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CHURCHES AND THE TAX ON UNRELATED BUSINESS INCOME

CHARLES M. WHELAN, S.J.*

The purpose of this memorandum is threefold:

1. To alert attorneys for dioceses and religious orders to the impending change in the liability of their clients to the federal income tax on unrelated business income;¹
2. To provide an introduction to the basic concepts of the tax on unrelated business income; and
3. To suggest certain steps which may be helpful to take at this time in preparation for the problems that will arise when the tax becomes effective with respect to churches and religious orders.

Although the focus of this memorandum is on the federal tax on unrelated business income, there is an important related tax question which should be noted immediately: liability for the state property tax. It seems at least unlikely that state and local authorities will continue to extend property tax exemptions to churches or church units that are held liable for the federal tax on unrelated business income. In many cases, imposition of the state property tax would be far more expensive than imposition of the federal tax on unrelated business income. Even in those states which permit proportional exemptions (depending on the amount of property devoted exclusively to exempt purposes), some difficult questions of the proper allocation of space are likely to arise.

Some states that have income taxes have already incorporated provisions that create a state tax on unrelated business income. The probabilities are high that federal income tax liability will also mean state income tax liability.

The points that will be considered in the balance of this memorandum are:

1. History of the Tax and of USCC's Position

* This memorandum has been drafted at the request, and with the active collaboration, of the Office of General Counsel of the United States Catholic Conference. I am particularly indebted to Wm. R. Considine, General Counsel, and George E. Reed for their advice and assistance. In its present form, however, the memorandum is still in the nature of an unofficial draft and is subject to further revision before formal issuance by the USCC Office of General Counsel.

¹ INT. REV. CODE OF 1954, §§ 511-14.

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HISTORY OF THE TAX AND OF USCC'S POSITION

Before 1950

If an exempt organization actively conducted a trade or business (as opposed to "passively" receiving income from investments in a trade or business), there was a question whether the exempt organization was really entitled to exemption or not. The Internal Revenue Code required (as it still does) that exempt organizations be devoted "exclusively" to exempt purposes. The pre-1950 decisions of the courts are not in perfect harmony. Even today, however, it remains true—quite apart from the unrelated business income tax provisions—that the tail cannot wag the dog. You cannot convert the Empire State Building into an exempt church by installing a chapel on the 99th floor.

Changes in 1950

Congress amended the Internal Revenue Code so as to impose the federal income tax on the unrelated business income of four categories of exempt organizations, including section 501(c)(3) organizations *except for*

churches and conventions or associations of churches. USCC (then NCWC) neither asked for nor opposed exception of churches. In the following years, however, USCC did attempt to make sure that "churches" included "religious orders." The IRS, however, was determined to tax the Christian Brothers on their brandy business, and specified in the regulations that only religious orders "performing sacerdotal functions" fell within the concept of "churches." As a result, the tax status of congregations of women was left unsettled. After an adverse decision to the Christian Brothers in *De La Salle Institute v. United States*,² the Brothers settled with the IRS and have ceased to be a focal point of IRS concern.

Developments in the 60's

It did not take tax lawyers very long to figure out ways around the reforms of 1950. Congress had struck only at the most obvious abuses. A number of the mass media (and importantly, CBS-TV and the *Wall Street Journal*) greatly publicized the business operations of churches. The leadership of many Protestant denominations became seriously concerned and issued statements calling for the abolition of the exemption of churches from the unrelated business income tax. Several suits were started by POAU challenging the constitutionality of the exemption. After circulating a questionnaire to the dioceses and after considerable deliberation on the subject, the USCC decided in 1969 to ask Congress to repeal the exemption of churches from the tax on unrelated business income. Such a repeal, it was judged, would not have much practical effect on the Catholic Church in the United States, would be good public relations, would remove a perennial source of financial temptation, and would eliminate a troublesome and dangerous constitutional question.

The Tax Reform Act of 1969

In this legislation Congress substantially amended sections 511-14 of the Internal Revenue Code. The tax on unrelated business income was extended to all section 501(c) organizations (including churches) except federal instrumentalities. Moreover, "unrelated debt-financed income" was included in the concept of unrelated business income.³

During the legislative proceedings that led to the enactment of the Tax Reform Act of 1969,⁴ USCC was successful in its sustained efforts to secure a "bail-out period" for churches and certain other provisions that would mitigate the impact of the unrelated business income tax on churches. The nature of these provisions will be explained below.

² 195 F. Supp. 891 (N.D. Cal. 1961).

³ INT. REV. CODE OF 1954, § 514.

⁴ Pub. L. No. 91-172, amending INT. REV. CODE OF 1954.

Developments Since 1969

Because of the complex changes made in many parts of the Code by the Tax Reform Act of 1969, the Treasury was slow in proposing new regulations. USCC was particularly attentive to how the Treasury would define "church" in any new regulations. When the Treasury finally did propose a definition, it turned out to be the same restrictive definition as in the prior regulations. USCC objected and was successful in persuading the Treasury to withdraw the proposed regulation. USCC, however, was not successful, despite the Treasury's assurances, in securing a regulation that explicitly included religious congregations of sisters and brothers in the Code concept of "church." At the present time, the only new (post-1969) definition of "church" in the regulations seems to have been inspired by Gertrude Stein:

*"Church or a convention or association of churches. An organization is described in section 170(b)(1)(A)(i) if it is a church or a convention or association of churches."*⁵

On the constitutional front, the Supreme Court has taken four actions since 1969 that affect the tax exemptions of churches. In *Walz v. Tax Commission*,⁶ the Court upheld the constitutionality of the traditional inclusion of houses of worship in the exemptions from property taxes. In *Diffenderfer v. Central Baptist Church of Miami*,⁷ the Court held that a challenge to the constitutionality of a Florida exemption of a church parking lot (commercially rented on weekdays) had been mooted by intervening legislation that repealed the exemption. In *Committee for Public Education and Religious Liberty (PEARL) v. Nyquist*,⁸ the Supreme Court held unconstitutional a New York State income tax adjustment for parents of children in parochial schools (thus raising questions about the constitutionality of tax relief that is limited to religious institutions). And by denying certiorari in *Christian Echoes National Ministry, Inc. v. United States*,⁹ the Supreme Court left standing a 10th Circuit decision¹⁰ that upheld the validity of the section 501(c)(3) restrictions on political activities of such exempt organizations (thus raising further questions whether churches enjoy any special constitutional status under the tax laws).

This brief survey of the highlights of the relevant tax history of the last 25 years indicates that there are still some basic unsettled statutory and constitutional questions in the area of churches and unrelated businesses. For reasons that will have to be explained elsewhere, I am satisfied that a persuasive argument can be made that (1) congregations of brothers

⁵ Treas. Reg. § 1.170A-9(a) (1974).

⁶ 397 U.S. 644 (1970).

⁷ 404 U.S. 412 (1972).

⁸ 413 U.S. 756 (1973).

⁹ 414 U.S. 864 (1973).

¹⁰ 470 F.2d 849 (10th Cir. 1972).

and of sisters, as well as of priests, are included within the Code concept of "church" and (2) that the special provisions for churches in the Tax Reform Act of 1969 are constitutional.

EFFECTIVE DATE OF THE TAX

January 1, 1976 is the key date. As usual, however, there are complications. The exact language is contained in section 512(b)(16).¹¹ The first thing to note is that there is no "bail-out period" for the tax on unrelated debt-financed income. If a church has had such income during the last few years, it has been liable for the tax. Secondly, the "bail-out period" for unrelated business income during tax years beginning before January 1, 1976 extends only to such income from a trade or business that a church (or its predecessor) was carrying on before May 27, 1969. If a church acquired a new trade or business on or after May 27, 1969, it has been liable for the tax on unrelated business income with respect to the new trade or business.

Congress (after considerable persuasion) provided the bail-out period for churches so that they could set their financial houses in order without undue sacrifice. It is important that churches be properly prepared for the imposition of tax liability for tax years beginning on or after January 1, 1976. There will be no justification for pleading surprise or lack of opportunity to be prepared.

MAJOR AREAS OF CONCERN: AUDITS AND RELATEDNESS

Audits

At the same time that Congress imposed the unrelated business income tax on churches, Congress was careful to provide protection for churches against unreasonable audits based on their real or supposed unrelated business activities.¹² Under this section, only a regional IRS director or higher official can order an audit of a church in order to determine its liability for the tax on unrelated business income, and then only after notifying the church in advance of the actual audit.¹³ Moreover, "no examination of the religious activities of such an organization shall be made

¹¹ INT. REV. CODE OF 1954, § 512(b)(16) provides:

(16) Except as provided in paragraph (4) [an inclusionary section relating to debt-financed property], in the case of a church, or convention or association of churches, for taxable years beginning before January 1, 1976, there shall be excluded all gross income derived from a trade or business and all deductions directly connected with the carrying on of such trade or business if such trade or business was carried on by such organization or its predecessor before May 27, 1969.

¹² See *id.* § 7605(c).

¹³ *Id.*

except to the extent necessary to determine whether such organization is a church or convention or association of churches, and no examination of the books of account of such an organization shall be made other than to the extent necessary to determine the amount of tax imposed by this title."¹⁴

There is reason to believe that IRS will start auditing churches for unrelated business income in 1975, rather than wait until 1976 or 1977. It is obviously important for the freedom of the Church that we invoke the safeguards provided by section 7605(c). At the same time we must be sensitive to the public relations problem involved in throwing a cloak of secrecy over church financial operations. Certainly, the "excessive entanglement" arguments used so severely against us in the school aid decisions of 1971 and 1973 can be turned around and used against excessive governmental audits. We should not contend, however, that government has no right to determine by competent evidence whether (a) a given organization is a church or (b) whether the organization is engaged in unrelated business activities. A fine balance needs to be struck between our public accountability and the freedom of our ministries.

Relatedness

The regulations state that for an activity to be substantially related to an exempt purpose, it must contribute importantly (other than by the raising of funds) to the accomplishment of the exempt purpose.¹⁵ This test seems reasonable in light of the legislative history of the tax on unrelated business income. The most serious questions that are likely to arise for churches have to do with what the exempt purposes of the churches are.

We should be vigilant in defending as properly religious the broad range of activities in which the Catholic Church has traditionally engaged. The fact that some of these activities may produce substantial amounts of income and even of net income should not deter us from claiming that they are substantially related to the function of the Church. At this time, it is impossible to tell how broad or narrow a view of church functions the IRS will take in the coming years. The tautological definition of church, however, in the new regulations under section 170(b)(1)(A)(i) is a sign that the IRS has serious unresolved difficulties about both the structure and the functions of churches.¹⁶

With respect to both audits and "relatedness," it is inevitable that the provisions of section 6033(a)(2) will be drawn into discussion. This section deals with exceptions from the informational filing requirements for organizations exempt under section 501(a), and speaks of "churches," "their

¹⁴ *Id.*

¹⁵ Treas. Reg. § 1.513-1(d)(2) (1971).

¹⁶ See text accompanying note 5 *supra*.

integrated auxiliaries," "the exclusively religious activities of any religious order," and "religious organizations." Just how these various terms will finally be related to each other, it is now impossible to tell. The important point to keep in mind is that we should never concede that churches and religious orders are mutually exclusive categories.

WHAT TO DO NOW

Review of Sources of Income and of Accounting Systems

The first step in preparing for the tax on unrelated business income is to look at the sources of income of a diocese or religious order to see whether any of them might arguably be from a substantially unrelated activity or from unrelated debt-financed property. If such a source of income exists, the next step is to determine whether the books are being kept in a way that would make compliance with the tax on unrelated business income possible. The proper tax forms should be secured, and a comparison made of the information required with the information that is available. The most likely problems in the accounting area will be whether suitable records have been kept for determining the basis and depreciation of property and for allocating expenses between related and unrelated activities. The question of when the fiscal year begins is also important: there is no tax for tax years beginning *before* January 1, 1976 (providing the unrelated trade or business was carried on prior to May 27, 1969). Accordingly, starting the fiscal year as late in the calendar year as is consistent with sound accounting principles will result in immunity from the tax through a substantial part of 1976.

Sharing of Information

Despite its enactment in 1950, the law of the tax on unrelated business income is still in its infancy. We can expect a great expansion, starting in 1976. Some method of pooling information (especially about actual IRS practices and private rulings or determination letters) is greatly to be desired. As in the past, the Office of General Counsel of the United States Catholic Conference will be happy to serve as a clearinghouse for information on developments in the unrelated business income tax. Attorneys for dioceses and religious orders are urged to keep the General Counsel's office informed of significant developments in their area.

Coordination of Efforts with IRS

It seems certain that the IRS will be asked to issue a number of rulings in connection with churches and the tax on unrelated business income. Without derogating from the freedom and responsibility of individual attorneys for their clients' affairs, it seems proper to suggest that a piecemeal, uncoordinated approach to the IRS is not in the best interests of the

Church as a whole. In the past, the Office of General Counsel of the USCC has served as the principal agent in dealing with the IRS on matters of general tax significance for the Church. The continuation of this tradition seems to be the most effective way to prevent long-range losses for short-term gains. At the same time it should be remembered that the Office of General Counsel never substitutes itself as the attorney for a particular diocesan or religious order client. It is a question of coordination, not of the substitution of responsibility and control.

SOME TYPICAL EXAMPLES OF UNRELATED BUSINESS INCOME

Although the Catholic Church firmly believes that all human activities are ultimately related to God, the Church has never taught that the operation of oil wells, race tracks or department stores is an inherently religious activity. Motivation may make an entrepreneur a saint, but it cannot make an unrelated business related. If the only reason a particular church is engaging in a particular business activity is to make money, that activity is unrelated in the tax sense. There was a time when the "destination principle" protected income from outright trades or businesses, but the tax on unrelated business income was intended precisely to reverse that result.

To the best of my present knowledge, there are only two typical situations in which dioceses or religious orders get involved in outright trades or businesses. The first is when some businessman gives his business to a diocese or religious order. The second is when a religious order that professes the monastic ideal of self-support engages in a trade or business as a deliberate means of supporting itself. The Cistercian Order, more commonly known as the Trappists, is a good example of this second category.

Congress, however, did not limit the coverage of the tax on unrelated business income to "outright" trades or businesses. In section 513(c) of the Code, Congress reached inside exempt activities to tax unrelated components such as advertising. The lawyer for any diocesan newspaper that carries advertising (or any other diocesan publication that does the same thing) needs to take a careful look at this section and the implementing regulations. If the publication operates at a net loss, there is obviously no tax problem. If the publication operates at a net gain, there may be a tax problem.

One traditional source of church income has been the conduct of bingo, bazaars and raffles. Such fund-raising activities go beyond the mere solicitation of contributions and clearly involve some element of *quid pro quo*. Are such activities unrelated trades or businesses? It can be argued that they are not, because they are not in competition with any existing commercial counterparts. On the other hand, there is a revenue ruling that a labor organization's income from public bingo games is unrelated busi-

ness income.¹⁷ Obviously, there will have to be further rulings in this area before any certainty can be attained.

Still another area of necessary concern is that of cooperative arrangements between church units for the performance of services that can be purchased on the open market. If a hospital runs its own laundry, there is no unrelated business income problem. But if a hospital starts performing laundry services for other hospitals, there is a problem; and there is also a problem if a group of hospitals get together and establish a common laundry to service their needs.

Finally, there is the problem of unrelated debt-financed income. As already mentioned, churches have been liable for the tax on this type of income for all tax years since 1970. Presumably, the attorneys for dioceses and religious orders are already familiar with the principal features of this type of income. The central idea is that if an exempt organization borrows money to make money rather than to carry on its exempt activities, the organization will be liable to the tax on unrelated business income. As always, however, there are numerous complications: section 514, which contains the statutory details, runs for eight pages in the Internal Revenue Code.

Since this memorandum is concerned more with diagnosis than with remedies, I will mention only the most basic analytical points here. No unrelated debt-financed problem arises unless a church possesses property with all three of the following characteristics: (a) the property is debt-financed with respect to its ownership; (b) the property is held for the production of income; and (c) the use of the property is not substantially related to the exercise of the church's exempt functions. Even if all three of these characteristics are present, there still may be no tax liability, thanks to the many exceptions which Congress has incorporated in section 514.

Three other points deserve brief mention: the "but for" rule, the 15-year "land rule" for churches, and the use of debt-financed property in an unrelated trade or business.

Under the "but for" rule, income-producing property will be considered debt-financed even though there is no acquisition indebtedness *if* it was reasonably foreseeable at the time of acquisition that buying the property outright would necessitate incurring a debt with respect to some other property or *if* an indebtedness was incurred prior to acquisition that would not have been incurred except to purchase the income-producing property outright.¹⁸

One common borrowing situation for churches is the acquisition of land for future use. If such property produces income during the period

¹⁷ Rev. Rul. 59-330, 1959-2 CUM. BULL. 153.

¹⁸ See INT. REV. CODE OF 1954, § 514(c). See also Treas. Reg. § 1.514(c)-1 (1972).

before it is actually put to exempt use, there would be, in principle, unrelated debt-financed income. Congress, however, has provided a 15-year tax-free period for churches, subject to certain limitations to prevent abuses.¹⁹ Other exempt organizations get only a 10-year period and are also subject to a "neighborhood" rule.²⁰

Finally, if debt-financed property is used in an unrelated trade or business, the income it produces will be considered "regular" unrelated business income, not both such income and debt-financed income. The Treasury, in its mercy, has decided that Congress did not mean to tax such income twice.²¹

Churches can avoid many problems in the unrelated debt-financed income area by keeping careful, accurate records of the timing, purposes and interrelationship of borrowings and acquisitions. Such records are particularly necessary for loans and acquisitions that are not part of the usual "course of business" of a church.

BASIC CONCEPTS OF THE TAX ON UNRELATED BUSINESS INCOME

There are several different ways to start analysis of an unrelated business income problem. One is to start at the top: is the activity in question a "trade or business" in the technical Code sense? Is it "regularly carried on" within the sense of section 512(a)(1)? Is it "substantially unrelated" within the meaning of section 513(a)? Another way, however—and in my judgment, a better way—is to start at the bottom: does the activity, or the income it produces, fall within one of the many modifications or exceptions Congress has created to the tax on unrelated business income? This second method of analysis is easier because the exceptions are clearer than the general rule. When possible, lawyers should avoid wrestling with the conceptual difficulties inherent in the first method of analysis. For one thing, the IRS is extremely reluctant to admit that an income-producing activity that is neither manifestly an exempt function nor covered by one of the exceptions still does not fall within the general rule.

Income Modifications

Section 512(b) contains 17 "modifications" of the concept of unrelated business taxable income. Some of these modifications (notably, the famous WWL modification in paragraph 17) are applicable only to the particular tax-exempt organizations that succeeded in lobbying for them. A number of the modifications, however, are of general application. I will note briefly the most important of them: dividends, interest, annuities and royalties

¹⁹ See INT. REV. CODE OF 1954, § 514(b)(3)(E).

²⁰ *Id.* § 514(b)(3)(A)-(D).

²¹ See Treas. Reg. § 1.514(b)-1(b)(2) (1972).

are not unrelated business income;²² rents from real property are not unrelated business income, but rents from combinations of real and personal property may be unrelated business income;²³ capital gains are not unrelated business income.²⁴

Note, however, that even with respect to dividends, interest, annuities, royalties, rentals from real property that had capital gains, if debt-financed property is involved, the income is unrelated business income to the extent of the debt-financing.²⁵ Note also the special rule in section 512(b)(15) with respect to the includibility in "gross income" of interest, annuities, royalties and rents (but not dividends or capital gains) received by a "controlling organization" from a "controlled organization."²⁶ The term "control" is defined in section 368(c) and means "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."²⁷

The income from certain types of research is not unrelated business income.²⁸ As already noted, paragraph 16 of section 512(b) is the "bail-out" provision for churches.²⁹

The modifications in section 512(b) affect deductions as well as inclusions with respect to unrelated business income. Paragraph 10 limits the charitable contribution deduction under section 170 to five percent of the unrelated business taxable income.³⁰ Paragraph 12 has the effect of creating \$1000 threshold for liability for the tax on unrelated business income. Moreover, paragraph 12 explicitly provides:

In the case of a diocese, province of a religious order, or a convention or association of churches, there shall also be allowed, with respect to each parish, individual church, district, or other local unit, a specific deduction equal to the lower of—(A) \$1,000, or (B) the gross income derived from any unrelated trade or business regularly carried on by such local unit.³¹

The "Substantially All" Exceptions

The modifications in section 512(b) relate to whether certain types of income are includible in unrelated business income and whether certain types of deductions are allowable against such income. In section 513(a)

²² INT. REV. CODE OF 1954, § 512(b)(1), (2).

²³ See *id.* § 512(b)(3).

²⁴ *Id.* § 512(b)(5).

²⁵ *Id.*

²⁶ *Id.* § 512(b)(15).

²⁷ *Id.* § 368(c).

²⁸ *Id.* § 512(b)(7)-(9).

²⁹ See note 11 and accompanying text *supra*.

³⁰ INT. REV. CODE OF 1954, § 512(b)(10).

³¹ *Id.* § 512(b)(12).

Congress lays down the general rule for what constitutes an unrelated trade or business and then creates three exceptions. Two of these exceptions are the "substantially all" exceptions; the third is the "primarily for the convenience" exception.

If substantially all the work in carrying on the trade or business is performed for an organization without compensation, the trade or business is not unrelated.³² The regulations do not specify what "substantially all" means, but there is reason to believe that 80 percent or more will satisfy this requirement. Obviously, there will be questions that must be answered about how you compute 80 percent (or any other percentage) of "work." It would seem appropriate to take the following factors into account: the total number of workers; the actual payroll and what the payroll would be if everyone were paid at the going rates; the total number of man-hours; and whether the "key personnel" are paid or volunteers. Moreover, there will also be questions, particularly with respect to the members of religious orders, about what "without compensation" means. In the past, the IRS has never treated the maintenance of members of religious orders as "compensation." There is no reason to think that the IRS has any present intention of changing its position, but it must be recognized that once the IRS discovers that section 513(a)(1) provides an escape hatch for certain religious orders with substantial business activities (such as the monastic orders), the IRS may well be tempted to try to lock the door.

The other "substantially all" exception to the definition of an unrelated trade or business is "the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions."³³ The usual type of "thrift shop" is, therefore, not an unrelated trade or business.

The "Primarily for the Convenience" Exception

If a church, or other section 501(c)(3) organization, carries on a trade or business primarily for the convenience of its "members, students, patients, officers, or employees," the trade or business is not unrelated.³⁴ In my judgment, it would be well not to push "convenience" too far. The legislative history makes it clear that the purpose of this exception was to continue the exemption of the income from facilities like cafeterias and gift shops which are on the working premises of the exempt organization and which are not freely open to the general public.

"Trade or Business"

If none of the modifications in section 512(b) or of the exceptions in

³² *Id.* § 513(a)(1).

³³ *Id.* § 513(a)(3).

³⁴ *Id.* § 513(a)(2).

section 513(a) suffices to take particular income or a particular activity out of the unrelated business category, it becomes necessary to consider whether the income-producing activity is a trade or business, whether it is regularly carried on, and whether it is substantially unrelated to the exempt organization's functions.

The Code concept of "trade or business" has been firmly established by the body of law built up under section 162.³⁵ This concept must be carefully distinguished from "holding property for the production of income."³⁶ Moreover, section 513(c) somewhat complicates the matter by stating that, for purposes of that section, "the term 'trade or business' includes any activity which is carried on for the production of income from the sale of goods or the performance of services."³⁷ Some proposed amendments to regulation section 1.513-1(b) make it clear that while the IRS will generally stick to the section 162 concept of a trade or business, it will in certain instances go beyond that concept. In particular, it will use section 513(c) to reach commercial advertising income of exempt organization publications.

The proposed amendments to regulation section 1.513-1 also place considerable emphasis upon "competition with nonexempt business endeavors" as a criterion of whether a particular activity is a trade or business. Congress did not use the word "competition" in the Code, but the legislative history provides substantial support for the IRS' position. On the other hand, we should never concede, as noted below, that "competition" proves *unrelatedness*.

"Regularly Carried On"

These words occur in section 512(a)(1). The Treasury explanation is in regulation section 1.513-1(c). The rules are somewhat complicated, but merely annual affairs are clearly excluded from "regularity." It should be noted that the IRS will consider the *manner* in which activities are pursued as well as their frequency and continuity in determining whether the activities are "regularly carried on." Even if the IRS is wrong in considering manner under this heading, it would certainly be right to do so in connection with "trade or business."

"Unrelated"

To be related enough to escape tax liability, the income-producing activity must have a substantial causal relationship to the achievement of exempt purposes. Merely providing money for the achievement of those purposes is not a "substantial causal relationship" in the tax sense. In

³⁵ *Id.* § 162 (deductions for ordinary and necessary trade or business expenses).

³⁶ *See id.* § 212.

³⁷ *Id.* § 513(c).

regulation section 1.513-1(d)(4) the Treasury applies these principles to four categories of situations: income from performance of exempt functions; disposition of the product of exempt functions; dual use of assets or facilities; and exploitation of exempt functions.³⁸ The examples which the Treasury gives should be carefully studied by any attorney who is forced to the ultimate defense that his client's income-producing activity is substantially related to the client's exempt functions.³⁹

JUDICIAL CONSTRUCTIONS

Although the total number of cases construing the unrelated business income provisions is not great, the courts have shown a commendable independence of the IRS and the regulations in reaching their decisions. The courts have also demonstrated a tendency observable in other complicated tax areas: the creation of judge-made rules over and above those embodied in the text of the Code.

Some of the decisions put great emphasis on profitability. Under this criterion, the more lucrative an activity is, the more likely it is to be held an unrelated trade or business. When high profitability is added to actual competitiveness with taxpaying businesses, the activity is almost certain to be held unrelated. And if the activity is carried on in a highly business-like way, as well as being highly profitable and actually competitive, it will be the rare judge who will find sufficient relatedness to defeat tax liability. On the other hand, where these three criteria are not met in a substantial degree, the courts have shown themselves fairly lenient in finding a substantial relationship between the income-producing activity and the exempt functions.

THE BASIC VALUES TO BE PRESERVED

First and foremost, we must defend the freedom of the Church in the selection of her ministries. I have already indicated that the relatedness argument is best avoided whenever possible; but when it is not possible, we should face it squarely and determinedly. The Church must not be confined to the church. The spiritual and corporal works of mercy are an integral part of her mission.

Secondly, in dealing with the IRS and the courts, we should never challenge the authority of Congress to tax commercial activities, whether those activities are religiously motivated or not. The temptation to take extreme positions on the constitutional immunity of the Church from taxation should be resisted in the same spirit in which Christ said: "Render unto Caesar what is Caesar's, and unto God what is God's." In this way

³⁸ Treas. Reg. § 1.513-1(d)(4) (1971).

³⁹ *Id.* § 1.513-1(d)(4)(iv) *Example(1)-(7)* (1971).

we will both perform our duties as citizens and provide the best guarantee we can for the continuing constitutionality of the traditional religious tax exemptions.