Presbyterian & Reformed Publishing Co. v. Commissioner, T.C. Memo. 1984-128

An organization initially granted tax-exempt status under section 501(c)(3) can have that status revoked retroactively if it is found to be operating with a substantial non-exempt commercial purpose, thereby failing the operational test for exclusive dedication to exempt purposes.

Summary

Presbyterian & Reformed Publishing Co. (Petitioner), initially granted tax-exempt status in 1939, challenged the Commissioner's retroactive revocation of its exempt status effective January 1, 1969. The IRS argued that Petitioner was not operated exclusively for exempt purposes under section 501(c)(3) but was engaged in business activities similar to commercial enterprises. The Tax Court upheld the revocation, but modified the retroactive date to January 1, 1975. The court found that while Petitioner had religious purposes, its substantial and increasing profits from book sales, pricing policies, competition with commercial publishers, and operational expansions demonstrated a substantial commercial purpose that was not merely incidental to its exempt religious mission. The court concluded that by 1975, Petitioner's operations had materially changed, justifying the revocation from that later date.

Facts

Petitioner was incorporated in 1931 with the stated purpose of publishing religious materials aligned with Presbyterian doctrine. It received tax-exempt status in 1939 based on its activities of publishing a religious paper. Initially, operations were small-scale and volunteer-based, with minimal profits. However, starting around 1969, Petitioner's book sales and profits grew significantly. Net profits from book sales increased dramatically from $3,105 in 1969 to over $100,000 by 1975, with substantial cash reserves accumulating. Petitioner expanded its operations, hired paid staff, and purchased a new office and warehouse facility. Its pricing policy was designed to consistently generate profits, and it competed with commercial religious publishers. While some books were published despite low sales projections and donations were made to religious causes, the court found the overall operation increasingly resembled a commercial enterprise.

Procedural History

In 1939, the IRS granted Petitioner tax-exempt status. In 1976, the IRS began reviewing Petitioner's exempt status, requesting additional information. In 1978, the District Director informed Petitioner of a potential revocation. On October 28, 1980, the IRS issued a final revocation letter, retroactively revoking the exemption to January 1, 1969. Petitioner challenged this revocation in Tax Court, seeking a declaratory judgment under section 7428.

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Issue(s)

1. Whether Petitioner was operated exclusively for exempt purposes within the meaning of section 501(c)(3).
2. If Petitioner was not operated exclusively for exempt purposes, whether the Commissioner abused his discretion in making the revocation retroactive to January 1, 1969.

Holding

1. No, for tax years from 1975 onwards. The Tax Court held that from 1975, Petitioner was not operated exclusively for exempt purposes because a substantial non-exempt commercial purpose predominated its operations.
2. Yes, in part. The Commissioner abused his discretion in making the revocation fully retroactive to January 1, 1969, but not in making it retroactive to January 1, 1975. The revocation was deemed appropriately retroactive to January 1, 1975, as a material change in operations occurred by then.

Court's Reasoning

The court applied the operational test, stating, "the purpose towards which an organization's activities are directed, and not the nature of the activities themselves, is ultimately dispositive." It emphasized that the presence of a "single * * * [nonexempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly * * * [exempt] purposes," citing *Better Business Bureau v. United States*. The court found several factors indicating a substantial commercial purpose:

- **Substantial Profits:** Petitioner's net profits grew dramatically, indicating a commercial character.
- **Pricing Policy:** Petitioner priced books to consistently generate profits, ensuring sales were never below cost, leading to "sizable net profit margins."
- **Competition with Commercial Publishers:** Petitioner competed in the market for religious literature, further suggesting a commercial purpose.
- **Operational Changes:** Petitioner adopted more aggressive commercial practices, including hiring paid workers, expanding facilities, and seeking more readers.

While acknowledging Petitioner's religious mission and some non-profit-oriented activities, the court concluded, "petitioner's substantial, and indeed, primary purpose was the nonexempt one of selling religious literature at a profit." Regarding retroactivity, the court found a material change in operations by 1975, justifying revocation from that date, but not from 1969, as the commercial character became demonstrably substantial by 1975.

Practical Implications

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This case clarifies that religious organizations engaged in publishing or other commercial activities must ensure their operations are primarily and consciously directed towards their exempt purpose, with commercial aspects being incidental. Substantial profits, pricing strategies, and operational methods that mirror commercial enterprises can jeopardize tax-exempt status, even for organizations with genuine religious goals. The case highlights the importance of maintaining a clear distinction between furthering exempt purposes and operating a business for profit, especially as an organization grows and becomes more successful. It also underscores the IRS's authority to retroactively revoke tax-exempt status when an organization's operations materially deviate from its originally represented exempt purpose, although such retroactivity may be limited to the date of material change.

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