Phi Delta Theta Fraternity v. Commissioner, 90 T. C. 1033 (1988)

Net investment income from a fraternity's endowment fund used to publish a magazine primarily for members is taxable as unrelated business income if the magazine's purpose is not exclusively educational.

Summary

Phi Delta Theta Fraternity, a tax-exempt organization under IRC section 501(c)(7), challenged the IRS's determination that the net investment income from its endowment fund, used to publish its magazine 'The Scroll,' was taxable as unrelated business income. The Tax Court held that the magazine's primary purpose was to disseminate fraternity news to its members, not to serve an exclusively educational purpose as required by IRC section 170(c)(4). Consequently, the net investment income was taxable because it was not set aside for an exempt purpose.

Facts

Phi Delta Theta Fraternity, a not-for-profit corporation and national office of a college men's fraternity, is exempt from federal income tax under IRC section 501(c)(7). The fraternity owns the Frank J. R. Mitchell Scroll Endowment Fund, which finances the publication of its magazine, 'The Scroll. ' The magazine, published since 1878, is distributed to approximately 60,000 recipients, primarily alumni and undergraduate members, with some copies sent to libraries and universities. The Scroll's content includes articles on successful alumni, fraternity news, and occasional educational pieces on topics like drug abuse. The net investment income from the endowment fund for the taxable year ending June 30, 1979, was $114,637, with $96,374. 21 used to cover the magazine's expenses.

Procedural History

The IRS issued a statutory notice on March 3, 1986, determining a deficiency in Phi Delta Theta's federal income tax for the taxable year ending June 30, 1979. Phi Delta Theta filed a petition with the United States Tax Court, contesting the IRS's determination that the net investment income from the Scroll Fund was taxable as unrelated business income. The Tax Court held that the income was taxable, and a decision was entered for the respondent.

Issue(s)

1. Whether the magazine 'The Scroll' was published for one of the exempt purposes specified in IRC section 170(c)(4).
2. Whether the net investment income of the Scroll Fund was set aside under IRC section 512(a)(3)(B) for an exempt purpose.

Holding

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1. No, because the primary purpose of ‘The Scroll’ was to disseminate fraternity news to its members, not to serve an exclusively educational purpose as required by IRC section 170(c)(4).
2. Due to the holding on the first issue, it was unnecessary to determine whether the funds were ‘set aside’ under IRC section 512(a)(3)(B).

Court’s Reasoning

The Tax Court applied the legal rule that income from an exempt organization’s endowment fund is taxable as unrelated business income unless it is set aside for a purpose specified in IRC section 170(c)(4). The court analyzed the content and purpose of ‘The Scroll,’ finding that its primary focus was on fraternity news and the achievements of its members, rather than providing instruction or training to develop capabilities or benefit the community. The court referenced the regulation defining ‘educational’ under IRC section 501(c)(3) and case law indicating that an educational purpose must be the substantial purpose of the organization. The court rejected the testimony of the fraternity’s expert witness, who argued that the magazine was 85% educational, stating that the magazine’s content did not directly instruct or train its members or the public. The court also noted that the magazine was primarily distributed to members, not the general public, further supporting its conclusion that the magazine’s purpose was not exclusively educational.

Practical Implications

This decision impacts how tax-exempt organizations, particularly fraternities and similar groups, should analyze the tax treatment of income from endowment funds used for publications. It clarifies that for income to be exempt, the publication must serve an exclusively educational purpose, not merely provide information to members. Legal practitioners advising such organizations should ensure that any publications funded by endowments are designed to meet the educational criteria set forth in IRC section 170(c)(4). The ruling also has implications for how similar cases involving the tax status of income from member-focused publications are analyzed, potentially affecting the tax strategies of other not-for-profit organizations. Subsequent cases have applied this ruling to determine the taxability of income from various types of organizational publications.

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