

## O. UBIT: CURRENT DEVELOPMENTS

by

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### 1. Introduction

The area of unrelated business income tax ("UBIT") continues to be both challenging and ever changing. In recent years, our CPE texts have contained various articles devoted to individual aspects of UBIT, such as royalties, associate member dues, sale of land, travel tours and corporate sponsorship.<sup>1</sup> These topics seem to be of perennial interest to exempt organizations and their representatives, who are interested in minimizing any potential tax liability through utilization of the many exceptions and modifications contained within the statutory construct. As organizations seek to uncover new sources of revenue to meet increasing needs, some of the more basic concepts within UBIT, such as what is a "trade or business" and whether an activity meets the "substantially related" test, merit renewed attention.

The purpose of this topic is to update previous CPE text discussions concerning a wide range of developments in the UBIT area. This topic will focus on relatively recent judicial opinions and administrative actions. These decisions have been grouped into such areas of interest as royalties, mailing lists and "affinity" credit cards, associate member dues, advertising, sale of real estate, and certain other activities, including insurance, museum gift shop sales and travel programs.

### 2. Sierra Club ("SC")

On June 20, 1996, the Court of Appeals for the Ninth Circuit decided Sierra Club, Inc. v. Commissioner, 1996 U.S. App. LEXIS 14869 ("SC III.") Confirming the Service's position that there is a distinction between payments for services and payments for the right to receive an intangible property right, the court held that royalties in IRC 512(b)(2) are defined as payments received for the right to use intangible property rights, and that royalties do not include payments for services. Based on this definition, the Court of Appeals upheld the decision of the Tax Court and found that income from mailing list rentals

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Proposed regulations addressing corporate sponsorship have not yet been finalized. See Prop. Treas. Regs. 1.513-4.

constituted royalty income. The Ninth Circuit also reversed and remanded to the Tax Court the issue of whether SC received royalty income from an affinity credit card program.

#### A. Background

IRC 512(b)(2) excludes royalties from the computation of unrelated business taxable income. However, the term "royalty" is defined in neither the statute nor the regulations. Reg. 1.512(b)-1 states generally that whether a particular item of income falls within any of the modifications provided in IRC 512(b) shall be determined by all the facts and circumstances in each case. More specific guidance as to the definition of a royalty can be found in Rev. Rul. 81-178, 1981-2 C.B. 135, which states the following:

Payments for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property, are ordinarily classified as royalties for federal tax purposes.... Similarly, payments for the use of a professional athlete's name, photograph, likeness, or facsimile signature are ordinarily characterized as royalties.... On the other hand, royalties do not include payments for personal services.

As discussed in the 1994 CPE text at p. 114, SC is an organization described in IRC 501(c)(4) that was formed to protect and restore the natural and human environment and promote responsible use of the earth's ecosystem. SC maintains mailing lists complete with donor and member information. To expand its data bank, SC exchanged its lists with other organizations. In addition, it permitted other organizations to use its lists for a fee. Although SC contracted with others to maintain and administer the rentals, it set the rates for the list rentals and retained the right to review and approve all rental requests as well as proposed materials and schedules for user mailings.

In addition to revenues received from renting out its mailing list, SC also derived income from an affinity credit card program. Pursuant to agreements with commercial enterprises, the organization's name and logo were used in marketing a credit card. In the Service's view, SC actively endorsed and marketed the credit card, while retaining rights to approve all promotional material. Fees were paid to the organization based on the total sales volume generated by cardholders. Solicitations for the credit card were sent by mail to the organization's members under the SC letterhead. The organization disagreed with the Service's conclusion that the amounts in question constituted unrelated business taxable income.

SC brought action in the Tax Court with respect to amounts attributable to both mailing lists and affinity credit cards.

### B. Mailing Lists

The Service has taken the position that income from the regular sale of membership mailing lists by an exempt organization is subject to the unrelated business income tax and is not a royalty under IRC 512(b)(2). The Tax Court, however, has not adopted this position. In Sierra Club, Inc. v. Commissioner, T.C. Memo. 1993-199 ("SC I"), the Tax Court held that the exchange of mailing lists, regardless of the tax status of the organizations involved, is a transaction which produces royalty income that is excludable from unrelated business taxable income. The Service argued that the legislative history of the unrelated business income tax indicated that only investment income was intended to be excluded as a royalty under IRC 512(b)(2). The Service also argued that IRC 513(h)(1)(B), while not generally applicable to IRC 501(c)(4) organizations, revealed Congressional intent that income received from mailing lists constituted unrelated business taxable income, absent an explicit exemption. IRC 513(h)(1)(B) states that exchanges or rentals of mailing lists between organizations, both of which are eligible to receive tax deductible contributions, do not constitute unrelated trade or business. Thus, an exchange of mailing lists between two IRC 501(c)(3) entities is not taxable. If, however, the exchange is, for example, between an IRC 501(c)(3) organization and an IRC 501(c)(6) entity, the exception is not available because the former may receive deductible contributions, but the latter may not. (For a more detailed review of the taxability of mailing lists, see the 1993 CPE text at p. 69.)

Notwithstanding the holding of the Tax Court in SC I, the Service's administrative position did not change. The continuity of this position is evidenced by TAM 95-02-009 (November 10, 1994), which held that the exchange of mailing lists between a nonprofit and other organizations generates unrelated business taxable income. This case involved an organization described in IRC 501(c)(4) that made its mailing list available on a reciprocal basis to other organizations. It used a commission paid broker for this purpose. The organization, whose mailing list was one of its most important assets, employed five individuals to maintain the list, remove stale names and add new ones. Because the exchange was not between exempt organizations to which contributions are deductible, the IRC 513(h)(1)(B) exception did not apply. The TAM concluded that the provision of mailing lists for a fee, whether for a cash payment or something of value, does not further exempt purposes. The TAM cited Disabled American Veterans v. United States, 227 Ct. Cl. 474, 650 F.2d 1178 (Ct. Cl. 1981) ("DAV I") and found that the extensive business activity in question precluded royalty treatment.

### C. Affinity Credit Cards

One year after the Tax Court's opinion in SC I concerning mailing lists, the Tax Court addressed the issue of "affinity" credit cards. In Sierra Club, Inc. v. Commissioner, 103 T.C. 307 (1994) ("SC II"), the Tax Court held that the revenue from an affinity credit card program did not constitute unrelated business income. Such credit card programs typically involve agreements between a for-profit and an exempt organization. Pursuant to one or more agreements, an exempt organization will authorize a credit card issuer to use the organization's name and logo in marketing the card to the organization's members along with access to the organization's mailing list. In return, the issuer typically pays a fee to the exempt organization.

In SC II, as noted earlier, the organization entered into an arrangement with American Bankcard Services (ABS) under which ABS would offer a credit card using SC's name and logo in marketing the credit card to SC members and supporters. ABS agreed to pay SC a fee based on the total sales volume generated by cardholders. SC also entered into an agreement with Chase Lincoln Bank, which would issue the credit cards, and SC would actively endorse and market the cards. Card solicitations were mailed to SC members under the SC letterhead, and SC retained rights to approve all promotional material. After examining the business activities of SC, the Tax Court concluded that no joint venture existed and that SC was not engaged in the business of selling financial services to its members. Further, the Tax Court concluded that revenues received by SC as part of its affinity card program were not received as compensation for services, but as payment for an intangible property right. Such compensation therefore constituted royalty income under IRC 512(b)(2).

In Alumni Association of the University of Oregon, Inc. v. Commissioner, T.C. Memo. 1996-63, the Tax Court adhered to its position that income produced from an affinity credit card program constitutes royalty income. The Tax Court held that a university alumni association's income from an affinity credit card program was royalty income and, as such, not unrelated business income.<sup>2</sup> The Alumni Association (the "Association") participated in an affinity credit card program to promote the University of Oregon among alumni and the general public, to provide a low cost credit card to alumni and University of Oregon supporters, and to provide revenue for its programs. The Association entered into an agreement with the United States National Bank ("USNB"), under which USNB agreed to provide announcements regarding activities and alumni

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The facts, analysis and conclusion in this case are essentially identical to those in Oregon State University Alumni Association, Inc. v. Commissioner, T.C. Memo. 1996-34.

news at USNB's expense and to place a full color advertisement in the Association's publication at the standard rate at least twice annually during the term of the agreement. In return, USNB received a list of names, addresses and graduation dates of alumni and the license to use the name, logo and official seal of the University of Oregon. In addition, the Association agreed to inform its members of the affinity credit card program, at its expense, at least once per year.

The court concluded that USNB paid for a valuable intangible property right, i.e., the Association's logo, a registered trademark. In doing so, the court distinguished DAV I, where the court held that the organization conducted a trade or business of renting its mailing list. DAV continuously rented its mailing list and employed two full-time employees to administer its rental lists. In contrast, the Association did not regularly rent its mailing list and devoted minimal time to the affinity card program. Finally, although the Association had a desire and intent to make money, it is not the expectation of gain which is dispositive, but whether a taxpayer engages in an "activity with continuity and regularity, and the primary purpose for engaging in the activity must be for profit."

The Service's administrative approach in the area of affinity credit cards can be found in TAM 95-09-002 (September 30, 1994). This case involved an organization described in IRC 501(c)(6), whose members were in a certain field of medical practice, and which had an affinity credit card program. For this purpose, the organization agreed to make its mailing list available to another entity three times per year, as well as actively promote the affinity card program among its members for a fee. The TAM concluded that such payments were not royalties and constituted unrelated business taxable income, based on the active promotion of the lists among the organization's members.

#### D. Court of Appeals Decision

In SC III, supra, the Court of Appeals for the Ninth Circuit took the opportunity to define "royalty." The Ninth Circuit first reviewed various definitions of royalties, including definitions from Webster's, Black's Law Dictionary and Rev. Rul. 81-178, supra. The court, however, was persuaded by the decisions of other courts, including DAV I, and Texas Farm Bureau v. United States, 53 F.3d 120 (5th Cir. 1995), Section 7, infra, which distinguished between payments for services and payments for the right to use an intangible property right. In addition, the court considered the purpose behind the unrelated business income tax. It noted that the tax, intended to level the playing field between exempt and taxable businesses, excludes categories of income "passive" in nature and hence less likely to create competition for taxable businesses.

Addressing the mailing list issue first, the Court of Appeals affirmed the Tax Court decision and concluded that SC received royalty income. In so concluding, the court noted that SC neither performed services relating to the mailing list rental nor marketed the mailing lists. SC merely collected a fee for the mailing list rental. The court, rejecting the argument that any active marketing activity would convert a royalty into a non-royalty, specifically noted that SC's activity in connection with the rental of its mailing list was substantially less than the amount of activity which other courts had found to preclude a finding of royalty income: "To hold otherwise would require us to hold that any activity on the part of the owner of intangible property to obtain a royalty renders the payment for the use of the right UBTI and not a royalty."

The Ninth Circuit's decision leaves unanswered the question of what services an exempt organization can perform in connection with mailing list rentals and still treat the income from them as royalty income. Although the court rejected the Tax Court's all inclusive definition of royalties as including "active" and "passive" income, it did not state what activities will cause an organization to have unrelated business taxable income. The court rejected the Government's argument that paying others to perform services does not change the reality that an exempt organization is engaged in the business of selling and marketing mailing lists. The court further ignored the significant review and approval rights maintained by SC.

The court in SC III also addressed the issue of whether income from an affinity credit card program constitutes unrelated business income. The Tax Court had earlier granted SC's motion for summary judgment on the question of whether income generated by the affinity card program constitutes royalties, concluding that the agreements entered into by SC were name and logo licensing agreements. Finding that the agreements were unclear as to whether they were licensing agreements or agreements for services, and that the Tax Court had failed to interpret the agreements in the light most favorable to the Service, the court reversed the partial grant of summary judgment and remanded the case to the Tax Court. As a result, we can anticipate at least an SC IV.

At the time this article was being prepared, no decision had been made as to what action, if any, the Government might take with respect to this case.

### 3. Other Royalty Issues

In PLR 95-52-019 (September 27, 1995), an IRC 501(c)(3) organization entered into an agreement whereby it was licensed, for a fee, to occupy land around a lake to be used for fishing. The organization planned to sell fishing

passes to the public and distribute revenue to its client social service and welfare agencies. Fishing passes entitled their owners to take fish, and to use parking and restroom facilities, a boat ramp and docks. The organization policed and supervised the area as well as provided utilities and trash removal. The ruling noted that the operation of the fishing facility was on a fee-for-service basis, with a fee charged that was similar to an admission fee to a private recreation center. The admission fee could not be characterized as a payment for the use of a valuable right, producing royalty income, but was more like a fee for the provision of services. Accordingly, the ruling concluded that the amounts in question constituted unrelated business taxable income.

PLR 95-03-024 (October 26, 1994) involved an IRC 501(c)(4) organization formed to participate in a federal program to provide certain groups in economically distressed Bering Sea coastal communities of Alaska with the opportunity to receive an allocation of the annual pollock fishing harvest off the coast of Alaska. The organization promoted the social welfare of the residents of the member communities. Pursuant to a requirement imposed by the State of Alaska, the organization entered into an agreement with an outside fish processing company whereby the company would harvest, process and market the quota in exchange for a royalty payment to the 501(c)(4). This company planned to make royalty payments based solely upon the number of metric tons of pollock harvested and a supplemental royalty amount based on the pollock roe produced and sold from the pollock harvest. The 501(c)(4) did not participate at all in harvesting, processing, or marketing. Relying on Rev. Rul. 81-178, *supra*, the ruling concluded that the revenues derived from the sale of the pollock allocation rights were royalties because they derived from the sale of a valuable right, and because the organization was not required to render any services in connection therewith.

#### 4. Associate Member Dues

Tax-exempt organizations may offer their members various products and services which are conditioned upon membership status. For example, it is not unusual for a tax-exempt organization that provides group insurance to offer associate or limited membership categories to individuals interested solely in insurance rather than full membership rights. (For a more detailed discussion of associate member dues, see the 1995 CPE text at p. 67.)

The application of the unrelated business income tax to exempt organizations with associate members has become a recurrent theme. Rev. Proc. 95-21, 1995-1 C.B. 686, discusses an organization described in IRC 501(c)(5) that received income from associate member dues. The revenue procedure provides

that dues payments from associate members will not be treated as gross income from the conduct of an unrelated trade or business unless the associate member category was formed or availed of for the principal purpose of producing unrelated business income. To make this determination, the line of inquiry will focus on the purposes and activities of the organization rather than of its members.

It is expected that additional guidance will be forthcoming regarding the treatment of associate member dues. The 1996 Treasury Department-Internal Revenue Service Priorities List for Tax Regulations and Other Administrative Guidance provides that guidance on the unrelated business income tax treatment of associate member dues paid to IRC 501(c)(6) organizations is a priority.

National League of Postmasters of the United States v. Commissioner, T.C. Memo. 1995-205, aff'd, 86 F.3d 59 (4th Cir. 1996) provides yet another example of the attention focused on unrelated business income and associate member dues. The National League of Postmasters of the United States (the "NLP") was formed to assist postmasters to improve professionalism and professional skills and to protect the employment rights of postmasters. The organization sponsored a health insurance plan available to all federal employees and retired federal annuitants eligible for benefits under the Federal Employees Health Benefits Program (the "FEHBP"). Because of restrictions against providing benefits to nonmembers, the NLP created a special class of members to whom it provided access to its health plan as well as certain other limited benefits. This special class received limited voting rights. The Tax Court focused on the issue of whether the trade or business of servicing this special class contributed importantly to the accomplishment of the organization's exempt purpose, so as to meet the "substantially related" test. It asked, "whether the manner in which petitioner conducted its ... activity during those years evinces its intention to use that activity for the purpose of contributing importantly to the accomplishment of any of its exempt purposes or whether that manner manifests its intention to raise revenue."

The NLP argued that since the members of the special class were in fact bona fide members of the NLP, that in itself would suffice to conclude that the dues it received during those years from the special class were not includable in unrelated business income. In making this argument the NLP relied on Rev. Rul. 62-17, 1962-1 C.B. 87, as well as National Association of Postal Supervisors v. United States, 944 F.2d 859, 861 (Fed. Cir. 1991) and American Postal Workers Union v. United States, 925 F.2d 480 (D.C. Cir. 1991).



The Tax Court, however, found that the authorities cited did not support the NLP's claim. First, Rev. Rul. 62-17 holds that the payment by a labor organization of health and other similar benefits to its individual members with funds contributed by its members would not preclude exemption of that organization as a labor organization under IRC 501(c)(5), provided that such benefits are paid under a plan that has as its objective the betterment of the conditions of its members. As such, the ruling was consistent with the court's application of the "substantially related" test of IRC 513(a) and Reg. 1.513-1(d)(2). Further, the court found that the cases cited could not be read as supporting the proposition that a labor organization's provision of health insurance to persons who are limited members will necessarily be substantially related to the accomplishment of its exempt purposes.

The court concluded that the activity conducted with respect to the special class of members was done in a manner suggesting an intent to raise revenue to support the NLP's main purpose of aiding postmasters, and hence was not substantially related to purposes for which it was granted exemption. The Tax Court's opinion is consistent with the Service's position.

The Service's position received further vindication with the Fourth Circuit's decision on June 14, 1996, upholding the Tax Court. The Court of Appeals concluded that the NLP's activities with respect to its associate members were not substantially related to the NLP's exempt purposes. In reaching its decision, the court rejected the argument that the NLP's purposes as set forth in its articles of incorporation were sufficiently broad to encompass non-postal federal employees. It found that the provision of health insurance, marketed in a commercial manner and available to retired federal employees who had never been NLP members, indicated that the provision of health benefits was not substantially related to improving the working conditions of associate members. Although the NLP argued that the benefits provided to associate members made them legitimate members, the court found that the NLP had not shown that any associate members had opted out of health benefits. The benefits that were offered were in fact of limited utility to associate members.

At the time this article was being prepared, H.R. 3448 had passed both houses of Congress. The proposed legislation, which applies to agricultural and horticultural organizations described in IRC 501(c)(5), provides that mandatory annual dues not exceeding \$100, as indexed for inflation, will be exempted from unrelated business income tax. This provision would apply to tax years beginning after December 31, 1994.

## 5. Advertising

The unrelated business income tax is an attempt to insure that tax-exempt organizations do not obtain an unfair competitive advantage over for-profit organizations. Absent such a tax, an exempt organization that receives advertising revenue could obtain such an advantage. Accordingly, IRC 513(c) provides that advertising is a trade or business, while Reg. 1.512(a)-1(f) provides that under IRC 513 and Reg. 1.513-1, amounts realized by an exempt organization from the sale of advertising in a periodical constitute gross income from an unrelated trade or business. Such advertising involves the exploitation of an exempt activity, namely the circulation and readership of the periodical developed through the production and distribution of the readership content of the periodical.

The Supreme Court has held that not all advertising by a tax-exempt organization may be subject to unrelated business income tax. In United States v. American College of Physicians, 475 U.S. 834, 106 S.Ct. 1591 (1986), the Court held that Congress did not intend to impose a blanket rule requiring the taxation of income from all commercial advertising by tax-exempt professional journals without a specific analysis of the circumstances. Nonetheless, the Court held that the advertisements in question were subject to tax since they were selected based not on educational purposes but for revenue potential.

In Chicago Metropolitan Ski Council v. Commissioner, 104 T.C. 341 (1995), the Tax Court held that Reg. 1.512(a)-1(f) applies to organizations described in IRC 501(c)(7). The case involved an organization that served its member ski clubs through the promotion of skiing activities. The organization also published a magazine funded, in part, by advertising. Ads generated net income while the editorial portion generated net losses. The Service disallowed the majority of publication expenses, allowing only those based solely on the fraction of total space taken up by advertising and ignoring such factors as the cost of advertising versus non-advertising space and the cost of color advertising. The Service argued that Reg. 1.512(a)-1(f) does not apply to social clubs, which are subject to the special rules contained in IRC 512(a)(3), rather than the general rules under IRC 512(a)(1). Moreover, it argued that allowing a deduction for all publishing expenses would frustrate Congressional intent by permitting social clubs to subsidize their social functions through the organizations' taxable income creating activities. The Tax Court rejected both arguments, finding that the legislative history of IRC 512(a)(3)(A) did not suggest an intent to exclude advertising income of social clubs from the directive of Reg. 1.512(a)-1(f), and that Regs. 1.512(a)-1(f)(3) and (4) provided adequate safeguards to prevent social clubs from gaining an unfair advantage over competing commercial enterprises.

The medical organization discussed in TAM 95-09-002 (September 30, 1994) published a monthly magazine with extensive advertising that it mailed to members and nonmembers. It also published a monthly newsletter that it mailed only to members. Although this newsletter normally contained no advertising, four special issues of the newsletter containing advertising paid for by pharmaceutical companies were distributed to all attendees of an annual convention. Another organization entered into an agreement that, in return for the exclusive right to sell advertising in the convention newsletter, it would "pay a royalty of \$5x plus 10% of all collected advertising revenues in excess of \$35x." In return, the IRC 501(c)(6) organization would provide an endorsement letter, exhibition list, contact names and phone numbers, and work space at the convention. The IRC 501(c)(6) organization retained final approval on all aspects of ad solicitation and on the actual ad copy.

The Service rejected the attempt to characterize payments received as a royalty. It found that the organization did not have a passive role with respect to the advertising. Further, although the organization argued that the publication of the newsletter only four times per year did not constitute an activity "regularly carried on," the TAM held that the solicitation and preparation of advertising were to be considered part of the activity.

The organization also argued that the convention newsletter was a qualified convention and trade show activity and, as such, any income was excluded from unrelated business income by virtue of IRC 513(d)(1). Although the TAM noted that a convention newsletter should be considered a "convention and trade show activity" within the meaning of IRC 513(d)(3)(A), it concluded that the advertising was an "exploitation" and, therefore, any income derived therefrom is subject to the unrelated business income tax. In addition, the TAM concluded that grants received from pharmaceutical companies, which rented exhibitor space from the organization and advertised in the monthly magazine, were convention and trade show activities used to fund traditional trade show activities and were therefore exempt under IRC 513(d)(1).

One of the monthly magazines contained a special section on a particular field of medical practice. The section consisted of four black and white pages containing information on health. It had two half page advertisements and one page containing health information which was sponsored by a pharmaceutical company. Although the organization argued that the sponsored page was educational in nature and exempt from unrelated business income tax, the TAM concluded that the four page insert had to be considered as a whole and that due to the commercial content of the advertisements, the insert as a whole did not meet the educational relatedness requirement. The TAM also concluded

that, although the insert had only been published twice and no such activity had been carried on previously, preparation time had to be taken into account. Such preparation time resulted in the activity being considered regularly carried on.

## 6. Sale of Real Estate

### A. In General

IRC 512(b)(5) excludes gains or losses from the sale, exchange, or other disposition of property from the computation of unrelated business taxable income. IRC 512(b)(5)(A) and (B) provide that this exception does not apply to gains or losses from the sale of (A) inventory, or (B) property held primarily for sale to customers in the ordinary course of the trade or business. (For a more detailed discussion of land sales, see the 1994 CPE text at p. 89.) The focus of the rulings in this area is whether property is held primarily for sale to customers in the ordinary course of the trade or business.

In PLR 95-05-020 (November 7, 1994) a school proposed to sell land which had been received by bequest and held for a significant period of time. The school's decision was prompted by the passage of legislation making it likely that the school would be forced to sell the land by condemnation suits to condominium lessees at prices significantly less than fair market value. Because the school was unsuccessful in its efforts to sell the land as a block to the condominium association, it proposed to make offers of the leased property directly to apartment owners.

In this case, the ruling concluded that the proposed transaction did not involve property held primarily for sale to customers in the ordinary course of business for purposes of IRC 512(b)(5). Therefore, the gain from its sale would not be taxed as unrelated business income. The ruling cited the following facts: the passage of legislation preventing the school from preserving the value of the land as an investment, the absence of advertising, the significant period of time during which the land was held, and the fact that the land was received by bequest and therefore not obtained with any investment intent.

Both PLR 95-10-039 (December 9, 1994) and PLR 95-09-041 (December 6, 1994) reached the same conclusion based on similar facts. As was the case with the school described in PLR 95-05-020, the organizations involved in these latter two rulings had held land received by bequest for a significant period of time, did not advertise, and faced condemnation proceedings. It was concluded that the sales would not result in unrelated business income since the land was not property held primarily for sale to customers in the ordinary course of business.

B. Special Rule for Social Clubs, et al.

IRC 512(a)(3)(D) governs the taxation of gains from real property sales by social clubs, VEBA's, supplemental unemployment compensation benefits trusts, and qualified group legal services organizations. These organizations recognize gain from the sale of property used directly in the performance of their exempt function only to the extent that the price of the old property exceeds that of new property used for the same purpose. IRC 512(a)(3)(D) applies, however, only if these organizations buy the new property within one year before the day they sell the old property or within three years after that day.

The Tax Court in Deer Park Country Club, T.C. Memo. 1995-567 (November 28, 1995, corrected December 4, 1995) reiterated its finding in Atlanta Athletic Club v. Commissioner, T.C. Memo. 1991-83, rev'd, 980 F.2d 1409 (11th Cir. 1993) that land subject to IRC 512(a)(3)(D) must be used for exempt functions prior to the sale. The Taxpayer in Deer Park was a country club described in IRC 501(c)(7) that purchased two tracts of land--one used for fishing and one as a golf course. It subsequently transferred the fishing property to the State of Illinois for cash and a 63.8 acre tract of farmland. From 1981 to 1986 the club rented the farmland. During this period it engaged a designer to develop plans for constructing an additional golf course, a swimming pool, and tennis courts. After consulting with banks regarding financing, the club agreed to devote 59 acres for recreational purposes and to subdivide for sale the remaining 4.8 acres.

The Tax Court held that IRC 512(a)(3)(D) requires a "use of assets or property that is both actual and direct in relation to the performance of its exempt function." The organization did not meet this test since the 4.8 acre tract had never been used for exempt purposes. In reaching its conclusion, the Tax Court noted that in IRC 512(a)(3)(D) Congress enacted a nonrecognition provision intended to be limited in scope. The court also noted that an organization's intent is irrelevant. Although the club may have originally intended to use the land for recreational purposes, the fact that the club never used the land in the performance of its exempt function was dispositive.

TAM 95-41-002 (February 3, 1995) considered the question of whether property was used directly in the performance of an organization's exempt function. The TAM discusses the application of IRC 512(a)(3)(D) to a hunting and fishing club described in IRC 501(c)(7). A logging company cleared club land that was part of the hunting range. The purpose of the clearing was to provide new growth and protection for grouse hunted on the land. The money received from the timber company was to be used to reconstruct four dams and for dam improvement, which would create a more manageable fishing environment and improve the aesthetic value of the club. Finding that the trees were

necessary for hunting purposes and that club members hiked on the property and enjoyed the aesthetic value of the trees when hunting did not occur, the TAM concluded that the timber was used directly in furthering the club's exempt purposes and, therefore, gain from the sale would be excluded under IRC 512(a)(3)(D).

## 7. Substantially Related

The heart of the unrelated business income tax may very well be the "substantially related" test. An activity is related to exempt purposes only where the conduct of the activity has a causal relationship to the achievement of exempt purposes (other than the need for income). It is substantially related where the conduct of the activity contributes importantly to the accomplishment of those purposes. Whether activities productive of gross income contribute importantly to the accomplishment of an exempt purpose depends in each case upon the facts and circumstances involved. Reg. 1.513-1(d).

### A. Insurance Activities

Generally, most exempt organizations must report as unrelated business income any amounts received from their involvement in insurance activities, since the provision of insurance is considered a commercial activity. For example, in Rev. Rul. 60-228, 1960-1, C.B. 200, the fee an agricultural organization received for services it provided to insurance companies was held to be subject to the unrelated business income tax. Similarly, income received by an exempt organization for serving as an insurance company's agent is subject to tax. See United States v. American Bar Endowment, 477 U.S. 105 (1986).

Income is unrelated business taxable income if the activity giving rise to it is (1) a trade or business, (2) regularly carried on, and (3) not substantially related to the entity's exempt purposes. If the entity alleges that the income is royalty income, it must be determined whether it truly is a fee for the use of a valuable property right, or compensation for services. As noted in Section 2, supra, royalties include fees arising from the grant of a license for use of an organization's trade name, trademark, or logo. The organization may approve, without risking its claim that the income constitutes a royalty, the quality or style of the goods or services associated with its name or mark.

In Texas Farm Bureau v. United States, 53 F.3d 120 (5th Cir. 1995), the Texas Farm Bureau ("TFB") and other state agricultural organizations created two insurance companies to provide reasonably priced insurance to rural residents. TFB then entered into several agreements with the insurance companies. In these contracts, TFB agreed to license its name to the insurance

companies and to provide them with administrative and clerical services in connection with their insurance activities in exchange for a fee. The companies agreed to pay TFB a percentage of the premiums paid.

TFB sought to divide the payment from the insurance companies into two parts: reimbursement to TFB for administrative and clerical expenses and a royalty for the use of the name and logo. In reviewing the contracts, the court found that TFB was required to perform substantial services, i.e., to use its own offices and influence to promote the insurance companies and to provide stationery and postage, secretarial and clerical help and office equipment. Therefore, the income received was not a royalty.

The court further noted that TFB's association with the insurance companies was not substantially related to its exempt purpose. In its opinion, the court stated the following:

...no substantial causal relationship exists between the insurance sales and the improvement of agricultural products or the development of a higher degree of efficiency in agricultural occupations. Further, many of the people who benefitted from these insurance policies are not ranchers or farmers, and the sale of policies to such people cannot contribute to TFB's exempt purpose. Any agricultural benefits derived from Life and Casualty's insurance policies were incidental benefits. There was no substantial causal relationship between the insurance sales and the fulfillment of TFB's exempt purpose.

#### B. Administrative Services

The Tax Court in Ohio Farm Bureau Federation, Inc. v. Commissioner, 106 T.C. No. 11 (1996), applied a causal relationship test to determine that an organization's activities were substantially related to its exempt purposes. Ohio Farm Bureau Federation ("Ohio Farm") is an IRC 501(c)(5) agricultural organization that sought to educate Ohio farmers and promote agricultural cooperatives. It formed a statewide cooperative, Landmark, Inc., with which it entered into an agreement whereby it would perform educational and promotional activities, including advertising, public relations, promoting research in agricultural fields and cooperatives generally, on behalf of the cooperative in exchange for a fee. Pursuant to the contract, Ohio Farm agreed to promote Landmark and cooperatives in general. Upon Landmark's merger with another corporation, Landmark and Ohio Farm agreed to terminate their contractual arrangement. Under the terms of the termination agreement, Ohio Farm, in exchange for a fee, agreed not to sponsor or promote, on an exclusive basis, a

specific competing enterprise. However, Ohio Farm could support and promote cooperatives on a non-exclusive basis.

The court found that neither this non-sponsorship/non-competition fee nor the service fee received by Landmark constituted unrelated business income. First, the Tax Court found that the service contract was substantially related to the organization's exempt purpose and benefited the members as a group. Second, the Tax Court addressed the non-sponsorship/non-competition fee and held that a one-time agreement not to compete in certain activities did not constitute a continuous and regular activity characteristic of a trade or business. Similarly, the one time agreement did not qualify as an activity regularly carried on.

The Chief Counsel's office had earlier reached a contrary conclusion on a similar issue in G.C.M. 39865 (December 12, 1991), which concerned an organization described in IRC 501(c)(13) that operated a mortuary as a wholly owned taxable subsidiary. In this G.C.M., a group of three individuals, who comprised the senior management group of both the mortuary and the cemetery, proposed to purchase the mortuary. As part of the sale, the cemetery agreed to enter into a covenant not to compete. In G.C.M. 39865, Chief Counsel stated that whether an activity is a trade or business depends on whether it is conducted with a profit motive, not whether it is active or passive. Further, the G.C.M. concluded that the covenant not to compete was a regularly carried on activity because the obligations continued throughout the term of the non-compete period. Since the operation of a mortuary is not part of the business of a cemetery, the obligation not to compete did not contribute importantly to the cemetery's exempt purpose.

In concluding that the yearly service fee did not constitute unrelated trade or business, the court emphasized the close connection between Ohio Farm and Landmark. From the time of Landmark's formation until 1955, the two organizations had common management. Until 1981 Ohio Farm had a controlling interest in Landmark. Ohio Farm's primary publication devoted editorial space to Landmark, and from 1981-1985 the two organizations shared office space. Ohio Farm referred its members to Landmark and was privy to Landmark's business plans, trade secrets, customer lists, and confidential trade practices. In 1985 Landmark was the only statewide cooperative.

In addressing the service fee, the court examined whether Ohio Farm's performance of these activities was substantially related to its exempt purpose. To determine whether a substantial relationship existed, the court adopted a two-part test set forth in Louisiana Credit Union League v. United States, 693 F.2d 525 (5th Cir. 1982):



Under the test, an income producing activity is substantially related to the exempt function of an exempt organization if (1) the activity is unique to the organization's tax-exempt purpose; and (2) if direct benefits flowing from the activities inure to its members in their capacities as members of the organization. In step one consideration is given to both the uniqueness of the relationship and the manner in which the organization carries on this endeavor. Under the second step it must be determined whether the activities benefit its members as members, rather than in their individual capacities.

With respect to the first prong, the court easily determined that Ohio Farm's educational activities were unique because they advanced the organization's exempt purpose of promoting cooperatives. Its distinctive relationship with Ohio farmers put it in a unique position to perform the activities covered by the service contract.

With respect to the second prong, the court cited as relevant factors to be considered whether fees are proportionate to benefits received, whether participation is limited to members, and whether the service in question is one commonly provided by for-profit entities. In finding the substantial relationship, the court distinguished Illinois Association of Professional Insurance Agents, Inc. v. Commissioner, 801 F.2d 987 (7th Cir. 1986) and National Water Well Association, Inc. v. Commissioner, 92 T.C. 75 (1989).<sup>3</sup>

In Illinois Association of Professional Insurance Agents, Inc. v. Commissioner, *supra*, a state association of independent insurance agents described in IRC 501(c)(6) provided its members errors and omissions (E & O) insurance that it actively promoted. The court held that the substantial profits made by the organization as well as its substantial involvement indicated that the activities of the organization constituted a trade or business. Any exempt function that the insurance program may have served was incidental to its purpose of raising revenues. Further, any benefits accrued to the agents, not the group. The court therefore concluded that the business of providing insurance was not substantially related to the organization's exempt purpose. In National Water Well Association, Inc. v. Commissioner, *supra*, the Tax Court held that premiums received by an IRC 501(c)(6) organization that actively sponsored and promoted an insurance program were not royalties. The Tax Court found that an organization's endorsement and sponsorship of an industry casualty program were not substantially related to its exempt purpose.

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<sup>3</sup> Neither of these cases applied the "uniqueness" test.

In contrast to the organizations discussed in National Water Well Association, Inc. v. Commissioner and Illinois Association of Professional Insurance Agents, Inc. v. Commissioner, *supra*, the Tax Court held that Ohio Farm educated its members, provided benefits not directly proportionate to the dues paid, and benefited members as a group.

Even assuming, for argument's sake, the validity of the "uniqueness test" set forth in the Louisiana Credit Union League, the Tax Court ignored the fact that the relationship of Ohio Farm to Ohio farmers was no more unique than that of the National Water Well Association or the Illinois Association of Professional Insurance Agents to its members; the services it provided were standard administrative services. The Tax Court also ignored the fact that Ohio Farm existed to promote cooperatives in general, a purpose inconsistent with its promotion of one organization. It is possible that more statewide cooperatives would have existed had Ohio Farm been actively promoting cooperatives in general. Further, had Ohio Farm been protecting the interests of its members rather than its own profitability, it would have provided information on other insurance policies.

As of the time this article was being prepared, no decision had been made as to whether the Tax Court's opinion would be appealed.

TAM 95-50-001 (August 23, 1995) involved an organization described in IRC 501(c)(6) that was formed to promote the common business interests of the motor transport industry. It engaged in legislative activities such as monitoring legislation and lobbying conducted by an independent contractor; the publishing of a monthly newsletter; monthly educational seminars providing information to members; and conducting of various annual events including a convention, parade, truck driving championships, a golf tournament, legislative forum, a holiday party, the sale of forms and publications to members and nonmembers, a free yearbook paid for by advertising, and a fee based drug program. The TAM discussed the various activities and concluded as follows:

- 1) The sale of forms and publications was an ordinary commercial activity that did not contribute to the improvement of industry business conditions and, as such, was unrelated trade or business.
- 2) Although the yearbook's advertising was not related to the organization's exempt purpose, and ordinarily any advertising revenue would be unrelated business taxable income under IRC 512(a)(1), because the organization itself devoted little time to the activity as did an outside firm, which received little compensation, the sale of advertising was an intermittent activity and not regularly carried on, because it was conducted without the competitive and promotional efforts typical of commercial endeavors.

- 3) The golf tour, although not related to the organization's exempt purposes, was an intermittent activity covered by Reg. 1.513-1(c)(2)(iii)'s exemption for annually recurrent activities.
- 4) Since the annual convention featured educational programs on topics of interest to the trucking industry, it was a related activity.
- 5) The materials and services offered as part of the drug testing program were offered on a commercial basis to members and nonmembers, and as such were not an incident of membership. Therefore, the activity was held to be an unrelated trade or business.
- 6) The annual parade and truck driving competition, the monthly newsletter, seminars and the lobbying conducted by an independent contractor were all considered to be in furtherance of exempt purposes. However, amounts derived from advertisements in the monthly newsletter were unrelated business income generated by a commercial activity regularly carried on.

TAM 95-41-003 (June 19, 1995) involved an organization described in IRC 501(c)(3) on the basis of lessening the burdens of government. It was formed to administer funds established by State statute to provide insurance coverage to school districts. These school districts were members of the organization's founding and controlling organization that paid a fee for the management services. The TAM concluded that the services helped the school districts to perform their essential government functions in a more cost efficient manner. Therefore, the organization conducted an activity that was substantially related and contributed importantly to its exempt purpose of lessening the burdens of government. Thus, the administrative services did not constitute unrelated trade or business.

### C. Museum Gift Shop Sales

TAM 95-50-003 (September 8, 1995) discusses whether the sale of merchandise from an exempt organization's gift shop, mail order catalogue and wholesale outlets constitutes unrelated business income. Although the organization conducted extensive off-site activities generating extensive income, the TAM held that the sale of merchandise by a museum at off-site locations was not necessarily unrelated trade or business. The TAM sets forth a method of analysis to be applied to each item sold:

To determine if the sale of an item by a museum is related to its exempt purpose, it is necessary to examine the museum's primary purpose for selling the item. (The buyer's reasons for purchase are immaterial.) Where the primary purpose behind the production

and sale of the item is to further the organization's exempt purpose, the sale is related, and income earned from that sale is exempt, even though the item has a utilitarian function or value. It is only where the primary purpose behind the production and sale of an item is to generate income, that the sale is taxable.

To determine whether this "primary purpose" test is met, a number of factors should be considered. Important factors include the degree of connection between the item and the museum collection, the extent to which an item relates to the form and design of the museum piece, and the relation of the overall impression derived from the article being sold to the original article.

The TAM then examined the various categories of merchandise sold by the museum to determine if the sale of the items was related to the museum's exempt purpose. The following items were found to be related:

- 1) books, tapes, records, films and compact discs on period topics and on restoration and collection activities undertaken by the museum;
- 2) toys, games, hats and flags;
- 3) non-prepackaged food products;
- 4) reproductions and adaptations of prototypes in the museum's collection;
- 5) contemporary products, such as film, batteries, flashbulbs, ponchos and umbrellas sold for the convenience of visitors;
- 6) some cards, ornaments and decorations; and,
- 7) note cards, calendars and postcards imprinted with representations of museum art work.

Items held to be unrelated to the museum's exempt purposes included:

- 1) miscellaneous contemporary products, such as newspapers, magazines, cigarettes and candy;
- 2) prepackaged foods, toiletries and tobacco products;
- 3) souvenirs and mementoes;
- 4) ornaments and decorations that were not part of the museum's collection;

- 5) products that were interpretations of or have designs taken from the historical period depicted by the museum other than reproductions or adaptations; and,
- 6) blank books, napkins, paper plates, stationery and address books.

Although raising the possibility of revisiting Rev. Rul. 73-104, 1973-1 C.B. 263, which holds that off-site sales of educational items in retail stores and through mail order catalogues can further an exempt purpose and are generally not subject to unrelated business income tax, the TAM reaffirmed Rev. Rul. 73-104. Finally, the TAM concluded that engraving done on-site, before on-lookers, and using a method used during the historical period depicted by the museum was related to the museum's exempt purpose, while income from engraving conducted off-site was subject to unrelated business income tax. Income from gift wrapping, done off-site, was also subject to tax.

#### D. Sale of Standard Forms

TAM 95-27-001 (January 30, 1995) involved sales by the local chapter of a national professional organization of various standard forms and agreements. The products were sold for use in the business activities of members and others. The purpose of the organization is to organize and unite in fellowship the members of a particular profession. The TAM relied on the two-part test applicable to business leagues for determining whether there is a substantial causal relationship between the activity and the accomplishment of the exempt purposes of the organization set forth in Louisiana Credit Union League v. United States, *supra*.

The TAM concluded that sales to the public were typical of commercial sales and distribution and hence not unique. Further, the forms helped members in their individual capacity rather than as members of the profession. Therefore, the TAM held that the sale of documents was not substantially related to the exempt purposes of the organization.

#### E. Travel and Similar Programs

TAM 95-21-004 (February 16, 1995) involved a travel program run by an organization formed to assist various children's shelters through financial contributions, fundraising and tutoring. The organization dedicated one room in its offices and one full-time employee to its travel agency operation. Operating a computer terminal, the employee booked local and international travel tours. The organization also had another full-time employee and two part-time employees, who dedicated most of their time to other fundraising activities and programs for children.

Sales were made via telephone calls or directly to individuals who entered the offices. This service was provided to the membership and to the general public via word of mouth of the membership. The organization advertised travel tours to its members through the use of fliers and brochures. Checks for travel services and all other fundraising activities were made payable to the organization.

The organization collected cash or credit card payments which were remitted to local commercial agencies from which the tickets were secured. It retained a commission from all cash payments, was remitted a commission from commercial agencies on credit card payments and received commissions from hotels as a result of the various local trips booked during the year. The TAM concluded that the travel service was a trade or business carried on for the production of income from the sale of goods or performance of services and did not contribute importantly to the accomplishment of its primary purpose of assisting children.

TAM 95-40-002 (May 31, 1995) discusses the operation of a golf and tennis program by an organization formed to broaden understanding and friendship with people of other nations through sports. The organization arranged various tours, consisting of parties, accommodations, meals and transportation for participants and families. It used related travel agencies for all travel arrangements. Although promoting international understanding is an exempt purpose, the TAM held that when a for-profit benefits substantially from the manner in which the activities of the related organization are carried on, the related organization is not tax-exempt. The TAM found that the program served substantial nonexempt purposes of promoting private business interests so as to preclude exemption, and that the income generated was not derived from an activity that contributed importantly to the accomplishment of exempt purposes.