in 1969 to \$82,127 in 1979.<sup>38</sup> Net profits on book sales rose from nothing for years prior to 1969, to a high of \$106,180 in 1975.<sup>39</sup> Cash on hand rose from \$14,890 in 1969, to a high of \$417,844 in 1976, before declining to \$111,826 in 1979.<sup>40</sup> The decrease between 1976 and 1979 resulted from the use of cash to build a new office and warehouse to keep pace with expanding operations.<sup>41</sup>

The Tax Court framed the crucial issue as whether the organization had a substantial nonexempt commercial purpose for engaging in the business of publishing and selling religious books.<sup>42</sup> The court noted that a single activity may further both exempt and nonexempt purposes, and that exemption must be denied if the activity furthers a substantial nonexempt purpose.<sup>43</sup> Foreshadowing the result it would reach, the Court remarked:

If . . . an organization's management decisions replicate those of commercial enterprises, it is a fair inference that at least one purpose is commercial, and hence nonexempt. And if this non-exempt goal is substantial, tax exempt status must be denied.

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organization published and sold Roman Catholic literature as its sole activity. The court held that the publication and sale of religious literature at a profit was a substantial nonexempt purpose, making the organization ineligible for exempt status. *Id.* at 936.

See also *Scripture Press Found. v. United States*, 285 F.2d 800 (Ct. Cl. 1961), *cert. denied*, 368 U.S. 985 (1962). Scripture Press was a religious publishing house, specializing in teaching materials. In determining that the organization was not exempt, the court emphasized its impressive profits and large accumulations of earnings. *Id.* at 803.

35. 79 T.C. 1070 (1982), *appeal docketed*, No. 1759-81X (3d Cir. Dec. 23, 1982).

36. *Id.* at 1079.

37. *Id.* at 1074-75.

38. *Id.* at 1079.

39. *Id.* at 1077.

40. *Id.* at 1078.

41. *Id.* at 1076.

42. *Id.* at 1082-83.

43. *Id.* at 1082.

Clearly petitioner's conduct of a growing and very profitable publishing business must imbue [sic] it with some commercial hue.<sup>44</sup>

The court went on to observe that the organization possessed numerous characteristics indicative of a forbidden commercial purpose: the making of substantial profits;<sup>45</sup> never charging below cost;<sup>46</sup> competing with commercial publishers;<sup>47</sup> expanding by searching out more readers and acquiring a larger facility;<sup>48</sup> paying wages to workers, royalties to authors, and entering into formal contracts with authors;<sup>49</sup> dropping plans that lost money;<sup>50</sup> and publishing some nondenominational works.<sup>51</sup> The court did not treat any one of these characteristics as conclusive, but held that all the characteristics, taken together, indicated that the organization's "substantial, and indeed, primary purpose was the nonexempt one of selling religious literature at a profit."<sup>52</sup> The court acknowledged that expansion could help the organization further its exempt religious purpose,<sup>53</sup> and it claimed to reject the notion that seemed implicit in the Service's arguments, that efficiency and success automatically negate tax exempt status.<sup>54</sup> Nevertheless, the court concluded that the organization's commercial methods reflected a substantial commercial purpose, thus disqualifying the organization from exempt status.<sup>55</sup>

### C. *Absence of Exempt Purpose or Presence of Nonexempt Purpose?*

The usual approach of the Service and the courts, when denying exempt status to an organization operating a profitable activity that directly accomplishes an exempt purpose, has not been to claim that the organization lacks an exempt purpose.

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44. *Id.* at 1083.

45. *Id.*

46. *Id.* at 1084-85.

47. *Id.* at 1085.

48. *Id.* at 1086.

49. *Id.*

50. *Id.*

51. *Id.* The nondenominational works were Christian, but not specifically Presbyterian.

52. *Id.* at 1087.

53. *Id.*

54. *Id.*

55. *Id.*

Rather, the claim has been that the organization is not operated *exclusively* for exempt purposes, because it also has a substantial nonexempt commercial purpose.<sup>56</sup> At first glance, the Supreme Court's recent decision in *Bob Jones University v. United States*<sup>57</sup> might seem to support a different argument: that an organization whose primary or sole activity is selling goods or services at a profit should be denied exempt status because it is totally lacking in any exempt purpose.

In *Bob Jones*, the Supreme Court determined that section 501(c)(3) incorporates elements of the common law of charitable trusts.<sup>58</sup> Any organization claiming exempt status, the Court held, must satisfy those incorporated elements. Thus, any exempt organization—even a religious, educational, or scientific organization—must be charitable in the common law sense.<sup>59</sup> The requirement that an exempt organization must be charitable in the common law sense is in addition to the requirement that the organization be organized and operated for one of the eight categories of exempt purposes specified by Congress.<sup>60</sup>

The decision in *Bob Jones* could be used to support the following argument: If all exempt organizations must be charitable, and if selling goods or services at a profit is not charitable, then no organization whose sole or primary activity is engaging in such sales can qualify for exemption. The problem with this analysis is that the second premise is incorrect. To be charitable in the common law sense, an organization need not give anything away or sell anything at or below cost. The Supreme Court in *Bob Jones* held only that all exempt organizations must be charitable in the sense that they confer a public benefit and that they not be illegal or violate established public policy.<sup>61</sup> The Court did not state that selling goods or services at a profit necessarily negates the existence of a charitable purpose, and, in fact, such a statement would have been at odds with the com-

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56. See *supra* notes 20-55 and accompanying text.

57. 103 S. Ct. 2017 (1983).

58. Such an examination reveals unmistakable evidence that underlying all relevant parts of the Code is the intent 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.

*Id.* at 2026.

59. *Id.* at 2025-29.

60. *Id.* at 2029 n.19.

61. *Id.* at 2025-29.

mon law of charitable trusts.

Under the common law concept of charity, any activity that benefits the community may be considered charitable.<sup>62</sup> The *Bob Jones* opinion<sup>63</sup> quotes Lord MacNaghten, in *Commissioners v. Pemsel*,<sup>64</sup> to the effect that charitable purposes include relief of poverty, advancement of education, advancement of religion, and any other purpose beneficial to the community. With charitable purposes so broadly described, an activity involving the sale of goods or services at a profit does not necessarily lack a charitable purpose.<sup>65</sup>

The Service acknowledged this point when it ruled that a hospital was operated in furtherance of the charitable purpose of the promotion of health, even though the hospital denied non-emergency treatment to indigents and operated at a profit.<sup>66</sup> The hospital's profits were used for expansion, replacement of facilities and equipment, debt amortization, improvement of patient care, medical training, education, and research.<sup>67</sup> In a recent revenue ruling,<sup>68</sup> the Service extended this rationale to a hospital that completely denied service to those unable to pay<sup>69</sup> and that operated at a profit. The Service ruled that the hospital was nevertheless exempt, because the "promotion of health is considered to be a charitable purpose," and "the hospital promotes the health of a sufficiently broad class of persons to benefit the community."<sup>70</sup>

In sum, there is little support for the argument that an organization necessarily lacks an exempt purpose if its sole or primary activity is the sale of goods or services at a profit. In fact, the attack of the Service and the courts against such organizations has not been that they lack exempt purposes, but that they may also possess substantial nonexempt purposes.

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62. *Id.*

63. *Id.* at 2027.

64. 1891 A.C. 531, 583.

65. See Note, *supra* note 7, at 272-74.

66. Rev. Rul. 69-545, 1969-2 C.B. 117.

67. *Id.* at 117. In *Simon v. Eastern Ky. Welfare Rights Org.*, 426 U.S. 26 (1976), the Supreme Court held that low-income individuals and organizations representing them lacked standing to challenge Rev. Rul. 69-545. *Id.* at 46.

68. Rev. Rul. 83-157, 1983-2 C.B. 94.

69. The hospital did not operate an emergency room because the community already had adequate emergency room facilities. *Id.* at 94.

70. *Id.*

## II. THE PROBLEMS WITH THE CURRENT APPROACH OF THE SERVICE AND THE COURTS

### A. *The Approach Confuses Means with Ends*

The Service and the courts assume that an organization operating a profitable business has as one of its purposes the nonexempt purpose of operating a business for a profit. Once this assumption is made, the organization can qualify for exemption only if its nonexempt purpose is not substantial.<sup>71</sup>

This analysis ignores the crucial distinction between purposes and activities drawn in section 501(c)(3). It is not the activity itself, but the purpose behind the activity, that must be exempt.<sup>72</sup> The nature of the activity must be considered, of course, in determining the purpose behind the activity. In that sense, the nature of the activity is relevant to the determination of whether the purpose is exempt; it is not, however, conclusive. Engaging in a business is merely an activity. Contrary to the assumption of the Service and the courts, that activity does not necessarily indicate the presence of a nonexempt commercial purpose.

Imagine a hospital, school, or religious publisher that distributes its goods or services free of charge. The Service would readily acknowledge that such an organization is operated solely for exempt purposes, because its activities directly accomplish an exempt charitable (hospital), educational (school), or religious (religious publisher) purpose. The commercialism issue arises only when such an organization—which would clearly qualify for exemption aside from concerns about commercial hues—charges fees and as a result earns a profit. The question, then, is whether an organization, which would qualify for exemption if it did not charge fees and earn a profit, can be disqualified because it charges fees and earns a profit.

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71. *Incorporated Trustees of the Gospel Worker Soc'y v. United States*, 510 F. Supp. 374, 378 (D.D.C.), *aff'd*, 672 F.2d 894 (D.C. Cir. 1981); *Fides Publishers Ass'n v. United States*, 263 F. Supp. 924, 935 (N.D. Ind. 1967); *Presbyterian & Reformed Publishing Co. v. Commissioner*, 79 T.C. 1070, 1082-83 (1982), *appeal docketed*, No. 1759-81X (3d Cir. Dec. 23, 1982); *Pulpit Resource v. Commissioner*, 70 T.C. 594, 610-11 (1978); *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352, 357 (1978). *See generally* Treas. Reg. § 1.501(c)(3)-1(c)(1) (1960).

72. *Presbyterian & Reformed Publishing Co. v. Commissioner*, 79 T.C. 1070, 1082 (1982), *appeal docketed*, No. 1759-81X (3d Cir. Dec. 23, 1982); *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352, 356-57 (1978). *See* Treas. Reg. § 1.501(c)(3)-1(c)(1) (1960). *See supra* notes 12-14 and accompanying text.

Making money is seldom an end in itself; ordinarily, it is merely a means (activity) to an end (purpose). A profit is made not for the sake of making a profit, but so that the profit may be put to some use. If an organization uses the profit it makes from an activity that directly accomplishes an exempt purpose in a manner consistent with the organization's avowed exempt purpose, then the making of the profit is a means to an exempt end, and there is no nonexempt commercial purpose.

For example, if an organization uses its profits to finance the expansion of a business activity whose operation directly accomplishes an exempt purpose, then the organization should retain its tax exempt status. Similarly, use of profits to fund non-self-supporting activities in furtherance of the organization's exempt purposes should not endanger exempt status.<sup>73</sup> If, on the other hand, the profit is used for some nonexempt purpose, such as the private benefit of those in control of the organization<sup>74</sup> or mere accumulation of wealth for its own sake (the rare case of making money as an end in itself),<sup>75</sup> then the organi-

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73. Both expenditures for capital improvements and expenditures for non-self-supporting activities would not be deductible by the organization and thus would not reduce taxable income. The improvements would, of course, have to be capitalized. I.R.C. § 263 (1982). Depreciation deductions might or might not be available, depending on the nature of the improvements, but a full current deduction would not be possible. Amounts spent on non-self-supporting activities would not generally be deductible, because expenditures that are not profit motivated are not deductible expenses under either § 162 or § 212. The unavailability of deductions for these two types of expenditures means that an organization may spend all its receipts for exempt purposes and yet have taxable income, assuming that it is not tax exempt. Such an organization may have income in a tax accounting sense, when in fact, it has no receipts that are not spent in furtherance of its exempt purposes. See Bittker & Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299 (1976), arguing that computing the "net income" of tax exempt organizations "would be a conceptually difficult, if not self-contradictory task." *Id.* at 307.

74. This would violate the statutory prohibition against the inurement of an exempt organization's net earnings to the benefit of private individuals, as well as the requirement that an exempt organization be operated exclusively for exempt purposes. I.R.C. § 501(c)(3) (1982).

75. Even though § 504 of the Code, which expressly prohibited unreasonable accumulations by exempt organizations, was repealed by § 101(j)(15) of the Tax Reform Act of 1969, the courts have properly continued to deny exempt status to organizations that have accumulated earnings far beyond any demonstrable exempt purpose—such as planned expansion—for the accumulation. *See, e.g.,* Incorporated Trustees of the Gospel Worker Soc'y v. United States, 510 F. Supp. 374 (D.D.C.), *aff'd*, 672 F.2d 894 (D.C. Cir. 1981); Western Catholic Church v. Commissioner, 73 T.C. 196 (1979), *aff'd*, 631 F.2d 736 (7th Cir. 1980), *cert. denied*, 450 U.S. 981 (1981). The principles involved are somewhat similar to those that apply to the accumulated earnings tax on nonexempt corporations under I.R.C. §§ 531-37 (1982). Although the accumulation of wealth for its own sake is not an exempt purpose, the Service and the courts must be careful not to penalize orga-

zation has a substantial nonexempt purpose, and it is not entitled to exemption.

The critical issue, under the purpose analysis mandated by both the Code and the regulations, is not whether the organization intends to make a profit, but what it intends to do with that profit. This is not to say that any business may be exempt, so long as its profits are used for charitable purposes. Section 502, dealing with "feeder" organizations, expressly provides that an organization does not qualify for exemption merely because all its profits are paid over to one or more exempt organizations.<sup>76</sup> Section 502 does not state that an organization whose profits are used for exempt purposes is not exempt; it simply says that something more is required for exemption. The something more is that the organization's business activity must directly accomplish an exempt purpose, independently of how it may use its profits.<sup>77</sup> This is ordinarily the case with organizations such as hospitals, schools, and religious publishers. It is not ordinarily the case with steel mills, automobile manufacturers, and night clubs.<sup>78</sup>

An exempt organization whose activities directly accomplish an exempt purpose must finance its operations, including any planned expansion, in some manner. It costs money to run a hospital, a school, or a religious press. Nothing in section 501(c)(3) disqualifies an organization that chooses to finance its operations through charging fees for its goods and services, as long as any profits are used to further the organization's exempt purposes.

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nizations whose accumulations are for exempt purposes, such as expansion. The Service acknowledged that expansion plans can justify accumulations by an exempt organization, when it approved the accumulation of profits for expansion by an exempt hospital. Rev. Rul. 69-545, 1969-2 C.B. 117, 118 (amplified by Rev. Rul. 83-157, 1983-2 C.B. 94).

76. A feeder organization is one that carries on a trade or business for a profit and pays all of its profits to one or more exempt organizations. I.R.C. § 502(a) (1982).

77. See Edward Orton, Jr., *Ceramic Found. v. Commissioner*, 56 T.C. 147, 161-62 (1971).

78. The typical steel mill, automobile manufacturer, or night club is not organized or operated for any of the exempt purposes enumerated in section 501(c)(3). On the other hand, the statutory focus on purposes, rather than activities, means that few kinds of business operations are inherently nonexempt. In this regard, see *Golden Rule Church Ass'n v. Commissioner*, 41 T.C. 719, 731 (1964), holding that a church subsidiary that operated several businesses was exempt. The church's businesses included a sawmill, a resort, a laundry, a ranch, and a nursery, all of which were operated to demonstrate that the church's teachings were applicable to the business world. *Id.* at 723-24. The court was influenced, however, by the fact that the business operations were consistently non-profitable. *Id.* at 730-31.

*B. The Approach Places an Unwarranted Emphasis on Competition with Nonexempt Organizations*

One of the factors frequently mentioned by the courts as evidence of a nonexempt commercial purpose is competition with nonexempt, for-profit enterprises.<sup>79</sup> The importance of such competition may loom even larger as a practical matter than as a theoretical one. For example, the Service regularly challenges the exempt status of religious publishers, which have considerable competition from nonexempt publishers.<sup>80</sup> By contrast, exempt organizations just as commercially engaged as religious publishers, but with little or no competition from nonexempt organizations, are seldom if ever challenged by the Service because of their business activities. Hospitals,<sup>81</sup> and educational organizations such as schools, colleges, professional and trade schools,<sup>82</sup> and museums, zoos, planetariums, and symphony orchestras, normally charge fees for their goods and services. Yet the Service rarely, if ever, contends that one of these organizations fails to satisfy the operational test of section 501(c)(3) because it has a nonexempt purpose of operating a business for profit. This is true even though a major hospital or university may be much more efficient and business-like (that is, have more commercial characteristics) than a small, struggling religious press. The difference in treatment appears to result from the fact that hospitals, schools, and museums have relatively few nonexempt competitors, whereas religious publishers have many.

Apparently the Service is not troubled by organizations with commercial hues when they are engaged in fields that traditionally have been considered charitable. But similar commercial hues do trouble the Service when exhibited by organizations engaged in fields where operation of businesses for the private

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79. See, e.g., *Scripture Press Found. v. United States*, 285 F.2d 800, 806 n.11 (Ct. Cl. 1961), cert. denied, 368 U.S. 985 (1962); *Presbyterian & Reformed Publishing Co. v. Commissioner*, 79 T.C. 1070, 1085 (1982), appeal docketed, No. 1759-81X (3d Cir. Dec. 23, 1982); *Plumstead Theatre Soc'y, Inc. v. Commissioner*, 74 T.C. 1324, 1332 (1980), aff'd, 675 F.2d 244 (9th Cir. 1982); *Pulpit Resource v. Commissioner*, 70 T.C. 594, 611 (1978); *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352, 358 (1978).

80. See *supra* notes 33-55 and accompanying text.

81. See discussion of Rev. Rul. 69-545, 1969-2 C.B. 117 and Rev. Rul. 83-157, 1983-2 C.B. 94, *supra* notes 66-70 and accompanying text. The hospital ruled exempt in Rev. Rul. 83-157 furnished its services only to those who were able to pay for them, and operated at a profit.

82. All these kinds of organizations are listed in Treas. Reg. § 1.501(c)(3)-1(d)(3)(ii) (1960) as types of exempt educational organizations.

benefit of their owners is the norm. The reason may be nothing more than an instinctive reaction. A school or hospital has no trouble with the Service because Service officials are accustomed to thinking of schools and hospitals as exempt, whereas a religious publisher has difficulties because Service officials think of publishing houses as commercial enterprises operated for the private benefit of their owners. This suggests the rather strange possibility that if, for example, hospitals organized and operated for the profit of their owners should eventually become the norm, exempt hospitals will be in danger of losing their exemptions, even if their activities and purposes have not changed in the least.<sup>83</sup>

When Congress enacted the tax on unrelated business income<sup>84</sup> in 1950, it did so with the purpose of curbing what it perceived as unfair business competition between exempt and nonexempt organizations.<sup>85</sup> Prior to 1950, exempt organizations paid no federal income tax on their income from businesses, even if the business activities had no substantial relation to the accomplishment of their exempt purposes.<sup>86</sup> Nonexempt competitors complained that tax exemption on business profits gave the exempt organizations an unfair competitive advantage.<sup>87</sup> Exempt organizations could use the profits they did not pay in taxes to cut prices or to expand their business operations. Concerned with the problem of unfair competition, Congress imposed a tax on the unrelated business income of exempt organizations. The tax does not apply, however, to profits from a business if the business activities are substantially related to the

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83. *But see* Clark, *Does the Nonprofit Form Fit the Hospital Industry?*, 93 HARV. L. REV. 1417 (1980) (raising the possibility that the nonprofit form actually fits no hospitals). *Cf.* BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, NATIONAL DATA BOOK AND GUIDE TO SOURCES STATISTICAL ABSTRACT OF THE UNITED STATES: 1984, at 113 (104th ed. 1983). Nongovernmental nonprofit hospitals (nonprofit in the sense of not being operated for the private benefit of their owners) outnumbered for-profit hospitals, 3,339 to 730, in 1980. *Id.* For-profit hospitals had 87,000 beds in 1980, compared with 693,000 beds for nongovernmental nonprofit hospitals. *Id.* The number of for-profit beds increased at a faster rate than nonprofit beds between 1970 and 1980 (although the increase in for-profit beds was less in absolute numbers than the increase in nonprofit beds). *Id.* In 1970 for-profit beds numbered 53,000, while nongovernmental nonprofit beds numbered 592,000. *Id.*

84. I.R.C. §§ 511-14 (1982).

85. *See infra* note 89.

86. The most celebrated example was New York University's noodle factory, which was the subject of *C. F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951).

87. Eliasberg, *Charity and Commerce, Section 501(c)(3): How Much Unrelated Business Activity?*, 21 TAX L. REV. 53, 74-76 (1965).

accomplishment of the organization's exempt purposes.<sup>88</sup> According to the Treasury Department, "[t]he primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete."<sup>89</sup>

A logical inference is that the unrelated business income provisions embody Congress' entire response to the unfair competition problem, and that the Service and the courts should not try to inject unfair competition considerations into interpretations of section 501(c)(3). If a business does not generate an unrelated business income tax because its conduct is substantially related to the accomplishment of an organization's exempt purposes, that business should not endanger the organization's exempt status under section 501(c)(3). Congress determined that, whatever problems of unfair competition were caused by substantially related businesses, they were not sufficient to justify taxing those businesses. The legislative history of the Tax Reform Act of 1969 so states: "A business competing with tax-paying organizations should not be granted an unfair competitive advantage by operating tax free *unless the business contributes importantly to the exempt function.*"<sup>90</sup> Thus, the competitive advantage of a business that contributes importantly to the exempt function has been sanctioned by Congress; such a business is not subject to the tax on unrelated business income. If the competition problems are insufficient to justify a tax on the profits of a substantially related business, they are certainly insufficient to justify a complete denial of exemption.<sup>91</sup>

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88. I.R.C. § 513(a) (1982). The conduct of a business is not substantially related to the accomplishment of an organization's exempt purposes merely because the organization devotes the profits from the business to exempt purposes. *Id.* See *supra* notes 17-19 and accompanying text.

89. Treas. Reg. § 1.513-1(b) (1976). For legislative history indicating Congress' concern with unfair competition in enacting the tax on unrelated business income, see S. REP. NO. 2375, 81st Cong., 2d Sess. 36 (1950), *reprinted in* 1950-2 C.B. 483, 504; H.R. REP. NO. 2319, 81st Cong., 2d Sess. 36 (1950), *reprinted in* 1950-2 C.B. 380, 408.

90. H.R. REP. NO. 413, 91st Cong., 1st Sess. 44, 50, *reprinted in* 1969 U.S. CODE CONG. & AD. NEWS 1645, 1695 (emphasis added). The Tax Reform Act of 1969 expanded the categories of exempt organizations subject to tax on their unrelated business income.

91. An attractive feature of the tax on unrelated business income is that it permits a compromise, rather than an all-or-nothing result. The Service and the courts may feel less need to deny exempt status to organizations engaged in unrelated businesses when they can simply tax the unrelated business income. The regulations state that an unre-

The approach of the Service and of some courts goes beyond the line that Congress has drawn. They have attempted to eliminate unfair competition from substantially related businesses by totally denying exempt status to organizations engaged in those businesses. This distorts the intent of Congress by giving related business, which can cause total denial of an exemption, less favorable treatment than unrelated business, which generally prompts only a tax on the unrelated business income. It also ignores the fact that Congress may have had good policy reasons for not acting to remove unfair competition caused by related businesses.

By granting exempt status and eligibility to receive deductible contributions to organizations organized and operated exclusively for exempt purposes, Congress made a conscious decision to favor those organizations. Congress may well have decided to favor those organizations even when there are nonexempt commercial enterprises engaged in the same fields. Tax exemption may be a competitive advantage if there are commercial competitors, but it is an advantage Congress fully intended to bestow. Perhaps Congress believed that the exempt purposes enumerated in section 501(c)(3) would be better accomplished by organizations whose assets were irrevocably dedicated to exempt purposes,<sup>92</sup> than by organizations designed to earn profits for the private benefit of their owners.

When exempt organizations engage in unrelated business activity, they are invading the domain of ordinary commercial

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lated business will cause denial of exempt status only if operation of the unrelated business is the organization's primary purpose. Treas. Reg. § 1.501(c)(3)-1(e)(1) (1960). (One commentator has suggested that no amount of unrelated business activity should ever lead to denial of exempt status. Eliasberg, *supra* note 87, at 100.) The result, then, is that the organization is taxed on its unrelated business income, but it is not taxed on other income, and it is eligible to receive tax-deductible charitable contributions. No such compromise is possible in the case of substantially related businesses. Since no tax is authorized under I.R.C. §§ 511-14, it is still all or nothing. That is apparently because Congress did not feel the need for any compromise in that area; complete exemption for organizations carrying on substantially related businesses was considered appropriate. In this regard, see Note, *The Macaroni Monopoly: The Developing Concept of Unrelated Business Income of Exempt Organizations*, 81 HARV. L. REV. 1280, 1284 (1968), stating that continued tax exemption for income from substantially related businesses is consistent with the basic rationale of tax exemption. Apparently the Service and the courts are not so sure, since they continue to deny exempt status because of substantially related businesses.

92. See Treas. Reg. § 1.501(c)(3)-1(b)(4) (1960), stating that an organization is not organized exclusively for exempt purposes unless its assets are irrevocably dedicated to exempt purposes.

enterprises, and they are entitled to no competitive advantage. But when ordinary commercial enterprises engage in businesses that can directly accomplish an exempt purpose—such as operating a hospital, a school, or a religious press—they have entered the sphere within which Congress has acted to favor exempt organizations. The exempt organizations may have a competitive advantage, but that is the price their commercial competitors must pay for seeking private gain in fields such as charity, education, and religion.<sup>93</sup> The commercial enterprises, not the exempt organizations, are the interlopers. Thus, the existence of commercial enterprises in competition with the substantially related business of an exempt organization should not affect the organization's exempt status.

Even if there were a legitimate concern about unfair competition from substantially related business activities of exempt organizations, the current approach of worrying about competition only in fields where nonexempt commercial competitors are flourishing is, precisely backwards. If there is a competitive advantage to tax exemption, it is probably greatest in those areas—such as education—in which there are few or no commercial competitors. The advantages of tax exemption may have made it difficult for commercial competitors to enter or remain in those fields. But in areas such as religious publishing, in which commercial competitors are flourishing, it appears that tax exemption has not seriously inconvenienced commercial competitors. If the presence or absence of commercial competition were a legitimate factor in determining an organization's qualifications for exemption, it would be the absence of competition, not its presence, that would make the organization's qualifications suspect.

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93. There is some question as to whether tax exemption really constitutes a competitive advantage. The supposed advantage of being able to cut prices has been questioned in Note, *Colleges, Charities, and the Revenue Act of 1950*, 60 YALE L.J. 851, 875-76 (1951). The Note argues that it is unlikely that exempt organizations, which are usually clamoring for funds, will forego current income in the hope that they can drive out nonexempt competition after a lengthy price war. The supposed advantage of being able to use untaxed profits for expansion has also been disputed in Note, *Preventing the Operation of Untaxed Business by Tax-Exempt Organizations*, 32 U. CHI. L. REV. 581, 591-92 (1962). According to the Note, the ability of an exempt organization to accumulate funds faster than a nonexempt organization affords no competitive advantage. If an opportunity for profitable expansion exists, taxed businesses can obtain funds in money and capital markets. Professor Bittker notes that, apparently, no empirical studies have been done on the question of whether tax exemption actually results in unfair competition. 4 B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 103.3 n.3 (1981).

Finally, it should be remembered that Congress retains the power to deny exempt status to organizations engaged in particular kinds of business activities, if Congress decides that the interests of commercial competitors so warrant. In *HCSC-Laundry v. United States*,<sup>94</sup> the Supreme Court interpreted section 501(e) as embodying a congressional decision, made at the urging of commercial laundries, to deny exempt status to cooperative hospital laundry services.<sup>95</sup> If such responses are needed in particular instances, they should be made by Congress, not by the Service or by the courts.

### C. *The Approach Wrongly Penalizes Efficiency and Success*

The characteristics that the Service and the courts object to as evincing a commercial hue are often nothing more than the necessary attributes of any efficient and successful large-scale activity, whether charitable or commercial. The smaller, less efficient, and less successful an organization, the better its chances of being recognized as exempt.<sup>96</sup>

In *Plumstead Theatre Society, Inc. v. Commissioner*,<sup>97</sup> the Tax Court issued a ringing rejection of the Service's contention that activities of a theater society, such as advertising in newspapers, selling tickets, and using professional actors, gave the society a forbidden commercial purpose. The court stated: "Nothing in section 501(c)(3) dictates that the public find out about petitioner's performances through word of mouth, that they be forced to watch amateurs act, or that they be seated totally free of charge."<sup>98</sup>

In *Presbyterian & Reformed Publishing Co. v. Commissioner*,<sup>99</sup> however, the Tax Court accepted the Service's argument that practices such as expanding operations by searching out new readers, acquiring a larger facility, and paying wages to workers and royalties to authors, were evidence of a forbidden commercial purpose. The court paid lip service to the idea that

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94. 450 U.S. 1 (1981).

95. *Id.* at 5-8.

96. The organizations whose exemptions may be spoiled by success are generally those with commercial competition. A major hospital or university may operate in an efficient, business-like manner without endangering its exemption; a religious publisher or a theatrical organization may not.

97. 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982).

98. *Id.* at 1332.

99. 79 T.C. 1070 (1982), *appeal docketed*, No. 1759-81X (3d Cir. Dec. 23, 1982).

expansion could be for exempt purposes, and purported to reject the Service's implication that efficiency and success automatically negate exempt status.<sup>100</sup> Nevertheless, the court treated the organization's efficiency and success as factors weighing against exemption.<sup>101</sup>

The perversity of this attitude is apparent. Nothing in section 501(c)(3) suggests that organizations are entitled to exemptions only as long as they are small, struggling, and inefficient. The larger, more successful, and more efficient an organization, the better it can carry out its exempt purposes. It should not be penalized for its success. The Service is not likely to revoke Harvard University's exemption because it is too large, successful, business-like, and efficient; the Presbyterian and Reformed Publishing Company should be dealt with by the Service on the same basis as Harvard University.

*D. The Approach Allows the Service and the Courts to  
Second-Guess Financial Policy Decisions That Should Have  
No Bearing on Tax Exempt Status*

Always pricing goods or services at or above cost is, according to several court opinions, substantial evidence of a commercial purpose.<sup>102</sup> This close questioning of financial policy decisions is a good example of what is wrong with the prevailing approach to exempt organizations operating businesses substantially related to the accomplishment of their exempt purposes.

It would be consistent with operation exclusively for exempt purposes for an organization to sell its goods and services below cost, so that all persons who could benefit from those goods or services could afford them. It would also be consistent with operation exclusively for exempt purposes always to charge at or above cost, so that the organization could be assured of enough revenue to carry on its operations, to weather future financial stringencies, or to expand to accomplish its exempt purposes on a larger scale. Either pricing policy is consistent with operation exclusively for exempt purposes. Which policy is best for a given

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100. *Id.* at 1087.

101. *Id.* See *supra* text accompanying notes 35-55.

102. *American Inst. for Economic Research v. United States*, 302 F.2d 934, 938 (Ct. Cl. 1962); *Presbyterian & Reformed Publishing Co. v. Commissioner*, 79 T.C. 1070, 1084 (1982), *appeal docketed*, No. 1759-81X (3d Cir. Dec. 23, 1982); *Peoples Translation Serv. v. Commissioner*, 72 T.C. 42, 50 (1979); *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352, 359-60 (1978).

organization is a question that those in control of the organization are especially well suited to answer, and that the Service and the courts are especially ill-suited to answer.

Why then have such pricing policies become a concern of the Service and the courts? They have assumed that any policy typical of a commercial enterprise—such as always pricing above cost—is a mark against exempt status, without even considering whether that policy might also be one that an exempt organization might use in pursuing its exempt purposes.

The Service and the courts should stop asking the irrelevant question of whether an organization's practices happen to resemble those of a commercial enterprise, and start asking the relevant question of whether an organization's practices are consistent, in the context of that organization, with operation exclusively for exempt purposes.

### III. CONCLUSION

Section 501(c)(3) does not justify the approach that the Service and the courts have taken in searching out supposed nonexempt commercial purposes in organizations operating businesses that directly accomplish exempt purposes. If the following two requirements are satisfied, the Service and the courts should not object that an exempt organization operates a business as its sole or primary activity. The first requirement is that the operation of the business directly accomplish exempt purposes, and the second requirement is that any profits be used for exempt purposes. If those two requirements are satisfied, there can be no valid objection under section 501(c)(3) to an exempt organization's business activities.

The resistance to such business activities of exempt organizations is typified by *Fides Publishers Association v. United States*.<sup>103</sup> In *Fides*, the court remarked that if an organization that publishes and sells religious literature at a profit is exempt, then "every publishing house would be entitled to an exemption on the ground that it furthers the education of the public."<sup>104</sup> This is wrong on two counts. First, it incorrectly assumes that everything that is published is educational within the meaning of section 501(c)(3).<sup>105</sup> Second, and more important, it ignores

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103. 263 F. Supp. 924 (N.D. Ind. 1967).

104. *Id.* at 935.

105. Although it ruled that the definition of education in Treas. Reg. § 1.501(c)(3)-

the requirement that an exempt organization's earnings must not inure to the benefit of any private individual. Not every publishing house would be exempt under the approach of this article because not every publishing house publishes only educational material, and because not every publishing house devotes its profits exclusively to exempt uses. Thus, there is no basis for the fear expressed by the *Fides* court. True, every publishing house that published only educational material and used all its profits for exempt purposes could qualify for exemption, but there is no abuse of exempt status in that. That is no more objectionable than the fact that all hospitals and universities can qualify for exemption if they devote their earnings solely to exempt purposes. Such a result is entirely consistent with the congressional purpose behind section 501(c)(3).

An organization that operates a business directly accomplishing exempt purposes, and that devotes all profits from that business to exempt purposes, does not serve mammon. Its only master is an exempt one. It is operated exclusively for exempt purposes, and it should be eligible for tax exempt status as an organization described in section 501(c)(3) of the Internal Revenue Code.

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1(d)(3) was unconstitutionally vague, the court in *Big Mama Rag, Inc. v. United States*, 631 F.2d 1030 (D.C. Cir. 1980) noted that "we by no means intend to suggest that tax-exempt status must be accorded to every organization claiming an educational mantle." *Id.* at 1040.