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SHOW ME THE MONEY: LEGAL AND PRUDENTIAL CONSIDERATIONS FOR RELIGIOUS ORGANIZATIONS PARTICIPATING IN FUND RAISING VENTURES

DEIRDRE DESSINGUE HALLORAN*

Traditionally, Catholic organizations have relied upon contributions, grants, and certain fees for exempt services in order to fund their charitable, religious, and educational programs. However, as these traditional sources of revenue have flattened out, Catholic organizations have increasingly turned to alternative sources of fund raising. It is important for these organizations to know that when contemplating any fund raising endeavor, an exempt organization should first insure that it does not jeopardize its tax-exempt status. Arrangements for compensating fund raisers should be reviewed carefully, particularly in light of the new excise tax on excess benefits transactions with disqualified persons.

Generally, fund raising endeavors are by their nature not related to exempt purposes. Therefore, organizations need to pay attention to the size and scope of their fund raising activities, since a single non-exempt purpose, if substantial in nature, could jeopardize exempt status. Part I

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Reference will be to organizations exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code.

Generally, to qualify for exemption under section 501(c)(3), an organization must meet the requirements of the organizational and operational tests. Treas. Reg. § 1.501(c)(3)-1 (1998).


this article will discuss tax issues typically implicated in fund raising endeavors. Part II will focus on the more common fund raising activities of exempt organizations and the tax consequences likely to be associated with such activities.

I. General Tax Considerations

A. Unrelated Business Income Tax

One issue frequently raised in fund raising endeavors is the applicability of unrelated business income tax ("UBIT"). In order to be liable for tax on unrelated trade or business income, an organization must have income from a trade or business that is regularly carried on and that is not substantially related to the organization's exempt purposes. The organization's need for money, which is the purpose of fund raising, does not make an activity related to its exempt purposes.\(^5\)

There are a number of common UBIT exceptions which may apply to various fund raising activities. The first is the volunteer exception, which applies to any trade or business in which substantially all the work is performed without compensation.\(^6\) This exception should cover fund raising activities by students, such as those cookie, candy, card and gift wrap sales which have "victimized" many over the years. In addition, courts have construed compensation to include noncash compensation, including provision of food, clothing, shelter and medical care.\(^7\)

The second exception is the convenience exception which covers any business carried on primarily for the convenience of members, students, patients, officers, or employees.\(^8\) A common example of this exception is the hospital gift shop and cafeteria.\(^9\) However, the IRS recently ruled that the convenience exception does not cover the use of a university's golf course by the families or guests of its employees.\(^10\) The third exception covers the sale of donated merchandise, which applies to charity thrift

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\(^7\) See Shiloh Youth Revival Ctrs. v. Commissioner, 88 T.C. 565, 580 (1987) (stating "compensation is unquestionably a broad concept that embraces noncash remuneration").


shops and similar operations.\textsuperscript{11}

Other exceptions are provided for the rental or exchange of mailing lists to other section 501(c)(3) organizations,\textsuperscript{12} and for royalty payments,\textsuperscript{13} defined as payments for the use of a valuable right, such as an organization's name or logo, but not for the provision of services.\textsuperscript{14}

Another exception covers the rental of real property, provided that the portion of the rent attributable to personal property is no more than 10\% of the total.\textsuperscript{15} However, this exception can be trumped if personal services are provided beyond the customary provisions of heating, lighting, trash collection, and cleaning of common areas,\textsuperscript{16} if the controlled subsidiary rules apply,\textsuperscript{17} or if the debt-financed property rules govern.\textsuperscript{18}

In addition, the distribution of low cost items incident to a charitable solicitation is not considered an unrelated trade or business.\textsuperscript{19} For 1997, the IRS defined a low cost item as one that costs no more than $6.90.\textsuperscript{20} To qualify for this exception, a recipient must be told that she is entitled to keep the low cost item regardless of whether any contribution is made.\textsuperscript{21} The IRS has ruled that the distribution of low-cost non-religious items by members of a religious organization did not qualify for the low cost item exception because the organization's solicitors failed to inform all contributors that they were entitled to keep the items, regardless of whether a contribution was made.\textsuperscript{22}

There is a further exception for non-commercial-type insurance that includes charitable gift annuities,\textsuperscript{23} church retirement or welfare benefits,\textsuperscript{24} and church property or casualty insurance.\textsuperscript{25} And finally, there is the bingo exception,\textsuperscript{26} which applies only to traditional bingo games in which all wagers are placed, winners determined and prizes distributed in the presence of all persons placing wagers.\textsuperscript{27}

\begin{itemize}
\item \textsuperscript{11} See I.R.C. § 513(a)(3) (1998); see also Treas. Reg. § 1.513-1(e)(3) (1998).
\item \textsuperscript{12} See I.R.C. § 513(b)(1)(B) (1998).
\item \textsuperscript{13} See I.R.C. § 512(b)(2) (1998).
\item \textsuperscript{14} See Rev. Rul. 81-178, 1981-2 C.B. 135 (defining “royalty”).
\item \textsuperscript{15} See I.R.C. § 512(b)(3) (1998).
\item \textsuperscript{16} See Treas. Reg. § 1.512(b)-1(c)(5) (1998).
\item \textsuperscript{17} See I.R.C. § 512(b)(13) (1998).
\item \textsuperscript{18} See I.R.C. § 514(a) (1998).
\item \textsuperscript{19} See I.R.C. § 513(b)(1)(A) (1998).
\item \textsuperscript{20} See Rev. Proc. 96-59, 1996-2 C.B. 396.
\item \textsuperscript{21} See I.R.C. § 513(b)(3) (1998).
\item \textsuperscript{24} See I.R.C. § 501(m)(3)(D) (1998).
\item \textsuperscript{25} See I.R.C. § 501(m)(3)(C) (1998).
\item \textsuperscript{26} See I.R.C. § 513(f) (1998).
\item \textsuperscript{27} See I.R.C. § 513(f)(2) (1998).
\end{itemize}
come from non-bingo games of chance is subject to UBIT, unless one of the other exceptions, such as the not regularly carried on or the volunteer exception, applies.\textsuperscript{28}

B. Deductibility

Charitable organizations must be aware, when conducting fund raising activities, of whether payments are deductible. The simple answer is payments are deductible only if they qualify as charitable gifts or contributions.\textsuperscript{29} To qualify as a gift, the payment must be a voluntary transfer of money or property made without receipt of or expectation of commensurate return benefit.\textsuperscript{30}

Quid pro quo arrangements involve payments that are partly contributions and partly payments for goods or services. Such payments are deductible only to the extent they exceed the fair market value of such goods or services and the payor intends to make a gift of the excess. The Supreme Court, in \textit{United States v. American Bar Endowment},\textsuperscript{31} adopted this test for deductibility,\textsuperscript{32} which was adopted in the final regulations on deductibility, substantiation and disclosure.\textsuperscript{33} In determining deductibility, certain items of insubstantial value may be disregarded. Generally, this refers to contributions of at least $34.50, where the item received in return costs $6.90 or less.\textsuperscript{34}

Quid pro quo payments made in a fund raising context are subject to disclosure either at the time of solicitation or payment,\textsuperscript{35} and are further subject to substantiation with respect to contributions of $250.00 or more.\textsuperscript{36}

C. Additional Considerations

In addition to federal law implications, fund raising endeavors can also present issues under state and local law. Depending on its size and scope, a fund raising activity can jeopardize an organization's state or local real property, personal property, sales and use, or income tax exemptions.

\textsuperscript{31} 477 U.S. 105 (1986).
\textsuperscript{32} See id. at 117.
\textsuperscript{34} Rev. Proc. 96-59, 1996-2 C.B. 396.
Depending on the type of activity, an organization may be required to collect and remit state or local sales taxes. The organization may also be required to meet various licensing requirements, and may subject itself to governmental oversight, regulation, or reporting requirements. Engagement in fund raising endeavors also raises prudential concerns. An activity may subject an exempt organization to additional liability risks. Organizations need to assess those risks and evaluate the need for increased insurance coverage.

Religious organizations need to assess the extent to which involvement in commercial-type fund raising activities may jeopardize their entitlement to various religious-freedom-based exemptions from statutory requirements, such as federal and state anti-discrimination and civil rights statues. In addition, religious organizations should assess the extent to which the public may view their involvement in various fund raising endeavors as inappropriate, indicative of "mission drift," or suggestive that the organization is "for sale to the highest bidder."

D. Postal Regulations

A final consideration religious organizations should be aware of when engaging in fund raising activities is the limitation on what can be mailed by exempt organizations. Under the postal regulations, exempt organizations with special nonprofit rate permits may not mail material on behalf of, or produced for, any organization that is not itself authorized to mail under such a special nonprofit rate permit. Nonprofit mail rates may not be used to mail any material that advertises or promotes any credit, debit, charge or similar card; any commercially available insurance policy; or any unrelated travel arrangement. For example, the Postal Service recently ruled that nonprofits may not mention the words "Visa" or "MasterCard" in announcements of membership benefits that include affinity cards, since the use of such brand names is considered promotional.

II. FUND RAISING VENTURES AND RELATED TAX IMPLICATIONS

A. Charity Auctions

Charity auctions are a perennial favorite, particularly among private schools. This fund raising technique involves the collection of desirable

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38 See DMM, § E670.5.4.
39 See Credit Card References on Nonprofit Standard Mail, PS-292 (E670.5) [February 1997] (on file with the author).
items to be auctioned in either a silent bid or live bid format. Generally, proceeds from charity auctions are not subject to UBIT, because they either are not regularly carried on, the auctioned merchandise was donated, or substantially all work is performed by volunteers.

The primary issue with respect to charity auctions is deductibility. Specifically, is any part of the contribution deductible and what are the substantiation and disclosure requirements? Items donated to the auction are deductible by the donor, with the exception of the contribution of services, which are not deductible under section 170. A section 170(f)(8) written substantiation statement should be provided if the value of the item donated is $250.00 or more.

As to an auction bidder, however, only the amount, if any, paid over the fair market value of the auctioned item is considered a deductible contribution. If the contributory element is $250.00 or more, substantiation must be obtained, including the charity's good faith estimate of the fair market value of the item. The final regulations make clear that the charity may use any reasonable methodology to determine fair market value, such as comparison with comparable retail prices, mark-up from wholesale cost, etc.

Section 6115 disclosure is an important issue for organizations conducting auctions. The most effective way of making the required disclosure with respect to quid pro quo payments in excess of $75.00 is to include the fair market value of each item in an auction catalogue that is given to each person attending the auction. The catalogue should contain a prominently featured statement that only amounts paid in excess of the listed fair market value are deductible as charitable contributions.

Finally, the issue of how to value celebrity presence, such as a round of golf with Tiger Woods, is frequently a factor at charity auctions. The final regulations conclude that celebrity presence generally does not increase the fair market value of an auctioned item.

B. Charity Bazaar

The charity bazaar is a slight variation on the charity auction. Items of merchandise are also donated for sale, but sale prices are fixed at what

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42 See Rev. Rul. 67-246, 1967-2 C.B. 105 ("[P]ayment... qualifies as a deductible gift only to the extent that it is shown to exceed the fair market value of any consideration received...").
is presumed to be their fair market value. Unlike the auction, at the charity bazaar there is no opportunity to bid prices beyond fair market value. Therefore, no part of the payment qualifies as a deductible contribution, and no substantiation or disclosure obligations are required. Like the auction, there generally will be no UBIT liability, because charity bazaars are not regularly carried on, goods are donated, or workers are volunteers.

C. Charity Social Event

This is a broad category that encompasses all manner of fundraising events, including charity balls, fashion shows, theater events, concerts, golf tournaments and the like. The major issue is what, if any, part of the admission fee is a deductible charitable contribution? To be deductible, the admission fee must exceed the fair market value of attendance at all components of the event. Substantiation and disclosure are required according to the usual rules. The best way to accomplish disclosure is on the face of the admission ticket, which should identify the fair market value of the event and indicate the amount of the fee, if any, that is tax-deductible. Tickets should not refer to the admission charge as a “donation,” and should avoid statements like “deductible to the full extent allowed by law.”

Finally, there is a significant distinction in terms of deductibility between not using benefits and actually refusing them. Simply failing to use tickets to a charity social event has no effect on deductibility. The “test of deductibility is not whether the right to admission [was] exercised, but whether the right was accepted or rejected.” In order to obtain full deductibility for any payment, all benefits must be rejected properly. Revenue Ruling 67-246 offers two examples of how to accomplish this. In one example, the taxpayer made the contribution and physically refused to accept the ticket to a charity concert. In the other, the charity used a “check the box” form that permitted donors to indicate that they did not want tickets to the event but were nonetheless enclosing contributions.

D. Charitable Gambling Activities

This topic covers a whole range of charitable games of chance, in-

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47 See id. at 107, Example 2.
48 See id., Examples 1 and 2.
49 See id., Example 1.
50 See id. at 108-09, Examples 3 and 7.
51 See id. at 108, Example 3.
52 See id. at 106.
53 See id. at 108-09, Examples 3 and 7.
cluding raffles, bingo, pull tabs, lotteries, and casino nights. With the exception of raffles discussed below, deductibility generally is not an issue. The major issues are UBIT, wagering excise tax, and withholding and reporting obligations.

1. Raffles

Raffles are lotteries in which each participant buys a chance to win a prize, with the winner determined by random drawing. Raffles generally are not subject to UBIT, because they are not regularly carried on, are carried on by volunteers, or involve donated merchandise. The important point with raffles is that although the value of a donated raffle prize is deductible, payments for raffle tickets are not. The purchaser receives something presumed to be of equal value for his payment, namely, the chance to win the prize. Therefore, raffle tickets should not use words like “contribution” or “donation,” or make misleading statements like “deductible to the extent provided by law.”

In addition, raffle tickets may not be mailed. Knowing use of the U.S. mails to send any lottery or raffle ticket or payment thereof can result in fine or imprisonment up to two years for the first offense and imprisonment up to five years for subsequent offenses. Such information may come as a surprise to religious organizations and other exempt groups conducting raffles via mail.

2. Bingo

Bingo is a game of chance played with cards “generally that are printed with five rows of five squares each. Participants place markers over randomly called numbers on the cards in an attempt to form a preselected pattern.” As previously noted, traditional bingo games that are operated in accordance with state and local law are not subject to UBIT on account of the statutory exception of section 513(f). However, this exception does not apply to instant bingo games, typically of the scratch-off or pull-tab variety, commonly called pickle cards, jar tickets, or break

55 See Goldman, 46 T.C. at 139 (stating that a raffle purchaser receives “full consideration” and is “not making a charitable contribution within the meaning of the statute”).
58 See id.
Instant bingo-type games use pre-printed gaming cards with concealed numbers or symbols that must be exposed by the player to determine wins or losses. The IRS has been consistent in its position that these instant games are subject to UBIT. Most recently in *Julius M. Israel Lodge of B'nai B'rith v. Commissioner*, the Fifth Circuit agreed that instant bingo did not qualify under the Code section 513(f), and therefore was subject to UBIT.

Instant bingo and all other non-bingo games of chance outside the State of North Dakota are subject to UBIT unless they qualify for another exception, such as not being regularly carried on or the volunteer labor exception. With regard to the latter exception, it is worth noting that compensation has been interpreted broadly to include tips received by bingo workers. Although free food and drink provided to gaming workers could constitute compensation, the Fifth Circuit held it is not compensation when the average worker receives the equivalent of only sixty-three cents per hour. Further, the IRS, in its 1996 Continuing Professional Education Text ("CPE Text"), stated that when an exempt organization conducting gaming activities makes a contribution to another exempt organization in return for the second organization providing "volunteers" to work the first organization's games, this "contribution" is considered compensation. Therefore, the workers are not afforded the "volunteer" classification necessary to avoid UBIT.

According to the IRS, charitable bingo and other games of chance are legal in forty-six states and the District of Columbia. However, Arkansas, Tennessee, Hawaii, and Utah do not permit them. This does not mean that every game will be legal in every jurisdiction or under every circumstance. Therefore, it is imperative for organizations to verify the legality and applicable restrictions on any game they propose. Failure to do so could subject the organization or its managers to fines or other penalties under state law. Also, even a traditional bingo game conducted in violation of state or local law will lose its UBIT exemption under Code section

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62 98 F.3d 190 (5th Cir. 1996).
63 See Announcement 89-138, 1989-45 I.R.B. 41 (discussing applicable rules for bingo and other gambling activities as they relate to tax exempt organizations).
64 See Executive Network Club, Inc. v. Commissioner, 69 T.C.M. (CCH) 1680, 1683 (1995) (holding that it is "well established that tips constitute compensation for services").
65 See Waco Lodge No. 166 v. Commissioner, 696 F.2d 372, 375 (5th Cir. 1983) (rejecting the notion that free drinks given to bingo workers was compensation when the value was "trifling").
67 See id. at 92.
513(f). Illegal gaming activities can also jeopardize exempt status, although the IRS has indicated that it generally will not revoke exemptions in the absence of a formal adjudication of illegality. And where illegality is found, inurement is usually not far behind.

3. Public Support

Gambling income can have a potentially adverse impact on the public support fractions of organizations that claim to be publicly supported under the provisions of section 501(a)(1) or 509(a)(2) of the Code. Problems typically arise as a result of taxable gaming income. Organizations with income from non-taxable bingo generally satisfy the applicable support fraction.

4. Wagering Excise Tax

The Code imposes a 0.25% excise tax on legal wagers and a 2% tax on illegal wagers. In addition, the Code imposes a $500 annual occupational tax on each individual receiving wagers. For the purposes of the applicable sections of the Code, a wager includes a bet placed in a lottery conducted for profit. Games where wagers are placed, winners are determined, and prizes are distributed in the presence of all persons placing wagers, e.g., traditional bingo, are not considered lotteries. Wagers or drawings conducted by exempt organizations are excluded from the term "lottery" if no part of the net proceeds inures to the benefit of any private shareholder or individual. This means that section 501(c)(3) organizations that operate their games properly will not be liable for wagering excise or occupational taxes. An exempt organization may not merely "sponsor" gaming activity that is actually conducted by third parties. In a 1994 ruling, the IRS concluded that a church was not liable for the section 4401 or 4411 taxes on its pull-tab operations.

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68 See id. at 99; see also Rev. Rul. 69-68, 1969-1 C.B. 153.
69 See 1996 CPE Text, supra note 66, at 97-98.
76 See Rev. Rul. 69-21, 1969-1 C.B. 290 (holding an exempt organization liable when they purchased a baseball pool and retained the seller to operate the pool).
5. Reporting and Withholding

Frequently, exempt organizations do not fully understand the reporting and withholding required with respect to gambling winnings. The type of gaming activity, the amount of winnings and the winnings to wager ratio dictate whether reporting, withholding, or both is required. The form W-2G (G is for gambling) and sometimes the form 1099 are used for these purposes. The general withholding rate is 28%. The 1996 IRS CPE Text contains a useful chart that summarizes the rules.

For bingo or slot machines, winnings of $1200 or more must be reported on form W-2G. If the winner provides a social security number, no withholding is required. If no social security number is given, backup withholding at a 31% rate is required. For other lotteries, including raffles, pull-tabs and other instant games, a single prize of less than $600 requires no reporting or withholding. A single prize between $600 and $5000 must be reported on form W-2G. A single prize exceeding $5000 requires reporting on form W-2G and withholding at 28%, provided the amount of the winnings is at least 300 times the amount of the wager. If the winner does not provide a social security number, 31% backup withholding is required.

Problems often arise with respect to raffles or other lotteries having non-cash prizes, such as a new car. There are two options. The winner could pay the required 28% to the organization, which in turn would report and pay it to the IRS. Alternatively, the organization could pay the withholding on behalf of the winner and then make the appropriate calculations on the W-2G, with the benefit of an algebraic formula and a calculator.

Prizes received in situations where no wager is required, such as door prizes, should be reported on form 1099 if the prize is $600 or more. In this situation, no withholding is required.

6. Gaming Fraud

The IRS is very concerned about fraud in charitable gaming activities and, as a result, has devoted an entire article in the 1997 CPE Text to this topic. In this excellent article, IRS alerts exempt organizations to the various possibilities for fraud. These possibilities include infiltration by

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78 See 1996 CPE Text, supra note 66 at 107-108.
82 Competti and Rosenberg, Detecting Fraud in Charity Gaming, Fiscal Year 1997 Continuing Professional Education Text, p.32.
organized crime, embezzlement schemes involving skimming from pull-tab and bingo games and rigging jackpots, diversion of profits through use of management or supply companies, and paying volunteer workers “under the table.”

The IRS Exempt Organizations Examination Program Work Plan for Fiscal Year 1997 requires IRS regions to apply 5-10% of total direct examination time to exempt organizations’ gaming activities. Less than 5% requires justification to the National Office.

E. Affinity Cards

Another widespread but nonetheless still controversial fund raising practice is the affinity credit card. This involves a fund raising arrangement between an exempt organization and a bank or other credit card issuer, whereby the exempt organization grants the bank the right to use its name and logo on a credit card, and provides the bank with its member mailing list. The organization, through a variety of means, encourages its members to accept and use the credit card. In return, the bank agrees to pay a fee for each member who accepts the card and a percentage of all charges made on members’ cards. In a nutshell, the issue is whether the income is subject to UBIT.

The IRS has consistently taken the position that income from affinity credit card arrangements is subject to UBIT, for several reasons. First, the IRS rejects arguments that these payments qualify as royalties exempt from UBIT under code section 512(b)(2), because exempt organizations are required to provide valuable services, which negate royalty classification. Second, the IRS states that the rental of mailing lists to a commercial entity subjects the payments to UBIT because code section 513(h)(1)(B) exempts from UBIT only list rentals to other section 501(c)(3) organizations.

In Sierra Club, Inc. v. Commissioner, the Tax Court disagreed with the IRS on this issue and held that the Sierra Club’s affinity card income constituted payment for the use of intangible property (the Sierra Club name, logo and mailing lists), and was therefore exempt from UBIT as royalty income. Relying on that decision, the Tax Court went on to rule

83 See id.
84 See id.
85 See Rev. Rul. 81-178, 1981-2 C.B. 135 (holding that payments for personal endorsements are payments for personal services not royalties under § 512(b)(2)).
87 103 T.C. 307 (1994), rev’d, 86 F.3d 1526 (9th Cir. 1996).
88 See id. at 344 (concluding that payment for intangible property constitutes royalties).
favorably on the affinity card programs of the University of Oregon\textsuperscript{89} and Oregon State.\textsuperscript{90}

However, the Ninth Circuit reversed the Tax Court on the Sierra Club royalty issue, and remanded the matter for trial on the question of whether payments received by Sierra Club under its affinity card program involved payments for services provided by Sierra Club, and, therefore, not royalties.\textsuperscript{91} This case is still pending.

The question of UBIT liability for affinity card programs remains unresolved. At least in the Ninth Circuit, an affinity card program limited to the licensing of an exempt organization’s name, logo and mailing list, but without services provided, would probably pass muster. However, the IRS continues to litigate this issue, most recently in the Tax Court against the Mississippi State University Alumni Association.\textsuperscript{92}

F. Rebate Card

A niche within the credit card industry is the rebate or private label credit card which is issued by a bank, but sponsored by an intermediary company. The sponsor negotiates with participating retailers to rebate a percentage on all purchases made with the card. The sponsor deducts an administrative fee, and then credits the remaining rebates to custodial accounts it maintains for cardholders. Charities get involved during the application process when each cardholder designates a charity to which the rebates should be paid. Significantly, at any time prior to payment to the designated charity, the cardholder may elect to either change charities or retain the rebates.

In a private letter ruling, the IRS concluded that since cardholders have the choice of retaining rebates or paying them to designated charities, the rebates paid to designated charities were voluntary and thereby qualified as deductible charitable contributions. The IRS also ruled that the rebates were not income to the cardholders but rather constituted price reductions on items purchased with the card.\textsuperscript{93}

\textsuperscript{89} See Alumni Ass’n of the Univ. of Or. v. Commissioner, 71 T.C.M. (CCH) 2093, 2100 (1996) (finding that income from an affinity card program is a royalty, thus excluded from the tax on unrelated business income).


\textsuperscript{91} See Sierra Club, Inc. v. Commissioner, 86 F.3d 1526, 1537 (9th Cir. 1996) (reversing the partial grant of summary judgment on whether the affinity card program’s income is a royalty).

\textsuperscript{92} See Mississippi State Univ. Alumni, Inc. v. Commissioner, 74 T.C.M. (CCH) 458, 469 (1997) (determining that income from an affinity card program is a royalty).

\textsuperscript{93} See Priv. Ltr. Rul. 96-23-035 (Mar. 8, 1996) (ruling that charitable contributions are deductible by the cardholder and that the cardholder does not realize income for participating in the rebate program).
G. Mailing List Rental

The final item in this grouping is the rental of mailing lists. The IRS takes the position that income from the rental of mailing lists to non-section 501(c)(3) organizations is subject to UBIT, on the grounds that section 513(h)(1)(B) constitutes the sole UBIT exception for the rental of mailing lists. In its first Sierra Club opinion, the Tax Court disagreed, holding that income from the rental of the Club’s mailing lists was royalty income, because it constituted income from the rental of an intangible asset.\textsuperscript{94} The Ninth Circuit affirmed this portion of the Tax Court’s opinion, noting that a royalty, by definition, is passive and cannot include compensation for services rendered by the owner of the property.\textsuperscript{95} However, the Ninth Circuit specifically rejected Sierra Club’s argument that any payment for use of a property right, such as a copyright, qualifies as a royalty, regardless of any additional services that are provided.\textsuperscript{96} The Court found it significant that Sierra Club had contracted with commercial list managers to administer and oversee the external use of its lists rather than performing the work itself.\textsuperscript{97}

H. Scrip

Another popular fund raising vehicle, particularly for churches and elementary and secondary schools, is the scrip or gift certificate program. In a scrip program, participating merchants sell gift certificates to exempt organizations at a discount. The certificates are then resold by the exempt organization to its members at face value, permitting the purchase of goods from the issuing merchants. The difference between the discounted purchase price and the face value represents the organization’s proceeds from the program. As scrip has become more popular, national scrip brokers have begun to emerge, serving as middlemen between merchants and exempt organizations. They negotiate deeper discounts based on volume, take their percentage, and frequently encourage exempt organizations to hire personnel to operate their scrip programs on a larger scale. This can be a problematic suggestion.

Payments for scrip are not deductible under section 170. The purchaser receives full value for his payment, so there is no element of contribution. As for UBIT, the IRS recently ruled that a church school’s scrip

\textsuperscript{94} See Sierra Club, Inc. v. Commissioner, 65 T.C.M. (CCH) 2582, 2592 (1993), aff’d, 86 F.3d 1526 (9th Cir. 1996) (holding that income from mailing list rental is not unrelated business taxable income because it is royalty income from the rental of an intangible asset).

\textsuperscript{95} See Sierra Club, 86 F.3d at 1531.

\textsuperscript{96} See id. at 1532.

\textsuperscript{97} See id. at 1535.
program, though unrelated to exempt purposes and regularly carried on, nonetheless avoided UBIT because it was operated by volunteers, namely parents of the school’s students.\textsuperscript{98} If paid staff operates a scrip program, as is suggested by some national scrip brokers, income from the program will be subject to UBIT.

I. Telephone Tithing

Frequently, exempt organizations are approached by long-distance telephone carriers seeking to expand their customer base. In the typical telephone tithing arrangement, the phone company agrees to pay the church or school a percentage of the long distance phone bill for every member who signs up for its service. In return, the church is required to endorse, advertise, or market the service to its members, provide membership lists, or mail company advertisements or applications to members.

The UBIT issues are similar to those presented in affinity credit card cases. If the exempt organization provides mailing lists or other services, such as advertising, marketing, endorsement, etc., the IRS takes the position that the telephone tithing income is subject to UBIT, and that the royalty exception does not apply.\textsuperscript{99}

J. Athletic Events

Athletic events can bring large sums of money to colleges and universities. One major issue is whether corporate sponsorship payments made in connection with college athletic events are payments for valuable advertising services and therefore subject to UBIT or are contributions for which the corporate sponsor merely receives grateful acknowledgment from the university. The controversial January 1993 regulations on this subject have never been finalized.\textsuperscript{100}

A second issue is the deductibility of amounts paid for the right to purchase tickets to university athletic events. Congress amended the Code to provide that 80% of such payments are deductible as charitable contributions.\textsuperscript{101} As a result, substantiation is required for any payment made for the right to purchase tickets of $312.50 or more, because under the 80%

\textsuperscript{98} See Priv. Ltr. Rul. 97-04-012 (Oct. 28, 1996) (ruling that sales of scrip by those who perform without compensation does not generate UBIT).

\textsuperscript{99} See Priv. Ltr. Rul. 94-50-028 (Dec. 16, 1994) (ruling that payments received for services performed are not royalties).

\textsuperscript{100} See Taxation of Tax-Exempt Organizations’ Income from Corporate Sponsorship, 58 Fed. Reg. 5687 (1993). Since the date of this presentation, Congress enacted section 513(i) of the Code, which excludes from unrelated trade or business the soliciting and receiving of "qualified sponsorship payments." This new Code provision largely follows the proposed regulations.

\textsuperscript{101} See I.R.C. § 170(f) (1997).
rule, the deductible portion of that payment would be $250 or more. For purposes of section 6115 disclosure, 20% of the amount paid will be treated as the fair market value of the right.

K. Travel Tours

For years the travel industry has been vocal about unfair competition from travel tours conducted by universities, their alumni associations, and religious organizations. The first issue of concern is inurement or private benefit, which can jeopardize exempt status, or in appropriate cases trigger excess benefits taxes. Exempt organizations should insure that their tours do not improperly benefit any travel agency or other individual involved in tour planning or operations.

Making travel tours available to members of a church or a university community is not per se an educational or religious activity. Even a tour with some educational or religious components, but with substantial recreational and leisure activities, will not qualify. However, a carefully structured tour designed to maximize educational or religious content can be related to exempt purposes and thereby avoid UBIT or jeopardizing exemption.

In determining whether a tour has an educational or religious purpose, the IRS will consider several relevant factors. First, there must be a bona fide educational methodology. For educational organizations, this might include organized study, reports, lectures, library access, reading lists, and mandatory participation. For religious organizations, it might include structured visits to significant worship sites, leadership by clergy, and an environment conducive to religious experience. The IRS will also consider the structure and design of the tour. It should be conducted in a highly professional manner, with daily lectures and related classroom studies. There might be intensive study and, where appropriate, academic credit. The reason the tour was selected and how it was advertised are also relevant. Appropriate brochures should stress educational content and use

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104 See Richardson and Barrett, Update on UBIT - Travel Tours, 1996 CPE Text, supra note 66, at 213.
of certified teachers, rather than the opportunities for recreation and shopping. It should be apparent that the tour was selected for its educational value and the experience of the tour leaders. Organizations must document all parts of their tours, from the planning stages through completion, in order to establish an exempt purpose.

L. Rental of Excess Capacity

Excess capacity at exempt organization facilities frequently provides an opportunity to increase income. However, it is important to recognize that a facility’s use for exempt activities does not immunize unrelated activities from taxation. The rental of excess space in church or school parking lots provides a good example. This is a fairly common practice that can qualify for the UBIT exemption for the rental of real property, depending on how the lease is structured. In a 1993 ruling, the IRS found that the rent from the lease of excess space in an exempt organization’s parking lot was not subject to UBIT because the organization leasing the lot, and not the exempt organization, was responsible for all aspects of its operation, including snow removal, patching, painting, and maintenance of signs and barriers.\footnote{111} If the exempt organization had provided these services, which would usually be the case where individual parking spaces are rented, the income would have been subject to UBIT. The IRS has also ruled that income from the operation of mailing services for other organizations is subject to UBIT.\footnote{112}

An exempt organization’s printing and publishing operations can further exempt purposes.\footnote{113} However, the scope of the publishing operation will be relevant. In one case, the IRS concluded that an organization that published religious and educational textbooks beyond what was necessary to support its own educational and religious operations was subject to UBIT on its excess operations.\footnote{114} However, even though this was a relatively large unrelated activity, the IRS ruled that it did not jeopardize exempt status because the organization also conducted significant educational and religious activities.

Another common practice is the rental of excess office space, school

\footnote{113} See Pulpit Resource v. Commissioner, 70 T.C. 594, 609 (1979) (holding that an organization which publishes and sells religious literature is organized exclusively for an exempt purpose); Presbyterian and Reformed Publ’g Co. v. Commissioner, 743 F.2d 148, 156 (3d Cir. 1984) (finding that religion-related publishing not controlled by any particular church does not justify revocation of the exemption); Priv. Ltr. Rul. 95-35-050 (Sept. 1, 1995) (the sale of books by the church’s founder is substantially related to a religious purpose).
auditoriums, and church halls. There are several options here. Excess space can be rented to related organizations and thus further the organization's exempt purposes. Space can also be rented to an unrelated exempt organization at below cost. This can further charitable purposes because the arrangement is donative in nature.

More typically, however, exempt organizations seek to rent excess space to unrelated organizations in a non-donative context in order to raise revenue. The ordinary commercial rental of excess office space will generally qualify as the rental of real property, which is excluded from UBIT under section 512(b)(3). However, if the rental arrangement includes meal services, maid services, or similar amenities, which frequently occurs when a retreat center is rented for corporate retreats, or the provision of catering services, as when a church hall is rented for wedding receptions, the income will not qualify for the rental of real property exception, and will be subject to UBIT.¹¹⁵

M. Time and Talent Programs

Time and talent programs do not really involve a fund raising device. However, they are common around the country. Frequently, parents or family members of students enrolled in Catholic schools are required to perform services either in addition to tuition payments or as a means of reducing tuition or fees. This may result in income and employment tax obligations.

There is no official IRS precedent on these programs. However, in 1990, the IRS offered an opinion on the time and talent program of the Diocese of Lafayette.¹¹⁶ Under the diocese's program, families of children were assessed a service fee or were permitted a reduction of tuition if they performed a set number of service hours, each of which was valued at a fixed monetary amount, such as $10. School-specified services could be performed by any family member, such as a parent, sibling, grandparent, aunt, or uncle, but not the student.

The IRS concluded that the individuals performing the services were employees of the school, and, therefore, must include as income the amount at which their services were valued, unless these amounts could be excluded as qualified tuition reductions under section 117(d). Section


117(d) applies only to tuition reduction provided to an employee of a school or to a person treated as an employee. Under section 132(f), dependent children fall within the category of those “treated as an employee,” but grandchildren, nieces, nephews, or siblings do not.

Therefore, the IRS ruled that if parents provided services, the value of their compensation is excludable from income as a qualified tuition reduction under section 117(d). However, this is not true when other family members provide services in a time and talent program. They must include the financial benefit received as taxable income, which is also subject to applicable employment tax withholding and reporting requirements.

CONCLUSION

Charitable organizations must be mindful of Code provisions and IRS decisions that could turn their fund raising efforts from revenue sources to tax liabilities – either as UBIT or through loss of tax-exempt status. With careful planning, charitable organizations can use alternative methods of fund raising to create substantial revenue to support their exempt purposes.