Fortunately for tax practitioners, but unhappily for our exempt organization clients, the creative minds at the Internal Revenue Service continue to find opportunities to assert that the required unrelated business income tax ("UBIT") has not been paid, at least not to a sufficient extent. Despite relative stability in the relevant provisions of the Internal Revenue Code (the "Code") and Treasury Regulations, new forms or sources of revenue for exempt organizations lead to UBIT controversies, and even some old revenue types continue to spark debate.

AFFINITY GROUP MARKETING ARRANGEMENTS

Affinity credit cards. A great deal of the attention of exempt organization advisors and managers in recent years has been captured by the judicial battles over so-called affinity credit cards. Although much of the attention has been focused on the question of whether payments received by exempt organizations from banks or other financial institutions are royalties protected from UBIT by section 512(b)(2) of the Code, the issue actually involves a broader set of considerations, only some of which have yet been resolved by the courts.

The most recent judicial decision involving affinity credit cards has been the Mississippi State Alumni case. The IRS asserted UBIT deficiencies for fiscal years ended 1989, 1990 and 1991 based on payments made to the Alumni Association, a section 501(c)(3) organization, by a bank that provided credit cards to Mississippi State University ("MSU") alumni. The credit cards bore the Alumni Association's name and MSU's "walking bulldog" trademark. The bank had contracted with the Alumni Association to acquire the rights to use the name, the trademark, the computerized list of names and addresses of alumni, and the facsimile signature of the executive director of the Association on "marketing materials" prepared and distributed by the bank. The bank used these rights in its credit card business and made payments to the Alumni Association for doing so.

Following the government's unwillingness to stipulate to the relevant facts, the Alumni Association presented uncontradicted evidence to the Tax Court at trial that the payments --

1. Were not produced by a trade or business regularly carried on by the Alumni Association;
2. Were produced by an activity related to the Association's exempt purpose of supporting and promoting MSU; and
3. Were payments for the right to use valuable intangible property rights, rather than for services rendered by the Alumni Association to the bank, and thus were royalties.

The government's principal legal positions at trial were that a "profit motive" is all that is required to find a trade or business that is regularly carried on, that the Association's arrangement with the bank could not be a related activity from the
Alumni Association’s perspective because the bank failed to provide credit cards to persons deemed uncreditworthy by the bank, and (pursuing the notion discarded by the Ninth Circuit Court of Appeals in Sierra Club, discussed below) that any modicum of activity by the exempt organization, even activity beneficial only to the exempt organization such as having its announcements of its meetings printed by the bank on its credit card bills, destroys royalty characterization.

The Tax Court decided on August 28, 1997, that the payments were royalties. It consequently found it unnecessary to rule on the other issues, but did find that the Association’s “activities were minimal and infrequent, were not conducted like a commercial business, and were not services for which [the bank] paid.” The government declined to appeal the decision to the Fifth Circuit Court of Appeals.

The Mississippi State Alumni decision followed a series of other judicial decisions generally favorable to the exempt organizations involved. As long ago as 1994, the Tax Court granted a partial summary judgment for Sierra Club, a section 501(c)(4) organization, with respect to income derived from an affinity credit card issued by a commercial bankcard company. The Tax Court ruled that the Sierra Club was not a joint venturer or partner with the bankcard company or its assignee, that it was not the owner of a business of selling financial services, and that the payments it received were payments for the use of intangible property (name, logo and mailing list) and thus were royalties within the meaning of section 512(b)(2) (following the reasoning of an earlier decision in the same case).

On appeal, the government argued that only "passive" royalties are protected by section 512(b)(2) and that the Sierra Club "actively" promoted the credit cards in order to increase the amount it would be paid by the bankcard company. Sierra Club responded that an exception only for "passive" royalties would be meaningless, since the generation of passive income would not be a trade or business and consequently would not even bring the UBIT provisions of the Code into play. The Club also argued that maintenance of its mailing list was for its own benefit, not the bankcard company’s, and that there is no competition with a for-profit business in licensing its name and logo.

The Court of Appeals reversed and remanded the Tax Court's grant of partial summary judgment on the affinity credit card issue; however, it affirmed the Tax Court's earlier partial summary judgment on the mailing list issue. In reversing and remanding, the Court of Appeals did not make a substantive decision on the affinity credit card issue; instead it determined that summary judgment was improperly based on disputed factual issues resolved in favor of Sierra Club. A factual determination is thus to be made by the Tax Court on remand.

The Tax Court tried the affinity card issue for three days in September of 1997. Proving the reality of every trial lawyer's fears, the Sierra Club’s principal witness died six weeks before the trial. The government's post-trial brief identifies the
Sierra Club's unrelated trade or business as "actively sponsoring, promoting and marketing" the affinity card. But the "actively" part of this argument refers to actions of a third party, an "agency" analysis which the government continues to assert as valid despite the Court of Appeals' decision to the contrary. Unfortunately for the Sierra Club, the Court of Appeals' opinion suggests that "endorsement," an undefined term, can destroy royalty characterization, so a victory here for the Sierra Club may still be uncertain.

Before the Ninth Circuit Court of Appeals rendered its decision in Sierra Club, the Tax Court had decided a similar affinity credit card dispute in favor of the Oregon State University Alumni Association, a section 501(c)(3) organization, in reasoning that follows the Tax Court's Sierra Club decisions. Factual distinctions from the Sierra Club situation were that the Alumni Association had to obtain the mailing list desired by the bank from a related entity, the Oregon State University ("OSU") Foundation, and that the mailing list was used for two other "commercial" activities -- a travel program and sales of OSU logo merchandise to alumni of the University. These different facts did not alter the result, for the Tax Court found that the Alumni Association was not in the business of selling its mailing list to all potentially interested users.

In another similar decision rendered before the Ninth Circuit Court's decision in Sierra Club, the Tax Court agreed with the Alumni Association of the University of Oregon in resisting an effort to impose UBIT on its affinity credit card revenues. The facts in the University of Oregon case were much the same as in the Oregon State University case, as is the opinion.

The Oregon State and University of Oregon decisions are presently on appeal before the Ninth Circuit Court of Appeals. The cases were consolidated before oral argument, which occurred on September 11, 1997. On appeal, the government argues that the definition of "royalty" used by the Tax Court is "contrary" to the definition used by the Ninth Circuit Court in its Sierra Club decision, in that the Tax Court did not expressly limit the term to payments that are "passive" and not payments for services. The government further argues that the services provided by the alumni associations were (1) allowing the bank to pay for an advertisement in alumni publications and to pay separately for printing letters, (2) informing alumni of the existence of the affinity card program, and (3) providing accurate rather than inaccurate addresses in its mailing list. Finally, the government asserts that the alumni associations are unfairly competing with General Motors, AT&T, and other sponsors of affinity credit cards, so there must be a taxable business. In assessing these arguments, one must wonder if the government would assert that, in order to protect the licensee's royalty payments from UBIT, a faculty inventor must not provide accurate information about a patent to a licensee of the university employer or not develop an invention competitive with General Motors' inventions.

A number of other affinity card and mailing list cases have also been filed in recent years. In American Academy of Ophthalmology v. Commissioner, a section 501(c)(6) organization based in California challenged taxation of
revenues derived from the rental of its mailing list to commercial users. The Academy argued that there was no trade or business regularly carried on, that the revenues were related, and that the payments were royalties. Unlike the situation in Sierra Club, the Academy's own employees performed the mailing list activities. The case was settled before it went to trial, with the organization's counsel characterizing the case as having been "dropped" by the IRS.

In *California Alumni Assn. v. Commissioner*, the Association is resisting asserted tax deficiencies based on a travel program, a group insurance program, a merchandising program, and an affinity card arrangement. The use of the Association's mailing list is the asserted basis for the deficiencies involving the insurance program, merchandising program and affinity credit card arrangement. The Association argues that the affinity card, insurance program and merchandise program were not regularly carried on by it and that, in any event, the payments were royalties. A joint status report was filed on December 17, 1997, asking for a trial date in May or June of 1998.

In *American Water Ski Assn. v. Commissioner*, a Section 501(c)(3) organization based in Florida challenges a $311,000 tax deficiency for calendar 1993 based on payments made under affinity credit card arrangement. The government's answer denies improper assessment and ups the stakes by asserting that the tax deficiency should be $704,000 since the examining agent failed to use the progressive tax rates in computing the proposed deficiency.

In *Common Cause v. Commissioner*, a section 501(c)(4) organization contests a $205,000 tax deficiency based on treating payments for use of a list of its members’ names and addresses as UBI. The organization's arguments are based on the royalty exclusion and the absence of a trade or business regularly carried on. The government's arguments appear to be much the same as those rejected in the Sierra Club mailing list decision. An appeal in this case would go to Court of Appeals for District of Columbia. The same issue and arguments as in Common Cause appear to be present in *Planned Parenthood Federation of America, Inc. v. Commissioner*. An appeal here would go to the Court of Appeals for the Second Circuit.

From the fact of these multiple Tax Court matters, one would conclude that the IRS has not yielded. Apparently, the IRS will conclude that a payment for intangible property rights is a royalty, but only in very limited circumstances. For example, royalty treatment was recognized in PLR 9705001, a technical advice memorandum dealing with a section 501(c)(6) organization's revenues from a business organization that purchases supplies at a discount for members of the profession represented by the exempt organization. The business organization is given the right to use the exempt organization's name, but not its mailing list, and the exempt organization provides no promotional or administrative services for the business entity. In these circumstances, the IRS concluded that no trade or business is present and that the payments for the use of the exempt organization's name are royalties. Where the use of membership lists is involved, the official Service position is that such arrangements are still deemed
Prior to the Mississippi State Alumni decision, examining agents had reportedly been instructed, in any case involving more than negligible UBI, to ignore the Tax Court's Sierra Club, University of Oregon and Oregon State decisions and to continue to assert deficiencies in affinity merchandising situations where any use of a mailing list or any "promotion" by the licensor can be found. The IRS had earlier professed to be seeking another affinity credit card case to take to a Court of Appeals other than the Ninth Circuit, but it settled the Michigan Alumni Association case that would have gone to the Sixth Circuit Court of Appeals, and it declined to appeal Mississippi State Alumni to the Fifth Circuit Court of Appeals. The government's strategy appears to be one of continued case shopping, hoping that it will find facts in American Water Ski, Common Cause, Planned Parenthood or some other case that will allow it a victory of some sort.

This summary recounts the latest of a decade or more of unproductive controversy between exempt organizations and the government over revenues from a source that few disinterested observers would consider an "unrelated business." Unfortunately, both private and governmental resources -- scarce to both sides -- have been expended in an unresolved struggle that distracts both sides from more important work. Perhaps final decisions in the Sierra Club, Oregon State, and University of Oregon cases will bring closure, but that conclusion is far from certain. In an earlier era, it might have been possible to craft a legislative solution, but the current regime of "balanced budget" tax legislation does not lend itself readily to a statutory conclusion to the controversy. This author hopes that a resolution might be created with Treasury and IRS leadership. Despite the rhetoric and advocacy that have prevailed in recent years, the Treasury (or perhaps even policy-level managers within the Service) could initiate a "refinement" of Rev. Rul. 81-178 that would allow the Service to adhere to its principles (or at least most of them) while removing unreasonable tax and administrative burdens from exempt organizations.

A plausible refinement would be a simple extension of the fragmentation concept to affinity credit card arrangements (and similar affinity group marketing arrangements) that would sanction "two part" contracts between exempt organizations and business users of names, logos, mailing lists and "endorsements." The parties could negotiate at arms' length a non-taxable royalty payment for the use of the exempt organization's intangible property rights and a taxable "services" payment for the (usually negligible) amount of time the exempt organization spends doing anything that is not inherent in making the intangible property rights available to the business user. The facts of the litigated affinity card cases show little, if any, such "services" activity by exempt organizations, but other cases, such as those involving group insurance sales, have demonstrated substantial services being provided by exempt organizations. A principled analysis such as this would not likely produce much revenue for the government, but tax revenues are not the maison d'etre for the UBIT provisions. Rather, the exempt community would have official guidance in arranging its affairs so as to minimize the liability and, in so doing, avoid any

Current UBIT Issues and Controversies
continued
unfair advantage over taxable businesses. Although this approach would not satisfy the "purists" on either side of the controversy, it would provide a resolution that most parties could tolerate.

Fragmentation. The key to the proposed administrative resolution suggested above is, of course, the fragmentation concept. In one situation, the IRS has concluded that an allocation of payments between royalties and compensation for services was appropriate in a contract for the provision of names, likenesses, insignia and consulting by individuals. But in another, the Service concluded that inseparable agreements for the use of the organization's name and logo and its mailing list taint the entire payments. The government's arguments on appeal in Oregon and Oregon State also reject any fragmentation between royalties and payments for services.

The Service uses fragmentation when it serves its purposes, but not otherwise. In PLR 9810030, the effort by a section 501(c)(6) organization to turn over all of the advertising business to a yearbook publisher was unsuccessful. Here, all advertising sales, content and publication were contracted out to the publisher. The Service ruled that the advertising business could not be separated from the provision of editorial content by the association. Thus, the IRS will have to find its way around these apparently conflicting views if it is to use fragmentation to terminate, at least prospectively, the current controversies.

Travel tours. As discussed above, the use of alumni associations and other affinity groups for merchandising purposes extends into the travel business as well as the banking business. The legal issues in dispute between exempt organizations and the IRS are, however, different from those in the affinity credit card cases. Factual differences usually preclude the royalty or "no trade or business" arguments, because it appears that most exempt organization sponsors of travel programs (curiously called "travel tours," a seemingly redundant description) admit to substantial staff involvement in these activities. As a consequence, the relatedness of the tour to the exempt organization's educational, religious or other exempt purposes is the usual area of factual and legal dispute. To assist the exempt community in compliance, IRS representatives in earlier years had commented publicly that contemporaneous documentation of an educational motivation would be a principal consideration. However, in April of this year, the Treasury released Proposed Regulations addressing travel programs which appear to restate rather than refine the government's official position. The proposed regulations say that each program will be judged by its own "facts and circumstances" and provide four examples to illustrate the factors that will control taxability of net income generated by the exempt organization.

The four examples are:
(1) A university alumni association sponsors a tour with no scheduled instruction, so UBIT results. (2) A cultural study organization provides 5-6 hours a day of organized study, so no UBIT results. (3) A social welfare/advocacy
organization arranges travel to Washington, D.C. for meetings with legislators and briefings on issues of concern to the organization. Because "substantially all" of the travelers' time is devoted to these related activities, no UBIT results.

(4) Largely repeating the facts of PLR 9702004, a membership organization open to Americans of a specific ethnic heritage provides two types of tours. In the earlier private analysis, which was a technical advice memorandum, the IRS concluded that tours that involve visits to places of historic, religious, and cultural significance, and tours that involve lectures by experts in history and civilization, were substantially educational in nature and therefore were related to the organization's exempt purposes. However, other tours were deemed to generate UBI, including those with a substantial component of vacation travel despite visits to museums and communities, and a tour that was essentially a stay at a seaside resort. The fourth example in the proposed regulations add to the description of the first type of tour the emphasis that "substantially all" of the travel time is spent in related activities.

In these proposed regulations, the government has done little to advance the relevant analysis. It is helpful, of course, to give regulatory authority to principles previously addressed only in private rulings, but the proposed regulations do not address the difficult issues of situations between the extremes of the examples given. And the proposed regulations adhere to an out-dated concept of formal, youth-oriented, institutionally-based education that is of questionable validity at the present day. The focus of the proposed regulations is also reflected in recently revised IRS publication which states the test to be whether a "formal educational program [is] conducted with these tours." But there is also a reference to "tours that differ from regular commercially operated tours," so perhaps there is meant to be a real opportunity to distinguish among different sorts of travel programs without requiring "formal" instruction.

A somewhat broader relatedness argument is presented to the Tax Court in California Alumni Association v. Commissioner, where the association asserts that the generation of financial and volunteer support from the alumni participating in the travel programs is related to the university's exempt purposes, so that the revenues produced by the travel programs are related to the association's exempt purpose of promoting the university. Alternatively, the Association asserts that the "substantial educational enrichment" of its alumni through the travel tours was a related activity. The revised IRS Pub. 598 expressly disputes the Association's first position: "Even if the tours . . . encourage alumni to [support the university, financially and otherwise], they do not contribute importantly to the organization's exempt purpose of promoting education." This issue was also submitted to the Tax Court in Mississippi State Alumni, with evidentiary support, but the Court found it unnecessary to address this facet of the case. It will be most interesting to observe the manner in which this issue is ultimately resolved through case law, if not legislation.
Presumably, the government hopes to resolve the controversy through finalization of the proposed regulations, not legislation or continued litigation. But the "travel tour" debate is a curious one to this author, because it appears that most, if not all, organized group travel programs of exempt organizations utilize the for-profit components of the travel industry. Not only are cruise lines, airlines, hotels and others involved, but the programs are arranged by tour companies that profit from (and presumably pay taxes on) the money spent by tour participants. The exempt organizations do have some small involvement in the actual travel arrangements, such as selecting attractive (IRS view) or informative (taxpayer view) itineraries and arranging for an organizational representative to accompany the tour group, but unless the tour is truly of the "mobile classroom" variety, the exempt organization's involvement in the travel arrangements is peripheral.

One might suspect that the real economic contest is between large "package tour" companies that can readily benefit from affinity group marketing techniques and small, local travel agencies that cannot use those same techniques. The only apparent economic advantage is a function of the marketing budget of the for-profit tour organizer, not tax avoidance by exempt organizations. While this author does not have a complete factual basis on which to judge this possible explanation, if true it would be scant justification for the travel industry's attacks on the exempt community. The itinerary planning is little more than an inquisitive individual would do in planning his or her own travels, and the organizational representative is typically along either to provide information or promote goodwill toward the organization, or both -- hardly a justification for taxation of the organization. Although the debate appears likely to be resolved on the educational vs. non-educational criteria suggested by the proposed regulations, some attention once again should be given to the underlying economic complaints of the for-profit travel industry so that, perhaps, whatever "unfair" advantage that might exist (other than the size, interest level and opportunity of the affinity group) is properly identified, accounted for, and taxed under the fragmentation approach proposed earlier.

Recreational facilities. Alumni and other friends of a university are also an affinity group for purposes of use of recreational facilities for a fee. The Service has in recent years provided technical advice that amounts received by a university from the use of its golf course by (a) alumni, (b) spouses and children of students, (c) spouses and dependents of university employees, (d) guests of members, and (e) major donors to the university will result in UBI. The treatment of dues-paying alumni in this technical advice is directly contrary to the position the Service took 13 years earlier. In the most recent situation, the university allowed "President's Club" donors to the university to utilize the golf course. Alumni who are dues-paying members of the alumni association, who are major alumni donors and who pay the greens fees were also permitted to use the course. Relying on a 1978 revenue ruling dealing with alumni association travel programs, the Service ruled that use of the golf course by alumni and donors does not "contribute importantly" to the accomplishment of the university's exempt purposes. The Service stated that it "specifically reject[ed] the argument
that by making available its golf course, the University is providing an inducement for alumni and President's Club members to make financial contributions or otherwise be involved in the university." In part, the Service stated that it reached this conclusion because the University "has failed to establish the existence of a substantial causal connection between alumni and President's Club member use of the golf course and the accomplishment of any exempt educational purpose. In fact, there is no requirement that alumni and President's Club members play with students, faculty, staff or even prospective students." Finally, the Service was unwilling to extend the "convenience" exception to spouses and children of students and employees or to guests of individuals expressly covered by the convenience exception.

This administrative position may be challenged in litigation. In *Oakland University v. Commissioner*, the University, located in Michigan, is challenging the imposition of UBIT on revenues derived from its golf course and publishing programs for a music festival. The University argues that the golf course revenues are related and that the publishing revenues are largely sponsorship payments.

Group insurance. As illustrated by the facts in *United States v. American Bar Endowment*, the affinity group marketing concept has been present in the insurance industry for many years. After years of controversy, Congress was persuaded to address the issue by adding section 501(m)(2)(A) to the Code, which provides that "the activity of providing commercial-type insurance shall be treated as an unrelated trade or business . . .," and that only certain limited types of insurance benefits are excluded from the term "commercial-type insurance." Generally, life insurance, disability insurance, medical insurance and similar forms of insurance often provided on a group basis by exempt organizations would be included within the meaning of "commercial-type insurance." Yet not all revenues from insurance arrangements are taxable.

In *Texas Farm Bureau v. United States*, the Court of Appeals ruled as a matter of law (overturning a jury verdict for the Farm Bureau) that payments received by the Farm Bureau, a section 501(c)(5) organization, from two partially-owned insurance companies were not royalties, but were income from promoting the insurance products and providing administrative and clerical services, taxable as UBI. The exempt organization agreed to provide office space, clerical supplies, telephone, administrative service, office supplies, and other goods and services essential to the conduct of an insurance business. The Court easily concluded that the payments were essentially for the personal services required to operate the insurance business in question, rather than royalties paid for use of intangible property rights.

In contrast, the case of *American Academy of Family Physicians v. United States*, involved a section 501(c)(6) organization that had established a for-profit subsidiary to manage a group insurance program it offered to its members and their employees. The Court of Appeals rejected the argument of the Internal Revenue Service that interest payments made by the insurance company to the
Academy for the right to use reserves constituted UBI. The Eighth Circuit Court concluded that the subsidiary, not the Academy, operated the insurance business, that the subsidiary was paying tax on its income and that the Academy was not involved in a trade or business.

The pending California Alumni Assn. case appears to involve on the issue of whether the providing of a mailing list to a group insurance broker is the providing of taxable services.

OTHER CURRENT CONTROVERSIES AND DEVELOPMENTS

Corporate advertising and sponsorships. Years ago, the IRS lost a significant UBIT case, National Collegiate Athletic Association v. Commissioner, on the basis that the revenue-generating activity was not regularly carried on by the exempt organization. In that case, the Court of Appeals concluded that the income received by the NCAA, a section 501(c)(3) organization, from an outside agency for the publication and sales of programs for the NCAA's annual men's basketball tournament was not derived from a trade or business "regularly carried on" within the meaning of the Regulations. In its Action on Decision, the Chief Counsel of the IRS stated that the IRS did not acquiesce in the decision and would continue to litigate the issue in appropriate cases.

It has done so, and in State Police Association of Massachusetts v. Commissioner, the IRS won a significant battle that included a rejection of the applicability of the NCAA case. A section 501(c)(5) labor organization representing state troopers in Massachusetts had solicited contributions to support publication of its annual yearbook. The contributors were acknowledged in the yearbook, and the IRS contended that the acknowledgment materials were advertising. The Service made a claim that, over an 7-year period, the Association owed $1,352,000 of tax, plus interest of almost the same amount and penalties of an additional $711,000. The tax, interest and penalties offset all of the contributions the Association had received. The yearbook published by the Association contained displays acknowledging the support from contributors, many of which were well-known companies such as McDonald's, AT&T, John Hancock, Kentucky Fried Chicken and Mobil Oil, but many others were small, local companies operating only in Massachusetts. The displays ranged from 1/6 of a page to a full page, depending upon the amount of contribution. In addition, an alphabetical listing of all of the contributors was included in the directory. The yearbook contained a number of editorials and articles of interest both to police officers and the general public. The IRS asserted that the Association's income was advertising income, rather than contributions, and that the income was therefore taxable. The Tax Court agreed that the income was advertising, without regard to the motivation of the business that made the contribution.

On appeal, in addition to procedural arguments, the association again disputed the nature of the payments, but also argued that there was no trade or business regularly carried on by it, as distinguished from the business of soliciting
payments conducted by the yearbook publisher and its "telemarketers." The association argued to no avail for sponsorship treatment under the then-existing proposed corporate sponsorship regulations (discussed below), since those regulations expressly excluded payments related to periodicals. The appellate court also refused to consider the motivation of those making payments for the yearbook’s support, concluding essentially that "if it looks like an ad, it is an ad." The association also argued to no avail that the outside firms were not its agents. Although this latter conclusion perhaps is in conflict with the Ninth Circuit Court’s opinion in Sierra Club, the Court concluded that the payment of taxes by the outside parties was not enough to avoid attribution of their activities to the association (and the Supreme Court has declined to hear the case). Finally, reliance on the NCAA decision was misplaced, according to the appellate court, since the yearbook was not tied to a once-a-year event.

Corporate sponsorship legislation. Of no help to the Massachusetts police association or similar sponsors of published materials, the Taxpayer Relief Act of 1997 excluded from UBI "qualified sponsorship payments," defined as payments made by a person engaged in a trade or business who will receive no substantial return benefit other than the use or acknowledgment of its name, logo or product lines. Acknowledgments in periodicals are excluded from the new protection, as are payments contingent on attendance or other exposure levels.

Under the new Code provision, effective for payments solicited or received after December 31, 1997, UBI includes payments for advertising, meaning qualitative or comparative language, price information or other indications of savings or value, or an endorsement or other inducement to purchase, sell or use such products or services.

Congress also decided that the provision by the exempt organization of facilities, services or other privileges to a sponsor or the sponsor’s designees, such as complimentary tickets or a reception for major donors, does not affect the sponsorship payment, but are to be evaluated separately to determine whether such goods or facilities constitute a substantial return benefit or a separate unrelated business activity. Thus, allocation of a single payment between sponsorship and advertising is expressly permitted by the new statute. The 1997 legislation largely codified proposed regulations which had never been finalized. However those proposed regulations took an "all or nothing" position that any advertising "tainted" the entire payment. Perhaps the Treasury and Service should accept this guidance from Congress and retreat from its "all or nothing" view in other UBIT areas.

Exclusive marketing arrangements. According to news reports, Pennsylvania State University has entered into an agreement with Pepsi which provides Penn State with a payment of $14 million for an exclusive soft drink arrangement for 12 years, and Georgia Institute of Technology is to receive $5.5 million from the McDonald's Corporation for placing the McDonald's logo on the floor of its basketball arena, for an exclusive right to sell food and drink in the arena, and
for renaming the facility as the "McDonald's Center."

Such arrangements would appear to combine elements of the licensing of an exempt organization's name and logo for use in a business organization's sales activities, the rental of space on the exempt organizations' premises for sales activities, the applicability of the convenience exception for point-of-sale advertising, and the new statutory provisions for sponsorship payments for placing a business name on an athletic facility. It seems likely that there will be many different factual situations that combine two or more of the elements, and it is far from clear that individual elements which do not produce UBI separately should be deemed to produce UBI when combined.

Moreover, a payment by a business to an exempt organization to have the exempt entity agree not to sell or advertise competing products sounds much like a covenant not to compete. In Ohio Farm Bureau Federation, Inc. v. Commissioner, the Tax Court ruled that a $2 million payment made by a cooperative organization to an exempt organization as part of a covenant not to compete was not subject to UBIT. Since the transaction was a one-time payment for an activity not regularly carried on, the Tax Court concluded that the payment was not derived from a trade or business regularly carried on. The IRS appears to have accepted this analysis, for the decision was not appealed by the IRS and in GCM 39891, Chief Counsel revoked GCM 39865 because the conclusion in the earlier GCM is contrary to the holding in Ohio Farm Bureau Federation.

In response to questions about the applicability of this "non-compete" analysis to exclusive marketing or distribution arrangements, a senior IRS official is reported to have stated that the government's Sierra Club analysis would apply, i.e., if no services are provided by the exempt organization, there will be no UBI generated, but if the exempt organization engages in sales or marketing efforts, it will have UBI from the joint venture or provision of services. The suggestion was also made that if the exempt organization enforces its obligation to the business, such as by preventing sales of competing products on its premises, some services are being provided. These comments suggest to this author that the parties involved in such arrangements would be well advised to identify clearly the specific components of each arrangement and the associated payments for each component and to use every opportunity to have the business entity performing any "activity" involved. Obviously, there is a potential for much controversy here, both factual and legal.

Sales of "exempt function" goods or services. In technical advice, the Service recently concluded that amounts paid to a section 501(c)(6) organization by its related section 501(c)(3) organization for various services were UBI. The charitable organization was engaged in economic development in a given area, and the trade association was engaged in promoting international trade activity in the same area by providing research materials, educational seminars, and assistance in translation, research, and other services. The charitable organization paid the trade association to handle its correspondence, maintain
its books and records, answer its telephones, and provide other administrative services. The Service saw no relationship between the administrative services and the exempt purposes of the trade association.

But a section 501(c)(4) organization's share of income from a limited liability company that provides administrative services for participants in a prepaid dental benefits plan is not UBI because the administrative services are related to exempt purposes.

The Service rendered technical advice that no UBTI was produced by a limited partnership composed of a corporate general partner and 39 unrelated exempt health care providers. The partnership performed group contracting services for its partners, obtaining group discounts for purchases actually made by each partner on its own behalf. The goods and services purchased ranged from drugs to surgical supplies to telephone services. The partnership generated income by way of fees paid by vendors as well as investment income from invested funds. The Service found the partnership to be engaged in a trade or business regularly carried on, but concluded that the investment income was protected by section 512(b) and that the fee income was substantially related because each limited partner's share of partnership income was no greater than its share of the purchases generating those fees.

Associate member dues. This controversy began, publicly at least, when the IRS said in 1995 that associate members’ dues will be treated as taxable income if the associate member category was created for the principal purpose of producing revenues for the organization. In 1997, the IRS modified the 1995 Revenue Procedure to take into account a statutory change that Congress enacted in 1996, but the 1997 pronouncement applied to agricultural or horticultural organizations only, not labor unions or trade associations. In fact, the 1997 Revenue Procedure specifically says that the 1995 Revenue Procedure applies to 501(c)(6) trade associations.

The general IRS position on associate member dues has been upheld by the courts. In National League of Postmasters v. Commissioner, the Court of Appeals affirmed the Tax Court's decision upholding the IRS' effort to tax dues paid by members who join an association solely to gain insurance or other benefits. That case involved a labor organization described in section 501(c)(5), but the reasoning of the decision would apply to other associations as well. In that particular case, the organization had two membership categories, one for postmasters and another for any other federal employee. The general federal employees had limited voting rights in the Association's activities and primarily benefitted from the group insurance, travel programs and legal services benefits. The IRS asserted that the dues paid by these members with limited benefits was subject to the unrelated business income tax. The Court agreed. The Association had asserted that the benefits it provided to the associate members were a part of its overall exempt purpose of improving working conditions for its members, but the Court found that the principal intention was to generate additional income for the Association.
The Service has continued to apply this analysis: Finding that the principal purpose for having allied members was not to produce UBI but to further exempt purposes, the Service provided technical advice that a section 501(c)(6) organization was not taxable on allied member dues. The persuasive facts were that the allied members actively participated in the organization's activities, in the governance of its chapters, and in strategic planning and steering committees for the organization. In addition, allied member dues were no more than, and often quite less than, regular members dues.

Subsidiaries and 512(b)(13). The 1997 Act expanded the range of UBI consequences for deductible payments received from "subsidiaries." Section 512(b)(13)'s ownership test now includes 50% ownership, either direct or indirect and measured by either voting power or value, of the subsidiary's stock. By including application of the constructive ownership rules of section 318, the section now extends to second tier and lower level subsidiaries.

CONCLUSION

Significant battles continue to be fought, in court, in Congress and in the halls of the Treasury and IRS, over UBIT issues that arise from changing perceptions and activities of exempt organizations and business organizations that seek to profit from what they have to offer. Few of the controversies summarized above deal with self-contained business activities of exempt organizations. Instead, most involve efforts by taxable businesses to gain a marketing advantage over their competitors. It remains to be seen whether the UBIT provisions promote or hinder fair competition in this environment.

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