F. UBIT: CURRENT DEVELOPMENTS

by
Sean Barnett, Shed Jessup and Charles Barrett

1. Introduction

The 1999 CPE Text contains a Topic beginning at p. 273 that updates the area of unrelated business income tax ("UBIT") by addressing issues such as travel tours, royalties, corporate sponsorship, subsidiaries, advertising, and gambling. More than two years have passed since this last update, but many of the same issues are still of great interest to TE/GE employees, as well as to exempt organizations and their representatives. Since our previous update, there have been a number of actions taken by Treasury, the courts and the Service with respect to ongoing items of interest and newly identified issues.

The purpose of this year's Topic is, once again, to update previous CPE Text discussions concerning a wide variety of developments during the past two years in the UBIT area. This Topic will focus on relatively recent regulatory, judicial and administrative actions affecting UBIT.

2. Travel Tours

Travel tour activities conducted by exempt organizations continue to present interesting questions with respect to UBIT. The 1999 CPE Text at p. 274 noted that in 1998, proposed regulations were published under I.R.C. 513 to clarify when the travel and tour activities of exempt organizations are substantially related to the purposes for which exemption was granted. Prop. Treas. Reg. section 1.513-7 provides that whether travel tour activities are substantially related to an organization's exempt purposes is determined by examining all the relevant facts and circumstances. The proposed regulations contained examples applying the facts and circumstances test in four situations.

The notice of proposed rulemaking solicited comments from the public. A public hearing was held on February 10, 1999. After consideration of all the comments, the proposed regulations under I.R.C. 513 were adopted as revised by Treasury Decision 8874 (65 FR 5771). The final regulations were effective as of February 7, 2000.

The preamble accompanying the final regulations states that organizations exempt from tax under I.R.C. 501(a) have diverse exempt purposes. Even among exempt organizations that share a common exempt purpose, such as education, the methods of accomplishing that purpose vary considerably. For that reason, the final regulations do not enumerate any specific factors that determine relatedness of travel tour activities to exempt purposes. Instead, they adopt the general facts and circumstances approach of the

proposed regulations. However, the final regulations do include new examples that provide additional guidance and focus on the substantially related test.

Reg. 1.513-7 provides that a determination of whether travel tour activities of an exempt organization are substantially related to its exempt purposes requires a consideration of all relevant facts and circumstances, including how a travel tour is developed, promoted and operated. The preamble states that with respect to travel tours, it is unnecessary to supplement the existing record keeping requirements under I.R.C. 6001 and 6033. Therefore, the final regulations do not impose additional record keeping requirements. However, the examples in the final regulations illustrate that contemporaneous documentation showing how an organization develops, promotes and operates the travel tour is relevant to the facts and circumstances analysis.

The final regulations state explicitly that the fragmentation rule in I.R.C. 513(c) and Reg. 1.513-1(b) applies to travel tours. The fragmentation rule provides that business activity of an exempt organization may be treated as an unrelated trade or business even though the activity is carried on within a larger framework of similar activities that may be related to the organization's exempt purposes. Thus, an exempt organization may conduct a variety of travel tours, some of which are considered related activities, and others of which are treated as unrelated businesses.

The following are summaries of some examples of related and unrelated travel tour activities that were included in the final regulations:

A. Environmental research trips conducted by an I.R.C. 501(c)(3) organization are substantially related to its exempt scientific purposes where tour participants assist biologists in collecting data for a scientific study and share rustic base accommodations with few amenities.

B. Travel tours conducted by an I.R.C. 501(c)(3) organization devoted to the study of ancient history and cultures are substantially related to its exempt educational purpose where tours of archaeological sites led by experts are part of a coordinated educational program designed to educate tour participants.

C. Travel tours conducted by an I.R.C. 501(c)(3) organization devoted to the study of the performing arts are not substantially related to its exempt educational purpose where the tour program is primarily social and recreational in nature, and the scheduled activities, which include sightseeing and attendance at various cultural events, are not part of a coordinated educational program.

3. Corporate Sponsorship

The Service published a Notice of Proposed Rulemaking (1993 proposed regulations) on January 22, 1993 (58 FR 5687), proposing that the regulations under I.R.C. 513 be amended to provide guidance on the proper tax treatment of sponsorship payments received by an exempt organization. The 1993 proposed regulations are the subject of an article in the 1994 CPE Text at p. 253.

The Taxpayer Relief Act of 1997, Public Law 105-34, section 965 (111 Stat. 788, 893-94), amended the Internal Revenue Code by adding I.R.C. 513(i). I.R.C. 513(i) governs the treatment of certain sponsorship payments by providing that qualified sponsorship payments are not subject to UBIT. I.R.C. 513(i) is discussed in the 1999 CPE Text at p. 282.

As noted by the preamble accompanying new proposed regulations, although I.R.C. 513(i) generally codifies the 1993 proposed regulations, there are some differences. To reflect these differences, and in response to comments submitted on the 1993 proposed regulations, the IRS issued new proposed regulations on March 1, 2000 (65 FR 11012).

The latest proposed regulations provide that as set forth in I.R.C. 513(i), qualified sponsorship payments are not unrelated business taxable income ("UBTI"). A qualified sponsorship payment is defined as a payment of money, a transfer of property, or the performance of services, by any person engaged in a trade or business, where there is no arrangement or expectation that the person will receive any substantial return benefit in exchange for the payment. A substantial return benefit is defined as any benefit other than (1) a use or acknowledgment of the payor's name or logo in connection with the exempt organization's activities, or (2) certain goods or services that have an insubstantial value under existing IRS guidelines.

Goods, services, or other benefits provided to the payor are considered insubstantial (and are, therefore, disregarded in determining whether a substantial return benefit has been conferred) if (1) they have an aggregate fair market value of not more than 2% of the payment, or $74 (adjusted for tax years beginning after calendar year 2000), whichever is less, or (2) the only benefits provided to the payor are token items (e.g., bookmarks, calendars, key chains, mugs, posters, etc.) which are considered low cost articles under I.R.C. 513(h)(2). If the fair market value of the benefits (or the cost, in the case of token items) exceeds these amounts or limits, then the entire fair market value of such benefits, not merely the excess amount, is a substantial return benefit.

Use or acknowledgment of the name or logo of the payor's trade or business in connection with the activities of an exempt organization does not constitute a substantial return benefit to the payor. The term "use or acknowledgment" includes logos and slogans that do not contain qualitative or comparative descriptions of the payor's

products or services; value-neutral descriptions of the payor's product-line or services; a list of the payor's locations, telephone numbers, or Internet address; and, the payor's brand or trade names and product or service listings. Use or acknowledgment does not include advertising.

The display or distribution, whether for free or remuneration, of the sponsor's product by the sponsor or the exempt organization to the general public at a sponsored event, is not considered an inducement to buy, sell, or use the sponsor's product and will not affect the determination of whether a payment is a qualified sponsorship payment.

An arrangement that acknowledges the payor as the exclusive sponsor of an exempt organization's activity generally does not, by itself, result in a substantial return benefit. Any portion of the payment attributable to the exclusive sponsorship arrangement, therefore, may be a qualified sponsorship payment. However, an arrangement that limits the sale, distribution, availability, or use of competing products, services, or facilities in connection with an exempt organization's activity generally results in a substantial return benefit. The portion of the payment attributable to the exclusive provider arrangement is not a qualified sponsorship payment.

The term "qualified sponsorship payment" does not include any payment the amount of which is contingent upon the level of attendance at one or more events, broadcast ratings, or other factors indicating the degree of public exposure to the sponsored activity. However, a payment that is contingent upon sponsored events or activities actually being conducted is not excluded from being a qualified sponsorship payment for that reason.

The proposed regulations apply to all forms of corporate sponsorship activities and not just corporate sponsorship events. Sponsored activities within the scope of I.R.C. 513(i) may include a single event (such as a bowl game or a television program), a series of related events (such as a concert series or sports tournament), an activity of extended or indefinite duration (such as an art exhibit), or continuing support of an exempt organization's operation. A payment may be a qualified sponsorship payment regardless of whether the sponsored activity conducted by the organization is substantially related to its tax-exempt purpose.

Consistent with I.R.C. 513(i), the tainting rule of the 1993 proposed regulations has been removed. If there is an arrangement or expectation that the payor will receive a substantial return benefit with respect to any payment, then only the portion, if any, of the payment that exceeds the fair market value of the substantial return benefit is a qualified sponsorship payment. However, if the exempt organization does not establish that the payment exceeds the fair market value of any substantial return benefit, then no portion of the payment constitutes a qualified sponsorship payment.

A payment that does not meet the criteria to be considered a qualified sponsorship payment is not automatically subject to UBIT. Rather, the unrelated business income tax treatment of any payment that is not a qualified sponsorship payment is determined under the existing principles and rules for taxing unrelated business income found in I.R.C. 512, 513, and 514.

The proposed regulations also add an example to Reg. 1.512(a)-1(e), which addresses the extent to which exempt organizations can use excess expenses from an exempt activity to offset income from a separate, unrelated business activity. The preamble notes that Treasury and the Service had concluded that the examples in the 1993 proposed regulations interpreted Reg. 1.512(a)-1(d) too broadly by allowing exempt organizations to apply excess expenses directly connected with the conduct of an exempt activity (such as the conduct of a bowl game) to offset income from a separate, unrelated business activity (such as the sale of clothing featuring the name and logo of the bowl game) which does not have a proximate and primary relationship to the exempt activity. The new example clarifies that Reg. 1.512(a)-1(d) applies only in circumstances where the unrelated business activity and the exempt activity are closely connected, such that a taxable entity pursuing the same business activity would normally also conduct the exempt activity.

Qualified sponsorship payments in the form of money or property, but not services, are treated as contributions received by the exempt organization for purposes of determining public support to the organization under I.R.C. 170(b)(1)(A)(vi) or I.R.C. 509(a)(2).

On June 21, 2000, the Service held a public hearing on the latest proposed regulations. Comments made by witnesses dealt mainly with the following issues: exclusive provider arrangements, substantial return benefit, and Internet links.

The greatest criticism was directed at the treatment of exclusive provider arrangements. One witness stated that the treatment of exclusive provider arrangements as a substantial return benefit is not supported by, and is contrary to, I.R.C. 513(i) and its legislative history. According to the witness, a correct reading of the statute and legislative history would indicate that payments under an exclusive provider arrangement are nothing other than qualified sponsorship payments. The witness also faulted the proposed regulations for incorrectly implying that payments under exclusive provider arrangements are automatically subject to the unrelated business income tax. Other witnesses contended that an exclusive provider contract is similar to a covenant not to compete in that both are payments to refrain from an activity. One witness noted that the Service has recognized that covenants not to compete do not rise to the level of unrelated business activity. Consequently, payments under an exclusive provider arrangement should not be treated as unrelated business income. Finally, a witness stated that the treatment of exclusive provider arrangements does not meet with business reality:

corporate sponsors do not expect that competing products will be distributed or made available at an event that they sponsor.

The definition of substantial return benefit was the topic of considerable discussion. One witness said that the determination should focus on the character of the item rather than on the value of the item. One witness noted that there was nothing in the legislative history that would equate the term "substantial return benefit" with something valued over $74. The witness interpreted congressional intent to be that substantial return benefit should be something that provides a significant inducement to a corporate sponsor to make the payment, such as an advertising element. The witness recommended that the regulations adopt a percentage approach rather than a dollar amount. The process of requiring a separate valuation of any item over $74 imposes significant administrative burdens on charitable entities. For that reason, consideration should be given to the character of the items being provided. Another witness argued that the $74 standard used to define substantial return benefit was far too low for organizations receiving high sponsorship payments, and that such a standard imposes a large administrative burden. It was suggested that the de minimis rule be raised to 15 percent or even one-third of the value of the sponsorship payment.

With respect to valuation, one witness requested that the regulations provide a safe harbor mechanism for meeting the requirements that the exempt organization value the substantial return benefit provided to the sponsor. The witness suggested, as an example, that the organization be allowed to base the estimate of fair market value on data provided by the corporate sponsor or as agreed upon by the parties.

Several witnesses mentioned that Internet links to a sponsor's home page are like telephone numbers, and should not be considered as advertising. They also urged the Service to refrain from automatically treating a web site as a periodical. Witnesses also commented that final regulations should make application of the rules prospective, and should grandfather existing contracts and renewal options.

At the time this Topic was being prepared, Treasury and Service employees were considering all the comments provided by the public and determining whether any changes to the proposed regulations are warranted. This process will hopefully result in the issuance of final regulations.

4. Royalties

Royalties are excluded from UBTI under I.R.C. 512(b)(2). Neither the Code nor the regulations define the term “royalty.” Reg. 1.512(b)-1 states that whether a particular item of income falls within the modifications provided in I.R.C. 512(b) shall be determined by all the facts and circumstances of each case.

The question of whether income from affinity credit card arrangements and from the rental of mailing lists is subject to tax has been an issue in a number of exempt organization cases. In 1999, several court cases were decided in favor of the taxpayer, with the courts holding that the income received by an exempt organization from affinity credit card arrangements or the rental of mailing lists is royalty income.

A. Affinity Credit Card Programs: Sierra Club

The case of Sierra Club, Inc. v. Commissioner, T.C. Memo. 1999-86, was before the Tax Court on remand from the Court of Appeals for the Ninth Circuit, Sierra Club, Inc. v. Commissioner, 86 F. 3d 1526 (9th Cir. 1996). The Ninth Circuit reversed an order of the Tax Court granting Sierra Club's ("SC's") motion for partial summary judgment. That order was issued pursuant to Sierra Club, Inc. v. Commissioner, 103 T.C. 307 (1994), which concluded that SC's receipts from its affinity credit card program did not constitute UBTI because they constituted royalties within the meaning of I.R.C. 512(b)(2). The Ninth Circuit determined that the Tax Court had improperly resolved disputed factual issues in favor of SC, and it remanded for findings of fact whether the receipts constitute royalties within the meaning of I.R.C. 512(b)(2). Prior developments in the Sierra Club case were covered in the 1997 CPE Text at p. 242.

An affinity credit card program is an arrangement by which an organization agrees with a credit card issuer that the organization's name and logo may appear on a credit card, and, thus, be used to market the card to an affinity group associated with the organization. The organization receives a small percentage of total amounts charged on the card.

In 1986, SC entered into an agreement with American Bankcard Services ("ABS"), whereby ABS would make available to SC members Visa or Mastercard credit cards with the name of SC on one side and the logo of SC on the reverse side. SC agreed to cooperate with ABS in the solicitation and encouragement of its members to utilize the services provided by ABS. ABS would be responsible for the development of all promotional materials designed to encourage the acquisition and use of the credit cards by the members of SC subject to the approval by SC of all such materials and programs. In return for the use of its name and logo, SC would receive from ABS fees of one-half of one percent of the total cardholder sales volume.

In April of 1986, SC provided ABS with an initial list of its members. Subsequently, on seven occasions, SC provided ABS with labels containing the names and addresses of new members. Advertisements for the credit card program appeared in three issues of SC's magazine, *Sierra*, during the years 1986 and 1987.

SC received from the credit card program $6,021 in 1986 and $303, 225 in 1987. The Service determined deficiencies in SC's 1986 and 1987 federal income taxes based

on adjustments made with respect to SC's participation in the credit card program. The Service adjusted SC's UBTI by including the receipts and determining that they did not constitute royalties within the meaning of I.R.C. 512(b)(2).

SC argued that the receipts were royalties within the meaning of I.R.C. 512(b)(2). It argued that its name, logo, and mailing list are all intangible assets which it licensed to ABS in return for payments that, in form and substance, were "royalties" as that term is used in I.R.C. 512(b)(2).

The Service argued that SC was in the business of marketing the credit card program to its members and was compensated for performing the following services: (1) controlling the marketing plans, (2) offering the affinity credit card as a member service, (3) placing advertisements for the affinity credit card in its magazines, and (4) actively endorsing and sponsoring the acquisition of the affinity credit card through brochures and letters from its officers.

The tax court agreed with SC. It concluded that the agreement between SC and ABS made available for ABS's use SC's name, marks, logo, and certain other intangible property used in marketing, as well as provided ABS access to SC's members by way of SC's mailing lists. Therefore, the financial consideration SC received under the agreement was, at least in part, consideration for the use of valuable intangible property. As such, it constituted royalties within the meaning of I.R.C. 512(b)(2).

The court found that the agreement between SC and ABS assigned to ABS responsibility for marketing the credit card program. Although the agreement subjects promotional and solicitation materials and programs developed by ABS to approval by SC, the court said that such control was exercised by SC to safeguard the valuable intangible property rights that it had licensed to ABS, and was not an indirect method of putting SC in the business of marketing. The court concluded that SC did not control the affinity credit card program's marketing plans except to the extent that it reserved the right to approve any use of its name, marks, and logo. Such reserved right is commonplace in licensing agreements. The mere retention of quality control rights by a licensor in a licensing agreement situation does not cause payments to the licensor under the agreements to lose their characterization as royalties. Therefore, SC did not control the marketing plan for the credit card program and, thus, was not compensated for providing marketing services.

The court then found that SC expressly did not treat the credit card as a membership service in the sense of a service offered and overseen by SC. SC's membership services department did not handle any inquiries regarding the credit card program, and SC did not provide any significant administrative services with respect to the services provided by ABS.

Addressing the issue of advertising, the court found that the agreement between SC and ABS did not require SC to accept advertisements from ABS. Even though SC did accept advertisements from ABS, SC charged ABS its usual rates for advertising. Therefore, the court found no basis for concluding that any portion of the receipts was in consideration for advertising services.

Finally, the court rejected the Service's argument that SC's obligation "to cooperate" imposed on it an obligation to perform services, particularly the service of endorsing and promoting the credit card program. The court noted that the Service had stated in Rev. Rul. 81-178, 1981-2, C.B. 135, that income from the endorsement of products, use of signatures and trademarks, and review of licensed products is a royalty within the meaning of I.R.C. 512(b)(2). The court found that the use of SC's name, marks, logo, and its continued endorsement was precisely the valuable consideration SC provided pursuant to the agreement, and was precisely for what ABS was paying. Although SC may have approved solicitations and communications to its members, it was ABS that designed and paid for those communications, which were primarily for its own benefit. The court concluded that SC's obligation to cooperate was not an agreement to endorse or promote the credit card program beyond the endorsement that necessarily results from SC's license of its logo, name, and other intangibles. Therefore, SC's endorsement and promotion of the credit card program were not in consideration of the receipt of anything other than "royalties" within the meaning of I.R.C. 512(b)(2).

B. Mailing Lists: Common Cause and Planned Parenthood

On June 22, 1999, the Tax Court handed down two virtually identical opinions in the cases of Common Cause v. Commissioner, 112 T.C. 332 (1999) and Planned Parenthood Federation of America, Inc. v. Commissioner, T.C. Memo. 1999-206. The issues presented in both cases were (1) whether, for purposes of UBIT, the petitioner's carrying on of a list rental business is substantially related to its exempt purpose; (2) if not, whether the list brokers, list manager, and computer house used by petitioner are agents of petitioner for the purpose of carrying on such a business; and (3) whether the mailer's list rental payments are royalties that are excluded from UBTI under I.R.C. 512(b)(2).

Both cases involved a list rental transaction, which the court described as follows: the mailer seeking to send mail to the individuals on a mailing list pays the owner of the list for the one-time right to send mail to the named individuals. If anyone responds to the mailing, the mailer then "owns" that name and can continue to send that individual additional mail. If an individual does not respond to the one-time mailing, the mailer may not directly send mail to that individual again.

In Common Cause, the mailing list owner was an organization exempt from federal income tax as an organization described in I.R.C. 501(c)(4). In Planned Parenthood, the

list owner was an organization described in I.R.C. 501(c)(3). Each organization maintained a list of names and addresses of members, donors, and other supporters. From that master list the organization created another "rental list" containing names, addresses and limited information about a segment of the organization's supporters. The rental list is made available for rent or exchange to other organizations. Because the opinions are so similar, it is enough to analyze just the Common Cause opinion.

Common Cause (CC) stores its rental list at Triplex Direct Marketing Corp. (Triplex). From CC's rental list, Triplex produces a copy on labels or magnetic tape for mailers. CC retains the services of Names in the News (Names), a list manager and list broker. As CC's list manager, Names promotes list rental transactions via distribution of data cards, solicitations, and sales calls directed at list brokers and potential customers.

In a typical list rental transaction, the mailer contacts Names either directly or through a list broker and submits a proposed list rental order. Names either disapproves the order because it is inconsistent with the standing instructions provided by CC or forwards the order to CC for final approval. Upon receiving approval, Names arranges with Triplex to fill the order. Triplex produces a copy of the rental according to the mailer's specifications and sends it to the mailer's mail house.

CC divides its rental list into three segments and charges a different price for each segment. A mailer rents the names of current members for $70 per 1,000 names, of former members for $60 per 1,000 names or of nonmember donors for $55 per 1,000 names. After receiving payment from the mailer or its list broker, Names deducts its commission, pays Triplex its fees, and remits the remainder to CC.

The Service determined deficiencies in CC's federal income taxes and contended that, in each of the list rental transactions, the mailer's entire payment (including the amount paid to Names and Triplex) constituted UBTI to CC because CC regularly carried on a list rental business that was not substantially related to its exempt purpose. The Service further contended that Names and Triplex were CC's agents for the purpose of carrying on the list rental business. CC, on the other hand, contended that the mailers' payments were excluded from UBTI as royalties under I.R.C. 512(b)(2).

Both CC and the Service accepted the definition of a royalty found in Rev. Rul. 81-178, supra. That ruling states that "to be a royalty, a payment must relate to the use of a valuable right. Payments for the use of trademarks, trade names, service marks, or copyrights … are ordinarily classified as royalties for federal tax purposes. * * * On the other hand, royalties do not include payments for personal services." Both parties also agreed that CC's rental list was a valuable intangible.

In several earlier cases, the court had held that the owner of an intangible may engage in certain activities to exploit and protect the intangible which do not change the

nature of the payment as a royalty. Therefore, in deciding whether any part of the mailing list rental payments constituted compensation to CC for goods or services, the court looked at the activities of each of the parties compensated in the list rental transaction to ascertain whether they had undertaken to exploit or protect CC's list. Activities undertaken to exploit or protect the list were designated "royalty-related activities."

The court first turned its attention to Names. In the context of list rental transactions, the list owner has certain intangible information regarding individuals whose names and addresses appear on its lists. To exploit that information, the list owner must first let others know that the list is available. Names' activities in distributing data cards and other forms of advertising directed to list brokers and potential mailers on CC's behalf were royalty-related activities. Additionally, to protect the value of its mailing list, a list owner will not allow individuals whose names appear on the list to receive mail that the list owner considers objectionable. Consequently, Names' activities in clearing with CC all list orders were royalty-related activities. To exploit the intangible and convey it to the user, the list owner must render it in tangible form. Thus, Names' activities in forwarding the order to Triplex for fulfillment and obtaining from Triplex a copy of the rental list were royalty-related activities. Finally, the owner of the intangible is entitled to be paid for its use. Thus, Names' activities in billing the mailer, paying Triplex, and remitting payment to CC were royalty-related activities. Thus, all activities engaged in by Names were royalty-related activities.

Regarding CC itself, the court found that the only activities in which CC engaged directly were review of data cards and approval of list rental transactions. The data cards are the means by which Names promotes and advertises CC's rental list. Review of promotional and advertising material by the owner of an intangible is not inconsistent with royalty treatment. Consequently, all of CC's activities are royalty-related activities.

As to Triplex, its activities consisted of printing a copy of CC's list on the medium chosen by the mailer, performing special selections chosen by the mailer, and shipping the completed order to the mailer. Since producing an intangible in tangible form is necessary for the exploitation of the intangible, Triplex's activities in printing a copy of CC's list on the medium chosen by the mailer were royalty-related. Furthermore, the culling out or special selection of certain names is ancillary to the maintenance and exploitation of the list. Finally, the activities of shipping the list to the mailer were also royalty-related because the list owner needs to send the information contained in the intangible to the user in order to exploit the intangible.

In contrast, the activities of list brokers are not royalty related. List brokers' activities are provided solely to the mailers for the mailers' convenience. Consequently any portion of the mailers' payments that is to compensate the list brokers for their activities in the mailing list transaction is not a royalty. On the other hand, such activities

are not necessarily attributable to the list owner on the theory that the list broker is acting as the list owner's agent. Rather, the question of agency is based on the surrounding facts and circumstances of each case. The court cited In re Shulman Trans. Enters., Inc., 744 F.2d 293 (2d Cir. 1984) that "an essential characteristic of an agency relationship is that the agent acts subject to the principal's direction and control." The court found that the list brokers acted solely on behalf of the mailers, and that CC did not exercise any control over the list brokers. Consequently, the court held that the list brokers were not agents of CC, and that neither their activities, nor the compensation they received for those activities, could be attributed to CC.

In conclusion, the court held that, with the exception of the list brokerage activities (which were not attributable to CC), all of the activities engaged in by the parties to the list rental transaction were royalty-related activities. As a result, the mailer's list rental payment in each list rental transaction was a royalty that is excluded from UBTI under I.R.C. 512(b)(2). In so holding, the court felt it unnecessary to address the issue of whether carrying on a list rental business is substantially related to CC's exempt purpose.

C. 1999 IRS Memorandum

In a memorandum dated December 16, 1999, the Exempt Organizations Area Managers were told that further litigation in cases involving affinity credit cards and mailing lists with facts similar to those decided in favor of taxpayers should no longer be pursued. Suspense of such cases was lifted and the cases were to be closed. The memorandum stated that other cases should be resolved in a manner consistent with existing precedent. The memorandum noted that consideration might be given to requesting technical advice in cases in which extensive services are provided, or where there is a good case for allocating the payment between the services and the intangible.

5. Advertising

In U.S. v. American College of Physicians, 475 U.S. 834 (1986), the Supreme Court held that when an exempt organization publishes a periodical containing articles and editorials pertaining to its exempt purpose, the sale of advertising in the publications is an unrelated trade or business if the conduct of the advertising business does not contribute importantly to the organization's exempt purposes. Cases involving issues with respect to advertising continue to be the subject of judicial and administrative actions.

A. Arkansas State Police Association

The petitioner in Arkansas State Police Association, Inc. v. Commissioner, T.C. Memo. 2001-38 is an I.R.C. 501(c)(5) organization, which was formed for the purpose of "promoting impartial enforcement of law and order, increasing efficiency in the police

profession, and cultivating a spirit of fraternity and mutual helpfulness among and between the Arkansas law enforcement community and the people of Arkansas."

Under an agreement between the police association (ASPA) and Brent-Wyatt West (BWW), a publishing company, three editions of *The Arkansas Trooper* ("the Magazine"), which is the official magazine of ASPA, were produced each year. Articles, photographs, letters, and publicity concerning Arkansas law enforcement activities were collected by an ASPA officer, reviewed, and submitted to BWW. An ASPA officer also reviewed a draft copy of each edition of the Magazine prior to publication.

Each edition of the Magazine contained numerous advertisements of Arkansas businesses. BWW employees solicited these advertisements, designed the layout of each edition of the Magazine, printed copies, and distributed the copies to ASPA members. An officer of ASPA reviewed the language of any advertising related to ASPA

As part of their agreement, BWW was authorized to use ASPA's name and logo in connection with the publication of the Magazine and the solicitation of advertisements. Income from the advertisements was divided between ASPA and BWW, with ASPA receiving 27% and BWW receiving 73%. In addition, BWW was required to pay ASPA an annual fee of $25,200.

For the years 1993 through 1996, ASPA received from BWW $876,697 in connection with the publication of the Magazine, consisting of four annual $25,200 payments and ASPA's share of the advertising proceeds. ASPA treated the $876,697 as royalty income and excluded it from UBTI. The Service determined deficiencies in ASPA's federal income taxes for each of the four years.

At trial, the parties stipulated that the publication of the Magazine was not substantially related to ASPA's tax-exempt purpose. The sole issue before the court was whether the payments ASPA received from the advertising should be treated under I.R.C. 512(b)(2) as royalty payments and excluded from ASPA's UBTI.

The court cited Fraternal Order of Police v. Commissioner, 833 F.2d 717 (7th Cir. 1987) affg. 87 T.C. 747 (1986), for the proposition that where an organization takes an active role in the publication of a magazine, payments received by the organization out of advertising sales proceeds do not qualify as excludable royalties under I.R.C. 512(b)(2).

The court also cited State Police Association of Massachusetts v. Commissioner, 125 F.3d 1 (1st Cir. 1997), for the proposition that when an organization maintains close supervision over, and involvement in, the content of the Magazine and in the sale of advertising, then the publishing company is acting as an agent of the organization. As a consequence, payments from the publishing company to the organization constitute UBTI.

In this case, ASPA participated significantly in, and maintained control over, most aspects of the publication of the Magazine. It possessed authority over the editorial content of the Magazine, and it received and reviewed the articles, photographs, letters and publicity for each edition.

The court compared this case with the affinity credit card cases and mailing list cases in which exempt organizations license their names to be used in the sale or promotion of another business's unrelated products. In those cases, the fees received by the organizations qualified as exempt royalty income. The court found this case dissimilar. ASPA's participation in the publication of its magazine was not passive or de minimis. The magazine was not a product of BWW, but of ASPA through which it promoted and actively sought not just to capitalize on the value of its name but to carry out its organizational purposes and objectives.

Consequently, the court held that the $876,697 that ASPA received from BWW as its share of the Magazine's advertising proceeds was not royalty income but, instead, UBTI.

B. Advertising in Student Newspapers

TAM 1999-14-035 (Nov. 23, 1998) describes an I.R.C. 501(c)(3) organization that publishes the daily student newspaper of a university as an educational activity for participating students. The organization is organized separately from the university for purposes of editorial independence, yet maintains a close working relationship with the university.

The organization's all-volunteer board consists mostly of students plus several faculty members. The editorial functions of the newspaper are conducted entirely by students. The "business" functions, including advertising, are conducted or supervised in whole or in part by non-students. The business functions are conducted by 17 student employees and 10 non-student employees. The non-student employees serve primarily as mentors or supervisors of the students. A few positions are filled exclusively by non-students because the positions cannot be suitably performed with student help.

Two non-student employees and eight students who are advertising sales representatives carry on the retail advertising function. Three other students serve as proofreaders and "runners" (running proposed ads to business customers for final approval). Classified ads, which are not actively solicited, are received by non-student workers, because it is impractical to coordinate the conduct of that work by students during prime school hours, particularly given the limited educational benefits of such work. However, students are involved with classified ads in the production layout process.

The organization's major source of income is from sales of retail advertising and classified advertising. The issue is whether the income derived from the advertising constitutes UBTI.

Since the organization's advertising activity is a business regularly carried on, the only question to be answered is whether the activity is substantially related to its educational purpose. In other words, does the performance of the advertising service contribute importantly to the accomplishment of the taxpayer's educational purpose?

Generally, an exempt organization's advertising in its periodical is regarded as an unrelated business, even if the publication of the editorial content of the periodical furthers exempt purposes. American College of Physicians, supra. However, the advertising function of a student-run newspaper may provide vocational training to the participating students. Example 5 of Reg. 1.513-1(d)(4)(iv) describes a campus newspaper at which the solicitation, sale, and publication of advertising are conducted by students under the supervision and instruction of the university. The example concludes that, although the services rendered to advertisers are of a commercial character, the advertising business contributes importantly to the university's educational program through the training of the students involved. The example mentions that this would be true even if the newspaper were published by a separate I.R.C. 501(c)(3) organization, qualified under university rules for recognition of student activities.

Expanding on that notion, this TAM states that the presence of non-student employees in the advertising department is not fatal to exemption, especially when they serve in a managerial or training capacity, or in positions where it is impractical to employ students. Nevertheless, the enterprise should be primarily a student enterprise. The mere incidental involvement of students is not enough to transform an otherwise unrelated business into a related one.

In this case, students perform most of the retail advertising activity even though non-student employees manage the activity. Since the retail advertising activity contributes importantly to the organization's educational purpose and the activity is primarily a student enterprise, the activity constitutes a related business.

Student participation in the classified advertising activity is not as apparent, since only non-students accept the ads over the phone and proofread the ads. Nevertheless, student involvement is more than incidental, because students are responsible for the ads during the layout and graphic design processes. Therefore, the classified advertising activity is also substantially related to the performance of the organization's educational purpose.

The TAM concludes that the income derived from advertising in the organization's newspaper constitutes income from a trade or business, the conduct of which is substantially related to the performance of the organization's educational function.

C. Attribution of Advertising Income to a Related Organization

In TAM 2001-02-051 (Sept. 5, 2000) an I.R.C. 501(c)(6) organization ("M") promoted the free newspaper industry in a certain State. Its members are local publishers of newspapers and shoppers circulated free of charge to households in a particular geographic area. M assists its members by conducting educational conferences, publishing a monthly newsletter, and by presenting awards for achievements in art, photography, news coverage, editorials, and community services.

In order to fund its member benefits, M entered into an agreement with a for-profit organization ("N"), to provide a benefit program to M's members. Under the program, N receives advertisements that are to be placed in members' newspapers. N types, assembles, and photocopies the advertisements, and sends them to M's members in mailings of 10 to 15 ads per week. Upon receiving the mailing, each member must lay out and typeset each ad for publication in its newspaper. N's involvement constitutes approximately one-fourth of the total time spent on the program, while member publishers' activities account for three-fourths.

M and N each receives a commission of 50% of net advertising proceeds from the program. If a member publisher solicits an ad on its own, it may keep 55% of the ad revenues, but must give 25% to M and 20% to N. The issue is whether the income received by M is UBTI under I.R.C. 512(a)(1).

The ads placed in member publisher newspapers and shoppers are of an ordinary commercial nature. They are not related to an exempt purpose under the standards set forth in American College of Physicians, supra. Furthermore, the advertising activity is regularly carried on within the meaning of I.R.C. 512(a)(1). Thus, if the advertising activity is conducted by M, or could be attributed to it, the net income received by M would constitute UBTI.

Under In re Shulman Trans. Enters., Inc., supra, the presence of an agency relationship is determined by all relevant facts and circumstances and is characterized by the principal's direction and control of the agent.

In State Police Association of Massachusetts v. Commissioner, supra, the association ("SPAM") retained independent contractors to publish a yearbook and recruit telemarketers. The court found that SPAM exercised tight control over the method and manner of solicitation, the composition of the sales pitch, the identity of the solicitors, financial aspects of the arrangement, the use of its name, advertising formats, and the

contents of the yearbook. Consequently, the contractors were deemed to be agents of SPAM, and the activities of the contractors were attributable to SPAM. SPAM's earnings from the activities of the contractors were subject to UBIT.

In this case, the facts and circumstances all suggest that M's members are not acting as its agents. There is no indication that they are subject to the control or direction of M. They are free to participate in the advertising program or not as they wish, and suffer no penalty for not participating.

Likewise, N cannot be considered an agent of M. Although M shares in the program's revenues, it does not control the manner in which N conducts the ad program. Thus, it is not like the situation in State Police Association of Massachusetts, supra, in which the exempt organization retained tight control over the independent contractors.

Consequently, the advertising placed in M's members' publications under the contract between M and N is not an activity that is conducted by M, nor is it an indirect activity of M on the basis of agency or attribution. M does not receive UBTI under I.R.C. 512(a)(1) from the newspaper-advertising program. Rather, the amounts received are in the nature of additional dues payments to M from its members. The TAM further notes that M may wish to advise its members that the amounts in question are not taxable to M, and M's members may wish to consider whether they should treat such amounts as part of their taxable income.

6. Subsidiaries of Exempt Organizations

A. Formation of a Taxable Subsidiary

PLR 1999-38-041 (June 28, 1999) describes an I.R.C. 501(c)(4) organization ("X") that has, as its primary exempt function, to promote the interests of older persons. X entered into various contractual agreements with third party service providers to offer various programs to its members, such as health insurance. In the past, X entered into contractual agreements with other service providers whereby X would receive contract fee payments from the respective service provider based upon the amount the service provider receives from X's members. In accordance with the agreements, the service providers are entitled to the use of X's name and logo.

Y is a wholly owned taxable subsidiary of X. X will assign to Y a portion of right, title, and interest in agreements with the service providers. X will reserve for itself all of its right, title and interest in its name, logos, symbol, marks, etc. All other rights will be assigned to Y. X entered into royalty agreements with service providers that use X's marks. Y has own staff. X has provided its mailing list to Y by a no-fee license. Y has the right to sublicense to service providers. Y will not pay X for this usage.

This PLR analyzed the issue of whether Y should be deemed an agent or instrumentality of X, whereby Y's activities would be attributed to X. To address this issue, the PLR considered the relationship between X and Y and analyzed the terms of an extensive agreement between the parties. Based on this analysis, the PLR noted that a majority of the Directors of Y will be independent of X and will not be current or former X Board members or officers. Also of importance is that X will not direct the day-to-day management of Y. Based on all the facts and other representations, it was determined the activities and income of Y will not be attributed to X for purposes of (1) X's continued qualification for exemption; and (2) X's possible receipt of UBTI with respect to Y's activities.

The PLR stated that I.R.C. 501(c)(4) organizations could organize, capitalize and own, provide services and assets to a taxable entity without violating the requirements for exemption. Since Y was organized with a bona fide intention that it will have some real and substantial business function, its existence will not be disregarded. Neither X's creation and initial capitalization of Y, nor its contribution of a no-fee license of its mailing list will result in UBTI under I.R.C. 512(a)(1). The PLR also stated that no opinion was being expressed on whether amounts derived by X from Y in return for providing administrative services constitute UBTI, nor was any opinion being expressed with regard to whether payments of rent and interest by Y to X would be subject to UBIT under I.R.C. 512(b)(13).

B. Subsidiaries and I.R.C. 512(b)(13)

PLR 1999-41-048 (July 20, 1999) analyzes the relationship among supporting and supported organizations, and how to categorize payments among them.

A is a university described in I.R.C. 501(c)(3) and classified under I.R.C. 509(a)(1) and 170(b)(1)(A)(ii). B is described in I.R.C. 501(c)(3) and classified as a supporting organization under I.R.C. 509(a)(3). B operates solely for A's benefit and functions principally to hold and manage certain endowments and long-term properties and programs for A's benefit. C is also described in I.R.C. 501(c)(3) and classified as a supporting organization under I.R.C. 509(a)(3). C operates solely for the benefit of A and B. B functions principally to hold and manage certain endowments and long-term properties and programs for A's benefit. C functions principally to receive contributed properties that are held temporarily, and manage these short-term contributed properties.

C proposes to form D, a general, for-profit, business corporation, primarily to provide real estate management and other services to or for A, B, and C's benefit. Initially, C will own all of D's capital stock; C will elect D's board of directors, consisting primarily of A, B, or C trustees, officers, or employees. D's activities will be limited to renting and managing real and personal property owned by A, B, or C.

All parties will operate as separate, independent and autonomous organizations. Neither A, B, nor C will be involved in D's management, and D will have its own employees, officers and directors. D's business purpose will be separate and distinct from A, B, or C, and D will make goods and services available to the general public and unaffiliated entities.

The PLR states that an exempt organization may invest its endowment and other funds without jeopardizing its tax-exempt status. Establishment of D requires further analysis to determine whether its activities are distinct from those of A, B, or C, so as not to jeopardize their exempt status. It was determined D was established with a bona fide intention that it will have real and substantial business functions. D will be separate and will pay rent and dividends to C.

The PLR notes that, generally, rent from real property is excluded from UBTI under I.R.C. 512(b)(3), unless, in accordance with I.R.C. 512(b)(13), the income is received from a controlled organization. In applying I.R.C. 512(b)(13) to the facts presented, the PLR used the attribution rules under I.R.C. 318 and concluded that the control test was far-reaching. The PLR states that A will be treated as owning all of the beneficial interests in both B and C. With regard to B and C, A will be a controlling organization, and B and C will be controlled entities. C will own all the stock of D and, therefore, D will be treated as a controlled entity with respect to C. Since A owns all of the beneficial interests in C, A will be treated as also owning all of the stock interest in D. Since A owns all the beneficial interest in B, B will be a controlling organization with respect to D and D will be a controlled organization with regard to B.

D will pay rent to A, B, and C and dividends to C. The receipt of dividends by C from D is not taxable because I.R.C. 512(b)(1) excludes dividends from UBTI, and I.R.C. 512(b)(13) does not apply to dividend payments. Normally the receipt of rental income from real property would be excluded from UBTI under I.R.C. 512(b)(3), unless the income received was from a controlled entity as defined in I.R.C. 512(b)(13). Since D is considered a controlled entity under I.R.C. 512(b)(13), rental payments to A, B and C will constitute UBTI.

C. Foreign Insurance Company

PLR 1999-28-042 (April 20, 1999) concerns an I.R.C. 501(c)(6) business league that owns N, a foreign insurance company, which is engaged in the business of reinsuring workers compensation insurance. M is considered a United States person, while N is a controlled foreign corporation, and all of N's income is insurance income under I.R.C. 953(a).

M intends to cause N to make an election to be treated as a domestic corporation. If N makes this election under I.R.C. 953(d)(1), N will be treated as transferring all of its

assets to a domestic corporation in connection with an I.R.C. 354 exchange. M will be required to include in gross income certain amounts under I.R.C. 1248, with respect to earnings and profits accumulated during a certain period of time. The section 1248 amount attributable to N stock will be treated as a taxable dividend.

The PLR concludes that the amount, if any, that M would be required to include in income if N makes the 953(d)(1) election will not be included as an item of gross income in computing UBTI by reason of I.R.C. 512(b)(17)(A). Therefore, such amount would be considered a dividend and excluded from M's taxable income by reason of I.R.C. 512(b)(1).

7. Substantially Related

A. Healthcare Providers/Fitness Centers

In PLR 2000-51-049 (Sept. 26, 2000) the Service was asked whether the operation of a sports and fitness center was substantially related to the exempt purpose of a community healthcare organization that is described in I.R.C. 501(c)(3). The healthcare provider purchased the sports and fitness center, which provides cardiac rehabilitation services, a fitness/wellness center, and a roller-skating rink. Applying the "fragmentation rule," the PLR looked at each activity in question and determined whether the substantially related test was met.

First, the PLR looked at the cardiac rehabilitation program and concluded that it promoted the health of the community within the meaning of Rev. Rul. 69-545, 1969-2 C.B. 117.

Second, the PLR reviewed the facts attendant to the operation of the sports and fitness center where membership consisted of members of the community, including the general public and the healthcare provider's employees. The fitness center has different categories of membership with corresponding fees that vary depending on members' age and restrictions on availability of facilities during certain hours. The healthcare provider, assisted by a professional consultant, conducted a survey of members. The survey data show that the fitness center is available to, and affordable by, an economic cross-section of the community. Accordingly, amounts derived from regular members constitute income from an activity substantially related to the organization's exempt purpose. Use by the general public furthered a charitable purpose since it was available to a significant segment of the community. Also, use of the fitness center by the organization's employees fell within the convenience exception under I.R.C. 513(a)(2).

Third, the operation of the roller-skating rink indicates that the nominal fees charged make it available to the community for a variety of activities.

The PLR concluded that the operation of the sports and fitness center is substantially related to the healthcare provider's exempt purpose under I.R.C. 501(c)(3) and is not an unrelated trade or business under I.R.C. 513.

PLR 2001-01-036 (Oct. 12, 2000) also addresses issues with respect to an exempt organization's operation of a sports and fitness center. The PLR describes a full service healthcare provider that operates various medical and healthcare facilities through supporting tax-exempt organizations. One such supporting organization operates a sports and fitness center consisting of a gymnasium, track, warm water hydrotherapy pool, lap pool, natatorium, racquetball/squash courts, and other sports and exercise areas. In addition, the center has a pro shop, which carries various health and fitness items for its members, and a café, operated primarily for the convenience of its employees and members.

The Service was asked whether the operation of the sports and fitness center was substantially related to the healthcare provider's exempt purpose under I.R.C. 501(c)(3). The fitness center provides rehabilitative services to the healthcare provider's patients, and it also provides extensive community education and prevention programs. Many of these programs are open to nonmembers and are free of charge. The fitness center conducted a study to ensure its services are affordable to a broad cross-section of the community. The facts, analysis, and conclusion here are consistent with PLR 2000-51-049.

The PLR concluded that the operation of the sports and fitness center is substantially related to the accomplishment of the healthcare provider's exempt purpose. However, income derived from sales of items by the pro shop that are not used at the fitness center, or income generated by the café from members of the general public would be subject to tax. The sports and fitness center furthers the exempt purpose of the healthcare providers and income derived therefrom is not UBTI.

B. Sale of Burial Caskets

PLR 2000-33-049 (May 24, 2000) considered the question of whether the sale of burial caskets by a monastery founded by members of a religious order constitutes an unrelated trade or business under I.R.C. 513. The monastery is described in I.R.C. 501(c)(3) and is included in the group exemption ruling of its church. The monastery proposes to sell burial caskets modeled after traditional caskets designed for its members, and which convey monastic values practiced by the monastery and its members. Each casket sale will be accompanied by written materials explaining the particular monastic values regarding funerals and burials. The caskets will be hand crafted and made of solid

wood, and a removable wooden cross may be placed in the lid of the casket. Although members of the monastery will not be involved in manufacturing the caskets, the organization will have complete authority over design, markings and style. Sales will be made to the monastery's practicing members and their relatives, alumni of its religious schools, the religious communities of the monastery's church, those who visit its facility, and the general public.

The PLR concluded that the sales of caskets that will be used in connection with the religious burial ceremonies or services of the church of which the monastery is a part will further its exempt religious purpose and will not constitute an unrelated trade or business under I.R.C. 513. However, sales of caskets to members of the general public that will not be used in connection with the religious burial ceremonies or services of the church will not be substantially related to the monastery's exempt purpose and will result in UBTI.

C. Sale of Land/Providing Municipal Services & Recreational Facilities

In TAM 2000-47-049 (Aug. 2, 2000) the Service considered whether an I.R.C. 501(c)(3) organization formed "to promote the intellectual, social, physical, moral and religious welfare of the people" generated UBTI by selling land, providing municipal-type services, and operating a golf course, tennis courts and boating facilities. The organization is located on hundreds of acres of land, and its grounds are organized spatially as a compact town. The grounds contain hundreds of buildings, including boarding rooms, single-family homes, condominiums, and small hotels. The area is designated as a national historic district. The organization provides summer courses in a variety of subjects. More than 200 faculty members and 8,000 students are involved in its operations. As its main source of financial support, the organization charges attendees fees for a nine week summer session.

Land Sales

The organization bought land, divided it into lots, made improvements, and sold the lots. The organization allowed purchasers to construct individual houses on the lots. The organization provides services typically associated with a municipality, such as police protection, garbage collection, and road maintenance. The organization acquired additional land with the intention to improve the land and sell it in order to increase its residential housing and to increase summer session attendance.

The organization relied on Junaluska Assembly Housing, Inc. v. Commissioner, 86 T.C. 1114 (1986), in which a church created a tax-exempt auxiliary to construct, sell, or lease housing on a tract of land. The auxiliary maintained it would neither advertise, nor use real estate agents to attract buyers. The housing units were made available only to individuals involved in or supportive of the church activities. In the subject TAM, the

Service concluded that facts and circumstances are distinguishable from Junaluska, in which the court concluded that the sale of land was substantially related to the organization's exempt purpose.

There was some evidence that one of the purposes of the sales was to increase the organization's potential clientele. However, the relationship between sales of lots and the organization's goal of increasing attendance was somewhat tenuous – no substantial causal relationship existed between land sales and provision of, or even participation in, the organization's educational programs. Buyers were not selected based on anticipated involvement, as in Junaluska. The sole criterion appears to be the amount of the buyer's offer.

It was concluded the land was acquired and improved for the primary purpose of sale to customers. The development and sale of the land constitute a trade or business done in a regular business manner and were not substantially related to the organization's exempt purpose. Therefore, income derived therefrom is UBTI under I.R.C. 512(a)(1).

Income from provision of municipal-type services

The organization provides water and sewer, garbage collection, and services to its own buildings, and to the private residences within the grounds. The TAM held that because of the absence of a profit motive in connection with services to private residences, income derived from providing such services was not from a trade or business and was not subject to tax. Also, provision and maintenance of commonly used facilities are substantially related to the organization's exempt purpose. Any benefit derived by private residents was merely incidental and did not result in private interests being served for purposes of I.R.C. 501(c)(3). In addition, the entire grounds of the organization have been designated as a national historic district and many of the buildings designated national historic structures. Therefore, the provision and maintenance of these commonly used facilities serve an exempt purpose under I.R.C. 501(c)(3) of preserving historic district status.

Income from golf course, tennis courts & boating facilities

The TAM concluded that user fees from students for the use of these facilities do not constitute UBTI under I.R.C. 512(a)(1). As described above, the organization offers a wide variety of courses and religious programs to its students in order for them to develop a well-rounded mind, as well as improved health and body. Therefore, the provision of recreational facilities is substantially related to the organization's exempt purpose. However, providing these facilities to non-students does not further the organization's exempt purpose. The use of the recreational facilities by members of the public is a regularly carried on trade or business not appreciably different from private,

for-profit facilities. As a result, user fees derived from non-students constitute UBTI under I.R.C. 512(a)(1).

D. Tearoom and Gift Shop

In TAM 2000-21-056 (Feb. 8, 2000) an I.R.C. 501(c)(3) organization ("M") assisted needy women in earning a living by providing a place where they could sell articles and foodstuffs prepared by them. M operates a consignment shop, a gift shop, and a tearoom in the same facility. The issue presented is whether the operation of the tearoom and the shops is substantially related to M's exempt purpose. It was held the operation of the tearoom and the gift shop was not substantially related to the exempt purpose of M.

M is a membership organization comprising women of the community who pay dues and are required to volunteer a minimum amount of time for M's activities. M stated it was organized to aid deserving women. The consignment shop, gift shop, and tearoom are all run by volunteers and paid employees. The consignment shop displays and sells goods made by the needy women and generates 33% of M's revenues. The gift shop purchases items from regular for-profit vendors for resale to the public, producing 28% of M's revenues. The tearoom is a luncheon facility selling to the general public. The tearoom accounts for 34% of M's revenues, its largest source of revenue.

The regulations do not provide for a quantitative limitation on the amount of unrelated business an organization may engage in under I.R.C. 501(c)(3), other than the fundamental requirement the organization must be organized and operated exclusively for a charitable purpose. Operation of the gift shop and the tearoom constitutes approximately 66% of M's resources. The Service position is that M's activities in the gift shop and tearoom are unrelated to M's exempt purpose except as a means to raise money for the operation of the consignment shop.

The TAM held that income earned by the gift shop and tearoom constituted UBTI under I.R.C. 512(a)(1), and those activities are not substantially related to M's stated purpose of aiding needy women. It was determined that since the gift shop items were purchased from for-profit vendors with the intent of adding an aura of sophistication to the consignment shop, the gift shop items have no substantial causal relationship to the sale of the items produced by the needy and deserving women in the consignment shop.

The conclusion that the tearoom was not substantially related to M's exempt purpose was based on the following: its operations are presumptively commercial; it competes directly with other restaurants; it uses profit-making pricing formulas; and, M lacks plans to solicit donations from the general public.

Finally, the operation of the tearoom and the gift shop does not represent a substantial nonexempt purpose that would cause revocation of M's exempt status under I.R.C. 501(c)(3).

E. Airplane Rental

In Museum of Flight Foundation v. United States, 63 F. Supp. 2d 1257 (W. D. Wash. 1999), Boeing donated an historical aircraft to the Museum of Flight Foundation ("the Museum"). Subsequently, Boeing identified a need for the aircraft to test airframes for new engines. The Museum leased the plane back to Boeing. The Museum has never leased any aircraft for any purposes. The Service assessed taxes against the museum on the lease income as UBTI under I.R.C. 512(a)(1). The Museum petitioned for court review, and, the court held the lease constituted a "one-time, completely fortuitous lease of unique equipment that was unavailable on the open market." The court held that the lease was sufficiently related to the museum's tax-exempt purpose. The court reasoned that the lease in this case did not constitute business that was regularly carried on. Therefore, the court held the lease income did not constitute UBTI.

8. Social Clubs

A. UBIT and the FICA Tip Credit under I.R.C. 45B

The question of whether and under what circumstances the FICA tip credit under I.R.C. 45B should be used in computing a social club's UBIT was first considered in TAM 1999-31-041 (April 28, 1999). The issue presented in this TAM is whether a country club ("T") may claim credit under I.R.C. 45B for all tips received by its employees, or is the credit limited to tips received in the carrying on of T's unrelated business activity

T, which is described in I.R.C. 501(c)(7), operates a golf course, related amenities, and a large clubhouse where food and beverages are served to members and guests. Employee tips were reported on T's employment tax returns. FICA and Medicare taxes were paid on all tips earned by employees. T allows members to sponsor private parties and, as a result, income was reported as nonmember income on Form 990-T. T filed an amended 990-T for 1994-96 to claim credit under I.R.C. 45B for employer social security and Medicare taxes paid on employee tips. T calculated the credit based on all tips received by its employees rather than calculating the credit only on the tips received with respect to its unrelated business activities.

The TAM concluded that the I.R.C. 45B credit may be claimed with respect to all tips received by the club's employees. T is allowed to calculate its UBIT using the I.R.C. 45B credit, since I.R.C. 45B does not prohibit tax-exempt organizations from claiming the credit, nor does it limit the credit to FICA taxes associated with UBIT.

Following the issuance of the TAM, questions arose as to whether the case had been correctly decided. In a memorandum dated January 13, 2000, Acting EO Area Managers were advised to suspend any refund claims from exempt organizations that want to use the I.R.C. 45B credit in computing their UBIT pending further consideration of this issue. Later in the year the reconsideration process was completed, and in a memorandum dated November 27, 2000, the Director of EO Examinations was advised to remove I.R.C. 45B cases from suspense and to process them in a manner consistent with TAM 1999-31-041.

B. Nonrecognition of Gain – Sale of Land

PLR 2001-04-038 (Nov. 3, 2000) addresses the question of when gain from the sale of a parcel of land qualifies for nonrecognition pursuant to I.R.C. 512(a)(3)(D). The subject entity ("M") is a social club that is described in I.R.C. 501(c)(7). M's exempt activity is the ownership and operation of facilities used for golfing, tennis, and for social interaction among its members.

M intends to sell undeveloped land that will not be used to expand its golf course to an unrelated developer. There is no evidence the property for sale has ever been used by M's members directly in the performance of M's exempt function. M acquired the undeveloped land from N as part of an entire transaction. N would not sell the desired property to M without the inclusion of the undeveloped land. M is not in the real estate business and has no intention of using the undeveloped parcel to further its exempt purpose. The key factor, for purposes of the nonrecognition of gain provision, is whether the proposed land for sale to the developer was used directly in the carrying out of M's exempt recreational purposes.

The PLR holds that since the undeveloped land was not used directly in furtherance of M's exempt recreational purposes, the transaction would not meet the requirements under I.R.C. 512(a)(3)(D). The net gain on the sale would be subject to UBIT.

Another case addressing this issue is PLR 1999-29-044 (April 26, 1999). There, a social club ("X") owns 274 acres which include a clubhouse, golf course, swimming pool, tennis courts, water basin, trees and shrubbery planting. X intends to sell 6.75 acres to an unrelated third party. Most of the property that is for sale (4.25 acres) is used by X as a water basin, fox shelter, landscape equipment storage, and a buffer zone in order to limit noise from the adjacent highway. The remaining portion of the land for sale (2.5 acres) has been used by golfers to retrieve balls as a result of errant shots.

The PLR states that use of the property as a water basin, fox shelter, landscape equipment storage, and a buffer zone does not sufficiently establish direct exempt function use. To meet the nonrecognition of gain provision of I.R.C. 512(a)(3)(D), the property sold must have been used directly in the performance of the organization's exempt function. Of the 6.75 acres available for sale, only 2.5 acres meet the

nonrecognition provision, since that portion of the property was used directly by golfers. As the entire 6.75 acres were not used to accommodate such members to any significant degree, an allocation between the exempt and nonexempt parts of the property is appropriate. The PLR concludes that any gain from the sale of the 2.5 acres will meet the requirements under I.R.C. 512(a)(3)(D) and will not be subject to UBIT; any gain from the remaining 4.25 acres will not meet the requirements of the provision and will be subject to tax.

C. Nonrecognition of Gain – Sale of Painting

The subject of PLR 2000-51-046 (Sept. 22, 2000) is a social club ("W"), which is described in I.R.C. 501(c)(7), and whose facilities consist of dining and sleeping quarters, squash courts, and exercise equipment. Among W's assets is a painting that was received as a bequest in 1933 and has been prominently displayed for many years in the main dining room, which was named for it.

W states that the painting is an important part of its exempt function because it enhances a room where exempt activities take place. W received an offer from an unrelated third party to buy the painting, which has substantially appreciated in value. W's insurance carrier advised the painting be moved to a more secure area due to inadequacy of security protection. W's Board of Directors decided it would be too costly to increase security, and a safer location would be in storage. W decided to sell the painting and use the proceeds to further its exempt purpose. There is no evidence that W is in the business of buying and selling artwork, nor is it an investor in art. W has never sold a painting before and has no intention of doing so in the future.

The PLR concludes that use of the painting in the manner described constitutes use directly in performance of W's exempt function. As the painting was used directly in the performance of W's exempt function, any gain from the sale will not be recognized under I.R.C. 512(a)(3)(D). The PLR notes that proceeds from the sale must be used by W directly in the performance of its exempt function within the period beginning one year before the sale date and ending three years after such date.

Another case addressing this issue is PLR 98-44-012 (July 30, 1998), where an I.R.C. 501(c)(7) social club ("Y") displays approximately 20 paintings throughout the club's facilities. Y claims the paintings are an important part of its exempt function, because they enhance the rooms where exempt activities take place and distinguish the club from other clubs. Y needs funds to renovate and improve its facilities in order to attract new members. An appraisal indicated that one of the paintings, which hung in Y's main dining room for many years, was very valuable. An individual discovered that the club owned this valuable painting and made an unsolicited offer for its purchase. Y accepted the offer.

The PLR states that there is no evidence that Y is in the business of buying and selling artwork, nor is it an investor in art. Y has never sold a painting before and has no intention of doing so in the future. As the painting was used directly in the performance of Y's exempt function, the PLR concludes that any gain from the sale will not be recognized under I.R.C. 512(a)(3)(D). The PLR notes that proceeds from the sale must be used by Y directly in the performance of its exempt function within the period beginning one year before the sale date and ending three years after such date.

9. Gambling

A. Maryland Tip Jars

In Vigilant Hose Company of Emmitsburg v. United States, 87 AFTR2d Par. 2001-996; No. WMN-00-371 (D.C. Md. 2001), the court considered whether proceeds from "tip jars" placed in taverns for the benefit of a volunteer fire department constituted UBTI under I.R.C. 512(a)(1). The organization, which is described in I.R.C. 501(c)(4), raised funds to support fire fighting activities by receiving proceeds from the operation of tip jars placed in three taverns. Tip jars are gambling devices in which players purchase sealed pieces of paper containing numbers or symbols which may entitle the player to a prize. State law allows such gambling and requires the operator of the tip jar and a nonprofit organization to jointly apply for and obtain a county permit.

According to the president of the organization, its role in the tip jar activity was limited to obtaining permits and purchasing tip jar tickets; the tavern operators decided when, whether and under what circumstances the tip jars should be operated. The government agreed that these were the only activities conducted by the organization, but argued that the activities of the tavern employees should be imputed to the organization pursuant to a "joint venture" theory.

The court concluded that the organization's activities were "insufficiently extensive" to rise to the level of a trade or business for purposes of the tax on unrelated business income. The court declined to impute the activities of the taverns to the organization because of the lack of retention or exercise of control over the tip jar operations. The court distinguished State Police Association of Massachusetts v. Commissioner, supra, which held that for-profit firms' advertising activities should be attributed to the exempt organization where such firms were agents of the organization.

At the time this Topic was being prepared, no decision had been made as to whether this case should be appealed.

B. Nebraska Pickle Cards

In Education Athletic Association v. Commissioner, T.C. Memo. 1999-75, an I.R.C. 501(c)(3) organization ("EAA") sought a declaratory judgment under I.R.C. 7428 following denial by the Service of its public charity status. EAA funded its exempt educational purpose by selling "pickle cards" to liquor establishments in Nebraska. Pickle cards are gambling devices, and during the years in question all of EAA's revenues were derived from the sale of pickle cards.

The Service took the position that because EAA received all of its financial support from the sale of pickle cards, it did not meet the requirements for classification as a public charity under I.R.C. 509(a)(2). The basis for this position was that the sale of pickle cards was an unrelated trade or business under I.R.C. 513. The Service therefore determined EAA was a private foundation.

EAA argued its sale of pickle cards was not an unrelated trade or business because, under Nebraska state law, only exempt organizations could sell pickle cards. EAA further argued that since only exempt organizations may sell pickle cards in the state, it was not in competition with for-profit entities, and therefore, it deserved public charity status.

The court rejected these arguments and held that the tax on unrelated business income was not limited to amounts earned by a trade or business whose operations were in competition with for-profit entities. The sale of the pickle cards, said the court, was not substantially related to EAA's exempt purpose. The court relied on the plain language of I.R.C. 513(a), and the regulations thereunder, which provide that mere production of income to fund an exempt organization's activities is insufficient to establish a substantial causal relationship between the trade or business and the exempt activity. The court concluded that income generated from the sale of pickle cards was UBTI.

C. More Pickle Cards

A case with facts somewhat similar to those in Education Athletic Association, supra, can be found in TAM 98-51-001 (August 20, 1998). There, an I.R.C. 501(c)(3) organization ("M") had, as its stated exempt purpose, to act as an amateur athletic organization. Almost all of M's income was derived from the sale of pickle cards. The TAM concluded that, for a number of reasons, M did not meet the requirements for continued recognition of exemption under I.R.C. 501(c)(3). However, even if M continued to be described in I.R.C. 501(c)(3), income from the sale of pickle cards would be subject to UBIT. Also, if M continued to be described in I.R.C. 501(c)(3), since almost all of M's revenues were from the sale of pickle cards, M would not meet the requirements for classification under I.R.C. 509(a)(2) and would be a private foundation.

10. Miscellaneous Issues

A. Securities Purchased on Margin

Margin securities cases go back more than 20 years. The latest of these is Henry E. & Nancy Horton Bartels Trust for the Benefit of the Univ. of New Haven v. United States, 209 F.3d 147 (2d Cir. 2000). There, the court considered whether amounts derived by an organization ("the Trust") described in I.R.C. 501(c)(3) from investing in securities purchased on margin constitute unrelated debt-financed income under I.R.C. 514.

The Trust was formed to provide support for the University of New Haven, and was classified as a supporting organization under I.R.C. 509(a)(3). The Trust invested in securities purchased "on margin," that is, using funds borrowed from its stockbroker. The Trust filed Form 990-T showing unrelated business income tax due on income derived from its margin securities. The Trust paid the tax in full but then filed a claim for refund of those payments. The Service denied the refund claim, and the Trust brought a refund action. The trial court ruled that the income in question is taxable and the Trust appealed this decision.

On appeal, the Trust argued that this income should not be subject to UBIT because its investment activities do not constitute a trade or business; there was no "unfair competition;" the Trust's securities purchased on margin are not "debt-financed property" under I.R.C. 514(b)(1); and, the exceptions to "debt-financed property" and "acquisition indebtedness" under I.R.C. 514(b)(1)(A)(i) and 514(c)(4) are applicable.

The court rejected the Trust's arguments with respect to "unfair competition" and that its investment activities do not constitute a trade or business. The court said that the purchase of securities on margin is a purchase using borrowed funds. Therefore, under I.R.C. 514(c), the securities are subject to an acquisition indebtedness and constitute debt-financed property under I.R.C. 514(b)(1). Since the securities constitute "debt-financed property," I.R.C. 512(b)(4) and 514(a)(1) require that the income derived from them be treated as an item of gross income derived from an unrelated trade or business. Therefore, this income is automatically included in the I.R.C. 512 computation of UBTI.

Finally, the court rejected the Trust's argument that purchasing securities on margin is "substantially related" to its exempt purpose under I.R.C. 514(b)(1)(A)(i), and that such activity is "inherent" to its exempt purpose under I.R.C. 514(c)(4). The court cited Elliot Knitwear Profit Sharing Plan v. Commissioner, 614 F.2d 347 (3d Cir. 1980) and held that securities purchased on margin constitute debt-financed property, and amounts derived therefrom are subject to UBIT.

B. Indexation of UBIT Amounts

Rev. Proc. 2001-13, 2001-3 I.R.B. 337, section 3.12, provides that, for tax years beginning in 2001, the limitation under I.R.C. 512(d)(1) for annual dues to an agricultural or horticultural organization described in I.R.C. 501(c)(5) is $116.

Section 3.13 of Rev. Proc. 2001-13 provides that, for tax years beginning in 2001, the unrelated business income of certain exempt organizations under I.R.C. 513(h)(2) does not include a "low cost article" of $7.60 or less.

C. Non-501(c) Rev. Ruls. that apply UBIT Principles

Rev. Rul. 98-41, 1998-2 C.B. 256, modifies Rev. Rul. 67-301 (effective for taxable years beginning on or after September 22, 1980) to provide that an employees' trust's proportionate share of the income of a common trust fund is unrelated business taxable income to the extent that it would have been if the investment producing the income had been made directly by the employees' trust.

Rev. Rul. 98-60, 1998-2 C.B. 751, discusses impermissible tenant service income received by a real estate investment trust (“REIT”) under I.R.C. 856. The Rev. Rul. describes two situations and applies Reg. 1.512(b)-1(c)(5), which states that rent from real property under I.R.C. 512(b)(3) does not include payments by tenants for services.