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UBIT UPDATE

DEIRDRE DESSINGUE HALLORAN*

INTRODUCTION

The Internal Revenue Code (the "Code") exempts certain organizations from federal taxation.¹ These organizations are, however, subject to an unrelated business income tax ("UBIT") for any "unrelated trade or business" they engage in.² The Code defines "unrelated trade or business" as any trade or business that is "not substantially related" to an organization's exempt purposes.³ An "unrelated trade or business" has three essential elements. It must be: (1) a trade or business as defined

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¹ I.R.C. § 501(a) (West Supp. 1994). In section 501, the Internal Revenue Code (the "Code") provides an extensive list of those organizations exempt from taxation. *See id.* § 501(c); *id.* § 501(d).

² *Id.* § 512(a)(1); *see id.* § 511(a)(1). Section 511 provides, in part: "[t]here is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every [exempt] organization . . . a tax computed as provided in section 11." *Id.* Section 512(a)(1) of the Code states: "the term 'unrelated business taxable income' means the gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it." *Id.* § 512(a)(1).

See generally Treas. Reg. § 1.513-1(b) (as amended in 1983). Section 1.513-1(b) states that "[t]he primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the non-exempt business endeavors with which they compete." *Id.*

³ I.R.C. § 513(a) (West Supp. 1994).

under section 162 of the Code;⁴ (2) regularly carried on; and (3) not substantially related to the organization's exempt purposes.⁵

To determine whether activities constitute a trade or business for purposes of federal tax exemption, the Internal Revenue Service (the "IRS") applies a doctrine known as the "fragmentation rule."⁶ This rule classifies or fragments an organization's activities into related and unrelated activities. An activity does not lose its identity as a trade or business merely because it is carried on as part of a larger activity or group of activities.⁷

An example of the way the IRS fragments activities arises in the publication of diocesan newspapers. Though editors may view the publication of a diocesan newspaper as an integrated activity, the IRS does not. Rather, the IRS considers newspaper advertising operations a separate trade or business that is unrelated to a newspaper's exempt operations. Thus, income generated from the sale of advertising in an otherwise exempt newspaper is subject to UBIT.

Perhaps the ultimate fragmentation occurred several years ago when the IRS required an item-by-item analysis of museum gift shops to

⁴ *Id.* § 162; see *id.* § 513(c) ("[F]or the purposes of this 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."); Treas. Reg. § 1.513-1(b) (as amended in 1983). Determining whether an organization's activities amount to trade or business requires an examination of the facts of each case. See *Commissioner v. Groetzinger*, 480 U.S. 23, 36 (1987). In *Groetzinger*, Justice Blackmon explained:

The phrase "trade or business" has been in § 162(a) and that section's predecessors for many years. Indeed, the phrase is common in the Code, for it appears in over 50 sections and 800 subsections and in hundreds of places in proposed and final income tax regulations [T]he code has never contained a definition of the words "trade or business" for general application, and no regulation has ever been issued expounding its meaning for all purposes.

Id. at 27.

⁵ Treas. Reg. § 1.513-1(a) (as amended in 1983). Regulation § 1.513-1(a) derives these three elements from sections 512 and 513 of the Code. *Id.* Section 512(a)(1) states that the unrelated trade or business must be "regularly carried on." I.R.C. § 512(a)(1) (West Supp. 1994). Section 513(a) defines "unrelated trade or business" as any trade or business which is not substantially related to the organization's exempt purposes. *Id.* § 513(a)(1).

⁶ See I.R.C. § 513(c) (West Supp. 1994) (stating that "an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar" exempt activities); see also *United States v. American College of Physicians*, 475 U.S. 834, 839-40 (1986). In *American College of Physicians*, Justice Marshall noted that Treasury Regulation § 1.513-1 "segregated the 'trade or business' of selling advertising space from the 'trade or business' of publishing a journal." *Id.* at 839 (discussing Treas. Reg. § 1.513-1(b)). This fragmentation approach was "widely criticized." *Id.* Nevertheless, the approach was subsequently endorsed by Congress in 1969 when it amended section 513(c) of the Code to include much of the language in § 1.513-1(b). *Id.*

⁷ Treas. Reg. § 1.513-1(b) (as amended in 1983).

identify items subject to UBIT. The IRS taxed items that were primarily utilitarian and exempted those items that were primarily educational.⁸

I. TRADE OR BUSINESS REGULARLY CARRIED ON

A. "Trade or Business"

Although neither section 162 nor the regulations define "trade or business," for the purposes of section 513,⁹ the term will include "any activity which is carried on for the production of income from the sale of goods or the performance of services."¹⁰ Generally, the IRS treats most activities as constituting a "trade or business." A more common issue for IRS scrutiny concerns whether an activity is "regularly carried on"—whether it exhibits "frequency and continuity" and is carried on in a manner similar to its commercial counterpart.¹¹

B. "Regularly Carried On"

The Treasury Regulations provide guidelines for determining whether an activity is "regularly carried on."¹² An activity's manner of conduct and time-span must be compared to those of similar commercial activities.¹³ For example, a sandwich stand operated for two weeks at a state fair by a hospital auxiliary is not considered "regularly carried on," yet an exempt organization's operation of a commercial parking lot every Saturday, fifty-two weeks a year is deemed "regularly carried on."¹⁴

This issue was addressed by *National Collegiate Athletic Ass'n v. Commissioner*,¹⁵ which involved advertising contained in a program for the "Final Four" men's collegiate basketball tournament.¹⁶ The IRS asserted that the income from the program's advertisements was subject to UBIT because the advertising activity was "regularly carried on."¹⁷ The

⁸ See, e.g., Priv. Ltr. Rul. 86-05-002 (Sept. 4, 1985). Examples of items considered related to the museum's primary "educational" purpose included exact replicas of furnishings on display at the museum and copies of various accessories on display at the museum. *Id.* Items considered primarily utilitarian, and thus unrelated to the primary purpose of the museum, were soaps, bath oils, and colognes. *Id.*

⁹ See *supra* note 4.

¹⁰ I.R.C. § 513(c) (West Supp. 1994); Treas. Reg. § 513-1(b) (as amended in 1983).

¹¹ Treas. Reg. § 1.513-1(c)(1). The regulation mandates that the "regularly carried on" requirement "be applied in light of the purpose of the unrelated business income tax to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete." *Id.*

¹² *Id.* § 1.513-1(c)(2).

¹³ *Id.* § 1.513-1(c)(2)(i).

¹⁴ *Id.*

¹⁵ *National Collegiate Athletic Ass'n v. Commissioner*, 914 F.2d 1417 (10th Cir. 1990), *action on decision*, 1991-015 (July 15, 1991).

¹⁶ *Id.* at 1419-20.

¹⁷ *Id.* at 1422-23.

IRS asserted that, since the advertisements were solicited by a professional agency over the course of an entire year, the advertising activity was "regularly carried on."¹⁸ The court upheld the organization's position that the length of the tournament was the appropriate standard for judging regularity,¹⁹ and concluded that a three-week annual tournament was not a "regularly carried on" activity.²⁰ While this decision represents only the view of the United States Court of Appeals for the Tenth Circuit, the IRS has indicated that it will continue to litigate the issue in other circuits²¹—perhaps in the hope that the Supreme Court will soon decide the controversy.²²

A private letter ruling issued in 1992 reached a particularly strained result on the "regularly carried on" issue.²³ That ruling involved an exempt business league that published a business directory every two or three years.²⁴ The IRS concluded that the directory was "regularly carried on," and, noting that the organization's executive director devoted six or seven months each year to work on the directory, found that its advertising income was subject to UBIT.²⁵ The IRS distinguished this scenario from one where advertisements are published in connection with annual fundraising events and attached great significance to the need for an annual "event."²⁶ The regulations contain an exception to the "regularly carried on" rule for advertising that relates to annual fundraising events, such as sporting events or music and dance perform-

¹⁸ *Id.* at 1422.

¹⁹ *Id.*

²⁰ *National Collegiate Athletic Ass'n*, 914 F.2d at 1422.

²¹ *National Collegiate Athletic Ass'n v. Commissioner*, action on decision, 1991-015 (July 15, 1991). The Internal Revenue Service ("IRS") disagreed with the Tenth Circuit's decision that soliciting and selling advertising space was merely preparatory time. *Id.* It stated that these activities are "part of the trade or business at issue, and . . . not merely preparatory to it." *Id.*

But see *Suffolk County Patrolmen's Benevolent Ass'n, Inc. v. Commissioner*, 77 T.C. 1314 (1981), *acq.*, 1984-2 C.B. 2. An exempt organization conducted an annual fundraising show and published a program in which local businesses placed advertisements. *Id.* at 1317. The advertisements were solicited approximately eight to sixteen weeks prior to the show. *Id.* at 1318. The court held that "the fundraising activities . . . during the years in issue were not conducted with sufficient frequency and continuity . . . to be regarded as having been 'regularly carried on.'" *Id.* at 1321. It further stated that the regulations and legislative history of the tax on unrelated business income failed to mention time apart from the duration of the taxable event. *Id.* at 1323.

²² *See* *National Collegiate Athletic Ass'n v. Commissioner*, action on decision, 1991-015 (July 15, 1991).

²³ *Priv. Ltr. Rul.* 93-02-035 (Oct. 23, 1992).

²⁴ *Id.*

²⁵ *Id.* The IRS also analyzed the advertising campaign in terms of the way it was conducted compared to the way competitive, non-exempt organizations advertise. *Id.* The policy underlying the statute is to remove an exempt organization's competitive edge. *Id.*

²⁶ *Id.*

ances.²⁷ The IRS conceded that advertisements in programs for fundraising events are not “regularly carried on,” but concluded that, in the absence of any underlying fundraising “event,” the regulations did not apply.²⁸

Some commercial activities, like the sale of Christmas cards, are carried on only seasonally. If an exempt organization engages in an activity in a manner similar to that of non-exempt organizations, any income derived from that activity will be subject to UBIT.²⁹ This will be the case even if the activity is conducted for a relatively short time. The activity’s seasonal time-span is comparable to the time-span over which a commercial counterpart activity would be conducted.³⁰ Yet, income-producing activities normally carried on by commercial organizations on a year-round basis are not “regularly carried on” by exempt organizations if they are performed occasionally or sporadically.³¹ This is so even if they are conducted on an annual basis.³²

C. *Relationship to Exempt Purposes*

The most qualitatively significant issue in determining whether an activity is an “unrelated trade or business” concerns the activity’s relatedness. The IRS requires a substantial causal relationship between an activity and an organization’s exempt purposes.³³ The fact that an organization requires specific income to further its exempt programs does not convert an “unrelated” activity into a “related one.”³⁴ An activity may relate to exempt purposes, yet be “carried on” to an extent greater than necessary to achieve those purposes. In these cases, income derived from the excess activity will be subject to UBIT.³⁵

Occasionally, an exempt activity will result in the creation of by-products that can be sold to raise income. A classic example is the section 501(c)(3) “scientific organization” that operates an experimental dairy farm that produces milk.³⁶ The IRS concluded that the exempt

²⁷ Treas. Reg. § 1.513-1(c)(2)(ii) (as amended in 1983).

²⁸ Priv. Ltr. Rul. 93-02-035 (Oct. 23, 1992). In addition to the IRS’s discussion of the six to seven month period associated with an event, it assessed the activity in terms of its commercial nature. *Id.* The IRS compared the activity to similar commercial activities and concluded that it was carried on regularly. *Id.*; see Treas. Reg. § 1.513-1(c)(2)(ii) (as amended in 1983) (comparing exempt organization’s activities to nonexempt organization’s commercial activities).

²⁹ Treas. Reg. § 1.513-1(c)(2)(ii).

³⁰ *Id.*

³¹ *Id.* § 1.513-1(c)(2)(iii).

³² *Id.*

³³ *Id.* § 1.513-1(d)(2).

³⁴ See I.R.C. § 513(c) (West Supp. 1994); Treas. Reg. § 1.513-1(d) (as amended in 1983).

³⁵ Treas. Reg. § 1.513-1(d)(3).

³⁶ See *id.* § 1.513-1(d)(4)(ii).

organization could sell the milk without adverse UBIT consequences; however, the sale of any processed products derived from the milk, such as cheese, ice cream, butter, or pastries, would be subject to UBIT.³⁷

Tax-exempt organizations frequently own facilities that are used for tax-exempt purposes, but have excess capacity. For example, retreat centers and college sports arenas contain this excess capacity and exempt organizations often attempt to capitalize on this "downtime" by renting their facilities for non-exempt purposes. Income derived from such activity cannot avoid UBIT simply because the facility is also used in exempt activities.³⁸ The IRS explicitly indicated how expenses should be allocated against unrelated income a decade ago when it litigated the issue against Rensselaer Polytechnic Institute ("RPI").³⁹ Since the IRS considered the aggregate amount of time that the RPI facility was available for use as the appropriate standard for computing overhead expenses, it argued that RPI should allocate its expenses based on its year-round availability.⁴⁰ Thus, if the facility were used for educational purposes for one-hundred days, and for non-educational purposes for one-hundred days, approximately one-third of the overhead expenses should be allocated against the unrelated business income. In contrast, RPI maintained that expenses should be based on actual use.⁴¹ Under this method, RPI would take one-half of the overhead expenses against unrelated business income, resulting in a more favorable tax outcome. The United States Court of Appeals for the Second Circuit agreed with RPI, holding that RPI's method of allocating expenses was in conformity with the standard mandated by the Treasury Regulations.⁴² The IRS has not acquiesced in that case.⁴³

D. Commercial-Type Insurance

Section 501(m)(2) of the Code subjects income from the provision of commercial-type insurance to UBIT.⁴⁴ The Code provides notable excep-

³⁷ *Id.*

³⁸ *Id.* § 1.513-1(d)(4)(iii).

³⁹ *Rensselaer Polytechnic Inst. v. Commissioner*, 732 F.2d 1058 (2d Cir. 1984), *action on decision*, 1987-014 (June 18, 1987).

⁴⁰ *Id.* at 1060.

⁴¹ *Id.*

⁴² *Id.* at 1062. However, Judge Mansfield, in dissent, argued that the majority's holding put exempt organizations at a competitive advantage over non-exempt organizations. *Id.* at 1064 (Mansfield, J., dissenting).

⁴³ *Commissioner v. Rensselaer Polytechnic Inst.*, *action on decision*, 1987-014 (June 18, 1987). The IRS reiterated Judge Mansfield's arguments in contesting the court's holding. *Id.* It recommended, however, that this case not be further litigated. *Id.* The IRS stated that any litigation should follow amendment of section 1.512(a)-1(c) of the Treasury Regulations. *Id.*

⁴⁴ I.R.C. § 501(m)(2) (West Supp. 1994).

tions for gift annuities,⁴⁵ church retirement and welfare benefits,⁴⁶ and church property and casualty insurance.⁴⁷ Income from these activities is not treated as unrelated business income.⁴⁸

II. EXCEPTIONS TO UBIT

A. Volunteer Exception

The "volunteer exception" applies when substantially all of the work in a particular activity is performed by volunteers.⁴⁹ The unofficial guideline for "substantially all" is eighty-five percent of the work.⁵⁰ The exception applies to activities conducted by volunteers such as church raffles and the sale of fundraising cookbooks. In one volunteer-exception case, *St. Joseph's Farms of Indiana v. Commissioner*, a mission farm was being operated by monks.⁵¹ The IRS argued that, despite the monks' religious motivation, income from the operation of the farm was subject to UBIT.⁵² Though the court agreed with this contention, it stated that the monks merely received sustenance, rather than a salary, for their work.⁵³ Since all of the monks received the same sustenance whether or not they worked on the farm, they were deemed "uncompensated" by the court.⁵⁴ Accordingly, the court held that the volunteer exception applied, and that income from the farm was not subject to UBIT.⁵⁵

Not surprisingly, the IRS has never agreed with this holding.⁵⁶ In the late 1970s, a series of private letter rulings were issued, the Cistercian Rulings, that addressed the volunteer exception.⁵⁷ The IRS con-

⁴⁵ *Id.* § 501(m)(3)(E).

⁴⁶ *Id.* § 501(m)(3)(D).

⁴⁷ *Id.* § 501(m)(3)(C).

⁴⁸ *Id.* § 501(m)(3).

⁴⁹ I.R.C. § 513(a)(1) (West Supp. 1994).

⁵⁰ See EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR 1982, at 124-25.

⁵¹ 85 T.C. 9 (1985), *nonacq.*, 1986-2 C.B. 1.

⁵² *Id.* at 20-23.

⁵³ *Id.* at 23-24.

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *St. Joseph's Farms of Indiana v. Commissioner*, *action on decision*, 1986-045 (July 28, 1986). The IRS did not agree with the tax court's finding that the monks were volunteers. *Id.* It provided three reasons why it did not ultimately appeal the case: (1) neither party raised the argument at trial; (2) the IRS was not prepared to present evidence concerning a "but for" connection because they were surprised by the argument; and (3) the Seventh Circuit would not be a good forum. *Id.*

⁵⁷ See, e.g., Priv. Ltr. Rul. 78-38-028 (June 21, 1978); Priv. Ltr. Rul. 78-38-029 (June 21, 1978); Priv. Ltr. Rul. 78-38-030 (June 21, 1978); Priv. Ltr. Rul. 78-38-031 (June 21, 1978); Priv. Ltr. Rul. 78-38-032 (June 21, 1978); Priv. Ltr. Rul. 78-38-033 (June 21, 1978); Priv. Ltr. Rul. 78-38-034 (June 21, 1978); Priv. Ltr. Rul. 78-38-035 (June 21, 1978); Priv. Ltr. Rul. 78-38-036 (June 21, 1978).

cluded that the monks' labor was "compensated" since the monks were provided with room, board, and other basic needs, and, thus, they could not be deemed "volunteers."⁵⁸

B. Convenience Exception

The "convenience exception" applies to any trade or business carried on primarily for the convenience of its members, students, patients, officers, or employees.⁵⁹ Classic examples include: the sale of pharmaceuticals by a hospital pharmacy to its patients, the sale of books by a university bookstore to students,⁶⁰ and a laundry facility operated by a university for student use.⁶¹ The primary issue concerning the convenience exception is determining who constitutes a member, patient, officer, or employee. Also, some college bookstores imitate mini-department stores and sell items that are not related to the educational needs of students. The IRS considers this an important audit issue.⁶²

C. Donated Merchandise & Low Cost Items Exceptions

The "donated merchandise exception" applies to the sale of merchandise which has been received as a contribution or gift.⁶³ This exception applies to thrift stores operated by charitable organizations. The Code also contains an exception for the distribution of low-cost items incident to charitable solicitations.⁶⁴ If an organization mails unrequested, low-cost items—for 1995, "low cost" is defined as \$6.60⁶⁵—as part of a fundraising effort, the organization is not liable for UBIT on the income it receives.⁶⁶

D. Mailing List Exception

A current, hot topic for the IRS concerns the rental or sale of mailing lists. Section 513(h)(1)(B) of the Code provides that income from the sale of member lists between or among section 501 organizations is not subject to UBIT.⁶⁷ The IRS takes the position that rentals, sales, or ex-

⁵⁸ Priv. Ltr. Ruls. 78-38-028 to 78-38-036 (June 21, 1978).

⁵⁹ I.R.C. § 513(a)(2) (West Supp. 1994).

⁶⁰ Treas. Reg. § 1.513-1(c)(2)(ii) (as amended in 1983).

⁶¹ *Id.* § 1.513-1(e)(3).

⁶² See, e.g., Gen. Couns. Mem. 35,811 (May 7, 1974); Gen. Couns. Mem. 33,323 (Aug. 29, 1966); Tech. Adv. Mem. 80-04-010 (1978).

⁶³ I.R.C. § 513(a)(3) (West Supp. 1994).

⁶⁴ *Id.* § 513(h)(1)(A).

⁶⁵ Rev. Proc. 94-72, 1994-50 I.R.B. 14.

⁶⁶ I.R.C. § 513(h)(3) (West Supp. 1994).

⁶⁷ *Id.* § 513(h)(1)(B).

changes with non-501(c)(3) organizations generate income which should be subject to UBIT.⁶⁸

E. Bingo & Gambling Activities Exception

Another important UBIT exception for many church entities applies to on-premises bingo games, where people place wagers and are awarded prizes on games of chance.⁶⁹ The exception does not apply to scratch-off bingo cards or to other forms of "walk-away" bingos games where the winner need not be present to win.

Since 1986, non-bingo gambling activities have been subject to UBIT, except in the state of North Dakota.⁷⁰ This means that there is UBIT liability for games like keno, pull tabs, lotteries, and "pickle jars," unless one of the other UBIT exceptions applies.⁷¹ In one case involving section 501(c)(8),⁷² a fraternal organization was held liable for UBIT on its weekly and monthly lotteries.⁷³ The lotteries were unrelated to exempt purposes, were regularly carried on, and since the lottery workers received commissions and salaries, the volunteer exception did not apply.⁷⁴

F. Miscellaneous Exceptions

Exemptions are also available for qualified convention and trade show activities conducted by section 501(c)(3), (c)(4), (c)(5), and (c)(6) organizations,⁷⁵ and for certain services, including data processing, food services, and laboratories provided at cost to hospitals with one-hundred or fewer beds.⁷⁶

III. MODIFICATIONS TO UBIT RULES

In addition to the exceptions listed in Part II, *supra*, the Code contains certain modifications to the unrelated income tax rules. While an exception means that an activity is not an unrelated trade or business,⁷⁷ a modification means that the IRS will not tax the exempt organization on income from a particular, unrelated activity. Major modification

⁶⁸ See Priv. Ltr. Rul. 40-29-047 (Aug. 20, 1990).

⁶⁹ I.R.C. § 513(f) (West Supp. 1994).

⁷⁰ Announcement 89-138, 1989-45 I.R.B. 41 (Nov. 6, 1989); Gen. Coun. Mem. 39,061 (Nov. 21, 1983).

⁷¹ Announcement 89-138, 1989-45 I.R.B. 41.

⁷² *United States v. Auxiliary to the Knights of St. Peter Claver*, 92-1 U.S. Tax Cas. (CCH) ¶ 50,176 (S.D. Ind. 1992).

⁷³ *Id.* at 83,671.

⁷⁴ *Id.* at 83,665-68.

⁷⁵ I.R.C. § 513(d) (West Supp. 1994).

⁷⁶ *Id.* § 513(e). This exception does not apply to laundry services. See *id.* § 501(e)(1)(A).

⁷⁷ See *id.* § 513(a); Treas. Reg. 1.513-1(e) (as amended in 1983).

categories include dividends,⁷⁸ interest,⁷⁹ annuities,⁸⁰ rents⁸¹ and royalties.⁸²

A. Royalties

A royalty is defined as a payment for the use of a valuable right.⁸³ One example of the operation of a royalty occurs in the licensing of an exempt organization's logo. The IRS has indicated that, in order for a payment to be classified as a royalty, it must be completely passive in nature.⁸⁴ If an organization provides substantial services to the licensee organization, these payments will not be classified as royalties.⁸⁵

The typical affinity credit card arrangement is instructive on the IRS's position concerning the royalty issue. A bank will offer an exempt organization a percentage of all sales charged to the organization's affinity credit card.⁸⁶ In return, an exempt organization is required to market or endorse the card to its membership.⁸⁷ These arrangements generally involve the sale of a mailing list, since the bank requires access to the organization's membership. The IRS has repeatedly refused to treat payments made in such arrangements as royalties.⁸⁸ This is due to the fact that the income is not considered passive due to the organization's marketing efforts. Moreover, since payments are made for the rental or sale of mailing lists to non-501(c)(3) organizations, which are taxable under section 513(h)(1)(B), the IRS will not treat these payments as royalties.⁸⁹

⁷⁸ I.R.C. § 512(b)(1).

⁷⁹ *Id.*

⁸⁰ *Id.* § 512(b)(1).

⁸¹ *Id.* § 512(b)(2).

⁸² *Id.* § 512(b)(3).

⁸³ See BLACK'S LAW DICTIONARY 1330 (6th ed. 1990).

⁸⁴ *But cf.* Gen. Couns. Mem. 37,416 (Feb. 14, 1978) (concluding there is no "operational 'active/passive' test" for royalties under section 512); Gen. Couns. Mem. 37,292 (Oct. 6, 1977) (suggesting that Congress considered royalties to be "inherently 'passive,' and did not intend to restrict" section 512 to "some unarticulated passivity test").

⁸⁵ I.R.C. § 512(b)(2) (West Supp. 1994); *see* Rev. Rul. 81-178, 1981-2 C.B. 135.

⁸⁶ Priv. Ltr. Rul. 92-22-001 (May 29, 1992).

⁸⁷ *Id.*

⁸⁸ *See, e.g., Fraternal Order of Police v. Commissioner*, 833 F.2d 717 (7th Cir. 1987) (holding income from sale of advertising space in exempt organization's publication was not passive income and, therefore, not royalties). *But see, e.g., Sierra Club, Inc. v. Commissioner*, 65 T.C.M. (CCH) 2582 (1993) (stating rental of mailing list constitutes royalty not subject to UBIT).

⁸⁹ *See* Gen. Couns. Mem. 39,727 (Jan. 25, 1988).

B. Rents from Real Property

Rents from real property are not subject to UBIT.⁹⁰ Rents from personal property are also exempt, provided that the rent attributable to the personalty is no more than ten percent of the total.⁹¹ If ten to fifty percent of the rent is attributable to the rental of personalty, then a pro rata share of the income will be subject to UBIT.⁹² If more than fifty percent of the rent is attributable to personalty, then the modification is lost and the entire rent will be taxed.⁹³

In addition, an exempt organization may only provide customary services such as light, heat, maintenance of common areas, and trash collection in connection with the rental of real property.⁹⁴ This issue frequently arises in retreat situations. If a retreat house is empty for a significant amount of time, it makes sense to rent out the excess time for conferences by unrelated entities. Typically, however, this may involve more than a rental of real property. A particular service may be more analogous to a hotel operation where maid service, food service, and similar amenities are provided. In these situations, the income will be subject to UBIT.

C. Exceptions to Modifications

The first exception applies to debt-financed income.⁹⁵ Where a person has income that otherwise avoids taxation under one of the section 512(b) modifications,⁹⁶ but the property giving rise to that income is subject to acquisition indebtedness—indebtedness incurred to acquire or im-

⁹⁰ See, e.g., *Harlan E. Moore Charitable Trust v. United States*, 9 F.3d 623 (7th Cir. 1993). "Excluded from the concept of unrelated business income . . . on the original provision [was] 'all rents from real property.'" *Id.* at 624; see also *Elliot Knitwear Profit Sharing Plan v. Commissioner*, 614 F.2d 347, 351 (3d Cir. 1980).

⁹¹ See *Treas. Reg.* § 1.512(b) (as amended in 1992).

⁹² *Id.* § 1.512(b)-1(c)(2).

⁹³ I.R.C. § 512(b)(3) (West Supp. 1994).

⁹⁴ *Treas. Reg.* § 1.512(b)-1(c)(5) (as amended in 1993).

⁹⁵ I.R.C. § 514(b) (West Supp. 1994); see *Kern County Electrical Pension Fund v. Commissioner*, 96 T.C. 845, 849 (1991). A new certificate of deposit purchased with money borrowed was characterized as debt-financed income. *Id.*

⁹⁶ See generally *Ocean Cove Corp. Retirement Plan and Trust v. United States*, 657 F. Supp. 776, 778 (S.D. Fla. 1987).

[T]he taxability of debt-financed income has no effect on the nonprofit organization's tax-exempt status. The taxpayer in this case can continue to avail itself of the tax-exempt privileges that qualified pension funds receive, but the income or profits attributable to the management of debt financed property is subject to federal income tax liabilities in the same way as would any other tax obligation derived from an unrelated business activity.

Id. (citing *Elliot Knitwear Profit Sharing Plan v. Commissioner*, 614 F.2d 347, 349 (3d Cir. 1980)); see *Alabama Cent. Credit Union v. United States*, 646 F. Supp. 1199, 1206 (N.D. Ala. 1986).

prove the property—a pro rata share of the income will still be subject to UBIT in proportion to the debt.⁹⁷ There is also a “controlled subsidiary exception” that overrides the modifications applicable to annuities, rents, royalties, and interest.⁹⁸ A controlled, for-profit subsidiary is defined as one having ownership of at least eighty percent of its total combined voting stock and at least eighty percent of the total number of shares of all its classes of stock.⁹⁹

IV. RECENT DEVELOPMENTS

A. *EP/EO Business Plan*

The Exempt Organizations and Employee Plans Strategic Business Plan for 1993 adds important insight on issues concerning the IRS. The first priority is the coordinated examination of health care organizations and colleges and universities. The second priority is political activity. “Unrelated trade or business” is the seventh item on the list. The IRS continues to be concerned about UBIT because its Taxpayer Compliance Management Program reveals an unusually low compliance level on Form 990-T filings.¹⁰⁰ The IRS wants to encourage voluntary compliance and to deal effectively with intentional noncompliance with the UBIT rules.

In the past, the IRS has successfully implemented a two-pronged approach with respect to other compliance problems. Several years ago, then-Assistant Commissioner Brauer addressed noncompliance on charitable contributions in quid pro quo situations. Commissioner Brauer indicated that the IRS would attack the problem first with an educational program and then with an enforcement program. This is how the IRS will address UBIT noncompliance. It will educate the public and then it will enforce the provision. The IRS has targeted several UBIT issues for particular attention, including: gambling by charitable organizations; corporate sponsorship; sales and services provided to nonmembers; marketing activities that involve travel tours; insurance programs and credit cards; and delinquent Form 990-T filers.

B. *Corporate Sponsorship*

To understand the proposed corporate sponsorship regulations that were promulgated in January 1993, the history behind the regulations must be reviewed. In August 1991, the IRS issued a private letter ruling

⁹⁷ I.R.C. § 514(a) (West Supp. 1994).

⁹⁸ *Id.* § 512(b)(13).

⁹⁹ *Id.* § 368(c).

¹⁰⁰ Form 990-T is the form used by the IRS for unrelated business income tax returns.

on the Mobil Oil Cotton Bowl.¹⁰¹ At issue were payments that the Cotton Bowl had received from its corporate sponsor, Mobil Oil Corporation, which the Cotton Bowl had characterized as charitable contributions.¹⁰² During the football game, the Mobil logo was visible on the field, on the players' uniforms, and all around the stadium.¹⁰³ Mobil commercials were shown at every commercial break. The IRS decided that Mobil's corporate sponsorship payments were not charitable contributions, but were taxable payments for valuable advertising that Mobil Oil received during the game.¹⁰⁴

The IRS subsequently issued audit guidelines in February 1992.¹⁰⁵ The audit guidelines stated that, where substantial benefits are provided to a corporate sponsor, sponsorship payments received by the exempt corporation generate UBIT to the exempt organization. Mere recognition of corporate sponsors, on the other hand, would not raise UBIT concerns. The IRS instructed examiners to review corporate sponsorship arrangements to determine: whether the exempt organization was required to perform any services, including advertising, in return for the payment; whether media coverage of the event was required by the contract; whether there were promotional arrangements that did more than simply acknowledge the sponsor; whether the payment was contingent on radio or television rights or ratings; whether the extension or renewal of the contract was contingent on public exposure; and whether the arrangement was subject to termination for the failure of the exempt organization to provide certain benefits.

Examiners were also instructed to review the other benefits that the corporate sponsor received, such as lavish hospitality suites, limousines, and VIP tickets provided to corporate executives. The IRS took the unprecedented step of holding public hearings on its proposed guidelines.¹⁰⁶ It received over three hundred comments, most of which criticized the guidelines.¹⁰⁷

¹⁰¹ Priv. Ltr. Rul. 91-47-007 (Aug. 16, 1991).

¹⁰² Mobil Oil Corporation made a corporate sponsorship payment of \$1.5 million to the Cotton Bowl Athletic Association as a charitable contribution. See Nathan Wirtschafter, *Fourth Quarter Choke: How the IRS Blew the Corporate Sponsorship Game*, 10 EXEMPT ORG. TAX REV. 501, 501 (1994).

¹⁰³ *Id.* Both end zones and the middle of the football field had "Mobil Cotton Bowl" chalked into the turf. *Id.* at 519. Additionally, the players' uniforms, goal posts, field entrance, and trophy contained similar Mobil insignias and logos. *Id.*

¹⁰⁴ See Tech. Adv. Mem. 91-47-007 (Aug. 16, 1991).

¹⁰⁵ Announcement 92-15, 92-5 I.R.B. 51 (Jan. 17, 1992).

¹⁰⁶ See 58 Fed. Reg. 5691 (Jan. 22, 1993) (providing notice of public hearing on proposed regulations governing definition of unrelated trade or business).

¹⁰⁷ See *Attorneys Criticize Corporate Sponsorship Regs.*, 8 EXEMPT ORG. TAX REV. 601 (1993) (discussing criticism of proposed regulations). But see *Comments on Corporate Spon-*

In January 1993, the IRS issued proposed regulations on corporate sponsorship that were considerably more liberal than the audit guidelines.¹⁰⁸ The proposed regulations establish some bright lines: they eliminate the focus on the benefits that corporate sponsors will receive, and they roughly parallel the Federal Communications Commission's sponsorship rules that apply to public broadcasting stations.¹⁰⁹

Under the proposed regulations, a distinction is drawn between advertisements, which are unrelated income, and acknowledgements, which are related income.¹¹⁰ Advertising is defined as any message or other programming material that is broadcast or otherwise transmitted, published, displayed, or distributed in exchange for any remuneration and which promotes or markets any company service, facility, or product.¹¹¹ Advertising includes: qualitative or comparative language ("Pepsi is better than Coke"); price information about a product; indication of savings with respect to the product; call to action ("Buy Reebok"); endorsement of a product; or inducement to buy, sell, lease, or otherwise use the corporate sponsor's product.¹¹²

Advertising does not include acknowledgements,¹¹³ which are defined as a mere recognition of corporate sponsorship.¹¹⁴ The key distinction between an advertisement and an acknowledgement is that an acknowledgement must identify the sponsor, rather than simply promote the sponsor's product. Under the proposed regulations, it would be an acknowledgement to show the corporate sponsor's logo or slogan, provided there is no comparative language, qualitative description, or call to action. One could provide a sponsor's location and telephone number, include value-neutral descriptions of the sponsor's product, and display the sponsor's product at an event without being subject to UBIT.¹¹⁵ Moreover, the distribution of a sponsor's product at a sponsored event would not be considered an inducement to use the sponsor's product, and thus would not implicate UBIT.¹¹⁶

sponsorship Regulations: Nonprofit Forum Praises Proposed Regs., 8 EXEMPT ORG. TAX REV. 365 (1993) (noting praise and support for proposed regulations).

¹⁰⁸ See 58 Fed. Reg. 5687, 5688-89 (Jan. 22, 1993).

¹⁰⁹ *Id.*

¹¹⁰ *Id.* at 5688. See Marlis L. Carson, *Corporate Sponsorship Regs Provide "Clear Line" for IRS, Charities, Says Owens*, 7 EXEMPT ORG. TAX REV. 918, 918 (1993) (comparing advertising with acknowledgements).

¹¹¹ 58 Fed Reg. at 5690.

¹¹² *Id.* at 5690-91 (citing examples of advertising income).

¹¹³ *Id.* at 5690.

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ 58 Fed. Reg. at 5688. Distribution of sponsor's products at a sponsored event constitutes mere acknowledgement, rather than advertisement under proposed regulations. *Id.*

The mere existence of a written contract or a contract's exclusivity or specificity would not determine whether a payment constituted advertising income.¹¹⁷ Rather, all of the surrounding facts and circumstances would be considered. Payments contingent on an event actually taking place would not be classified as advertising payments, but payments contingent upon a particular attendance level or on broadcast ratings would be classified as advertising income subject to UBIT.¹¹⁸ The regulations take a "bad apple" approach to implementing corporate sponsorship rules. If any statement constituted advertising, all payments received from a particular sponsor would be tainted and subsequently treated as advertising income¹¹⁹—one bad apple spoils the entire bushel.

Finally, the proposed regulations would remove the confusion that existed under the examination guidelines on advertising payments and quid pro quo exchanges.¹²⁰ Thus, corporate sponsorship benefits such as limousines, hospitality suites, sky boxes, or VIP event tickets would no longer be factors in determining whether a payment constituted an advertising payment.¹²¹ The fair market value of these benefits would be assessed to reduce the value of any charitable contribution made by the corporate sponsor.¹²²

C. College and University Audit Guidelines

In January 1993, the IRS promulgated new college and university audit guidelines.¹²³ The guidelines focus on accounting methods, financial information, compensation arrangements, fringe benefit issues, joint ventures, scholarships, fellowships, and unrelated business income tax issues.¹²⁴ The targets under the audit guidelines include: college bookstores; share-crop leasing; the sale of electricity to public utilities; the use of university facilities in unrelated activities; the operation of hotels, motels or parking lots; and travel tours. The IRS targeted seven universities for comprehensive audits. The "select seven" include one Catholic university, St. John's University in New York.

Courts have held certain college or university activities to be "unrelated business income." These activities include advertising in a univer-

¹¹⁷ *Id.* at 5690.

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ *Id.*

¹²¹ 58 Fed. Reg. at 5690.

¹²² *Id.* at 5688 (following Rev. Rul. 67-246, 1967-2 C.B. 104).

¹²³ See Announcement 93-2, 1993-2 I.R.B. 39.

¹²⁴ *Id.*

sity medical journal,¹²⁵ manufacturing automobiles and chinaware,¹²⁶ and operating theaters and oil wells.¹²⁷

D. Royalty Income

The royalty question continues to plague the IRS, and numerous letter rulings have been issued on the subject.¹²⁸ Organizations attempt to characterize the payments they receive as royalties in order to avoid UBIT.¹²⁹ However, "neither the Code nor the regulations provide a precise definition of 'royalties' . . . Revenue Ruling 81-178 [is cited as] the single definition of 'royalty'."¹³⁰ If the agreement is for the use of the organization's trademarks, trade names, service marks, copyrights, and members' names, likeness, and signatures, then the amounts received are royalties. If the agreement requires the personal services of organization members, the payments received are considered compensation for the services, not royalties.¹³¹ If the exempt organization is actively involved in the venture or the arrangement involves the sale of a mailing list, then the IRS will not view the payments as royalties.¹³²

E. Insurance Rebates

The IRS has been successful in litigating cases where exempt organizations provide insurance benefits or programs for their membership, and in return receive payments from the insurance company which are characterized as commissions, rebates, or dividends. Congress intended to prevent this sort of unfair competition between tax-exempt organizations and taxable businesses by providing for the unrelated business income tax.¹³³ The IRS has implemented Congress' legislative intent to

¹²⁵ See *United States v. American College of Physicians*, 475 U.S. 834, 834 (1986).

¹²⁶ See *Revenue Revision of 1950: Hearings before the House Committee on Ways and Means*, 81st Cong., 2d Sess., at 18-19 (1950) (describing unrelated business activities for universities, including production of automobile parts and chinaware).

¹²⁷ See *Harlan E. Moore Charitable Trust v. United States*, 9 F.3d 623, 624 (7th Cir. 1993) (citing *American College of Physicians*, 475 U.S. 834).

¹²⁸ See Priv. Ltr. Rul. 92-22-001 (Sept. 30, 1991); Priv. Ltr. Rul. 92-20-054 (Feb. 20, 1992); Priv. Ltr. Rul. 92-49-001 (May 29, 1992); Priv. Ltr. Rul. 92-47-001 (Oct. 8, 1992); Priv. Ltr. Rul. 92-50-001 (July 14, 1992).

¹²⁹ See I.R.C. § 512(b)(2) (West Supp. 1994).

¹³⁰ *Texas Farm Bureau v. United States*, 822 F. Supp. 371, 378 (W.D. Tex. 1993).

¹³¹ *Id.* at 378-79.

¹³² See *Sierra Club v. Commissioner*, Tech. Mem. 1993-199 (May 10, 1993). The Tax Court held that income received from the use of a mailing list in connection with an affinity credit card operation was excludable royalty income under § 512(b)(2)). *Id.* The court denied summary judgment on the issue of whether Sierra Club provided substantial services in connection with the rental of the mailing lists. *Id.*

¹³³ See *United States v. American Bar Endowment*, 477 U.S. 105, 105 (1986).

insurance to insurance rebates, and the courts have generally followed suit.¹³⁴

CONCLUSION

Despite a religious organization's exempt purposes, many activities carried on by it may be subject to federal taxation. To be aware of the tax consequences of its activities, a diocese must focus on the distinctions drawn by the IRS when determining whether unrelated business income is generated.

¹³⁴ See, e.g., *Independent Ins. Agents of Huntsville, Inc. v. Commissioner*, 998 F.2d 898 (11th Cir. 1993); Priv. Ltr. Rul. 92-23-002 (Feb. 13, 1992); *American Bar Endowment*, 477 U.S. at 105.

